

BARNES GROUP INC  
Form 10-Q  
November 03, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-4801

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**BARNES GROUP INC.**

(Exact name of registrant as specified in its charter)

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Delaware  
(State or other jurisdiction of  
incorporation or organization)  
123 Main Street, Bristol, Connecticut

06-0247840  
(I.R.S. Employer  
Identification No.)  
06011-0489

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(Address of Principal Executive Offices)

(860) 583-7070

(Zip Code)

(Registrant's telephone number, including area code)

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

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

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

The registrant had outstanding 52,183,101 shares of common stock as of November 1, 2006.

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**Barnes Group Inc.**

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**For the Quarterly Period Ended September 30, 2006**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****BARNES GROUP INC.****CONSOLIDATED STATEMENTS OF INCOME**

(Dollars in thousands, except per share data)

(Unaudited)

|   | Three months ended<br>September 30, |                                     | Nine months ended<br>September 30, |                                     |
|---|-------------------------------------|-------------------------------------|------------------------------------|-------------------------------------|
|   | 2006                                | 2005<br>As Adjusted<br>(See Note 3) | 2006                               | 2005<br>As Adjusted<br>(See Note 3) |
| Net sales   | \$ 322,048                          | \$ 271,518                          | \$ 930,826                         | \$ 825,768                          |
| Cost of sales                                     | 203,493                             | 172,070                             | 592,496                            | 526,572                             |
| Selling and administrative expenses               | 87,989                              | 79,998                              | 250,939                            | 238,768                             |
|   | 291,482                             | 252,068                             | 843,435                            | 765,340                             |
| Operating income                                  | 30,566                              | 19,450                              | 87,391                             | 60,428                              |
| Other income                                      | (21)                                | 533                                 | 856                                | 10,065                              |
| Interest expense                                  | 6,768                               | 4,387                               | 16,906                             | 12,892                              |
| Other expenses                                    | 309                                 | 174                                 | 694                                | 716                                 |
| Income before income taxes                        | 23,468                              | 15,422                              | 70,647                             | 56,885                              |
| Income taxes                                      | 4,607                               | 27                                  | 15,306                             | 12,430                              |
| Net income  | \$ 18,861                           | \$ 15,395                           | \$ 55,341                          | \$ 44,455                           |
| Per common share: <sup>(1)</sup>                  |                                     |                                     |                                    |                                     |
| Net income:                                       |                                     |                                     |                                    |                                     |
| Basic   | \$ .36                              | \$ .32                              | \$ 1.10                            | \$ .95                              |
| Diluted   | .35                                 | .31                                 | 1.06                               | .91                                 |
| Dividends   | .125                                | .11                                 | .36                                | .31                                 |
| Average common shares outstanding: <sup>(1)</sup> |                                     |                                     |                                    |                                     |
| Basic   | 51,868,493                          | 47,394,820                          | 50,188,177                         | 46,994,458                          |
| Diluted   | 53,526,824                          | 49,647,536                          | 52,415,932                         | 48,737,774                          |

(1) As adjusted for the 2-for-1 stock split in the second quarter of 2006. See Note 2.  
See accompanying notes.

**Table of Contents****BARNES GROUP INC.****CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands)

(Unaudited)

|   | September 30,<br>2006 | December 31,<br>2005<br>As Adjusted<br>(See Note 3) |
|---|-----------------------|---|
| <b>Assets</b>   |                       |   |
| Current assets  |                       |   |
| Cash and cash equivalents   | \$ 32,150             | \$ 28,112   |
| Accounts receivable, less allowances (2006 - \$3,779; 2005 - \$3,063) | 203,272               | 155,595   |
| Inventories   | 185,770               | 159,238   |
| Deferred income taxes   | 22,292                | 24,563  |
| Prepaid expenses  | 14,944                | 11,157  |
| <br>Total current assets  | <br>458,428           | <br>378,665   |
| Deferred income taxes   | 20,107                | 22,478  |
| Property, plant and equipment   | 558,105               | 489,746   |
| Less accumulated depreciation   | (349,732)             | (332,690)   |
|   | 208,373               | 157,056   |
| Goodwill  | 349,478               | 235,299   |
| Other intangible assets, net  | 242,020               | 163,849   |
| Other assets  | 52,527                | 48,513  |
| <br>Total assets  | <br>\$ 1,330,933      | <br>\$ 1,005,860                                    |
| <b>Liabilities and Stockholders Equity</b>                            |                       |   |
| Current liabilities   |                       |   |
| Notes payable   | \$                    | \$ 4,000  |
| Accounts payable  | 156,825               | 120,158   |
| Accrued liabilities   | 107,467               | 93,615  |
| Long-term debt - current  | 20,999                | 40,084  |
| <br>Total current liabilities   | <br>285,291           | <br>257,857   |
| Long-term debt  | 415,199               | 241,941   |
| Accrued retirement benefits   | 90,326                | 88,036  |
| Other liabilities   | 31,141                | 16,869  |
| Commitments and Contingencies (Note 14)                               |                       |   |
| Stockholders equity   |                       |   |
| Common stock - par value \$0.01 per share                             |                       |   |
| Authorized: (2006 150,000,000 shares; 2005 60,000,000 shares)         |                       |   |
| Issued: Shares at par value (2006 52,187,514; 2005 48,839,388)        | 522                   | 488   |
| Additional paid-in capital  | 185,815               | 136,962   |
| Treasury stock, at cost (2006 229,631 shares; 2005 831,820 shares)    | (4,586)               | (14,590)  |
| Retained earnings   | 340,852               | 304,274   |

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|   |              |              |
|---|--------------|--------------|
| Accumulated other non-owner changes to equity | (13,627)     | (25,977)     |
| Total stockholders' equity                    | 508,976      | 401,157      |
| Total liabilities and stockholders' equity    | \$ 1,330,933 | \$ 1,005,860 |

See accompanying notes.

**Table of Contents****BARNES GROUP INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Dollars in thousands)

(Unaudited)

|  | Nine months ended<br>September 30, |                                     |
|--|------------------------------------|-------------------------------------|
|  | 2006                               | 2005<br>As Adjusted<br>(See Note 3) |
| <b>Operating activities:</b>   |                                    |                                     |
| Net income   | \$ 55,341                          | \$ 44,455                           |
| Adjustments to reconcile net income to net cash from operating activities: |                                    |                                     |
| Depreciation and amortization  | 30,704                             | 25,868                              |
| Gain on disposition of property, plant and equipment                       | (423)                              | (247)                               |
| Non-cash stock-based compensation expense                                  | 6,175                              | 12,900                              |
| Gain on the sale of NASCO  |                                    | (8,892)                             |
| Changes in assets and liabilities, net of the effects of acquisitions:     |                                    |                                     |
| Accounts receivable  | (21,496)                           | (21,993)                            |
| Inventories  | (13,085)                           | (21,643)                            |
| Prepaid expenses   | (3,141)                            | (229)                               |
| Accounts payable   | 10,645                             | 5,594                               |
| Accrued liabilities  | 2,991                              | 3,739                               |
| Deferred income taxes  | 3,092                              | 2,471                               |
| Long-term pension assets   | (2,594)                            | (1,150)                             |
| Other  | 1,595                              | (3,987)                             |
| <b>Net cash provided by operating activities</b>                           | <b>69,804</b>                      | <b>36,886</b>                       |
| <b>Investing activities:</b>   |                                    |                                     |
| Proceeds from disposition of property, plant and equipment                 | 2,939                              | 963                                 |
| Proceeds from the sale of NASCO  |                                    | 18,600                              |
| Capital expenditures   | (32,579)                           | (18,313)                            |
| Business acquisitions, net of cash acquired                                | (143,530)                          | (19,214)                            |
| Revenue sharing program payments   | (35,400)                           | (40,250)                            |
| Other  | (5,533)                            | (1,043)                             |
| <b>Net cash used by investing activities</b>                               | <b>(214,103)</b>                   | <b>(59,257)</b>                     |
| <b>Financing activities:</b>   |                                    |                                     |
| Net change in other borrowings   | (4,229)                            | 4,404                               |
| Payments on long-term debt   | (102,840)                          | (139,237)                           |
| Proceeds from the issuance of long-term debt                               | 253,052                            | 162,029                             |
| Proceeds from the issuance of common stock                                 | 23,140                             | 4,938                               |
| Common stock repurchases   | (690)                              | (48)                                |
| Dividends paid   | (18,260)                           | (14,604)                            |
| Other  | (1,235)                            | (1,721)                             |
| <b>Net cash provided by financing activities</b>                           | <b>148,938</b>                     | <b>15,761</b>                       |
| <b>Effect of exchange rate changes on cash flows</b>                       | <b>(601)</b>                       | <b>1,764</b>                        |
| <b>Increase (decrease) in cash and cash equivalents</b>                    | <b>4,038</b>                       | <b>(4,846)</b>                      |

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|  |           |           |
|--|-----------|-----------|
| Cash and cash equivalents at beginning of period | 28,112    | 36,335    |
| Cash and cash equivalents at end of period       | \$ 32,150 | \$ 31,489 |

### Supplemental Disclosure of Cash Flow Information:

Non-cash financing and investing activities in 2006 and 2005 include the acquisition of intangible assets in the amounts of \$48,550 and \$31,750, respectively, and the recognition of the corresponding liabilities in connection with the aftermarket revenue sharing programs ( RSPs ). In 2006, non-cash investing and financing activities include the issuance of \$30,682 of common stock in connection with the acquisition of Heinz Hänggi AG, Stanztechnik.

See accompanying notes.



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**BARNES GROUP INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(All dollar amounts included in the notes are stated in thousands except per share data.)**

**1. Summary of Significant Accounting Policies**

The accompanying unaudited consolidated balance sheet and the related consolidated statements of income and cash flows have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. The consolidated financial statements do not include all information and notes required by generally accepted accounting principles for complete financial statements. The balance sheet as of December 31, 2005, as adjusted, has been derived from the 2005 financial statements of Barnes Group Inc. (the Company). For additional information, please refer to the consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. In the opinion of management, all adjustments, including normal recurring accruals considered necessary for a fair presentation, have been included. Operating results for the nine-month period ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

See Note 3 for discussion of the Company's change in accounting as a result of the adoption of Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payments as of January 1, 2006 and the adjustment of previously reported amounts.

**2. Stock Split**

On April 20, 2006, the Company's Board of Directors declared a two-for-one stock split of the Company's common stock, in the form of a 100 percent stock dividend. All stockholders of record on May 30, 2006 received one additional share of Barnes Group Inc. common stock for each share held on that date. The additional share of common stock was distributed to stockholders of record in the form of a stock dividend on June 9, 2006. All share and per-share amounts in the accompanying consolidated financial statements and notes to consolidated financial statements have been adjusted to apply the effect of the stock split retrospectively.

**3. Stock-Based Compensation**

The Company previously accounted for stock-based employee compensation plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and its related interpretations. Effective January 1, 2006, the Company adopted SFAS No. 123R Share-Based Payments which requires the cost of all share-based payments, including stock options, to be measured at fair value on the grant date and recognized in the results of operations. This change did not have a material impact on the 2006 nine-month period results. Forfeitures were previously recorded as incurred; however, the revised Statement requires that an estimated forfeiture rate be applied to outstanding awards, the impact of which was not material upon adoption. Prior to the adoption of this Statement, the Company presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Consolidated Statements of Cash Flows. In accordance with SFAS No. 123R, the Company records the cash flows resulting from tax deductions in excess of compensation for those options, if any, as financing cash flows. The Company has elected to utilize the modified retrospective method of adoption and therefore all periods presented prior to January 1, 2006 were adjusted to reflect the impact of the standard as if it had been adopted on January 1, 1995, the original effective date of SFAS No. 123, Accounting for Stock Issued to Employees. The amounts that are reported in the Company's results of operations for the adjusted periods are the pro forma amounts previously disclosed under SFAS No. 123. As a result of the change in accounting, the following amounts were adjusted.

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|  | As                      |            | As         |
|--|-------------------------|------------|------------|
|  | Previously<br>Reported* | Adjustment | Adjusted   |
| <b>Consolidated Statements of Income:</b>    |                         |            |            |
| <b>Three months ended September 30, 2005</b> |                         |            |            |
| Selling and administrative expenses          | \$ 76,824               | \$ 3,174   | \$ 79,998  |
| Income taxes                                 | 1,241                   | (1,214)    | 27         |
| Net income                                   | 17,354                  | (1,959)    | 15,395     |
| Net income per common share basic            | .37                     | (.05)      | .32        |
| Net income per common share diluted          | .35                     | (.04)      | .31        |
| Average common shares outstanding diluted    | 49,320,956              | 326,580    | 49,647,536 |
| <b>Nine months ended September 30, 2005</b>  |                         |            |            |
| Selling and administrative expenses          | \$ 231,618              | \$ 7,150   | \$ 238,768 |
| Income taxes                                 | 15,165                  | (2,735)    | 12,430     |
| Net income                                   | 48,869                  | (4,414)    | 44,455     |
| Net income per common share basic            | 1.04                    | (.09)      | .95        |
| Net income per common share diluted          | 1.01                    | (.10)      | .91        |
| Average common shares outstanding diluted    | 48,497,798              | 239,976    | 48,737,774 |
| <b>Year ended December 31, 2005</b>          |                         |            |            |
| Selling and administrative expenses          | \$ 309,991              | \$ 10,310  | \$ 320,301 |
| Income taxes                                 | 17,553                  | (3,944)    | 13,609     |
| Net income                                   | 60,517                  | (6,366)    | 54,151     |
| Net income per common share basic            | 1.28                    | (.13)      | 1.15       |
| Net income per common share diluted          | 1.24                    | (.14)      | 1.10       |
| Average common shares outstanding diluted    | 48,803,274              | 215,108    | 49,018,382 |
| <b>Year ended December 31, 2004</b>          |                         |            |            |
| Selling and administrative expenses          | \$ 284,223              | \$ 7,150   | \$ 291,373 |
| Income taxes                                 | 8,601                   | (2,750)    | 5,851      |
| Net income                                   | 34,426                  | (4,400)    | 30,026     |
| Net income per common share basic            | .74                     | (.09)      | .65        |
| Net income per common share diluted          | .72                     | (.09)      | .63        |
| Average common shares outstanding diluted    | 47,672,926              | 262,342    | 47,935,268 |
| <b>Year ended December 31, 2003</b>          |                         |            |            |
| Selling and administrative expenses          | \$ 261,983              | \$ 5,484   | \$ 267,467 |
| Income taxes                                 | 5,289                   | (1,646)    | 3,643      |
| Net income                                   | 32,913                  | (3,838)    | 29,075     |
| Net income per common share basic            | .77                     | (.09)      | .68        |
| Net income per common share diluted          | .74                     | (.08)      | .66        |
| Average common shares outstanding diluted    | 44,203,120              | 6,540      | 44,209,660 |
| <b>Year ended December 31, 2002</b>          |                         |            |            |
| Selling and administrative expenses          | \$ 209,192              | \$ 7,125   | \$ 216,317 |
| Income taxes                                 | 5,741                   | (2,743)    | 2,998      |
| Net income                                   | 26,802                  | (4,382)    | 22,420     |
| Net income per common share basic            | .71                     | (.11)      | .60        |
| Net income per common share diluted          | .70                     | (.12)      | .58        |

\* Share and per-share amounts have been adjusted to reflect the effect of the 2-for-1 stock split. See Note 2.

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| <b>Consolidated Balance Sheet:</b>  | <b>As<br/>Previously<br/>Reported**</b> | <b>Adjustment</b> | <b>As<br/>Adjusted</b> |
|-------------------------------------|---|-------------------|------------------------|
| <b>December 31, 2005</b>            |   |                   |                        |
| Deferred income tax asset long-term | \$ 16,526                               | \$ 5,952          | \$ 22,478              |
| Additional paid-in capital          | 102,577                                 | 34,385            | 136,962                |
| Retained earnings                   | 332,707                                 | (28,433)          | 304,274                |

\*\* Additional paid-in capital amount has been adjusted to reflect the effect of the 2-for-1 stock split. See Note 2.

Please refer to the Company's Annual Report on Form 10-K as filed February 27, 2006 for a description of the Company's stock incentive award plans and their general terms. As of September 30, 2006, incentives had been awarded in the form of incentive stock rights, performance share unit awards and restricted stock unit awards (collectively Rights) and stock options. The Company has elected to use the straight-line method to recognize compensation costs. Stock option awards vest over a period ranging from six months to five years. The maximum term of stock option awards is 10 years. Upon exercise of a stock option or upon vesting of Rights, shares are issued from treasury shares held by the Company or from authorized shares. Effective January 1, 2006, the Company eliminated the reload feature relative to its stock option awards and decreased the discount for stock purchases under its Employee Stock Purchase Plan from 15% to 5%.

During the three months ended September 30, 2006 and 2005, the Company recognized \$1,846 and \$5,194, respectively, of stock-based compensation cost and \$705 and \$1,986, respectively, of related tax benefits. During the nine months ended September 30, 2006 and 2005, the Company recognized \$6,175 and \$12,900, respectively, of stock-based compensation cost and \$2,361 and \$4,934, respectively, of related tax benefits. At September 30, 2006, the Company had \$9,714 of unrecognized compensation costs related to unvested awards. The costs are expected to be recognized over a weighted average period of 3.0 years.

The following table summarizes information about the Company's stock option awards during the nine months ended September 30, 2006.

|                                 | <b>Number<br/>Of Shares</b> | <b>Weighted-Average<br/>Exercise Price</b> |
|---------------------------------|-----------------------------|--|
| Outstanding, January 1, 2006    | 6,399,176                   | \$ 14.29                                   |
| Granted                         | 291,900                     | 18.64                                      |
| Exercised                       | (172,562)                   | 11.85                                      |
| Forfeited                       | (2,350)                     | 11.72                                      |
| Outstanding, March 31, 2006     | 6,516,164                   | 14.55                                      |
| Granted                         | 14,000                      | 20.44                                      |
| Exercised                       | (1,434,372)                 | 13.91                                      |
| Forfeited                       | (7,166)                     | 13.81                                      |
| Outstanding, June 30, 2006      | 5,088,626                   | 14.74                                      |
| Granted                         | 26,000                      | 18.22                                      |
| Exercised                       | (21,036)                    | 12.54                                      |
| Forfeited                       | (10,642)                    | 12.68                                      |
| Outstanding, September 30, 2006 | 5,082,948                   | 14.77                                      |
| Exercisable, September 30, 2006 | 3,801,217                   | 14.84                                      |

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The Company received cash proceeds from the exercise of stock options of \$321 and \$1,162 in the third quarter of 2006 and 2005, respectively, and \$22,262 and \$3,797 in the nine months ended September 30, 2006 and 2005, respectively. The total intrinsic value (the amount by which the stock price exceeds the exercise price of the option on the date of exercise) of the stock options exercised during the three months ended September 30, 2006 and 2005 was \$93 and \$6,342, respectively, and during the nine months ended September 30, 2006 and 2005 was \$12,717 and \$10,740, respectively. The Company has not realized any tax benefits for tax deductions from awards exercised in these periods because the Company has tax loss carryforwards available.

The weighted average fair value of stock options granted in the three months ended September 30, 2006 and 2005 was \$4.52 and \$2.91, respectively, and in the nine months ended September 30, 2006 and 2005 was \$4.65 and \$2.63, respectively. The fair value of each stock option grant on the date of grant was estimated using the Black-Scholes option-pricing model based on the following weighted average assumptions:

|                         | Three months ended<br>September 30, |       | Nine months ended<br>September 30, |       |
|-------------------------|-------------------------------------|-------|------------------------------------|-------|
|                         | 2006                                | 2005  | 2006                               | 2005  |
| Risk-free interest rate | 4.55%                               | 4.02% | 4.55%                              | 3.78% |
| Expected life (years)   | 5.1                                 | 2.0   | 5.2                                | 2.4   |
| Expected volatility     | 30%                                 | 30%   | 30%                                | 30%   |
| Expected dividend yield | 3.16%                               | 2.75% | 3.16%                              | 2.87% |

The risk-free rate is based on the term structure of interest rates at the time of the option grant. The expected life represents an estimate of the period of time that options are expected to remain outstanding. Assumptions of expected volatility of the Company's common stock and expected dividend yield are estimates of future volatility and dividend yields based on historical trends.

The following table summarizes information about stock options outstanding that are expected to vest and stock options outstanding that are exercisable at September 30, 2006:

| Shares    | Options Outstanding, Expected to Vest |                           |                                 | Shares    | Options Outstanding, Exercisable |                           |                                 |
|-----------|---------------------------------------|---------------------------|---------------------------------|-----------|----------------------------------|---------------------------|---------------------------------|
|           | Weighted-Average Exercise Price       | Aggregate Intrinsic Value | Weighted-Average Remaining Term |           | Weighted-Average Exercise Price  | Aggregate Intrinsic Value | Weighted-Average Remaining Term |
| 4,974,381 | \$14.77                               | \$14,285                  | 5.5 years                       | 3,801,217 | \$14.84                          | \$10,389                  | 4.5 years                       |

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The following table summarizes information about the Company's Rights during the nine months ended September 30, 2006.

|                                | Number    | Weighted-Average |
|--------------------------------|-----------|------------------|
|                                | Of Units  | Fair Value       |
| Non-vested, January 1, 2006    | 1,832,946 | \$ 12.01         |
| Granted                        | 216,430   | 18.63            |
| Forfeited                      | (14,390)  | 12.20            |
| Vested / Issued                | (439,394) | 14.47            |
| Non-vested, March 31, 2006     | 1,595,592 | 12.89            |
| Granted                        | 10,698    | 19.44            |
| Forfeited                      | (14,996)  | 12.67            |
| Vested / Issued                | (207,100) | 9.66             |
| Non-vested, June 30, 2006      | 1,384,194 | 13.40            |
| Granted                        | 32,775    | 18.14            |
| Forfeited                      | (14,261)  | 13.10            |
| Vested / Issued                | (17,930)  | 14.03            |
| Non-vested, September 30, 2006 | 1,384,778 | 13.50            |

As of September 30, 2006, there were 1,384,778 non-vested Rights outstanding, of which 1,186,378 Rights vest upon meeting certain service conditions and 198,400 Rights vest upon satisfying established performance goals. Of the 1,186,378 Rights that vest upon meeting service conditions, 394,000 Rights have accelerated vesting provisions based upon meeting established market conditions. Fifty percent of these Rights vest upon the fair market value of the Company's stock price exceeding 200% of the grant date fair market value for 30 consecutive trading days. The remaining 50% vest on the first anniversary of such 30<sup>th</sup> consecutive trading date or, if earlier, the vesting date. During the second quarter of 2006, the vesting acceleration conditions of 372,000 Rights were satisfied. Fifty percent of these Rights vested on May 9, 2006 and the remaining 50% will vest on the first anniversary. If the fair market value of the Company's stock exceeds \$28.55 for 30 consecutive days, 208,000 Rights will meet the market condition. The vesting acceleration conditions related to these Rights were not satisfied as of September 30, 2006.

**4. Net Income Per Common Share**

For the purpose of computing diluted net income per share, the weighted-average number of shares outstanding was increased by 1,658,331 and 2,252,716 for the three-month periods ended September 30, 2006 and 2005, respectively, and 2,227,755 and 1,743,316 for the nine-month periods ended September 30, 2006 and 2005, respectively, to account for the potential dilutive effects of stock-based incentive plans. As of September 30, 2006, there were 5,082,948 options for shares of common stock outstanding of which 4,043,792 were considered dilutive. As of September 30, 2005, there were 6,727,380 options for shares of common stock outstanding of which 6,722,380 were considered dilutive. There were no adjustments to net income for the purposes of computing income available to common stockholders for those periods.

The Convertible Senior Subordinated Notes are convertible, under certain circumstances, into a combination of cash and common stock of the Company. The conversion price is approximately \$21.08 per share of common stock. As of September 30, 2006, the Company's market price per share did not exceed the conversion price of the notes. As such, under the net share settlement method, there were no potential shares issuable under the notes that were considered dilutive.

**Table of Contents****5. Acquisitions**

On May 17, 2006, the Company completed its acquisition of Heinz Hänggi AG, Stanztechnik ( Heinz Hänggi ) of Bettlach, Switzerland, a developer and manufacturer of high-precision punched and fine-blanked components. Its range of manufacturing solutions allows Heinz Hänggi to serve diversified industries, including high-precision components for transportation suppliers, the power tools sector, the watch industry, consumer electronics, telecommunications, medical devices, and textile machinery sectors. A majority of Heinz Hänggi's sales are in Europe, and it is a significant global producer of orifice plates, used in fuel injectors. Heinz Hänggi is being integrated into the Associated Spring segment. The Company reported \$12,252 in sales from Heinz Hänggi for the period from the acquisition date through September 30, 2006. The purchase price of 162.0 million Swiss francs (\$132,019 U.S. Dollars) was paid through a combination of 122.0 million Swiss francs (\$101,337 U.S. Dollars) in cash and 1,628,676 shares (post-stock split) of Barnes Group Inc. common stock (\$30,682 based upon a market value determined at the time of the purchase agreement). The purchase cost, consisting of the purchase price of \$132,019 plus transaction costs of \$2,455, net of cash acquired of \$7,672, was \$126,802.

On July 31, 2006, the Company acquired the KENT Division ( KENT ) of Premier Farnell. KENT distributes adhesives, sealants, specialty cleaning chemicals, abrasives, tools and other consumables to the European transportation aftermarket and industrial maintenance market. KENT is being integrated into the Barnes Distribution segment. The Company reported \$12,721 in sales from KENT for the period from the acquisition date through September 30, 2006. The purchase price of 23.7 million pounds sterling (\$44,295 U.S. Dollars) was paid in cash. The purchase cost, consisting of the purchase price of \$44,295 plus transaction costs of \$2,392, net of cash acquired of \$1,503, was \$45,184.

The following table summarizes the estimates of fair values of the assets acquired and liabilities assumed at the date of the acquisitions. The Company is in the process of obtaining third-party valuations of certain assets acquired with Heinz Hänggi and KENT. The purchase price allocations are subject to finalization of the valuation of certain assets and liabilities. As a result, preliminary amounts assigned to assets and liabilities are subject to revision.

|                                  | As of<br>Acquisition<br>Dates |
|----------------------------------|-------------------------------|
| Current assets                   | \$ 34,986                     |
| Property, plant and equipment    | 43,976                        |
| Intangible and other assets      | 23,387                        |
| Goodwill                         | 103,198                       |
| <b>Total assets acquired</b>     | <b>205,547</b>                |
| Current liabilities              | (17,405)                      |
| Other liabilities                | (16,156)                      |
| <b>Total liabilities assumed</b> | <b>(33,561)</b>               |
| <b>Net assets acquired</b>       | <b>\$ 171,986</b>             |

During the third quarter of 2006, the Company obtained a third-party valuation of the property, plant and equipment acquired with Heinz Hänggi. As a result of this valuation, property, plant and equipment declined by \$38,438 from the estimates used in the June 30, 2006 balance sheet.

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The following table reflects the unaudited pro forma operating results of the Company for the three months and nine months ended September 30, 2006 and 2005, which give effect to the acquisitions of Heinz Hänggi and KENT as if they had occurred on January 1, 2006 and January 1, 2005, respectively. The pro forma results are based on assumptions that the Company believes are reasonable under the circumstances. The pro forma results are not necessarily indicative of the operating results that would have occurred if the acquisitions had been effective January 1, 2006 and January 1, 2005, nor are they intended to be indicative of results that may occur in the future. The underlying pro forma information includes the historical financial results of the Company, Heinz Hänggi and KENT adjusted for certain items including depreciation and amortization expense associated with the assets acquired and the Company's financing arrangements. The pro forma information does not include the effects of any synergies and cost reduction initiatives related to the acquisitions.

|                              | Three months ended |            | Nine months ended |            |
|------------------------------|--------------------|------------|-------------------|------------|
|                              | September 30,      |            | September 30,     |            |
|                              | 2006               | 2005       | 2006              | 2005       |
| Net sales                    | \$ 327,525         | \$ 296,270 | \$ 989,928        | \$ 906,158 |
| Income before income taxes   | 24,969             | 17,649     | 77,228            | 63,392     |
| Net income                   | 20,074             | 17,030     | 60,319            | 49,317     |
| Net income per common share: |                    |            |                   |            |
| Basic                        | \$ .39             | \$ .35     | \$ 1.18           | \$ 1.01    |
| Diluted                      | .38                | .33        | 1.13              | .98        |

**6. Comprehensive Income**

Comprehensive income includes all changes in equity during a period except those resulting from the investment by, and distributions to, stockholders. For the Company, comprehensive income for the period includes net income and other non-owner changes to equity, which comprise foreign currency translation adjustments and deferred gains and losses related to certain derivative instruments.

**Statements of Comprehensive Income**

(Unaudited)

|  | Three months ended |             | Nine months ended |             |
|--|--------------------|-------------|-------------------|-------------|
|  | September 30,      |             | September 30,     |             |
|  | 2006               | 2005        | 2006              | 2005        |
|  |                    | As Adjusted |                   | As Adjusted |
| Net income   | \$ 18,861          | \$ 15,395   | \$ 55,341         | \$ 44,455   |
| Unrealized gains (losses) on hedging activities, net of income taxes | (76)               | 377         | 39                | 429         |
| Foreign currency translation adjustments                             | 2,765              | 2,777       | 12,311            | (1,372)     |
| Comprehensive income   | \$ 21,550          | \$ 18,549   | \$ 67,691         | \$ 43,512   |

**Table of Contents****7. Inventories**

The components of inventories consisted of:

|                           | September 30,<br>2006 | December 31,<br>2005 |
|---------------------------|-----------------------|----------------------|
| Finished goods            | \$ 112,564            | \$ 100,833           |
| Work-in-process           | 39,747                | 32,105               |
| Raw material and supplies | 33,459                | 26,300               |
|                           | \$ 185,770            | \$ 159,238           |

On January 1, 2006, the Company adopted SFAS No. 151, Inventory Costs, an amendment of Accounting Research Bulletin ( ARB ) No. 43, Chapter 4. This Statement amended the guidance in ARB No. 43 to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material, and required that those items be recognized as current-period charges. Additionally, the Statement required that allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. Adoption of this Statement did not have a material impact on the Company's financial position, results of operations or cash flows.

**8. Goodwill and Other Intangible Assets****Goodwill:**

The following table sets forth the change in the carrying amount of goodwill for each reportable segment and for the Company for the nine-month period ended September 30, 2006:

|                                       | Barnes<br>Distribution | Associated<br>Spring | Barnes<br>Aerospace | Total<br>Company |
|---------------------------------------|------------------------|----------------------|---------------------|------------------|
| January 1, 2006                       | \$ 124,326             | \$ 80,187            | \$ 30,786           | \$ 235,299       |
| Goodwill acquired, net of adjustments | 28,567                 | 78,453               |                     | 107,020          |
| Foreign currency translation          | 532                    | 6,627                |                     | 7,159            |
| September 30, 2006                    | \$ 153,425             | \$ 165,267           | \$ 30,786           | \$ 349,478       |

The changes in the goodwill recorded at Barnes Distribution include \$24,745 of goodwill from the acquisition of KENT during the third quarter of 2006. Additionally, during 2006 Barnes Distribution goodwill was increased as a result of contingent purchase price adjustments for the achievement of certain performance targets related to the Toolcom Supplies Limited ( Toolcom ) acquisition of 0.9 million pounds sterling (approximately \$1,700 U.S. Dollars) and the Service Plus Distributors, Inc. ( Service Plus Distributors ) acquisition of \$1,500. The purchase price allocations of the Toolcom and Service Plus Distributors acquisitions were finalized during the third quarter of 2006 resulting in minor adjustments to intangible asset valuations and the payment of additional costs.

The changes in the goodwill recorded at Associated Spring include \$78,453 of goodwill from the acquisition of Heinz Hänggi during the second quarter of 2006. Additionally, the foreign currency translation adjustment at Associated Spring was due primarily to the effect of the changes in the exchange rate on the goodwill related to the Nitrogen Gas Spring business in Sweden.

The goodwill related to the KENT and Heinz Hänggi acquisitions is not deductible for tax purposes. The purchase price allocations of these acquisitions are subject to finalization of the valuation of certain assets and liabilities. As a result, preliminary amounts assigned to assets and liabilities are subject to revision.



**Table of Contents****Other Intangible Assets:**

Other intangible assets consisted of:

|                                      | Range of<br>Life (Years) | September 30, 2006 |                             | December 31, 2005 |                             |
|--------------------------------------|--------------------------|--------------------|-----------------------------|-------------------|-----------------------------|
|                                      |                          | Gross<br>Amount    | Accumulated<br>Amortization | Gross<br>Amount   | Accumulated<br>Amortization |
| <b>Amortized intangible assets:</b>  |                          |                    |                             |                   |                             |
| Revenue sharing programs             | Up to 30                 | \$ 190,200         | \$ (4,209)                  | \$ 134,000        | \$ (1,957)                  |
| Customer lists/relationships         | 10                       | 28,333             | (5,412)                     | 19,133            | (3,735)                     |
| Patents, trademarks/trade names      | 5-30                     | 24,703             | (3,709)                     | 11,446            | (2,755)                     |
| Other                                | Up to 15                 | 8,262              | (1,454)                     | 3,331             | (658)                       |
|                                      |                          | 251,498            | (14,784)                    | 167,910           | (9,105)                     |
| Foreign currency translation         |                          | 1,300              |                             | 1,038             |                             |
| Unamortized intangible pension asset |                          | 4,006              |                             | 4,006             |                             |
| <b>Other intangible assets</b>       |                          | <b>\$ 256,804</b>  | <b>\$ (14,784)</b>          | <b>\$ 172,954</b> | <b>\$ (9,105)</b>           |

Amortization of intangible assets is expected to increase from approximately \$7,800 in 2006 to \$10,600 in 2010.

During the first nine months of 2006, the Company entered into additional aftermarket RSP agreements with a major aerospace customer, General Electric Company ( General Electric ), under which the Company is the sole supplier of certain aftermarket parts to this customer. As consideration for these agreements, the Company agreed to pay participation fees of \$57,050 of which \$8,500 has been paid and the remainder will be paid through April 2007. Additionally, in March 2006 an adjustment to a previous aftermarket RSP was made which reduced the related intangible asset by \$850.

In connection with the acquisition of Heinz Hänggi in May 2006, the Company recorded intangible assets of \$15,699 related to customer lists and relationships, patents, a non-compete agreement and sales order backlog. In July 2006, in connection with the KENT acquisition, the Company recorded intangible assets of \$7,683 related to customer lists and relationships, trademarks and tradenames.

**9. Business Reorganization**

Business reorganization accruals are included in accrued liabilities. In connection with the Barnes Precision Valve acquisition and a plan to streamline its global operations, the Company recorded certain exit costs in 2005 resulting from a plan to reorganize certain business facilities and involuntarily terminate employees. The Company recorded \$716 of severance costs as assumed liabilities during 2005, which related primarily to involuntary terminations of salaried and hourly personnel at a U.S. facility. Additional costs related to these actions are being expensed as incurred. The Company recorded expense of approximately \$600 during the third quarter of 2006 and approximately \$1,100 through the first nine months of 2006 related to these actions. Management estimates the additional cost of completing this restructuring is \$400. The reorganization is expected to be completed by the end of 2006.

**Table of Contents****10. Debt**

On June 23, 2006, the Company entered into an amended and restated revolving credit agreement which increased the available bank credit to \$400,000, increased the number of participating banks to 17 and permitted borrowings in currencies other than the U.S. Dollar. Other provisions of the revolving credit agreement remained unchanged. Pursuant to the amended and restated agreement, the Company pays interest at an interest rate of LIBOR plus a spread ranging from 0.55% to 1.35% depending on the Company's debt ratio at the time of the borrowing. Additionally, the Company pays a facility fee, calculated on the full amount of the borrowing facility, at a rate ranging from 0.20% to 0.40%, depending on the Company's debt ratio at the end of each calendar quarter. The maturity date of the facility is January 2011. The Company's borrowing capacity is limited by various debt covenants in the agreement. The Company is required to maintain a ratio of consolidated senior debt to EBITDA, as defined in the amended and restated revolving credit agreement, of not more than 3.25 times at the end of each fiscal quarter ending on or before September 30, 2007, after which the ratio will decrease to 3.00 times. In addition, the agreement requires the Company to maintain a ratio of Total Debt to EBITDA, as defined in the amended and restated revolving credit agreement, of not more than 4.00 times for each quarter ending on or before September 30, 2007, and thereafter of not more than 3.75 times at the end of any fiscal quarter. The actual ratio of Total Debt to EBITDA at September 30, 2006 was 2.69 times and would have allowed additional borrowings of \$212,000.

Additionally, on January 11, 2006, the Company amended its 7.66% Senior Notes due November 12, 2007, its 7.80% Senior Notes due November 12, 2010 and its 9.34% Senior Notes due November 21, 2008 (the "Notes"). The amendments conform the restrictive covenants of the Notes with those in the amended and restated revolving credit agreement with respect to permitted acquisitions, restriction on liens, permitted indebtedness, permitted investments and consolidated leverage ratio requirements.

Borrowings under the revolving credit agreement were used, in part, to fund the recent acquisitions (see Note 5) and to repay borrowings and interest under the Company's term loan facility with The Development Bank of Singapore which became due as of June 30, 2006 and the related settlement of forward currency exchange contracts. On June 30, 2006, the Company made a payment of Yen 2,214.3 million (approximately \$19,300 U.S. Dollars), which included a balloon payment of Yen 2,127.0 million (approximately \$18,500 U.S. Dollars) and the final semi-annual principal installment of Yen 87.3 million (approximately \$800 U.S. Dollars), plus interest.

**11. Pension and Other Postretirement Benefits**

Pension and other postretirement benefits expense consisted of the following:

| Pensions                           | Three months ended |          | Nine months ended |          |
|------------------------------------|--------------------|----------|-------------------|----------|
|                                    | September 30,      |          | September 30,     |          |
|                                    | 2006               | 2005     | 2006              | 2005     |
| Service cost                       | \$ 1,197           | \$ 2,675 | \$ 7,463          | \$ 8,302 |
| Interest cost                      | 4,584              | 4,882    | 15,081            | 14,789   |
| Expected return on plan assets     | (6,924)            | (7,410)  | (22,481)          | (23,303) |
| Amortization of transition assets  |                    | (3)      | (1)               | (9)      |
| Amortization of prior service cost | 468                | 294      | 1,261             | 877      |
| Recognized losses                  | 639                | 379      | 1,760             | 930      |
| Settlement loss                    | 376                |          | 376               |          |
| Curtailement gain                  | (33)               | (256)    | (33)              | (722)    |
| Special termination benefits       | 12                 |          | 38                |          |
| Net periodic benefit cost          | \$ 319             | \$ 561   | \$ 3,464          | \$ 864   |

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|                                    | Three months ended |          | Nine months ended |          |
|------------------------------------|--------------------|----------|-------------------|----------|
|                                    | September 30,      |          | September 30,     |          |
| Other Postretirement Benefits      | 2006               | 2005     | 2006              | 2005     |
| Service cost                       | \$ 323             | \$ 176   | \$ 1,410          | \$ 854   |
| Interest cost                      | 1,118              | 1,119    | 3,290             | 3,349    |
| Amortization of prior service cost | 422                | 133      | 873               | 374      |
| Recognized losses                  | 216                | 102      | 690               | 586      |
| Net periodic benefit cost          | \$ 2,079           | \$ 1,530 | \$ 6,263          | \$ 5,163 |

During the third quarter of 2006, the Company updated certain actuarial assumptions underlying the calculation of the net periodic benefit costs related to its U.S. pension and other postretirement benefit plans including its assumptions related to the expected long-term rate of return on assets, salary scale, turnover rates and retirement rates. As a result, the Company's full year 2006 net periodic benefit cost estimate was reduced by approximately \$1,700.

**12. Income Taxes**

The Company's effective tax rate for the first nine months of 2006 was 21.7%, compared with 21.9% for the corresponding period in 2005, and 20.0% for the full year 2005. The 2006 and 2005 effective tax rates include certain discrete items including, in 2005, the tax impact of the gain on the sale of the NASCO joint venture ( NASCO ) offset, in part, by the tax benefits related to the Company being awarded multi-year Pioneer tax status in the Republic of Singapore. The 2006 discrete items include the tax benefits related to the Company being awarded additional multi-year Pioneer tax status in the Republic of Singapore. The Company's effective tax rates in the third quarters of 2006 and 2005 reflect the impact of the discrete items recorded in the period.

**13. Information on Business Segments**

The following tables set forth information about the Company's operations by its three reportable business segments:

|                             | Three months ended |             | Nine months ended |             |
|-----------------------------|--------------------|-------------|-------------------|-------------|
|                             | September 30,      |             | September 30,     |             |
|                             | 2006               | 2005        | 2006              | 2005        |
|                             |                    | As Adjusted |                   | As Adjusted |
| Net sales                   |                    |             |                   |             |
| Barnes Distribution         | \$ 135,417         | \$ 113,959  | \$ 385,316        | \$ 340,906  |
| Associated Spring           | 111,951            | 100,249     | 335,059           | 321,283     |
| Barnes Aerospace            | 77,185             | 59,301      | 218,048           | 171,237     |
| Intersegment sales          | (2,505)            | (1,991)     | (7,597)           | (7,658)     |
| Total net sales             | \$ 322,048         | \$ 271,518  | \$ 930,826        | \$ 825,768  |
| Operating profit            |                    |             |                   |             |
| Barnes Distribution         | \$ 9,175           | \$ 7,373    | \$ 26,999         | \$ 18,391   |
| Associated Spring           | 10,069             | 5,536       | 29,912            | 24,096      |
| Barnes Aerospace            | 11,326             | 6,590       | 30,494            | 18,149      |
| Total operating profit      | 30,570             | 19,499      | 87,405            | 60,636      |
| Interest income             | 230                | 469         | 792               | 903         |
| Interest expense            | (6,768)            | (4,387)     | (16,906)          | (12,892)    |
| Other income (expense), net | (564)              | (159)       | (644)             | 8,238       |
| Income before income taxes  | \$ 23,468          | \$ 15,422   | \$ 70,647         | \$ 56,885   |



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The acquisition of Heinz Hänggi during the second quarter of 2006 added \$145,714 of assets to Associated Spring. The acquisition of Kent during the third quarter of 2006 added \$59,833 of assets to Barnes Distribution. The aftermarket RSP agreements entered into in 2006 added \$57,050 of intangible assets to the Barnes Aerospace segment assets.

Barnes Distribution's operating profit in the third quarter of 2005 includes the positive adjustment of \$1,814 that was recorded to correct inaccuracies in recording inventory receipts from 2000 through 2005. Management concluded that such corrections were immaterial, both quantitatively and qualitatively, to the 2005 financial statements and immaterial to the previously reported results of prior periods to which they relate. Additionally, other income (expense) in the nine-month period ended September 30, 2005 includes the gain of \$8,892 on the sale of NASCO.

## **14. Commitments and Contingencies**

### **Product Warranties**

The Company provides product warranties in connection with the sale of its products. From time to time, the Company is subject to customer claims with respect to product warranties. Product warranty liabilities were not significant as of September 30, 2006.

### **Contingent Payments**

In connection with the Toolcom Supplies Ltd. acquisition in August 2005, 2.2 million pounds sterling of the purchase price were payable within two years of the closing date, contingent upon the occurrence of certain events or the achievement of certain performance targets. In the second quarter of 2006, 0.9 million pounds sterling (approximately \$1,700 U.S. Dollars) had been earned and were paid in the third quarter of 2006. The remaining balance of 1.3 million pounds sterling (approximately \$2,400 U.S. Dollars) as of September 30, 2006 will be recorded if and when paid.

In connection with the Service Plus Distributors acquisition in September 2005, \$3,700 of the purchase price could be earned within three years of the closing date, contingent upon the occurrence of certain events or the achievement of certain performance targets. In the third quarter of 2006, \$1,500 had been earned and will be paid in the fourth quarter of 2006. The remaining balance of \$2,200 as of September 30, 2006 will be recorded if and when paid.

### **Income Taxes**

In the normal course of business, the Company and its subsidiaries are examined by various tax authorities, including the Internal Revenue Service (the IRS). The IRS completed its review of the Company for the tax years 2000 through 2002. The IRS has proposed changes to these tax years which could result in a tax cost of approximately \$16,500, plus a potential penalty of 20% of the tax assessment plus interest. The Company and its advisors believe the Company's tax position on the issues raised by the IRS is correct and, therefore, the Company will vigorously defend its position. The Company and its advisors believe the Company will prevail on this issue. Any additional impact on the Company's liability for income taxes cannot presently be determined, but the Company believes the outcome will not have a material impact on its results of operations, financial position or cash flows.

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With respect to the unaudited consolidated financial information of Barnes Group Inc. for the three-month and nine-month periods ended September 30, 2006 and 2005, PricewaterhouseCoopers LLP reported that they have applied limited procedures in accordance with professional standards for a review of such information. However, their separate report dated November 1, 2006 appearing herein, states that they did not audit and they do not express an opinion on that unaudited consolidated financial information. PricewaterhouseCoopers LLP has not carried out any significant or additional audit tests beyond those that would have been necessary if their report had not been included. Accordingly, the degree of reliance on their report should be restricted in light of the limited nature of the review procedures applied. PricewaterhouseCoopers LLP is not subject to the liability provisions of Section 11 of the Securities Act of 1933, as amended, for their report on the unaudited consolidated financial information because that report is not a report or a part of the registration statement prepared or certified by PricewaterhouseCoopers LLP within the meaning of Sections 7 and 11 of the Securities Act of 1933, as amended.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of

Barnes Group Inc.

We have reviewed the accompanying consolidated balance sheet of Barnes Group Inc. and its subsidiaries as of September 30, 2006, and the related consolidated statements of income for each of the three-month and nine-month periods ended September 30, 2006 and 2005 and the consolidated statements of cash flows for the nine-month periods ended September 30, 2006 and 2005. This interim financial information is the responsibility of the Company's management.

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

Based on our review, we are not aware of any material modifications that should be made to the accompanying consolidated interim financial information for it to be in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 3 to the consolidated financial information, the Company adopted Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*, effective January 1, 2006.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2005, and the related consolidated statements of income, of stockholders' equity and of cash flows for the year then ended, management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2005 and the effectiveness of the Company's internal control over financial reporting as of December 31, 2005; and in our report dated February 24, 2006, we expressed unqualified opinions thereon. The consolidated financial statements and management's assessment of the effectiveness of internal control over financial reporting referred to above are not presented herein. As discussed in Note 3 to the consolidated financial information, the Company adopted Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*, effective January 1, 2006, and accordingly the accompanying December 31, 2005 balance sheet information reflects adjustments relating to this adoption. We have not audited the accompanying balance sheet information.

/s/ PricewaterhouseCoopers LLP  
PricewaterhouseCoopers LLP

Hartford, Connecticut

November 1, 2006

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

Please refer to the Overview found in the Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. This Overview sets forth key management objectives and key performance indicators used by management as well as key industry and economic data tracked by management.

All financial information presented has been adjusted to reflect the Company's change in accounting for stock-based compensation, as of January 1, 2006, as a result of the adoption of SFAS No. 123R. See Note 3 of the Notes to the Consolidated Financial Statements of this Quarterly Report on Form 10-Q for further discussion of the impact of this adjustment.

As discussed in Note 2, the Company's Board of Directors declared a two-for-one stock split in the second quarter of 2006. All share and per-share amounts have been adjusted to reflect the effect of the stock split.

**Third Quarter 2006 Highlights**

In the third quarter, the Company achieved record sales of \$322.0 million, an increase of 18.6% over the 2005 period, reflecting incremental sales from recent acquisitions and organic sales growth within all three business segments. This sales growth, along with operational improvements and cost reductions resulted in a year-over-year increase in operating income of 57.1%.

In July 2006, the Company acquired the KENT Division of Premier Farnell. KENT distributes adhesives, sealants, specialty cleaning chemicals, abrasives, tools and other consumables to the European transportation aftermarket and industrial maintenance market. KENT is being integrated into the Barnes Distribution segment.

Barnes Aerospace added to its aftermarket RSP agreements by entering into an additional aftermarket RSP agreement with General Electric, further expanding its long-term position for aftermarket sales of aircraft engine parts.

**RESULTS OF OPERATIONS****SALES**

| <i>(in millions)</i> | Three months ended |                 |                |              | Nine months ended |                 |                 |              |
|----------------------|--------------------|-----------------|----------------|--------------|-------------------|-----------------|-----------------|--------------|
|                      | September 30,      |                 |                |              | September 30,     |                 |                 |              |
|                      | 2006               | 2005            | \$ Change      | % Change     | 2006              | 2005            | \$ Change       | % Change     |
| Barnes Distribution  | \$ 135.4           | \$ 114.0        | \$ 21.4        | 18.8%        | \$ 385.3          | \$ 340.9        | \$ 44.4         | 13.0%        |
| Associated Spring    | 112.0              | 100.2           | 11.8           | 11.7%        | 335.1             | 321.3           | 13.8            | 4.3%         |
| Barnes Aerospace     | 77.2               | 59.3            | 17.9           | 30.2%        | 218.0             | 171.2           | 46.8            | 27.3%        |
| Intersegment sales   | (2.6)              | (2.0)           | (0.6)          | (25.8)%      | (7.6)             | (7.6)           | 0.0             | 0.8%         |
| <b>Total</b>         | <b>\$ 322.0</b>    | <b>\$ 271.5</b> | <b>\$ 50.5</b> | <b>18.6%</b> | <b>\$ 930.8</b>   | <b>\$ 825.8</b> | <b>\$ 105.0</b> | <b>12.7%</b> |

The Company reported net sales of \$322.0 million in the third quarter of 2006, an increase of \$50.5 million, or 18.6%, over the third quarter of 2005. The sales increase reflected \$23.9 million from recent acquisitions, \$23.2 million of organic sales growth and \$3.4 million from the strengthening of foreign currencies against the U.S. Dollar, mainly in Canada, Europe and Brazil. The third quarter 2005 acquisitions of Toolcom and Service Plus Distributors and the 2006 acquisition of KENT added \$16.3 million of incremental sales to Barnes Distribution while the Heinz Hänggi acquisition in 2006 contributed \$7.6 million of incremental sales to Associated Spring.



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Sales for the nine months ended September 30, 2006 were \$930.8 million, an increase of \$105.0 million, or 12.7%, over the 2005 period driven by \$58.5 million of organic sales growth and \$40.7 million from acquisitions. Toolcom, Service Plus Distributors and KENT added \$28.4 million of incremental sales to Barnes Distribution while the Heinz Hänggi acquisition contributed \$12.3 million of incremental sales to Associated Spring. Additionally, the strengthening of foreign currencies against the U.S. Dollar contributed approximately \$5.8 million of incremental sales.

**Expenses and Operating Income**

| <i>(in millions)</i>                | Three months ended |                       |           |          | Nine months ended |                       |           |          |
|-------------------------------------|--------------------|-----------------------|-----------|----------|-------------------|-----------------------|-----------|----------|
|                                     | 2006               | September 30,<br>2005 | \$ Change | % Change | 2006              | September 30,<br>2005 | \$ Change | % Change |
|                                     |                    | As Adjusted           |           |          |                   | As Adjusted           |           |          |
| Cost of sales                       | \$ 203.5           | \$ 172.1              | \$ 31.4   | 18.3%    | \$ 592.5          | \$ 526.6              | \$ 65.9   | 12.5%    |
| % of sales                          | 63.2%              | 63.4%                 |           |          | 63.7%             | 63.8%                 |           |          |
| Gross profit                        | \$ 118.6           | \$ 99.4               | \$ 19.2   | 19.2%    | \$ 338.3          | \$ 299.2              | \$ 39.1   | 13.1%    |
| % of sales                          | 36.8%              | 36.6%                 |           |          | 36.3%             | 36.2%                 |           |          |
| Selling and administrative expenses | \$ 88.0            | \$ 80.0               | \$ 8.0    | 10.0%    | \$ 250.9          | \$ 238.8              | \$ 12.1   | 5.1%     |
| % of sales                          | 27.3%              | 29.5%                 |           |          | 26.9%             | 28.9%                 |           |          |
| Operating income                    | \$ 30.6            | \$ 19.5               | \$ 11.1   | 57.1%    | \$ 87.4           | \$ 60.4               | \$ 27.0   | 44.6%    |
| % of sales                          | 9.5%               | 7.2%                  |           |          | 9.4%              | 7.3%                  |           |          |

Operating income was \$30.6 million in the third quarter of 2006, an increase of 57.1% over 2005. For the year-to-date period, operating income improved to \$87.4 million, a 44.6% increase. All three business segments contributed to the increase in operating income. Operating income margin for the quarter improved to 9.5% from 7.2% a year ago and on a year-to-date basis to 9.4% from 7.3%.

Cost of sales increased 18.3% in the third quarter of 2006 over the same period in 2005, in line with the 18.6% increase in sales. Overall gross profit margins improved 0.2 percentage points, a result of gross profit margins improvements at all three business segments which was due in part to sales mix changes and operating efficiencies. Additionally, the 2005 result includes an adjustment to accounts payable and cost of sales at Barnes Distribution to correct inaccuracies in recording inventory receipts from 2000 through 2005. This adjustment reduced cost of sales by \$1.8 million in 2005.

Selling and administrative expenses increased 10.0% in the third quarter, but declined 2.2 percentage points when measured as a percentage of sales. This reduction was due in part to lower stock-based compensation expense and lower expenses as a percentage of sales at Associated Spring and Barnes Aerospace.

**Other Income/Expense**

Other income, net of other expense, decreased in the three-month period ended September 30, 2006 as compared to the 2005 period as a result of foreign exchange losses in the 2006 period compared to foreign exchange gains in the 2005 period and lower interest income in 2006. For the nine-month period, other income, net of other expenses, decreased mainly as a result of the sale of the Company's investment in NASCO in the second quarter of 2005 which resulted in a gain of \$8.9 million.

Interest expense increased in 2006 compared to 2005 due to higher average borrowings used primarily to fund recent acquisitions.

**Table of Contents****Income Taxes**

The Company's effective tax rate for the first nine months of 2006 was 21.7% compared with 21.9% for the corresponding period in 2005, and 20.0% for the full year 2005. The 2006 and 2005 effective tax rates include certain discrete items including, in 2005, the tax impact of the gain on the sale of the NASCO joint venture offset, in part, by the tax benefits related to the Company being awarded multi-year Pioneer tax status in the Republic of Singapore. The 2006 discrete items include the tax benefits related to the Company being awarded additional multi-year Pioneer tax status in the Republic of Singapore. The major item that could impact the future tax rates is the mix of income between the U.S. and the various foreign operations.

In the normal course of business, the Company and its subsidiaries are examined by various tax authorities, including the IRS. The IRS completed its review of the Company for the tax years 2000 through 2002. The IRS has proposed changes to these tax years which could result in a tax cost of approximately \$16.5 million, plus a potential penalty of 20% of the tax assessment plus interest. The Company and its advisors believe the Company's tax position on the issues raised by the IRS is correct and, therefore, the Company will vigorously defend its position. The Company and its advisors believe the Company will prevail on this issue. Any additional impact on the Company's liability for income taxes cannot presently be determined, but the Company believes the outcome will not have a material impact on its results of operations, financial position or cash flows.

**Net Income and Net Income Per Share**

| <i>(in millions, except per share)</i> | Three months ended |               |           |          | Nine months ended |               |           |          |
|--|--------------------|---------------|-----------|----------|-------------------|---------------|-----------|----------|
|  | 2006               | September 30, |           | % Change | 2006              | September 30, |           | % Change |
|  |                    | 2005          | \$ Change |          |                   | 2005          | \$ Change |          |
|  |                    | As Adjusted   |           |          |                   | As Adjusted   |           |          |
| Net income                             | \$ 18.9            | \$ 15.4       | \$ 3.5    | 22.5%    | \$ 55.3           | \$ 44.5       | \$ 10.8   | 24.5%    |
| Net income per share:                  |                    |               |           |          |                   |               |           |          |
| Basic                                  | \$ .36             | \$ .32        | \$ .04    | 12.5%    | \$ 1.10           | \$ .95        | \$ .15    | 15.8%    |
| Diluted                                | .35                | .31           | .04       | 12.9%    | 1.06              | .91           | .15       | 16.5%    |
| Average common shares outstanding:     |                    |               |           |          |                   |               |           |          |
| Basic                                  | 51.9               | 47.4          | 4.5       | 9.4%     | 50.2              | 47.0          | 3.2       | 6.8%     |
| Diluted                                | 53.5               | 49.6          | 3.9       | 7.8%     | 52.4              | 48.7          | 3.7       | 7.5%     |

Net income increased 22.5% in the third quarter of 2006 compared to 2005. An increase in basic and diluted average shares outstanding adversely impacted the increase in earnings per share when compared to the increase in net income. Basic and diluted average shares outstanding increased 9.4% and 7.8%, respectively, as a result of 1,628,676 (post-stock split) shares issued for the Heinz Hänggi acquisition and shares issued for employee stock plans.

The 2005 third quarter included \$2.6 million (\$0.05 per diluted share) of Singapore Pioneer Status tax benefit that related to income reported in prior periods and the \$1.1 million after-tax (\$0.02 per diluted share) favorable adjustment to cost of sales at Barnes Distribution. The 2005 year-to-date period included \$1.4 million (\$0.03 per diluted share) of Singapore Pioneer Status tax benefit related to income reported in periods prior to January 1, 2005, the \$1.1 million after-tax (\$0.02 per diluted share) favorable adjustment to cost of sales at Barnes Distribution and the after-tax impact of the gain on the sale of NASCO of \$4.0 million (\$0.08 per diluted share).

**Table of Contents****Financial Performance by Business Segment****Barnes Distribution**

| <i>(in millions)</i> | Three months ended |               |           |          | Nine months ended |               |           |          |
|----------------------|--------------------|---------------|-----------|----------|-------------------|---------------|-----------|----------|
|                      | 2006               | September 30, |           | % Change | 2006              | September 30, |           | % Change |
|                      |                    | 2005          | \$ Change |          |                   | 2005          | \$ Change |          |
|                      |                    | As Adjusted   |           |          |                   | As Adjusted   |           |          |
| Sales                | \$ 135.4           | \$ 114.0      | \$ 21.4   | 18.8%    | \$ 385.3          | \$ 340.9      | \$ 44.4   | 13.0%    |
| Operating profit     | 9.2                | 7.4           | 1.8       | 24.4%    | 27.0              | 18.4          | 8.6       | 46.8%    |
| Operating margin     | 6.8%               | 6.5%          |           |          | 7.0%              | 5.4%          |           |          |

Barnes Distribution achieved sales of \$135.4 million in the third quarter of 2006, an 18.8% increase over the third quarter of 2005 reflecting sales from acquisitions of 14.3%, organic sales growth of 3.1% and the favorable impact of foreign currencies of 1.4%. Sales were \$385.3 million in the first nine months of 2006, a 13.0% increase over the comparable 2005 period. Sales growth in the third quarter of 2006 as compared to the 2005 period was driven by incremental sales from the 2005 acquisitions of Toolcom and Service Plus Distributors and the 2006 acquisition of KENT of \$16.3 million and organic sales growth of \$3.5 million. Organic sales growth in the three-month and nine-month periods was driven by further market penetration in North America, particularly in Corporate accounts and Tier II relationships. Foreign currency favorably impacted sales by approximately \$1.6 million in the third quarter of 2006.

Barnes Distribution's operating profit for the third quarter of 2006 increased 24.4% and operating profit in the first nine months of 2006 increased 46.8%. Operating profit increases in both periods were positively impacted by contributions from recent acquisitions, higher sales and lower stock-based compensation expense. Partially offsetting these factors was a shift in the business mix and additional supplier costs which were not offset fully by higher selling prices. Additionally, as discussed previously, in the third quarter of 2005, Barnes Distribution recorded the out-of-period \$1.8 million reduction to costs of sales which positively impacted operating profit.

Outlook: Barnes Distribution continues to focus on organic sales growth with an emphasis on expanding its strategic growth initiatives, including Corporate accounts and Tier II relationships, and its team selling model. In addition, management is aggressively pursuing product cost recovery through higher pricing. Organic growth may be impacted by the health of the economies in which Barnes Distribution operates. The acquisition of Premier Farnell's KENT division in the third quarter of 2006 will further enhance Barnes Distribution's European presence. Operating profit is expected to be positively impacted by the KENT acquisition, investments in operational efficiencies and pricing efforts. The integration of KENT is proceeding as planned; however costs associated with the integration may negatively impact operating profits in the near-term.

| <i>(in millions)</i> | Three months ended |               |           |          | Nine months ended |               |           |          |
|----------------------|--------------------|---------------|-----------|----------|-------------------|---------------|-----------|----------|
|                      | 2006               | September 30, |           | % Change | 2006              | September 30, |           | % Change |
|                      |                    | 2005          | \$ Change |          |                   | 2005          | \$ Change |          |
|                      |                    | As Adjusted   |           |          |                   | As Adjusted   |           |          |
| Sales                | \$ 112.0           | \$ 100.2      | \$ 11.8   | 11.7%    | \$ 335.1          | \$ 321.3      | \$ 13.8   | 4.3%     |
| Operating profit     | 10.1               | 5.5           | 4.6       | 81.9%    | 29.9              | 24.1          | 5.8       | 24.1%    |
| Operating margin     | 9.0%               | 5.5%          |           |          | 8.9%              | 7.5%          |           |          |

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Associated Spring's sales for the third quarter of 2006 were \$112.0 million, an 11.7% increase over the third quarter of 2005, and \$335.1 million for the first nine months of 2006, a 4.3% increase over the comparable period of 2005. The third quarter 2006 sales included incremental sales from the Heinz Hänggi acquisition of \$7.6 million. Organic sales grew approximately \$2.4 million, or 2.4%, in the third quarter of 2006, primarily the result of increased sales in the traditional operations. Foreign currency favorably impacted sales by approximately \$1.8 million in the third quarter of 2006.

Associated Spring's operating profit was \$10.1 million in the third quarter of 2006, an 81.9% increase from the comparable 2005 period. The higher operating profit reflects the profit contribution from the recent acquisition of Heinz Hänggi, higher profits at traditional operations and lower stock-based compensation expense compared to the year-ago period. This was offset, in part, by \$0.6 million of reorganization costs related to a plant closure and costs for the transfer of certain production to lower-cost facilities. On a year-to-date basis, operating profit increased 24.1% to \$29.9 million primarily as a result of similar profit contribution trends and lower operating profit from the specialty operations.

Outlook: Management continues to focus on broad-based growth in its specialty and traditional operations. Specialty operations continue to improve from a slowdown in sales during the first half of 2006, a trend that management expects to continue based upon customer order forecasts, new program wins and an increasing backlog. Associated Spring continues to strengthen its specialty operations through investments in capacity, geographic expansion and acquisitions, such as the second quarter 2006 acquisition of Heinz Hänggi which expanded its product scope and geographic presence. While management expects continued modest sales growth in its traditional business in the fourth quarter, decreases are expected from the heavy duty truck market in 2007. Management continues to focus on profitable sales growth through increased product pricing and improving the operational performance of its businesses through the transfer of certain production to lower-cost facilities and other productivity initiatives. The reorganization of Barnes Precision Valve is substantially complete and is expected to be finalized by the end of 2006. The additional cost of completing this restructuring in the fourth quarter is estimated to be approximately \$0.4 million.

**Barnes Aerospace**

| <i>(in millions)</i> | Three months ended |               |           |          | Nine months ended |               |           |          |
|----------------------|--------------------|---------------|-----------|----------|-------------------|---------------|-----------|----------|
|                      | 2006               | September 30, |           | % Change | 2006              | September 30, |           | % Change |
|                      |                    | 2005          | \$ Change |          |                   | 2005          | \$ Change |          |
|                      |                    | As Adjusted   |           |          |                   | As Adjusted   |           |          |
| Sales                | \$ 77.2            | \$ 59.3       | \$ 17.9   | 30.2%    | \$ 218.0          | \$ 171.2      | \$ 46.8   | 27.3%    |
| Operating profit     | 11.3               | 6.6           | 4.7       | 71.9%    | 30.5              | 18.1          | 12.4      | 68.0%    |
| Operating margin     | 14.7%              | 11.1%         |           |          | 14.0%             | 10.6%         |           |          |

Barnes Aerospace's third quarter 2006 sales were \$77.2 million, a 30.2% increase over the third quarter of 2005, and \$218.0 million for the first nine months of 2006, a 27.3% increase over the comparable 2005 period. The third quarter and year-to-date sales increases reflect growth in aftermarket sales of 75.9% and 57.3%, respectively, driven by higher RSP sales and increased overhaul and repair sales. Sales to original equipment manufacturers (OEMs) increased 15.4% and 17.7%, respectively, for the quarter and year-to-date periods on the strength of the OEM backlog. Barnes Aerospace generated orders of \$118.6 million in the third quarter, which included \$68.0 million of commercial OEM orders driven in large part by orders received through a new strategic supply agreement with the Goodrich Aerostructures Group of Rohr, Inc. Direct and indirect military orders were \$25.8 million, a 54% increase over the 2005 third quarter. The order backlog at Barnes Aerospace at the end of the third quarter of 2006 was \$367.7 million, up 36.5% from \$269.3 million at December 31, 2005. Approximately 58% of the backlog at September 30, 2006 is expected to be shipped within the next 12 months.

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Barnes Aerospace's third quarter 2006 operating profit was \$11.3 million, a 71.9% increase from the 2005 period. For the year-to-date period, operating profit in 2006 increased 68.0% to \$30.5 million from the comparable 2005 period. In both periods, operating profit was positively impacted by the profit contribution from the high-margin aftermarket RSPs, and the higher sales volume of the aftermarket business.

Outlook: Management expects continued aftermarket sales growth at Barnes Aerospace based on the strength of the overhaul and repair business and the additional RSPs. The overhaul and repair demand is expected to continue to benefit from recent service requirements on certain parts. Similarly, OEM sales are expected to continue to grow as a result of deliveries against the increased OEM backlog. Barnes Aerospace's participation in a large engine program and other strategic engine programs are expected to positively impact sales. Management is focused on operational improvements and adding capacity to meet increased demand by making capital investments and transferring certain production to Singapore. Operating profits are expected to continue to be positively impacted by the high-margin aftermarket RSPs and contributions from the higher sales volume in the overhaul and repair and OEM businesses. Lead times on raw materials remain long, particularly for titanium. Management continues to attempt to minimize potential exposure to material shortages and price increases through procurement and sales initiatives. Profits could be impacted by raw material prices and availability, the effects of transferring production between facilities, and new product introductions.

**LIQUIDITY AND CAPITAL RESOURCES**

Management assesses the Company's liquidity in terms of its overall ability to generate cash to fund its operating and investing activities. Of particular importance in the management of liquidity are cash flows generated from operating activities, capital expenditure levels, dividends, capital stock transactions, effective utilization of surplus cash positions overseas and adequate lines of credit.

The Company's ability to generate cash from operations in excess of its internal operating needs is one of its financial strengths. Management continues to focus on cash flow and working capital management, and anticipates that operating activities in 2006 will generate significant cash. This operating cash flow may be supplemented with external borrowings to meet near-term organic business expansion and the Company's current financial commitments. Any future acquisitions are expected to be financed through internal cash, borrowings and equity, or a combination thereof.

**Cash Flow**

| <i>(in millions)</i>        | Nine months ended<br>September 30, |                     | \$<br>Change |
|-----------------------------|------------------------------------|---------------------|--------------|
|                             | 2006                               | 2005<br>As Adjusted |              |
| Operating activities        | \$ 69.8                            | \$ 36.9             | \$ 32.9      |
| Investing activities        | (214.1)                            | (59.3)              | (154.8)      |
| Financing activities        | 148.9                              | 15.8                | 133.1        |
| Exchange rate effect        | (0.6)                              | 1.8                 | (2.4)        |
| Increase (decrease) in cash | \$ 4.0                             | \$ (4.8)            | \$ 8.8       |

Operating activities provided \$69.8 million in cash in the first nine months of 2006 compared to \$36.9 million in the first nine months of 2005. In the first nine months of 2006, operating cash flows were positively impacted by the improved operating performance and reduced working capital requirements compared to the 2005 period. The higher usage of working capital in 2005 resulted from a larger investment in inventory at Barnes Aerospace in support of organic sales growth. The year-over-year change in Other operating activities includes the impact of the change in the funding of the Company's contribution to the Company's 401(k) Retirement Savings Plan from cash to stock which resulted in a lower usage of cash in 2006.

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Cash used by investing activities in the first nine months of 2006 included \$96.1 million and \$45.2 million, respectively, for the Heinz Hänggi and KENT acquisitions, net of cash acquired. Capital expenditures in the first nine months of 2006 were \$32.6 million compared to \$18.3 million in the 2005 period. The higher expenditure level in 2006 reflected investments made to increase capacity primarily at Barnes Aerospace. For the Company in total, capital expenditures are expected to be between \$40 and \$45 million for the full year 2006. Included in investing activities in 2005 is \$18.6 million related to the proceeds from the sale of NASCO. Participation fee payments related to the aftermarket RSPs were \$35.4 million, which was \$4.9 million lower than the 2005 period. At September 30, 2006, the Company had a \$48.6 million liability payable in 2006 and 2007 for participation fees under the aftermarket RSPs, which is included in accounts payable.

Cash from financing activities in the first nine months of 2006 included a net increase in borrowings of \$146.0 million compared to an increase of \$27.2 million in the 2005 period. Proceeds from the borrowings in 2006 were used primarily to fund the recent acquisitions and repay borrowings from The Development Bank of Singapore, which became due on June 30, 2006. To a lesser extent, borrowings were also used to finance operating activities in the U.S., particularly working capital requirements, as well as to fund capital expenditures and dividends. Proceeds from the issuance of common stock increased \$18.2 million to \$23.1 million in 2006 as a result of stock option exercises. Total cash used to pay dividends increased in the 2006 period to \$18.3 million from \$14.6 million in the 2005 period due to an increase in the quarterly dividend to \$0.125 per share (effected for the stock split) and the increase in the number of shares outstanding.

At September 30, 2006, the Company held \$32.2 million in cash and cash equivalents, nearly all of which are held outside of the U.S. Since the repatriation of this cash to the U.S. would have adverse tax consequences, the balances remain outside the U.S. to fund future international growth investments, including capital expenditures, acquisitions and aftermarket RSP participation fees.

The Company maintains borrowing facilities with banks to supplement internal cash generation. During the second quarter of 2006, the Company entered into an amended and restated revolving credit agreement which increased the available bank credit to \$400.0 million. At September 30, 2006, \$198.0 million was borrowed at an interest rate of 6.19% under this borrowing facility which matures in January 2011. The Company did not have any borrowings under uncommitted short-term bank credit lines at September 30, 2006.

Borrowing capacity is limited by various debt covenants in the revolving credit agreement. The most restrictive borrowing covenant requires the Company to maintain a ratio of Total Debt to EBITDA, as defined in the revolving credit agreement, of not more than 4.00 times at September 30, 2006. The ratio requirement will decrease to 3.75 times for any fiscal quarter ending after September 30, 2007. The actual ratio at September 30, 2006 was 2.69 times and would have allowed additional borrowings of \$212.0 million.

The Company believes its credit facilities, coupled with cash generated from operations, are adequate for its anticipated future requirements.

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### **OTHER MATTERS**

#### **Critical Accounting Policies**

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant accounting policies are disclosed in Note 1 of the Notes to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. The most significant areas involving management judgments and estimates are described in Management's Discussion and Analysis of Financial Conditions and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. There have been no material changes to such judgments and estimates other than the following change related to stock-based compensation. Actual results could differ from those estimates.

**Stock-Based Compensation:** The Company accounts for its stock-based employee compensation plans at fair value on the grant date and recognizes the related cost in its statement of operations in accordance with SFAS No. 123R, Share-Based Payment, which the Company adopted effective January 1, 2006 utilizing the modified retrospective method. The Company previously accounted for its stock-based employee compensation plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and its related interpretations. The fair values of stock options are estimated using the Black-Scholes option-pricing model. The fair values of other stock awards are estimated based on the market value of the Company's stock price on the grant date. See Note 3 of the Notes to the Consolidated Financial Statements of this Quarterly Report for further discussion.

#### **Recent Accounting Changes**

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109), which is effective for fiscal years beginning after December 15, 2006. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on disclosure and transition. The Company is currently evaluating the impact this Interpretation will have on the Company's financial position, results of operations and cash flows.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB No. 108 was issued in order to eliminate the diversity of practice surrounding how public companies quantify financial statement misstatements and is effective for the Company for the year ending December 31, 2006. The Company is currently evaluating the impact this SAB will have on the Company's financial position, results of operations and cash flows.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This Statement defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and expands disclosures about fair value measurements. This Statement will be effective for the Company in 2008. The Company is currently evaluating the impact this Statement will have on the Company's financial position, results of operations and cash flows.

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In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. This Statement requires an employer to recognize the overfunded or underfunded status of its defined benefit postretirement plans as an asset or liability in its statement of financial position and to recognize changes in the funded status on comprehensive income in the year in which the changes occur. This Statement will be effective for the Company for the year ending December 31, 2006. The Company is currently evaluating the impact this Statement will have on the Company's financial position, results of operations and cash flows.

**EBITDA**

Earnings before interest, taxes, depreciation and amortization (EBITDA) for the first nine months of 2006 were \$118.2 million compared to \$95.6 million in the first nine months of 2005. Included in the \$95.6 million in 2005 is \$8.9 million related to the gain on the sale of NASCO, the \$2.6 million tax benefit related to the Pioneer Status in Singapore and the \$1.8 million favorable adjustment to cost of sales at Barnes Distribution. EBITDA is a measurement not in accordance with generally accepted accounting principles (GAAP). The Company defines EBITDA as net income plus income taxes, interest expense and depreciation and amortization which the Company incurs in the normal course of business. The Company does not intend EBITDA to represent cash flows from operations as defined by GAAP, and the reader should not consider it as an alternative to net income, net cash provided by operating activities or any other items calculated in accordance with GAAP, or as an indicator of the Company's operating performance. The Company's definition of EBITDA may not be comparable with EBITDA as defined by other companies. Accordingly, the measurement has limitations depending on its use. The Company believes EBITDA is commonly used by financial analysts and others in the industries in which the Company operates and, thus, provides useful information to investors.

Following is a reconciliation of EBITDA to the Company's net income (in millions):

|                               | Nine months ended<br>September 30, |             |
|-------------------------------|------------------------------------|-------------|
|                               | 2006                               | 2005        |
|                               |                                    | As Adjusted |
| Net income                    | \$ 55.3                            | \$ 44.5     |
| Add back:                     |                                    |             |
| Income taxes                  | 15.3                               | 12.4        |
| Depreciation and amortization | 30.7                               | 25.8        |
| Interest expense              | 16.9                               | 12.9        |
| <br>EBITDA                    | <br>\$ 118.2                       | <br>\$ 95.6 |

**Forward-looking Statements**

This quarterly report may contain certain forward-looking statements as defined in the Private Securities Litigation and Reform Act of 1995. These forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from those expressed in the forward-looking statements. The risks and uncertainties, which are described in our periodic filings with the Securities and Exchange Commission, include, among others, uncertainties arising from the behavior of financial markets; future financial performance of the industries or customers that we serve; changes in market demand for our products and services; integration of acquired businesses; changes in raw material prices and availability; our dependence upon revenues and earnings from a small number of significant customers; uninsured claims; and numerous other matters of global, regional or national scale, including those of a political, economic, business, competitive, regulatory and public health nature. The Company assumes no obligation to update our forward-looking statements.



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**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

There has been no significant change in the Company's exposure to market risk during the first nine months of 2006. For discussion of the Company's exposure to market risk, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

**Item 4. Controls and Procedures**

Management, including the Company's President and Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based upon, and as of the date of, that evaluation, the President and Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective, in all material respects, to ensure that information required to be disclosed in the reports the Company files and submits under the Securities Exchange Act of 1934 (the Exchange Act), as amended, (i) is recorded, processed, summarized and reported as and when required, and (ii) is accumulated and communicated to the Company's management, including our President and Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

**Table of Contents****PART II. OTHER INFORMATION****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds****(c) Issuer Purchases of Equity Securities**

| Period               | (a)<br>Total Number<br>of Shares (or<br>Units)<br>Purchased <sup>(1)</sup> | (b)<br>Average Price<br>Paid Per Share<br>(or Unit) <sup>(1)</sup> | (c)<br>Total Number of<br>Shares (or Units)<br>Purchased as Part<br>of Publicly<br>Announced Plans<br>or Programs | (d)<br>Maximum<br>Number (or<br>Approximate<br>Dollar Value) of<br>Shares (or Units)<br>that May Yet Be<br>Purchased Under<br>the Plans or<br>Programs <sup>(3)</sup> |
|----------------------|--|--|---|---|
| July 1-31, 2006      |  | \$   |   | 561,552   |
| August 1-31, 2006    | 4,949  | \$ 16.23   | 1,100   | 560,452   |
| September 1-30, 2006 | 638  | \$ 16.71   |   | 560,452   |
| Total                | 5,587 <sup>(2)</sup>   | \$ 16.29   | 1,100   |   |

(1) Share and per-share amounts reflect the two-for-one stock split in the second quarter of 2006.

(2) Other than 1,100 shares purchased in the third quarter of 2006 which were purchased as part of the Company's publicly announced plan, all acquisitions of equity securities during the third quarter of 2006 were the result of the operation of the terms of the Company's stockholder-approved equity compensation plans and the terms of the equity rights granted pursuant to those plans to pay for the related income tax upon issuance of shares. The purchase price of a share of stock used for tax withholding is the market price on the date of the exercise of the option.

(3) The program was publicly announced on April 12, 2001 authorizing repurchase of up to 1 million shares of its common stock. The 2-for-1 stock split did not impact these amounts.

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**Item 6. Exhibits**

**(a) Exhibits**

|              |  |
|--------------|--|
| Exhibit 15   | Letter regarding unaudited interim financial information.  |
| Exhibit 31.1 | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| Exhibit 31.2 | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| Exhibit 32   | Certification Pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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**SIGNATURES**

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

Date: November 3, 2006

Barnes Group Inc.  
(Registrant)

/s/ WILLIAM C. DENNINGER  
**William C. Denninger**

**Senior Vice President, Finance**

**Chief Financial Officer**

**(the principal Financial Officer)**

Date: November 3, 2006

/s/ FRANCIS C. BOYLE, JR.  
**Francis C. Boyle, Jr.**

**Vice President, Controller**

**(the principal Accounting Officer)**

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**EXHIBIT INDEX**

**Barnes Group Inc.**

**Quarterly Report on Form 10-Q**

**For Quarter ended September 30, 2006**

| <b>Exhibit No.</b> | <b>Description</b>   | <b>Reference</b>            |
|--------------------|--|-----------------------------|
| 15                 | Letter regarding unaudited interim financial information.  | Filed with this report.     |
| 31.1               | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   | Filed with this report.     |
| 31.2               | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   | Filed with this report.     |
| 32                 | Certification pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. | Furnished with this report. |