

GOODRICH CORP  
Form 10-Q  
May 05, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

Form 10-Q

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**  
For The Quarterly Period Ended March 31, 2006

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**  
For the transition period from      to      .  
Commission file number 1-892

**GOODRICH CORPORATION**

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

**New York**

*(State of incorporation)*

**34-0252680**

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

**Four Coliseum Centre  
2730 West Tyvola Road  
Charlotte, North Carolina**

*(Address of principal executive offices)*

**28217**

*(Zip Code)*

**Registrant's telephone number, including area code: (704) 423-7000**

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of March 31, 2006, there were 123,907,696 shares of common stock outstanding (excluding 14,000,000 shares held by a wholly owned subsidiary). There is only one class of common stock.

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

**Report of Independent Registered Public Accounting Firm**

To the Shareholders and Board of Directors of Goodrich Corporation

We have reviewed the condensed consolidated balance sheet of Goodrich Corporation as of March 31, 2006, and the related condensed consolidated statement of income for the three months ended March 31, 2006 and 2005, and the condensed consolidated statement of cash flows for the three months ended March 31, 2006 and 2005. These financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Goodrich Corporation as of December 31, 2005, and the related consolidated statements of income, shareholders' equity, and cash flows for the year then ended, not presented herein; and in our report dated February 20, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2005, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Ernst & Young LLP  
Charlotte, North Carolina  
May 1, 2006

**CONDENSED CONSOLIDATED STATEMENT OF INCOME (UNAUDITED)**

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Dollars in millions, except per share amounts)</b>	
<b>Sales</b>	\$ 1,423.8	\$ 1,275.5
Operating costs and expenses:		
Cost of sales	1,043.9	929.7
Selling and administrative costs	237.2	215.7
	1,281.1	1,145.4
<b>Operating Income</b>	142.7	130.1
Interest expense	(32.0)	(33.9)
Interest income	1.1	0.9
Other income (expense) net	(10.6)	(10.1)
Income from continuing operations before income taxes	101.2	87.0
Income tax benefit (expense)	99.1	(30.2)
<b>Income From Continuing Operations</b>	200.3	56.8
Income from discontinued operations net of income taxes	0.6	0.7
Cumulative effect of change in accounting	0.6	
<b>Net Income</b>	\$ 201.5	\$ 57.5
<b>Basic Earnings Per Share:</b>		
Continuing operations	\$ 1.62	\$ 0.47
Discontinued operations		0.01
Cumulative effect of change in accounting	0.01	
<b>Net Income</b>	\$ 1.63	\$ 0.48
<b>Diluted Earnings Per Share:</b>		
Continuing operations	\$ 1.59	\$ 0.46
Discontinued operations		0.01
Cumulative effect of change in accounting	0.01	
<b>Net Income</b>	\$ 1.60	\$ 0.47
<b>Dividends Declared Per Common Share</b>	\$ 0.20	\$ 0.20

See Notes to Condensed Consolidated Financial Statements (Unaudited).

**CONDENSED CONSOLIDATED BALANCE SHEET (UNAUDITED)**

	<b>March 31, 2006</b>	<b>December 31, 2005</b>
	<b>(Dollars in millions, except share amounts)</b>	
<b>Current Assets</b>		
Cash and cash equivalents	\$ 283.0	\$ 251.3
Accounts and notes receivable, less allowances for doubtful receivables (\$23.3 at March 31, 2006 and \$23.5 at December 31, 2005)	788.5	709.2
Inventories net	1,393.6	1,308.4
Deferred income taxes	99.4	101.3
Prepaid expenses and other assets	48.7	55.2
<b>Total Current Assets</b>	<b>2,613.2</b>	<b>2,425.4</b>
Property, plant and equipment net	1,198.9	1,194.3
Prepaid pension	318.7	337.8
Goodwill	1,319.7	1,318.4
Identifiable intangible assets net	459.7	462.3
Deferred income taxes	48.9	42.8
Other assets	678.3	673.0
<b>Total Assets</b>	<b>\$ 6,637.4</b>	<b>\$ 6,454.0</b>
<b>Current Liabilities</b>		
Short-term debt	\$ 28.6	\$ 22.3
Accounts payable	589.4	534.1
Accrued expenses	747.6	764.9
Income taxes payable	189.5	284.4
Deferred income taxes	8.0	7.2
Current maturities of long-term debt and capital lease obligations	1.5	1.7
<b>Total Current Liabilities</b>	<b>1,564.6</b>	<b>1,614.6</b>
Long-term debt and capital lease obligations	1,740.4	1,742.1
Pension obligations	848.3	844.2
Postretirement benefits other than pensions	293.4	300.0
Deferred income taxes	44.3	42.1
Other non-current liabilities	438.0	438.0
Commitments and contingent liabilities		
<b>Shareholders Equity</b>		
Common stock \$5 par value Authorized 200,000,000 shares; issued 137,538,824 shares at March 31, 2006 and 136,727,436 shares at December 31, 2005 (excluding 14,000,000 shares held by a wholly owned subsidiary)	687.7	683.6
Additional paid-in capital	1,243.3	1,203.3
Income retained in the business	462.0	285.6
Accumulated other comprehensive income (loss)	(267.6)	(283.0)

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Common stock held in treasury, at cost (13,631,128 shares at March 31, 2006 and 13,621,128 shares at December 31, 2005)	(417.0)	(416.5)
<b>Total Shareholders Equity</b>	1,708.4	1,473.0
<b>Total Liabilities And Shareholders Equity</b>	\$ 6,637.4	\$ 6,454.0

See Notes to Condensed Consolidated Financial Statements (Unaudited).

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**CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)**

	<b>Three Months Ended March 31, 2006                  2005 (Dollars in millions)</b>	
<b>Operating Activities</b>		
Net income	\$ 201.5	\$ 57.5
Adjustments to reconcile net income to net cash provided by operating activities:		
Income from discontinued operations	(0.6)	(0.7)
Cumulative effect of change in accounting	(0.6)	
Restructuring and consolidation:		
Expenses	1.5	3.2
Payments	(1.8)	(3.4)
Asset impairments	0.9	
Depreciation and amortization	56.3	54.7
Excess tax benefits on equity instruments issued under share- based payment arrangements	(1.2)	
Stock-based compensation expense	22.4	11.4
Deferred income taxes	(4.2)	(28.8)
Change in assets and liabilities, net of effects of acquisitions and dispositions of businesses:		
Receivables	(96.6)	(103.5)
Change in receivables sold, net		24.3
Inventories	(82.6)	(65.7)
Other current assets	9.1	3.4
Accounts payable	62.8	20.9
Accrued expenses	(17.7)	(2.5)
Income taxes payable	(87.7)	49.8
Tax benefit on non-qualified options		4.5
Pension contributions	(7.1)	(3.3)
Other non-current assets and liabilities	11.2	(5.0)
<b>Net Cash Provided By Operating Activities</b>	<b>65.6</b>	<b>16.8</b>
<b>Investing Activities</b>		
Purchases of property, plant and equipment	(43.2)	(26.8)
Proceeds from sale of property, plant and equipment	0.1	0.2
Payments received (payments made) in connection with acquisitions, net of cash acquired		(8.8)
<b>Net Cash Used In Investing Activities</b>	<b>(43.1)</b>	<b>(35.4)</b>
<b>Financing Activities</b>		
Increase (decrease) in short-term debt, net	6.1	(1.0)
Proceeds from issuance of long-term debt		
Repayment of long-term debt and capital lease obligations	(0.4)	(0.5)
Proceeds from issuance of common stock	18.5	34.1
Purchases of treasury stock	(0.4)	(0.6)

Dividends	(24.6)	(23.8)
Excess tax benefits on equity instruments issued under share- based payment arrangements	1.2	
Distributions to minority interest holders	(1.0)	(2.4)
<b>Net Cash (Used In) Provided By Financing Activities</b>	<b>(0.6)</b>	<b>5.8</b>
<b>Discontinued Operations</b>		
Net cash provided by (used in) operating activities	9.1	2.9
Net cash provided by (used in) investing activities		(0.2)
Net cash provided by (used in) financing activities		
Net cash provided by discontinued operations	9.1	2.7
Effect of exchange rate changes on cash and cash equivalents	0.7	(1.4)
Net increase (decrease) in cash and cash equivalents	31.7	(11.5)
Cash and cash equivalents at beginning of year	251.3	297.9
Cash and cash equivalents at end of period	\$ 283.0	\$ 286.4

See Notes to Condensed Consolidated Financial Statements (Unaudited).



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

**Note 1. Basis of Interim Financial Statement Preparation**

The accompanying unaudited condensed consolidated financial statements of Goodrich Corporation and its subsidiaries have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. Unless indicated otherwise or the context requires, the terms we, our, us, Goodrich or Company refer to Goodrich Corporation and its subsidiaries. The Company believes that all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain amounts in prior year financial statements have been reclassified to conform to the current year presentation. Operating results for the three months ended March 31, 2006 are not necessarily indicative of the results that may be achieved for the twelve months ending December 31, 2006. For further information, refer to the consolidated financial statements and footnotes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. Unless otherwise noted, disclosures pertain to the Company's continuing operations.

**Note 2. New Accounting Standards**

**Accounting Changes and Error Corrections**

During May 2005, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3 (SFAS 154). Under APB Opinion No. 20, most voluntary changes in accounting principle were recognized by including the cumulative effect of changing to the new accounting principle in net income in the period of change. SFAS 154 requires retrospective application to prior period financial statements of changes in accounting principle, unless it is impracticable to determine the period-specific effects of the cumulative effect of the change. SFAS 154 will apply to all accounting changes made after adoption of the statement, which is required by the fiscal year beginning after December 15, 2005. The Company adopted SFAS 154 on January 1, 2006. The adoption of SFAS 154 did not have a material impact on the Company's financial condition, results of operations or cash flows for the three months ended March 31, 2006.

**Inventory Costs**

During November 2004, the FASB issued Statement of Financial Accounting Standards No. 151, Inventory Costs (SFAS 151), an amendment of ARB No. 43, Chapter 4. Adoption of SFAS 151 was required by the year beginning January 1, 2006. The amendments made by SFAS 151 clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) should be recognized as current period charges and requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. While SFAS 151 enhances ARB 43 and clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage), the statement also removes inconsistencies between ARB 43 and International Accounting Standards (IAS) 2 and amends ARB 43 to clarify that abnormal amounts of costs should be recognized as period costs. Under some circumstances, according to ARB 43, the above listed costs may be so abnormal as to require treatment as current period charges. SFAS 151 requires these items be recognized as current period charges regardless of whether they

meet the criterion of so abnormal and requires allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. This statement will apply to the Company's businesses if they become subject to abnormal costs as defined in SFAS 151. The Company adopted SFAS 151 on January 1, 2006. The adoption of SFAS 151 did not have a material impact on the Company's financial condition, results of operations or cash flows for the three months ended March 31, 2006.

#### **Accounting for Certain Hybrid Financial Instruments**

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments (SFAS 155), which amends Statement of Financial Accounting No. 133 and Statement of Financial Accounting 140, and improves the financial reporting of certain hybrid financial instruments by requiring more consistent accounting that eliminates exemptions and simplifies the accounting for those instruments. SFAS 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company has not issued or acquired the hybrid instruments included in the scope of SFAS 155 and does not expect the adoption of SFAS 155 to have a material impact on the Company's financial condition, results of operations or cash flows.

#### **Accounting for Servicing of Financial Assets**

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, Accounting for Servicing of Financial Assets - An Amendment of FASB Statement No. 140 (SFAS 156). SFAS 156 requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable. The statement permits, but does not require, the subsequent measurement of servicing assets and servicing liabilities at fair value. SFAS 156 is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company does not expect the adoption of SFAS 156 to have a material impact on the Company's financial condition, results of operations or cash flows.

#### **Note 3. Restructuring and Consolidation Costs**

The Company incurred \$1.5 million and \$3.2 million of net restructuring and consolidation costs during the three months ended March 31, 2006 and 2005, respectively. The charges in 2006 primarily relate to restructuring actions initiated during 2005 to downsize a foreign facility.

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Dollars in millions)</b>	
Engine Systems	\$ 0.2	\$ 0.2
Airframe Systems	0.4	2.2
Electronic Systems	0.9	0.8
	<b>\$ 1.5</b>	<b>\$ 3.2</b>
Personnel-related costs	\$ 0.7	\$ 2.5
Facility closure and other costs	0.8	0.7
	<b>\$ 1.5</b>	<b>\$ 3.2</b>
Cost of sales	\$ 0.9	\$ 3.0
Selling and administrative costs	0.6	0.2
	<b>\$ 1.5</b>	<b>\$ 3.2</b>



Restructuring and consolidation reserves at March 31, 2006, as well as the activity during the three months ended March 31, 2006, consisted of:

		<b>(Dollars in millions)</b>
Reserve balance December 31, 2005	\$	6.5
Restructuring charges		1.5
Used as intended		(1.8)
Return to profit		
Foreign exchange adjustments		0.1
Reserve balance at March 31, 2006	\$	6.3

***Future Restructuring and Consolidation Costs for Programs Announced and Initiated***

During 2005, the Company announced and initiated a restructuring program to downsize a German facility in the Electronic Systems segment with partial transfers of operations to existing facilities in Florida and India. The aim of this project is to reduce operating costs and foreign exchange exposure. The total restructuring cost is expected to be approximately \$15 million, of which approximately \$10 million relates to costs yet to be incurred in 2006 and in 2007. Approximately \$1 million was paid in the three months ended March 31, 2006.

Additional expected costs by segment and type are as follows:

	<b>Personnel- Related Costs</b>	<b>Facility Closure Costs</b>	<b>Total</b>
	<b>(Dollars in millions)</b>		
Engine Systems	\$ 0.4	\$	\$ 0.4
Airframe Systems			
Electronic Systems	5.8	4.2	10.0
Total	\$ 6.2	\$ 4.2	\$ 10.4

**Note 4. Other Income (Expense) Net**

Other Income (Expense) Net consisted of the following:

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Dollars in millions)</b>	
Retiree health care expenses related to divested businesses	\$ (4.8)	\$ (4.7)
Expenses related to divested businesses	(1.4)	(1.4)
Minority interest and equity in affiliated companies	(3.8)	(2.8)
Other net	(0.6)	(1.2)
Other income (expense) net	\$ (10.6)	\$ (10.1)

**Note 5. Earnings Per Share**

The computation of basic and diluted earnings per share for income from continuing operations is as follows:

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(In millions, except per share amounts)</b>	
<b>Numerator:</b>		
Numerator for basic and diluted earnings per share income from continuing operations	\$ 200.3	\$ 56.8
<b>Denominator:</b>		
Denominator for basic earnings per share weighted- average shares	123.5	119.8
Effect of dilutive securities:		
Stock options, employee stock purchase plan, restricted shares and restricted share units	2.0	2.2
Other deferred compensation shares	0.1	0.1
	2.1	2.3
Denominator for diluted earnings per share adjusted weighted- average shares and assumed conversion	125.6	122.1
Per share income from continuing operations:		
Basic	\$ 1.62	\$ 0.47
Diluted	\$ 1.59	\$ 0.46

At March 31, 2006 and 2005, the Company had outstanding approximately 7.1 million and 9.5 million stock options, respectively. Stock options are included in the diluted earnings per share calculation using the treasury stock method, unless the effect of including the stock options would be anti-dilutive. Of the 7.1 million and 9.5 million stock options outstanding, 0.8 million and 2.8 million were anti-dilutive stock options excluded from the diluted earnings per share calculation at March 31, 2006 and 2005, respectively.

During the three months ended March 31, 2006 and 2005, the Company issued approximately 0.8 million and 1.4 million, respectively, of shares of common stock pursuant to stock option exercises and other stock-based compensation.

**Note 6. Inventories**

Inventories consist of the following:

	<b>March 31, 2006</b>	<b>December 31, 2005</b>
	<b>(Dollars in millions)</b>	
<b>FIFO or average cost (which approximates current costs):</b>		
Finished products	\$ 312.1	\$ 218.1
In process	842.7	908.7
Raw materials and supplies	329.1	280.3

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	1,483.9	1,407.1
Less:		
Reserve to reduce certain inventories to LIFO basis	(43.8)	(43.5)
Progress payments and advances	(46.5)	(55.2)
Total	\$ 1,393.6	\$ 1,308.4

The pre-production and excess-over-average inventory accounted for under long-term contract accounting and deferred engineering costs recoverable under long-term contractual arrangements were \$304.4 million and \$276 million as of March 31, 2006 and December 31,

2005, respectively. These amounts are included in In process inventory above.

**Note 7. Goodwill**

The changes in the carrying amount of goodwill by segment for the three months ended March 31, 2006 are as follows:

	<b>Balance December 31, 2005</b>	<b>Business Combinations Completed or Finalized (Dollars in millions)</b>	<b>Foreign Currency Translation</b>	<b>Balance March 31, 2006</b>
Engine Systems	\$ 483.1	\$	\$ 3.0	\$ 486.1
Airframe Systems	239.6		2.3	241.9
Electronic Systems	595.7	(2.8) (a)	(1.2)	591.7
	\$ 1,318.4	\$ (2.8)	\$ 4.1	\$ 1,319.7

- (a) Represents a revision of plan provisions used in the actuarial valuation of other postretirement benefits related to the acquisition of the aeronautical systems businesses in the Electronic Systems segment.

**Note 8. Financing Arrangements**

**Credit Facilities**

The Company has a \$500 million committed global syndicated revolving credit facility that expires in May 2010. Borrowings under this facility bear interest, at the Company's option, at rates tied to the agent bank's prime rate or, for U.S. Dollar or Great Britain Pounds Sterling borrowings, the London interbank offered rate and for Euro Dollar borrowings, the EURIBO rate. The Company is required to pay a facility fee of 15 basis points per annum on the total \$500 million committed line. Further, if the amount outstanding exceeds 50 percent of the total commitment, a usage fee of 12.5 basis points per annum on the amount outstanding is payable by the Company. These fees and the interest rate margin on outstanding revolver borrowings are subject to change as the Company's credit ratings change. At March 31, 2006 and December 31, 2005, there were \$34.9 million in borrowings and \$19.6 million in letters of credit outstanding under the new facility. The level of unused borrowing capacity under the Company's committed syndicated revolving credit facility varies from time to time depending in part upon its compliance with financial and other covenants set forth in the related agreement, including the consolidated net worth requirement and maximum leverage ratio. The Company is currently in compliance with all such covenants. As of March 31, 2006, the Company had borrowing capacity under this facility of \$445.5 million, after reductions for borrowings and letters of credit

outstanding.

At March 31, 2006, the Company also maintained \$75 million of uncommitted domestic money market facilities and \$127.7 million of uncommitted and committed foreign working capital facilities with various banks to meet short-term borrowing requirements. At March 31, 2006 there was \$28.6 million outstanding in borrowings under these facilities. At December 31, 2005, the Company maintained \$75 million of uncommitted domestic money market facilities and \$111.5 million of uncommitted and committed foreign working capital facilities with \$22.4 million outstanding in borrowings under these facilities. These credit facilities are provided by a small number of commercial banks that also provide the Company with committed credit through the syndicated revolving credit facility described above and with various cash management, trust and other services.



The Company's credit facilities do not contain any credit rating downgrade triggers that would accelerate the maturity of its indebtedness. However, a ratings downgrade would result in an increase in the interest rate and fees payable under its committed syndicated revolving credit facility. Such a downgrade also could adversely affect the Company's ability to renew existing or obtain access to new credit facilities in the future and could increase the cost of such new facilities.

The Company has an outstanding contingent liability for guaranteed debt and lease payments of \$2.3 million and letters of credit and bank guarantees of \$52.5 million. It is not practical to obtain independent estimates of the fair values for the contingent liability for guaranteed debt and lease payments and for letters of credit.

The Company's committed syndicated revolving credit facility contains various restrictive covenants that, among other things, place limitations on the payment of cash dividends and the repurchase of the Company's capital stock. Under the most restrictive of these covenants, \$766.5 million of income retained in the business and additional paid in capital was free from such limitations at March 31, 2006.

#### **Note 9. Off Balance Sheet Arrangements**

##### **Lease Commitments**

The Company finances its use of certain of its office and manufacturing facilities as well as machinery and equipment, including corporate aircraft, under various committed lease arrangements provided by financial institutions. Certain of these arrangements allow the Company to claim a deduction for tax depreciation on the assets, rather than the lessor, and allow the Company to lease aircraft and equipment having a maximum unamortized value of \$55 million at March 31, 2006. At March 31, 2006, \$19.6 million of future minimum lease payments was outstanding under these arrangements. Additionally, the Company has residual value guarantees under these arrangements of \$24.8 million (see Note 16, "Guarantees"). The Company is obligated to either purchase or remarket the leased corporate aircraft and equipment at the end of the lease term. The residual values were established at lease inception. The lease terms mature in 2011 and 2012. The other arrangements are standard operating leases. Future minimum lease payments under the standard operating leases approximated \$133.3 million at March 31, 2006.

##### **Sale of Receivables**

At March 31, 2006, the Company had in place a variable rate trade receivables securitization program pursuant to which the Company could sell receivables up to a maximum of \$140 million. Accounts receivable sold under this program were \$97.1 million at March 31, 2006.

Continued availability of the securitization program is conditioned upon compliance with covenants, related primarily to operation of the securitization, set forth in the related agreements. The Company is currently in compliance with all such covenants. The securitization does not contain any credit rating downgrade triggers.

**Note 10. Pensions and Postretirement Benefits****Pensions**

The following table sets forth the components of net periodic benefit costs (income) for the three months ended March 31, 2006 and 2005. The net periodic benefit costs (income) for divested or discontinued operations retained by the Company are included in the amounts below.

	<b>U.S. Plans</b>		<b>U.K. Plans</b>		<b>Other Non-U.S. Plans</b>	
	<b>Three Months Ended March 31,</b>		<b>Three Months Ended March 31,</b>		<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(Dollars in millions)</b>					
Service cost	\$ 13.7	\$ 10.8	\$ 7.2	\$ 6.1	\$ 1.1	\$ 0.8
Interest cost	38.3	36.4	8.1	7.7	1.2	1.1
Expected rate of return on plan assets	(45.9)	(42.6)	(11.8)	(10.9)	(1.4)	(0.9)
Amortization of transition obligation						
Amortization of prior service cost	2.2	2.2				
Amortization of actuarial (gain) loss	16.0	11.2	0.3		0.3	
Periodic benefit cost (income)	24.3	18.0	3.8	2.9	1.2	1.0
Settlements and curtailments (gain) loss						
Special termination benefit charge (credit)						
Net benefit cost (income)	\$ 24.3	\$ 18.0	\$ 3.8	\$ 2.9	\$ 1.2	\$ 1.0

The following table provides the weighted average assumptions used to determine the net periodic benefit costs (income).

	<b>U.S. Plans</b>		<b>U.K. Plans</b>		<b>Other Non-U.S. Plans</b>	
	<b>Three Months Ended March 31,</b>		<b>Three Months Ended March 31,</b>		<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Discount rate	5.64%	5.875%	4.75%	5.50%	4.76%	5.75%
Expected long-term return on assets	9.00%	9.00%	8.50%	8.50%	8.34%	8.50%
Rate of compensation increase	3.63%	3.63%	3.50%	3.50%	3.34%	3.50%

**U.S Retirement Plan Changes in 2006**

In the fourth quarter of 2005, the Company changed certain aspects of its U.S. qualified defined benefit pension plan and U.S. qualified defined contribution plan. Employees hired on and after January 1, 2006, will not participate in the Company's qualified defined benefit plan (Goodrich Employees Pension Plan). These new employees will receive a higher level of company contribution in the Company's qualified defined contribution plan (Goodrich Employees Savings Plan). New employees will receive a dollar for dollar match on the first 6 percent of pay contributed, plus an automatic annual employer contribution of 2 percent of pay. However, this 2 percent employer contribution is subject to a 3-year vesting requirement. During the first half of 2006, persons employed by the Company at December 31, 2005 must elect whether they want to continue with the current benefits in the defined benefit and defined contribution plans or cease to earn additional service in the pension plan as of June 30, 2006 and receive the higher level of company contributions in the defined contribution plan. Those employees choosing the latter option will continue to have pay received after June 30, 2006 included in their final average earnings used to calculate their pension benefit.

This change in retirement benefits may result in a 2006 curtailment charge and a revision to 2006 pension expense for the remainder of the year after the curtailment date as a result of remeasuring the Company's U.S. pension plan assumptions. The charge and updated pension expense will be known when we can reasonably estimate the effect of the employee elections.

**Postretirement Benefits Other Than Pensions**

The following table sets forth the components of net periodic benefit costs (income) for the three months ended March 31, 2006 and 2005. The postretirement benefit related to divested and discontinued operations retained by the Company are included in the amounts below.

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Dollars in millions)</b>	
Service cost	\$	\$ 0.3
Interest cost	4.6	6.3
Amortization of prior service cost	(0.1)	
Amortization of actuarial (gain) loss	(0.2)	0.5
Periodic benefit cost (income)	4.3	7.1
Settlements and curtailments (gain) loss		
Special termination benefit charge (credit)		
Net benefit cost (income)	\$ 4.3	\$ 7.1

The net periodic benefit cost for the three months ended March 31, 2006 includes a non-recurring reduction of \$3.2 million for a revision in the plan provisions used in the actuarial valuation of other postretirement benefits related to the acquisition of the aeronautical systems businesses. The \$3.2 million reduction of net periodic benefit cost consists of \$0.4 million reduction to service cost, \$1.2 million reduction to interest cost and \$1.6 million reduction to the amortization of actuarial (gains) losses.

The following table provides the assumptions used to determine the net periodic benefit costs (income).

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>
Discount rate	5.55%	5.875%

Healthcare trend rate	9% in 2006 to 5% in 2010	9% in 2005 to 5% in 2008
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**Note 11. Comprehensive Income/(Loss)**

Total comprehensive income consisted of the following:

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Dollars in millions)</b>	
<b>Comprehensive Income/(Loss)</b>		
Net income	\$ 201.5	\$ 57.5
Other comprehensive income/(loss):		
Unrealized foreign currency translation gains (losses) during period	11.8	0.7
Gains (losses) on cash flow hedges	3.6	(18.2)
Total	\$ 216.9	\$ 40.0

Accumulated other comprehensive income/(loss) consisted of the following:

	<b>March 31, 2006</b>	<b>December 31, 2005</b>
	<b>(Dollars in millions)</b>	
<b>Accumulated Other Comprehensive Income/(Loss)</b>		
Cumulative unrealized foreign currency translation gains (losses)	\$ 147.0	\$ 135.2
Minimum pension liability adjustments	(424.1)	(424.1)
Accumulated gains (losses) on cash flow hedges	9.5	5.9
Total	\$ (267.6)	\$ (283.0)

The minimum pension liability amounts above are net of deferred taxes of \$247.8 million at both March 31, 2006 and December 31, 2005. The accumulated gain on cash flow hedges above is net of deferred taxes of \$5 million and \$3.2 million at March 31, 2006 and December 31, 2005, respectively. No income taxes are provided on foreign currency translation gains as foreign earnings are considered permanently invested.

#### **Note 12. Income Taxes**

The Company's effective tax rate for the three months ended March 31, 2006 was (97.9) percent. The effective tax rate varies from the statutory rate of 35 percent primarily due to the reversal of tax reserves in connection with favorable tax settlements related to the IRS examinations of Rohr, Inc. and subsidiaries (for the period from July, 1986 through December, 1997) and Coltec Industries Inc and subsidiaries (for the period December, 1997 through July, 1999), which reduced the tax rate by approximately 130 percentage points (see Note 15, Contingencies for further discussion related to these contingencies). The effective tax rate also varied from the statutory rate of 35 percent due to tax benefits from export sales and domestic production activities which reduced the effective rate by approximately 5 percentage points, earnings in foreign jurisdictions taxed at rates different from the statutory U.S. federal rate, including the impact of tax holidays, which reduced the effective rate by approximately 1 percentage point, adjustments to valuation allowances associated with certain deferred tax assets in foreign jurisdictions which increased the effective tax rate by approximately 2 percentage points and other adjustments to reserves for tax contingencies, including interest thereon, net of tax, which increased the effective rate by approximately 2 percentage points. The Company's effective tax rate during the three months ended March 31, 2006 was not reduced for the benefit of U.S. Research and Development (R&D) Credits because the federal statute authorizing the R&D Credit has not been extended beyond December 31, 2005. The Company estimates that the effective tax rate as of March 31, 2006 would have been approximately 1 percentage point lower had the Company been able to consider the tax benefits associated with the R&D Credit.

In accordance with Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (SFAS 5), the Company records tax contingencies when the exposure item becomes probable and reasonably estimable. As of December 31, 2005, the Company had tax contingency reserves of approximately \$325.6 million. During the three months ended March 31, 2006, the Company recorded a net benefit of \$95.5 million, made payments of \$0.6 million (net of federal tax benefit), and had other miscellaneous adjustments of \$0.2 million. The net benefit primarily related to the reversal of tax reserves in connection with favorable tax settlements discussed above and in Note 15,

Contingencies. As of March 31, 2006, the Company had recorded tax contingency reserves of approximately \$229.7 million. The contingencies that comprise the reserves are more fully described in Note 15, Contingencies.

**Note 13. Business Segment Information**

The Company has three business segments: Engine Systems, Airframe Systems and Electronic Systems.

**Engine Systems**

Engine Systems is a major supplier of:

Nacelles;

Pylons;

Thrust reversers and related aircraft engine housing components;

Engine and fuel controls;

Pumps;

Fuel delivery systems; and

Structural and rotating components (such as discs, blisks, shafts and airfoils) for both aerospace and industrial gas turbine applications.

The segment includes aerostructures, engine controls, turbomachinery products, turbine fuel technologies and customer services businesses.

The aerostructures business manufactures nacelle systems, pylons, thrust reversers, related engine housing components and cargo systems. This business also sells aftermarket parts to airlines and performs maintenance repair and overhaul services.

The engine controls business provides engine control systems and components for jet engines used on commercial and military aircraft, including:

- Fuel metering controls;
- Fuel pumping systems;
- Electronic control software and hardware;
- Variable geometry actuation controls;
- Afterburner fuel pump and metering unit nozzles; and
- Engine health monitoring systems.

The customer services business primarily supports aftermarket products and sales.

The fuel delivery business provides fuel nozzles, injectors, valves and manifolds for aerospace, industrial gas turbine engines and non-aerospace applications that require liquid atomization.

*Airframe Systems*

Airframe Systems provides systems and components pertaining to aircraft:

Taxi;

Take-off;

Flight control;

Landing; and

Stopping.

Several businesses within the segment are linked by their ability to contribute to the integration, design, manufacture and service of entire aircraft undercarriage systems, including:

Landing gear;

Wheels and brakes; and

Certain brake controls.

Airframe Systems also includes the:

Aviation technical services business, which performs:

- Comprehensive total aircraft maintenance, repair, overhaul; and
- Modification services for many commercial airlines, independent operators, aircraft leasing companies and airfreight carriers.

Actuation systems business, which provides:

- Systems that control the movement of steering systems for missiles and electro-mechanical systems that are characterized by high power, low weight, low maintenance, resistance to extreme temperatures and vibrations and high reliability; and
- Actuators for primary flight control systems that operate elevators, ailerons and rudders, and secondary flight controls systems such as flaps and slats.

Engineered polymer products business, which provides:

- Large-scale marine composite structures and acoustic materials;
- Acoustic/vibration damping structures; and
- Fireproof composites.



***Electronic Systems***

Electronic Systems produces a wide array of products that provide:

Flight performance measurements;

Flight management; and

Control and safety data.

Included are a variety of sensor systems that measure and manage:

Aircraft fuel and monitor oil debris;

Engine and transmission; and

Structural health.

The segment's products also include:

Ice detection systems;

Interior and exterior aircraft lighting systems;

Landing gear cables and harnesses;

Satellite control;

Data management;

Payload systems;

Launch and missile telemetry systems;

Airborne surveillance and reconnaissance systems;

Laser warning systems;

Aircraft evacuation systems;

De-icing systems;

Ejection seats;

Crew and attendant seating;

Engine shafts primarily for helicopters;

Electronic flight bags;

Air data probes;

Reduced vertical separation minimums (RVSM) sensors;

Specialty heated products;

Potable water systems;

Drain masts;

Proximity sensors;

Laser perimeter awareness systems (LPAS); and

Cockpit video systems.

Electronic Systems also include the power systems and hoists and winches businesses.

The power systems business provides systems that produce and control electrical power for commercial and military aircraft, including:

Electric generators for both main and back-up electrical power;

Electric starters and electric starter generating systems; and

Power management and distribution systems.

The hoists and winches business provides airborne hoists and winches used on both helicopters and fixed wing aircraft. The segment also produces short wave (SWIR) and near infrared (NIR) imaging products for a variety of military and commercial customers as a result of the acquisition of Sensors Unlimited, Inc. (SUI) in 2005.

Segment operating income is total segment revenue reduced by operating expenses identifiable with that business segment. The accounting policies of the reportable segments are the same as those for Goodrich consolidated.

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Dollars in millions)</b>	
Net customer sales:		
Engine Systems	\$ 610.5	\$ 528.1
Airframe Systems	470.3	442.7
Electronic Systems	343.0	304.7
	\$ 1,423.8	\$ 1,275.5
Intersegment sales:		
Engine Systems	\$ 4.9	\$ 9.1
Airframe Systems	12.1	12.9
Electronic Systems	13.0	7.9
	\$ 30.0	\$ 29.9
Segment operating income:		
Engine Systems	\$ 118.7	\$ 90.5
Airframe Systems	14.3	27.8
Electronic Systems	36.9	32.3
	169.9	150.6
Corporate general and administrative expenses	(27.2)	(20.5)
Total operating income	\$ 142.7	\$ 130.1

#### **Note 14. Derivatives and Hedging Activities**

##### **Cash Flow Hedges**

The Company has subsidiaries that conduct a substantial portion of their business in Euros, Great Britain Pounds Sterling, Canadian Dollars and Polish Zlotys but have significant sales contracts that are denominated in U.S. Dollars. Periodically, the Company enters into forward contracts to exchange U.S. Dollars for Euros, Great Britain Pounds Sterling, Canadian Dollars and Polish Zlotys to hedge a portion of the Company's exposure from U.S. Dollar sales.



The forward contracts described above are used to mitigate the potential volatility to earnings and cash flow arising from changes in currency exchange rates that impact the Company's U.S. Dollar sales for certain foreign operations. The forward contracts are being accounted for as cash flow hedges. The forward contracts are recorded in the Company's Unaudited Condensed Consolidated Balance Sheet at fair value with the offset reflected in Accumulated Other Comprehensive Income/(Loss), net of deferred taxes. The notional value of the forward contracts at March 31, 2006 was \$1,158.5 million. The fair value of the forward contracts at March 31, 2006, was a net asset of \$14.2 million, including:

\$20.9 million recorded as a current asset in Prepaid Expenses and

\$5.4 million recorded as a non-current asset in Other Assets; partially offset by,

\$11.1 million recorded as a current liability in Accrued Expenses and

\$1 million recorded as a non-current liability in Other Non-Current Liabilities.

The total fair value of the Company's forward contracts of \$14.2 million (before deferred taxes of \$5 million) at March 31, 2006, combined with \$0.1 million of gains on previously matured hedges of intercompany sales and \$0.2 million of gains from forward contracts terminated prior to the original maturity dates is recorded in Accumulated Other Comprehensive Income and will be reflected in income as earnings are affected by the hedged items. As of March 31, 2006, the portion of the \$14.5 million that would be reclassified into earnings as an increase in sales to offset the effect of the hedged item in the next 12 months is a gain of \$10.1 million. These forward contracts mature on a monthly basis with maturity dates that range from April 2006 to December 2008.

#### **Fair Value Hedges**

The Company enters into interest rate swaps to increase the Company's exposure to variable interest rates. The Company has the following interest rate swaps outstanding as of March 31, 2006.

A \$50 million fixed-to-floating interest rate swap on the 6.45 percent notes due in 2008; and

Two \$50 million fixed-to-floating interest rate swaps on the 7.50 percent notes due in 2008

The settlement and maturity dates on each swap are the same as those on the referenced notes. In accordance with SFAS 133, the interest rate swaps are being accounted for as fair value hedges and the carrying value of the notes has been adjusted to reflect the fair values of the interest rate swaps. The fair value of the interest rate swaps was a liability/(loss) of \$5.2 million at March 31, 2006.

### **Other Forward Contracts**

As a supplement to the foreign exchange cash flow hedging program, the Company enters into forward contracts to manage its foreign currency risk related to the translation of monetary assets and liabilities denominated in currencies other than the relevant functional currency. These forward contracts mature monthly and the notional amounts are adjusted periodically to reflect changes in net monetary asset balances. The gains or losses on these forward contracts are being recorded in Cost of Sales in order to mitigate the earnings impact of the translation of net monetary assets and liabilities. Under this program, as of March 31, 2006, the Company had forward contracts with a notional value of \$45.4 million to buy Great Britain Pounds Sterling, forward contracts with a notional value of \$13.2 million to buy Euros and forward contracts with a notional value of \$55.4 million to sell Canadian Dollars.

### **Note 15. Contingencies**

#### **General**

There are pending or threatened against the Company or its subsidiaries various claims, lawsuits and administrative proceedings, all arising from the ordinary course of business with respect to commercial, product liability, asbestos and environmental matters, which seek remedies or damages. The Company believes that any liability that may finally be determined with respect to commercial and non-asbestos product liability claims should not have a material effect on its consolidated financial position, results of operations or cash flow. From time to time, the Company is also involved in legal proceedings as a plaintiff involving tax, contract, patent protection, environmental and other matters. Gain contingencies, if any, are recognized when they are realized. Legal costs are generally expensed as incurred.

#### **Environmental**

The Company is subject to various domestic and international environmental laws and regulations which may require that it investigate and remediate the effects of the release or disposal of materials at sites associated with past and present operations, including sites at which the Company has been identified as a potentially responsible party under the federal Superfund laws and comparable state laws. The Company is currently involved in the investigation and remediation of a number of sites under these laws.

Estimates of the Company's environmental liabilities are based on currently available facts, present laws and regulations and current technology. Such estimates take into consideration the Company's prior experience in site investigation and remediation, the data concerning cleanup costs available from other companies and regulatory authorities and the professional judgment of the Company's environmental specialists in consultation with outside environmental specialists, when necessary. Estimates of the Company's environmental liabilities are further subject to uncertainties regarding the nature and extent of site contamination, the range of remediation alternatives available, evolving remediation standards, imprecise engineering evaluations and estimates of appropriate cleanup technology, methodology and cost, the extent of corrective actions that may be required and the number and financial condition of other potentially responsible parties, as well as the extent of their responsibility for the remediation.

Accordingly, as investigation and remediation of these sites proceed, it is likely that adjustments in the Company's accruals will be necessary to reflect new information. The amounts of any such adjustments could have a material adverse effect on the results of operations in a given period, but the amounts, and the possible range of loss in excess of the amounts accrued, are not reasonably estimable. Based on currently available information, however, the Company does not believe that future environmental costs in excess of those accrued with respect to sites for which it has been identified as a potentially responsible party are likely to have a material adverse effect on its financial condition. There can be no assurance, however, that additional future developments, administrative actions or liabilities relating to environmental matters will not have a material adverse effect on its results of operations or cash flows in a given period.

Environmental liabilities are recorded when the liability is probable and the costs are reasonably estimable, which generally is not later than at completion of a feasibility study or when the Company has recommended a remedy or has committed to an appropriate plan of action. The liabilities are reviewed periodically and, as investigation and remediation proceed, adjustments are made as necessary. Liabilities for losses from environmental remediation obligations do not consider the effects of inflation and anticipated expenditures are not discounted to their present value. The liabilities are not reduced by possible recoveries from insurance carriers or other third parties, but do reflect anticipated allocations among potentially responsible parties at federal Superfund sites or similar state-managed sites and an assessment of the likelihood that such parties will fulfill their obligations at such sites.

The Company's Unaudited Condensed Consolidated Balance Sheet included an accrued liability for environmental remediation obligations of \$80.1 million and \$81 million at March 31, 2006 and December 31, 2005, respectively. At March 31, 2006 and December 31, 2005, \$16.8 million and \$18.3 million, respectively, of the accrued liability for environmental remediation was included in current liabilities as Accrued Expenses. At March 31, 2006 and December 31, 2005, \$32 and \$31.4 million, respectively, was associated with ongoing operations and \$48.1 million and \$49.6 million, respectively, was associated with businesses previously disposed of or discontinued.

The timing of expenditures depends on a number of factors that vary by site, including the nature and extent of contamination, the number of potentially responsible parties, the timing of regulatory approvals, the complexity of the investigation and remediation, and the standards for remediation. The Company expects that it will expend present accruals over many years, and will complete remediation in less than 30 years at all sites for which it has been identified as a potentially responsible party. This period includes operation and monitoring costs that are generally incurred over 15 to 25 years.

#### **Asbestos**

The Company and a number of its subsidiaries have been named as defendants in various actions by plaintiffs alleging injury or death as a result of exposure to asbestos fibers in products, or which may have been present in its facilities. A number of these cases involve maritime claims, which have been and are expected to continue to be administratively dismissed by the court. These actions primarily relate to previously owned businesses. The Company believes that pending and reasonably anticipated future actions, net of anticipated insurance recoveries, are not likely to have a material adverse effect on the Company's financial condition, results of operations or cash flows. There can be no assurance, however, that future legislative or other developments will not have a material adverse effect on the Company's results of operations in a given period.

The Company believes that substantial insurance coverage is available to it related to any remaining claims. However, the primary layer of insurance coverage for most of these claims is provided by the Kemper Insurance Companies. Kemper has indicated that, due to capital constraints and downgrades from various rating agencies, it has ceased underwriting new business and now focuses on administering policy commitments from prior years. Kemper has also indicated that it is currently operating under a run-off plan approved by the Illinois Department of Insurance. The Company cannot predict the impact of Kemper's financial position on the availability of the Kemper insurance. In addition, a portion of the Company's primary and excess layers of general liability insurance coverage for most of these claims was provided by insurance subsidiaries of London United Investments plc (KWELM). KWELM is insolvent and in the process of distributing its assets and dissolving. In September 2004, the Company entered into a settlement agreement with KWELM pursuant to which the Company agreed to give up its rights with respect to the KWELM insurance policies in exchange for \$18.3 million, subject to increase under certain circumstances. The settlement represents a negotiated payment for the Company's loss of insurance coverage, as it no longer has the KWELM insurance available for claims that would have qualified for coverage. The initial settlement amount of \$18.3 million was paid to the Company during 2004, was recorded as a deferred settlement credit and will be used to offset asbestos and other toxic tort claims in future periods.

The KWELM insolvent fund managers made additional settlement distributions to the Company during the three months ended March, 31, 2006 and during the year ended December 31, 2005 totaling \$1.8 million and \$11.3 million, respectively, following completion of the insolvent scheme of arrangement process in the United Kingdom. The additional distribution was recorded as a deferred settlement credit and will be used to offset asbestos and other toxic tort claims in future periods. One final distribution may be made depending on the final valuation of KWELM.

#### **Liabilities of Divested Businesses**

##### ***Asbestos***

In May 2002, the Company completed the tax-free spin-off of its Engineered Products (EIP) segment, which at the time of the spin-off included EnPro Industries, Inc. (EnPro) and Coltec Industries Inc (Coltec). At that time, two subsidiaries of Coltec were defendants in a significant number of personal injury claims relating to alleged asbestos-containing products sold by those subsidiaries. It is possible that asbestos-related claims might be asserted against the Company on the theory that it has some responsibility for the asbestos-related liabilities of EnPro, Coltec or its subsidiaries, even though the activities that led to those claims occurred prior to the Company's ownership of any of those subsidiaries. Also, it is possible that a claim might be asserted against the Company that Coltec's dividend of its aerospace business to the Company prior to the spin-off was made at a time when Coltec was insolvent or caused Coltec to become insolvent. Such a claim could seek recovery from the Company on behalf of Coltec of the fair market value of the dividend.

A limited number of asbestos-related claims have been asserted against the Company as successor to Coltec or one of its subsidiaries. The Company believes that it has substantial legal defenses against these claims, as well as against any other claims that may be asserted against the Company on the theories described above. In addition, the agreement between EnPro and the Company that was used to effectuate the spin-off provides the Company with an indemnification from EnPro covering, among other things, these liabilities. The success of



any such asbestos-related claims would likely require, as a practical matter, that Coltec's subsidiaries were unable to satisfy their asbestos-related liabilities and that Coltec was found to be responsible for these liabilities and was unable to meet its financial obligations. The Company believes any such claims would be without merit and that Coltec was solvent both before and after the dividend of its aerospace business to the Company. If the Company is ultimately found to be responsible for the asbestos-related liabilities of Coltec's subsidiaries, it believes such finding would not have a material adverse effect on its financial condition, but could have a material adverse effect on its results of operations and cash flows in a particular period. However, because of the uncertainty as to the number, timing and payments related to future asbestos-related claims, there can be no assurance that any such claims will not have a material adverse effect on the Company's financial condition, results of operations and cash flows. If a claim related to the dividend of Coltec's aerospace business were successful, it could have a material adverse impact on the Company's financial condition, results of operations and cash flows.

**Other**

In connection with the divestiture of the Company's tire, vinyl and other businesses, the Company has received contractual rights of indemnification from third parties for environmental and other claims arising out of the divested businesses. Failure of these third parties to honor their indemnification obligations could have a material adverse effect on the Company's financial condition, results of operations and cash flows.

**Guarantees**

At March 31, 2006, the Company had an outstanding contingent liability for guarantees of debt and lease payments of \$2.3 million, letters of credit and bank guarantees of \$52.5 million and residual value of lease obligations of \$24.8 million (see Note 16, "Guarantees").

**Commercial Airline Customers**

Several of the Company's commercial airline customers are experiencing financial difficulties. The Company performs ongoing credit evaluations on the financial condition of all of its customers and maintains reserves for uncollectible accounts receivable based upon expected collectibility. Although the Company believes that its reserves are adequate, it is not able to predict the future financial stability of these customers. Any material change in the financial status of any one or group of customers could have a material adverse effect on the Company's financial condition, results of operations or cash flows. The extent to which extended payment terms are granted to customers may negatively affect future cash flow.

**Aerostructures Long-Term Contracts**

The aerostructures business has several long-term contracts in the pre-production phase. This phase includes design of the product to meet customer specifications as well as design of the manufacturing processes to manufacture the production product. Also involved in this phase is securing supply of material and subcomponents produced by third party suppliers that are generally accomplished through long-term supply agreements. Because these contracts cover periods of up to 15 years or more, there is risk that estimates of future costs made during the pre-production phase will be different from actual costs and that difference could be significant.

**Compliance with Specialty Metals Clause in U.S. Defense Contracts and Subcontracts**

Many companies in the aerospace industry are experiencing challenges regarding compliance with certain provisions set forth in Department of Defense (DoD) Appropriations Acts that are often referred to generally as the Berry Amendment. The Berry Amendment provisions are implemented through the Department of Defense Federal Acquisition Regulation Supplement (DFARS). One of the DFARS clauses (252.225-7014 (Alternate I)) implementing the Berry Amendment restricts the country of origin for certain specialty metals used in certain products to be delivered to the DoD. This DFARS clause requires that any specialty metals (in most cases involving stainless steel or titanium) incorporated into an article to be delivered under a DoD contract must be melted in the United States or its outlying areas, or must be melted or incorporated into an article manufactured in a list of qualifying countries. The Alternate I version of this clause applies to DoD contracts involving, among other items, aircraft and missile and space systems, and requires all subcontractors *at any tier* to comply

with the clause's restrictions on the use of specialty metals. Compliance with this requirement is especially difficult in connection with stainless steel fasteners purchased from global sources.

The Company has certain contracts and subcontracts that contain DFARS 252.225-7014 (Alternate I). Delivering supplies and/or submitting payment requests for supplies that do not comply with DFARS 252.225-7014 (Alternate I), when applicable, could subject the Company to potentially significant penalties if the non-compliance is not disclosed to the purchaser. In addition, disclosing any non-compliance with this DFARS clause can result in customers not accepting or conditionally accepting the non-compliant supplies. The Company is currently evaluating its compliance with the clause and is unable at this time to estimate the financial effect on the Company that may be associated with any non-compliance.

#### **Tax**

The Company is continuously undergoing examination by the Internal Revenue Service (IRS), as well as various state and foreign jurisdictions. The IRS and other taxing authorities routinely challenge certain deductions and credits reported by the Company on its income tax returns. In accordance with SFAS 109, Accounting for Income Taxes, and SFAS 5, Accounting for Contingencies, the Company establishes reserves for tax contingencies that reflect its best estimate of the deductions and credits that it may be unable to sustain, or that it could be willing to concede as part of a broader tax settlement. Differences between the reserves for tax contingencies and the amounts ultimately owed by the Company are recorded in the period they become known. Adjustments to the Company's reserves could have a material effect on the Company's financial statements. As of March 31, 2006, the Company had recorded tax contingency reserves of approximately \$229.7 million.

In 2000, Coltec, the Company's former subsidiary, made a \$113.7 million payment to the IRS for an income tax assessment and the related accrued interest arising out of certain capital loss deductions and tax credits taken in 1996. On February 13, 2001, Coltec filed suit against the U.S. Government in the U.S. Court of Federal Claims seeking a refund of this payment. The trial portion of the case was completed in May 2004. On November 2, 2004, the Company was notified that the trial court ruled in favor of Coltec and ordered the Government to refund federal tax payments of \$82.8 million to Coltec. This tax refund would also bear interest to the date of payment. As of March 31, 2006, the interest amount was approximately \$53.1 million before tax, or approximately \$34.5 million after tax. The U.S. Court of Federal Claims entered a final judgment in this case on February 15, 2005. During July 2005, the Government filed its brief related to its appeal of the decision with the U.S. Court of Appeals for the Federal Circuit. Coltec filed its brief related to the U.S. Government's appeal on September 6, 2005. Oral arguments were heard by the U.S. Court of Appeals for the Federal Circuit on February 8, 2006. A decision is expected by the U.S. Court of Appeals for the Federal Circuit sometime in 2006. If the trial court's decision is ultimately upheld, the Company will be entitled to the tax refund and related interest pursuant to an agreement with Coltec. If the Company receives these amounts, it expects to record income of approximately \$150 million, after tax, based on interest through March 31, 2006, including the release of previously established reserves. If the IRS were to ultimately prevail in this case, Coltec will not owe any additional interest or taxes with respect to 1996. The Company may, however, be required by the IRS to pay up to \$32.7 million plus accrued interest with respect to the same items claimed by Coltec in its tax returns for 1997 through 2000. The amount of the previously estimated tax liability if the IRS were to prevail for the 1997 through 2000 period remains fully reserved.

In 2000, the IRS issued a statutory notice of deficiency asserting that Rohr, Inc. (Rohr), a subsidiary of the Company, was liable for \$85.3 million of additional income taxes for the fiscal years ended July 31, 1986 through 1989. In 2003, the IRS issued an additional statutory notice of deficiency asserting that Rohr was liable for \$23 million of additional income taxes for the fiscal years ended July 31, 1990 through 1993. The proposed assessments relate primarily to the timing of certain tax deductions and tax credits. Rohr filed petitions in the U.S. Tax Court opposing the proposed assessments. The Company previously reached a tentative settlement agreement with the IRS with regard to the proposed assessments that required further review by the Joint Committee on Taxation (JCT). On March 15, 2006 the Company received notification that the JCT approved the tentative settlement agreement entered into with the IRS. As a result of receiving the JCT notification, the Company recorded a tax benefit of approximately \$72.2 million, primarily related to the reversal of tax reserves, during the three months ended March 31, 2006.

The current IRS examination cycle began on September 29, 2005 and involves the taxable years ended December 31, 2000 through December 31, 2004. The prior examination cycle which began in March 2002, includes the consolidated income tax groups in the audit periods identified below:

Rohr, Inc. and Subsidiaries	July, 1995	December, 1997 (through date of acquisition)
Coltec Industries Inc and Subsidiaries	December, 1997	July, 1999 (through date of acquisition)
Goodrich Corporation and Subsidiaries	1998-1999 (including Rohr and Coltec)	

There were numerous tax issues that had been raised by the IRS as part of the prior examination, including, but not limited to, transfer pricing, research and development credits, foreign tax credits, tax accounting for long-term contracts, tax accounting for inventory, tax accounting for stock options, depreciation, amortization and the proper timing for certain other deductions for income tax purposes. The IRS and the Company previously reached tentative settlement agreements on substantially all of the issues raised with respect to the prior examination cycle. Due to the amount of tax involved, certain portions of the tentative settlement agreements were required to be reviewed by the JCT. The Company received notification on April 25, 2006 that the JCT approved the tentative settlement agreement entered into with the IRS with regard to Rohr, Inc. and Subsidiaries (for the period from July, 1995 through December, 1997), (see Note 19, Subsequent Events ). As a result of receiving the JCT notification, the Company recorded a tax benefit of approximately \$14.9 million, primarily related to the reversal of tax reserves, during the three months ended March 31, 2006. In addition to the JCT approvals with regard to Rohr, the Company reached agreement with the IRS regarding most of the issues with respect to Coltec Industries Inc and Subsidiaries (for the period from December, 1997 through July, 1999). Consequently, the Company recorded a tax benefit of approximately \$44.4 million, primarily related to the reversal of tax reserves during the three months ended March 31, 2006. The Company cannot predict the timing or ultimate outcome of a final settlement of the remaining unresolved issues. If the Company settles pursuant to previous discussions, the Company would anticipate reversing some portion of previously established reserves.

Rohr has been under examination by the State of California for the tax years ended July 31, 1985, 1986 and 1987. The State of California has disallowed certain expenses incurred by one of Rohr's subsidiaries in connection with the lease of certain tangible property. California's Franchise Tax Board held that the deductions associated with the leased equipment were non-business deductions. The additional tax associated with the Franchise Tax Board's position is approximately \$4.5 million. The amount of accrued interest associated with the additional tax is approximately \$19 million as of March 31, 2006. In addition, the State of California enacted an amnesty provision that imposes nondeductible penalty interest equal to 50 percent of the unpaid

interest amounts relating to taxable years ended before 2003. The penalty interest is approximately \$10 million as of March 31, 2006. The tax and interest amounts continue to be contested by Rohr. The Company believes that it is adequately reserved for this contingency. Rohr made a voluntary payment during the three months ended March 31, 2005 of approximately \$3.9 million related to items that were not being contested, consisting of approximately \$0.6 million related to tax and approximately \$3.3 million related to interest on the tax. Rohr made an additional payment during the three months ended December 31, 2005 of approximately \$4.5 million related to the contested tax amount pursuant to the State's assessment notice dated October 20, 2005. No payment has been made for the \$19 million of interest or \$10 million of penalty interest. Under California law, Rohr may be required to pay the full amount of interest prior to filing any suit for refund. If required, Rohr expects to make this payment and file suit for a refund before the end of 2007.

**Note 16. Guarantees**

The Company extends financial and product performance guarantees to third parties. As of March 31, 2006, the following environmental remediation indemnification and financial guarantees were outstanding:

	<b>Maximum Potential Payment (Dollars in millions)</b>	<b>Carrying Amount of Liability</b>
Environmental remediation indemnification (Note 15, Contingencies )	No limit	\$ 15.4
Financial Guarantees:		
Debt and lease payments	\$ 2.3	\$
Residual value on leases	\$24.8	\$

At March 31, 2006, the Company had an outstanding contingent liability for guarantees of debt and lease payments of \$2.3 million, letters of credit and bank guarantees of \$52.5 million and residual value of lease obligations of \$24.8 million.

**Debt and Lease Payments**

The debt and lease payments primarily represent obligations of the Company under industrial development revenue bonds to finance additions to facilities that have since been divested. Each of these obligations was assumed by a third party in connection with the Company's divestiture of the related facilities. If the assuming parties default, the Company will be liable for payment of the obligations. The industrial development revenue bonds mature in February 2008.

**Residual Value on Leases**

Residual value on leases relates to corporate aircraft pursuant to which the Company is obligated to either purchase or remarket the aircraft at the end of the lease term. The residual values were established at lease inception. The lease terms mature in 2011 and 2012.

**Service and Product Warranties**

The Company provides service and warranty policies on certain of its products. The Company accrues liabilities under service and warranty policies based upon specific claims and a review of historical warranty and service claim experience in accordance with SFAS 5. Adjustments are made to accruals as claim data and historical experience change. In addition, the Company incurs discretionary costs to service its products in connection with product performance issues.

The changes in the carrying amount of service and product warranties for the three months ended March 31, 2006 are as follows:

	<b>(Dollars in millions)</b>	
Balance at December 31, 2005	\$	162.4
Service and product warranty provision		13.8
Return to profit		(0.7)
Used as intended		(14.4)
Foreign currency translation		1.5
Balance at March 31, 2006	\$	162.6

The current and long-term portions of service and product warranties were as follows:

	<b>March 31, 2006</b>	<b>December 31, 2005</b>
	<b>(Dollars in millions)</b>	
Short-term liabilities	\$ 62.4	\$ 61.0
Long-term liabilities	100.2	101.4
Total	\$ 162.6	\$ 162.4

**Note 17. Share-Based Compensation Plans**

On December 16, 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004) (SFAS 123(R)), *Share-Based Payment*, which is a revision of Statement of Financial Accounting Standards No. 123,

*Accounting for Stock-Based Compensation* (SFAS 123). SFAS 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees* and amends Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows*. The Company adopted the SFAS 123 fair value-based method of accounting for share-based payments effective January 1, 2004 using the modified prospective method described in Statement of Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure*. The Company adopted SFAS 123(R) on January 1, 2006 using the modified-prospective transition method.

At March 31, 2006, the Company has seven types of share-based compensation awards outstanding, which are described more fully below. Because the Company adopted the accounting provisions of SFAS 123 effective January 1, 2004, the compensation cost recognized in accordance with SFAS 123 during the years ended December 31, 2004 and 2005 should be consistent with the cost that would have been recorded under SFAS 123(R), except for the following differences:

SFAS 123(R) requires entities to apply the same attribution method to all awards subject to graded vesting. The Company has two types of share-based compensation awards that are subject to graded vesting: stock options and restricted stock units. In the years prior to January 1, 2006, stock options were accounted for under the straight-line attribution method and restricted stock units were accounted for under the accelerated attribution method. Effective upon the adoption of SFAS 123(R), the Company



made a policy election to apply the straight-line method to all share-based awards that are subject to graded vesting. If the straight-line method had always been applied to restricted stock unit grants, before tax compensation expense during the three months ended March 31, 2005 would have been lower by approximately \$0.8 million (\$0.5 million after tax). As a result of applying the straight-line method, the Company expects that before tax compensation expense recognized during the year ending December 31, 2006 will be approximately \$1 million lower than it would have been under the accelerated method.

The Company previously accounted for forfeitures as they occurred. Under SFAS 123(R), the Company is required to estimate expected forfeitures at the grant date and recognize compensation cost only for those awards expected to vest. Effective January 1, 2006, the Company recorded income of \$1.8 million (\$1.1 million after tax, or \$0.01 per diluted share) to adjust previously recognized compensation cost on unvested awards to the amount of compensation cost that would have been recognized had forfeitures been estimated. This amount was recorded as a cumulative effect of a change in accounting.

In accordance with SFAS 123, the Company previously recorded compensation cost on performance unit awards using the intrinsic-value method. However, SFAS 123(R) requires liability awards to be accounted for using the fair value method. One-half of the Company's performance unit awards have a market condition, which must be considered in the determination of fair value. Effective January 1, 2006, the Company recorded expense of \$0.9 million (\$0.5 million after tax) to adjust previously recognized compensation cost on vested performance unit awards to the amount of compensation that would have been recognized had the fair value of the awards been recorded prior to the adoption of SFAS 123(R). This amount was recorded as a cumulative effect of a change in accounting.

Prior to the adoption of SFAS 123(R), the Company presented all excess tax benefits of deductions resulting from share-based payments as operating cash flows in the Statement of Cash Flows. SFAS 123(R) requires the cash flows from tax deductions in excess of compensation cost to be classified as financing cash flows. The \$1.2 million excess pro forma tax benefit classified as a financing cash inflow during the three months ended March 31, 2006 would have been classified net cash provided by operating activities prior to the adoption of SFAS 123(R).

Compensation expense on share-based payment grants made subsequent to January 1, 2006 to retirement eligible individuals will be recognized over the requisite service period (i.e., through date of retirement eligibility). In accordance with SEC guidance, expense related to grants prior to the adoption of SFAS 123(R) will continue to be recognized over the explicit vesting period, which is generally three or five years, with acceleration of any remaining unrecognized compensation cost when an employee actually retires. As a result of applying this provision of SFAS 123(R), before tax compensation cost of approximately \$11 million (\$7 million after tax, or \$0.06 per diluted share) was recognized during the three months ended March 31, 2006 as compared to approximately \$1 million that would have been recorded under the previous method. If this provision would have been applied to all awards granted subsequent to December 31, 1994 (the effective date of SFAS 123), before tax compensation cost during the three months ended March 31, 2005 would have been higher by approximately \$8 million. For the year ending December 31, 2006, the Company expects that before tax compensation cost will be approximately \$9 million higher than it would have been under the previous method.

The compensation cost recorded for share-based compensation plans during the three months ended March 31, 2006 totaled \$22.4 million as compared to \$11.4 million during the three months ended March 31, 2005. The



increase of \$11 million was primarily driven by approximately \$10 million of incremental compensation expense recognized during the three months ended March 31, 2006 as a result of recognizing an accelerated portion of the total compensation expense on 2006 awards granted to employees who are retirement eligible or will become retirement eligible prior to the normal vesting date.

The total income tax benefit recognized in the income statement for share-based compensation awards was \$7.9 million and \$4.3 million for the three months ended March 31, 2006 and 2005, respectively. There was no compensation cost related to share-based plans capitalized as part of inventory and fixed assets during the three months ended March 31, 2006 and 2005. As of March 31, 2006, total compensation cost related to nonvested share-based compensation awards not yet recognized totaled \$59.7 million, which is expected to be recognized over a weighted-average period of 2.2 years.

The Company administers the Goodrich Equity Compensation Plan (the Plan) as part of its long-term incentive compensation program. The Plan, as approved by the Company's shareholders, permits the Company to issue stock options, performance shares, restricted stock awards, restricted stock units and several other equity-based compensation awards. Currently, the Plan, which will expire on April 17, 2011, unless renewed, makes 11,000,000 shares of common stock of the Company available for grant, together with shares of common stock available as of April 17, 2001 for future awards under the Company's 1999 Stock Option Plan, and any shares of common stock representing outstanding 1999 Stock Option Plan awards as of April 17, 2001 that are not issued or otherwise are returned to the Company after that date. Historically, the Company has issued shares upon exercise of options or vesting of other share-based compensation awards. During the three months ended March 31, 2006, the Company only repurchased shares to the extent required to meet the minimum statutory tax withholding requirements.

#### **Stock Options**

Generally, options granted on or after January 1, 2004 are exercisable at the rate of 33 1/3 percent after one year, 66 2/3 percent after two years and 100 percent after three years. Options granted to employees who are eligible for retirement on the date of grant or will become retirement eligible prior to the end of the vesting term are expensed over the period through which the employee will become retirement eligible because the awards are earned upon retirement from the Company. Compensation expense for options to employees who are not retirement eligible is recognized on a straight-line basis over three years. The term of each stock option cannot exceed 10 years from the date of grant. All options granted under the Plan have been granted at an exercise price that is not less than 100 percent of the market value of the stock on the date of grant, as determined pursuant to the plan. Dividends are not paid or earned on stock options.

The fair value of each option award is estimated on the date of grant using the Black-Scholes-Merton formula. The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar options giving consideration to the contractual terms, vesting schedules and expectations of future employee exercise behavior. The Company does not issue traded options. Accordingly, the Company uses historical volatility instead of implied volatility. The historical volatility is calculated over a term commensurate with the expected term of the options. The risk-free rate during the option term is based on the U.S. Treasury yield curve in effect at the time of grant. The dividend yield is based on the expected annual dividends during the term of the options divided by the fair value of the stock on the grant date. The fair value for options issued during the three months ended March 31, 2006 and 2005 was based upon the following weighted-average assumptions:

	<b>2006</b>	<b>2005</b>
Risk-Free Interest Rate (%)	4.3	4.0
Dividend Yield (%)	2.0	2.6
Volatility Factor (%)	36.1	40.6
Weighted-Average Expected Life of the Options (years)	5.5	7.0

A summary of option activity during the three months ended March 31, 2006 is presented below:

	Shares (in thousands)	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term	Aggregate Intrinsic Value (in millions)
Outstanding at January 1, 2006	6,951.7	\$ 30.85		
Granted	696.3	40.43		
Exercised	(522.3)	29.33		
Forfeited or expired	(6.8)	38.52		
Outstanding at March 31, 2006	7,118.9	\$ 31.89	5.5 years	\$ 83.1
Vested or expected to vest (1)	7,073.3	\$ 31.85	5.5 years	\$ 82.8
Exercisable at March 31, 2006	5,759.3	\$ 30.86	4.6 years	\$ 61.9

(1) Represents outstanding options reduced by expected forfeitures.

As of March 31, 2006, the total compensation expense related to nonvested options not yet recognized totaled \$11.3 million. The weighted-average grant date fair value of options granted was \$13.43 per option during the three months ended March 31, 2006 and \$11.79 per option during the three months ended March 31, 2005.

During the three months ended March 31, 2006, the amount of cash received from exercise of stock options totaled \$15.3 million and the tax benefit realized from stock options exercised totaled \$2 million. The total intrinsic value of options exercised during the three months ended March 31, 2006 and 2005 was \$6.8 million and \$5.5 million, respectively.

#### **Restricted Stock Units**

Generally, 50 percent of the Company's restricted stock units vest and are converted to stock at the end of the third year, an additional 25 percent at the end of the fourth year and the remaining 25 percent at the end of the fifth year. In certain circumstances, the vesting term is three years. Restricted stock units granted to employees who are eligible for retirement on the date of grant or will become retirement eligible prior to the end of the vesting term are expensed over the period through which the employee will become retirement eligible since the awards vest upon retirement from the Company. Compensation expense for restricted stock units granted to employees who are not retirement eligible is recognized on a straight-line basis over the vesting period. Cash dividend equivalents are paid to participants each quarter. Dividend equivalents paid on units expected to vest are recognized as a reduction in retained earnings.

The fair value of the restricted stock units is determined based upon the average of the high and low grant date fair value of the Company's units on the grant date. The weighted-average grant date fair value of units granted during the three months ended March 31, 2006 was \$40.41 per unit as compared to \$32.20 per unit during the three months ended March 31, 2005.

A summary of the status of the Company's restricted stock units as of March 31, 2006 and changes during the three months then ended is presented below:

	Shares (in thousands)	Weighted- Average Grant date Fair Value
Nonvested at January 1, 2006	1,095.1	\$ 31.55
Granted	586.4	40.44
Vested	(53.0)	32.45
Forfeited	(15.7)	34.57
Nonvested at March 31, 2006	1,612.8	\$ 34.72

As of March 31, 2006, there was \$32.6 million of total unrecognized compensation cost related to nonvested restricted stock units, which is expected to be recognized over a weighted-average period of 2.6 years. The total fair value of units vested during the three months ended March 31, 2006 and 2005 was \$2.2 million and \$0.1 million, respectively. The tax benefit realized from vested restricted stock units totaled \$0.8 million during the three months ended March 31, 2006.

#### **Restricted Stock Awards**

Restricted stock awards have not been granted since the year ended December 31, 2004. As of March 31, 2006, 52,025 awards were nonvested. The unrecognized compensation related to these shares was \$0.1 million, which is expected to be recognized over a weighted-average period of less than 1 year. The total fair value of shares vested during the three months ended March 31, 2006 and 2005 was \$0.3 million and \$1.7 million, respectively. The tax benefit realized from vested restricted stock awards totaled \$0.1 million during the three months ended March 31, 2006.

#### **Performance Units**

Performance share units awarded to the Company's senior management are paid in cash. The target for one-half of the award is based on the fair value of the Company's stock at the end of the three-year term, as adjusted by a performance condition. The performance condition is based upon achievement of certain financial goals over a three-year measurement period. Since the award will be paid in cash, it is recorded as a liability. At each reporting period, the fair value represents the fair market value of the Company's stock as adjusted by achievement of the performance objectives. If it is determined that the goals will not be met, any recognized compensation through the date of determination is recognized as income.

The target for the other half of the awards is based on the fair value of the Company's stock at the end of the three-year term, as adjusted by a market condition. Because the awards have a market condition, it was included in the calculation of the fair value. The fair value of each award is estimated each reporting period using a Monte Carlo Simulation approach in a risk-neutral framework based upon historical volatility, risk free rates and correlation matrix. Because the award is recorded as a liability, the fair value is updated at each reporting period until settlement. The units vest over a three-year term. Participants who are eligible for retirement are entitled to the pro rata portion of the units earned through the date of retirement, death or disability. Units due to retirees are not paid out until the end of the original three-year term and at the fair value calculated at the end of the term. Dividends accrue on performance units during the measurement period and are reinvested in additional performance units. A summary of performance share unit activity during the three months ended March 31, 2006 is presented below:

	Shares (in thousands)	Weighted- Average Fair Value	Weighted- Average Remaining Contractual Term	Aggregate Fair Value (in millions)
Outstanding at January 1, 2006	683.5	\$ 39.38		
Units granted, dividends reinvested and additional shares due to performance condition	315.7	45.18		
Converted and paid out	(313.7)	32.20		
Forfeited	(36.6)	46.95		
Outstanding at March 31, 2006	648.9	\$ 45.90	1.8 years	\$ 29.8
Vested or expected to vest (1)	569.1	\$ 45.69	1.8 years	\$ 26.0

(1) Represents outstanding units reduced by expected forfeitures.

As of March 31, 2006, the total compensation cost related to nonvested performance units not yet recognized totaled \$15.7 million. The weighted-average grant date fair value of units granted was \$46.21 per unit during the three months ended March 31, 2006 and \$32.43 per unit during the three months ended March 31, 2005. The total payments during the three months ended March 31, 2006 and 2005 approximated \$10.1 million and \$3.7 million, respectively.

#### **Employee Stock Purchase Plan**

The Company administers the Employee Stock Purchase Plan under which 2,000,000 shares are reserved for issuance. Employees with six months of continuous service prior to an offering period are eligible to participate in the plan. Eligible employees may elect to become participants in the plan and may contribute up to \$12,000 per year through payroll deductions to purchase stock purchase rights. Participants may, at any time and for any reason, cancel their payroll deduction authorizations and have the balance in their stock purchase right account applied to the purchase of shares or have the amount refunded. The offering period begins on January 1, or July 1 for new employees with at least two months of service, and ends on December 31 of each year. The stock purchase rights are used to purchase the common stock of the Company at the lesser of: (i) 85 percent of the fair market value of a share as of the grant date applicable to the participant or (ii) 85 percent of the fair market value of a share as of the last day of the offering period. The fair market value of a share is defined as the

average of the closing price per share as reflected by composite transactions on the New York Stock Exchange throughout a period of ten trading days ending on the determination date. Dividends are not paid or earned on stock purchase rights.

The fair value of the stock purchase rights are calculated as follows: 15 percent of the fair value of a share of nonvested stock and 85 percent of the fair value of a one-year share option. The fair value of a one-year share option was estimated at the date of grant using the Black-Scholes-Merton formula and the following assumptions:

	2006	2005
Risk-Free Interest Rate (%)	4.4	2.8
Dividend Yield (%)	2.0	2.6
Volatility Factor (%)	34.9	40.6
Weighted-Average Expected Life of the Option (years)	1.0	1.0

The weighted-average grant date fair value of rights granted was \$10.94 per right during the three months ended March 31, 2006 and \$9.00 per right during the three months ended March 31, 2005. The total intrinsic value of rights exercised during the three months ended March 31, 2006 and 2005 was \$3.3 million and \$1.6 million, respectively. As of March 31, 2006, the projected annual contributions under the plan are \$8.1 million.

#### **Outside Director Phantom Share Plan**

Each non-management Director receives an annual grant of phantom shares under the Outside Director Phantom Share Plan equal in value to \$60,000. Dividend equivalents accrued on all phantom shares are credited to a Director's account. All phantom shares are fully vested on the date of grant. Following termination of service as a Director, the cash value of the phantom shares will be paid to each Director in a single lump sum, five annual installments or ten annual installments. The value of each phantom share is determined on the relevant date by the fair market value of the common stock of the Company on such date.

The phantom shares outstanding are recorded at fair market value on each reporting date. At March 31, 2006, the intrinsic value totaled \$5 million on 114,000 phantom shares outstanding, reflecting a per share fair value of \$43.61. At March 31, 2005, the intrinsic value totaled \$4 million on 102,000 phantom shares outstanding, reflecting a per share fair value of \$38.29. Cash payments during the three months ended March 31, 2006 totaled \$37,000.

#### **Outside Director Deferral Plan**

Non-management Directors may elect to defer annual retainer and meeting fees under the Outside Director Deferral Plan. The plan permits non-management Directors to elect to defer a portion or all of the annual retainer and meeting fees into a phantom share account. Amounts deferred into the phantom share account accrue dividend equivalents. The plan provides that amounts deferred into the phantom share account are paid out in shares of common stock of the Company following termination of service as Director in a single lump sum, five annual installments or ten annual installments.

The shares outstanding under the plan are recorded at the grant date fair value, which is the fair value of the common stock of the Company on the date the deferred fees would ordinarily be paid in cash. At March 31, 2006, 95,000 shares were outstanding. The weighted-average grant date fair value per share was \$30.76 and \$29.65 during the three months ended March 31, 2006 and 2005, respectively. There were no shares issued under this plan during the three months ended March 31, 2006.

**Note 18. Discontinued Operations**

Income from discontinued operations for the three months ended March 31, 2006 represents insurance settlements with several insurers relating to the recovery of environmental remediation costs at a former plant previously recorded as a discontinued operation.

On April 19, 2005, the Company completed the sale of JcAir Inc. (Test Systems) to Aeroflex Incorporated, for \$34 million in cash, net of expenses and purchase price adjustments. The gain on the sale of \$13.2 million after tax was recorded in the three months ended June 30, 2005. Test Systems was previously reported in the Electronic Systems segment. The amount of goodwill included in the gain on the sale of Test Systems was \$7.8 million.

Discontinued operations for the three months ended March 31, 2006 and March 31, 2005 were as follows:

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Dollars in millions)</b>	
Sales	\$	\$ 6.5
Operating income	\$ 1.0	\$ 1.1
Income tax expense	(0.4)	(0.4)
Income from discontinued operations	\$ 0.6	\$ 0.7

**Note 19. Subsequent Events**

On April 11, 2006, the Company entered into a definitive agreement with a third party to sell its Turbomachinery Products business (TmP). The results of operations of this business are reflected in continuing operations in the Engine Systems segment at March 31, 2006 since the approval for this disposition was granted by the Board of Directors in April 2006. The transaction is subject to, among other things, financing satisfactory to the buyer and receipt of certain customer consents and government approvals. The sale is expected to close late in the second quarter of 2006. The sale price is \$83 million, which is expected to generate after tax cash flow of approximately \$90 million. The Company expects to report an after tax gain on the sale of the business of approximately \$10 to \$15 million, depending on certain adjustments. The expected divestiture of TmP and the results of operations of TmP will be reflected as discontinued operations for all periods presented starting in the second quarter 2006 and prior periods will be restated at that time.

On April 25, 2006, the Company received notification that the Joint Committee on Taxation (JCT) approved a proposed settlement entered into with the IRS with regard to Rohr, Inc. and Subsidiaries (for the period from July, 1995 through December, 1997). As a result of receiving the JCT notification, the Company recorded a tax benefit of approximately \$14.9 million, primarily related to the reversal of tax reserves, during the three months ended March 31, 2006.

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

YOU SHOULD READ THE FOLLOWING DISCUSSION AND ANALYSIS IN CONJUNCTION WITH OUR UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS INCLUDED ELSEWHERE IN THIS DOCUMENT.

THIS MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS CONTAINS FORWARD-LOOKING STATEMENTS. SEE FORWARD-LOOKING INFORMATION IS SUBJECT TO RISK AND UNCERTAINTY FOR A DISCUSSION OF CERTAIN OF THE UNCERTAINTIES, RISKS AND ASSUMPTIONS ASSOCIATED WITH THESE STATEMENTS. UNLESS OTHERWISE NOTED HEREIN, DISCLOSURES PERTAIN ONLY TO OUR CONTINUING OPERATIONS.

**OVERVIEW**

We are one of the largest worldwide suppliers of aerospace components, systems and services to the commercial and general aviation airplane markets. We are also a leading supplier of systems and products to the global defense and space markets. Our business is conducted globally with manufacturing, service and sales undertaken in various locations throughout the world. Our products and services are principally sold to customers in North America, Europe and Asia.

**Key Market Channels for Products and Services, Growth Drivers and Industry and our Highlights**

We participate in three key market channels: commercial and general aviation airplane original equipment (OE); commercial and general aviation airplane aftermarket; and defense and space.

***Commercial and General Aviation Airplane OE***

Commercial and general aviation airplane OE includes sales of products and services for new airplanes produced by Airbus S.A.S. (Airbus) and The Boeing Company (Boeing), as well as regional, business and small airplane manufacturers.

The key growth drivers in this market channel include the number of orders for new airplanes, which will be delivered to the manufacturers' customers over a period of several years, OE manufacturer production and delivery rates and introductions of new airplane models such as the Boeing 787 and 747-8 and the Airbus A380 and A350 airplanes. We have significant sales content on most of the airplanes manufactured in this market channel. We have benefited from increased production rates and deliveries of Airbus and Boeing airplanes and from our substantial content on many of the more popular regional and general aviation airplanes. We were also awarded several new contracts for our products on airplanes currently in a pre-production stage, including the Airbus A380 and A350 and the Boeing 787 and 747-8, which should provide substantial future sales growth for us.

During 2005, orders for Airbus and Boeing commercial airplanes were at record levels, with many of the orders for deliveries beyond 2008. While orders for regional airplanes were not nearly as strong in 2005 as those for the larger airplanes, the unfilled backlog of orders remained substantial. During 2005, orders for general aviation airplanes, including business jets, continued to be strong as well.

***Commercial and General Aviation Airplane Aftermarket***

The commercial and general aviation airplane aftermarket channel includes sales of products and services for existing commercial and general aviation airplanes, primarily to airlines and freight forwarders around the world.

The key growth drivers in this channel include worldwide passenger capacity growth measured by Available Seat Miles (ASM) and the size of the airplane fleet. Other important factors affecting growth in this market channel are the age of the airplanes in the fleet and Gross Domestic Product (GDP) trends in countries and regions around the world. We estimate that capacity in the global airline system, as measured by ASMs, will grow at about 5 percent annually in 2006 through 2010. It is expected that the global airplane fleet will continue to grow in 2006 and beyond, as the OE manufacturers are expected to deliver more airplanes than are retired.

We have significant product content on most of the airplane models that are currently in service. We have benefited from good growth in ASMs, especially in Asia, as well as the aging of the worldwide fleet of airplanes.

***Defense and Space***

Worldwide defense and space sales include sales to prime contractors such as Boeing, Northrop Grumman, Lockheed Martin, the U.S. Government and foreign companies and governments.

The key growth drivers in this channel include the level of defense spending by the U.S. and foreign governments, the number of new platform starts, the level of military flight operations and the level of upgrade, overhaul and maintenance activities associated with existing platforms.

The market for our defense and space products is global, and is not dependent on any single program, platform or customer. While we anticipate fewer new platform starts over the next several years, which are expected to negatively affect defense and space original equipment (OE) sales, we anticipate that upgrades on existing platforms will be necessary, and will provide long-term growth in this market channel. Additionally, we are participating in, and developing new products for, the rapidly expanding homeland defense and surveillance and reconnaissance markets, which should further strengthen our position in this market channel.



**Long-term Sustainable Growth**

We believe we are well positioned to continue to grow our commercial airplane and defense and space sales due to:

Awards for key products on important new programs, including the Airbus A380 and A350, the Boeing 787 and 747-8, the Embraer 190, the Dassault Falcon 7X and the Lockheed Martin F-35 JSF and F-22 Raptor;

Growing commercial airplane fleet, which should fuel sustained aftermarket strength;

Balance in the large commercial airplane market, with strong sales to both Airbus and Boeing;

Aging of the existing Airbus and regional and business airplane fleets, which should result in increased aftermarket support;

Increased number of long-term agreements for product sales on new and existing commercial airplanes;

Increased opportunities for aftermarket growth due to airline outsourcing; and

Expansion of our product offerings in support of high growth areas in the defense and space market channel.

**First Quarter 2006 Sales Content by Market Channel**

During the quarter ended March 31, 2006, 95 percent of our sales were from our three primary market channels (described above). Following is a summary of the percentage of sales by market channel:

	<b>Quarter Ended March 31, 2006</b>
Airbus Commercial OE	18%
Boeing Commercial OE	9%
Regional and General Aviation Airplane OE	8%
<b>Total Commercial and General Aviation Airplane OE</b>	<b>35%</b>
Large Commercial Airplane Aftermarket	27%
Regional and General Aviation Airplane Aftermarket	6%
Heavy Airplane Maintenance	3%
<b>Total Commercial and General Aviation Airplane Aftermarket</b>	<b>36%</b>
<b>Total Defense and Space</b>	<b>24%</b>
Other	5%
<b>Total</b>	<b>100%</b>

**First Quarter 2006 Summary Performance**

	<b>First Quarter</b>		
	<b>2006</b>	<b>2005</b>	<b>% Change</b>
	<b>(Dollars in millions, except diluted EPS)</b>		
Sales	\$1,423.8	\$1,275.5	11.6%
Segment Operating Income	\$ 169.9	\$ 150.6	12.8%
% of Sales	11.9%	11.8%	
Income from Continuing Operations	\$ 200.3	\$ 56.8	252.6%
Net Income	\$ 201.5	\$ 57.5	250.4%
Capital Expenditures	\$ 43.2	\$ 26.8	61.2%
Net Cash Provided by Operating Activities	\$ 65.6	\$ 16.8	290.5%
Diluted EPS:			
Continuing Operations	\$ 1.59	\$ 0.46	245.6%
Net Income	\$ 1.60	\$ 0.47	240.4%

Our first quarter 2006 sales and income performance was driven primarily by sales growth in our commercial, regional and general aviation market channels:

Large commercial airplane original equipment sales increased 27 percent;

Regional, business and general aviation airplane original equipment sales increased 25 percent, led by strong sales growth for our aerostructures products;

Commercial and general aviation airplane aftermarket sales increased by 16 percent, with continued strong sales of our aerostructures products and services; and

Defense and space sales of both original equipment and aftermarket products and services decreased, as anticipated, by less than 3 percent. Strong military and space sales growth in the Electronic Systems segment was offset by a decrease in sales associated with certain of our aerostructures contracts that concluded in 2005.

Net income during the quarters ended March 31, 2006 and 2005 were also impacted by the following:

Stock-based compensation We implemented SFAS 123, on a modified prospective basis, and a new stock option and restricted stock unit program on January 1, 2004. The cost of each annual restricted stock unit grant is amortized over a five-year vesting period. Consequently, expense increases year-over-year as each new restricted stock unit grant is added. Also, under the provisions of SFAS 123(R), beginning in 2006, we have recognized the value of stock options and restricted stock units granted to all employees who are, or who become, eligible for retirement on an accelerated basis. In total, these items resulted in an increase in stock-based compensation expense, for 2006 compared to 2005, of approximately \$11 million before tax (\$7 million after tax, or \$0.05 per diluted share).

Our effective tax rate from continuing operations was a (97.9) percent benefit during the quarter ended March 31, 2006 as compared to 34.7 percent expense during the quarter ended March 31, 2005. The change in our effective tax rate resulted primarily from the reversal of reserves in connection with favorable tax settlements related to the IRS examinations of Rohr, Inc. and subsidiaries (for the period from July, 1986 through December, 1997) and Coltec Industries Inc and subsidiaries (for the period from December, 1997 through July, 1999), which changed the effective tax rate by approximately 130 percentage points. Our effective income tax rate was also decreased by a smaller valuation allowance

recorded against certain losses in foreign jurisdictions offset in part by growth in before tax book income relative to our significant permanent items. Our effective tax rate during the quarter ended March 31, 2006 was not reduced for the benefit of U.S. Research and Development (R&D) Credits because the federal statute authorizing the R&D Credit has not been extended beyond December 31, 2005. We estimate that the effective tax rate as of March 31, 2006 would have been approximately 1 percentage point lower had the Company been able to consider the tax benefits associated with the R&D Credit.

Cash flow from operations for the quarter ended March 31, 2006 was \$65.6 million as compared to \$16.8 million for the quarter ended March 31, 2005. The increase in net cash from operations was primarily due to higher income after considering non-cash expenses and improved management of working capital.

Capital expenditures were \$43.2 million for the quarter ended March 31, 2006, as compared to \$26.8 million for the quarter ended March 31, 2005.

#### **2006 Outlook**

Based on the strong first quarter commercial aftermarket sales in the our aerostructures business, our sales to airlines and package carriers for large commercial and regional aircraft aftermarket parts and services are now expected to grow by more than 7 percent in 2006, compared to 2005. Our other major market assumptions for 2006 are unchanged from that provided in our 2005 Annual Report on Form 10-K.

We continue to expect that full year 2006 sales will be toward the upper end of the range of \$5.6 - \$5.7 billion. We now expect our 2006 net income per diluted share to be in the range of \$3.38 - \$3.58, which includes increases of approximately \$0.05 associated with the expected continuation of very strong commercial aftermarket sales, and \$1.13 per diluted share for the previously discussed tax settlements and the impact of the expected sale of the Turbomachinery Products business (TmP). The outlook includes increased expenses for pension, foreign exchange and stock-based compensation that are now expected to be approximately \$0.29 per diluted share, compared to 2005. We now expect cash flow from operations, minus capital expenditures, to be in the range of \$100 to \$150 million, which includes anticipated second half 2006 tax payments of approximately \$90 million primarily related to the reversal of timing items for interest deductions reported on prior year income tax returns. This outlook continues to include significant cash expenditures for investments in recently awarded programs such as the Boeing 787 Dreamliner and the Airbus A350, capital expenditures to support higher original equipment deliveries at Boeing and Airbus, and productivity initiatives that are expected to enhance margins over the long-term. We expect capital expenditures in 2006 to be in the range of \$240 to \$260 million. Additionally, during the second quarter 2006, we expect cash flow from discontinued operations of approximately \$90 million associated with the anticipated sale of TmP. The cash flow from this sale is not included in the cash flow from operations, minus capital expenditures, outlook discussed above.

The current sales, net income and cash flow from operations outlook for 2006 does not include resolution of the previously disclosed Coltec tax litigation and resolution of the remaining items in the IRS examination cycle for the tax years through 1999, the impact of acquisitions or divestitures, other than the expected sale of TmP, resolution of potential remaining A380 contractual disputes with Northrop Grumman or the effect of changes to our retirement plans. The sales projections continue to include the expected full-year sales from TmP. We expect TmP to be reported as a discontinued operation starting with the reporting of our June 30, 2006 results and expect to remove the associated sales from our outlook at that time.

Our 2006 outlook is based on the following market assumptions:

We expect deliveries of Airbus and Boeing large commercial aircraft to increase by more than 20 percent in 2006, and by a somewhat lesser amount in 2007. Our sales of large commercial aircraft original equipment products are projected to increase by 10 to 15 percent in 2006. This expected growth rate is lower than the growth rate in aircraft deliveries because many of our products are delivered well in advance of manufacturers deliveries to their customers, causing sales to occur in 2005 for planes to be delivered well into 2006.

Capacity in the global airline system, as measured by available seat miles (ASMs), is expected to continue to grow at about 5 percent in 2006, compared to 2005. Our sales to airlines and package carriers for large commercial and regional aircraft aftermarket parts and services are now expected to grow by more than 7 percent in 2006, compared to 2005.

Total regional and business aircraft production is expected to be flat or slightly down in 2006, compared to 2005, as deliveries of business jets are expected to increase, partially offsetting the expected decrease in regional aircraft deliveries. Deliveries to Embraer in support of its EMBRAER 190 aircraft, which includes a significant content of our products, are expected to enable us to increase our original equipment sales in this market channel for the full year 2006 by approximately 5 percent, compared to 2005.

Defense and space sales (original equipment and aftermarket) are expected to be relatively flat to slightly down in 2006, compared to 2005. Sales for the C-5 Reliability Enhancement and Re-engining Program are expected to temporarily decrease in 2006 as the program transitions from research and development to production in 2007 and sales of military aftermarket products are also expected to decline in the customer services business. These decreases are expected to be largely offset by strong growth in the sales of military and space products in our optical and space systems business.

Our 2006 outlook includes significant increases in costs associated with pension expense, foreign exchange and stock-based compensation. Our assumptions for these items are discussed below:

**Pension expense** We set the discount rate, actuarial assumptions and expected long-term rate of return for 2006 on January 1, 2006. Based on actuarial assumptions and interest rates and asset values as of January 1, 2006, we expect to incur additional pension expense of approximately \$19 million before tax (\$12 million after tax, or \$0.10 per diluted share) during 2006, compared to 2005. This expectation is based on a discount rate assumption of 5.64 percent for the U.S. plans and includes the benefit of our voluntary contributions to our U.S. plans during 2005. This assumption excludes any impact from a remeasurement of our U.S. pension plan assumptions as may be required as a result of the disposition of TmP or the retirement changes discussed within the Critical Accounting Policies

**Pension and Postretirement Benefits Other than Pensions** section.

**Foreign exchange** We are currently about 90 percent hedged for our expected 2006 foreign exchange exposure. Based on these hedges and current market conditions, it is expected that foreign currency translation related to sales and expenses denominated in currencies other than the U.S. dollar will have an unfavorable impact of approximately \$26 million before tax (\$16 million after tax, or \$0.13 per diluted share) during 2006, compared to 2005, as gains from hedges maturing in 2006 will be less than gains realized in 2005.

**Stock-based compensation** We implemented SFAS 123, prospectively, and a new stock option and restricted stock unit program on January 1, 2004. The cost of each annual restricted stock unit grant is amortized over a five-year vesting period. Consequently, expense increases year-over-year as each new restricted stock unit grant is added. Also, under the provisions of SFAS 123(R), beginning in 2006, we have recognized the value of stock options and restricted stock units granted to all employees who are, or who become, eligible for retirement on an accelerated basis. In total, these items resulted in an increase in stock-based compensation expense, for 2006 compared to 2005, of approximately \$12 million before tax (\$8 million after tax, or \$0.06 per diluted share).

## **RESULTS OF OPERATIONS**

### **Adoption of SFAS No. 123(R)**

On December 16, 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004) (SFAS 123(R)), *Share-Based Payment*, which is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123). SFAS 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees* and amends Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows*. We adopted the SFAS 123 fair value-based method of accounting for share-based payments effective January 1, 2004 using the modified prospective method described in Statement of Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure*. We adopted SFAS 123(R) on January 1, 2006 using the modified-prospective transition method.

At March 31, 2006, we have seven types of share-based compensation awards outstanding, which are described more fully in Note 17, *Share-Based Compensation Plans*, to our condensed consolidated financial statements. Because we adopted the accounting provisions of SFAS 123 effective January 1, 2004, the compensation cost recognized in accordance with SFAS 123 during the years ended December 31, 2004 and 2005 should be consistent with the cost that would have been recorded under SFAS 123(R), except for the following differences between the two statements:

SFAS 123(R) requires entities to apply the same attribution method to all awards subject to graded vesting.

We have two types of share-based compensation awards that are subject to graded vesting: stock options and restricted stock units. These awards are described more fully in Note 17, *Share-Based Compensation Plans*, to our condensed consolidated financial statements. In the years prior to January 1, 2006, stock options were accounted for under the straight-line attribution method and restricted stock units were accounted for under the accelerated attribution method. Effective upon the adoption of SFAS 123(R), we made a policy election to apply the straight-line method to all share-based awards that are subject to graded vesting. If the straight-line method had always been applied to restricted stock unit grants, before tax compensation expense during the quarter ended March 31, 2005 would have been

lower by approximately \$0.8 million (\$0.4 million after tax). As a result of applying the straight-line method, we expect that before tax compensation expense recognized during the twelve months ending December 31, 2006 will be approximately \$1 million lower than it would have been under the accelerated method.

We previously accounted for forfeitures as they occurred. Under SFAS 123(R), we are required to estimate expected forfeitures at the grant date and recognize compensation cost only for those awards expected to vest. Effective January 1, 2006, we recorded income of \$1.8 million (\$1.1 million after tax, or \$0.01 per diluted share) to adjust previously recognized compensation cost on unvested awards to the amount of compensation cost that would have been recognized had forfeitures been estimated. This amount was recorded as a cumulative effect of a change in accounting.

In accordance with SFAS 123, we previously recorded compensation cost on performance unit awards, described more fully in Note 17, Share-Based Compensation Plans, to our condensed consolidated financial statements, using the intrinsic-value method. However, SFAS 123(R) requires liability awards to be accounted for using the fair value method. One-half of our performance unit awards have a market condition, which must be considered in the determination of fair value. Effective January 1, 2006, we recorded expense of \$0.9 million (\$0.5 million after tax) to adjust previously recognized compensation cost on vested performance unit awards to the amount of compensation that would have been recognized had the fair value of the awards been recorded prior to the adoption of SFAS 123(R). This amount was recorded as a cumulative effect of a change in accounting.

Prior to the adoption of SFAS 123(R), we presented all excess tax benefits of deductions resulting from share-based payments as operating cash flows in the Statement of Cash Flows. SFAS 123(R) requires the cash flows from tax deductions in excess of the compensation cost to be classified as financing cash flows. The \$1.2 million excess tax benefit classified as a financing cash inflow during the quarter ended March 31, 2006 would have been classified as an operating cash inflow prior to the adoption of SFAS 123(R).

Compensation expense on share-based payment grants made subsequent to January 1, 2006 to retirement eligible individuals will be recognized over the requisite service period (i.e., through date of retirement eligibility). In accordance with SEC guidance, expense related to grants prior to the adoption of SFAS 123(R) will continue to be recognized over the explicit vesting period, which is generally three or five years, with acceleration of any remaining unrecognized compensation cost when an employee actually retires. As a result of applying this provision of SFAS 123(R), before tax compensation cost of approximately \$11 million (\$7 million after tax, or \$0.06 per diluted share) was recognized during the first quarter of 2006 as compared to approximately \$1 million that would have been recorded under the previous method. If this provision would have been applied to all awards granted subsequent to December 31, 1994 (the effective date of SFAS 123), before tax compensation cost during the three months ended March 31, 2005 would have been higher by approximately \$8 million. For the year ending December 31, 2006, we expect that before tax compensation cost will be approximately \$9 million higher than it would have been under the previous method.

The compensation cost that has been recorded for share-based compensation awards during the quarter ended March 31, 2006 totaled \$22.4 million as compared to \$11.4 million during the quarter ended March 31, 2005. The increase of \$11 million was primarily driven by approximately \$10 million of incremental compensation

expense recognized during the quarter ended March 31, 2006 as a result of recognizing an accelerated portion of the total compensation expense on 2006 awards granted to employees who are retirement eligible or will become retirement eligible prior to the normal vesting date. As of March 31, 2006, total compensation cost related to nonvested share-based compensation awards not yet recognized totaled \$59.7 million, which is expected to be recognized over a weighted-average period of 2.2 years.

**Quarter Ended March 31, 2006 Compared with Quarter Ended March 31, 2005**

	<b>Quarter Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Dollars in millions)</b>	
Sales	\$ 1,423.8	\$ 1,275.5
Segment Operating Income	\$ 169.9	\$ 150.6
Corporate General and Administrative Costs	(27.2)	(20.5)
Total Operating Income	142.7	130.1
Net Interest Expense	(30.9)	(33.0)
Other Income (Expense) Net	(10.6)	(10.1)
Income Tax Benefit (Expense)	99.1	(30.2)
Income from Continuing Operations	200.3	56.8
Income from Discontinued Operations	0.6	0.7
Cumulative Effect of Change in Accounting	0.6	
Net Income	\$ 201.5	\$ 57.5

Changes in sales and segment operating income are discussed within the Business Segment Performance section below.

Corporate general and administrative costs of \$27.2 million for the quarter ended March 31, 2006 increased \$6.7 million, or 32.7 percent, from \$20.5 million for the quarter ended March 31, 2005 primarily due to the following:

- Higher incentive compensation, including the adoption of SFAS 123(R), of approximately \$2 million;

- Higher salary and benefits resulting from inflationary increases of approximately \$3 million; and

- Higher professional services of approximately \$2 million.

Corporate general and administrative costs as a percentage of sales were 1.9 percent in the quarter ended March 31, 2006 and 1.6 percent in the quarter ended March 31, 2005, as a result of the factors noted above.

Net interest expense of \$30.9 million in the quarter ended March 31, 2006 decreased \$2.1 million, or 6.4 percent from \$33 million in the quarter ended March 31, 2005, primarily due to lower debt levels in 2006.

Other Income (Expense) Net increased by \$0.5 million, or 5 percent, to expense of \$10.6 million in the quarter ended March 31, 2006 from expense of \$10.1 million in the quarter ended March 31, 2005.

Our effective tax rate from continuing operations during the quarter ended March 31, 2006 included a tax benefit of \$131.5 million primarily from the reversal of tax reserves in connection with the settlements of the IRS examinations of Rohr, Inc. and subsidiaries (for the period July, 1986 through December, 1997), and Coltec

Industries Inc and subsidiaries (for the period December, 1997 through July, 1999). The effective tax rate excluding the tax settlements was 32.1 percent during the quarter ended March 31, 2006 and 34.7 percent during the quarter ended March 31, 2005. The decrease in our effective tax rate was also due to a smaller valuation allowance recorded against certain losses in foreign jurisdictions offset in part by growth in before tax book income relative to our significant permanent items. Our effective tax rate during the quarter ended March 31, 2006 was not reduced for the benefit of U.S. Research and Development (R&D) Credits because the federal statute authorizing the R&D Credit has not been extended beyond December 31, 2005. We estimate that the effective tax rate as of March 31, 2006 would have been approximately 1 percentage point lower had the Company been able to consider the tax benefits associated with the R&D Credit.

Income from discontinued operations, after tax, was \$0.6 million during the quarter ended March 31, 2006, which primarily reflects a gain recognized as a result of our settlement with several insurers relating to the recovery of environmental remediation costs at a former plant. Income from discontinued operations for Test Systems included net income of \$0.7 million in the quarter ended March 31, 2005.

The cumulative effect from the change in accounting resulted in a gain of \$0.6 million from the adoption of SFAS 123(R) on January 1, 2006 as previously discussed.

#### **BUSINESS SEGMENT PERFORMANCE**

Our operations are reported as three business segments: Engine Systems, Airframe Systems and Electronic Systems. An analysis of Net Customer Sales and Operating Income by business segment follows.

In the following table, segment operating income is total segment revenue reduced by operating expenses directly identifiable with that business segment.

#### **Quarter Ended March 31, 2006 Compared with the Quarter Ended March 31, 2005**

	Quarter Ended March 31,			% of Sales	
	2006	2005	% Change	2006	2005
	(Dollars in millions)				
<b>NET CUSTOMER SALES</b>					
Engine Systems	\$ 610.5	\$ 528.1	15.6		
Airframe Systems	470.3	442.7	6.2		
Electronic Systems	343.0	304.7	12.6		
Total Sales	\$ 1,423.8	\$ 1,275.5	11.6		
<b>SEGMENT OPERATING INCOME</b>					
Engine Systems	\$ 118.7	\$ 90.5	31.2	19.4	17.1
Airframe Systems	14.3	27.8	(48.6)	3.0	6.3
Electronic Systems	36.9	32.3	14.2	10.8	10.6
Segment Operating Income	\$ 169.9	\$ 150.6	12.8	11.9	11.8

**Engine Systems:** Engine Systems segment sales of \$610.5 million in the quarter ended March 31, 2006 increased \$82.4 million, or 15.6 percent, from \$528.1 million in the quarter ended March 31, 2005. The increase was due to the following:

Higher commercial and general aviation airplane OE, aftermarket and maintenance, repair and overhaul (MRO) sales volume of approximately \$88 million primarily in our aerostructures, cargo and engine controls businesses; and



Higher sales volume of approximately \$15 million of regional and business OE and aftermarket products primarily from our aerostructures business.

The increase in sales was partially offset by a decline in defense sales volume in our aerostructures and cargo businesses of approximately \$27 million.

Engine Systems segment operating income increased \$28.2 million, or 31.2 percent, from \$90.5 million in the quarter ended March 31, 2005 to \$118.7 million in the quarter ended March 31, 2006. Segment operating income was higher due to:

Higher sales volume as described above generating operating income of approximately \$40 million; and