

# DONALDSON CO INC

## FORM 10-K (Annual Report)

Filed 09/24/10 for the Period Ending 07/31/10

Address	1400 W. 94TH ST. MINNEAPOLIS, MN 55431
Telephone	6128873131
CIK	0000029644
Symbol	DCI
SIC Code	3564 - Industrial and Commercial Fans and Blowers and Air Purification Equipment
Industry	Misc. Capital Goods
Sector	Capital Goods
Fiscal Year	07/31

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

**Form 10-K**

**Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934** for the fiscal year ended July 31, 2010 or

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

for the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 1-7891

**DONALDSON COMPANY, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**41-0222640**

(I.R.S. Employer Identification No.)

**1400 West 94th Street,  
Minneapolis, Minnesota**

(Address of principal executive offices)

**55431**

(Zip Code)

Registrant's telephone number, including area code: (952) 887-3131

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
Common Stock, \$5 Par Value	New York Stock Exchange
Preferred Stock Purchase Rights	New York Stock Exchange

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

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.  Yes  No

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such short period that the registrant was required to submit and post such files)  Yes  No

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

As of January 29, 2010, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of voting and non-voting common stock held by non-affiliates of the registrant was \$2,921,508,161 (based on the closing price of \$38.24 as reported on the New York Stock Exchange as of that date).

As of August 31, 2010, there were approximately 76,329,445 shares of the registrant's common stock outstanding.

Documents Incorporated by Reference

Portions of the registrant's Proxy Statement for its 2010 annual meeting of stockholders (the "2010 Proxy Statement") are incorporated by reference in Part III, as specifically set forth in Part III.

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DONALDSON COMPANY, INC.

ANNUAL REPORT ON FORM 10-K

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## PART I

### Item 1. Business

#### General

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

The Company is a worldwide manufacturer of filtration systems and replacement parts. The Company’s product mix includes air and liquid filtration systems and exhaust and emission control products. Products are manufactured at 40 plants around the world and through three joint ventures. The Company has two reporting segments: Engine Products and Industrial Products. Products in the Engine Products segment consist of air filtration systems, exhaust and emissions systems, liquid filtration systems, and replacement filters. The Engine Products segment sells to original equipment manufacturers (“OEMs”) in the construction, mining, agriculture, aerospace, defense and truck markets and to OEM dealer networks, independent distributors, private label accounts and large equipment fleets. Products in the Industrial Products segment consist of dust, fume and mist collectors, compressed air purification systems, liquid filtration systems, air filtration systems for gas turbines, PTFE membranes and laminates, and specialized air filtration systems for diverse applications including computer hard disk drives. The Industrial Products segment sells to various industrial end-users, OEMs of gas-fired turbines and OEMs and end-users requiring clean air and liquids.

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

	Year Ended July 31,		
	2010	2009	2008
<b>Engine Products segment</b>			
Off-Road Products	12%	13%	16%
Aerospace and Defense Products	6%	6%	4%
On-Road Products	4%	4%	6%
Aftermarket Products*	35%	29%	28%
Retrofit Emissions Products	1%	2%	1%
*includes replacement part sales to the Company’s OEMs customers			
<b>Industrial Products segment</b>			
Industrial Filtration Solutions Products	24%	27%	27%
Gas Turbine Products	8%	11%	10%
Special Applications Products	10%	8%	8%

Financial information about segment operations appears in Note J in the Notes to Consolidated Financial Statements on page 49.

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

#### Seasonality

A number of the Company’s end markets are dependent on the construction, agricultural and power generation industries, which are generally stronger in the second half of the Company’s fiscal year. The first two quarters of the fiscal year also contain the traditional summer and winter holiday periods, which are characterized by more Customer plant closures.

## **C ompetition**

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

## **R aw Materials**

The principal raw materials that the Company uses are steel, filter media and plastics. The Company purchases a variety of types of steel. Commodity prices generally increased throughout the year, but the impact was moderated by certain long term supply contracts. The Company anticipates a further impact from rising commodity prices in Fiscal 2011, specifically steel, as these contracts expired at the end of Fiscal 2010. The Company experienced no significant supply problems in the purchase of its raw materials. The Company typically has multiple sources of supply for the raw materials essential to its business, and is not required to carry significant amounts of raw material inventory to secure supplier allotments. However, the Company does stock finished goods inventory at its regional distribution centers in order to meet anticipated Customer demand.

## **P atents and Trademarks**

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

## **M ajor Customers**

There were no Customers that accounted for over 10 percent of net sales in Fiscal 2010 and 2009. Sales to Caterpillar Inc. and its subsidiaries ("Caterpillar") accounted for 10 percent of net sales in Fiscal 2008. Caterpillar has been a Customer of the Company for many years and purchases many models and types of products for a variety of applications. There were no Customers over 10 percent of gross accounts receivable in Fiscal 2010 or 2009.

## **B acklog**

At August 31, 2010, the backlog of orders expected to be delivered within 90 days was \$361.1 million. All of this backlog is expected to be shipped during Fiscal 2011. The 90-day backlog at August 31, 2009, was \$259.2 million. Backlog is one of many indicators of business conditions in the Company's markets. However, it is not always indicative of future results for a number of reasons, including short lead times in the Company's replacement parts business and the timing of orders in many of the Company's Engine OEM and Industrial markets.

## **R e search and Development**

During Fiscal 2010, the Company spent \$44.5 million on research and development activities. Research and development expenses include basic scientific research and the application of scientific advances to the development of new and improved products and their uses. The Company spent \$40.6 million and \$43.8 million in Fiscal 2009 and Fiscal 2008, respectively, on research and development activities. Substantially all commercial research and development is performed in-house.

## **E nvironmental Matters**

The Company does not anticipate any material effect on its capital expenditures, earnings or competitive position during Fiscal 2011 due to compliance with government regulations regulating the discharge of materials into the environment or otherwise relating to the protection of the environment.

## **E mployees**

The Company employed over 12,300 persons in worldwide operations as of August 31, 2010.



## **Geographic Areas**

Financial information about geographic areas appears in Note J of the Notes to Consolidated Financial Statements on page 49.

## **Item 1A. Risk Factors**

There are inherent risks and uncertainties associated with our global operations that involve the manufacture and sale of products for highly demanding Customer applications throughout the world. These risks and uncertainties could adversely affect our operating performance and financial condition. The following discussion, along with discussions elsewhere in this report, outlines the risks and uncertainties that we believe are the most material to our business. In light of the recent global economic slowdown, we want to further highlight the risks and uncertainties associated with: world economic factors and the ongoing economic uncertainty that is impacting many regions of the world, our Customers' financial condition, the potential for some OEM Customers to increase their reliance on their own filtration capabilities, currency fluctuations, commodity prices, political factors, the Company's international operations, highly competitive markets, governmental laws and regulations, including the impact of the economic stimulus and financial reform measures being implemented by governments around the world, the implementation of our new information systems, potential global events resulting in instability and unpredictability in the world's markets, including financial bailouts of sovereign nations, political changes, military and terrorist activities, health outbreaks and other factors discussed below. 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.

### **Operating internationally carries risks which could negatively affect our financial performance.**

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

- political and military events,
- legal and regulatory requirements, including import, export, defense regulations and foreign exchange controls,
- tariffs and trade barriers,
- potential difficulties in staffing and managing local operations,
- credit risk of local Customers and distributors,
- difficulties in protecting intellectual property,
- local economic, political and social conditions, specifically in China and Thailand where we have significant investments and
- potential global health outbreaks.

### **Maintaining a competitive advantage requires continuing investment with uncertain returns.**

We operate in highly competitive markets and have numerous competitors who may already be well established in those markets. We expect our competitors to continue improving the design and performance of their products and to introduce new products that could be competitive in both price and performance. We believe that we have certain technological advantages over our competitors, but maintaining these advantages requires us to continually invest in research and development, sales and marketing, and Customer service and support. There is no guarantee that we will be successful in maintaining these advantages. We make investments in new technologies that address increased performance and regulatory requirements around the globe. There is no guarantee that we will be successful in completing development or achieving sales of these products or that the margins on such products will be acceptable. Our financial performance may be negatively impacted if a competitor's successful product innovation reaches the market before ours or gains broader market acceptance.

A few of our major OEM Customers also manufacture filtration systems. Although these OEM Customers rely on us and other suppliers for some of their filtration systems, they sometimes choose to manufacture additional filtration systems for their own use. There is also a risk that a Customer could acquire one or more of our competitors.



We may be adversely impacted by changes in technology that could reduce or eliminate the demand for our products. These risks include:

- breakthroughs in technology which provide a viable alternative to diesel engines and
- reduced demand for disk drive products by flash memory or a similar technology, which would eliminate the need for our filtration solutions.

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

The businesses and product lines in which we participate are very competitive and we risk losing business based on a wide range of factors including technology, price, geographic coverage, product performance and Customer service. Large Customers continue to seek productivity gains and lower prices from their suppliers. We may lose business or negatively impact our margins if we are unable to deliver the best value to our Customers.

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

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

Sales to Caterpillar accounted for slightly less than 10 percent of our net sales in Fiscal 2010 and 2009 and 10 percent of our net sales in Fiscal 2008. An adverse change in Caterpillar's financial performance or a material reduction in our sales to Caterpillar could negatively impact our operating results.

**Changes in our product mix impacts our financial performance.**

We sell products that have varying profit margins. Our financial performance can be impacted depending on the mix of products we sell during a given period.

**Unavailable or higher cost materials could impact our financial performance.**

We obtain raw materials including steel, filter media and plastics and other components from third-party suppliers and tend to carry limited raw material inventories. An unanticipated delay in delivery by our suppliers could result in the inability to deliver on-time and meet the expectations of our Customers. This could negatively affect our financial performance. An increase in commodity prices during a recession or an otherwise challenging business and economic environment could result in lower operating margins.

**Difficulties with the Company's information technology systems could adversely affect our results.**

The Company has many information technology systems that are important to the operation of its businesses. The Company could encounter difficulties in developing new systems or maintaining and upgrading existing systems. Such difficulties could lead to significant expenses due to disruption in business operations and could adversely affect the Company's results.

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

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

**Acquisitions may have an impact on our results.**

We have made and continue to pursue acquisitions. We cannot guarantee that these acquisitions will have a positive impact on our results. These acquisitions could negatively impact our profitability due to operating and integration inefficiencies, the incurrence of debt, contingent liabilities and amortization expenses related to intangible assets. There are also a number of other risks involved in acquisitions. We could lose key existing Customers, have difficulties in assimilating the acquired operations, assume unanticipated legal liabilities, or lose key employees.

**Compliance with environmental laws and regulations can be costly.**

We are subject to many environmental laws and regulations in the jurisdictions in which we operate. We routinely incur costs in order to comply with these laws and regulations. We may be adversely impacted by new or changing laws and regulations that affect both our operations and our ability to develop and sell products that meet our Customers' requirements. The Company's Retrofit Emissions Products are highly regulated and may be adversely impacted due to the failure to obtain regulatory approvals and delays in granting or the loss of required product verifications.

## I tem 1B. Unresolved Staff Comments

None.

## I tem 2. Properties

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

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

<b><u>Americas</u></b>	<b><u>Europe / Middle East / Africa</u></b>
Auburn, Alabama (E)	Kadan, Czech Republic (I)
Riverbank, California (I)*	Klasterec, Czech Republic
Valencia, California (E)*	Domjean, France (E)
Dixon, Illinois	Paris, France (E)
Frankfort, Indiana	Dulmen, Germany (E)
Cresco, Iowa	Flensburg, Germany (I)
Grinnell, Iowa (E)	Haan, Germany (I)
Nicholasville, Kentucky	Ostiglia, Italy
Bloomington, Minnesota	Cape Town, South Africa
Chillicothe, Missouri (E)	Johannesburg, South Africa*
St. Charles, Missouri (E)*	Barcelona, Spain (I)
Philadelphia, Pennsylvania (I)	Hull, United Kingdom
Greeneville, Tennessee	Leicester, United Kingdom (I)
Baldwin, Wisconsin	
Stevens Point, Wisconsin	<b><u>Australia</u></b>
Sao Paulo, Brazil (E)*	Wyong, Australia
Athens, Canada (I)	
Aguascalientes, Mexico	<b><u>Asia</u></b>
Monterrey, Mexico (I)	Hong Kong, China*
	Wuxi, China
<b><u>Joint Venture Facilities</u></b>	New Delhi, India
Champaign, Illinois (E)	Gunma, Japan
Jakarta, Indonesia	Rayong, Thailand (I)
Dammam, Saudi Arabia (I)	
	<b><u>Third-Party Logistics Providers</u></b>
<b><u>Distribution Centers</u></b>	Wuxi, China
Wyong, Australia	Mumbai, India
Brugge, Belgium	Plainfield, Indiana (I)
Rensselaer, Indiana	Gunma, Japan
Ostiglia, Italy	Singapore
Aguascalientes, Mexico	Greeneville, Tennessee (I)
Johannesburg, South Africa	

The Company's properties are utilized for both the Engine and Industrial Products segments except as indicated with an (E) for Engine or (I) for Industrial. The Company leases certain of its facilities, primarily under long-term leases. The facilities denoted with an asterisk (\*) are leased facilities. In Wuxi, China a portion of the operations are conducted in leased facilities. The Company uses third-party logistics providers for some of its product distribution and neither leases nor owns the facilities. The Company considers its properties to be suitable for their present purposes, well-maintained and in good operating condition.

## I tem 3. Legal Proceedings

The Company records provisions with respect to identified claims or lawsuits when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Claims and lawsuits are reviewed quarterly and provisions are taken or adjusted to reflect the status of a particular matter. The Company believes the recorded reserves in its consolidated financial statements are adequate in light of the probable and estimable outcomes. Any

recorded liabilities were not material to the Company's financial position, results of operation or liquidity and the Company does not believe that any of the currently identified claims or litigation will materially affect its financial position, results of operation or liquidity.

On March 31, 2008 S&E Quick Lube, a filter distributor, filed a lawsuit in U.S. District Court for the District of Connecticut alleging that twelve filter manufacturers, including the Company, engaged in a conspiracy to fix prices, rig bids, and allocate U.S. Customers for aftermarket automotive filters. This lawsuit seeks various remedies including injunctive relief and monetary damages of an unspecified amount and is a purported class action on behalf of direct purchasers of automotive aftermarket filters from the defendants. Parallel purported class actions, including on behalf of a variety of direct and indirect purchasers of aftermarket filters, have been filed by other plaintiffs in a variety of jurisdictions in the United States and Canada. The U.S. cases have been consolidated into a single multi-district litigation in the Northern District of Illinois. In addition, on April 16, 2009, the Attorney General of the State of Florida filed a complaint in the U.S. District Court for the Northern District of Illinois based on these same allegations. The Company will vigorously defend the claims raised in these lawsuits. The Company understands that the Antitrust Division of the Department of Justice ("DOJ") was investigating the allegations raised in these suits and issued subpoenas in connection with that investigation. The Company was not contacted by the DOJ in connection with the DOJ investigation, but public reports indicate that the DOJ officially closed that investigation in January 2010. In June 2010, the United States gave notice of its election to decline intervention in a qui tam action entitled United States of America, ex rel. William G. Burch v. Champion Laboratories, Inc. et al., which had been filed under seal in December 2009 in the United States District Court for the Northern District of Oklahoma. After that notice, the matter no longer remained under seal. In August 2010, the County of Suffolk, New York, filed a purported class action entitled County of Suffolk, New York, v. Champion Laboratories, et al., in the United States District Court for the Eastern District of New York. Both the Burch qui tam action and the Suffolk action contain allegations similar to those made in the multi-district litigation already pending in the Northern District of Illinois. As of September 1, 2010, the Company has not been served with a complaint in either action. The Company denies any liability in either action and intends to vigorously defend the claims raised in these lawsuits. In June 2010, the Attorney General of the State of Washington served the Company with a Civil Investigative Demand inquiring into the same issues as those raised in the complaint filed by the State of Florida. The Company is cooperating with the Washington investigation but has denied any wrongdoing.

On May 19, 2010 the Air Resources Board for the State of California ("ARB") revoked its verification of the Company's DFM Diesel Multi-Stage Filter System ("DMF") for use with on-road diesel engines, which verification was issued on December 16, 2005. Under the ARB revocation, as of May 17, 2010, the DMF system may not be sold, installed or offered for sale as an ARB verified system. The Company issued a product bulletin for its DMF product on February 8, 2010 and subsequently submitted a proposal to ARB to address a failure mode that can occur when an engine is not operating in compliance with the requirements for engine performance and temperature. On July 28, 2010, ARB issued its approval for the Company's service campaign. The Company is currently working with the Environmental Protection Agency ("EPA") regarding its service campaign for sales outside California as well as EPA verification for the DMF.

In addition, ARB has notified the Company by letter, that it may seek fines and penalties in connection with the sales of the DMF product. The Company denies that any sales were made in California without ARB verification. Donaldson is not currently selling any DMF product and is evaluating and working with both ARB and the United States Environmental Protection Agency to obtain the necessary approvals for the DMF product. At the present time, we do not anticipate a material adverse impact to our results of operations or financial position due to the issues related to the DMF product.

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

No matters were submitted to a vote of security holders of the Company during the quarter ended July 31, 2010.

#### **Executive Officers of the Registrant**

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

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<u>Name</u>	<u>Age</u>	<u>Positions and Offices Held</u>	<u>First Fiscal Year Appointed as an Executive Officer</u>
Tod E. Carpenter	51	Vice President, Europe and Middle East	2008
William M. Cook	57	Chairman, President and Chief Executive Officer	1994
Sandra N. Joppa	45	Vice President, Human Resources	2005
Norman C. Linnell	51	Vice President, General Counsel and Secretary	1996
Charles J. McMurray	56	Senior Vice President, Industrial Products	2003
Mary Lynne Perushek	52	Vice President and Chief Information Officer	2006
David W. Timm	57	Vice President, Asia-Pacific	2007
Thomas R. VerHage	57	Vice President and Chief Financial Officer	2004
Jay L. Ward	46	Senior Vice President, Engine Products	2006
Debra L. Wilfong	55	Vice President and Chief Technology Officer	2007

Mr. Carpenter joined the Company in 1996 and has held various positions, including Gas Turbine Systems General Manager from 2002 to 2004; General Manager, Industrial Filtration Systems (IFS) Sales from 2004 to 2006; General Manager, IFS Americas in 2006; and Vice President, Global IFS from 2006 to 2008. Mr. Carpenter was appointed Vice President, Europe and Middle East in August 2008.

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

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

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

Mr. McMurray joined the Company in 1980 and has held various positions, including Director, Global Information Technology from 2001 to 2003; Vice President, Human Resources from 2004 to 2005; and Vice President, Information Technology, Europe, South Africa and Mexico from 2005 to 2006. Mr. McMurray became Senior Vice President, Industrial Products in September 2006.

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

Mr. Timm joined the Company in 1983 and has held various positions, including General Manager, Disk Drive from 1995 to 2005 and General Manager, Gas Turbine Systems Products from 2005 to 2006. Mr. Timm was appointed Vice President, Asia-Pacific in December 2006.

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

Mr. Ward joined the Company in 1998 and has held various positions, including Director, Operations from 2001 to 2003; Director, Product and Business Development, IFS Group from 2003 to 2004; Managing Director, Europe from 2004 to 2006; and Vice President, Europe and Middle East from 2006 to 2008. Mr. Ward was appointed Senior Vice President, Engine Products in August 2008.

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

Effective August 2, 2010, Mr. Lowell F. Schwab retired as Senior Vice President, Global Operations.



## P ART II

**Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

The common shares of the Company are traded on the New York Stock Exchange under the symbol DCI. The amount and frequency of all cash dividends declared on the Company’s common stock for Fiscal 2010 and 2009 appear in Note M of the Notes to Consolidated Financial Statements on page 53. As of September 22, 2010, there were 2,033 shareholders of record of common stock.

The low and high sales prices for the Company’s common stock for each full quarterly period during Fiscal 2010 and 2009 were as follows:

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>
Fiscal 2010	\$32.60 - 39.82	\$35.24 - 45.19	\$37.24 - 47.38	\$40.51 - 48.21
Fiscal 2009	\$28.04 - 49.00	\$23.40 - 36.29	\$21.82 - 34.37	\$31.00 - 38.93

The following table sets forth information in connection with purchases made by, or on behalf of, the Company or any affiliated purchaser of the Company, of shares of the Company’s common stock during the quarterly period ended July 31, 2010.

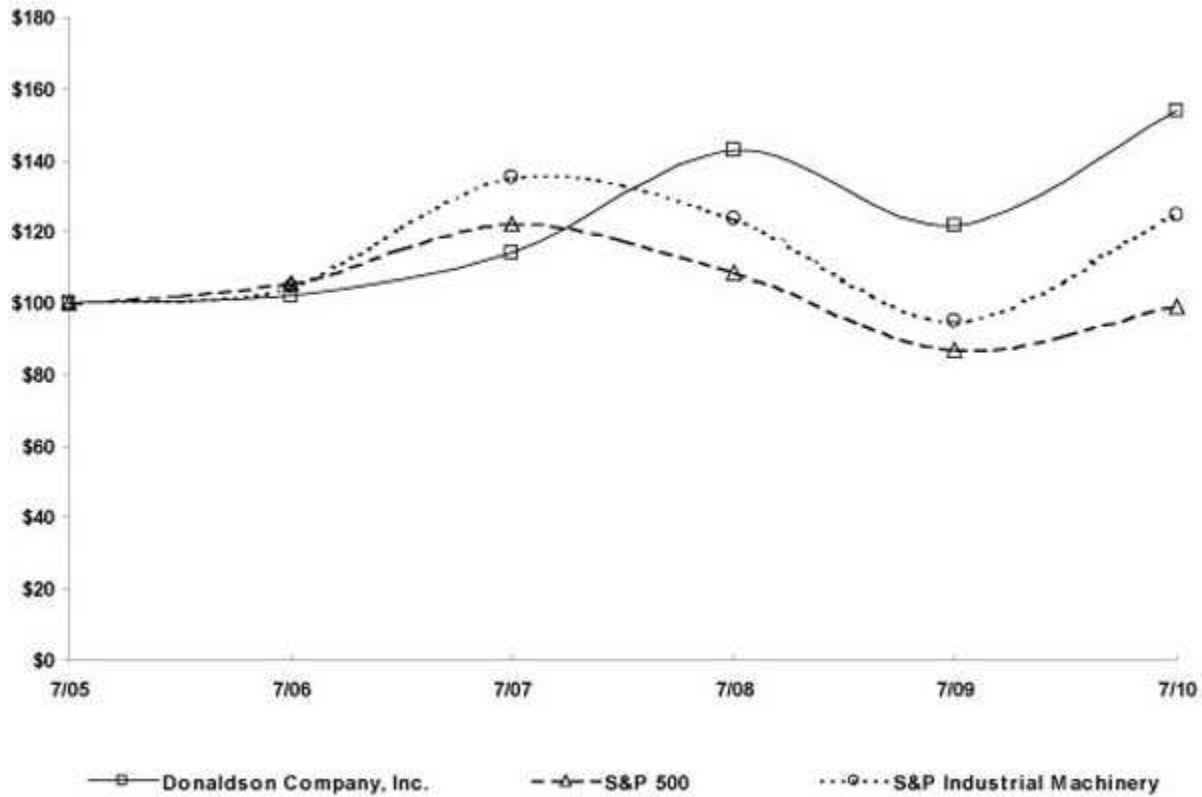
<u>Period</u>	<u>Total Number of Shares Purchased (1)</u>	<u>Average Price Paid per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs</u>
May 1 - May 31, 2010	284,550	\$ 42.19	284,550	7,715,450
June 1 - June 30, 2010	516,181	\$ 42.45	516,181	7,199,269
July 1 - July 31, 2010	220,131	\$ 42.48	212,029	6,987,240
Total	<u>1,020,862</u>	\$ 42.38	<u>1,012,760</u>	6,987,240

- (1) On March 26, 2010, the Company announced that the Board of Directors authorized the repurchase of up to 8.0 million shares of common stock. This repurchase authorization, which is effective until terminated by the Board of Directors, replaced the existing authority that was authorized on March 31, 2006. There were no repurchases of common stock made outside of the Company’s current repurchase authorization during the quarter ended July 31, 2010. However, the “Total Number of Shares Purchased” column of the table above includes 8,102 previously owned shares tendered by option holders in payment of the exercise price of options. While not considered repurchases of shares, the Company does at times withhold shares that would otherwise be issued under equity-based awards to cover the withholding taxes due as a result of exercising stock options or payment of equity-based awards.



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

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN**  
Among Donaldson Company, Inc., the S&P 500 Index  
and the S&P Industrial Machinery Index



	Year Ended July 31,					
	2010	2009	2008	2007	2006	2005
Donaldson Company, Inc.	\$ 153.89	\$ 121.82	\$ 142.67	\$ 113.94	\$ 101.95	\$ 100.00
S&P 500	99.14	87.09	108.81	122.39	105.38	100.00
S&P Industrial Machinery	124.67	94.99	123.63	135.33	104.72	100.00

## I tem 6. Selected Financial Data

The following table sets forth selected financial data for each of the fiscal years in the five-year period ended July 31, 2010 (in millions, except per share data):

	Year Ended July 31,				
	2010	2009	2008	2007	2006
Net sales	\$ 1,877.1	\$ 1,868.6	\$ 2,232.5	\$ 1,918.8	\$ 1,694.3
Income from continuing operations	166.2	131.9	172.0	150.7	132.3
Diluted earnings per share	2.10	1.67	2.12	1.83	1.55
Total assets	1,499.5	1,334.0	1,548.6	1,319.0	1,124.1
Long-term obligations	256.2	253.7	176.5	129.0	100.5
Cash dividends declared per share	0.480	0.460	0.430	0.370	0.410
Cash dividends paid per share	0.470	0.455	0.420	0.360	0.320

## I tem 7. Management's Discussion and Analysis of Financial Condition and Results of Operation

### Results of Operation

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

#### Overview

The Company is a worldwide manufacturer of filtration systems and replacement parts. The Company's core strengths are leading filtration technology, strong Customer relationships, and global presence. The Company operates through two reporting segments, Engine Products and Industrial Products, and has a product mix including air and liquid filtration systems and exhaust and emission control products. As a worldwide business, the Company's results of operations are affected by conditions in the global economic environment. Under normal economic conditions, the Company's market diversification between its OEM and replacement parts Customers, its diesel engine and industrial end markets, and its North American and international end markets has helped to limit the impact of weakness in any one product line, market or geography on the consolidated results of the Company.

The Company reported sales in Fiscal 2010 of \$1,877.1 million, up 0.5 percent from \$1,868.6 million in the prior year. The Company's results were positively impacted by foreign currency translation. The impact of foreign currency translation increased sales by \$43.2 million. Excluding the current year impact of foreign currency translation, worldwide sales decreased 1.9 percent during the year.

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

	Year Ended July 31,	
	2010	2009
Net sales, excluding foreign currency translation	\$ 1,833.9	\$ 1,945.4
Foreign currency translation impact	43.2	(76.8)
Net sales	<u>\$ 1,877.1</u>	<u>\$ 1,868.6</u>

The Company's net earnings were positively impacted by foreign currency translation. The impact of foreign currency translation during the year increased net earnings by \$3.6 million. Excluding the current year impact of foreign currency translation, net earnings increased 23.3 percent.

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

	Year Ended July 31,	
	2010	2009
Net earnings, excluding foreign currency translation	\$ 162.6	\$ 135.7
Foreign currency translation impact, net of tax	3.6	(3.8)
Net earnings	\$ 166.2	\$ 131.9

The Company reported diluted earnings per share of \$2.10, a 25.7 percent increase from \$1.67 in the prior year.

Included in the Fiscal 2010 results are pre-tax restructuring charges of \$10.2 million, compared to \$17.8 million in the prior year. Gross margin and operating expenses include \$7.5 million and \$2.7 million of restructuring expenses, respectively, in Fiscal 2010. This year's charges were primarily related to a downsizing at a plant in Germany which included severance and asset impairments for the building and inventory.

The effective tax rate for Fiscal 2010 was 27.8 percent compared to 18.3 percent in Fiscal 2009. The increase in effective tax rate is primarily due to a decrease in discrete tax benefits. Fiscal 2009 contained \$19.6 million of discrete tax benefits, which predominantly occurred in the second quarter, and primarily related to changes to uncertain tax position reserves in connection with the effective settlements of court cases and examinations in various jurisdictions covering various years. Fiscal 2010 contained \$4.3 million of discrete tax benefits, primarily recorded in the second quarter, from the expiration of the statute of limitations at foreign subsidiaries and other discrete items. Without consideration of discrete items, the average underlying tax rate decreased over the prior year to 29.7 percent from 30.4 percent, mainly due to the mix of earnings between tax jurisdictions.

The Company continued to improve an already strong liquidity position, which allowed for continued investment in the business while increasing cash reserves and increasing its dividend. While Fiscal 2010 was still impacted by the global recession, many of the Company's businesses saw various stages of recovery during Fiscal 2010, and the Company expects a continued recovery in many of the end markets during fiscal 2011, with higher growth in the emerging economies. The Company believes sales in many of its product lines will continue to increase during the next fiscal year. This view is factored into the Fiscal 2011 outlook discussed below.

Following is financial information for the Company's Engine and Industrial Products segments. Corporate and Unallocated includes corporate expenses determined to be non-allocable to the segments and interest income and expense. See further discussion of segment information in Note J of the Company's Notes to Consolidated Financial Statements.

	Engine Products	Industrial Products	Corporate & Unallocated	Total Company
	(thousands of dollars)			
<b>2010</b>				
Net sales	\$ 1,094,371	\$ 782,693	\$ —	\$ 1,877,064
Earnings before income taxes	150,473	96,444	(16,741)	230,176
<b>2009</b>				
Net sales	\$ 1,001,961	\$ 866,668	\$ —	\$ 1,868,629
Earnings before income taxes	83,797	89,526	(11,898)	161,425
<b>2008</b>				
Net sales	\$ 1,229,171	\$ 1,003,350	\$ —	\$ 2,232,521
Earnings before income taxes	158,931	102,420	(25,188)	236,163

During Fiscal 2010, the Company's Engine Products segment net sales increased as a percent of total net sales to 58.3 percent compared to 53.6 percent in the prior year. For the Company's Industrial Products segment, net sales as a percent of total net sales decreased to 41.7 percent from 46.4 percent in the prior year.

Many factors within the Company's reporting segments contributed to the Company's results for Fiscal 2010 including gradual improvement in global economic conditions, the Company's program of Continuous Improvement initiatives, new product introductions, emerging market growth and the expansion of the Company's distribution capabilities. In the Engine Products segment, the Company experienced increased sales in many end-markets and regions. The earnings improvement for the current fiscal year was also driven by a greater mix of higher-margin Aftermarket sales versus lower-margin first-fit product sales, better absorption of fixed manufacturing costs due to the increase in production volumes, benefits related to completed restructuring efforts and Continuous Improvement initiatives. The global Aftermarket sales increases were driven by rebounds in equipment utilization rates in the mining, construction and transportation industries. Retrofit Emissions Products sales decreased as a result of lower

utilization of federal and state grants and subsidies for retrofit products and delays in obtaining product verifications from federal and state agencies. In the Industrial Products segment which generally is a later economic cycle business, international sales decreased due to a reduced demand for industrial dust collectors and compressed air purification systems, reflecting the downturn in general manufacturing activity in Europe and Asia. Gas Turbine Products sales remained slow due to a deceleration in Customer demand for large gas turbine power generation projects as a result of the decrease in global electrical power requirements. Offsetting these decreases was an increase in sales in Special Applications Products due to demand increasing for disk drive filters from the manufacturers of hard disk drives used in computers, data storage devices, and other electronic products.

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

	<u>2010</u>	<u>2009</u> (thousands of dollars)	<u>2008</u>
<b>Engine Products segment:</b>			
Off-Road Products	\$ 222,329	\$ 243,691	\$ 361,143
Aerospace and Defense Products	111,977	119,094	87,538
On-Road Products	81,874	71,958	123,146
Aftermarket Products*	660,263	536,122	631,432
Retrofit Emissions Products	17,928	31,096	25,912
Total Engine Products segment	<u>1,094,371</u>	<u>1,001,961</u>	<u>1,229,171</u>
<b>Industrial Products segment:</b>			
Industrial Filtration Solutions Products	454,653	503,611	600,526
Gas Turbine Products	150,131	206,760	213,138
Special Applications Products	177,909	156,297	189,686
Total Industrial Products segment	<u>782,693</u>	<u>866,668</u>	<u>1,003,350</u>
Total Company	<u>\$ 1,877,064</u>	<u>\$ 1,868,629</u>	<u>\$ 2,232,521</u>

\* Includes replacement part sales to the Company's OEM Customers.

## Outlook

The Company expects a continued recovery in many of its end-markets in FY11, with higher growth in the emerging economies. The Company forecasts its full year FY11 EPS to be between \$2.28 and \$2.48.

- The Company is planning its total FY11 sales to be approximately \$2 billion. For the full year FY11 versus FY10, higher local currency sales should be partially offset by foreign currency translation based on the Company's planned rates for the Euro of US\$1.27 and 87 Yen to the US\$.
- In its gross margin, the Company forecasts an increase in its purchased raw material costs and a less favorable sales mix compared to FY10. The Company also plans to make several key operating investments totaling approximately \$18 million, to support the Company's strategic growth plans. Consequently, the Company expects its full year operating margin to be 12.5 to 13.5 percent.
- The Company's full year FY11 tax rate is projected to be between 27 and 30 percent.
- The Company expects that cash generated by operating activities will be between \$230 and \$260 million in Fiscal 2011. Capital spending in Fiscal 2011 is projected to be between \$70 and \$80 million. The Company will continue to use its cash flow for dividends, potential acquisitions, capital projects and maintenance of its strong liquidity position.

**Engine Products** – The Company expects full year sales to increase 6 to 11 percent, including the impact of foreign currency translation.

- The Company anticipates sales to its construction and mining equipment OEM Customers to continue to improve as their production rates increase. The Company also projects a modest improvement in the farm equipment market.

- The Company is forecasting slightly lower sales for its Aerospace and Defense Products due to the continued slowdown in U.S. military activity in Iraq and decreases in U.S. government spending for major programs.
- In the Company's OEM On-Road Products' business, it believes that build rates for heavy- and medium-duty trucks at its OEM customers will continue improving.
- The Company's Aftermarket Products' sales are expected to continue to grow as utilization rates for both heavy trucks and off-road equipment increase. The Company also expects to continue benefitting from the increasing amount of equipment in the field with PowerCore<sup>®</sup> and its other proprietary filtration systems.

**Industrial Products** - The Company forecasts full year FY11 sales to increase 3 to 8 percent, including the impact of foreign currency translation.

- The Company's Industrial Filtration Solution's sales are projected to increase 3 to 8 percent as the demand for new filtration equipment is expected to improve as general industry capital spending increases.
- The Company expects its Gas Turbine Products' sales to be stable as the large power generation market appears to be bottoming out. The Company's longer-term outlook remains very positive with the eventual recovery of the global economy.
- Special Applications Products' sales are projected to increase 6 to 11 percent, as the end markets for the Company's disk drive filters and membrane products are expected to grow.

## **Fiscal 2010 Compared to Fiscal 2009**

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

Sales for the Engine Products segment were \$1,094.4 million, an increase of 9.2 percent from \$1,002.0 million in the prior year. Engine Products sales in the United States remained relatively flat in Fiscal 2010 compared to Fiscal 2009, increasing only 0.1 percent in the current fiscal year. International Engine Products sales increased 19.2 percent from the prior year. The impact of foreign currency increased sales by \$24.2 million, or 2.4 percent. Earnings before income taxes as a percentage of Engine Products segment sales of 13.7 percent increased from 8.4 percent in the prior year. The earnings improvement for the current fiscal year was driven by a greater mix of higher-margin Aftermarket sales versus lower-margin first-fit product sales, better absorption of fixed manufacturing costs due to the increase in production volumes and benefits related to completed restructuring efforts and other Continuous Improvement initiatives. In addition, restructuring expenses for the Engine Products segment were down \$5.3 million over the prior year, but this was more than offset by \$6.2 million of increased warranty expenses related to Retrofit Emissions Products.

Worldwide sales of Off-Road Products were \$222.3 million, a decrease of 8.8 percent from \$243.7 million in the prior year. Sales in the United States decreased 15.0 percent to \$95.1 million for the fiscal year. Internationally, sales of Off-Road Products were down 3.4 percent from the prior year, with sales decreasing in Europe by 10.7 percent, which were slightly offset by an increase in Off-Road sales in Asia of 7.4 percent. The Company's overall decrease was driven by a weakness in the early portion of the fiscal year with a gradual strengthening in end-markets in the last half of the fiscal year. This was evident in the gradual improvement of sales to OEMs during the last months of the fiscal year. The first half of the year was down primarily due to declines in spending in the residential and non-residential construction markets. The latter half of the year saw increases in the mining industry as a result of higher commodity prices and improvements in worldwide construction activity.

Worldwide sales of On-Road Products were \$81.9 million, an increase of 13.8 percent from \$72.0 million in the prior year. On-Road Products sales in the United States increased 3.4 percent from the prior year, primarily as a result of a slight market share improvement and higher content per truck. The Company performed better than the impact due to the change in truck build rates for the year in Class 8 truck builds, which decreased by 3.7 percent and medium duty truck build rates which increased 0.3 percent. International On-Road Products sales increased 25.2 percent from the prior year, driven by increased sales in Asia of 45.2 percent, as a result of increased truck exports by the Company's Japanese OEM Customers to higher growth emerging markets, and rebounding sales in Europe during the second half of the fiscal year.

Worldwide Engine Aftermarket Products sales of \$660.3 million increased 23.2 percent from \$536.1 million in the prior year. Sales in the United States increased 15.6 percent over the prior year. International sales increased 29.5 percent from the prior year, primarily driven by sales increases in Asia, Latin America and Europe of 36.5 percent, 27.8 percent and 24.6 percent, respectively. The sales increases in the United States and internationally were driven by rebounds in equipment utilization rates in the mining, construction and transportation industries. The Company also improved its distribution capabilities to be closer to and better serve its Customers and increased sales due to the Company's recent market share "wins."

Worldwide sales of Retrofit Emissions Products were \$17.9 million, a decrease of 42.3 percent from \$31.1 million in the prior year. The Company's Retrofit Emissions Products sales are solely in the United States. Sales of Retrofit Emissions Products decreased as a result of continuing postponements in the availability of government grant money and delays and losses of regulatory approval for certain of the Company's products, including the DMF product.

Worldwide sales of Aerospace and Defense Products were \$112.0 million, a 6.0 percent decrease from \$119.1 million in the prior year. Sales in the United States decreased 9.0 percent over the prior year as a result of slowdowns in government procurement for major defense programs. Internationally, sales of Aerospace and Defense Products increased 8.0 percent over the prior year. The international sales increased primarily as a result of the startup of recent defense program wins.

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

Sales for the Industrial Products segment were \$782.7 million, a decrease of 9.7 percent from \$866.7 million in the prior year. International Industrial Products sales decreased 8.2 percent and sales in the United States decreased 13.3 percent from the prior year. The impact of foreign currency increased sales by \$19.0 million, or 2.2 percent. Despite the 9.7 percent decrease in sales, earnings before income taxes as a percentage of Industrial Products segment sales were 12.3 percent, increasing from 10.3 percent in the prior year. The improvement in earnings as a percent of sales over the prior year was driven by better execution on large project shipments, increased plant utilization, improved product mix, and Continuous Improvement initiatives. Restructuring expenses in Fiscal 2010 were \$8.3 million, a decrease from \$10.1 million in Fiscal 2009.

Worldwide sales of Industrial Filtration Solutions Products of \$454.7 million decreased 9.7 percent from \$503.6 million in the prior year. Sales in the United States, Europe and Asia decreased 9.6 percent, 11.8 percent and 7.1 percent, respectively. Sales in Mexico decreased 16.7 percent in Fiscal 2010 as compared to Fiscal 2009. Overall, the Company experienced weak sales conditions for its Industrial Filtration Solutions products during the beginning of the fiscal year, with conditions improving towards the end of the fiscal year. The decreased sales in Europe and Asia were due to reduced demand for industrial dust collectors and compressed air purification systems due to the downturn in general manufacturing activity. Domestic sales decreased due to a decline in general industrial activity that did not stabilize until late in the fiscal year, as evidenced by a 19 percent drop in machine tool consumption in the United States during fiscal year 2010 as compared to fiscal year 2009.

Worldwide sales of Gas Turbine Products were \$150.1 million, a decrease of 27.4 percent from \$206.8 million in the prior year. Gas Turbine Products sales are typically large systems and, as a result, the Company's shipments and revenues fluctuate from period to period. Incoming orders declined 9 percent in Fiscal 2010 versus Fiscal 2009, a reflection of the reduced demand for power generation projects globally. Sales remained slow due to a deceleration in Customer demand for large gas turbine power generation projects as a result of the decrease in global electrical power requirements and also as a result of one Customer's increased utilization of its own internal filtration businesses.

Worldwide sales of Special Applications Products were \$177.9 million, a 13.8 percent increase from \$156.3 million in the prior year. Domestic Special Application Products sales increased 5.9 percent, driven by an increase in sales to industrial Customers of PTFE membranes. International sales of Special Application Products increased 15.1 percent over the prior year, primarily in Asia, which increased 18.6 percent. These international sales increases were driven by improved demand for the Company's Customers' hard disk drives as the end-markets for computers, data storage devices and other electronic products have rebounded. Overall, the Company's market growth is comparable with published disk drive build rates.

*Consolidated Results* The Company reported net earnings for Fiscal 2010 of \$166.2 million compared to \$131.9 million in Fiscal 2009, an increase of 26.0 percent. Diluted net earnings per share was \$2.10, up 25.7 percent from



\$1.67 in the prior year. The Company's operating income of \$238.2 million increased from prior year operating income of \$170.0 million by 40.2 percent.

The table below shows the percentage of total operating income contributed by each segment for each of the last three fiscal years. Corporate and Unallocated includes corporate expenses determined to be non-allocable to the segments and interest income and expense:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Engine Products	60.7%	44.5%	61.1%
Industrial Products	40.2%	51.8%	42.1%
Corporate and Unallocated	(0.9)%	3.7%	(3.2)%
Total Company	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

International operating income, prior to corporate expense allocations, totaled 80.3 percent of consolidated operating income in Fiscal 2010 as compared to 77.9 percent in Fiscal 2009. Total international operating income increased 44.6 percent from the prior year. This increase is attributable to increased Customer sales and stronger foreign currencies. The table below shows the percentage of total operating income contributed by each major geographic region for each of the last three fiscal years:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
United States	19.7%	22.1%	10.6%
Europe	24.6%	23.3%	43.3%
Asia - Pacific	45.3%	43.5%	37.9%
Other	10.4%	11.1%	8.2%
Total Company	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

Gross margin for Fiscal 2010 was 35.1 percent, an increase from 31.6 percent in the prior year. The improved gross margin was the result of improved fixed cost absorption, a higher mix of replacement filter sales, savings from restructuring actions and ongoing Continuous Improvement initiatives. Within gross margin, the Company incurred \$7.5 million in restructuring and asset impairment charges during the fiscal year, compared to \$10.1 million last year. This year's charges were primarily related to a downsizing at a plant in Germany and included severance and asset impairments for the building and inventory.

Operating expenses for Fiscal 2010 were \$420.5 million or 22.4 percent of sales, as compared to \$419.8 million or 22.5 percent in the prior year. Operating expenses as a percent of sales was relatively flat and included \$15.1 million of higher incentive compensation expense partially offset by a \$5.0 million decrease in restructuring costs as compared to the prior year. During the fiscal year the Company increased warranty accruals due to specific warranty matters in our Retrofit Emissions Products group, recording an expense of \$6.2 million for this matter during the year.

Interest expense of \$12.0 million decreased \$5.0 million from \$17.0 million in the prior year as a result of reduced debt levels and lower interest rates throughout the year. Net other income totaled \$3.9 million in Fiscal 2010 down from \$8.5 million in the prior year. Components of other income for Fiscal 2010 were as follows: interest income of \$1.3 million, earnings from non-consolidated joint ventures of \$2.0 million, royalty income of \$7.2 million, charitable donations of \$1.6 million, foreign exchange losses of \$4.6 million and other miscellaneous income and expense items resulting in expenses of \$0.4 million.

The effective tax rate for Fiscal 2010 was 27.8 percent compared to 18.3 percent in Fiscal 2009. The increase in effective tax rate is primarily due to a decrease in discrete tax benefits. Fiscal 2009 contained \$19.6 million of discrete tax benefits, which predominantly occurred in the second quarter, and primarily related to changes to uncertain tax position reserves in connection with the effective settlements of court cases and examinations in various jurisdictions covering various years. Fiscal 2010 contained \$4.3 million of discrete tax benefits, primarily recorded in the second quarter, from the expiration of the statute of limitations at foreign subsidiaries and other discrete items. Without consideration of discrete items, the average underlying tax rate improved over the prior year to 29.7 percent from 30.4 percent mainly due to the mix of earnings between tax jurisdictions.

Total backlog at July 31, 2010, was \$628.3 million, up 19.0 percent from the same period in the prior year. Backlog is one of many indicators of business conditions in the Company's markets. However, it is not always indicative of future results for a number of reasons, including short lead times in the Company's replacement parts businesses and the timing of receipt of orders in many of the Company's Engine OEM and Industrial markets. In the Engine Products segment, total open order backlog increased 31.5 percent from the prior year. In the Industrial

Products segment, total open order backlog decreased 1.8 percent from the prior year. Because some of the change in backlog can be attributed to a change in the ordering patterns of the Company's Customers and/or the impact of foreign exchange translation rates, it may not necessarily correspond to future sales.

## **Fiscal 2009 Compared to Fiscal 2008**

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

Sales for the Engine Products segment were \$1,002.0 million, a decrease of 18.5 percent from \$1,229.2 million in the prior year. International Engine Products sales decreased 24.3 percent and sales in the United States decreased 12.4 percent from the prior year. The impact of foreign currency decreased sales by \$38.9 million, or 3.2 percent. Earnings before income taxes as a percentage of Engine Products segment sales of 8.4 percent decreased from 12.9 percent in the prior year. The Engine Products segment has been negatively impacted by lower absorption of fixed manufacturing costs due to the drop in sales volumes and increased costs related to restructuring, offset by cost savings as a result of workforce reductions already completed, improved distribution efficiencies as compared to the prior year and the impact of Continuous Improvement initiatives control measures including reductions in incentive compensation.

Worldwide sales of Off-Road Products were \$243.7 million, a decrease of 32.5 percent from \$361.1 million in the prior year. Sales in the United States decreased 12.3 percent. Global mining activity started declining due to decreased commodity prices in the second quarter of Fiscal 2009, and remained weak throughout the remainder of the year. Spending in U.S. residential and non-residential construction markets was down more than 27 percent and 5 percent, respectively, over prior year, resulting in a decrease in the sales of the Company's products into those markets. Internationally, sales of Off-Road Products were down 35.0 percent from the prior year, with sales decreasing in both Europe and Asia by 38.1 percent and 30.3 percent, respectively. Sales in the European construction equipment end market decreased due to a decline in construction activity related to the economic downturn. Sales to the European agricultural end market also decreased. In Asia, sales have declined significantly in Japan in the construction end markets.

Worldwide sales of On-Road Products were \$72.0 million, a decrease of 41.6 percent from \$123.1 million in the prior year. On-Road Products sales in the United States decreased 43.2 percent from the prior year, primarily as a result of a 29 percent decrease in Class 8 truck build rates, 40 percent decrease in medium duty truck build rates by the Company's Customers and a reduction in high value product mix over the prior year. International On-Road Products sales decreased 39.6 percent from the prior year, driven by decreased sales in Europe and Asia of 51.0 percent and 32.5 percent, respectively, reflecting the economic downturn for freight activity and new truck build rates.

Worldwide Engine Aftermarket Products sales of \$536.1 million decreased 15.1 percent from \$631.4 million in the prior year. Sales in the United States decreased 12.2 percent over the prior year, driven by inventory adjustments at the Company's Customers and decreases in utilization rates in the mining, construction and transportation industries. International sales decreased 17.4 percent from the prior year, primarily driven by sales decreases in Europe and Asia of 26.1 percent and 8.0 percent, respectively, due to weak economic conditions.

Worldwide sales of Retrofit Emission products were \$31.1 million, an increase of 20.0 percent from \$25.9 million in the prior year. The increase in Retrofit Emissions products is the result of increased government programs and increased funding for Retrofit Emissions products.

Worldwide sales of Aerospace and Defense products were \$119.1 million, a 36.0 percent increase from \$87.5 million in the prior year. International sales of Aerospace and Defense products increased 5.8 percent and domestic sales increased 45.0 percent over the prior year. Domestic Aerospace and Defense sales benefited from the acquisition of Western Filter Corporation, which resulted in \$15.4 million of incremental sales over the prior year, and continued strong demand for filters for military equipment.

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

Sales for the Industrial Products segment were \$866.7 million, a decrease of 13.6 percent from \$1,003.4 million in the prior year. International Industrial Products sales decreased 14.2 percent and sales in the United States decreased 12.3 percent from the prior year. The impact of foreign currency decreased sales by \$37.9 million, or 3.8 percent.



Despite the 13.6 percent decrease in sales, earnings before income taxes as a percentage of Industrial Products segment sales of 10.3 percent increased from 10.2 percent in the prior year. The improvement in earnings as a percent of sales over the prior year was driven by better execution on large project shipments, cost savings from restructuring actions, reductions in incentive compensation expense, and the impact of Continuous Improvement initiatives. These were slightly offset by lower absorption of fixed costs and restructuring costs.

Worldwide sales of Industrial Filtration Solutions Products of \$503.6 million decreased 16.1 percent from \$600.5 million in the prior year. Sales in the United States and Europe decreased 18.3 percent and 21.0 percent, respectively. Sales in Asia remained relatively flat as compared to the prior year. The decline in Europe was due to reduced demand for industrial dust collectors and compressed air purification systems which fell with the downturn in general manufacturing activity during the year. Domestic sales decreased from the prior year as a result of this same decline in general industrial activity. The results in the year were also influenced by the sale of the air dryer business in Maryville, Tennessee, on October 31, 2008 and the acquisition of LMC West, Inc. (LMC West) in February of Fiscal 2008. The sale of the air dryer business in Maryville, Tennessee, decreased sales \$7.6 million over last year. The acquisition of LMC West contributed to \$7.0 million of sales during the twelve months of Fiscal 2009 and \$4.7 million during the latter six months of Fiscal 2008.

Worldwide sales of Gas Turbine Products were \$206.8 million, a decrease of 3.0 percent from \$213.1 million in the prior year. Gas Turbine Products sales are typically large systems and, as a result, the Company's shipments and revenues fluctuate from quarter to quarter. Incoming orders declined 58 percent in Fiscal 2009 versus Fiscal 2008, a reflection of the reduced demand for power generation projects globally.

Worldwide sales of Special Applications Products were \$156.3 million, a 17.6 percent decrease from \$189.7 million in the prior year. Domestic Special Application Products sales decreased 10.0 percent. International sales of Special Application Products decreased 18.7 percent over the prior year. The primary decreases internationally were in Europe and Asia, which decreased 25.5 and 17.3 percent, respectively, due to a significant reduction in demand for hard disk drive filters, semiconductor filtration systems and PTFE membrane filtration products. The reduction in demand is primarily a result of a worldwide contraction in the end markets for computers, data storage devices and other electronic products that began in the second quarter of Fiscal 2009.

*Consolidated Results* The Company reported net earnings for Fiscal 2009 of \$131.9 million compared to \$172.0 million in Fiscal 2008, a decrease of 23.3 percent. Diluted net earnings per share was \$1.67, down 21.2 percent from \$2.12 in the prior year. The Company's operating income of \$170.0 million decreased from prior year operating income of \$245.8 million by 30.9 percent.

The table below shows the percentage of total operating income contributed by each segment for each of the last three fiscal years. Corporate and Unallocated includes corporate expenses determined to be non-allocable to the segments and interest income and expense:

	<u>2009</u>	<u>2008</u>	<u>2007</u>
Engine Products	44.5%	61.1%	62.9%
Industrial Products	51.8%	42.1%	37.8%
Corporate and Unallocated	3.7%	(3.2)%	(0.7)%
Total Company	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

International operating income, prior to corporate expense allocations, totaled 77.9 percent of consolidated operating income in Fiscal 2009 as compared to 89.4 percent in Fiscal 2008. Total international operating income decreased 39.8 percent from the prior year. This decrease is attributable to restructuring charges internationally exceeding domestic restructuring costs, weaker foreign currencies and overall weak business conditions abroad. The table below shows the percentage of total operating income contributed by each major geographic region for each of the last three fiscal years:

	<u>2009</u>	<u>2008</u>	<u>2007</u>
United States	22.1%	10.6%	22.3%
Europe	23.3%	43.3%	34.8%
Asia - Pacific	43.5%	37.9%	38.6%
Other	11.1%	8.2%	4.3%
Total Company	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

Gross margin for Fiscal 2009 was 31.6 percent, a decrease from 32.5 percent in the prior year. The Company had \$10.1 million in restructuring costs which reduced gross margin in the year. In addition, lower absorption of fixed costs due to the drop in production volumes, net of savings from completed restructuring related activities, negatively impacted gross margin by approximately \$23 million. Partially offsetting these factors were the positive impacts of improved product mix, improved distribution efficiencies, and better execution on large project shipments. During Fiscal 2008, the Company began using a new warehouse management system at its main U.S. distribution center. The Company encountered start-up problems during the transition to the new systems which, although now resolved, resulted in \$7.6 million in unanticipated charges in Fiscal 2008 that did not recur in Fiscal 2009. The Company also incurred a charge of approximately \$5.0 million to pretax income related to the use of the Last-In, First-Out (LIFO) accounting method for its U.S. inventories, which charges increasing commodity costs to income immediately. As commodity costs were relatively flat in Fiscal 2009, the Company did not experience a similar impact from rising commodity prices.

Operating expenses for Fiscal 2009 were \$419.8 million or 22.5 percent of sales, as compared to \$480.1 million or 21.5 percent in the prior year. Operating expenses as a percent of sales increased due to sales volume declines and \$7.7 million in restructuring cost during the year, offset by \$19.4 million in benefits from restructuring actions taken and \$19.5 million of lower incentive compensation expense as compared to the prior year.

Interest expense of \$17.0 million increased \$0.4 million from \$16.6 million in the prior year as a result of higher debt levels. Net other income totaled \$8.5 million in Fiscal 2009 up from \$6.9 million in the prior year. Components of other income for Fiscal 2009 were as follows: interest income of \$1.6 million, earnings from non-consolidated joint ventures of \$2.3 million, royalty income of \$6.1 million, charitable donations of \$0.6 million, foreign exchange losses of \$0.4 million and other miscellaneous income and expense items resulting in expenses of \$0.5 million.

The effective tax rate for Fiscal 2009 was 18.3 percent compared to 27.2 percent in Fiscal 2008. The decrease in effective rate is primarily due to the settlements of long-standing court cases and examinations in various jurisdictions for tax years 2003 through 2006, the reassessment of the corresponding unrecognized tax benefits for the subsequent open years and a favorable resolution of a foreign tax matter. Partially offsetting these effects, the Company's Fiscal 2009 tax rate was unfavorably impacted by an increased expense from the repatriation of foreign earnings. Absent these items, the underlying tax rate for the Fiscal 2009 has decreased from Fiscal 2008 by 1.2 points to 30.4 percent. The reinstatement of the U.S. Research and Experimentation credit, changes in current year unrecognized tax benefits, reduced statutory tax rates and the mix of earnings between foreign jurisdictions all contributed to the reduction in the underlying rate.

Total backlog at July 31, 2009, was \$528.0 million, down 33.7 percent from the same period in the prior year. Backlog is one of many indicators of business conditions in the Company's markets. However, it is not always indicative of future results for a number of reasons, including short lead times in the Company's replacement parts businesses and the timing of receipt of orders in many of the Company's Engine OEM and Industrial markets. In the Engine Products segment, total open order backlog decreased 31.8 percent from the prior year. In the Industrial Products segment, total open order backlog decreased 36.8 percent from the prior year. Because some of the change in backlog can be attributed to a change in the ordering patterns of the Company's Customers and/or the impact of foreign exchange translation rates, it may not necessarily correspond to future sales.

## **Liquidity and Capital Resources**

*Financial Condition* At July 31, 2010, the Company's capital structure was comprised of \$55.5 million of current debt, \$256.2 million of long-term debt and \$746.6 million of shareholders' equity. The Company had cash and cash equivalents of \$232.0 million at July 31, 2010. The ratio of long-term debt to total capital was 25.5 percent and 26.9 percent at July 31, 2010 and 2009, respectively.

Total debt outstanding increased \$23.0 million during the year to \$311.7 million outstanding at July 31, 2010. Short-term borrowings outstanding at the end of the year were \$20.4 million higher as compared to the prior year, and long-term debt increased \$2.6 million (including current maturities) from the prior year.

The following table summarizes the Company's cash obligations as of July 31, 2010, for the years indicated (thousands of dollars):

Contractual Obligations	Total	Payments Due by Period			
		Less than 1 year	1 - 3 years	3 - 5 years	More than 5 years
Long-term debt obligations	\$ 256,248	\$ 5,070	\$ 44,025	\$ 99,233	\$ 107,920
Capital lease obligations	890	466	395	29	—
Interest on long-term debt obligations	64,024	13,095	23,359	14,207	13,363
Operating lease obligations	20,918	8,966	9,580	2,330	42
Purchase obligations <sup>(1)</sup>	161,256	142,612	18,236	62	346
Pension and deferred compensation <sup>(2)</sup>	61,481	4,272	7,708	7,600	41,901
Total <sup>(3)</sup>	\$ 564,817	\$ 174,481	\$ 103,303	\$ 123,461	\$ 163,572

- (1) Purchase obligations consist primarily of inventory, tooling, contract employment services and capital expenditures. The Company's purchase orders for inventory are based on expected Customer demand, and quantities and dollar volumes are subject to change.
- (2) Pension and deferred compensation consists of long-term pension liabilities and salary and bonus deferrals elected by certain executives under the Company's deferred compensation plan. Deferred compensation balances earn interest based on a treasury bond rate as defined by the plan and are payable at the election of the participants.
- (3) In addition to the above contractual obligations, the Company may be obligated for additional cash outflows of \$21.5 million of potential tax obligations, including accrued interest and penalties. The payment and timing of any such payments is affected by the ultimate resolution of the tax years that are under audit or remain subject to examination by the relevant taxing authorities, and are therefore not currently capable of estimation by period.

The Company's general funding policy for its pension plans is to make at least the minimum contributions as required by applicable regulations. Additionally, the Company may elect to make additional contributions up to the maximum tax deductible contribution. As such, the Company made contributions of \$11.2 million to its U.S. pension plans in Fiscal 2010. There is no minimum funding requirement for the Company's U.S. pension plans for Fiscal 2011. The Company is currently evaluating whether or not a U.S. pension contribution will be made in Fiscal 2011. The Company made contributions of \$3.8 million to its non-U.S. pension plans in Fiscal 2010 and estimates that it will contribute approximately \$3.9 million in Fiscal 2011 based upon the local government prescribed funding requirements. Future estimates of the Company's pension plan contributions may change significantly depending on the actual rate of return on plan assets, discount rates and regulatory requirements.

The Company has a five-year, multi-currency revolving facility with a group of banks under which the Company may borrow up to \$250 million. This facility matures on April 2, 2013. The agreement provides that loans may be made under a selection of currencies and rate formulas including Base Rate Advances or Off Shore Rate Advances. The interest rate on each advance is based on certain market interest rates and leverage ratios. Facility fees and other fees on the entire loan commitment are payable over the duration of this facility. There was \$50.0 million outstanding at July 31, 2010 and \$20.0 million outstanding at July 31, 2009. At July 31, 2010 and 2009, \$180.0 million and \$210.0 million, respectively, was available for further borrowing under such facilities. The amount available for further borrowing reflects a reduction for issued standby letters of credit, as discussed below. The weighted average interest rate on these short-term borrowings outstanding at July 31, 2010 and 2009 was 0.6 percent.

The Company has three uncommitted credit facilities in the United States, which provide unsecured borrowings for general corporate purposes. At July 31, 2010 and 2009, there was \$70.0 million available for use. There were no amounts outstanding at July 31, 2010. As of July 31, 2009, \$9.6 million was outstanding under these facilities with a weighted average interest rate of 0.5 percent.

The Company also has a €100 million program for issuing treasury notes for raising short, medium and long-term financing for its European operations. There was nothing outstanding on this program at July 31, 2010 and 2009. Additionally, the Company's European operations have lines of credit with an available limit of €60.5 million. There was nothing outstanding on these lines of credit as of July 31, 2010 and 2009.

Other international subsidiaries may borrow under various credit facilities. There was nothing outstanding under these credit facilities as of July 31, 2010 and 2009.

During Fiscal 2010, credit availability in the global credit markets became easier and market interest rates remained low. The Company has assessed the implications of these factors on its current business and believes that its current financial resources are sufficient to continue financing its operations for the next twelve months. There can be no assurance, however, that the cost or availability of future borrowings will not be impacted by future capital market disruptions.

Certain note agreements contain debt covenants related to working capital levels and limitations on indebtedness. As of July 31, 2010, the Company was in compliance with all such covenants. The Company currently expects to remain in compliance with these covenants.

Also, at July 31, 2010 and 2009, the Company had outstanding standby letters of credit totaling \$20.0 million, upon which no amounts had been drawn. The letters of credit guarantee payment to third parties in the event the Company is in breach of a specified bond financing agreement and insurance contract terms as detailed in each letter of credit.

Shareholders' equity increased \$58.0 million in Fiscal 2010 to \$746.6 million at July 31, 2010. The increase was primarily due to the current year earnings of \$166.2 million, \$12.3 million of stock options exercised, \$6.9 million of stock option expense and \$6.3 million in tax reductions to employee plans. These increases were partially offset by \$66.7 million of treasury stock repurchases, \$36.9 million of dividend declarations, changes to foreign currency translation of \$16.0 million, and \$14.8 million (net of tax) of adjustments related to the pension liability.

*Cash Flows* During Fiscal 2010, \$203.0 million of cash was generated from operating activities, compared with \$276.9 million in Fiscal 2009. Operating cash flows decreased as the improvement in the economy resulted in increases in accounts receivable and inventory levels to support the higher business levels of \$196.3 million and \$92.0 million, respectively. The increased demand and improved results also led to increases in accounts payable and accrued compensation of \$110.9 million and \$36.7 million, respectively. Cash flow generated by operations was used primarily to support \$42.7 million of net capital expenditures, \$66.7 million for stock repurchases and \$36.2 million for dividend payments. Cash and cash equivalents increased \$88.3 million during Fiscal 2010.

Net capital expenditures for property, plant and equipment totaled \$42.7 million in Fiscal 2010 and \$45.6 million in Fiscal 2009. Net capital expenditures is comprised of purchases of property, plant, and equipment of \$43.1 million and \$46.1 million in both Fiscal 2010 and 2009, respectively, partially offset by proceeds from the sale of property, plant and equipment of \$0.5 million in Fiscal 2010 and 2009. Fiscal 2010 capital expenditures primarily related to new plant capacity additions, productivity enhancing investments at various plants worldwide, and tooling to manufacture new products.

Capital spending in Fiscal 2011 is planned to be between \$70.0 million to \$80.0 million. It is anticipated that Fiscal 2011 capital expenditures will be financed primarily by cash on hand, cash generated from operations, and existing lines of credit.

The Company expects that cash generated by operating activities will exceed \$200 million in Fiscal 2011. At July 31, 2010, the Company had cash of \$232.0 million, which exists at subsidiaries outside of the United States. The Company also had \$250.0 million available under existing credit facilities in the United States, €160.5 million or \$209.4 million, available under existing credit facilities in Europe and \$42.4 million available under various credit facilities and currencies in Asia and the rest of the world. The Company believes that the combination of existing cash, available credit under existing credit facilities, and the expected cash generated by operating activities will be adequate to meet cash requirements for Fiscal 2011, including debt repayment, issuance of anticipated dividends, possible share repurchase activity, and capital expenditures.

*Dividends* The Company's dividend policy is to maintain a payout ratio, which allows dividends to increase with the long-term growth of earnings per share. The Company's dividend payout ratio target is 20 percent to 30 percent of the average earnings per share of the last three years. With the Company's declaration on July 30, 2010 of a \$0.125 per share dividend to be paid, the dividend payout ratio was 26.0 percent on July 31, 2010.

*Share Repurchase Plan* The Board of Directors authorized the repurchase of 8.0 million shares of common stock under the stock repurchase plan dated March 26, 2010. This repurchase authorization replaces the existing authority that was approved on March 31, 2006. In Fiscal 2010 the Company repurchased 1.7 million shares of common stock for \$66.7 million, or 2.1 percent, at an average price of \$40.38 per share. The Company repurchased 0.8 million shares for \$32.8 million in Fiscal 2009. The Company repurchased 2.2 million shares for \$92.2 million in Fiscal 2008. As of July 31, 2010 the Company had remaining authorization to repurchase 7.0 million shares pursuant to the current authorization.

*Off-Balance Sheet Arrangements* The Company does not have any off-balance sheet arrangements, with the exception of the guarantee of 50 percent of certain debt of its joint venture, AFSI as further discussed in Note K of the Company's Notes to Consolidated Financial Statements. As of July 31, 2010 the joint venture had \$25.2 million of outstanding debt. The Company does not believe that this guarantee will have a current or future effect on its financial condition, results of operation, liquidity or capital resources.

*New Accounting Standards* In June 2009 FASB updated the accounting standards related to the consolidation of variable interest entities (VIEs). The standard amends current consolidation guidance and requires additional disclosures about an enterprise's involvement in VIEs. The standard is effective for interim and annual reporting periods beginning after November 15, 2009. The adoption of the revised standard did not have a material impact on the Company's financial statements in Fiscal 2010.

## Market Risk

The Company's market risk includes the potential loss arising from adverse changes in foreign currency exchange rates and interest rates. The Company manages foreign currency market risk from time to time through the use of a variety of financial and derivative instruments. The Company does not enter into any of these instruments for trading purposes to generate revenue. Rather, the Company's objective in managing these risks is to reduce fluctuations in earnings and cash flows associated with changes in foreign currency exchange rates. The Company uses forward exchange contracts and other hedging activities to hedge the U.S. dollar value resulting from existing recognized foreign currency denominated asset and liability balances and also for anticipated foreign currency transactions. The Company also naturally hedges foreign currency through its production in the countries in which it sells its products. The Company's market risk on interest rates is the potential decrease in fair value of long-term debt resulting from a potential increase in interest rates. See further discussion of these market risks below and in Note E of the Notes to Consolidated Financial Statements.

*Foreign Currency* During Fiscal 2010, the U.S. dollar was slightly weaker throughout the year compared to many of the currencies of the foreign countries in which the Company operates. The overall weakness of the dollar had a positive impact on the Company's international net sales results because the foreign denominated revenues translated into more U.S. dollars.

It is not possible to determine the true impact of foreign currency translation changes. However, the direct effect on reported net sales and net earnings can be estimated. For the year ended July 31, 2010, the impact of foreign currency translation resulted in an overall increase in reported net sales of \$43.2 million, an increase in operating expenses of \$10.5 million and an increase in reported net earnings of \$3.6 million. Foreign currency translation had a positive impact in most regions around the world. In Europe, the weaker U.S. dollar relative to the euro resulted in an increase of \$6.9 million in reported net sales. The weaker U.S. dollar relative to the Australian dollar, Japanese yen, South African rand, Thai baht and Korean won also had a positive impact on foreign currency translation, with an increase in reported net sales of \$10.8 million, \$8.6 million, \$7.1 million, \$2.5 million and \$2.4 million, respectively, and an increase in reported net earnings of \$1.2 million, \$0.4 million, \$0.6 million, \$0.6 million and \$0.5 million, respectively.

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

The foreign subsidiaries of the Company generally purchase the majority of their input costs and then sell to many of their Customers in the same local currency.

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



*Interest* The Company's exposure to market risks for changes in interest rates relates primarily to its short-term investments, short-term borrowings and interest rate swap agreements as well as the potential increase in fair value of long-term debt resulting from a potential decrease in interest rates. The Company has no earnings or cash flow exposure due to market risks on its long-term debt obligations as a result of the fixed-rate nature of the debt. However, interest rate changes would affect the fair market value of the debt. As of July 31, 2010 the estimated fair value of long-term debt with fixed interest rates was \$269.8 million compared to its carrying value of \$252.6 million. The fair value is estimated by discounting the projected cash flows using the rate that similar amounts of debt could currently be borrowed. As of July 31, 2010 the Company's financial liabilities with exposure to changes in interest rates consisted mainly of \$57.8 million of short-term debt outstanding. Assuming a hypothetical increase of one-half percent in short-term interest rates, with all other variables remaining constant, interest expense would have increased \$0.7 million in Fiscal 2010.

*Pensions* The Company is exposed to market return fluctuations on its qualified defined benefit pension plans. Although the market value of these assets increased in Fiscal 2010, we adjusted our long-term rate of return from 8.5 percent to 8.0 percent on our U.S. plans to update and reflect our future expectation for returns. In addition, we lowered our discount rate used to value our pension obligation for our U.S. plans from 6.0 percent to 5.25 percent. These changes in our accounting assumptions resulted in our plans being underfunded by \$58.2 million at July 31, 2010 since the projected benefit obligation exceeded the fair value of the plan assets.

### **Critical Accounting Policies**

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

*Revenue recognition and allowance for doubtful accounts* Revenue is recognized when both product ownership and the risk of loss have transferred to the Customer and the Company has no remaining obligations. The Company records estimated discounts and rebates as a reduction of sales in the same period revenue is recognized. Accruals for warranties on products sold are recorded based on historical return percentages and specific product recall campaigns. Allowances for doubtful accounts are estimated by management based on evaluation of potential losses related to Customer receivable balances. The Company determines the allowance based on historical write-off experience in the industry, regional economic data, and evaluation of specific Customer accounts for risk of loss. The Company reviews its allowance for doubtful accounts monthly. Account balances are charged off against the allowance when the Company feels it is probable the receivable will not be recovered. The Company does not have any off-balance sheet credit exposure related to its Customers. The establishment of this reserve requires the use of judgment and assumptions regarding the potential for losses on receivable balances. Though management considers these balances adequate and proper, changes in economic conditions in specific markets in which the Company operates could have an effect on reserve balances required.

*Goodwill and other intangible assets* Goodwill is assessed for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The Company performs impairment assessments for its reporting units and uses a discounted cash flow model based on management's judgments and assumptions to determine the estimated fair value. An impairment loss generally would be recognized when the carrying amount of the reporting unit's net assets exceeds the estimated fair value of the reporting unit. The Company performed an impairment assessment during the third quarter of Fiscal 2010 to satisfy its annual impairment requirement. The impairment assessment in the third quarter indicated that the estimated fair value of each reporting unit exceeded its corresponding carrying amount, including recorded goodwill and, as such, no impairment existed at that time. Other intangible assets with definite lives continue to be amortized over their estimated useful lives. Definite lived intangible assets are also subject to impairment assessments. A considerable amount of management judgment and assumptions are required in performing the impairment assessments, principally in determining the fair value of each reporting unit.

While the Company believes its judgments and assumptions are reasonable, different assumptions could change the estimated fair values and, therefore, impairment charges could be required.

*Income taxes* As part of the process of preparing the Company's Consolidated Financial Statements, management is required to estimate income taxes in each of the jurisdictions in which the Company operates. This process involves estimating actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and book accounting purposes. These differences result in deferred tax assets and liabilities, which are included within the Company's Consolidated Balance Sheet. These assets and liabilities are evaluated by using estimates of future taxable income streams and the impact of tax planning strategies. Management assesses the likelihood that deferred tax assets will be recovered from future taxable income and to the extent management believes that recovery is not likely, a valuation allowance is established. To the extent that a valuation allowance is established or increased, an expense within the tax provision is included in the statement of operations. Reserves are also estimated for uncertain tax positions that are currently unresolved. The Company routinely monitors the potential impact of such situations and believes that it is properly reserved. Valuations related to tax accruals and assets can be impacted by changes to tax codes, changes in statutory tax rates and the Company's future taxable income levels. As of July 31, 2010, the liability for unrecognized tax benefits, accrued interest and penalties was \$21.5 million.

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

To develop the assumption regarding the expected long-term rate of return on assets for its U.S. pension plans, the Company considered the historical returns and the future expectations for returns for each asset class, as well as the target asset allocation of the pension portfolio. This resulted in the selection of the 8.0 percent long-term rate of return on assets assumption as of July 31, 2010 for developing the Fiscal 2011 expense for the Company's U.S. pension plans. In addition, we lowered our discount rate used to value our pension obligation for our U.S. plans from 6.0 percent to 5.25 percent. The expected long-term rate of return on assets assumption for the plans outside the U.S. reflects the investment allocation and expected total portfolio returns specific to each plan and country. The expected long-term rate of return on assets shown in the pension benefit disclosure for non-U.S. plans is an asset-based weighted average of all non-U.S. plans.

Reflecting the relatively long-term nature of the plans' obligations, approximately 45 percent of the plans assets are invested in equity securities, 30 percent in alternative investments (funds of hedge funds), 10 percent in real assets (investments into funds containing commodities and real estate), 10 percent in fixed income and 5 percent in private equity. Within equity securities, the Company targets an allocation of 15 percent international, 15 percent equity long / short, 10 percent small cap and 5 percent large cap.

A one percent change in the expected long-term rate of return on U.S. plan assets, from 8.5 percent, would have changed the Fiscal 2010 annual pension expense by approximately \$2.7 million. The expected long-term rate of return on assets assumption for the plans outside the U.S. follows the same methodology as described above but reflects the investment allocation and expected total portfolio returns specific to each plan and country.

The Company's objective in selecting a discount rate for its pension plans is to select the best estimate of the rate at which the benefit obligations could be effectively settled on the measurement date taking into account the nature and duration of the benefit obligations of the plan. In making this best estimate, the Company looks at rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the benefits. This process includes assessing the universe of bonds available on the measurement date with a quality rating of Aa or better. Similar appropriate benchmarks are used to determine the discount rate for the non-U.S. plans. As of the measurement date of July 31, 2010, the Company decreased its discount rate for the U.S. pension plans to 5.25 percent from 6.00 percent as of July 31, 2009. The decrease of 75 basis points is consistent with published bond indices. The change increased the Company's U.S. projected benefit obligation as of July 31, 2010 by approximately 20.0 million and is expected to increase pension expense in fiscal year 2011 by approximately \$1.5 million.

#### **Safe Harbor Statement under the Securities Reform Act of 1995**

The Company, through its management, may make forward-looking statements reflecting the Company's current views with respect to future events and financial performance. These forward-looking statements, which may be included in reports filed under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), in press

releases and in other documents and materials as well as in written or oral statements made by or on behalf of the Company, are subject to certain risks and uncertainties, including those discussed in Item 1A of this Form 10-K, which could cause actual results to differ materially from historical results or those anticipated. The words or phrases “will likely result,” “are expected to,” “will continue,” “estimate,” “project,” “believe,” “expect,” “anticipate,” “forecast” and similar expressions are intended to identify forward-looking statements within the meaning of Section 21e of the Exchange Act and Section 27A of the Securities Act of 1933, as amended, as enacted by the Private Securities Litigation Reform Act of 1995 (“PSLRA”). In particular the Company desires to take advantage of the protections of the PSLRA in connection with the forward-looking statements made in this Annual Report on Form 10-K, including those contained in the “Outlook” section of Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operation.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date such statements are made. In addition, the Company wishes to advise readers that the factors listed in Item 1A of this Form 10-K, as well as other factors, could affect the Company’s performance and could cause the Company’s actual results for future periods to differ materially from any opinions or statements expressed. These factors include, but are not limited to risks associated with: world economic factors and the ongoing economic uncertainty, the potential for some Customers to increase their reliance on their own filtration capabilities, currency fluctuations, commodity prices, political factors, the Company’s international operations, highly competitive markets, environmental laws and regulations, including regulatory approvals for Retrofit Emission Products, governmental laws and regulations, including the impact of the various economic stimulus and financial reform measures being implemented, the implementation of our new information technology systems, potential global events resulting in market instability including financial bailouts of sovereign nations, political changes, military and terrorist activities, health outbreaks and other factors included in Item 1A of this Report on Form 10-K. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

## **Item 7A. Quantitative and Qualitative Disclosures about Market Risk**

Market risk disclosure appears in Management’s Discussion and Analysis on page 21 under “Market Risk.”



## **Item 8. Financial Statements and Supplementary Data**

### **Management's Report on Internal Control over Financial Reporting**

Management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. Management conducted an evaluation of the effectiveness of internal control over financial reporting based on the framework in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”). Based on this evaluation, management concluded that the Company’s internal control over financial reporting was effective as of July 31, 2010. The Company’s independent registered public accounting firm, PricewaterhouseCoopers LLP, has audited the effectiveness of the Company’s internal control over financial reporting as of July 31, 2010, as stated in this report which follows in Item 8 of this Form 10-K.

/s/ William M. Cook

William M. Cook  
Chief Executive Officer  
September 24, 2010

/s/ Thomas R. VerHage

Thomas R. VerHage  
Chief Financial Officer  
September 24, 2010

**Report of Independent Registered Public Accounting Firm**

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

In our opinion, the accompanying consolidated balance sheets and the related statements of earnings, shareholders' equity and cash flows present fairly, in all material respects, the financial position of Donaldson Company, Inc. and its subsidiaries at July 31, 2010 and July 31, 2009, and the results of their operations and their cash flows for each of the three years in the period ended July 31, 2010, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of July 31, 2010, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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

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

/s/ PricewaterhouseCoopers LLP  
PricewaterhouseCoopers LLP  
Minneapolis, Minnesota  
September 24, 2010

**Consolidated Statements of Earnings**  
**Donaldson Company, Inc. and Subsidiaries**

	Year ended July 31,		
	2010	2009	2008
	(thousands of dollars, except share and per share amounts)		
Net sales	\$ 1,877,064	\$ 1,868,629	\$ 2,232,521
Cost of sales	1,218,316	1,278,923	1,506,659
Gross margin	658,748	589,706	725,862
Selling, general and administrative	376,018	379,108	436,293
Research and development	44,486	40,643	43,757
Operating income	238,244	169,955	245,812
Interest expense	11,975	17,018	16,550
Other income, net	(3,907)	(8,488)	(6,901)
Earnings before income taxes	230,176	161,425	236,163
Income taxes	64,013	29,518	64,210
Net earnings	<u>\$ 166,163</u>	<u>\$ 131,907</u>	<u>\$ 171,953</u>
Weighted average shares - basic	77,848,528	77,967,141	79,304,373
Weighted average shares - diluted	79,177,772	79,199,838	81,247,069
Net earnings per share - basic	\$ 2.13	\$ 1.69	\$ 2.17
Net earnings per share - diluted	\$ 2.10	\$ 1.67	\$ 2.12

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

**Consolidated Balance Sheets**  
**Donaldson Company, Inc. and Subsidiaries**

	At July 31,	
	2010	2009
	(thousands of dollars, except share amounts)	
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 232,000	\$ 143,687
Accounts receivable, less allowance of \$6,315 and \$7,387	358,917	280,187
Inventories	203,631	180,238
Deferred income taxes	22,054	21,501
Prepays and other current assets	43,613	51,154
Total current assets	<u>\$ 860,215</u>	<u>\$ 676,767</u>
Property, plant and equipment, net	365,892	381,068
Goodwill	165,315	169,027
Intangible assets, net	58,292	65,386
Other assets	49,792	41,748
Total assets	<u>\$ 1,499,506</u>	<u>\$ 1,333,996</u>
<b>Liabilities and shareholders' equity</b>		
<b>Current liabilities</b>		
Short-term borrowings	\$ 50,000	\$ 29,558
Current maturities of long-term debt	5,536	5,496
Trade accounts payable	165,907	123,063
Accrued employee compensation and related taxes	73,632	54,662
Accrued liabilities	40,546	39,624
Other current liabilities	53,635	47,681
Total current liabilities	<u>389,256</u>	<u>300,084</u>
Long-term debt	256,192	253,674
Deferred income taxes	7,076	9,416
Other long-term liabilities	100,349	82,204
Total liabilities	<u>752,873</u>	<u>645,378</u>
<b>Commitments and contingencies (Note K)</b>		
<b>Shareholders' equity</b>		
Preferred stock, \$1.00 par value, 1,000,000 shares authorized, none issued	—	—
Common stock, \$5.00 par value, 120,000,000 shares authorized, 88,643,194 shares issued in 2010 and 2009	443,216	443,216
Retained earnings	744,247	615,817
Stock compensation plans	22,326	19,894
Accumulated other comprehensive loss	(40,486)	(9,677)
Treasury stock, 12,222,381 and 11,295,409 shares in 2010 and 2009, at cost	(422,670)	(380,632)
Total shareholders' equity	<u>746,633</u>	<u>688,618</u>
Total liabilities and shareholders' equity	<u>\$ 1,499,506</u>	<u>\$ 1,333,996</u>

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

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

	Year ended July 31,		
	2010	2009	2008
	(thousands of dollars)		
<b>Operating Activities</b>			
Net earnings	\$ 166,163	\$ 131,907	\$ 171,953
Adjustments to reconcile net earnings to net cash provided by operating activities			
Depreciation and amortization	59,232	58,597	56,732
Equity in losses (earnings) of affiliates, net of distributions	183	(982)	(1,558)
Deferred income taxes	3,025	(4,726)	(1,205)
Tax benefit of equity plans	(4,625)	(2,663)	(9,178)
Stock compensation plan expense	8,253	1,900	9,312
Other, net	(6,110)	(7)	(2,528)
Changes in operating assets and liabilities, net of acquired businesses			
Accounts receivable	(79,308)	116,983	(29,779)
Inventories	(25,826)	66,145	(49,400)
Prepays and other current assets	(3,970)	(11,489)	(4,755)
Trade accounts payable and other accrued expenses	85,988	(78,738)	33,940
Net cash provided by operating activities	<u>203,005</u>	<u>276,927</u>	<u>173,534</u>
<b>Investing Activities</b>			
Purchases of property, plant and equipment	(43,149)	(46,080)	(72,152)
Proceeds from sale of property, plant and equipment	490	511	1,330
Acquisitions, investments and divestitures of affiliates	(250)	(74,318)	(2,377)
Net cash used in investing activities	<u>(42,909)</u>	<u>(119,887)</u>	<u>(73,199)</u>
<b>Financing Activities</b>			
Proceeds from long-term debt	531	80,471	50,297
Repayments of long-term debt	(5,508)	(7,745)	(33,074)
Change in short-term borrowings	20,713	(103,695)	12,478
Purchase of treasury stock	(66,696)	(32,773)	(92,202)
Dividends paid	(36,242)	(35,166)	(33,003)
Tax benefit of equity plans	4,625	2,663	9,178
Exercise of stock options	13,053	4,476	9,308
Net cash used in financing activities	<u>(69,524)</u>	<u>(91,769)</u>	<u>(77,018)</u>
Effect of exchange rate changes on cash	(2,259)	(4,941)	4,803
Increase in cash and cash equivalents	88,313	60,330	28,120
Cash and cash equivalents, beginning of year	143,687	83,357	55,237
Cash and cash equivalents, end of year	<u>\$ 232,000</u>	<u>\$ 143,687</u>	<u>\$ 83,357</u>
<b>Supplemental Cash Flow Information</b>			
Cash paid during the year for:			
Income taxes	\$ 40,032	\$ 41,196	\$ 50,629
Interest	11,446	14,861	14,589

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

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

	Common Stock	Additional Paid-in Capital	Retained Earnings	Stock Compensation Plans	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
	(thousands of dollars, except per share amounts)						
<b>Balance July 31, 2007</b>	\$ 443,216	\$ —	\$ 387,257	\$ 20,821	\$ 70,008	\$ (296,604)	\$ 624,698
Comprehensive income							
Net earnings			171,953				171,953
Foreign currency translation					57,151		57,151
Additional minimum pension liability, net of tax					(14,671)		(14,671)
Net gain on cash flow hedging derivatives					395		395
Comprehensive income							214,828
Treasury stock acquired						(92,202)	(92,202)
Stock options exercised		(7,827)	(9,810)	4,223		20,883	7,469
Deferred stock and other activity		(2,981)	2,564	3,474		1,363	4,420
Performance awards		(675)	279	(1,453)		955	(894)
Stock option expense			4,214				4,214
Tax reduction - employee plans		11,483					11,483
Adjustment to adopt income tax guidance			(336)				(336)
Dividends (\$0.430 per share)			(33,645)				(33,645)
<b>Balance July 31, 2008</b>	<u>443,216</u>	<u>—</u>	<u>522,476</u>	<u>27,065</u>	<u>112,883</u>	<u>(365,605)</u>	<u>740,035</u>
Comprehensive income							
Net earnings			131,907				131,907
Foreign currency translation					(63,385)		(63,385)
Pension liability adjustment, net of deferred taxes					(58,593)		(58,593)
Net loss on cash flow hedging derivatives					(582)		(582)
Comprehensive income							9,347
Treasury stock acquired						(32,773)	(32,773)
Stock options exercised		(2,998)	(6,151)			12,104	2,955
Deferred stock and other activity		(529)	(88)	(4,344)		3,710	(1,251)
Performance awards		(266)	(60)	(2,827)		1,932	(1,221)
Stock option expense			4,143				4,143
Tax reduction - employee plans		3,793					3,793
Adjustment to adopt retirement benefit compensation guidance, net of tax			(887)				(887)
Dividends (\$0.460 per share)			(35,523)				(35,523)
<b>Balance July 31, 2009</b>	<u>443,216</u>	<u>—</u>	<u>615,817</u>	<u>19,894</u>	<u>(9,677)</u>	<u>(380,632)</u>	<u>688,618</u>
Comprehensive income							
Net earnings			166,163				166,163
Foreign currency translation					(15,961)		(15,961)
Pension liability adjustment, net of deferred taxes					(14,780)		(14,780)
Net loss on cash flow hedging derivatives					(68)		(68)
Comprehensive income							135,354
Treasury stock acquired						(66,696)	(66,696)
Stock options exercised		(5,608)	(7,678)	2,676		22,951	12,341
Deferred stock and other activity		(704)	(30)	(244)		1,707	729
Performance awards		7	(7)				—
Stock option expense			6,891				6,891
Tax reduction - employee plans		6,305					6,305
Dividends (\$0.480 per share)			(36,909)				(36,909)
<b>Balance July 31, 2010</b>	<u>\$ 443,216</u>	<u>\$ —</u>	<u>\$ 744,247</u>	<u>\$ 22,326</u>	<u>\$ (40,486)</u>	<u>\$ (422,670)</u>	<u>\$ 746,633</u>

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. (“Donaldson” or the “Company”), is a worldwide manufacturer of filtration systems and replacement parts. The Company’s product mix includes air and liquid filtration systems and exhaust and emission control products. Products are manufactured at 40 plants around the world and through three joint ventures. Products are sold to original equipment manufacturers (“OEMs”), distributors and dealers, and directly to end users.

*Principles of Consolidation* The Consolidated Financial Statements include the accounts of Donaldson Company, Inc. and all majority-owned subsidiaries. All intercompany accounts and transactions have been eliminated. The Company’s three joint ventures that are not majority-owned are accounted for under the equity method. The Company does not have any variable interests in variable interest entities as of July 31, 2010. The Company uses a fiscal period which ends on a calendar basis for international affiliates and on the Friday nearest to July 31 for U.S. purposes.

*Use of Estimates* The preparation of Financial Statements in conformity with U.S. GAAP 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 foreign operations, local currencies are considered the functional currency. Assets and liabilities are translated to U.S. dollars at year-end exchange rates and the resulting gains and losses arising from the translation of net assets located outside the United States are recorded as a cumulative translation adjustment, a component of Accumulated Other Comprehensive Income (loss) in the Consolidated Balance Sheets. Elements of the Consolidated Statements of Earnings are translated at average exchange rates in effect during the year. Realized and unrealized foreign currency transaction gains and losses are included in Other income, net in the Consolidated Statements of Earnings. Foreign currency transaction losses of \$4.6 million, \$0.2 million and \$3.1 million are included in Other income, net in the Consolidated Statements of Earnings in Fiscal 2010, 2009, and 2008, respectively.

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

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

*Inventories* Inventories are stated at the lower of cost or market. U.S. 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 31 percent and 33 percent of total inventories at July 31, 2010 and 2009, respectively. For inventories valued under the LIFO method, the FIFO cost exceeded the LIFO carrying values by \$32.7 million and \$34.0 million at July 31, 2010 and 2009, respectively. Results of operations for all periods presented were not materially affected by the liquidation of LIFO inventory. The components of inventory are as follows (thousands of dollars):

	At July 31,	
	2010	2009
Materials	\$ 79,371	\$ 71,518
Work in process	23,163	20,022
Finished products	101,097	88,698
Total inventories	<u>\$ 203,631</u>	<u>\$ 180,238</u>

*Property, Plant and Equipment* Property, plant and equipment are stated at cost. Additions, improvements or major renewals are capitalized, while expenditures that do not enhance or extend the asset’s useful life are charged to

operating expense as incurred. Depreciation is computed under the straight-line method. Depreciation expense was \$53.2 million in Fiscal 2010, \$52.9 million in Fiscal 2009 and \$52.4 million in Fiscal 2008. The estimated useful lives of property, plant and equipment are 10 to 40 years for buildings, including building improvements, and 3 to 10 years for machinery and equipment. The components of property, plant and equipment are as follows (thousands of dollars):

	At July 31,	
	2010	2009
Land	\$ 21,771	\$ 21,793
Buildings	240,787	242,049
Machinery and equipment	587,977	600,198
Construction in progress	26,223	18,507
Less accumulated depreciation	(510,866)	(501,479)
Total property, plant and equipment, net	<u>\$ 365,892</u>	<u>\$ 381,068</u>

*Internal-Use Software* The Company capitalizes direct costs of materials and services used in the development and purchase of internal-use software. Amounts capitalized are amortized on a straight-line basis over a period of five years and are reported as a component of machinery and equipment within property, plant and equipment.

*Goodwill and Other Intangible Assets* Goodwill represents the excess of the purchase price over the fair value of net assets acquired in business combinations under the purchase method of accounting. Other intangible assets, consisting primarily of patents, trademarks and Customer relationships and lists, are recorded at cost and are amortized on a straight-line basis over their estimated useful lives of 3 to 20 years. Goodwill is assessed for impairment annually or if an event occurs or circumstances change that would indicate the carrying amount may be impaired. The impairment assessment for goodwill is done at a reporting unit level. Reporting units are one level below the business segment level, but can be combined when reporting units within the same segment have similar economic characteristics. An impairment loss generally would be recognized when the carrying amount of the reporting unit's net assets exceeds the estimated fair value of the reporting unit. The Company completed its annual impairment assessment in the third quarters of Fiscal 2010 and 2009, which indicated no impairment.

*Recoverability of Long-Lived Assets* The Company reviews its long-lived assets, including identifiable intangibles, 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, the carrying value is reduced.

*Income Taxes* The provision for income taxes is computed based on the pretax income included in the Consolidated Statements of Earnings. 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 (Loss)* Comprehensive income (loss) consists of net income, foreign currency translation adjustments, net changes in the funded status of pension retirement obligations, and net gain or loss on cash flow hedging derivatives, and is presented in the Consolidated Statements of Changes in Shareholders' Equity. The components of the ending balances of accumulated other comprehensive income (loss) are as follows (thousands of dollars):

	At July 31,		
	2010	2009	2008
Foreign currency translation adjustment	\$ 59,194	\$ 75,155	\$ 138,540
Net gain (loss) on cash flow hedging derivatives, net of deferred taxes	(462)	(394)	188
Pension liability adjustment, net of deferred taxes	(99,218)	(84,438)	(25,845)
Total accumulated other comprehensive income (loss)	<u>\$ (40,486)</u>	<u>\$ (9,677)</u>	<u>\$ 112,883</u>

Cumulative foreign translation is not adjusted for income taxes. All translation relates to permanent investments in non-U.S. subsidiaries.



**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 common equivalent shares relating to stock options and stock incentive plans. Certain outstanding options were excluded from the diluted net earnings per share calculations because their exercise prices were greater than the average market price of the Company's common stock during those periods. There were 845,827 options, 1,158,451 options, and 245,344 options excluded from the diluted net earnings per share calculation for the fiscal year ended July 31, 2010, 2009 and 2008, respectively.

In June 2008, the Financial Accounting Standards Board (FASB) issued new guidance related to earnings per share. This guidance provides that unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of basic earnings per share (EPS). The Company adopted the guidance in the first quarter of Fiscal 2010 and is required to retrospectively adjust all prior-period EPS data. The resulting impact of the adoption of the guidance was to include unvested restricted shares of 80,325, 88,105 and 96,769 for the fiscal years 2010, 2009 and 2008, respectively, in the basic weighted average shares outstanding calculation. This resulted in no change in the Company's basic and diluted EPS as reported in the prior periods presented.

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

	<u>2010</u>	<u>2009</u>	<u>2008</u>
	(thousands of dollars, except per share amounts)		
Weighted average shares - basic	77,849	77,967	79,304
Diluted share equivalents	1,329	1,233	1,943
Weighted average shares - diluted	79,178	79,200	81,247
Net earnings for basic and diluted earnings per share computation	\$ 166,163	\$ 131,907	\$ 171,953
Net earnings per share - basic	\$ 2.13	\$ 1.69	\$ 2.17
Net earnings per share - diluted	\$ 2.10	\$ 1.67	\$ 2.12

**Treasury Stock** Repurchased common stock is stated at cost and is presented as a separate reduction of shareholders' equity.

**Research and Development** Research and development costs are charged against earnings in the year incurred. Research and development expenses include basic scientific research and the application of scientific advances to the development of new and improved products and their uses.

**Stock-Based Compensation** The Company offers stock-based employee compensation plans, which are more fully described in Note H. Stock-based employee compensation cost is recognized using the fair-value based method.

**Revenue Recognition** Revenue is recognized when both product ownership and the risk of loss have transferred to the Customer and the Company has no remaining obligations. The Company records estimated discounts and rebates as a reduction of sales in the same period revenue is recognized. Shipping and handling costs for Fiscal 2010, 2009 and 2008 totaling \$49.8 million, \$50.4 million and \$53.0 million, respectively, are classified as a component of operating expenses.

**Product Warranties** The Company provides for estimated warranty costs at the time of sale and accrues for specific items at the time their existence is known and the amounts are determinable. The Company estimates warranty costs using standard quantitative measures based on historical warranty claim experience and evaluation of specific Customer warranty issues. For a warranty reserve reconciliation see Note K.

**Derivative Instruments and Hedging Activities** 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.

**Exit or Disposal Activities** The Company accounts for costs relating to exit or disposal activities based on FASB guidance related to exit or disposal cost obligations. This guidance addresses recognition, measurement and reporting

of costs associated with exit and disposal activities including restructuring. See Note L for disclosures related to restructuring.

*Guarantees* Upon issuance of a guarantee, the Company recognizes a liability for the fair value of an obligation assumed under a guarantee. See Note K for disclosures related to guarantees.

*New Accounting Standards* In June 2009 the FASB updated the accounting standards related to the consolidation of variable interest entities (VIEs). The standard amends current consolidation guidance and requires additional disclosures about an enterprise's involvement in VIEs. The standard is effective for interim and annual reporting periods beginning after November 15, 2009. The adoption of the revised standard is not expected to have a material impact on the Company's financial statements.

**NOTE B**  
**Goodwill and Other Intangible Assets**

The Company has allocated goodwill to its Industrial Products and Engine Products segments. There was no acquisition or disposition activity during Fiscal 2010. Additions to goodwill and other intangible assets in Fiscal 2009 relate to the acquisition of 100 percent of the stock of Western Filter Corporation on October 15, 2008 for \$78.5 million, as part of the Engine Products segment. The weighted average life of the intangibles acquired in this acquisition is 17.6 years and consists primarily of Customer related intangibles. Goodwill associated with this acquisition is tax deductible. Dispositions of goodwill and other intangible assets in Fiscal 2009 relate to the sale of the air dryer business in Maryville, Tennessee, on October 31, 2008 for \$4.6 million, which resulted in a loss on sale of \$0.6 million. This air dryer business was part of the Industrial Products segment. Financial results for each of the above acquisitions are included in the Company's consolidated results from the date of acquisition. Pro forma financial results are not presented as the acquisitions are not material, individually or in the aggregate. The Company completed its annual impairment assessment in the third quarter of Fiscal 2010 and 2009, which indicated no impairment.

Following is a reconciliation of goodwill for the years ended July 31, 2010 and 2009:

	<u>Engine Products</u>	<u>Industrial Products</u>	<u>Total Goodwill</u>
		(thousands of dollars)	
Balance as of July 31, 2008	\$ 19,126	\$ 115,036	\$ 134,162
Acquisition activity	43,646	—	43,646
Disposition activity	—	(1,089)	(1,089)
Foreign exchange translation	(1,190)	(6,502)	(7,692)
Balance as of July 31, 2009	<u>\$ 61,582</u>	<u>\$ 107,445</u>	<u>\$ 169,027</u>
Foreign exchange translation	(668)	(3,044)	(3,712)
Balance as of July 31, 2010	<u>\$ 60,914</u>	<u>\$ 104,401</u>	<u>\$ 165,315</u>

Intangible assets are comprised of patents, trademarks and Customer relationships and lists. Following is a reconciliation of intangible assets for the years ended July 31, 2010 and 2009:

	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Net Intangible Assets</u>
		(thousands of dollars)	
Balance as of July 31, 2008	\$ 62,242	\$ (15,925)	\$ 46,317
Intangibles acquired	26,710	—	26,710
Intangibles sold	(300)	114	(186)
Amortization expense	—	(5,601)	(5,601)
Foreign exchange translation	(2,843)	989	(1,854)
Balance as of July 31, 2009	<u>\$ 85,809</u>	<u>\$ (20,423)</u>	<u>\$ 65,386</u>
Amortization expense	—	(6,007)	(6,007)
Foreign exchange translation	(2,322)	1,235	(1,087)
Balance as of July 31, 2010	<u>\$ 83,487</u>	<u>\$ (25,195)</u>	<u>\$ 58,292</u>

Net intangible assets consist of patents, trademarks and tradenames of \$20.5 million and \$23.9 million as of July 31, 2010 and 2009, respectively, and Customer related intangibles of \$37.8 million and \$41.5 million as of July 31, 2010 and 2009, respectively. Expected amortization expense relating to existing intangible assets is as follows (in thousands):

<u>Fiscal Year</u>	
2011	\$ 5,835
2012	\$ 5,733
2013	\$ 5,570
2014	\$ 5,197
2015	\$ 3,733

**NOTE C**  
**Credit Facilities**

The Company has a five-year, multi-currency revolving facility with a group of banks under which the Company may borrow up to \$250 million. This facility matures on April 2, 2013. The agreement provides that loans may be made under a selection of currencies and rate formulas including Base Rate Advances or Off Shore Rate Advances. The interest rate on each advance is based on certain market interest rates and leverage ratios. Facility fees and other fees on the entire loan commitment are payable over the duration of this facility. There was \$50.0 million outstanding at July 31, 2010 and \$20.0 million outstanding at July 31, 2009. At July 31, 2010 and 2009, \$180.0 million and \$210.0 million, respectively, were available for further borrowing under such facilities. The amount available for further borrowing reflects a reduction for issued standby letters of credit, as discussed below. The weighted average interest rate on these short-term borrowings outstanding at July 31, 2010 and 2009 was 0.6 percent.

Certain revolver agreements contain debt covenants related to working capital levels and limitations on indebtedness. As of July 31, 2010, the Company was in compliance with all such covenants. The Company currently expects to remain in compliance with these covenants.

The Company also has three uncommitted credit facilities in the United States, which provide unsecured borrowings for general corporate purposes. At July 31, 2010 and 2009, there was \$70.0 million available for use. There were no amounts outstanding at July 31, 2010. As of July 31, 2009, \$9.6 million was outstanding under these facilities with a weighted average interest rate of 0.5 percent.

The Company also has a €100 million program for issuing treasury notes for raising short, medium and long-term financing for its European operations. There was nothing outstanding on this program at July 31, 2010 and 2009. Additionally, the Company's European operations have lines of credit with an available limit of €60.5 million. There was nothing outstanding on these lines of credit as of July 31, 2010 and 2009.

Other international subsidiaries may borrow under various credit facilities. There was nothing outstanding under these credit facilities as of July 31, 2010 and 2009.

As discussed further in Note K, at July 31, 2010 and 2009, the Company had outstanding standby letters of credit totaling \$20.0 million, upon which no amounts had been drawn. The letters of credit guarantee payment to third parties in the event the Company is in breach of specified bond financing agreement and insurance contract terms as detailed in each letter of credit.

**NOTE D**  
**Long-Term Debt**

Long-term debt consists of the following:

	<u>2010</u>	<u>2009</u>
	(thousands of dollars)	
6.39% Unsecured senior notes due August 15, 2010, interest payable semi-annually. This note was repaid on August 16, 2010	\$ 4,999	\$ 9,981
4.85% Unsecured senior notes, interest payable semi-annually, principal payment of \$30.0 million due December 17, 2011	30,000	30,000
6.59% Unsecured senior notes, interest payable semi-annually, principal payment of \$80.0 million due November 14, 2013	80,000	80,000
5.48% Unsecured senior notes, interest payable semi-annually, principal payment of \$50.0 million due June 1, 2017	50,000	50,000
5.48% Unsecured senior notes, interest payable semi-annually, principal payment of \$25.0 million due September 28, 2017	25,000	25,000
5.48% Unsecured senior notes, interest payable semi-annually, principal payment of \$25.0 million due November 30, 2017	25,000	25,000
1.418% Guaranteed senior notes, interest payable semi-annually, principal payment of ¥1.2 billion due January 31, 2012	13,884	12,679
2.019% Guaranteed senior note, interest payable semi-annually, principal payment of ¥1.65 billion due May 18, 2014	19,091	17,434
Variable Rate Industrial Development Revenue Bonds (“Low Floaters”) interest payable monthly, principal payment of \$7.755 million due September 1, 2024, interest rate of 0.40% as of July 31, 2010	7,755	7,755
Capitalized lease obligations and other, with various maturity dates and interest rates	890	1,321
Interest Rate Swap contract, notional \$80.0 million maturing November 14, 2013, terminated August 17, 2010	4,590	—
Terminated interest rate swap contract	519	—
<b>Total</b>	<u>261,728</u>	<u>259,170</u>
Less current maturities	5,536	5,496
<b>Total long-term debt</b>	<u>\$ 256,192</u>	<u>\$ 253,674</u>

Annual maturities of long-term debt are \$5.5 million in 2011, \$44.2 million in 2012, \$0.1 million in 2013, \$99.1 million in 2014 and \$107.8 million thereafter. There are no maturities in 2015. As of July 31, 2010, the estimated fair value of long-term debt with fixed interest rates was \$269.8 million compared to its carrying value of \$252.6 million.

On November 14, 2008 the Company issued an \$80 million senior unsecured note. The note is due on November 14, 2013. The debt was issued at face value and bears interest payable semi-annually at a rate of 6.59 percent. The proceeds from the note were used to refinance existing debt and for general corporate purposes.

Certain note agreements contain debt covenants related to working capital levels and limitations on indebtedness. As of July 31, 2010, the Company was in compliance with all such covenants. The Company currently expects to remain in compliance with these covenants.

**NOTE E**  
**Financial Instruments and Fair Value**

*Derivatives* The Company uses forward exchange contracts to manage its exposure to fluctuations in foreign exchange rates. The Company also uses interest rate swaps to manage its exposure to changes in the fair value of its fixed-rate debt resulting from interest rate fluctuations. 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 or trading purposes. The Company enters into derivative transactions only with counterparties with high credit ratings. 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 material losses.

The Company enters into forward exchange contracts of generally less than one year to hedge forecasted transactions between its subsidiaries and to reduce potential exposure related to fluctuations in foreign exchange rates

for existing recognized assets and liabilities. It also utilizes forward exchange contracts for anticipated intercompany and third-party transactions such as purchases, sales and dividend payments denominated in local currencies. Forward exchange contracts are designated as cash flow hedges as they are designed to hedge the variability of cash flows associated with the underlying existing recognized or anticipated transactions. Changes in the value of derivatives designated as cash flow hedges are recorded in other comprehensive income (loss) 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. Effectiveness is measured using spot rates to value both the hedge contract and the hedged item. The excluded forward points, as well as any ineffective portions of hedges, are recorded in earnings through the same line as the underlying transaction. During Fiscal 2010, \$0.2 million of losses were recorded due to the exclusion of forward points from the assessment of hedge effectiveness.

These unrealized losses and gains are reclassified, as appropriate, when earnings are affected by the variability of the underlying cash flows during the term of the hedges. The Company expects to record \$0.7 million of net deferred losses from these forward exchange contracts during the next twelve months.

The Company entered into and settled an interest rate lock in October 2008. The interest rate lock settlement resulted in a \$0.5 million gain, net of deferred taxes of \$0.2 million, which will be amortized into income over the life of the related debt.

The following summarizes the Company's fair value of outstanding derivatives at July 31, 2010, and 2009, on the Consolidated Balance Sheets (thousands of dollars):

	At July 31,	
	2010	2009
Asset derivatives recorded under the caption Prepaids and other current assets		
Foreign exchange contracts	\$ 807	\$ 493
Asset derivatives recorded under the caption Other assets		
Interest rate swap asset	\$ 4,590	\$ —
Liability derivatives recorded under the caption Other current liabilities		
Foreign exchange contracts	\$ 2,127	\$ 2,366

The impact on Accumulated Other Comprehensive Income (OCI) and earnings from foreign exchange contracts that qualified as cash flow hedges for the twelve months ended July 31, 2010 and 2009, was as follows (thousands of dollars):

	July 31,	
	2010	2009
Net carrying amount at beginning of year	\$ (650)	\$ 188
Cash flow hedges deferred in OCI	(3,789)	(1,826)
Cash flow hedges reclassified to income (effective portion)	3,788	580
Change in deferred taxes	(9)	408
Net carrying amount at July 31	<u>\$ (660)</u>	<u>\$ (650)</u>

The Company's derivative financial instruments present certain market and counterparty risks, however, concentration of counterparty risk is mitigated as the Company deals with a variety of major banks worldwide. In addition, only conventional derivative financial instruments are utilized. The Company would not be materially impacted if any of the counterparties to the derivative financial instruments outstanding at July 31, 2010, failed to perform according to the terms of its agreement. At this time, the Company does not require collateral or any other form of securitization to be furnished by the counterparties to its derivative instruments.

The fair values of the Company's financial assets and financial liabilities listed below reflect the amounts that would be received to sell the assets or paid to transfer the liabilities in an orderly transaction between market participants at the measurement date (exit price). The fair values are based on inputs other than quoted prices that are observable for the asset or liability. These inputs include foreign currency exchange rates and interest rates. The financial assets and financial liabilities are primarily valued using standard calculations and models that use as their basis readily observable market parameters. Industry standard data providers are the primary source for forward and spot rate information for both interest rates and currency rates.

	Significant Other Observable Inputs (Level 2)*	
	At July 31,	
	2010	2009
Forward exchange contracts – net liability position	\$ (1,320)	\$ (1,873)
Interest rate swaps – net asset position	4,590	—

\*Inputs to the valuation methodology of level 2 assets include quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; inputs other than quoted prices that are observable for the asset or liability; and inputs that are derived principally from or corroborated by observable market data by correlation or other means.

*Fair Value of Financial Instruments* At July 31, 2010 and 2009, the Company's financial instruments included cash and cash equivalents, accounts receivable, accounts payable, short-term borrowings, long-term debt, and derivative contracts. The fair values of cash and cash equivalents, accounts receivable, accounts payable, and short-term borrowings approximated carrying values because of the short-term nature of these instruments. Derivative contracts are reported at their fair values based on third-party quotes. As of July 31, 2010, the estimated fair value of long-term debt with fixed interest rates was \$269.8 million compared to its carrying value of \$252.6 million. The fair value is estimated by discounting the projected cash flows using the rate that similar amounts of debt could currently be borrowed.

*Credit Risk* The Company is exposed to credit loss in the event of nonperformance by counterparties in interest rate swaps and foreign exchange forward contracts. Collateral is generally not required of the counterparties or of the Company. In the unlikely event a counterparty fails to meet the contractual terms of an interest rate swap or foreign exchange forward contract, the Company's risk is limited to the fair value of the instrument. There was one interest rate swap outstanding at July 31, 2010, which was subsequently terminated August 17, 2010. The Company had no interest rate swaps outstanding at July 31, 2009. The Company actively monitors its exposure to credit risk through the use of credit approvals and credit limits, and by selecting major international banks and financial institutions as counterparties. The Company has not had any historical instances of non-performance by any counterparties, nor does it anticipate any future instances of non-performance.

## NOTE F Employee Benefit Plans

*Pension Plans* The Company and certain of its international subsidiaries have defined benefit pension plans for many of their hourly and salaried employees. There are two types of domestic plans. The first type of domestic plan is a traditional defined benefit pension plan primarily for production employees. The second is a plan for salaried workers that provides defined benefits pursuant to a cash balance feature whereby a participant accumulates a benefit comprised of a percentage of current salary that 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. During Fiscal 2009, the Company changed its measurement date to July 31, in accordance with the measurement date provisions of FASB guidance related to retirement benefit compensation.

Net periodic pension costs for the Company's pension plans include the following components:

	2010	2009	2008
	(thousands of dollars)		
Net periodic cost:			
Service cost	\$ 13,184	\$ 15,385	\$ 15,996
Interest cost	19,445	18,481	17,702
Expected return on assets	(28,390)	(29,143)	(28,275)
Transition amount amortization	226	193	164
Prior service cost amortization	293	438	380
Actuarial (gain)/loss amortization	2,864	1,088	(58)
Curtailment loss	—	910	—
Settlement gain	—	—	(35)
Net periodic benefit cost	<u>\$ 7,622</u>	<u>\$ 7,352</u>	<u>\$ 5,874</u>



During Fiscal 2009, negotiations with one of our unions resulted in a freeze in pension benefits at one of our U.S. plants. In exchange for the freezing of the plan, participants will be eligible for a Company match in a defined contribution plan. The freeze in the plan resulted in a curtailment loss of \$0.9 million during Fiscal 2009.

Effective July 31, 2007 the Company adopted FASB guidance related to retirement benefit compensation. This guidance requires recognition of the overfunded or underfunded status of defined benefit postretirement plans as an asset or liability in the statement of financial position. It also requires that changes in the funded status are recognized in accumulated other comprehensive income in the year in which the adoption occurs and in other comprehensive income in the following years. The retirement benefit compensation guidance provisions regarding the change in the measurement date of postretirement benefits plans required the Company to change its measurement date. The adoption of the measurement date provisions resulted in an after-tax decrease to Retained earnings of \$0.9 million, a decrease to Other assets of \$0.5 million, increase to Other long-term liabilities of \$0.8 million and an increase to Deferred income taxes of \$0.5 million.

The obligations and funded status of the Company's pension plans as of 2010 and 2009, is as follows:

	<u>2010</u>	<u>2009</u>
	(thousands of dollars)	
<b>Change in benefit obligation:</b>		
Benefit obligation, beginning of year	\$ 338,154	\$ 330,258
Service cost	13,183	18,730
Interest cost	19,445	22,868
Participant contributions	1,043	1,476
Actuarial (gain)/loss	31,918	(1,077)
Currency exchange rates	(6,531)	(13,338)
Benefits paid	(19,309)	(20,763)
Benefit obligation, end of year	<u>\$ 377,903</u>	<u>\$ 338,154</u>
<b>Change in plan assets:</b>		
Fair value of plan assets, beginning of year	\$ 297,479	\$ 378,695
Actual return on plan assets	31,013	(62,057)
Company contributions	15,064	13,356
Participant contributions	1,043	1,476
Currency exchange rates	(5,556)	(13,228)
Benefits paid	(19,309)	(20,763)
Fair value of plan assets, end of year	<u>\$ 319,734</u>	<u>\$ 297,479</u>
<b>Funded status:</b>		
Underfunded status at July 31, 2010 and 2009	<u>\$ (58,169)</u>	<u>\$ (40,675)</u>

The net underfunded status of \$58.2 million at July 31, 2010 is recognized in the accompanying Consolidated Balance Sheet as \$2.6 million within Other assets for the Company's over funded plans and \$60.8 million within Other long-term liabilities for the Company's underfunded plans. Included in Accumulated other comprehensive loss at July 31, 2010 are the following amounts that have not yet been recognized in net periodic pension expense: unrecognized actuarial losses of \$147.3 million, unrecognized prior service cost of \$3.9 million, and unrecognized transition obligations of \$2.9 million. The actuarial loss, prior service cost and unrecognized transition obligation are included in Accumulated other comprehensive loss, net of tax. The amounts expected to be recognized in net periodic pension expense during Fiscal 2011 are \$2.1 million, \$0.5 million and \$0.2 million, respectively. The accumulated benefit obligation for all defined benefit pension plans was \$332.4 million and \$296.7 million at July 31, 2010 and 2009, respectively.

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 \$282.7 million, \$266.0 million and \$230.3 million, respectively, as of July 31, 2010, and \$246.7 million, \$234.3 million and \$213.3 million, respectively, as of July 31, 2009.

For the years ended July 31, 2010 and 2009 the U.S. pension plans represented approximately 73 percent and 72 percent, respectively, of the Company's total plan assets, and approximately 74 percent and 72 percent, respectively, of the Company's total projected benefit obligation.

The weighted-average discount rates and rates of increase in future compensation levels used in determining the actuarial present value of the projected benefit obligation are as follows:

<b>Weighted average actuarial assumptions</b>	<b>2010</b>	<b>2009</b>
<b>All U.S. plans:</b>		
Discount rate	5.25%	6.00%
Rate of compensation increase	5.00%	5.00%
<b>Non - U.S. plans:</b>		
Discount rate	5.17%	5.90%
Rate of compensation increase	3.69%	3.87%

The weighted-average discount rates, expected returns on plan assets and rates of increase in future compensation levels used to determine the net periodic benefit cost are as follows:

<b>Weighted average actuarial assumptions</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>
<b>All U.S. plans:</b>			
Discount rate	6.00%	6.00%	6.00%
Expected return on plan assets	8.50%	8.50%	8.50%
Rate of compensation increase	5.00%	5.00%	5.00%
<b>Non - U.S. plans:</b>			
Discount rate	5.90%	6.30%	5.23%
Expected return on plan assets	6.64%	7.14%	7.49%
Rate of compensation increase	3.87%	4.48%	4.01%

*Expected Long-Term Rate of Return* To develop the expected long-term rate of return on assets assumption, the Company considered the historical returns and the future expectations for returns for each asset class, as well as the target asset allocation of the pension portfolio. As of our measurement date of July 31, 2010, the Company decreased its long-term rate of return for the U.S. pension plans to 8.0 percent from 8.5 percent as of July 31, 2009. The Company believes that based on the asset mix and the target asset allocation the 8.0 percent rate is an appropriate rate. This is slightly below the Company's twenty year average but above the five and ten year averages. Thus, the Company will use the 8.0 percent rate for the calculation of its Fiscal 2011 net periodic cost. The expected long-term rate of return on assets assumption for the plans outside the U.S. reflects the investment allocation and expected total portfolio returns specific to each plan and country. The expected long-term rate of return on assets shown in the pension benefit disclosure for non-U.S. plans is an asset-based weighted average of all non-U.S. plans.

*Discount Rate* The Company's objective in selecting a discount rate is to select the best estimate of the rate at which the benefit obligations could be effectively settled on the measurement date, taking into account the nature and duration of the benefit obligations of the plan. In making this best estimate, the Company looks at rates of return on high-quality fixed-income investments currently available, and expected to be available, during the period to maturity of the benefits. This process includes looking at the universe of bonds available on the measurement date with a quality rating of Aa or better. Similar appropriate benchmarks are used to determine the discount rate for the non-U.S. plans. The discount rate for non-U.S. plans disclosed in the assumptions used to determine net periodic benefit cost and to determine benefit obligations is based upon a weighted average, using year-end projected benefit obligations, of all non-U.S. plans.



*Plan Assets* The fair values of the assets held by the U.S. pension plans by asset category are as follows (in millions):

<b>Asset Category</b>	<b>Total</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
<b>U.S. Assets</b>				
Cash	\$ 0.9	0.9	—	—
Global Equity Securities	101.3	54.5	44.4	2.4
Fixed Income Securities	17.1	17.1	—	—
Private Equity	14.8	—	—	14.8
Absolute Return	72.5	—	64.3	8.2
Real Assets	25.9	—	9.6	16.3
<b>Total U.S.Assets</b>	<b>\$ 232.5</b>	<b>\$ 72.5</b>	<b>\$ 118.3</b>	<b>\$ 41.7</b>

Global equity consists of publicly traded U.S. and non-U.S. equities, Australasia, Far East (EAFE) index funds, equity private placement funds, and some cash and cash equivalents. Publicly traded equities are valued at the closing price reported in the active market in which the individual securities are traded. Index funds are valued at the net asset value (NAV) as determined by the custodian of the fund. The NAV is based on the fair value of the underlying assets owned by the fund, minus its liabilities then divided by the number of units outstanding.

Fixed income consists primarily of investment grade debt securities, but may include up to 10% in high yield securities (“junk bonds”) rated B or higher by Moody’s or S&P. It may also include up to 20% in securities dominated in foreign currencies. Corporate and other bonds and notes are valued at either the yields currently available on comparable securities of issuers with similar credit ratings or valued under a discounted cash flows approach that maximizes observable inputs, such as current yields of similar instruments, but includes adjustments for certain risks that may not be observable such as credit and liquidity risks.

Private equity consists of interests in partnerships that invest in U.S. and non-U.S. debt and equity securities. The portfolio is a diversified mix of partnership interests including buyouts, distressed debt, growth equity, mezzanine, real estate, and venture capital investments. Partnership interests are valued using the most recent general partner statement of fair value, updated for any subsequent partnership interests’ cash flow.

Absolute return consists primarily of private partnership interests in hedge funds of funds. Partnership interests are valued using the NAV as determined by the administrator or custodian of the fund.

Real Assets consist of commodity funds, REITS (Real Estate Investment Trusts), and interests in partnerships that invest in private real estate, commodity, and timber investments. Private investments are valued using the most recent partnership statement of fair value, updated for any subsequent partnership interests’ cash flows. Commodity funds and REITS are valued at the closing price reported in the active market in which they are traded.

The following table sets forth a summary of changes in the fair values of the U.S. pension plans’ Level 3 assets for the year ended July 31, 2010 (in millions):

	<b>Global Equity</b>	<b>Private Equity</b>	<b>Absolute Return</b>	<b>Real Assets</b>	<b>Total</b>
Beginning balance at August 1, 2009	2.7	11.4	16.4	15.5	46.0
Unrealized gains	0.1	1.8	0.6	0.1	2.6
Net transfers into (out of) Level 3	(0.4)	1.6	(8.8)	0.7	(6.9)
Ending balance at July 31, 2010	<u>\$ 2.4</u>	<u>\$ 14.8</u>	<u>\$ 8.2</u>	<u>\$ 16.3</u>	<u>\$ 41.7</u>

Fair values of the assets held by the international pension plans by asset category are as follows (in millions):

Asset Category	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>International Assets</b>				
Global Equity Securities	\$ 26.8	26.8	—	—
Fixed Income Securities	20.7	—	20.7	—
Equity/Fixed Income	34.2	12.5	—	21.7
Real Assets	5.5	—	5.5	—
<b>Total International Assets</b>	<u>\$ 87.2</u>	<u>\$ 39.3</u>	<u>\$ 26.2</u>	<u>\$ 21.7</u>

Global equity consists of a fixed weights index fund, used to maintain a fixed 50/50 distribution between UK and overseas assets. Publicly traded equities are valued at the closing price reported in the active market in which the individual securities are traded.

Fixed income consists of corporate bond funds with the investment objective to achieve active corporate bond returns which are inflation linked and paid as a single payment in 2055. Corporate bonds and notes are valued at either the closing price reported if traded on an active market or at yields currently available on comparable securities of issuers with similar credit ratings or valued under a discounted cash flows approach that maximizes observable inputs, such as current yields of similar instruments, but includes adjustments for certain risks that may not be observable such as credit and liquidity risks.

Equity/Fixed Income consists of Level 1 assets that are part of a unit linked fund with a strategic asset allocation of 40% fixed income products and 60% equity type products. Assets are valued at either the closing price reported if traded on an active market or at yields currently available on comparable securities of issuers with similar credit ratings. Index funds are valued at the net asset value (NAV) as determined by the custodian of the fund. The Level 3 assets are composed of mathematical reserves on individual contracts and the Company does not have any influence on the investment decisions as made by the insurer due to the specific minimum guaranteed return characteristics of this type of contract. European insurers in general, broadly have a strategic asset allocation with 80% -90% fixed income products and 20%-10% equity type products (including real estate).

Real Assets consists of property funds. Property funds are valued using the most recent partnership statement of fair value, updated for any subsequent partnership interests' cash flows.

The following table sets forth a summary of changes in the fair values of the International pension plans' Level 3 assets for the year ended July 31, 2010 (in millions):

	Equity/Fixed Income
Beginning balance at August 1, 2009	\$ 23.1
Unrealized gains	0.3
Foreign currency exchange	(1.9)
Purchases, sales, issuances and settlements, net	0.2
Ending balance at July 31, 2010	<u>\$ 21.7</u>

*Investment Policies and Strategies.* For the Company's U.S. plans, the Company uses a total return investment approach to achieve a long-term return on plan assets, with a prudent level of risk for the purpose of meeting its retirement income commitments to employees. The plan's investments are diversified to assist in managing risk. The Company's asset allocation guidelines target an allocation of 45 percent equity securities, 30 percent alternative investments (funds of hedge funds), 10 percent real assets (investments into funds containing commodities and real estate), 10 percent fixed income and 5 percent private equity. Within equity securities, the Company will target an allocation of 15 percent international, 15 percent equity long/short, 10 percent small cap and 5 percent large cap. These target allocation guidelines are determined in consultation with the Company's investment consultant, and through the use of modeling the risk/return trade-offs among asset classes utilizing assumptions about expected annual return, expected volatility/standard deviation of returns and expected correlations with other asset classes. Investment policy

and performance is measured and monitored on an ongoing basis by the Company's investment committee through its use of an investment consultant and through quarterly investment portfolio reviews.

For the Company's non-U.S. plans, the general investment objectives are to maintain a suitably diversified portfolio of secure assets of appropriate liquidity which will generate income and capital growth to meet, together with any new contributions from members and the Company, the cost of current and future benefits.

*Estimated Contributions and Future Payments* The Company's general funding policy for its pension plans is to make at least the minimum contributions as required by applicable regulations. Additionally, the Company may elect to make additional contributions up to the maximum tax deductible contribution. As such, the Company made contributions of \$11.2 million to its U.S. pension plans in Fiscal 2010. There is no minimum funding request for the Company's U.S. plans for Fiscal 2011. The Company is currently evaluating whether or not a U.S. pension contribution will be made in Fiscal 2011. The Company made contributions of \$3.8 million to its non-U.S. pension plans in Fiscal 2010 and estimates that it will contribute approximately \$3.9 million in Fiscal 2011 based upon the local government prescribed funding requirements. Future estimates of the Company's pension plan contributions may change significantly depending on the actual rate of return on plan assets, discount rates and regulatory requirements.

Estimated future benefit payments for the Company's U.S. and non-U.S. plans are as follows (thousands of dollars):

Fiscal Year	
2011	\$ 21,032
2012	\$ 23,294
2013	\$ 21,958
2014	\$ 23,416
2015	\$ 24,392
2016-2020	\$ 158,567

*Postemployment and Postretirement Benefit Plans* The Company provides certain postemployment and postretirement health care benefits for certain U.S. employees for a limited time after termination of employment. The Company has recorded a liability for its postretirement benefit plan in the amount of \$1.6 million and \$1.7 million as of July 31, 2010 and July 31, 2009, respectively. The annual cost resulting from these benefits is not material. During Fiscal 2009, union negotiations have resulted in one U.S. plant freezing the plan. This change resulted in a curtailment gain of \$1.4 million. For measurement purposes, a 7.6 percent annual rate of increase in the per capita cost of covered health care benefits was assumed for Fiscal 2010. The Company has assumed that the long-term rate of increase will decrease gradually to an ultimate annual rate of 4.5 percent. A one-percentage point increase in the health care cost trend rate would increase the Fiscal 2010 and 2009 liability by \$0.1 million.

*Retirement Savings and Employee Stock Ownership Plan* The Company provides a contributory employee savings plan to U.S. employees that permits participants to make contributions by salary reduction pursuant to section 401(k) of the Internal Revenue Code. Through April 13, 2009, employee contributions of up to 25 percent of compensation were matched at a rate equaling 100 percent of the first 3 percent contributed and 50 percent of the next 2 percent contributed. The Company's contributions under this plan are based on the level of employee contributions as well as a discretionary contribution based on performance of the Company. The Plan was amended effective April 13, 2009 to reduce Company fixed matching contributions to the Plan for exempt employees. After April 13, 2009 fixed matching contributions for exempt employees were calculated at 50 percent of up to 3 percent of compensation deferred by the participant and deposited into the Plan and 25 percent of the next 2 percent of compensation deferred by the participant and deposited to the Plan. In addition, the Company fixed matching contribution was eliminated for Company Executive Officers and Vice Presidents. Effective March 29, 2010 the Company reinstated the original matching contributions which were in effect prior to April 13, 2009, and also reinstated the Company fixed matching contribution for Company Executive Officers and Vice Presidents. Total contribution expense for these plans was \$4.5 million, \$5.1 million and \$8.3 million for the years ended July 31, 2010, 2009 and 2008, respectively. This plan also includes shares from an Employee Stock Ownership Plan ("ESOP"). As of July 31, 2010 all shares of the ESOP have been allocated to participants. Total ESOP shares are considered to be shares outstanding for earnings per share calculations.

*Deferred Compensation and Other Benefit Plans* The Company provides various deferred compensation and other benefit plans to certain executives. The deferred compensation plan allows these employees to defer the receipt of all of their bonus and other stock related compensation and up to 75 percent of their salary to future periods. Other benefit

plans are provided to supplement the benefits for a select group of highly compensated individuals which are reduced because of compensation limitations set by the Internal Revenue Code. The Company has recorded a liability in the amount of \$8.8 million and \$10.0 million as of the year ended July 31, 2010 and July 31, 2009, respectively, related primarily to its deferred compensation plans.

**NOTE G**  
**Shareholders' Equity**

*Stock Rights* On January 27, 2006 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 Rights Agreement, dated as of January 27, 2006 by and between the Company and Wells Fargo Bank, N.A., as Rights Agent, one right was issued on March 3, 2006 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 \$143.00 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 \$.001 per right and will expire, unless earlier redeemed, on March 2, 2016.

*Stock Compensation Plans* The Stock Compensation Plans in the Consolidated Statements of Changes in Shareholders' Equity consist of the balance of amounts payable to eligible participants for stock compensation that was deferred to a Rabbi Trust pursuant to the provisions of the 2001 Master Stock Incentive Plan, as well as performance awards payable in common stock discussed further in Note H.

*Treasury Stock* The Company believes that the share repurchase program is a way of providing return to its shareholders. The Board of Directors authorized the repurchase, at the Company's discretion, of 8.0 million shares of common stock under the stock repurchase plan dated March 26, 2010. As of July 31, 2010, the Company had remaining authorization to repurchase 7.0 million shares under this plan. Following is a summary of treasury stock share activity for Fiscal 2010 and 2009:

	<u>2010</u>	<u>2009</u>
Balance at beginning of year	11,295,409	11,021,619
Stock repurchases	1,651,600	802,000
Net issuance upon exercise of stock options	(667,991)	(355,491)
Issuance under compensation plans	(46,197)	(99,612)
Discretionary stock paid into 401(k) plan	—	(60,122)
Other activity	(10,440)	(12,985)
Balance at end of year	<u>12,222,381</u>	<u>11,295,409</u>

**NOTE H**  
**Stock Option Plans**

*Employee Incentive Plans* In November 2001 shareholders approved the 2001 Master Stock Incentive Plan (the "Plan") that 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 ("SAR"), dividend equivalents, dollar-denominated awards, and other stock-based awards. Options under the Plan are granted to key employees at market price at the date of grant. Options are exercisable for up to 10 years from the date of grant. The Plan also allows for the granting of performance awards to a limited number of key executives. As administered by the Human Resources Committee of the Company's Board of Directors, these performance 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 these plans totaled \$0.5 million in Fiscal 2010. The Company recorded a net reversal of performance award expense in Fiscal 2009 of \$3.1 million due to the reversal of \$3.6 million of Long-Term Compensation Plan expense recognized in prior periods based upon actual and forecasted results. Performance award expense under these plans totaled \$4.2 million in Fiscal 2008.

Stock options issued from Fiscal 2000 to Fiscal 2010 become exercisable for non-executives in equal increments over three years. Stock options issued from Fiscal 2000 to Fiscal 2010 became exercisable for most executives immediately upon the date of grant. Certain other stock options issued to executives during Fiscal 2004, 2006 and

2007 become exercisable in equal increments over three years. For Fiscal 2010 the Company recorded pretax compensation expense associated with stock options of \$6.9 million and recorded \$2.5 million of related tax benefit.

Stock-based employee compensation cost is recognized using the fair-value based method. The Company determined the fair value of these awards using the Black-Scholes option pricing model with the following weighted average assumptions:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Risk - free interest rate	< 0.01 - 3.9%	1.4 - 4.0%	2.1 - 4.2%
Expected volatility	24.4 - 32.3%	21.6 - 25.5%	15.2 - 22.4%
Expected dividend yield	1.0%	1.0%	1.0%
Expected life			
Director original grants without reloads	8 years	8 years	8 years
Non - officer original grants	7 - 8 years	7 years	7 years
Officer original grants with reloads	4 years	4 years	3 years
Reload grants	<8 years	<5 years	<3 years
Officer original grants without reloads	8 years	7 years	7 years

Reload grants are grants made to officers or directors who exercised a reloadable option during the fiscal year and made payment of the purchase price using shares of previously owned Company stock. The reload grant is for the number of shares equal to the shares used in payment of the purchase price and/or withheld for minimum tax withholding.

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 2010, 2009 and 2008 is \$13.23, \$8.56 and \$10.60 per share, respectively, using the Black-Scholes pricing model.

The following table summarizes stock option activity:

	<u>Options Outstanding</u>	<u>Weighted Average Exercise Price</u>
Outstanding at July 31, 2009	4,998,125	\$ 26.94
Granted	643,974	42.41
Exercised	(848,990)	20.84
Canceled	(21,297)	41.94
Outstanding at July 31, 2010	<u>4,771,812</u>	30.04

The total intrinsic value of options exercised during Fiscal 2010, 2009 and 2008 was \$19.5 million, \$9.1 million and \$26.2 million, respectively.

Shares reserved at July 31, 2010 for outstanding options and future grants were 12,063,674. Shares reserved consist of shares available for grant plus all outstanding options. An amount is added to shares reserved each year based on shares outstanding adjusted for certain items as detailed in the Plan. The aggregate number of shares of common stock that may be issued under all awards under the Plan in any calendar year may not exceed 1.5 percent of the sum of the Company's outstanding shares of common stock, the outstanding share equivalents, as determined by the Company in the calculation of earnings per share on a fully diluted basis, and shares held in treasury of the Company as reported for the Company's most recent fiscal year that ends during such calendar year.

The following table summarizes information concerning outstanding and exercisable options as of July 31, 2010:

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$12 to \$22	1,378,067	1.68	\$ 17.22	1,378,067	\$ 17.22
\$22 to \$32	1,273,348	3.90	30.14	1,241,128	30.10
\$32 to \$42	1,274,570	6.38	34.83	1,179,001	34.60
\$42 and above	845,827	8.60	43.57	566,163	44.12
	<u>4,771,812</u>	4.75	30.04	<u>4,364,359</u>	29.07

At July 31, 2010 the aggregate intrinsic value of shares outstanding and exercisable was \$83.2 million and \$80.3 million, respectively.

The following table summarizes the status of options which contain vesting provisions:

	Options	Weighted Average Grant Date Fair Value
Non - vested at July 31, 2009	292,777	\$ 10.21
Granted	289,750	14.02
Vested	(168,662)	10.25
Canceled	(6,412)	11.40
Non - vested at July 31, 2010	<u>407,453</u>	12.89

The total fair value of shares vested during Fiscal 2010, 2009, and 2008 was \$8.0 million, \$7.9 million and \$6.3 million, respectively.

As of July 31, 2010 there was \$3.1 million of total unrecognized compensation cost related to non-vested stock options granted under the Plan. This unvested cost is expected to be recognized during Fiscal 2011, Fiscal 2012 and Fiscal 2013.

#### NOTE I Income Taxes

The components of earnings before income taxes are as follows:

	2010	2009	2008
	(thousands of dollars)		
Earnings before income taxes:			
United States	\$ 85,987	\$ 69,863	\$ 73,445
Foreign	144,189	91,562	162,718
Total	<u>\$ 230,176</u>	<u>\$ 161,425</u>	<u>\$ 236,163</u>

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

	<u>2010</u>	<u>2009</u>	<u>2008</u>
	(thousands of dollars)		
<b>Income taxes:</b>			
<b>Current</b>			
Federal	\$ 25,455	\$ 18,624	\$ 27,180
State	2,206	2,444	619
Foreign	33,327	13,176	37,616
	<u>60,988</u>	<u>34,244</u>	<u>65,415</u>
<b>Deferred</b>			
Federal	3,860	(3,888)	(4,712)
State	20	90	2
Foreign	(855)	(928)	3,505
	<u>3,025</u>	<u>(4,726)</u>	<u>(1,205)</u>
<b>Total</b>	<u>\$ 64,013</u>	<u>\$ 29,518</u>	<u>\$ 64,210</u>

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

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Statutory U.S. federal rate	35.0%	35.0%	35.0%
State income taxes	0.8	1.3	0.3
Foreign taxes at lower rates	(8.2)	(7.5)	(7.6)
Export, manufacturing and research credits	(0.9)	(0.5)	(0.6)
Tax on repatriation of earnings	0.1	0.7	(0.6)
Change in unrecognized tax benefits	1.2	(10.6)	0.5
Other	(0.2)	(0.1)	0.2
	<u>27.8%</u>	<u>18.3%</u>	<u>27.2%</u>

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

	<u>2010</u>	<u>2009</u>
	(thousands of dollars)	
<b>Deferred tax assets:</b>		
Accrued expenses	\$ 9,130	\$ 8,438
Compensation and retirement plans	39,438	30,916
Tax credit and NOL carryforwards	954	1,439
Inventory reserves	8,324	10,183
Other	1,846	2,232
<b>Deferred tax assets:</b>	<u>59,692</u>	<u>53,208</u>
Valuation allowance	(604)	(1,053)
<b>Net deferred tax assets</b>	<u>59,088</u>	<u>52,155</u>
<b>Deferred tax liabilities:</b>		
Depreciation and amortization	(30,248)	(31,593)
Other	(1,420)	(2,923)
<b>Deferred tax liabilities</b>	<u>(31,668)</u>	<u>(34,516)</u>
<b>Net deferred tax asset</b>	<u>\$ 27,420</u>	<u>\$ 17,639</u>

The effective tax rate for Fiscal 2010 was 27.8 percent compared to 18.3 percent in Fiscal 2009. The increase in effective tax rate is primarily due to a decrease in discrete tax benefits. Fiscal 2009 contained \$19.6 million of discrete tax benefits, which predominantly occurred in the second quarter, and primarily related to changes to uncertain tax position reserves in connection with the effective settlements of court cases and examinations in various jurisdictions covering various years. Fiscal 2010 contained \$4.3 million of discrete tax benefits, primarily recorded in the second quarter, from the expiration of the statute of limitations at foreign subsidiaries and other discrete items. Without consideration of discrete items, the average underlying tax rate decreased over the prior year to 29.7 percent from 30.4 percent mainly due to the mix of earnings between tax jurisdictions.



The Company has not provided for U.S. income taxes on additional undistributed earnings of non-U.S. subsidiaries of approximately \$579.0 million. The Company currently plans to permanently reinvest these undistributed earnings overseas. 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.

The Company has cumulative pre-tax loss carryforwards of \$4.2 million, which exist in various international subsidiaries. If fully realized, the unexpired net operating losses may be carried forward to offset future local income tax payments of \$1.0 million, at current rates of tax. Approximately 5 percent of these net operating losses expire within the next three years, while the majority of the remaining net operating loss carryforwards expire more than 5 years out or have no statutory expiration under current local laws. However, as it is more-likely - than - not that certain of these losses will not be realized, a valuation allowance of \$ 0.6 million exists as of July 31, 20 10.

The Company maintains a reserve for uncertain tax benefits. The accounting standard defines the threshold for recognizing the benefits of tax return positions in the financial statements as “more-likely-than-not” to be sustained by the taxing authorities based solely on the technical merits of the position. If the recognition threshold is met, the tax benefit is measured and recognized as the largest amount of tax benefit that in the Company’s judgment is greater than 50 percent likely to be realized. A reconciliation of the beginning and ending amount of gross unrecognized tax benefits is as follows:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
	(thousands of dollars )		
Gross unrecognized tax benefits at beginning of fiscal year	\$ 16,928	\$ 32,002	\$ 28,209
Additions for tax positions of the current year	3,122	3,527	8,221
Additions for tax positions of prior years	470	772	2,322
Reductions for tax positions of prior years	(179)	(8,258)	(540)
Settlements	—	(10,092)	—
Reductions due to lapse of applicable statute of limitations	(1,347)	(1,023)	(6,210)
Gross unrecognized tax benefits at end of fiscal year	<u>\$ 18,994</u>	<u>\$ 16,928</u>	<u>\$ 32,002</u>

The Company recognizes interest and penalties accrued related to unrecognized tax benefits in income tax expense. During the fiscal year ended July 31, 2010, the Company recognized interest expense, net of tax benefit, of approximately \$0.5 million. At July 31, 2010 and July 31, 2009, accrued interest and penalties on a gross basis were \$2.5 million and \$1.8 million, respectively.

The Company’s uncertain tax positions are affected by the tax years that are under audit or remain subject to examination by the relevant taxing authorities. The following tax years, in addition to the current year, remain subject to examination, at least for certain issues, by the major tax jurisdictions indicated:

<u>Major Jurisdictions</u>	<u>Open Tax Years</u>
Belgium	2005 through 2009
China	2000 through 2009
France	2007 through 2009
Germany	2004 through 2009
Italy	2003 through 2009
Japan	2009
Mexico	2005 through 2009
Thailand	2005 through 2009
United Kingdom	2009
United States	2007 through 2009

If the Company were to prevail on all unrecognized tax benefits recorded, substantially all of the unrecognized tax benefits would benefit the effective tax rate. With an average statute of limitations of about 5 years, up to \$3.2 million of the unrecognized tax benefits could potentially expire in the next 12 month period, unless extended by audit. It is reasonably possible that an additional reduction in unrecognized tax benefits may occur within the fiscal year due to settlement of several worldwide tax disputes; however, quantification of an estimated range and timing cannot be made at this time.



**NOTE J**  
**Segment Reporting**

Consistent with FASB guidance related to segment reporting, the Company 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 OEMs in the construction, mining, agriculture, aerospace, defense and truck markets and to independent distributors, OEM dealer networks, private label accounts and large equipment fleets. Products include air filtration systems, exhaust and emissions systems, liquid filtration systems, and replacement filters.

The Industrial Products segment sells to various industrial end-users, OEMs of gas-fired turbines, and OEMs and end-users requiring clean air and liquids. Products include dust, fume and mist collectors, compressed air purification systems, liquid filtration systems, air filtration systems for gas turbines, PTFE membranes and laminates, and specialized air filtration systems for diverse applications including computer hard disk drives.

Corporate and Unallocated includes corporate expenses determined to be non-allocable to the segments and interest income and expense. Assets included in Corporate and Unallocated principally are cash and cash equivalents, inventory reserves, certain prepaids, certain investments, other assets, and assets allocated to general corporate purposes.

The Company has 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 an allocation methodology to assign costs and assets to the segments. A certain amount of costs and assets relate to general corporate purposes and are 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.

The Company is an integrated enterprise, characterized by substantial intersegment cooperation, cost allocations, and sharing of assets. Therefore, we do not represent that these segments, if operated independently, would report the operating profit and other financial information shown below.

Segment detail is summarized as follows:

	<u>Engine Products</u>	<u>Industrial Products</u>	<u>Corporate &amp; Unallocated</u>	<u>Total Company</u>
	(thousands of dollars)			
<b>2010</b>				
Net sales	\$ 1,094,371	\$ 782,693	\$ —	\$ 1,877,064
Depreciation and amortization	32,630	21,738	4,864	59,232
Equity earnings in unconsolidated affiliates	1,859	160	—	2,019
Earnings before income taxes	150,473	96,444	(16,741)	230,176
Assets	674,587	504,867	320,052	1,499,506
Equity investments in unconsolidated affiliates	14,860	625	—	15,485
Capital expenditures, net of acquired businesses	23,770	15,835	3,544	43,149
<b>2009</b>				
Net sales	\$ 1,001,961	\$ 866,668	\$ —	\$ 1,868,629
Depreciation and amortization	31,517	21,156	5,924	58,597
Equity earnings in unconsolidated affiliates	2,172	94	—	2,266
Earnings before income taxes	83,797	89,526	(11,898)	161,425
Assets	610,341	495,228	228,427	1,333,996
Equity investments in unconsolidated affiliates	15,474	517	—	15,991
Capital expenditures, net of acquired businesses	24,785	16,637	4,658	46,080
<b>2008</b>				
Net sales	\$ 1,229,171	\$ 1,003,350	\$ —	\$ 2,232,521
Depreciation and amortization	27,386	19,314	10,032	56,732
Equity earnings in unconsolidated affiliates	1,876	34	—	1,910
Earnings before income taxes	158,931	102,420	(25,188)	236,163
Assets	628,444	590,273	329,905	1,548,622
Equity investments in unconsolidated affiliates	15,190	506	—	15,696
Capital expenditures, net of acquired businesses	34,830	24,564	12,758	72,152

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

	<u>2010</u>	<u>2009</u>	<u>2008</u>
	(thousands of dollars)		
<b>Engine Products segment:</b>			
Off-Road Products	\$ 222,329	\$ 243,691	\$ 361,143
Aerospace and Defense Products	111,977	119,094	87,538
On-Road Products	81,874	71,958	123,146
Aftermarket Products*	660,263	536,122	631,432
Retrofit Emissions Products	17,928	31,096	25,912
Total Engine Products segment	<u>1,094,371</u>	<u>1,001,961</u>	<u>1,229,171</u>
<b>Industrial Products segment:</b>			
Industrial Filtration Solutions Products	454,653	503,611	600,526
Gas Turbine Products	150,131	206,760	213,138
Special Applications Products	177,909	156,297	189,686
Total Industrial Products segment	<u>782,693</u>	<u>866,668</u>	<u>1,003,350</u>
Total Company	<u>\$ 1,877,064</u>	<u>\$ 1,868,629</u>	<u>\$ 2,232,521</u>

\* Includes replacement part sales to the Company's OEM Customers.

Geographic sales by origination and property, plant and equipment:

	Net Sales	Property, Plant & Equipment - Net
	(thousands of dollars)	
<b>2010</b>		
United States	\$ 745,400	\$ 139,717
Europe	545,803	122,646
Asia - Pacific	460,470	72,950
Other	125,391	30,579
Total	<u>\$1,877,064</u>	<u>\$ 365,892</u>
<b>2009</b>		
United States	\$ 778,979	\$ 141,052
Europe	567,117	138,350
Asia - Pacific	419,423	71,686
Other	103,110	29,980
Total	<u>\$1,868,629</u>	<u>\$ 381,068</u>
<b>2008</b>		
United States	\$ 888,658	\$ 144,429
Europe	766,797	166,195
Asia - Pacific	471,275	65,829
Other	105,791	38,706
Total	<u>\$2,232,521</u>	<u>\$ 415,159</u>

*Concentrations* There were no Customers over 10 percent of net sales during Fiscal 2010 and 2009. Sales to one Customer accounted for 10 percent of net sales in Fiscal 2008. There were no Customers over 10 percent of gross accounts receivable in Fiscal 2010, 2009, and 2008.

#### **NOTE K** **Commitments and Contingencies**

The Company and Caterpillar Inc. equally own the shares of Advanced Filtration Systems Inc. (AFSI), an unconsolidated joint venture, and guarantee certain debt of the joint venture. As of July 31, 2010, the joint venture had \$25.2 million of outstanding debt, of which the Company guarantees half. In addition, during Fiscal 2010, 2009 and 2008, the Company recorded its equity in earnings of this equity method investment of \$0.4 million, \$1.0 million and \$0.6 million and royalty income of \$5.4 million, \$5.1 million and \$5.4 million, respectively, related to AFSI.

The Company provides for warranties on certain products. In addition, the Company may incur specific Customer warranty issues. Following is a reconciliation of warranty reserves (in thousands of dollars):

Balance at August 1, 2008	\$ 11,523
Accruals for warranties issued during the reporting period	2,942
Accruals related to pre - existing warranties (including changes in estimates)	(2,141)
Less settlements made during the period	(3,109)
Balance at July 31, 2009	\$ 9,215
Accruals for warranties issued during the reporting period	12,389
Accruals related to pre - existing warranties (including changes in estimates)	(1,244)
Less settlements made during the period	(4,653)
Balance at July 31, 2010	<u>\$ 15,707</u>

During Fiscal 2010, the Company increased warranty accruals due to a specific warranty matter in our Retrofit Emissions Products group. We recorded an expense of \$6.2 million for this matter in Fiscal 2010.

At July 31, 2010 and 2009, the Company had a contingent liability for standby letters of credit totaling \$20.0 million, which have been issued and are outstanding. The letters of credit guarantee payment to third parties in the event the Company is in breach of a specified bond financing agreement and insurance contract terms as detailed in each letter of credit. At July 31, 2010 and 2009, there were no amounts drawn upon these letters of credit.

The Company records provisions with respect to identified claims or lawsuits when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Claims and lawsuits are reviewed quarterly and



provisions are taken or adjusted to reflect the status of a particular matter. The Company believes the recorded reserves in its consolidated financial statements are adequate in light of the probable and estimable outcomes. The recorded liabilities were not material to the Company's financial position, results of operation or liquidity and the Company does not believe that any of the currently identified claims or litigation will materially affect its financial position, results of operation or liquidity.

On March 31, 2008 S&E Quick Lube, a filter distributor, filed a lawsuit in U.S. District Court for the District of Connecticut alleging that twelve filter manufacturers, including the Company, engaged in a conspiracy to fix prices, rig bids, and allocate U.S. Customers for aftermarket automotive filters. This lawsuit seeks various remedies including injunctive relief and monetary damages of an unspecified amount and is a purported class action on behalf of direct purchasers of automotive aftermarket filters from the defendants. Parallel purported class actions, including on behalf of a variety of direct and indirect purchasers of aftermarket filters, have been filed by other plaintiffs in a variety of jurisdictions in the United States and Canada. The U.S. cases have been consolidated into a single multi-district litigation in the Northern District of Illinois. In addition, on April 16, 2009 the Attorney General of the State of Florida filed a complaint in the U.S. District Court for the Northern District of Illinois based on these same allegations. The Company will vigorously defend the claims raised in these lawsuits. The Company understands that the Antitrust Division of the Department of Justice ("DOJ") was investigating the allegations raised in these suits and issued subpoenas in connection with that investigation. The Company was not contacted by the DOJ in connection with the DOJ investigation, but public reports indicate that the DOJ officially closed that investigation in January 2010. In June 2010, the United States gave notice of its election to decline intervention in a qui tam action entitled United States of America, ex rel. William G. Burch v. Champion Laboratories, Inc. et al., which had been filed under seal in December 2009 in the United States District Court for the Northern District of Oklahoma. After that notice, the matter no longer remained under seal. In August 2010, the County of Suffolk, New York, filed a purported class action entitled County of Suffolk, New York, v. Champion Laboratories, et al., in the United States District Court for the Eastern District of New York. Both the Burch qui tam action and the Suffolk action contain allegations similar to those made in the multi-district litigation already pending in the Northern District of Illinois. As of September 1, 2010, the Company has not been served with a complaint in either action. The Company denies any liability in either action and intends to vigorously defend the claims raised in these lawsuits. In June 2010, the Attorney General of the State of Washington served the Company with a Civil Investigative Demand inquiring into the same issues as those raised in the complaint filed by the State of Florida. The Company is cooperating with the Washington investigation but has denied any wrongdoing.

On May 19, 2010, the Air Resources Board for the State of California ("ARB") revoked its verification of the Company's DFM Diesel Multi-Stage Filter System ("DMF") for use with on-road diesel engines, which verification was issued on December 16, 2005. Under the ARB revocation, as of May 17, 2010, the DMF system may not be sold, installed or offered for sale as an ARB verified system. The Company issued a product bulletin for its DMF product on February 8, 2010 and subsequently submitted a proposal to ARB to address a failure mode that can occur when an engine is not operating in compliance with the requirements for engine performance and temperature. On July 28, 2010, ARB issued its approval for the Company's service campaign. The Company is currently working with the Environmental Protection Agency ("EPA") regarding its service campaign for sales outside California as well as EPA verification for the DMF.

In addition, ARB has notified the Company by letter, that it may seek fines and penalties in connection with the sales of the DMF product. The Company denies that any sales were made in California without ARB verification. Donaldson is not currently selling any DMF product and is evaluating and working with both ARB and the United States Environmental Protection Agency to obtain the necessary approvals for the DMF product. At the present time, we do not anticipate a material adverse impact to our results of operations or financial position due to the issues related to the DMF product.

## NOTE L Restructuring

The following is a reconciliation of restructuring reserves (in thousands of dollars):

Balance at July 31, 2008	\$ —
Accruals for restructuring during the reporting period	17,755
Less settlements made during the period	(13,915)
Balance at July 31, 2009	\$ 3,840
Accruals for restructuring during the reporting period	10,165
Less settlements made during the period	(9,866)
Balance at July 31, 2010	<u>\$ 4,139</u>

Certain restructuring actions commenced in Fiscal 2009 in response to the dramatic downturn in the worldwide economy and these actions and related costs carried over into Fiscal 2010. In Fiscal 2010, the Engine Products segment and Industrial Products segment incurred \$1.9 million and \$8.3 million, respectively. In Fiscal 2009, Engine Products segment, Industrial Products segment, and Corporate and Unallocated incurred \$7.2 million, \$10.1 million and \$0.5 million, respectively. In addition to the restructuring charges discussed above, we also incurred asset impairment charges of \$2.1 related to a downsizing at a plant in Germany. The Company expects to settle its remaining liability during Fiscal 2011.

Restructuring expense detail is summarized as follows (in thousands):

	Fiscal Year	
	2010	2009
Gross Margin	\$ 7,488	\$ 10,109
Operating expenses	2,677	7,646
Total restructuring expenses	<u>\$ 10,165</u>	<u>\$ 17,755</u>

## NOTE M Quarterly Financial Information (Unaudited)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(In thousands)			
<b>2010</b>				
Net sales	\$ 428,080	\$ 436,122	\$ 497,619	\$ 515,243
Gross margin	148,400	145,947	177,371	187,030
Net earnings	34,569	30,966	49,458	51,170
Basic earnings per share	0.44	0.40	0.64	0.66
Diluted earnings per share	0.44	0.39	0.62	0.65
Dividends declared per share	—	0.115	0.120	0.245
Dividends paid per share	0.115	0.115	0.120	0.120
<b>2009</b>				
Net sales	\$ 573,260	\$ 460,601	\$ 413,447	\$ 421,321
Gross margin	186,703	134,012	130,782	138,209
Net earnings	47,962	33,793	26,598	23,554
Basic earnings per share	0.62	0.43	0.34	0.30
Diluted earnings per share	0.60	0.43	0.34	0.30
Dividends declared per share	—	0.230	—	0.230
Dividends paid per share	0.110	0.115	0.115	0.115

The quarters ended October 31, 2009, January 31, 2010, April 30, 2010, and July 31, 2010, include restructuring charges after-tax of \$0.9 million or \$0.01 per share, \$3.6 million or \$0.05 per share, \$2.7 million or \$0.03 per share, and less than \$0.1 million, respectively. The quarters ended January 31, 2009, April 30, 2009, and July 31, 2009, include restructuring charges after-tax of \$2.9 million or \$0.04 per share, \$4.7 million or \$0.06 per share, and \$4.5 million or \$0.05 per share, respectively.

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

None.



## **I tem 9A. Controls and Procedures**

### **Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this report (the “Evaluation Date”), the Company carried out an evaluation, under the supervision and with the participation of management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Company’s disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the Evaluation Date, the Company’s disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in applicable rules and forms, and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

### **Changes in Internal Control over Financial Reporting**

No change in the Company’s internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) identified in connection with such evaluation during the fiscal quarter ended July 31, 2010, has materially affected, or is reasonably likely to materially affect, the Company’s internal control over financial reporting.

### **Management’s Report on Internal Control over Financial Reporting**

See Management’s Report on Internal Control over Financial Reporting under Item 8 on page 25.

### **Report of Independent Registered Public Accounting Firm**

See Report of Independent Registered Public Accounting Firm under Item 8 on page 26.

## **I tem 9B. Other Information**

None.

## **P ART III**

## **I tem 10. Directors, Executive Officers and Corporate Governance**

The information under the captions “Item 1: Election of Directors”; “Director Selection Process,” “Audit Committee,” “Audit Committee Expertise; Complaint-Handling Procedures,” and “Section 16(a) Beneficial Ownership Reporting Compliance” of the 2010 Proxy Statement is incorporated herein by reference. Information on the Executive Officers of the Company is found under the caption “Executive Officers of the Registrant” on page 6 of this Annual Report on Form 10-K.

The Company has adopted a code of business conduct and ethics in compliance with applicable rules of the Securities and Exchange Commission that applies to its principal executive officer, its principal financial officer and its principal accounting officer or controller, or persons performing similar functions. A copy of the code of business conduct and ethics is posted on the Company’s website at [www.donaldson.com](http://www.donaldson.com). The code of business conduct and ethics is available in print, free of charge to any shareholder who requests it. The Company will disclose any amendments to, or waivers of, the code of business conduct and ethics for the Company’s principal executive officer, principal financial officer, and principal accounting officer on the Company’s website.

## **I tem 11. Executive Compensation**

The information under the captions “Compensation Committee Report,” “Executive Compensation,” “Compensation Risk Analysis” and “Director Compensation” of the 2010 Proxy Statement is incorporated herein by reference.

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

The information under the captions “Security Ownership” and “Equity Compensation Plan Information” of the 2010 Proxy Statement is incorporated herein by reference.





The following table sets forth information as of July 31, 2010 regarding the Company's equity compensation plans:

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted - average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
	(a)	(b)	(c)
<b>Equity compensation plans approved by security holders:</b>			
1980 Master Stock Compensation Plan:			
Stock Options	—	—	—
Deferred Stock Gain Plan	48,467	\$ 13.5635	—
1991 Master Stock Compensation Plan:			
Stock Options	700,086	\$ 18.2171	—
Deferred Stock Option Gain Plan	363,473	\$ 33.5041	—
Deferred LTC/Restricted Stock	145,220	\$ 22.1041	—
2001 Master Stock Incentive Plan:			
Stock Options	3,494,982	\$ 32.2188	See Note 1
Deferred Stock Option Gain Plan	1,818	\$ 44.4784	—
Deferred LTC/Restricted Stock	154,273	\$ 30.7998	See Note 1
Long Term Compensation	28,698	\$ 38.0100	See Note 1
<b>Subtotal for plans approved by security holders</b>	<u>4,937,017</u>	<u>\$ 29.8411</u>	
<b>Equity compensation plans not approved by security holders:</b>			
Non qualified Stock Option Program for Non - Employee Directors			
	576,744	\$ 31.2181	See Note 2
ESOP Restoration	28,332	\$ 12.6190	See Note 3
<b>Subtotal for plans not approved by security holders</b>	<u>605,076</u>	<u>\$ 30.3472</u>	
<b>Total</b>	<u>5,542,093</u>	<u>\$ 29.8964</u>	

Note 1: Shares authorized for issuance during the 10-year term are limited in each plan year to 1.5% of the Company's "outstanding shares" (as defined in the 2001 Master Stock Incentive Plan).

Note 2: The stock option program for non-employee directors (filed as exhibit 10-N to the Company's 1998 Form 10-K report) provides for each non-employee director to receive annual option grants of 7,200 shares. The 2001 Master Stock Incentive Plan, which was approved by the Company's stockholders on November 16, 2001 also provides for the issuance of stock options to non-employee directors.

Note 3: The Company has a non-qualified ESOP Restoration Plan established on August 1, 1990 (filed as exhibit 10-E to the Company's Form 10-Q for the quarter ended January 31, 1998), to supplement the benefits for executive employees under the Company's Employee Stock Ownership Plan that would otherwise be reduced because of the compensation limitations under the Internal Revenue Code. The ESOP's 10-year term was completed on July 31, 1997 and the only ongoing benefits under the ESOP Restoration Plan are the accrual of dividend equivalent rights to the participants in the Plan.

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

The information under the captions "Policy and Procedures Regarding Transactions with Related Persons" and "Board Oversight and Director Independence" of the 2010 Proxy Statement is incorporated herein by reference.

### **Item 14. Principal Accounting Fees and Services**

The information under the caption "Information Regarding the Independent Registered Public Accounting Firm" of the 2010 Proxy Statement is incorporated herein by reference.

**PART IV**

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

Documents filed with this report:

(1) Financial Statements

Consolidated Statements of Earnings — years ended July 31, 2010, 2009 and 2008

Consolidated Balance Sheets — July 31, 2010 and 2009

Consolidated Statements of Cash Flows — years ended July 31, 2010, 2009 and 2008

Consolidated Statements of Changes in Shareholders' Equity — years ended July 31, 2010, 2009 and 2008

Notes to Consolidated Financial Statements

Report of Independent Registered Public Accounting Firm

(2) Financial Statement Schedules —

Schedule II Valuation and qualifying accounts

All other schedules (Schedules I, III, IV and V) for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instruction, or are inapplicable, and therefore have been omitted.

(3) Exhibits

The exhibits listed in the accompanying index are filed as part of this report or incorporated by reference as indicated therein.

**SIGNATURES**

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

**DONALDSON COMPANY, INC.**

Date: September 24, 2010

By: /s/ William M. Cook

William M. Cook  
Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on September 24, 2010.

<u>/s/ William M. Cook</u> William M. Cook	President, Chief Executive Officer and Chairman (principal executive officer)
<u>/s/ Thomas R. VerHage</u> Thomas R. VerHage	Vice President and Chief Financial Officer (principal financial officer)
<u>/s/ James F. Shaw</u> James F. Shaw	Controller (principal accounting officer)
<u>*</u> F. Guillaume Bastiaens	Director
<u>*</u> Janet M. Dolan	Director
<u>*</u> Jack W. Eugster	Director
<u>*</u> John F. Grundhofer	Director
<u>*</u> Michael J. Hoffman	Director
<u>*</u> Paul David Miller	Director
<u>*</u> Jeffrey Noddle	Director
<u>*</u> Willard D. Oberton	Director
<u>*</u> Ajita G. Rajendra	Director
<u>*</u> John P. Wiehoff	Director
<u>*By: /s/ Norman C. Linnell</u> Norman C. Linnell As attorney-in-fact	

**S SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS****DONALDSON COMPANY, INC. AND SUBSIDIARIES**  
(thousands of dollars)

Description	Balance at Beginning of Period	Additions		Deductions (B)	Balance at End of Period
		Charged to Costs and Expenses	Charged to Other Accounts (A)		
<b>Year ended July 31, 2010:</b>					
Allowance for doubtful accounts deducted from accounts receivable	\$ 7,387	\$ 1,063	\$ (293)	\$ (1,842)	\$ 6,315
<b>Year ended July 31, 2009:</b>					
Allowance for doubtful accounts deducted from accounts receivable	\$ 7,509	\$ 1,240	\$ (534)	\$ (828)	\$ 7,387
<b>Year ended July 31, 2008:</b>					
Allowance for doubtful accounts deducted from accounts receivable	\$ 6,768	\$ 1,126	\$ 537	\$ (922)	\$ 7,509

Note A - Allowance for doubtful accounts foreign currency translation losses (gains) recorded directly to equity.

Note B - Bad debts charged to allowance, net of reserves and changes in estimates.

**E XHIBIT INDEX**  
**ANNUAL REPORT ON FORM 10-K**

3-A	— Restated Certificate of Incorporation of Registrant as currently in effect
* 3-B	— Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Stock of Registrant, dated as of March 3, 2006 (Filed as Exhibit 3-B to Form 10-Q Report filed for the first quarter ended October 31, 2006)
* 3-C	— Amended and Restated Bylaws of Registrant (as of January 30, 2009) (Filed as Exhibit 3-C to Form 10-Q Report for the Second Quarter ended January 31, 2009)
* 4	— **
* 4-A	— Preferred Stock Amended and Restated Rights Agreement between Registrant and Wells Fargo Bank, N.A., as Rights Agent, dated as of January 27, 2006 (Filed as Exhibit 4.1 to Form 8-K Report filed February 1, 2006)
*10-A	— Officer Annual Cash Incentive Plan (Filed as Exhibit 10-A to 2006 Form 10-K Report)***
*10-B	— 1980 Master Stock Compensation Plan as Amended (Filed as Exhibit 10-A to Form 10-Q Report filed for the first quarter ended October 31, 2008)***
*10-C	— Form of Performance Award Agreement under 1991 Master Stock Compensation Plan (Filed as Exhibit 10-B to Form 10-Q Report filed for the first quarter ended October 31, 2008)***
*10-D	— ESOP Restoration Plan (2003 Restatement) (Filed as Exhibit 10-D to 2009 Form 10-K Report)***
*10-E	— Deferred Compensation Plan for Non-employee Directors as amended (Filed as Exhibit 10-C to Form 10-Q Report filed for the first quarter ended October 31, 2008)***
*10-F	— Independent Director Retirement and Benefit Plan as amended (Filed as Exhibit 10-D to Form 10-Q Report filed for the first quarter ended October 31, 2008)***
*10-G	— Excess Pension Plan (2003 Restatement) (Filed as Exhibit 10-G to 2009 Form 10-K Report)***
*10-H	— Supplementary Executive Retirement Plan (2003 Restatement) (Filed as Exhibit 10-H to 2009 Form 10-K Report)***
*10-I	— 1991 Master Stock Compensation Plan as amended (Filed as Exhibit 10-E to Form 10-Q Report filed for the first quarter ended October 31, 2008)***
*10-J	— Form of Restricted Stock Award under 1991 Master Stock Compensation Plan (Filed as Exhibit 10-F to Form 10-Q Report filed for the first quarter ended October 31, 2008)***
*10-K	— Form of Agreement to Defer Compensation for certain Executive Officers (Filed as Exhibit 10-G to Form 10-Q Report filed for the first quarter ended October 31, 2008)***
*10-L	— Stock Option Program for Non-employee Directors (Filed as Exhibit 10-H to Form 10-Q Report filed for the first quarter ended October 31, 2008)***
*10-M	— Note Purchase Agreement among Donaldson Company, Inc. and certain listed Insurance Companies Dated as of July 15, 1998 (Filed as Exhibit 10-I to Form 10-Q Report filed for the first quarter ended October 31, 2008)
10-N	— Second Supplement and First Amendment to Note Purchase Agreement among Donaldson Company, Inc. and certain listed Insurance Companies dated as of September 30, 2004
*10-O	— 2001 Master Stock Incentive Plan (Filed as Exhibit 10-O to 2009 Form 10-K Report)***
10-P	— Form of Officer Stock Option Award Agreement under the 2001 Master Stock Incentive Plan ***
10-Q	— Form of Non-Employee Director Non-Qualified Stock Option Agreement under the 2001 Master Stock Incentive Plan ***
10-R	— Agreement dated August 29, 2005, by and between Donaldson Company, Inc. and William G. Van Dyke ***
*10-S	— Restated Compensation Plan for Non-Employee Directors dated July 28, 2006 (Filed as Exhibit 99.1 to Form 8-K Report filed August 4, 2006)***
*10-T	— Restated Long-Term Compensation Plan dated May 23, 2006 (Filed as Exhibit 99.2 to Form 8-K Report filed August 4, 2006)***
*10-U	— Qualified Performance-Based Compensation Plan (Filed as Exhibit 10-DD to 2006 Form 10-K Report)***
*10-V	— Deferred Compensation and 401(k) Excess Plan (2005 Restatement) (Filed as Exhibit 10-EE to 2006 Form 10-K Report)***

- \*10-W — Deferred Stock Option Gain Plan (2005 Restatement) (Filed as Exhibit 10-FF to 2006 Form 10-K Report)\*\*\*
- \*10-X — Excess Pension Plan (2005 Restatement) (Filed as Exhibit 10-GG to 2006 Form 10-K Report)\*\*\*
- \*10-Y — Supplemental Executive Retirement Plan (2005 Restatement) (Filed as Exhibit 10-HH to 2006 Form 10-K Report)\*\*\*

## Table of Contents

*10-Z	—	Form of Management Severance Agreement for Executive Officers (Filed as Exhibit 10-A to Form 10-Q Report for the Third Quarter ended April 30, 2008)***
11	—	Computation of net earnings per share (See “Earnings Per Share” in “Summary of Significant Accounting Policies” in Note A in the Notes to Consolidated Financial Statements on page 31)
21	—	Subsidiaries
23	—	Consent of PricewaterhouseCoopers LLP
24	—	Powers of Attorney
31-A	—	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31-B	—	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	—	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* Exhibit has previously been filed with the Securities and Exchange Commission and is incorporated herein by reference as an exhibit.

\*\* Pursuant to the provisions of Regulation S-K Item 601(b)(4)(iii)(A) copies of instruments defining the rights of holders of certain long-term debts of the Company and its subsidiaries are not filed and in lieu thereof the Company agrees to furnish a copy thereof to the Securities and Exchange Commission upon request.

\*\*\* Denotes compensatory plan or management contract.

Note: Exhibits have been furnished only to the Securities and Exchange Commission. Copies will be furnished to individuals upon request.



**RESTATED CERTIFICATE OF INCORPORATION****OF****DONALDSON COMPANY, INC.**

FIRST. The name of this corporation is "DONALDSON COMPANY, INC."

SECOND. The registered office of the corporation in the State of Delaware is 4305 Lancaster Pike, City of Wilmington, County of New Castle; and the name of its registered agent at such address is Corporation Service Company.

THIRD. The nature of the business and the objects and purposes proposed to be transacted, promoted and carried on are to do any and all of the things herein mentioned as fully and to the same extent as natural persons might or could do, viz.:

To manufacture, buy, sell, distribute, market and in any manner deal in and with, as manufacturer, jobber, distributor, agent, or otherwise, air cleaners for gas engines, spark-arresting mufflers, breathers, crank-case ventilating systems, all kinds of automotive and mechanical devices, accessories, appliances, parts, tools, products and supplies, and all kinds of products, articles, and things used or useful in connection with automobiles, tractors, trucks, buses, motorcycles, motor vehicles of any kind, boats, airplanes, or airships.

To carry on a general manufacturing and jobbing business and any business incidental thereto or useful in connection therewith.

To purchase, lease, hire or otherwise acquire real and personal property, improved and unimproved, of every kind and description and to sell, dispose of, lease, convey and mortgage said property, or any part thereof; to acquire, hold, lease, manage, operate, develop, control, build, erect, maintain for the purpose of said corporation, construct, reconstruct or purchase, either directly or through ownership of stock in any corporation, any lands, buildings, offices, stores, warehouses, mills, shops, factories, plants, machinery, rights, easements, permits, privileges, franchises and licenses, and all other things which may at any time be necessary or convenient for the purposes of the corporation; to sell, lease, hire or otherwise dispose of the lands, buildings or other property of the corporation, or any part thereof.

To purchase or otherwise acquire, hold, use, sell, or in any manner dispose of and to grant licenses or other rights therein and in any manner deal with patents, inventions, improvements, processes, formulas, trade-marks, trade-names, rights and licenses secured under letters patent, copyrights or otherwise; to enter into any and all license agreements and to pay royalties thereunder.

To subscribe or cause to be subscribed for, and to purchase and otherwise acquire, hold, sell, assign, transfer, mortgage, pledge, exchange, distribute and otherwise dispose of the whole

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or any part of the shares of the capital stock, bonds, coupons, mortgages, deeds of trust, debentures, securities, obligations, evidences of indebtedness, notes, good will, rights, assets and property of any and every kind or any part thereof of any other corporation or corporations, association or associations, now or hereafter existing and whether created by the laws of the State of Delaware, or of any other State, Territory or Country, and to operate, manage and control such properties, or any of them, either in the name of such other corporation or corporations or in the name of this corporation, and while owners of any of said shares of capital stock to exercise all the rights, powers and privileges of ownership of every kind and description including the right to vote thereon, with power to designate some person for that purpose from time to time to the same extent as natural persons might or could do.

To manufacture, purchase, lease or otherwise acquire, hold, own, repair, mortgage, pledge or otherwise hypothecate, sell, assign and transfer, or otherwise dispose of, to invest, trade, deal in and deal with goods, wares and merchandise, and real, personal and mixed property of every class and description, wherever situate; and in particular lands, buildings, business concerns and undertakings, book debts and claims, and any interest in real or personal property, and any claims against such property, or against any person or company, and to carry on any business, concern or undertaking so acquired.

To acquire the good will, rights and property and to undertake the whole or any part of the assets and liabilities, of any person, firm, association or corporation; to pay for the same in cash, the stock of this company, bonds or otherwise; to hold or in any manner to dispose of the whole or any part of the property so purchased; to conduct in any lawful manner the whole or any part of any business so acquired and to exercise all the powers necessary or convenient in and about the conduct and management of such business.

To borrow money from and to lend money to any other corporation, or any firm, association, or individual, including corporations in which this corporation is interested as a stockholder or otherwise.

To enter into, make and perform contracts of every kind for any lawful purpose, without limit as to amount, with any person, firm, association or corporation, town, city, county, state, territory or government.

To draw, make, accept, endorse, discount, execute and issue promissory notes, drafts, bills of exchange, warrants, debentures and other negotiable or transferable instruments.

To issue bonds, debentures or obligations and to secure the same by mortgage, pledge, deed of trust or otherwise.

To purchase, hold and reissue the shares of its capital stock.

To carry on any or all of its operations and business and to promote its objects within the State of Delaware or elsewhere, without restriction as to place or amount.

To carry on any other business in connection therewith.

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To do all and everything necessary, suitable, convenient or proper for the accomplishment of any of the purposes, or the attainment of any one or more of the objects herein enumerated or incidental to the powers herein named, or which shall at any time appear conducive or expedient for the protection or benefit of the corporation.

To do any or all of the things herein set forth to the same extent as natural persons might or could do and in any part of the world, as principals, agents, contractors, trustees or otherwise, alone or in company with others.

The foregoing clauses shall be construed both as objects and powers, and it is hereby expressly provided that the foregoing enumeration of specific powers shall not be held to limit or restrict in any manner the powers of this corporation, and are in furtherance of, and in addition to, and not in limitation of the general powers conferred by the laws of the State of Delaware.

It is the intention that the purposes, objects and powers specified in this Article Third and all sub-divisions thereof shall, except as otherwise expressly provided, in nowise be limited or restricted by reference to or inference from the terms of any other clause or paragraph of this article, and that each of the purposes, objects and powers specified in this Article Third shall be regarded as independent purposes, objects and powers.

FOURTH. The total number of shares of stock of all classes which the Corporation shall have authority to issue is 121,000,000 divided into 1,000,000 shares of Preferred Stock of the par value of \$1.00 each and 120,000,000 shares of Common Stock of the par value of \$5.00 each.

The designations and the powers, preferences and rights, and the qualifications, limitations or restrictions thereof, of each class of stock are as follows:

The Board of Directors is expressly authorized at any time, and from time to time, to provide for the issuance of shares of Preferred Stock in one or more series, with such voting powers, full or limited, or without voting powers and with such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the resolution or resolutions providing for the issue thereof adopted by the Board of Directors, subject to the limitations prescribed by law and in accordance with the provisions hereof, including (but without limiting the generality thereof) the following:

(a) The designation of the series and the number of shares to constitute the series.

(b) The dividend rate of the series, the conditions and dates upon which such dividends shall be payable, the relation which such dividends shall bear to the dividends payable on any other class or classes of stock, and whether such dividends shall be cumulative or non-cumulative.

(c) Whether the shares of the series shall be subject to redemption by the corporation and, if made subject to such redemption, the times, prices and other terms and conditions of such redemption.

(d) The terms and amount of any sinking fund provided for the purchase or redemption of the shares of the series.

(e) Whether or not the shares of the series shall be convertible into or exchangeable for shares of any other class or classes or of any other series of any class or classes of stock of the corporation, and, if provision be made for conversion or exchange, the times, prices, rates, adjustments and other terms and conditions of such conversion or exchange.

(f) The extent, if any, to which the holders of the shares of the series shall be entitled to vote with respect to the election of directors or otherwise.

(g) The restrictions, if any, on the issue or reissue of any additional Preferred Stock.

(h) The rights of the holders of the shares of the series upon the dissolution, liquidation, or winding up of the corporation.

Subject to the prior or equal rights, if any, of the Preferred Stock of any and all series stated and expressed by the Board of Directors in the resolution or resolutions providing for the issuance of such Preferred Stock, the holders of Common Stock shall be entitled (i) to receive dividends when and as declared by the Board of Directors out of any funds legally available therefor, (ii) in the event of any dissolution, liquidation or winding up of the corporation, to receive the remaining assets of the corporation, ratably according to the number of shares of Common Stock held, and (iii) to one vote for each share of Common Stock held. No holder of Common Stock shall have any pre-emptive right to purchase or subscribe for any part of any issue of stock or of securities of the corporation convertible into stock of any class whatsoever, whether now or hereafter authorized.

FIFTH. The minimum amount of capital with which it will commence business is one Thousand Dollars (\$1,000.00).

SIXTH. The name and place of residence of each of the incorporators are as follows:

<u>NAME</u>	<u>RESIDENCE</u>
S.L. MACKEY	WILMINGTON, DELAWARE
J. SKRIVAN	WILMINGTON, DELAWARE
M. C. PALMATARY	WILMINGTON, DELAWARE

SEVENTH. The existence of this corporation is to be perpetual.

EIGHTH. The private property of the stockholders of this corporation shall not be subject to the payment of corporate debts to any extent whatever.

NINTH. In furtherance and not in limitation of the powers conferred by the laws of the State of Delaware, the board of directors is expressly authorized:

To make, alter, amend and repeal the by-laws;

To set apart out of any of the funds of the corporation available for dividends a reserve or reserves for any proper purpose and to alter or abolish any such reserve; to authorize and cause to be executed mortgages and liens upon the property and franchises of this corporation.

To designate, by resolution passed by a majority of the whole board, one or more committees, each to consist of two or more directors, which committees, to the extent provided in such resolution or in the by-laws of the corporation, shall have and may exercise any or all of the powers of the board of directors in the management of the business and affairs of this corporation and have power to authorize the seal of this corporation to be affixed to all papers which may require it.

From time to time to determine whether and to what extent and at what times and places and under what conditions and regulations the books and accounts of this corporation, or any of them other than the stock ledger, shall be open to the inspection of the stockholders, and no stockholder shall have any right to inspect any account or book or document of the corporation, except as conferred by law or authorized by resolution of the directors or of the stockholders.

To sell, lease or exchange all of its property and assets, including its good will and its corporate franchises, upon such terms and conditions and for such consideration, which may be in whole or in part shares of stock in, and/or other securities of, any other corporation or corporations, when and as authorized by the affirmative vote of the holders of a majority of the stock issued and outstanding having voting power given at a stockholders' meeting duly called for that purpose.

Directors need not be elected by ballot.

TENTH. In the absence of fraud, no contract or transaction between this corporation and any other association or corporation shall be affected by the fact that any of the directors or officers of this corporation are interested in or are directors or officers of such other association or corporation, and any director or officer of this corporation individually may be a party to, or may be interested in, any such contract or transaction of this corporation; and no such contract or transaction of this corporation with any person or persons, firm, association or corporation shall be affected by the fact that any director or officer of this corporation is a party to, or interested in, such contract or transaction, or in any way connected with such person or persons, firm, association or corporation; and each and every person who may become a director or officer of this corporation is hereby relieved from any liability that might otherwise exist from thus contracting with this corporation for the benefit of himself or any person, firm, association or corporation in which he may be in any way interested; provided, however, that in any such case the fact of such interests shall be disclosed to the other directors or stockholders acting upon or in reference to such contract or transaction.

ELEVENTH. This corporation may in its By-Laws make any other provision or requirements for the management or conduct of the business of this corporation, provided the

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same be not inconsistent with the provisions of this certificate or contrary to the laws of the State of Delaware, or of the United States.

TWELFTH. This corporation reserves the right to amend, alter, change, add to or repeal any provision contained in this Certificate of Incorporation in the manner now or hereafter prescribed by statute, and all rights conferred upon officers, directors, and stockholders herein are granted subject to this reservation. Any action required or permitted to be taken by the stockholders of this corporation must be effected at an annual or special meeting of stockholders and may not be effected by any consent in writing by such stockholders.

THIRTEENTH.

1. In addition to any affirmative vote required by law or this Certificate of Incorporation, and except as otherwise expressly provided in paragraph 2 of this Article Thirteenth:

- (a) any merger, consolidation or share exchange of the corporation or any Subsidiary (as hereinafter defined) with any Interested Stockholder (as hereinafter defined) or any other corporation (whether or not itself an Interested Stockholder) which is, or after such merger, consolidation or share exchange would be, an Affiliate (as hereinafter defined) of an Interested Stockholder; or
- (b) any sale, lease, exchange, mortgage, pledge, transfer or other disposition (in one transaction or a series of transactions) to or with any Interested Stockholder or any Affiliate of any Interested Stockholder of any assets of the corporation or any Subsidiary having an aggregate Fair Market Value (as hereinafter defined) of \$10,000,000 or more; or
- (c) the issuance or transfer by the corporation or any Subsidiary (in one transaction or a series of transactions) of any securities of the corporation or any Subsidiary to any Interested Stockholder or any Affiliate of any Interested Stockholder in exchange for cash, securities or other property (or a combination thereof) having an aggregate Fair Market Value of \$5,000,000 or more; or
- (d) the adoption of any plan or proposal for the liquidation or dissolution of the corporation proposed by or on behalf of an Interested Stockholder or any Affiliate of any Interested Stockholder; or
- (e) any reclassification of securities (including any reverse stock split), or recapitalization of the corporation, or any merger or consolidation of the corporation with any of its Subsidiaries or any other transaction (whether or not with or into or

otherwise involving an Interested Stockholder) which has the effect, directly or indirectly, of increasing the proportionate share of the outstanding shares of any class of equity or convertible securities of the corporation or any Subsidiary which is directly or indirectly owned by any Interested Stockholder or any Affiliate of any Interested Stockholder;

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shall require the affirmative vote of the holders of at least 75% of the then outstanding shares of capital stock of the corporation entitled to vote in the election of directors (the "Voting Stock"), voting together as a single class (each share of Voting Stock having the number of votes granted to it pursuant to Article Fourth of this Certificate of Incorporation). Such affirmative vote shall be required notwithstanding the fact that no vote may be required, or that a lesser percentage may be specified, by law or in any agreement with any national securities exchange or otherwise.

The term "Business Combination" as used in this Article Thirteenth shall mean any transaction which is referred to in any one or more of sub-paragraphs (a) through (e) of this paragraph 1.

2. The provisions of paragraph 1 of this Article Thirteenth shall not be applicable to any particular Business Combination, and such Business Combination shall require only such affirmative vote as is required by law and any other provision of this Certificate of Incorporation, if all of the conditions specified in either of the following sub-paragraphs (a) or (b) are met:

(a) The Business Combination shall have been approved by a majority of the Disinterested Directors (as hereinafter defined).

(b) All of the following conditions shall have been met:

(i) The aggregate amount of cash and the Fair Market Value as of the date of the consummation of the Business Combination of consideration other than cash to be received per share by holders of Common Stock in such Business Combination shall be at least equal to the highest per share price (including any brokerage commissions, transfer taxes and soliciting dealers' fees) paid by the Interested Stockholder for any share of Common Stock acquired by it within the two year period immediately prior to the first public announcement of the proposal of the Business Combination (the "Announcement Date") or in the transaction in which it became an Interested Stockholder, whichever is higher, after giving effect to any appropriate adjustment for stock dividends, stock splits and similar recapitalizations.

(ii) The aggregate amount of cash and the Fair Market Value as of the date of the consummation of the Business Combination of consideration other than cash to be received per share by holders of shares of any class of outstanding Preferred Stock (as hereinafter defined) shall be at least equal to the higher of (A) the highest per share price (including any brokerage commissions, transfer taxes and soliciting dealers' fees) paid by the Interested Stockholder for any shares of such class of Preferred Stock acquired by it (i) within the two-year period immediately prior to the Announcement Date or (ii) in the transaction in which it became an Interested Stockholder, whichever is higher; or (B) the highest preferential amount per share to which the holders of shares of such class of Preferred

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Stock would be entitled in the event of any voluntary or involuntary liquidation, dissolution or winding up of the affairs of the corporation, regardless of whether the Business Combination to be consummated constitutes such an event. The provisions of this sub-paragraph (b)(ii) shall be required to be met with respect to every class of outstanding Preferred Stock, whether or not the Interested Stockholder has previously acquired any shares of a particular class of Preferred Stock.

(iii) The consideration to be received by holders of a particular class of outstanding Voting Stock shall be in cash or in the same form as the Interested Stockholder has previously paid for shares of such class of Voting Stock. If the Interested Stockholder has paid for shares of any class of Voting Stock with varying forms of consideration, the form of consideration for such class of Voting Stock shall be either cash or the form used to acquire the largest number of shares of such class of Voting Stock previously acquired by it.

(iv) A Proxy or information statement describing the proposed Business Combination and complying with the requirements of the Securities Exchange Act of 1934 and the rules and regulations thereunder (or any subsequent

provisions replacing such Act, rules or regulations) shall be mailed by the Company to public stockholders of the corporation at least 30 days prior to the consummation of such Business Combination (whether or not such proxy or information statement is required to be mailed pursuant to such Act or subsequent provisions).

3. For the purposes of this Article Thirteenth.

(a) "Person" shall mean any individual, firm, corporation or other entity.

(b) "Interested Stockholder" shall mean any person (other than the corporation or any Subsidiary) who:

(i) is the beneficial owner (as hereinafter defined) of more than 10% of the voting power of the outstanding Voting Stock; or

(ii) is an Affiliate of the corporation and at any time within the two-year period immediately prior to the date in question was the beneficial owner of 10% or more of the voting power of the then outstanding Voting Stock; or

(iii) is an assignee of or has otherwise succeeded to any shares of Voting Stock which were at any time within the two-year period immediately prior to the date in question beneficially owned by any Interested Stockholder, if such assignment or succession shall have occurred in the course of a transaction or series of transactions not

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involving a public offering within the meaning of the Securities Act of 1933.

(c) A person shall be a "beneficial owner" of any voting Stock:

(i) which such person or any of its Affiliates or Associates beneficially owns, directly or indirectly; or

(ii) which such person or any of its Affiliates or Associates has, directly or indirectly, (A) the right to acquire (whether such right is exercisable immediately or only after the passage of time), pursuant to any agreement, arrangement or understanding or upon the exercise of conversion rights, exchange rights, warrants or options, or otherwise, or (B) the right to vote pursuant to any agreement, arrangement or understanding; or

(iii) which are beneficially owned, directly or indirectly, by any other person with which such person or any of its Affiliates or Associates has any agreement, arrangement or understanding for the purpose of acquiring, holding, voting or disposing of any shares of Voting Stock.

(d) For the purposes of determining whether a person is an Interested Stockholder pursuant to sub-paragraph (b) of this paragraph 3, the number of shares of Voting Stock deemed to be outstanding shall include shares deemed owned through application of sub-paragraph (c) of this paragraph 3 but shall not include any other shares of Voting Stock which may be issuable pursuant to any agreement, arrangement or understanding, or upon exercise of conversion rights, warrants or options, or otherwise.

(e) "Affiliate" or "Associate" shall have the respective meanings ascribed to such terms in Rule 12b-2 of the General Rules and Regulations under the Securities Exchange Act of 1934, as in effect on August 13, 1985.

(f) "Subsidiary" means any corporation of which a majority of any class of equity security is owned, directly or indirectly, by the corporation; provided, however, that for the purposes of the definition of Interested Stockholder set forth in sub-paragraph (b) of this paragraph 3, the term "Subsidiary" shall mean only a corporation of which a majority of each class of equity security is owned, directly or indirectly, by the corporation.

(g) The term "Disinterested Director" means any member of the Board of Directors of the corporation (the "Board") who is unaffiliated with the Interested Stockholder and was a member of the Board prior to the time that the Interested Stockholder became an Interested Stockholder, and any successor of a Disinterested Director who is unaffiliated with the Interested Stockholder and is recommended to succeed a Disinterested Director by a majority of Disinterested Directors then on the Board.

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(h) The term "Fair Market Value" means: (i) in the case of stock, the highest closing sale price during the 30-day period immediately preceding the date in question of a share of such stock on the Composite Tape for New York Stock Exchange-Listed Stocks, or, if such stock is not quoted on the Composite Tape, on the New York Stock Exchange, or, if such stock is not listed on such Exchange, on the principal United States securities exchange registered under the Securities Exchange Act of 1934 on which such stock is listed, or, if such stock is not listed on any such exchange, the highest closing bid quotation with respect to a share of such stock during the 30-day period preceding the date in question on the National Association of Securities Dealers, Inc. Automated Quotations System or any system then in use, or if no such quotations are available, the fair market value on the date in question of a share of such stock as determined by the Board in good faith; and (ii) in the case of property other than cash or stock, the fair market value of such property on the date in question as determined in good faith by a majority of Disinterested Directors.

(i) The term "Preferred Stock" shall mean the Preferred Stock, Preference Stock and Cumulative Preferred Stock and any other class of preferred stock which may from time to time be authorized in or by the Certificate of Incorporation of the Corporation and which by the terms of its issuance is specifically designated "Preferred Stock" for purposes of this Article Thirteenth.

(j) In the event of any Business Combination in which the corporation survives, the phrase "consideration other than cash" as used in sub-paragraphs (b)(i) and (ii) of paragraph 2 of this Article Thirteenth shall include the shares of Common Stock and/or the shares of any other class of Voting Stock retained by the holders of such shares.

4. Nothing contained in this Article Thirteenth shall be construed to relieve any Interested Stockholder from any fiduciary obligation imposed by law.

5. A majority of the Disinterested Directors shall have the power to interpret all of the terms and provisions of this Article Thirteenth and to make any other factual determination as is necessary.

6. Notwithstanding any other provisions of this Certificate of Incorporation, the By-Laws of the corporation (and notwithstanding the fact that a lesser percentage may be specified by law, this Certificate of Incorporation or the By-Laws of the corporation), the affirmative vote of the holders of 75% or more of the shares of Voting Stock, voting together as a single class, shall be required to amend or repeal, or adopt any provisions inconsistent with, this Article Thirteenth; provided, however, that this paragraph 6 shall not apply to, and such 75% vote shall not be required for, any amendment, repeal or adoption unanimously recommended by the Board of Directors if all such directors are persons who would be eligible to serve as Disinterested Directors within the meaning of this Article Thirteenth.

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FOURTEENTH. No director of the corporation shall be personally liable to the corporation or its stockholders for monetary damage for breach of fiduciary duty as a director, except for liability (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under Section 174 of the Delaware General Corporation Law, or (iv) for any transaction from which the director derived an improper personal benefit.

Dated: November 23, 2004

/s/ Norman C. Linnell

Norman C. Linnell  
Vice President and Secretary





DONALDSON COMPANY, INC.

\$30,000,000  
4.85% Senior Notes, Series 2004-A  
Due December 17, 2011

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SECOND SUPPLEMENT AND  
FIRST AMENDMENT TO  
NOTE PURCHASE AGREEMENT

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Dated as of September 30, 2004

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PPN: 257651 B\*9

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SECOND SUPPLEMENT AND  
FIRST AMENDMENT TO  
NOTE PURCHASE AGREEMENT

THIS SECOND SUPPLEMENT AND FIRST AMENDMENT TO NOTE PURCHASE AGREEMENT (this "Second Supplement") is entered into as of September 30, 2004 between Donaldson Company, Inc., a Delaware corporation (the "Company"), each Purchaser listed in the attached Schedule A (individually a "Purchaser" and collectively, the "Purchasers") and the other holders of outstanding Notes executing the signature pages hereto for the purpose of agreeing to Section 1(c) hereof and the amendments to the Note Purchase Agreement (the "other noteholders") contained herein.

RECITALS

A. The Company has previously entered into a Note Purchase Agreement dated as of July 15, 1998 with the institutions listed in Schedule A thereto and a First Supplement to Note Purchase Agreement dated as of August 1, 1998 with the institutions named in Schedule A thereto (as so supplemented, the "Note Purchase Agreement");

B. The Purchasers and other noteholders own all of the Notes outstanding as set forth in the attached Schedule B;

C. The Company has entered into an amended and restated credit agreement with its banks that provides, among other things, for the obligations of the Company thereunder to be guaranteed by certain Subsidiaries of the Company; and

D. The Company desires to issue and sell, and the Purchasers desire to purchase, an additional series of Notes (as defined in the Note Purchase Agreement) pursuant to the Note Purchase Agreement and in accordance with the terms set forth below;

NOW, THEREFORE, the Company, the Purchasers and the other noteholders agree as follows:

1. Authorization of the New Series of Notes; Subsidiary Guaranty; Release .

(a) Description of Series 2004-A Notes . The Company has authorized the issue and sale of \$30,000,000 aggregate principal amount of Notes to be designated as its 4.85% Senior Notes, Series 2004-A, due December 17, 2011 (the "Series 2004-A Notes," such term to include any such Notes issued in substitution therefor pursuant to Section 13 of the Note Purchase Agreement). The Series 2004-A Notes shall be substantially in the form set out in Exhibit 1(a), with such changes therefrom, if any, as may be approved by the Purchasers and the Company.

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(b) Subsidiary Guaranties . All of the outstanding Notes and the Series 2004-A Notes, will be guaranteed by the Subsidiary Guarantors pursuant to a guaranty substantially in the form set out in Exhibit 1(b) (the "Subsidiary Guaranty").

(c) Release of Subsidiary Guaranty . Each holder of a Note agrees to release and discharge a Subsidiary Guarantor from the Subsidiary Guaranty upon written request of the Company, provided that (i) such Subsidiary has been, or concurrently with the release by the holders of Notes, will be released and discharged as guarantor under and in respect of the Credit Agreement and any other Indebtedness of the Company; (ii) such release and discharge is not part of a plan of financing that contemplates such Subsidiary Guarantor guaranteeing any other Indebtedness of the Company or becoming a borrower under the Credit Agreement; (iii) no Default or Event of Default exists or will exist immediately following such release and discharge; (iv) if any fee or other consideration is paid or given to any holder of Indebtedness in connection with such release, other than the repayment of all or a portion of such Indebtedness, each holder of a Note receives equivalent consideration on a pro rata basis; and (v) at the time of such written request, the Company delivers to each holder of Notes a certificate of a Responsible Officer certifying the matters set forth in clauses (i) through (iv).

2. Sale and Purchase of Series 2004-A Notes . Subject to the terms and conditions of this Second Supplement and the Note Purchase Agreement, the Company will issue and sell to the Purchasers, and the Purchasers will purchase from the Company, at the Closing provided for in Section 3, Series 2004-A Notes in the principal amount specified opposite their names in the attached Schedule A at the purchase price of 100% of the principal amount thereof. The obligations of the Purchasers hereunder are several and not joint obligations and no Purchaser shall have any liability to any Person for the performance or non-performance by any other Purchaser hereunder.

3. Closing . The sale and purchase of the Series 2004-A Notes to be purchased by the Purchasers shall occur at the offices of Gardner Carton & Douglas LLP, Suite 3700, 191 North Wacker Drive, Chicago, Illinois 60606 at 9:00 a.m., Chicago time, at a closing on December 17, 2004 (the "Closing") or on such other Business Day thereafter, not later than December 31, 2004, as may be agreed upon by the Company and the Purchasers. At the Closing the Company will deliver to each Purchaser the Series 2004-A Notes to be purchased by it in the form of a single Note (or such greater number of Series 2004-A Notes in denominations of at least \$500,000 as the Purchasers may request) dated the date of the Closing and registered in its name (or in the name of its nominee), against delivery by the Purchasers to the Company or its order of immediately available funds in the amount of the purchase price therefor by wire transfer of immediately available funds for the account of the Company to account number 1502-5005-4130 at US Bank – Minneapolis, US Bank Place, 601 Second Avenue South, Minneapolis, MN 55402, ABA No. 0910-0002-2. If at the Closing the Company shall fail to tender such Series 2004 Notes to a Purchaser as provided above in this Section 3, or any of the conditions specified in Section 4 of the Note Purchase Agreement, as modified or expanded by Section 4 hereof, shall not have been fulfilled to such Purchaser's satisfaction, such Purchaser shall, at its election, be relieved of all further obligations under this Agreement, without thereby waiving any rights it may have by reason of such failure or such nonfulfillment.

4. Conditions to Closing. Each Purchaser's obligation to purchase and pay for the Series 2004-A Notes to be sold to it at the Closing is subject to the fulfillment to its satisfaction, prior to or at the Closing, of the conditions set forth in Section 4 of the Note Purchase Agreement, as hereafter modified, and to the following additional conditions:

(a) References in Section 4 of the Note Purchase Agreement to "Series 1998-A Notes" shall be deemed to be references to the Series 2004-A Notes and references to the "Closing" shall be deemed to refer to the Closing as such term is defined in this Second Supplement;

(b) The legal opinions, and forms thereof, called for by Section 4.4 of the Note Purchase Agreement shall be appropriately modified to reflect this Second Supplement and the transactions contemplated herein, including the authorization, execution and enforceability of the Subsidiary Guaranty and other matters related thereto;

(c) At least three Business Days prior to the date of the Closing, each Purchaser shall have received a copy of written instructions signed by a Responsible Officer on letterhead of the Company confirming the information specified in Section 3 including (i) the name and address of the transferee bank, (ii) such transferee bank's ABA number and (iii) the account name and number into which the purchase price for the Notes is to be deposited;

(d) Each Subsidiary Guarantor shall have executed and delivered the Subsidiary Guaranty and each Purchaser and each other holder of Notes shall have received an executed counterpart thereof; and

(e) The Purchasers and their special counsel shall have been provided with a copy of the executed Credit Agreement.

5. Representations and Warranties of the Company. The Company represents and warrants to the Purchasers that each of the representations and warranties contained in Section 5 of the Note Purchase Agreement is true and correct as of the date hereof (a) except that all references to "Purchasers" and "you" therein shall be deemed to refer to the Purchasers and each Purchaser hereunder, all references to "this Agreement" shall be deemed to refer to the Note Purchase Agreement as supplemented and amended by this Second Supplement, all references to "Notes" therein shall be deemed to include the Series 2004-A Notes, and (b) except for changes to such representations and warranties or the Schedules referred to therein, which changes are set forth in the attached Schedule 5. Section 5 of the Note Purchase Agreement also is amended to modify or add the following representations and warranties:

(a) Section 5.3 is amended to read in its entirety as follows:

### **5.3 Disclosure.**

Except as disclosed in Schedule 5.3, and except for projections, as to which no representation or warranty is made other than as stated in the next

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sentence, this Agreement, the documents, certificates or other writings delivered to you by or on behalf of the Company in connection with the transactions contemplated hereby, including the financial statements listed in Schedule 5.5, taken as a whole, do not contain any untrue statement of a material fact or omit to state any material fact necessary to make the statements therein not misleading in light of the circumstances under which they were made. The projections included in the materials delivered to you by or on behalf of the Company are based on good faith estimates and assumptions that the Company believes are reasonable. Except as expressly described in Schedule 5.3, or in one of the documents, certificates or other writings identified therein, or in the financial statements listed in Schedule 5.5, since July 31, 2003, there has been no change in the financial condition, operations, business, properties or prospects of the Company or any Subsidiary, except changes that individually or in the aggregate could not reasonably be expected to have a Material Adverse Effect. There is no fact known to the Company that could reasonably be expected to have a Material Adverse Effect that has not been set forth herein or in the other documents, certificates and other writings delivered to you by or on behalf of the Company specifically for use in connection with the transactions contemplated hereby.

(b) Section 5.14 is amended to read in its entirety as follows (and all references therein to the 1998-A Notes shall be deemed to refer to the Series 2004-A Notes):

### **5.14. Use of Proceeds; Margin Regulations.**

The Company will apply the proceeds of the sale of the Series 1998-A Notes to the repayment of Indebtedness to banks. No part of the proceeds from the sale of the Series 1998-A Notes hereunder will be used, directly or indirectly, for the purpose of buying or carrying any margin stock within the meaning of Regulation U of the Board of Governors of the Federal Reserve

System (12 CFR 221), other than repurchases of stock of the Company that are in compliance with Regulation U, or for the purpose of buying or carrying or trading in any securities under such circumstances as to involve the Company in a violation of Regulation X of said Board (12 CFR 224) or to involve any broker or dealer in a violation of Regulation T of said Board (12 CFR 220). Margin stock does not constitute more than 10% of the value of the consolidated assets of the Company and its Subsidiaries and the Company does not have any present intention that margin stock will constitute 25% or more of the value of such assets. As used in this Section, the terms “margin stock” and “purpose of buying or carrying” shall have the meanings assigned to them in said Regulation U.

(c) Section 5.16 is amended to read in its entirety as follows:

**5.16. Foreign Assets Control Regulations, Anti-Terrorism Order, etc.**

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Neither the sale of the Notes by the Company hereunder nor its use of the proceeds thereof will violate (a) the Trading with the Enemy Act, as amended, (b) any of the foreign assets control regulations of the United States Treasury Department (31 CFR, Subtitle B, Chapter V, as amended) or any enabling legislation or executive order relating thereto, (c) the Anti-Terrorism Order or (d) the United States Foreign Corrupt Practices Act of 1977, as amended. Without limiting the foregoing, neither the Company nor any Subsidiary (i) is a blocked person described in the Specially Designated Nationals and Blocked Persons List of the Office of Foreign Assets Control or in Section 1 of the Anti-Terrorism Order or (ii) to the knowledge of the Company, engages in any dealings or transactions, or is otherwise associated, with any such person. The Company and its Subsidiaries are in compliance, in all material respects, with all applicable provisions of the USA Patriot Act.

(d) A new Section 5.19 is added to read in its entirety as follows:

**5.19. Solvency of Subsidiary Guarantors.**

After giving effect to the transactions contemplated herein and after giving due consideration to any rights of contribution (i) the fair value of the assets of each Subsidiary Guarantor (both at fair valuation and at present fair saleable value) exceeds its liabilities, (ii) each Subsidiary Guarantor is able to and expects to be able to pay its debts as they mature, and (iii) each Subsidiary Guarantor has capital sufficient to carry on its business as conducted and as proposed to be conducted.

6. Representations of the Purchasers. Each Purchaser confirms to the Company that the representations set forth in Section 6.1 of the Note Purchase Agreement are true and correct as to it, except that all references therein to “you” therein shall be deemed to refer to each Purchaser hereunder, and all references to “Series 1998-A Notes” therein shall be deemed to include the Series 2004-A Notes. Each Purchaser also represents to the Company that it is an “accredited investor” as that term is defined in Rule 501(a) of Regulation D under the Securities Act. Section 6.2 of the Note Purchase Agreement is amended to read in its entirety, which is confirmed by each Purchaser:

**6.2. Source of Funds.**

Each Purchaser represents that that at least one of the following statements is an accurate representation as to each source of funds (a “Source”) to be used by it to pay the purchase price of the Notes to be purchased by it hereunder:

(a) the Source is an “insurance company general account” (as the term is defined in the United States Department of Labor’s Prohibited Transaction Exemption (“PTE”) 95-60) in respect of which the reserves and liabilities (as defined by the annual statement for life insurance companies approved by the National Association of Insurance

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Commissioners (the “NAIC Annual Statement”) for the general account contract(s) held by or on behalf of any employee benefit plan together with the amount of the reserves and liabilities for the general account contract(s) held by or on behalf of any other employee benefit plans maintained by the same employer (or affiliate thereof as defined in PTE 95-60) or by the same employee organization in the general account do not exceed 10% of the total reserves and liabilities of the general account (exclusive of separate account liabilities) plus surplus as set forth in the NAIC Annual Statement filed with its state of domicile; or

(b) the Source is a separate account that is maintained solely in connection with its fixed contractual obligations under which the amounts payable, or credited, to any employee benefit plan (or its related trust) that has any interest in such separate account (or to any participant or beneficiary of such plan (including any annuitant)) are not affected in any manner by the investment performance of the separate account; or

(c) the Source is either (i) an insurance company pooled separate account, within the meaning of PTE 90-1 (issued January 29, 1990), or (ii) a bank collective investment fund, within the meaning of PTE 91-38 (issued August 12, 1991) and, except as it has disclosed to the Company in writing pursuant to this paragraph (c), no employee benefit plan or group of plans maintained by the same employer or employee organization beneficially owns more than 10% of all assets allocated to such pooled separate account or collective investment fund; or

(d) the Source constitutes assets of an “investment fund” (within the meaning of Part V of PTE 84-14 (the “QPAM Exemption”)) managed by a “qualified professional asset manager” or “QPAM” (within the meaning of Part V of the QPAM Exemption), no employee benefit plan’s assets that are included in such investment fund, when combined with the assets of all other employee benefit plans established or maintained by the same employer or by an affiliate (within the meaning of Section V(c)(1) of the QPAM Exemption) of such employer or by the same employee organization and managed by such QPAM, exceed 20% of the total client assets managed by such QPAM, the conditions of Part I(c) and (g) of the QPAM Exemption are satisfied, neither the QPAM nor a person controlling or controlled by the QPAM (applying the definition of “control” in Section V(e) of the QPAM Exemption) owns a 5% or more interest in the Company and (i) the identity of such QPAM and (ii) the names of all employee benefit plans whose assets are included in such investment fund have been disclosed to the Company in writing pursuant to this clause (d); or

(e) the Source constitutes assets of a “plan(s)” (within the meaning of Section IV of PTE 96-23 (the “INHAM Exemption”))

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managed by an “in-house asset manager” or “INHAM” (within the meaning of Part IV of the INHAM exemption), the conditions of Part I(a), (g) and (h) of the INHAM Exemption are satisfied, neither the INHAM nor a person controlling or controlled by the INHAM (applying the definition of “control” in Section IV(h) of the INHAM Exemption) owns a 5% or more interest in any Obligor and (i) the identity of such INHAM and (ii) the name(s) of the employee benefit plan(s) whose assets constitute the Source have been disclosed to the Company in writing pursuant to this clause (e); or

(f) the Source is a governmental plan; or

(g) the Source is one or more employee benefit plans, or a separate account or trust fund comprised of one or more employee benefit plans, each of which has been identified to the Company in writing pursuant to this paragraph (g); or

(h) the Source does not include assets of any employee benefit plan, individual retirement account or other arrangement subject to the prohibited transaction rules under ERISA or the Code.

As used in this Section 6, the terms “employee benefit plan”, “governmental plan” and “separate account” shall have the respective meanings assigned to such terms in Section 3 of ERISA.

7. Scheduled Prepayments of the Series 2004-A Notes. No regularly scheduled prepayments are due on the Series 2004-A Notes prior to their stated maturity.

8. Section 10 of Note Purchase Agreement. Section 10 of the Note Purchase Agreement is amended as follows:

(a) Schedule 10.2. Schedule 10.2 is replaced by Schedule 10.2 to this Second Supplement.

(b) New Section 10.9. A new Section 10.9 is added to read in its entirety as follows:

**10.9. Additional Subsidiary Guarantors.**

The Company will cause any Subsidiary that is organized under the laws of any state or other jurisdiction of the United States and that (whether or not required by the terms of the Credit Agreement) is to guarantee, Indebtedness in respect of the Credit Agreement, to enter into the Subsidiary Guaranty concurrently therewith and as a part thereof to deliver to each of holder of the Notes:

(a) a copy of an executed Joinder to the Subsidiary Guaranty;

(b) a certificate signed by a Responsible Officer of the Company or of such Subsidiary confirming the accuracy of the representations and warranties in paragraphs (a) through (g) of the Joinder to the Subsidiary Guaranty, with respect to such Subsidiary and the Subsidiary Guaranty as it relates to such Subsidiary, as applicable; and

(c) an opinion of counsel (who may be counsel for the Company) reasonably satisfactory to the Required Holders addressed to each holder of the Notes to the effect that the Subsidiary Guaranty of such Subsidiary has been duly authorized, executed and delivered and that the Subsidiary Guaranty constitutes the legal, valid and binding contract and agreement of such Subsidiary enforceable against such Subsidiary in accordance with its terms, except as enforcement of such terms may be limited by bankruptcy, insolvency, fraudulent conveyance and similar laws affecting the enforcement of creditors' rights generally and by general equitable principles.

9. Section 11 of the Note Purchase Agreement. Section 11 of the Note Purchase Agreement is amended as follows:

(a) Section 11(c). Section 11(c) is amended to read in its entirety as follows:

(c) the Company defaults in the performance of or compliance with any term contained in Section 7.1(e) or Sections 10.1 through 10.9; or

(b) Section 11(e). Section 11(e) is amended to read in its entirety as follows:

(e) any representation or warranty made in writing by or on behalf of the Company or any Subsidiary Guarantor or by any officer of the Company or any Subsidiary Guarantor in this Agreement or in the Subsidiary Guaranty or in any writing furnished in connection with the transactions contemplated hereby proves to have been false or incorrect in any material respect on the date as of which made; or

(c) New Section 11(k). A new Section 11(k) is added to read in its entirety as follows:

(k) any Subsidiary Guarantor defaults in the performance of or compliance with any term contained in the Subsidiary Guaranty or the Subsidiary Guaranty ceases to be in full force and effect, except as provided in Section 1(c) of the Second Supplement, or is declared to be null and void in whole or in material part by a court or other governmental or regulatory authority having jurisdiction or the validity or enforceability thereof shall be contested by the Company or any Subsidiary Guarantor or any of them renounces any of the same or denies that it has any or further liability thereunder.

10. Section 15.1 of the Note Purchase Agreement. Section 15.1 of the Note Purchase Agreement is amended to read in its entirety as follows:

### **15.1. Transaction Expenses.**

Whether or not the transactions contemplated hereby are consummated, the Company will pay all costs and expenses (including reasonable attorneys' fees of one special counsel for you and the Other Purchasers collectively and, if reasonably required, local or other counsel) incurred by you and each Other Purchaser or holder of a Note in connection with such transactions and in connection with any amendments, waivers or consents under or in respect of this Agreement, the Notes or the Subsidiary Guaranty (whether or not such amendment, waiver or consent becomes effective), including: (a) the costs and expenses incurred in enforcing or defending (or determining whether or how to enforce or defend) any rights under this Agreement, the Notes or the Subsidiary Guaranty or in responding to any subpoena or other legal process or informal investigative demand issued in connection with this Agreement, the Notes or the Subsidiary Guaranty, or by reason of being a holder of any Note and (b) the costs and expenses, including financial advisors' fees, incurred in connection with the insolvency or bankruptcy of the Company or any Subsidiary or in connection with any work-out or restructuring of the transactions contemplated hereby and by the Notes and the Subsidiary Guaranty. The Company will pay, and will save you and each other holder of a Note harmless from, all claims in respect of any fees, costs or expenses if any, of brokers and finders (other than

those retained by you).

11. **Definitions; Schedule B.** The following definitions in Schedule B are amended in their entirety or the following new definitions are added to Schedule B, in the appropriate alphabetical order:

**“Anti-Terrorism Order”** means Executive Order 13224 of September 23, 2001 Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten to Commit, or Support Terrorism (66 Fed. Reg. 49079 (2001)).

**“Credit Agreement”** means the Amended and Restated Credit Agreement dated as of September 2, 2004 among the Company, various subsidiaries of the Company, The Bank of Tokyo-Mitsubishi, Ltd., Chicago Branch, Lloyds TSB Bank plc, and U.S. Bank National Association, as Co-Syndication Agents, Bank of America, N.A., as Administrative Agent and L/C Issuer and the other Lenders party thereto and Banc of America Securities LLC, as Sole Lead Arranger and Sole Book Manager, as such agreement may be hereafter amended, modified, restated, supplemented, refinanced, increased or reduced from time to time, and any successor credit agreement or similar facilities.

**“INHAM Exemption”** is defined in Section 6.2(e) of the Second Supplement.

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**“Material Adverse Effect”** means a material adverse effect on (a) the business, operations, affairs, financial condition, assets or properties of the Company and its Restricted Subsidiaries taken as a whole, or (b) the ability of the Company to perform its obligations under this Agreement and the Notes, or (c) the ability of any Subsidiary Guarantor to perform its obligations under the Subsidiary Guaranty, or (d) the validity or enforceability of this Agreement, the Notes or the Subsidiary Guaranty.

**“NAIC Annual Statement”** is defined in Section 6.2(a) of the Second Supplement.

**“Priority Debt”** means, as of any date, the sum (without duplication) of (a) unsecured Indebtedness of Domestic Restricted Subsidiaries on such date (other than (i) Indebtedness owed to the Company or another Restricted Subsidiary (ii) Indebtedness of a Person outstanding at the time such Person is merged or consolidated with, or becomes, a Restricted Subsidiary) and (iii) Guaranties by a Subsidiary Guarantor of the Notes and of Indebtedness in respect of the Credit Agreement and (b) Indebtedness of the Company and its Domestic Restricted Subsidiaries secured by Liens permitted by Section 10.2(j) on such date.

**“QPAM Exemption”** is defined in Section 6.2(d) of the Second Supplement.

**“Second Supplement”** means the Second Supplement and First Amendment to Note Purchase Agreement dated as of September 30, 2004 between the Company and the Purchasers and other holders of Notes named in Schedules A and B thereto.

**“Significant Subsidiary”** means, as of the date of determination, (a) any Subsidiary Guarantor and (b) any other Restricted Subsidiary the assets or revenues of which account for more than 10% of the Consolidated Total Assets of the Company and its Restricted Subsidiaries at the end of the most recently ended fiscal period or more than 10% of the consolidated revenues of the Company and its Restricted Subsidiaries for the most recently completed four fiscal quarters.

**“Subsidiary Guarantor”** means Donaldson Capital, Inc., a Minnesota corporation and a Subsidiary, and any other Subsidiary that is organized under the laws of any state or other jurisdiction of the United States and that hereafter becomes a party to the Subsidiary Guaranty.

**“Subsidiary Guaranty”** is defined in Section 1(a) of the Second Supplement.

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**“USA Patriot Act”** means Public Law 107-56 of the United States of America, United and Strengthening America by Providing Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001.

In addition, the reference to “the date of this Agreement” in clause (d) of the definition of “Restricted Investments” is amended to refer to “the

date of the Second Supplement” and Schedule B-1 is amended by substituting therefor Schedule B-1 to this Second Supplement.

12. Applicability of Note Purchase Agreement. Except as otherwise expressly provided herein (and expressly permitted by the Note Purchase Agreement), all of the provisions of the Note Purchase Agreement are incorporated by reference herein and shall apply to the Series 2004-A Notes as if expressly set forth in this Supplement and, except as so provided or where the context otherwise requires, references in the Note Purchase Agreement to “Series 1998-A Notes” and to the “Notes” shall be deemed to refer to the Series 2004-A Notes and to include the Series 2004-A Notes.

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IN WITNESS WHEREOF, the Company, the Purchasers and the other noteholders have caused this Second Supplement to be executed and delivered as of the date set forth above.

DONALDSON COMPANY, INC.

By: /s/ William M. Cook

Name: William M. Cook

Title: President & CEO

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METROPOLITAN LIFE INSURANCE  
COMPANY

By: /s/ Timothy Powell



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Name: Timothy Powell  
Title: Director

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STATE FARM LIFE INSURANCE  
COMPANY

By: /s/ Jeff Attwood

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Name: Jeff Attwood  
Title: Investment Officer

By: /s/ Larry Rottunda

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Name: Larry Rottunda  
Title: Assistant Secretary

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The undersigned holders of Series 1998-A Notes have caused this Second Supplement to be executed solely for the purpose of agreeing to the provisions of Section 1(c) and consenting to the amendments to the Note Purchase Agreement provided for in this Second Supplement.

PRINCIPAL LIFE INSURANCE  
COMPANY,  
ON BEHALF OF ONE OR MORE  
SEPARATE ACCOUNTS

By: Principal Global Investors, LLC,  
a Delaware limited liability company,  
its authorized signatory

By: /s/ Douglas A. Drees  
\_\_\_\_\_

Its: Douglas A. Drees, Counsel

By: /s/ Joellen J. Watts  
\_\_\_\_\_

Its: Joellen J. Watts, Counsel

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MIDLAND NATIONAL LIFE INSURANCE  
COMPANY

By: Midland Advisors Company, as agent

By: /s/ Tyson Rehfeld  
\_\_\_\_\_

Name: Tyson Rehfeld

Title: Vice President

AMERITAS LIFE INSURANCE CORP.

By: Ameritas Investment Advisors, Inc.,  
as agent

By: /s/ Andrew S. White

Name: Andrew S. White  
Title: Vice President

AMERITAS VARIABLE LIFE INSURANCE  
COMPANY

By: Ameritas Investment Advisors, Inc.,  
as agent

By: /s/ Andrew S. White

Name: Andrew S. White  
Title: Vice President

Schedule A to  
Second Supplement

INFORMATION RELATING TO PURCHASERS

<u>Name of Purchaser</u>	<u>Principal Amount of Series 2004-A Notes to be Purchased</u>
Metropolitan Life Insurance Company	\$15,000,000

METROPOLITAN LIFE INSURANCE COMPANY

1 MetLife Plaza  
27-01 Queens Plaza North  
Long Island City, New York 11101

(Securities to be registered in the name of Metropolitan Life Insurance Company)

(1) All scheduled payments of principal and interest by wire transfer of immediately available funds to:

Bank Name: JPMorgan Chase Bank  
ABA Routing #: 021-000-021  
Account No.: 002-2-410591  
Account Name: Metropolitan Life Insurance Company  
Ref: Donaldson Company 4.85% Senior Notes, Series 2004-A due  
December 17, 2011

with sufficient information to identify the source and application of such funds, including issuer, PPN#, interest rate, maturity and whether payment is of principal, interest, make whole amount or otherwise.

For all payments other than scheduled payments of principal and interest, the Company shall seek instructions from the holder, and in the absence of instructions to the contrary, will make such payments to the account and in the manner set forth above.

- (2) All notices and communications:

Metropolitan Life Insurance Company  
Investments, Private Placements  
10 Park Avenue  
Morristown, New Jersey 07962-1902  
Attention: Director  
Facsimile (973) 355-4250

Schedule A

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**With a copy** OTHER than with respect to deliveries of financial statements **to:**

Metropolitan Life Insurance Company  
10 Park Avenue  
Morristown, New Jersey 07962-1902  
Attention: Chief Counsel-Securities Investments (PRIV)  
Facsimile (973) 355-4338

- (3) Original notes delivered to:

Metropolitan Life Insurance Company  
Securities Investments, Law Department  
10 Park Avenue  
Morristown, New Jersey 07962-1902  
Attention: Sandip Khosla, Esq.

- (4) Taxpayer I.D. Number: 13-5581829

INFORMATION RELATING TO PURCHASERS

**STATE FARM LIFE INSURANCE COMPANY**  
**TAX ID #37-0533090**

**Participation/Series:** \$15,000,000/2004-A

**Wire Transfer Instructions:**

JPMorganChase  
ABA# 021000021  
Attn: SSG Private Income Processing  
A/C# 900 9 000200  
For further State Farm Life Insurance Company  
credit to: Custody Account # G06893  
RE: PPN #: 257651 B\* 9 Rate: 4.85% Maturity Date: 12/17/11

**Send notices, financial statements, officer's certificates and other correspondence to:**

State Farm Life Insurance Company  
Investment Dept. E-8  
One State Farm Plaza  
Bloomington, IL 61710

**Send confirms to:**

State Farm Life Insurance Company  
Investment Accounting Dept. D-3  
One State Farm Plaza  
Bloomington, IL 61710

**Send the original security (via registered mail) to:**

JPMorganChase  
Attn: Barbara Walsh  
(North America Insurance)  
3 Chase Metrotech Center-5th Floor  
Brooklyn, New York 11245

**Send an additional copy of the original security plus an original set of closing documents and two conformed copies of the Note Purchase Agreement to:**

State Farm Insurance Companies  
One State Farm Plaza  
Bloomington, Illinois 61710  
Attn: Investment Legal E-3  
Larry Rottunda, Investment Counsel

<u>Holder</u>	<u>Principal Amount</u>		
	<u>6.20% Senior Notes, Series-1998-A, Tranche 1</u>	<u>6.31% Senior Notes, Series-1998-A, Tranche 2</u>	<u>6.39% Senior Notes, Series 1998-B</u>
Metropolitan Life Insurance Company		\$ 22,000,000	\$ 25,000,000
Principal Life Insurance Company	\$ 10,000,000		
Midland National Life Insurance Company*	5,000,000		
State Farm Life Insurance Company	5,000,000	5,000,000	
Ameritas Life Insurance Company	2,000,000		
Ameritas Variable Life Insurance Company	1,000,000		
Total	\$ 23,000,000	\$ 27,000,000	\$ 25,000,000

\* Beneficial owner. Registered in the name of Hare & Co.

#### Schedule B

Schedule B-1 to  
Second Supplement

#### EXISTING INVESTMENTS

Investment in Advanced Filtration Systems Inc.	\$ 9,594,000
Investment in PT Panata Jaya Mandiri	\$ 4,186,000
Investment in Rashed al-Rashed & Sons-Donaldson Ltd.	\$ 761,000
Investment in Onboard Technologies	\$ 200,000
Loan to Jay Ward in the amount of	\$ 10,000
Loan to Mys-Tec Sales, Inc. in the amount of	\$ 292,000

Schedule B-1

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Schedule 5 to  
Second Supplement

EXCEPTIONS TO REPRESENTATIONS  
AND WARRANTIES

**Section 5.4.** Schedule 5.4 is replaced by Schedule 5.4 to this Second Supplement.

**Section 5.5.** Schedule 5.5 is replaced by Schedule 5.5 to this Second Supplement.

**Section 5.8.** Schedule 5.8 is replaced by Schedule 5.8 to this Second Supplement.

**Section 5.9.** Reference to December 31, 1990 shall be deemed to refer to July 31, 2000.

**Section 5.11.** Schedule 5.11 is replaced by Schedule 5.11 to this Second Supplement.

**Section 5.13.** Reference to the number 42 shall be deemed to refer to 4.

**Section 5.15.** Reference to April 20, 1998 shall be deemed to refer to July 31, 2004 and Schedule 5.15 is replaced with Schedule 5.15 to this Second Supplement.

Schedule 5

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Schedule 5.3 to  
Second Supplement

DISCLOSURE MATERIALS

Schedule 5.3

Schedule 5.4 to  
Second Supplement

**SUBSIDIARIES AND OWNERSHIP OF SUBSIDIARY STOCK**

**(i) Subsidiaries**

\*Unless otherwise noted, all listed subsidiaries are owned 100% by Donaldson Company, Inc. or a Subsidiary of the Donaldson Company, Inc.

Donaldson Capital, Inc. (Minnesota, U.S.A.)  
Nippon Donaldson, Ltd. (Japan)  
Donaldson Korea Company, Ltd. (Republic of South Korea)  
Donaldson Filtration (Asia Pacific) Pte. Ltd. (Singapore)  
Donaldson Australasia Pty, Ltd. (Australia)  
Donaldson India Filter Systems Private Limited (India)  
P.T. Donaldson Systems Indonesia (Indonesia) (96.5% net ownership by the Donaldson Company, Inc.)  
ASHC, Inc (U.S.A.)  
    Prestadora de Servicios Aquas S. de R.L. de C.V. (Mexico)

Donaldson Filtration Industrial S. de R.L. de C.V. (Mexico)  
Donaldson S.A. de C.V. (Mexico)  
    DIEMO S.A. de C.V. (Mexico)

Donaldson Sales, Inc. (Barbados)  
Donaldson do Brazil M&E Limitida (Brazil)  
Donaldson Filtration Systems Pty, Ltd. (South Africa)  
Donaldson Canada, Inc. (Canada)  
ultrafilter Pty, Ltd (Australia)  
ultrafilter Co Ltd. (Thailand)  
Donaldson Filtration Inc. (Phillipines)  
Donaldson Filtration sdn hdn (Malaysia)  
PT ultrafilter (Indonesia)  
ultrafilter Pte Ltd.

-Donaldson Luxembourg S.a.r.l. (Luxembourg)  
    Donaldson Coordination Center, B.V.B.A. (Belgium)  
    Donaldson Torit, B.V. (Netherlands)  
        Donaldson Nederland B.V. (Netherlands)  
        ultrafilter B.V. (Netherlands)



Donaldson Schweiz GmbH (Switzerland)  
ultrafilter AG (Switzerland)  
Donaldson Filtre Sistemleri Ticaret Ltd Sirketi (Turkey)  
ultrafilter s.r.o. (Slovakia)  
ultrafilter sp. zoo (Poland)

Schedule 5.4

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Donaldson Polska sp. zoo (Poland)  
ultrafilter AS (Norway)  
Donaldson Italia Srl (Italy)  
Donaldson Filtration Österreich GmbH (Austria)  
ultrafilter s.l. (Spain)  
ultrafilter s.r.o (Czech Republic)  
Donaldson Czech Republic (Czech Republic)

Donaldson France, S.A.S. (France)  
Tecnov Donaldson, S.A.S. (France)  
ultrafilter S.A.S. (France)  
Donaldson Filtros Iberica S.L. (Spain)

Donaldson Scandinavia APS (Denmark)  
ultrafilter APS (Denmark)

Donaldson Far East Limited (Hong Kong)  
Donaldson (Wuxi) Filters Co., Ltd. (China)  
Shanghai Donaldson Filtration Co., Ltd. (China)  
Donaldson Ltd. (Thailand)

Donaldson Europe, B.V.B.A. (Belgium)  
Donaldson Belgie B.V.B.A. (Belgium)

Donaldson UK Holding Ltd. (UK)  
ultrafilter Ltd. (UK)  
DCE Donaldson Ltd. (UK)  
DFCH Ltd. (UK)  
Donaldson Filter Components Ltd. (UK)  
Tetratroc Europe Ltd. (UK)  
DCE Ltd. (UK)  
DCE Group Ltd. (UK)  
Donaldson Ibérica, Soluciones en Filtracion, S.L. (Spain)  
DCE Donaldson (Pty) Ltd. (South Africa)

Donaldson Deutschland Holding GmbH (Germany)  
Donaldson GmbH (Germany)  
Torit DCE GmbH (Germany)  
ultrafilter kft (Hungary)

Donaldson Filtration Deutschland GmbH (Germany)  
ultratroc GmbH (Germany)  
ultra air GmbH (Germany)  
Quality Air GmbH (Germany)  
ultrafilter s.r.l. (Romania)  
ultrafilter International AG (Switzerland)

**(ii) Other Affiliates**

Advanced Filtration Systems Inc. (Illinois, USA) 50%  
PT Panata Jaya Mandiri (Jakarta, Indonesia) 30%  
Rashed al-Rashed & Sons-Donaldson Ltd. (Dammam, Saudi Arabia) 49%

**(iii) Directors and Officers**

Directors:

F. Guillaume Bastiaens, Vice Chairman, Cargill, Inc.  
William M. Cook, President and Chief Executive Officer, Donaldson Company, Inc.  
Janet M. Dolan, President and Chief Executive Officer, Tennant Company  
Jack W. Eugster, Non-Executive Chairman, ShopKo Stores, Inc.  
John F. Grundhofer, Chairman Emeritus, U.S. Bancorp  
Kendrick B. Melrose, Chairman and Chief Executive Officer, The Toro Company  
Paul David Miller, Chairman, Alliant Techsystems Inc.  
Jeffrey Noddle, Chairman, President and Chief Executive Officer, SUPERVALU INC.  
William G. Van Dyke, Chairman, Donaldson Company, Inc.  
John P. Wiehoff, Chief Executive Officer and President, C.H. Robinson Worldwide, Inc.

Officers :

William G. Van Dyke, Chairman, Donaldson Company, Inc.  
William M. Cook, President and Chief Executive Officer, Donaldson Company, Inc.  
James R. Giertz, Senior Vice President, Commercial and Industrial  
Nickolas Priadka, Senior Vice President, International  
Lowell F. Schwab, Senior Vice President, Engine Systems and Parts  
Dale M. Couch, Vice President and General Manager, Asia Pacific  
Norman C. Linnell, Vice President, General Counsel and Secretary  
Charles J. McMurray, Vice President, Human Resources  
Geert Henk Touw, Vice President and General Manager, Europe/Middle East/Africa  
William I. Vann, Vice President, Operations  
Thomas R. VerHage, Vice President and Chief Financial Officer

Schedule 5.4

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Schedule 5.5 to  
Second Supplement

**FINANCIAL STATEMENTS**

The only financial statements provided by Donaldson Company, Inc. (other than financial statements delivered to the Purchasers in their capacity as holders of Notes pursuant to Section 7.1(a) and (b)) are the following financial summaries included in the Offering Memorandum described in Schedule 5.3:

Summary of Historical Financial Information (Fiscal 2001-2003)

Summary of Projected Financial Information (Fiscal 2004-2009)

### LITIGATION

The Company is appealing a judgment entered against it in the Engineering Products Company v. Donaldson patent infringement case, which case is discussed in the Company's press release dated August 13, 2004, the text of which appears below:

Press Release

Source: Donaldson Company, Inc.

#### **Donaldson Company to Appeal Judgment** Friday August 13, 6:00 am ET

MINNEAPOLIS, Aug. 13 /PRNewswire-FirstCall/ — Donaldson Company, Inc. (NYSE: DCI – News ) announced today the outcome of post trial motions in the jury trial between Donaldson and Engineered Products Company, Inc. (“EPC”). In 1998, EPC filed a patent infringement lawsuit against Donaldson in the U.S. Federal District Court for the Northern District of Iowa. On May 11, 2004, the jury found in favor of EPC on its willful infringement claims against Donaldson. On August 12, 2004, the Court ruled that damages should be approximately \$16.0 million. Donaldson intends to vigorously challenge the judgment and will appeal the decision to the Federal Circuit Court of Appeals. This appeal could take up to two years or longer. EPC's patent expired on May 1, 2001 and will not impact Donaldson's ongoing business operations. Donaldson confirms previous guidance of delivering its 15th consecutive year of double-digit earnings growth when it issues its fourth quarter earnings release on August 31.

#### **About Donaldson Company, Inc.**

Donaldson Company, Inc., headquartered in Minneapolis, is a leading worldwide provider of filtration systems and replacement parts. Founded in 1915, Donaldson is a technology-driven company committed to satisfying customer needs for filtration solutions through innovative research and development. Donaldson serves customers in the industrial and engine markets including dust collection, power generation, specialty filtration, compressed air purification, off-road equipment, industrial compressors, and trucks. Our 10,000 employees contribute to the company's success at over 30 manufacturing locations around the world. In fiscal year 2003, Donaldson reported sales of more than \$1.2 billion and achieved its 14th consecutive year of double-digit earnings growth. Donaldson is a member of the S&P MidCap 400 Index and Donaldson shares are traded on the New York Stock Exchange under the symbol DCI. Additional company information is available at <http://www.donaldson.com>

**LICENSES, PERMITS, ETC.**

The Company is appealing a judgment entered against it in the Engineering Products Company v. Donaldson patent infringement case, which case is discussed in the Company's press release dated August 13, 2004 (see Schedule 5.8).

The Company also has various ongoing legal assessments and actions relating to violation of certain intellectual property rights of the Company, none of which, however, individually or in the aggregate, could reasonably be expected to have a Material Adverse Effect.

## Schedule 5.11

Schedule 5.15 to  
Second Supplement**INDEBTEDNESS**

Amounts in \$ Millions:

## Short-term debt:

Multi-currency revolving facility	\$	0.0	
Uncommitted credit facilities		12.4	
Credit facilities of international subsidiaries		7.3	\$ 19.7
		<u>          </u>	<u>          </u>

## Current maturities of long-term debt

6.20% Unsecured senior notes due July 15, 2005	\$	23.0	
1.9475% Guaranteed senior notes due Jan 29, 2005		10.7	
Aggregated current capital leases		0.6	\$ 34.3
		<u>          </u>	<u>          </u>

## Long-term debt:

6.31% Unsecured senior notes due July 15, 2008	\$	28.6	
6.39% Unsecured senior notes due August 15, 2010		24.5	
1.51% Guaranteed note due March 28, 2006		7.1	
9.4% Secured installment note due January 31, 2007		0.1	
Aggregated Long-term Capital Leases		2.6	
Variable rate industrial development revenue bonds due September 1, 2024		8.0	\$ 70.9
		<u>          </u>	<u>          </u>

NOTE: Since the close of F'04 (7-31-04), the Donaldson Company, Inc. engaged in the following material transactions.

- The Donaldson Company, Inc. has amended and restated its existing \$150 million three year credit agreement that was to mature on September 27, 2005. The amendment extends the maturity date of the facility to September 2, 2009.

- The Donaldson Company, Inc. has drawn \$75 Million under its amended and restated credit agreement.
- The Company has repurchased three million shares, or approximately 3.5 percent, of its outstanding common stock after the market closed on September 3, 2004. The shares were purchased from Banc of America Securities LLC under an overnight share repurchase program at a total cost of approximately \$86.5 million.

Schedule 5.15

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Schedule 10.2 to  
Second Supplement

**LIENS**

Donaldson Filtration Systems (Pty) Ltd Secured Note of 726,000 Rand

Capitalized leases in the aggregate amount of Euro 2,657,000

Schedule 10.2

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Exhibit 1(a) to  
Second Supplement

**[FORM OF SERIES 2004-A NOTE]**

DONALDSON COMPANY, INC.

4.85% Senior Note, Series 2004-A  
due December 17, 2011

No. [\_\_\_\_\_]   
 \$[\_\_\_\_\_]

[Date]   
 PPN: 257651 B\*9

FOR VALUE RECEIVED, the undersigned, DONALDSON COMPANY, INC. (herein called the "Company"), a corporation organized and existing under the laws of the State of Delaware, promises to pay to [ ], or registered assigns, the principal sum of \$[ ] on December 17, 2011, with interest (computed on the basis of a 360-day year of twelve 30-day months) (a) on the unpaid balance thereof at the rate of 4.85% per annum from the date hereof, payable semiannually, on June 17 and December 17 in each year, commencing with the June 17 or December 17 next succeeding the date hereof, until the principal hereof shall have become due and payable, and (b) to the extent permitted by

law on any overdue payment (including any overdue prepayment) of principal, any overdue payment of interest and any overdue payment of any Make-Whole Amount (as defined in the Note Purchase Agreement referred to below), payable semiannually as aforesaid (or, at the option of the registered holder hereof, on demand), at a rate per annum from time to time equal to the greater of (i) 6.85% or (ii) 2% over the rate of interest publicly announced by Bank of America, NA from time to time in Chicago, Illinois as its "base" or "prime" rate.

Payments of principal of, interest on and any Make-Whole Amount with respect to this Note are to be made in lawful money of the United States of America at the principal office of Bank of America, NA in Chicago, Illinois or at such other place as the Company shall have designated by written notice to the holder of this Note as provided in the Note Purchase Agreement referred to below.

This Note is one of a series of Notes (herein called the "Notes") issued pursuant to a Note Purchase Agreement dated as of July 15, 2004, as supplemented and amended by a First Supplement dated as of August 1, 1998 and a Second Supplement and First Amendment dated as of September 30, 2004 (as so supplemented and amended and as hereafter from time to time amended and supplemented, the "Note Purchase Agreement"), and is entitled to the benefits thereof. Each holder of this Note will be deemed, by its acceptance hereof, (i) to have agreed to the confidentiality provisions set forth in Section 20 of the Note Purchase Agreement and (ii) to have made the representations set forth in Sections 6.1 (to the extent such representation is required for such transfer) and 6.2 of the Note Purchase Agreement. The Notes have not been registered under the Securities Act of 1933, as amended.

#### Schedule 5

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This Note is a registered Note and, as provided in Section 13 of the Note Purchase Agreement, upon surrender of this Note for registration of transfer, duly endorsed, or accompanied by a written instrument of transfer duly executed, by the registered holder hereof or such holder's attorney duly authorized in writing, a new Note for a like principal amount will be issued to, and registered in the name of, the transferee. Prior to due presentment for registration of transfer, the Company may treat the person in whose name this Note is registered as the owner hereof for the purpose of receiving payment and for all other purposes, and the Company will not be affected by any notice to the contrary.

This Note is subject to optional prepayment, in whole or from time to time in part, at the times and on the terms specified in the Note Purchase Agreement but not otherwise.

If an Event of Default, as defined in the Note Purchase Agreement, occurs and is continuing, the principal of this Note may be declared or otherwise become due and payable in the manner, at the price (including any applicable Make-Whole Amount) and with the effect provided in the Note Purchase Agreement.

Payment of the principal of, and interest and Make-Whole Amount, if any, on this Note, and all other amounts due under the Note Purchase Agreement, is guaranteed pursuant to the terms of a Subsidiary Guaranty dated as of December 17, 2004 of certain Subsidiaries of the Company.\*

This Note shall be construed and enforced in accordance with, and the rights of the parties shall be governed by, the law of the State of Illinois excluding choice-of-law principles of the law of such State that would require the application of the laws of a jurisdiction other than such State.

DONALDSON COMPANY, INC.

By: \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_

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\* This paragraph must be deleted at such time as there are no Subsidiary Guarantors.

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Exhibit 1(a)

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Exhibit 1(b) to  
Second Supplement

#### FORM OF SUBSIDIARY GUARANTY

THIS GUARANTY (this "Guaranty") dated as of December 17, 2004 is made by the undersigned (each, a "Guarantor"), in favor of the holders from time to time of the Notes hereinafter referred to and their respective successors and assigns (collectively, the "Holders" and each individually, a "Holder").

#### WITNESSETH:

WHEREAS, Donaldson Company, Inc. (the "Company") entered into a Note Purchase Agreement dated as of July 15, 1998, a First Supplement to Note Purchase Agreement dated as of August 1, 1998 and a Second Supplement and First Amendment dated as of September 30, 2004 (the Note Purchase Agreement as so supplemented and amended and as it may hereafter be amended, supplemented, restated or otherwise modified from time to time in accordance with its terms, the "Note Purchase Agreement");

WHEREAS, the Note Purchase Agreement provides for the issuance by the Company of up to \$150,000,000 aggregate principal amount of Notes (as defined in the Note Purchase Agreement), of which the Company has heretofore issued \$50,000,000 aggregate principal amount of Series 1998-A Notes and \$25,000,000 aggregate principal amount of Series 1998-B Notes and, concurrently with the delivery by the Guarantors of this Guaranty, is issuing \$30,000,000 aggregate principal amount of Series 2004-A Notes;

WHEREAS, the Parent owns, directly or indirectly, all of the issued and outstanding capital stock or partnership interests of each Guarantor and, by virtue of such ownership and otherwise, each Guarantor will derive substantial benefits from the purchase by the Holders of the Company's Notes;

WHEREAS, it is a condition precedent to the obligation of the Holders to purchase the Notes that each Guarantor shall have executed and delivered this Guaranty to the Holders; and

WHEREAS, each Guarantor desires to execute and deliver this Guaranty to satisfy the conditions described in the preceding paragraph;

NOW, THEREFORE, in consideration of the premises and other benefits to each Guarantor, and of the purchase of the Company's Notes by the Holders, and for other good and valuable consideration, the receipt and sufficiency of which are acknowledged, each Guarantor makes this Guaranty as follows:

Schedule 5

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SECTION 1. Definitions. Any capitalized terms not otherwise herein defined shall have the meanings attributed to them in the Note Purchase Agreement.

SECTION 2. Guaranty. Each Guarantor, jointly and severally with each other Guarantor, unconditionally and irrevocably guarantees to the Holders the due, prompt and complete payment by the Company of the principal of, Make-Whole Amount, if any, and interest on, and each other amount due under, the Notes or the Note Purchase Agreement, when and as the same shall become due and payable (whether at stated maturity or by required or optional prepayment or by declaration or otherwise) in accordance with the terms of the Notes and the Note

Purchase Agreement (the Notes and the Note Purchase Agreement being sometimes hereinafter collectively referred to as the “Note Documents” and the amounts payable by the Company under the Note Documents, and all other monetary obligations of the Company thereunder (including reasonable attorneys’ fees and expenses), being sometimes collectively hereinafter referred to as the “Obligations”). This Guaranty is a guaranty of payment and not just of collectibility and is in no way conditioned or contingent upon any attempt to collect from the Company or upon any other event, contingency or circumstance whatsoever. If for any reason whatsoever the Company shall fail or be unable duly, punctually and fully to pay such amounts as and when the same shall become due and payable, each Guarantor, without demand, presentment, protest or notice of any kind, will forthwith pay or cause to be paid such amounts to the Holders under the terms of such Note Documents, in lawful money of the United States, at the place specified in the Note Purchase Agreement, or perform or comply with the same or cause the same to be performed or complied with, together with interest (to the extent provided for under such Note Documents) on any amount due and owing from the Company. Each Guarantor, promptly after demand, will pay to the Holders the reasonable costs and expenses of collecting such amounts or otherwise enforcing this Guaranty, including, without limitation, the reasonable fees and expenses of counsel. Notwithstanding the foregoing, the right of recovery against each Guarantor under this Guaranty is limited to the extent it is judicially determined with respect to any Guarantor that entering into this Guaranty would violate Section 548 of the United States Bankruptcy Code or any comparable provisions of any state law, in which case such Guarantor shall be liable under this Guaranty only for amounts aggregating up to the largest amount that would not render such Guarantor’s obligations hereunder subject to avoidance under Section 548 of the United States Bankruptcy Code or any comparable provisions of any state law.

SECTION 3. Guarantor’s Obligations Unconditional. The obligations of each Guarantor under this Guaranty shall be primary, absolute and unconditional obligations of each Guarantor, shall not be subject to any counterclaim, set-off, deduction, diminution, abatement, recoupment, suspension, deferment, reduction or defense based upon any claim each Guarantor or any other person may have against the Company or any other person, and to the full extent permitted by applicable law shall remain in full force and effect without regard to, and shall not be released, discharged or in any way affected by, any circumstance or condition whatsoever (whether or not each Guarantor or the Company shall have any knowledge or notice thereof), including:

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- (a) any termination, amendment or modification of or deletion from or addition or supplement to or other change in any of the Note Documents or any other instrument or agreement applicable to any of the parties to any of the Note Documents;
  - (b) any furnishing or acceptance of any security, or any release of any security, for the Obligations, or the failure of any security or the failure of any person to perfect any interest in any collateral;
  - (c) any failure, omission or delay on the part of the Company or the Parent to conform or comply with any term of any of the Note Documents or any other instrument or agreement referred to in paragraph (a) above, including, without limitation, failure to give notice to any Guarantor of the occurrence of a “Default” or an “Event of Default” under any Note Document;
  - (d) any waiver of the payment, performance or observance of any of the obligations, conditions, covenants or agreements contained in any Note Document, or any other waiver, consent, extension, indulgence, compromise, settlement, release or other action or inaction under or in respect of any of the Note Documents or any other instrument or agreement referred to in paragraph (a) above or any obligation or liability of the Company or the Parent, or any exercise or non-exercise of any right, remedy, power or privilege under or in respect of any such instrument or agreement or any such obligation or liability;
  - (e) any failure, omission or delay on the part of any of the Holders to enforce, assert or exercise any right, power or remedy conferred on such Holder in this Guaranty, or any such failure, omission or delay on the part of such Holder in connection with any Note Document, or any other action on the part of such Holder;
  - (f) any voluntary or involuntary bankruptcy, insolvency, reorganization, arrangement, readjustment, assignment for the benefit of creditors, composition, receivership, conservatorship, custodianship, liquidation, marshaling of assets and liabilities or similar proceedings with respect to the Company, the Parent, any Guarantor or to any other person or any of their respective properties or creditors, or any action taken by any trustee or receiver or by any court in any such proceeding;
  - (g) any discharge, termination, cancellation, frustration, irregularity, invalidity or unenforceability, in whole or in part, of any of the Note Documents or any other agreement or instrument referred to in paragraph (a) above or any term hereof;
  - (h) any merger or consolidation of the Company or the Parent or any Guarantor into or with any other corporation, or any sale, lease or transfer of any of the assets of the Company or the Parent or any Guarantor to any other person;



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- (i) any change in the ownership of any shares of capital stock of the Company or the Parent or any change in the corporate relationship between the Company or the Parent and any Guarantor, or any termination of such relationship;
- (j) any release or discharge, by operation of law, of any other Guarantor from the performance or observance of any obligation, covenant or agreement contained in this Guaranty; or
- (k) any other occurrence, circumstance, happening or event whatsoever, whether similar or dissimilar to the foregoing, whether foreseen or unforeseen, and any other circumstance which might otherwise constitute a legal or equitable defense or discharge of the liabilities of a guarantor or surety or which might otherwise limit recourse against any Guarantor.

SECTION 4. Full Recourse Obligations. The obligations of each Guarantor set forth herein constitute the full recourse obligations of such Guarantor enforceable against it to the full extent of all its assets and properties.

SECTION 5. Waiver. Each Guarantor unconditionally waives, to the extent permitted by applicable law, (a) notice of any of the matters referred to in Section 3, (b) notice to such Guarantor of the incurrence of any of the Obligations, notice to such Guarantor or the Company of any breach or default by such Company with respect to any of the Obligations or any other notice that may be required, by statute, rule of law or otherwise, to preserve any rights of the Holders against such Guarantor, (c) presentment to or demand of payment from the Company or the Guarantor with respect to any amount due under any Note Document or protest for nonpayment or dishonor, (d) any right to the enforcement, assertion or exercise by any of the Holders of any right, power, privilege or remedy conferred in the Note Purchase Agreement or any other Note Document or otherwise, (e) any requirement of diligence on the part of any of the Holders, (f) any requirement to exhaust any remedies or to mitigate the damages resulting from any default under any Note Document, (g) any notice of any sale, transfer or other disposition by any of the Holders of any right, title to or interest in the Note Purchase Agreement or in any other Note Document and (h) any other circumstance whatsoever which might otherwise constitute a legal or equitable discharge, release or defense of a guarantor or surety or which might otherwise limit recourse against such Guarantor.

SECTION 6. Subrogation, Contribution, Reimbursement or Indemnity. Until one year and one day after all Obligations have been paid in full, each Guarantor agrees not to take any action pursuant to any rights which may have arisen in connection with this Guaranty to be subrogated to any of the rights (whether contractual, under the United States Bankruptcy Code, as amended, including Section 509 thereof, under common law or otherwise) of any of the Holders against the Company or against any collateral security or guaranty or right of offset held by the Holders for the payment of the Obligations. Until one year and one day after all Obligations have been paid in full, each Guarantor agrees not to take any action pursuant to any contractual, common law, statutory or other rights of reimbursement, contribution, exoneration or indemnity (or any similar right) from or against the Company which may have arisen in

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connection with this Guaranty. So long as the Obligations remain, if any amount shall be paid by or on behalf of the Company to any Guarantor on account of any of the rights waived in this paragraph, such amount shall be held by such Guarantor in trust, segregated from other funds of such Guarantor, and shall, forthwith upon receipt by such Guarantor, be turned over to the Holders (duly endorsed by such Guarantor to the Holders, if required), to be applied against the Obligations, whether matured or unmatured, in such order as the Holders may determine. The provisions of this paragraph shall survive the term of this Guaranty and the payment in full of the Obligations.

SECTION 7. Effect of Bankruptcy Proceedings, etc. This Guaranty shall continue to be effective or be automatically reinstated, as the case may be, if at any time payment, in whole or in part, of any of the sums due to any of the Holders pursuant to the terms of the Note Purchase Agreement or any other Note Document is rescinded or must otherwise be restored or returned by such Holder upon the insolvency, bankruptcy, dissolution, liquidation or reorganization of the Company or any other person, or upon or as a result of the appointment of a custodian, receiver, trustee or other officer with similar powers with respect to the Company or other person or any substantial part of its property, or otherwise, all as though such payment had not been made. If an event permitting the acceleration of the maturity of the principal amount of the Notes shall at any time have occurred and be continuing, and such acceleration shall at such time be prevented by reason of the pendency against the Company or any other person of a case or proceeding under a bankruptcy or insolvency law, each Guarantor agrees that, for purposes of this Guaranty and its obligations hereunder, the maturity of the principal amount of the Notes and all other Obligations shall be deemed to have been accelerated with the same effect as if any Holder had accelerated the same in accordance with the terms of the Note

Purchase Agreement or other applicable Note Document, and such Guarantor shall forthwith pay such principal amount, Make-Whole Amount, if any, and interest thereon and any other amounts guaranteed hereunder without further notice or demand.

SECTION 8. Term of Agreement. This Guaranty and all guaranties, covenants and agreements of each Guarantor contained herein shall continue in full force and effect and shall not be discharged until the earlier to occur of (i) such time as all of the Obligations shall be paid and performed in full and all of the agreements of such Guarantor hereunder shall be duly paid and performed in full and (ii) such Guarantor is released by the Holders pursuant to Section 1(c) of the Second Supplement.

SECTION 9. Representations and Warranties. Each Guarantor represents and warrants to each Holder that:

(a) such Guarantor is duly organized, validly existing and in good standing under the laws of its jurisdiction of organization and has the power and authority to own or hold under lease the properties it purports to own or hold under lease and to transact the business it transacts and proposes to transact;

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(b) such Guarantor has the power and authority to execute and deliver this Guaranty and to perform the provisions hereof, and this Guaranty has been duly authorized by all necessary action on the part of such Guarantor;

(c) this Guaranty constitutes the legal, valid and binding obligation of such Guarantor enforceable against such Guarantor in accordance with its terms, except as such enforceability may be limited by (i) applicable bankruptcy, insolvency, fraudulent conveyance, reorganization, moratorium or other similar laws affecting the enforcement of creditors' rights generally and (ii) general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law);

(d) the execution, delivery and performance of this Guaranty will not (i) contravene, result in any breach of, or constitute a default under, or result in the creation of any Lien in respect of any property of such Guarantor under, any agreement, or corporate charter or by-laws to which such Guarantor is bound or by which such Guarantor or any of its properties may be bound or affected, (ii) conflict with or result in a breach of any of the terms, conditions or provisions of any order, judgment, decree, or ruling of any court, arbitrator or Governmental Authority applicable to such Subsidiary Guarantor or (iii) violate any provision of any statute or other rule or regulation of any Governmental Authority applicable to such Guarantor;

(e) no consent, approval or authorization of, or registration, filing or declaration with, any Governmental Authority is required in connection with the execution, delivery or performance by such Guarantor of this Guaranty;

(f) there are no actions, suits or proceedings pending or, to the knowledge of such Guarantor, threatened against or affecting such Guarantor, or any property of such Guarantor, in any court or before any arbitrator of any kind or before or by any Governmental Authority that, individually or in the aggregate, could reasonably be expected to have a Material Adverse Effect;

(g) after giving effect to the transactions contemplated in the Note Purchase Agreement and after giving due consideration to any rights of contribution (i) the fair value of the assets of such Guarantor (both at fair valuation and at present fair saleable value) exceeds its liabilities, (ii) such Guarantor is able to and expects to be able to pay its debts as they mature, and (iii) such Guarantor has capital sufficient to carry on its business as conducted and as proposed to be conducted.

SECTION 10. Notices. All notices and communications provided for hereunder shall be in writing and sent by telecopy if the sender on the same day sends a confirming copy of such notice by a recognized overnight delivery service (charges prepaid), or by registered or certified mail with return receipt requested (postage prepaid), or by a recognized overnight delivery service (with charges prepaid) (a) if to the Company or any Holder at the address set forth in the Note Purchase Agreement or (b) if to a Guarantor, in care of the Company at the Company's address set forth in the Note Purchase Agreement, or in each case at such other address as the

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Company, any Holder or such Guarantor shall from time to time designate in writing to the other parties. Any notice so addressed shall be deemed to be given when actually received.

SECTION 11. Survival. All warranties, representations and covenants made by each Guarantor herein or in any certificate or other instrument delivered by it or on its behalf hereunder shall be considered to have been relied upon by the Holders and shall survive the execution and delivery of this Guaranty, regardless of any investigation made by any of the Holders. All statements in any such certificate or other instrument shall constitute warranties and representations by such Guarantor hereunder.

SECTION 12. Submission to Jurisdiction. Each Guarantor irrevocably submits to the jurisdiction of the courts of the State of Illinois and of the courts of the United States of America having jurisdiction in the State of Illinois for the purpose of any legal action or proceeding in any such court with respect to, or arising out of, this Guaranty, the Note Purchase Agreement or the Notes. Each Guarantor consents to process being served in any suit, action or proceeding by mailing a copy thereof by registered or certified mail, postage prepaid, return receipt requested. Each Guarantor agrees that such service upon receipt (i) shall be deemed in every respect effective service of process upon it in any such suit, action or proceeding and (ii) shall, to the fullest extent permitted by law, be taken and held to be valid personal service upon and personal delivery to such Guarantor.

SECTION 13. Miscellaneous. Any provision of this Guaranty which is prohibited or unenforceable in any jurisdiction shall, as to such jurisdiction, be ineffective to the extent of such prohibition or unenforceability without invalidating the remaining provisions hereof, and any such prohibition or unenforceability in any jurisdiction shall not invalidate or render unenforceable such provision in any other jurisdiction. To the extent permitted by applicable law, each Guarantor hereby waives any provision of law that renders any provisions hereof prohibited or unenforceable in any respect. The terms of this Guaranty shall be binding upon, and inure to the benefit of, each Guarantor and the Holders and their respective successors and assigns. No term or provision of this Guaranty may be changed, waived, discharged or terminated orally, but only by an instrument in writing signed by each Guarantor and the Required Holders. The section and paragraph headings in this Guaranty are for convenience of reference only and shall not modify, define, expand or limit any of the terms or provisions hereof, and all references herein to numbered sections, unless otherwise indicated, are to sections in this Guaranty. This Guaranty shall in all respects be governed by, and construed in accordance with, the laws of the State of Illinois, excluding choice-of-law principles of the law of such State that would require the application of the laws of a jurisdiction other than such State.

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IN WITNESS WHEREOF, each Guarantor has caused this Guaranty to be duly executed as of the day and year first above written.

[Name of Guarantor]

By: \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_

[Name of Guarantor]

By: \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_

[Name of Guarantor]

By: \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_

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FORM OF JOINDER TO SUBSIDIARY GUARANTY

The undersigned (the "Guarantor"), joins in the Subsidiary Guaranty dated as of December 17, 2004 from the Guarantors named therein in favor of the Holders, as defined therein, and agrees to be bound by all of the terms thereof and represents and warrants to the Holders that:

(a) such Guarantor is duly organized, validly existing and in good standing under the laws of its jurisdiction of organization and has the power and authority to own or hold under lease the properties it purports to own or hold under lease and to transact the business it transacts and proposes to transact;

(b) such Guarantor has the power and authority to execute and deliver this Guaranty and to perform the provisions hereof, and this Guaranty has been duly authorized by all necessary action on the part of such Guarantor;

(c) this Guaranty constitutes the legal, valid and binding obligation of such Guarantor enforceable against such Guarantor in accordance with its terms, except as such enforceability may be limited by (i) applicable bankruptcy, insolvency, fraudulent conveyance, reorganization, moratorium or other similar laws affecting the enforcement of creditors' rights generally and (ii) general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law);

(d) the execution, delivery and performance of this Guaranty will not (i) contravene, result in any breach of, or constitute a default under, or result in the creation of any Lien in respect of any property of such Guarantor under, any agreement, or corporate charter or by-laws to which such Guarantor is bound or by which such Guarantor or any of its properties may be bound or affected, (ii) conflict with or result in a breach of any of the terms, conditions or provisions of any order, judgment, decree, or ruling of any court, arbitrator or Governmental Authority applicable to such Subsidiary Guarantor or (iii) violate any provision of any statute or other rule or

regulation of any Governmental Authority applicable to such Guarantor;

(e) no consent, approval or authorization of, or registration, filing or declaration with, any Governmental Authority is required in connection with the execution, delivery or performance by such Guarantor of this Guaranty;

(f) there are no actions, suits or proceedings pending or, to the knowledge of such Guarantor, threatened against or affecting such Guarantor, or any property of such Guarantor, in any court or before any arbitrator of any kind or before or by any Governmental Authority that, individually or in the aggregate, could reasonably be expected to have a Material Adverse Effect;

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(g) after giving effect to the transactions contemplated by the giving of this Joinder and giving due consideration to any rights of contribution (i) the fair value of the assets of such Guarantor (both at fair valuation and at present fair saleable value) exceeds its liabilities, (ii) such Guarantor is able to and expects to be able to pay its debts as they mature, and (iii) such Guarantor has capital sufficient to carry on its business as conducted and as proposed to be conducted.

Capitalized Terms used but not defined herein have the meanings ascribed in the Subsidiary Guaranty.

IN WITNESS WHEREOF, the undersigned has caused this Joinder to Subsidiary Guaranty to be duly executed as of \_\_\_\_\_, \_\_\_\_.

[Name of Guarantor]

By: \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_

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**2001 MASTER STOCK INCENTIVE PLAN  
STOCK OPTION AWARD AGREEMENT**

This Stock Option Award Agreement (the "Agreement") is made as of this xx day of xxxx, by and between Donaldson Company, Inc., a Delaware corporation (together with its subsidiaries, "Donaldson") and «FIRSTNAME» «INITIAL» «LASTNAME», an employee of Donaldson ("Employee").

Donaldson has adopted the 2001 Master Stock Incentive Plan (the "Plan") which permits issuance of stock options for the purchase of shares of Common Stock of Donaldson. Donaldson is now granting this option under the Plan, and in consideration of the Employee's and Donaldson's covenants in this Agreement. Capitalized terms not defined below should have the meaning defined for such term in the Plan.

1. Grant of Option. Donaldson grants Employee the right and option (the "Option") to purchase all or any part of an aggregate of «NUMBER» («SHARES») shares of Donaldson's Common Stock, par value \$5.00 per share ("Shares"), at the Option purchase price of \$xx.xx per share subject to the terms and conditions in this Agreement and in the Plan. A copy of the Plan will be furnished upon request of Employee. The date of grant is xxxx. The Option terminates at the close of business ten (10) years from the date of grant or at an earlier time period specified in this Agreement.

2. Vesting of Option Rights. The Option is fully vested and may be exercised by Employee from and after the date of grant as to any or all of the Shares.

3. Exercise of Option after Death or Termination of Employment. The Option shall terminate and may no longer be exercised if Employee ceases to be employed by Donaldson, except that:

(a) If Employee's employment is terminated for any reason, voluntary or involuntary, other than for Employee's death or disability (as set forth in Section 3(b)) or normal retirement (as set forth in Section 3(c)), Employee may at any time within a period of one (1) month after such termination exercise the Option to the extent the Option was exercisable by Employee on the date of the termination of Employee's employment.

(b) If Employee shall die while the Option is still exercisable according to its terms and Employee shall not have fully exercised the Option, such Option may be exercised at any time within thirty-six (36) months after Employee's death by the personal representatives or administrators of Employee, as applicable, or by any person or persons to whom the Option is transferred by will or the applicable laws of descent and distribution, to the extent of the full number of shares Employee was entitled to purchase under the Option on the date of death.

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(c) If employment is terminated because Employee has become disabled (within the meaning of Section 22(e)(3) of the Internal Revenue Code of 1986, as amended (the "Code")) while in the employ of Donaldson and Employee shall not have fully exercised the Option, such Option may be exercised at any time within thirty-six (36) months after Employee's date of termination of employment for disability by Employee, personal representatives or administrators, or guardians of Employee, as applicable, to the extent of the full number of shares Employee is entitled to purchase under the Option. Employee shall continue to have exercise rights accrue during such thirty-six (36) month period according to the vesting schedule set forth in Section 2.

(d) Employee, in the event of normal retirement on or after age 55, shall continue to have the ten (10) year term to exercise this Option set forth in Section 1 and shall continue to have exercise rights accrue according to the vesting schedule set forth in Section 2.

4. Method of Exercise of Option. The Option may be exercised only within the Option period by serving written notice of exercise on Donaldson at its principal office which is as of this date located at 1400 W. 94<sup>th</sup> Street, Bloomington, Minnesota, Attention: Treasurer. The notice must state the number of shares being exercised and include payment in full of the purchase price. Payment of the purchase price shall be made in cash or, with the approval of Donaldson (which may be given in its sole discretion), in Common Stock of Donaldson having a fair market value equal to the full purchase price of the shares being acquired or a combination of cash and such shares. For these purposes, the fair market value of Donaldson's Common Stock as of any date shall be as reasonably determined by Donaldson.

5. Donaldson's Repurchase Right During Initial Three-Year Period. If Employee's employment with Donaldson is terminated for any reason whatsoever prior to xxxx (other than for death, disability or normal retirement as defined in Section 3 or a termination resulting from a

Change in Control as defined in Section 7), then, in the event that Employee exercises this Option within the period beginning six (6) months prior to such termination and ending on xxxx (the "Repurchase Period"), Donaldson shall have the right and option in its sole discretion to repurchase from Employee, and Employee agrees to sell to Donaldson the Shares purchased by Employee upon the exercise of this Option within the Repurchase Period for a purchase price equal to the price paid by Employee for the Shares. Donaldson shall notify Employee of its election to repurchase the Shares within ninety (90) days following Employee's termination of employment within the Repurchase Period. Within thirty (30) days of demand by Donaldson, Employee shall deliver to Donaldson either (i) the stock certificates representing the number of Shares that Donaldson has elected to repurchase and, in that event, Donaldson shall pay to Employee the purchase price as provided above, or (ii) at the election of Donaldson, in lieu of repurchasing such shares, Donaldson shall have the right to collect from Employee any gain received by Employee pursuant to the exercise of this Option during the Repurchase Period. The gain on any exercise of the Option shall be determined by multiplying the number of shares purchased pursuant to the Option times the excess of the fair market value of a Share on the date of exercise (without regard to any subsequent increase or decrease in the fair market value) over the exercise price. The fair market value of Donaldson's Common Stock as of any date shall be as reasonably determined by Donaldson. Donaldson also shall have the right to set-off any amounts due to the Employee by Donaldson

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under any plan, contract or arrangement against the Employee's obligations to deliver cash or Shares under this Section 5.

6. Forfeiture of Option and Option Gain Resulting from Certain Activities.

(a) If, at any time that (i) is within two (2) years after the date that Employee has exercised the Option or (ii) within two (2) years after the date of the termination of Employee's employment with Donaldson for any reason whatsoever while an option agreement under the Plan is in effect, whichever is longer, Employee engages in any Forfeiture Activity (as defined below) then (A) the Option shall immediately terminate effective as of the date any such activity first occurred, and (B) any gain received by Employee pursuant to the exercise of this Option must be paid to Donaldson within thirty (30) days of demand by Donaldson. The gain on any exercise of the Option shall be determined by multiplying the number of shares purchased pursuant to the Option times the excess of the fair market value of a share of Donaldson's Common Stock on the date of exercise (without regard to any subsequent increase or decrease in the fair market value) over the exercise price. The fair market value of Donaldson's Common Stock as of any date shall be as reasonably determined by Donaldson.

(b) Employee shall be deemed to have engaged in a Forfeiture Activity if Employee (i) directly or indirectly engages in any business activity on his or her own behalf or as a partner, shareholder, director, trustee, principal, agent, employee, consultant or otherwise of any person or entity which is in any respect in competition with or competitive with Donaldson, or solicits, entices or induces any employee or representative of Donaldson to engage in any such activity, (ii) directly or indirectly solicits, entices or induces (or assists any other person or entity in soliciting, enticing or inducing) any customer or potential customer (or agent, employee or consultant of any customer or potential customer) with whom Employee had contact in the course of his or her employment with Donaldson to deal with a competitor of Donaldson, or (iii) fails to hold in a fiduciary capacity for the benefit of Donaldson all confidential information, knowledge and data, including customer lists and information, business plans and business strategy ("Confidential Data") relating in any way to the business of Donaldson for so long as such Confidential Data remains confidential.

(c) If any court of competent jurisdiction shall determine that this forfeiture provision is invalid in any respect, the court so holding may limit such covenant either or both in time, in area or in any other manner which the court determines such that the covenant shall be enforceable against Employee. Employee shall acknowledge that the remedy of law for any breach of this covenant not to compete will be inadequate, and that Donaldson shall be entitled, in addition to any remedy of law, to preliminary and permanent injunctive relief.

7. Exercisability upon Change in Control. In the event of a "Change in Control" of Donaldson, any outstanding Options granted under this Agreement shall no longer be subject to Section 5 and shall remain exercisable thereafter until they are either exercised or expire by their terms. The term "Change in Control" shall have the following meaning assigned to it in this Agreement. A "Change in Control" of Donaldson shall have occurred if (i) any "person" as such

trustee or other fiduciary holding securities under an employee benefit plan of Donaldson or any corporation owned, directly or indirectly, by the shareholders of Donaldson in substantially the same proportions as their ownership of stock of Donaldson), either is or becomes the "beneficial owner" (as defined in Rule 13d-3 under the Exchange Act), directly or indirectly, of securities of Donaldson representing 30% or more of the combined voting power of Donaldson's then outstanding securities, (ii) during any period of two (2) consecutive years, individuals who at the beginning of such period constitute the Board of Directors of Donaldson (the "Board"), and any new director (other than a director designated by a person who has entered into an agreement with Donaldson to effect a transaction described in clause (i), (iii) or (iv) of this subparagraph) whose election by the Board or nomination for election by Donaldson's shareholders was approved by a vote of at least two-thirds (2/3) of the directors then still in office who either were directors at the beginning of the period or whose election or nomination for election was previously so approved, cease for any reason to constitute at least a majority thereof, unless the approval of the election or nomination for election of such new directors was in connection with an actual or threatened election or proxy contest, (iii) the shareholders of Donaldson approve a merger or consolidation of Donaldson with any other corporation, other than (A) a merger or consolidation which would result in the voting securities of Donaldson outstanding immediately prior thereto continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity) more than 80% of the combined voting power of the voting securities of Donaldson or such surviving entity outstanding immediately after such merger or consolidation or (B) a merger or consolidation effected to implement a recapitalization of Donaldson (or similar transaction) in which no "person" (as hereinabove defined) acquires more than 30% of the combined voting power of Donaldson's then outstanding securities or (iv) the shareholders of Donaldson approve a plan of complete liquidation of Donaldson or an agreement for the sale or disposition of Donaldson of all or substantially all of Donaldson's assets or any transaction having a similar effect.

8. Miscellaneous .

(a) Neither the Plan nor this Agreement shall (i) be deemed to give any individual a right to remain an employee of Donaldson, (ii) restrict the right of Donaldson to discharge any employee, with or without cause, or (iii) be deemed to be a written contract of employment. Employee shall have none of the rights of a shareholder with respect to shares subject to the Option until such shares shall have been issued to Employee upon exercise of the Option.

(b) The exercise of all or any parts of the Option shall only be effective at such time that the sale of shares of Common Stock pursuant to such exercise will not violate any state or federal securities or other laws.

(c) The Option may not be transferred, except by will or the laws of descent and distribution to the extent provided in subsection 3 (b), and during Employee's lifetime the Option is exercisable only by Employee, provided, however, that notwithstanding the above, this Option shall be transferable by Employee to immediate family members and

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related estate planning entities designated in a stock transfer form approved by Donaldson and delivered to Donaldson as provided in Section 4 for written notice.

(d) It is understood and agreed that the Option price is the per share fair market value of such shares on the date of this Agreement. The Option is not intended to be an Incentive Stock Option within the meaning of Section 422 of the Code. The Option is issued pursuant to the Plan and is subject to its terms.

(e) If there shall be any change in the Common Stock subject to the Option through merger, consolidation, reorganization, recapitalization, dividend or other distribution, stock split or other similar corporate transaction or event of Donaldson, appropriate adjustments shall be made by Donaldson in the number of shares and the price per share of the shares subject to the Option in order to prevent dilution or enlargement of the Option rights granted hereunder; provided, however, that the number of shares subject to the Option shall always be a whole number.

(f) In order to provide Donaldson with the opportunity to claim the benefit of any income tax deduction which may be available to it upon the exercise of the Option and in order to comply with all applicable federal or state income tax laws or regulations, Donaldson may take such action as it deems appropriate to insure that, if necessary, all applicable federal or state payroll, withholding, income or other taxes are withheld or collected from Employee.

(g) Donaldson, in its sole and absolute discretion, may allow Employee to satisfy Employee's federal and state income tax withholding obligations (including FICA) upon exercise of the Option by (i) having Donaldson withhold a portion of the shares of Common Stock otherwise to be delivered upon exercise of the Option having a fair market value equal to the amount of federal and state income tax required to be withheld upon such exercise, in accordance with such rules as Donaldson may from time to time establish, or (ii) delivering to Donaldson shares of its Common Stock other than the shares issuable upon exercise of the Option with a fair market value equal to such taxes, in accordance with such rules.

(h) This Option grant shall be effective only after signature by both parties and delivering a signed original copy to the Company



at the address in Section 4. Employee shall not disclose either the contents or any of the terms and conditions of the Option to any other person and agrees that Donaldson shall have the right in its sole discretion to immediately terminate the Option without the right to exercise any part thereof in the event of such disclosure by Employee.

(i) This Agreement shall be construed and enforced in accordance with the laws of the State of Minnesota, except with respect to its rules relating to conflicts of law. Employee consents to the exclusive jurisdiction of the state and federal courts of the State of Minnesota in connection with any controversies relating to or arising out of this Agreement, and agrees that any and all litigation relating to or arising out of this Agreement shall be venued in Hennepin County, Minnesota.

**IN WITNESS WHEREOF** , Donaldson and Employee have duly executed this Agreement as of the date set forth in the first paragraph.

**DONALDSON COMPANY, INC.**

By: \_\_\_\_\_  
Its: President and Chief Executive Officer

**EMPLOYEE:**

\_\_\_\_\_  
«FIRST NAME» «INITIAL» «LAST NAME»

Date: \_\_\_\_\_

NON-EMPLOYEE DIRECTOR  
NON-QUALIFIED STOCK OPTION AGREEMENT

OPTION AGREEMENT made this xxx day of xxx, xxxx, by and between Donaldson Company, Inc., a Delaware corporation (hereinafter, together with its subsidiaries, called "Donaldson"), and «FirstName» «Initial» «LastName», a non-employee Director of Donaldson (hereinafter called "Participant").

In consideration of the mutual covenants hereinafter set forth and for other good and valuable consideration, the parties agree as follows:

1. Donaldson irrevocably grants to the Participant the right and option to purchase all or any part of an aggregate of xxx shares of Common Stock, par value of \$5.00 per share, of Donaldson together with a restoration option ("Reload"). This option is granted pursuant to the Donaldson Company Non-Qualified Stock Option Program for Non-Employee Directors (the "Plan"). A Reload shall be automatically granted if Participant exercises this option when the market value of Common Stock exceeds the purchase price, in paragraph 2, by 25%. The Reload is applicable only on the exercise by Participant while a Director. The Reload provision shall not be applicable if Participant transfers the option grant as provided for in paragraph 4, except that the Reload provision shall continue to apply to a transfer to a revocable trust where the Participant retains beneficial ownership and control. Participant acknowledges receipt of a copy of the Plan.

2. The purchase price of the shares of Common Stock subject to this option is xx.xx per share. The date of grant is xxxx.

3. The term of this option is for the period of ten years from and after the date of grant, or such shorter period as may be provided by the provisions of the Plan. The option may be exercised during the period from and after the date of grant. Subject to the limitations herein and to the extent not exercised in prior years, the right to exercise this option shall be cumulative and may be exercised at any time or from time to time during the term as to any or all full shares which may be purchasable under the provisions of this Agreement.

4. This option shall not be transferable otherwise than by will or the laws of descent and distribution and may be exercised during the lifetime of the Participant only by Participant; provided, however, that notwithstanding the above, this option shall be transferable by Participant to immediate family members and related estate planning entities.

5. Participant may exercise this option in whole or in part at any time during the term as specified above but not after ten years from the date of grant; provided, that if Participant dies, this option may be exercised within three years after death, but not after ten years from the date granted, by Participant's estate or by the person or persons who acquire the right to exercise this option by bequest, inheritance or otherwise by reason of such death. Donaldson and Participant

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recognize that this Agreement in no way restricts the right of Donaldson to terminate Participant's membership consistent with applicable Delaware laws.

6. Subject to the terms and conditions of this Agreement, this option may be exercised by written notice to the Company at its principal office, which is now located at 1400 West 94th Street, Bloomington, Minnesota, Attention: Treasurer. Such notice shall state the election to exercise the option and the number of shares in respect of which it is being exercised, shall be signed by the person or persons so exercising the option. Such notice shall be accompanied by payment in full of the purchase price of the shares purchased. Payment of the exercise price may be made in cash or in whole or in part in Common Stock of the Company valued at the Market Value (as defined in the Master Plan) on the day preceding the date of exercise. The Company will issue and deliver a certificate or certificates representing the shares to be received as soon as practicable after completion of these requirements. In the event the option shall be exercised pursuant to paragraphs 4 or 5 by any person or persons other than the Participant such notice shall be accompanied by appropriate proof of the right of such person or persons to exercise the option.

7. In the event of a Change in Control of Donaldson (as defined below), any outstanding options granted under this Agreement not previously vested and exercisable shall become fully vested and exercisable and shall remain exercisable thereafter until they are either exercised or expire by their terms. The term "Change in Control" shall have the following meaning assigned to it in this Agreement. A "Change in Control" of Donaldson shall have occurred if (i) any "person" as such term is used in Sections 13(d) and 14(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") (other than Donaldson, any trustee or other fiduciary holding securities under an employee benefit plan of Donaldson or any corporation owned, directly or indirectly, by the shareholders of Donaldson in substantially the same proportions as their ownership of stock of Donaldson), either is or becomes the "beneficial owner" (as defined in Rule 13d-3 under the Exchange Act), directly or indirectly, of securities of Donaldson representing 30% or more of the combined voting power of Donaldson's then outstanding securities, (ii) during any period of two consecutive years (not including any period prior to the effective date of this Master Plan),

individuals who at the beginning of such period constitute the Board of Directors of Donaldson (the "Board"), and any new director (other than a director designated by a person who has entered into an agreement with Donaldson to effect a transaction described in clause (i), (iii) or (iv) of this subparagraph) whose election by the Board or nomination for election by Donaldson's shareholders was approved by a vote of at least two-thirds (2/3) of the directors then still in office who either were directors at the beginning of the period or whose election or nomination for election was previously so approved, cease for any reason to constitute at least a majority thereof, unless the approval of the election or nomination for election of such new directors was in connection with an actual or threatened election or

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proxy contest, (iii) the shareholders of Donaldson approve a merger or consolidation of Donaldson with any other corporation, other than (A) a merger or consolidation which would result in the voting securities of Donaldson outstanding immediately prior thereto continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity) more than 80% of the combined voting power of the voting securities of Donaldson or such surviving entity outstanding immediately after such merger or consolidation or (B) a merger or consolidation effected to implement a recapitalization of Donaldson (or similar transaction) in which no "person" (as hereinabove defined) acquires more than 30% of the combined voting power of Donaldson's then outstanding securities or (iv) the shareholders of Donaldson approve a plan of complete liquidation of Donaldson or an agreement for the sale or disposition by Donaldson of all or substantially all of Donaldson's assets or any transaction having a similar effect.

8. If all or any portion of the option is exercised subsequent to any stock dividend or split, recapitalization, consolidation, or the like, occurring after the date hereof, as a result of which securities of any class shall be issued in respect of outstanding shares of Common Stock, or shares of Common Stock shall be changed into the same or a different number of shares or other securities of the same or other class or classes, then the Board of Directors shall determine if any equitable adjustment is necessary to protect the Participant against dilution and shall determine the terms of such adjustment, if any. In the case of any stock dividend or split effected after the date hereof, the number of shares to be granted hereunder shall be automatically adjusted to prevent dilution of the potential benefits intended to be made available hereunder.

IN WITNESS WHEREOF, Donaldson and the Participant have duly executed this Agreement as of the day and year first above written.

DONALDSON COMPANY, INC.

PARTICIPANT

By:

\_\_\_\_\_  
William M. Cook

\_\_\_\_\_  
<<FIRST  
NAME>> <<INITIAL>> <<LAST  
NAME>>

Its: President and Chief Executive Officer

## RETIREMENT CONSULTING AND NONCOMPETE AGREEMENT

This Agreement made and entered into this 29th day of August, 2005 by and between Donaldson Company, Inc., a Delaware corporation (the "Company") and William G. Van Dyke ("WVD");

WITNESSETH THAT:

WHEREAS, WVD has been employed in the capacities of Chairman, President and Chief Executive Officer of the Company for many years and retired as a director, officer and employee effective August 1, 2005;

WHEREAS, the Board and Company desires to continue to have the right to consult with WVD and to receive the continuing benefit of a noncompete agreement and WVD desires to make himself available to provide consulting services to the Company and is willing to agree to the noncompetition restriction upon the terms and conditions herein specified;

NOW, THEREFORE, the parties hereto hereby agree as follows:

1. Term of the Agreement. The period during which WVD shall provide consulting services to the Company shall commence on September 1, 2005, and terminate on August 31, 2010 or on the earlier death of WVD. The term will consist of five one-year periods commencing on September 1<sup>st</sup> and ending on August 31<sup>st</sup> each year.
  2. Consulting Services. At the request of the Chief Executive Officer of the Company, WVD shall investigate, research, consider, explore and consult with and advise the Company concerning such matters relating to business strategy, operations and corporate governance and other matters as the Company shall determine. The Company and WVD contemplate that the consulting services of WVD will require WVD to make himself available from time to time for consultation with the Chief Executive Officer of the Company. WVD shall direct his communications to the Chief Executive Officer, or such other officer as the Chief Executive Officer shall designate.
  3. Allowance. The Company agrees to provide to WVD the following allowance in consideration of his availability for consulting services, the expenses to be incurred by WVD, and the noncompetition agreement:
    - a. The sum of \$111,000, payable in one installment within 30 days of the commencement of the agreement, which means it shall be due and payable on or before October 1, 2005.
    - b. To assist WVD in providing services, the Company shall provide a computer and peripherals, desk chair and fax machine. WVD shall be responsible for all expenses other than expenses incurred as part of authorized travel approved in advance by the Company in connection with such services. Expense accounts shall be submitted to the Controller, or such other officer as the Chief Executive Officer of the Company may designate.
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4. Status of WVD. WVD shall be an independent contractor and shall not be an employee or agent of the Company. He shall determine for himself the details of providing services pursuant to this agreement. WVD shall have no authority to commit or bind the Company unless specifically so authorized in writing by the Company and then only to the extent of such authorization.
  5. Noncompete Agreement. WVD agrees that during the term of this agreement, he will not
    - (a) directly or indirectly, as a consultant, employee, director, partner, stockholder, or agent, engage in or have a financial interest in, any business which is engaged in the manufacture or sale of products or the performance of services which are in competition with the products then manufactured or sold or the services then performed by the Company or any of its subsidiaries;
    - (b) induce employees of the Company or any of its subsidiaries to join any such competing business; or
    - (c) solicit customers of the Company in competition with the Company.

Clause (a) above shall not apply to the ownership of not more than 1% of the outstanding stock of any class of a public corporation registered under Section 12(b) or 12(g) of the Securities Exchange Act of 1934.
  6. Notices. Any notice given under this agreement shall be sufficient if in writing and delivered or sent by certified or registered mail, if to the Company at 1400 West 94th Street, Minneapolis, MN 55431, Attention: President, and if to WVD at 5425 West Highwood Drive, Edina, MN 55436, or at such other address as either may advise the other by written notice.

7. Assignment. This agreement shall not be assignable by WVD and shall be binding upon and inure to the benefit of the Company and its successors and assigns.
8. Governing Law. This agreement shall be governed by and construed in accordance with the laws of the State of Minnesota.

IN WITNESS WHEREOF the parties hereto have executed this agreement on the day and year first above written.

DONALDSON COMPANY, INC.

By:

/s/ William M. Cook

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William M. Cook, President and CEO

/s/ William G. Van Dyke

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William G. Van Dyke

**Consent of Independent Registered Public Accounting Firm**

We hereby consent to the incorporation by reference in the Registration Statement on Form S-8 (No. 333-107444, 333-97771, 333-56027, 33-27086, 2-90488 and 33-44624) of Donaldson Company, Inc. of our report dated September 24, 2010 relating to the financial statements, financial statement schedule and the effectiveness of internal control over financial reporting, which appears in this Annual Report on Form 10-K.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

Minneapolis, Minnesota  
September 24, 2010

**Certification of Chief Executive Officer  
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, William M. Cook, certify that:

1. I have reviewed this annual report on Form 10-K of Donaldson Company, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: September 24, 2010

/s/ William M. Cook  
William M. Cook  
Chief Executive Officer

**Certification of Chief Financial Officer  
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Thomas R. VerHage, certify that:

1. I have reviewed this annual report on Form 10-K of Donaldson Company, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: September 24, 2010

/s/ Thomas R. VerHage  
Thomas R. VerHage  
Chief Financial Officer



Pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes–Oxley Act of 2002, the following certifications are being made to accompany the annual report on Form 10-K for the fiscal year ended July 31, 2010 for Donaldson Company, Inc.:

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER**

I, William M. Cook, Chief Executive Officer of Donaldson Company, Inc., certify that:

1. The Annual Report on Form 10-K of Donaldson Company, Inc. for the fiscal year ended July 31, 2010 (the “Report”), fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Donaldson Company, Inc.

Date: September 24, 2010

/s/ William M. Cook  
William M. Cook  
Chief Executive Officer

**CERTIFICATION OF CHIEF FINANCIAL OFFICER**

I, Thomas R. VerHage, Chief Financial Officer of Donaldson Company, Inc., certify that:

1. The Annual Report on Form 10-K of Donaldson Company, Inc. for the fiscal year ended July 31, 2010 (the “Report”), fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Donaldson Company, Inc.

Date: September 24, 2010

/s/ Thomas R. VerHage  
Thomas R. VerHage  
Chief Financial Officer