

PARKER HANNIFIN CORP
Form 10-Q
February 02, 2007

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

FORM 10-Q

X QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended December 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 1-4982

PARKER-HANNIFIN CORPORATION

(Exact name of registrant as specified in its charter)

OHIO
(State or other jurisdiction of
incorporation or organization)

34-0451060
(IRS Employer
Identification No.)

6035 Parkland Blvd., Cleveland, Ohio
(Address of principal executive offices)

44124-4141
(Zip Code)

Registrant's telephone number, including area code: (216) 896-3000

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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 (check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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

Number of Common Shares outstanding at December 31, 2006 115,771,243

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

PARKER-HANNIFIN CORPORATION

CONSOLIDATED STATEMENT OF INCOME

(Dollars in thousands, except per share amounts)

(Unaudited)

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|------------------------------------|--------------|----------------------------------|--------------|
| | 2006 | 2005 | 2006 | 2005 |
| Net sales | \$ 2,511,152 | \$ 2,157,537 | \$ 5,062,725 | \$ 4,271,088 |
| Cost of sales | 1,938,007 | 1,705,683 | 3,885,365 | 3,361,436 |
| Gross profit | 573,145 | 451,854 | 1,177,360 | 909,652 |
| Selling, general and administrative expenses | 292,855 | 245,845 | 584,865 | 482,859 |
| Interest expense | 22,304 | 19,587 | 39,476 | 36,058 |
| Other (income) expense, net | (6,777) | 10,898 | (13,403) | 11,171 |
| Income from continuing operations before income taxes | 264,763 | 175,524 | 566,422 | 379,564 |
| Income taxes | 71,796 | 46,500 | 162,871 | 106,692 |
| Income from continuing operations | \$ 192,967 | \$ 129,024 | \$ 403,551 | \$ 272,872 |
| Income from discontinued operations | | | | 28,884 |
| Net income | \$ 192,967 | \$ 129,024 | \$ 403,551 | \$ 301,756 |
| Basic earnings per share: | | | | |
| Income from continuing operations | \$ 1.66 | \$ 1.09 | \$ 3.44 | \$ 2.30 |
| Income from discontinued operations | | | | .24 |
| Net income per share | \$ 1.66 | \$ 1.09 | \$ 3.44 | \$ 2.54 |
| Diluted earnings per share: | | | | |
| Income from continuing operations | \$ 1.64 | \$ 1.07 | \$ 3.39 | \$ 2.27 |
| Income from discontinued operations | | | | .24 |
| Net income per share | \$ 1.64 | \$ 1.07 | \$ 3.39 | \$ 2.51 |
| Cash dividends per common share | \$.26 | \$.23 | \$.52 | \$.46 |

See accompanying notes to consolidated financial statements.

PARKER-HANNIFIN CORPORATION

CONSOLIDATED BALANCE SHEET

(Dollars in thousands)

| | (Unaudited) December 31, 2006 | June 30, 2006 |
|--|-------------------------------------|------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 157,098 | \$ 171,553 |
| Accounts receivable, net | 1,524,240 | 1,592,323 |
| Inventories: | | |
| Finished products | 539,387 | 520,159 |
| Work in process | 571,484 | 494,469 |
| Raw materials | 203,529 | 168,250 |
| | 1,314,400 | 1,182,878 |
| Prepaid expenses | 49,281 | 64,238 |
| Deferred income taxes | 131,228 | 127,986 |
| Total current assets | 3,176,247 | 3,138,978 |
| Plant and equipment | 4,181,937 | 4,086,367 |
| Less accumulated depreciation | 2,475,142 | 2,392,573 |
| | 1,706,795 | 1,693,794 |
| Goodwill | 2,170,715 | 2,010,458 |
| Intangible assets, net | 469,222 | 471,095 |
| Other assets | 933,316 | 859,107 |
| Total assets | \$ 8,456,295 | \$ 8,173,432 |
| LIABILITIES | | |
| Current liabilities: | | |
| Notes payable | \$ 439,180 | \$ 72,039 |
| Accounts payable, trade | 700,973 | 770,665 |
| Accrued liabilities | 658,536 | 698,014 |
| Accrued domestic and foreign taxes | 120,094 | 140,387 |
| Total current liabilities | 1,918,783 | 1,681,105 |
| Long-term debt | 1,066,330 | 1,059,461 |
| Pensions and other postretirement benefits | 834,413 | 811,479 |
| Deferred income taxes | 108,669 | 118,544 |
| Other liabilities | 211,035 | 261,640 |
| Total liabilities | 4,139,230 | 3,932,229 |
| SHAREHOLDERS' EQUITY | | |
| Serial preferred stock, \$.50 par value; authorized 3,000,000 shares; none issued | | |
| Common stock, \$.50 par value; authorized 600,000,000 shares; issued 120,683,890 shares at December 31 and 120,683,890 shares at June 30 | 60,342 | 60,342 |
| Additional capital | 533,043 | 510,869 |
| Retained earnings | 4,258,772 | 3,916,412 |
| Unearned compensation related to guarantee of ESOP debt | (20,478) | (25,809) |
| Deferred compensation related to stock options | 2,347 | 2,347 |

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| | | |
|--|--------------|--------------|
| Accumulated other comprehensive (loss) | (130,250) | (194,819) |
| | 4,703,776 | 4,269,342 |
| Less treasury shares, at cost: 4,912,647 shares at December 31 and 368,695 shares at June 30 | (386,711) | (28,139) |
| Total shareholders' equity | 4,317,065 | 4,241,203 |
| Total liabilities and shareholders' equity | \$ 8,456,295 | \$ 8,173,432 |

See accompanying notes to consolidated financial statements.

PARKER-HANNIFIN CORPORATION

CONSOLIDATED STATEMENT OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

| | Six Months Ended December 31, | |
|---|----------------------------------|------------|
| | 2006 | 2005 |
| <u>CASH FLOWS FROM OPERATING ACTIVITIES</u> | | |
| Net income | \$ 403,551 | \$ 301,756 |
| Adjustments to reconcile net income to net cash provided by operations: | | |
| Net (income) from discontinued operations | | (28,884) |
| Depreciation | 126,390 | 121,600 |
| Amortization | 21,808 | 15,078 |
| Stock-based compensation | 24,218 | 22,802 |
| Deferred income taxes | (27,099) | (30,529) |
| Foreign currency transaction (gain) loss | (20,759) | 4,641 |
| (Gain) loss on sale of plant and equipment | (8,806) | 12,952 |
| Changes in assets and liabilities: | | |
| Accounts receivable, net | 113,742 | 94,186 |
| Inventories | (107,839) | (39,127) |
| Prepaid expenses | 11,763 | 5,607 |
| Other assets | (97,430) | 52,994 |
| Accounts payable, trade | (83,499) | (49,800) |
| Accrued payrolls and other compensation | (40,754) | (65,020) |
| Accrued domestic and foreign taxes | (20,076) | 4,816 |
| Other accrued liabilities | (279) | (7,823) |
| Pensions and other postretirement benefits | 15,712 | 8,584 |
| Other liabilities | (2,996) | 5,620 |
| Discontinued operations | | (9,266) |
| Net cash provided by operating activities | 307,647 | 420,187 |
| <u>CASH FLOWS FROM INVESTING ACTIVITIES</u> | | |
| Acquisitions (less cash acquired of \$1,050 in 2006 and \$17,013 in 2005) | (160,429) | (818,036) |
| Capital expenditures | (115,441) | (105,859) |
| Proceeds from sale of plant and equipment | 23,694 | 6,405 |
| Proceeds from sale of businesses | | 92,715 |
| Other | (1,771) | 379 |
| Discontinued operations | | (100) |
| Net cash (used in) investing activities | (253,947) | (824,496) |
| <u>CASH FLOWS FROM FINANCING ACTIVITIES</u> | | |
| Net (payments for) proceeds from common share activity | (360,616) | 1,813 |
| Proceeds from notes payable, net | 370,942 | 435,256 |
| Proceeds from long-term borrowings | 3,011 | 528,360 |
| (Payments for) long-term borrowings | (19,771) | (528,820) |
| Dividends | (61,192) | (54,669) |
| Net cash (used in) provided by financing activities | (67,626) | 381,940 |
| Effect of exchange rate changes on cash | (529) | (373) |

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| | | |
|--|------------|------------|
| Net (decrease) in cash and cash equivalents | (14,455) | (22,742) |
| Cash and cash equivalents at beginning of year | 171,553 | 336,080 |
| Cash and cash equivalents at end of period | \$ 157,098 | \$ 313,338 |

See accompanying notes to consolidated financial statements.

PARKER-HANNIFIN CORPORATION**BUSINESS SEGMENT INFORMATION BY INDUSTRY****(Dollars in thousands)****(Unaudited)**

The Company operates in three reportable business segments: Industrial, Aerospace and Climate & Industrial Controls. The Industrial Segment is the largest and includes a significant portion of International operations.

Industrial - This segment produces a broad range of motion control and fluid systems and components used in all kinds of manufacturing, packaging, processing, transportation, mobile construction, agricultural and military machinery and equipment. Sales are made directly to major original equipment manufacturers (OEMs) and through a broad distribution network to smaller OEMs and the aftermarket.

Aerospace - This segment designs and manufactures products and provides aftermarket support for commercial, military and general aviation aircraft, missile and spacecraft markets. The Aerospace Segment provides a full range of systems and components for hydraulic, pneumatic and fuel applications.

Climate & Industrial Controls - This segment manufactures motion-control systems and components for use primarily in the refrigeration and air conditioning and transportation industries.

Business Segment Results by Industry

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|------------------------------------|---------------------|----------------------------------|---------------------|
| | 2006 | 2005 | 2006 | 2005 |
| Net sales | | | | |
| Industrial: | | | | |
| North America | \$ 959,663 | \$ 929,734 | \$ 1,960,428 | \$ 1,858,965 |
| International | 922,011 | 676,526 | 1,799,715 | 1,297,290 |
| Aerospace | 402,039 | 345,274 | 804,397 | 694,081 |
| Climate & Industrial Controls | 227,439 | 206,003 | 498,185 | 420,752 |
| Total | \$ 2,511,152 | \$ 2,157,537 | \$ 5,062,725 | \$ 4,271,088 |
| Segment operating income | | | | |
| Industrial: | | | | |
| North America | \$ 133,890 | \$ 130,230 | \$ 287,028 | \$ 267,360 |
| International | 121,769 | 68,068 | 249,300 | 148,509 |
| Aerospace | 67,778 | 47,322 | 136,403 | 102,105 |
| Climate & Industrial Controls | 6,963 | 9,914 | 37,787 | 28,530 |
| Total segment operating income | 330,400 | 255,534 | 710,518 | 546,504 |
| Corporate general and administrative expenses | 43,960 | 28,489 | 80,630 | 57,316 |
| Income from continuing operations before interest expense and other | 286,440 | 227,045 | 629,888 | 489,188 |
| Interest expense | 22,304 | 19,587 | 39,476 | 36,058 |
| Other (income) expense | (627) | 31,934 | 23,990 | 73,566 |
| Income from continuing operations before income taxes | \$ 264,763 | \$ 175,524 | \$ 566,422 | \$ 379,564 |

PARKER-HANNIFIN CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Dollars in thousands, except per share amounts

1. Management representation

In the opinion of the management of the Company, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position as of December 31, 2006, the results of operations for the three and six months ended December 31, 2006 and 2005 and cash flows for the six months then ended. These financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company's 2006 Annual Report on Form 10-K. Interim period results are not necessarily indicative of the results to be expected for the full fiscal year.

2. Consolidated statement of cash flows revision

In order to bring the Consolidated Statement of Cash Flows presentation in compliance with Financial Accounting Standards Board (FASB) Statement No. 95, the Company has revised the Consolidated Statement of Cash Flows for the six months ended December 31, 2005 to separately disclose the operating, investing, and financing portions of the cash flows attributable to discontinued operations. The Company had previously reported these amounts on a combined basis. The revision resulted in a decrease in net cash provided by operating activities of \$9.3 million and an increase in net cash used in investing activities of \$0.1 million for the six months ended December 31, 2005.

3. New accounting pronouncements

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement 109 (FIN 48)*. FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company has not yet determined the effect on the Company's financial position or results of operations of complying with the provisions of FIN 48.

In August 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*. Statement No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. Statement No. 157 is effective for fiscal years beginning after November 15, 2007. The Company has not yet determined the effect on the Company's financial position or results of operations of complying with the provisions of Statement No. 157.

In September 2006, the FASB issued FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. Statement No. 158 amends FASB Statements No. 87, 88, 106 and 132R. Statement No. 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. The funded status recognition provision is effective for the Company as of the end of the fiscal year ending June 30, 2007.

3. New accounting pronouncements, continued

Statement No. 158 also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial condition. The measurement date provision of Statement No. 158 is effective for the Company for the fiscal year ending June 30, 2009. The Company has not yet determined the effect on the Company's financial position of complying with the provisions of Statement No. 158.

4. Product warranty

In the ordinary course of business, the Company warrants its products against defect in design, materials and workmanship over various time periods. The warranty accrual as of December 31, 2006 and June 30, 2006 is immaterial to the financial position of the Company and the change in the accrual for the current quarter and first six months of fiscal 2007 is immaterial to the Company's results of operations and cash flows.

5. Earnings per share

The following table presents a reconciliation of the numerator and denominator of basic and diluted earnings per share from continuing operations for the three and six months ended December 31, 2006 and 2005.

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|-------------|------------------|-------------|
| | December 31, | | December 31, | |
| | 2006 | 2005 | 2006 | 2005 |
| <u>Numerator:</u> | | | | |
| Income from continuing operations | \$ 192,967 | \$ 129,024 | \$ 403,551 | \$ 272,872 |
| <u>Denominator:</u> | | | | |
| Basic - weighted average common shares | 115,938,153 | 118,821,006 | 117,305,843 | 118,851,843 |
| Increase in weighted average from dilutive effect of equity-based awards | 1,988,245 | 1,503,162 | 1,833,847 | 1,533,925 |
| Diluted - weighted average common shares, assuming exercise of equity-based awards | 117,926,398 | 120,324,168 | 119,139,690 | 120,385,768 |
| Basic earnings per share from continuing operations | \$ 1.66 | \$ 1.09 | \$ 3.44 | \$ 2.30 |
| Diluted earnings per share from continuing operations | \$ 1.64 | \$ 1.07 | \$ 3.39 | \$ 2.27 |

For the three months ended December 31, 2006 and 2005, 922,498 and 2,332,787 common shares subject to equity-based awards, respectively, were excluded from the computation of diluted earnings per share because the effect of their exercise would be anti-dilutive. For the six months ended December 31, 2006 and 2005, 1,544,323 and 1,815,839 common shares subject to equity-based awards, respectively, were excluded from the computation of diluted earnings per share because the effect of their exercise would be anti-dilutive.

6. Stock repurchase program

The Company has a program to repurchase common shares of the Company. Under the program, the Company is authorized to repurchase an amount of common shares each fiscal year equal to the greater of 5 million shares or five percent of the shares outstanding as of the end of the prior fiscal year. Repurchases are funded primarily from operating cash flows, and the shares are initially held as treasury stock. The Company repurchased 2,377,627 shares of its common stock at an average price of \$82.99 per share during the three-month period ended December 31, 2006. Fiscal year-to-date, the Company repurchased 5 million shares at an average price of \$78.61 per share. On January 25, 2007, the Company's Board of Directors approved an increase in the number of shares authorized for repurchase under this program so that, as of that date, the aggregate number of shares available for repurchase was equal to 10 million.

7. Comprehensive income

The Company's primary items of other comprehensive income (loss) are foreign currency translation adjustments and unrealized gains (losses) on marketable equity securities and cash flow hedges. Comprehensive income for the three and six months ended December 31, 2006 and 2005 was as follows:

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|------------------------------------|-------------------|----------------------------------|-------------------|
| | 2006 | 2005 | 2006 | 2005 |
| Net income | \$ 192,967 | \$ 129,024 | \$ 403,551 | \$ 301,756 |
| Foreign currency translation adjustments | 66,195 | 6,640 | 64,451 | (15,183) |
| Realized (gain) on marketable equity securities | | (9) | | (18) |
| Unrealized (loss) on marketable equity securities | | (1) | | (8) |
| Realized loss on cash flow hedges | 59 | 40 | 118 | 40 |
| Unrealized gain on cash flow hedges | | 4,667 | | 5,161 |
| Comprehensive income | \$ 259,221 | \$ 140,361 | \$ 468,120 | \$ 291,748 |

Foreign currency translation adjustments are net of taxes of \$6,808 and \$5,296 for the three and six months ended December 31, 2006, respectively, and \$346 and \$1,925 for the three and six months ended December 31, 2005, respectively. The realized (gain) on marketable equity securities is net of taxes of \$6 and \$14 for the three and six months ended December 31, 2005, respectively, and is reflected in the Other (income) expense, net caption in the Consolidated Statement of Income. The unrealized (loss) on marketable equity securities is net of taxes of \$2 for the six months ended December 31, 2005. The realized loss on cash flow hedges is net of taxes of \$37 and \$74 for the three and six months ended December 31, 2006, respectively, and \$24 for the three and six months ended December 31, 2005, and is reflected in the Interest expense caption in the Consolidated Statement of Income. The unrealized gain on cash flow hedges is net of taxes of \$2,800 and \$3,116 for the three and six months ended December 31, 2005, respectively.

8. Business realignment charges

During the second quarter of fiscal 2007, the Company recorded a \$6,620 charge (\$4,087 after-tax or \$.03 per diluted share) for the costs to structure its businesses in light of current and anticipated customer demand. The Company believes the realignment actions will positively impact future results of operations but will have no material effect on liquidity and sources and uses of capital. The charge primarily consists of severance costs and costs to relocate machinery and equipment. The severance costs are attributable to approximately 255 employees in the Industrial Segment. A portion of the severance payments have been made with the remaining payments expected to be made by June 30, 2007. The business realignment costs are presented in the Consolidated Statement of Income for the three months ended December 31, 2006 as follows: \$5,653 in Cost of sales and \$967 in Selling, general and administrative expenses.

During the first six months of fiscal 2007, the Company recorded charges of \$10,445 (\$6,448 after-tax or \$.05 per diluted share) for business realignment costs primarily related to the Industrial Segment. The business realignment costs are presented in the Consolidated Statement of Income for the six months ended December 31, 2006 as follows: \$8,960 in Cost of sales and \$1,485 in Selling, general and administrative expenses.

During the second quarter of fiscal 2006, the Company recorded a \$3,914 charge (\$2,442 after-tax or \$.02 per diluted share) for the costs to structure its businesses in light of current and anticipated customer demand. The Company believes the realignment actions will positively impact future results of operations but will have no material effect on liquidity and sources and uses of capital. The charge primarily consists of severance costs and costs to relocate machinery and equipment. The severance costs are attributable to 135 employees in the Industrial Segment. All severance payments have been made. The business realignment costs are presented in the Cost of sales caption in the Consolidated Statement of Income for the three months ended December 31, 2005.

During the first six months of fiscal 2006, the Company recorded charges of \$6,684 (\$4,174 after-tax or \$.03 per diluted share) for business realignment costs related to the Industrial Segment and Climate & Industrial Controls Segment. The business realignment costs are presented in the Consolidated Statement of Income for the six months ended December 31, 2005 as follows: \$5,776 in Cost of sales and \$908 in Selling, general and administrative expenses.

9. Goodwill and intangible assets

The changes in the carrying amount of goodwill for the six months ended December 31, 2006 are as follows:

| | Industrial Segment | Aerospace Segment | Climate & Industrial Controls Segment | Total |
|------------------------------|--------------------|-------------------|---------------------------------------|--------------|
| Balance June 30, 2006 | \$ 1,625,983 | \$ 87,543 | \$ 296,932 | \$ 2,010,458 |
| Acquisitions | 110,269 | | 13,052 | 123,321 |
| Foreign currency translation | 35,341 | 11 | 1,380 | 36,732 |
| Goodwill adjustments | 6,272 | 180 | (6,248) | 204 |
| Balance December 31, 2006 | \$ 1,777,865 | \$ 87,734 | \$ 305,116 | \$ 2,170,715 |

9. Goodwill and intangible assets, continued

Goodwill adjustments primarily represent final adjustments to the purchase price allocation for acquisitions completed within the last twelve months.

Intangible assets are amortized on the straight-line method over their legal or estimated useful lives. The following summarizes the gross carrying value and accumulated amortization for each major category of intangible assets:

| | December 31, 2006 | | June 30, 2006 | |
|--------------------------|-----------------------|--------------------------|-----------------------|--------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Patents | \$ 80,685 | \$ 25,795 | \$ 66,767 | \$ 22,289 |
| Trademarks | 172,247 | 18,925 | 133,576 | 13,289 |
| Customer lists and other | 318,210 | 57,200 | 351,366 | 45,036 |
| Total | \$ 571,142 | \$ 101,920 | \$ 551,709 | \$ 80,614 |

Total intangible amortization expense for the six months ended December 31, 2006 was \$21,022. The estimated amortization expense for the five years ending June 30, 2007 through 2011 is \$38,205, \$35,448, \$34,113, \$33,662 and \$30,552, respectively.

10. Retirement benefits

Net periodic pension cost recognized included the following components:

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|------------------------------------|-----------|----------------------------------|-----------|
| | 2006 | 2005 | 2006 | 2005 |
| Service cost | \$ 18,483 | \$ 19,291 | \$ 38,457 | \$ 39,384 |
| Interest cost | 37,712 | 33,669 | 75,016 | 66,745 |
| Expected return on plan assets | (44,805) | (37,330) | (86,909) | (73,226) |
| Net amortization and deferral and other | 19,358 | 22,709 | 36,150 | 43,421 |
| Net periodic benefit cost | \$ 30,748 | \$ 38,339 | \$ 62,714 | \$ 76,324 |

10. Retirement benefits, continued

Postretirement benefit cost recognized included the following components:

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|------------------------------------|----------|----------------------------------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| Service cost | \$ 331 | \$ 455 | \$ 828 | \$ 1,029 |
| Interest cost | 1,409 | 1,148 | 2,850 | 2,779 |
| Net amortization and deferral and other | (236) | (62) | (290) | 131 |
| Net periodic benefit cost | \$ 1,504 | \$ 1,541 | \$ 3,388 | \$ 3,939 |

During the first six months of fiscal 2007, the Company made \$111 million in voluntary contributions to its qualified defined benefit plans. The Company expects to contribute a total of approximately \$190 million to its qualified defined benefit plans in fiscal 2007. The majority of the remaining contribution expected to be made in fiscal 2007 is discretionary.

11. Divestiture

In December 2005, the Company divested the Thermoplastics division. The Thermoplastics division was part of the Industrial Segment for segment reporting purposes. This divestiture resulted in a loss of \$11,018 (\$9,770 after-tax or \$.08 per diluted share) and is reflected in Other (income) expense, net in the Consolidated Statement of Income

In August 2005, the Company divested the Astron Building business. This business was part of the Other Segment for segment reporting purposes. The results of operations for this business unit have been presented as discontinued operations for all periods presented. Included in the income from discontinued operations is an after-tax gain on disposal of \$27,753.

PARKER-HANNIFIN CORPORATION

FORM 10-Q

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FOR THE THREE AND SIX MONTHS ENDED DECEMBER 31, 2006

AND COMPARABLE PERIODS ENDED DECEMBER 31, 2005

OVERVIEW

The Company is a leading worldwide diversified manufacturer of motion control technologies and systems, providing precision engineered solutions for a wide variety of commercial, mobile, industrial and aerospace markets.

The Company's order rates provide a near-term perspective of the Company's outlook particularly when viewed in the context of prior and future order rates. The Company publishes its order rates on a monthly basis. The lead time between the time an order is received and revenue is realized generally ranges from one day to 12 weeks for commercial, mobile and industrial orders and from one day to 18 months for aerospace orders. The Company believes the leading economic indicators of these markets that have a strong correlation to the Company's future order rates are the Institute of Supply Management (ISM) index of manufacturing activity with respect to commercial, mobile and industrial markets and aircraft miles flown, revenue passenger miles and Department of Defense spending for aerospace markets.

An ISM index above 50 indicates that the manufacturing economy is expanding resulting in the expectation that the Company's order rates in the North American commercial, mobile and industrial markets should be positive year-over-year. The ISM index at the end of December 2006 was 51.4 compared to 53.8 at the end of June 2006. With respect to the aerospace market, aircraft miles flown and revenue passenger miles continue to show improvement over comparable fiscal 2006 levels while Department of Defense spending in fiscal 2007 is expected to increase slightly from its fiscal 2006 level.

The Company also believes that there is a high correlation between interest rates and industrial manufacturing activity. The Federal Reserve has not raised the federal funds rate during fiscal 2007 but did raise the federal funds rate eight times during fiscal 2006. Additional increases in interest rates could have a negative impact on industrial production thereby lowering future order rates.

The Company's major opportunities for growth are as follows:

Leverage the Company's broad product line with customers desiring to consolidate their vendor base and outsource engineering,

Marketing systems solutions for customer applications,

Expand the Company's business presence outside of North America,

New product introductions, including those resulting from the Company's innovation initiatives, and

Strategic acquisitions in a consolidating industry.

The financial condition of the Company remains strong as evidenced by the continued generation of substantial cash flows from operations, a debt to debt-equity ratio of 25.9 percent, ample borrowing capabilities and strong credit ratings. Cash flows from operations for the first six months of fiscal 2007 were \$307.6 million or 6.1% of sales after making \$111 million in voluntary contributions to the Company's qualified defined benefit plans.

Many acquisition opportunities remain available to the Company within its target markets. During the first six months of fiscal 2007, the Company completed six acquisitions whose aggregate annual revenues were approximately \$109 million. Acquisitions will continue to be considered from time to time to the extent there is a strong strategic fit, while at the same time, maintaining the Company's strong financial position. The Company will also continue to assess the strategic fit of its existing businesses and initiate efforts to divest businesses that are not considered to be a good long-term fit for the Company.

The Company routinely faces challenges regarding improving premier customer service levels, managing changes in raw material prices and the rising expenses related to employee retirement and health care benefits. The Company is currently focused on maintaining its financial strength through the current Industrial North American slowdown, especially in the automotive and heavy-duty truck markets. The Company has implemented a number of strategic financial performance initiatives relating to growth and margin improvement in order to meet these challenges, including strategic procurement, strategic pricing, lean enterprise and business realignments.

The discussion below is structured to separately discuss the Consolidated Statement of Income, Results by Business Segment, Balance Sheet and Statement of Cash Flows.

CONSOLIDATED STATEMENT OF INCOME

| (dollars in millions) | Three months ended December 31, | | Six months ended December 31, | |
|---|------------------------------------|------------|----------------------------------|------------|
| | 2006 | 2005 | 2006 | 2005 |
| Net sales | \$ 2,511.2 | \$ 2,157.5 | \$ 5,062.7 | \$ 4,271.1 |
| Gross profit | \$ 573.1 | \$ 451.9 | \$ 1,177.4 | \$ 909.7 |
| Gross profit margin | 22.8% | 20.9% | 23.3% | 21.3% |
| Selling, general and administrative expenses | \$ 292.9 | \$ 245.8 | \$ 584.9 | \$ 482.9 |
| Selling, general and administrative expenses, as a percent of sales | 11.7% | 11.4% | 11.6% | 11.3% |
| Interest expense | \$ 22.3 | \$ 19.6 | \$ 39.5 | \$ 36.1 |
| Other (income) expense, net | \$ (6.8) | \$ 10.9 | \$ (13.4) | \$ 11.2 |
| Effective tax rate from continuing operations | 27.1% | 26.5% | 28.8% | 28.1% |
| Income from continuing operations | \$ 193.0 | \$ 129.0 | \$ 403.6 | \$ 272.9 |
| Income from continuing operations, as a percent of sales | 7.7% | 6.0% | 8.0% | 6.4% |
| Discontinued operations | | | | \$ 28.9 |
| Backlog | \$ 2,782.5 | \$ 2,494.9 | \$ 2,782.5 | \$ 2,494.9 |

Net sales for the current-year quarter and first six months of fiscal 2007 increased 16.4 percent and 18.5 percent, respectively, over the comparable prior-year net sales amounts reflecting higher volume experienced in all Segments. Acquisitions in the last 12 months contributed about 39 percent of the net sales increase in the current-year quarter and about 46 percent of the increase for the first six months of fiscal 2007. The effect of currency rate changes increased net sales by approximately \$78 million and \$118 million in the current-year quarter and first six months of fiscal 2007, respectively.

Gross profit margin increased for the current-year quarter and first six months of fiscal 2007 due to a combination of the increase in sales as well as the effects of the Company's financial performance initiatives, especially in the Industrial International businesses. Included in gross profit are business realignment charges of \$5.7 million and \$3.9 million in the current-year quarter and prior-year quarter, respectively, and \$9.0 million and \$5.8 million for the first six months of fiscal 2007 and 2006, respectively.

Selling, general and administrative expenses increased for the current-year quarter and first six months of fiscal 2007 primarily due to the higher sales volume, higher research and development expenses and higher incentive compensation.

Interest expense for the current-year quarter and first six months of fiscal 2007 increased primarily due to higher average debt outstanding.

Other (income) expense, net in the current-year quarter and first six months of fiscal 2007 included \$6.2 million of income related to the final accounting for a divestiture completed in fiscal 2002. Other (income) expense, net for the first six months of fiscal 2007 included \$4.6 million of income related to a litigation settlement. Other (income) expense, net for the prior-year quarter and first six months of fiscal 2006 included a loss of \$11.0 million resulting from the divestiture of the Thermoplastics division.

Effective tax rate from continuing operations for the current-year quarter and first six months of fiscal 2007 reflects an \$11.0 million benefit, \$6.3 million of which relates to fiscal 2006, resulting from the renewal of the Federal Tax Credit for Increasing Research Activities.

Income from continuing operations for the current-year quarter and first six months of fiscal 2007 was positively affected by a decrease in expense of approximately \$6.4 million and \$11.9 million, respectively, related to qualified defined benefit plans, resulting primarily from changes in actuarial assumptions and the amortization of actuarial losses.

Discontinued operations represents the operating results and related gain on the sale, net of tax of the Astron Buildings business which was divested in August 2005. Included in discontinued operations for the six months ended December 31, 2005 is an after-tax gain on the sale of Astron of approximately \$27.8 million. The gain is primarily attributable to foreign currency translation adjustments.

Backlog increased from the prior-year quarter due to an increase in order rates throughout most businesses in all Segments, especially in Industrial International. Backlog increased from the June 30, 2006 amount of \$2,695.9 million primarily due to an increase in order rates in the Industrial International businesses.

RESULTS BY BUSINESS SEGMENT

Industrial Segment

| (dollars in millions) | Three months ended December 31, | | Six months ended December 31, | |
|---|------------------------------------|------------|----------------------------------|------------|
| | 2006 | 2005 | 2006 | 2005 |
| Net sales | | | | |
| North America | \$ 959.7 | \$ 929.7 | \$ 1,960.4 | \$ 1,859.0 |
| International | 922.0 | 676.5 | 1,799.7 | 1,297.3 |
| Operating income | | | | |
| North America | 133.9 | 130.2 | 287.0 | 267.4 |
| International | \$ 121.8 | \$ 68.1 | \$ 249.3 | \$ 148.5 |
| Operating income, as a percent of net sales | | | | |
| North America | 14.0% | 14.0% | 14.6% | 14.4% |
| International | 13.2% | 10.1% | 13.9% | 11.4% |
| Backlog | \$ 1,264.7 | \$ 1,062.9 | \$ 1,264.7 | \$ 1,062.9 |

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The Industrial Segment operations experienced the following percentage changes in net sales in the current year compared to the equivalent prior-year period:

| | | Period ending December 31 | |
|--------------------------|-----------------------------------|---------------------------|------------|
| | | Three months | Six months |
| Industrial North America | as reported | 3.2% | 5.5% |
| | Acquisitions | 2.2% | 3.3% |
| | Currency | 0.0% | 0.2% |
| Industrial North America | without acquisitions and currency | 1.0% | 2.0% |
| Industrial International | as reported | 36.3% | 38.7% |
| | Acquisitions | 14.1% | 19.4% |
| | Currency | 10.1% | 7.7% |
| Industrial International | without acquisitions and currency | 12.1% | 11.6% |
| Total Industrial Segment | as reported | 17.1% | 19.1% |
| | Acquisitions | 7.2% | 9.9% |
| | Currency | 4.3% | 3.3% |
| Total Industrial Segment | without acquisitions and currency | 5.6% | 5.9% |

The above presentation reconciles the percentage changes in net sales of the Industrial operations reported in accordance with U.S. GAAP to percentage changes in net sales adjusted to remove the effects of acquisitions made within the prior four fiscal quarters as well as the effects of currency exchange rates. The effects of acquisitions and currency exchange rates are removed to allow investors and the Company to meaningfully evaluate the percentage changes in net sales on a comparable basis from period to period.

Excluding the effects of acquisitions and foreign currency changes, the slight increase in Industrial North American sales for the current-year quarter and first six months of fiscal 2007 reflects higher end-user demand experienced across most of the Industrial North American markets, particularly in the construction, mining, microelectronics, oil and gas and general industrial machinery markets, partially offset by lower demand in the automotive market. The increase in Industrial International sales for the current-year quarter and first six months of fiscal 2007 is primarily attributed to higher volume across most markets in all regions, particularly in Europe and the Asia Pacific region.

The increase in Industrial North American margins for the first six months of fiscal 2007 and the increase in Industrial International margins for the current-year quarter and first six months of fiscal 2007 is primarily due to the higher sales volume, benefits realized from the Company's financial performance initiatives and benefits from past business realignments. Industrial North American and Industrial International margins were negatively impacted by higher business realignment costs in the current-year quarter as compared to the prior-year quarter. Also, acquisitions, not yet fully integrated, negatively impacted Industrial International margins in the current-year quarter and both Industrial North American and Industrial International margins for the first six months of fiscal 2007.

The increase in backlog from a year ago is primarily due to higher order rates experienced in virtually all of the markets of the Industrial Segment with the largest portion of the increase being experienced in the Industrial International businesses. Backlog increased from the June 30, 2006 amount of \$1,177.8 million primarily due to higher order rates in the Industrial International operations.

The Company anticipates Industrial North American sales for fiscal 2007 will exceed their fiscal 2006 level by less than one percent and Industrial International sales for fiscal 2007 will exceed their fiscal 2006 level by approximately 28 percent. Industrial North American operating margins in fiscal 2007 are

expected to increase to a range of 14.8 percent to 15.2 percent and Industrial International operating margins are expected to range from 13.3 percent to 13.7 percent. The Company expects to continue to take the actions necessary to structure appropriately the Industrial Segment operations to operate in their current economic environment. Such actions may include the necessity to record additional business realignment charges in fiscal 2007.

Aerospace Segment

| (dollars in millions) | Three months ended December 31, | | Six months ended December 31, | |
|---|------------------------------------|------------|----------------------------------|------------|
| | 2006 | 2005 | 2006 | 2005 |
| Net sales | \$ 402.0 | \$ 345.3 | \$ 804.4 | \$ 694.1 |
| Operating income | \$ 67.8 | \$ 47.3 | \$ 136.4 | \$ 102.1 |
| Operating income, as a percent of net sales | 16.9% | 13.7% | 17.0% | 14.7% |
| Backlog | \$ 1,328.6 | \$ 1,270.5 | \$ 1,328.6 | \$ 1,270.5 |

The increase in sales in the Aerospace Segment for the current-year quarter and first six months of fiscal 2007 is primarily due to an increase in both commercial original equipment manufacturer (OEM) and aftermarket volume. The higher margins were primarily due to a higher concentration of sales occurring in the aftermarket businesses in the current-year quarter and first six months of fiscal 2007.

The increase in backlog from the prior-year quarter is due to higher order rates experienced in the commercial businesses. Shipments were about the same as order rates in the current-year quarter resulting in the slight increase in backlog from the June 30, 2006 amount of \$1,328.3 million. For fiscal 2007, sales are expected to increase approximately nine percent from their fiscal 2006 level and operating margins are expected to range from 15.2 percent to 15.6 percent. Heavier commercial OEM volume in future product mix could result in lower margins.

Climate & Industrial Controls Segment

| (dollars in millions) | Three months ended December 31, | | Six months ended December 31, | |
|---|------------------------------------|----------|----------------------------------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| Net sales | \$ 227.4 | \$ 206.0 | \$ 498.2 | \$ 420.8 |
| Operating income | \$ 7.0 | \$ 9.9 | \$ 37.8 | \$ 28.5 |
| Operating income, as a percent of net sales | 3.1% | 4.8% | 7.6% | 6.8% |
| Backlog | \$ 189.2 | \$ 161.5 | \$ 189.2 | \$ 161.5 |

The Climate & Industrial Controls Segment operations experienced the following percentage changes in net sales in the current year compared to the equivalent prior-year period:

| | Period ending December 31 | |
|---|---------------------------|------------|
| | Three months | Six months |
| CIC Segment as reported | 10.4% | 18.4% |
| Acquisitions | 8.7% | 10.7% |
| Currency | 2.4% | 1.9% |
| CIC Segment without acquisitions and currency | (0.7)% | 5.8% |

The above presentation reconciles the percentage changes in net sales of the Climate & Industrial Controls Segment reported in accordance with U.S. GAAP to percentage changes in net sales adjusted to remove the effects of acquisitions made within the prior four fiscal quarters as well as the effects of currency exchange rates. The effects of acquisitions and currency exchange rates are removed to allow investors and the Company to meaningfully evaluate the percentage changes in net sales on a comparable basis from period to period.

Excluding the effects of acquisitions and foreign currency changes, the increase in sales in the Climate & Industrial Controls Segment for the first six months of fiscal 2007 is primarily due to higher end-user demand in the residential air conditioning market. The lower margins in the current-year quarter are primarily due to product mix as well as costs incurred to integrate recent acquisitions. The higher margins for the first six months of fiscal 2007 is primarily due to the higher sales volume and the absence of business realignment costs incurred in the first half of fiscal 2006.

The increase in backlog from the prior-year quarter is primarily due to acquisitions as well as higher order rates in the residential air conditioning market. Backlog declined slightly from the June 30, 2006 amount of \$189.8 million primarily due to shipments exceeding new orders in the residential air conditioning market. For fiscal 2007, sales are expected to increase by approximately four percent from their fiscal 2006 level and operating margins are expected to be in a range of 7.1 percent to 7.5 percent. The Company expects to continue to take the actions necessary to structure appropriately the Climate & Industrial Controls Segment to operate in their current economic environment. Such actions may include the necessity to record additional business realignment charges in fiscal 2007.

Corporate general and administrative expenses were \$44.0 million in the current-year quarter compared to \$28.5 million in the prior-year quarter and were \$80.6 million for the first six months of fiscal 2007 compared to \$57.3 million for the first six months of fiscal 2006. As a percent of sales, corporate general and administrative expenses for the current-year quarter increased to 1.8 percent compared to 1.3 percent for the prior-year quarter and increased to 1.6 percent for the first six months of fiscal 2007 compared to 1.3 percent for the first six months of fiscal 2006. The higher expense in the current-year quarter and first six months of fiscal 2007 is primarily due to higher research and development expenses, fees for professional services and employee welfare and benefit expenses.

Included in Other (income) expense (in the Business Segment Results by Industry) for the current-year quarter and first six months of fiscal 2007 are \$14.1 million and \$16.0 million, respectively, of foreign currency transaction gains compared to a gain of \$2.2 million in the prior-year quarter and a loss of \$5.6 million for the first six months of fiscal 2006. Other (income) expense for the current-year quarter and first six months of fiscal 2007 includes \$3.4 million and \$8.9 million, respectively, of pension expense compared to \$12.9 million and \$25.2 million for the prior-year quarter and first six months of fiscal 2006, respectively. The decrease in expense primarily results from changes in actuarial assumptions and lower amortization of actuarial losses. Other (income) expense for the first six months of fiscal 2007 includes a gain of \$4.6 million related to a litigation settlement and a gain of \$6.2 million related to the final accounting for a divestiture completed in fiscal 2002. Other (income) expense for the first six months of fiscal 2006 includes a loss on a divestiture of \$11.0 million.

DISCONTINUED OPERATIONS

In August 2005, the Company divested its Astron Buildings business. The following results of operations for this business unit have been presented as discontinued operations for the six months ended December 31, 2005.

| (in millions) | 2005 |
|---|-----------|
| Net sales | \$ 21,672 |
| Operating income, net of taxes | 1,131 |
| Gain on sale of discontinued operations, net of taxes | 27,753 |
| Income from discontinued operations | \$ 28,884 |

BALANCE SHEET

| (in millions) | December 31, 2006 | June 30, 2006 |
|--|----------------------|------------------|
| Accounts receivable | \$ 1,524.2 | \$ 1,592.3 |
| Inventories | 1,314.4 | 1,182.9 |
| Plant and equipment, net of accumulated depreciation | 1,706.8 | 1,693.8 |
| Goodwill | 2,170.7 | 2,010.5 |
| Intangible assets, net | 469.2 | 471.1 |
| Other assets | 933.3 | 859.1 |
| Accounts payable, trade | 701.0 | 770.7 |
| Accrued liabilities | 658.5 | 698.0 |
| Accrued domestic and foreign taxes | 120.1 | 140.4 |
| Shareholders' equity | 4,317.1 | 4,241.2 |
| Working capital | \$ 1,257.0 | \$ 1,458.0 |
| Current ratio | 1.66 | 1.87 |

Accounts receivable are primarily receivables due from customers for sales of product (\$1,339.4 million at December 31, 2006 and \$1,475.9 million at June 30, 2006). Accounts receivable decreased \$68.1 million with days sales outstanding relating to trade accounts receivable decreasing to 49 days from 51 days at June 30, 2006.

Inventories increased \$131.5 million since June 30, 2006, with days supply increasing to 71 days from 60 days at June 30, 2006. The increase in days supply of inventory during the first six months of fiscal 2007 is primarily due to a build in inventory in certain businesses in order to meet increasing customer demand.

Plant and equipment, net of accumulated depreciation increased primarily due to current-year acquisitions partially offset by depreciation exceeding capital expenditures.

Goodwill increased primarily as a result of current-year acquisitions.

Other assets increased since June 30, 2006 primarily as a result of \$111.0 million in voluntary contributions that were made to the Company's qualified defined benefit pension plans during the first six months of fiscal 2007.

Accounts payable, trade decreased \$69.7 million from June 30, 2006 primarily due to the timing of payments for purchases.

Accrued liabilities decreased \$39.5 million primarily as a result of the payment of fiscal 2006 incentive compensation during the first six months of fiscal 2007 partially offset by current-year acquisitions.

Accrued domestic and foreign taxes decreased primarily due to timing of tax payments.

Due to the weakening of the dollar, foreign currency translation adjustments resulted in an increase in shareholders' equity of \$64.5 million during the first half of fiscal 2007. The translation adjustments primarily affected Accounts receivable, Inventories, Plant and equipment, Goodwill and Long-term debt.

STATEMENT OF CASH FLOWS

| (in millions) | Six months ended December 31, | |
|---|----------------------------------|-----------|
| | 2006 | 2005 |
| Cash provided by (used in): | | |
| Operating activities | \$ 307.6 | \$ 420.2 |
| Investing activities | (254.0) | (824.5) |
| Financing activities | (67.6) | 382.0 |
| Effect of exchange rates | (0.5) | (0.4) |
| Net (decrease) in cash and cash equivalents | \$ (14.5) | \$ (22.7) |

Cash flows from operating activities - The decrease in net cash provided by operating activities in fiscal 2007 is primarily due to an increase in cash used to fund the Company's qualified defined benefit plans as well as an increase in inventories.

Cash flow used in investing activities - The decrease in the amount of cash used in investing activities in fiscal 2007 is attributable primarily to a decrease in acquisition activity and the absence of proceeds from the sale of businesses partially offset by an increase in capital expenditures.

Cash flow from financing activities - The decrease in cash provided by financing activities from the prior year is due to common stock activity which used cash of \$360.6 million in fiscal 2007 compared to providing cash of \$1.8 million in fiscal 2006. The change in common stock activity in fiscal 2007 is primarily due to a higher level of repurchases of the Company's common stock for treasury during the first six months of fiscal 2007 compared to the first six months of fiscal 2006.

The Company's goal is to maintain no less than an A rating on senior debt to ensure availability and reasonable cost of external funds. As a means of achieving this objective, the Company has established a financial goal of maintaining a ratio of debt to debt-equity of no more than 37 percent.

| Debt to Debt-Equity Ratio (in millions) | December 31, 2006 | June 30, 2006 |
|---|----------------------|------------------|
| Debt | \$ 1,505.5 | \$ 1,131.5 |
| Debt & equity | \$ 5,822.6 | \$ 5,372.7 |
| Ratio | 25.9% | 21.1% |

The Company has a line of credit totaling \$1,025 million through a multi-currency revolving credit agreement with a group of banks, of which \$654.1 million was available as of December 31, 2006. The Company has the right, no more than once a year, to increase the facility amount, in minimum increments of \$25 million up to a maximum facility amount of \$1,250 million. The credit agreement expires October 2011, however the Company has the right to request a one-year extension of the expiration date on an annual basis. The credit agreement supports the Company's commercial paper note program, which is rated A-1 by Standard & Poor's, P-1 by Moody's and F-1 by Fitch, Inc. These ratings are considered investment grade. The revolving credit agreement requires a facility fee of

5/100ths of one percent of the commitment per annum at the Company's present rating level. The revolving credit agreement contains provisions that increase the facility fee of the credit agreement in the event the Company's credit ratings are lowered. A lowering of the Company's credit ratings would not limit the Company's ability to use the credit agreement nor would it accelerate the repayment of any outstanding borrowings.

The Company's revolving credit agreement and indentures governing certain debt agreements contain various covenants, the violation of which would limit or preclude the use of the revolving credit agreement for future borrowings, or might accelerate the maturity of the related outstanding borrowings covered by the indentures. At the Company's present rating level, the most restrictive financial covenant provides that the ratio of secured debt to net tangible assets be less than 10 percent. As of December 31, 2006, the ratio of secured debt to net tangible assets was less than one percent. The Company is in compliance with all covenants and expects to remain in compliance during the term of the agreement and indentures.

NEW ACCOUNTING PRONOUNCEMENTS

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*—An Interpretation of FASB Statement 109 (FIN 48). FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company has not yet determined the effect on the Company's financial position or results of operations of complying with the provisions of FIN 48.

In August 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*. Statement No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. Statement No. 157 is effective for fiscal years beginning after November 15, 2007. The Company has not yet determined the effect on the Company's financial position or results of operations of complying with the provisions of Statement No. 157.

In September 2006, the FASB issued FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. Statement No. 158 amends FASB Statements No. 87, 88, 106 and 132R. Statement No. 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. The funded status recognition provision is effective for the Company as of the end of the fiscal year ending June 30, 2007. Statement No. 158 also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial condition. The measurement date provision of Statement No. 158 is effective for the Company for the fiscal year ending June 30, 2009. The Company has not yet determined the effect on the Company's financial position of complying with the provisions of Statement No. 158.

FORWARD-LOOKING STATEMENTS

Forward-looking statements contained in this Report on Form 10-Q and other written reports and oral statements are made based on known events and circumstances at the time of release, and as such, are subject in the future to unforeseen uncertainties and risks. All statements regarding future performance, earnings projections, events or developments are forward-looking statements. It is possible that the future performance and earnings projections of the Company may differ materially from current expectations, depending on economic conditions within both its industrial and aerospace markets, and the Company's ability to maintain and achieve anticipated benefits associated with announced realignment activities, strategic initiatives to improve operating margins and growth and innovation initiatives. A change in the economic conditions in individual markets may have a particularly volatile effect on segment performance.

Among other factors which may affect future performance are:

changes in business relationships with and purchases by or from major customers or suppliers, including delays or cancellations in shipments, or significant changes in financial condition,

uncertainties surrounding timing, successful completion or integration of acquisitions,

threats associated with and efforts to combat terrorism,

competitive market conditions and resulting effects on sales and pricing,

increases in raw material costs that cannot be recovered in product pricing,

the Company's ability to manage costs related to insurance and employee retirement and health care benefits, and

global economic factors, including manufacturing activity, air travel trends, currency exchange rates, difficulties entering new markets and general economic conditions such as inflation and interest rates.

The Company undertakes no obligation to update or publicly revise these forward-looking statements to reflect events or circumstances that arise after the date of this Report.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company enters into forward exchange contracts and costless collar contracts to reduce its exposure to fluctuations in related foreign currencies. These contracts are with major financial institutions and the risk of loss is considered remote. The Company does not hold or issue derivative financial instruments for trading purposes. In addition, the Company's foreign locations, in the ordinary course of business, enter into financial guarantees through financial institutions, which enable customers to be reimbursed in the event of nonperformance by the Company. The total carrying and fair value of open contracts and any risk to the Company as a result of these arrangements is not material to the Company's financial position, liquidity or results of operations.

The Company's debt portfolio contains variable rate debt, inherently exposing the Company to interest rate risk. The Company's objective is to maintain a 60/40 mix between fixed rate and variable rate debt thereby limiting its exposure to changes in near-term interest rates.

ITEM 4. CONTROLS AND PROCEDURES

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's principal executive officer and principal financial officer, of the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the second quarter of fiscal 2007. Based on this evaluation, the principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures are effective.

There has been no change in the Company's internal control over financial reporting during the quarter ended December 31, 2006 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PARKER-HANNIFIN CORPORATION

PART II - OTHER INFORMATION

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

- (a) *Unregistered Sales of Equity Securities.* Not applicable.
 (b) *Use of Proceeds.* Not applicable.
 (c) *Issuer Purchases of Equity Securities.*

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid Per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1) | (d) Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
|--------------------------|--|--|--|---|
| October 1, 2006 through | | | | |
| October 31, 2006 | 387,700 | \$ 82.36 | 387,700 | 6,660,027 |
| November 1, 2006 through | | | | |
| November 30, 2006 | 1,684,910(2) | \$ 83.17 | 1,684,300 | 4,975,727 |
| December 1, 2006 through | | | | |
| December 31, 2006 | 305,627 | \$ 82.77 | 305,627 | 4,670,100 |
| Total: | 2,378,237 | \$ 82.99 | 2,377,627 | 4,670,100 |

- (1) On August 16, 1990, the Company publicly announced that its Board of Directors authorized the repurchase by the Company of up to 3.0 million shares of its common stock. From time to time, the Board of Directors has adjusted the number of shares authorized for repurchase under this program. On each of February 1, 2006 and January 25, 2007, the Company publicly announced that its Board of Directors approved an increase in the number of shares authorized for repurchase under this program so that, beginning on each date, the aggregate number of shares authorized for repurchase was equal to 10 million. There is no expiration date for this program.
- (2) Includes 610 shares surrendered to the Company by certain non-employee Directors in order to satisfy tax withholding obligations upon the vesting of restricted stock under the Company's Non-Employee Director's Stock Plan.

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

(a) The Annual Meeting of the Shareholders of the Company was held on October 25, 2006.

(b) Not applicable.

(c)(i) The Shareholders elected four directors to the three-year class whose term of office will expire in 2009, as follows:

| | Votes For | Votes Withheld |
|----------------------|------------|----------------|
| Robert J. Kohlhepp | 75,863,533 | 32,210,789 |
| Giulio Mazzalupi | 74,198,887 | 33,875,435 |
| Klaus-Peter Müller | 74,326,096 | 33,748,226 |
| Markos I. Tambakeras | 74,284,017 | 33,790,305 |

(ii) The Shareholders ratified the appointment of PricewaterhouseCoopers LLP as independent registered public accounting firm of the Company for the fiscal year ending June 30, 2007, as follows:

| | |
|---------|-------------|
| For | 104,913,336 |
| Against | 2,225,419 |
| Abstain | 935,567 |

(iii) The Shareholders approved a shareholder proposal requesting that the Board of Directors take the steps necessary to declassify the election of Directors, as follows:

| | |
|------------------|------------|
| For | 70,260,097 |
| Against | 26,534,497 |
| Abstain | 1,504,607 |
| Broker non-votes | 9,775,121 |

(d) Not applicable.

Item 6. Exhibits.

The following documents are furnished as exhibits and are numbered pursuant to Item 601 of Regulation S-K:

| | |
|------------------|---|
| Exhibit 12 | Computation of Ratio of Earnings to Fixed Charges as of December 31, 2006. |
| Exhibit 31(i)(a) | Certification of the Principal Executive Officer Pursuant to 17 CFR 240.13a-14(a), as Adopted Pursuant to §302 of the Sarbanes-Oxley Act of 2002. |
| Exhibit 31(i)(b) | Certification of the Principal Financial Officer Pursuant to 17 CFR 240.13a-14(a), as Adopted Pursuant to §302 of the Sarbanes-Oxley Act of 2002. |
| Exhibit 32 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to §906 of the Sarbanes-Oxley Act of 2002. |

SIGNATURE

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

PARKER-HANNIFIN CORPORATION

(Registrant)

/s/ Timothy K. Pistell
Timothy K. Pistell
Executive Vice President - Finance and Administration
and Chief Financial Officer

Date: February 2, 2007

EXHIBIT INDEX

| Exhibit No. | Description of Exhibit |
|--------------------|---|
| Exhibit 12 | Computation of Ratio of Earnings to Fixed Charges as of December 31, 2006. |
| Exhibit 31(i)(a) | Certification of the Principal Executive Officer Pursuant to 17 CFR 240.13a-14(a), as Adopted Pursuant to §302 of the Sarbanes-Oxley Act of 2002. |
| Exhibit 31(i)(b) | Certification of the Principal Financial Officer Pursuant to 17 CFR 240.13a-14(a), as Adopted Pursuant to §302 of the Sarbanes-Oxley Act of 2002. |
| Exhibit 32 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to §906 of the Sarbanes-Oxley Act of 2002. |