DERMA SCIENCES, INC.
Form 10-K
March 28, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

S Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2012

.. 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: 1-31070

DERMA SCIENCES, INC.

(Name of Issuer in Its Charter)

Delaware (State or other jurisdiction of incorporation or organization)	23-2328753 (I.R.S. Employer Identification No.)
214 Carnegie Center, Suite 300, Princeton, New Jersey (Address of principal executive offices)	08540 (Zip code)

Registrant's telephone number: (609) 514-4744

Securities registered under Section 12(b) of the Exchange Act:

Title of each class	Name of each exchange on which registered
Common Stock, $.01 par value	The NASDAQ Stock Market LLC

Securities registered under Section 12(g) of the Exchange Act:

None.

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes ¨ No x

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes ¨ No x

Indicate by checkmark 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 x No ¨

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files).

Yes x No ¨

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes ¨ No x

The aggregate market value of the common equity stock held by non-affiliates, computed by reference to the average bid and asked prices of such stock as of June 30, 2012, was approximately $69,477,274.

The number of shares outstanding of the issuer's common equity as of March 27, 2013 was 16,621,222.

Documents Incorporated by Reference

Portions of the Registrant’s definitive proxy statement for its 2013 annual meeting of stockholders are incorporated by reference in Part III of this report.

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Part I

Item 1. Business

Overview

Derma Sciences, Inc. ("Derma Sciences") and its subsidiaries Sunshine Products, Inc., Derma Sciences Canada Inc., Derma First Aid Products, Inc., MedEfficiency, Inc. and Derma Sciences Europe LTD are referred to collectively as "we," "our," "us" and the "Company." Our executive offices are located at 214 Carnegie Center, Suite 300, Princeton, New Jersey 08540. Derma Sciences was incorporated under the laws of Colorado on September 10, 1984. On June 3, 1996, we changed our state of domicile to Pennsylvania and on September 14, 2012, we changed our state of domicile to Delaware.

On April 16, 2012, the Company acquired all of the outstanding stock of MedEfficiency, Inc. ("MedEfficiency") pursuant to the terms of an Agreement and Plan of Merger, previously disclosed. MedEfficiency develops, manufactures and markets medical devices for treating chronic wounds and lower extremity injuries, specializing in total contact casting ("TCC") products. The TCC-EZ total contact cast system is MedEfficiency's lead product, in addition to a line of traditional and specialized contact casts and related equipment. The Company has distributed MedEfficiency's TCC products since 2008 under an exclusive distribution agreement.

Derma Sciences is a medical technology company focused on three segments of the wound care marketplace: pharmaceutical wound care, advanced wound care and traditional wound care products. The Company has one pharmaceutical wound care product under development that has successfully completed its Phase 2 study and has initiated its Phase 3 study in 2013. The Company maintains manufacturing facilities in Toronto, Canada and Nantong, China and a well-established network of third party suppliers for its products. The majority of our products are sold through distributors to various health care providers such as wound care centers, extended care facilities, acute care facilities, home health care agencies and physicians' offices. Some of our products are sold through retail channels. The Company markets its products principally through direct sales representatives in the United States (the "U.S."), Canada and the United Kingdom (the "U.K."), and through independent distributors within other select international markets.

Products

Advanced Wound Care

Our advanced wound care products include the following:

MEDIHONEY is a line of novel, patented dressings, comprised of a high percentage of Active *Leptospermum* Honey. This unique type of honey has been shown in scientific studies to have antimicrobial, anti-inflammatory and immunomodulatory activities. *Medihoney* dressings are ideal for the management of non-chronic and hard-to-heal wounds including chronic ulcers, burns and post-operative wounds. The dressings are non-toxic and have been shown in a large scale, randomized controlled study to promote healing.

TCC-EZ is a novel, patented advanced dressing system for the management of diabetic foot ulcers. It is considered a "next generation" total contact casting (TCC) system. TCC has been shown in multiple randomized controlled studies to achieve 89% heal rates. However, traditional TCC is utilized in less than 2% of otherwise indicated cases due to various factors such as long application times, frequency of application error and patient dissatisfaction as a result of the heavy nature of the cast. *TCC-EZ* virtually eliminates these issues as it can be applied in less than one-third the time of a traditional TCC. *TCC-EZ* is a one-step process, so application errors are uncommon, and the cast itself is significantly lighter, due to its open weave pattern, than a traditional TCC.

XTRASORB is a novel, proprietary line of dressings that utilizes super absorbent polymer technologies. While other absorbing dressings currently on the market use open cell structures to capture fluid, *Xtrasorb* dressings convert fluid within the dressings to a gel, thus locking the exudates into the dressings. *Xtrasorb* dressings have a distinct advantage over competitive dressings in that they absorb more fluid and hold the fluid away from the wound, thus avoiding further deterioration of the wound.

BIOGUARD is a line of novel, patented barrier dressings that contain an active antimicrobial compound. This compound, a cationic biocide, is intrinsically bound to the dressing through a proprietary process resulting in the inability for the compound to separate from the dressing. These dressings are ideal for prophylactic use in the prevention of hospital or community acquired infections through wound sites. The dressings have been shown to kill 99.9% of virulent bacteria such as methicillin resistant *staphylococcus aureus* (MRSA) in less than one minute, and 99.999% of MRSA in less than one hour.

ALGICELL AG is a proprietary antimicrobial dressing utilizing ionic silver as its active ingredient. The dressing can absorb up to 20 times its weight in wound fluid. These dressings compare favorably to the market leading dressings at a cost-effective price point.

Other advanced wound care products include a range of moist, occlusive dressings such as hydrocolloids, foams, hydrogels, alginates, additional silver antimicrobial dressings, cleansers and our proprietary *Dermagran* products.

We continue to evaluate certain products and technologies within the advanced wound care market. Once products and technologies are identified, we may enter into licensing agreements or joint venture relationships with owners of the products and technologies.

Traditional Wound Care

Our traditional wound care line consists of gauze sponges and bandages, non-adherent impregnated dressings, retention devices, paste bandages and other compression devices. We also manufacture and market a broad line of adhesive bandages and related first aid products for the medical, industrial, private label and retail markets.

We manufacture private label wound care and adhesive bandages for a number of U. S. and international customers.

We market a line of wound closure strips, nasal tube fasteners and a variety of catheter fasteners to doctors, clinics, nursing homes, hospitals and other institutions. Our specialty securement and closure device products incorporate our proprietary polyamide fabrics in combination with a pressure sensitive skin-friendly adhesive. These product combinations result in an ideal balance between elasticity and adherence, making the products unique in their ability to safely hold devices in place on the skin while assisting with the closure of sensitive areas of the skin where a good cosmetic outcome is a priority. We also market a line of traditional rigid wound closure strips.

We market general purpose and specialized skin care products to nursing homes, hospitals, home healthcare agencies and other institutions. These products include barrier creams and ointments, antibacterial cleansing foams and sprays, shampoos and body washes, hand sanitizers, bath additives, body oils and moisturizers.

Pharmaceutical Wound Care

We are currently developing DSC127, an angiotensin analog licensed from the University of Southern California in November 2007, for use in wound healing and scar reduction. The compound has shown activity in these areas in pre-clinical animal model testing. The compound has successfully completed a Phase 1 study in healthy volunteers and a Phase 2 study on patients with diabetic foot ulcers. Topline results of this study were reported in February and May 2011. Full results of the study were published by a major international advanced wound care journal in July 2012 (Wound Repair and Regeneration 20:482-490).

DSC127 is a patented, topically applied novel angiotensin analog that targets receptors that are up-regulated upon injury to tissue. The drug has been shown to improve epithelialization, granulation and vascularization, accelerating wound healing in a variety of normal and diabetic animal models. This finding suggests that DSC127 produces different actions at the wound site during various stages of healing. There were no safety concerns observed in the preclinical, Phase 1 and Phase 2 trials of DSC127.

The potential markets for DSC127 include: (1) the $10 billion chronic wound market; (2) the $8 billion scar prevention/reduction market; (3) the $6 billion burn market; and (4) the $6 billion radiation and other wound markets (pending New Drug Application (“NDA”) approvals for each respective indication).

In June of 2011, we put together a consulting team comprised of senior regulatory, medical, clinical, chemistry, manufacturing and control, bioanalytical and non-clinical executives. Led by our group president of advanced wound care and pharmaceutical development and vice president of clinical and product development, this consulting group helped to prepare the clinical, Chemistry, Manufacturing and Control (“CMC”), and non-clinical programs for the drug’s initial indication of Diabetic Foot Ulcer healing. We had a productive end of Phase 2 meeting with the U.S. Food and Drug Administration (“FDA”) in October of 2012, and subsequently submitted the protocols for our two pivotal studies to the FDA in November and December of 2012. The Company initiated its first Phase 3 study in February of 2013, and expects to initiate the second Phase 3 study in April of 2013. The Company is planning to hold a CMC meeting with the FDA during the second quarter of 2013.

Sales and Marketing

In 2012, sales in the U.S. accounted for 71%, Canada for 20% and the rest of the world for 9% of our total sales. Our sales and marketing infrastructure is split into two groups, Advanced Wound Care and Traditional Wound Care. The Advanced Wound Care group is comprised of the Group President and the sales and marketing infrastructure that supports sales of our Advanced Wound Care products throughout the U.S. and the rest of the world. This infrastructure includes the Company's global marketing department, the U.S. and U.K.-based sales organizations, and the personnel responsible for management of international distributors outside of the U.S. Canada, and the Europe/Middle East/Africa ("EMEA") region. The Traditional Wound Care group is comprised of the Group President and the sales and marketing infrastructure that supports the sales of our Traditional Wound Care, First Aid and Private Label / Contract Manufacturing business. This infrastructure includes the Canadian, Private Label/Contract Manufacturing, and First Aid, sales organizations, personnel responsible for management of distributors in the U.S. and Canada and our corporate accounts team.

United States

In the U.S., we employ a direct sales force and have relationships with a number of national, regional and local distributors (with their own sales forces) to sell our products. The majority of our sales are made to distributors and large institutional customers who sell the products to end users.

Our Advanced Wound Care sales and marketing infrastructure in the U.S. consists of a vice president of sales and marketing leading our global marketing team and direct sales force. Our direct sales force consists of four regional managers, 38 direct territory representatives, four TCC product specialists, and two sales administrators. The global marketing team consists of three managers (one associate director and two senior product managers) responsible for corporate and product marketing for our five key advanced wound care brands. Our Advanced Wound Care sales and marketing infrastructure is also supported by a clinical resource manager and four clinical resource specialists who are responsible for supporting all geographic regions. The Traditional Wound Care sales and marketing infrastructure in the U.S. consists of a vice president of distribution, a vice president of first aid products, a vice president and a director of corporate accounts, and a director of private label/contract manufacturing sales. Our sales employees receive a base salary together with commissions based upon sales achievement within their area of responsibility.

Canada

In Canada, we employ a sales manager, three direct sales representatives and one manufacturer's representative covering the major population centers. Our direct sales representatives receive a base salary together with commissions based upon territory sales. Our manufacturer's representative is paid commission based upon territory

sales achievement and is reimbursed for expenses. The majority of our Canadian sales are to hospitals pursuant to tender contracts with national, provincial and local buying groups. These institutional contracts are generally exclusive in nature and are awarded for a term of one to five years. Nursing home, home healthcare, physician office and retail sales are for the most part made through local dealers and government sponsored Community Care Access Centres (CCAC) agencies.

In May 2005, we entered into an agreement with a Canadian company, our only customer in Canada, to serve as the exclusive distributor of our products in Canada. The distribution agreement has been amended from time to time, the latest being January 2011. The amended agreement expires in April 2016. The distributor maintains strategically located distribution centers and over 50 sales representatives throughout Canada. We believe the agreement provides us with the means to supplement our direct sales force and better serve our customers throughout Canada.

For the years ended December 31, 2012 and 2011, our Canadian distributor accounted for 20% and 24%, respectively, of the Company's consolidated net sales.

Other Foreign Markets

We have a direct selling organization in the U.K. consisting of five sales representatives and a sales administrator. This staff is managed by the general manager of this business unit. The general manager is also responsible for managing distributor relationships within the rest of Europe, the Middle East and Africa. Throughout the rest of the world, we sell our products utilizing distribution agreements.

Competition

In the U.S., our traditional wound care products compete in a commodity oriented marketplace with Covidien, Dukal, Medline, Medical Action and a number of others. In the advanced wound care products marketplace, we compete principally with Convatec, Smith & Nephew, Molnlycke and Systagenix. Our adhesive bandage and related first aid products compete with Medline, ASO and Dynerex in the medical market, Medline and ASO in the industrial market, ASO, Medline and Liberty in the private label market and Johnson & Johnson, 3M and Medline in the retail market. The market for wound closure strips and catheter fasteners is characterized by a wide range of generic competition. The most dominant competitor in the suture strip market is 3M. Our skin care products compete in a commodity oriented marketplace with Medline, Provon and a number of others.

In Canada, our traditional wound care products compete in a commodity-oriented marketplace with Covidien, Medicom, Medical Mart and a number of others. In the advanced wound care products marketplace, we compete principally with the same competitors as we compete with in the U.S., together with a number of domestic generic companies. Internationally, we compete with global and local multinationals and domestic advanced wound care companies.

Our ability to remain competitive is based on our ability to provide our customers with a broad range of quality products at a competitive price with superior customer service. The prospective ability to develop products cost effectively and/or acquire and commercialize new products that provide superior value is an integral component of our ability to stay competitive. We believe that the breadth and quality of our existing product lines, the infrastructure in place to cost effectively source and market our products and the skill and dedication of our employees will allow us to successfully compete.

Product Sourcing

We lease manufacturing and warehousing facilities in Toronto, Canada, and Nantong, China, and employ contract manufacturers in Mexico and China. Approximately 70% of our products are manufactured at these four locations. The remaining 30% of our products are manufactured by third party manufacturers in the U.S., China and other countries.

Our manufacturing facilities and the two contract manufacturers are monitored by our management and quality control teams who oversee production activity. Most of the equipment in these facilities is owned and used exclusively by us.

In our Toronto facility, we manufacture advanced and traditional wound care products. This facility has the capability of liquid packaging, blister/vacuum packaging, impregnation, die-cutting and steam sterilization. We also have a research and development laboratory on site. The Toronto facility is ISO 13485:2003, ISO 9001:2008, and Directive 93/42/EEC certified and SGS registered.

In our Nantong facility, we manufacture principally traditional and some advanced wound care products. This facility is primarily designed for production of low volume labor intensive specialty products. The quality control team at Nantong has the responsibility to oversee and inspect all products produced in China (including third party suppliers) for us. The Nantong facility is ISO 9001:2008 certified and TUV registered.

In our China contract manufacturing facility we have adhesive bandages and related first aid products manufactured on our behalf. The China facility is ISO 13485:2003 certified and NQA registered. In our Mexico contract manufacturing facility we have a line of paste bandages manufactured for us. The Mexico facility is ISO 9001:2008 and ISO 13485:2004 certified and Aenor IQNET registered.

A number of traditional and advanced wound care products are sourced in semi-finished and finished form directly from suppliers. Derma Canada also serves in a distributor capacity (sourcing finished products directly from suppliers) for a number of medical device products in Canada.

We maintain a long-standing network of suppliers for our outsourced products. The majority of our outsourced products utilize readily available components. Accordingly, there are numerous companies capable of manufacturing these products to applicable regulatory standards. Given the availability of other suppliers, as well as our policy regarding maintenance of adequate safety stock levels, we do not believe that a temporary interruption in supply or loss of one or more of our suppliers would have a long-term detrimental impact on our operations.

We require that all of our suppliers conform to the standards set forth in the Good Manufacturing Practice (“GMP”) regulations promulgated by the U.S. FDA and local health agencies.

Patents, Trademarks, Proprietary and Non-Proprietary Technology

We own or license a number of trademarks covering the Company and its products. In addition, we own or license over 50 U.S. patents, corresponding foreign patents and patent applications. Most of our patents relating to our DSC127 technology are held under license agreements of indefinite duration. In 2012, we entered into an agreement extending our *Bioguard* license in perpetuity and in 2010 we entered into an agreement extending our *Medihoney* license in perpetuity. Subject to meeting minimum royalty and other specified conditions, we expect to maintain these licenses indefinitely. We also have a number of non-patented formulations and process technologies that, together with the aforementioned patents, provide competitive advantages in the marketplace.

We believe our patents, proprietary and non-proprietary technology, afford us reasonable protection against the unauthorized copying of the technology embodied in the subject products.

Government Regulation

United States — Scope of Regulation

The manufacture, distribution and advertising of our products are subject to regulation by numerous federal and state governmental agencies in the U.S. The FDA is responsible for enforcement of the Federal Food, Drug and Cosmetic Act, as amended, ("FDC Act") which regulates drugs and devices manufactured and distributed in interstate commerce. Many of our products are classified either as over-the-counter drugs or medical devices pursuant to the FDC Act. The Federal Trade Commission ("FTC") administers the Federal Trade Commission Act ("FTC Act") which regulates the advertising of products including over-the-counter drugs and devices. All states have individual laws analogous to the FDC Act and the FTC Act.

The FDA, regulates and imposes substantial requirements upon the research, development, pre-clinical and clinical testing, labeling, manufacture, quality control, storage, approval, advertising, promotion, marketing, distribution and export of pharmaceutical products, as well as significant reporting and record-keeping obligations. State governments may also impose obligations in these areas. The process required by the FDA before prescription drugs may be marketed in the U.S. generally involves the following:

- pre-clinical laboratory evaluations, including formulation and stability testing, and animal tests performed under the FDA's Good Laboratory Practices regulations to assess pharmacological activity and toxicity potential;

submission and approval of an Investigational New Drug Application, ("IND"), including results of pre-clinical tests, manufacturing information, and protocols for clinical tests, which must become effective before clinical trials may begin in the U.S.;

- obtaining approval of Institutional Review Boards ("IRBs") to administer the products to human subjects in clinical trials;
- adequate and well-controlled human clinical trials to establish the safety and efficacy of the product for the product's intended use;
- development of manufacturing processes which conform to FDA current Good Manufacturing Practices ("cGMPs"), as confirmed by FDA inspection;
- submission of results for pre-clinical and clinical studies, and chemistry, manufacture and controls information on the product to the FDA in an NDA; and
- FDA review and approval of an NDA, prior to any commercial sale or shipment of a product.

The testing and approval process requires substantial time, effort, and financial resources, and it is not certain that any approval will be granted on a timely basis, if at all.

The results of the pre-clinical studies, together with initial specified manufacturing information, the proposed clinical trial protocol, and information about the participating investigators are submitted to the FDA as part of an IND, which must become effective before human clinical trials are initiated in the U.S. Additionally, an independent IRB must review and approve each study protocol and oversee conduct of the trial. An IND becomes effective 30 days after receipt by the FDA, unless the FDA, within the 30-day period, raises concerns or questions about the conduct of the trials as outlined in the IND and imposes a clinical hold. If the FDA imposes a clinical hold, the IND sponsor must resolve the FDA's concerns before clinical trials can begin. Pre-clinical tests and studies can take several years to complete, and there is no guarantee that an IND submitted based on such tests and studies will become effective within any specific time period, if at all.

Human clinical trials are typically conducted in three sequential phases that may overlap.

- *Phase I:* The drug is initially introduced into healthy human subjects or patients and tested for safety and dosage tolerance. Absorption, metabolism, distribution, and excretion testing is generally performed at this stage.

- *Phase II:* The drug is studied in controlled, exploratory therapeutic trials in a limited number of subjects with the disease or medical condition for which the new drug is intended to be used in order to identify possible adverse effects and safety risks, to determine the preliminary or potential efficacy of the product for specific targeted diseases or medical conditions, and to determine dosage tolerance and the optimal effective dose.

- *Phase III:* When Phase II studies demonstrate that a specific dosage range of the drug is likely to be effective and the drug has an acceptable safety profile, controlled, large-scale therapeutic Phase III trials are undertaken at multiple study sites to demonstrate clinical efficacy and to further test for safety in an expanded patient population.

The FDA, the IRB or we may suspend or terminate clinical trials at any time on various grounds, including a finding that the subjects or patients are being exposed to an unacceptable health risk.

Results of pre-clinical studies and clinical trials, as well as detailed information about the manufacturing process, quality control methods, and product composition, among other things, are submitted to the FDA as part of an NDA seeking approval to market and commercially distribute the product on the basis of a determination that the product is safe and effective for its intended use. Before approving an NDA, the FDA will inspect the facilities at which the product is manufactured and will not approve the product unless cGMP compliance is satisfactory. If applicable regulatory criteria are not satisfied, the FDA may deny the NDA or require additional testing or information. As a condition of approval, the FDA also may require post-marketing testing or surveillance to monitor the product's safety or efficacy. Even after an NDA is approved, the FDA may impose additional obligations or restrictions (such as labeling changes), or even suspend or withdraw a product approval on the basis of data that arise after the product reaches the market, or if compliance with regulatory standards is not maintained. We cannot be certain that any NDA we submit will be approved by the FDA on a timely basis, if at all. Also, any such approval may limit the indicated uses for which the product may be marketed. Any refusal to approve, delay in approval, suspension or withdrawal of approval, or restrictions on indicated uses could have a material adverse impact on our business prospects.

Each NDA must be accompanied by a user fee, pursuant to the requirements of the Prescription Drug User Fee Act ("PDUFA"), and its amendments. According to the FDA's fee schedule, effective on October 1, 2011 for the fiscal year 2012, the user fee for an application requiring clinical data, such as an NDA, is $1,841,500. The FDA adjusts the PDUFA user fees on an annual basis. PDUFA also imposes an annual product fee for prescription drugs ($98,970), and an annual establishment fee ($520,100) on facilities used to manufacture prescription drugs. A written request can be submitted for a waiver for the application fee for the first human drug application that is filed by a small business, but there are no waivers for product or establishment fees. We are not at the stage of development with our products where we are subject to these fees, but they are significant expenditures that may be incurred in the future and must be

paid at the time of application submissions to the FDA.

Satisfaction of FDA requirements typically takes several years. The actual time required varies substantially, based upon the type, complexity, and novelty of the pharmaceutical product, among other things. Government regulation imposes costly and time-consuming requirements and restrictions throughout the product life cycle and may delay product marketing for a considerable period of time, limit product marketing, or prevent marketing altogether. Success in pre-clinical or early stage clinical trials does not ensure success in later stage clinical trials. Data obtained from pre-clinical and clinical activities are not always conclusive and may be susceptible to varying interpretations that could delay, limit, or prevent marketing approval. Even if a product receives marketing approval, the approval is limited to specific clinical indications. Further, even after marketing approval is obtained, the discovery of previously unknown problems with a product may result in restrictions on the product or even complete withdrawal of the product from the market.

After product approval, there are continuing significant regulatory requirements imposed by the FDA, including record-keeping requirements, obligations to report adverse side effects in patients using the products, and restrictions on advertising and promotional activities. Quality control and manufacturing procedures must continue to conform to cGMPs, and the FDA periodically inspects facilities to assess cGMP compliance. Additionally, post-approval changes in ingredient composition, manufacturing processes or facilities, product labeling, or other areas may require submission of a NDA Supplement to the FDA for review and approval. New indications will require additional clinical studies and submission of a NDA Supplement. Failure to comply with FDA regulatory requirements may result in an enforcement action by the FDA, including Warning Letters, product recalls, suspension or revocation of product approval, seizure of product to prevent distribution, impositions of injunctions prohibiting product manufacture or distribution, and civil and criminal penalties. Maintaining compliance is costly and time-consuming. We cannot be certain that we, or our present or future suppliers or third-party manufacturers, will be able to comply with all FDA regulatory requirements, and potential consequences of noncompliance could have a material adverse impact on our business prospects.

The FDA's policies may change, and additional governmental regulations may be enacted that could delay, limit, or prevent regulatory approval of our products or affect our ability to manufacture, market, or distribute our products after approval. Moreover, increased attention to the containment of healthcare costs in the U.S. and in foreign markets could result in new government regulations that could have a material adverse effect on our business. Our failure to obtain coverage, an adequate level of reimbursement, or acceptable prices for our future products could diminish any revenues we may be able to generate. Our ability to commercialize future products will depend in part on the extent to which coverage and reimbursement for the products will be available from government and health administration authorities, private health insurers, and other third-party payers. European Union member states and U.S. government and other third-party payers increasingly are attempting to contain healthcare costs by consideration of new laws and regulations limiting both coverage and the level of reimbursement for new drugs. We cannot predict the likelihood, nature or extent of adverse governmental regulation that might arise from future legislative or administrative action, either in the U.S. or abroad.

Under the Drug Price Competition and Patent Term Restoration Act of 1984, a sponsor may obtain marketing exclusivity for a period of time following FDA approval of certain drug applications, regardless of patent status, if the drug is a new chemical entity or if new clinical studies were required to support the marketing application for the drug. This marketing exclusivity prevents a third party from obtaining FDA approval for an identical or nearly identical drug under an Abbreviated New Drug Application or a "505(b)(2) New Drug Application." The statute also allows a patent owner to obtain an extension of applicable patent terms for a period equal to one-half the period of time elapsed between the filing of an IND and the filing of the corresponding NDA plus the period of time between the filing of the NDA and FDA approval, with a five year maximum patent extension. We cannot be certain that we will be able to take advantage of either the patent term extension or marketing exclusivity provisions of these laws.

Our activities also may be subject to state laws and regulations that affect our ability to develop and sell our products. We are also subject to numerous federal, state, and local laws relating to such matters as safe working conditions, clinical, laboratory, and manufacturing practices, environmental protection, fire hazard control, and disposal of hazardous or potentially hazardous substances. We may incur significant costs to comply with such laws and regulations now or in the future, and the failure to comply may have a material adverse impact on our business

prospects.

Canada — Scope of Regulation

The Medical Devices Regulations have been established under the authority of the Food and Drugs Act and apply to all medical devices imported and sold in Canada. The Medical Devices Bureau of the Therapeutic Products Directorate is the national authority that monitors and evaluates the safety, effectiveness and quality of diagnostic and therapeutic medical devices sold in Canada.

The Health Products and Food Branch Inspectorate of Health Canada regulates drugs and the processes used to manufacture drugs. A Drug Establishment License is required for activities such as fabrication, packaging/labeling, importation, distribution, wholesale and testing. Derma Canada is subject to periodic inspection by the Health Products and Food Branch Inspectorate. Our last inspection was in September 2011, which resulted in a Compliance Rating.

Other Foreign Regulatory Authorities – Scope of Regulation

Whether or not FDA approval has been obtained, approval of medical drugs and devices by regulatory authorities in foreign countries must be obtained prior to marketing drugs and devices in such countries. The requirements governing the conduct of clinical trials and product approval vary widely from country to country and the time required for approval may be longer or shorter than that required for FDA approval. Although there are procedures for unified filings for certain European countries, most countries currently maintain their own product approval procedures and requirements.

Other Regulatory Requirements

In addition to the regulatory framework for product approvals, we are subject to regulation under state and federal law, including requirements regarding occupational safety, laboratory practices, environmental protection and hazardous substance control, and may be subject to other present and future local, state, federal and foreign regulation.

We are also subject to federal, state and foreign laws and regulations adopted for the protection of the environment and the health and safety of employees.

We believe that the Company is in compliance with all such laws, regulations and standards currently in effect and that the cost of continued compliance with such laws, regulations and standards will not have a material adverse effect on us.

Third Party Reimbursement in the United States

In the U.S., we sell our wound care products to nursing homes, hospitals, home healthcare agencies, retail and “closed door” pharmacies and similar institutions. The patients at these institutions for whose care our products are purchased often are covered by medical insurance. Accordingly, our customers routinely seek reimbursement for the cost of our wound care products from third party payors such as Medicare, Medicaid, health maintenance organizations and private insurers. The availability of reimbursement from such third party payors is a factor in our sales of wound care products.

Federal and state governments, as well as private insurers, will continue their pursuit of programs designed to control or reduce the cost of health care. These cost cutting measures may include reductions in reimbursements and/or increases in mandatory rebates for wound care products. As such, there is uncertainty as to whether, and to what extent, reimbursements for our products will continue to be available.

Employees

We had 237 full-time and seven part-time employees at December 31, 2012. Of these employees, 118 are located in the U.S., 77 in Canada, 41 in China and eight in Europe. We consider our employee relations to be satisfactory.

Item 1A. Risk Factors

We have a history of losses and can offer no assurance of future profitability.

We incurred losses of $12,070,431 in 2012 and $4,340,411 in 2011, and additional losses in previous years. At December 31, 2012, we had an accumulated deficit of $40,206,758. We cannot offer any assurance that we will be able to generate sustained or significant future earnings.

Our liquidity may be dependent upon amounts available through additional debt or equity financings.

We have a history of operating losses and negative cash flow from operating activities. As such, we have utilized funds from offerings of our equity securities to fund our operations. We have taken steps to improve our overall liquidity and believe we have sufficient liquidity to meet our needs for the next twelve months. However, in the event our cash flow from operating activities is insufficient to meet our requirements, we may be forced either to secure a line of credit or seek additional equity financing. The sale of additional securities could result in additional dilution to our stockholders. The incurrence of indebtedness would result in increased debt service obligations and could result in operating and financing covenants that would restrict our operations. There can be no assurance that such financing would be available or, if available, that such financing could be obtained upon terms acceptable to us.

Our foreign operations are essential to our economic success and are subject to various unique risks.

Our future operations and earnings will depend to a large extent on the results of our international operations and our ability to maintain a continuous supply of wound care products from our international operations and suppliers. While we do not envision any adverse change to our international operations or suppliers, adverse changes to these operations, as a result of political, governmental, regulatory, economic, exchange rate, labor, logistical or other factors, could have a material adverse effect on our future operating results.

The rate of reimbursement for the purchase of our products by government and private insurance is subject to change.

Sales of several of our wound care products depend partly on the ability of our customers to obtain reimbursement for the cost of our products from government health administration agencies such as Medicare and Medicaid. Both government health administration agencies and private insurance firms continuously seek to reduce healthcare costs. Our ability to commercialize our products successfully will depend in part on the extent to which reimbursement for the costs of such products and related treatments will be available from government health administration authorities, private health insurers and other third-party payors. Significant uncertainty exists as to the reimbursement status of newly approved medical products. The continuing efforts of the government, insurance companies, managed care organizations and other payors of healthcare services to contain or reduce costs of healthcare may adversely affect:

- Our ability to set a price we believe is fair for our products;
- Our ability to generate revenues or achieve or maintain profitability; and
- The availability to us of capital.

Payors are increasingly attempting to contain healthcare costs by limiting both coverage and the level of reimbursement, particularly for new therapeutic products or where payors perceive that the target indication of the new product is well served by existing drugs or other treatments. Accordingly, even if coverage and reimbursement are provided, market acceptance of our products would be adversely affected if the amount of coverage and/or reimbursement available for the use of our products proved to be unprofitable for healthcare providers or less profitable than alternative treatments.

There have been federal and state legislation changes which has subjected the pricing of healthcare goods and services to government control and made other changes to the U.S. healthcare system. While we cannot predict the outcome of current or future legislation, we anticipate, particularly given the recent enactment of healthcare reform legislation that Congress and state legislatures will continue to introduce initiatives directed at lowering the total cost of healthcare. In addition, in certain foreign markets the pricing of drugs is subject to government control and reimbursement may in some cases be unavailable or insufficient. It is uncertain if future legislation, whether domestic or abroad, will be

adopted that might affect our products. It is also uncertain what actions federal, state or private payors for healthcare treatment and services may take in response to any such healthcare reform proposals or legislation. Any such healthcare reforms could have a material and adverse effect on the marketability of any products for which we ultimately receive FDA or other regulatory agency approval or for which we receive government sponsored reimbursements.

Medical excise tax enacted into law becomes effective in 2013.

The Patient Protection and Affordable Care Act imposes, among other things, an annual excise tax of 2.3% on any entity that manufactures or imports medical devices offered for sale in the U.S. beginning in 2013. Our analysis indicates a portion of our existing sales will be subject to this excise tax. At this time, the impact of this tax is not expected to be material. We will continue to evaluate the financial impact of this tax on our business. Presently, there can be no assurance that our business will not be materially adversely affected by this excise tax.

Our success may depend upon our ability to protect our patents and proprietary technology.

We own patents, both in the U.S. and abroad, for several of our products, and rely upon the protection afforded by our patents and trade secrets to protect our technology. Our future success may depend upon our ability to protect our intellectual property. However, the enforcement of intellectual property rights can be both expensive and time consuming. Therefore, we may not be able to devote the resources necessary to prevent infringement of our intellectual property. Also, our competitors may develop or acquire substantially similar technologies without infringing our patents or trade secrets. For these reasons, we cannot be certain that our patents and proprietary technology will provide us with a competitive advantage.

Government regulation plays a significant role in our ability to acquire and market products.

Government regulation by the U.S. Food and Drug Administration and similar agencies in other countries is a significant factor in the development, manufacturing and marketing of many of our products and in our acquisition or licensing of new products. Complying with government regulations is often time consuming and expensive and may involve delays or actions adversely impacting the marketing and sale of our current or future products.

Approximately 30% of our products are sourced from third parties.

Approximately 30% of our products are sourced in raw, semi-finished and finished form directly from third party suppliers. None of these suppliers presently account for more than 10% of our sales with the exception of *Medihoney* which represented 15% of our net sales in 2012. We maintain good relations with our third party suppliers. With the exception of *Medihoney*, there are several third party suppliers available for each of our products. If a current supplier were unable or unwilling to continue to supply our products, sale of the affected products could be delayed for the period necessary to secure a replacement.

The technology utilized in many of our advanced wound care products is licensed from third parties and could become unavailable.

A significant percentage of our advanced wound care products utilize technology that we license on an exclusive basis from third parties. These products include *Medihoney* dressings, *Bioguard* dressings and *TCC-EZ* total contact casts. The licensing agreements that we have with the owners of these technologies are of limited duration (with the exception of *Medihoney* and *Bioguard,* which are in perpetuity) and renewals of the agreements are at the discretion of the licensors. In addition, in some instances the maintenance of the license agreements requires that we meet various

minimum sales and/or minimum royalty requirements. If we fail to meet the minimum sales or minimum royalty requirements of a given license agreement, there is a possibility that the agreement will be cancelled or not renewed or that our exclusivity under the license agreement will be withdrawn. If any of these events were to occur, our ability to sell the products utilizing the licensed technology could be lost or compromised and our revenues and potential profits could be adversely affected.

Competitors could invent products superior to ours and cause our products and technology to become obsolete.

The wound care sector of the medical products industry is characterized by rapidly evolving technology and intense competition. Our competitors currently manufacture and distribute a variety of products that are in many respects comparable to our products. Many suppliers of competing products are considerably larger and have much greater resources than we do. In addition, many specialized products companies have formed collaborations with large, established companies to support research, development and commercialization of wound care products which may be competitive with ours. Academic institutions, government agencies and other public and private research organizations are also conducting research activities and may commercialize wound care products on their own or through joint ventures. While we have no specific knowledge of products under development by our competitors, it is possible that these competitors may develop technologies and products that are more effective than any we currently have. If this occurs, any of our products and technology affected by these developments could become obsolete.

Although we are insured, any material product liability claims could adversely affect our business.

We sell over-the-counter products and medical devices and are exposed to the risk of lawsuits claiming alleged injury caused by our products. Among the grounds for potential claims against us are injuries due to alleged product inefficacy and injuries resulting from infection due to allegedly non-sterile products. Although we carry product liability insurance with limits of $1.0 million per occurrence and $2.0 million aggregate with $10.0 million in umbrella coverage, this insurance may not be adequate to reimburse us for all damages that we could suffer as a result of successful product liability claims. Also, defending against a claim could be time consuming and costly. No material product liability claim has ever been made against us and we are not aware of any pending product liability claims. However, a successful material product liability suit could adversely affect our business.

The potential increase in common shares due to the conversion, exercise or vesting of outstanding dilutive securities may have a depressive effect upon the market value of our shares.

Up to 5,619,576 shares of our common stock were potentially issuable at December 31, 2012 upon the conversion, exercise or vesting of outstanding convertible preferred stock, warrants, options and restricted stock units. The shares of common stock potentially issuable upon conversion, exercise or vesting of these securities are substantial compared to the 16,524,723 shares of common stock outstanding at December 31, 2012.

Earnings per share of common stock may be substantially diluted by the existence of these dilutive securities regardless of whether they are converted, exercised or issued. This dilution of earnings per share could have a depressive effect upon the market value of our common stock.

Our stock price has been volatile and this volatility is likely to continue.

Historically, the market price of our common stock has been volatile. The high and low bid prices for the years 2008 through 2012 are set forth in the table below:

Derma Sciences, Inc.
Trading Range – Common Stock

Year	Low	High

2008	$ 1.60	$	10.80		
2009	$ 1.92	$	6.80		
2010	$ 4.40	$	9.00		
2011	$ 4.50	$	12.72		
2012	$ 6.94	$	11.nt:-1.00em">RSU Awards outstanding at end of period	342	$ 31.07
RSU Awards vested and deferred at end of period				40	$ 32.31

The aggregate intrinsic value of RSU Awards settled during the three months ended March 29, 2009 was $0.8 million and the aggregate intrinsic value of RSU Awards outstanding and RSU Awards vested and deferred as of March 29, 2009 was $8.0 million and $0.9 million, respectively.

A summary of the status of all RSU MIPs granted to employees and non-employee directors as of March 29, 2009 and changes during the three month period then ended is presented in the table below (RSUs in thousands):

	RSUs	Weighted Average Exercise Price
RSU MIPs outstanding at beginning of period	137	$ 20.29
Granted	141	14.89
Settled	(35)	18.63
Cancelled	(14)	18.63
RSU MIPs outstanding at end of period	229	$ 17.32
RSU MIPs vested and deferred at end of period	20	$ 10.84

The aggregate intrinsic value of RSU MIPs settled during the three months ended March 29, 2009 was $1.0 million and the aggregate intrinsic value of RSU MIPs outstanding and RSU MIPs vested and deferred as of March 29, 2009 was $1.1 million and $0.3 million, respectively.

(4) Inventories

Inventories consist of the following (In thousands):

	March 29, 2009	December 31, 2008
Raw materials	$ 67,297	$ 68,954
Work in process	67,140	70,656
Finished goods	43,102	43,681
	$ 177,539	$ 183,291

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(5) Goodwill and Intangible Assets

The following table shows goodwill, by segment, as of March 29, 2009 (In thousands):

	Instrumentation & Thermal Fluid Controls Products	Energy Products	Consolidated Total
Goodwill as of December 31, 2008	$ 6,801	$ 25,291	$ 32,092
Business acquisitions	2,270		2,270
Purchase price adjustment of previous acquisition	392		392
Currency translation adjustments	(36)	(21)	(57)
Goodwill as of March 29, 2009	$ 9,427	$ 25,270	$ 34,697

The table below presents gross intangible assets and the related accumulated amortization as of March 29, 2009 (In thousands):

	Gross Carrying Amount	Accumulated Amortization
Patents	$ 6,042	$ (5,404)
Trademarks and trade names	17,258	
Land use rights	426	(36)
Customer relationships	25,959	(6,302)
Other	6,570	(1,771)
Total	$ 56,255	$ (13,513)
Net carrying value of intangible assets	$ 42,742	

The table below presents estimated remaining amortization expense for intangible assets recorded as of March 29, 2009 (In thousands):

	2009	2010	2011	2012	2013	After 2013
Estimated amortization expense	$ 1,935	$ 2,580	$ 2,580	$ 2,256	$ 2,229	$ 13,904

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(6) Segment Information

The following table presents certain reportable segment information (In thousands):

	Instrumentation & Thermal Fluid Controls Products	Energy Products	Corporate/ Eliminations	Consolidated Total
Three Months Ended March 29, 2009				
Net revenues	$ 86,340	$ 89,307	$	$ 175,647
Intersegment revenues	1	221	(222)	
Operating income (loss)	2,853	17,304	(5,365)	14,792
Interest income				(146)
Interest expense				178
Other income, net				(183)
Income before income taxes				$ 14,943
Identifiable assets	275,009	343,744	(40,812)	577,941
Capital expenditures	1,646	874	56	2,576
Depreciation and amortization	2,099	1,325	37	3,461
Three Months Ended March 30, 2008				
Net revenues	$ 88,450	$ 88,125	$	$ 176,575
Intersegment revenues		12	(12)	
Operating income (loss)	9,994	14,303	(4,788)	19,509
Interest income				(202)
Interest expense				347
Other expense, net				401
Income before income taxes				$ 18,963
Identifiable assets	414,236	341,826	(46,149)	709,913
Capital expenditures	2,228	623		2,851
Depreciation and amortization	2,102	1,383	45	3,530

Each reporting segment is individually managed and has separate financial results that are reviewed by our chief operating decision-maker. Each segment contains closely related products that are unique to the particular segment. For further discussion of the products included in each segment refer to Note 1 of the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2008.

In calculating operating income for each reporting segment, substantial administrative expenses incurred at the corporate level for the benefit of other reporting segments were allocated to the segments based upon specific identification of costs, employment related information or net revenues.

Corporate / Eliminations are reported on a net after allocations basis. Inter-segment intercompany transactions affecting net operating profit have been eliminated within the respective operating segments.

The operating loss reported in the Corporate / Eliminations column in the preceding table consists primarily of the following corporate expenses: compensation and fringe benefit costs for executive management and other corporate staff; corporate development costs (relating to mergers and acquisitions); human resource development and benefit plan administration expenses; legal, accounting and other professional and consulting fees; facilities, equipment and maintenance costs; and travel and various other administrative costs. The above costs are incurred in the course of furthering the business prospects of the Company and relate to activities such as: implementing strategic business growth opportunities; corporate governance; risk management; treasury; investor relations and shareholder services; regulatory compliance; and stock transfer agent costs.

The total assets for each operating segment have been reported as the Identifiable Assets for that segment, including inter-segment intercompany receivables, payables and investments in other CIRCOR companies. Identifiable assets reported in Corporate / Eliminations include both corporate assets, such as cash, deferred taxes, prepaid and other assets, fixed assets, as well as the elimination of all inter-segment intercompany assets. The elimination of intercompany assets results in negative amounts reported in

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Corporate / Eliminations for Identifiable Assets for the periods ended March 29, 2009 and March 30, 2008. Corporate Identifiable Assets after elimination of intercompany assets were $19.8 million and $16.2 million as of March 29, 2009 and December 31, 2008, respectively.

(7) Special Charges

For the three months ended March 29, 2009, we classified payments received related to a 2007 asset sale within our Energy Products Segment as income in special charges of $1.1 million. For the three months ended March 30, 2008, we recorded special charges of $0.2 million at the corporate level related to share-based compensation in connection with the retirement of our former CFO.

(8) Earnings Per Common Share (In thousands, except per share amounts):

	Three Months Ended					
	March 29, 2009			March 30, 2008		
	Net Income	Shares	Per Share Amount	Net Income	Shares	Per Share Amount
Basic EPS	$ 10,460	16,916	$ 0.62	$ 12,895	16,679	$ 0.77
Dilutive securities, common stock options		98	(0.01)		193	(0.01)
Diluted EPS	$ 10,460	17,014	$ 0.61	$ 12,895	16,872	$ 0.76

There were 270,241 and 94,173 anti-dilutive stock options and RSUs for the three months ended March 29, 2009 and March 30, 2008, respectively. These anti-dilutive stock options and RSUs were excluded from the calculation of diluted earnings per share.

(9) Financial Instruments

Fair Value

The carrying amounts of cash and cash equivalents, trade receivables and trade payables approximate fair value because of the short maturity of these financial instruments. Short-term investments are carried at cost which approximates fair value at the balance sheet date. The fair value of our variable rate debt approximates its carrying value.

Accounting Policies

Using qualifying criteria defined in Statement No. 133, derivative instruments are designated and accounted for as either a hedge of a recognized asset or liability (fair value hedge) or a hedge of a forecasted transaction (cash flow hedge). For a fair value hedge, both the effective and ineffective portions of the change in fair value of the derivative instrument, along with an adjustment to the carrying amount of the hedged item for fair value changes attributable to the hedged risk, are recognized in earnings. For a cash flow hedge, changes in the fair value of the derivative instrument that are highly effective are deferred in accumulated other comprehensive income or loss until the underlying hedged item is recognized in earnings. If the effective portion of fair value or cash flow hedges were to cease to qualify for hedge accounting, or to be terminated, it would continue to be carried on the balance sheet at fair value until settled; however, hedge accounting would be discontinued prospectively. If forecasted transactions were no longer probable of occurring within the specified time period or within an additional two month period thereafter, amounts previously deferred in accumulated other comprehensive income or loss would be recognized immediately in earnings. During the three months ended March 29, 2009, we did not have any hedges that qualified for hedge accounting.

Foreign Currency Risk

We use forward contracts to manage the currency risk related to certain business transactions denominated in foreign currencies. To the extent the underlying transactions hedged are completed, the contracts do not subject us to significant risk from exchange rate movements because they offset gains and losses on the related foreign currency denominated transactions. Our foreign currency forward contracts have not been designated as hedging instruments and, therefore, do not qualify for fair value or cash flow hedge treatment under the criteria of SFAS No. 133. Therefore, any unrealized gains and losses on our contracts are recognized as a component of other expense in the consolidated statements of operations. As of March 29, 2009, we had nine forward contracts to sell currencies with a face value of $14.7 million which approximates fair value. This compares to six forward contracts to sell currencies with a face value of $1.8 million which approximated fair value as of March 30,

2008.

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We have determined that the majority of the inputs used to value our foreign currency forward contracts fall within Level 2 of the SFAS No. 157 fair value hierarchy. The credit valuation adjustments, such as estimates of current credit spreads to evaluate the likelihood of default by ourselves and our counterparties are Level 3 inputs. However we have assessed the significance of the impact of the credit valuation adjustments on the overall valuation of our foreign currency forward contracts and determined that the credit valuation adjustments are not significant to the overall valuation. As a result, we have determined that our derivative valuations in their entirety are classified in Level 2 of the fair value hierarchy.

We do not use derivative financial instruments for trading purposes. Risk management strategies are reviewed and approved by senior management before implementation.

(10) Comprehensive Income

Comprehensive income for the three months ended March 29, 2009 and March 30, 2008 consists of the following (In thousands):

	Three Months Ended	
	March 29, 2009	**March 30, 2008**
Net income	$ 10,460	$ 12,895
Cumulative translation adjustments	(1,877)	7,758
Total comprehensive income	$ 8,583	$ 20,653

(11) Commitments and Contingencies

Like many other manufacturers of fluid control products, our subsidiary Leslie Controls, Inc. (Leslie), which we acquired in 1989, has been and continues to be named as a defendant in product liability actions brought on behalf of individuals who seek compensation for their alleged exposure to airborne asbestos fibers. In some instances, we also have been named individually and/or as alleged successor in interest in these cases.

As of the end of March 2009, Leslie was a named defendant in approximately 1,103 active, unresolved asbestos-related claims filed in California, Texas, New York, Massachusetts, Pennsylvania, West Virginia, Rhode Island and 24 other states. Approximately 578 of these claims involve claimants allegedly suffering from (or the estates of decedents who allegedly died from) mesothelioma, a fatal malignancy associated with asbestos exposure.

In addition to these claims, Leslie remains a named defendant in approximately 4,700 unresolved asbestos-related claims filed in Mississippi. Since 2004, however, the Mississippi Supreme Court has interpreted joinder rules more strictly, and the state legislature enacted a tort reform act under which each plaintiff must independently satisfy venue provisions, thus preventing thousands of out-of-state claimants from tagging onto a single in-state plaintiff s case. As a result of these changes, Mississippi state court judges since 2004 have severed and dismissed tens of thousands of out-of-state asbestos claims against numerous defendants including Leslie. We continue to expect that most of the remaining Mississippi claims against Leslie will be dismissed as well. Leslie has not incurred any indemnity costs in Mississippi and defense costs to resolve these Mississippi claims have not been significant. While it is possible that certain dismissed claims could be re-filed in Mississippi or in other jurisdictions, any such re-filings likely would be made on behalf of one or a small number of related individuals who could demonstrate actual injury and some connection to Leslie s products.

Leslie s asbestos-related claims generally involve its fluid control products. Leslie management believes that any asbestos was incorporated entirely within the product in a way that would not allow for any ambient asbestos during normal operation or during normal inspection and repair procedures. Leslie and its insurers general strategy has been to vigorously defend these claims. Nevertheless, while we strongly believe that exposure to Leslie s products has not caused asbestos-related illness to any plaintiff, juries or courts have reached a different conclusion in particular cases and could do so in others.

Leslie has resolved a number of asbestos-related claims over the past few years and continues to do so for strategic reasons, including avoidance of defense costs and the possible risk of excessive verdicts. The amounts expended on asbestos-related claims in any year are generally impacted by the number of claims filed, the volume of pre-trial proceedings, and the numbers of trials and settlements.

During 2007, Los Angeles state court juries rendered two verdicts that, if allowed to stand, would result in a liability to Leslie of approximately $3.8 million. Although Leslie accrued a liability during 2007 for each of these verdicts, both verdicts have been appealed. With respect to each verdict, we believe there are strong grounds for overturning such verdict, significantly reducing the amount of the award or for requiring a new trial. In addition, Leslie has recorded $0.6 million in accrued interest for both adverse verdicts.

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Accounting Indemnity and Defense Cost Liabilities and Assets

Leslie records an estimated liability associated with reported asbestos claims when it believes that a loss is both probable and can be reasonably estimated. Prior to the fourth quarter of 2007, with respect to its unresolved pending claims, Leslie did not believe that it had sufficient information to assess the likelihood of resolving such claims. Accordingly, Leslie accrued for defense costs as incurred, and accrued for pending claims only when resolution of a particular claim was probable and the probable loss was estimable. As a practical matter, the claims accrual generally occurred close in time to when a settlement agreement for a particular claim was reached. In most cases, settlement payments are paid to claimants within thirty to sixty days of settlement.

During the fourth quarter of 2007, we engaged Hamilton, Rabinovitz and Associates, Inc. (HR&A), a firm specializing in estimating expected liabilities of mass tort claims, to help us determine an estimate of Leslie s asbestos-related liabilities. Because Leslie s claims experience is both limited and variable, HR&A concluded that any estimate of pending or future liabilities of Leslie s asbestos claims would be highly uncertain from a statistical perspective. Leslie s management determined, however, that, by using its historical (albeit limited and variable) average cost by disease classification in resolving closed claims, and by applying this information to the mix of current open claims, it could make a reasonable estimate of the indemnity costs to be incurred in resolving such current open claims. As a result, Leslie recorded a liability of $9.0 million during the fourth quarter of 2007 for the estimated indemnity cost associated with resolution of its then current open claims. During the fourth quarter of 2008, HR&A updated its analysis and reaffirmed its conclusion that a forecast of the number and value of any future asbestos claims is unwarranted and highly uncertain from a statistical perspective.

As of March 29, 2009, Leslie has recorded asbestos liabilities of $25.0 million ($13.3 million short-term and $11.7 million long-term) compared to $19.2 million as of December 31, 2008. The $25.0 million liability as of March 29, 2009 is comprised of $16.4 million for existing claims, $4.4 million related to adverse verdicts and $4.2 million for incurred but unpaid legal costs. Asbestos related insurance receivable amounts totaled $9.1 million ($7.7 million short-term and $1.4 million long-term) as of March 29, 2009 compared to $10.7 million as of December 31, 2008. The $9.1 million receivable as of March 29, 2009 is comprised of $4.1 million for existing claims, $2.3 million related to adverse verdicts and $2.7 million for incurred but unpaid legal costs.

A summary of Leslie s unpaid existing asbestos claims and incurred asbestos defense cost liabilities and the related insurance recoveries is provided below.

In Thousands	March 29, 2009	December 31, 2008
Existing claim indemnity liability	$ 20,780	$ 16,661
Incurred defense cost liability	4,212	2,584
Insurance recoveries receivable	(9,087)	(10,765)
Net asbestos liability	$ 15,905	$ 8,480

Although Leslie believes its estimates are reasonable, such estimates are also highly uncertain, especially because Leslie s claims history is relatively limited, recent and quite variable. Depending on future events, the actual costs of resolving these pending claims could be substantially higher or lower than the current estimate. Some of the more significant unknown or uncertain factors that will affect these costs going forward include:

the severity of the injuries alleged by each pending claimant;

increases or decreases in Leslie s average settlement costs;

possible adverse or favorable jury verdicts;

rulings on unresolved legal issues in various jurisdictions that bear on Leslie s legal liability;

the numbers of claims that will be dismissed with no indemnity payments;

the impact of potential changes in legislative or judicial standards in different jurisdictions; and

the potential bankruptcies of other companies named as defendants in asbestos-related claims.

As a result of these factors, Leslie is unable to estimate a range of additional losses that may be reasonably possible in the event that actual indemnity costs of resolving pending claims are higher than our estimate. In addition, while the likelihood of future claims is probable, Leslie s management cannot estimate the amount of future claims or any range of losses that may be reasonably possible

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arising from such claims. With respect to current claims, critical information is known regarding such factors as disease mix, jurisdiction and identity of plaintiff s counsel. Such information is of course unknown with respect to any future claims, and Leslie s management believes that the disease mix, jurisdictional information and plaintiff counsel identity associated with its current case experience, which has been both limited and variable, cannot reasonably be extrapolated to any future filings. Moreover, Leslie management believes that appellate actions recently commenced and currently pending in certain jurisdictions such as California, together with movements toward legislative and judicial reform in such jurisdictions, may significantly alter the litigation landscape, thus affecting both the rate at which claims may be filed as well as the likelihood of incurring indemnity amounts on account of such future claims and the level of indemnity that may be incurred to resolve such claims.

First Quarter 2009 Experience and Financial Statement Impact

During the three months ended March 29, 2009, there were 222 asbestos claims filed and 87 claims resolved with respect to Leslie. For the three months ended March 29, 2009, Leslie s gross estimated asbestos indemnity and defense costs totaled $9.9 million of which $1.6 million was paid by insurance. (Leslie s insurance coverage is further discussed below). This compares to $3.7 million estimated gross asbestos indemnity and defense costs paid for the same period in 2008 of which $2.6 million was paid by insurance. The following tables provide more specific information regarding Leslie s claim activity and defense costs during the three months ended March 29, 2009 as well as the financial impact for the three month periods ended March 29, 2009 and March 30, 2008 (excluding open Mississippi cases for which we anticipate dismissal of virtually all such cases for the reasons described above):

	Three Months Ended March 29, 2009
Beginning open cases	968
Cases filed	222
Cases resolved and dismissed	(87)
Ending open cases	1,103
Ending open mesothelioma cases	578

(In Thousands)	March 29, 2009	March 30, 2008
Indemnity costs accrued	$ 4,602	$ 1,283
Adverse verdicts interest costs (verdicts appealed)	90	
Defense cost incurred	3,166	2,426
Insurance recoveries adjustment	2,069	
Insurance recoveries accrued	(1,664)	(2,633)
Net pre-tax asbestos expense	$ 8,263	$ 1,076

Insurance

Historical

To date, Leslie s insurers have paid the majority of the costs associated with its defense and settlement of asbestos-related actions. Under Leslie s cost-sharing arrangements with its insurers, Leslie s insurers have historically paid 71% of defense and settlement costs associated with asbestos-related claims and Leslie was responsible for the remaining 29% of all such defense and indemnity costs. The amount of indemnity available under Leslie s primary layer of insurance coverage was therefore reduced by 71% of any amounts paid through settlement or verdict.

Recent Developments

During the third quarter of 2008, Zurich, an insurer that paid 8% of Leslie s historical asbestos defense and indemnity costs, informed Leslie that it had reached its maximum indemnity obligation under the applicable insurance policy and that Leslie, therefore, was now responsible for the 8% share previously paid by Zurich. More recently, however, Zurich acknowledged that its calculations concerning policy exhaustion were

incorrect. As a result, Zurich is obligated to reimburse Leslie for a portion of the additional indemnity and defense costs incurred by Leslie since Zurich s original notification. Nonetheless, we believe that, upon making such reimbursement, Zurich will have completed its obligations to Leslie under the policy and Leslie will be responsible for the 8% share previously paid by Zurich.

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During the first quarter of 2009, one of Leslie s other primary insurers, Continental Casualty, a CNA company (Continental), informed Leslie that indemnity payments had exhausted a three-year policy covering Leslie from 1967 through 1970. In so claiming, Continental expressed its belief that the policy in question contained a single aggregate limit of $1 million for the three-year period rather than annual limits of $1 million for each of the three years. As a result of the revised claimed coverage limit, Continental believes that its allocation under the cost sharing arrangement is now 15.44% compared to the 27% historically paid by Continental. Leslie strongly disagrees with Continental s position and intends to vigorously dispute Continental s position. Leslie has reaffirmed its position that there are two additional years of insurance coverage with $1 million policy limits. However, in light of the uncertainty surrounding this dispute, Leslie has reduced its insurance recovery receivable by $2.1 million in the first quarter of 2009.

Remaining Insurance

As of March 29, 2009, we believe that the aggregate amount of indemnity (on a cash basis) remaining on Leslie s primary layer of insurance was approximately $6.1 million. After giving effect to our accrual for adverse verdicts currently on appeal, the remaining amount of Leslie s primary layer of insurance is $4.1 million. From a financial statement perspective, however, after giving effect to our accrual for the estimated indemnity cost of resolving pending claims, Leslie recorded the maximum amount of available primary layer insurance as of September 2008. As a result, asbestos related indemnity costs are no longer partially offset by a corresponding insurance recovery. However, defense costs, recognized as incurred, will continue to be partially offset by insurance until such time as the aggregate amount of indemnity claims paid out (on a cash basis) by the remaining two primary layer insurance carriers exceeds policy limits. The amount of this partial insurance recovery may vary depending upon the outcome of the disagreement with Continental within an anticipated range of 51.4% and 63% of such defense costs. While we cannot reasonably predict when Leslie s primary layer will be fully exhausted, if Leslie s rate of settlements were to continue at a pace consistent with the past year, and, assuming no payments on account of any adverse verdicts, policy limits would be reached within approximately one year. If however, Leslie were to be required to make payments on account of any adverse verdicts, the time period within which such policy limits would be reached could be significantly shorter than one year.

In addition to its primary layer of insurance, Leslie does have limited available excess insurance coverage. However, some of this excess insurance lies above layers of excess insurance written by insolvent insurers, which could affect when Leslie may be able to recover this excess insurance. Moreover, unlike primary policies under which defense costs do not erode policy limits, the terms of excess policies typically provide that covered defense costs do erode policy limits. As a result, upon exhaustion of its primary layer of insurance, Leslie will become responsible for a substantial majority of any indemnity and defense costs, which could have a material adverse effect on our financial condition, results of operations, and cash flows.

Expected Limitations and Other Matters

We believe that payment of any litigation-related asbestos liabilities of Leslie (Leslie currently constitutes approximately 5% of the Company s consolidated revenues and 1% of the Company s shareholders equity) is legally limited to the net assets of that subsidiary. This belief is based on the principle of American law that a shareholder (including a parent corporation) is generally not liable for an incorporated entity s obligations.

Smaller numbers of asbestos-related claims have also been filed against two of our other subsidiaries Spence Engineering Company, Inc. (Spence), the stock of which we acquired in 1984; and Hoke, Inc. (Hoke), the stock of which we acquired in 1998. Due to the nature of the products supplied by these entities, the markets they serve and our historical experience in resolving these claims, we do not believe that asbestos-related claims will have a material adverse effect on the financial condition, results of operations or liquidity of Spence or Hoke, or the financial condition, consolidated results of operations or liquidity of the Company.

Standby Letters of Credit

We execute standby letters of credit, which include bid bonds and performance bonds, in the normal course of business to ensure our performance or payments to third parties. The aggregate notional value of these instruments was $37.3 million at March 29, 2009. Our historical experience with these types of instruments has been good and no claims have been paid in the current or past five fiscal years. We believe that the likelihood of demand for payments relating to the outstanding instruments is remote. These instruments have expiration dates ranging from less than one month to four years from March 29, 2009.

The following table contains information related to standby letters of credit instruments outstanding as of March 29, 2009 (In thousands):

Term Remaining

	Maximum Potential Future Payments
0 12 months	$ 11,306
Greater than 12 months	25,950
Total	$ 37,256

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(12) Defined Pension Benefit Plans

We maintain two pension benefit plans, a qualified noncontributory defined benefit plan and a nonqualified, noncontributory defined benefit supplemental plan that provides benefits to certain highly compensated officers and employees. To date, the supplemental plan remains an unfunded plan. These plans include significant pension benefit obligations which are calculated based on actuarial valuations. Key assumptions are made in determining these obligations and related expenses, including expected rates of return on plan assets and discount rates. Benefits are based primarily on years of service and employees compensation.

As of July 1, 2006, in connection with a revision to our retirement plan, we froze the pension benefits of our qualified noncontributory plan participants. Under the revised plan, such participants generally do not accrue any additional benefits under the defined benefit plan after July 1, 2006.

Effective December 2006, we adopted the recognition and disclosure provisions of SFAS No.158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R) . We recognized in the balance sheet the underfunded status of the defined benefit post-retirement plans, measured as the difference between the fair value of plan assets and the projected benefit obligation. Changes in the funded status of the plan in the year in which the change occurs are recognized in other comprehensive income.

Effective March 1, 2008, the Company s former Chief Executive Officer and Chief Financial Officer retired from the Company and became eligible for pension payments under the nonqualified, supplemental employees retirement plan (SERP). During the three months ended March 29, 2009, we did not make any cash contributions to our qualified defined benefit pension plan. For the remainder of 2009, we are not expecting to make voluntary cash contributions to our qualified defined benefit pension plan, although global capital market and interest rate fluctuations may impact future funding requirements. Based on a desire to ensure compliance with Section 409A of the Internal Revenue Service Code, during the three months ended March 29, 2009, we facilitated a mandatory cash-out to all active and terminated employees of the SERP, who were not currently receiving benefit payments. This pension settlement resulted in $0.2 million of pre-tax expense during the first quarter of 2009.

Additionally, substantially all of our U.S. employees are eligible to participate in a 401(k) savings plan. Under this plan, we make a core contribution and match a specified percentage of employee contributions, subject to certain limitations.

The components of net benefit expense are as follows (In thousands):

	Three Months Ended	
	March 29, 2009	March 30, 2008
Service cost-benefits earned	$ 87	$ 109
Interest cost on benefits obligation	511	490
Estimated return on assets	(402)	(573)
Prior service cost amortization	4	5
Transition obligation amortization		(2)
(Gain)/loss amortization	199	31
Net periodic cost of defined pension benefit plans	$ 399	$ 60

(13) Income Taxes

The Company has accounted for uncertainty in income taxes in accordance with FASB Interpretation No. 48. At December 31, 2008 and at March 29, 2009, we had $2.4 million of unrecognized benefits, respectively, all of which would affect our effective tax rate if recognized in any future period.

We recognize interest and penalties related to uncertain tax positions in income tax expense. As of March 29, 2009, we have approximately $0.3 million of accrued interest related to uncertain tax positions.

The Company files consolidated and separate income tax returns in the United States Federal jurisdiction and in many state and foreign jurisdictions. Substantially all material state and foreign income tax matters have been concluded for years through 2000. The Company has concluded examinations by the Internal Revenue Service through 2003 and the statute of limitations on the year 2004 has expired. The 2007 tax year is currently under examination by the Internal Revenue Service.

In 2007, German tax authorities commenced audits of certain German income tax returns for years ranging from 2001 through 2005. To date, there are no proposed adjustments.

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The Company anticipates that by March 31, 2010, total unrecognized tax benefits will decrease by approximately $0.8 million as a result of settlements of current audits.

(14) Guarantees and Indemnification Obligations

As permitted under Delaware law, we have agreements whereby we indemnify certain of our officers and directors for certain events or occurrences while the officer or director is, or was, serving at our request in such capacity. The term of the indemnification period is for the officer s or director s lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. However, we have directors and officers liability insurance policies that limit our exposure for events covered under the policies and should enable us to recover a portion of any future amounts paid. As a result of the coverage under these insurance policies, we believe the estimated fair value of these indemnification agreements is minimal and, therefore, have no liabilities recorded from those agreements as of March 29, 2009.

In connection with our industrial revenue bond financing arrangement which benefits one of our subsidiaries, we are obligated to indemnify the banks in connection with certain errors in the administration of these financing arrangements to the extent such errors are not willful and do not constitute gross negligence. This indemnification obligation is unlimited as to time and amount. We have never been required to make any payments pursuant to this indemnification. As a result, we believe the estimated fair value of this indemnification agreement is minimal. Accordingly, we have no liabilities recorded for those agreements as of March 29, 2009.

We record provisions for the estimated cost of product warranties, primarily from historical information, at the time product revenue is recognized. While we engage in extensive product quality programs and processes, our warranty obligation is affected by product failure rates, utilization levels, material usage, service delivery costs incurred in correcting a product failure, and supplier warranties on parts delivered to us. Should actual product failure rates, utilization levels, material usage, service delivery costs or supplier warranties on parts differ from our estimates, revisions to the estimated warranty liability would be required.

The following table sets forth information related to our product warranty reserves for the three months ended and as of March 29, 2009 (In thousands):

Balance beginning December 31, 2008	$ 3,032
Provisions	486
Claims settled	(791)
Currency translation adjustments	(40)
Balance ending March 29, 2009	$ 2,687

(15) Business Acquisition

During March 2009, we acquired the stock of Bodet Aero (Bodet), located in Chemille, France and its affiliate Atlas Productions (Atlas), located in Tanger, Morocco. Bodet and Atlas are leading manufacturers of electro-mechanical and fluidic controls for the aerospace, defense, and transportation markets with annual revenues of approximately $13 million. These businesses will be part of our Aerospace Products Group and be reported in the Instrumentation and Thermal Fluid Controls Segment. In connection with these acquisitions, we recorded estimated fair values of $11.8 million for current assets, $4.0 million for fixed assets, $8.1 million for current liabilities, $3.3 million for debt, and $1.4 million for identified intangible assets. The excess of the purchase price over the fair value of the net identifiable assets of $2.3 million was recorded as goodwill.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Quarterly Report on Form 10-Q contains certain statements that are forward-looking statements as that term is defined under the Private Securities Litigation Reform Act of 1995 (the Act) and releases issued by the Securities and Exchange Commission. The words may, hope, should, expect, plan, anticipate, intend, believe, estimate, predict, potential, continue, and other expressions which are predic future events and trends and which do not relate to historical matters, identify forward-looking statements. We believe that it is important to communicate our future expectations to our stockholders, and we, therefore, make forward-looking statements in reliance upon the safe harbor

provisions of the Act. However, there may be events in the future that we are not able to accurately predict or control, and our actual results may differ materially from the expectations we describe in our forward-looking statements. Forward-looking statements involve known and unknown risks, uncertainties and other factors, which may cause our actual results, performance or achievements to differ materially from anticipated future results, performance or achievements expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, the cyclicality and highly competitive nature of some of

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our end markets which can affect the overall demand for and pricing of our products, changes in the price of and demand for oil and gas in both domestic and international markets, variability of raw material and component pricing, changes in our suppliers performance, fluctuations in foreign currency exchange rates, our ability to continue operating our manufacturing facilities at efficient levels including our ability to continue to reduce costs, our ability to generate increased cash by reducing our inventories, our prevention of the accumulation of excess inventory, our ability to successfully implement our acquisition strategy, increasing interest rates, our ability to successfully defend product liability actions including asbestos cases impacting our Leslie subsidiary, as well as the uncertain continuing impact on economic and financial conditions in the United States and around the world as a result of terrorist attacks, current Middle Eastern conflicts and related matters. ***We advise you to read further about certain of these and other risk factors set forth in Part I, Item 1A, Risk Factors of our Annual Report filed on Form 10-K for the year ended December 31, 2008, together with subsequent reports we have filed with the Securities and Exchange Commission on Forms 10-Q and 8-K, which may supplement, modify, supersede, or update those risk factors.*** *We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.*

Overview

CIRCOR International, Inc. is a leading provider of valves and fluid control products for the industrial, aerospace, petrochemical, and energy markets. We offer one of the industry s broadest and most diverse range of products a range that allows us to supply end-users with a wide array of valves and component products for fluid systems.

We have organized the Company into two segments: Instrumentation and Thermal Fluid Controls Products and Energy Products. The Instrumentation and Thermal Fluid Controls Products segment serves our broadest variety of end-markets, including military and commercial aerospace, chemical processing, marine, power generation, commercial HVAC systems, food and beverage processing, and other general industrial markets. The Energy Products segment primarily serves the oil and gas exploration, production and distribution markets.

Our growth strategy includes organic profitable growth as well as strategic acquisitions that extend our current offering of engineered flow control products. For organic growth, our businesses focus on developing new products and reacting quickly to changes in market conditions in order to help grow our revenues. Regarding acquisitions, we have made fifteen acquisitions in the last eight years that extended our product offerings. In February 2006, we acquired two businesses: Hale Hamilton Valves Limited and its subsidiary Cambridge Fluid Systems (Hale Hamilton), a leading provider of high pressure valves and flow control equipment, and Sagebrush Pipeline Equipment Company (Sagebrush) which provides pipeline flow control and measurement equipment to oil and gas markets. In July 2007, we purchased the assets of Survival Engineering, Inc. (SEI), a leader in the design of pneumatic controls and inflation systems for the aerospace, marine, defense, and industrial markets. In May 2008, we acquired Motor Technology, Inc. (Motor Tech), a leader in the design and manufacture of specialty electric motors, actuators, and tachometers for aerospace, defense, medical and transportation markets. In March 2009, we acquired Bodet Aero (Bodet) and its affiliate Atlas Productions (Atlas), leading manufacturers of electro-mechanical and fluidic controls for the aerospace, defense and transportation markets.

Regarding cash flow and liquidity, we used $4.7 million in cash flow from operating activities in the first three months of 2009. This compares to $1.9 million used during the same period of 2008. The lower cash generated from operating activities was primarily due to decreases in accounts payable, accrued expenses and other liabilities. As of March 29, 2009, we believe we remain a well-capitalized company with total debt-to-equity of 7%.

Basis of Presentation

All significant intercompany balances and transactions have been eliminated in consolidation. Certain prior period financial statement amounts have been reclassified to conform to currently reported presentations. We monitor our business in two segments: Instrumentation and Thermal Fluid Controls Products and Energy Products.

We operate and report financial information using a 52-week fiscal year ending December 31. The data periods contained within our Quarterly Reports on Form 10-Q reflect the results of operations for the 13-week, 26-week and 39-week periods which generally end on the Sunday nearest the calendar quarter-end date.

Critical Accounting Policies

The following discussion of accounting policies is intended to supplement the section Summary of Significant Accounting Policies presented in Note 2 to our consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2008. These policies were selected because they are broadly applicable within our operating units. The expenses and accrued liabilities or allowances related to certain of these policies are initially based on our best estimates at the time of original entry in our accounting records. Adjustments are

recorded when our actual experience, or new information concerning our expected experience, differs from underlying initial estimates. These adjustments could be material if our actual or expected experience were to change significantly in a short period of time. We make frequent comparisons of actual experience and expected experience in order to mitigate the likelihood of material adjustments.

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There have been no significant changes from the methodology applied by management for critical accounting estimates previously disclosed in our most recent Annual Report on Form 10-K.

Revenue Recognition

Revenue is recognized when products are delivered, title and risk of loss have passed to the customer, no significant post-delivery obligations remain and collection of the resulting receivable is reasonably assured. Shipping and handling costs invoiced to customers are recorded as components of revenues and the associated costs are recorded as cost of revenues.

Cash, Cash Equivalents, and Short-term Investments

Cash and cash equivalents consist of amounts on deposit in checking and savings accounts with banks and other financial institutions. Short-term investments primarily consist of bank repurchase agreements which generally have short-term maturities and are carried at cost which generally approximates fair value.

Allowance for Inventory

We typically analyze our inventory aging and projected future usage on a quarterly basis to assess the adequacy of our inventory allowances. We provide inventory allowances for excess, slow-moving, and obsolete inventories determined primarily by estimates of future demand. The allowance is measured on an item-by-item basis determined based on the difference between the cost of the inventory and estimated market value. The provision for inventory allowance is a component of our cost of revenues. Assumptions about future demand are among the primary factors utilized to estimate market value. At the point of the loss recognition, a new, lower-cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis.

Our net inventory balance was $177.5 million as of March 29, 2009, compared to $183.3 million as of December 31, 2008. Our inventory allowance as of March 29, 2009 was $12.7 million, compared with $12.5 million as of December 31, 2008. Our provision for inventory obsolescence was $1.1 million and $1.3 million for the first quarter of 2009 and 2008, respectively.

If there were to be a sudden and significant decrease in demand for our products, or if there were a higher incidence of inventory obsolescence because of changing technology and customer requirements, we could be required to increase our inventory allowances and our gross profit could be adversely affected.

Inventory management remains an area of focus as we balance the need to maintain adequate inventory levels to ensure competitive lead times against the risk of inventory obsolescence because of changing technology and customer requirements.

Penalty Accruals

Some of our customer agreements, primarily in our project related businesses, contain late shipment penalty clauses whereby we are contractually obligated to pay consideration to our customers if we do not meet specified shipment dates. The accrual for estimated penalties is shown as a reduction of revenue and is based on several factors including limited historical customer settlement experience and management s assessment of specific shipment delay information. As of the March 29, 2009, we have accrued $12.1 million related to these potential late shipment penalties. As we conclude performance under these agreements, the actual amount of consideration paid to our customers may vary significantly from the amounts we currently have accrued.

Purchase Accounting

In connection with our acquisitions, we assess and formulate a plan related to the future integration of the acquired entity. This process begins during the due diligence process and is concluded within twelve months of the acquisition. Our methodology for determining the fair values relating to purchase acquisitions is determined through established valuation techniques for industrial manufacturing companies and we typically utilize third party valuation firms to assist in the valuation of certain tangible and intangible assets.

In December 2007, the FASB issued SFAS No. 141R, Business Combinations Statement 141R, a replacement of SFAS No. 141. SFAS 141R is effective for fiscal years beginning on or after December 15, 2008 and applies to all business combinations. SFAS 141R provides that, upon initially obtaining control, an acquirer shall recognize 100% of the fair values of acquired assets, including goodwill, and assumed liabilities, with only limited exceptions, even if the acquirer has not acquired 100% of its target. Additionally, SFAS 141R changes current practice, in part,

as follows: (1) contingent consideration arrangements will be fairly valued at the acquisition date and included on that basis in the purchase price consideration; (2) transaction costs will be expensed as incurred, rather than capitalized as part of the purchase price; (3) pre-acquisition contingencies, such as legal issues, will generally have to be accounted for in purchase accounting at fair value; and (4) in order to accrue for a restructuring plan in purchase accounting, the requirements in SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, would have to be

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met at the acquisition date. The adoption of this standard as of January 1, 2009 had no material effect on our results of operations or financial condition although the new standard could materially change the accounting for business combinations consummated subsequent to that date.

Legal Contingencies

We are currently involved in various legal claims and legal proceedings, some of which may involve substantial dollar amounts. Periodically, we review the status of each significant matter and assess our potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount can be estimated, we accrue a liability for the estimated loss. Significant judgment is required in both the determination of probability and the determination as to whether an exposure can be reasonably estimated. Because of uncertainties related to these matters, accruals are based on the best information available at the time. As additional information becomes available, we reassess the potential liability related to our pending claims and litigation and may revise our estimates. Such revisions in the estimates of the potential liabilities could have a material adverse effect on our business, results of operations and financial position. For more information related to our outstanding legal proceedings, see Commitments and Contingencies in Note 11 of the accompanying consolidated financial statements as well as Legal Proceedings in Part II, Item 1.

Impairment Analysis

As required by SFAS No. 142, Goodwill and Intangible Assets , we perform an annual assessment as to whether there is an indication that goodwill and certain intangible assets are impaired. We also perform impairment analyses whenever events and circumstances indicate that they may be impaired. In assessing the fair value of goodwill, we use our best estimates of future cash flows from operating activities and capital expenditures of the reporting unit, the estimated terminal value for each reporting unit, and a discount rate based on the weighted average cost of capital.

Certain negative macroeconomic factors began to impact the global credit markets in late 2008 and we noted significant adverse trends in business conditions in the fourth quarter of 2008. Concurrent with these adverse developments, we commenced our annual impairment assessment of goodwill and certain intangible assets. In connection with preparing the impairment assessment, we identified deterioration in the expected future financial performance of our Instrumentation and Thermal Fluid Controls segment compared to the expected future financial performance of this segment at the end of 2007. We also determined that the appropriate discount rate (based on weighted average cost of capital) as of December 31, 2008 was significantly higher than the discount rate in our 2007 impairment assessment. As a result, we recognized goodwill and intangible impairments of $140.3 million and $1.0 million, respectively, within the Instrumentation and Thermal Fluid Controls segment for the year ended December 31, 2008.

The goodwill recorded on the consolidated balance sheet as of March 29, 2009 increased $2.6 million to $34.7 million compared to $32.1 million as of December 31, 2008. This increase is primarily due to the $2.3 million acquisitions of Bodet and Atlas in March 2009 within our Instrumentation and Thermal Fluid Controls segment. There have been no further indicators of impairment as of March 29, 2009.

Income Taxes

Significant management judgment is required in determining our provision for income taxes, deferred tax assets and liabilities and any valuation allowance. Our effective tax rates differ from the statutory rate due to the impact of research and product development tax credits, extraterritorial income exclusion, domestic manufacturing deduction, state taxes, and the tax impact of non-U.S. operations. Our effective tax rate was 44.9%, 31.1%, and 30.6% for 2008, 2007 and 2006, respectively. Our tax rate for 2008 included the tax impact of an adjustment for goodwill and intangible impairment of $141.3 million for which the tax basis was $32.8 million. Excluding the goodwill and impairment charge, the 2008 effective tax rate would have been 30.3%.

For 2009, we expect an effective income tax rate of 30%. Our future effective tax rates could be adversely affected by earnings being lower than anticipated in countries where we have lower statutory rates and vice versa. Changes in the valuation of our deferred tax assets or liabilities, or changes in tax laws or interpretations thereof may also adversely affect our future effective tax rate. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes.

Regarding deferred income tax assets, we maintained a total valuation allowance of $9.1 million at March 29, 2009 and at December 31, 2008, respectively, due to uncertainties related to our ability to utilize these assets, primarily consisting of certain foreign tax credits, state net operating losses and state tax credits carried forward. The valuation allowance is based on estimates of taxable income in each of the jurisdictions in which we operate and the period over which our deferred tax assets will be recoverable. If market conditions improve and future results of operations exceed our current expectations, our existing tax valuation allowances

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may be adjusted, resulting in future tax benefits. Alternatively, if market conditions deteriorate or future results of operations are less than expected, future assessments may result in a determination that some or all of the deferred tax assets are not realizable. Consequently, we may need to establish additional tax valuation allowances for all or a portion of the gross deferred tax assets, which may have a material adverse effect on our business, results of operations and financial condition.

Pension Benefits

We maintain two pension benefit plans, a qualified noncontributory defined benefit plan and a nonqualified, noncontributory defined benefit supplemental plan that provides benefits to certain highly compensated officers and employees. To date, the supplemental plan remains an unfunded plan. These plans include significant pension benefit obligations which are calculated based on actuarial valuations. Key assumptions are made in determining these obligations and related expenses, including expected rates of return on plan assets and discount rates. Benefits are based primarily on years of service and employees compensation. As of July 1, 2006, in connection with a revision to our retirement plan, we froze the pension benefits of our qualified noncontributory plan participants. Under the revised plan, such participants generally do not accrue any additional benefits under the defined benefit plan after July 1, 2006 and instead receive enhanced benefits associated with our defined contribution 401(k) plan in which substantially all of our U.S. employees are eligible to participate.

In 2009, we currently do not expect to make voluntary cash contributions to our pension plans, although global capital market and interest rate fluctuations will impact future funding requirements.

Results of Operations for the Three Months Ended March 29, 2009 Compared to the Three Months Ended March 30, 2008

The following tables set forth the results of operations, percentage of net revenues and the period-to-period percentage change in certain financial data for the three months ended March 29, 2009 and March 30, 2008:

	(Dollars in thousands)				
	Three Months Ended March 29, 2009		Three Months Ended March 30, 2008		% Change
Net revenues	$ 175,647	100.0%	$ 176,575	100.0%	(0.5)%
Cost of revenues	119,628	68.1	121,686	68.9	(1.7)
Gross profit	56,019	31.9	54,889	31.1	2.1
Selling, general and administrative expenses	34,099	19.4	34,145	19.3	(0.1)
Asbestos charges	8,263	4.7	1,075	0.6	668.7
Special charges	(1,135)	(0.6)	160	0.1	(809.4)
Operating income	14,792	8.4	19,509	11.0	(24.2)
Other (income) expense:					
Interest expense, net	32	0.0	145	0.1	(77.9)
Other (income) expense, net	(183)	(0.1)	401	0.2	(145.6)
Total other (income) expense	(151)	(0.1)	546	0.3	(127.7)
Income before income taxes	14,943	8.5	18,963	10.7	(21.2)
Provision for income taxes	4,483	2.6	6,068	3.4	(26.1)
Net income	$ 10,460	6.0%	$ 12,895	7.3%	(18.9)%

Net Revenues

Net revenues for the three months ended March 29, 2009 decreased by $0.9 million, or 0.5%, to $175.6 million from $176.6 million for the three months ended March 30, 2008. The decrease in net revenues for the three months ended March 29, 2009 was attributable to the following:

	Three Months Ended					
Segment	March 29, 2009	March 30, 2008	Total Change	Acquisitions	Operations	Foreign Exchange
	(In thousands)					
Instrumentation & Thermal Fluid Controls	$ 86,340	$ 88,450	$ (2,110)	$ 2,427	$ 1,517	$ (6,054)
Energy	89,307	88,125	1,182		8,945	(7,763)
Total	$ 175,647	$ 176,575	$ (928)	$ 2,427	$ 10,462	$ (13,817)

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The Instrumentation and Thermal Fluid Controls Products segment accounted for 49% of net revenues for the three months ended March 29, 2009 compared to 50% for the three months ended March 30, 2008. Likewise, our Energy Products segment accounted for 51% of net revenues for the three months ended March 29, 2009 compared to 50% for the three months ended March 30, 2008.

Instrumentation and Thermal Fluid Controls Products revenues decreased $2.1 million, or 2%, for the quarter ended March 29, 2009 compared to the quarter ended March 30, 2008. This segment s quarterly revenues were negatively impacted by lower Euro exchange rates compared to the US dollar partially offset by higher aerospace sales and by $2.4 million in incremental revenues resulting from the acquisitions of Motor Tech in May 2008 and Bodet and Atlas in March 2009. This segment s customer orders decreased 32% in the first quarter 2009 compared to the same period last year with particular weakness in HVAC, general industry markets, semiconductor, and a large multi-year maritime order booked in 2008. The backlog increased to $170.9 million as of March 29, 2009 compared to $159 million as of March 30, 2008. For the remainder of 2009, we expect market conditions to remain under pressure for most of the general industrial, commercial HVAC, power generation, semiconductor and aerospace end markets served by this segment. Due to the volatility and uncertainty in these markets, as well as currency fluctuations, at this time we are uncertain of the magnitude and duration of recent declines and the impact on this segment.

Energy Products revenues increased by $1.2 million, or 1%, for the quarter ended March 29, 2009 compared to the quarter ended March 30, 2008. The increase in revenues was the net result of an incremental $8.9 million from organic increases primarily due to large international projects and fabricated systems in North America offset by $7.8 million in lower revenues resulting from foreign currency fluctuations due to lower Euro compared to the US dollar. Orders for this segment declined $80.0 million to $45.8 million for the three months ended March 30, 2009 compared to $125.9 million for the three months ended March 30, 2008 primarily due to delays in large international projects and a reduction in drilling and production activities resulting from lower oil and natural gas pricing. Backlog has declined by $165.3 million to $127.3 million as of March 30, 2009 compared to the same period in 2008. With the sharp declines in drilling rig counts and volatile prices for gas and oil, we anticipate a continued decline in energy orders during the remainder of 2009 compared to 2008. Due to the volatility and uncertainty in these markets, as well as currency fluctuations, at this time we are uncertain as to the magnitude and duration of these declines and the impact on this segment.

Gross Profit

Consolidated gross profit increased $1.1 million, or 2%, to $56.0 million for the quarter ended March 29, 2009 compared to $54.9 million for the quarter ended March 30, 2008. Consolidated gross margin increased 80 basis points to 31.9% for the quarter ended March 29, 2009 from 31.1% for the quarter ended March 30, 2008.

Gross profit for the Instrumentation and Thermal Fluid Controls Products segment increased $0.1 million or 0.5% for the quarter ended March 29, 2009 compared to the quarter ended March 30, 2008. Unfavorable foreign exchange rates impacted gross profit by $2.2 million offsetting benefits of $1.5 million from organic growth due to improved mix, productivity and material costs and $0.8 million from the recent acquisitions of Motor Tech, Bodet, and Atlas. We continue to look at outsourcing and foreign-sourcing to lower our cost of goods sold. During the quarter ended March 29, 2009, we established a subsidiary in India to advance our outsourcing and supply chain capabilities. In addition, during the first quarter of 2009, we acquired Atlas to enhance the low cost manufacturing capabilities and capacity of our European aerospace businesses. We also remain focused on lean manufacturing initiatives to not only achieve more linear and efficient production levels but also to ensure a more predictable flow of inventory from our global suppliers.

Gross profit for the Energy Products segment increased $1.0 million or 4% for the quarter ended March 29, 2009 compared to the quarter ended March 30, 2008. This segment s quarterly gross profit increased $3.7 million due primarily to the growth in large international projects and fabricated systems in North America partially offset by $2.7 million due to lower foreign exchange rates compared to the US dollar.

Selling, General and Administration

Selling, general and administrative expenses remained unchanged at $34.1 million for the three months ended March 29, 2009 compared to the same period ended March 30, 2008. Selling, general and administrative expenses as a percentage of revenues increased 0.1% to 19.4% for the three months ended March 29, 2009 compared to March 30, 2008.

Selling, general and administrative expenses for the Instrumentation and Thermal Fluid Controls Products segment increased 0.1% or $0.1 million compared to the first quarter 2008.

Selling, general and administrative expenses for the Energy Products segment decreased 8% or $0.9 million. The majority of this decrease, $0.6 million was due to lower foreign exchange rates for the Euro. The remainder was primarily due to lower commissions and selling expenses partially offset by severance expenses

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Corporate, general and administrative expenses increased $0.7 million in the first quarter of 2009 from the same period in 2008. The increase was primarily due to higher pension expenses and professional fees partially offset by lower equity compensation expenses.

Asbestos Charges, Net

Asbestos charges are associated with our Leslie subsidiary in the Instrumentation and Thermal Fluid Controls segment. Net asbestos related costs increased $7.2 million to $8.3 million for the three months ended March 30, 2009 compared to $1.1 million for the three months ended March 30, 2008. This increase was comprised of $3.4 million higher indemnity costs related to recent settlements and the increased level of open claims, $3.0 million in lower insurance recoveries primarily due to the exhaustion and revised coverage limits of certain insurance policies, as well as $0.8 million due to higher gross defense costs attributed to the higher case activities.

Special Charges

Special charges for the three months ended March 30, 2009 were comprised of $1.1 million in income related to payments received on an asset sold within our Energy Products Segment during 2007.

Operating Income

The change in operating income for the three months ended March 29, 2009 compared to the three months ended March 30, 2008 was as follows:

	Three Months Ended					
Segment	March 29, 2009	March 30, 2008	Total Change	Acquisitions	Operations	Foreign Exchange
			(Dollars In thousands)			
Instrumentation & Thermal Fluid Controls	$ 2,853	$ 9,994	$ (7,141)	$ 367	$ (6,749)	$ (759)
Energy	17,304	14,303	3,001		4,986	(1,985)
Corporate	(5,365)	(4,788)	(577)		(577)	
Total	$ 14,792	$ 19,509	$ (4,717)	$ 367	$ (2,340)	$ (2,744)

Operating income decreased 24% or $4.7 million for the three months ended March 29, 2009 compared to the three months ended March 30, 2008, on a 0.5% decrease in revenues.

Operating income for the Instrumentation and Thermal Fluid Controls Products segment decreased $7.1 million, or 72% for the first quarter of 2009 compared to the same period last year. This decrease is due almost entirely to increased asbestos related costs. Operating margins decreased 800 basis points to 3.3% on a revenue decrease of 2%. Higher asbestos costs and unfavorable foreign currency transactions were partially offset by improved product mix, productivity, lower material costs as well as incremental income from the Motor Tech, Bodet, and Atlas acquisitions.

Operating income for the Energy Products segment increased $3.0 million, or 21% for the first quarter 2009, as its operating margin increased 310 basis points to 19.3% on a revenue increase of 1%, compared to the first quarter 2008. Its increased operating income benefited from a favorable mix of large international oil and gas projects partially offset by lower foreign exchange rates compared to the US dollar.

Interest Expense, Net

Interest expense, net, decreased $0.1 million to zero for the three months ended March 29, 2009 compared to the three months ended March 30, 2008. The decrease in interest expense, net was primarily due to lower debt borrowings from our revolving credit facility.

Provision for Taxes

The effective income tax rate was 30.0% and 32.0% for each of the first quarters of 2009 and 2008, respectively. The decrease in the income tax rate for the first quarter 2009 compared to the first quarter 2008 was primarily due to lower earnings in jurisdictions with higher tax rates.

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Net Income

Net income decreased 19% to $10.5 million in the first quarter 2009 on essentially flat revenues, compared to the same quarter in 2008. This decrease is primarily attributable to increased asbestos related costs, unfavorable foreign exchange rates compared to the US dollar, and higher corporate expenses offset by improved product mix and operating efficiencies at both of our Energy Products and Instrumentation and Thermal Fluid Controls Products segments.

Liquidity and Capital Resources

Our liquidity needs arise primarily from capital investment in machinery, equipment and the improvement of facilities, funding working capital requirements to support business growth initiatives, acquisitions, dividend payments, and debt service costs. Excluding our first quarter results, we have historically generated cash from operations. We believe we remain in a strong financial position, with resources available for reinvestment in existing businesses, strategic acquisitions and managing our capital structure on a short and long-term basis.

The following table summarizes our cash flow activities for the three months ended March 29, 2009 (In thousands):

Cash flow (used in) or provided by:	
Operating activities	$ (4,695)
Investing activities	(12,381)
Financing activities	6,081
Effect of exchange rates on cash and cash equivalents	(365)
Decrease in cash and cash equivalents	$ (11,360)

During the three months ended March 29, 2009, we used $4.7 million in cash from operating activities compared to $1.9 million used during the three months ended March 30, 2008. The use of cash for operating activities was primarily due to lower net income and increases in working capital as of March 29, 2009, compared to the same period in 2008. The $12.4 million used by investing activities consisted primarily of $6.7 million for the Bodet and Atlas acquisitions, $3.2 million in net purchases of investments, and $2.6 million used for the purchase of capital equipment. Financing activities provided $6.1 million which included a net $7.0 million of debt borrowings offset by $0.7 million used to pay dividends to shareholders and $0.3 million tax effect of share-based compensation.

As of March 29, 2009 and December 31, 2008, total debt was $23.6 million and $13.2 million, respectively. Total debt as a percentage of total shareholders equity was 7% as of March 29, 2009 compared to 4% as of December 31, 2008.

In December 2005, we entered into a new five-year, unsecured bank agreement that provided a $95 million revolving credit facility and we terminated the previously available $75 million revolving credit facility. In October 2006, we amended our credit agreement to increase the unsecured revolving credit facility to $125 million and to allow for additional indebtedness not to exceed $80 million. This revolving credit facility is available to support our acquisition program, working capital requirements and general corporate purposes. As of March 29, 2009, we had borrowings of $14.1 million outstanding under our revolving credit facility and $37.3 million allocated to support outstanding letters of credit.

Certain of our loan agreements contain covenants that require, among other items, maintenance of certain financial ratios and also limit our ability to: enter into secured and unsecured borrowing arrangements; issue dividends to shareholders; acquire and dispose of businesses; transfer assets among domestic and international entities; participate in certain higher yielding long-term investment vehicles; and issue additional shares of our stock. As of March 29, 2009, we were in compliance with all covenants related to our existing debt obligations.

The ratio of current assets to current liabilities was 2.36:1 at March 29, 2009, compared to 2.05:1 at December 31, 2008. Cash and cash equivalents were $36.1 million as of March 29, 2009, compared to $47.5 million as of December 31, 2008.

In 2009, we expect to generate positive cash flow from operating activities sufficient to support our capital expenditures, to reduce our outstanding revolving credit facility balance to zero and to pay dividends approximating $2.5 million based on our current dividend practice of paying $0.15 per share annually. Based on our expected cash flows from operations and contractually available borrowings under our credit facilities, we expect to have sufficient liquidity to fund working capital needs and future growth. We continue to search for strategic acquisitions

in the flow control market. A larger acquisition may require additional borrowings and or the issuance of our common stock.

The public and private capital markets in the United States and around the world continue to experience extreme volatility, disruption and general slowdown at unprecedented levels. This has spawned an unprecedented deterioration in many industrial markets including several of the markets into which we sell our products. The breadth, depth and duration of this crisis remains

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uncertain. These conditions can adversely affect our revenue, results of operations and overall financial growth. Additionally, many lenders and institutional investors have reduced, and in some cases, ceased to provide funding to borrowers, including other financial institutions. A prolonged constriction on future lending by banks or investors could result in higher interest rates on future debt obligations or could restrict our ability to obtain sufficient financing to meet our long-term operational and capital needs or could limit our ability in the future to consummate strategic acquisitions. The current uncertainty and turmoil in the credit markets may also negatively impact the ability of our customers and vendors to finance their operations which, in turn, could result in a decline of our sales and in our ability to obtain necessary raw materials and components, thus potentially having an adverse effect on our business, financial condition and results of operations.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements, other than operating leases, that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources that is material to investors.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Sensitivity Risk

As of March 29, 2009, our primary interest rate risk is related to borrowings under our revolving credit facility and our industrial revenue bond. The interest rates for our revolving credit facility and industrial revenue bond fluctuate with changes in short-term interest rates. We had $14.1 million borrowed under our revolving credit facility as of March 29, 2009. Based upon expected levels of borrowings under our credit facility in 2009 and our current balances for our industrial revenue bond, an increase in variable interest rates of 100 basis points would have an effect on our annual results of operations and cash flows of approximately $0.2 million.

Foreign Currency Exchange Risk

We use forward contracts to manage the currency risk related to certain business transactions denominated in foreign currencies. To the extent the underlying transactions hedged are completed, the contracts do not subject us to significant risk from exchange rate movements because they offset gains and losses on the related foreign currency denominated transactions. Our foreign currency forward contracts have not been designated as hedging instruments and, therefore, do not qualify for fair value or cash flow hedge treatment under the criteria of Statement No. 133. Therefore, the unrealized gains and losses on our contracts have been recognized as a component of other expense in the consolidated statements of operations. As of March 29, 2009, we had nine forward contracts to sell currencies with a face value of $14.7 million which approximates fair value.

We have determined that the majority of the inputs used to value our foreign currency forward contracts fall within Level 2 of the SFAS No. 157 fair value hierarchy. The credit valuation adjustments, such as estimates of current credit spreads to evaluate the likelihood of default by ourselves and our counterparties are Level 3 inputs. However we have assessed the significance of the impact of the credit valuation adjustments on the overall valuation of our foreign currency forward contracts and determined that the credit valuation adjustments are not significant to the overall valuation. As a result, we have determined that our derivative valuations in their entirety are classified in Level 2 of the fair value hierarchy.

We do not use derivative financial instruments for trading purposes. Risk management strategies are reviewed and approved by senior management before implementation.

ITEM 4.