

WE'RE HERE BECAUSE..



THIRTEEN CONSECUTIVE RECORD YEARS

2002 Annual Report



WE'RE HERE BECAUSE ... diversification means much more than diversity of products – a keystone of our strategy. It also means global diversification – by end market, supply sources, labor expertise and logistical advantage. It is this global focus that drives decisions to locate our high-volume disk drive filter business (cover) in Wuxi, China.



> **WUXI, CHINA.** Donaldson Company operations in China represent a major – and growing – component of our global strategy. Our two state-of-the-art cleanrooms in Wuxi produced more than 175 million disk drive filters during fiscal 2002. We also have facilities producing industrial air filtration equipment and filtration membranes.

About the Company

Donaldson Company, Inc., is a leading worldwide manufacturer of filtration systems and replacement parts. The company's product mix includes air and liquid filters and exhaust and emission control products for mobile equipment; in-plant air cleaning systems; compressed air purification systems; air intake systems for industrial gas turbines; and specialized filters for such diverse applications as computer disk drives, aircraft passenger cabins and semiconductor processing. Products are manufactured at more than three dozen Donaldson plants around the world and through four joint ventures.

Our financial objective is to build shareholder value through superior share price appreciation and consistent dividend payouts. We believe value is created by delivering consistent, double-digit growth in earnings per share. Growth will be achieved by aggressively pursuing new opportunities in our existing and related markets. Consistency will be reinforced by maintaining a diversified portfolio of related filtration businesses around the world.

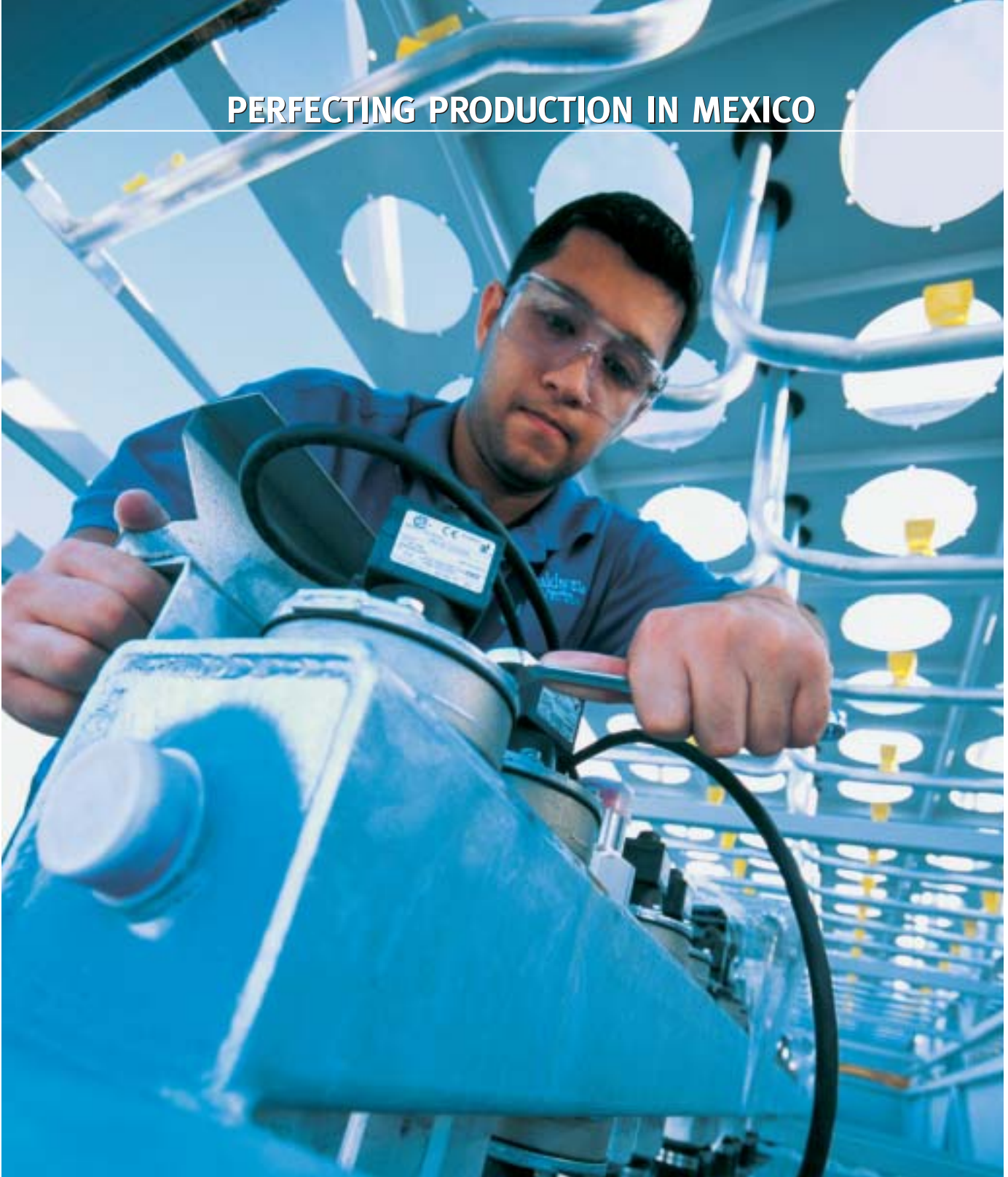
Mission Statement

To provide superior return for our shareholders, through consistent, long-term earnings growth built on global leadership in filtration solutions, thereby creating security, opportunity and challenge for our employees.

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PERFECTING PRODUCTION IN MEXICO



> **MONTERREY, MEXICO.** Today, one year after opening the Monterrey plant, about two-thirds of our North American gas turbine output is manufactured here. The plant is continuing to develop its highly motivated workforce and grow its capabilities.



ONE OF OUR MOST NOTABLE SUCCESSES is our year-over-year gross margin improvement – even as we’ve responded to price reduction pressure in our markets. One factor: aggressive cost management from the design phase through delivery to our customer. This includes relocation of our manufacturing capabilities when it makes good sense. The evolution in bringing gas turbine solutions to the market is a good example. First, we shifted to a modular design strategy for these large systems, increasing both production capacity and product margins. We then moved a portion of our production to lower-cost suppliers in Mexico, and finally, last year opened our own dedicated plant in Monterrey. Our Mexican presence now consists of three manufacturing plants and a sales office in Mexico City.

OPTIMIZED TO COMPETE IN EUROPE



> **HULL, ENGLAND.** This geographically critical manufacturing and distribution operation supports our industrial air, gas turbine and engine businesses throughout the European markets. Dramatic increases in production volume over the past 10 years parallel our progress growing our air filter business through the combination of new products, new customers and geographic expansion.



DONALDSON COMPANY'S PAN-EUROPEAN STRUCTURE is complex and compelling. Complex because we conduct business daily in 10 different currencies and at least 10 distinct languages. Compelling because we sustain both a targeted, local-market approach *and* the big-picture perspective required to win global opportunities. Our customers' business models drive us to structure, produce, sell and service markets that expand daily. In addition to balanced growth in existing Western European markets, our strategy emphasizes diversified expansion into Eastern Europe and the Middle East. Our European presence now consists of 11 manufacturing plants and more than 20 offices in 20 countries.

AGGRESSIVE IN ASIA-PACIFIC

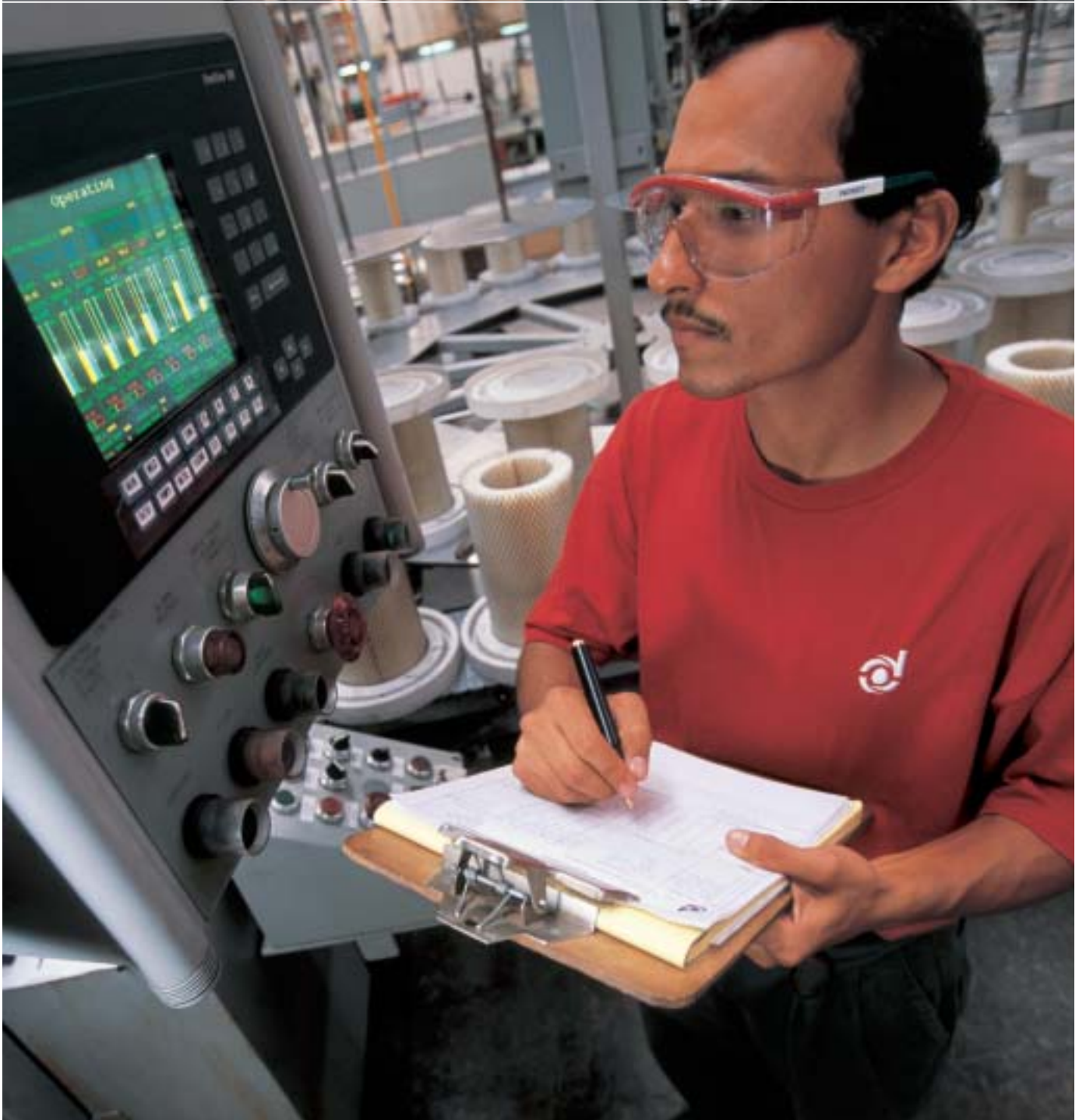


> **GUNMA, JAPAN.** During the past two years, a comprehensive program to improve return-on-investment at Nippon Donaldson has tripled the ROI from single-digit levels to above 20 percent, despite the on-going Japanese recession.



FISCAL 2002 MADE THE THIRD YEAR of a region-wide diversification focus, which includes significant progress expanding our product offerings and leveraging our low-cost production capabilities. China, the base for our disk drive business, also is now home to our Asian industrial air filtration production. Additional gas turbine capabilities have come on line in India. Engine aftermarket distribution increased in Southeast Asia, mainland China and New Zealand. Our Asian presence now consists of eight manufacturing plants and more than 20 offices in 11 countries.

CAPITALIZING ON THE AFTERMARKET

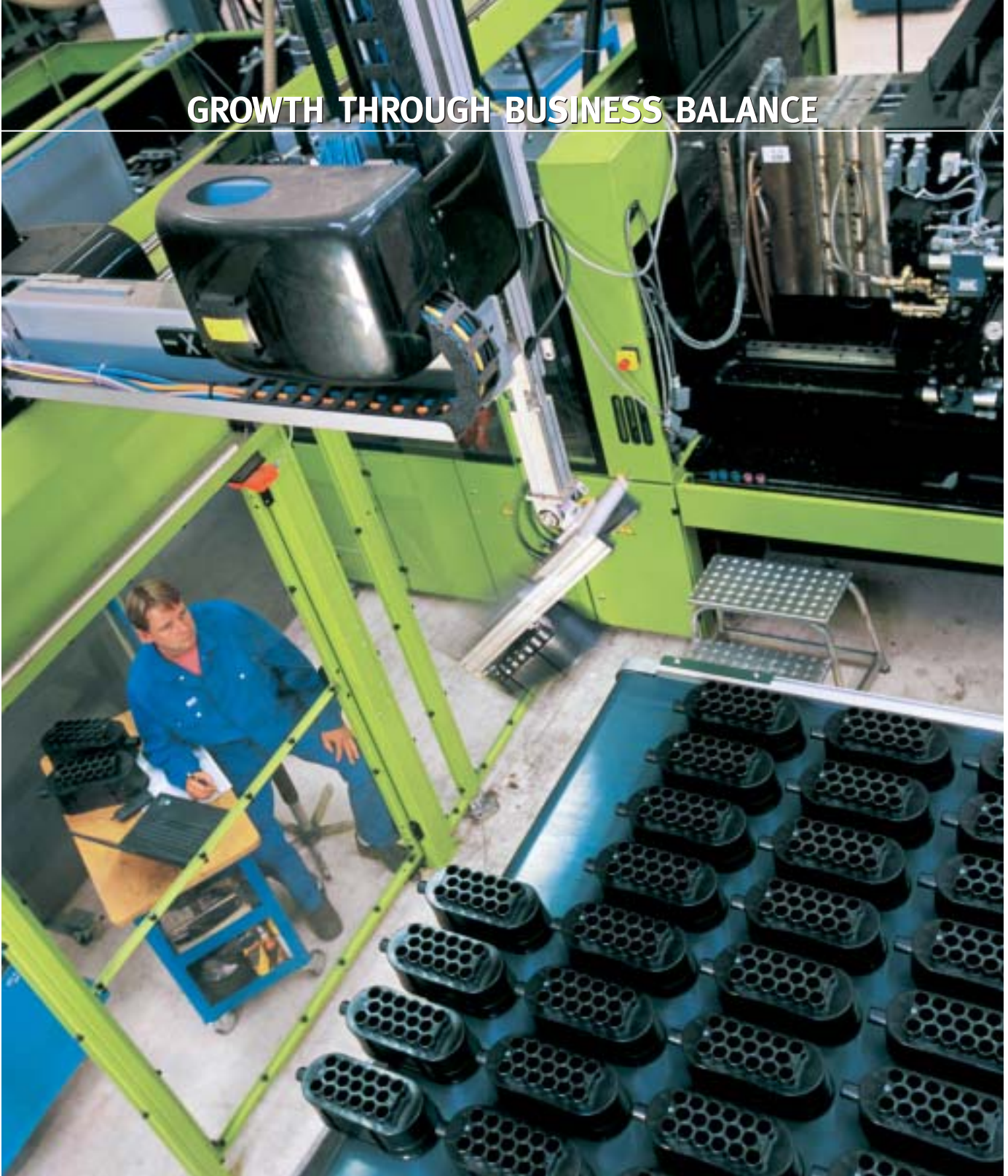


> **AGUASCALIENTES, MEXICO.** Aguascalientes is strategically important for supplying customers in the United States, Mexico and South America with replacement filters and parts. Aguascalientes' low cost structure, skilled workforce and central location allow us to deliver high-quality filters and parts where and when the customer needs them.



SIGNIFICANT SALES AND EARNINGS GROWTH opportunities exist where Donaldson's unique filtration technologies intersect with ever-growing aftermarket demand. Expertise in the science of filtration leads to development of value-added solutions that provide us with the competitive edge supplying end-users with replacement parts. The higher-margin aftermarket business will also grow along with our expanding international presence. North America also remains a growth territory as we continue to introduce new products and expand distribution outlets and channels to win more share of the replacement parts business.

GROWTH THROUGH BUSINESS BALANCE



> **DÜLMEN, GERMANY.** Opened in 1970, the Dülmen plant and sales office is one of our longest established international operations. It's also at the leading edge of capitalizing on steadily growing European opportunities in applications ranging from engine air intake systems to industrial air filtration systems.



OUR INDUSTRIAL/COMMERCIAL BUSINESS represented only one-third of Donaldson's revenue a decade ago. In fiscal 2002, our Industrial/Commercial segment comprised almost one-half of sales. We achieved this strategic balance by leveraging our existing customer relationships, extending our technologies into new markets and products, and using our applications expertise to increase customer value. Examples include: miniature disk drives migrating into consumer devices such as digital cameras; leveraging our PowerCore™ technology into our gas turbine business, reducing both the footprint and cost to our customers; and Donaldson Torit Downflo® Oval 1™ providing more effective and efficient filtration while requiring significantly less floor space.



> **WILLIAM G. VAN DYKE**
Chairman, President and Chief Executive Officer

DEAR SHAREHOLDERS > After 30 years here, I'm still sometimes surprised, impressed – and delighted – with what a good company this is. I am pleased to be writing to you about our 13th consecutive year of double-digit earnings growth – our best ever.

The Donaldson people rose to the challenge of a second consecutive difficult revenue year. Despite those conditions, resulting in a year of no revenue growth, we improved all other lines of our income statement, improved inventory and overall working capital levels and used record cash flow to reduce debt costs, buy back stock and fund our acquisition activity.

The past fiscal year was the most difficult revenue environment in 20 years, and yet we not only extended our string of double-digit earnings growth, but clearly strengthened our business in the process. There is no magic to this. What it took was a commitment from people all over our company to control the impact that

this business cycle was going to have on their lives. They refocused on making the business run better. In dozens of locations around the world, we saw truly stunning operating improvements. Processes changed. Product lines pared. Facilities closed; more cost-efficient ones were opened and brought on line ahead of schedule. The list goes on, but it has a simple manifestation: six consecutive quarters of climbing gross margin, yielding a record 31 percent for the year. Most exciting of all: the work that delivered these results is a work in process and promises additional lift going forward.

FINANCIAL HIGHLIGHTS

Donaldson Company, Inc. and Subsidiaries

Year ended July 31	2002	2001	% change
Net sales (000s)	\$1,126,005	\$1,137,015	(1.0)%
Net earnings (000s)	86,883	75,548	15.0%
Return on sales	7.7%	6.6%	1.1 pts.
Return on average shareholders' equity	24.8%	25.2%	(.4) pts.
Long-term capitalization ratio	21.5%	23.7%	(2.2) pts.
Diluted earnings per share	\$ 1.90	\$ 1.66	14.5%
Dividends paid per share	\$.310	\$.295	5.1%
Shareholders' equity per share	\$ 8.72	\$ 7.19	21.3%
Diluted shares outstanding (000s)	45,714	45,612	.2%
Employees at year-end	8,166	8,230	(.8)%
Sales per employee (000s)	\$ 137.9	\$ 138.2	(.2)%

Our fundamental business model is that effective diversification of our end markets will support consistent, superior results. That model was once again tested and reinforced in fiscal 2002, as continued strength in gas turbine and an upturn in truck offset weakness in industrial capital spending, which impacted most of our industrial product offering.

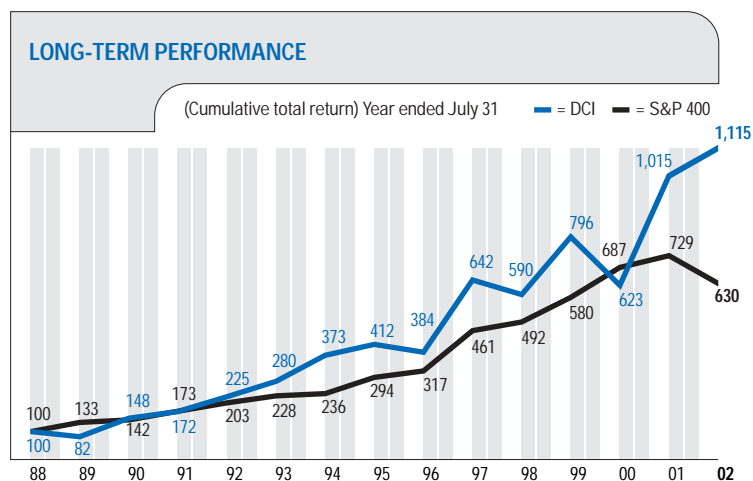
Geographic diversification again played an important role. Overseas revenues grew faster than U.S. revenues in all six of our major product groups. With 39 percent of sales coming from outside the United States, we moved closer to our goal of a 50:50 split between domestic and overseas. The results reinforced our belief in the great growth opportunities outside the United States.

A recurring question from investors concerns how Donaldson will cope with the now certain contraction in gas turbine. It is a fact that we expect the North American gas turbine contraction to be severe, dropping perhaps \$50 million from next year's gas turbine sales. However, the larger fact is that we are seeing improvements in the

end markets for our other businesses, and expect organic growth from our existing businesses to roughly offset the slowdown in gas turbine.

Having said that, none of us takes this North American gas turbine contraction lightly. Manufacturers' forecasts are strikingly severe. Still, our North American downturn will be softened by increased market share in Europe, where demand remains strong. Replacement filters should see solid growth, as plants we equipped during the early part of the boom are starting to come due for their first filter replacements.

To fill the gas turbine hole, the Engine business appears to be turning up. Incoming orders have trended up strongly since the second quarter – especially overseas. New equipment orders in the fourth quarter were up 5 percent domestically and 24 percent overseas from last year. Coupling higher volume with ongoing improvements in Engine profitability gives us important leverage for the coming year.



We think that *too much* has been made of the North American “pre-buy” in heavy trucks – at least as it pertains to Donaldson. Yes, it will buoy our first quarter numbers and deflate at least the second quarter. But, in the end, we expect to equip *more* trucks this year than last – truck sales will be a helpful, though not a critical, piece of fiscal 2003. More important will be the impact of increased volume in emissions products and of several new light truck intake programs coming on line this year:

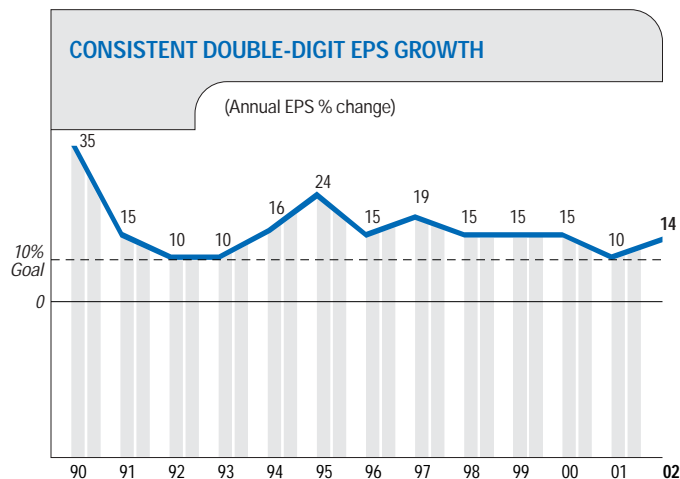
In industrial air filtration – dust collection – the good news is that the business contraction appears finally to be at an end. Fourth quarter delivered the first positive sequential quarter in two years. While this doesn’t yet translate into an upturn, we’ve pared our product line and our cost structure so that incremental revenue, when it comes, will have an immediate bottom line impact.

In sum, fourth quarter order volume for Engine was up 10 percent and, exclusive of North American gas turbine, Industrial was up 6 percent. If we do no better than hold gains like that for ‘03, we’ll comfortably backfill the

projected gas turbine drop. Revenue from the recently completed ultrafilter acquisition will likely add another \$100 million.

So with our operations in solid shape and continuing to improve, and a cautious, modest, careful optimism about the revenue outlook, the other piece of the story for next year is the marrying of our latest acquisition, **ultrafilter**, into the company. As a European manufacturer of replacement parts for compressed air purification, ultrafilter satisfies all three dimensions of our diversification strategy. In one transaction we achieved better balance between the U.S. and overseas economies, between capital equipment and replacement parts and between the mobile-diesel and industrial markets. This better-balanced portfolio should enhance the stability of our performance over time.

This acquisition builds on the AirMaze acquisition of two years ago. Where AirMaze brought us to the filtration needs of the compressor itself, ultrafilter moves out of the compressor room to all points of use in the factory.



Ultrafilter's products remove particulate, mist and moisture from the compressed air stream that ultimately finds its way to conveying systems, pneumatic tools, controls, spraying operations and many other applications.

Ultrafilter is about a \$100 million business and has grown at a rate of 14 percent over the past five years, but operating margins have been slim as the business was run as a privately held German company. Combining ultrafilter's growth track with Donaldson's operating controls, systems and infrastructure yields a business opportunity that will play a meaningful role in our future financial performance.

Cyclical markets inevitably deliver periods of low sales growth – 2003 will be the third consecutive year where a down cycle has subtracted \$50 million from one of our prime markets. Yet, through the strength of our solid operations and the dedication of our employees, we have reaffirmed our commitment to earnings growth.

The headwind is abating. This year, while coping with the gas turbine change, we expect some modest sales lift from our other businesses, and we're a long way from done with tuning our operations. We remain committed to sustaining our earnings growth record.

Sincerely,

WILLIAM G. VAN DYKE

Chairman, President and Chief Executive Officer

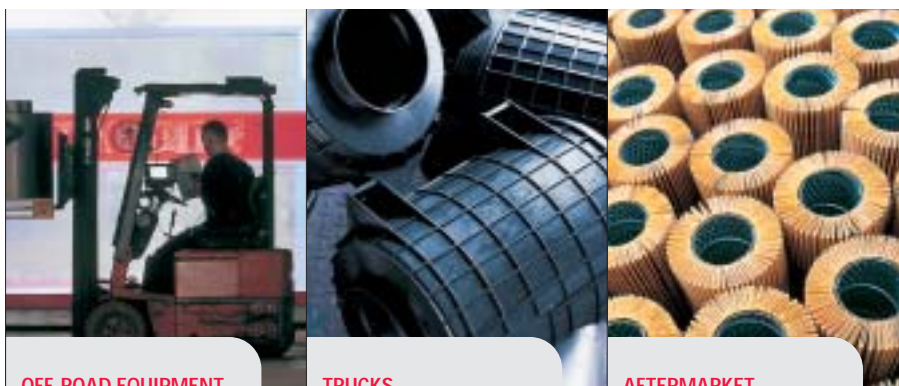
INDUSTRIAL PRODUCTS OPERATING SEGMENT

2002 REVENUE **\$514 MILLION**

PRODUCTS	 <p>INDUSTRIAL AIR FILTRATION</p> <p>Under the trade names Donaldson Torit® and Donaldson Torit DCE®, Donaldson provides equipment to control and capture process dust, fumes and mist in manufacturing and industrial processing plants. In addition, a full line of replacement filter cartridges, bags and spare parts are offered.</p>	 <p>GAS TURBINE SYSTEMS</p> <p>Donaldson provides complete systems to deliver clean air to combustion turbines. Products include self-cleaning filter units, static air filter units, inlet ducting and silencing, evaporative coolers, chiller coils, inlet heating and anti-icing systems. Also, a full line of replacement filters and parts is offered.</p>	 <p>SPECIAL APPLICATIONS</p> <p>Donaldson provides a wide range of high efficiency media, filters and filtration systems for various commercial, industrial and product applications.</p>		
	<p>Product is applied in a wide variety of industrial settings including metal working plants, paint operations, welding stations, woodworking shops and food processing plants.</p>	<p>Essentially all combustion turbines require inlet air filtration and noise attenuation systems. These turbines provide base electricity, peaking capacity and remote power generation for special applications such as pipelines and off-shore oil drilling platforms.</p>	<p>Products for the computer disk drive market include particulate filters, desiccant pouches and chemical adsorbing filter pouches. Customers include major disk drive manufacturers such as IBM, Seagate and Western Digital.</p>	<p>Products for special market applications include aircraft cabin air filters, chemical filter systems for semi-conductor processing facilities, as well as other filters for process-critical applications.</p>	<p>Donaldson sells expanded PTFE membrane through its Tetratrec unit. Primary applications for this membrane are industrial dust collection, product recovery applications and specialty fabrics.</p>
	<p>\$175 MILLION</p>	<p>\$231 MILLION</p>	<p>\$108 MILLION</p>		
	<p>Dedicated field sales force uses multiple selling channels to end-users including: direct selling, distribution, installers, OEM accounts and telemarketing.</p>	<p>Products are primarily sold to gas turbine OEMs (e.g., General Electric, Solar, Siemens Westinghouse). Replacement parts are sold direct to end-users.</p>	<p>Products are sold to disk drive manufacturers by a direct sales force supported by product development and application engineers.</p>	<p>Products are primarily sold direct to end-users.</p>	<p>Membrane and laminates are sold to various filter and garment manufacturers.</p>
APPLICATIONS					
2002 REVENUE					
ROUTES TO MARKET					

ENGINE PRODUCTS OPERATING SEGMENT

2002 REVENUE **\$612 MILLION**



	END-MARKETS	OFF-ROAD EQUIPMENT	TRUCKS	AFTERMARKET
<p>Donaldson sells a broad line of filters and housings for industrial hydraulic and lubricating fluids.</p>	REPRESENTATIVE CUSTOMERS	<p>Products sold to industrial equipment and defense contractor OEMs for agriculture, construction, mining, military and other industrial applications.</p>	<p>Products sold to manufacturers of medium- and heavy-duty trucks.</p>	<p>Broad line of replacement filters and hard parts for all of the equipment applications noted at left.</p>
	REPRESENTATIVE CUSTOMERS	<p>Caterpillar, John Deere, Komatsu, CNH, Volvo Construction Equipment, General Dynamics and Stewart & Stevenson</p>	<p>Freightliner, PACCAR, Volvo, Scania, International and Mitsubishi</p>	<p>Original equipment dealers (such as Freightliner dealers or Caterpillar dealers), independent distributors and private label accounts</p>
<p>Products are sold through an extensive network of industrial distributors.</p>	2002 REVENUE	<p>\$186 MILLION</p>	<p>\$91 MILLION</p>	<p>\$335 MILLION</p>
	PRODUCT FAMILIES	<p>Engine Intake Air Filtration Systems ✓</p> <p>Exhaust Systems ✓</p> <p>Hydraulic Filtration Systems ✓</p> <p>Lube, Fuel and Coolant Filtration Systems ✓</p> <p>Cabin Air Filters ✓</p>	<p>✓</p> <p>✓</p> <p></p> <p>✓</p> <p>✓</p>	<p>✓</p> <p>✓</p> <p>✓</p> <p>✓</p> <p>✓</p>

ELEVEN-YEAR COMPARISON OF RESULTS

Donaldson Company, Inc. and Subsidiaries

(Thousands of dollars, except per share amounts)

	2002	2001	2000	1999
OPERATING RESULTS				
Net sales	\$1,126,005	\$1,137,015	\$1,092,294	\$944,139
Gross margin	\$ 349,492	341,734	327,521	275,681
Gross margin percentage	31.0%	30.1%	30.0%	29.2%
Operating income	\$ 123,850	112,108	105,594	88,390
Operating income percentage	11.0%	9.9%	9.7%	9.4%
Interest expense	\$ 6,531	11,608	9,880	6,993
Earnings before income taxes	\$ 119,018	104,928	100,333	89,210
Income taxes	\$ 32,135	29,380	30,100	26,763
Effective income tax rate	27.0%	28.0%	30.0%	30.0%
Net earnings	\$ 86,833	75,548	70,233	62,447
Return on sales	7.7%	6.6%	6.4%	6.6%
Return on average shareholders' equity	24.8%	25.2%	25.9%	24.1%
Return on investment	19.2%	19.1%	19.4%	19.0%
FINANCIAL POSITION				
Total assets	\$ 850,131	706,830	677,525	542,246
Current assets	\$ 456,484	407,227	383,347	326,388
Current liabilities	\$ 272,790	217,279	243,590	142,055
Working capital	\$ 183,694	189,948	139,757	184,333
Current ratio	1.7	1.9	1.6	2.3
Current debt	\$ 60,394	59,416	85,313	20,696
Long-term debt	\$ 105,019	99,259	92,645	86,691
Total debt	\$ 165,413	158,675	177,958	107,387
Shareholders' equity	\$ 382,621	319,093	280,165	262,763
Long-term capitalization ratio	21.5%	23.7%	24.9%	24.8%
Property, plant and equipment, net	\$ 240,913	207,658	204,545	182,180
Net expenditures on property, plant and equipment	\$ 40,529	38,924	36,417	29,539
Depreciation and amortization	\$ 31,751	38,577	34,326	27,686
SHAREHOLDER INFORMATION				
Net earnings per share – assuming dilution	\$ 1.90	1.66	1.51	1.31
Dividends paid per share	\$.31	.295	.27	.23
Shareholders' equity per share	\$ 8.72	7.19	6.27	5.69
Shares outstanding (000s)	43,885	44,383	44,658	46,197
Common stock price range, per share				
High	\$ 44.99	33.05	24 .81	25.88
Low	\$ 26.93	19.13	19.13	14.44

Amounts are adjusted for all stock splits and reflect adoption of SFAS 128.

Return on investment is net earnings divided by average long-term debt plus average shareholders' equity.

Long-term capitalization ratio is long-term debt divided by long-term debt plus shareholders' equity.

⁽¹⁾Excludes the cumulative effect of an accounting change of \$2,206, or \$.08 per share, in 1994.

	1998	1997	1996	1995	1994	1993	1992
	\$940,351	\$833,348	\$758,646	\$703,959	\$593,503	\$533,327	\$482,104
	263,262	250,273	222,874	197,979	166,599	152,236	133,574
	28.0%	30.0%	29.4%	28.1%	28.1%	28.5%	27.7%
	86,799	82,715	75,642	65,531	52,079	45,246	41,249
	9.2%	9.9%	10.0%	9.3%	8.8%	8.5%	8.6%
	4,671	2,358	2,905	3,089	3,362	2,723	2,681
	86,441	79,094	71,120	63,172	50,193	44,682	41,721
	29,390	28,474	27,684	24,636	18,244	16,468	15,952
	34.0%	36.0%	38.9%	39.0%	36.3%	36.9%	38.2%
	57,051	50,620	43,436	38,536	31,949 ⁽¹⁾	28,214	25,769
	6.1%	6.1%	5.7%	5.5%	5.4%	5.3%	5.3%
	22.8%	21.4%	19.3%	18.8%	17.6%	16.9%	17.2%
	20.5%	20.8%	18.5%	17.6%	16.0%	15.0%	14.8%
	512,987	467,501	402,850	381,042	337,360	300,217	286,348
	300,817	283,367	250,751	247,904	220,308	196,014	187,360
	165,068	177,346	138,578	123,747	115,757	93,666	89,956
	135,749	106,021	112,173	124,157	104,551	102,348	97,404
	1.8	1.6	1.8	2.0	1.9	2.1	2.1
	45,896	42,674	13,145	20,800	16,956	7,595	11,425
	51,553	4,201	10,041	10,167	16,028	18,920	23,482
	97,449	46,875	23,186	30,967	32,984	26,515	34,907
	255,671	243,865	228,880	221,173	189,697	174,008	160,303
	16.8%	1.7%	4.2%	4.4%	7.8%	9.8%	12.8%
	178,867	154,595	124,913	110,640	99,559	90,515	84,899
	54,705	47,327	39,297	25,334	24,642	15,005	15,538
	25,272	21,494	21,674	20,529	16,365	14,752	14,047
	1.14	.99	.84	.73	.59 ⁽¹⁾	.51	.46
	.19	.17	.15	.14	.12	.10	.09
	5.28	4.93	4.52	4.23	3.58	3.19	2.91
	48,382	49,452	50,650	52,370	53,020	54,564	55,138
	27.19	20.38	14.00	14.00	13.06	10.06	7.94
	18.56	12.69	11.94	10.94	9.13	7.00	5.19

MANAGEMENT'S DISCUSSION AND ANALYSIS

Results of Operations

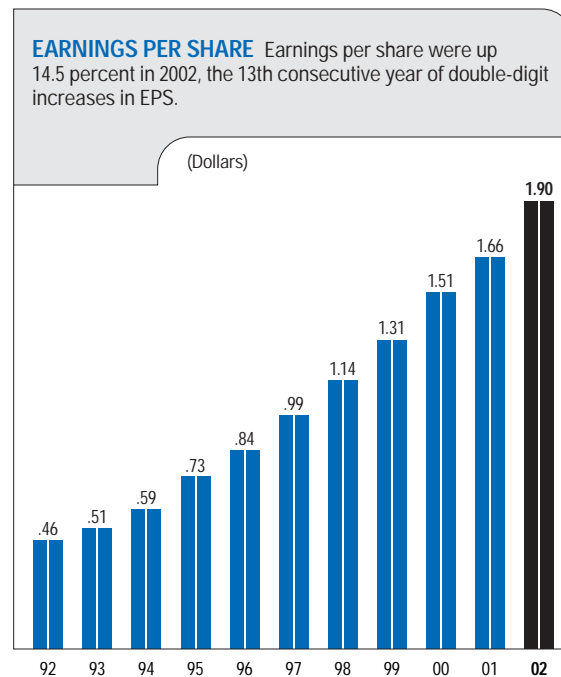
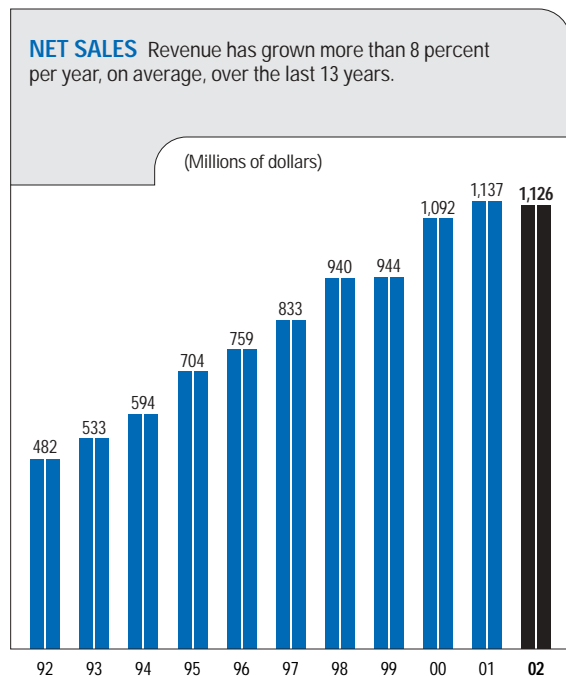
The following discussion of the company's financial condition and results of operations should be read in conjunction with the Consolidated Financial Statements and Notes thereto and other financial information included elsewhere in this Report.

Fiscal 2002 Compared to Fiscal 2001 The company reported sales in 2002 of \$1.126 billion, down 1.0 percent from \$1.137 billion last year. Despite a decrease in sales, the company achieved its 13th consecutive year of double-digit earnings growth. The company's diversification of filtration products was important to its success in fiscal 2002 in a difficult economic environment. Decreased sales in the Industrial Products segment were partially offset by increased sales in the Engine Products segment.

Sales for the Industrial Products segment were \$514.4 million, down 3.0 percent from a record \$530.2 million in the prior year. Sales totals do not include results from ultrafilter international AG ("ultrafilter"), which was acquired immediately prior to the end of the fiscal year. Within the Industrial Products segment, sales of gas turbine products were a record \$230.9 million, up 18.4 percent from a record \$195.0 million in the prior year. Sales of gas turbine products were strong domestically as well as internationally as market conditions remained steady outside of North America. Based on public comments from gas turbine manufacturers, the company expects the North American gas turbine contraction to be

severe, possibly reducing gas turbine sales in the next fiscal year by \$50 million. Sales in industrial air filtration products (formerly referred to as dust collection) of \$175.7 million decreased 19.2 percent from \$217.3 million in the prior year, impacted by weakness in industrial capital spending. Although these sales decreased from the prior year, sales of industrial air filtration products improved 21.8 percent in the fourth quarter of fiscal 2002 over the third quarter, showing the first meaningful improvement on a sequential quarter basis in two years. Sales of special application products were \$107.8 million, an 8.5 percent decrease from a record \$117.8 million in the prior year, reflecting weakness in the markets served by these products such as the computer, electronics, semiconductor and aircraft markets.

Sales for the Engine Products segment were \$611.6 million, up 0.8 percent from \$606.8 million in the prior year. This increase from the prior year reflects improved business conditions in some of the markets served by products in this segment. Within the Engine Products segment, sales of truck products were \$91.2 million, up 14.5 percent from \$79.7 million in the prior year, reflecting increased demand for new truck orders in the North American truck market prior to the new October 2002 diesel emissions regulations. Sales of off-road products were \$185.6 million, an increase of 2.1 percent from \$181.8 million in the prior year. After-market product sales of \$334.8 million decreased 3.1 percent from \$345.3 million in the prior year.



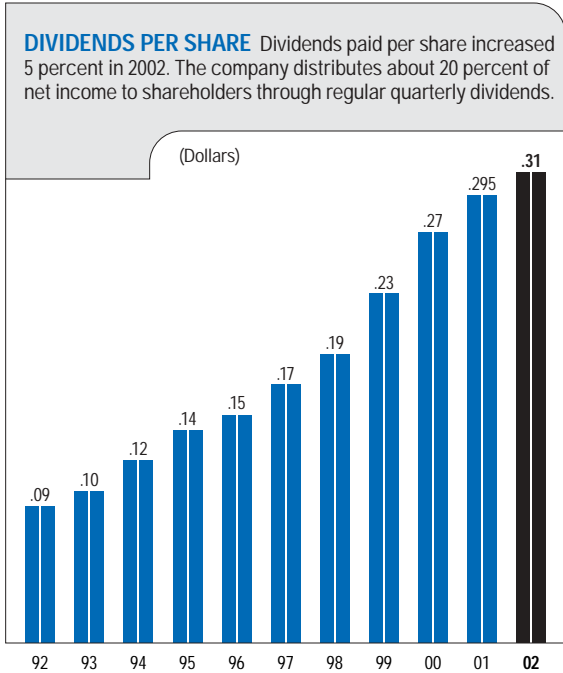
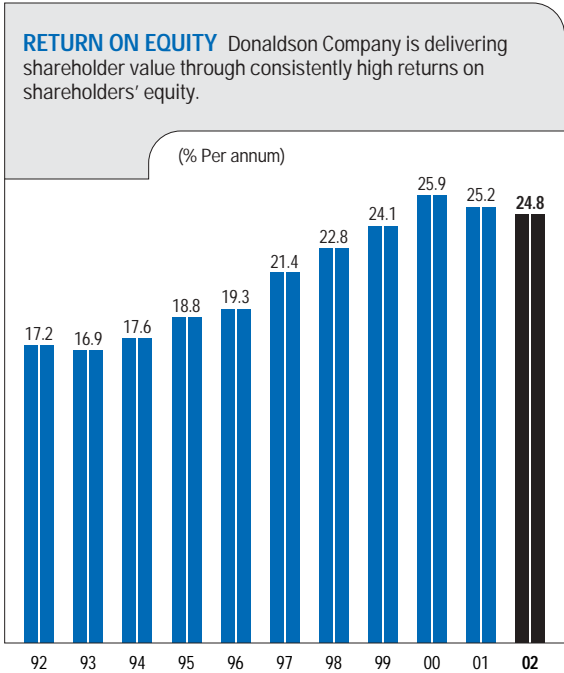
Domestic sales in the Industrial Products segment decreased 5.8 percent from the prior year. Within this segment, domestic gas turbine product sales posted an increase of 16.0 percent from the prior year. Offsetting this increase was a decrease in sales of industrial air filtration products of 25.7 percent from the prior year, as the pace of recovery in the U.S. manufacturing economy remained slow with historically high levels of excess capacity. Additionally, domestic sales of special application products decreased 23.0 percent from the prior year reflecting a general weakness in the served markets.

Domestic sales in the Engine Products segment were down 1.3 percent from the prior year. Within this segment, higher demand in the North American truck market drove an increase of domestic truck product sales of 12.6 percent from the prior year. Offsetting this increase was a decrease in domestic aftermarket product sales of 4.8 percent resulting from weakness in U.S. truck and construction equipment utilization. Domestic sales of off-road products also declined from the prior year posting a decrease of 1.9 percent.

In U.S. dollars, total international sales increased 2.9 percent from the prior year. Excluding the negative impact of foreign currency translation of \$5.2 million, sales increased 4.1 percent over the prior year. Total international sales in the Industrial Products segment were up 1.1 percent from the prior year. International sales of products within this segment were mixed. International

sales of gas turbine products increased 25.7 percent, reflecting positive market conditions outside of North America with Europe showing the most improvement in these sales. International sales of industrial air filtration products and special applications products decreased 9.4 percent and 2.0 percent, respectively. Total international sales in the Engine Products segment were up 4.8 percent from the prior year. International sales of aftermarket products were flat while international sales of off-road and truck products increased from the prior year by 9.5 percent and 20.3 percent, respectively.

The company reported record net earnings for 2002 of \$86.9 million compared to \$75.5 million in 2001, an increase of 15.0 percent. Net earnings per share – diluted were \$1.90, up 14.5 percent from \$1.66 in the prior year. Despite a decrease in sales for the year, the company achieved its 13th consecutive year of double-digit earnings growth. This was a result of the company’s efforts in improving operating performance as well as improvements made to the company’s manufacturing infrastructure, product costs and expenses. These efforts have resulted in more efficient operations across the company. The company’s operating income increased from the prior year by 10.5 percent. Operating income in the Engine Products segment showed significant growth from the prior year as it grew to over 50 percent of total operating income in the year from about 40 percent in the prior year. This growth reflects the efforts in improving operating efficiencies in the North



American Engine business. Operating income in the Industrial Products segment grew slightly during the year. International operating income totaled 68.9 percent of consolidated operating income in 2002 as compared to 64.6 percent in 2001. Of the 2002 international operating income, Europe contributed 41.0 percent while Asia-Pacific contributed 55.1 percent. Total international operating income increased 3.5 percent from the prior year. In U.S. dollars, Europe's operating income increased 14.6 percent and on a local currency basis increased 10.9 percent from strong results throughout the Engine Products segment and gas turbine products within the Industrial Products segment. On a local currency basis, Asia-Pacific's operating income increased 0.9 percent with mixed results across the entities within Asia-Pacific. In U.S. dollars, Asia-Pacific's operating income decreased by 3.2 percent due to continued weakness in the Japanese yen.

Gross margin for 2002 increased to 31.0 percent compared to 30.1 percent in the prior year. Ongoing efforts to reduce product costs and improve the company's manufacturing infrastructure through plant rationalization drove margin improvements, more than offsetting continued strong pricing pressures from major customers.

Operating expenses as a percentage of sales for 2002 and 2001 were 20.0 percent and 20.2 percent, respectively. Operating expenses in 2002 totaled \$225.6 million compared to \$229.6 million in 2001, a decrease of \$4.0 million, or 1.7 percent. The decrease in operating expenses relative to the prior year reflects the company's expense reduction initiatives, implemented late in fiscal 2001, which reduced the number of contractors and temporary employees and managed discretionary spending levels.

Interest expense decreased \$5.1 million, or 43.7 percent, partially due to lower interest rates and lower short-term debt levels throughout most of the year. This decrease is also due to a decrease in interest expense (\$1.2 million) on a portion of the company's long-term debt as a result of an interest rate swap agreement entered into in fiscal 2001. Other income, net totaled \$1.7 million in 2002 compared to \$4.4 million in the prior year. Components of other income for 2002 were as follows: interest income of \$0.9 million, earnings from non-consolidated joint ventures of \$4.2 million, \$2.5 million of funding to the Donaldson Foundation, foreign exchange losses of \$1.3 million resulting from the movement of cash into Europe to complete the ultrafilter acquisition and other miscellaneous income and expense items netting to \$0.4 million of miscellaneous income.

The effective income tax rate of 27.0 percent in 2002 decreased from the 28.0 percent tax rate in 2001. The tax rate was adjusted in the second quarter of fiscal 2002 to reflect state tax savings from infrastructure improvements. The company anticipates maintaining the 27.0 effective income tax rate for the foreseeable future.

Total backlog was \$307.6 million, down 13.4 percent from the same period in the prior year. In the Industrial Products segment, total backlog decreased 29.4 percent from the same period in the prior year reflecting the projected downturn in the North American gas turbine market. In the Engine Products segment, total backlog increased 3.4 percent compared to the same period in the prior year, reflecting improvement in business conditions in the markets served. Hard order backlog, goods scheduled for delivery within 90 days, was \$178.3 million, down 0.9 percent from \$179.9 million in the prior year. In the Industrial Products segment, overall hard order backlog decreased 10.9 percent from the prior year. Within this segment, hard order backlog for gas turbine products and industrial air filtration products decreased 21.1 percent and 7.4 percent from the prior year, respectively. These decreases were somewhat offset by a strong increase in special application products of 34.3 percent. In the Engine Products segment, overall hard order backlog increased 8.7 percent from the prior year. Within this segment, truck products showed a solid increase of 22.9 percent from the prior year. Hard order backlog for aftermarket products decreased slightly at 0.3 percent, while off-road products posted an increase of 7.6 percent.

The company completed the acquisition of ultrafilter for \$68.3 million in cash on July 12, 2002. The acquisition is reflected in the consolidated balance sheet as of July 31, 2002. Ultrafilter's results of operations will be included in the consolidated financial statements beginning with fiscal 2003 as the results in fiscal 2002 were not material to the company as a whole. Ultrafilter is a global leader in the design and manufacture of components, replacement parts and complete systems for the compressed air purification industry. Ultrafilter's operations will be included in the Industrial Products segment.

Fiscal 2001 Compared to Fiscal 2000 The company reported record sales in 2001 of \$1.137 billion. This was an increase of 4.1 percent over prior year sales of \$1.092 billion. Excluding the impact of businesses acquired in 2000, sales for the year ended July 31, 2001 were up 0.5 percent over the prior year. This modest growth in sales for the year reflected the diversification of our Industrial Products and Engine Products segments as shown by the strength in the gas turbine market offsetting the slump in the North

American truck market. Sales for the Industrial Products segment were a record \$530.2 million, up 26.7 percent over the prior year. Excluding the acquisition of DCE dust control business of Invensys, plc ("DCE"), sales for the year were up 18.9 percent from the prior year. Leading this increase were sales in gas turbine products with an increase over the prior year of 66.6 percent to record sales of \$195.0 million, reflecting the continued high demand in this market. Sales in industrial air filtration and special application products also increased from the prior year by 12.5 percent and 8.9 percent, respectively. Excluding the acquisition of DCE, sales of industrial air filtration products decreased 4.4 percent from the prior year. Sales for the Engine Products segment of \$606.8 million were down 10.0 percent over the prior year reflecting the U.S. economic weakness and the strong U.S. dollar overseas. Worldwide markets for medium and heavy-duty trucks were severely depressed, reflected in a decrease in truck product sales of 47.6 percent from the prior year. Excluding the company's second quarter exit from a block of truck related business due to unfavorable commercial terms, sales were down 37.1 percent from the prior year. Sales in off-road products decreased 5.9 percent from the prior year while aftermarket product sales increased 5.0 percent.

Domestic Industrial Products sales increased 28.1 percent from the prior year. This increase was led by strong sales of gas turbine systems products domestically, reflecting continued demand for large turbines in North America, with domestic sales almost doubling from the prior year. Domestic sales of industrial air filtration products grew slightly with an increase of 1.7 percent, while sales of special application products domestically decreased 8.2 percent. Domestic Engine Products sales were down 10.5 percent from the prior year. The medium and heavy-duty truck market continued to show its effects on the company's truck product sales domestically with a decrease of 51.8 percent from the prior year. This was somewhat offset by increases in domestic aftermarket and off-road product sales of 1.7 percent and 13.1 percent, respectively.

In U.S. dollars, total international sales increased 5.6 percent from the prior year. Excluding the negative impact of foreign currency translation of \$35.6 million, sales increased 14.4 percent over the prior year. Total international Industrial Products sales were up 24.9 percent from the prior year. Sales of all products within this segment were strong internationally, with increases across the board. Leading this growth were sales of industrial air filtration products with an increase of 34.1 percent from the prior year. Sales of gas turbine products and special application products increased 20.2 percent and 18.9 percent from the

prior year, respectively. Total international Engine Products sales were down 8.9 percent compared to the prior year despite an increase in aftermarket product sales of 11.3 percent. International sales of off-road and truck products decreased from the prior year by 28.3 percent and 29.0 percent, respectively.

The company reported record net earnings for 2001 of \$75.5 million compared to \$70.2 million in 2000, an increase of 7.6 percent. Net earnings per share – diluted were \$1.66, up 10.0 percent from \$1.51 in the prior year. With only a modest increase in sales, the increase in net earnings is also a result of cost management, particularly in plant rationalization efforts throughout the year and other cost reduction initiatives in the second half of the year. This along with the decrease in the company's effective tax rate due to increased profitability from foreign operations helped to offset the effect of negative foreign currency exchange rates. The Industrial Products segment continued to grow, contributing 46.6 percent of consolidated sales, approximately 70.0 percent of the operating income and all of the growth in operating income for the year. International operating income totaled approximately 68.9 percent and 62.1 percent of consolidated operating income in 2001 and 2000, respectively. International operations also contributed all of the growth in operating income. Europe's operating income increased 7.1 percent (16.2 percent in local currency) as a result of strong gas turbine results, the completion of the DCE integration and improved results in most markets. Asia-Pacific's operating income increased by 38.0 percent (44.4 percent in local currency), led by increases from Japan's ROI improvement project and strong disk drive results in the Hong Kong and Wuxi, China, operations.

Gross margin for 2001 remained virtually flat with only a slight increase to 30.1 percent compared to 30.0 percent in the prior year. This reflects an improved product mix and benefits of plant rationalization efforts, offsetting strong pricing pressure from major customers.

Operating expenses as a percentage of sales for 2001 and 2000 were 20.2 percent and 20.3 percent, respectively. Operating expenses in 2001 totaled \$229.6 million compared to \$221.9 million in 2000, an increase of \$7.7 million, or 3.5 percent. The increase in operating expenses relative to the prior year reflects higher sales levels and the continued impact of the businesses acquired in 2000.

Interest expense increased \$1.7 million, or 17.5 percent, primarily due to higher short-term debt levels throughout the year related to last year's acquisitions. Other income totaled \$4.4 million in 2001 compared to other income of \$4.6 million in the prior year. The major components

of other income in 2001 were: interest income of \$1.2 million, earnings from non-consolidated joint ventures of \$3.0 million, and other miscellaneous income and expense items netting to \$0.2 million of miscellaneous income.

The effective income tax rate of 28.0 percent in 2001 decreased from the 30.0 percent tax rate in 2000. The tax rate was adjusted in the third quarter to provide for the increased contributions from the company's international operations in lower tax rate countries and reflects the foreign tax credit generated by the receipt of a dividend from the company's operations in Japan. The company anticipates that it will have a comparable proportion of income coming from its international operations located in lower tax rate countries in 2002. The company anticipates that its effective income tax rate will be approximately 28.0 percent in 2002.

Total backlog was \$355.3 million, up 7.2 percent from the same period last year. In the Industrial Products segment, total backlog increased 16.8 percent from the same period last year. In the Engine Products segment, total backlog was down 1.3 percent compared to the same period last year. Hard order backlog, goods scheduled for delivery in 90 days, was \$179.9 million, down 2.1 percent from \$183.7 million in the prior year. Within the Industrial Products segment, hard order backlog for gas turbine products increased 28.7 percent from the prior year. This increase was offset by decreases in industrial air filtration and special application products of 26.2 percent and 24.1 percent, respectively, resulting in a slight overall increase in the Industrial Products segment from the prior year. In the Engine Products segment, overall hard order backlog decreased 4.5 percent from the prior year. Within this segment, off-road and truck products posted decreases of 6.4 percent and 16.3 percent, respectively, while after-market hard order backlog increased 4.5 percent from the prior year.

Liquidity and Capital Resources

Financial Condition At July 31, 2002, the company's capital structure was comprised of \$60.4 million of current debt, \$105.0 million of long-term debt and \$382.6 million of shareholders' equity. The ratio of long-term debt to total capital was 21.5 percent and 23.7 percent at July 31, 2002 and 2001, respectively.

Total debt outstanding increased \$6.7 million for the year to \$165.4 million outstanding at July 31, 2002. The increase is a result of an increase in long-term debt of \$5.8 million from the prior year. The increase in long-term debt is primarily due to an increase in an unsecured senior

note of \$1.5 million as a result of an interest rate swap agreement entered into in fiscal 2001 and the addition of capitalized lease obligations of \$3.5 million resulting from the acquisition of ultrafilter. Long-term debt also increased by \$0.7 million due to foreign exchange translation for two guaranteed notes in our Japan operations due to continued weakness in the Japanese yen. Short-term borrowings outstanding at the end of the year increased \$0.9 million as compared to the prior year.

The company has a multi-currency revolving credit facility totaling \$100.0 million with a group of banks and an additional \$45.0 million available for use under uncommitted facilities which provide unsecured borrowings for general corporate purposes. There was \$35.5 million outstanding under these facilities at July 31, 2002.

The following table summarizes the company's fixed cash obligations as of July 31, 2002 over various future years (in thousands):

Contractual Cash Obligations	Total	Payments Due by Period			
		Less than 1 Year	1 - 3 Years	4 - 5 Years	After 5 Years
Long-term debt	\$105,076	\$ 57	\$39,660	\$38,640	\$26,719
Short-term debt	60,337	60,337	-	-	-
Total	\$165,413	\$60,394	\$39,660	\$38,640	\$26,719

At July 31, 2002, the company had a contingent liability for standby letters of credit totaling \$14.8 million that have been issued and are outstanding. Currently, there are no amounts drawn on these letters of credit.

The company believes that the combination of present capital resources, internally generated funds, and unused financing sources are adequate to meet cash requirements for fiscal 2003.

Shareholders' equity increased \$63.5 million in 2002 to \$382.6 million. The increase was due to current year earnings of \$86.9 million offset by \$21.3 million of treasury stock repurchases, \$13.7 million of dividend payments and a net increase in other comprehensive income of \$9.9 million and \$1.7 million of other miscellaneous stock activity. The increase in other comprehensive income consisted primarily of a foreign currency translation adjustment of \$13.5 million offset by an additional minimum pension liability of \$3.3 million.

Cash Flows During fiscal 2002, \$154.3 million of cash was generated from operating activities, compared with \$82.8 million in 2001 and \$88.5 million in 2000. The increase in 2002 was primarily due to a decrease in accounts receivable of \$8.1 million, a decrease in inventory of \$13.6 million and an increase in accounts payable and other accrued expenses of \$25.2 million during the year.

In addition to cash generated from operating activities, the company increased its outstanding short-term debt by \$3.0 million while net long-term debt increased by \$1.6 million. Cash flow generated by operations was used primarily to support \$40.5 million for capital expenditures, \$21.3 million for stock repurchases and \$13.7 million for dividend payments. Cash and cash equivalents increased \$9.5 million during 2002.

Capital expenditures for property, plant and equipment totaled \$40.5 million in 2002, compared to \$38.9 million in 2001 and \$36.4 million in 2000. Capital expenditures primarily related to productivity enhancing investments at various plants worldwide and continuing upgrades to the U.S. information systems.

Capital spending in 2003 is planned at \$45.0 million. Significant planned expenditures include the further upgrade of U.S. information systems and investment in manufacturing equipment and tooling. It is anticipated that 2003 capital expenditures will be financed primarily by cash generated from operations and existing lines of credit.

Dividends The company's dividend policy is to maintain a payout ratio which allows dividends to increase with the long-term growth of earnings per share, while sustaining dividends in down years. The company's dividend payout ratio target is 20.0 percent to 25.0 percent of the average earnings per share of the last three years. The current quarterly dividend of 8.5 cents per share equates to 20.1 percent of the average net earnings per share for 2000 through 2002.

Share Repurchase Plan In fiscal 2002, the company repurchased 0.7 million shares of common stock on the open market for \$21.3 million under the share repurchase plan authorized in January 2001, at an average price of \$32.37 per share. The company repurchased 0.5 million shares for \$10.3 million in 2001 and 1.7 million shares for \$35.9 million in 2000.

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

New Accounting Standards In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." Major provisions of these statements are as follows: all business combinations must now use the purchase method of accounting; intangible assets acquired in a business combination must be recorded separately from goodwill if they arise from contractual or other legal rights or are separable from the acquired entity and can be sold, transferred, licensed, rented or exchanged, either individually or as a part of a related contract, asset or liability; goodwill and intangible assets with indefinite lives are not amortized but tested for impairment annually and whenever there is an impairment indicator; all acquired goodwill must be assigned to reporting units for purposes of impairment testing and segment reporting. The company adopted the provisions of these statements as of August 1, 2001. As required by SFAS No. 142, the company has performed step one of the impairment testing of goodwill for the balances as of August 1, 2001. The results of this test show that the fair market value of the reporting units that the goodwill is assigned to is higher than the book values of those reporting units resulting in no goodwill impairment. The company will perform impairment tests annually and whenever events or circumstances occur indicating that goodwill or other intangible assets might be impaired. As of August 1, 2001, the company is no longer amortizing goodwill. Goodwill amortization expense was \$2.7 million and \$1.9 million, net of income taxes, for the year ended July 31, 2001 and 2000, respectively. The company estimates that goodwill amortization expense would have been approximately \$2.6 million, net of income taxes, for the year ended July 31, 2002.

The following table presents a reconciliation of net income and earnings per share adjusted for the exclusion of goodwill, net of income taxes:

(In thousands, except per share amounts)	2002	2001	2000
Reported net income	\$86,883	\$75,548	\$70,233
Add goodwill amortization, net of tax	-	2,722	1,895
Adjusted net income	\$86,883	\$78,270	\$72,128
Basic earnings per share:			
Reported basic earnings per share	\$ 1.97	\$ 1.70	\$ 1.54
Add goodwill amortization, net of tax	-	.06	.04
Adjusted basic earnings per share	\$ 1.97	\$ 1.76	\$ 1.58
Diluted earnings per share:			
Reported diluted earnings per share	\$ 1.90	\$ 1.66	\$ 1.51
Add goodwill amortization, net of tax	-	.06	.04
Adjusted diluted earnings per share	\$ 1.90	\$ 1.72	\$ 1.55

As of July 31, 2002 and 2001, goodwill was \$86.4 million and \$57.5 million, respectively. In fiscal 2002, goodwill increased \$28.1 million for the acquisition of ultrafilter and decreased \$0.5 million for the reversal of restructuring reserves that were unused from previous acquisitions. The remaining increase of \$1.3 million was due to foreign exchange translation. For the Industrial Products and Engine Products segments, goodwill as of July 31, 2002 totaled \$62.6 million and \$23.8 million, respectively, and as of July 31, 2001 totaled \$33.4 million and \$24.1 million, respectively.

In June 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations." This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 is effective for the company in fiscal 2003. Management does not expect this statement to have a material impact on the company's consolidated financial statements.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 establishes a single model for the impairment of long-lived assets and broadens the presentation of discontinued operations to include more disposal transactions. SFAS No. 144 is effective for the company in fiscal 2003. Management does not expect this statement to have a material impact on the company's consolidated financial statements.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS No. 146 addresses significant issues relating to the recognition, measurement and reporting of costs associated with exit and disposal activities including restructuring. SFAS No. 146 is effective for the company in fiscal 2003.

Market Risk

The company's market risk includes the potential loss arising from adverse changes in foreign currency exchange rates and interest rates. The company manages foreign currency market risk, from time to time, through the use of a variety of financial and derivative instruments. The company does not enter into any of these instruments for trading purposes to generate revenue. Rather, the company's objective in managing these risks is to reduce fluctuations

in earnings and cash flows associated with changes in foreign currency exchange rates. The company uses forward exchange contracts and other hedging activities to hedge the U.S. dollar value resulting from anticipated foreign currency transactions. The company's market risk on interest rates is the potential increase in fair value of long-term debt resulting from a potential decrease in interest rates. See further discussion of these market risks below.

Foreign Currency During 2002, overall the U.S. dollar strengthened throughout the year relative to the currencies of the foreign countries in which the company operates. The stronger dollar had a negative impact on the company's international net sales results because the foreign denominated revenues translated into fewer U.S. dollars. The overall impact to net earnings, though, was nominal.

It is not possible to determine the true impact of foreign currency translation changes; however, the direct effect on net sales and net earnings can be estimated. For the year ended July 31, 2002, the impact of foreign currency translation resulted in an overall decrease in net sales of \$5.2 million but had a nominal impact on net earnings. Foreign currency translation had a negative impact in Japan, where the stronger U.S. dollar relative to the Japanese yen resulted in a decrease in net sales of \$6.4 million and a decrease in net earnings of \$0.3 million. The stronger U.S. dollar relative to the South African rand also had a negative impact on foreign currency translation with a decrease in net sales of \$4.7 million and a decrease in net earnings of \$0.2 million. In Europe, the euro strengthened, and almost reached parity with the U.S. dollar by the end of the fiscal year. This resulted in an increase in net sales of \$5.7 million and an increase in net earnings of \$0.4 million. Going forward, the company expects local currency results to remain strong; excluding the effect of translation, revenues outside the United States increased 4.1 percent for the year ended July 31, 2002.

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

The foreign subsidiaries of the company purchase products and parts in various currencies. As a result, the company may be exposed to cost increases relative to local

currencies in the markets to which it sells. To mitigate such adverse trends, the company, from time to time, enters into forward exchange contracts and other hedging activities. Additionally, foreign currency positions are partially offsetting and are netted against one another to reduce exposure.

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

Interest The company's exposure to market risks for changes in interest rates relates primarily to our short-term investments, short-term borrowings and interest rate swap agreement. We have no earnings or cash flow exposure due to market risks on our long-term debt obligations as a result of the fixed-rate nature of the debt. However, interest rate changes would affect the fair market value of the debt. At July 31, 2002, the fair value of the company's long-term debt approximates market. Market risk is estimated as the potential decrease in fair value resulting from a hypothetical one-half percent increase in interest rates and amounts to approximately \$3.3 million.

During fiscal 2001, the company entered into an interest rate swap agreement effectively converting a portion of the company's interest rate exposure from a fixed-rate to a variable rate basis to hedge against the risk of higher borrowing costs in a declining interest rate environment. The company does not enter into interest rate swap contracts for speculative or trading purposes, as the differential to be paid or received on the interest rate swap agreement is accrued and recognized as an adjustment to interest expense as interest rates change. The interest rate swap agreement has an aggregate notional amount of \$27.0 million maturing on July 15, 2008. The variable rate is based on the current six-month London Interbank Offered Rates ("LIBOR"). This transaction resulted in a decrease to interest expense of \$1.2 million for the year ended July 31, 2002.

Critical Accounting Policies

The company's consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the use of estimates, judgments and assumptions that affect the reported

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

Allowance for doubtful accounts – Allowances for doubtful accounts are estimated by management based on evaluation of potential losses related to customer receivable balances. Estimates are developed by using standard quantitative measures based on historical losses, adjusting for current economic conditions and, in some cases, evaluating specific customer accounts for risk of loss. The establishment of this reserve requires the use of judgment and assumptions regarding the potential for losses on receivable balances. Though management considers these balances adequate and proper, changes in economic conditions in specific markets in which the company operates could have an effect on reserve balances required.

Inventory – The company's inventories are valued at the lower of cost or market. Reserves for shrink and obsolescence are estimated using standard quantitative measures based on historical losses, including issues related to specific inventory items. Though management considers these balances adequate and proper, changes in economic conditions in specific markets in which the company operates could have an effect on reserve balances required.

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

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

Forward-Looking Statements

The company desires to take advantage of the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995 and is making this cautionary statement in connection with such safe harbor legislation. This Annual Report to Shareholders, any Form 10-K, Form 10-Q, Form 8-K, earnings releases or other press releases of the company or any other written or oral statements made by or on behalf of the company may include forward-looking statements which reflect the company’s current views with respect to future events and financial performance. The words “believe,” “expect,” “anticipate,” “intends,” “estimate,” “forecast,” “plan,” “project,” “should” and similar expressions are intended to identify “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. All forecasts and projections in this Annual Report are “forward-looking statements,” and are based on management’s current expectations of the company’s near-term results, based on current information available to the company.

The company wishes to caution investors that any forward-looking statements made by or on behalf of the company are subject to uncertainties and other factors that could cause actual results to differ materially from such statements. These uncertainties and other risk factors include, but are not limited to: risks associated with currency fluctuations, commodity prices, world economic factors, political factors, the company’s substantial international operations including key disk drive filter production facilities in China, highly competitive markets, changes in product demand and changes in the geographic and product mix of sales, acquisition opportunities and integration of recent acquisitions, including the acquisition of ultra-filter, facility and product line rationalization, research and development expenditures, including ongoing information technology improvements, and governmental laws and regulations, including diesel emissions controls. For a more detailed explanation of the foregoing and other risks, see exhibit 99, which is part of the company’s Form 10-K filed with the Securities and Exchange Commission. The company wishes to caution investors that other factors may in the future prove to be important in affecting the company’s results of operations. New factors emerge from time to time and it is not possible for management to predict all such factors, nor can it assess the impact of each such factor on the business or the extent to which any factor, or a combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

Investors are further cautioned not to place undue reliance on such forward-looking statements as they speak only to the company’s views as of the date the statement is made. The company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

CONSOLIDATED STATEMENTS OF EARNINGS

Donaldson Company, Inc. and Subsidiaries

(Thousands of dollars, except share and per share amounts) Year ended July 31,	2002	2001	2000
Net sales	\$1,126,005	\$1,137,015	\$1,092,294
Cost of sales	776,513	795,281	764,773
Gross Margin	349,492	341,734	327,521
Selling, general and administrative	197,492	201,201	194,623
Research and development	28,150	28,425	27,304
Operating Income	123,850	112,108	105,594
Interest expense	6,531	11,608	9,880
Other (income) expense, net	(1,699)	(4,428)	(4,619)
Earnings Before Income Taxes	119,018	104,928	100,333
Income taxes	32,135	29,380	30,100
Net Earnings	\$ 86,883	\$ 75,548	\$ 70,233
Weighted Average Shares – Basic	44,158,074	44,381,082	45,716,482
Weighted Average Shares – Diluted	45,714,409	45,612,165	46,664,196
Net Earnings Per Share – Basic	\$ 1.97	\$ 1.70	\$ 1.54
Net Earnings Per Share – Diluted	\$ 1.90	\$ 1.66	\$ 1.51

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED BALANCE SHEETS

Donaldson Company, Inc. and Subsidiaries

(Thousands of dollars, except share amounts) At July 31,	2002	2001
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 45,586	\$ 36,136
Accounts receivable, less allowance of \$6,620 and \$6,309	251,417	230,046
Inventories		
Raw materials	49,162	50,426
Work in process	16,796	21,209
Finished products	51,733	40,999
Total Inventories	117,691	112,634
Deferred income taxes	18,417	12,746
Prepays and other current assets	23,373	15,665
Total Current Assets	456,484	407,227
Property, Plant and Equipment, at cost		
Land	13,549	6,890
Buildings	134,660	117,029
Machinery and equipment	375,275	345,073
Construction in progress	29,240	22,603
	552,724	491,595
Less accumulated depreciation	(311,811)	(283,937)
	240,913	207,658
Intangible Assets	103,681	58,205
Other Assets	49,053	33,740
Total Assets	\$ 850,131	\$ 706,830
LIABILITIES & SHAREHOLDERS' EQUITY		
Current Liabilities		
Short-term borrowings	\$ 60,337	\$ 59,393
Current maturities of long-term debt	57	23
Trade accounts payable	115,299	100,287
Accrued employee compensation and related taxes	31,171	29,945
Accrued liabilities	31,542	17,597
Other current liabilities	34,384	10,034
Total Current Liabilities	272,790	217,279
Long-term Debt	105,019	99,259
Deferred Income Taxes	13,376	9,189
Other Long-term Liabilities	76,325	62,010
Commitments and Contingencies (Note J)		
Shareholders' Equity		
Preferred stock, \$1.00 par value, 1,000,000 shares authorized, none issued	-	-
Common stock, \$5.00 par value, 80,000,000 shares authorized, 49,655,954 shares issued in 2002 and 2001	248,280	248,280
Retained earnings	274,395	203,499
Accumulated other comprehensive loss	(14,296)	(24,235)
Treasury stock – 5,741,417 and 5,273,121 shares in 2002 and 2001, at cost	(125,758)	(108,451)
Total Shareholders' Equity	382,621	319,093
Total Liabilities & Shareholders' Equity	\$ 850,131	\$ 706,830

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Donaldson Company, Inc. and Subsidiaries

(Thousands of dollars) Year ended July 31,	2002	2001	2000
OPERATING ACTIVITIES			
Net earnings	\$ 86,883	\$ 75,548	\$ 70,233
Adjustments to reconcile net earnings to net cash provided by operating activities			
Depreciation and amortization	31,751	38,577	34,326
Equity in (earnings) loss of affiliates	82	(635)	74
Deferred income taxes	(5,266)	7,093	(449)
Other	(2,973)	(12,949)	3,121
Changes in operating assets and liabilities, net of acquired businesses			
Accounts receivable	8,053	(35,220)	(5,704)
Inventories	13,608	2,816	(26,227)
Prepays and other current assets	(2,979)	2,838	(3,316)
Trade accounts payable and other accrued expenses	25,153	4,731	16,437
Net Cash Provided by Operating Activities	154,312	82,799	88,495
INVESTING ACTIVITIES			
Purchases of property, plant and equipment	(40,529)	(38,924)	(36,417)
Acquisitions and investments in affiliates	(68,349)	-	(88,220)
Net Cash Used in Investing Activities	(108,878)	(38,924)	(124,637)
FINANCING ACTIVITIES			
Proceeds from long-term debt	1,590	9,462	5,752
Repayments of long-term debt	(23)	(1,136)	(4,522)
Change in short-term borrowings	2,961	(24,417)	66,328
Purchase of treasury stock	(21,271)	(10,297)	(35,923)
Dividends paid	(13,713)	(13,092)	(12,384)
Exercise of stock options	(1,334)	525	326
Net Cash (Used in) Provided by Financing Activities	(31,790)	(38,955)	19,577
Effect of exchange rate changes on cash	(4,194)	(801)	(1,053)
Increase (Decrease) in Cash and Cash Equivalents	9,450	4,119	(17,618)
Cash and Cash Equivalents, Beginning of Year	36,136	32,017	49,635
Cash and Cash Equivalents, End of Year	\$ 45,586	\$ 36,136	\$ 32,017

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Donaldson Company, Inc. and Subsidiaries

(Thousands of dollars, except per share amounts)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
BALANCE JULY 31, 1999	\$248,280	\$ 1,833	\$ 87,687	\$ (5,670)	\$ (69,367)	\$262,763
Comprehensive income						
Net earnings			70,233			70,233
Foreign currency translation				(4,853)		(4,853)
Comprehensive income						65,380
Treasury stock acquired					(35,923)	(35,923)
Stock options exercised			(3,360)		2,555	(805)
Tax reduction – employee plans		1,134				1,134
Cash dividends (\$.27 per share)			(12,384)			(12,384)
BALANCE JULY 31, 2000	248,280	2,967	142,176	(10,523)	(102,735)	280,165
Comprehensive income						
Net earnings			75,548			75,548
Foreign currency translation				(13,717)		(13,717)
Additional minimum pension liability				(341)		(341)
Net gain on cash flow hedging derivatives				346		346
Comprehensive income						61,836
Treasury stock acquired					(10,297)	(10,297)
Stock options exercised		(6,196)	(1,124)		4,262	(3,058)
Performance awards			(9)		319	310
Tax reduction – employee plans		3,229				3,229
Cash dividends (\$.295 per share)			(13,092)			(13,092)
BALANCE JULY 31, 2001	248,280	–	203,499	(24,235)	(108,451)	319,093
Comprehensive income						
Net earnings			86,883			86,883
Foreign currency translation				13,515		13,515
Additional minimum pension liability				(3,256)		(3,256)
Net loss on cash flow hedging derivatives				(320)		(320)
Comprehensive income						96,822
Treasury stock acquired					(21,271)	(21,271)
Stock options exercised		(3,023)	(2,329)		3,749	(1,603)
Performance awards			55		215	270
Tax reduction – employee plans		3,023				3,023
Cash dividends (\$.31 per share)			(13,713)			(13,713)
BALANCE JULY 31, 2002	\$248,280	\$ –	\$274,395	\$(14,296)	\$(125,758)	\$382,621

The accompanying notes are an integral part of these consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Donaldson Company, Inc. and Subsidiaries

> NOTE A

Summary of Significant Accounting Policies

Description of Business Donaldson Company, Inc., is a leading worldwide manufacturer of filtration systems and replacement parts. The company's product mix includes air and liquid filters and exhaust and emission control products for mobile equipment; in-plant air cleaning systems; compressed air purification systems; air intake systems for industrial gas turbines; and specialized filters for such diverse applications as computer disk drives, aircraft passenger cabins and semi-conductor processing. Products are manufactured at more than three dozen Donaldson plants around the world and through four joint ventures.

Principles of Consolidation The consolidated financial statements include the accounts of Donaldson Company, Inc. and all majority-owned subsidiaries (the company). All significant inter-company accounts and transactions have been eliminated. The company also has four joint ventures that are not majority-owned, all accounted for on the equity method. Certain amounts in prior periods have been reclassified to conform to the current presentation. The reclassifications had no impact on the company's net earnings or shareholders' equity as previously reported.

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

Foreign Currency Translation For most foreign operations, local currencies are considered the functional currency. Assets and liabilities are translated using the exchange rates in effect at the balance sheet date. Results of operations are translated using the average exchange rates prevailing throughout the period. Translation gains or losses, net of applicable deferred taxes, are accumulated in the foreign currency adjustment in accumulated other comprehensive income (loss) in shareholders' equity. Foreign currency transaction losses of \$1.3 million in 2002 are included in earnings before income taxes. There were no significant foreign currency transaction gains or losses in 2001. Foreign currency transaction losses of \$0.2 million in 2000 are included in earnings before income taxes.

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

Inventories Inventories are stated at the lower of cost or market. Domestic inventories are valued using the last-in, first-out (LIFO) method, while the international subsidiaries use the first-in, first-out (FIFO) method. Inventories valued at LIFO were approximately 41 percent and 53 percent of total inventories at July 31, 2002 and 2001, respectively.

For inventories valued under the LIFO method, the FIFO cost exceeded the LIFO carrying values by \$20.8 million and \$22.5 million at July 31, 2002 and 2001, respectively.

Property, Plant and Equipment Property, plant and equipment are stated at cost. Additions, improvements or major renewals are capitalized, while expenditures that do not enhance or extend the asset's useful life are charged to operating expense as incurred. Depreciation is computed principally by use of declining balance methods on facilities and equipment acquired on or prior to July 31, 1992. The company adopted the straight-line depreciation method for all property acquired after July 31, 1992. Depreciation expense was \$31.7 million in 2002 and 2001 and \$32.1 million in 2000. The cost and related accumulated depreciation of assets sold or disposed of are removed from the accounts and the resulting gain or loss, if any, is recognized.

The estimated useful lives of property, plant and equipment are as follows:

Buildings	10 to 40 years
Machinery and equipment	3 to 10 years

Intangible Assets Goodwill represents the excess of the purchase price of acquired companies over the fair value of net assets acquired. As a result of adopting Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets," in the first quarter of fiscal 2002 the company no longer amortizes goodwill. See pro forma effects of adopting this standard under "New Accounting Standards" later in Note A. Other intangible assets are recorded at cost and are amortized on a straight-line basis over their estimated useful lives. There was no significant amortization expense in 2002. Amortization expense was \$3.8 million and \$2.7 million in 2001 and 2000, respectively. Accumulated amortization was \$9.6 million as of July 31, 2002 and 2001.

Impairment of Long-Lived Assets The company reviews the long-lived assets, including identifiable intangibles and associated goodwill, for impairment when events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If impairment indicators are present and the estimated future undiscounted cash flows are less than the carrying value of the assets and any related goodwill, the carrying value is reduced to the estimated fair value as measured by the undiscounted cash flows.

Income Taxes Deferred tax assets and liabilities are recognized for the expected future tax consequences attributed to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to reverse. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized.

Comprehensive Income Comprehensive income consists of net income, foreign currency translation adjustments, additional minimum pension liability and net gain or loss on cash flow hedging derivatives, and is presented in the Consolidated Statements of Changes in Shareholders' Equity.

Earnings Per Share The company's basic net earnings per share is computed by dividing net earnings by the weighted average number of outstanding common shares. The company's diluted net earnings per share is computed by dividing net earnings by the weighted average number of outstanding common shares and dilutive shares relating to stock options.

The following table presents information necessary to calculate basic and diluted earnings per share:

(In thousands, except per share amounts)	2002	2001	2000
Weighted average shares – basic	44,158	44,381	45,716
Dilutive shares	1,556	1,231	948
Weighted average shares – diluted	45,714	45,612	46,664
Net earnings for basic and diluted earnings per share computation	\$86,883	\$75,548	\$70,233
Net earnings per share – basic	\$ 1.97	\$ 1.70	\$ 1.54
Net earnings per share – diluted	\$ 1.90	\$ 1.66	\$ 1.51

Treasury Stock Repurchased common stock is stated at cost and is presented as a separate reduction of shareholders' equity. The company believes the share repurchase program is an excellent means of returning value to the shareholders.

Research and Development All expenditures for research and development are charged against earnings in the year incurred.

Stock-Based Compensation SFAS No. 123, "Accounting for Stock-Based Compensation," encourages, but does not require, companies to record compensation cost for stock-based employee compensation plans at fair value. The company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations. Accordingly, compensation cost for stock options is measured as the excess, if any, of the quoted market price of the company's stock at the date of the grant over the amount an employee must pay to acquire the stock. Compensation cost for performance equity units is recorded based on the quoted market price of the company's stock at the end of the period.

Revenue Recognition Revenue is recognized when product is shipped and invoiced and title to the goods transfers to customers. The company records estimated discounts and rebates as a reduction of sales in the same period revenue is recognized. Shipping and handling costs are classified as a component of cost of sales.

Product Warranties The company provides for estimated warranty costs and accrues for specific items at the time their existence is known and the amounts are determinable.

Derivative Instruments and Hedging Activities In fiscal 2001, the company adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities – an amendment of FASB Statement No. 133." With the adoption of SFAS 133, the company recognizes all derivatives on the balance sheet at fair value. Derivatives that are not hedges are adjusted to fair value through income. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives are either offset against the change in fair value of the hedged assets, liabilities or firm commitments through earnings or recognized in shareholders' equity through other comprehensive income until the hedged item is recognized. Gains or losses related to the ineffective portion of any hedge are recognized through earnings in the current period. The impact of the adoption of SFAS 133 was not considered material to the company.

The company uses derivative instruments, primarily forward exchange contracts and interest rate swaps, to manage its exposure to fluctuations in foreign exchange rates and interest rates. It is the company's policy to enter into derivative transactions only to the extent true exposures exist; the company does not enter into derivative transactions for speculative purposes. The company enters into

derivative transactions only with highly rated counterparties. These transactions may expose the company to credit risk to the extent that the instruments have a positive fair value, but the company has not experienced any material losses, nor does the company anticipate any losses.

Each derivative transaction the company enters into is designated at inception as a hedge and is expected to be highly effective as the critical terms of these instruments are the same as those of the underlying risks being hedged. The company evaluates hedge effectiveness at inception and on an ongoing basis. When a derivative is no longer expected to be highly effective, hedge accounting is discontinued. Hedge ineffectiveness, if any, is recorded in earnings on the same line as the underlying transaction risk.

The company is exposed to changes in the fair value of its fixed-rate debt resulting from interest rate fluctuations. To hedge this exposure, the company entered into a fixed to variable interest rate swap. This interest rate swap is accounted for as a fair value hedge. The fair value of the swap is recorded net of the underlying outstanding debt. Changes in the payment of interest resulting from the interest rate swap are recorded as an offset to interest expense. Effectiveness is assessed based on changes in the fair value of the underlying debt, using incremental borrowing rates currently available on loans with similar terms and maturities. See Note D for further discussion of the interest rate swap.

The company enters into forward exchange contracts to hedge forecasted transactions with its foreign subsidiaries, to reduce potential exposure related to fluctuations in foreign exchange rates for anticipated intercompany transactions such as purchases, sales and royalty payments denominated in local currencies. Forward exchange contracts designated as cash flow hedges are designed to hedge the variability of cash flows associated with the underlying anticipated transactions. Changes in the value of derivatives designated as cash flow hedges are recorded in other comprehensive income in shareholders' equity until earnings are affected by the variability of the underlying cash flows. At that time, the applicable amount of gain or loss from the derivative instrument that is deferred in shareholders' equity is reclassified to earnings and is included in other income or expense. Effectiveness is assessed based on changes in forward rates. Ineffective portions of the hedges are recorded in earnings through the same line as the underlying transaction.

Unrealized gains from cash flow hedges recorded in Accumulated Other Comprehensive Income as of July 31, 2002 were not material. These unrealized gains will be reclassified, as appropriate, into earnings during the next 12 months.

New Accounting Standards In June 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." Major provisions of these statements are as follows: all business combinations must now use the purchase method of accounting; intangible assets acquired in a business combination must be recorded separately from goodwill if they arise from contractual or other legal rights or are separable from the acquired entity and can be sold, transferred, licensed, rented or exchanged, either individually or as a part of a related contract, asset or liability; goodwill and intangible assets with indefinite lives are not amortized but tested for impairment annually and whenever there is an impairment indicator; all acquired goodwill must be assigned to reporting units for purposes of impairment testing and segment reporting. The company adopted the provisions of these statements as of August 1, 2001. As required by SFAS No. 142, the company has performed step one of the impairment testing of goodwill for the balances as of August 1, 2001. The results of this test show that the fair market value of the reporting units that the goodwill is assigned to is higher than the book values of those reporting units resulting in no goodwill impairment. The company will perform impairment tests annually and whenever events or circumstances occur indicating that goodwill or other intangible assets might be impaired. As of August 1, 2001, the company is no longer amortizing goodwill. Goodwill amortization expense was \$2.7 million and \$1.9 million, net of income taxes, for the year ended July 31, 2001 and 2000, respectively. The company estimates that goodwill amortization expense would have been approximately \$2.6 million, net of income taxes, for the year ended July 31, 2002.

The following table presents a reconciliation of net income and earnings per share adjusted for the exclusion of goodwill, net of income taxes:

(In thousands, except per share amounts)	2002	2001	2000
Reported net income	\$86,883	\$75,548	\$70,233
Add goodwill amortization, net of tax	-	2,722	1,895
Adjusted net income	\$86,883	\$78,270	\$72,128
Basic earnings per share:			
Reported basic earnings per share	\$ 1.97	\$ 1.70	\$ 1.54
Add goodwill amortization, net of tax	-	.06	.04
Adjusted basic earnings per share	\$ 1.97	\$ 1.76	\$ 1.58
Diluted earnings per share:			
Reported diluted earnings per share	\$ 1.90	\$ 1.66	\$ 1.51
Add goodwill amortization, net of tax	-	.06	.04
Adjusted diluted earnings per share	\$ 1.90	\$ 1.72	\$ 1.55

As of July 31, 2002 and 2001, goodwill was \$86.4 million and \$57.5 million, respectively. In fiscal 2002, goodwill increased \$28.1 million for the acquisition of ultrafilter and decreased \$0.5 million for the reversal of restructuring reserves that were unused from previous acquisitions. The remaining increase of \$1.3 million was due to foreign exchange translation. For the Industrial Products and Engine Products segments, goodwill as of July 31, 2002 totaled \$62.6 million and \$23.8 million, respectively, and as of July 31, 2001 totaled \$33.4 million and \$24.1 million, respectively.

In June 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations." This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 is effective for the company in fiscal 2003. Management does not expect this statement to have a material impact on the company's consolidated financial statements.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 establishes a single model for the impairment of long-lived assets and broadens the presentation of discontinued operations to include more disposal transactions. SFAS No. 144 is effective for the company in fiscal 2003. Management does not expect this statement to have a material impact on the company's consolidated financial statements.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS No. 146 addresses significant issues relating to the recognition, measurement and reporting of costs associated with exit and disposal activities including restructuring. SFAS No. 146 is effective for the company in fiscal 2003.

> NOTE B

Acquisitions, Plant Closures and Plant Openings

Acquisitions All acquisitions were accounted for as purchases. The purchase price assigned to the net assets acquired was based on the fair value of such assets and liabilities at the respective acquisition dates. The operating results of these acquired companies have been included in the consolidated statement of earnings from the dates of acquisition with the exception of the acquisition of ultrafilter international AG, which took place immediately prior

to the end of fiscal 2002. Consolidated pro forma earnings and earnings per share would not be materially different from the reported amounts for all years presented.

The company completed the purchase of all of the outstanding shares of ultrafilter international AG ("ultrafilter") for \$68.3 million in cash on July 12, 2002. Ultrafilter is headquartered in Haan, Germany with operations in 30 countries. Ultrafilter is a global leader in the design and manufacture of components, replacement parts and complete systems for the compressed air purification industry. Its products include compressed air filters and a wide assortment of replacement filters, a complete offering of refrigeration and desiccant dryers and condensate management devices. The acquisition of ultrafilter satisfies the company's diversification strategy by expanding the company's presence in industrial markets, focuses on replacement parts and expands revenues outside of the United States. This acquisition in compressed air purification builds on the acquisition of AirMaze Corporation in fiscal 2000 which brought the company access to the filtration needs of the compressor itself and ultrafilter moves out of the compressor room to all of the points of use in the factory. The company has completed a preliminary purchase price allocation resulting in an excess of purchase price over the fair values of the net assets acquired of \$28.1 million. The company has not yet finalized the allocation of the purchase price to the assets acquired and liabilities assumed and thus it is subject to change. Ultrafilter's operations are a part of the company's Industrial Products segment. Restructuring liabilities recorded in conjunction with the acquisition were approximately \$1.2 million as of July 31, 2002 for costs associated with the termination and relocation of employees.

The company acquired the DCE dust control business of Invensys, plc ("DCE") for \$56.4 million effective February 1, 2000. DCE, which was headquartered in Leicester, England (UK), with smaller facilities in Germany and the United States and assembly operations in South Africa, Australia and Japan, is a major participant in the global dust collection industry. The excess of purchase price over the fair values of the net assets acquired was \$31.5 million and was recorded as goodwill. DCE operations are part of the company's Industrial Products segment. The integration of DCE resulted in a reduction in the work force of approximately 140 employees during fiscal 2001. During fiscal 2002, the unused balance of restructuring liabilities recorded in conjunction with the acquisition of \$0.5 million of costs associated with the closure and sale of acquired facilities as well as termination and relocation of employees was reversed against goodwill. Costs incurred and

charged to these reserves associated with the closure and sale of acquired facilities amounted to \$0.9 million for the fiscal year ended July 31, 2002. Costs incurred and charged to these reserves associated with the termination and relocation of employees amounted to \$0.7 million for the fiscal year ended July 31, 2002. During the fiscal year ended July 31, 2001, costs incurred and charged to these reserves amounted to \$0.8 million associated with the closure and sale of acquired facilities and \$0.8 million associated with the termination and relocation of employees. Adjustments to these reserves for the fiscal year ended July 31, 2001 amounted to an increase of \$0.9 million.

The company completed the purchase of all of the outstanding shares of AirMaze Corporation (“AirMaze”) for \$31.9 million in cash effective November 1, 1999. AirMaze was merged into Donaldson Company, Inc. effective April 1, 2000. AirMaze products include heavy-duty air and liquid filters, air/oil separators and high purity air filter products. AirMaze manufacturing facilities are located in Stow, Ohio, and Greeneville, Tennessee. The excess of purchase price over the fair values of the net assets acquired was \$27.2 million and was recorded as goodwill. AirMaze operations are a part of the company’s Engine Products segment. The integration of AirMaze resulted in a reduction in the work force of approximately 15 employees during fiscal 2001. During fiscal 2002, the unused balance of restructuring liabilities recorded in conjunction with the acquisition of \$0.2 million for costs associated with the termination and relocation of employees was reversed against goodwill. There were no costs incurred and charged to this reserve for the fiscal year ended July 31, 2002. Costs incurred and charged to this reserve amounted to \$0.3 million and adjustments to this reserve amounted to a decrease of \$0.7 million for the fiscal year ended July 31, 2001.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition.

(Thousands of dollars)	ultrafilter	DCE	AirMaze
Current assets	\$ 42,153	\$28,742	\$ 9,389
Property, plant and equipment	21,189	14,346	5,975
Goodwill	28,082	31,458	27,193
Other non-current assets	20,189	874	–
Total assets acquired	111,613	75,420	42,557
Current liabilities	27,941	16,758	4,640
Long-term debt	3,546	–	3,991
Other long-term liabilities	11,777	2,301	2,067
Total liabilities assumed	43,264	19,059	10,698
Net assets acquired	\$ 68,349	\$56,361	\$31,859

Other non-current assets include other intangible assets such as patents and trademarks and deferred tax assets. Other long-term liabilities include deferred tax liabilities and other miscellaneous long-term liabilities.

Plant Closures During fiscal 2002, the company closed its manufacturing facility located in Old Saybrook, Connecticut. The closure of this facility was completed by the end of the fiscal year. A pretax charge of \$0.3 million was recorded in fiscal 2002 in the company’s consolidated statement of earnings. This charge was primarily related to severance and other employee-related costs associated with the elimination of approximately 30 positions. Additionally, the company closed its manufacturing facility located in Guilin, China. The closure of this facility was completed by the end of the fiscal year. A pretax charge of \$0.2 million was recorded in fiscal 2002 in the company’s consolidated statement of earnings. The charge was primarily related to severance and other employee-related costs associated with the elimination of approximately 44 positions.

During fiscal 2001, the company closed its manufacturing facilities located in Mooresville, North Carolina, and Louisville, Kentucky. The closures of these facilities were completed by the end of the fiscal year. For the closure of the Mooresville manufacturing facility, a pretax charge of \$0.7 million was recorded in fiscal 2001 in the company’s consolidated statements of earnings. For the closure of the Louisville manufacturing facility, costs were charged against the purchase liabilities recorded in conjunction with the acquisition of DCE. These charges were primarily related to severance and other employee-related costs associated with the elimination of approximately 130 positions in Mooresville and 80 positions in Louisville.

During fiscal 2000, the company completed the closure of its manufacturing facility located in Oelwein, Iowa. A pretax charge of \$2.8 million was recorded in fiscal 1999 in the company’s consolidated statements of earnings. The charge was primarily related to severance and other employee-related costs associated with the elimination of approximately 125 positions.

Plant Openings During fiscal 2002, the company opened new manufacturing facilities both domestically and internationally. Domestically, the company opened new headquarters and a new manufacturing facility for production of its Tetratex™ PTFE technologies in Ginko Industrial Park in Northampton Township, Pennsylvania. The new facility combined and consolidated the operations from three existing facilities while doubling manufacturing capacity.

Internationally, the company opened a new manufacturing facility in Monterrey, Mexico. The facility was constructed to produce gas turbine products and employs approximately 130 employees. Additionally, during the year the company expanded its manufacturing facilities in Wuxi, China. The expansion included a new clean room used in the production of disk drive products and a new manufacturing facility for the production of industrial air filtration products. The expansion of these facilities added approximately 430 employees.

During fiscal 2000, the company opened a new manufacturing facility in Auburn, Alabama. The facility was constructed to produce mufflers for the truck manufacturers located in the southwestern U.S. region and employs approximately 100 employees.

> NOTE C

Credit Facilities

In December 1997, the company amended and renewed a five-year multi-currency revolving facility with a group of participating banks under which it may borrow up to \$100.0 million. The agreement provides that loans may be made under a selection of currencies and rate formulas including Base Rate Advance or Eurocurrency Rate Advance. The interest rate on each advance is based on certain adjusted leverage and debt-to-capitalization ratios. Facility fees and other fees on the entire loan commitment are payable for the duration of this facility. There was \$20.0 million and \$50.0 million outstanding at July 31, 2002 and July 31, 2001, respectively, leaving \$80.0 million and \$50.0 million available for further borrowing under such facility at July 31, 2002 and July 31, 2001, respectively. The weighted average interest rate on these short-term borrowings outstanding at July 31, 2002 and 2001 was 2.00 percent and 3.99 percent, respectively.

The company also has three agreements under uncommitted credit facilities, which provide unsecured borrowings for general corporate purposes. At July 31, 2002 and 2001, there was \$45.0 million and \$35.0 million available for use under these facilities, respectively. There was \$15.5 million and \$7.7 million outstanding under these facilities at July 31, 2002 and 2001, respectively. The weighted average interest rate on these short-term borrowings outstanding at July 31, 2002 and 2001 was 2.05 percent and 3.98 percent, respectively.

International subsidiaries may borrow under various credit facilities. As of July 31, 2002 and 2001, borrowings under these facilities were \$24.8 million and \$1.7 million,

respectively. This increase in short-term debt reflects borrowings for the acquisition of ultrafilter at the end of fiscal 2002. The weighted average interest rate on these international borrowings outstanding at July 31, 2002 and 2001 was 3.17 percent and 10.73 percent, respectively.

Also, at July 31, 2002, the company had outstanding standby letters of credit totaling \$14.8 million. Currently, there are no amounts drawn upon these letters of credit.

> NOTE D

Long-Term Debt

Long-term debt consists of the following:

(Thousands of dollars)	2002	2001
6.20% Unsecured senior notes due July 15, 2005, interest payable semi-annually, principal payment of \$23.0 million is due July 15, 2005	\$ 23,000	\$23,000
6.31% Unsecured senior notes due July 15, 2008, interest payable semi-annually, principal payment of \$28.6 million is due July 15, 2008	28,640	27,157
6.39% Unsecured senior notes due August 15, 2010, interest payable semi-annually, principal payments of \$5.0 million, to be paid annually commencing August 16, 2006	25,000	25,000
1.9475% Guaranteed senior note due January 29, 2005, interest payable semi-annually, principal amount of 1.2 billion yen is due January 29, 2005	9,996	9,592
1.51% Guaranteed note due March 28, 2006, interest payable quarterly, principal amount of .8 billion yen is due March 28, 2006	6,664	6,395
Variable Rate Industrial Development Revenue Bonds ("Lower Floaters") due September 1, 2024, principal amount of \$8.0 million, interest payable monthly, and an interest rate of 1.6% as of July 31, 2002	8,000	8,000
Capitalized lease obligations, with maturity dates of March 31, 2009 and February 2, 2012 resulting from the ultrafilter acquisition. Capital lease obligations have principal amounts of \$2.9 million and \$0.6 million with interest rates of 6.02% and 6.51%, respectively	3,546	-
Other	230	138
Total	105,076	99,282
Less current maturities	57	23
Total long-term debt	\$105,019	\$99,259

Annual maturities of long-term debt for 2003 and 2004 are not significant and are \$33.0 million in 2005, \$6.7 million in 2006 and \$5.0 million in 2007. The company estimates that the carrying value of long-term debt approximates its fair market value.

On June 6, 2001, the company entered into an interest rate swap agreement effectively converting a portion of the company's interest rate exposure from a fixed rate to a variable rate basis. The interest rate swap agreement has an

aggregate notional amount of \$27.0 million maturing on July 15, 2008. The variable rate is based on the current six-month London Interbank Offered Rates (“LIBOR”). This transaction resulted in a decrease to interest expense of \$1.2 million for the year ended July 31, 2002. As of July 31, 2002, the fair market value of the interest rate swap was \$1.6 million.

Total interest paid relating to all debt was \$6.1 million, \$11.1 million and \$9.1 million in 2002, 2001 and 2000, respectively. In addition, total interest expense recorded in 2002, 2001 and 2000 was \$6.5 million, \$11.6 million and \$9.9 million, respectively. Certain note agreements contain debt covenants related to working capital levels and limitations on indebtedness. Further, the company is restricted from paying dividends or repurchasing common stock if its tangible net worth (as defined) does not exceed certain minimum levels. As of July 31, 2002, the company was in compliance with all such covenants.

> NOTE E

Employee Benefit Plans

Pension Plans Donaldson Company, Inc. and certain of its subsidiaries have defined benefit pension plans for substantially all hourly and salaried employees. The domestic plan provides defined benefits pursuant to a cash balance feature whereby a participant accumulates a benefit comprised of a percentage of current salary which varies with years of service, interest credits and transition credits. The international plans generally provide pension benefits based on years of service and compensation level. The company's general funding policy is to make contributions as required by applicable regulations. The assets are primarily invested in diversified equity and debt portfolios. In 2000, the actuarial valuation date was changed from July 31 to April 30. This change did not have a material impact on the actuarial valuation.

Costs for the company's pension plans include the following components:

(Thousands of dollars)	2002	2001	2000
Net periodic cost:			
Service cost	\$ 10,351	\$ 6,935	\$ 6,084
Interest cost	11,850	11,626	9,852
Expected return on assets	(14,415)	(12,862)	(11,475)
Transition amount amortization	75	173	(1,097)
Prior service cost amortization	158	119	64
Actuarial (gain) loss amortization	(77)	(829)	71
Net periodic benefit cost	\$ 7,942	\$ 5,162	\$ 3,499

The funded status of the company's pension plans as of April 30, 2002 and April 30, 2001, is as follows:

(Thousands of dollars)	2002	2001
Change in benefit obligation:		
Benefit obligation, beginning of year	\$150,101	\$137,056
Addition of non-U.S. plans	16,786	16,589
Service cost	10,351	6,936
Interest cost	11,850	11,626
Participant contributions	580	125
Plan amendments	1,433	174
Actuarial (gain)/loss	2,553	(10,012)
Currency exchange rates	(203)	(2,022)
Benefits paid	(10,673)	(10,371)
Benefit obligation, end of year	\$182,778	\$150,101
Change in plan assets:		
Fair value of plan assets, beginning of year	\$143,201	\$146,210
Addition of non-U.S. plans	15,613	7,857
Actual return on plan assets	10,300	(10,978)
Company contributions	14,791	11,250
Participant contributions	580	125
Currency exchange rates	41	(892)
Benefits paid	(10,673)	(10,371)
Fair value of plan assets, end of year	\$173,853	\$143,201
Reconciliation of funded status:		
Funded (unfunded) status	\$ (8,925)	\$ (6,900)
Unrecognized actuarial (gain) loss	10,342	2,322
Unrecognized prior service cost	3,802	2,527
Unrecognized net transition obligation	3,527	3,792
Fourth quarter contributions	416	1,891
Net amount recognized in consolidated balance sheet	\$ 9,162	\$ 3,632
Amounts recognized in consolidated balance sheet consist of:		
Prepaid benefit cost	\$ 17,586	\$ 9,853
Accrued benefit liability	(8,423)	(6,220)
Additional minimum liability	(11,399)	(5,126)
Intangible asset	7,801	4,784
Accumulated other comprehensive income	3,597	341
Net amount recognized in consolidated balance sheet	\$ 9,162	\$ 3,632

The projected benefit obligation, accumulated benefit obligation and fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets were \$47.3 million, \$45.3 million and \$31.7 million, respectively, as of April 30, 2002 and \$20.9 million, \$17.1 million and \$5.8 million, respectively, as of April 30, 2001.

Weighted average actuarial assumptions	April 30, 2002	April 30, 2001	July 31, 2000
All U.S. plans:			
Discount rate	7.25%	7.50%	8.00%
Expected return on plan assets	8.50%	9.00%	9.00%
Rate of compensation increase	5.00%	5.50%	6.00%
Non-U.S. plans:			
Discount rate	4.59%	2.50%	N/A
Expected return on plan assets	6.63%	4.00%	N/A
Rate of compensation increase	3.39%	2.00%	N/A

The expected return on plan assets is used in the development of the net periodic benefit cost for the fiscal year ending in the year shown.

Pension expense related to international plans was \$4.1 million, \$4.3 million and \$2.5 million for 2002, 2001 and 2000, respectively.

401(k) Savings Plan The company provides a contributory employee savings plan to domestic employees which permits participants to make contributions by salary reduction pursuant to section 401(k) of the Internal Revenue Code. The company's contributions under this plan are based on the level of employee contributions including a discretionary contribution based on performance of the company. Total contribution expense was \$6.8 million, \$4.1 million and \$4.2 million for the years ended July 31, 2002, 2001 and 2000, respectively.

> NOTE F

Shareholders' Equity

Stock Rights On January 12, 1996, the Board of Directors of the company approved the extension of the benefits afforded by the company's existing rights plan by adopting a new shareholder rights plan. Pursuant to the new Rights Agreement, dated as of January 12, 1996, by and between the company and Wells Fargo Bank Minnesota, N.A., as Rights Agent, one right was issued on March 4, 1996 for each outstanding share of common stock of the company upon the expiration of the company's existing rights. Each of the new rights entitles the registered holder to purchase

from the company one one-thousandth of a share of Series A Junior Participating Preferred Stock, without par value, at a price of \$130.00 per one one-thousandth of a share. The rights, however, will not become exercisable unless and until, among other things, any person acquires 15 percent or more of the outstanding common stock of the company. If a person acquires 15 percent or more of the outstanding common stock of the company (subject to certain conditions and exceptions more fully described in the Rights Agreement), each right will entitle the holder (other than the person who acquired 15 percent or more of the outstanding common stock) to purchase common stock of the company having a market value equal to twice the exercise price of a right. The rights are redeemable under certain circumstances at \$.01 per right and will expire, unless earlier redeemed, on March 3, 2006.

Employee Incentive Plans In November 2001, shareholders approved the 2001 Master Stock Incentive Plan (the "Plan") which replaced the 1991 Plan that expired on December 31, 2001 and provided for similar awards. The Plan extends through December 2011 and allows for the granting of nonqualified stock options, incentive stock options, restricted stock, stock appreciation rights (SARs), dividend equivalents, dollar-denominated awards and other stock-based awards. The Plan allows for the granting of performance awards to a limited number of key executives. The awards are payable in common stock and are based on a formula which measures performance of the company over a three-year period. Performance award expense under the 1991 Plan totaled \$2.6 million, \$2.4 million and \$1.7 million in 2002, 2001 and 2000, respectively. Options under the Plan are granted to key employees at or above market price at the date of grant. Options are exercisable for up to 10 years from the date of grant.

Stock Options Stock options issued after fiscal 1998 become exercisable for non-executives in each of the following three years, in an equal number of shares each year and become exercisable for executives immediately upon the date of grant. Stock options issued during fiscal 1997 and 1998 become exercisable in each of the following three years, in an equal number of shares each year, for both executives and non-executives. Stock options issued prior to fiscal 1997 for non-executives and during fiscal 1996 for executives become exercisable in a four-year period in an equal number of shares each year. Prior to fiscal 1996, stock options vested immediately for executives.

In fiscal 1997, the company adopted the disclosure-only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123 encourages entities to adopt a fair value-based method of accounting for

employee stock compensation plans, but allows companies to continue to account for those plans using the accounting prescribed by APB Opinion 25, "Accounting for Stock Issued to Employees." The company has elected to continue to account for stock-based compensation using APB 25, making pro forma disclosures of net earnings and earnings per share as if the fair value-based method had been applied. Accordingly, no compensation expense has been recorded for the stock option plan. Had compensation expense for the stock option plan been determined under SFAS No. 123 in fiscal 2002, 2001 and 2000, the company's net income and diluted earnings per share would have been approximately \$83.0 million and \$1.82, \$71.0 million and \$1.56, and \$67.7 million and \$1.45, respectively.

For purposes of computing compensation cost of stock options granted, the fair value of each stock option grant was estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions: risk free interest rate of 2.85 percent, 4.72 percent and 6.5 percent in 2002, 2001 and 2000, respectively; two, three, six, or seven year lives in 2002, and two or seven year lives in 2001 and 2000; expected volatility of 30.9 percent, 30.5 percent and 29.7 percent in 2002, 2001 and 2000, respectively; and 1.0 percent expected dividend yield in 2002, 2001 and 2000. Black-Scholes is a widely accepted stock option pricing model; however, the ultimate value of stock options granted will be determined by the actual lives of options granted and the actual future price levels of the company's common stock.

The weighted average fair value for options granted during fiscal 2002, 2001 and 2000 is \$9.56, \$8.01 and \$7.49 per share, respectively.

The number and option price of options granted were as follows:

	Options Outstanding	Weighted Average Exercise Price
Outstanding at July 31, 1999	3,382,322	\$14.50
Granted	489,086	23.01
Exercised	(204,004)	10.09
Canceled	(14,468)	20.41
Outstanding at July 31, 2000	3,652,936	15.86
Granted	862,515	26.04
Exercised	(1,025,995)	12.88
Canceled	(25,297)	21.19
Outstanding at July 31, 2001	3,464,159	19.24
Granted	633,968	36.12
Exercised	(603,551)	15.11
Canceled	(23,661)	26.60
Outstanding at July 31, 2002	3,470,915	\$22.99

At July 31, 2002, 2001 and 2000, there were 2,955,018, 2,954,542 and 3,109,926 options exercisable, respectively. Shares reserved at July 31, 2002 for outstanding options and future grants were 4,235,652. Shares reserved consist of shares available for grant plus all outstanding options. An amount is added to shares reserved each year based on criteria set in the plan.

The following table summarizes information concerning currently outstanding and exercisable options:

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$5 to \$15	713,622	1.82	\$11.98	713,622	\$11.98
\$15 to \$25	1,471,224	5.87	21.05	1,392,809	20.94
\$25 to \$35	695,169	7.34	26.81	516,887	27.11
\$35 and above	590,900	8.99	36.60	331,700	36.77
	3,470,915	5.86	\$22.99	2,955,018	\$21.63

> NOTE G Income Taxes

The components of earnings before income taxes are as follows:

(Thousands of dollars)	2002	2001	2000
Earnings before income taxes:			
United States	\$ 62,294	\$ 48,705	\$ 54,913
Foreign	56,724	56,223	45,420
Total	\$119,018	\$104,928	\$100,333

The components of the provision for income taxes are as follows:

(Thousands of dollars)	2002	2001	2000
Income taxes:			
Current:			
Federal	\$21,146	\$ 8,502	\$18,192
State	1,900	622	2,361
Foreign	14,355	13,163	9,996
	37,401	22,287	30,549
Deferred:			
Federal	(5,033)	7,304	52
State	(287)	417	3
Foreign	54	(628)	(504)
	(5,266)	7,093	(449)
Total	\$32,135	\$29,380	\$30,100

The tax effects of temporary differences that give rise to deferred tax assets and liabilities are as follows:

(Thousands of dollars)	2002	2001	2000
Deferred tax assets:			
Compensation and retirement plans	\$ 9,226	\$ 3,619	\$ 12,839
Accrued expenses	7,658	6,938	7,818
NOL carryforwards	6,346	6,092	8,174
Inventories	1,967	1,938	1,526
Investment in joint venture	777	636	754
Cumulative translation adjustment	-	-	4,574
Other	6,094	3,215	3,162
Gross deferred tax assets	32,068	22,438	38,847
Valuation allowance	(2,158)	(2,054)	(4,499)
Net deferred tax assets	29,910	20,384	34,348
Deferred tax liabilities:			
Depreciation and amortization	(15,698)	(16,209)	(14,626)
Other	(9,171)	(618)	(903)
Gross deferred tax liabilities	(24,869)	(16,827)	(15,529)
Net deferred tax assets	\$ 5,041	\$ 3,557	\$ 18,819

The following table reconciles the U.S. statutory income tax rate with the effective income tax rate:

	2002	2001	2000
Statutory U.S. federal rate	35.0%	35.0%	35.0%
State income taxes	1.0	0.4	1.5
Foreign taxes at lower rates	(4.6)	(8.2)	(6.1)
Other	(4.4)	0.8	(0.4)
	27.0%	28.0%	30.0%

U.S. income taxes have not been provided on approximately \$187.0 million of undistributed earnings of non-U.S. subsidiaries. The company plans to reinvest these undistributed earnings. If any portion were to be distributed, the related U.S. tax liability may be reduced by foreign income taxes paid on those earnings plus any available foreign tax credit carryovers. Determination of the unrecognized deferred tax liability related to these undistributed earnings is not practicable.

While non-U.S. operations have been profitable overall, cumulative tax losses of \$20.0 million are carried as net operating losses in certain international subsidiaries. These losses can be carried forward to offset future taxable income. The majority of such carryforwards expire after 2003. Due to the uncertainty of being able to realize certain of these losses, a valuation allowance of \$2.1 million has been recorded at July 31, 2002.

The company made cash payments for income taxes of \$23.7 million, \$16.2 million and \$24.6 million in 2002, 2001 and 2000, respectively.

> NOTE H Segment Reporting

Consistent with SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," the company has identified two reportable segments: Engine Products and Industrial Products. Segment selection was based on the internal organizational structure, management of operations and performance evaluation by management and the company's Board of Directors.

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

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

Corporate and Unallocated include corporate expenses determined to be non-allocable to the segments, interest income and expense, non-operating income and expense, and expenses not allocated to the business segments in the same period. Assets included in Corporate and Unallocated principally are cash and cash equivalents, inventory reserves, certain prepaids, certain investments, other assets and assets allocated to intercompany transactions.

The company has developed an internal measurement system to evaluate performance and allocate resources based on profit or loss from operations before income taxes. The company's manufacturing facilities serve both reporting segments. Therefore, the company uses a complex allocation methodology to assign costs and assets to the segments. A certain amount of costs and assets is assigned to intercompany activity and is not assigned to either segment. Certain accounting policies applied to the reportable segments differ from those described in the summary of significant accounting policies. The reportable segments account for receivables on a gross basis and account for inventory on a standard cost basis.

Segment allocated assets are primarily accounts receivable, inventories, property, plant and equipment and goodwill. Reconciling items included in Corporate and Unallocated are created based on accounting differences between segment reporting and the consolidated, external reporting as well as internal allocation methodologies.

Segment detail is summarized as follows (in thousands):

	Engine Products	Industrial Products	Corporate & Unallocated	Total Company
2002				
Net sales	\$611,647	\$514,358	\$ -	\$1,126,005
Depreciation and amortization	16,095	9,427	6,229	31,751
Equity earnings in unconsolidated affiliates	4,160	-	-	4,160
Earnings before income taxes	69,894	73,047	(23,923)	119,018
Assets	324,952	381,467	143,712	850,131
Equity investments in unconsolidated affiliates	14,033	-	-	14,033
Capital expenditures, net of acquired businesses	20,544	12,033	7,952	40,529
2001				
Net sales	\$606,810	\$530,205	\$ -	\$1,137,015
Depreciation and amortization	23,100	11,268	4,209	38,577
Equity earnings in unconsolidated affiliates	3,017	-	-	3,017
Earnings before income taxes	49,539	72,891	(17,502)	104,928
Assets	315,706	228,505	162,619	706,830
Equity investments in unconsolidated affiliates	14,115	-	-	14,115
Capital expenditures, net of acquired businesses	23,308	11,370	4,246	38,924
2000				
Net sales	\$673,982	\$418,312	\$ -	\$1,092,294
Depreciation and amortization	20,959	8,509	4,858	34,326
Equity earnings in unconsolidated affiliates	4,392	-	-	4,392
Earnings before income taxes	57,453	53,862	(10,982)	100,333
Assets	320,805	172,837	183,883	677,525
Equity investments in unconsolidated affiliates	13,600	-	-	13,600
Capital expenditures, net of acquired businesses	22,236	9,028	5,153	36,417

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

(In thousands)	2002	2001	2000
Engine Products segment:			
Off-road products	\$ 185,607	\$ 181,795	\$ 193,229
Transportation products	91,244	79,670	151,950
Aftermarket products	334,796	345,345	328,803
Total Engine Products segment	611,647	606,810	673,982
Industrial Products segment:			
Industrial air filtration products	175,663	217,343	193,119
Gas turbine products	230,897	195,042	117,038
Special application products	107,798	117,820	108,155
Total Industrial Products segment	514,358	530,205	418,312
Total company	\$1,126,005	\$1,137,015	\$1,092,294

Geographic sales by origination and property, plant and equipment (in thousands):

	Property, Plant & Net Sales Equipment - Net	
2002		
United States	\$ 687,889	\$139,975
Europe	225,669	40,013
Asia-Pacific	184,269	21,652
Other	28,178	39,273
Total	\$1,126,005	\$240,913
2001		
United States	\$ 711,268	\$138,631
Europe	211,397	36,801
Asia-Pacific	185,395	19,609
Other	28,955	12,617
Total	\$1,137,015	\$207,658
2000		
United States	\$ 688,899	\$135,480
Europe	206,429	37,698
Asia-Pacific	166,221	22,304
Other	30,745	9,063
Total	\$1,092,294	\$204,545

Sales to one customer accounted for 13 percent and 12 percent of net sales in 2002 and 2001, respectively. There were no sales over 10 percent of net sales to any customer in 2000. One customer accounted for 18 percent and 21 percent of gross accounts receivable in 2002 and 2001, respectively.

> NOTE I

Quarterly Financial Information (Unaudited)

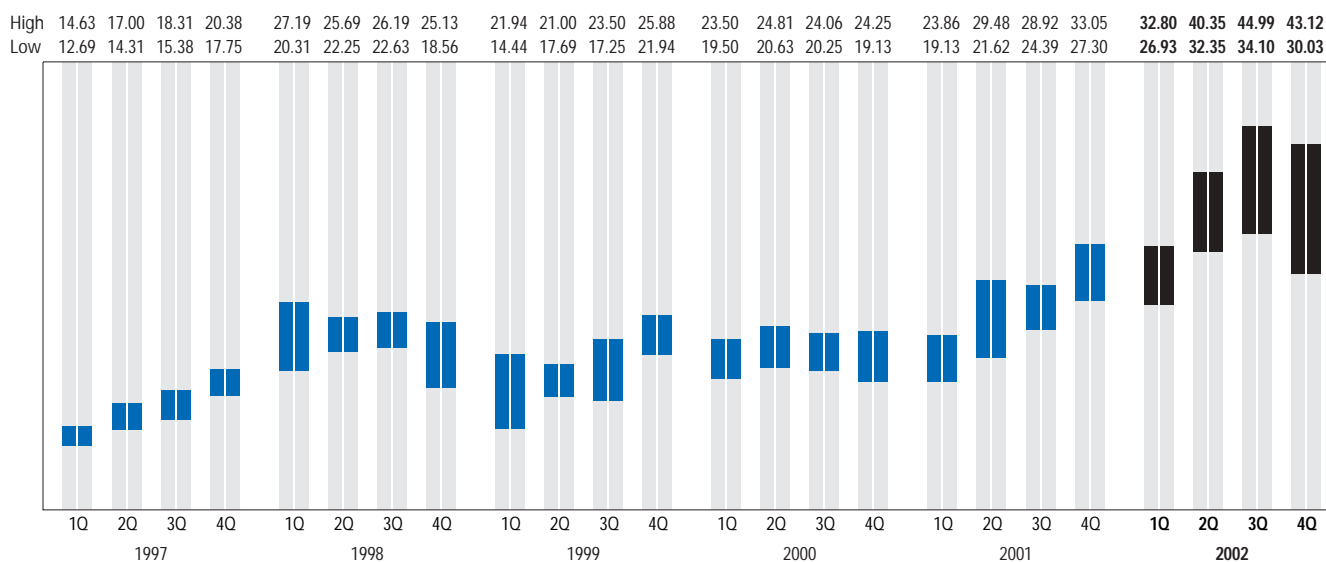
(Thousands of dollars, except per share amounts)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2002				
Net sales	\$288,429	\$264,281	\$269,423	\$303,872
Gross margin	88,318	81,274	84,976	94,924
Net earnings	19,724	20,760	21,474	24,925
Diluted earnings per share	.43	.45	.47	.55
Dividends declared per share	.075	.080	.080	.085
2001				
Net sales	\$289,869	\$279,631	\$269,721	\$297,794
Gross margin	85,956	86,316	79,180	90,282
Net earnings	16,804	18,105	17,826	22,813
Diluted earnings per share	.37	.40	.39	.50
Dividends declared per share	.075	.075	.075	.075

> NOTE J

Commitments and Contingencies

The company is involved in litigation arising in the ordinary course of business. In the opinion of management, the outcome of litigation currently pending will not materially affect the company's results of operations, financial condition or liquidity.

SIX-YEAR QUARTERLY HIGH-LOW STOCK PRICES (Unaudited)



REPORT OF INDEPENDENT ACCOUNTANTS

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

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of earnings, changes in shareholders' equity and cash flows present fairly, in all material respects, the consolidated financial position of Donaldson Company Inc. as of July 31, 2002, and the consolidated results of its operations and its cash flow for the period ended July 31, 2002, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of Donaldson Company Inc.'s management; our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion. The financial statements of Donaldson Company Inc. as of July 31, 2001, and for the two years in the period then ended, were audited by other independent accountants who have ceased operations. Those independent accountants expressed an unqualified opinion on those financial statements in their report dated August 27, 2001.



PricewaterhouseCoopers LLP
August 21, 2002

The following report is a copy of a report previously issued by Arthur Andersen LLP. This report relates to prior years' financial statements. This report has not been reissued by Arthur Andersen LLP.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

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

We have audited the accompanying consolidated balance sheets of Donaldson Company, Inc. (a Delaware corporation) and subsidiaries as of July 31, 2001 and 2000, and the related consolidated statements of earnings, changes in shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. The consolidated financial statements of Donaldson Company, Inc. and subsidiaries as of July 31, 1999, were audited by other auditors whose report dated September 8, 1999, expressed an unqualified opinion on those statements.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Donaldson Company, Inc. and subsidiaries as of July 31, 2001 and 2000, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States.



Minneapolis, Minnesota,
August 27, 2001

CORPORATE AND SHAREHOLDER INFORMATION

NYSE Listing

The common shares of Donaldson Company, Inc. are traded on the New York Stock Exchange, under the symbol DCI.

Shareholder Information

For any concerns relating to your current or prospective shareholdings, please contact Shareowner Services at (800)468-9716 or (651)450-4064.

Annual Meeting

The annual meeting of shareholders will be held at 10 a.m. on Friday, November 15, 2002, at Donaldson Company, Inc., 1400 West 94th Street, Bloomington, Minnesota. You are welcome to attend.

10-K Reports

Copies of the Report 10-K, filed with the Securities and Exchange Commission, are available on request from Shareholder Services, Donaldson Company, Inc., M.S. 101, P.O. Box 1299, Minneapolis, MN 55440.

Auditors

PricewaterhouseCoopers LLP
Minneapolis, Minnesota

Public Relations Counsel

Padilla Speer Beardsley Inc.
Minneapolis, Minnesota

Transfer Agent and Registrar

Wells Fargo Bank Minnesota, N.A.
South St. Paul, Minnesota

Dividend Reinvestment Plan

As of September 20, 2002, 1,130 of Donaldson Company's approximately 1,871 shareholders of record were participating in the Dividend Reinvestment Plan. Under the plan, shareholders can invest Donaldson Company dividends in additional shares of company stock. They may also make periodic voluntary cash investments for the purchase of company stock.

Both alternatives are provided without service charges or brokerage commissions. Shareholders may obtain a brochure giving further details by writing Wells Fargo Bank Minnesota, N.A., Shareowner Services, P.O. Box 64854, St. Paul, MN 55164-0854.

BOARD OF DIRECTORS

F. Guillaume Bastiaens, 59,
Vice Chairman,
Cargill, Inc., Minneapolis
(Agribusiness).
Director since 1995. ⁽²⁾ ⁽³⁾

Paul B. Burke, 46,
Retired Chairman, President
and Chief Executive Officer,
BMC Industries, Inc., Minneapolis
(Manufacturing).
Director since 1996. ⁽¹⁾ ⁽³⁾

Janet M. Dolan, 53,
President and Chief Executive Officer,
Tennant Company, Minneapolis
(Manufacturing).
Director since 1996. ⁽²⁾ ⁽³⁾

Jack W. Eugster, 57,
Non-Executive Chairman,
ShopKo Stores, Inc., Green Bay, WI
(Specialty Discount Retailer).
Director since 1993. ⁽¹⁾ ⁽³⁾

John F. Grundhofer, 63,
Chairman,
U.S. Bancorp, Minneapolis
(Financial Services).
Director since 1997. ⁽¹⁾ ⁽³⁾

Kendrick B. Melrose, 62,
Chairman and Chief Executive Officer,
The Toro Company, Minneapolis
(Manufacturing).
Director since 1991. ⁽¹⁾ ⁽²⁾

Paul David Miller, 60,
Chairman and Chief Executive Officer,
Alliant Techsystems Inc., Minneapolis
(Defense).
Director since 2001. ⁽³⁾

Jeffrey Noddle, 56,
Chairman, President and
Chief Executive Officer,
SUPERVALU INC., Minneapolis
(Food Retailer and Distributor).
Director since 2000. ⁽¹⁾ ⁽²⁾

S. Walter Richey, 66,
Retired Chairman, President
and Chief Executive Officer,
Meritex, Inc., Minneapolis
(Distribution Services).
Director since 1991. ⁽²⁾ ⁽³⁾

Stephen W. Sanger, 56,
Chairman and Chief Executive Officer,
General Mills, Inc., Minneapolis
(Consumer Products).
Director since 1992. ⁽¹⁾ ⁽²⁾

William G. Van Dyke, 57,
Chairman, President
and Chief Executive Officer,
Donaldson Company, Inc.
Director since 1994.

(1) Human Resources Committee

(2) Audit Committee

(3) Corporate Governance Committee

CORPORATE OFFICERS

William G. Van Dyke, 57,
Chairman, President
and Chief Executive Officer.
30 years service.

William M. Cook, 49,
Senior Vice President, International
and Chief Financial Officer.
22 years service.

James R. Giertz, 45,
Senior Vice President,
Commercial and Industrial.
9 years service.

Nickolas Priadka, 56,
Senior Vice President,
Engine Systems and Parts.
33 years service.

Lowell F. Schwab, 54,
Senior Vice President, Operations.
23 years service.

Dale M. Couch, 59,
Vice President and General Manager,
Asia Pacific.
5 years service.

Norman C. Linnell, 43,
Vice President, General Counsel
and Secretary.
7 years service.

John E. Thames, 52,
Vice President, Human Resources.
14 years service.

Geert Henk Touw, 57,
Vice President and General Manager,
Europe/Africa/Middle East.
17 years service.

Thomas A. Windfeldt, 53,
Vice President, Controller.
22 years service.



W. Cook J. Giertz L. Schwab W. Van Dyke N. Priadka



T. Windfeldt G. Touw D. Couch J. Thames N. Linnell

WORLDWIDE OPERATIONS

World Headquarters

Donaldson Company, Inc.
1400 West 94th Street
Minneapolis, Minnesota
U.S.A.

U.S. Plants

Auburn, Alabama
Norcross, Georgia
Dixon, Illinois
Frankfort, Indiana
Cresco, Iowa
Grinnell, Iowa
Nicholasville, Kentucky
Port Huron, Michigan
Chillicothe, Missouri
Stow, Ohio
Philadelphia, Pennsylvania
Greeneville, Tennessee
Baldwin, Wisconsin
Stevens Point, Wisconsin

Distribution Centers

Ontario, California
Rensselaer, Indiana
Antwerp, Belgium
Singapore

Joint Ventures

Advanced Filtration Systems Inc.
Champaign, Illinois
MSCA, LLC
Monticello, Indiana
PT Panata Jaya Mandiri
Jakarta, Indonesia
Rashed Al-Rashed & Sons –
Donaldson Company Limited
Dammam, Saudi Arabia

Subsidiaries

Donaldson Australasia Pty. Limited
Wyong, Australia
Donaldson Sales, Inc.
Barbados
Donaldson Coordination Center, B.V.B.A.
Leuven, Belgium
Donaldson Europe, B.V.B.A.
Leuven, Belgium
Brugge, Belgium (plant)
Donaldson Czech Republic s.r.o.
Prague, Czech Republic
Donaldson Scandinavia APS
Horsholm, Denmark
Donaldson France, S.A.S.
Bron, France
Tecnov Donaldson, S.A.S.
Domjean, France
Donaldson Gesellschaft m.b.H.
Torit DCE G.m.b.H
Dülmen, Germany
ultrafilter international, AG and
subsidiaries
Haan, Germany
Donaldson India Filter Systems Pvt. Ltd.
New Delhi, India
PT Donaldson Systems Indonesia
Jakarta, Indonesia
Donaldson Italia s.r.l.
Ostiglia, Italy
Nippon Donaldson Limited
Tokyo, Japan
Donaldson Luxembourg S.a.r.l.
Luxembourg
Donaldson, S.A. de C.V.
Aguascalientes, Mexico
Diemo S.A. de C.V.
Guadalajara, Mexico

Donaldson Filtration Industrial
S. de R.L. de C.V.
Monterrey, Mexico
Donaldson Torit, B.V.
Donaldson Nederland B.V.
Krommenie, Netherlands
Donaldson Far East Limited
Hong Kong, S.A.R., People's Republic
of China
Donaldson (Wuxi) Filters Co., Ltd.
Wuxi, People's Republic of China
Donaldson Polska Sp. z.o.o.
Warsaw, Poland
Donaldson Filtration (Asia Pacific) Pte. Ltd.
Singapore
Donaldson Filtration Systems
(Proprietary) Ltd.
Cape Town, South Africa
Donaldson Korea Co., Ltd.
Seoul, South Korea
Donaldson Ibérica,
Soluciones en Filtracion, S.L.
Barcelona, Spain
Donaldson Filtros Iberica S.L.
Madrid, Spain
Donaldson Schweiz G.m.b.H.
Aarau, Switzerland
Donaldson Filter Components Limited
Hull, United Kingdom
DCE Donaldson Ltd.
Leicester, United Kingdom
Tetrattec Europe Limited
Wigan, United Kingdom
Donaldson Capital, Inc.
Minneapolis, Minnesota



Donaldson
Filtration Solutions

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