

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

Curtiss-Wright Corporation is a multinational provider of highly engineered products and services. The Corporation is positioned as a market leader across a diversified array of niche markets through engineering and technological leadership, precision manufacturing, and strong relationships with our customers. The Corporation provides products and services to a number of global markets, such as defense, commercial aerospace, nuclear power, oil and gas, automotive, and general industrial. The Corporation has achieved balanced growth through the successful application of its core competencies in engineering and precision manufacturing, adapting these competencies to new markets through internal product development and a disciplined program of strategic acquisitions. Approximately 50% of revenues are generated from defense-related markets.

Company Organization

The Corporation manages and evaluates its operations based on the products and services it offers and the different markets it serves. Based on this approach, the Corporation has three reportable segments: Flow Control, Motion Control, and Metal Treatment. The Flow Control segment primarily designs, manufactures, distributes, and services a broad range of highly engineered flow-control products. These products are for severe service military and commercial applications including power generation, oil and gas, and general industrial. The Motion Control segment primarily designs, develops, and manufactures high-performance mechanical systems, drive systems, embedded computing solutions, and electronic controls and sensors for the defense, aerospace, and general industrial markets. Metal Treatment provides a variety of metallurgical services, principally shot peening, laser peening, heat treating, and coatings, for various industries including aerospace, automotive, construction equipment, oil and gas, petrochemical, and general industrial. For further information on our products and services and the major markets served by our three segments, see the inside cover page of this Annual Report.

The Corporation records sales and related profits on production and service type contracts as units are shipped or as services are rendered. This method is used in our Metal Treatment segment and in some of the business units within the Motion Control and Flow Control segments, which serve commercial markets. For certain contracts that require performance over an extended period before deliveries begin, sales and estimated profits are recorded by applying the percentage-of-completion method of accounting.

Results of Operations

ANALYTICAL DEFINITIONS

Throughout management's discussion and analysis of financial condition and results of operations, the terms "incremental" and "base" are used to explain changes from period to period. For quarterly reporting purposes, acquisitions are segregated from the results of the Corporation's base businesses for a full year or, in the more likely event of a mid-quarter acquisition, 5 quarters. For full-year reporting purposes, acquisitions remain segregated for two years, and the remaining businesses are referred to as the "base" businesses. An acquisition is considered base when the reporting period includes fully comparable current and prior-period data. Therefore, for the year ended December 31, 2004, our organic growth excludes all acquisitions since January 1, 2003.

YEAR ENDED DECEMBER 31, 2004 COMPARED WITH YEAR ENDED DECEMBER 31, 2003

Curtiss-Wright Corporation recorded consolidated net sales of \$955.0 million and net earnings of \$65.1 million, or \$3.02 per diluted share, for the year ended December 31, 2004. Sales for the current year increased 28% over 2003 sales of \$746.1 million. Net earnings for 2004 increased 24% from 2003 net earnings of \$52.3 million, or \$2.50 per diluted share.

The increase in revenues was mainly driven by a complete year of revenues generated from the 2003 acquisitions of Systran Corporation, Novatronics/Pickering, E/M Engineered Coatings Solutions, Advanced Materials Process, and Collins Technology and contributions from the 2004 acquisitions, primarily Dy 4 Systems, Inc., Primagraphics, Nova Machine Products, Trentec, Inc., Groquip, Synergy, and the Government Marine Business Unit of Flowserve Corporation. See Note 2 to the Consolidated Financial Statements for further information regarding acquisitions. Including the eleven businesses acquired in 2004, the Corporation has acquired twenty-four new businesses since 2001. The acquisitions made during the last two years contributed \$154.2 million in incremental sales in 2004 (or 74% of the total sales increase from 2003). The remaining base business units experienced organic sales growth of 7% in 2004, led by the Metal Treatment segment, which grew organically by 21%. The Flow Control and Motion Control segments experienced solid organic sales growth of 5% and 4%, respectively. The organic growth in the Flow Control segment was achieved in 2004 despite a decrease in overall revenue from the U.S. Navy of approximately \$9 million.

In our base businesses, higher metal treatment sales of our global shot peening, laser peening, and heat treating services of \$21.8 million, higher sales of certain flow control products to the power generation market of \$15.0 million, the oil and gas industry of \$6.4 million, and the defense electronics markets of \$5.7 million, and higher sales of our motion control products to the military aerospace market of \$14.7 million and commercial aerospace aftermarket services of \$5.9 million all contributed to the organic sales growth for 2004 as compared to 2003. These increases in our base businesses were partially offset by lower sales of certain flow control products to the U.S. Navy due to timing of contractual revenues, a decrease of \$14.5 million, and lower sales of motion control electronic products of \$10.6 million for use in global ground defense markets due to the wind down on certain production projects. Favorable foreign currency translation had a favorable impact on sales of \$15.8 million for 2004 as compared to 2003.

Operating income for 2004 totaled \$110.7 million, an increase of 24% from operating income of \$89.3 million in 2003. The increase is primarily attributed to higher sales volume, favorable mix, and previously implemented cost reduction initiatives. The contributions of the 2003 and 2004 acquisitions mentioned above amounted to \$11.0 million in incremental operating income in 2004 as compared to 2003. In addition to the contribution of the new acquisitions, 2004 operating income benefited from organic growth in our remaining base businesses, which improved 13% overall and was driven by strong organic growth in our Metal Treatment and Motion Control segments of 55% and 22%, respectively, from the prior year period. The improvement in Metal Treatment's base businesses' operating income was the result of higher volume and favorable sales mix due to the higher laser peening sales. The improvement in the Motion Control's base businesses' operating income was due to higher volume, reductions in certain

reserve requirements, favorable sales mix from commercial aerospace aftermarket services and spares, and implemented cost control initiatives. Operating income from the base businesses within our Flow Control segment increased 9% in 2004 over 2003, due to higher volume, contract cost overruns and inventory write-offs in 2003 that did not reoccur in 2004, and a stronger sales mix for our power generation products. The increase was partially offset by the lower overall volume to the U.S. Navy, driven by the profit impact related to the two large higher margin contracts in 2003 that did not reoccur in 2004. Additionally, the Corporation increased its reserves for environmental remediation during 2004, resulting in a \$3.9 million increase in environmental remediation and administrative expenses over 2003. Foreign currency translation had a favorable impact on operating income of \$2.9 million for 2004 as compared to 2003.

Overall consolidated operating margins were down slightly in 2004 as compared to 2003. Strong margins within our business segments were achieved despite the absorption of \$5.3 million of environmental costs, \$2.5 million in costs associated with Sarbanes-Oxley Section 404 compliance, and lower pension income of \$2.1 million in 2004, due to additional costs resulting from the acquisitions and slightly lower investment returns. The operating margins have been somewhat lower than historical levels in recent years, principally related to the large number of acquisitions made since 2001. Although the new acquisitions continue to have a positive effect on operating income, the operating margins of the overall Corporation are lower because the margins of the newly acquired companies are below those of our base businesses. We consider this to be a short-term issue that will be more than offset by the benefits of diversification, the implementation of cost control measures, and increased future profitability. The integration of our recent acquisitions continues to progress as planned. In addition to having improved operating margins for almost all of our recent acquisitions, we have initiated programs to cross-market products and share technologies across our businesses.

The increase in net earnings for 2004 as compared to 2003 is mainly due to higher segment operating income. The improvement in operating income was partially offset by higher interest expense due to higher debt levels associated with the funding of the Corporation's acquisition program, which accounted for approximately 60% of the increase, and higher interest rates. Net earnings for 2004 included certain one-time tax benefits of \$3.4 million. The tax benefits primarily resulted from the change in legal structure of one of our subsidiaries and a favorable IRS Appeals settlement relating to the 1993 tax year.

Backlog at December 31, 2004 was \$627.7 million compared with \$505.5 million at December 31, 2003 and \$478.5 million at December 31, 2002. Acquisitions made during 2004 represented \$75.8 million of the backlog at December 31, 2004. New orders received in 2004 totaled \$998.9 million, which represents a 34% increase over 2003 new orders of \$743.1 million and a 109% increase over new orders received in 2002. Acquisitions made during 2003 and 2004 contributed \$158.4 million in incremental new orders received in 2004. It should be noted that metal treatment services, repair and overhaul services, and after-market sales, which represent approximately 25% of the Corporation's total sales for 2004, are sold with very modest lead times. Accordingly, the backlog for these businesses is less of an indication of future sales than the backlog of the majority of the products and services of the Motion Control and Flow Control segments, in which a significant portion of sales is derived from long-term contracts.

YEAR ENDED DECEMBER 31, 2003 COMPARED WITH YEAR ENDED DECEMBER 31, 2002

Curtiss-Wright Corporation recorded consolidated net sales of \$746.1 million and net earnings of \$52.3 million, or \$2.50 per diluted share, for the year ended December 31, 2003. Sales during 2003 increased 45% over 2002 sales of \$513.3 million. Net earnings for 2003 increased 16% from 2002 net earnings of \$45.1 million, or \$2.16 per diluted share.

The increase in revenues was mainly driven by a complete year of revenues generated from the 2002 acquisitions of EMD, Tapco International, Penny & Giles, and Autronics and contributions from the 2003 acquisitions, primarily E/M Engineered Coatings Solutions and Collins Technologies. See Note 2 to the Consolidated Financial Statements for further information regarding acquisitions. Including the seven businesses acquired in 2003, the Corporation had acquired thirteen new businesses since 2001. The acquisitions made during 2002 and 2003 contributed \$221.8 million in incremental sales during 2003. The remaining business units experienced organic sales growth of 6% in 2003, led by the Flow Control segment, which grew organically by 13% due to higher valve sales to the nuclear and non-nuclear naval programs and higher sales of new products to the commercial nuclear power generation market. Higher sales of shot peening services for the aerospace market in Europe, sales from our new laser peening technology, and higher sales from our domestic aerospace and ground defense businesses also contributed to the higher sales in 2003. These increases in our base businesses were partially offset by sales declines in commercial aerospace component overhaul and repair services and commercial aerospace original equipment manufacturers' ("OEM") products. Foreign currency translation had a favorable impact on sales of \$14.1 million for the 2003 as compared to 2002.

Operating income for 2003 totaled \$89.3 million, an increase of 29% from operating income of \$69.0 million in 2002. The increase is primarily attributed to the contributions of acquisitions mentioned above, which amounted to \$25.1 million in incremental operating income. In 2003, we reclassified pension income derived from the Curtiss-Wright Pension Plan into operating income for all periods presented. The 2003 pension income decreased \$5.6 million from 2002 due to lower investment returns on the Corporation's pension assets. The amount recorded as pension income reflects the extent to which the return on plan assets exceeds the cost of providing benefits in the same year, as detailed further in Note 14 to the Consolidated Financial Statements. In addition to the contribution of the new acquisitions, 2003 operating income benefited from higher sales to the commercial nuclear power generation markets, higher sales and more favorable sales mix of products to the military aerospace, domestic ground defense, and naval markets. These increases were offset by lower margins as a result of lower volume in the commercial aerospace OEM and overhaul and repair businesses, and cost overruns and inventory adjustments within our Flow Control segment. Foreign currency translation had a favorable impact on operating income of \$2.7 million for 2003 as compared to 2002.

The increase in net earnings for 2003 as compared to 2002 was mainly due to the higher segment operating income. The improvement in operating income was partially offset by lower non-operating other income and higher interest expense associated with higher debt levels.

Backlog at December 31, 2003 was \$505.5 million compared with \$478.5 million at December 31, 2002 and \$242.3 million at December

31, 2001. Acquisitions made during 2003 represented \$15.6 million of the backlog at December 31, 2003. New orders received in 2003 totaled \$743.1 million, which represented a 55% increase over 2002 new orders of \$478.2 million and a 128% increase over new orders received in 2001. Acquisitions made during 2002 and 2003 contributed \$208.0 million in incremental new orders received in 2003.

Economic and Industry-wide Factors

The softness in both the U.S. economy and the global commercial aerospace industry in recent years have had an adverse impact on growth of the Corporation; however, economic reports suggest that both sectors are showing signs of improvement. In addition, steady U.S. military spending levels and increased penetration into certain other served markets have provided a positive offset to weaker commercial markets. Looking forward, many factors could impact the Corporation's future performance, including future defense spending in the U.S., changes in global gross domestic product, volatility of the geopolitical situations, and the pace of economic recovery.

GENERAL ECONOMY

Many of our industrial businesses are driven in large part by growth of the U.S. Gross Domestic Product (GDP). Based upon certain economic reports, the U.S. economy's output (real GDP) is expected to grow at a modest but healthy rate slightly below 4% in 2005. This forecast is predicated on the assumption that oil prices will stabilize or even decline after reaching extremely high levels in 2004. If this were to occur, it should help to restrain inflation which should prompt the U.S. Federal Reserve to show restraint in its campaign to raise interest rates in 2005. According to the economic reports, however, interest rates are expected to rise modestly throughout 2005. Unemployment is also expected to drop slowly over the next two years, as the corporate sector increases output first through productivity gains followed by the addition of labor. This, combined with the recent weakness in the U.S. dollar, should lead to improvement in the performance of U.S. companies.

It appears that, at least in the U.S., economic indicators are showing signs of a recovery; however, we remain cautiously optimistic that this recovery, in fact, will occur in the near term. If and when it does, our businesses that are largely economic driven, such as commercial aerospace, oil and gas, and general industrial, are well positioned to take advantage of the recovery.

DEFENSE

Approximately 50% of our business is in the military sector, predominantly in the U.S., characterized by long-term programs and contracts driven primarily by the U.S. Department of Defense ("DoD") budget.

The U.S. DoD budget reflects growing pressure from costs to support the global war on terrorism and in part initiatives aimed at transforming and modernizing its current platforms and capabilities. The fiscal 2005 DoD procurement budget reflects a 7% overall increase over fiscal 2004 funding levels, after taking into account Congressionally directed rescissions. The 2005 budget includes continued investment funding for key programs supportive of transformation initiatives but is balanced with increased spending for modernization and upgrading of existing equipment in support of current global operations and requirements. We anticipate future DoD spending to produce increased investment specifically in electronics for military hardware necessary

to upgrade existing platforms and facilitate "network centric warfare" equipment and systems as part of the military's transformation plans.

Curtiss-Wright's Flow Control and Motion Control segments are well positioned on many high performance defense platforms, including the next-generation aircraft carrier, the nuclear submarine program, the F/A-22, the V-22, the Joint Strike Fighter and Unmanned Aerial Vehicle programs, such as the Global Hawk. As a result of our reputation and past performance, we are involved in many of the future systems that are currently in various stages of development. However, growing cost concerns are driving serious review of critical defense programs, which may have an impact on U.S. DoD budget levels going forward, as could many other uncertainties such as budget deficit levels and geopolitical uncertainty.

In early January 2005, certain news reports indicated that the as yet unpublished U.S. Deputy Secretary of Defense's fiscal 2006 Future Year Defense Plan (FYDP) includes a \$30 billion proposed cut in the overall DoD budgets over the next six years. The proposed cuts, if approved in their entirety, which the Corporation considers unlikely at this time, are not expected to have a material impact on the Corporation. The primary proposed budget cut that could impact the Corporation would be the decrease in the F/A-22 production program from 277 aircraft to 180, which is proposed to take effect primarily in 2009. Currently, there is much debate about this program cut and it is unclear whether or not this proposed cut will, in fact, occur. If this proposed reduction were to be approved, it is not expected to have a material impact on the Corporation. In addition, the reports suggest that the FYDP includes a substantial increase in appropriations to the Army, potentially for programs for which we have content. Although the program detail is not as of yet clear as to what programs will be affected, we are well positioned on many high performance platforms for the Army which could potentially receive increased funding. In the short term, the "War on Terrorism" is placing demand on the prime contractors to service current field operations which should lead to increased outsourcing for the procurement of certain electronic products that the Company provides. Additionally, delays in new program funding may result in increased upgrades of existing equipment upon which the Corporation currently has content.

There is the possibility that defense spending may decrease in the future, which could adversely affect the Corporation's operations and financial condition. While DoD funding fluctuates year-by-year and program-by-program, the biggest risk facing the Corporation would be the termination of a major program. Other than the proposed reduction in the F/A-22 program mentioned above, the Corporation is not aware of any other such material program termination for which the Corporation has content. If a material program were to be terminated, the termination process takes several years to wind down, which may provide the Corporation ample time to react before any potential impact occurs. In addition to the above, there are other risks associated with our defense businesses, such as failure of a prime contractor customer to perform on a contract, pricing and/or design specifications that may not always be finalized at the time the contract is bid, and the failure and/or inability of certain sole source suppliers to provide product to the Corporation, which could have an adverse impact on the Corporation's financial performance. While alternatives could be identified to replace a sole source supplier, a transition could result in increased costs and manufacturing delays. Our outlook for our defense business looks positive for the near to intermediate term.

COMMERCIAL AEROSPACE

Approximately 18% of our business serves the global commercial aerospace industry. Global airline traffic is a primary driver for long-term growth in the commercial aerospace industry. Economic growth is the prime driver of global airline traffic demand. For the past several years global airline traffic has stagnated primarily due to the impact of terrorist attacks, SARS, and the war in Iraq. However, recent improvement in the global economy has led to increased demand for both passenger and freight air transport. Based upon industry data, global Revenue Passenger Miles for 2004 have increased approximately 15% over 2003 and are expected to increase at an average annual rate of 6% over the period 2004-2008. Although a sharp rise in fuel costs in late 2004 put profitability pressure on airlines, which slowed procurement of new aircraft and extended maintenance schedules, fuel prices are expected to recover in 2005, which should stimulate procurement of new aircraft, a key driver of the Corporation's commercial aerospace business. In fact, the two major global aircraft manufacturers are projecting healthy increases in production levels in both 2005 and 2006. Growth in airline traffic will require increased passenger carrying capacity ("seats") in the system, which can be met by a mix of large commercial aircraft and smaller regional jets supporting the hub-and-spoke system, and mid-sized long-range aircraft servicing point-to-point routes. Based upon market data, we expect to see a steady improvement in the commercial aerospace market in 2005.

Curtiss-Wright's Motion Control segment is a provider of OEM aerospace components and systems and its Metal Treatment segment provides services to aircraft manufacturers. While the emergence of low cost carriers and improved economic conditions has contributed to this industry's recovery, concerns still exist regarding the financial weakness of many airlines and the threat of another major terrorist attack, which could have an adverse impact on this industry and the Corporation's operating results and financial position.

Over the past several years, the Corporation has diversified itself away from dependence on commercial aerospace and has sized its resources to appropriate levels in order to protect profitability. The Corporation is well positioned on a number of commercial aerospace platforms and will benefit from a recovery in this industry, which is expected to occur over the next couple of years.

POWER GENERATION

There are several factors that might precipitate an expansion in commercial nuclear power, including increasing pressure on environmental issues, a pro-nuclear U.S. political leadership, and continued growth in global demand for power. Nuclear power has minimal impact on the environment, is one of the most economical forms of generating electricity, and does not depend upon oil and gas imports. The U.S. nuclear power industry is expected to grow primarily since most of the 103 existing plants are or will be applying for plant life extensions. As of December 31, 2004, approximately 30 plants have received 20 year life extensions and 16 additional plants' applications are pending approval. In addition, several plants are evaluating the potential to add capacity through plant expansion and upgrades. This expansion, combined with new plant construction in Asia and other parts of the world, as well as the possibility of new plant construction in the U.S., should drive expansion in this industry.

Curtiss-Wright's Flow Control segment is well positioned to take part in this expansion. The recent history of plant life extension approvals in the U.S. and continued strong build programs in Asia are encouraging. However, there is no guarantee that the nuclear alternative will continue to be fully endorsed in the U.S. and other parts of the world, or that the Nuclear Regulatory Commission will authorize the construction of new facilities in the U.S. In addition, the geopolitical climate is volatile, which could impact future nuclear plant construction levels around the world.

OIL AND GAS

The drivers that impact this market include capital spending in North America, Asia, and Europe for new construction and upgrades to comply with environmental regulations and maintenance and overhaul spending to retrofit existing facilities with improved equipment and technologies to increase plant flexibility, reliability, production and profitability. Additionally, increased usage of oil and natural gas, increased demand from emerging economies and increased demand for aftermarket services will also affect this market going forward.

The current outlook for hydrocarbon products continues to be optimistic. According to market data, several encouraging developments occurred in 2004, including strengthened global refining margins, refining operating rates continuing to be over 94% in the U.S., increases in petrochemical production on a global basis, and continued global economic recovery. Increases in consumer product demand for petrochemicals and refined products are projected to continue through 2005.

Capital expenditures in the processing industries are expected to increase in the next few years. A recent article in an industry trade publication indicated improving economic fundamentals that will bolster most flow control product-consuming sectors and strengthen underdeveloped infrastructures in Asia, Latin America, and Eastern Europe.

Based upon market data, capital expenditures in the processing industries are expected to increase over the next few years. The long-term global forecast is projecting a solid increase in sales of flow control products (valves, pumps, motors) to the processing industries. As the world continues to depend on natural resources, oil exploration deepens, and transport requirements widen, there should be opportunities to provide our flow control products to meet these challenges. The proposed and enacted environmental regulations in the U.S. and other developed countries could drive increased demand for flow control products by as much as 8-10% over the next few years. However, it is uncertain whether certain economic recoveries can be sustained or whether anticipated future environmental regulatory changes will actually occur, and whether such regulatory changes will have an impact on this industry.

2004 Segment Performance

Curtiss-Wright operates in three principal operating segments on the basis of products and services offered: Flow Control, Motion Control, and Metal Treatment. See Note 16 to the Consolidated Financial Statements for further segment financial information. The following table sets forth revenues, operating income, operating margin, and the percentage changes on those items, as compared with the prior year periods, by operating segment:

	Year Ended December 31,			Percent Changes	
	2004	2003	2002	2004 vs. 2003	2003 vs. 2002
<i>(In thousands, except percentages)</i>					
SALES:					
Flow Control	\$388,139	\$341,271	\$172,455	13.7%	97.9%
Motion Control	388,576	265,905	233,437	46.1%	13.9%
Metal Treatment	178,324	138,895	107,386	28.4%	29.3%
Total Curtiss-Wright	\$955,039	\$746,071	\$513,278	28.0%	45.4%
OPERATING INCOME:					
Flow Control	\$ 44,651	\$ 39,991	\$ 20,693	11.7%	93.3%
Motion Control	44,903	30,350	29,579	48.0%	2.6%
Metal Treatment	28,279	19,055	14,403	48.4%	32.3%
Total Segments	117,833	89,396	64,675	31.8%	38.2%
Pension (Expense) Income	(500)	1,611	7,208	-131.0%	-77.6%
Corporate & Other	(6,614)	(1,677)	(2,846)	294.4%	41.1%
Total Curtiss-Wright	\$110,719	\$ 89,330	\$ 69,037	23.9%	29.4%
OPERATING MARGINS:					
Flow Control	11.5%	11.7%	12.0%		
Motion Control	11.6%	11.4%	12.7%		
Metal Treatment	15.9%	13.7%	13.4%		
Total Segments	12.3%	12.0%	12.6%		
Total Curtiss-Wright	11.6%	12.0%	13.5%		

FLOW CONTROL

The Corporation's Flow Control segment reported sales of \$388.1 million for 2004, a 14% increase over 2003 sales of \$341.3 million. The higher sales are primarily due to the contributions of the 2004 asset acquisitions of Nova Machine Products Corporation, Trentec, Inc., Groth Equipment Corporation, and the Government Marine Business Unit. The 2004 incremental sales from these acquisitions amounted to \$30.7 million. The remaining business units of this segment produced organic sales growth of 5%. The solid organic growth was lead by stronger sales of valves, pumps, other electro-mechanical products, and field services to the power generation market, which increased \$15.0 million due to additional orders, new teaming arrangements, and expedited plant outage service requirements. Increased demand helped drive record new orders of our coker valves for the oil and gas industry, which positively impacted sales by \$9.2 million, and higher sales of our electronic products to the U.S. Navy, which increased \$5.7 million, also contributed to the organic growth. This increase was partially offset by lower sales of flow control products to the U.S. Navy of \$14.5 million due to the timing of contractual revenues. In 2003, the Flow Control segment completed the shipment of two large projects to the U.S. Navy, which generated approximately \$25 million in sales. The segment was able to partially offset the impact of these completed naval projects with higher sales of pumps and other generators for aircraft carriers and submarines and increased demand for the non-nuclear ball valves to the U.S. Navy. Sales

of the remaining valve product lines to the oil and gas industry were down in 2004 as compared to the prior year. In addition, foreign currency translation favorably impacted sales by \$2.3 million in 2004 as compared to 2003.

Operating income for the year increased by 12% over the prior year. The increase was mainly due to solid organic growth of 9% and the contributions from the 2004 acquisitions, which generated operating income of \$1 million in 2004. The increase in organic operating income is mainly due to contract cost overruns on a safety relief valve project and inventory write-offs of approximately \$2.9 million in 2003 that did not reoccur in 2004, higher volume and a stronger sales mix within our power generation products, and higher overall volumes for our valve products to the oil and gas industry and electronic products to the U.S. Navy. The increase was partially offset by the lower volume to the U.S. Navy, driven by the profit impact related to the two large higher margin contracts in 2003 that did not reoccur in 2004. These projects contributed approximately \$9.7 million in operating income in 2003. Foreign currency translation had a \$0.2 million positive impact on 2004 operating income as compared to 2003.

The Corporation's Flow Control segment reported sales of \$341.3 million for 2003, a 98% increase over 2002 sales of \$172.5 million. The higher sales largely reflect the full year of revenues from the acquisitions of EMD and TAPCO International, Inc. completed in the fourth quarter of 2002. The 2003 incremental sales from these acquisitions

amounted to \$170.3 million, driven mainly by strong financial performance from EMD. The remaining business units of this segment produced organic sales growth of 13%, which was driven by higher sales to the commercial nuclear power generation market, nuclear and non-nuclear naval programs, and domestic and international oil and gas markets. Higher sales to the commercial nuclear power generation markets were due to the launch of new product lines and the expedited outage service requirements by the power generation plants. The non-nuclear naval products sales growth was due to new products, such as ball valves and JP-5 fuel valve systems, and higher electronic sales drove the nuclear naval product growth. Sales of the coker valve products to the petrochemical and oil and gas markets were up due to new orders while the remaining product lines in those markets were essentially flat with the prior year. In addition, foreign currency translation favorably impacted sales by \$2.4 million in 2003 as compared to 2002.

Operating income for 2003 increased by 93% over 2002. Acquisitions made in the fourth quarter of 2002 generated incremental operating income of \$21.3 million in 2003, while the balance of the segment businesses rose 2% over 2002. The organic growth was mainly driven by higher volume mentioned above, favorable sales mix, and improved productivity gained from the relocation of the electronics unit, offset by slightly lower margins related to start-up costs on the new product launches and cost overruns on a safety relief valve project. In addition, unanticipated shipping delays and a delay in launching strategic plans for improved operating cost efficiencies at our international unit resulted in an operating loss for the year. However, in late 2003, a new enterprise resource planning system was installed and various process improvements were implemented. Foreign currency translation had a \$0.2 million positive impact on 2003 operating income as compared to 2002.

Backlog at December 31, 2004 is \$396.3 million compared with \$317.8 million at December 31, 2003 and \$304.3 million at December 31, 2002. New orders received in 2004 totaled \$436.7 million, which represents a 24% increase over 2003 new orders of \$353.7 million and a 160% increase over new orders received in 2002. Approximately 50% of the increase in new orders for 2004 is due to the 2004 acquisitions. The remaining improvement is due to record orders for our coker valves to the oil and gas industry and higher overall commercial orders.

MOTION CONTROL

The Corporation's Motion Control segment reported sales of \$388.6 million for 2004, a 46% increase over 2003 sales of \$265.9 million. The higher sales largely reflect the contributions of the 2004 acquisitions of Dy 4, PrimaGraphics, and Synergy, and the full year contributions of the December 2003 acquisitions of Systran, Novatronics, and Pickering. The 2004 incremental sales associated with these acquisitions amounted to \$110.8 million. Sales from the remaining base businesses grew 4% organically. Improvement in commercial aerospace aftermarket sales contributed \$5.9 million to the growth, \$2.8 million of which came from the Corporation's repair and overhaul business, with the remainder attributable mainly to increased sensors and controls sales. Drive system sales to the European ground defense market declined by \$2.9 million as expedited customer delivery requirements shifted production from the beginning of 2004 into 2003. Domestic electro-mechanical systems production experienced a slight increase in domestic military aerospace sales, with F/A-22 production and spares revenue replacing F-16 spares sales, which had ramped up at

the end of 2003. The base embedded computing businesses were essentially flat, with increased sales to the domestic military aerospace market of \$10.1 million driven by new contract wins including the start of full scale production of radar warning systems for the U.S. Army's helicopter programs and the design, development, and integration of the actuators for the 767 refueling program. These wins were offset by declines to the domestic ground defense market of \$10.6 million mainly from scheduled production declines on the Abrams tank and the Bradley Fighting Vehicle, while Bradley spares revenue remained strong through 2004 due to the support of the Iraqi war effort. Additionally, foreign currency translation favorably impacted sales in 2004 by \$7.7 million as compared to 2003.

Operating income for 2004 increased 48% over the prior year. Acquisitions made in 2003 and 2004 generated incremental operating income of \$8.9 million, while the base businesses increased 22%. The improvement was driven by the higher sales volume, favorable sales mix from commercial aerospace aftermarket services and spares, and implemented cost control initiatives, offset by lower margin development work performed in anticipation of follow on production orders. The segment benefited from reductions in reserve requirements at its European sensors business totaling \$1.7 million during 2004, resulting in a \$2.5 million variance in a year over year comparison, since the majority of the reserves were recorded in 2003. Foreign currency translation had a \$1.2 million positive impact on 2004 operating income as compared to 2003.

Motion Control segment sales in 2003 were 14% higher than 2002 sales of \$233.4 million. The higher sales largely reflect the full year contributions of the April 2002 acquisitions of Penny & Giles ("P&G") and Autronics and the contributions of the 2003 acquisitions of Collins Technologies, Peritek, Systran, and Novatronics. The 2003 incremental sales associated with these acquisitions amounted to \$28.0 million. Sales from the remaining base businesses were essentially flat. Strong domestic ground defense sales, primarily related to the expedited deliveries of spare parts for the Bradley Fighting Vehicle to support the Iraqi war effort, an increase in sales of military aerospace products, primarily resulting from new orders for F-16 spare parts and the Joint Strike Fighter development, and higher sales of military electronics for the Global Hawk unmanned aerial reconnaissance system were offset by lower volume associated with the overhaul and repair services provided to the global commercial airline industry and lower OEM commercial aircraft production. The softening in the demand for the commercial aerospace business and related services, which began in 2001, continued through 2003. In addition, foreign currency translation favorably impacted sales in 2003 by \$6.4 million as compared to 2002.

Operating income for 2003 increased 3% over the prior year. Acquisitions made in 2002 and 2003 generated incremental operating income of \$2.3 million, while the balance of the segment businesses was essentially flat as compared to 2002. Slightly lower operating income from the base businesses was mainly due to the lower volume, lower overhead absorption, and the write-off of obsolete inventory at our overhaul and repair services business unit. Operating income of our commercial aerospace OEM business also declined due to lower volume. This decline was offset by higher operating income for our military aerospace products, which rose due to volume and cost improvements. Higher operating income for our land-based defense businesses was due to higher volume and more favorable sales mix

from the spare parts for the Bradley Fighting Vehicle. Foreign currency translation had a \$0.9 million favorable impact on operating income in 2003 as compared to 2002.

Backlog at December 31, 2004 was \$229.6 million compared with \$186.3 million at December 31, 2003 and \$173.2 million at December 31, 2002. Acquisitions made during 2004 represents \$37.5 million of the backlog at December 31, 2004. New orders received in 2004 totaled \$383.5 million, which represents a 53% increase over 2003 new orders of \$250.1 million and an 89% increase over new orders received in 2002. The increase is mainly due to the segment's 2003 and 2004 acquisitions, which accounted for \$105.5 million in incremental new orders in 2004 versus 2003.

METAL TREATMENT

The Corporation's Metal Treatment segment reported sales of \$178.3 million in 2004, an increase of 28% over 2003 sales of \$138.9 million. Organic sales growth of 21% contributed \$24.7 million to the increase. The organic growth was due to strong sales growth from our new laser peening technology, which contributed \$4.8 million in incremental sales, as well as solid growth in our global shot peening services, which contributed \$14.2 million of incremental sales mainly in the German automotive, European commercial aerospace, and North American commercial and military aerospace markets. Sales from the heat treating division were up \$2.8 million over the prior year period mainly due to overflow from a competitor and new aluminum treatment capabilities for the aerospace industry. The remaining sales increase was due to contributions from 2003 and 2004 acquisitions, which contributed \$12.7 million of incremental sales during 2004. The main contributor to this increase was the E/M Engineered Coatings Solutions businesses, which were acquired in April 2003. In addition, foreign currency translation favorably impacted sales by \$5.8 million as compared to 2003.

Operating income for 2004 increased 48% to \$28.3 million from \$19.1 million during 2003. Margin improvement was due to higher sales volume, favorable sales mix due to higher laser peening sales, and implemented cost reduction initiatives. Offsetting the margin improvements were increased medical costs and higher energy costs as compared to the prior year period. Foreign currency translation had a \$1.5 million positive impact on 2004 operating income as compared to the prior year period.

Metal Treatment sales for 2003 were 29% higher than 2002 sales of \$107.4 million. The higher sales largely reflect the contributions from the acquisition of the assets of Advanced Material Process ("AMP") in March 2003 and E/M Engineered Coatings Solutions in April 2003 and the full year contributions of the 2002 acquisitions of the assets of Brenner Tool & Die, Inc. and Ytstruktur Arboga AB. The 2003 incremental sales associated with these acquisitions amounted to \$23.5 million. Sales from the remaining base businesses grew 7% mainly due to domestic and international sales from our new laser peening technology. Our core shot peening sales were down slightly in our North American divisions due mainly to slow downs in the commercial aerospace and automotive markets. The improvement in core shot peening sales from our European divisions was mainly driven by favorable foreign currency translation. Sales from our heat treating services were essentially flat year over year, whereas the sales from our reed valve product line declined due to the softness in the automotive industry. Foreign currency translation had a \$5.2 million positive impact on 2003 sales as compared to 2002.

Operating income for 2003 increased 32% from the prior year. Acquisitions made in 2002 and 2003 generated incremental operating income of \$1.6 million. This incremental income is net of a loss associated with our finishing division, which was negatively impacted by a customer bankruptcy. The base businesses rose 22% over 2002. The organic operating income growth is due to favorable sales mix from our laser peening services, higher volume overall, and the benefit from cost reduction initiatives. In 2002, this segment incurred higher start-up costs at new facilities and nonrecurring costs associated with the relocation of a shot peening facility. Foreign currency translation favorably impacted 2003 operating income by \$1.6 million as compared to 2002.

Backlog at December 31, 2004 was \$1.9 million compared with \$1.4 million at December 31, 2003 and \$1.0 million at December 31, 2002. New orders received in 2004 totaled \$178.7 million, which represents a 28% increase from 2003 new orders of \$139.4 million and a 67% increase over new orders received in 2002. The increase is mainly due to the improvement in the global economy, which positively impacted the core shot peening business and the segment's recent acquisitions.

CORPORATE AND OTHER EXPENSES

The Corporation had non-segment operating costs of \$6.6 million in 2004. The operating costs consisted mainly of environmental remediation and administrative expenses, consulting fees associated with Sarbanes-Oxley Section 404 compliance, incremental compensation cost, debt financing expenses, and other administrative expenses.

The Corporation had non-segment operating costs of \$1.7 million in 2003. The operating costs consisted mainly of environmental remediation and administrative expenses, incremental compensation cost, additional workers compensation insurance cost, director fees associated with additional Board of Directors' meetings and a stock award, debt financing expenses, and other administrative expenses. These expenses were partially offset by the collection of interest on a 2002 net legal settlement.

Non-segment operating costs for 2002 were \$2.8 million, which consisted mainly of net environmental remediation and administrative expenses, post-employment expenses, professional consulting costs associated with the integration of the recent acquisitions, debt commitment fee expenses associated with the Corporation's prior credit agreements, insurance costs, charitable contributions, and other administrative expenses. These expenses were partially offset by a net legal settlement.

NON-OPERATING INCOME/EXPENSES

The Corporation recorded non-operating other income (excluding interest expense) in 2004, 2003 and 2002, of \$0.1 million, \$0.4 million, and \$4.5 million, respectively. In 2002, the Corporation recorded non-recurring items, the net effect of which had a favorable pre-tax impact in 2002 of \$3.6 million.

INTEREST EXPENSE

Interest expense increased \$6.4 million in 2004 as compared to 2003. Higher debt levels associated with the funding of acquisitions accounted for approximately 60% of the increase, and the remaining increase was due to higher interest rates. Similarly, 2003 increased \$3.9 million from 2002.

PROVISION FOR INCOME TAXES

The effective tax rates for 2004, 2003, and 2002 are 34.1%, 37.8%, and 37.1%, respectively. The 2004 effective tax rate included nonrecurring benefits totaling \$3.4 million resulting primarily from the change in legal structure of one of our subsidiaries and a favorable IRS appeals settlement relating to the 1993 tax year.

The 2003 effective tax rate included the benefit of the restructuring of some of our European operations. The 2002 effective rate included a one-time benefit of 1.3% associated with the recovery of research and development tax credits related to earlier years.

Liquidity and Capital Resources

SOURCES AND USES OF CASH

The Corporation derives the majority of its operating cash inflow from receipts on the sale of goods and services and cash outflow for the procurement of materials and labor and is therefore subject to market fluctuations and conditions. A substantial portion of the Corporation's business is in the defense sector, which is characterized by long-term contracts. Most of our long-term contracts allow for several billing points (progress or milestones) that provide the Corporation with cash receipts as costs are incurred throughout the project rather than upon contract completion, thereby reducing working capital requirements. In some cases, these payments can exceed the costs incurred on a project.

OPERATING ACTIVITIES

The Corporation's working capital was \$212.2 million at December 31, 2004, a decrease of \$26.4 million from the working capital at December 31, 2003 of \$238.6 million. The ratio of current assets to current liabilities was 2.1 to 1 at December 31, 2004, compared with a ratio of 2.8 to 1 at December 31, 2003. Cash and cash equivalents totaled \$41.0 million in the aggregate at December 31, 2004, down from \$98.7 million at December 31, 2003. The decrease is primarily due to the use of available cash to fund the acquisition of Dy 4 Systems, Inc. on January 31, 2004. Excluding the impact on cash, working capital increased \$33.1 million due to the acquisition of eleven businesses in 2004. In addition to the impact of these acquisitions, working capital changes were highlighted by an increase in receivables of \$39.9 million and an increase in accounts payable and accrued expenses of \$19.8 million. Unbilled receivables increased substantially due to funding and other operational delays by certain customers as well as increased contracts for which progress billings do not apply. The increase in accounts payable and accrued expenses is due to the timing of year-end payments and higher accrued compensation.

Short-term debt was \$1.6 million at December 31, 2004 and \$1.0 million at December 31, 2003. Long-term debt was \$340.9 million at December 31, 2004, an increase of \$116.7 million from the balance at December 31, 2003. The increase in long-term debt is due to additional funds borrowed to purchase eleven businesses during 2004. Days sales outstanding at December 31, 2004 decreased to 47 days from 56 days at December 31, 2003 while inventory turnover increased to 5.8 turns at December 31, 2004 as compared to 5.5 turns at December 31, 2003.

The Corporation's balance of cash and cash equivalents totaled \$98.7 million at December 31, 2003, an increase of \$51.0 million from the balance at December 31, 2002. Excluding the impact on cash, working capital increased \$9.2 million due to the acquisition of seven

businesses in 2003. In addition to the impact of these acquisitions, working capital changes were also highlighted by a decrease in deferred revenue due to a reduction in those contracts whose billings were in excess of incurred costs. Accrued expenses increased mainly due to higher accrued interest on the Senior Notes. Short-term debt was \$1.0 million at December 31, 2003, a decrease of \$31.8 million from the balance at December 31, 2002. The decrease in short-term debt was due to repayment of the majority of outstanding indebtedness under the existing revolving credit facilities. Days sales outstanding at December 31, 2003 increased to 56 days from 51 days at December 31, 2002, while inventory turnover increased to 5.5 turns at December 31, 2003 as compared to 4.8 turns at December 31, 2002.

INVESTING ACTIVITIES

The Corporation has acquired twenty-four businesses since 2001 and expects to continue to seek acquisitions that are consistent with our long-term growth strategy. A combination of cash resources, funds available under the Corporation's credit agreement, and proceeds from the Corporation's Senior Notes issue were utilized to fund these acquisitions, which totaled \$247.4 million and \$69.8 million in 2004 and 2003, respectively. As noted in Note 2 to the Consolidated Financial Statements, certain acquisition agreements contain contingent purchase price adjustments, such as potential earn-out payments. During 2004, the Corporation made approximately \$3.0 million in such payments relative to prior period acquisitions. Additional acquisitions will depend, in part, on the availability of financial resources at a cost of capital that meets our stringent criteria. As such, future acquisitions, if any, may be funded through the use of the Corporation's cash and cash equivalents, through additional financing available under the credit agreements, or through new financing alternatives.

Capital expenditures were \$32.5 million in 2004, \$33.3 million in 2003, and \$35.0 million in 2002. In 2004 principal capital expenditures included new and replacement machinery and equipment within the business segments and for the expansion of new product lines and facilities. Capital expenditures in 2003 included building expansions, a new laser peening facility and associated laser machinery, and various other machinery and equipment. Capital expenditures in 2002 included the construction of a new facility, additional machinery and equipment for start-up operations, and new Enterprise Resource Planning computer systems at two facilities.

FINANCING ACTIVITIES

On July 23, 2004, the Corporation amended its existing credit facility, increasing the available line of credit from \$225 million to \$400 million. The Corporation plans to use the credit line for working capital purposes, internal growth initiatives, funding of future acquisitions, and other general corporate purposes. The agreement expires in 2009.

At December 31, 2004, the Corporation had a \$400 million revolving credit agreement (the "Agreement") with a group of ten banks. Borrowings under the Agreement bear interest at a floating rate based on market conditions. In addition, the Corporation's interest rate and level of facility fees are dependent on certain financial ratio levels, as defined in the Agreement. The Corporation is subject to annual facility fees on the commitments under the Agreement. In connection with the Agreement, the Corporation paid customary transaction fees that have been deferred and are being amortized over the term of the Agreement. The Corporation is required under the Agreement to maintain certain

financial ratios and meet certain financial tests, the most restrictive of which is a debt to capitalization limit of 55%. The Agreement does not contain any subjective acceleration clauses. At December 31, 2004, the Corporation is in compliance with these covenants and had the flexibility to issue additional debt of \$365 million without exceeding the covenant limit defined in the Agreement. The Corporation would consider other financing alternatives to maintain capital structure balance and ensure compliance with all debt covenants. Cash borrowings (excluding letters of credit) under the Agreement at December 31, 2004 were \$124.5 million as compared to \$8.9 million at December 31, 2003. The unused credit available under the agreement at December 31, 2004 was \$256.7.

On September 25, 2003 the Corporation issued \$200.0 million of Senior Notes (the "Notes"). The Notes consist of \$75.0 million of 5.13% Senior Notes that mature on September 25, 2010 and \$125.0 million of 5.74% Senior Notes that mature on September 25, 2013. The Notes are senior unsecured obligations and are equal in right of payment to the Corporation's existing senior indebtedness. The Corporation, at its option, can prepay at any time all or from time to time any part of, the Notes, subject to a make-whole amount in accordance with the terms of the Note Purchase Agreement. In connection with the Notes, the Corporation paid customary fees that have been deferred and will be amortized over the terms of the Notes. The Corporation is required under the Note Purchase Agreement to maintain certain financial ratios, the most restrictive of which is a debt to capitalization limit of 60%. At December 31, 2004, the Corporation is in compliance with these covenants.

On November 6, 2003 the Corporation entered into two interest rate swap agreements with notional amounts of \$20 million and \$60 million effectively to convert the fixed interest on the \$75 million 5.13% Senior Notes and \$125 million 5.74% Senior Notes, respectively, to variable rates based on specified spreads over six-month LIBOR. In the short-term, the swaps are expected to provide the Corporation with a lower level of interest expense related to the Notes.

Industrial revenue bonds, which are collateralized by real estate, were \$14.3 million at December 31, 2004 and \$14.4 million at December 31, 2003. The loans outstanding under the Senior Notes, Interest Rate Swaps, Revolving Credit Agreement, and Industrial Revenue Bonds had variable interest rates averaging 3.65% for 2004 and 2.88% for 2003.

FUTURE COMMITMENTS

Cash generated from operations are considered adequate to meet the Corporation's operating cash requirements for the upcoming year, including planned capital expenditures of approximately \$50 million, interest payments of approximately \$14 million to \$16 million, estimated income tax payments of approximately \$40 million to \$50 million, dividends of approximately \$8 million, pension funding of approximately \$10 million, and additional working capital requirements. The Corporation has approximately \$2 million in short-term environmental liabilities, which is management's estimation of cash requirements for 2005. Additionally, the Corporation is committed to potential earn-out payments on seven of its acquisitions dating back to 2001, which are estimated to be approximately \$4 million to \$6 million in 2005. There can be no assurance, however, that the Corporation will continue to generate cash flow at the current level. If cash generated from operations is not sufficient to support these requirements and investing activities, the Corporation may be required to reduce capital

expenditures, refinance a portion of its existing debt, or obtain additional financing.

In 2005, capital expenditures are expected to be approximately \$50 million due to the full-year effect of the 2004 acquisitions and the continued expansion of the segments. These expenditures will include construction of new facilities, expansion of facilities to accommodate new product lines, and new machinery and equipment, such as additional investment in our laser peening technology.

The following table quantifies our significant future contractual obligations and commercial commitments as of December 31, 2004:

(In thousands)	Debt Principal Repayments ⁽¹⁾	Operating Leases	Total
2005	\$ 1,630	\$15,846	\$ 17,476
2006	59	12,933	12,992
2007	5,060	11,074	16,134
2008	62	9,141	9,203
2009	124,564	6,016	130,580
Thereafter	208,994	17,727	226,721
Total	\$340,369	\$72,737	\$413,106

⁽¹⁾ Amounts exclude a \$2.1 million adjustment to the fair value of long-term debt relating to the Corporation's interest rate swap agreements that will not be settled in cash.

The Corporation does not have material purchase obligations. Most of our raw material purchase commitments are made directly pursuant to specific contract requirements.

Undistributed earnings of \$23.3 million from the Corporation's foreign subsidiaries are considered permanently reinvested. The American Jobs Creation Act of 2004 provides a one-time dividends received deduction on the repatriation of certain foreign earnings to a U.S. taxpayer, of which the Corporation is considering for possible repatriation a range of zero to \$23 million, which would result in additional income tax expense of zero to \$3 million. Additional information regarding the repatriation of foreign earnings is presented in Note 9.

On March 3, 2005, the Corporation completed the acquisition of Indal Technologies, Inc. The purchase price of 78 million Canadian dollars (approximately \$63 million) was funded from the revolving credit facility. See Recent Development for more information on this acquisition.

Critical Accounting Policies

Our consolidated financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles in the United States of America. Preparing consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. These estimates and assumptions are affected by the application of our accounting policies. Critical accounting policies are those that require application of management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain and may change in subsequent periods. We believe that the following are some of the more critical judgment areas in the application of our accounting policies that affect our financial condition and results of operations:

REVENUE RECOGNITION

The realization of revenue refers to the timing of its recognition in the accounts of the Corporation and is generally considered realized or realizable and earned when the earnings process is substantially complete and all of the following criteria are met: 1) persuasive evidence of an arrangement exists; 2) delivery has occurred or services have been rendered; 3) the Corporation's price to its customer is fixed or determinable; and 4) collectibility is reasonably assured.

The Corporation records sales and related profits on production and service type contracts as units are shipped and title and risk of loss has transferred or as services are rendered. This method is used in our Metal Treatment segment and in some of the business units within the Motion Control and Flow Control segments that serve non-military markets.

For certain contracts in our Flow Control and Motion Control segments that require performance over an extended period before deliveries begin, sales and estimated profits are recorded by applying the percentage-of-completion method of accounting. The percentage-of-completion method of accounting is used primarily for the Corporation's defense contracts and certain long-term commercial contracts. This method recognizes revenue and profit as the contracts progress towards completion. For certain contracts that contain a significant number of performance milestones, as defined by the customer, sales are recorded based upon achievement of these performance milestones. The performance milestone method is an output measure of progress towards completion made in terms of results achieved. For certain fixed price contracts, where none or a limited number of milestones exist, the cost-to-cost method is used, which is an input measure of progress towards completion. Under the cost-to-cost input method, sales and profits are recorded based on the ratio of costs incurred to an estimate of costs at completion.

Application of percentage-of-completion methods of revenue recognition requires the use of reasonable and dependable estimates of the future material, labor, and overhead costs that will be incurred. The percentage-of-completion method of accounting for long-term contracts requires a disciplined cost estimating system in which all functions of the business are integrally involved. These estimates are determined based upon industry knowledge and experience of the Corporation's engineers, project managers, and financial staff. These estimates are significant and reflect changes in cost and operating performance throughout the contract and could have a significant impact on operating performance. Adjustments to original estimates for contract revenue, estimated costs at completion, and the estimated total profit are often required as work progresses throughout the contract and as experience and more information is obtained, even though the scope of work under the contract may not change. These changes are recorded on a cumulative basis in the period they are determined to be necessary.

Under the percentage-of-completion method of accounting, provisions for estimated losses on uncompleted contracts are recognized in the period in which the likelihood of such losses is determined. Certain contracts contain provisions for the redetermination of price and, as such, management defers a portion of the revenue from those contracts until such time as the price has been finalized.

Some of the Corporation's customers withhold certain amounts from the billings they receive. These retainages are generally not due until the project has been completed and accepted by the customer.

INVENTORY

Inventory costs include materials, direct labor, and manufacturing overhead costs, which are stated at the lower of cost or market, where market is limited to the net realizable value. The Corporation estimates the net realizable value of its inventories and establishes reserves to reduce the carrying amount of these inventories to net realizable value, as necessary. We continually evaluate the adequacy of the inventory reserves by reviewing historical scrap rates, on-hand quantities, as compared with historical and projected usage levels and other anticipated contractual requirements. The stated inventory costs are also reflective of the estimates used in applying the percentage-of-completion revenue recognition method.

The Corporation purchases materials for the manufacture of components for sale. The decision to purchase a set quantity of a particular item is influenced by several factors including: current and projected price, future estimated availability, existing and projected contracts to produce certain items, and the estimated needs for its businesses.

For certain of its long-term contracts, the Corporation utilizes progress billings, which represent amounts billed to customers prior to the delivery of goods and services and are recorded as a reduction to inventory and receivables. Progress billings are generally based on costs incurred, including direct costs, overhead, and general and administrative costs.

PENSION AND OTHER POSTRETIREMENT BENEFITS

The Corporation, in consultation with its actuaries, determines the appropriate assumptions for use in determining the liability for future pension and other postretirement benefits. The most significant of these assumptions include the number of employees who will receive benefits along with the tenure and salary level of those employees, the expected return on plan assets, the discount rates used to determine plan obligations, and the trends in the costs of medical and other health care benefits in the case of the postretirement benefit obligations. Changes in these assumptions, if significant in future years, will have an effect on the Corporation's pension and postretirement expense, associated pension and postretirement assets and liabilities, and our annual cash requirements to fund these plans.

The discount rate used to determine the benefit obligations of the plans as of December 31, 2004 and the annual periodic costs for 2005 were lowered in 2004 for the EMD Pension Plan and EMD Postretirement Benefit Plan to better reflect current economic conditions. The reduction in the discount rate increased the benefit obligation on the plans. The Corporation also increased the rate of future compensation costs for the EMD Pension Plan to better reflect current conditions. This rate increase caused an additional increase to the benefit obligation. The change in these two assumptions was based upon current and future economic indicators. A quarter of one percentage point decrease in the discount rate would have the effect of increasing the annual pension expense by \$0.4 million and the pension benefit obligation by \$7.7 million.

The overall expected return on assets assumption is based on a combination of historical performance of the pension fund and expectations of future performance. The historical returns are determined using the market-related value of assets, which is the same value used in the calculation of annual net periodic benefit cost. The market-related value of assets includes the recognition of realized and unrealized gains and losses over a five-year period, which effectively

averages the volatility associated with the actual performance of the plan's assets from year to year. Although over the last ten years the market related value of assets had an average annual yield of 10.9%, the actual returns averaged 9.4% during the same period. The Corporation has consistently used the 8.5% rate as a long-term overall average return. Given the uncertainties of the current economic and geopolitical landscapes, we consider the 8.5% to be a reasonable assumption of the future long-term investment returns.

The long-term medical trend assumptions starts with a current rate that is in line with expectations for the near future, and then grades the rates down over time until it reaches an ultimate rate that is close to expectations for growth in GDP. The reasoning is that medical trends cannot continue to be higher than the rate of GDP growth in the long term. Any change in the expectation of these rates to return to a normal level will have an impact on the Corporation.

The timing and amount of future pension income or expense to be recognized each year is dependent on the demographics and expected earnings of the plan participants, the expected interest rates in effect in future years, and the actual and expected investment returns of the assets in the pension trust.

See Note 14 for further information on the Corporation's pension and postretirement plans, including an estimate of future cash contributions.

ENVIRONMENTAL RESERVES

The Corporation provides for environmental reserves on a site by site basis when, in conjunction with internal and external legal counsel, it is determined that a liability is both probable and estimable. In many cases, the liability is not fixed or capped when the Corporation first records a liability for a particular site. If only a range of potential liability can be estimated and no amount within the range is more probable than another, a reserve will be established at the low end of that range. At sites involving multiple parties, the Corporation accrues environmental liabilities based upon its expected share of the liability, taking into account the financial viability of other jointly liable partners. Judgment is required when we make assumptions and estimate costs expected to be incurred for environmental remediation activities due to, among other factors, difficulties in assessing the extent and type of environmental remediation to be performed, the impact of complex environmental regulations and remediation technologies, and agreements between potentially responsible parties to share in the cost of remediation. In estimating the future liability and continually evaluating the sufficiency of such liabilities, the Corporation weighs certain factors including the Corporation's participation percentage due to a settlement by or bankruptcy of other potentially responsible parties, a change in the environmental laws requiring more stringent requirements, an increase or decrease in the estimated time required to remediate, a change in the estimate of future costs that will be incurred to remediate the site, and changes in technology related to environmental remediation. The Corporation does not believe that continued compliance with environmental laws applicable to its operations will have a material adverse effect on its financial condition or results of operation. However, given the level of judgment and estimation used in the recording of environmental reserves, it is reasonably possible that materially different amounts could be recorded if different assumptions were used or if circumstances were to change, such as environmental regulations or remediation solution remedies.

As of December 31, 2004, the Corporation's environmental reserves totaled \$25.2 million, the majority of which is long-term. Approximately 80% of the environmental reserves represent the current value of anticipated remediation costs and are not discounted primarily due to the uncertainty of timing of expenditures. The remaining environmental reserves are discounted to reflect the time value of money since the amount and timing of cash payments for the liability are reliably determinable. The discount rate used was 4%, which produces an amount at which the environmental liability could be settled in an arm's length transaction with a third party. All environmental reserves exclude any potential recovery from insurance carriers or third-party legal actions.

PURCHASE ACCOUNTING

The Corporation applies the purchase method of accounting to its acquisitions. Under this method, the purchase price, including any capitalized acquisition costs, is allocated to the underlying tangible and intangible assets acquired and liabilities assumed based on their respective fair market values, with any excess recorded as goodwill. The Corporation, generally in consultation with third-party valuation advisors, determines the fair values of such assets and liabilities. During 2004, the fair value of assets acquired, net of cash, and liabilities assumed through acquisitions were estimated to be \$303.0 million and \$42.3 million, respectively. The assigned initial fair value to these acquisitions are tentative and may be revised prior to finalization, which is to be completed within a reasonable period, generally within one year of acquisition.

GOODWILL

The Corporation has \$364.3 million in goodwill as of December 31, 2004. The recoverability of goodwill is subject to an annual impairment test based on the estimated fair value of the underlying businesses. Additionally, goodwill is tested for impairment when an event occurs or if circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. These estimated fair values are based on estimates of future cash flows of the businesses. Factors affecting these future cash flows include the continued market acceptance of the products and services offered by the businesses, the development of new products and services by the businesses and the underlying cost of development, the future cost structure of the businesses, and future technological changes. Management estimates are also used for the Corporation's cost of capital in discounting the projected future cash flows and the Corporation utilizes an independent third party cost of capital analysis in determination of its estimates. If it has been determined that impairment has occurred, the Corporation may be required to recognize an impairment of its asset, which would be limited to the difference between the book value of the asset and its fair value. Any such impairment would be recognized in full in the reporting period in which it has been identified.

OTHER INTANGIBLE ASSETS

Other intangible assets are generally the result of acquisitions and consist primarily of purchased technology, customer related intangibles, trademarks and service marks, and technology licenses. Intangible assets are recorded at their fair values as determined through purchase accounting and are amortized ratably to match their cash flow streams over their estimated useful lives, which range from 1 to 20 years. The Corporation reviews the recoverability of intangible assets, including the related useful lives, whenever events or changes in cir-

cumstances indicate that the carrying amount might not be recoverable. Any impairment would be recorded in the reporting period in which it has been identified.

Recently Issued Accounting Standards

In May 2004, the FASB issued FASB Staff Position (“FSP”) 106-2, “Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003.” This guidance supersedes FSP 106-1 issued in January 2004 and clarifies the accounting and disclosure requirements for employers with postretirement benefit plans that have been or will be affected by the passage of the Medicare Prescription Drug Improvement and Modernization Act of 2003 (“the Act”). The Act introduces two new features to Medicare that an employer needs to consider in measuring its obligation and net periodic postretirement benefit costs. The effective date for the new requirements is the first interim or annual period beginning after June 15, 2004. Additional information regarding the impact of the Act is presented in Note 14.

In November 2004, the FASB issued SFAS No. 151, (“Inventory Costs—an amendment of ARB No. 43, Chapter 4”). This Statement amends the guidance in ARB No. 43, Chapter 4, “Inventory Pricing,” to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage), requiring that these items be recognized as current-period charges regardless of whether they meet the criterion of “so abnormal.” In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. This Statement is effective for annual reporting periods beginning after June 15, 2005. The Corporation does not anticipate that the adoption of this statement will have a material impact on the Corporation’s results of operation or financial condition.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), “Accounting for Stock-Based Compensation.” This Statement requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award—the requisite service period (usually the vesting period). No compensation cost is recognized for equity instruments for which employees do not render the requisite service. Employee share purchase plans will not result in recognition of compensation cost if certain conditions are met; those conditions are much the same as the related conditions in Statement 123. This Statement is effective as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. The Corporation has not yet determined the impact of this pronouncement.

In December 2004, the FASB issued SFAS No. 153, “Exchanges of Non-monetary Assets and Amendment of APB Opinion No. 29.” This statement eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21 (b) of APB Opinion No. 29 and replaces it with an exception for exchanges that do not have commercial substance. This Statement specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. This Statement is effective for annual reporting periods beginning after June 15, 2005. The Corporation does not anticipate that the adoption of this statement will have a material impact on the Corporation’s results of operation or financial condition.

In December 2004, the FASB issued FSP 109-1, “Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004.” The FASB staff believes that the deduction should be accounted for as a special deduction in accordance with Statement 109. The staff also believes that the special deduction should be considered by an enterprise in measuring deferred taxes when graduated tax rates are a significant factor and when assessing whether an evaluation allowance is required. This FSP became effective upon issuance. The adoption of this FSP did not have a material impact on the Corporation’s results of operation or financial position.

In December 2004, the FASB issued FSP 109-2, “Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004.” The American Jobs Creation Act of 2004 provides for a special one-time tax deduction of 85 percent of certain foreign earnings that are repatriated. FASB 109 left intact the provisions of APB Opinion No. 23 “Accounting for Income Taxes—Special Areas,” which provides an exception related to foreign earnings that will not be repatriated. Under this exception, income taxes were not required to be accrued. This FSP became effective upon issuance; however the FASB staff is allowing additional time to evaluate its effect. The Corporation does not anticipate that the adoption of this FSP will have a material impact on the Corporation’s results of operation or financial condition. Additional information regarding this FSP is presented in Note 9.

Recent Development

On March 3, 2005, the Corporation acquired the outstanding shares of Indal Technologies, Inc (“Indal”). The purchase price of the acquisition, subject to customary adjustments as provided for in the Stock Purchase Agreement, was 78.0 million Canadian dollars (approximately \$63 million). Management funded the purchase from the Corporation’s revolving credit facility. Revenues of the purchased business were 49.4 million Canadian dollars (approximately \$38.2 million) for the year ended December 31, 2004. Indal’s operations are located in Toronto, Canada. Management intends to incorporate the operations of Indal into the Corporation’s Motion Control segment.