NATCO GROUP INC
Form 10-Q
November 09, 2006
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# Form 10-Q

**(Mark One)**

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the quarterly period ended September 30, 2006**

**OR**

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the transition period from to**

**Commission file number 1-15603**

# NATCO Group Inc.

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Delaware** | **22-2906892** |
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |

**2950 North Loop West**

**7th Floor**

| | |
|---|---|
| **Houston, Texas** | **77092** |
| **(Address of principal executive offices)** | **(Zip Code)** |

**713-683-9292**

**(Registrant s telephone number, including area code)**

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

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

Large accelerated filer ¨ Accelerated filer þ Non-accelerated filer ¨

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

As of October 31, 2006, the issuer had outstanding 17,323,147 shares of common stock, par value $0.01 per share.

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**NATCO GROUP INC.**

**FORM 10-Q**

**For the Quarter Ended September 30, 2006**

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**PART I FINANCIAL INFORMATION**

**Item 1.** ***Financial Statements***

**NATCO GROUP INC. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**(in thousands, except share and par value data)**

| | September 30, 2006 (unaudited) | December 31, 2005 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 20,934 | $ 9,198 |
| Trade accounts receivable, less allowance for doubtful accounts of $1,862 and $1,123 as of September 30, 2006 and December 31, 2005, respectively | 123,695 | 111,770 |
| Inventories | 48,434 | 37,194 |
| Deferred income tax assets, net | 4,309 | 3,465 |
| Prepaid expenses and other current assets | 3,614 | 3,612 |
| Total current assets | 200,986 | 165,239 |
| Property, plant and equipment, net | 32,852 | 33,263 |
| Goodwill, net | 81,199 | 80,891 |
| Deferred income tax assets, net | 2,917 | 3,329 |
| Other assets, net | 1,474 | 1,021 |
| Total assets | $ 319,428 | $ 283,743 |
| **LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Trade accounts payable and other | $ 36,107 | $ 48,720 |
| Accrued expenses and other | 47,489 | 41,781 |
| Customer advanced billings and payments | 42,825 | 18,272 |
| Current portion of long-term debt | | 6,429 |
| Income taxes payable | 3,181 | 890 |
| Total current liabilities | 129,602 | 116,092 |
| Long-term debt, excluding current installments | 4,500 | 20,964 |
| Long-term deferred tax liabilities | 1,087 | 483 |
| Postretirement benefits and other long-term liabilities | 10,504 | 9,814 |
| Total liabilities | 145,693 | 147,353 |
| Commitments and contingencies | | |
| Minority interest | 380 | |
| Series B redeemable convertible preferred stock (aggregate redemption value of $15,000), $.01 par value. 15,000 shares authorized, issued and outstanding (net of issuance costs) | 14,222 | 14,222 |
| Stockholders equity: | | |
| Preferred stock, $.01 par value. Authorized 5,000,000 shares (of which 500,000 are designated as Series A and 15,000 are designated as Series B); no shares issued and outstanding (except Series B | | |

| | | |
|---|---|---|
| shares above) | | |
| Series A preferred stock, $.01 par value. Authorized 500,000 shares; no shares issued and outstanding | | |
| Common stock, $.01 par value. Authorized 50,000,000 shares; issued and outstanding 17,313,147 and 16,914,052 shares as of September 30, 2006 and December 31, 2005, respectively | 173 | 169 |
| Additional paid-in-capital | 111,640 | 101,671 |
| Retained earnings | 45,579 | 19,914 |
| Treasury stock, no shares and 2,550 shares at cost as of September 30, 2006 and December 31, 2005, respectively | | (22) |
| Accumulated other comprehensive income | 1,741 | 436 |
| Total stockholders equity | 159,133 | 122,168 |
| Total liabilities, redeemable convertible preferred stock and stockholders equity | $ 319,428 | $ 283,743 |

See accompanying notes to unaudited consolidated financial statements.

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**NATCO GROUP INC. AND SUBSIDIARIES**

**UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS**

**(in thousands, except per share data)**

| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|---|---|---|---|---|
| Revenue: | | | | |
| Products | $ 104,248 | $ 83,368 | $ 309,261 | $ 231,016 |
| Services | 27,930 | 19,032 | 69,390 | 54,688 |
| Total | $ 132,178 | $ 102,400 | $ 378,651 | $ 285,704 |
| Cost of goods sold and services: | | | | |
| Products | $ 82,219 | $ 66,593 | $ 241,913 | $ 186,493 |
| Services | 13,745 | 10,958 | 34,130 | 30,679 |
| Total | $ 95,964 | $ 77,551 | $ 276,043 | $ 217,172 |
| Gross profit | $ 36,214 | $ 24,849 | $ 102,608 | $ 68,532 |
| Selling, general and administrative expense | 19,964 | 14,645 | 53,688 | 43,647 |
| Depreciation and amortization expense | 1,299 | 1,276 | 4,163 | 3,931 |
| Closure, severance and other | 2,325 | 2,076 | 2,570 | 2,166 |
| Interest expense | 491 | 942 | 1,922 | 3,033 |
| Interest cost on postretirement benefit liability | (100) | 210 | | 630 |
| Interest income | (96) | (5) | (215) | (70) |
| Minority interest | 400 | | 380 | |
| Other, net | (2,213) | 1,630 | (2,084) | 2,024 |
| Income before income tax expense | $ 14,144 | $ 4,075 | $ 42,184 | $ 13,171 |
| Income tax expense | 4,741 | 1,686 | 15,396 | 5,361 |
| Net income | $ 9,403 | $ 2,389 | $ 26,788 | $ 7,810 |
| Preferred stock dividends | 375 | 375 | 1,125 | 1,125 |
| Net income allocable to common stockholders | $ 9,028 | $ 2,014 | $ 25,663 | $ 6,685 |
| Earnings per share: | | | | |
| Basic | $ 0.53 | $ 0.12 | $ 1.53 | $ 0.42 |
| Diluted | $ 0.49 | $ 0.12 | $ 1.40 | $ 0.41 |
| Weighted average number of shares of common stock: | | | | |
| Basic | 17,016 | 16,260 | 16,824 | 16,005 |
| Diluted | 19,307 | 16,793 | 19,139 | 16,364 |

See accompanying notes to unaudited consolidated financial statements.

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**NATCO GROUP INC. AND SUBSIDIARIES**

**UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(in thousands)**

| | Nine Months Ended September 30, 2006 | 2005 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 26,788 | $ 7,810 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Deferred income tax expense (benefit) | 73 | (560) |
| Depreciation and amortization expense | 4,163 | 3,931 |
| Non-cash interest expense | 198 | 369 |
| Write off of unamortized loan costs | 160 | |
| Stock compensation expense | 3,650 | 1,894 |
| Tax benefit of stock options exercised | 66 | 1,274 |
| Minority interest | 380 | |
| Revaluation of warrants | | 1,778 |
| Interest cost on postretirement benefit liability | | 630 |
| Net payments on postretirement benefit liability | (587) | (1,146) |
| Loss (Gain) on disposition of property, plant and equipment | 272 | (1,011) |
| Gain on sale of investment | (2,464) | |
| Change in assets and liabilities: | | |
| Increase in trade accounts receivable | (8,907) | (14,061) |
| (Increase) decrease in inventories | (10,776) | 5,711 |
| Increase in prepaid expense and other current assets | (126) | (392) |
| (Increase) decrease in long-term assets | 1,129 | (566) |
| Decrease in accounts payable | (11,763) | (7,731) |
| Increase in accrued expenses and other | 3,189 | 9,832 |
| Increase in other income tax payable | 2,292 | |
| Increase in customer advanced billings and payments | 24,353 | 3,069 |
| Net cash provided by operating activities | 32,090 | 10,831 |
| Cash flows from investing activities: | | |
| Capital expenditures for property, plant and equipment | (3,565) | (2,397) |
| Proceeds from sales of property, plant and equipment | 48 | 2,340 |
| Proceeds from sale of investment | 3,000 | |
| Investments in joint venture | (412) | |
| Net cash used in investing activities | (929) | (57) |
| Cash flows from financing activities: | | |
| Repayments under long-term revolving credit agreements | | (3,936) |
| Repayments of long-term debt | (22,893) | (7,621) |
| Proceeds from stock issuances related to stock options, net | 3,021 | 6,530 |
| Excess tax benefit of stock options exercised and restricted stock | 3,273 | |
| Change in bank overdrafts | (2,337) | (6) |
| Dividends paid | (750) | (750) |
| Deferred financing fees | (454) | (115) |
| Treasury shares acquired | (15) | |

| | | |
|---|---|---|
| Net cash used in financing activities | (20,155) | (5,898) |
| Effect of exchange rate changes on cash and cash equivalents | 730 | 378 |
| Increase in cash and cash equivalents | 11,736 | 5,254 |
| Cash and cash equivalents at beginning of period | 9,198 | 2,194 |
| Cash and cash equivalents at end of period | $ 20,934 | $ 7,448 |
| Cash payments for: | | |
| Interest | $ 1,404 | $ 2,463 |
| Income taxes | $ 9,631 | $ 5,939 |

See accompanying notes to unaudited consolidated financial statements.

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NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

**(1) Basis of Presentation**

The accompanying consolidated interim financial statements and related disclosures are unaudited and prepared by NATCO Group Inc. pursuant to accounting principles generally accepted in the United States of America ( U.S. GAAP ) for interim consolidated financial statements and the rules and regulations of the United States Securities and Exchange Commission. As permitted by these regulations, certain information and footnote disclosures that would typically be required in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted. However, the Company s management believes that these statements reflect all the normal recurring adjustments necessary for a fair presentation, in all material respects, of the results of operations for the periods presented, so that these interim financial statements are not misleading. These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K filing for the year ended December 31, 2005.

To prepare financial statements in accordance with generally accepted accounting principles, the Company s management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, and reported amounts of revenue and expenses incurred during the reporting period. Actual results could differ from those estimates.

References to NATCO and the Company are used throughout this document and relate collectively to NATCO Group Inc. and its consolidated subsidiaries.

**(2) Inventories**

Inventories consisted of the following amounts:

| | September 30, 2006 (unaudited) | December 31, 2005 |
|---|---|---|
| | (in thousands) | |
| Finished goods | $ 9,861 | $ 9,670 |
| Work-in-process | 24,141 | 15,138 |
| Raw materials and supplies | 20,874 | 17,180 |
| Inventories at FIFO and weighted average | 54,876 | 41,988 |
| Excess of FIFO over LIFO cost | (6,442) | (4,794) |
| Net inventories | $ 48,434 | $ 37,194 |

The Company s net inventories as of September 30, 2006 and December 31, 2005 by valuation method are shown below:

| | September 30, 2006 (unaudited) | December 31, 2005 |
|---|---|---|
| | (in thousands) | |
| FIFO | $ 9,425 | $ 7,556 |
| Weighted average cost | 832 | 845 |
| LIFO | 38,177 | 28,793 |

| | | |
|---|---|---|
| Net inventories | $ 48,434 | $ 37,194 |

There were no reductions in LIFO layers as of September 30, 2006 and December 31, 2005.

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NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**(3) Costs and Estimated Earnings on Uncompleted Contracts**

Costs and estimated earnings on uncompleted contracts were as follows:

| | September 30, 2006 (unaudited) | December 31, 2005 |
|---|---|---|
| | (in thousands) | |
| Cost incurred on uncompleted contracts | $ 169,242 | $ 109,757 |
| Estimated earnings | 52,068 | 34,419 |
| | 221,310 | 144,176 |
| Less: Billings to date | 226,450 | 128,516 |
| | $ (5,140) | $ 15,660 |
| Included in the accompanying balance sheet under the captions:[1] | | |
| Trade accounts receivable | $ 37,425 | $ 30,705 |
| Customer advanced billings and payments | (42,565) | (15,045) |
| | $ (5,140) | $ 15,660 |

(1) Trade accounts receivable and Customer advanced billings and payments in this table relate only to major contracts and therefore do not agree to the balance sheet accounts Trade accounts receivable and Customer advanced billings and payments.

**(4) Goodwill and Intangible Assets**

In accordance with the Statement of Financial Accounting Standard No. 142 ( SFAS No. 142 ), Goodwill and Other Intangible Assets, the Company evaluates intangible assets with indefinite lives, including goodwill, on an impairment basis, while intangible assets with a defined term, such as patents, are amortized over the useful life of the asset.

*Goodwill*

Net goodwill of $81.2 million and $80.9 million at September 30, 2006 and December 31, 2005 was comprised of $47.6 million and $47.4 million for the Oil & Water Technologies reporting unit, $29.2 million and $29.1 million for the Gas Technologies reporting unit, $4.4 million and $4.4 million for the Automation & Controls reporting unit, respectively. The increase of $308,000 in net goodwill was due entirely to a fluctuation in the exchange rates between the US currency and Canadian currency.

In accordance with SFAS No. 142, the Company tested each business segment for impairment of goodwill at December 31, 2005, and, based upon the results of this testing, management determined that goodwill was not impaired. The Company tests each business segment for goodwill impairment annually, as required by the pronouncement, or more frequently if there are indications of goodwill impairment. No additional testing was performed during the quarter ended September 30, 2006, as management noted no indications of goodwill impairment.

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**NATCO GROUP INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Intangible assets*

Intangible assets subject to amortization as of September 30, 2006 and December 31, 2005 were:

| | As of September 30, 2006 | | As of December 31, 2005 | |
|---|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| | (unaudited) | | | |
| | (in thousands) | | | |
| **Type of intangible assets** | | | | |
| Deferred financing fees | $ 858 | $ 360 | $ 1,112 | $ 711 |
| Patents | 582 | 116 | 195 | 77 |
| Other | 693 | 195 | 621 | 128 |
| Total | $ 2,133 | $ 671 | $ 1,928 | $ 916 |

The increase in intangible assets for the nine months ended September 30, 2006 was primarily due to an investment in intangible assets during the first quarter of 2006 as a result of the Company s purchase of a 50% ownership interest in a joint venture that fabricates a pilotless ignition system for controlling gas-fired heaters used in connection with oil and gas wellhead equipment.

Amortization expense of $71,000 and $310,000 was recognized related primarily to Deferred financing fees, Patents and Other for the three and nine months ended September 30, 2006, respectively, compared to $103,000 and $421,000 for the three and nine months ended September 30, 2005, respectively. During the third quarter of 2006, the Company recorded expense of $160,000 to write-off the majority of the remaining deferred financing fees associated with its 2004 term loan and revolving credit facilities which were refinanced as of July 12, 2006, as discussed in Note 8, Debt. The estimated aggregate amortization expense for these intangible assets for the fiscal year ending December 31, 2006 and for each of the following four fiscal years is: 2006 $380,000; 2007 $209,000; 2008 $209,000; 2009 $209,000; and 2010 $209,000. For segment reporting purposes, these intangible assets, net of the related accumulated amortization expense, were allocated to each segment.

**(5) Warranty Costs**

Estimated future warranty obligations related to products are charged to cost of goods sold in the period in which the related revenue is recognized. A tabular reconciliation of the changes in the Company s aggregate product warranty liability included in the Company s Consolidated Balance Sheet liability account Accrued expenses and other for the nine months ended September 30, 2006 is set forth below (unaudited, in thousands).

| | |
|---|---|
| Balance at December 31, 2005 | $ 2,773 |
| Payments/charges | (1,968) |
| Net accruals | 2,480 |
| Foreign currency translation | 110 |
| Balance at September 30, 2006 | $ 3,395 |

**(6) Closure, Severance and Other**

On December 15, 2005, the Board of Directors approved the final phase of restructuring the Company s U.K. operations by consolidating the Gloucester, England office into our Camberley, England location. At September 30, 2006, the Company had a liability remaining of $149,000 with respect to this phase of the U.K.

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NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

restructuring. The Company finalized the rationalization of office lease expenses associated with vacating the Gloucester facility and accrued $2.3 million of estimated costs in the three months ended September 30, 2006. Other related operating costs incurred associated with the office consolidation during the nine months ending September 30, 2006 amounted to $349,000 of non-cash accelerated leasehold improvement amortization and $488,000 of relocation and other costs. As of September 30, 2006, the total estimated liability is $2.5 million, including foreign currency translation of $65,000.

Pursuant to an amendment to his then effective employment agreement with the Company, entered into in September 2005, Mr. Patrick M. McCarthy agreed to continue as President of the Company in exchange for certain benefits and payments which included, among other things, payment of certain severance benefits, a guaranteed bonus for 2005, acceleration of vesting of certain options, lapse in restrictions on a portion of his restricted stock awards and continuation of certain health benefits following termination. The Company recorded a charge of $1.2 million in the third quarter of 2005 related to this amendment, in addition to the previously accrued expense of $155,000 related to his 2005 bonus. On June 26, 2006, the Company and Mr. McCarthy entered into an amended and restated Employment Agreement (the Employment Agreement ), which became effective July 1, 2006. Under the terms of the Employment Agreement, which was reviewed and approved by the Company s Board of Directors, Mr. McCarthy was named as the Company s President and Chief Operating Officer to serve until July 1, 2009. While the Company did not incur additional charges with respect to effectiveness of the Employment Agreement, it remains liable for the severance obligation under the former arrangement, to be paid upon Mr. McCarthy s termination. At September 30, 2006, the Company had an aggregate liability of $938,000 related to this matter.

In July and December 2004, the Company recorded severance expense of $2.5 million and $1.3 million, respectively, related to the termination of two executives and certain other administrative and operating personnel in the U.S., U.K. and Canada. At September 30, 2006, the Company had an aggregate liability of $633,000 related to these matters.

Following is a summary of Closure, severance and other expense:

| | Three Months Ended September 30, 2006 | | Nine Months Ended September 30, 2006 | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| | (unaudited, in thousands) | | | |
| Severance | $ 49 | $ 2,032 | $ 293 | $ 2,072 |
| Closure cost | 2,276 | | 2,276 | |
| Contract expenses and other | | 44 | 1 | 94 |
| | $ 2,325 | $ 2,076 | $ 2,570 | $ 2,166 |

A roll forward of the Company s accrued Closure, severance and other expense from December 31, 2005 to September 30, 2006 follows (unaudited, in thousands):

| | |
|---|---|
| Balance at December 31, 2005 | $ 2,197 |
| Payments | (830) |
| Severance accrual and other | 294 |
| Closure cost | 2,276 |
| Foreign exchange impact | 124 |
| Balance at September 30, 2006 | $ 4,061 |

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NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The estimated payment schedule for these remaining liabilities at September 30, 2006 is $405,000 in 2006; $1,430,000 in 2007; $473,000 in 2008; $765,000 in 2009; and $482,000 in 2010.

**(7) Income Taxes**

The Company s effective income tax rate for the nine months ended September 30, 2006 and 2005 was 36.5% and 40.7%, respectively, which exceeded the amount that would have resulted from applying the U.S. federal statutory tax rate due to the impact of state income taxes, foreign income tax rate differentials, permanent differences, tax credits and the change in valuation allowances recorded. The decrease in the effective tax rate was primarily attributable to a decrease in permanent book versus tax differences and the generation of tax credits. The main decrease in permanent book versus tax differences was due to a nondeductible mark-to-market expense on warrants exercised in 2005 that was not incurred in 2006.

**(8) Debt**

The Company had the following consolidated borrowings as of the date indicated:

| | September 30, 2006 (unaudited) | December 31, 2005 |
|---|---|---|
| | (in thousands) | |
| 2004 term loan and revolving credit facilities with variable interest rate (6.25% to 6.44% at December 31, 2005) and quarterly payments of principal and interest of $1.6 million due March 31, 2007 | $ | $ 27,393 |
| 2006 revolving credit facilities with an interest rate of 6.56% at September 30, 2006 and scheduled to mature on June 30, 2011 | 4,500 | |
| Revolving credit bank loans (export sales facility) with variable interest rate and monthly interest payments due March 31, 2007 | | |
| Total | $ 4,500 | $ 27,393 |
| Less current installments | | (6,429) |
| Long-term debt | $ 4,500 | $ 20,964 |

On July 12, 2006, the Company terminated the 2004 term loan and revolving credit facilities and entered into a new 2006 revolving credit facilities agreement with a maturity of June 30, 2011. During October 2006, we paid down the remaining $4.5 million of our debt outstanding under the 2006 facilities.

*2006 Revolving Credit Facilities*

The 2006 revolving credit facilities provide for a total borrowing capacity of $85.0 million, consisting of a U.S. revolving facility with a borrowing capacity of $65.0 million, a Canadian revolving facility with a borrowing capacity of $5.0 million and a U.K. revolving facility with a borrowing capacity of $15.0 million. These revolving credit facilities are scheduled to mature on June 30, 2011. The borrowing capacities under the 2006 revolving credit facilities agreement are not subject to any monthly borrowing base limitations. In addition to the base commitments, these new facilities permit the Company to require an increase in the aggregate borrowing capacity by $50.0 million if certain requirements are met.

We incurred $454,000 of deferred financing fees related to the 2006 revolving credit facilities agreement, which are amortized over the 2006 revolving credit facilities agreement s five-year term, using straight-line amortization method.

The 2006 revolving credit facilities agreement provides for interest at a rate based upon the ratio of Funded Debt to EBITDA, as defined in the credit facility ( EBITDA ), and ranging from, at the Company s election,

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**NATCO GROUP INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(1) a low of the London Interbank Offered Rate ( LIBOR ) plus 1.00% to a high of LIBOR plus 2.00% or (2) a low of a Base Rate, as defined in the credit facility ( Base Rate ) plus 0.00% to a high of a Base Rate plus 1.00%. The Company is obligated to pay commitment fees related to this agreement on the undrawn portion of the facility, depending upon the ratio of Funded Debt to EBITDA, which was calculated at 0.25% of the undrawn portion of the facility at September 30, 2006.

Aggregate borrowings of $4.5 million were outstanding under the 2006 revolving credit facilities at September 30, 2006, which bore interest at a rate of 6.56%. The Company had letters of credit outstanding of $11.4 million at September 30, 2006. Availability under the 2006 revolving credit facilities is reduced by the amount of our outstanding letters of credit and loans. Fees related to these letters of credit were approximately 1.0% of the outstanding balance at September 30, 2006. These letters of credit support contract performance and warranties and expire at various dates through June 2009.

During the quarter ended September 30, 2006, we decreased our debt, both under the 2004 term loan and the 2006 revolving credit facilities, by $15.3 million, from $19.8 million at June 30, 2006 to $4.5 million at September 30, 2006. During October we paid the remaining $4.5 million of our debt outstanding under the 2006 facilities.

The 2006 revolving credit facilities agreement is secured by a first lien or first priority security interest in or pledge of substantially all of the assets of the borrowers and certain subsidiaries, including accounts receivable, inventory, equipment, intangibles, equity interests in U.S. subsidiaries, 66 $^{1}/_{3}$% of the equity interest in active, non-U.S. subsidiaries and interests in certain contracts. Assets of the Company and its active U.S. subsidiaries secure the US, Canadian, U.K. revolving facilities, assets of the Company s Canadian subsidiary also secure the Canadian facility and assets of the Company s U.K. subsidiaries also secure the U.K. facility. The U.S. facility is guaranteed by each U.S. subsidiary of the Company, while the Canadian and U.K. facilities are guaranteed by NATCO Group Inc., each of its U.S. subsidiaries and the Canadian subsidiary or the U.K. subsidiaries, as applicable.

The 2006 revolving credit facilities agreement contains restrictive covenants including, among others, those that limit the amount of Funded Debt to EBITDA, impose a minimum fixed charge coverage ratio and impose a minimum tangible net worth requirement. We were in compliance with all restrictive debt covenants as of September 30, 2006. Pursuant to the 2006 revolving credit facilities, the Company is not permitted to make any distributions of any property or cash to its stockholders other than dividends required under its Series B Preferred Stock and certain other dividends not to exceed, in the aggregate, $3.0 million per year, if certain conditions related to Funded Debt to EBITDA and borrowing capacity are met, or $1.5 million per year, in the aggregate, if such conditions are not met. Subject to certain restrictions, the Company also has the ability to buy back up to $25.0 million in value of its common stock.

*Export Sales Facility*

On July 23, 2004, the Company and two of its subsidiaries entered into an international revolving credit agreement with Wells Fargo HSBC Trade Bank, N.A. providing for loans of up to $10.0 million, subject to borrowing base limitations. This working capital facility for export sales is secured by specific project inventory and receivables, as well as certain other inventory, accounts receivable and equipment, and is partially guaranteed by the U.S. Export-Import Bank. Loans under this facility mature on March 31, 2007, and bear interest at either (1) a Base Rate, as defined in the agreement, less 0.25% or (2) LIBOR plus 2.00%, at the Company s election. There were no loans outstanding at September 30, 2006. Letters of credit outstanding under this facility as of September 30, 2006 were $9.8 million. This facility had fees related to letters of credit of approximately 1.00% of the outstanding balance.

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NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

*Other*

At September 30, 2006, the Company had unsecured letters of credit and bonds totaling $317,000.

**(9) Accrued Expenses and Other**

Accrued expenses and other consisted of the following:

| | September 30, 2006 (unaudited) | December 31, 2005 |
|---|---|---|
| | (in thousands) | |
| Accrued compensation and benefits | $ 10,194 | $ 9,182 |
| Accrued insurance | 3,433 | 2,447 |
| Accrued warranty and product costs | 3,395 | 2,773 |
| Accrued project costs | 25,355 | 21,832 |
| Accrued closure, severance and other | 2,596 | 2,197 |
| Taxes and other | 2,516 | 3,350 |
| Totals | $ 47,489 | $ 41,781 |

**(10) Postretirement Benefits**

The Company maintains postretirement benefit plans that provide health care and life insurance benefits for retired employees of a predecessor company. These plans are accounted for in accordance with SFAS No. 106, Employers Accounting for Postretirement Benefits Other than Pensions. The Company has adopted SFAS No. 132, Employer s Accounting for Pensions and Other Postretirement Benefits, which revised disclosures about pension and other postretirement benefit plans.

From May 2004 to December 31, 2005, the Company accounted for the prescription drug benefit under its retiree medical plans in accordance with SFAS No. 106-2, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003. On December 31, 2005, the Company amended the postretirement benefit plans to eliminate prescription drug coverage for post-age 65 participants along with increases in retiree premiums and elimination of dental coverage for one of the groups of retirees of a predecessor company. Under the amended plans, retirees bear additional costs of coverage. As a result, SFAS No. 106-2 no longer applied to the Company starting January 1, 2006, and our SFAS No. 106 net periodic cost has been reduced since that date. As of December 31, 2005 the recorded liability for the accumulated postretirement benefit obligation was $10.0 million, while the actuarially determined amount for this obligation was $7.8 million. This difference is primarily due to the plan amendments made in December 2005 that increased retiree premiums and reduced certain plan benefits.

SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, requires an employer with publicly traded equity securities to recognize the funded status of a benefit plan and the related disclosure requirements. The Company will adjust the liability according to SFAS No. 158 and does not expect any potential negative impact on its consolidated results of operations, financial position or cash flows resulting from the adoption of the standard upon the effective date of December 31, 2006.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the components of net periodic benefit cost under the Company s postretirement benefit plans as of September 30, 2006 and 2005, respectively:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| | (unaudited, in thousands) | | | |
| Unrecognized prior service cost | $ (484) | $ (177) | $ (1,152) | $ (531) |
| Interest cost | 108 | 210 | 323 | 630 |
| Unrecognized loss | 276 | 177 | 829 | 531 |
| Net periodic benefit cost[(1)] | $ (100) | $ 210 | $ | $ 630 |

During the quarter ended September 30, 2006, the Company made an adjustment of $100,000 to reduce the net periodic benefit cost as a result of lower participation in the plans.

(1) Net periodic benefit cost is referred to as Interest cost on postretirement benefit liability in the Unaudited Consolidated Statements of Operations and the reconciliation of the total segment profit to net income in Note 15, Industry Segments.

**(11) Litigation**

The Company and its subsidiaries are defendants or otherwise involved in a number of other legal proceedings in the ordinary course of their business. While we insure against certain risks to the extent deemed prudent by our management, we can offer no assurance that the type or value of this insurance will meet the liabilities that may arise from any pending or future legal proceedings related to our business activities. While we cannot predict the outcome of any legal proceedings with certainty, in the opinion of management, our ultimate liability with respect to these pending lawsuits is not expected to have a material adverse effect on our consolidated financial position, results of operations or cash flows.

**(12) Stock-Based Compensation**

*Stock-Based Compensation information under SFAS No. 123R*

In December 2004, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 123 (Revised 2004), Share-Based Payment (SFAS No. 123R). This amendment requires expensing of stock options and other share-based payments and supersedes SFAS No. 123, which allowed companies to choose between expensing stock options or showing pro forma disclosure only. This standard became effective for the Company as of January 1, 2006 and applies to all awards granted, modified, canceled or repurchased after that date as well as the unvested portion of prior awards.

On November 10, 2005, the FASB issued a FASB Staff Position ( FSP ) FAS 123 R-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards. The Company evaluated the alternative methods provided in this Statement and elected to apply the long-haul method starting January 1, 2006.

Certain of our employees and non-employee directors participate in long-term incentive compensation plans that provide, among other things, for grants of options to acquire shares of the Company s common stock, and awards of restricted stock and other forms of stock-based compensation. Stock options currently outstanding under these plans have no performance requirements, vest annually over periods of three to four years and have a maximum term of up to ten years. The Company had 992,130 shares available for future awards under its incentive compensation plans as of September 30, 2006. Under SFAS No. 123R, share-based compensation cost

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**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

is measured at the grant date, based on the estimated fair value of the award, and is recognized as an expense over the employee s requisite service period. The requisite service period for stock options and fixed awards are based on the vesting period determined at date of grant. The requisite service period for performance-based awards is based on the best estimate of the period over which the performance criteria is expected to be met. Under the Company s long-term incentive plans, the fair market value of the restricted stock awards is determined on the date of grant and is amortized and ratably charged to income. The Company has issued both fixed and performance-based restricted stock awards under its plans. Under SFAS No. 123R, fixed awards are amortized over the vesting period provided in the award (typically, from one to three years), while performance awards are amortized over the period the Company expects will be required to meet the performance requirements. The Company uses a modified prospective application methodology permitted under SFAS No. 123R, which provides for certain changes to the method for valuing share-based compensation. Under the modified prospective application, prior periods are not revised for comparative purposes.

The Company values share-based options by applying the Black-Scholes-Merton Single Option Reduced Term valuation method which was previously used for the Company s pro forma information required under SFAS No. 123 and SFAS No. 148. This valuation model requires management to make assumptions about the volatility of the Company s common stock, the expected term of outstanding stock options, the Company s risk-free interest rate and expected dividend payments during the contractual life of the options.

The following assumptions were used to determine the fair value of stock option awards granted during nine months ended September 30, 2006. There were no options granted during the three months ended September 30, 2006:

| | Nine months ended September 30, 2006 (unaudited) |
|---|---|
| Expected term | 6.0 years |
| Volatility | 45.00% |
| Risk-free interest rate | 4.22% 4.91% |
| Dividend yield | 0.00% |

Volatility was evaluated based upon historical data of the Company s stock price from the New York Stock Exchange from the date of our initial public offering, January 28, 2000 to June 30, 2006.

The risk-free interest rate, as determined on the date of grant, was based upon observed interest rates associated with U.S. Treasury zero coupon instruments with a term similar to the expected term calculated as discussed below. The Company does not anticipate paying any dividends on its common stock for the foreseeable future.

The expected term for options was six years and was computed using the Simplified Method as permitted by SFAS No. 123R. This assumption was based on the Company s opinion that the recent option exercise history may not necessarily reflect future exercise behavior and that historical data for the previous years approximates this term.

Share-based compensation expense was recognized in the Unaudited Consolidated Statement of Operations for the three months and nine months ended September 30, 2006 based on awards ultimately expected to vest. SFAS No. 123R requires forfeitures to be estimated at the date of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated at annual rates of 2.833% and 3.0%, respectively for stock options granted and restricted stock awarded during the three and nine months ended September 30, 2006 based on the Company s historical cancellation and forfeiture experience. The Company

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

changed its estimated forfeiture rate for restricted stock from 0.833% to 3.0% due to forfeitures during the third quarter of 2006 as required by SFAS No. 123R. The cumulative effect of this change decreased compensation expense for the three months ended September 30, 2006 by $51,000.

The components of total share-based compensation expense, related to all of the Company s share-based awards, recognized for the three and nine months ended September 30, 2006 follow:

| | Three Months Ended September 30, 2006 | Nine Months Ended September 30, 2006 |
|---|---|---|
| | (unaudited, in thousands) | |
| Share-based compensation expense | $ 2,552 | $ 3,650 |
| Less: Tax benefit of share-based compensation expense | (949) | (1,351) |
| Share-based compensation expense, net of tax | $ 1,603 | $ 2,299 |

Share-based compensation expense includes $1.1 million of non-cash compensation expense, net of $650,000 tax benefit or $1.7 million pre-tax, for the correction of an error that should have been recorded in the fiscal year 2005 related to stock options issued in 1998, at a price set in anticipation of an initial public offering, which were subsequently canceled and re-issued at a lower price in March 1999. We later became a public company in January 2000. Compensation expense should have been determined using variable accounting per FASB Interpretation No. ( FIN ) 44, Accounting for Certain Transactions involving Stock Compensation, which was issued subsequent to the time these options were re-priced but had retroactive effect. Management discovered the error in the quarter ended September 30, 2006 and has deemed it to be immaterial for both the 2005 and 2006 periods and with respect to the quarterly trends in earnings for both periods. The Company has corrected the accounting to properly recognize the compensation expense by applying variable accounting to these awards as required by FIN 44. Effective with the January 1, 2006 adoption of SFAS No. 123R, variable accounting is no longer applicable to these re-priced stock options and therefore there will be no further impact related to these options in 2006 or future periods.

*Reconciliation*

A tabular reconciliation of the changes in long-term incentive compensation plans for the nine months ended September 30, 2006 is set forth below (unaudited).

| | Stock Option Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|
| Balance at December 31, 2005 | 1,066,789 | $ 9.17 | | |
| Granted | 222,221 | $ 35.53 | | |
| Exercised | (341,504) | $ 8.83 | | |
| Canceled / forfeited | (51,891) | $ 12.81 | | |
| Balance at September 30, 2006 | 895,615 | $ 15.63 | 6.68 | $ 11,798 |
| Vested | 532,859 | $ 9.07 | 5.03 | $ 10,514 |
| Unvested | 362,756 | $ 25.26 | 9.10 | $ 1,284 |

There were no options granted during the three months ended September 30, 2006. The weighted average grant date fair value of stock options granted during nine months ended September 30, 2006 was $17.81. The weighted average grant date fair value was $5.02 for stock options granted during the three and nine months ended September 30, 2005. The total intrinsic value of share options exercised during the three and nine months ended September 30, 2006 was $2.6 million and $9.0 million, respectively, and for the three and nine months ended September 30, 2005 was $4.4 million and $5.2 million, respectively. As of September 30, 2006 there was $3.8 million of unrecognized compensation cost related to stock options granted. This cost is expected to be recognized over a weighted-average period of 2.2 years.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A tabular reconciliation of the changes in restricted stock for the nine months ended September 30, 2006 is set forth below (unaudited).

| | Number of Shares | Weighted Average Grant Date Fair Value |
|---|---|---|
| Unvested at December 31, 2005 | 238,071 | $ 10.29 |
| Granted | 72,081 | $ 32.87 |
| Vested | (56,147) | $ 8.33 |
| Forfeited | (14,040) | $ 18.16 |
| Unvested at September 30, 2006 | 239,965 | $ 16.78 |

The weighted average grant date fair value of restricted shares awarded during nine months ended September 30, 2006 and September 30, 2005 was $32.87 and $10.12, respectively. There were no restricted shares awarded during the three months ended September 30, 2006 or September 30, 2005. The total intrinsic value of restricted shares vested during the three and nine months ended September 30, 2006 was $0.4 million and $2.2 million, respectively. The total intrinsic value of restricted shares vested during the three and nine months ended September 30, 2005 was $1.0 million and $1.1 million, respectively. As of September 30, 2006 there was $2.4 million of unrecognized compensation cost related to restricted stock arrangements. This cost is expected to be recognized over a weighted-average period of 2.03 years.

The Company may elect to issue new shares or treasury shares, if any, under its long-term incentive compensation plans. The Company had no treasury stock as of September 30, 2006.

*Pro Forma Information under SFAS No. 123 for Periods Prior to Fiscal 2006*

Prior to the effective date of SFAS No. 123R, the Company accounted for its employee stock option plans by applying the provisions of Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, as permitted by SFAS No. 123, Accounting for Stock Based Compensation. SFAS No. 123 allowed entities to recognize as expense over the vesting period, the fair value of all stock-based awards on the date of grant. If entities applied the provisions of APB Opinion No. 25, pro forma net income and earnings per share disclosures were required for all employee stock option grants made in 1995 and subsequent years, as if the fair value-based method defined in SFAS No. 123 had been applied.

Pro forma disclosures required by SFAS No. 123 for the three and nine months ended September 30, 2005 were as follows:

| | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2005 |
|---|---|---|
| | (unaudited; in thousands, except per share amounts) | |
| Net income allocable to common stockholders as reported | $ 2,014 | $ 6,685 |
| Add: Restricted stock expense, net of related tax effects | 589 | 1,126 |
| Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects | (602) | (887) |

| | | | | |
|---|---|---|---|---|
| Pro forma income | $ | 2,001 | $ | 6,924 |
| Earnings per share: | | | | |
| Basic as reported | $ | 0.12 | $ | 0.42 |
| Basic pro forma | $ | 0.12 | $ | 0.43 |
| Diluted as reported | $ | 0.12 | $ | 0.41 |
| Diluted pro forma | $ | 0.12 | $ | 0.42 |

**NATCO GROUP INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company utilized the Black-Scholes-Merton valuation method to calculate the pro forma information for stock-based compensation expense as it relates to stock options as presented above. The following table summarizes assumptions used to determine pro forma compensation expense under SFAS No. 123 as of June 30, 2005:

| | |
|---|---|
| Expected Term | 3.5 7 years |
| Volatility | 47% |
| Risk-free interest rate | 1.49% 6.52% |
| Dividend yield | 0.0% |

**(13) Warrants**

On March 25, 2003, the Company issued 15,000 shares of Series B Convertible Preferred Stock and warrants to purchase 248,800 shares of NATCO s common stock to a private investment fund. The warrants had an exercise price of $10.00 per share of common stock and were to expire on March 25, 2006. The Company had the ability to force the exercise of the warrants if NATCO s common stock traded above $13.50 per share for 30 consecutive trading days, at which point the holder could elect to (1) exercise the warrants in full, (2) exercise for the net amount of shares issuable after deduction of the exercise price from the current market price of the shares on the date preceding the exercise date or (3) not to exercise the warrants, resulting in their termination. The warrants contained a provision whereby the holder could require the Company to make a net-cash settlement for the warrants in the case of a change in control. The warrants were deemed to be derivative instruments and, therefore, the warrants were recorded at fair value as of the issuance date. Fair value, as agreed with the counter-party to the agreement, was calculated by applying a pricing model that included subjective assumptions for stock volatility, expected term that the warrants would be outstanding, a dividend rate of zero and an overall liquidity factor. The Company recorded the resulting liability of $99,000 as of the issuance date.

On August 26, 2005, the investment fund exercised all of the warrants pursuant to the cashless exercise provision contained in the warrant instrument, resulting in no cash payment to the Company. The number of shares of common stock issued to the investment fund was calculated based on the average of the closing price of the Company s shares on the New York Stock Exchange for the ten trading-day period ending on the day prior to the exercise. The average price was $17.933, resulting in the issuance of 110,061 shares of common stock in exchange for the warrants.

**(14) Earnings per Share**

In accordance with SFAS No. 128 Earnings per Share, the Company computed basic earnings per share by dividing net income allocable to common stockholders by the weighted average number of shares outstanding for the period. Net income allocable to common stockholders at September 30, 2006 represented net income less preferred stock dividends accrued. The Company determined diluted earnings per common and potential common share at September 30, 2006 as net income allocable to common stockholders divided by the weighted average number of shares outstanding for the period, after applying the if-converted method to determine any incremental shares associated with convertible preferred stock, stock options and restricted stock outstanding.

As of January 1, 2006, the Company adopted SFAS No. 123R and computed incremental shares according to SFAS No. 123R requirements. The assumed proceeds used in the Treasury Method include the windfall tax benefit related to unrecognized compensation expense. For purposes of the weighted average shares calculation, restricted shares as to which the performance criteria have not been met were excluded.

If anti-dilutive common shares were included for the three and nine months ended September 30, 2006, the impact would have been a reduction of approximately 63,823 and 79,060 shares, respectively. The lapse of

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**NATCO GROUP INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

restrictions on certain shares of restricted stock in the second and third quarters of 2006 and various new grants of stock options during the second quarter of 2006 accounted for the changes in the weighted average number of shares for basic and diluted common stock for the three and nine months ended September 30, 2006. For the three months and nine months ended September 30, 2006, 1.9 million shares issuable upon conversion of the Series B Preferred Shares were included in the calculation of incremental shares, as the inclusion of these shares was dilutive at the level of income in these two periods.

The following table presents the computation of basic and diluted earnings per common and potential common share for the three and nine months ended September 30, 2006 and 2005, respectively:

| | Three Months Ended September 30, 2006 | | | Three Months Ended September 30, 2005 | | |
|---|---|---|---|---|---|---|
| | Income | Weighted Average Shares Outstanding | Per-share Amount | Income | Weighted Average Shares Outstanding | Per-share Amount |
| | (unaudited; in thousands, except per-share amounts) | | | | | |
| Net income | $ 9,403 | | | $ 2,389 | | |
| Less: Convertible preferred stock dividends accrued | (375) | | | (375) | | |
| *Basic EPS:* | | | | | | |
| Income allocable to common stockholders | 9,028 | 17,016 | $ 0.53 | $ 2,014 | 16,260 | $ 0.12 |
| Effect of dilutive securities: | | | | | | |
| Warrants | | | | | 55 | |
| Stock options | | 310 | | | 368 | |
| Restricted stock | | 59 | | | 110 | |
| Convertible preferred stock | | 1,922 | | | | |
| *Diluted EPS:* | | | | | | |
| Plus: Convertible preferred stock dividends accrued | 375 | | | | | |
| Income allocable to common stockholders | $ 9,403 | 19,307 | $ 0.49 | $ 2,014 | 16,793 | $ 0.12 |

| | Nine Months Ended September 30, 2006 | | | Nine Months Ended September 30, 2005 | | |
|---|---|---|---|---|---|---|
| | Income | Weighted Average Shares Outstanding | Per-share Amount | Income | Weighted Average Shares Outstanding | Per-share Amount |
| | (unaudited; in thousands, except per-share amounts) | | | | | |
| Net income | $ 26,788 | | | $ 7,810 | | |
| Less: Convertible preferred stock dividends accrued | (1,125) | | | (1,125) | | |
| *Basic EPS:* | | | | | | |
| Income allocable to common stockholders | $ 25,663 | 16,824 | $ 1.53 | $ 6,685 | 16,005 | $ 0.42 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Effect of dilutive securities: | | | | | | |
| Warrants | | | | | 32 | |
| Stock options | | 341 | | | 252 | |
| Restricted stock | | 52 | | | 75 | |
| Convertible preferred stock | | 1,922 | | | | |
| | | | | | | |
| *Diluted EPS:* | | | | | | |
| Plus: Convertible preferred stock dividends accrued | 1,125 | | | | | |
| | | | | | | |
| Income allocable to common stockholders | $ 26,788 | 19,139 | $ 1.40 | $ 6,685 | 16,364 | $ 0.41 |

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**NATCO GROUP INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(15) Industry Segments**

The Company s operating segments are Oil & Water Technologies, Gas Technologies and Automation & Controls.

The Oil & Water Technologies segment includes both standard and traditional oil and gas separation and dehydration equipment sales and related services and built-to-order systems focused primarily on oil and water production and processing.

The Gas Technologies segment includes our $CO_2$ membrane business, the assets and operating relationship related to our gas processing facilities in West Texas, $H_2S$ removal technologies including Shell Paques and other built-to-order gas-related technologies that focus on removing contaminants from the gas stream.

The Automation & Controls segment focuses on the manufacture and sale of new control panels and systems which monitor and control oil and gas production, as well as field service activities including repair, maintenance, testing and inspection services for existing systems.

The Company allocates corporate and other expenses to each of its business segments. This allocation is driven by a formula based on headcount, total assets, revenue and bookings. Corporate assets are allocated to the segments based on the total assets of the segment. The accounting policies of the reportable segments were consistent with the policies used to prepare the Company s consolidated financial statements for the respective periods presented. The Company evaluates the performance of its operating segments based on total segment profit, which is defined as net income that includes minority interest expense but before net interest expense, depreciation and amortization expense, closure, severance and other, interest cost on postretirement benefit liability, other, net and income taxes.

Summarized financial information concerning the Company s reportable segments is shown in the following table.

| | Oil & Water Technologies | Gas Technologies | Automation & Controls | Eliminations | Total |
|---|---|---|---|---|---|
| | | | (unaudited, in thousands) | | |
| **Three Months Ended September 30, 2006** | | | | | |
| Revenue from unaffiliated customers | $ 94,018 | $ 15,478 | $ 22,682 | $ | $ 132,178 |
| Inter-segment revenue | $ 2,013 | $ | $ 1,199 | (3,212) | $ |
| Segment profit | $ 7,645 | $ 4,899 | $ 3,306 | $ | $ 15,850 |
| Total assets | $ 224,717 | $ 61,678 | $ 33,033 | $ | $ 319,428 |
| Capital expenditures | $ 733 | $ 217 | $ 142 | $ | $ 1,092 |
| Depreciation and amortization | $ 735 | $ 452 | $ 112 | $ | $ 1,299 |
| **Three Months Ended September 30, 2005** | | | | | |
| Revenue from unaffiliated customers | $ 76,114 | $ 12,798 | $ 13,488 | $ | $ 102,400 |
| Inter-segment revenue | $ 98 | $ | $ 1,254 | $ (1,352) | $ |
| Segment profit | $ 2,961 | $ 6,546 | $ 697 | $ | $ 10,204 |
| Total assets | $ 180,533 | $ 59,099 | $ 23,360 | $ | $ 262,992 |
| Capital expenditures | $ 452 | $ 98 | $ 44 | $ | $ 594 |
| Depreciation and amortization | $ 628 | $ 556 | $ 92 | $ | $ 1,276 |

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NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

| | Oil & Water Technologies | Gas Technologies | Automation & Controls | Eliminations | Total |
|---|---|---|---|---|---|
| | (unaudited, in thousands) | | | | |
| **Nine months Ended September 30, 2006** | | | | | |
| Revenue from unaffiliated customers | $ 270,650 | $ 44,959 | $ 63,042 | $ | $ 378,651 |
| Inter-segment revenue | $ 6,023 | $ | $ 3,527 | $ (9,550) | $ |
| Segment profit | $ 21,528 | $ 18,382 | $ 8,630 | $ | $ 48,540 |
| Total assets | $ 224,717 | $ 61,678 | $ 33,033 | $ | $ 319,428 |
| Capital expenditures | $ 2,836 | $ 275 | $ 454 | $ | $ 3,565 |
| Depreciation and amortization | $ 2,403 | $ 1,462 | $ 298 | $ | $ 4,163 |
| **Nine months Ended September 30, 2005** | | | | | |
| Revenue from unaffiliated customers | $ 215,186 | $ 27,972 | $ 42,546 | $ | $ 285,704 |
| Inter-segment revenue | $ 620 | $ | $ 3,175 | $ (3,795) | $ |
| Segment profit | $ 6,878 | $ 14,426 | $ 3,581 | $ | $ 24,885 |
| Total assets | $ 180,533 | $ 59,099 | $ 23,360 | $ | $ 262,992 |
| Capital expenditures | $ 1,914 | $ 153 | $ 330 | $ | $ 2,397 |
| Depreciation and amortization | $ 1,999 | $ 1,653 | $ 279 | $ | $ 3,931 |

The following table reconciles total segment profit to net income as set forth below:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| | (unaudited, in thousands) | | | |
| Total segment profit | $ 15,850 | $ 10,204 | $ 48,540 | $ 24,885 |
| Interest expense | 491 | 942 | 1,922 | 3,033 |
| Interest income | (96) | (5) | (215) | (70) |
| Depreciation and amortization | 1,299 | 1,276 | 4,163 | 3,931 |
| Closure, severance and other | 2,325 | 2,076 | 2,570 | 2,166 |
| Interest cost on postretirement benefit liability | (100) | 210 | | 630 |
| Other, net | (2,213) | 1,630 | (2,084) | 2,024 |
| Net income before income taxes | $ 14,144 | $ 4,075 | $ 42,184 | $ 13,171 |
| Income tax provision | 4,741 | 1,686 | 15,396 | 5,361 |
| Net income | $ 9,403 | $ 2,389 | $ 26,788 | $ 7,810 |

The following table provides further information on revenue by product line within the Oil & Water Technologies segment for the three and nine months ended September 30, 2006 and 2005.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| | (unaudited, in thousands) | | | |
| Traditional/standard/used equipment | $ 63,153 | $ 46,671 | $ 182,617 | $ 141,921 |
| Built-to-order | 33,825 | 30,754 | 95,603 | 77,678 |
| Eliminations | (947) | (1,213) | (1,547) | (3,793) |

| | | | | |
|---|---|---|---|---|
| Total Oil & Water Technologies segment revenue | $ 96,031 | $ 76,212 | $ 276,673 | $ 215,806 |

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**(16) Disposition**

On July 20, 2006, the Company sold a portion of its investment in NATCO Japan Company Ltd. to Modec Inc. and Daiichi Jitsugyo, Ltd., an existing shareholder, for a total cash consideration of $3.0 million. The Company recognized a $2.5 million gain on the sale in the quarter ended September 30, 2006, net of the existing equity cost basis and legal fees.

The Company continues to own 60% of NATCO Japan after the sale. The Company continues to exercise financial control over NATCO Japan and will consolidate its activities into the Company s consolidated financial statements. In addition, the Company will record a minority interest expense for the portion of earnings related to the minority interest ownership of its joint venture partners. For the three months ended September 30, 2006, the Company recorded $400,000 as a minority interest expense.

**(17) Recent Accounting Pronouncements**

In November 2004, the FASB issued SFAS No. 151, Inventory Costs, an amendment of Accounting Research Bulletin ( ARB ) No. 43, Chapter 4. SFAS No. 151 amends ARB No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) should be recognized as current period charges. In addition, SFAS No. 151 requires that allocation of fixed production overhead to inventory be based on the normal capacity of the production facilities. SFAS No. 151 became effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company adopted this pronouncement on June 15, 2005, with no material impact on its consolidated results of operations, financial position or cash flows.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets , which amends APB Opinion No. 29. The guidance in APB Opinion No. 29, Accounting for Nonmonetary Transactions, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The amendment made by SFAS No. 153 eliminates the exception for exchanges of similar productive assets and replaces it with a broader exception for exchanges of nonmonetary assets that do not have commercial substance. This statement became effective on June 15, 2005. The Company adopted the standard as of the effective date with no material impact on its consolidated results of operations, financial position or cash flows.

In March 2005, the FASB issued Interpretation No. ( FIN ) 47, Accounting for Conditional Asset Retirement Obligations. FIN 47 clarifies that the term conditional asset retirement obligation, as used in SFAS No. 143, Accounting for Asset Retirement Obligations, refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. Uncertainty about the timing and (or) method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The Interpretation is effective no later than the end of fiscal years ending after December 15, 2005. The Company adopted this standard on January 1, 2006. The adoption of this standard did not have a material effect on the Company s consolidated results of operations, financial position or cash flows.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections A Replacement of APB Opinion No. 20 and FASB Statement No. 3. The new standard changes the requirements for the accounting for and reporting of a change in accounting principle. Among other changes, SFAS No. 154

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**NATCO GROUP INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented on the new accounting principle, unless it is impracticable to do so. SFAS No. 154 also provides that (1) a change in method of depreciating or amortizing a long-lived non-financial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements should be termed a restatement. The new standard is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company adopted this standard on January 1, 2006. The adoption of this standard did not have a material effect on the Company s consolidated results of operations, financial position or cash flows.

In September 2005, the FASB s Emerging Issues Task Force (EITF) issued EITF No. 04-13, Accounting for Purchases and Sales of Inventory with the Same Counterparty. This pronouncement provides additional accounting guidance for situations involving inventory exchanges between parties to that contained in APB Opinion No. 29, Accounting for Nonmonetary Transactions and SFAS No. 153, Exchanges of Nonmonetary Assets. The standard is effective for new arrangements entered into in reporting periods beginning after

March 15, 2006, and to all inventory transactions that are completed after December 15, 2006 for arrangements entered into prior to March 15, 2006. The Company adopted this standard on January 1, 2006. The adoption of this standard did not have a material effect on the Company s consolidated results of operations, financial position or cash flows.

In September 2005, the U.S. Securities and Exchange Commission ( SEC ) staff revised EITF No. D-98, Classification and Measurement of Redeemable Securities, primarily to provide guidance on (1) the earnings per share treatment of redeemable common stock and (2) the application of EITF No. D-98 to share-based payment arrangements with employees. The guidance on the earnings per share treatment of redeemable common stock in EITF No. D-98 to share-based payment arrangements with employees is effective in the first fiscal period beginning after September 15, 2005. The Company adopted EITF No. D-98 as of the effective date as it relates to the earnings per share treatment of redeemable common stock, and has applied the application to share-based payment arrangements with employees concurrently with the adoption of SFAS No. 123R. The adoption of this standard did not have a material effect on the Company s consolidated results of operations, financial position or cash flows.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140, which is effective for fiscal years beginning after September 15, 2006. The statement was issued to clarify the application of FASB Statement No. 133 to beneficial interests in securitized financial assets and to improve the consistency of accounting for similar financial instruments, regardless of the form of the instruments. The Company is in the process of evaluating the impact, if any, of this standard on its consolidated results of operations, financial position or cash flows and will adopt it on January 1, 2007.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140, which is effective for fiscal years beginning after September 15, 2006. This statement was issued to simplify the accounting for servicing rights and to reduce the volatility that results from using different measurement attributes. The Company is in the process of evaluating the impact, if any, of this standard on its consolidated results of operations, financial position or cash flows and will adopt it on January 1, 2007.

In March 2006, the EITF issued EITF No. 05-01, Accounting for the Conversion of an Instrument that Became Convertible upon the Issuer s Exercise of a Call Option. This issue requires that the issuance of equity securities to settle a debt instrument that became convertible on the issuer s exercise of a call option be accounted

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NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

for as a conversion if the debt instrument contains a substantive conversion feature as of its issuance date. Absent a substantive conversion feature, it should be accounted for as a debt extinguishment. EITF No. 05-01 is effective for periods beginning after June 28, 2006. The Company adopted this standard as of July 1, 2006. The adoption of this standard did not have a material effect on the Company s consolidated results of operations, financial position or cash flows.

In March 2006, the EITF issued EITF No. 06-03, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation). EITF No. 06-03 requires that the presentation of taxes assessed by a governmental authority that are directly imposed on a revenue-producing transaction between a seller and a customer on either a gross (included in revenue and costs) or a net (excluded from revenue) basis is an accounting policy decision that should be disclosed pursuant to APB Opinion No. 22. In addition, if any of such taxes are reported on a gross basis, a company should disclose, on an aggregate basis, the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amount are significant. This issue will be applied to financial reports for interim and annual reporting periods beginning after December 15, 2006. The Company currently reports Revenue on a net basis. The Company is in the process of evaluating the impact, if any, of this standard on its consolidated results of operations, financial position or cash flows and will adopt it on January 1, 2007.

In June 2006, the FASB issued FIN 48, Accounting for Uncertainty in Income Taxes. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return as well as provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The interpretation is effective for fiscal years beginning after December 15, 2006. The Company is in the process of evaluating the impact, if any, of this standard on its consolidated results of operations, financial position or cash flows and will adopt it on January 1, 2007.

In September 2006, the FASB issued FSP No. AUG AIR-1, Accounting for Planned Major Maintenance Activities, which prohibits the use of the accrue-in-advance method of accounting for planned major maintenance activities in annual and interim financial reporting periods. FSP AUG AIR-1 is effective for the fiscal year beginning after December 15, 2006. The Company is in the process of evaluating the impact of FSP AUG AIR-1 on its consolidated results of operations, financial position or cash flows and will adopt it on January 1, 2007.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which will become effective for the Company as of January 1, 2008. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures of fair value measurements. The Company has not yet determined the impact of this Standard on its consolidated results of operations, financial position or cash flows and will adopt it on January 1, 2008.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans. The statement requires an employer with publicly traded equity securities to recognize the funded status of a benefit plan and the related disclosure requirements as of the end of the fiscal year ending after December 15, 2006. The Company currently measures the plans assets and benefit obligations as of the Company s fiscal year end date. The Company s recorded liability for the accumulated postretirement benefit obligation is currently greater than the actuarially determined amount of this obligation. Therefore, the

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**NATCO GROUP INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Company does not expect any potential negative impact on its consolidated results of operations, financial position or cash flows resulting from the adoption of the standard as of December 31, 2006.

In September 2006, the SEC released Staff Accounting Bulletin No. 108 ( SAB 108 ), Considering the effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, which provides interpretive guidance on the U.S. Securities and Exchange Commission s views regarding the process of quantifying materiality of financial statements. SAB No. 108 is effective for fiscal years ending after November 15, 2006, with early application for the first interim period ending after November 15, 2006. The Company is in the process of evaluating the impact, if any, of this provision on its consolidated results of operations, financial position and cash flows.

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

**Forward-Looking Statements**

Management s Discussion and Analysis includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words believe, expect, plan, intend, estimate, project, could, may and similar expressions are intended to identify forward-looking statements. Forward-looking statements in this document include, but are not limited to, discussions regarding indicated trends in the level of oil and gas exploration and production and the effect of such conditions on the Company s results of operations (see Industry and Business Environment ), future uses of and requirements for financial resources (see Liquidity and Capital Resources ), and bookings and backlog levels in 2006 (see Liquidity and Capital Resources ). Our expectations about our business outlook, customer spending, oil and gas prices, our business environment and that of the industry in general are only our expectations regarding these matters. Actual results may differ materially from those expressed in the forward-looking statements for reasons including, but not limited to: market factors such as pricing and demand for petroleum related products, the level of petroleum industry exploration and production expenditures, the effects of competition, world economic conditions, the level of drilling activity, the legislative environment in the United States and other countries, policies of OPEC, conflict involving the United States or in major petroleum producing or consuming regions, acts of terrorism, the development of technology that could lower overall finding and development costs, weather patterns, the overall condition of capital and equity markets for countries in which we operate.

**Overview**

Our organization has three operating segments: Oil & Water Technologies, Gas Technologies and Automation & Controls.

The Oil & Water Technologies segment includes both standard and traditional oil and gas separation, dehydration equipment sales and related services and built-to-order systems focused primarily on oil and water production and processing.

The Gas Technologies segment includes our $CO_2$ membrane business, the assets and operating relationship related to our gas processing facilities in West Texas, $H_2S$ removal technologies including Shell Paques and other built-to-order gas-related technologies that focus on removing contaminants from the gas stream.

The Automation & Controls segment focuses on the manufacture and sale of new control panels and systems which monitor and control oil and gas production, as well as field service activities including repair, maintenance, testing and inspection services for existing systems.

**Critical Accounting Policies**

The preparation of our consolidated financial statements requires us to make certain estimates and assumptions that affect the results reported in our consolidated financial statements and accompanying notes. These estimates and assumptions are based on historical experience and on our future expectations that we believe to be reasonable under the circumstances. Note 2 to the consolidated financial statements filed in our Annual Report on Form 10-K for the year ended December 31, 2005, contains a summary of our significant accounting policies. We believe the following accounting policies are the most critical in the preparation of our consolidated financial statements:

*Revenue Recognition: Percentage of Completion Method.* We recognize revenue and related costs when products are shipped or services are rendered for (1) time and materials and service contracts, (2) manufactured goods produced in standard manufacturing operations and sold in the ordinary course of business through regular marketing channels and (3) certain customized manufactured goods that are smaller jobs with less customization, making them similar to such standard manufactured goods (that is, contracts valued at $250,000 or less having

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contract durations of four months or less). We recognize revenue using the percentage of completion method on contracts greater than $250,000 and having contract durations in excess of four months that represent customized, engineered orders of our products and qualify for such treatment in accordance with the requirements of AICPA Statement of Position 81-1, Accounting for Performance of Certain Production-Type Contracts ( SOP 81-1 ). In addition, we use the percentage of completion method on all Automation & Controls segment s equipment fabrication and sales projects that qualify for such treatment in accordance with the requirements of SOP 81-1. The Automation & Controls segment sells customized products fabricated to order pursuant to a large number of smaller contracts with durations of two to three months, with occasional large systems projects of longer duration. The segment does not produce standard units or maintain an inventory of products for sale. Due to the nature of the segment s equipment fabrication and sales operations, and the potential for wide variations in our results of operations that could occur from applying the as shipped methodology to smaller contracts for these customized, fabricated goods, this segment recognizes revenue, regardless of contract value or duration, applying the percentage of completion method. For the nine months ended September 30, 2006, approximately 50.4% of total Company revenue was recorded on an as shipped or as performed basis and approximately 49.6% was recorded using the percentage of completion method.

With respect to contract revenue recorded utilizing the percentage of completion method, earned revenue is based on the percentage that costs incurred to date relate to total estimated costs of the project, after giving effect to the most recent estimates of total cost. Total estimated contract cost is a critical accounting estimate because it can materially affect revenue and net income and it requires us to make judgments about matters that are uncertain. Total costs expected to be incurred, and therefore recognition of revenue, could be affected by various internal or external factors including, but not limited to: changes in project scope (change orders), changes in productivity, scheduling, the cost and availability of labor, the cost and availability of raw materials, the weather, client delays in providing approvals at benchmark stages of the project and the timing of deliveries from third-party providers of key components. The cumulative impact of revisions in total cost estimates during the progress of work is reflected in the period in which these changes become known. Earned revenue reflects the original contract price adjusted for agreed claims and change order revenue, if applicable. Losses expected to be incurred on the jobs in progress, after consideration of estimated probable minimum recoveries from claims and change orders, are charged to income as soon as such losses are known. Claims for additional contract revenue are recognized if it is probable the claim will result in additional revenue and the amount can be reliably estimated. We generally recognize revenue and earnings to which the percentage of completion method is applied over a period of two to nine quarters. In the event a project is terminated by our customer before completion, our customer is liable for costs incurred under the contract. We believe our operating results should be evaluated over a term of one to three years to evaluate our performance under long-term contracts, after all change orders, scope changes and cost recoveries have been negotiated and realized.

Estimates are subjective in nature and it is possible that we could have used different estimates of total contract costs in our calculation of revenue recognized using the percentage of completion method. For the nine months ended September 30, 2006, the Company had $134.5 million in revenue attributable to open percentage completion projects having an aggregate gross margin of 20.7%. If we had used a different estimate of total contract costs for each contract in progress at September 30, 2006, a 1% increase or decrease in the estimated margin earned on each contract would have increased or decreased each of total revenue and pre-tax income for the nine months ended September 30, 2006, by approximately $1.7 million. At September 30, 2006, the Company had three contracts in a loss position estimated at an aggregate of $1.4 million.

*Impairment Testing: Goodwill.* As required by Statement of Financial Accounting Standards ( SFAS ) No. 142, Goodwill and Other Intangible Assets, we evaluate goodwill annually for impairment by comparing the fair value of operating assets to the carrying value of those assets, including any related goodwill. As required by SFAS No. 142, we identify separate reportable units for purposes of this evaluation. In determining carrying value, we segregate assets and liabilities that, to the extent possible, are clearly identifiable by specific reportable unit. Certain corporate and other assets and liabilities, that are not clearly identifiable by specific reportable unit, are allocated in accordance with the standard. Fair value is determined by discounting projected future cash flows at our cost of capital rate, as calculated. In determining projected future cash flows for each segment, we make

assumptions regarding the following key indicators: future market and sales growth rates (domestic and international), cost inflation, margin expectations, capital expenditure levels and tax levels. The fair value is then compared to the carrying value of the reportable unit to determine whether or not impairment has occurred at the reportable unit level. In the event an impairment is indicated, an additional test is performed whereby an implied fair value of goodwill is determined through an allocation of the fair value to the reporting unit s assets and liabilities, whether recognized or unrecognized, in a manner similar to a purchase price allocation, in accordance with SFAS No. 141, Business Combinations. Any residual fair value after this purchase price allocation would be assumed to relate to goodwill. If the carrying value of the goodwill exceeded the residual fair value, we would record an impairment charge for that amount.

Net goodwill of $81.2 million and $80.9 million at September 30, 2006 and December 31, 2005, was comprised of $47.6 million and $47.4 million for the Oil & Water Technologies reporting unit, $29.2 million and $29.1 million for the Gas Technologies reporting unit, $4.4 million and $4.4 million for the Automation & Controls reporting unit, respectively. The increase of $0.3 million in net goodwill was due entirely to the fluctuation in the exchange rates between the U.S. currency and Canadian currency.

In accordance with SFAS No. 142, the Company tested each business segment for impairment of goodwill at December 31, 2005, and, based upon the results of this testing, management determined that goodwill was not impaired. The Company tests each business segment for goodwill impairment annually, as required by the pronouncement, or more frequently if there are indications of goodwill impairment. No additional testing was performed during the quarter ended September 30, 2006, as management noted no indications of goodwill impairment.

*Deferred Income Tax Assets: Valuation Allowance.* We account for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. SFAS No. 109 requires us to provide a valuation allowance for any deferred income tax assets we believe may not be utilized through future operations. Deferred income tax assets, not requiring valuation allowances largely relates to U.S. post-retirement obligations, accrued liabilities and reserves that have not been deducted for tax purposes, and the carryforward of foreign tax credits. Based upon the level of historical taxable income and projected future taxable income over the periods to which our deferred tax assets are deductible in the U.S. and Canadian tax jurisdictions, we believe it is more likely than not we will realize the benefits of these deductible differences and carry forwards. However, the amount of the deferred tax asset considered realizable could change if future taxable income differs from our projections in the U.S. and Canadian tax jurisdictions. In all other foreign tax jurisdictions, we are currently not considering projections of future taxable income to determine the realizability of our deductible differences and carryforwards. As of September 30, 2006, we have a valuation allowance of $1.6 million related to our U.K. operations and another $142,000 related to other international operations.

**Recent Accounting Pronouncements**

In November 2004, the FASB issued SFAS No. 151, Inventory Costs, an amendment of Accounting Research Bulletin ( ARB ) No. 43, Chapter 4. SFAS No. 151 amends ARB No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) should be recognized as current period charges. In addition, SFAS No. 151 requires that allocation of fixed production overhead to inventory be based on the normal capacity of the production facilities. SFAS No. 151 became effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company adopted this pronouncement on June 15, 2005, with no material impact on its consolidated results of operations, financial position or cash flows.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets , which amends APB Opinion No. 29. The guidance in APB Opinion No. 29, Accounting for Nonmonetary Transactions, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the

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assets exchanged. The amendment made by SFAS No. 153 eliminates the exception for exchanges of similar productive assets and replaces it with a broader exception for exchanges of nonmonetary assets that do not have commercial substance. This statement became effective on June 15, 2005. The Company adopted the standard as of the effective date with no material impact on its consolidated results of operations, financial position or cash flows.

In March 2005, the FASB issued Interpretation No. ( FIN ) 47, Accounting for Conditional Asset Retirement Obligations. FIN 47 clarifies that the term conditional asset retirement obligation, as used in SFAS No. 143, Accounting for Asset Retirement Obligations, refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. Uncertainty about the timing and (or) method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The Interpretation is effective no later than the end of fiscal years ending after December 15, 2005. The Company adopted this standard on January 1, 2006. The adoption of this standard did not have a material effect on the Company s consolidated results of operations, financial position or cash flows.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections A Replacement of APB Opinion No. 20 and FASB Statement No. 3. The new standard changes the requirements for the accounting for and reporting of a change in accounting principle. Among other changes, SFAS No. 154 requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented on the new accounting principle, unless it is impracticable to do so. SFAS No. 154 also provides that (1) a change in method of depreciating or amortizing a long-lived non-financial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements should be termed a restatement. The new standard is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company adopted this standard on January 1, 2006. The adoption of this standard did not have a material effect on the Company s consolidated results of operations, financial position or cash flows.

In September 2005, the FASB s Emerging Issues Task Force (EITF) issued EITF No. 04-13, Accounting for Purchases and Sales of Inventory with the Same Counterparty. This pronouncement provides additional accounting guidance for situations involving inventory exchanges between parties to that contained in APB Opinion No. 29, Accounting for Nonmonetary Transactions and SFAS No. 153, Exchanges of Nonmonetary Assets. The standard is effective for new arrangements entered into in reporting periods beginning after March 15, 2006, and to all inventory transactions that are completed after December 15, 2006 for arrangements entered into prior to March 15, 2006. The Company adopted this standard on January 1, 2006. The adoption of this standard did not have a material effect on the Company s consolidated results of operations, financial position or cash flows.

In September 2005, the SEC staff revised EITF No. D-98, Classification and Measurement of Redeemable Securities, primarily to provide guidance on (1) the earnings per share treatment of redeemable common stock and (2) the application of EITF No. D-98 to share-based payment arrangements with employees. The guidance on the earnings per share treatment of redeemable common stock in EITF No. D-98 to share-based payment arrangements with employees is effective in the first fiscal period beginning after September 15, 2005. The Company adopted EITF No. D-98 as of the effective date as it relates to the earnings per share treatment of redeemable common stock, and has applied the application to share-based payment arrangements with employees concurrently with the adoption of SFAS No. 123R. The adoption of this standard did not have a material effect on the Company s consolidated results of operations, financial position or cash flows.

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In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140, which is effective for fiscal years beginning after September 15, 2006. This statement was issued to simplify the accounting for servicing rights and to reduce the volatility that results from using different measurement attributes. The Company is in the process of evaluating the impact, if any, of this standard on its consolidated results of operations, financial position or cash flows and will adopt it on January 1, 2007.

In March 2006, the EITF issued EITF No. 05-01, Accounting for the Conversion of an Instrument that Became Convertible upon the Issuer s Exercise of a Call Option. This issue requires that the issuance of equity securities to settle a debt instrument that became convertible on the issuer s exercise of a call option be accounted for as a conversion if the debt instrument contains a substantive conversion feature as of its issuance date. Absent a substantive conversion feature, it should be accounted for as a debt extinguishment. EITF No. 05-01 is effective for periods beginning after June 28, 2006. The Company adopted this standard as of July 1, 2006. The adoption of this standard did not have a material effect on the Company s consolidated results of operations, financial position or cash flows.

In March 2006, the EITF issued EITF No. 06-03, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation). EITF No. 06-03 requires that the presentation of taxes assessed by a governmental authority that are directly imposed on a revenue-producing transaction between a seller and a customer on either a gross (included in revenue and costs) or a net (excluded from revenue) basis is an accounting policy decision that should be disclosed pursuant to APB Opinion No. 22. In addition, if any of such taxes are reported on a gross basis, a company should disclose, on an aggregate basis, the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amount are significant. This issue will be applied to financial reports for interim and annual reporting periods beginning after December 15, 2006. The Company currently reports Revenue on a net basis. The Company is in the process of evaluating the impact, if any, of this standard on its consolidated results of operations, financial position or cash flows and will adopt it on January 1, 2007.

In June 2006, the FASB issued FIN 48, Accounting for Uncertainty in Income Taxes. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return as well as provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The interpretation is effective for fiscal years beginning after December 15, 2006. The Company is in the process of evaluating the impact, if any, of this standard on its consolidated results of operations, financial position or cash flows and will adopt it on January 1, 2007.

In September 2006, the FASB issued FSP No. AUG AIR-1, Accounting for Planned Major Maintenance Activities, which prohibits the use of the accrue-in-advance method of accounting for planned major maintenance activities in annual and interim financial reporting periods. FSP AUG AIR-1 is effective for the fiscal year beginning after December 15, 2006. The Company is in the process of evaluating the impact of FSP AUG AIR-1 on its consolidated results of operations, financial position or cash flows and will adopt it on January 1, 2007.

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In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans. The statement requires an employer with publicly traded equity securities to recognize the funded status of a benefit plan and the related disclosure requirements as of the end of the fiscal year ending after December 15, 2006. The Company currently measures the plans assets and benefit obligations as of the Company s fiscal year end date. The Company s recorded liability for the accumulated postretirement benefit obligation is currently greater than the actuarially determined amount of this obligation. Therefore, the Company does not expect any potential negative impact on its consolidated results of operations, financial position or cash flows resulting from the adoption of the standard as of December 31, 2006.

In September 2006, the SEC released Staff Accounting Bulletin No. 108 ( SAB 108 ), Considering the effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, which provides interpretive guidance on the U.S. Securities and Exchange Commission s views regarding the process of quantifying materiality of financial statements. SAB No. 108 is effective for fiscal years ending after November 15, 2006, with early application for the first interim period ending after November 15, 2006. The Company is in the process of evaluating the impact, if any, of this provision on its consolidated results of operations, financial position and cash flows.

**Industry and Business Environment**

As one of the leading providers of wellhead process equipment, systems and services used in the production of oil and gas, our revenue and results of operations are closely tied to demand for oil and gas products and spending by oil and gas companies for exploration and development of oil and gas reserves. These companies generally invest more in exploration and development efforts during periods of favorable oil and gas commodity prices, and invest less during periods of unfavorable oil and gas prices. As supply and demand change, commodity prices fluctuate, producing cyclical trends in the industry. During periods of lower demand, revenue for service providers such as NATCO generally decline, as existing projects are completed, new projects are postponed and pricing decreases due to competitive pressures. During periods of recovery or growth, revenue for process equipment providers can lag behind the industry due to the timing of new project awards.

Changes in commodity prices have impacted our business over the past several years. The following table summarizes the average price of domestic crude oil and Brent crude oil per barrel, the wellhead price of natural gas per thousand cubic feet ( mcf ), as published by the U.S. Department of Energy; the number of rotary drilling rigs in operation, as published by Baker Hughes Incorporated, for the nine months ended September 30, 2006 and 2005, as well as averages for the years ended December 31, 2005 and 2004:

| | **Nine Months Ended September 30,** | | **Twelve Months Ended December 31,** | |
|---|---|---|---|---|
| | **2006** | **2005** | **2005** | **2004** |
| Average price of crude oil per barrel in the U.S. | $ 68.10 | $ 55.37 | $ 56.54 | $ 41.47 |
| Average price of Brent crude oil per barrel | $ 67.04 | $ 53.66 | $ 54.47 | $ 38.26 |
| Average wellhead price of natural gas per mcf in the U.S. | $ 6.54 | $ 6.62 | $ 7.52 | $ 5.50 |
| Average U.S. rig count | 1,739 | 1,452 | 1,380 | 1,190 |
| Average International rig count (excludes North America)(1) | 949 | 852 | 850 | 781 |

(1) The Iran and Sudan rig counts were discontinued from the Baker Hughes publication beginning January 2006. For comparative purposes, the 2005 and 2004 rig count numbers presented above exclude Iran and Sudan.

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Historically, we have viewed operating rig counts as a benchmark of spending in the U.S. oil and gas industry for exploration and development efforts. Our standard and traditional equipment sales and parts and services business generally correlates to changes in rig activity, but tends to lag behind the North American rig count trend.

From a longer-term perspective, the US Department of Energy projects that the worldwide and U.S. demand for and consumption of petroleum and natural gas products will increase through 2030, with expected higher global consumption rates, driven by demand for refined products and the use of natural gas to power plants that generate electricity. As demand grows and reserves in the United States decline, producers and service providers in the oil and gas industry may continue to rely more heavily on global sources of energy and expansion into new markets. The industry continues to seek more innovative and technologically efficient means to extract hydrocarbons from existing fields, as production profiles change. As a result, additional and more complex equipment may be required to produce oil and gas from these fields. Also, many new oil and gas fields produce lower quality or contaminated hydrocarbon streams, requiring more complex production equipment. In general, these trends should increase the demand for our products and services.

**Results of Operations**

The following discussion of our historical results of operations and financial condition should be read in conjunction with our consolidated financial statements and related notes.

**Three Months Ended September 30, 2006 Compared to Three Months Ended September 30, 2005 (unaudited)**

***Consolidated Revenue and Gross Profit***

| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Change | Percentage Change |
|---|---|---|---|---|
| | (unaudited) (in thousands, except percentage change) | | | |
| Revenue[1] | $ 132,178 | $ 102,400 | $ 29,778 | 29% |
| Cost of goods sold and services[1] | 95,964 | 77,551 | 18,413 | 24% |
| Gross profit | $ 36,214 | $ 24,849 | 11,365 | 46% |
| Gross margin | 27% | 24% | 3% | 13% |

(1) The table above includes inter-segment elimination amounts for both Revenue and Cost of goods sold and services of $3.2 million and $1.4 million for the three months ended September 30, 2006 and 2005, respectively.

*Revenue*. Revenue of $132.2 million for the three months ended September 30, 2006 increased $29.8 million, or 29%, from $102.4 million for the three months ended September 30, 2005 as a result of increased business activity in each of our three operating segments, particularly in the Oil & Water Technologies segment where year over year increases were experienced in standard equipment sales along with higher parts and service sales.

*Gross Profit.* Gross profit for the three months ended September 30, 2006 increased $11.4 million, or 46%, to $36.2 million, compared to $24.8 million for the three months ended September 30, 2005 primarily due to increased sales, improved pricing and overall job execution improvements. As a percentage of revenue, gross margin was 27% and 24% for the quarters ended September 30, 2006 and September 30, 2005, respectively.

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*Oil & Water Technologies*

| | Three Months Ended September 30, 2006 | 2005 | Change | Percentage Change |
|---|---|---|---|---|
| | (unaudited) (in thousands, except percentage change) | | | |
| Revenue | $ 96,031 | $ 76,212 | $ 19,819 | 26% |
| Cost of goods sold and services | 72,802 | 61,814 | 10,988 | 18% |
| Gross profit | $ 23,229 | $ 14,398 | $ 8,831 | 61% |
| Gross margin | 24% | 19% | 5% | 26% |

Oil & Water Technologies segment revenue increased $19.8 million, or 26%, for the three months ended September 30, 2006, compared to the three months ended September 30, 2005. Of the increase, $6.3 million was attributable to an increase in international built-to-order projects and $13.5 million resulted primarily from the growth in standard and traditional equipment sales of $11.7 million in North America and Mexico along with a $1.8 million increase in parts and service sales.

Inter-segment revenue for this business segment was $2.0 million for the three months ended September 30, 2006 compared to $98,000 for the three months ended September 30, 2005.

Gross profit for the Oil & Water Technologies segment increased $8.8 million, or 61%, for the three months ended September 30, 2006 compared to the three months ended September 30, 2005, primarily due to increased sales, improved pricing and overall job execution improvements. Partially offsetting the improved gross profit is an additional reserve recorded for projected cost overruns on a built-to-order project scheduled for completion and delivery in the first quarter of 2007 amounting to approximately $700,000. As a percentage of revenue, gross margin was 24% and 19% for the three month period ended September 30, 2006 and 2005, respectively. The increase in gross margin, net of the recorded cost overruns, is attributable to a variety of factors including a greater percentage of higher margin parts and service activities, improved pricing across the product lines and overall favorable job execution as compared to the prior year period.

*Gas Technologies*

| | Three Months Ended September 30, 2006 | 2005 | Change | Percentage Change |
|---|---|---|---|---|
| | (unaudited) (in thousands, except percentages) | | | |
| Revenue | $ 15,478 | $ 12,798 | $ 2,680 | 21% |
| Cost of goods sold and services | 7,937 | 4,968 | 2,969 | 60% |
| Gross profit | $ 7,541 | $ 7,830 | $ (289) | (4)% |
| Gross margin | 49% | 61% | (12)% | (20)% |

Revenue of $15.5 million for the three months ended September 30, 2006 for the Gas Technologies segment increased $2.7 million, or 21%, compared to $12.8 million for the three months ended September 30, 2005 primarily as a result of the substantial completion of a $CO_2$ membrane built-to-order project in Southeast Asia which added an incremental $6.5 million over the prior year s quarter. Partially offsetting this increase in revenue was a $4.0 million decrease in replacement membrane sales over the prior year s quarter.

There was no inter-segment revenue for this business segment for the three months ended September 30, 2006 and September 30, 2005.

Gross profit for the Gas Technologies segment for the three months ended September 30, 2006 decreased $289,000, or 4%, compared to the three months ended September 30, 2005. Gross margin, as a percentage of

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revenue, was 49% and 61% for the three months ended September 30, 2006 and 2005, respectively. The decrease in gross margin reflects a revenue mix weighted more heavily to built-to-order projects in the quarter, which typically have lower margins than replacement membrane sales and $CO_2$ processing operations.

***Automation & Controls***

| | Three Months Ended September 30, 2006 | 2005 | Change | Percentage Change |
|---|---|---|---|---|
| | (unaudited) (in thousands, except percentages) | | | |
| Revenue | $ 23,881 | $ 14,742 | $ 9,139 | 62% |
| Cost of goods sold and services | 18,437 | 12,121 | 6,316 | 52% |
| Gross profit | $ 5,444 | $ 2,621 | $ 2,823 | 108% |
| Gross margin | 23% | 18% | 5% | 28% |

Revenue for the Automation & Controls segment of $23.9 million for the three months ended September 30, 2006 increased $9.1 million, or 62%, compared to $14.7 million for the three months ended September 30, 2005. This increase was primarily due to continued storm damage repair work in the Gulf of Mexico of approximately $5.3 million related to the after-effects of hurricanes Katrina and Rita, incremental packaged automation product sales of $2.8 million and higher contributions of $1.0 million from international activities, primarily in West Africa and Kazakhstan. The prior year s quarter was impacted by approximately $1.2 million of revenue loss in the segment s Gulf of Mexico operations due to facility and work interruptions related to the effect of hurricanes Katrina and Rita.

Inter-segment revenue for this business segment was $1.2 million for the three months ended September 30, 2006, compared to $1.3 million for the three months ended September 30, 2005.

Gross profit for the Automation & Controls segment increased $2.8 million, or 108%, for the three months ended September 30, 2006 compared to the three months ended September 30, 2005, primarily due to the increased revenue. There was an approximate $400,000 of margin loss in the prior year s quarter from decreased activity in the Gulf of Mexico due to the effect of hurricanes Katrina and Rita as well as a loss provision recorded on a job due to project execution problems. Gross margin, as a percentage of revenue increased to 23% for the three months ended September 30, 2006 from 18% for the three months ended September 2005 primarily as a result of improved pricing and job execution on the Gulf of Mexico work along with a relative increase in the higher margin international service work in West Africa and Kazakhstan.

*Selling, General and Administrative Expense.* Selling, general and administrative expense of $20.0 million for the three months ended September 30, 2006 increased $5.3 million or 36%, compared to the three months ended September 30, 2005. The increase was primarily due to increased compensation expense of approximately $1.6 million associated with stock-based incentive compensation, employee retention programs and increased headcount related to higher activity levels, relocation costs of $400,000 associated with the office move in the UK, as well as a gain of $630,000 on the sale of a facility in the prior year s quarter not reflected in the 2006 quarter results. Other general increases of approximately $1.0 million in support costs were incurred year over year associated with the increased business activity.

In addition, during the three months ended September 30, 2006, the Company recorded $1.7 million of non-cash compensation cost for the correction of an error that should have been recorded in the fiscal year 2005 related to stock options issued in 1998, at a price set in anticipation of an initial public offering, which were subsequently canceled and reissued at a lower price in March 1999. We later became a public company in January 2000. Compensation expense should have been determined using variable accounting per FASB Interpretation No. ( FIN ) 44, Accounting for Certain Transactions involving Stock Compensation, which was

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issued subsequent to the time these options were re-priced but had retroactive effect. Management discovered the error in the quarter ended September 30, 2006 and has deemed it to be immaterial for both the 2005 and 2006 periods and with respect to the quarterly trends in earnings for both periods. The Company has corrected the accounting to properly recognize the compensation expense by applying variable accounting to these awards as required by FIN 44.

Overall headcount increased from 1,799 employees at September 30, 2005 to 1,928 employees at September 30, 2006 primarily in our manufacturing and field service staffing levels as a direct result of the higher business activity.

*Depreciation and Amortization Expense.* Depreciation and amortization expense of $1.3 million for the three months ended September 30, 2006, increased $23,000, or 2%, compared to the three months ended September 30, 2005.

*Closure, Severance and Other.* Closure, severance and other expense of $2.3 million for the three months ended September 30, 2006 represents our estimated and accrued U.K. office closure costs. Closure, severance and other expenses of $2.1 million for the three months ended September 30, 2005 included $1.2 million for the then-anticipated separation of the Company s President and severance costs of $799,000 related to the restructuring of our UK operations.

*Interest expense.* Interest expense of $491,000 for the three months ended September 30, 2006 decreased by $451,000 or 48%, compared to the three months ended September 30, 2005 primarily as a result of debt reduction over the past year.

*Interest Cost on Postretirement Benefit Liability*. Interest Cost on Postretirement Benefit Liability for the three months ended September 30, 2006 was reduced by $100,000 to reflect the lower participation in the plan primarily as a result of changes made to the plan in late 2005 which reduced benefits and increased participant contributions.

*Interest Income.* Interest income of $96,000 for the three months ended September 30, 2006 increased $91,000 compared to the three months ended September 30, 2005, reflecting higher cash balances during the current period and higher interest rates.

*Minority Interest.* Minority interest expense of $400,000 for the three months ended September 30, 2006 reflects the Company s recognition, beginning this quarter, of the expense for the portion of earnings related to the minority interest ownership in our consolidated joint ventures.

*Other, net.* Other, net was a $1.8 million gain, which consisted of a $2.5 million gain on the sale of a partial interest in NATCO Japan, offset by $400,000 due to minority interest expense associated with our Japan joint venture, $160,000 of write-off of unamortized deferred financing fees associated with the terminated 2004 term loan and revolving credit facilities and $92,000 of net realized and unrealized foreign exchange transaction losses. Other, net was a $1.6 million expense for the three months ended September 30, 2005 related primarily to $1.2 million resulting from the change in valuation of the outstanding warrants to purchase our common stock and net realized and unrealized foreign currency exchange transaction losses of $351,000.

*Provision for Income Taxes.* Income tax expense for the three months ended September 30, 2006 was $4.7 million compared to $1.7 million for the three months ended September 30, 2005. The change in tax expense was primarily attributable to an increase in pre-tax income to $14.1 million for the three months ended September 30, 2006 from pre-tax income of $4.1 million for the three months ended September 30, 2005. The effective tax rate for the three months ended September 30, 2006 was 33.5% compared to 41.4% for the three months ended September 30, 2005. The decrease in the effective tax rate was primarily attributable to a decrease in permanent book versus tax differences and the generation of tax credits. The main decrease in permanent book versus tax differences was due to a nondeductible mark-to-market expense on warrants exercised in 2005 that was not incurred in 2006.

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**Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005 (unaudited)**

***Consolidated Revenue and Gross Profit***

| | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 | Change | Percentage Change |
|---|---|---|---|---|
| | (unaudited) (in thousands, except percentages) | | | |
| Revenue[1] | $ 378,651 | $ 285,704 | $ 92,947 | 33% |
| Cost of goods sold and services[1] | 276,043 | 217,172 | 58,871 | 27% |
| Gross profit | $ 102,608 | $ 68,532 | $ 34,076 | 50% |
| Gross margin | 27% | 24% | 3% | 13% |

(1) The table above includes inter-segment elimination amounts for both Revenue and Cost of goods sold and services of $9.6 million and $3.8 million for the nine months ended September 30, 2006 and 2005, respectively.

*Revenue.* Revenue of $378.7 million for the nine months ended September 30, 2006 increased $92.9 million, or 33%, from $285.7 million for the nine months ended September 30, 2005 as a result of increased business activity in each of our three operating segments, particularly the Oil & Water Technologies segment.

*Gross Profit.* Gross profit for the nine months ended September 30, 2006 increased $34.1 million, or 50%, to $102.6 million compared to $68.5 million for the nine months ended September 30, 2005 as a result of increased sales, improved pricing and overall job execution improvements. As a percentage of revenue, gross margin was 27% and 24% for the quarters ended September 30, 2006 and September 30, 2005, respectively.

***Oil & Water Technologies***

| | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 | Change | Percentage Change |
|---|---|---|---|---|
| | (unaudited) (in thousands, except percentages) | | | |
| Revenue | $ 276,673 | $ 215,806 | $ 60,867 | 28% |
| Cost of goods sold and services | 213,065 | 174,220 | 38,845 | 22% |
| Gross profit | $ 63,608 | $ 41,586 | $ 22,022 | 53% |
| Gross margin | 23% | 19% | 4% | 21% |

Oil & Water Technologies segment revenue increased $60.9 million, or 28%, for the nine months ended September 30, 2006, compared to the nine months ended September 30, 2005. Approximately $33.0 million of the increase was due higher international and domestic business and project awarding activities in the built-to-order product line and approximately $27.0 million of this increase was due to higher demand for our standard and traditional equipment and services.

Inter-segment revenue for this business segment was $6.0 million for the nine months ended September 30, 2006, compared to $620,000 for the nine months ended September 30, 2005.

Gross profit for the Oil & Water Technologies segment increased $22.0 million, or 53%, for the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005. Continued strength in sales of our standard and traditional equipment and services accounted for $14.5 million of the increase. Built-to-order projects both domestically and internationally contributed $7.5 million of the increase, net of approximately $1.7 million recorded for projected cost overruns on a built-to-order project scheduled for completion and delivery in the first quarter of 2007. Higher profitability and margins were a result of pricing increases especially in North American activities and continued improvements in overall job execution. As a percentage of revenue, gross margin was 23% and 19% for the nine-month periods ended September 30, 2006 and 2005, respectively.

***Gas Technologies***

| | Nine Months Ended September 30, 2006 | 2005 | Change | Percentage Change |
|---|---|---|---|---|
| | | (unaudited) (in thousands, except percentages) | | |
| Revenue | $ 44,959 | $ 27,972 | $ 16,987 | 61% |
| Cost of goods sold and services | 20,887 | 10,118 | 10,769 | 106% |
| Gross profit | $ 24,072 | $ 17,854 | $ 6,218 | 35% |
| Gross margin | 54% | 64% | (10)% | (16)% |

Gas Technologies segment revenue of $45.0 million for the nine months ended September 30, 2006 increased $17.0 million or 61%, compared to $28.0 million for the nine months ended September 30, 2005. This increase was primarily due to higher built-to-order project activity levels of $17.5 million, primarily related to a major Southeast Asian project, and higher $CO_2$ processing revenue of $1.0 million partially offset by a decrease in membrane sales of approximately $1.5 million.

There was no inter-segment revenue for this business segment for the nine months ended September 30, 2006 and 2005.

Gross profit for the Gas Technologies segment for the nine months ended September 30, 2006 increased $6.2 million, or 35% compared to the nine months ended September 30, 2005 primarily as a result of the increase in sales. Gross margin, as a percentage of revenue, for Gas Technologies was 54% and 64% for the nine month periods ended September 30, 2006 and 2005, respectively. The decrease in gross margin was attributable to the lower margin revenue mix due to a higher concentration of built-to-order projects and lower membrane sales in the 2006 period.

***Automation & Controls***

| | Nine Months Ended September 30, 2006 | 2005 | Change | Percentage Change |
|---|---|---|---|---|
| | | (unaudited) (in thousands, except percentages) | | |
| Revenue | $ 66,569 | $ 45,722 | $ 20,847 | 46% |
| Cost of goods sold and services | 51,641 | 36,630 | 15,011 | 41% |
| Gross profit | $ 14,928 | $ 9,092 | $ 5,836 | 64% |
| Gross margin | 22% | 20% | 2% | 10% |

Revenue for the Automation & Controls segment of $66.6 million increased $20.8 million or 46%, for the nine months ended September 30, 2006 compared to $45.7 million for the nine months ended September 30, 2005. This increase was primarily due to the continued strength in the Gulf of Mexico field services work related to the after effects of hurricanes Katrina and Rita of approximately $10.2 million, an increase in the packaged automation product sales contributing approximately $9.7 million and an increase in our international field service work primarily in West Africa and Kazakhstan of approximately $1.0 million. The prior year s quarter was impacted by approximately $1.2 million of revenue loss in the segment s Gulf of Mexico operations due to facility and work interruptions related to the effect of hurricanes Katrina and Rita.

Inter-segment revenue for this business segment was $3.5 million for the nine months ended September 30, 2006 compared to $3.2 million for the nine months ended September 30, 2005.

Gross profit for the Automation & Controls segment increased $5.8 million, or 64%, for the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005 primarily due to the increased revenue. Gross margin as a percentage of revenue was 22% and 20% for the nine months ended September 30, 2006 and 2005, respectively. The increase in gross margin is primarily a result of increased pricing for the field services work in the Gulf of Mexico and higher packaged automation product sales, along with improved job execution.

*Selling, General and Administrative Expense.* Selling, general and administrative expense of $53.7 million for the nine months ended September 30, 2006, increased $10.0 million, or 23%, compared to the nine months ended September 30, 2005. Approximately $4.0 million was due to higher compensation costs associated with the increased headcount, employee retention programs and variable stock-based incentive compensation; $2.2 million was due to higher support costs related to the increased business activity; approximately $600,000 was

associated with the office move in the U.K.; $500,000 related to higher pre-order engineering costs associated with increased bid activities; and $1.0 million was attributable to a gain on the sale of assets in the prior year.

In addition, during the nine months ended September 30, 2006, the Company recorded $1.7 million of non-cash compensation cost for the correction of an error that should have been recorded in the fiscal year 2005 related to stock options issued in 1998, at a price set in anticipation of an initial public offering, which were subsequently canceled and reissued at a lower price in March 1999. We later became a public company in January 2000. Compensation expense should have been determined using variable accounting per FASB Interpretation No. ( FIN ) 44, Accounting for Certain Transactions involving Stock Compensation, which was issued subsequent to the time these options were re-priced but had retroactive effect. Management discovered the error in the quarter ended September 30, 2006 and has deemed it to be immaterial for both the 2005 and 2006 periods and with respect to the quarterly trends in earnings for both periods. The Company has corrected the accounting to properly recognize the compensation expense by applying variable accounting to these awards as required by FIN 44.

Overall headcount increased from 1,799 employees at September 30, 2005 to 1,928 employees at September 30, 2006 primarily in our manufacturing and field service staffing levels as a direct result of the higher business activity.

*Depreciation and Amortization Expense.* Depreciation and amortization expense of $4.2 million for the nine months ended September 30, 2006, increased $230,000, or 6%, compared to the nine months ended September 30, 2005. The increase was attributable primarily to depreciation from additions in the second quarter of 2006 of operating equipment and to the amortization of intangible assets associated with our investment in a joint venture that fabricates a pilotless burner ignition system for controlling gas-fired heaters used in connection with oil and gas wellhead equipment.

*Closure, severance and other.* Closure, severance and other expenses of $2.6 million for the nine months ended September 30, 2006 represented $2.3 million of our U.K. office closure cost and approximately $300,000 related to severance and other costs. Closure, severance and other expenses of $2.2 million for the nine months ended September 30, 2005 consisted of the $2.1 million Closure, severance and other expenses recorded during the third quarter 2005 and a miscellaneous other expense of approximately $100,000.

*Interest expense.* Interest expense of $1.9 million for the nine months ended September 30, 2006 decreased by $1.1 million or 37%, compared to the nine months ended September 30, 2005 due primarily to debt reductions over the last twelve months.

*Interest Cost on Postretirement Benefit Liability*. Interest cost on postretirement liability of $0 for the nine months ended September 30, 2006 decreased by $630,000 compared to the nine months ended September 30,

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2005 due to the lower participation in the plan primarily as a result of changes made to the plan in late 2005 which reduced benefits and increased participant contributions.

*Interest Income.* Interest income of $215,000 for the nine months ended September 30, 2006 increased $145,000, compared to the nine months ended September 30, 2005 reflecting the higher cash balances during the current period and higher interest rates.

*Minority Interest*. Minority interest expense of $380,000 for the nine months ended September 30, 2006 reflects the Company s recognition, beginning this period, of the expense for the portion of earnings related to the minority interest ownership in our consolidated joint ventures.

*Other, net.* Other, net for the nine months ended September 30, 2006 was a net $1.7 million gain, which included the $2.5 million gain related to the sale of a partial interest in our Japan joint venture, offset by $380,000 due to minority interest expense associated with that venture, $160,000 of write off of unamortized debt costs associated with the termination in the third quarter of 2006 of the 2004 term loan and revolving credit facilities and the nine months of net realized and unrealized foreign exchange transaction losses of $199,000. Other, net was a $2.0 million expense for the nine months ended September 30, 2005 related primarily to $1.8 million of expense related to the change in valuation of the outstanding warrants to purchase our common stock and $171,000 related to net realized and unrealized foreign currency exchange transaction losses.

*Provision for Income Taxes.* Income tax expense for the nine months ended September 30, 2006 was $15.4 million compared to $5.4 million for the nine months ended September 30, 2005. The change in tax expense was primarily attributable to an increase in pre-tax income to $42.2 million for the nine months ended September 30, 2006 from pre-tax income of $13.2 million for the nine months ended September 30, 2005. The effective tax rate for the nine months ended September 30, 2006 was 36.5% compared to 40.7% for the nine months ended September 30, 2005. The decrease in the effective tax rate was primarily attributable to a decrease in permanent book versus tax differences and the generation of tax credits. The main difference in permanent book versus tax differences was due to a nondeductible mark-to-market expense on warrants exercised in 2005 that was not incurred in 2006.

**Liquidity and Capital Resources**

*Financial Condition and Liquidity*

*2006 Revolving Credit Facilities*

On July 12, 2006, the Company terminated the 2004 term loan and revolving credit facilities and entered into a new 2006 revolving credit facilities agreement with a maturity of June 30, 2011.

The 2006 revolving credit facilities provide for a total borrowing capacity of $85.0 million, consisting of a U.S. revolving facility with a borrowing capacity of $65.0 million, a Canadian revolving facility with a borrowing capacity of $5.0 million and a U.K. revolving facility with a borrowing capacity of $15.0 million. These revolving credit facilities are scheduled to mature on June 30, 2011. The borrowing capacities under the 2006 revolving credit facilities agreement are not subject to any monthly borrowing base limitations. In addition to the base commitments, these new facilities permit the Company to require an increase in the aggregate borrowing capacity by $50.0 million if certain requirements are met.

We incurred $454,000 of deferred financing fees related to the 2006 revolving credit facilities agreement, which are amortized over the 2006 revolving credit facilities agreement s five-year term, using straight-line amortization method.

The 2006 revolving credit facilities agreement provides for interest at a rate based upon the ratio of Funded Debt to EBITDA, as defined in the credit facility ( EBITDA ), and ranging from, at the Company s election,

(1) a low of the London Interbank Offered Rate ( LIBOR ) plus 1.00% to a high of LIBOR plus 2.00% or (2) a low of a Base Rate, as defined in the credit facility ( Base Rate ) plus 0.00% to a high of a Base Rate plus 1.00%. The Company is obligated to pay commitment fees related to this agreement on the undrawn portion of the facility, depending upon the ratio of Funded Debt to EBITDA, which was calculated at 0.25% of the undrawn portion of the facility at September 30, 2006.

Aggregate borrowings of $4.5 million were outstanding under the 2006 revolving credit facilities at September 30, 2006, which bore interest at a rate of 6.56%. The Company had letters of credit outstanding of $11.4 million at September 30, 2006. Availability under the 2006 revolving credit facilities is reduced by the amount of our outstanding letters of credit and loans. Fees related to these letters of credit were approximately 1.0% of the outstanding balance at September 30, 2006. These letters of credit support contract performance and warranties and expire at various dates through June 2009.

During the quarter ended September 30, 2006, we decreased our debt, both under the 2004 term loan and the 2006 revolving credit facilities, by $15.3 million, from $19.8 million at June 30, 2006 to $4.5 million at September 30, 2006. During October we paid the remaining $4.5 million of our debt outstanding under the 2006 facilities.

The 2006 revolving credit facilities agreement is secured by a first lien or first priority security interest in or pledge of substantially all of the assets of the borrowers and certain subsidiaries, including accounts receivable, inventory, equipment, intangibles, equity interests in U.S. subsidiaries, 66 $^{1}/_{3}$% of the equity interest in active, non-U.S. subsidiaries and interests in certain contracts. Assets of the Company and its active U.S. subsidiaries secure the US, Canadian, U.K. revolving facilities, assets of the Company s Canadian subsidiary also secure the Canadian facility and assets of the Company s U.K. subsidiaries also secure the U.K. facility. The U.S. facility is guaranteed by each U.S. subsidiary of the Company, while the Canadian and U.K. facilities are guaranteed by NATCO Group Inc., each of its U.S. subsidiaries and the Canadian subsidiary or the U.K. subsidiaries, as applicable.

The 2006 revolving credit facilities agreement contains restrictive covenants including, among others, those that limit the amount of Funded Debt to EBITDA, impose a minimum fixed charge coverage ratio and impose a minimum tangible net worth requirement. We were in compliance with all restrictive debt covenants as of September 30, 2006. Pursuant to the 2006 revolving credit facilities, the Company is not permitted to make any distributions of any property or cash to its stockholders other than dividends required under its Series B Preferred Stock and certain other dividends not to exceed, in the aggregate, $3.0 million per year, if certain conditions related to Funded Debt to EBITDA and borrowing capacity are met, or $1.5 million per year, in the aggregate, if such conditions are not met. Subject to certain restrictions, the Company also has the ability to buy back up to $25.0 million in value of its common stock.

*Export Sales Facility*

On July 23, 2004, the Company and two of its subsidiaries entered into an international revolving credit agreement with Wells Fargo HSBC Trade Bank, N.A. providing for loans of up to $10.0 million, subject to borrowing base limitations. This working capital facility for export sales is secured by specific project inventory and receivables, as well as certain other inventory, accounts receivable and equipment, and is partially guaranteed by the U.S. Export-Import Bank. Loans under this facility mature on March 31, 2007, and bear interest at either (1) a Base Rate, as defined in the agreement, less 0.25% or (2) LIBOR plus 2.00%, at the Company s election. There were no loans outstanding at September 30, 2006. Letters of credit outstanding under this facility as of September 30, 2006 were $9.8 million. This facility had fees related to letters of credit of approximately 1.00% of the outstanding balance.

*Other*

At September 30, 2006, the Company had unsecured letters of credit and bonds totaling $317,000. At September 30, 2006, available borrowing capacity under the 2006 revolving credit facilities and export sales

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credit agreement were $73.6 million and $200,000, respectively. Although no assurances can be given, we believe that our operating cash flow, supported by our borrowing capacity, will be adequate to fund operations for at least the next twelve months. Should we decide to pursue acquisition opportunities, the determination of our ability to finance these acquisitions will be a critical element of the analysis of the opportunities.

*Cash and Cash Equivalents*

The company had cash and cash equivalents of $20.9 million as of September 30, 2006, which includes highly liquid, short-term investments totaling $19.7 million that accrue interest at a weighted average rate of 4.37%.

*Working capital*

As of September 30, 2006, we had cash and cash equivalents and working capital of $20.9 million and $71.4 million respectively, compared to $9.2 million and $49.1 million as of December 31, 2005, respectively. The increase in working capital from December 31, 2005 to September 30, 2006 of $22.3 million or 45% was due primarily to an $11.7 million increase in cash and cash equivalents, an $11.9 million increase in trade receivables and an $11.2 million increase in inventory, primarily work in progress attributable to the increased business activity, offset by a net increase of $13.5 million in current liabilities primarily related to increased accrued expenses and customer advances partially offset with a decrease in trade accounts payable and the elimination of the current portion of long-term debt.

*Cash Flow*

| | For the Nine Months Ended September 30, | |
|---|---|---|
| | 2006 | 2005 |
| | (in thousands) (Unaudited) | |
| Net cash provided by (used in): | | |
| Operating activities | $ 32,090 | $ 10,831 |
| Investing activities | (929) | (57) |
| Financing activities | (20,155) | (5,898) |
| Effect of exchange rate changes on cash and cash equivalents | 730 | 378 |
| Net increase in cash | $ 11,736 | $ 5,254 |

Net cash provided by operating activities for the nine months ended September 30, 2006 was $32.1 million compared to $10.8 million provided by operating activities for the nine months ended September 30, 2005. The increase in net cash provided by operating activities in 2006, compared to 2005 was largely due to the significant increase in net income in the nine months ended September 30, 2006 versus 2005 as adjusted for non-cash items, offset by an increase in working capital consisting primarily of trade receivables and inventories, as a result of increased business activity. Trade receivables will fluctuate depending on business levels, invoice terms, timing of collections and, for large projects particularly, achieving contractual milestones that permit invoicing for interim payments.

Net cash used in investing activities for the nine months ended September 30, 2006 was $929,000 compared to net cash used in investing activities of $57,000 for the nine months ended September 30, 2005. The proceeds of $3.0 million from the sale of a partial interest in NATCO Japan was offset by $3.6 million of capital expenditures related primarily to leasehold improvements and expansions of certain manufacturing and processing facilities. The Company also made a $412,000 investment in other long-term intangible assets related to the purchase of a 50% ownership interest in a joint venture that fabricates a pilotless ignition system for controlling gas-fired heaters used in connection with oil and gas wellhead equipment. The primary use of funds for the nine months ended September 30, 2005 was for capital expenditures of $2.4 million, largely offset by $2.3 million in proceeds from the sale of certain operating assets.

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Net cash used in financing activities for the nine months ended September 30, 2006 and 2005 was $20.2 million and $5.9 million, respectively. The primary use of cash for the nine months ended September 30, 2006 was $2.3 million related to bank overdrafts, $750,000 in payment of dividends on our preferred stock, $454,000 of financing costs and $22.9 million of repayments of long-term debt, of which $7.6 million related to the terminated 2004 term loan and revolving credit facilities and $15.3 million related to the 2006 revolving credit facilities. Sources of cash for the nine months ended September 30, 2006 were $3.3 million of excess tax benefit related to stock options exercised and lapse of restrictions on restricted stock and $3.0 million net proceeds from stock issuances related to stock options exercises. The primary use of cash for the nine months ended September 30, 2005 was primarily long-term debt repayment of $11.6 million and $750,000 in payment of dividends on our preferred stock, offset in part by $6.5 million of proceeds from the exercise of stock options.

*Preferred Shares*

On March 25, 2003, we issued 15,000 shares of Series B Convertible Preferred Stock ( Series B Preferred Shares ), and warrants to purchase 248,800 shares of our common stock, to a private investment fund, for an aggregate price of $15.0 million. Approximately $99,000 of the aggregate purchase price was allocated to the warrants. Proceeds from the issuance of these securities, net of related issuance costs of $679,000, were used to reduce our outstanding revolving debt balances and for other general corporate purposes.

Each of the Series B Preferred Shares has a face value of $1,000 and pays a cumulative dividend of 10% per annum of face value, which is payable semi-annually on June 15 and December 15 of each year, except the initial dividend payment which was payable on July 1, 2003. Each of the Series B Preferred Shares is convertible, at the option of the holder, into (1) a number of shares of common stock equal to the face value of such Series B Preferred Share divided by the conversion price, which was $7.805 (or an aggregate of 1,921,845 shares) at September 30, 2006, and (2) a cash payment equal to the amount of dividends on such share that have accrued since the prior semi-annual dividend payment date.

In the event of a change in control, as defined in the certificate of designations for the Series B Preferred Shares, each holder of the Series B Preferred Shares has the right to convert the Series B Preferred Shares into common stock or to cause the Company to redeem for cash some or all of the Series B Preferred Shares at an aggregate redemption price equal to the greater of (1) the sum of (a) $1,000 (adjusted for stock splits, stock dividends, etc.) multiplied by the number of shares to be redeemed, plus (b) an amount (not less than zero) equal to the product of $500 (adjusted for stock splits, stock dividends, etc.) multiplied by the aggregate number of Series B Preferred Shares to be redeemed less the sum of the aggregate amount of dividends paid in cash since the issuance date, plus any gain on the related stock warrants, and (2) the aggregate face value of the Series B Preferred Shares plus the aggregate amount of dividends that have accrued on such shares since the last dividend payment date.

We have the right to call for redemption, the Series B Preferred Shares for cash on or after March 25, 2008, at a redemption price per share equal to the face value of the Series B Preferred Shares plus the amount of dividends that have been accrued but not paid since the most recent semi-annual dividend payment date.

Due to the cash redemption features upon a change in control as described above, the Series B Preferred Shares do not qualify for permanent equity treatment in accordance with the Emerging Issues Task Force Topic D-98: Classification and Measurement of Redeemable Securities, which specifically requires that permanent equity treatment be precluded for any security with redemption features that are not solely within the control of the issuer. Therefore, we have accounted for the Series B Preferred Shares as temporary equity in the accompanying balance sheet, and have not assigned any value to our right to redeem the Series B Preferred Shares on or after March 25, 2008.

If the Series B Preferred Shares were redeemed under contingent redemption features, any redemption amount greater than carrying value would be recorded as a reduction of income allocable to common shareholders when the event becomes probable.

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If we were to fail to pay dividends for two consecutive periods or any redemption price due with respect to the Series B Preferred Shares for a period of 60 days following the payment date, we would be in default under the terms of such shares. During a default period, (1) the dividend rate on the Series B Preferred Shares would increase to 10.25% and (2) we would be restricted from paying dividends on, or redeeming or acquiring our common or other outstanding stock, with limited exceptions. If we were to fail to set aside or make payments in cash of any redemption price due with respect to the Series B Preferred Shares, and the holders elect, our right to redeem the shares may be terminated.

*Warrants*

We issued warrants to purchase Company common stock to a private investment fund in 2003 that had an exercise price of $10.00 per share of common stock and were to expire on March 25, 2006. The Company adjusted this liability to fair value from the date of issuance through the date of exercise and recorded an expense of $1.8 million for the year ended December 31, 2005.

On August 26, 2005, the investment fund exercised in full its warrants pursuant to a cashless exercise provision contained in the warrant instrument, which resulted in no cash payment to the Company. The final number of shares of common stock issued to the investment fund was calculated based on the average of the closing price of the Company s shares on the New York Stock Exchange for the ten trading-day period ending on the day prior to the exercise. The average price was $17.933, resulting in the issuance of 110,061 shares of common stock in exchange for the warrants.

**Bookings and Backlog**

*Bookings*

The Company s bookings for the three months and nine months ended September 30, 2006 and 2005 were:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| | (unaudited, in thousands) | | | |
| Bookings: | | | | |
| Oil & Water Technologies. | $ 79,934 | $ 92,122 | $ 273,812 | $ 273,914 |
| Gas Technologies | 10,059 | 24,445 | 91,652 | 41,848 |
| Automation & Controls. | 22,837 | 18,442 | 62,595 | 49,299 |
| Total bookings | $ 112,830 | $ 135,009 | $ 428,059 | $ 365,061 |

Our bookings were $112.8 million compared to $135.0 million for the three months ended September 30, 2006 and 2005, and $428.1 million compared to $365.1 million for the nine months ended September 30, 2006 and 2005, respectively. For the three months ended September 30, 2006, bookings decreased $12.2 million or 13% in the Oil & Water Technologies segment, primarily due to delays in built-to-order project awards and lower orders pursued for traditional product sales. For the three months ended September 30, 2006, bookings decreased $14.4 million or 59% in the Gas Technologies segment but increased $49.8 million or 119% for the nine months ended September 30, 2006 due to a $46.4 million Southeast Asian project that the Company was awarded during the second quarter of 2006. Bookings in the Automation & Controls segment increased $4.4 million or 24% due primarily to continuing field services work in the Gulf of Mexico on hurricane repair jobs of $2.0 million and an increase in field services work in Kazakhstan of $1.6 million.

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*Backlog*

The Company s backlog as of September 30, 2006 and December 31, 2005 were:

| | As of September 30, 2006 | As of December 31, 2005 |
|---|---|---|
| | (unaudited, in thousands) | |
| Backlog: | | |
| Oil & Water Technologies | $ 152,933 | $ 131,383 |
| Gas Technologies | 57,119 | 15,908 |
| Automation & Controls | 10,380 | 9,640 |
| Total backlog | $ 220,432 | $ 156,931 |

Our sales backlog at September 30, 2006 was $220.4 million, compared to $156.9 million at December 31, 2005, an increase of $63.5 million or 40%. Backlog increased by $21.6 million in the Oil & Water Technologies segment by $41.2 million in the Gas Technologies segment and by $740,000 in the Automation & Controls segment from December 31, 2005 to September 30, 2006.

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

Our operations are conducted around the world in a number of different countries. Accordingly, future earnings are exposed to changes in foreign currency exchange rates. The majority of our foreign currency transactions relate to operations in Canada and the U.K. In Canada, most contracts are denominated in Canadian dollars, and most of the costs incurred are in Canadian dollars, which mitigates risks associated with currency fluctuations. In the U.K., many of our sales contracts and material purchases are denominated in a currency other than British pounds sterling, primarily U.S. dollars and euros, whereas our engineering and overhead costs are principally denominated in British pounds sterling. We have currency risk on our U.K. activities because a significant portion of their current backlog is in U.S. dollars. We attempt to minimize our exposure to foreign currency exchange rate risk by requiring settlement in our functional currencies, when possible. However, we do not currently enter into forward contracts or other currency-related derivative hedge arrangements.

Our financial instruments are subject to changes in interest rates, including our revolving credit facilities and our working capital facility for export sales. We replaced our 2004 term loan and revolving credit facilities on July 12, 2006 as discussed in detail in the notes to our financial statements included in Part I, Item 1 of this report. At September 30, 2006, we had borrowings of $4.5 million outstanding under the 2006 revolving credit facilities, at an interest rate of 6.56%.

Based on past market movements and possible near-term market movements, we do not believe that potential near-term losses in future earnings, fair values or cash flows from changes in interest rates are likely to be material. Assuming our current level of borrowings, a 100 basis point increase in interest rates under the 2006 revolving credit facilities would decrease our current quarter net income and our cash flow from operations by $7,000. In the event of an adverse change in interest rates, we could take action to mitigate our exposure. However, due to the uncertainty of actions that could be taken and the possible effects, this calculation assumes no such actions. Furthermore, this calculation does not consider the effects of a possible change in the level of overall economic activity that could exist in such an environment.

**Item 4.** ***Controls and Procedures***

**Controls and Procedures**

We maintain controls and procedures designed to ensure that the information that we are required to disclose in the reports we file with or submit to the SEC under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Commission s rules and

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is accumulated and communicated to our management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect our internal control over financial reporting. It should be noted that the design of any system of internal control is based, in part, upon assumptions about the likelihood of certain future events, and there can be no assurance that any design will be successful in achieving its stated objectives under all potential future conditions, regardless of how remote. In addition, an internal control system, no matter how well conceived and operated, can only provide reasonable, not absolute, assurance the objectives of the internal control system will be met. Therefore, we do not expect our disclosure controls to prevent all errors and fraud.

As of September 30, 2006, we carried out an evaluation, with the participation of our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended). Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2006.

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## PART II OTHER INFORMATION

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

The following table summarizes the surrenders of the Company s equity securities during the three months ended September 30, 2006:

| Period | Total Number of Shares Purchased(1) | Average Price Paid per Share(2) | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| July 1 to 31, 2006 | | | | |
| August 1 to 31, 2006 | 14,040 | | | |
| September 1 to 30, 2006 | | | | |
| Three months ended September 30, 2006 | 14,040 | | | |

(1) This acquisition of equity securities was the result of the forfeiture of restricted stock on termination of employment pursuant to the terms of the Company s shareholder approved equity compensation plans and the terms of the equity grants pursuant to those plans.

(2) Excludes forfeited restricted stock since the purchase price was zero.

**Item 6.** ***Exhibits***

| Exhibit No. | Description |
|---|---|
| 10.1 | Form of Performance Unit Award Agreement |
| 10.2 | Employment Agreement dated October 9, 2006 between Bradley P. Farnsworth and the Company, incorporated by reference to Exhibit 10.1 to the Company s Current Report on form 8-K filed October 13, 2006, File No. 1-15603 |
| 10.3 | Loan Agreement dated as of July 12, 2006 among NATCO Group Inc., as Borrower, NATCO Canada, Ltd., as Canadian borrower, Axsia Group Limited, as UK Borrower, Wells Fargo Bank, National Association, as US Agent and Lead Arranger, HSBC Bank Canada, as Canadian Agent, HSBC Bank PLC, as UK Agent, Bank of America, N.A., as Syndications Agent, and the other lenders parties thereto, incorporated by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K filed July 14, 2006, File No. 1-15603 |
| 31.1 | Certification of Chief Executive Officer of NATCO Group Inc. pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes- Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer of NATCO Group Inc. pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes- Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer of NATCO Group Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

| | |
|---|---|
| | NATCO GROUP INC. |
| Date: November 9, 2006 | By: /s/ JOHN U. CLARKE<br>**John U. Clarke**<br>**Chairman of the Board and Chief Executive Officer** |
| Date: November 9, 2006 | By: /s/ B |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Balance, December 31, 2005** | 90,508,221 | 0.9 | 894.7 | 825.4 | (0.1) | (150.1) | (158.7) | 3.9 |
| Cumulative effect of adjustments from the adoption of SAB No. 108, net of taxes | | | | 13.6 | | | | |
| Adjusted balance, January 1, 2006 | 90,508,221 | 0.9 | 894.7 | 839.0 | (0.1) | (150.1) | (158.7) | 3.9 |
| Net loss | | | | (64.9) | | | | |
| Issuance of restricted stock | 8,832 | | 0.2 | | | | | |
| Stock options exercised | 660,850 | | 10.8 | | | | | |
| Stock compensation | | | 3.3 | | | | | |
| Reclassification due to the adoption of SFAS No. 123R | | | (0.1) | | 0.1 | | | |
| Additional minimum pension liability, net of taxes | | | | | | 6.6 | | |
| Deferred gains and losses on derivatives, net | | | | | | | | 0.1<br>(2.0) |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Deferred gains and losses on derivatives held by affiliates, net | | | | | | | | |
| Adjustment related to the adoption of SFAS No. 158, net of taxes | | | | | | (26.8) | | |
| Change in cumulative translation adjustment | | | | | | | 136.7 | |
| **Balance, December 31, 2006** | 91,177,903 | $ 0.9 | $ 908.9 | $ 774.1 | $ | $ (170.3) | $ (22.0) | $ 2.0 |

See accompanying notes to Consolidated Financial Statements.

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**AGCO CORPORATION**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(in millions)**

| | Years Ended December 31, 2006 | 2005 | 2004 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net (loss) income | $ (64.9) | $ 31.6 | $ 158.8 |
| Adjustments to reconcile net (loss) income to net cash provided by operating activities: | | | |
| Depreciation | 98.6 | 89.4 | 84.3 |
| Deferred debt issuance cost amortization | 6.4 | 7.2 | 13.2 |
| Goodwill impairment charge | 171.4 | | |
| Amortization of intangibles | 16.9 | 16.5 | 15.8 |
| Stock compensation | 3.5 | 0.2 | 0.3 |
| Equity in net earnings of affiliates, net of cash received | (8.8) | (14.5) | (6.1) |
| Deferred income tax provision | 10.6 | 107.9 | 14.5 |
| Gain on sale of property, plant and equipment | (0.8) | (3.0) | (8.7) |
| Write-down of property, plant and equipment | 0.3 | 0.3 | 9.5 |
| Changes in operating assets and liabilities, net of effects from purchase of businesses: | | | |
| Accounts and notes receivable, net | 32.5 | 103.6 | (39.9) |
| Inventories, net | 66.2 | (42.1) | (65.1) |
| Other current and noncurrent assets | (26.5) | (22.3) | (10.5) |
| Accounts payable | 55.1 | 39.8 | 53.2 |
| Accrued expenses | 44.3 | (44.6) | 38.5 |
| Other current and noncurrent liabilities | 37.4 | (23.7) | 8.1 |
| Total adjustments | 507.1 | 214.7 | 107.1 |
| Net cash provided by operating activities | 442.2 | 246.3 | 265.9 |
| Cash flows from investing activities: | | | |
| Purchases of property, plant and equipment | (129.1) | (88.4) | (78.4) |
| Proceeds from sales of property, plant and equipment | 3.9 | 10.5 | 46.0 |
| Sale/(purchase) of businesses, net of cash acquired | | 0.4 | (765.7) |
| (Investments in)/proceeds from sale of unconsolidated affiliates, net | (2.9) | (23.4) | 1.0 |
| Net cash used in investing activities | (128.1) | (100.9) | (797.1) |
| Cash flows from financing activities: | | | |
| Proceeds from debt obligations | 538.2 | 670.2 | 1,450.5 |
| Repayments of debt obligations | (708.2) | (901.1) | (1,036.9) |
| Proceeds from issuance of common stock | 10.8 | 1.4 | 303.0 |
| Payment of debt issuance costs | (4.9) | | (21.1) |

| | | | |
|---|---|---|---|
| Net cash (used in) provided by financing activities | (164.1) | (229.5) | 695.5 |
| Effects of exchange rate changes on cash and cash equivalents | 30.5 | (20.9) | 14.3 |
| Increase (decrease) in cash and cash equivalents | 180.5 | (105.0) | 178.6 |
| Cash and cash equivalents, beginning of year | 220.6 | 325.6 | 147.0 |
| Cash and cash equivalents, end of year | $ 401.1 | $ 220.6 | $ 325.6 |

See accompanying notes to Consolidated Financial Statements.

**AGCO CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Operations and Summary of Significant Accounting Policies**

***Business***

AGCO Corporation ( AGCO or the Company ) is a leading manufacturer and distributor of agricultural equipment and related replacement parts throughout the world. The Company sells a full range of agricultural equipment, including tractors, combines, hay tools, sprayers, forage equipment and implements. The Company s products are widely recognized in the agricultural equipment industry and are marketed under a number of well-known brand names including: AGCO®, Challenger®, Fendt®, Gleaner®, Hesston®, Massey Ferguson®, New Idea®, RoGator®, Spra-Coupe®, Sunflower®,Terra-Gator®, Valtra® and White™ Planters. The Company distributes most of its products through a combination of approximately 3,200 independent dealers and distributors. In addition, the Company provides retail financing in the United States, Canada, Brazil, Germany, France, the United Kingdom, Australia, Ireland and Austria through its retail finance joint ventures with Coöperative Centrale Raiffeisen-Boerenleenbank B.A., or Rabobank .

***Basis of Presentation***

The Consolidated Financial Statements represent the consolidation of all wholly-owned companies, majority-owned companies and joint ventures where the Company has been determined to be the primary beneficiary under Financial Accounting Standards Board ( FASB ) Interpretation No. 46R, Consolidation of Variable Interest Entities ( FIN 46R ). The Company records investments in all other affiliate companies using the equity method of accounting. Other investments representing an ownership of less than 20% are recorded at cost. All significant intercompany balances and transactions have been eliminated in the Consolidated Financial Statements.

Certain prior period amounts have been reclassified to conform to the current period presentation.

***Joint Ventures***

The Company currently has equity interests in joint ventures with other entities. For those joint ventures where the Company is not the primary beneficiary as determined under FIN 46R, the Company accounts for its investments under the equity method of accounting.

The Company analyzed the provisions of FIN 46R as they relate to the accounting for its investments in joint ventures and determined that it is the primary beneficiary of one of its joint ventures, GIMA. GIMA was established in 1994 between AGCO and Renault Agriculture S.A. ( Renault ) to cooperate in the field of purchasing, design and manufacturing of components for agricultural tractors. Each party has a 50% ownership in the joint venture and had an original investment of approximately $4.8 million in the joint venture. GIMA has no third-party debt obligations. The consolidation of GIMA does not have a material impact on the results of operations or financial position of the Company. The equity interest of Renault is reported as a minority interest, included in Other noncurrent liabilities in the accompanying Consolidated Balance Sheets as of December 31, 2006 and 2005.

On May 25, 2006, the Company established AGCO SM Group, a joint venture located in Russia between AGCO and Sibmashholding, Co. Ltd., for the purpose of distributing Fendt and Valtra branded equipment throughout Russia and Kazakhstan. The Company has a 51% ownership in the joint venture and had an original investment of less than $0.1 million in the joint venture. The Company began consolidating the accounts of AGCO SM Group upon its establishment.

***Revenue Recognition***

Sales of equipment and replacement parts are recorded by the Company when title and risks of ownership have been transferred to an independent dealer, distributor or other customer. Payment terms vary by market

**AGCO CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

and product with fixed payment schedules on all sales. The terms of sale generally require that a purchase order or order confirmation accompany all shipments. Title generally passes to the dealer or distributor upon shipment and the risk of loss upon damage, theft or destruction of the equipment is the responsibility of the dealer, distributor or third-party carrier. In certain foreign countries, the Company retains a form of title to goods delivered to dealers until the dealer makes payment so that the Company can recover the goods in the event of customer default on payment. This occurs as the laws of some foreign countries do not provide for a seller s retention of a security interest in goods in the same manner as established in the United States Uniform Commercial Code. The only right the Company retains with respect to the title are those enabling recovery of the goods in the event of customer default on payment. The dealer or distributor may not return equipment or replacement parts while its contract with the Company is in force. Replacement parts may be returned only under promotional and annual return programs. Provisions for returns under these programs are made at the time of sale based on the terms of the program and historical returns experience. The Company may provide certain sales incentives to dealers and distributors. Provisions for sales incentives are made at the time of sale for existing incentive programs. These provisions are revised in the event of subsequent modification to the incentive program.

In the United States and Canada, all equipment sales to dealers are immediately due upon a retail sale of the equipment by the dealer. If not already paid by the dealer in the United States and Canada, installment payments are required generally beginning seven to 13 months after shipment with the remaining outstanding equipment balance generally due within 12 to 18 months of shipment. Interest generally is charged on the outstanding balance six to 12 months after shipment. Sales terms of some highly seasonal products provide for payment and due dates based on a specified date during the year regardless of the shipment date. Equipment sold to dealers in the United States and Canada is paid in full on average within 12 months of shipment. Sales of replacement parts generally are payable within 30 days of shipment with terms for some larger seasonal stock orders generally requiring payment within six months of shipment.

In other international markets, equipment sales are generally payable in full within 30 to 180 days of shipment. Payment terms for some highly seasonal products have a specified due date during the year regardless of the shipment date. Sales of replacement parts generally are payable within 30 to 90 days of shipment with terms for some larger seasonal stock orders generally payable within six months of shipment.

In certain markets, particularly in North America, there is a time lag, which varies based on the timing and level of retail demand, between the date the Company records a sale and when the dealer sells the equipment to a retail customer.

***Foreign Currency Translation***

The financial statements of the Company s foreign subsidiaries are translated into United States currency in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 52, Foreign Currency Translation. Assets and liabilities are translated to United States dollars at period-end exchange rates. Income and expense items are translated at average rates of exchange prevailing during the period. Translation adjustments are included in Accumulated other comprehensive loss in stockholders equity. Gains and losses, which result from foreign currency transactions, are included in the accompanying Consolidated Statements of Operations.

***Use of Estimates***

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The estimates made by management primarily relate to accounts and notes receivable, inventories,

**AGCO CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

deferred income tax valuation allowances, valuation of goodwill and intangible assets and certain accrued liabilities, principally relating to reserves for volume discounts and sales incentives, warranty, product liability and workers compensation obligations and pensions and postretirement benefits.

***Adoption of SEC Staff Accounting Bulletin No. 108***

In September 2006, the Securities and Exchange Commission ( SEC ) staff issued Staff Accounting Bulletin 108 Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ( SAB 108 ). SAB 108 requires that public companies utilize a dual-approach to assessing the quantitative effects of financial misstatements. This dual approach includes both an income statement focused assessment, sometimes referred to as the rollover method, and a balance sheet focused assessment, sometimes referred to as the iron curtain method. The guidance in SAB 108 must be applied to annual financial statements for fiscal years ending after November 15, 2006, or the Company s year ended December 31, 2006. The transition provisions of SAB 108 permit a registrant to adjust opening retained earnings for the cumulative effect of immaterial errors related to prior years deemed to be material if corrected in the current year.

Historically, the Company has evaluated uncorrected misstatements utilizing the rollover method. Pursuant to the adoption of SAB 108, the Company identified two uncorrected misstatements that it previously determined were not material to prior years under the rollover method. Under the iron curtain method, these items were deemed to be material to the Company s financial statements for the year ended December 31, 2006, and, therefore, the Company recorded an adjustment to increase its opening retained earnings balance as of January 1, 2006 by approximately $13.6 million, net of taxes, in accordance with the implementation guidance of SAB 108. The first uncorrected misstatement related to excess contingency reserve balances of approximately $10.9 million, net of taxes, that had accumulated over several years. A majority of those excess contingency reserve balances ceased accumulating as of December 31, 2001. The second uncorrected misstatement of $2.7 million related to the under-capitalization of certain parts inventory volume and purchase-related variances during the years ended December 31, 2004 and 2005.

***Cash and Cash Equivalents***

The Company considers all investments with an original maturity of three months or less to be cash equivalents. Cash equivalents at December 31, 2006 and 2005 of $273.5 million and $146.3 million, respectively, consisted of overnight repurchase agreements with financial institutions.

***Accounts and Notes Receivable***

Accounts and notes receivable arise from the sale of equipment and replacement parts to independent dealers, distributors or other customers. Payments due under the Company s terms of sale generally range from one to 12 months and are not contingent upon the sale of the equipment by the dealer or distributor to a retail customer. Under normal circumstances, payment terms are not extended and equipment may not be returned. In certain regions, including the United States and Canada, the Company is obligated to repurchase equipment and replacement parts upon cancellation of a dealer or distributor contract. These obligations are required by national, state or provincial laws and require the Company to repurchase dealer or distributor s unsold inventory, including inventory for which the receivable has already been paid.

For sales outside of the United States and Canada, the Company does not normally charge interest on outstanding receivables with its dealers and distributors. For sales to certain dealers or distributors in the United States and Canada, where approximately 22% of the Company s net sales were generated in 2006, interest is charged at or above prime lending rates on outstanding receivable balances after interest-free periods. These interest-free periods vary by product and generally range from one to 12 months, with the exception of certain seasonal products, which bear interest after various periods up to 23 months depending on

**AGCO CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the time of year of the sale and the dealer s or distributor s sales volume during the preceding year. For the year ended December 31, 2006, 12.2% and 6.7% of the Company s net sales had maximum interest-free periods ranging from one to six months and seven to 12 months, respectively. Net sales with maximum interest-free periods ranging from 13 to 23 months were insignificant during 2006. Actual interest-free periods are shorter than above because the equipment receivable from dealers or distributors in the United States and Canada is due immediately upon sale of the equipment to a retail customer. Under normal circumstances, interest is not forgiven and interest-free periods are not extended. In May 2005, the Company completed an agreement to permit transferring, on an ongoing basis, the majority of interest-bearing receivables in North America to its United States and Canadian retail finance joint ventures. Upon transfer, the receivables maintain standard payment terms, including required regular principal payments on amounts outstanding, and interest charges at market rates. Under this arrangement, qualified dealers may obtain additional financing through the United States and Canadian retail finance joint ventures.

Accounts and notes receivable are shown net of allowances for sales incentive discounts available to dealers and for doubtful accounts. Cash flows related to the collection of receivables are reported within Cash flows from operating activities within the Company s Consolidated Statements of Cash Flows. Accounts and notes receivable allowances at December 31, 2006 and 2005 were as follows (in millions):

| | 2006 | 2005 |
|---|---|---|
| Sales incentive discounts | $ 82.6 | $ 92.1 |
| Doubtful accounts | 37.7 | 40.6 |
| | $ 120.3 | $ 132.7 |

The Company transfers certain accounts receivable to various financial institutions primarily under its accounts receivable securitization facilities (Note 4). The Company records such transfers as sales of accounts receivable when it is considered to have surrendered control of such receivables under the provisions of SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a Replacement of SFAS No. 125 ( SFAS No. 140 ).

***Inventories***

Inventories are valued at the lower of cost or market using the first-in, first-out method. Market is net realizable value for finished goods and repair and replacement parts. For work in process, production parts and raw materials, market is replacement cost. At December 31, 2006 and 2005, the Company had recorded $84.7 million and $79.7 million, respectively, as adjustments for surplus and obsolete inventories. These adjustments are reflected within Inventories, net.

Inventories, net at December 31, 2006 and 2005 were as follows (in millions):

| | 2006 | 2005 |
|---|---|---|

| | | |
|---|---|---|
| Finished goods | $ 468.7 | $ 477.3 |
| Repair and replacement parts | 331.9 | 307.5 |
| Work in process | 59.8 | 63.3 |
| Raw materials | 204.5 | 214.4 |
| Inventories, net | $ 1,064.9 | $ 1,062.5 |

Cash flows related to the sale of inventories are reported within Cash flows from operating activities within the Company s Consolidated Statements of Cash Flows.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Property, Plant and Equipment***

Property, plant and equipment are recorded at cost, less accumulated depreciation and amortization. Depreciation is provided on a straight-line basis over the estimated useful lives of ten to 40 years for buildings and improvements, three to 15 years for machinery and equipment and three to ten years for furniture and fixtures. Expenditures for maintenance and repairs are charged to expense as incurred.

Property, plant and equipment, net at December 31, 2006 and 2005 consisted of the following (in millions):

| | 2006 | 2005 |
|---|---|---|
| Land | $ 53.4 | $ 47.3 |
| Buildings and improvements | 259.4 | 220.2 |
| Machinery and equipment | 768.2 | 606.3 |
| Furniture and fixtures | 142.9 | 139.0 |
| Gross property, plant and equipment | 1,223.9 | 1,012.8 |
| Accumulated depreciation and amortization | (580.0) | (451.4) |
| Property, plant and equipment, net | $ 643.9 | $ 561.4 |

***Goodwill and Other Intangible Assets***

SFAS No. 142, Goodwill and Other Intangible Assets ( SFAS No. 142 ), establishes a method of testing goodwill and other indefinite-lived intangible assets for impairment on an annual basis or on an interim basis if an event occurs or circumstances change that would reduce the fair value of a reporting unit below its carrying value. The Company s initial assessment and its annual assessments involve determining an estimate of the fair value of the Company s reporting units in order to evaluate whether an impairment of the current carrying amount of goodwill and other indefinite-lived intangible assets exists. Fair values are derived based on an evaluation of past and expected future performance of the Company s reporting units. A reporting unit is an operating segment or one level below an operating segment, for example, a component. A component of an operating segment is a reporting unit if the component constitutes a business for which discrete financial information is available and the Company s executive management team regularly reviews the operating results of that component. In addition, the Company combines and aggregates two or more components of an operating segment as a single reporting unit if the components have similar economic characteristics. The Company s reportable segments reported under the guidance of SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, are not its reporting units, with the exception of its Asia/Pacific geographical segment.

The Company utilized a combination of valuation techniques, including a discounted cash flow approach and a market multiple approach when making its annual and interim assessments. As stated above, goodwill is tested for impairment on an annual basis and more often if indications of impairment exist. The results of the Company s analyses conducted as of October 1, 2005 and 2004 indicated that no reduction in the carrying amount of goodwill was required. In 2006, sales and operating income of the Company s Sprayer operations declined significantly as compared to prior years. In addition, the Company s projections for the Sprayer business did not result in a valuation sufficient to support the carrying amount of the goodwill balance on the Company s Consolidated Balance Sheet. As a result, the Company concluded that the goodwill associated with its Sprayer operations was impaired, and recognized a write-down of the total amount of recorded goodwill of approximately $171.4 million during the fourth quarter of 2006. The results of the Company s analyses conducted as of October 1, 2006 associated with its other reporting units indicated that no reduction in their carrying amounts of goodwill was required.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Changes in the carrying amount of acquired intangible assets during 2006 and 2005 are summarized as follows (in millions):

| **Gross carrying amounts:** | **Trademarks and Tradenames** | **Customer Relationships** | **Patents and Technology** | **Total** |
|---|---|---|---|---|
| Balance as of December 31, 2004 | $ 32.9 | $ 81.7 | $ 51.4 | $ 166.0 |
| Foreign currency translation | (0.2) | (0.2) | (6.3) | (6.7) |
| Balance as of December 31, 2005 | 32.7 | 81.5 | 45.1 | 159.3 |
| Foreign currency translation | 0.2 | 8.1 | 5.0 | 13.3 |
| Balance as of December 31, 2006 | $ 32.9 | $ 89.6 | $ 50.1 | $ 172.6 |

| **Accumulated amortization:** | **Trademarks and Tradenames** | **Customer Relationships** | **Patents and Technology** | **Total** |
|---|---|---|---|---|
| Balance as of December 31, 2004 | $ 3.7 | $ 9.4 | $ 7.8 | $ 20.9 |
| Amortization expense | 1.2 | 8.3 | 7.0 | 16.5 |
| Foreign currency translation | (0.1) | | (1.3) | (1.4) |
| Balance as of December 31, 2005 | 4.8 | 17.7 | 13.5 | 36.0 |
| Amortization expense | 1.2 | 8.6 | 7.1 | 16.9 |
| Foreign currency translation | | 2.0 | 1.9 | 3.9 |
| Balance as of December 31, 2006 | $ 6.0 | $ 28.3 | $ 22.5 | $ 56.8 |

| **Indefinite-lived intangible assets:** | **Trademarks and Tradenames** |
|---|---|
| Balance as of December 31, 2004 | $ 93.1 |

| | | |
|---|---|---|
| Foreign currency translation | | (4.9) |
| Balance as of December 31, 2005 | | 88.2 |
| Foreign currency translation | | 3.9 |
| Balance as of December 31, 2006 | $ | 92.1 |

The Company amortizes certain acquired intangible assets primarily on a straight-line basis over their estimated useful lives, which range from three to 30 years. The acquired intangible assets have a weighted average useful life as follows:

| **Intangible Asset** | **Weighted-Average Useful Life** |
|---|---|
| Trademarks and tradenames | 30 years |
| Technology and patents | 7 years |
| Customer relationships | 10 years |

For the years ended December 31, 2006, 2005 and 2004, acquired intangible asset amortization was $16.9 million, $16.5 million and $15.8 million, respectively. The Company estimates amortization of existing intangible assets will be $17.0 million for 2007, $16.9 million for 2008, $16.8 million for 2009, $16.7 million for 2010 and $9.9 million for 2011.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In accordance with SFAS No. 142, the Company determined that two of its trademarks have an indefinite useful life. The Massey Ferguson trademark has been in existence since 1952 and was formed from the merger of Massey-Harris (established in the 1890 s) and Ferguson (established in the 1930 s). The Massey Ferguson brand is currently sold in over 140 countries worldwide, making it one of the most widely sold tractor brands in the world. As a result of the Company s acquisition of Valtra in January 2004 (Note 2), the Company identified the Valtra trademark as an indefinite-lived asset. The Valtra trademark has been in existence since the late 1990 s, but is a derivative of the Valmet trademark which has been in existence since 1951. Valtra and Valmet are used interchangeably in the marketplace today and Valtra is recognized to be the tractor line of the Valmet name. The Valtra brand is currently sold in approximately 50 countries around the world. Both the Massey Ferguson brand and the Valtra brand are primary product lines of the Company s business and the Company plans to use these trademarks for an indefinite period of time. The Company plans to continue to make investments in product development to enhance the value of these brands into the future. There are no legal, regulatory, contractual, competitive, economic or other factors that the Company is aware of that the Company believes would limit the useful lives of the trademarks. The Massey Ferguson and Valtra trademark registrations can be renewed at a nominal cost in the countries in which the Company operates.

Changes in the carrying amount of goodwill during the years ended December 31, 2006, 2005 and 2004 are summarized as follows (in millions). See Note 2 for further information regarding adjustments related to income taxes:

| | North America | South America | Europe/Africa/ Middle East | Consolidated |
|---|---|---|---|---|
| Balance as of December 31, 2003 | $ 165.5 | $ 42.3 | $ 123.9 | $ 331.7 |
| Acquisitions | | 68.8 | 289.6 | 358.4 |
| Foreign currency translation | | 9.7 | 30.8 | 40.5 |
| Balance as of December 31, 2004 | 165.5 | 120.8 | 444.3 | 730.6 |
| Adjustments related to income taxes | 8.5 | | (3.8) | 4.7 |
| Foreign currency translation | | 16.2 | (54.8) | (38.6) |
| Balance as of December 31, 2005 | 174.0 | 137.0 | 385.7 | 696.7 |
| Adjustments related to income taxes | | (3.1) | 13.4 | 10.3 |
| Impairment of goodwill | (170.9) | | (0.5) | (171.4) |
| Foreign currency translation | | 12.5 | 44.0 | 56.5 |
| Balance as of December 31, 2006 | $ 3.1 | $ 146.4 | $ 442.6 | $ 592.1 |

***Long-Lived Assets***

During 2006, 2005 and 2004, the Company reviewed its long-lived assets for impairment whenever events or changes in circumstances indicated that the carrying amount of an asset may not be recoverable in accordance with the provisions of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets ( SFAS No. 144 ). Under SFAS No. 144, an impairment loss is recognized when the undiscounted future cash flows estimated to be generated by the asset to be held and used are not sufficient to recover the unamortized balance of the asset. An impairment loss would be recognized based on the difference between the carrying values and estimated fair value. The estimated fair value is determined based on either the discounted future cash flows or other appropriate fair value methods with the amount of any such deficiency charged to income in the current year. If the asset being tested for recoverability was acquired in a business combination, intangible assets resulting from the acquisition that are related to the asset are included in the assessment. Estimates of future cash flows are based on many factors, including current operating results, expected market trends and competitive influences. The Company also evaluates the amortization periods

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

assigned to its intangible assets to determine whether events or changes in circumstances warrant revised estimates of useful lives. Assets to be disposed of by sale are reported at the lower of the carrying amount or fair value, less estimated costs to sell. During 2004, the Company recorded a write-down of property, plant and equipment to its fair value of $8.2 million in conjunction with assets related to the rationalization of its Randers, Denmark combine manufacturing facility.

***Accrued Expenses***

Accrued expenses at December 31, 2006 and 2005 consisted of the following (in millions):

| | 2006 | 2005 |
|---|---|---|
| Reserve for volume discounts and sales incentives | $ 134.7 | $ 118.2 |
| Warranty reserves | 125.3 | 122.8 |
| Accrued employee compensation and benefits | 144.3 | 126.5 |
| Accrued taxes | 106.1 | 77.6 |
| Other | 119.3 | 116.7 |
| | $ 629.7 | $ 561.8 |

***Warranty Reserves***

The warranty reserve activity for the years ended December 31, 2006, 2005 and 2004 consisted of the following (in millions):

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Balance at beginning of the year | $ 122.8 | $ 135.0 | $ 98.5 |
| Acquisitions | | | 14.9 |
| Accruals for warranties issued during the year | 124.5 | 126.0 | 111.5 |
| Settlements made (in cash or in kind) during the year | (117.6) | (128.1) | (97.6) |
| Foreign currency translation | 7.2 | (10.1) | 7.7 |
| Balance at the end of the year | $ 136.9 | $ 122.8 | $ 135.0 |

The Company s agricultural equipment products are generally under warranty against defects in material and workmanship for a period of one to four years. The Company accrues for future warranty costs at the time of sale based on historical warranty experience. Approximately $11.6 million of warranty reserves are included in Other noncurrent liabilities in the Company s Consolidated Balance Sheet as of December 31, 2006.

***Insurance Reserves***

Under the Company s insurance programs, coverage is obtained for significant liability limits as well as those risks required to be insured by law or contract. It is the policy of the Company to self-insure a portion of certain expected losses related primarily to workers compensation and comprehensive general, product and vehicle liability. Provisions for losses expected under these programs are recorded based on the Company s estimates of the aggregate liabilities for the claims incurred.

**Stock Incentive Plans**

***Stock Compensation Expense***

During the first quarter of 2006, the Company adopted SFAS No. 123R (Revised 2004), Share-Based Payment ( SFAS No. 123R ), which is a revision of SFAS No. 123, Accounting for Stock-Based

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Compensation ( SFAS No. 123 ). During 2006, the Company recorded approximately $3.6 million of stock compensation expense in accordance with SFAS No. 123R. Refer to Note 10 for additional information regarding the Company s stock incentive plans that were in place during 2006. During 2005 and 2004, the Company recorded approximately $0.4 million and $0.5 million, respectively, in accordance with APB No. 25. The stock compensation expense was recorded as follows (in millions):

| | Years Ended December 31, 2006 | 2005 | 2004 |
|---|---|---|---|
| Cost of goods sold | $ 0.1 | $ | $ |
| Selling, general and administrative expenses | 3.5 | 0.4 | 0.5 |
| Total stock compensation expense | $ 3.6 | $ 0.4 | $ 0.5 |

***Proforma disclosure under SFAS No. 123 for 2005 and 2004***

Prior to the adoption of SFAS No. 123R, the Company accounted for all stock-based compensation awarded under its former Non-employee Director Incentive Plan (the Director Plan ), Long-Term Incentive Plan (the LTIP ) and Stock Option Plan (the Option Plan ) as prescribed under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB No. 25 ), and provided the disclosures required under SFAS No. 123 and SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure ( SFAS No. 148 ). As discussed further in Note 10, the Company s LTIP and Director Plan were terminated in December 2005. APB No. 25 required no recognition of compensation expense for options granted under the Option Plan as long as certain conditions were met. There was no compensation expense recorded under APB No. 25 for the Option Plan during 2005 and 2004. APB No. 25 required recognition of compensation expense under the Director Plan and the LTIP at the time the award was earned. There were no grants under the Option Plan during the years ended December 31, 2006, 2005 and 2004. For disclosure purposes only, under SFAS No. 123, the Company estimated the fair value of grants under the Company s Option Plan using the Black-Scholes option pricing model and the Barrier option model for awards granted under the Director Plan and the LTIP. Based on these models, the weighted average fair value of options granted under the Option Plan and the weighted average fair value of awards granted under the Director Plan and the LTIP, were as follows:

| | 2005 | 2004 |
|---|---|---|
| Director Plan | $ 12.93 | $ 17.67 |
| LTIP | 15.05 | 16.21 |
| Option Plan | | |
| Weighted average assumptions under Black-Scholes and Barrier option models: | | |
| Expected life of awards (years) | 4.4 | 4.7 |
| Risk-free interest rate | 4.0% | 3.2% |

| | | |
|---|---|---|
| Expected volatility | 41.9% | 48.6% |
| Expected dividend yield | | |

The fair value of the grants and awards are amortized over the vesting period for stock options and awards earned under the Director Plan and LTIP and over the performance period for unearned awards under the Director Plan and LTIP. The following table illustrates the effect on net income and earnings per common

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

share if the Company had applied the fair value recognition provisions of SFAS No. 123 and SFAS No. 148 (in millions, except per share data):

| | Years Ended December 31, 2005 | Years Ended December 31, 2004 |
|---|---|---|
| Net income, as reported | $ 31.6 | $ 158.8 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | 0.2 | 0.3 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (17.6) | (7.7) |
| Pro forma net income | $ 14.2 | $ 151.4 |
| Earnings per share: | | |
| Basic as reported | $ 0.35 | $ 1.84 |
| Basic pro forma | $ 0.16 | $ 1.76 |
| Diluted as reported | $ 0.35 | $ 1.71 |
| Diluted pro forma | $ 0.16 | $ 1.63 |

The 2004 diluted as reported and pro forma earnings per share include the impact of the Company s 13/4% contingently convertible senior subordinated notes. The 2005 pro forma earnings per share include the impact of the cancellation of awards under the Director Plan and LTIP in December 2005 (Note 10).

***Research and Development Expenses***

Research and development expenses are expensed as incurred and are included in engineering expenses in the Consolidated Statements of Operations.

***Advertising Costs***

The Company expenses all advertising costs as incurred. Cooperative advertising costs are normally expensed at the time the revenue is earned. Advertising expenses for the years ended December 31, 2006, 2005 and 2004 totaled approximately $36.0 million, $35.8 million and $37.2 million, respectively.

***Shipping and Handling Expenses***

All shipping and handling fees charged to customers are included as a component of net sales. Shipping and handling costs are included as a part of cost of goods sold, with the exception of certain handling costs included in selling, general and administrative expenses in the amount of $19.8 million, $18.6 million and $16.8 million for the years ended December 31, 2006, 2005 and 2004, respectively.

***Interest Expense, Net***

Interest expense, net for the years ended December 31, 2006, 2005 and 2004 consisted of the following (in millions):

| | **2006** | **2005** | **2004** |
|---|---|---|---|
| Interest expense | $ 71.4 | $ 96.0 | $ 92.3 |
| Interest income | (16.2) | (16.0) | (15.3) |
| | $ 55.2 | $ 80.0 | $ 77.0 |

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Income Taxes***

Income taxes are accounted for under the asset and liability method, as prescribed under the provisions of SFAS No. 109, Accounting for Income Taxes ( SFAS No. 109 ). Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

***Net Income (Loss) Per Common Share***

The computation, presentation and disclosure requirements for earnings (loss) per share are presented in accordance with SFAS No. 128, Earnings Per Share. Basic earnings (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during each period. Diluted earnings (loss) per common share assumes exercise of outstanding stock options, vesting of restricted stock and the appreciation of the excess conversion value of the contingently convertible senior subordinated notes using the treasury stock method when the effects of such assumptions are dilutive.

During the fourth quarter of 2004, the Emerging Issues Task Force ( EITF ) reached a consensus on EITF Issue No. 04-08, Accounting Issues Related to Certain Features of Contingently Convertible Debt and the Effect on Diluted Earnings per Share ( EITF 04-08 ). EITF 04-08 requires that shares subject to issuance from contingently convertible debt should be included in the calculation of diluted earnings per share using the if-converted method regardless of whether a market price trigger has been met. The Company adopted EITF 04-08 during the fourth quarter of 2004 and included approximately 9.0 million additional shares of common stock that may have been issued upon conversion of the Company s former 13/4% convertible senior subordinated notes in its diluted earnings per share calculation for the year ended December 31, 2004 and through the six months ended June 30, 2005. In addition, diluted earnings per share prior to the fourth quarter of 2004 was required to be restated for each period that the convertible debt was outstanding. The Company s 13/4% convertible senior subordinated notes were issued on December 23, 2003. As the Company is not benefiting losses in the United States for tax purposes, the interest expense associated with the convertible senior subordinated notes included in the diluted earnings per share calculation does not reflect a tax benefit. On June 29, 2005, the Company completed an exchange of its $201.3 million aggregate principal amount of 13/4% convertible senior subordinated notes. The Company exchanged its existing convertible notes for new notes that provide for (i) the settlement upon conversion in cash up to the principal amount of the converted new notes with any excess conversion value settled in shares of the Company s common stock, and (ii) the conversion rate to be increased under certain circumstances if the new notes are converted in connection with certain change of control transactions occurring prior to December 10, 2010, but otherwise are substantially the same as the old notes. The impact of the exchange resulted in a reduction in the diluted weighted average shares outstanding of approximately 9.0 million shares on a prospective basis. Dilution of weighted shares outstanding subsequent to the exchange depends on the Company s stock price once the market price trigger or other specified conversion circumstances are met for the excess conversion value using the treasury stock method (Note 7). The Company s 11/4% convertible senior subordinated notes due 2036, issued in December of 2006, will also potentially impact the dilution of weighted shares outstanding for the excess conversion value using the treasury stock method (Note 7). A reconciliation of net (loss) income and weighted average common

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

shares outstanding for purposes of calculating basic and diluted earnings (loss) per share is as follows (in millions, except per share data):

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Basic net (loss) income per share: | | | |
| Net (loss) income | $ (64.9) | $ 31.6 | $ 158.8 |
| Weighted average number of common shares outstanding | 90.8 | 90.4 | 86.2 |
| Basic net (loss) income per share | $ (0.71) | $ 0.35 | $ 1.84 |
| Diluted net (loss) income per share: | | | |
| Net (loss) income | $ (64.9) | $ 31.6 | $ 158.8 |
| After-tax interest expense on contingently convertible senior subordinated notes | | | 4.6 |
| Net (loss) income for purposes of determining dilutive net (loss) income per share | $ (64.9) | $ 31.6 | $ 163.4 |
| Weighted average number of common shares outstanding | 90.8 | 90.4 | 86.2 |
| Dilutive stock options and restricted stock awards | | 0.3 | 0.4 |
| Weighted average assumed conversion of contingently convertible senior subordinated notes | | | 9.0 |
| Weighted average number of common and common share equivalents outstanding for purposes of computing diluted (loss) earnings per share | 90.8 | 90.7 | 95.6 |
| Diluted net (loss) income per share | $ (0.71) | $ 0.35 | $ 1.71 |

Stock options and stock-settled stock appreciation rights ( SSARs ) to purchase 0.1 million shares for the year ended December 31, 2006, and stock options to purchase 0.5 million and 0.5 million shares for the years ended December 31, 2005 and 2004, respectively, were outstanding but not included in the calculation of weighted average common and common equivalent shares outstanding because the option exercise prices were higher than the average market price of the Company s common stock during the related period. In addition, the weighted average common shares outstanding for purposes of computing diluted net loss per share for the year ended December 31, 2006 do not include the assumed conversion of the Company s 13/4% convertible senior subordinated notes or the impact of dilutive stock options and SSARs, as the impact would have been dilutive. The number of shares excluded from the weighted average common shares outstanding for the years ended December 31, 2006 and 2005 was approximately 1.2 million shares and 4.4 million shares, respectively.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Comprehensive Income (Loss)***

The Company reports comprehensive income (loss), defined as the total of net income (loss) and all other non-owner changes in equity and the components thereof in the Consolidated Statements of Stockholders Equity. The components of other comprehensive income (loss) and the related tax effects for the years ended December 31, 2006, 2005 and 2004 are as follows (in millions):

| | | 2006 | |
|---|---|---|---|
| | **Before-tax Amount** | **Income Taxes** | **After-tax Amount** |
| Additional minimum pension liability | $ 7.8 | $ (1.2) | $ 6.6 |
| Unrealized gain on derivatives | 0.1 | | 0.1 |
| Unrealized loss on derivatives held by affiliates | (2.0) | | (2.0) |
| Foreign currency translation adjustments | 136.7 | | 136.7 |
| Total components of other comprehensive income | $ 142.6 | $ (1.2) | $ 141.4 |

| | | 2005 | |
|---|---|---|---|
| | **Before-tax Amount** | **Income Taxes** | **After-tax Amount** |
| Additional minimum pension liability | $ (3.2) | $ 0.4 | $ (2.8) |
| Unrealized gain on derivatives held by affiliates | 4.7 | (1.9) | 2.8 |
| Foreign currency translation adjustments | (39.6) | | (39.6) |
| Total components of other comprehensive loss | $ (38.1) | $ (1.5) | $ (39.6) |

| | | 2004 | |
|---|---|---|---|
| | **Before-tax Amount** | **Income Taxes** | **After-tax Amount** |
| Additional minimum pension liability | $ (27.4) | $ 8.5 | $ (18.9) |
| Unrealized gain on derivatives held by affiliates | 6.3 | (2.5) | 3.8 |
| Foreign currency translation adjustments | 69.3 | | 69.3 |
| Total components of other comprehensive income | $ 48.2 | $ 6.0 | $ 54.2 |

***Financial Instruments***

The carrying amounts reported in the Company s Consolidated Balance Sheets for Cash and cash equivalents, Accounts and notes receivable and Accounts payable approximate fair value due to the immediate or short-term maturity of these financial instruments. The carrying amount of long-term debt under the Company s credit facility (Note 7) approximates fair value based on the borrowing rates currently available to the Company for loans with similar terms and average maturities. At December 31, 2006, the estimated fair values of the Company s 67/8% senior subordinated notes, 13/4% convertible notes (Note 7) and 11/4% convertible notes (Note 7), based on their listed market values, were $274.2 million, $307.3 million and $199.5 million, respectively, compared to their carrying values of $264.0 million, $201.3 million and $201.3 million, respectively. At December 31, 2005, the estimated fair values of the Company s 67/8% senior subordinated notes and 13/4% convertible notes, based on their listed market values, were $246.4 million and $187.2 million, respectively, compared to their carrying values of $237.0 million and $201.3 million, respectively.

The Company enters into foreign currency forward contracts to hedge the foreign currency exposure of certain receivables, payables and committed purchases and sales. These contracts are for periods consistent with the exposure being hedged and generally have maturities of one year or less. At December 31, 2006 and

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

2005, the Company had foreign currency forward contracts outstanding with gross notional amounts of $356.5 million and $255.3 million, respectively. The Company had an unrealized gain of $1.2 million and an unrealized loss of $0.3 million on foreign currency forward contracts at December 31, 2006 and 2005, respectively, which are reflected in the Company s Consolidated Statements of Operations. These foreign currency forward contracts do not subject the Company s results of operations to risk due to exchange rate fluctuations because gains and losses on these contracts generally offset gains and losses on the exposure being hedged. The Company does not enter into any foreign currency forward contracts for speculative trading purposes.

During the second quarter of 2006, the Company designated certain foreign currency option contracts as cash flow hedges of expected sales. The effective portion of the fair value gains or losses on these cash flow hedges were recorded in other comprehensive income and subsequently reclassified into net sales as the sales were recognized. These amounts offset the effect of the changes in foreign exchange rates on the related sale transactions. The amount of the gain recorded in other comprehensive income that was reclassified to net sales during the year ended December 31, 2006 was approximately $4.0 million on an after-tax basis. These contracts all expired prior to December 31, 2006.

The notional amounts of foreign exchange forward contracts do not represent amounts exchanged by the parties and therefore are not a measure of the Company s risk. The amounts exchanged are calculated on the basis of the notional amounts and other terms of the contracts. The credit and market risks under these contracts are not considered to be significant.

***Accounting Changes***

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, ( SFAS No. 159 ). SFAS No. 159 provides companies with an option to report selected financial assets and liabilities at fair value and to provide additional information that will help investors and other users of financial statements to understand more easily the effect on earnings of the company s choice to use fair value. It also requires companies to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. The Company is required to adopt SFAS No. 159 on January 1, 2008 and is currently evaluating the impact, if any, of SFAS No. 159 on its Consolidated Financial Statements.

In September 2006, the SEC staff issued SAB 108. SAB 108 requires that public companies utilize a dual-approach to assessing the quantitative effects of financial misstatements. This dual approach includes both an income statement focused assessment and a balance sheet focused assessment. The guidance in SAB 108 must be applied to annual financial statements for fiscal years ending after November 15, 2006. See Adoption of SEC Staff Accounting Bulletin No. 108 for further information.

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 No. 158 ). SFAS No. 158 requires an employer that sponsors one or more single-employer defined benefit plans to (i) recognize the overfunded or underfunded status of a benefit plan in its statement of financial position, (ii) recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to SFAS No. 87, Employers Accounting for Pensions , or SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions , (iii) measure defined benefit plan assets and obligations as of the date of the employer s fiscal year-end, and (iv) disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition assets or obligations. SFAS No. 158 is effective for the Company s year ended December 31, 2006. The adoption of SFAS No. 158 had a $26.8 million impact to the Company s consolidated accumulated other

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

comprehensive loss balance as of December 31, 2006, related to its underfunded defined benefit pension and retirement health care plans, primarily in the United Kingdom and the United States. See Note 8 for a discussion of the Company s defined benefit pension and postretirement health care benefit plans.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 establishes a common definition for fair value to be applied to guidance regarding U.S. generally accepted accounting principles, requiring use of fair value, establishes a framework for measuring fair value, and expands disclosure about such fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact of the adoption of SFAS No. 157 on its 2008 consolidated financial position and results of operations.

In September 2006, the FASB issued FASB Staff Position ( FSP ) AUG AIR-1 Accounting for Planned Major Maintenance Activities ( FSP AUG AIR-1 ). FSP AUG AIR-1 amends the guidance on the accounting for planned major maintenance activities; specifically it precludes the use of the previously acceptable accrue in advance method. FSP AUG AIR-1 is effective for fiscal years beginning after December 15, 2006. The implementation of this standard is not expected to have a material impact on the Company s consolidated financial position or results of operations, as the Company does not employ the accrue in advance method.

In June 2006, the EITF reached a consensus on EITF Issue No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements, ( EITF 06-4 ), which requires the application of the provisions of SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions ( SFAS No. 106 ), to endorsement split-dollar life insurance arrangements. SFAS No. 106 would require the Company to recognize a liability for the discounted future benefit obligation that the Company will have to pay upon the death of the underlying insured employee. An endorsement-type arrangement generally exists when the Company owns and controls all incidents of ownership of the underlying policies. EITF 06-4 is effective for fiscal years beginning after December 15, 2007. The Company may have certain policies subject to the provisions of this new pronouncement, but does not believe the adoption of EITF 06-4 will have a material impact on its consolidated results of operations or financial position during its 2008 fiscal year.

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 ). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, and disclosure. FIN 48 is effective for fiscal years beginning after December 15, 2006. The adoption of FIN 48 is not expected to have a material effect on the Company s 2007 Consolidated Financial Statements.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140 ( SFAS No. 156 ). SFAS No. 156 requires an entity to recognize a servicing asset or liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in specified situations. Such servicing assets or liabilities would be initially measured at fair value, if practicable, and subsequently measured at amortized value or fair value based upon an election of the reporting entity. SFAS No. 156 also specifies certain financial statement presentations and disclosures in connection with servicing assets and liabilities.
SFAS No. 156 is effective for fiscal years beginning after September 15, 2006 and may be adopted earlier but only if the adoption is in the first quarter of the fiscal year. The adoption of SFAS No. 156 is not expected to have a material

effect on the Company s 2007 Consolidated Financial Statements.

In March 2006, the EITF reached a consensus on EITF Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (that is,

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Gross versus Net Presentation) ( EITF 06-3 ), which allows companies to adopt a policy of presenting taxes in the income statement on either a gross or net basis. Taxes within the scope of this EITF would include taxes that are imposed on a revenue transaction between a seller and a customer; for example, sales taxes, use taxes, value-added taxes and some types of excise taxes. EITF 06-3 is effective for interim and annual reporting periods beginning after December 15, 2006. EITF 06-3 will not impact the method for recording and reporting these sales taxes in the Company s consolidated results of operations or financial position as the Company s policy is to exclude all such taxes from net sales and present such taxes in the Consolidated Statements of Operations on a net basis.

In April 2005, the SEC adopted a new rule that changed the adoption date of SFAS No. 123R. The Company adopted SFAS No. 123R effective January 1, 2006, and is using the modified prospective method of adoption. The application of the expensing provisions of SFAS No. 123R in 2006 resulted in pre-tax expense of approximately $3.6 million. See Notes 1 and 10 where the Company s stock compensation plans are discussed.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs-An Amendment of ARB No. 43, Chapter 4 ( SFAS No. 151 ). SFAS No. 151 amends the guidance in Accounting Research Bulletin No. 43, Chapter 4, Inventory Pricing ( ARB No. 43 ), to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Among other provisions, the new rule requires that items such as idle facility expense, excessive spoilage, double freight and rehandling costs be recognized as current-period charges regardless of whether they meet the criterion of so abnormal as stated in ARB No. 43. Additionally, SFAS No. 151 requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for fiscal years beginning after June 15, 2005. The Company s adoption of SFAS No. 151 in 2006 did not have a material impact on the Company s consolidated results of operations or financial position.

**2. Acquisitions**

On January 5, 2004, the Company acquired the Valtra tractor and diesel engine operations of Kone Corporation, a Finnish company, for 604.6 million, net of approximately 21.4 million cash acquired (or approximately $760 million, net). Valtra is a global tractor and off-road engine manufacturer in the Nordic region of Europe and Latin America. The acquisition of Valtra provided the Company with the opportunity to expand its business in significant global markets by utilizing Valtra s technology and productivity leadership in the agricultural equipment market. The results of operations for the Valtra acquisition have been included in the Company s Consolidated Financial Statements as of and from the date of acquisition. The Company completed the initial funding of the cash purchase price of Valtra through the issuance of $201.3 million principal amount of 13/4% convertible senior subordinated notes in December 2003, funds borrowed under revolving credit and term loan facilities that were entered into January 5, 2004, and $100.0 million borrowed under an interim bridge facility that was also closed on January 5, 2004. The interim bridge facility was subsequently repaid in April 2004 upon completion of a common stock offering (Note 9).

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Valtra acquisition was accounted for in accordance with SFAS No. 141, Business Combinations, and accordingly, the Company allocated the purchase price to the assets acquired and the liabilities assumed based on their fair values as of the acquisition date. The following table presents the allocation of the acquisition cost, including professional fees and other related acquisition costs, to the assets acquired and liabilities assumed, based upon their fair value:

| | | (in millions) |
|---|---|---|
| Cash and cash equivalents | $ | 27.1 |
| Accounts receivable | | 146.2 |
| Inventories | | 155.5 |
| Other current and noncurrent assets | | 12.5 |
| Property, plant and equipment | | 175.0 |
| Intangible assets | | 156.9 |
| Goodwill | | 358.4 |
| Total assets acquired | | 1,031.6 |
| Accounts payable | | 77.9 |
| Accrued expenses | | 78.1 |
| Other current liabilities | | 24.3 |
| Pension and postretirement benefits | | 19.6 |
| Other noncurrent liabilities | | 34.2 |
| Total liabilities assumed | | 234.1 |
| Net assets acquired | $ | 797.5 |

The net assets acquired included transaction costs incurred during 2004.

The Company recorded approximately $358.4 million of goodwill and approximately $156.9 million of other identifiable intangible assets as follows (in millions):

| **Intangible Asset** | | **Amount** | **Weighted-Average Useful Life** |
|---|---|---|---|
| Tradename | $ | 1.0 | 10 years |
| Tradename | | 36.9 | Indefinite |
| Technology and patents | | 46.7 | 7 years |
| Customer relationships | | 72.3 | 10 years |

$ 156.9

The acquired intangible assets have a weighted average useful life of approximately nine years.

At the date of acquisition, there were two components of tax-deductible goodwill specifically related to the operations of Valtra Finland. The first component of tax deductible goodwill of approximately $201.1 million relates to goodwill for financial reporting purposes, and this asset will generate deferred income taxes in the future as the asset is amortized for income tax purposes. The second component of tax-deductible goodwill of approximately $157.7 million relates to tax deductible goodwill in excess of goodwill for financial reporting purposes. The tax benefits associated with this excess will be applied to reduce the amount of goodwill for financial reporting purposes in the future, if and when such tax benefits are realized for income tax return purposes. During 2006, the Company recorded additional goodwill of approximately 17.2 million (or approximately $22.7 million as of December 31, 2006) associated with the reallocation of certain intangible assets to goodwill for income tax purposes in Finland as well as additional pre-acquisition income tax

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

contingencies identified at a Valtra European sales office. During 2006 and 2005, the Company realized approximately $9.3 million and $3.8 million, respectively, in tax benefits associated with the excess tax basis deductible goodwill, thus resulting in reductions of goodwill for financial reporting purposes.

At the date of acquisition, the Company identified certain income tax contingencies associated with the operations of Valtra Brazil that related to pre-acquisition tax years. During 2006, it was determined that the identified contingencies no longer existed. The Company therefore recognized a reduction in goodwill of approximately $3.1 million associated with the reversal of such contingent liabilities.

## 3. Restructuring and Other Infrequent Expenses

The Company recorded restructuring and other infrequent expenses of $1.0 million, $0.0 million and $0.1 million for the years ended December 31, 2006, 2005 and 2004, respectively. The charges in 2006 include severance costs associated with the rationalization of certain parts, sales, marketing and administrative functions in the United Kingdom and Germany, as well as the rationalization of certain Valtra European sales offices located in Denmark, Norway, Germany and the United Kingdom. The net charges in 2005 include a $1.5 million gain on the sale of property, plant and equipment related to the completion of auctions of machinery and equipment associated with the rationalization of the Randers, Denmark combine manufacturing operations. The gain was offset by $0.8 million of employee retention payments and facility closure costs incurred associated with the Randers rationalization, as well as $0.7 million of severance and other facility closure costs related to the rationalization of the Company s Finnish tractor manufacturing, sales and parts operations. The Company did not record an income tax benefit or provision associated with the charges or gain relating to the Randers rationalization during 2005. The 2004 net charges consisted of an $8.2 million pre-tax write-down of property, plant and equipment associated with the Randers rationalization, $3.3 million of severance and facility closure costs associated with the Randers rationalization, a $1.4 million charge associated with the rationalization of certain administrative functions within the Company s Finnish tractor manufacturing facility, as well as $0.5 million of charges associated with various rationalization initiatives in Europe and the United States initiated in 2002, 2003 and 2004. These charges were offset by gains on the sale of the Company s Coventry, England manufacturing facility and related machinery and equipment of $8.3 million, $0.9 million of restructuring reserve reversals related to the Coventry closure and a reversal of $4.1 million of the previously established provision related to the Company s U.K. pension plan. The Company did not record an income tax benefit associated with the charges relating to the Randers rationalization during 2004, when the plan was announced.

***Coventry, United Kingdom European headquarters rationalization***

During the third quarter of 2006, the Company initiated the restructuring of certain parts, sales, marketing and administrative functions within its Coventry, United Kingdom European headquarters, resulting in the termination of approximately 13 employees. The Company recorded severance costs of approximately $0.4 million associated with the restructuring during 2006. All employees had been terminated and all severance costs had been paid as of December 31, 2006.

***German sales office rationalizations***

During the third quarter of 2006, the Company announced the closure of two of its sales offices located in Germany, one of which was a Valtra sales office. The closures will result in the termination of approximately 16 employees. The Company recorded severance costs of approximately $0.5 million associated with the closures during 2006. None of the severance costs had been paid as of December 31, 2006 and none of the employees had been terminated. The severance costs and related terminations are expected to be paid and completed during 2007.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Valtra European sales office rationalizations***

During the second quarter of 2005, the Company announced that it was changing its distribution arrangements for its Valtra and Fendt products in Scandinavia by entering into a distribution agreement with a third-party distributor to distribute Valtra and Fendt equipment in Sweden and Valtra equipment in Norway and Denmark. As a result of this agreement and the decision to close other Valtra European sales offices, the Company initiated the restructuring and closure of its Valtra sales offices located in the United Kingdom, Spain, Denmark and Norway, resulting in the termination of approximately 24 employees. The Danish and Norwegian sales offices were transferred to the third-party Scandinavian equipment distributor in October 2005, which included the transfer of certain employees, assets and lease and supplier contracts. The Company recorded severance costs, asset write-downs and other facility closure costs of approximately $0.4 million, $0.1 million and $0.1 million, respectively, related to these closures during 2005. During the fourth quarter of 2005, the Company completed the sale of property, plant and equipment associated with the sales offices in the United Kingdom and Norway and recorded a gain of approximately $0.2 million, which was reflected within Restructuring and other infrequent expenses within the Company s Consolidated Statements of Operations. The Company paid approximately $0.2 million and $0.4 million of severance and other facility closure costs during 2005 and 2006, respectively. During the first quarter of 2006, the Company recorded an additional $0.1 million of severance costs related to these closures. As of December 31, 2006, all of the employees had been terminated and all severance and other facility closure costs had been paid.

***Valtra Finland administrative and European parts rationalizations***

During the fourth quarter of 2004, the Company initiated the restructuring of certain administrative functions within its Finnish operations, resulting in the termination of approximately 58 employees. During 2004, the Company recorded severance costs of approximately $1.4 million associated with this rationalization. The Company recorded an additional $0.1 million of severance costs during the first quarter of 2005 associated with this rationalization and incurred and paid approximately $0.8 million of severance costs during 2005. During the fourth quarter of 2005, the Company reversed $0.1 million of previously established provisions related to severance costs as severance claims were finalized during the quarter. As of March 31, 2006, all of the 58 employees had been terminated. The $0.6 million of severance payments accrued at December 31, 2006 are expected to be paid through 2009. In addition, during 2005, we incurred and expensed approximately $0.3 million of contract termination costs associated with the rationalization of our Valtra European parts distribution operations.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Randers, Denmark Rationalization***

During the third quarter of 2004, the Company announced and initiated a plan related to the restructuring of its European combine manufacturing operations located in Randers, Denmark, to include the elimination of the facility s component manufacturing operations, as well as the rationalization of the combine model range to be assembled in Randers. The restructuring plan will reduce the cost and complexity of the Randers manufacturing operations, by simplifying the model range. The Company now outsources manufacturing of the majority of parts and components to suppliers and has retained critical key assembly operations at the Randers facility. Component manufacturing operations ceased in February 2005. The components of the restructuring expenses are summarized in the following table (in millions):

| | Write-down of Property, Plant and Equipment | Employee Severance | Employee Retention Payments | Facility Closure Costs | Total |
|---|---|---|---|---|---|
| 2004 provision | $ 8.2 | $ 1.1 | $ 2.1 | $ 0.1 | $ 11.5 |
| Less: Non-cash expense | 8.2 | | | | 8.2 |
| Cash expense | | 1.1 | 2.1 | 0.1 | 3.3 |
| 2004 cash activity | | (0.2) | (0.4) | | (0.6) |
| Foreign currency translation | | | 0.1 | | 0.1 |
| Balances as of December 31, 2004 | | 0.9 | 1.8 | 0.1 | 2.8 |
| 2005 provision | | | 0.6 | 0.3 | 0.9 |
| 2005 provision reversal | | | (0.1) | | (0.1) |
| 2005 cash activity | | (0.9) | (2.1) | (0.4) | (3.4) |
| Foreign currency translation | | | (0.2) | | (0.2) |
| Balances as of December 31, 2005 | $ | $ | $ | $ | $ |

The write-down of certain property, plant and equipment within the component manufacturing operation represents the impairment of real estate and machinery and equipment resulting from the restructuring, as the rationalization eliminated a majority of the square footage utilized in the facility. The impairment charge was based upon the estimated fair value of the assets compared to their carrying value. The estimated fair value of the property, plant and equipment was based on current conditions in the market. The carrying value of the property, plant and equipment was approximately $11.6 million before the $8.2 million impairment charge. The machinery, equipment and tooling was disposed of or sold. A portion of the buildings, land and improvements are being marketed for sale. The impaired property, plant and equipment associated with the Randers rationalization was reported within the Company s

Europe/Africa/Middle East segment. During the second quarter of 2005, the Company completed auctions of remaining machinery and equipment and recorded a gain of approximately $1.5 million associated with such actions. The gain was reflected within Restructuring and other infrequent expenses within the Company s Consolidated Statements of Operations. The severance costs relate to the termination of 298 employees. As of December 31, 2005, all of the 298 employees had been terminated. The employee retention payments relate to incentives paid to Randers employees who remained employed until certain future termination dates and were accrued over the term of the retention period. During the third quarter of 2005, the Company reversed $0.1 million of previously established provisions related to retention payments as employee retention claims were finalized during the quarter. The facility closure costs included certain noncancelable operating lease terminations and other facility exit costs. The Company also recorded a write-down of approximately $3.7 million of inventory, reflected in costs of goods sold, during 2004, related to inventory that was identified as obsolete as a result of the rationalization.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Coventry Rationalization***

During the second quarter of 2002, the Company announced and initiated a restructuring plan related to the closure of its tractor manufacturing facility in Coventry, England and the relocation of existing production at Coventry to the Company s Beauvais, France and Canoas, Brazil manufacturing facilities. The closure of this facility was consistent with the Company s strategy to reduce excess manufacturing capacity. This particular facility manufactured transaxles and assembled tractors in the range of 50 to 110 horsepower. The trend towards higher horsepower tractors resulting from the consolidation of farms had caused this product segment of the industry to decline over recent years, which negatively impacted the facility s utilization. The components of the restructuring expenses incurred and paid during 2004 and 2005 are summarized in the following table (in millions):

| | Employee Severance | Employee Retention Payments | Facility Closure Costs | Total |
|---|---|---|---|---|
| Balances as of December 31, 2003 | $ 0.5 | $ 2.0 | $ 1.6 | $ 4.1 |
| 2004 provision reversal | | (0.4) | (0.5) | (0.9) |
| 2004 cash activity | (0.5) | (1.4) | (0.8) | (2.7) |
| Foreign currency translation | | 0.1 | 0.1 | 0.2 |
| Balances as of December 31, 2004 | | 0.3 | 0.4 | 0.7 |
| 2005 cash activity | | (0.3) | (0.4) | (0.7) |
| Balances as of December 31, 2005 | $ | $ | $ | $ |

On January 30, 2004, the Company sold the land, buildings and improvements of the Coventry facility for approximately $41.0 million, and as a result of that sale, recognized a net gain, after selling costs, of approximately $6.9 million. This gain was reflected in Restructuring and other infrequent expenses in the Company s Consolidated Statements of Operations for the year ended December 31, 2004. The Company leased part of the facility back from the buyers through November 2006. The Company received approximately $34.4 million of the sale proceeds on January 30, 2004 and the remaining $6.6 million on January 28, 2005. In addition, the Company completed the auctions of the remaining machinery and equipment, as well as finalized the sale of the facility (and associated selling costs) during the second quarter of 2004, and recorded an additional $1.4 million in net gains related to such actions. The net gains were reflected in Restructuring and other infrequent expenses in the Company s Consolidated Statements of Operations for the year ended December 31, 2004.

The employee severance costs relate to the termination of 1,049 employees. All employees had been terminated as of December 31, 2004. The employee retention payments relate to incentives paid to Coventry employees who remained employed until certain future termination dates and were accrued over the term of the retention period. The facility closure costs include certain noncancelable operating lease terminations and other facility exit costs. During 2004, the Company reversed approximately $0.9 million of provisions related to the restructuring that had been previously established. The reversals were necessary to adequately reflect more accurate estimates of remaining obligations related to retention payments, lease termination payouts and other exit costs, as some employees had been redeployed or had been terminated earlier than estimated, and as some supplier and rental contracts had been finalized and terminated earlier than anticipated.

During 2004, Restructuring and other infrequent expenses in the Company s Consolidated Statements of Operations included a credit of approximately £2.5 million (or approximately $4.1 million) due to a reduction in a previously established reserve for benefits under the Company s U.K. pension plan. This reduction reflects a reassessment, based upon an analysis of prior employee terminations in light of a U.K.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Court of Appeals interpretation of the Company s U.K. pension plan, of the number of former employees entitled to receive benefits.

***DeKalb Rationalization***

In March 2003, the Company announced the closure of the Challenger track tractor facility located in DeKalb, Illinois and the relocation of production to its facility in Jackson, Minnesota. Production at the DeKalb facility ceased in May 2003 and was relocated and resumed in the Minnesota facility in June 2003. The DeKalb plant assembled Challenger track tractors in the range of 235 to 500 horsepower. After a review of cost reduction alternatives, it was determined that current and future production levels at that time were not sufficient to support a stand-alone track tractor site.

The Company sold the DeKalb facility real estate during the fourth quarter of 2004, for approximately $3.0 million before associated selling costs, and recorded a net loss on the sale of the facilities of approximately $0.1 million. The loss was reflected in Restructuring and other infrequent expenses in the Company s Consolidated Statements of Operations.

***2002, 2003 and 2004 Functional Rationalizations***

During 2002 through 2004, the Company initiated several rationalization plans and recorded restructuring and other infrequent expenses in total of approximately $5.0 million during 2002, 2003 and 2004. The expenses primarily related to severance costs and certain lease termination and other exit costs associated with the rationalization of the Company s European engineering and marketing personnel, certain components of the Company s German manufacturing facilities located in Kempten and Marktoberdorf, Germany, the rationalization of the Company s European combine engineering operations and the closure and consolidation of the Company s Valtra United States and Canadian sales offices into its existing United States and Canadian sales organizations. The Company did not record any costs associated with these rationalizations during 2005 and 2006. Of the $5.0 million of total costs, approximately $4.0 million relate to severance costs associated with the termination of approximately 215 employees in total. At December 31, 2005, all accrued expenses had been incurred and paid.

**4. Accounts Receivable Securitization**

At December 31, 2006 and 2005, the Company had accounts receivable securitization facilities in the United States, Canada, and Europe totaling approximately $495.2 million and $480.3 million, respectively. In October 2006, the Company s European securitization was renewed and restructured so that wholesale receivables are sold through a qualifying special purpose entity (a QSPE ). In addition, the new securitization eliminates the requirement to maintain certain debt rating levels from Standard and Poor s and Moody s Investor Services that was applicable to the previous securitization facility. During 2004, the Company amended certain provisions of its United States and Canadian receivable securitization facilities including the expansion of the facilities by an additional $30.0 million and $10.0 million, respectively, and to eliminate the requirement to maintain certain debt rating levels from Standard and Poor s and Moody s Investor Services. Outstanding funding under these facilities totaled approximately $429.6 million at December 31, 2006 and $462.7 million at December 31, 2005. The funded balance has the effect of reducing accounts receivable and short-term liabilities by the same amount. During 2006, the Company did not fully utilize its securitization facility in the United States due to the Company s efforts to reduce dealer inventory levels, which resulted in a reduction in wholesale accounts receivable available for sale.

Under these facilities, wholesale accounts receivable are sold on a revolving basis to commercial paper conduits through a wholly-owned special purpose U.S. subsidiary and a QSPE in the United Kingdom. The Company has reviewed its accounting for its securitization facilities and its wholly-owned special purpose in the United States and its QSPE in the United Kingdom in accordance with SFAS No. 140 and FIN 46R. In the

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

United States, due to the fact that the receivables sold to the commercial paper conduits are an insignificant portion of the conduits total asset portfolios and such receivables are not siloed, consolidation is not appropriate under FIN 46R, as the Company does not absorb a majority of losses under such transactions. In Europe, the commercial paper conduit that purchases a majority of the receivables is deemed to be the majority beneficial interest holder of the QSPE, and thus consolidation by the Company is not appropriate under FIN 46R, as the Company does not absorb a majority of losses under such transactions. In addition, these facilities are accounted for as off-balance sheet transactions in accordance with the provisions of SFAS No. 140.

Losses on sales of receivables primarily from securitization facilities were $29.9 million in 2006, $22.4 million in 2005 and $15.6 million in 2004, and are included in other expense, net in the Company s Consolidated Statements of Operations. The losses are determined by calculating the estimated present value of receivables sold compared to their carrying amount. The present value is based on historical collection experience and a discount rate representing the spread over LIBOR as prescribed under the terms of the agreements. Other information related to these facilities and assumptions used in loss calculations are summarized below (dollar amounts in millions):

| | United States | | Canada | | Europe | | Total | |
|---|---|---|---|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 |
| Unpaid balance of receivables sold at December 31 | $ 266.6 | $ 333.4 | $ 80.6 | $ 94.8 | $ 142.8 | $ 142.3 | $ 490.0 | $ 570.5 |
| Retained interest in receivables sold | $ 26.2 | $ 53.3 | $ 20.6 | $ 34.8 | $ 13.6 | $ 19.7 | $ 60.4 | $ 107.8 |
| Credit losses on receivables sold | $ 2.0 | $ 3.4 | $ 1.3 | $ 0.9 | $ | $ | $ 3.3 | $ 4.3 |
| Average liquidation period (months) | 3.1 | 3.7 | 3.1 | 3.7 | 2.5 | 2.1 | | |
| Discount rate | 5.7% | 4.0% | 4.7% | 3.5% | 3.4% | 3.0% | | |

The Company continues to service the sold receivables and maintains a retained interest in the receivables. No servicing asset or liability has been recorded since the estimated fair value of the servicing of the receivables approximates the servicing income. The retained interest in the receivables sold is included in the caption Accounts and notes receivable, net in the accompanying Consolidated Balance Sheets. The Company s risk of loss under the securitization facilities is limited to a portion of the unfunded balance of receivables sold which is approximately 15% of the funded amount. The Company maintains reserves for the portion of the residual interest it estimates is uncollectible. At December 31, 2006 and 2005, approximately $0.5 million and $1.4 million, respectively, of the unpaid balance of receivables sold was past due 60 days or more. The fair value of the retained interest is approximately $59.3 million and $105.9 million, respectively, compared to the carrying amount of $60.4 million and $107.8 million, respectively, at December 31, 2006 and 2005, and is based on the present value of the receivables calculated in a method consistent with the losses on sales of receivables discussed above. Assuming a 10% and 20% increase in the average liquidation period, the fair value of the residual interest would decline by $0.1 million and $0.2 million, respectively. Assuming a 10% and 20% increase in the discount rate, the fair value of the residual interest would decline by $0.1 million and $0.2 million, respectively. For 2006, the Company received approximately $1,162.4 million from sales of receivables and $5.2 million for servicing fees. For 2005, the Company received $1,272.4 million from sales of receivables and $6.4 million for servicing fees. For 2004, the Company received approximately $1,270.2 million from sales of receivables and $5.6 million for servicing fees.

In May 2005, the Company completed an agreement to permit transferring, on an ongoing basis, the majority of its wholesale interest-bearing receivables in North America to AGCO Finance LLC and AGCO Finance Canada, Ltd., its United States and Canadian retail finance joint ventures. The Company has a 49% ownership interest in these joint ventures. The transfer of the receivables is without recourse to the Company, and the Company continues to service the receivables. The Company does not maintain any direct retained interest in the receivables. No servicing asset or liability has been recorded since the estimated fair value of

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the servicing of the receivables approximates servicing income. The initial transfer of the wholesale interest-bearing receivables resulted in net proceeds of approximately $94 million, which were used to redeem the Company s $250 million 91/2% senior notes (Note 7). As of December 31, 2006 and 2005, the balance of interest-bearing receivables transferred to AGCO Finance LLC and AGCO Finance Canada, Ltd. under this agreement was approximately $124.1 million and $109.9 million, respectively.

## 5. Investments in Affiliates

Investments in affiliates as of December 31, 2006 and 2005 were as follows (in millions):

| | 2006 | 2005 |
|---|---|---|
| Retail finance joint ventures | $ 175.5 | $ 150.4 |
| Manufacturing joint venture | 3.3 | 2.6 |
| Other joint ventures | 12.8 | 11.7 |
| | $ 191.6 | $ 164.7 |

The manufacturing joint venture as of December 31, 2006 and 2005 consisted of a joint venture with a third party manufacturer to produce engines in South America. The other joint ventures represent minority investments in farm equipment manufacturers, distributors and licensees.

The Company s equity in net earnings of affiliates for the years ended December 31, 2006, 2005 and 2004 were as follows (in millions):

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Retail finance joint ventures | $ 25.8 | $ 22.0 | $ 18.3 |
| Manufacturing and other joint ventures | 2.0 | 0.6 | 2.3 |
| | $ 27.8 | $ 22.6 | $ 20.6 |

Summarized combined financial information of the Company s retail finance joint ventures as of December 31, 2006 and 2005 and for the years ended December 31, 2006, 2005 and 2004 were as follows (in millions):

| | As of December 31, | |
|---|---|---|
| | 2006 | 2005 |
| Total assets | $ 3,642.0 | $ 3,046.6 |

| | | |
|---|---|---|
| Total liabilities | 3,283.6 | 2,739.4 |
| Partners equity | 358.4 | 307.2 |

| | For the Years Ended December 31, | | |
|---|---|---|---|
| | 2006 | 2005 | 2004 |
| Revenues | $ 232.2 | $ 187.3 | $ 175.1 |
| Costs | 152.3 | 114.0 | 113.9 |
| Income before income taxes | $ 79.9 | $ 73.3 | $ 61.2 |

The majority of the assets of the Company s retail finance joint ventures represent finance receivables. The majority of the liabilities represent notes payable and accrued interest. Under the various joint venture agreements, Rabobank or its affiliates are obligated to provide financing to the joint venture companies. The Company does not guarantee the debt obligations of the retail finance joint ventures (Note 13).

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The portion of the Company s retained earnings balance which represents undistributed retained earnings of equity method investees is approximately $105.4 million as of December 31, 2006.

## 6. Income Taxes

The sources of (loss) income before income taxes and equity in net earnings of affiliates were as follows for the years ended December 31, 2006, 2005 and 2004 (in millions):

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| United States | $ (267.1) | $ (50.4) | $ (18.6) |
| Foreign | 247.9 | 210.5 | 243.0 |
| (Loss) income before income taxes and equity in net earnings of affiliates | $ (19.2) | $ 160.1 | $ 224.4 |

The provision for income taxes by location of the taxing jurisdiction for the years ended December 31, 2006, 2005 and 2004 consisted of the following (in millions):

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Current: | | | |
| United States: | | | |
| Federal | $ (6.1) | $ (5.4) | $ (3.8) |
| State | | (0.1) | |
| Foreign | 69.0 | 48.7 | 75.5 |
| | 62.9 | 43.2 | 71.7 |
| Deferred: | | | |
| United States: | | | |
| Federal | (3.9) | 90.8 | 0.6 |
| State | | | |
| Foreign | 14.5 | 17.1 | 13.9 |
| | 10.6 | 107.9 | 14.5 |
| | $ 73.5 | $ 151.1 | $ 86.2 |

At December 31, 2006, the Company s foreign subsidiaries had approximately $1.4 billion of undistributed earnings. These earnings are considered to be indefinitely invested, and, accordingly, no income taxes have been provided on these earnings. Determination of the amount of unrecognized deferred taxes on these earnings is not practical; however, unrecognized foreign tax credits would be available to reduce a portion of the tax liability.

On October 22, 2004, the United States enacted the American Jobs Creation Act ( AJCA ) of 2004. The AJCA provides multi-national companies an election to deduct from taxable income 85% of eligible dividends repatriated from foreign subsidiaries. The AJCA generally allowed companies to take advantage of this special deduction from November 2004 through the end of calendar year 2005. The Company did not propose a qualifying plan of repatriation for 2005 or 2004.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

A reconciliation of income taxes computed at the United States federal statutory income tax rate (35%) to the provision for income taxes reflected in the Consolidated Statements of Operations for the years ended December 31, 2006, 2005 and 2004 is as follows (in millions):

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| (Benefit) provision for income taxes at United States federal statutory rate of 35% | $ (6.7) | $ 56.0 | $ 78.5 |
| State and local income taxes, net of federal income tax benefit | (3.8) | (0.6) | (0.6) |
| Taxes on foreign income which differ from the United States statutory rate | 14.8 | (4.8) | 2.8 |
| Tax effect of permanent differences | 32.4 | (10.2) | 7.5 |
| Change in valuation allowance | 36.7 | 110.8 | (3.1) |
| Other | 0.1 | (0.1) | 1.1 |
| | $ 73.5 | $ 151.1 | $ 86.2 |

The significant components of the deferred tax assets and liabilities at December 31, 2006 and 2005 were as follows (in millions):

| | 2006 | 2005 |
|---|---|---|
| Deferred Tax Assets: | | |
| Net operating loss carryforwards | $ 246.6 | $ 192.9 |
| Sales incentive discounts | 43.0 | 42.5 |
| Inventory valuation reserves | 19.6 | 23.2 |
| Pensions and postretirement health care benefits | 81.6 | 77.1 |
| Warranty and provisions | 41.7 | 61.6 |
| Other | 40.0 | 32.5 |
| Total gross deferred tax assets | 472.5 | 429.8 |
| Valuation allowance | (291.4) | (252.8) |
| Total net deferred tax assets | 181.1 | 177.0 |
| Deferred Tax Liabilities: | | |
| Tax over book depreciation and amortization | 171.7 | 140.8 |
| Other | 11.4 | 9.3 |
| Total deferred tax liabilities | 183.1 | 150.1 |

| | | |
|---|---|---|
| Net deferred tax (liabilities) assets | $ (2.0) | $ 26.9 |
| | | |
| Amounts recognized in Consolidated Balance Sheets: | | |
| Deferred tax assets current | $ 36.8 | $ 39.7 |
| Deferred tax assets noncurrent | 105.5 | 84.1 |
| Other current liabilities | (29.4) | (8.8) |
| Other noncurrent liabilities | (114.9) | (88.1) |
| | $ (2.0) | $ 26.9 |

The Company has recorded a net deferred tax liability of $2.0 million as of December 31, 2006 and a net deferred tax asset of $26.9 million as of December 31, 2005. As reflected in the preceding table, the Company

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

established a valuation allowance of $291.4 million and $252.8 million as of December 31, 2006 and 2005, respectively.

The change in the valuation allowance for the years ended December 31, 2006, 2005 and 2004 was an increase of $38.6 million, $109.9 million, and $1.2 million, respectively. During the fourth quarter of 2005, the Company recognized a non-cash deferred income tax charge of $90.8 million related to increasing the valuation allowance against its United States deferred tax assets. SFAS No. 109 requires the establishment of a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. In accordance with SFAS No. 109, the Company assessed the likelihood that its deferred tax assets would be recovered from estimated future taxable income and available tax planning strategies and determined that the adjustment to the valuation allowance at December 31, 2006, 2005 and 2004 was appropriate. In making this assessment, all available evidence was considered including the current economic climate, as well as reasonable tax planning strategies. The Company believes it is more likely than not that the Company will realize the remaining deferred tax assets, net of the valuation allowance, in future years.

The Company had net operating loss carryforwards of $693.4 million as of December 31, 2006, with expiration dates as follows: 2011 $8.0 million, and thereafter or unlimited $685.4 million. These net operating loss carryforwards include United States net loss carryforwards of $396.0 million and foreign net operating loss carryforwards of $297.4 million. The Company paid income taxes of $43.6 million, $55.9 million, and $83.4 million for the years ended December 31, 2006, 2005 and 2004, respectively.

## 7. Long-Term Debt

Long-term debt consisted of the following at December 31, 2006 and 2005 (in millions):

| | 2006 | 2005 |
|---|---|---|
| Credit facility | $ 111.4 | $ 401.5 |
| 13/4% Convertible senior subordinated notes due 2033 | 201.3 | 201.3 |
| 11/4% Convertible senior subordinated notes due 2036 | 201.3 | |
| 67/8% Senior subordinated notes due 2014 | 264.0 | 237.0 |
| Other long-term debt | 7.0 | 8.3 |
| | 785.0 | 848.1 |
| Less: Current portion of long-term debt | (6.3) | (6.3) |
| 13/4% Convertible senior subordinated notes due 2033 | (201.3) | |
| Total long-term debt, less current portion | $ 577.4 | $ 841.8 |

On December 4, 2006, the Company issued $201.3 million of 11/4% convertible senior subordinated notes due December 15, 2036 and received proceeds of approximately $196.4 million, after related fees and expenses. The notes are unsecured obligations and are convertible into cash and shares of the Company s common stock upon satisfaction of certain conditions, as discussed below. The notes provide for (i) the settlement upon conversion in cash up to the principal amount of the notes with any excess conversion value settled in shares of the Company s common stock, and (ii) the conversion rate to be increased under certain circumstances if the notes are converted in connection with certain change of control transactions occurring prior to December 15, 2013. Pursuant to EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock, ( EITF 00-19 ), the embedded conversion feature has been classified as equity. Interest is payable on the notes at 11/4% per annum, payable semi-annually in arrears in cash on June 15 and December 15 of each year, beginning on June 15, 2007. The notes are convertible into shares of the Company s common stock at an effective price of $40.73 per share, subject to adjustment. Holders may convert the notes only under the following circumstances: (1) during any fiscal quarter, if the closing sales price of the Company s common stock exceeds 120% of the conversion price for at

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

least 20 trading days in the 30 consecutive trading days ending on the last trading day of the preceding fiscal quarter; (2) during the five business day period after a five consecutive trading day period in which the trading price per note for each day of that period was less than 98% of the product of the closing sale price of the Company s common stock and the conversion rate; (3) if the notes have been called for redemption; or (4) upon the occurrence of certain corporate transactions. Beginning December 15, 2013, the Company may redeem any of the notes at a redemption price of 100% of their principal amount, plus accrued interest. Holders of the notes may require the Company to repurchase the notes at a repurchase price of 100% of their principal amount, plus accrued interest, on December 15, 2013, 2016, 2021, 2026 and 2031. Holders may also require the Company to repurchase all or a portion of the notes upon a fundamental change, as defined in the indenture, at a repurchase price equal to 100% of the principal amount of the notes to be repurchased, plus any accrued and unpaid interest. The notes are senior subordinated obligations and are subordinated to all of the Company s existing and future senior indebtedness and effectively subordinated to all debt and other liabilities of the Company s subsidiaries. The notes are equal in right of payment with the Company s 67/8% senior subordinated notes due 2014 and its 13/4% convertible senior subordinated notes due 2033.

The Company used the net proceeds received from the issuance of the 11/4% convertible senior subordinated notes, as well as available cash, to repay $196.9 million of its outstanding United States dollar denominated term loan and 79.1 million of its outstanding Euro denominated term loan. In addition, the Company recorded interest expense of approximately $2.0 million for the proportionate write-off of deferred debt issuance costs associated with the term loan balances that were repaid. The Company s United States dollar denominated and Euro denominated term loans are discussed further below.

The Company s credit facility provides for a $300.0 million multi-currency revolving credit facility, a $300.0 million United States dollar denominated term loan and a 120.0 million Euro denominated term loan. The maturity date of the revolving credit facility is December 2008 and the maturity date for the term loan facility is June 2009. The Company is required to make quarterly payments towards the United States dollar denominated term loan and Euro denominated term loan of $0.75 million and 0.3 million, respectively (or an amortization of one percent per annum until the maturity date of each term loan). The revolving credit and term loan facilities are secured by a majority of the Company s United States, Canadian, Finnish and U.K. based assets and a pledge of a portion of the stock of its domestic and material foreign subsidiaries. Interest accrues on amounts outstanding under the revolving credit facility, at the Company s option, at either (1) LIBOR plus a margin ranging between 1.25% and 2.0% based upon the Company s senior debt ratio or (2) the higher of the administrative agent s base lending rate or one-half of one percent over the federal funds rate plus a margin ranging between 0.0% and 0.75% based on the Company s senior debt ratio. Interest accrues on amounts outstanding under the term loans at LIBOR plus 1.75%. The credit facility contains covenants restricting, among other things, the incurrence of indebtedness and the making of certain payments, including dividends. The Company also must fulfill financial covenants including, among others, a total debt to EBITDA ratio, a senior debt to EBITDA ratio and a fixed charge coverage ratio, as defined in the facility. As of December 31, 2006, the Company had total borrowings of $111.4 million under the credit facility, which included $73.3 million under the United States dollar denominated term loan facility, 28.9 million (approximately $38.1 million) under the Euro denominated term loan facility and no amounts outstanding under the multi-currency revolving credit facility. As of December 31, 2006, the Company had availability to borrow $292.2 million under the revolving credit facility. As of December 31, 2005, the Company had total borrowings of $401.5 million under the credit facility, which included $272.5 million under the United States dollar denominated term loan facility, 108.9 million (approximately $129.0 million) under the Euro denominated term loan facility and no amounts outstanding under the multi-currency revolving credit facility. As of December 31, 2005, the Company had availability to borrow $292.9 million under the revolving credit facility.

On June 29, 2005, the Company exchanged its $201.3 million of 13/4% convertible senior subordinated notes due 2033 for new notes which provide for (i) the settlement upon conversion in cash up to the principal

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

amount of the converted new notes with any excess conversion value settled in shares of the Company s common stock, and (ii) the conversion rate to be increased under certain circumstances if the new notes are converted in connection with certain change of control transactions occurring prior to December 10, 2010, but otherwise are substantially the same as the old notes. Pursuant to EITF 00-19, the embedded conversion feature has been classified as equity. The notes are unsecured obligations and are convertible into cash and shares of the Company s common stock upon satisfaction of certain conditions, as discussed below. Interest is payable on the notes at 13/4% per annum, payable semi-annually in arrears in cash on June 30 and December 31 of each year. The notes are convertible into shares of the Company s common stock at an effective price of $22.36 per share, subject to adjustment. Holders may convert the notes only under the following circumstances: (1) during any fiscal quarter, if the closing sales price of the Company s common stock exceeds 120% of the conversion price for at least 20 trading days in the 30 consecutive trading days ending on the last trading day of the preceding fiscal quarter; (2) during the five business day period after a five consecutive trading day period in which the trading price per note for each day of that period was less than 98% of the product of the closing sale price of the Company s common stock and the conversion rate; (3) if the notes have been called for redemption; or (4) upon the occurrence of certain corporate transactions. Beginning January 1, 2011, the Company may redeem any of the notes at a redemption price of 100% of their principal amount, plus accrued interest. Holders of the notes may require the Company to repurchase the notes at a repurchase price of 100% of their principal amount, plus accrued interest, on December 31, 2010, 2013, 2018, 2023 and 2028. The impact of the exchange completed in June 2005, as discussed above, will reduce the diluted weighted average shares outstanding in future periods. The reduction in the diluted shares was approximately 9.0 million shares on a prospective basis and will vary in the future based on the Company s stock price, once the market price trigger or other specified conversion circumstances have been met.

As of December 31, 2006, the closing sales price of the Company s common stock had exceeded 120% of the conversion price of $22.36 per share for at least 20 trading days in the 30 consecutive trading days ending December 31, 2006, and, therefore, the Company classified the 13/4% convertible senior subordinated notes as a current liability. Future classification of the notes between current and long-term debt is dependent on the closing sales price of the Company s common stock during future quarters. The Company believes it is unlikely the holders of the notes would convert the notes under the provisions of the indenture agreement, thereby requiring the Company to repay the principal portion in cash. In the event the notes were converted, the Company believes it could repay the notes with available cash on hand, funds from the Company s existing $300.0 million multi-currency revolving credit facility, or a combination of these sources.

On June 23, 2005, the Company completed the redemption of its $250 million 91/2% senior notes due 2008. The Company redeemed the notes at a price of approximately $261.9 million, which included a premium of 4.75% over the face amount of the senior notes. The premium of approximately $11.9 million and the write-off of the remaining balance of deferred debt issuance costs of approximately $2.2 million were recognized in interest expense, net during the second quarter of 2005. The funding source for the redemption was a combination of cash generated from the transfer of North American wholesale interest-bearing receivables to the Company s United States and Canadian retail finance joint ventures, AGCO Finance LLC and AGCO Finance Canada, Ltd., as well as from revolving credit facility borrowings and available cash on hand (Note 4).

On April 23, 2004, the Company sold 200.0 million of 67/8% senior subordinated notes due 2014 and received proceeds of approximately $234.0 million, after offering related fees and expenses. The 67/8% senior subordinated notes are unsecured obligations and are subordinated in right of payment to the Company s existing or future senior indebtedness. Interest is payable on the notes at 67/8% per annum, payable semi-annually on April 15 and October 15 of each year, beginning October 15, 2004. Beginning April 15, 2009, the Company may redeem the notes, in whole or in part, initially at 103.438% of their principal amount, plus accrued interest, declining to 100% of their principal amount, plus accrued interest, at any time on or after April 15, 2012. In addition, before April 15, 2009, the Company may redeem the notes, in whole or in part, at

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

a redemption price equal to 100% of the principal amount, plus accrued interest plus a make-whole premium. Before April 15, 2007, the Company also may redeem up to 35% of the notes at 106.875% of their principal amount using the proceeds from sales of certain kinds of capital stock. The notes include certain covenants restricting the incurrence of indebtedness and the making of certain restrictive payments, including dividends.

At December 31, 2006, the aggregate scheduled maturities of long-term debt, excluding the current portion of long-term debt are as follows (in millions):

| | |
|---|---|
| 2008 | $ 5.4 |
| 2009 | 103.1 |
| 2010 | 0.8 |
| 2011 | 0.9 |
| 2012 | 0.8 |
| Thereafter | 466.4 |
| | $ 577.4 |

Cash payments for interest were $70.5 million, $97.8 million and $95.6 million for the years ended December 31, 2006, 2005 and 2004, respectively.

The Company has arrangements with various banks to issue standby letters of credit or similar instruments, which guarantee the Company s obligations for the purchase or sale of certain inventories and for potential claims exposure for insurance coverage. At December 31, 2006, outstanding letters of credit issued under the revolving credit facility totaled $7.8 million.

**8. Employee Benefit Plans**

The Company has defined benefit pension plans covering certain employees, principally in the United States, the United Kingdom, Germany, Finland, Norway, France, Australia, Argentina and Brazil. The Company also provides certain postretirement health care and life insurance benefits for certain employees principally in the United States.

Effective December 31, 2006, the Company adopted the recognition and disclosure provisions of SFAS No. 158. The key changes under the new Statement are as follows:

*Recognition of funded status in the statement of financial position.* SFAS No. 158 requires an employer that sponsors one or more single-employer defined benefit plans to recognize the overfunded or underfunded status of a benefit plan, measured as the difference between the fair value of plan assets and the benefit obligation (the projected benefit obligation for defined benefit pension plans and the accumulated postretirement benefit obligation for other postretirement plans) in its statement of financial position.

*Recognition of unamortized amounts in Accumulated Other Comprehensive Income.* SFAS No. 158 requires that companies recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to SFAS No. 87, Employers Accounting for Pensions ( SFAS No. 87 ), or SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions ( SFAS No. 106 ). In other words, the change in funded status of the plan in the year in which the change occurs is reflected through a combination of the net annual pension cost (which is a component of net income) and a company s accumulated other comprehensive income or loss (which is a component of stockholder s equity).

*Elimination of use of early measurement date.* SFAS No. 158 requires companies to measure defined benefit plan assets and obligations as of the date of the company s fiscal year-end. The measurement provision

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

of SFAS No. 158 will be effective for years beginning after December 15, 2008. The Company has not yet adopted the measurement provisions of SFAS No. 158 as of December 31, 2006. Upon adoption, this change will only impact the measurement of the Company s U.K. pension plan.

*Additional disclosures.* Last, SFAS No. 158 requires companies to disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. In addition, companies must disclose the current and noncurrent components of the assets and liabilities of its defined benefit pension and other postretirement plans.

Prior to the adoption of the recognition provisions of SFAS No. 158, the Company accounted for its defined benefit pension plans under SFAS No. 87 and its postretirement health care plans under SFAS No. 106, as well as the disclosure provisions under SFAS No. 132(R), Employers Disclosures about Pensions and Other Postretirement Benefits An Amendment of FASB Statements No. 87, 88 and 106 ( SFAS No. 132(R) ). SFAS No. 87 required that a liability (referred to as the additional minimum pension liability) be recorded when the accumulated benefit obligation exceeded the fair value of plan assets. Adjustments were recorded as non-cash charges to the Company s accumulated other comprehensive loss within stockholders equity reflected as additional minimum liability adjustments. SFAS No. 106 required that the liability recorded should represent the actuarial present value of all future benefits attributable to an employee s service rendered to date, with no requirement to reflect an additional minimum liability for the difference between the accumulated benefit obligation and plan assets, if any. Upon adoption of the recognition provisions of SFAS No. 158, the Company recognized the difference between the projected benefit obligation (which includes the impact of future salary increases) and the accumulated benefit obligation related to its defined pension benefit plans, as well as the entire obligation related to its unfunded postretirement health care and life insurance benefit plans in the United States. This resulted in an increase to accumulated other comprehensive loss of approximately $26.8 million, net of taxes, an increase to liabilities of approximately $37.5 million, an increase to other noncurrent assets of approximately $1.6 million and an increase to noncurrent deferred tax assets of approximately $9.1 million.

SFAS No. 158 is effective for periods ending on or after December 15, 2006 and retroactive application is not permitted. Therefore, the disclosures below for the year ended December 31, 2006 reflect the provisions under SFAS No. 158, and the disclosures for the years ended December 31, 2005 and 2004 reflect the requirements under SFAS No. 132(R).

Net annual pension costs for the years ended December 31, 2006, 2005 and 2004 are set forth below (in millions):

| **Pension benefits** | **2006** | **2005** | **2004** |
|---|---|---|---|
| Service cost | $ 5.0 | $ 4.9 | $ 4.8 |
| Interest cost | 40.4 | 38.7 | 37.1 |
| Expected return on plan assets | (38.6) | (33.0) | (31.3) |
| Amortization of net actuarial loss | 19.8 | 16.7 | 16.9 |
| Amortization of prior service (credit) cost | (0.2) | (0.1) | 0.5 |
| Curtailment and other gain | (0.4) | (2.3) | |

| | | | |
|---|---|---|---|
| Special termination benefits | | | (4.1) |
| Net annual pension cost | $ 26.0 | $ 24.9 | $ 23.9 |

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The weighted average assumptions used to determine the net annual pension costs for the Company s pension plans for the years ended December 31, 2006, 2005 and 2004 are as follows:

| **All plans:** | **2006** | **2005** | **2004** |
|---|---|---|---|
| Weighted average discount rate | 5.0% | 5.6% | 5.7% |
| Weighted average expected long-term rate of return on plan assets | 7.1% | 7.1% | 7.1% |
| Rate of increase in future compensation | 3.0-4.0% | 3.0-4.0% | 3.0-4.0% |
| **U.S. based plans:** | | | |
| Weighted average discount rate | 5.5% | 5.75% | 6.25% |
| Weighted average expected long-term rate of return on plan assets | 8.0% | 8.0% | 8.0% |
| Rate of increase in future compensation | N/A | N/A | N/A |

Net annual postretirement costs for the years ended December 31, 2006, 2005 and 2004 are set forth below (in millions, except percentages):

| **Postretirement benefits** | **2006** | **2005** | **2004** |
|---|---|---|---|
| Service cost | $ 0.2 | $ 0.7 | $ 0.7 |
| Interest cost | 1.7 | 2.2 | 2.6 |
| Amortization of prior service cost | (0.1) | 0.2 | (0.6) |
| Amortization of unrecognized net loss | 0.6 | 1.1 | 1.2 |
| Other | | | 1.9 |
| Curtailment gain | | (1.9) | |
| Net annual postretirement cost | $ 2.4 | $ 2.3 | $ 5.8 |
| Weighted average discount rate | 5.5% | 5.75% | 6.25% |

The following tables set forth reconciliations of the changes in benefit obligation, plan assets and funded status as of December 31, 2006 and 2005 (in millions):

| | **Pension Benefits** | | **Postretirement Benefits** | |
|---|---|---|---|---|
| **Change in benefit obligation** | **2006** | **2005** | **2006** | **2005** |
| Benefit obligation at beginning of year | $ 776.3 | $ 751.2 | $ 33.2 | $ 45.1 |
| Service cost | 5.0 | 4.9 | 0.2 | 0.7 |
| Interest cost | 40.4 | 38.7 | 1.7 | 2.2 |
| Plan participants contributions | 1.4 | 0.8 | | |

| | | | | |
|---|---|---|---|---|
| Actuarial (gain) loss | (17.9) | 101.4 | (5.8) | (4.4) |
| Divestiture of business | (1.1) | | | |
| Amendments | | (0.5) | | (2.3) |
| Curtailment gain | | (0.7) | | (4.7) |
| Benefits paid | (41.9) | (42.1) | (2.6) | (3.4) |
| Foreign currency exchange rate changes | 96.7 | (77.4) | | |
| Benefit obligation at end of year | $ 858.9 | $ 776.3 | $ 26.7 | $ 33.2 |

**AGCO CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

| **Change in plan assets** | **Pension Benefits 2006** | **Pension Benefits 2005** | **Postretirement Benefits 2006** | **Postretirement Benefits 2005** |
|---|---|---|---|---|
| Fair value of plan assets at beginning of year | $ 527.9 | $ 499.7 | $ | $ |
| Actual return on plan assets | 40.3 | 85.6 | | |
| Employer contributions | 26.6 | 27.3 | 2.6 | 3.4 |
| Plan participants contributions | 1.4 | 0.8 | | |
| Benefits paid | (41.9) | (37.0) | (2.6) | (3.4) |
| Other | | 1.7 | | |
| Divestiture of business | (0.8) | | | |
| Foreign currency exchange rate changes | 66.8 | (50.2) | | |
| Fair value of plan assets at end of year | $ 620.3 | $ 527.9 | $ | $ |
| Funded status | $ (238.6) | $ (248.4) | $ (26.7) | $ (33.2) |
| Unrecognized net actuarial loss | 241.4 | 251.3 | 3.7 | 10.1 |
| Unrecognized prior service credit | (3.0) | (2.9) | (0.4) | (0.5) |
| Accumulated other comprehensive loss | (238.4) | (216.4) | (3.3) | N/A |
| Net amount recognized | $ (238.6) | $ (216.4) | $ (26.7) | $ (23.6) |
| Amounts recognized in Consolidated Balance Sheets: | | | | |
| Other long-term asset | $ 1.6 | N/A | $ | N/A |
| Other current liabilities | (6.6) | N/A | (2.1) | N/A |
| Pensions and postretirement health care benefits (noncurrent) | (233.6) | (216.4) | (24.6) | (23.6) |
| Net amount recognized | $ (238.6) | $ (216.4) | $ (26.7) | $ (23.6) |

Accrued pension costs of approximately $5.1 million and $4.4 million have been classified as current liabilities within Accrued expenses in the Company s Consolidated Balance Sheets as of December 31, 2006 and 2005, respectively, related to the Company s phased retirement plan obligations in Germany.

As of December 31, 2006, the Company s accumulated other comprehensive loss included a net actuarial loss of approximately $241.4 million and a net prior service credit of approximately $3.0 million related to the Company s defined benefit pension plans. The estimated net actuarial loss and net prior service credit for defined benefit pension plans that will be amortized from the Company s accumulated other comprehensive loss during the year ended December 31, 2007 are approximately $15.0 million and $0.2 million, respectively.

As of December 31, 2006, the Company s accumulated other comprehensive loss included a net actuarial loss of approximately $3.7 million and a net prior service credit of approximately $0.4 million related to the Company s U.S. postretirement health care benefit plans. The estimated net actuarial loss and net prior service credit for postretirement health care benefit plans that will be amortized from the Company s accumulated other comprehensive loss during the year ended December 31, 2007 are approximately $0.1 million and $0.1 million, respectively.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The weighted average assumptions used to determine the benefit obligation for the Company s pension plans as of December 31, 2006 and 2005 are as follows:

| **All plans:** | **2006** | **2005** |
|---|---|---|
| Weighted average discount rate | 5.1% | 5.0% |
| Weighted average expected long-term rate of return on plan assets | 7.1% | 7.1% |
| Rate of increase in future compensation | 3.0-4.0% | 3.0-4.0% |
| **U.S. based plans:** | | |
| Weighted average discount rate | 5.8% | 5.5% |
| Weighted average expected long-term rate of return on plan assets | 8.0% | 8.0% |
| Rate of increase in future compensation | N/A | N/A |

The aggregate projected benefit obligation, accumulated benefit obligation and fair value of plan assets for pension and other postretirement plans with accumulated benefit obligations in excess of plan assets were $881.4 million, $817.8 million and $609.3 million, respectively, as of December 31, 2006 and $770.0 million, $732.3 million and $515.8 million, respectively, as of December 31, 2005. The projected benefit obligation, accumulated benefit obligation and fair value of plan assets for the Company s U.S. based pension plans were $49.7 million, $49.7 million and $43.7 million, respectively, as of December 31, 2006, and $52.1 million, $52.1 million and $41.7 million, respectively, as of December 31, 2005. In accordance with SFAS No. 158, at December 31, 2006, the Company s accumulated comprehensive loss reflects a reduction to equity of $241.7 million, net of taxes of $74.1 million, primarily related to the Company s U.K. and U.S. pension plans where the projected benefit obligation exceeded the plan assets. In accordance with SFAS No. 87, at December 31, 2005, the Company s accumulated comprehensive loss reflects a reduction to equity of $216.4 million, net of taxes of $66.3 million, related to the recording of a minimum pension liability primarily related to the Company s U.K. pension plan where the accumulated benefit obligation exceeded plan assets.

The Company utilizes a September 30 measurement date to determine the pension benefit measurements for the Company s U.K. pension plan. The Company utilizes a December 31 measurement date to determine the pension and postretirement benefit measurements for the Company s plans in the United States and the rest of the world.

For the year ended December 31, 2006, the Company based the discount rate used to determine the projected benefit obligation for its U.S. pension plans, postretirement health care benefit plans and Executive Nonqualified Pension Plan ( ENPP ) by matching the projected cash flows of its plans to the Citibank pension discount curve. Prior to December 31, 2006, the Company based the discount rate used to determine the projected benefit obligation for its U.S. pension plans on the Moody s Investor Service Aa bond yield as of December 31 of each year. For its non-U.S. plans, the Company bases the discount rate on comparable indices within each of those countries, such as the 15-year iBoxx AA corporate bond yield in the United Kingdom. The indices used in the United States, the United Kingdom and other countries were chosen to match the expected plan obligations and related expected cash flows.

The weighted average asset allocation of the Company s U.S. pension benefit plans at December 31, 2006 and 2005 are as follows:

| **Asset Category** | **2006** | **2005** |
|---|---|---|
| Large cap domestic equity securities | 43% | 47% |
| International equity securities | 15% | 12% |
| Domestic fixed income securities | 19% | 28% |
| Other investments | 23% | 13% |
| Total | 100% | 100% |

**AGCO CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The weighted average asset allocation of the Company s non- U.S. pension benefit plans at December 31, 2006 and 2005 are as follows:

| Asset Category | 2006 | 2005 |
|---|---|---|
| Equity securities | 49% | 51% |
| Fixed income securities | 31% | 38% |
| Other investments | 20% | 11% |
| Total | 100% | 100% |

All tax-qualified pension fund investments in the United States are held in the AGCO Corporation Master Pension Trust. The Company s global pension fund strategy is to diversify investments across broad categories of equity and fixed income securities with appropriate use of alternative investment categories to minimize risk and volatility. The Company s U.S. target allocation of retirement fund investments is 50% large cap domestic equity securities, 10% international equity securities, 20% domestic fixed income securities, and 20% invested in other investments. The Company has noted that over very long periods, this mix of investments would achieve an average return in excess of 9%. In arriving at the choice of an expected return assumption of 8% for its U.S. based plans, the Company has tempered this historical indicator with lower expectations for returns on equity investments in the future, as well as considered administrative costs of the plans. To date, the Company has not invested pension funds in its own stock, and has no intention of doing so in the future. The Company s non-U.S. target allocation of retirement fund investments is 50% equity securities, 30% fixed income securities and 20% percent invested in other investments. The majority of the Company s non-U.S. pension fund investments are related to the Company s pension plan in the United Kingdom. The Company has noted that over very long periods, this target mix of investments would achieve an average return in excess of 7.5%. In arriving at the choice of an expected return assumption of 7% for its U.K.-based pension plan, the Company has tempered this historical indicator with a slightly lower expectation of future returns on equity investments, as well as plan expenses.

The weighted average discount rate used to determine the benefit obligation for the Company s postretirement benefit plans for the years ended December 31, 2006 and 2005 was 5.8% and 5.5%, respectively.

For measuring the expected postretirement benefit obligation at December 31, 2006, a 9% health care cost trend rate was assumed for 2007, decreasing 1.0% per year to 5.0% and remaining at that level thereafter. For measuring the expected postretirement benefit obligation at December 31, 2005, a 9% health care cost trend rate was assumed for 2006, decreasing 1.0% per year to 5.0% and remaining at that level thereafter. Changing the assumed health care cost trend rates by one percentage point each year and holding all other assumptions constant would have the following effect to service and interest cost for 2007 and the accumulated postretirement benefit obligation at December 31, 2006 (in millions):

| | One Percentage Point Increase | One Percentage Point Decrease |
|---|---|---|

| | | | | |
|---|---|---|---|---|
| Effect on service and interest cost | $ | | $ | |
| Effect on accumulated benefit obligation | $ | 2.7 | $ | (2.3) |

In December 2003, the United States Congress enacted the Medicare Prescription Drug, Improvement and Modernization Act of 2003 that provides a prescription drug subsidy, beginning in 2006, to companies that sponsor postretirement health care plans that provide drug benefits. Based upon the final regulations released in January 2005, during the third quarter of 2005, the Company reviewed the provisions of its postretirement health care plans with its actuaries to determine whether the benefits offered by its plans met the statutory definition of actuarially equivalent prescription drug benefits that qualify for the federal subsidy. Based upon this review, the Company believes that two of its plans qualify for the subsidy. In accordance with FSP

**AGCO CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

No. 106-2, Accounting and Disclosure Requirements Related to the Medicare Prescription, Drug, Improvement and Modernization Act of 2003, the Company began reflecting the impact of the anticipated subsidies as of July 1, 2005 on a prospective basis, and revalued its projected benefit obligation as of July 1, 2005.

During 2005, the Company recognized a curtailment of two of its postretirement health care plans, resulting in a $1.9 million decrease to its net postretirement cost.

The Company currently estimates its minimum contributions and benefit payments for 2007 to its U.S. based defined pension plans and postretirement health care and life insurance benefit plans will aggregate approximately $1.9 million and $2.2 million, respectively. The Company currently estimates its minimum contributions for underfunded plans and benefit payments for unfunded plans for 2007 to its non-U.S.-based defined pension plans will aggregate approximately $26.2 million, of which approximately $21.1 million relates to its U.K. pension plan.

During 2006, approximately $41.9 million of benefit payments were made related to the Company s pension plans. At December 31, 2006, the aggregate expected benefit payments for all of the Company s pension plans are as follows (in millions):

| | |
|---|---|
| 2007 | $ 42.1 |
| 2008 | 43.0 |
| 2009 | 43.8 |
| 2010 | 44.4 |
| 2011 | 44.8 |
| 2012 through 2016 | 242.5 |
| | $ 460.6 |

During 2006, approximately $2.6 million of benefit payments were made related to the Company s U.S. postretirement benefit plans. At December 31, 2006, the aggregate expected benefit payments for the Company s U.S. postretirement benefit plans are as follows (in millions):

| | |
|---|---|
| 2007 | $ 2.2 |
| 2008 | 1.8 |
| 2009 | 1.7 |
| 2010 | 1.6 |
| 2011 | 1.5 |
| 2012 through 2016 | 9.1 |
| | $ 17.9 |

The Company s Supplemental Executive Retirement Plan ( SERP ) is an unfunded plan that provides Company executives with retirement income for a period of ten years based on a percentage of their final base salary, reduced by the executive s social security benefits and 401(k) employer matching contributions account. Prior to January 1, 2007, the benefit paid to the executive was equal to 3% of the final base salary times credited years of service, with a maximum benefit of 60% of the final base salary. Benefits under the SERP vested at age 65 or, at the discretion of the Company s Board of Directors, at age 62 reduced by a factor to recognize early commencement of the benefit payments.

On November 3, 2006, the Company entered into an Executive Nonqualified Pension Plan, effective January 1, 2007 (the 2007 ENPP ), which is intended to amend and restate the Company s existing SERP plan to provide senior Company executives with an appropriate retirement benefit. The 2007 ENPP provides a group of senior Company executives with retirement income for a period of 15 years based on a percentage of

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

their average final salary and bonus, reduced by the executive s social security benefits and 401(k) employer matching contributions account. The benefit paid to the executives ranges from 2.25% to 3% of the average of the last three years of their base salary plus bonus prior to their termination of employment ( final earnings ) times credited years of service, with a maximum benefit of 45% to 60% of the final earnings, depending on the level of the executive. Benefits under the 2007 ENPP vest if the participant has attained age 50 with at least ten years of service (five years of which include years of participation in the 2007 ENPP), but are not payable until the participant reaches age 65 or upon termination of services because of death or disability, adjusted to reflect payment prior to age 65.

Net annual ENPP and SERP cost and the measurement assumptions for the plans for the years ended December 31, 2006, 2005 and 2004 are set forth below (in millions):

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Service cost | $ 0.9 | $ 0.6 | $ 0.6 |
| Interest cost | 0.5 | 0.4 | 0.4 |
| Amortization of prior service cost | 0.4 | 0.3 | 0.3 |
| Recognized actuarial gain | | | (0.1) |
| Net annual ENPP/SERP costs | $ 1.8 | $ 1.3 | $ 1.2 |
| Discount rate | 5.5% | 5.75% | 6.25% |
| Rate of increase in future compensation | 5.0% | 5.0% | 5.0% |

The following tables set forth reconciliations of the changes in benefit obligation and funded status as of December 31, 2006 and 2005 (in millions):

| **Change in benefit obligation** | **2006** | **2005** |
|---|---|---|
| Benefit obligation at beginning of year | $ 8.1 | $ 7.4 |
| Service cost | 0.9 | 0.6 |
| Interest cost | 0.5 | 0.4 |
| Actuarial (gain) loss | (1.4) | 0.1 |
| Amendments | 2.6 | |
| Benefits paid | (0.4) | (0.4) |
| Benefit obligation at end of year | $ 10.3 | $ 8.1 |
| Funded status | $ (10.3) | $ (8.1) |
| Unrecognized net actuarial gain | (1.8) | (0.3) |
| Unrecognized prior service cost | 4.5 | 2.3 |
| Accumulated other comprehensive loss | (2.7) | N/A |

| | | |
|---|---|---|
| Net amount recognized | $ (10.3) | $ (6.1) |
| | | |
| Amounts recognized in Consolidated Balance Sheets: | | |
| Other current liabilities | $ (0.4) | N/A |
| Pensions and postretirement health care benefits (noncurrent) | (9.9) | $ (6.1) |
| | | |
| Net amount recognized | $ (10.3) | $ (6.1) |

The weighted average discount rate used to determine the benefit obligation for the Company s 2007 ENPP and SERP plans for the years ended December 31, 2006 and 2005 was 5.8% and 5.5%, respectively.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

At December 31, 2006, the Company s accumulated other comprehensive loss included a net actuarial gain of approximately $1.8 million and a net prior service cost of approximately $4.5 million related to the Company s ENPP plan. The estimated net actuarial gain and net prior service cost related to the ENPP that will be amortized from the Company s accumulated other comprehensive loss during the year ended December 31, 2007 are approximately $0.1 million and $0.5 million, respectively.

In accordance with SFAS No. 158, at December 31, 2006, the Company recorded a reduction to equity of $2.7 million, related to the unfunded projected benefit obligation of the Company s ENPP. As the Company is not benefiting losses for tax purposes in the United States, there was no tax impact to this charge.

During 2006, approximately $0.4 million of benefit payments were made related to the Company s ENPP plan. At December 31, 2006, the aggregate expected benefit payments for the Company s ENPP plan are as follows (in millions):

| | |
|---|---|
| 2007 | $ 0.4 |
| 2008 | 0.5 |
| 2009 | 0.5 |
| 2010 | 0.7 |
| 2011 | 0.8 |
| 2012 through 2016 | 5.4 |
| | $ 8.3 |

The Company maintains separate defined contribution plans covering certain employees primarily in the United States, the United Kingdom and Brazil. Under the plans, the Company contributes a specified percentage of each eligible employee s compensation. The Company contributed approximately $8.5 million, $8.3 million and $7.5 million for the years ended December 31, 2006, 2005 and 2004, respectively.

**9. Common Stock**

At December 31, 2006, the Company had 150.0 million authorized shares of common stock with a par value of $0.01 per share, with approximately 91.2 million shares of common stock outstanding, approximately 1.9 million shares reserved for issuance under the Company s 2001 Stock Option Plan (Note 10), and approximately 3.5 million shares reserved for issuance under the 2006 Long Term Incentive Plan (the 2006 Plan ) (Note 10).

On April 7, 2004, the Company sold 14,720,000 shares of its common stock in an underwritten public offering, and received net proceeds of approximately $300.1 million. The Company used the net proceeds to repay a $100.0 million interim bridge loan facility, to repay borrowings under its credit facility and to pay offering related fees and expenses.

The Company has a stockholder rights plan, which was adopted in April 1994 following stockholder approval. The plan provides that each share of common stock outstanding will have attached to it the right to purchase a one-hundredth of a share of Junior Cumulative Preferred Stock, with a par value $0.01 per share. The purchase price per a one-hundredth of a share is $100.00, subject to adjustment. The rights will be exercisable only if a person or group ( acquirer ) acquires 20% or more of the Company s common stock or announces a tender offer or exchange offer that would result in the acquisition of 20% or more of the Company s common stock or, in some circumstances, if additional conditions are met. Once they are exercisable, the plan allows stockholders, other than the acquirer, to purchase the Company s common stock or securities of the acquirer with a then current market value of two times the exercise price of the right. The rights are redeemable for $0.01 per right, subject to adjustment, at the option of the Company s board of

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

directors. The rights will expire on April 26, 2014, unless they are extended, redeemed or exchanged by the Company before that date.

**10. Stock Incentive Plans**

At the Company s April 2006 annual stockholders meeting, the Company obtained stockholder approval for the 2006 Plan under which up to 5,000,000 shares of common stock may be issued. The 2006 Plan allows the Company, under the direction of the Board of Director s Compensation Committee, to make grants of performance shares, stock appreciation rights, stock options and stock awards to employees, officers and non-employee directors of the Company. The Company s Board of Directors approved the grants of awards during 2006 effective under the employee and director stock incentive plans described below.

***Employee Plans***

The Company s Board of Directors approved two new stock incentive plans to Company executives and key managers. The primary long-term incentive plan is a performance share plan that provides for awards of shares of common stock based on achieving financial targets, such as targets for earnings per share and return on invested capital, as determined by the Company s Board of Directors. The stock awards are earned over a performance period, and the number of shares earned is determined based on the cumulative or average results for the period, depending on the measurement. Performance periods are consecutive and overlapping three-year cycles and performance targets are set at the beginning of each cycle. In order to transition to the new performance share plan, the Company established award targets in 2006 for both a one-year and two-year performance period in addition to the normal three-year period. The plan provides for participants to earn from 33% to 200% of the target awards depending on the actual performance achieved with no shares earned if performance is below the established minimum target. Awards earned under the performance share plan will be paid in shares of common stock at the end of each performance period. Participants may elect to forfeit a portion of the earned award in order to fully satisfy federal, state and employment taxes which are payable at the time the shares are earned. The Company recorded stock compensation expense of approximately $1.4 million associated with these awards during 2006. Compensation expense recorded was based on the price of the Company s common stock on April 27, 2006 (the date of the Company s annual stockholder meeting) with respect to the initial grants under the plan, and based upon the stock price as of the grant date for subsequent grants made during the third quarter of 2006. The compensation expense associated with these awards is being amortized ratably over the vesting or performance period based on the Company s projected assessment of the level of performance that will be achieved and earned. No compensation expense was recorded associated with the Company s one-year performance period transition plan, as no shares were earned. The weighted average grant-date fair value of performance awards granted under the 2006 Plan during the year ended December 31, 2006 was $23.86. Performance award transactions during the year ended December 31, 2006 were as follows and are presented as if the Company were to achieve its target levels of performance under the plan:

| | |
|---|---|
| Shares awarded | 742,000 |
| Shares forfeited or unearned | (99,917) |
| Shares earned | |
| Shares awarded but not earned at December 31 | 642,083 |

In addition to the performance share plan, certain executives and key managers will be eligible to receive grants of SSARs or incentive stock options depending on the participant s country of employment. The SSARs provide a participant with the right to receive the aggregate appreciation in stock price over the market price of the Company s common stock at the date of grant, payable in shares of the Company s common stock. The participant may exercise his or her SSAR at any time after the grant is vested but no later than seven years

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

after the date of grant. The SSARs vest ratably over a four-year period from the date of grant. SSAR award grants made to certain executives and key managers under the 2006 Plan were made with the base price equal to the price of the Company s common stock on the date of grant. The Company recorded stock compensation expense of approximately $0.3 million associated with SSAR award grants during 2006. The compensation expense associated with these awards is being amortized ratably over the vesting period. There are no awards currently exercisable as of December 31, 2006. The Company estimated the fair value of the grants using the Black-Scholes option pricing model. The weighted average grant-date fair value of SSARs granted under the 2006 Plan and the weighted average assumptions under the Black-Sholes option model were as follows for the year ended December 31, 2006:

| | Year Ended December 31, 2006 |
|---|---|
| SSARs | $ 8.78 |
| Weighted average assumptions under Black-Scholes option model: | |
| Expected life of awards (years) | 5.5 |
| Risk-free interest rate | 5.0% |
| Expected volatility | 41.5% |
| Expected dividend yield | |

SSAR transactions during the year ended December 31, 2006 were as follows:

| | |
|---|---|
| SSARs granted | 229,250 |
| SSARs exercised | |
| SSARs canceled or forfeited | (7,500) |
| SSARs outstanding at December 31 | 221,750 |
| SSAR price ranges per share: | |
| Granted | $ 23.80-26.00 |
| Exercised | |
| Canceled or forfeited | $ 23.80 |
| Weighted average SSAR exercise prices per share: | |
| Granted | $ 23.89 |
| Exercised | |
| Canceled or forfeited | 23.80 |
| Outstanding at December 31 | 23.89 |

At December 31, 2006, the weighted average remaining contractual life of SSARs outstanding was approximately six years.

As of December 31, 2006, the total compensation cost related to unvested SSARs not yet recognized was approximately $1.7 million and the weighted-average period over which it is expected to be recognized is approximately three years. As of December 31, 2006, the total compensation cost related to unearned performance awards not yet recognized, assuming minimum thresholds of performance are achieved, was approximately $3.7 million, and the weighted-average period over which it is expected to be recognized is approximately two years.

On February 15, 2007, the Company granted 515,000 performance award shares (if the Company were to achieve the target levels of performance) and 224,500 SSARs under the 2006 Plan.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Director Restricted Stock Grants***

The Company s Board of Directors approved a plan to provide $25,000 in annual restricted stock grants to all non-employee directors effective on the first day of each calendar year. The shares are restricted as to transferability for a period of three years, but are not subject to forfeiture. In the event a director departs from the Company s Board of Directors, the non-transferability period would expire immediately. The plan allows for the director to have the option of forfeiting a portion of the shares awarded in lieu of a cash payment contributed to the participant s tax withholding to satisfy the participant s statutory minimum federal, state, and employment taxes which would be payable at the time of grant. The January 1, 2006 grant equated to 11,550 shares of common stock, of which 8,832 shares of common stock were issued, after shares were withheld for withholding taxes. The Company recorded stock compensation expense of approximately $0.3 million during 2006 associated with these grants.

As of December 31, 2006, of the 5,000,000 shares reserved for issuance under the 2006 Plan, 3,485,251 shares were available for grant, assuming the maximum number of shares are earned related to the performance award grants discussed above.

On January 1, 2007, the Company granted 8,080 shares of common stock under the 2006 Plan, of which 6,346 shares of common stock were issued, after shares were withheld for withholding taxes.

***Former Non-employee Director Stock Incentive Plan and Long-Term Incentive Plan***

In December 2005, the Company s Board of Directors elected to terminate the Company s LTIP and Director Plan, and the outstanding awards under those plans were cancelled. The decision to terminate the plans and related cancellations was made primarily to avoid recognizing compensation cost in the Company s future financial statements upon adoption of SFAS No. 123R for these awards and to establish a new long-term incentive program. The new accounting provisions of SFAS No. 123R do not allow for the reversal of previously recognized compensation expense if market-based performance awards, such as stock price targets, are not met. The new long-term incentive program has performance-based targets. As of December 31, 2005, 75,000 awarded but unearned shares under the Director Plan were cancelled. The remaining 15,000 awarded but unearned shares under the Director Plan were cancelled during January 2006. As of December 31, 2005, 857,000 awarded but unearned shares under the LTIP were cancelled. The remaining 135,000 shares were cancelled in January 2006. Awards cancelled prior to December 31, 2005 did not result in any compensation expense under the provisions of APB No. 25. However, awards cancelled after January 1, 2006 are subject to the provisions of SFAS No. 123R, and, therefore, the Company recorded approximately $1.3 million of stock compensation expense during the first quarter of 2006 associated with those cancellations.

***Former Non-employee Director Stock Incentive Plan***

The Company s former Director Plan provided for restricted stock awards to non-employee directors based on increases in the price of the Company s common stock. The awarded shares were earned in specified increments for each 15% increase in the average market value of the Company s common stock over the initial base price established under the plan. When an increment of the awarded shares was earned, the shares were issued to the participant in the form of restricted stock which vested at the earlier of 12 months after the specified performance period or upon departure from the Company s Board of Directors. When the restricted shares were earned, a cash bonus equal to 40%

of the value of the shares on the date the restricted stock award was earned was paid by the Company to satisfy a portion of the estimated income tax liability to be incurred by the participant. In addition, as of December 31, 2006, there were 8,999 shares that had been earned but were not vested under the Director Plan.

**AGCO CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Former Long-Term Incentive Plan***

The Company s former LTIP provided for restricted stock awards to executives based on increases in the price of the Company s common stock. The awarded shares were earned over a five-year performance period in specified increments for each 20% increase in the average market value of the Company s common stock over the established initial base price. For all restricted stock awards prior to 2000, earned shares were issued to the participant in the form of restricted stock which generally carried a five-year vesting period with one-third of each earned award vesting at the end of the third, fourth and fifth year after each award was earned. In 2000, the LTIP was amended to replace the vesting schedule with a non-transferability period for all future grants. Accordingly, for restricted stock awards in 2000 through 2005, earned shares were subject to a non-transferability period, which expired over a five-year period with the transfer restrictions lapsing in one-third increments at the end of the third, fourth and fifth year after each award was earned. During the non-transferability period, participants were restricted from selling, assigning, transferring, pledging or otherwise disposing of any earned shares, but earned shares were not subject to forfeiture. In the event a participant terminated employment with the Company, the non-transferability period was extended by two years. When the earned shares had been vested and were no longer subject to forfeiture, the Company was obligated to pay a cash bonus equal to 40% of the value of the shares on the date the shares were earned in order to satisfy a portion of the estimated income tax liability to be incurred by the participant.

For awards granted in 2000 and thereafter, the Company recorded the entire compensation expense relating to the market value of the earned shares and related cash bonus in the period in which the award was earned. For awards granted prior to 2000, the market value of awards earned was added to common stock and additional paid-in capital and an equal amount was deducted from stockholders equity as unearned compensation. The LTIP unearned compensation and the amount of cash bonus paid when the awarded shares became vested were amortized to expense ratably over the vesting period.

The Company recognized compensation expense associated with the former LTIP and Director Plan of $0.1 million, $0.4 million and $0.5 million for the years ended December 31, 2006, 2005 and 2004, respectively, consisting of compensation expense relating to earned shares, amortization of stock awards for earned shares issued prior to 2000 and the related cash bonuses.

In 2001, the former LTIP was amended to permit a participant to elect to forfeit a portion of an earned award in order to fully satisfy federal, state and employment taxes which were payable at the time the shares and the related cash bonus were earned. The number of shares of common stock equal to the value of the participant s tax liability, net of the cash bonus, were thereby forfeited in lieu of an additional cash payment contributed to the participant s tax withholding. In 2005 and 2004, zero and 1,513 earned shares, respectively, were forfeited in this manner.

For awards granted prior to 2000, the number of shares vested during the years 2006, 2005 and 2004 were 15,000, 15,000 and 4,166, respectively. All awards granted after 2000 vest immediately upon being earned.

***Stock Option Plan***

The Company s Option Plan provides for the granting of nonqualified and incentive stock options to officers, employees, directors and others. The stock option exercise price is determined by the Company s Board of Directors except in the case of an incentive stock option for which the purchase price shall not be less than 100% of the fair market value at the date of grant. Each recipient of stock options is entitled to immediately exercise up to 20% of the options issued to such person, and the remaining 80% of such options vest ratably over a four-year period and expire no later than ten years from the date of grant. There were no grants under the Option Plan during the years ended December 31, 2006, 2005 and 2004. The Company estimated the fair value of grants under the Company s Option Plan using the Black-Scholes option pricing model for disclosure purposes only prior to the adoption of SFAS No. 123R. The fair value of the grants were amortized over the applicable

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

vesting period. As a result of applying the provisions of SFAS No. 123R, the Company recognized $0.2 million of stock compensation expense associated with stock options that vested during 2006.

Stock option transactions during the year ended December 31, 2006 were as follows:

| | | **2006** |
|---|---|---|
| Options outstanding at January 1 | | 1,249,058 |
| Options granted | | |
| Options exercised | | (660,850) |
| Options canceled | | (77,038) |
| Options outstanding at December 31 | | 511,170 |
| Options available for grant at December 31 | | 1,919,837 |
| Option price ranges per share: | | |
| Granted | $ | |
| Exercised | | 10.06-22.31 |
| Canceled | | 22.31-25.50 |
| Weighted average option prices per share: | | |
| Outstanding at January 1 | $ | 18.02 |
| Granted | | |
| Exercised | | 16.39 |
| Canceled | | 25.46 |
| Outstanding at December 31 | | 18.71 |

At December 31, 2006, the outstanding options had a weighted average remaining contractual life of approximately three years and there were 505,170 options currently exercisable with option prices ranging from $8.50 to $31.25 and with a weighted average exercise price of $18.68 and an aggregate intrinsic value of $6.2 million.

The following table sets forth the exercise price range, number of shares, weighted average exercise price, and remaining contractual lives by groups of similar price:

| | **Options Outstanding** | | | **Options Exercisable** | |
|---|---|---|---|---|---|
| **Range of Exercise Prices** | **Number of Shares** | **Weighted Average Remaining Contractual Life (Years)** | **Weighted Average Exercise Price** | **Exercisable as of December 31, 2006** | **Weighted Average Exercise Price** |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| $ 8.50 $11.88 | 141,700 | 3.6 | $ | 10.97 | 141,700 | $ | 10.97 |
| $15.12 $22.31 | 278,500 | 3.7 | $ | 18.70 | 272,500 | $ | 18.65 |
| $23.00 $31.25 | 90,970 | 0.5 | $ | 30.78 | 90,970 | $ | 30.78 |
| | 511,170 | | | | 505,170 | | |

The total intrinsic value of options exercised during the years ended December 31, 2006, 2005 and 2004 was approximately $7.0 million, $0.7 million and $1.6 million, respectively, and the total fair value of shares vested during the same periods was approximately $0.2 million, $1.1 million and $1.8 million, respectively. There were 6,000 stock options that were not vested as of December 31, 2006. Cash proceeds received from stock option exercises during 2006, 2005 and 2004 was approximately $10.8 million, $1.4 million and $3.3 million, respectively. The Company did not realize a tax benefit from the exercise of these options.

**11. Derivative Instruments and Hedging Activities**

The Company applies the provisions of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities as amended by SFAS No. 138, Accounting for Certain Derivative Instruments and

**AGCO CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Certain Hedging Activities An Amendment of FASB Statement No. 133. All derivatives are recognized on the consolidated balance sheets at fair value. On the date the derivative contract is entered into, the Company designates the derivative as either (1) a fair value hedge of a recognized liability, (2) a cash flow hedge of a forecasted transaction, (3) a hedge of a net investment in a foreign operation, or (4) a non-designated derivative instrument. The Company primarily engages in derivatives that are designated as non-designated derivative instruments. Changes in the fair value of non-designated derivative contracts are reported in current earnings.

The Company formally documents all relationships between hedging instruments and hedged items, as well as the risk management objectives and strategy for undertaking various hedge transactions. The Company formally assesses, both at the hedge s inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flow of hedged items. When it is determined that a derivative is no longer highly effective as a hedge, hedge accounting is discontinued on a prospective basis.

***Foreign Currency Risk***

The Company has significant manufacturing operations in the United States, France, Germany, Finland, Brazil and Denmark, and it purchases a portion of its tractors, combines and components from third-party foreign suppliers, primarily in various European countries and in Japan. The Company also sells products in over 140 countries throughout the world. The Company s most significant transactional foreign currency exposures are the Euro, Brazilian real and the Canadian dollar in relation to the United States dollar.

The Company attempts to manage its transactional foreign exchange exposure by hedging foreign currency cash flow forecasts and commitments arising from the settlement of receivables and payables and from future purchases and sales. Where naturally offsetting currency positions do not occur, the Company hedges certain, but not all, of its exposures through the use of foreign currency forward contracts. The Company s hedging policy prohibits foreign currency forward contracts for speculative trading purposes.

The Company uses foreign currency forward contracts to economically hedge receivables and payables on the Company and its subsidiaries balance sheets that are denominated in foreign currencies other than the functional currency. These forward contracts are classified as non-designated derivatives instruments. Gains and losses on such contracts are historically substantially offset by losses and gains on the remeasurement of the underlying asset or liability being hedged. Changes in the fair value of non-designated derivative contracts are reported in current earnings.

During 2006, the Company designated certain foreign currency option contracts as cash flow hedges of expected sales. The effective portion of the fair value gains or losses on these cash flow hedges are recorded in other comprehensive loss and subsequently reclassified into net sales as the sales are recognized. These amounts offset the effect of the changes in foreign exchange rates on the related sale transactions. The amount of the gain recorded in other comprehensive loss that were reclassified to net sales during the year ended December 31, 2006 was approximately $4.0 million on an after-tax basis. These contracts all expired prior to December 31, 2006.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table summarizes the activity in accumulated other comprehensive loss related to the derivatives held by the Company during the year ended December 31, 2006 (in millions). There were no derivatives held by the Company accounted for as hedges during 2005 or 2004:

| | Before-Tax Amount | Income Tax | After-Tax Amount |
|---|---|---|---|
| Accumulated derivative net gains as of December 31, 2005 | $ | $ | $ |
| Net changes in fair value of derivatives | 4.1 | | 4.1 |
| Net gains reclassified from accumulated other comprehensive loss into income | 4.0 | | 4.0 |
| Accumulated derivative net gains as of December 31, 2006 | $ 0.1 | $ | $ 0.1 |

The Company uses foreign currency forward contracts to economically hedge receivables and payables on the Company and its subsidiaries balance sheets that are denominated in foreign currencies other than the functional currency. These forward contracts are classified as non-designated derivatives instruments. For the years ended December 31, 2006, 2005 and 2004, the Company recorded a net gain of approximately $13.4 million and net losses of approximately $0.3 million and $37.6 million, respectively, under the caption of other expense, net. These gains or losses were substantially offset by losses or gains on the remeasurement of the underlying asset or liability being hedged.

***Interest Rate Risk***

The Company may use interest rate swap agreements to manage its exposure to interest rate changes. Currently, the Company has no interest rate swap agreements outstanding.

In addition to the above, the Company recorded a deferred loss of $2.0 million, net of taxes, for the year ended December 31, 2006 and a deferred gain of $2.8 million and $3.8 million, net of taxes, for the years ended December 31, 2005 and 2004, respectively, to other comprehensive income (loss) related to derivatives held by affiliates. The losses and gains are related to interest rate swap contracts in the Company s retail finance joint ventures. These swap contracts have the effect of converting floating rate debt to fixed rates in order to secure the retail finance joint ventures yields against their fixed rate loan portfolios.

The Company s senior management establishes the Company s foreign currency and interest rate risk management policies. These policies are reviewed periodically by the Audit Committee of the Company s Board of Directors. The policy allows for the use of derivative instruments to hedge exposures to movements in foreign currency and interest rates. The Company s policy prohibits the use of derivative instruments for speculative purposes.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

## 12. Commitments and Contingencies

The future payments required under the Company s significant commitments as of December 31, 2006 are as follows (in millions):

| | Payments Due By Period | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2007 | 2008 | 2009 | 2010 | 2011 | Thereafter | Total |
| Interest payments related to long-term debt[1] | $ 27.5 | $ 26.7 | $ 22.3 | $ 18.3 | $ 18.3 | $ 41.1 | $ 154.2 |
| Capital lease obligations | 2.3 | 1.3 | 0.3 | | | | 3.9 |
| Operating lease obligations | 29.7 | 22.4 | 16.4 | 11.7 | 9.5 | 59.8 | 149.5 |
| Unconditional purchase obligations[2] | 64.1 | 34.8 | 15.2 | 4.8 | 4.4 | 5.1 | 128.4 |
| Other short-term and long-term obligations[3] | 32.1 | 23.8 | 23.6 | 23.5 | 23.4 | 160.5 | 286.9 |
| Total contractual cash obligations | $ 155.7 | $ 109.0 | $ 77.8 | $ 58.3 | $ 55.6 | $ 266.5 | $ 722.9 |

(1) Estimated interest payments are calculated assuming current interest rates over minimum maturity periods specified in debt agreements. Debt may be repaid sooner or later than such minimum maturity periods.

(2) Unconditional purchase obligations exclude routine purchase orders entered into in the normal course of business. As a result of the rationalization of the Company s European combine manufacturing operations during 2004, the Company entered into an agreement with a third-party manufacturer to produce certain combine model ranges over a five-year period. The agreement provides that we will purchase a minimum quantity of 200 combines per year, at a cost of approximately 16.2 million per year (or approximately $21.4 million) through May 2009.

(3) Other short-term and long-term obligations include estimates of future minimum contribution requirements under our U.S. and non-U.S. defined benefit pension and postretirement plans. These estimates are based on current legislation in the countries we operate within and are subject to change.

| | Amount of Commitment Expiration Per Period | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2007 | 2008 | 2009 | 2010 | 2011 | Thereafter | Total |
| Guarantees | $ 79.1 | $ 5.2 | $ 3.7 | $ | $ | $ | $ 88.0 |

***Off Balance Sheet Arrangements***

***Guarantees***

At December 31, 2006, the Company was obligated under certain circumstances to purchase through the year 2010 up to $7.2 million of equipment upon expiration of certain operating leases between AGCO Finance LLC and AGCO Finance Canada Ltd., the Company s retail finance joint ventures in North America, and end users. The Company also maintains a remarketing agreement with these joint ventures, whereby the Company is obligated to repurchase repossessed inventory at market values. The Company has an agreement with AGCO Finance LLC which limits the Company s purchase obligations under this arrangement to $6.0 million in the aggregate per calendar year. The Company believes that any losses that might be incurred on the resale of this equipment will not materially impact the Company s financial position or results of operations.

At December 31, 2006, the Company guaranteed indebtedness owed to third parties of approximately $80.8 million, primarily related to dealer and end user financing of equipment. The Company believes the credit risk associated with these guarantees is not material to its financial position.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Other***

In addition, at December 31, 2006, the Company had foreign currency forward contracts to buy an aggregate of approximately $166.0 million of United States dollar equivalents and foreign currency forward contracts to sell an aggregate of approximately $172.3 million United States dollar equivalents. All contracts have a maturity of less than one year (Note 11).

From time to time, the Company sells certain trade receivables under factoring arrangements to financial institutions throughout the world. The Company evaluates the sale of such receivables pursuant to the guidelines of SFAS No. 140 and has determined that these facilities should be accounted for as off-balance sheet transactions in accordance with SFAS No. 140.

Total lease expense under noncancelable operating leases was $37.8 million, $37.6 million and $35.0 million for the years ended December 31, 2006, 2005 and 2004, respectively.

***Contingencies***

As a result of recent Brazilian tax legislative changes impacting value added taxes ( VAT ), the Company recorded a reserve of approximately $20.0 million and $21.4 million against its outstanding balance of Brazilian VAT taxes receivable as of December 31, 2006 and 2005, respectively, due to the uncertainty as to the Company s ability to collect the amounts outstanding.

In February 2006, the Company received a subpoena from the SEC in connection with a non-public, fact-finding inquiry entitled In the Matter of Certain Participants in the Oil for Food Program. This subpoena requested documents concerning transactions under the United Nations Oil for Food Program by the Company and certain of the Company s subsidiaries. The subpoena arises from sales by the Company s subsidiaries of farm equipment to the Iraq ministry of agriculture. The Company is cooperating fully with the inquiry. The subpoena does not imply there have been any violations of the federal securities or other laws. However, should the SEC (or the U.S. Department of Justice, which is participating in the SEC s inquiry) determine that the Company has violated federal law, the Company could be subject to civil or criminal fines and penalties, or both. A similar proceeding has been initiated against one of the Company s subsidiaries in Denmark, and on November 28, 2006, the French government initiated an investigation of one of the Company s subsidiaries in France. It is not possible to predict the outcome of these inquiries or their impact, if any, on the Company.

The Company is party to various claims and lawsuits arising in the normal course of business. It is the opinion of management, after consultation with legal counsel, that those claims and lawsuits will not have a material adverse effect on the financial position or results of operations of the Company.

## 13. Related Party Transactions

Rabobank, a AAA rated financial institution based in the Netherlands, is a 51% owner in the Company s retail finance joint ventures which are located in the United States, Canada, Brazil, Germany, France, the United Kingdom, Australia, Ireland and Austria. Rabobank is also the principal agent and participant in the Company s revolving credit facility and securitization facilities (Notes 4 and 7). The majority of the assets of the Company s retail finance joint ventures represent finance receivables. The majority of the liabilities represent notes payable and accrued interest. Under the various joint venture agreements, Rabobank or its affiliates are obligated to provide financing to the joint venture companies, primarily through lines of credit. The Company does not guarantee the debt obligations of the retail finance joint ventures other than a portion of the retail portfolio in Brazil that is held outside the joint venture by Rabobank Brazil. Prior to 2005, the Company s joint venture in Brazil had an agency relationship with Rabobank whereby Rabobank provided the funding. In February 2005, the Company made a $21.3 million investment in its retail finance joint venture with Rabobank Brazil. With the additional investment, the joint venture s organizational structure is now more comparable to the Company s other retail finance joint ventures and will result in the gradual elimination of

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the Company s solvency guarantee to Rabobank for the portfolio that was originally funded by Rabobank Brazil. As of December 31, 2006, the solvency requirement for the portfolio held by Rabobank was approximately $8.3 million.

The Company s retail finance joint ventures provide retail financing and wholesale financing to its dealers. The terms of the financing arrangements offered to the Company s dealers are similar to arrangements the retail finance joint ventures provide to unaffiliated third parties. At December 31, 2006, the Company was obligated under certain circumstances to purchase through the year 2010 up to $7.2 million of equipment upon expiration of certain operating leases between AGCO Finance LLC and AGCO Finance Canada Ltd, its retail joint ventures in North America, and end users. The Company also maintains a remarketing agreement with these joint ventures (Note 12). In addition, as part of sales incentives provided to end users, the Company may from time to time subsidize interest rates of retail financing provided by its retail joint ventures. The cost of those programs is recognized at the time of sale to the Company s dealers.

In May 2005, the Company completed an agreement to permit transferring, on an ongoing basis, the majority of its wholesale interest-bearing receivables in North America to AGCO Finance LLC and AGCO Finance Canada, Ltd. The Company has a 49% ownership interest in these joint ventures. The transfer of the receivables is without recourse to the Company and the Company continues to service the receivables. The Company does not maintain any direct retained interest in the receivables. No servicing asset or liability has been recorded since the estimated fair value of the servicing of the receivables approximates servicing income. The initial transfer of the wholesale interest-bearing receivables resulted in net proceeds of approximately $94 million, which were used to redeem the Company s $250 million 91/2% senior notes (Note 7). As of December 31, 2006 and 2005, the balance of interest- bearing receivables transferred to AGCO Finance LLC and AGCO Finance Canada, Ltd. under this agreement was approximately $124.1 million and $109.9 million, respectively.

During 2006, 2005 and 2004, the Company had net sales of $190.9 million, $153.8 million and $162.8 million, respectively, to BayWa Corporation, a German distributor, in the ordinary course of business. The President and CEO of BayWa Corporation is also a member of the Board of Directors of the Company.

During 2006 and 2005, the Company made license fee payments and purchased raw materials, including engines, totaling approximately $211.3 million and $184.5 million, respectively, from Caterpillar Inc., in the ordinary course of business. One of the Group Presidents of Caterpillar Inc. is also a member of the Board of Directors of the Company.

During 2006, 2005 and 2004, the Company purchased approximately $1.4 million, $4.4 million and $2.4 million, respectively, of equipment components from its manufacturing joint venture, Deutz AGCO Motores SA, at prices approximating cost.

## 14. Segment Reporting

The Company has four reportable segments: North America; South America; Europe/Africa/Middle East; and Asia/Pacific. Each regional segment distributes a full range of agricultural equipment and related replacement parts. The Company evaluates segment performance primarily based on income from operations. Sales for each regional segment are based on the location of the third-party customer. All intercompany transactions between the segments have been eliminated. The Company s selling, general and administrative expenses and engineering expenses, excluding corporate expense, are charged to each segment based on the region and division where the expenses are incurred. As a result, the components of operating income for one

**AGCO CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

segment may not be comparable to another segment. Segment results for the years ended December 31, 2006, 2005 and 2004 are as follows (in millions):

| Years Ended December 31, | North America | South America | Europe/Africa/ Middle East | Asia/ Pacific | Consolidated |
|---|---|---|---|---|---|
| **2006** | | | | | |
| Net sales | $ 1,283.8 | $ 657.2 | $ 3,334.4 | $ 159.6 | $ 5,435.0 |
| (Loss) income from operations | (37.8) | 45.2 | 279.4 | 20.3 | 307.1 |
| Depreciation | 24.3 | 16.4 | 55.4 | 2.5 | 98.6 |
| Assets | 678.4 | 342.2 | 1,283.7 | 79.5 | 2,383.8 |
| Capital expenditures | 17.7 | 11.2 | 99.7 | 0.5 | 129.1 |
| **2005** | | | | | |
| Net sales | $ 1,607.8 | $ 648.5 | $ 2,988.7 | $ 204.7 | $ 5,449.7 |
| Income from operations | 17.1 | 37.8 | 242.5 | 35.0 | 332.4 |
| Depreciation | 25.3 | 14.2 | 47.0 | 2.9 | 89.4 |
| Assets | 760.3 | 346.1 | 1,091.4 | 79.8 | 2,277.6 |
| Capital expenditures | 14.6 | 8.6 | 64.6 | 0.6 | 88.4 |
| **2004** | | | | | |
| Net sales | $ 1,412.5 | $ 796.8 | $ 2,873.0 | $ 191.0 | $ 5,273.3 |
| Income from operations | 32.2 | 127.0 | 186.8 | 32.9 | 378.9 |
| Depreciation | 22.3 | 10.4 | 47.3 | 4.3 | 84.3 |
| Assets | 766.9 | 342.5 | 1,305.0 | 63.6 | 2,478.0 |
| Capital expenditures | 13.5 | 11.1 | 49.1 | 4.7 | 78.4 |

A reconciliation from the segment information to the consolidated balances for income from operations and total assets is set forth below (in millions):

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Segment income from operations | $ 307.1 | $ 332.4 | $ 378.9 |
| Corporate expenses | (45.4) | (40.8) | (39.0) |
| Restricted stock compensation | (3.5) | (0.4) | (0.5) |
| Restructuring and other infrequent expenses | (1.0) | | (0.1) |
| Goodwill impairment charge | (171.4) | | |
| Amortization of intangibles | (16.9) | (16.5) | (15.8) |
| Consolidated income from operations | $ 68.9 | $ 274.7 | $ 323.5 |

| | | | |
|---|---|---|---|
| Segment assets | $ 2,383.8 | $ 2,277.6 | $ 2,478.0 |
| Cash and cash equivalents | 401.1 | 220.6 | 325.6 |
| Receivables from affiliates | 2.1 | 2.0 | 7.9 |
| Investments in affiliates | 191.6 | 164.7 | 114.5 |
| Deferred tax assets, other current and noncurrent assets | 335.9 | 288.1 | 402.5 |
| Intangible assets, net | 207.9 | 211.5 | 238.2 |
| Goodwill | 592.1 | 696.7 | 730.6 |
| Consolidated total assets | $ 4,114.5 | $ 3,861.2 | $ 4,297.3 |

**AGCO CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Net sales by customer location for the years ended December 31, 2006, 2005 and 2004 were as follows (in millions):

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Net sales: | | | |
| United States | $ 1,008.0 | $ 1,291.0 | $ 1,168.1 |
| Canada | 200.2 | 240.1 | 176.9 |
| Germany | 627.0 | 534.9 | 470.1 |
| France | 624.8 | 569.7 | 604.7 |
| United Kingdom and Ireland | 322.6 | 286.5 | 301.0 |
| Finland and Scandinavia | 657.5 | 641.2 | 634.4 |
| Other Europe | 857.6 | 681.5 | 673.6 |
| South America | 644.0 | 634.5 | 786.0 |
| Middle East | 151.2 | 212.2 | 127.1 |
| Asia | 58.6 | 84.4 | 72.0 |
| Australia | 101.0 | 120.3 | 119.0 |
| Africa | 93.8 | 62.7 | 62.2 |
| Mexico, Central America and Caribbean | 88.7 | 90.7 | 78.2 |
| | $ 5,435.0 | $ 5,449.7 | $ 5,273.3 |

Net sales by product for the years ended December 31, 2006, 2005 and 2004 were as follows (in millions):

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Net sales: | | | |
| Tractors | $ 3,634.7 | $ 3,577.4 | $ 3,394.6 |
| Combines | 214.0 | 277.7 | 361.8 |
| Application equipment | 266.8 | 307.8 | 265.8 |
| Other machinery | 566.7 | 552.0 | 551.4 |
| Replacement parts | 752.8 | 734.8 | 699.7 |
| | $ 5,435.0 | $ 5,449.7 | $ 5,273.3 |

Property, plant and equipment and amortizable intangible assets by country as of December 31, 2006 and 2005 was as follows (in millions):

| | 2006 | 2005 |
|---|---|---|

| | | |
|---|---|---|
| United States | $ 123.7 | $ 129.0 |
| Finland | 204.6 | 178.4 |
| Germany | 176.7 | 138.7 |
| Brazil | 146.3 | 142.9 |
| France | 78.5 | 74.8 |
| Other | 29.9 | 20.9 |
| | $ 759.7 | $ 684.7 |

**Item 9.** ***Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

None.

**Item 9A.** ***Controls and Procedures***

The Company s management, including the Chief Executive Officer and the Chief Financial Officer, does not expect that the Company s disclosure controls or the Company s internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. Because of the inherent limitations in a cost effective control system, misstatements due to error or fraud may occur and not be detected. We will conduct periodic evaluations of our internal controls to enhance, where necessary, our procedures and controls.

**Evaluation of Disclosure Controls and Procedures**

Our Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of December 31, 2006, have concluded that, as of such date, our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission s rules and forms.

**Management s Annual Report on Internal Control over Financial Reporting**

Management of the Company is responsible for establishing and maintaining effective internal control over financial reporting as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. The Company s internal control over financial reporting is designed to provide reasonable assurance to the Company s management and board of directors regarding the preparation and fair presentation of published financial statements for external purposes in accordance with generally accepted accounting principles. In assessing the effectiveness of the Company s internal controls over financial reporting, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ( COSO ) in *Internal Control Integrated Framework.*

Management assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2006. Based on this assessment, management believes that, as of December 31, 2006, the Company s internal control over financial reporting is effective based on the criteria referred to above.

KPMG LLP, the independent registered public accounting firm that audited the Consolidated Financial Statements of the Company included in this Annual Report on Form 10-K, has issued an attestation report on management s assessment of the Company s internal control over financial reporting as of December 31, 2006. The attestation report, which expresses KPMG LLP s unqualified opinion on management s assessment and on the effectiveness of the Company s internal control over financial reporting as of December 31, 2006, is included in this Item under the heading Report of Independent Registered Public Accounting Firm.

**Changes in Internal Control over Financial Reporting**

There were no changes in our internal control over financial reporting that occurred during our last fiscal quarter that has materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

However, as a result of the Company s processes to comply with the Sarbanes-Oxley Act of 2002, enhancements to the Company s internal control over financial reporting were implemented as management addressed and remediated deficiencies that had been identified.

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders
AGCO Corporation:

We have audited management s assessment, included in the accompanying Management s Report on Internal Control over Financial Reporting, that AGCO Corporation maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). AGCO Corporation s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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 (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) 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 (3) 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.

In our opinion, management s assessment that AGCO Corporation maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, AGCO Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of AGCO Corporation and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders equity and cash flows for each of the years in the three-year period ended December 31, 2006, and our report dated February 28, 2007 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Atlanta, Georgia
February 28, 2007

**Item 9B.** ***Other Information***

None.

## PART III

The information called for by Items 10, 11, 12, 13 and 14, if any, will be contained in our Proxy Statement for the 2007 Annual Meeting of Stockholders which we intend to file in April 2007.

### Item 10. *Directors, Executive Officers and Corporate Governance*

The information with respect to directors and committees required by this Item set forth in our Proxy Statement for the 2007 Annual Meeting of Stockholders in the sections entitled Election of Directors, Directors Continuing in Office and Board of Directors and Certain Committees of the Board incorporated herein by reference. The information with respect to executive officers required by this Item set forth under the heading Executive Officers of the Registrant on pages 10 and 11 of this Form 10-K and our Proxy Statement for the 2007 Annual Meeting of Stockholders in the section entitled Section 16(a) Beneficial Ownership Reporting Compliance is incorporated herein by reference.

The information under the heading Available Information set forth on page 9 of this Form 10-K is incorporated herein by reference. The code of ethics referenced therein applies to our principal executive officer, principal financial officer, principal accounting officer and controller and the persons performing similar functions.

### Item 11. *Executive Compensation*

The information with respect to executive compensation and its establishment required by this Item set forth in our Proxy Statement for the 2007 Annual Meeting of Stockholders in the sections entitled Board of Directors and Certain Committees of the Board, Compensation Committee Interlocks and Insider Participation, Executive Compensation and Compensation Committee Report is incorporated herein by reference.

### Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters*

(a) *Securities Authorized for Issuance Under Equity Compensation Plans*

AGCO maintains its 2006 Plan and its Option Plan pursuant to which we may grant equity awards to eligible persons. For additional information see Note 10, Stock Incentive Plans, in the Notes to Consolidated Financial Statements included in this filing. The following table gives information about equity awards under our Plans.

| Plan Category | (a) Number of Securities to be issued upon exercise of outstanding awards under the Plans | (b) Weighted-average exercise price of outstanding awards under the Plans | (c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
|---|---|---|---|
| Equity compensation plans approved by security holders | 2,017,087 | $ 22.57 | 5,405,088 |
| Equity compensation plans not approved by security holders | 3,500 | 18.76 | |

| | | | |
|---|---|---|---|
| Total | 2,020,587 | $ 22.56 | 5,405,088 |

(b) *Security Ownership of Certain Beneficial Owners and Management*

The information required by this Item set forth in our Proxy Statement for the 2007 Annual Meeting of Stockholders in the section entitled Principal Holders of Common Stock is incorporated herein by reference.

**Item 13.** ***Certain Relationships and Related Transactions, and Director Independence***

The information required by this Item set forth in our Proxy Statement for the 2007 Annual Meeting of Stockholders in the section entitled Certain Relationships and Related Transactions is incorporated herein by reference.

**Item 14.** ***Principal Accountant Fees and Services***

The information required by this Item set forth in our 2007 Proxy Statement for the Annual Meeting of Stockholders in the sections entitled Audit Committee Report and Board of Directors and Certain Committees of the Board is incorporated herein by reference.

## PART IV

**Item 15.** ***Exhibits and Financial Statement Schedules***

(a) The following documents are filed as part of this Form 10-K:

(1) The Consolidated Financial Statements, Notes to Consolidated Financial Statements, Report of Independent Registered Public Accounting Firm for AGCO Corporation and its subsidiaries are presented on pages 52 to 106 under Item 8 of this Form 10-K.

(2) Financial Statement Schedules:

The following Consolidated Financial Statement Schedule of AGCO Corporation and its subsidiaries are included herein on pages II-1 and II-2.

| **Schedule** | **Description** |
|---|---|
| Schedule II | Valuation and Qualifying Accounts |

Schedules other than that listed above have been omitted because the required information is contained in Notes to the Consolidated Financial Statements or because such schedules are not required or are not applicable.

(3) The following exhibits are filed or incorporated by reference as part of this report. Each management contract or compensation plan required to be filed as an exhibit is identified by an asterisk (*).

| **Exhibit Number** | **Description of Exhibit** | **The filings referenced for incorporation by reference are AGCO Corporation** |
|---|---|---|
| 3.1 | Certificate of Incorporation | June 30, 2002, Form 10-Q, Exhibit 3.1 |
| 3.2 | By-Laws | December 31, 2001, Form 10-K, Exhibit 3.2 |
| 4.1 | Rights Agreement | March 31, 1994, Form 10-Q; August 8, 1999, Form 8-A/A, Exhibit 4.1<br>April 23, 2004, Form 8-A/A, Exhibit 4.1 |
| 4.2 | Indenture dated as of December 23, 2003 | January 7, 2004, Form 8-K, Exhibit 4.1; Registration Statement No. 333-125255, Exhibit 4.2 |
| 4.3 | Indenture dated as of April 23, 2004 | April 15, 2004, Form 8-K, Exhibit 4.1 |
| 4.5 | Indenture dated as of December 4, 2006 | December 4, 2006, Form 8-K, Exhibit 10.1 |
| 10.1 | 2006 Long-term Incentive Stock Plan * | |

| | | |
|---|---|---|
| | | March 31, 2006, DEF 14A, Appendix A; July 31, 2006, Form 8-K, Exhibit 10.1 |
| 10.2 | Form of Non-Qualified Stock Option Award Agreement * | March 31, 2006, Form 10-Q, Exhibit 10.2 |
| 10.3 | Form of Incentive Stock Option Award Agreement * | March 31, 2006, Form 10-Q, Exhibit 10.3 |
| 10.4 | Form of Stock Appreciation Rights Agreement * | March 31, 2006, Form 10-Q, Exhibit 10.4 |
| 10.5 | Form of Restricted Stock Agreement * | March 31, 2006, Form 10-Q, Exhibit 10.5 |
| 10.6 | Form of Performance Share Award | March 31, 2006, Form 10-Q, Exhibit 10.6 |

| Exhibit Number | Description of Exhibit | The filings referenced for incorporation by reference are AGCO Corporation |
|---|---|---|
| 10.7 | 2001 Stock Option Plan * | March 31, 2001, Form 10-Q, Exhibit 10.2 |
| 10.8 | 1991 Stock Option Plan * | December 31, 1998, Form 10-K, Exhibit 10.8 |
| 10.9 | Form of Stock Option Agreements * | Registration Statement #33-43437 |
| 10.10 | Amended and Restated Long-Term Incentive Plan (LTIP III) * | December 31, 2000, Form 10-K, Exhibit 10.3<br>December 31, 2001, Form 10-K, Exhibit 10.4<br>December 3, 2004, Form 8-K, Exhibit 10.1 |
| 10.11 | Non-employee Director Stock Incentive Plan * | December 31, 1997, Form 10-K, Exhibit 10.11<br>December 31, 2001, Form 10-K, Exhibit 10.6<br>March 25, 2003, DEF 14A, Appendix A |
| 10.12 | Management Incentive Compensation Plan * | December 31, 1995, Form 10-K, Exhibit 10.14 |
| 10.13 | Executive Non-qualified Pension Plan * | September 30, 2006, Form 10-Q, Exhibit 10.2 |
| 10.14 | Amended and Restated Executive Non-qualified Pension Plan * | September 30, 2006, Form 10-Q, Exhibit 10.3 |
| 10.15 | Employment Agreement with Martin Richenhagen * | June 30, 2004, Form 10-Q, Exhibit 10.1 |
| 10.16 | Employment Agreement with Andrew H. Beck * | June 30, 2002, Form 10-Q, Exhibit 10.2 |
| 10.17 | Employment Agreement with Garry L. Ball * | December 31, 2004, Form 10-K, Exhibit 10.11 |
| 10.18 | Employment Agreement with Stephen D. Lupton * | December 31, 2002, Form 10-K, Exhibit 10.22 and December 31, 2004, Form 10-K, Exhibit 10.13 |
| 10.19 | Employment Agreement with Hubertus Muehlhaeuser | September 2, 2005, Form 8-K, Exhibit 10.1 |
| 10.20 | Employment Agreement with Gary Collar | Filed herewith |
| 10.21 | Receivables Purchase Agreement dated as of January 27, 2000 | December 31, 1999, Form 10-K, Exhibit 10.12<br>March 31, 2004, Form 10-Q, Exhibit 10.2 |
| 10.22 | Credit Agreement dated as of December 22, 2003 | January 7, 2004, Form 8-K, Exhibit 10.1<br>March 31, 2004, Form 10-Q, Exhibit 10.4<br>September 30, 2004, Form 10-Q, |

Exhibit 10.1
March 31, 2005, Form 10-Q,
Exhibit 10.1
December 31, 2005, Form 10-K,
Exhibit 10.16 March 31, 2006,
Form 10-Q, Exhibit 10.1
September 30, 2006, Form 10-Q,
Exhibit 10.4
December 1, 2006, Form 8-K,
Exhibit 10.1

| Exhibit Number | Description of Exhibit | The filings referenced for incorporation by reference are AGCO Corporation |
|---|---|---|
| 10.23 | Canadian Receivables Purchase Agreement dated as of April 11, 2001 | June 30, 2001, Form 10-Q, Exhibit 10.1<br>March 31, 2004, Form 10-Q, Exhibit 10.3 |
| 10.24 | European Receivables Transfer Agreement | September 30, 2006, Form 10-Q, Exhibit 10.1 |
| 10.25 | Director Compensation Agreement | Filed herewith |
| 21.0 | Subsidiaries of the Registrant | Filed herewith |
| 23.1 | Consent of KPMG LLP | Filed herewith |
| 24.0 | Powers of Attorney | Filed herewith |
| 31.1 | Certification of Martin Richenhagen | Filed herewith |
| 31.2 | Certification of Andrew H. Beck | Filed herewith |
| 32.1 | Certification of Martin Richenhagen and Andrew H. Beck | Filed herewith |

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

AGCO Corporation

By: /s/ Martin Richenhagen
Martin Richenhagen
*Chairman, President and*
*Chief Executive Officer*

Dated: March 1, 2007

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant in the capacities and on the date indicated.

| Signature | Title | Date |
|---|---|---|
| /s/ Martin Richenhagen<br>Martin Richenhagen | Chairman, President and Chief Executive Officer | March 1, 2007 |
| /s/ Andrew H. Beck<br>Andrew H. Beck | Senior Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer) | March 1, 2007 |
| P. George Benson *<br>P. George Benson | Director | March 1, 2007 |
| W. Wayne Booker *<br>W. Wayne Booker | Director | March 1, 2007 |
| Herman Cain *<br>Herman Cain | Director | March 1, 2007 |
| Wolfgang Deml *<br>Wolfgang Deml | Director | March 1, 2007 |
| Francisco R. Gros *<br>Francisco R. Gros | Director | March 1, 2007 |

| | | |
|---|---|---|
| Gerald B. Johanneson * | Director | March 1, 2007 |
| Gerald B. Johanneson | | |
| Curtis E. Moll * | Director | March 1, 2007 |
| Curtis E. Moll | | |
| David E. Momot * | Director | March 1, 2007 |
| David E. Momot | | |

| Signature | Title | Date |
|---|---|---|
| Gerald L. Shaheen * | Director | March 1, 2007 |
| Gerald L. Shaheen | | |
| Hendrikus Visser * | Director | March 1, 2007 |
| Hendrikus Visser | | |

*By:
/s/ Andrew H. Beck

Andrew H. Beck
*Attorney-in-Fact*
March 1, 2007

**ANNUAL REPORT ON FORM 10-K**

**ITEM 15 (A)(2)**

**FINANCIAL STATEMENT SCHEDULE**
**YEAR ENDED DECEMBER 31, 2006**

**SCHEDULE II**

**AGCO CORPORATION AND SUBSIDIARIES**
**SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS**
**(in millions)**

| Description | Balance at Beginning of Period | Additions: Acquired Businesses | Additions: Charged to Costs and Expenses | Deductions | Foreign Currency Translation | Balance at End of Period |
|---|---|---|---|---|---|---|
| Year ended December 31, 2006 | | | | | | |
| Allowances for sales incentive discounts | $ 92.1 | $ | $ 123.3 | $ (132.8) | $ | $ 82.6 |
| Year ended December 31, 2005 | | | | | | |
| Allowances for sales incentive discounts | $ 84.7 | $ | $ 157.0 | $ (149.6) | $ | $ 92.1 |
| Year ended December 31, 2004 | | | | | | |
| Allowances for sales incentive discounts | $ 76.5 | $ | $ 136.8 | $ (128.6) | $ | $ 84.7 |

| Description | Balance at Beginning of Period | Additions: Acquired Businesses | Additions: Charged to Costs and Expenses | Deductions | Foreign Currency Translation | Balance at End of Period |
|---|---|---|---|---|---|---|
| Year ended December 31, 2006 | | | | | | |
| Allowances for doubtful accounts | $ 40.6 | $ | $ 1.5 | $ (7.2) | $ 2.8 | $ 37.7 |
| Year ended December 31, 2005 | | | | | | |
| Allowances for doubtful accounts | $ 54.9 | $ | $ 2.3 | $ (14.1) | $ (2.5) | $ 40.6 |
| Year ended December 31, 2004 | | | | | | |
| Allowances for doubtful accounts | $ 47.2 | $ 9.4 | $ 3.2 | $ (7.2) | $ 2.3 | $ 54.9 |

| Description | Balance at Beginning of Period | Additions: Charged to Costs and Expenses | Additions: Reversal of Accrual | Deductions | Foreign Currency Translation | Balance at End of Period |
|---|---|---|---|---|---|---|

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year ended December 31, 2006 | | | | | | | | | | | | |
| Accruals of severance, relocation and other integration costs | $ | 0.8 | $ | 1.0 | $ | | $ | (0.7) | $ | | $ | 1.1 |
| Year ended December 31, 2005 | | | | | | | | | | | | |
| Accruals of severance, relocation and other integration costs | $ | 5.0 | $ | 1.4 | $ | (0.2) | $ | (5.2) | $ | (0.2) | $ | 0.8 |
| Year ended December 31, 2004 | | | | | | | | | | | | |
| Accruals of severance, relocation and other integration costs | $ | 3.3 | $ | 5.0 | $ | (0.4) | $ | (3.1) | $ | 0.2 | $ | 5.0 |

| | | | Additions | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Description** | **Balance at Beginning of Period** | | **Acquired Businesses** | | **Charged to Costs and Expenses*** | | **Deductions** | | **Foreign Currency Translation** | | **Balance at End of Period** | |
| Year ended December 31, 2006 | | | | | | | | | | | | |
| Deferred tax valuation allowance | $ | 252.8 | $ | (3.8) | $ | 37.7 | $ | | $ | 4.7 | $ | 291.4 |
| Year ended December 31, 2005 | | | | | | | | | | | | |
| Deferred tax valuation allowance | $ | 142.9 | $ | (9.5) | $ | 122.0 | $ | | $ | (2.6) | $ | 252.8 |
| Year ended December 31, 2004 | | | | | | | | | | | | |
| Deferred tax valuation allowance | $ | 141.7 | $ | 7.6 | $ | (6.2) | $ | | $ | (0.2) | $ | 142.9 |

* Amounts charged through other comprehensive loss during the years ended December 31, 2006, 2005 and 2004 were $(1.1) million, $0.6 million and $1.0 million, respectively.