

FULLER H B CO  
Form 10-Q  
October 06, 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 2, 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 001-09225

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**H.B. FULLER COMPANY**

(Exact name of Registrant as specified in its charter)

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**Minnesota**  
(State or other jurisdiction of  
incorporation or organization)

**41-0268370**  
(I.R.S. Employer  
Identification No.)

**1200 Willow Lake Boulevard, Vadnais Heights, Minnesota**  
(Address of principal executive offices)

**55110-5101**  
(Zip Code)

**(651) 236-5900**

(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 checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares outstanding of the Registrant's Common Stock, par value \$1.00 per share, was 59,632,460 as of September 29, 2006.

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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****H.B. FULLER COMPANY AND SUBSIDIARIES****Consolidated Statements of Income**

(In thousands, except per share amounts)

(Unaudited)

|   | 13 Weeks Ended       |                    | 39 Weeks Ended       |                    |
|---|----------------------|--------------------|----------------------|--------------------|
|   | September 2,<br>2006 | August 27,<br>2005 | September 2,<br>2006 | August 27,<br>2005 |
| <b>Net revenue</b>  | \$ 388,949           | \$ 358,091         | \$ 1,125,742         | \$ 1,099,003       |
| Cost of sales   | (278,610)            | (260,509)          | (805,881)            | (811,158)          |
| Gross profit  | 110,339              | 97,582             | 319,861              | 287,845            |
| Selling, general and administrative expenses  | (75,739)             | (73,460)           | (230,651)            | (232,290)          |
| Gains (losses) from sales of assets   | (14)                 | 278                | 831                  | 7,076              |
| Other income (expense), net   | 274                  | (25)               | 280                  | (839)              |
| Interest expense  | (4,575)              | (2,942)            | (12,285)             | (9,166)            |
| <b>Income before income taxes, minority interests, and income from equity investments</b> | 30,285               | 21,433             | 78,036               | 52,626             |
| Income taxes  | (7,454)              | (6,855)            | (21,779)             | (16,999)           |
| Minority interests in (income) loss of subsidiaries                                       | (259)                | 312                | (993)                | 786                |
| Income from equity investments  | 1,626                | 651                | 3,745                | 1,844              |
| <b>Net income</b>   | \$ 24,198            | \$ 15,541          | \$ 59,009            | \$ 38,257          |
| <b>Net earnings per share:</b>  |                      |                    |                      |                    |
| Basic   | \$ 0.41              | \$ 0.27            | \$ 1.01              | \$ 0.67            |
| Diluted   | \$ 0.40              | \$ 0.26            | \$ 0.99              | \$ 0.66            |
| <b>Weighted-average shares outstanding:</b>   |                      |                    |                      |                    |
| Basic   | 59,157               | 57,635             | 58,643               | 57,335             |
| Diluted   | 60,281               | 58,864             | 59,876               | 58,349             |
| <b>Dividends declared per common share</b>  | \$ 0.06250           | \$ 0.06125         | \$ 0.18625           | \$ 0.1800          |

See accompanying notes to consolidated financial statements.

**H.B. FULLER COMPANY AND SUBSIDIARIES****Consolidated Balance Sheets**

(In thousands, except share and per share amounts)

(Unaudited)

|   | September 2,<br>2006 | December 3,<br>2005 |
|---|----------------------|---------------------|
| <b>Assets</b>   |                      |                     |
| <b>Current assets:</b>  |                      |                     |
| Cash and cash equivalents   | \$ 123,613           | \$ 157,631          |
| Trade receivables   | 241,885              | 246,596             |
| Allowance for doubtful accounts   | (8,099)              | (8,046)             |
| Inventories   | 157,022              | 142,984             |
| Other current assets  | 56,858               | 43,269              |
| <b>Total current assets</b>   | <b>571,279</b>       | <b>582,434</b>      |
| Property, plant and equipment, net  | 310,672              | 298,852             |
| Restricted cash   | 15,000               |                     |
| Other assets  | 126,557              | 128,213             |
| Goodwill  | 196,764              | 80,815              |
| Other intangibles, net  | 172,221              | 17,243              |
| <b>Total assets</b>   | <b>\$ 1,392,493</b>  | <b>\$ 1,107,557</b> |
| <b>Liabilities and Stockholders' Equity</b>   |                      |                     |
| <b>Current liabilities:</b>   |                      |                     |
| Notes payable   | \$ 10,880            | \$ 9,597            |
| Current installments of long-term debt  | 25,000               | 25,240              |
| Trade payables  | 164,799              | 135,292             |
| Accrued payroll and employee benefits   | 44,617               | 47,496              |
| Other accrued expenses  | 34,848               | 30,045              |
| Income taxes payable  | 13,972               | 14,188              |
| <b>Total current liabilities</b>  | <b>294,116</b>       | <b>261,858</b>      |
| Long-term debt, excluding current installments  | 252,000              | 112,001             |
| Accrued pension liabilities   | 101,619              | 96,034              |
| Other liabilities   | 49,821               | 34,218              |
| Minority interests in consolidated subsidiaries   | 17,370               | 16,361              |
| <b>Total liabilities</b>  | <b>714,926</b>       | <b>520,472</b>      |
| <b>Commitments and contingencies</b>  |                      |                     |
| <b>Stockholders' equity:</b>  |                      |                     |
| Preferred stock (no shares outstanding) Shares authorized 10,045,900  |                      |                     |
| Common stock, par value \$1.00 per share, Shares authorized 160,000,000, Shares issued and outstanding 59,632,315 in 2006 and 29,184,754 on a pre-split basis in 2005 | 59,632               | 29,185              |
| Additional paid-in capital  | 82,476               | 58,450              |
| Retained earnings   | 525,319              | 507,217             |
| Accumulated other comprehensive income (loss)   | 10,140               | (7,767)             |

|   |                     |                     |
|---|---------------------|---------------------|
| <b>Total stockholders' equity</b>                 | <u>677,567</u>      | <u>587,085</u>      |
| <b>Total liabilities and stockholders' equity</b> | <u>\$ 1,392,493</u> | <u>\$ 1,107,557</u> |

See accompanying notes to consolidated financial statements.

**H.B. FULLER COMPANY AND SUBSIDIARIES****Consolidated Statements of Cash Flows**

(In thousands)

(Unaudited)

|   | <b>39 Weeks Ended</b>        |                            |
|---|------------------------------|----------------------------|
|   | <b>September 2,<br/>2006</b> | <b>August 27,<br/>2005</b> |
| <b>Cash flows from operating activities:</b>                                  |                              |                            |
| Net income  | \$ 59,009                    | \$ 38,257                  |
| Adjustments to reconcile net income to net cash used in operating activities: |                              |                            |
| Depreciation and amortization   | 37,319                       | 41,347                     |
| Deferred income taxes   | (4,757)                      | (1,809)                    |
| Gains from sales of assets  | (831)                        | (7,076)                    |
| Share-based compensation  | 4,483                        | 1,324                      |
| Excess tax benefit from share-based compensation                              | (5,446)                      |                            |
| Change in assets and liabilities, net of assets and liabilities acquired:     |                              |                            |
| Accounts receivables, net   | 25,836                       | 20,842                     |
| Inventories   | (962)                        | (8,883)                    |
| Other assets  | (11,431)                     | (4,059)                    |
| Accounts payables   | 18,841                       | (20,657)                   |
| Accrued payroll / employee benefits   | (3,825)                      | 7,471                      |
| Other accrued expenses  | 2,101                        | (14,363)                   |
| Restructuring liability   | (240)                        | (2,252)                    |
| Income taxes payable  | 5,161                        | 7,607                      |
| Accrued pension liabilities   | 3,556                        | (457)                      |
| Other liabilities   | 2,375                        | 3,246                      |
| Other   | (1,513)                      | 4,378                      |
| <b>Net cash provided by operating activities</b>                              | <b>129,676</b>               | <b>64,916</b>              |
| <b>Cash flows from investing activities:</b>                                  |                              |                            |
| Purchased property, plant and equipment                                       | (12,838)                     | (17,871)                   |
| Purchased business, net of cash acquired                                      | (309,386)                    |                            |
| Purchased investment  |                              | (2,297)                    |
| Proceeds from sale of business  | 2,515                        |                            |
| Proceeds from sale of investment  |                              | 8,000                      |
| Proceeds from sale of property, plant and equipment                           | 499                          | 11,282                     |
| Proceeds from repayment of note receivable from equity method investee        |                              | 9,781                      |
| <b>Net cash provided by (used in) investing activities</b>                    | <b>(319,210)</b>             | <b>8,895</b>               |
| <b>Cash flows from financing activities:</b>                                  |                              |                            |
| Proceeds from long-term debt  | 195,000                      |                            |
| Repayment of long-term debt   | (55,241)                     | (22,740)                   |
| Net proceeds (payments) from/on notes payable                                 | 1,191                        | (75)                       |
| Dividends paid  | (11,022)                     | (10,421)                   |
| Options exercised   | 14,970                       | 7,440                      |
| Excess tax benefit from share-based compensation                              | 5,446                        |                            |
| Repurchased common stock  | (506)                        | (339)                      |
| <b>Net cash provided by (used in) financing activities</b>                    | <b>149,838</b>               | <b>(26,135)</b>            |
| Effect of exchange rate changes   | 5,678                        | (1,929)                    |
| <b>Net change in cash and cash equivalents</b>                                | <b>(34,018)</b>              | <b>45,747</b>              |
| Cash and cash equivalents at beginning of period                              | 157,631                      | 67,028                     |

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|   |            |            |
|---|------------|------------|
| <b>Cash and cash equivalents at end of period</b> | \$ 123,613 | \$ 112,775 |
|---|------------|------------|

Supplemental disclosure of cash flow information:

|                                   |           |           |
|-----------------------------------|-----------|-----------|
| Dividends paid with company stock | \$ 29,886 | \$ 40     |
| Cash paid for interest            | \$ 9,383  | \$ 12,677 |
| Cash paid for income taxes        | \$ 11,592 | \$ 10,321 |

See accompanying notes to consolidated financial statements.

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**H.B. FULLER COMPANY AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

(Amounts in thousands, except share and per share amounts)

**Note 1: Accounting Policies**

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information necessary for a fair presentation of results of operations, financial position, and cash flows in conformity with U.S. generally accepted accounting principles. In the opinion of management, the interim consolidated financial statements reflect all adjustments of a normal recurring nature considered necessary for a fair presentation of the results for the periods presented. Operating results for interim periods are not necessarily indicative of results that may be expected for the fiscal year as a whole. The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses, and related disclosures at the date of the financial statements and during the reporting period. Actual results could differ from these estimates. These unaudited interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the company's Annual Report on Form 10-K for the year ended December 3, 2005 as filed with the Securities and Exchange Commission.

The company has made certain reclassifications to the fiscal 2005 consolidated financial statements, as previously reported, to conform to current classification. These reclassifications did not change net income as previously reported. Reclassifications associated with the adoptions of SFAS 123R (see Note 3), required certain share-based awards previously reported as liabilities and contra-equity accounts to be classified as additional paid in capital.

On July 13, 2006, the company's board of directors approved a two-for-one stock split of its common stock. The stock split was payable on August 4, 2006 to shareholders of record as of July 28, 2006. The split was in the form of a stock dividend, with shareholders receiving an additional share for each existing share held. All references in the Consolidated Financial Statements to the number of common shares and related per share amounts reflect the effect of the stock split.

On July 13, 2006, the Board of Directors of the company approved a new shareholder rights plan. The shareholder rights plan provides each holder of a share of common stock a right to purchase one one-hundredth of a share of preferred stock for \$95, subject to adjustment. Only whole preferred stock shares can be issued. Preferred Shares purchased upon exercise of the rights will not be redeemable. Each preferred share will be entitled to a preferential quarterly dividend payment, a preferential liquidation payment, voting rights, and participation in any merger, consolidation or other transaction in which common shares are exchanged. These rights are not currently exercisable. However, upon the occurrence of certain events, such as (1) the acquisition of 15 percent or more of the company's outstanding common stock by a person or group of affiliated persons (an "acquiring person") or (2) the public announcement of a tender offer, the consummation of which would result in a person or group of affiliated persons becoming an acquiring person, each right would entitle the holder to purchase \$95 worth of common stock (or in some circumstances common stock of the acquiring person) at one half of its then market value. Rights held by an acquiring person are void. The company may redeem or exchange the rights in certain instances. Unless extended or redeemed, the rights expire on July 31, 2016.

**Recently Issued Accounting Pronouncements:**

In March 2005, the FASB issued FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" (FIN 47). FIN 47 clarifies that a conditional asset retirement obligation, as used in SFAS No. 143, "Accounting for Asset Retirement Obligations," refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of the settlement are conditional on a future event that may or may not be within the control of the entity. The Statement is effective for the company no later than December 2, 2006. The company is in the process of evaluating the impact of FIN 47 on its financial condition, results of operations and cash flows.

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for income taxes by

prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is applicable beginning December 2, 2007. The cumulative effect of applying the provisions of FIN 48, if any, will be reported as an adjustment to the opening balance of retained earnings on December 2, 2007. The company is in the process of evaluating the impact of FIN 48 on its financial condition, results of operations and cash flows.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year's financial statements are materially misstated. SAB 108 requires registrants to apply the new guidance for the first time that it identifies material errors in existence at the beginning of the first fiscal year ending after November 15, 2006 by correcting those errors through a one-time cumulative effect adjustment to beginning-of-year retained earnings. The company is currently evaluating SAB 108 and has not yet determined the impact on its results of operations or financial position.

**Note 2: Acquisitions and Divestitures**

**Autotek Sealants, Inc.:** Autotek provides bonding, sealing and coating technology to the automotive industry. The company's 70 percent owned automotive joint venture acquired a 48 percent ownership in Autotek on May 2, 2001. On September 26, 2005, the joint venture purchased the remaining 52 percent of Autotek for \$894. Consideration consisted of \$500 paid in cash, \$357 in the form of a promissory note and \$37 from direct external costs. The company accounted for this transaction as a step acquisition and began to report 100 percent of Autotek's net results beginning in the fourth quarter of 2005.

The acquisition of the remaining 52 percent adjusted goodwill by \$149 and eliminated the minority interest liability of \$856. In the fourth quarter of 2005, the company repaid the \$500 of debt, which the automotive joint venture guaranteed.

In the first quarter of 2006, the company settled the promissory note to the previous owner for an amount of \$316, which included adjustments for uncollected accounts receivable and an additional tax obligation paid by the company.

The following summarized unaudited pro forma consolidated results of operations are presented as if the acquisition of the remaining 52 percent of Autotek had occurred on November 28, 2004 (beginning of fiscal 2005). The unaudited pro forma results are not necessarily indicative of future earnings or earnings that would have been reported had the acquisition been completed as presented.

|                       | 13 weeks ended  | 39 weeks ended  |
|-----------------------|-----------------|-----------------|
|                       | August 27, 2005 | August 27, 2005 |
| Net revenue           | \$ 358,091      | \$ 1,099,003    |
| Net income            | \$ 15,399       | \$ 37,803       |
| Net income per share: |                 |                 |
| Basic                 | \$ 0.27         | \$ 0.66         |
| Diluted               | \$ 0.26         | \$ 0.65         |

**Sekisui-Fuller Joint Ventures:** In the second quarter of 2005, the company completed its definitive agreements to enter into business-related partnerships in Japan and China with Sekisui Chemical Co., Ltd. In Japan, Sekisui and the company merged their Japanese adhesives businesses on April 1, 2005 to create Sekisui-Fuller Company, Ltd. H.B. Fuller contributed \$15,629 of current assets, \$11,463 of long-term assets, \$8,665 of current liabilities, \$10,639 of long-term liabilities in aggregate, net assets of \$7,788. The long-term assets included \$2,488 of goodwill allocated from the Global Adhesives operating segment. In exchange, H.B. Fuller received a 40 percent ownership in Sekisui-Fuller Company, Ltd. with an option to purchase an additional 10 percent in 2007 for \$12,000. Additionally, the joint venture agreement included provisions requiring the company to fund the operations of the joint venture in the

event such capital contributions are approved by the joint venture board of directors. The merger was accounted for as a formation of a corporate joint venture. As a result, the company's interest in the joint venture was recorded at the carry-over basis of its Japan adhesives business. Therefore, no gain or loss was recorded on the merger. H.B. Fuller will account for this investment under the equity method. Subsequent to closing, \$9,781 of intercompany debt, initially assumed by the joint venture at formation, was retired through a cash payment to the company on April 14, 2005.

With respect to China, the company received \$8,000 from Sekisui on May 26, 2005 in exchange for a 20 percent investment in H.B. Fuller's China entities and an option for Sekisui to increase its investment to 30 percent in 2007 for \$4,000. As a result of the 20 percent investment sold, the company recorded a pre-tax gain of \$4,665. Sekisui's option to purchase an additional 10 percent in 2007 was initially recorded as a liability at a fair value of \$688 and was subsequently marked-to-market at September 2, 2006 to \$608. The company will continue to mark-to-market this liability through earnings in subsequent periods. H.B. Fuller will continue to consolidate China with the portion owned by Sekisui represented as a minority interest liability.

**Roanoke Companies Group, Inc.:** On January 30, 2006, the company signed an asset purchase agreement, under which it agreed to acquire substantially all the assets of Roanoke Companies Group, Inc. and assume certain operating liabilities. On March 17, 2006, the acquisition was completed. Roanoke is a leading U.S. manufacturer of pre-mix grouts, mortars and other products designed to enhance the installation of flooring systems with 2005 revenue of approximately \$80,000. They are focused particularly on the retail home improvement market segment and are included in the company's Full-Valu/Specialty operating segment.

The total purchase price for the acquisition was approximately \$275,384, which includes direct external acquisition costs of \$869. In addition, if certain profitability thresholds are met, certain continuing members of Roanoke's senior management may receive additional cash consideration of up to \$15,000 (in total), which would be paid out over a two-year period. Based on management's review of those profitability thresholds, no amounts have been paid out or accrued as of September 2, 2006.

The company funded the transaction with \$80,384 in existing cash and \$195,000 in new debt. \$15,000 of the purchase price was placed into escrow to cover indemnification by the seller and shareholders. This amount is recorded in long-term restricted cash and other long-term liabilities. The company utilized its revolving credit agreement to provide the initial debt financing. The credit agreement was amended to increase the commitment level to \$250,000, and revise the imbedded accordion feature.

The acquired assets consist primarily of assets used by Roanoke in the operation of its business, including, without limitation, certain real property, intellectual property, equipment, accounts, contracts and intangibles. The valuation of the net assets received involved allocations of the consideration paid to \$20,581 of current assets, \$23,746 of property, plant and equipment, \$146,900 of intangible assets, \$94,894 of goodwill, \$10,581 of current liabilities and \$156 of long-term liabilities. All of the goodwill was assigned to the Full-Valu/Specialty operating segment and is tax deductible over 15 years. Of the \$146,900 of acquired intangibles, \$131,000 and \$15,900 was assigned to customer relationships and trademarks / trade names that have expected lives of 20 years and 15 years, respectively.

The following summarized unaudited pro forma consolidated results of operations are presented as if the acquisition of Roanoke had occurred on November 28, 2004 (beginning of fiscal 2005). The unaudited pro forma results are not necessarily indicative of future earnings or earnings that would have been reported had the acquisition been completed as presented.

|                       | 13 weeks ended  |                   | 39 weeks ended  |                 |
|-----------------------|-----------------|-------------------|-----------------|-----------------|
|                       | August 27, 2005 | September 2, 2006 | August 27, 2005 | August 27, 2005 |
| Net revenue           | \$ 379,585      | \$ 1,149,674      | \$ 1,159,100    |                 |
| Net income            | \$ 17,008       | \$ 59,024         | \$ 41,901       |                 |
| Net income per share: |                 |                   |                 |                 |
| Basic                 | \$ 0.30         | \$ 1.01           | \$ 0.73         |                 |
| Diluted               | \$ 0.29         | \$ 0.99           | \$ 0.72         |                 |

**Henkel KGaA's insulating glass sealant business:** On March 27, 2006, the company signed an asset purchase agreement with Henkel KGaA, under which the company agreed to acquire Henkel's insulating glass sealant business. On June 9, 2006, the acquisition was completed. The insulating glass sealant business manufactures sealants for windows used in both residential and commercial construction. This business has a strong presence in Europe and an expanding presence in Asia. The acquired business is included in the company's Full-Valu/Specialty operating segment.

The total purchase price for the acquisition was approximately \$33,409, which excludes direct external acquisition costs. Direct external costs are expected to be finalized in the fourth quarter of 2006. The company funded the transaction with existing cash.

The acquired assets consist of inventory, manufacturing equipment, and intangibles. The preliminary analysis of the valuation of the net assets received involved allocations of the consideration paid to \$3,166 of current assets, \$1,393 of equipment, \$13,297 of intangible assets, \$15,702 of goodwill and \$149 of long-term liabilities. All of the goodwill was assigned to the Full-Valu/Specialty operating segment and is tax deductible over 5 to 15 years. Of the \$13,297 of acquired intangibles, \$8,358 was assigned to customer relationships with an expected life of approximately 7 years and \$4,939 was assigned to intellectual property and trademarks that have expected lives of 10 years. Allocation of consideration paid is expected to be finalized during the fourth quarter of 2006.

The following summarized unaudited pro forma consolidated results of operations are presented as if the acquisition had occurred on November 28, 2004 (beginning of fiscal 2005). The unaudited pro forma results are not necessarily indicative of future earnings or earnings that would have been reported had the acquisition been completed as presented.

|                       | 13 weeks ended    |                 | 39 weeks ended    |                 |
|-----------------------|-------------------|-----------------|-------------------|-----------------|
|                       | September 2, 2006 | August 27, 2005 | September 2, 2006 | August 27, 2005 |
| Net revenue           | \$ 389,712        | \$ 371,108      | \$ 1,145,202      | \$ 1,139,924    |
| Net income            | \$ 24,208         | \$ 16,110       | \$ 59,250         | \$ 40,046       |
| Net income per share: |                   |                 |                   |                 |
| Basic                 | \$ 0.41           | \$ 0.28         | \$ 1.01           | \$ 0.70         |
| Diluted               | \$ 0.40           | \$ 0.27         | \$ 0.99           | \$ 0.69         |

### Note 3: Accounting for Share-Based Compensation

The company has various share-based compensation programs, which provide for equity awards including stock options, restricted stock and deferred compensation. These equity awards fall under several plans and are described below.

Effective December 4, 2005, the start of the first quarter of fiscal 2006, the company began recording compensation expense associated with share-based awards and other forms of equity compensation in accordance with Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment*, (SFAS 123R) as interpreted by SEC Staff Accounting Bulletin No. 107. SFAS 123R supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS 123R is similar to the approach described in SFAS No. 123, *Accounting For Stock-Based Compensation* (SFAS 123). However, SFAS 123R requires all share-based payments to employees and non-employee directors, including grants of employee stock options, to be recognized in the income statement based on their fair values at the date of grant.

Historically, the company accounted for share-based compensation under the recognition and measurement principles of APB 25 and related interpretations. No compensation expense related to stock option plans was reflected in the company's Consolidated Statements of Income as all options had an exercise price equal to the market value of the underlying common stock on the date of grant. SFAS 123 established accounting and disclosure requirements using a fair-value-based method of accounting for share-based employee compensation plans. As permitted by SFAS 123, the company elected to continue

to apply the intrinsic-value-based method of APB 25, described above, and adopted only the disclosure requirements of SFAS 123, as amended by SFAS No. 148, *Accounting For Stock-Based Compensation - Transition and Disclosure*.

The company adopted the modified prospective transition method provided for under SFAS 123R, and consequently has not retroactively adjusted results from prior periods. Under this transition method, compensation cost associated with share-based awards recognized in the third quarter of fiscal year 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of December 3, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123, and (b) compensation cost for all share-based payments granted subsequent to December 3, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R.

#### Equity Compensation Plans

The company currently grants stock options, restricted stock and stock-based units under equity compensation and deferred compensation plans.

Non-qualified stock options are granted to officers and key employees at prices not less than fair market value at the date of grant. These non-qualified options are generally exercisable beginning one year from the date of grant in cumulative yearly amounts of 25 percent and generally have a contractual term of 10 years. Options exercised represent newly issued shares.

Restricted stock awards are nonvested stock awards that may include grants of restricted stock shares or restricted stock units. Restricted stock awards are independent of option grants and are generally subject to forfeiture if employment terminates prior to the release of the restrictions. Such awards vest in either three, four or ten years from the date of grant or 25 percent per year over a four year period; depending on the grant. During the vesting period, ownership of the shares cannot be transferred. Restricted stock shares granted represent newly issued shares and have the same cash dividend and voting rights as other common stock and are considered to be currently issued and outstanding. Restricted stock units have dividend equivalent rights equal to the cash dividend paid on restricted stock shares. However, restricted stock units do not have voting rights of common stock and are not considered issued and outstanding. Restricted stock units become newly issued shares when vested. The company expenses the cost of the restricted stock awards, which is the grant date fair market value, ratably over the period during which the restrictions lapse. The grant date fair value is the company's closing stock price on the date of grant.

**Directors' Deferred Compensation Plan:** This plan allows non-employee directors to defer all or a portion of their retainer and meeting fees in a number of investment choices, including units representing shares of company common stock. The company provides a 10 percent match on deferred compensation invested in these units. These units are required to be paid out in company common stock.

**1998 Directors' Stock Incentive Plan:** This plan offers non-employee directors incentives to put forth maximum efforts for the success of the business and to afford non-employee directors an opportunity to acquire a proprietary interest in the company. This plan permits granting of (a) restricted stock and (b) shares for amounts non-employee directors deferred under the Directors' Deferred Compensation Plan.

**Year 2000 Stock Incentive Plan:** This plan allows for granting of awards to employees. On April 6, 2006, this plan was amended to, among other things, extend the term of the plan until January 26, 2016. The plan permits granting of (a) stock options; (b) stock appreciation rights; (c) restricted stock awards; (d) performance awards; (e) dividend equivalents; and (f) other awards based on the company's common stock.

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**1992 Stock Incentive Plan:** This plan permitted granting of (a) stock options; (b) stock appreciation rights; (c) restricted stock awards; (d) performance awards; (e) dividend equivalents; and (f) other awards based on the company's common stock. Since inception of the Year 2000 Stock Incentive Plan, no more awards have been granted under this plan.

**Key Employee Deferred Compensation Plan:** This plan allows key employees to defer a portion of their eligible compensation in a number of investment choices, including units, representing shares of company

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common stock. The company provides a 10 percent match on deferred compensation invested in these units. The company also provides a match for certain amounts specified in the plan related to matching contributions under the 401(k) plan.

A summary of shares reserved and available by plan for issuance follows:

|   | Shares Reserved | Shares Available at<br>September 2, 2006 |
|---|-----------------|--|
| Directors Deferred Compensation Plan    | 300,000         | None                                     |
| 1998 Directors Stock Incentive Plan     | 800,000         | 498,956                                  |
| Year 2000 Stock Incentive Plan          | 10,400,000      | 5,522,434                                |
| 1992 Stock Incentive Plan               | 3,600,000       | None                                     |
| Key Employee Deferred Compensation Plan | 400,000         | 99,555                                   |

Grant-Date Fair Value

The company uses the Black-Scholes option pricing model to calculate the grant-date fair value of an award. The fair value of options granted during the 13 and 39 weeks ended September 2, 2006 and August 27, 2005 were calculated using the following assumptions:

|                                       | 13 Weeks Ended <sup>1,2</sup> |                   | 39 Weeks Ended <sup>2</sup> |     |
|---------------------------------------|-------------------------------|-------------------|-----------------------------|-----|
|                                       | September 2, 2006             | September 2, 2006 | August 27,<br>2005          |     |
| Expected life (in years)              | 5.1                           | 5.7               | 7.5                         | 7.5 |
| Weighted-average expected volatility  | 45.51%                        | 45.72%            | 37.90%                      |     |
| Expected volatility                   | 45.50% - 45.62%               | 45.50% - 46.0%    | 37.62% - 37.92%             |     |
| Risk-free interest rate               | 4.99%                         | 4.87%             | 4.30%                       |     |
| Expected dividend yield               | 1.27%                         | 1.31%             | 1.60%                       |     |
| Weighted-average fair value of grants | \$ 8.38                       | \$ 8.45           | \$ 5.82                     |     |

<sup>1</sup> There were no options granted for the 13 week period ended August 27, 2005.

<sup>2</sup> Share data adjusted for effect of 2-for-1 stock split effective July 28, 2006.

**Expected life** The company uses historical employee exercise and option expiration data to estimate the expected life assumption for the Black-Scholes grant-date valuation. The company believes that this historical data is currently the best estimate of the expected term of a new option. The company uses a weighted-average expected life for all awards. As part of its SFAS 123R adoption, the company examined its historical pattern of option exercises in an effort to determine if there were any discernable activity patterns based on certain employee populations. From this analysis, the company identified two employee populations: executives and non-executives. The analysis showed that employees above a specific pay-grade held onto their stock options for a longer period of time as compared to non-executives. Prior to adoption of SFAS 123R, the company calculated the expected life based on one employee population.

**Expected volatility** The company uses the company stock's historical volatility for the same period of time as the expected life. The company has no reason to believe that its future volatility will differ from the past.

**Risk-free interest rate** The rate is based on the U.S. Treasury yield curve in effect at the time of the grant for the same period of time as the expected life.

**Expected dividend yield** The calculation is based on the total expected annual dividend payout divided by the average stock price.

Expense

The company uses the straight-line attribution method to recognize expense for all option awards with graded vesting and restricted stock awards with cliff vesting. The company used the graded attribution method for restricted stock awards with graded vesting issued prior to the adoption of SFAS 123R. All share-based awards issued after the adoption of SFAS 123R will be expensed under the straight-line attribution method.

Some share-based awards are eligible to vest early in the event of retirement, involuntary termination, death, disability or change in control. To be eligible for retirement early vesting, an employee must meet certain age and service requirements. Option awards are eligible for early vesting under retirement if the employee is age 55 or older and has either 5 or 10 years of service, depending upon the grant. Restricted stock awards are eligible for early vesting under retirement if the employee is age 65 or older. All awards early vest in the event of death, disability or change in control. Some restricted stock awards allow for early vesting if the employee is involuntarily terminated.

SFAS 123R requires compensation costs associated with share-based awards to be recognized over the requisite service period, which for the company is the period between the grant date and the earlier of the award's stated vesting term or the date the employee is eligible for retirement. The company immediately recognizes the entire amount of share-based compensation cost for employees that are eligible for retirement at the date of grant. For awards granted to employees approaching retirement eligibility, the company recognizes compensation cost on a straight-line basis over the period from grant date through the retirement eligibility date. Share-based compensation expense for employees who are not retirement eligible is recognized on a straight-line basis over the statutory vesting period of the award.

The amount of share-based compensation recognized during a period is based on the value of the portion of the awards that are ultimately expected to vest. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The term "forfeitures" is distinct from "cancellations" or "expirations" and represents only the unvested portion of the surrendered award. The company currently expects, based on an analysis of its historical forfeitures and known forfeitures on existing awards, that approximately 85 percent and 91 percent of its unvested outstanding options and restricted stock awards will vest, respectively. This analysis will be re-evaluated quarterly and the forfeiture rate will be adjusted as necessary. Ultimately, the actual expense recognized over the vesting period will only be for those shares that vest.

Total share-based compensation expense of \$1,588 and \$4,483 has been included in the company's Consolidated Statements of Income for the 13 and 39 week periods ended September 2, 2006, respectively. Included in this amount is \$772 and \$2,656 of stock option expense for the 13 and 39 week periods ended September 2, 2006, respectively, that was recognized as a result of adopting SFAS 123R. No amount of share-based compensation was capitalized. The impact of adopting SFAS 123R is as follows:

|  | 13 Weeks<br>Ended    | 39 Weeks<br>Ended    |
|--|----------------------|----------------------|
|  | September 2,<br>2006 | September 2,<br>2006 |
| Selling, general and administrative expenses         | \$ (772)             | \$ (2,656)           |
| Share-based compensation expense before income taxes | (772)                | (2,656)              |
| Tax benefit  | 305                  | 1,022                |
| Share-based compensation expense after income taxes  | \$ (467)             | \$ (1,634)           |
| Effect on:   |                      |                      |
| Earnings per share - Basic                           | \$ (0.01)            | \$ (0.03)            |

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|                    |         |    |        |    |        |
|--------------------|---------|----|--------|----|--------|
| Earnings per share | Diluted | \$ | (0.01) | \$ | (0.03) |
|--------------------|---------|----|--------|----|--------|

Prior to the adoption of SFAS 123R, benefits of tax deductions in excess of recognized compensation costs (excess tax benefits) were reported as operating cash flows. SFAS 123R requires that they be recorded as a financing cash inflow rather than a deduction of taxes paid. For the 13 and 39 weeks ended September 2, 2006, there was \$290 and \$5,446 of excess tax benefit recognized resulting from share-based compensation cost.

In November 2005, the FASB issued FASB Staff Position 123(R)-3, *Transition Election Related to Accounting for the Tax Effects of Share-based Payment Awards* ( FSP 123R-3 ). FSP 123R-3 provides an elective alternative transition method of calculating the additional paid in capital pool ( APIC Pool ) of excess tax benefits available to absorb tax deficiencies recognized subsequent to the adoption of SFAS 123R to the method otherwise required by paragraph 81 of SFAS 123R. The company may take up to one year from the effective date of FSP 123R-3 to evaluate its available alternatives and make its one-time election. After evaluating the alternative methods, the company believes it will elect the transitional method described in FSP 123R-3 and used this to estimate its APIC Pool upon adoption of SFAS 123R. Upon adoption of SFAS 123R, the company estimated that its APIC Pool was \$993. Exercises of stock options, restricted stock lapsings and deferred compensation payouts in the 39 weeks ended September 2, 2006 increased the APIC Pool to \$6,142.

The following table details the effect on net income and earnings per share had share-based compensation expense been recorded for the 13 and 39 weeks ended August 27, 2005 based on the fair-value method under SFAS 123. The reported and pro forma net income and earnings per share for the 13 and 39 week periods ended September 2, 2006 are the same since share-based compensation expense was calculated under the provisions of SFAS 123R.

|  | 13 Weeks<br>Ended  | 39 Weeks<br>Ended  |
|--|--------------------|--------------------|
|  | August 27,<br>2005 | August 27,<br>2005 |
| Net income, as reported  | 15,541             | 38,257             |
| Add back: Share-based compensation expense recorded, net of related tax effects  | 435                | 1,134              |
| Net income excluding share-based compensation  | 15,976             | 39,391             |
| Deduct: Total share-based compensation expense determined under fair value based method for all awards, net of related tax effects | (1,012)            | (2,858)            |
| Pro forma net income   | 14,964             | 36,533             |
| Basic income per share:  |                    |                    |
| As reported  | \$ 0.27            | \$ 0.67            |
| Pro forma  | \$ 0.26            | \$ 0.64            |
| Diluted income per share:  |                    |                    |
| As reported  | \$ 0.26            | \$ 0.66            |
| Pro forma  | \$ 0.25            | \$ 0.63            |

As of September 2, 2006, there was \$6,439 of unrecognized compensation costs related to unvested stock option awards, which is expected to be recognized over a weighted-average period of 2.7 years. Unrecognized compensation costs related to unvested restricted stock awards was \$3,373, which is expected to be recognized over a weighted-average period of 2.0 years.

#### Share-based Activity

Option activity for the 39 weeks ended September 2, 2006 was as follows:

| <u>Options</u> | <u>Weighted-</u> |
|----------------|------------------|
|----------------|------------------|

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|                                  |             | <u>Average<br/>Exercise Price</u> |
|----------------------------------|-------------|-----------------------------------|
| Outstanding at December 3, 2005  | 4,311,226   | \$ 13.44                          |
| Granted                          | 46,100      | 19.36                             |
| Exercised                        | (1,189,160) | 12.59                             |
| Forfeited or Cancelled           | (163,656)   | 14.22                             |
|                                  | <hr/>       | <hr/>                             |
| Outstanding at September 2, 2006 | 3,004,510   | \$ 13.82                          |

The fair value of options granted during the 13 weeks ended September 2, 2006 was \$220. No options were granted in the third quarter of 2005. Total intrinsic value of options exercised during the 13 weeks

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ended September 2, 2006 and August 27, 2005 was \$300 and \$2,033, respectively. Intrinsic value is the difference between the company's closing stock price on the respective trading day and the exercise price, multiplied by the number of options exercised. The fair value of options granted during the 39 weeks ended September 2, 2006 and August 27, 2005 was \$390 and \$5,256, respectively. Total intrinsic value of options exercised during the 39 weeks ended September 2, 2006 and August 27, 2005 was \$13,238 and \$2,867, respectively. Proceeds received from option exercises during the 13 and 39 weeks ended September 2, 2006 were \$464 and \$14,970, respectively.

The following table summarizes information concerning outstanding and exercisable options as of September 2, 2006:

| Range of<br>Exercise Prices | Options Outstanding <sup>4</sup> |                   |                    |                    | Options Exercisable <sup>4</sup> |                   |                    |                    |
|-----------------------------|----------------------------------|-------------------|--------------------|--------------------|----------------------------------|-------------------|--------------------|--------------------|
|                             | Options                          | Life <sup>1</sup> | Price <sup>2</sup> | Value <sup>3</sup> | Options                          | Life <sup>1</sup> | Price <sup>2</sup> | Value <sup>3</sup> |
| \$5.01-\$10.00              | 394,798                          | 4.1               | \$ 9.49            | \$ 3,892           | 394,798                          | 4.1               | \$ 9.49            | \$ 3,892           |
| \$10.01-\$15.00             | 1,848,786                        | 6.9               | 13.75              | 10,344             | 970,688                          | 6.1               | 13.46              | 5,713              |
| \$15.01-\$20.00             | 760,926                          | 9.3               | 16.21              | 2,400              | 5,122                            | 5.8               | 15.31              | 21                 |
|                             | 3,004,510                        | 7.1               | \$ 13.82           | \$ 16,636          | 1,370,608                        | 5.5               | \$ 12.33           | \$ 9,626           |

<sup>1</sup> Represents the weighted-average remaining contractual life in years.

<sup>2</sup> Represents the weighted-average exercise price.

<sup>3</sup> Represents the aggregate intrinsic value based on the company's closing stock price on the last trading day of the quarter for in-the-money options.

<sup>4</sup> Share data adjusted for effect of 2-for-1 stock split effective July 28, 2006.

Nonvested restricted stock awards as of September 2, 2006 and changes during the 39 weeks ended September 2, 2006 were as follows:

|                                | Units    | Shares   | Total     | Weighted-Average Grant Date Fair Value | Weighted-Average Remaining Contractual Life (in Years) |
|--------------------------------|----------|----------|-----------|--|--|
| Nonvested at December 3, 2005  | 151,530  | 499,820  | 651,350   | \$ 14.34                               | 2.6  |
| Granted                        |          | 12,474   | 12,474    | 21.57                                  | 3.0  |
| Vested                         | (53,470) | (59,784) | (113,254) | 11.79                                  | 0.5  |
| Forfeited                      | (19,984) | (10,292) | (30,276)  | 14.21                                  | 1.6  |
| Nonvested at September 2, 2006 | 78,076   | 442,218  | 520,294   | \$ 15.07                               | 2.0  |

Total fair value of restricted stock vested during the 13 weeks ended September 2, 2006 and August 27, 2005 was \$1,325 and \$1,316, respectively. Total fair value of restricted stock vested during the 39 weeks ended September 2, 2006 and August 27, 2005 was \$2,957 and \$1,945, respectively. The total fair value of nonvested restricted stock at September 2, 2006 was \$10,068.

The company repurchased 7,306 and 11,348 restricted stock shares during the 13 weeks ended September 2, 2006 and August 27, 2005, respectively, in conjunction with restricted stock share vestings. The company repurchased 20,368 and 21,394 restricted stock shares during the

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39 weeks ended September 2, 2006 and August 27, 2005, respectively, in conjunction with restricted stock share vestings. The repurchases relate to statutory minimum tax withholding. The company does not expect any additional restricted stock shares to be repurchased in fiscal 2006.

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Deferred compensation units are fully vested at the date of contribution. Deferred compensation units outstanding as of September 2, 2006 and changes during the 39 weeks ended September 2, 2006 were as follows:

|                                     | 39 Weeks Ended September 2, 2006 |           |          |
|-------------------------------------|----------------------------------|-----------|----------|
|                                     | Non-employee                     |           |          |
|                                     | Directors                        | Employees | Total    |
| Units outstanding December 3, 2005  | 184,023                          | 180,233   | 364,256  |
| Participant contributions           | 14,708                           | 13,190    | 27,898   |
| Company match contributions         | 15,174                           | 11,804    | 26,978   |
| Payouts                             | (26,218)                         | (31,097)  | (57,315) |
| Units outstanding September 2, 2006 | 187,687                          | 174,130   | 361,817  |

**Note 4: Earnings Per Share:**

A reconciliation of the common share components for the basic and diluted earnings per share calculations follows:

|   | 13 Weeks Ended    |                 | 39 Weeks Ended    |                 |
|---|-------------------|-----------------|-------------------|-----------------|
|   | September 2, 2006 | August 27, 2005 | September 2, 2006 | August 27, 2005 |
| Weighted-average common shares basic                  | 59,157,316        | 57,634,586      | 58,642,511        | 57,335,248      |
| Equivalent shares from share based compensation plans | 1,123,708         | 1,229,834       | 1,233,587         | 1,014,040       |
| Weighted-average common shares diluted                | 60,281,024        | 58,864,420      | 59,876,098        | 58,349,288      |

Basic earnings per share is calculated by dividing net income by the weighted average number of common shares outstanding during the applicable period. Diluted earnings per share is based upon the weighted average number of common and common equivalent shares outstanding during the applicable period. The difference between basic and diluted earnings per share is attributable to share-based compensation awards. The company uses the treasury stock method to calculate the effect of outstanding shares, which computes total employee proceeds as the sum of (a) the amount the employee must pay upon exercise of the award, (b) the amount of unearned share-based compensation costs attributed to future services and (c) the amount of tax benefits, if any, that would be credited to additional paid-in capital assuming exercise of the award. Share-based compensation awards for which total employee proceeds exceed the average market price over the applicable period have an antidilutive effect on earnings per share, and accordingly, are excluded from the calculation of diluted earnings per share.

Share-based compensation awards for 46,275 and 28,520 shares, for the 13 week periods ended September 2, 2006 and August 27, 2005, respectively; and 80,583 and 39,462 shares for the 39 week periods ended September 2, 2006 and August 27, 2005, respectively were excluded from the diluted earnings per share calculation because they were antidilutive.

**Note 5: Comprehensive Income**

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The components of total comprehensive income follows:

|                                   | 13 Weeks Ended       |                    | 39 Weeks Ended       |                    |
|-----------------------------------|----------------------|--------------------|----------------------|--------------------|
|                                   | September 2,<br>2006 | August 27,<br>2005 | September 2,<br>2006 | August 27,<br>2005 |
| Net income                        | \$ 24,198            | \$ 15,541          | \$ 59,009            | \$ 38,257          |
| Other comprehensive income        |                      |                    |                      |                    |
| Foreign currency translation, net | (863)                | (1,839)            | 17,907               | (12,844)           |
| Total comprehensive income        | \$ 23,335            | \$ 13,702          | \$ 76,916            | \$ 25,413          |

Components of accumulated other comprehensive income follows:

| <b>Accumulated Other Comprehensive Income</b>       | <b>September 2,<br/>2006</b> | <b>December 3,<br/>2005</b> |
|---|------------------------------|-----------------------------|
| Foreign currency translation adjustment             | \$ 38,596                    | \$ 20,689                   |
| Minimum pension liability                           | (28,456)                     | (28,456)                    |
| <b>Total accumulated other comprehensive income</b> | <b>\$ 10,140</b>             | <b>\$ (7,767)</b>           |

**Note 6: Components of Net Periodic Benefit Cost related to Pension and Other Postretirement Benefit Plans:**

|                                     | <b>13 Weeks Ended September 2, 2006 and August 27, 2005</b> |               |                       |                 |                                    |                 |
|-------------------------------------|---|---------------|-----------------------|-----------------|------------------------------------|-----------------|
|                                     | <b>Pension Benefits</b>                                     |               |                       |                 | <b>Other</b>                       |                 |
|                                     | <b>U.S. Plans</b>   |               | <b>Non-U.S. Plans</b> |                 | <b>Postretirement<br/>Benefits</b> |                 |
| <b>Net periodic cost (benefit):</b> | <b>2006</b>   | <b>2005</b>   | <b>2006</b>           | <b>2005</b>     | <b>2006</b>                        | <b>2005</b>     |
| Service cost                        | \$ 1,824  | \$ 1,684      | \$ 662                | \$ 473          | \$ 470                             | \$ 515          |
| Interest cost                       | 4,079   | 3,902         | 1,541                 | 1,428           | 978                                | 1,057           |
| Expected return on assets           | (4,964)   | (5,364)       | (1,327)               | (1,006)         | (942)                              | (958)           |
| Amortization:                       |   |               |                       |                 |                                    |                 |
| Prior service cost                  | 126   | 143           | (1)                   | (1)             | (554)                              | (324)           |
| Actuarial loss                      | 1,329   | 462           | 503                   | 259             | 849                                | 907             |
| Transition amount                   |   |               | 9                     | 8               |                                    |                 |
| <b>Net periodic benefit cost</b>    | <b>\$ 2,394</b>   | <b>\$ 827</b> | <b>\$ 1,387</b>       | <b>\$ 1,161</b> | <b>\$ 801</b>                      | <b>\$ 1,197</b> |

|                                     | <b>39 Weeks Ended September 2, 2006 and August 27, 2005</b> |                 |                       |                 |                                    |                 |
|-------------------------------------|---|-----------------|-----------------------|-----------------|------------------------------------|-----------------|
|                                     | <b>Pension Benefits</b>                                     |                 |                       |                 | <b>Other</b>                       |                 |
|                                     | <b>U.S. Plans</b>   |                 | <b>Non-U.S. Plans</b> |                 | <b>Postretirement<br/>Benefits</b> |                 |
| <b>Net periodic cost (benefit):</b> | <b>2006</b>   | <b>2005</b>     | <b>2006</b>           | <b>2005</b>     | <b>2006</b>                        | <b>2005</b>     |
| Service cost                        | \$ 5,472  | \$ 5,052        | \$ 1,917              | \$ 1,545        | \$ 1,410                           | \$ 1,547        |
| Interest cost                       | 12,237  | 11,706          | 4,455                 | 4,496           | 2,934                              | 3,170           |
| Expected return on assets           | (14,892)  | (16,091)        | (3,838)               | (3,169)         | (2,826)                            | (2,874)         |
| Amortization:                       |   |                 |                       |                 |                                    |                 |
| Prior service cost                  | 378   | 429             | (2)                   | 9               | (1,662)                            | (971)           |
| Actuarial loss                      | 3,987   | 1,385           | 1,456                 | 813             | 2,547                              | 2,720           |
| Transition amount                   |   |                 | 26                    | 31              |                                    |                 |
| <b>Net periodic benefit cost</b>    | <b>\$ 7,182</b>   | <b>\$ 2,481</b> | <b>\$ 4,014</b>       | <b>\$ 3,725</b> | <b>\$ 2,403</b>                    | <b>\$ 3,592</b> |

In August 2006, the company began a process to diversify its U.S. Pension asset portfolio. As of September 2, 2006, approximately 25 percent of the reinvestment process was complete. At the end of this process, 100 percent of the portfolio will be reinvested with each reinvestment reflecting a target asset allocation of approximately 80 percent equities and 20 percent fixed income securities. This process is expected to be completed by May 31, 2008.

**Note 7: Inventories**

The composition of inventories follows:

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|                | <b>September 2,<br/>2006</b> | <b>December 3,<br/>2005</b> |
|----------------|------------------------------|-----------------------------|
| Raw materials  | \$ 76,500                    | \$ 70,738                   |
| Finished goods | 97,894                       | 87,721                      |
| LIFO reserve   | (17,372)                     | (15,475)                    |
|                | \$ 157,022                   | \$ 142,984                  |

**Note 8: Derivatives**

Derivatives consisted primarily of forward currency contracts used to manage foreign currency denominated assets and liabilities. Because derivative instruments outstanding were not designated as hedges for accounting purposes, the gains and losses related to mark-to-market adjustments were recognized as other income or expense in the income statements during the periods in which the derivative instruments were outstanding. Management does not enter into any speculative positions with regard to derivative instruments.

As of September 2, 2006, the company had forward foreign currency contracts maturing between September 5, 2006 and July 5, 2007. The fair value effect associated with these contracts was net unrealized gains of \$15 at September 2, 2006.

**Note 9: Commitments and Contingencies**

**Environmental:** Currently the company is involved in various environmental investigations, clean-up activities and administrative proceedings or lawsuits. In particular, the company is currently deemed a potentially responsible party (PRP) or defendant, generally in conjunction with numerous other parties, in a number of government enforcement and private actions associated with hazardous waste sites. As a PRP or defendant, the company may be required to pay a share of the costs of investigation and clean-up of these sites. In addition, the company is engaged in environmental remediation and monitoring efforts at a number of current and former company operating facilities, including an investigation of environmental contamination at its Sorocaba, Brazil facility. Soil and water samples have been collected on and around the Sorocaba facility, and recent test results indicate that certain contaminants, including carbon tetrachloride and other solvents, may exist in the soil at the Sorocaba facility and in the groundwater at both the Sorocaba facility and some neighboring properties. The company is continuing to work with Brazilian regulatory authorities to determine the necessary scope of remediation at the facility and the neighboring properties. As of September 2, 2006, \$2,104 was recorded as a liability for expected investigation and remediation expenses remaining for this site. Once the full scope of any necessary remediation is determined, the company may be required to record additional liabilities related to investigation and remediation costs at the Sorocaba facility.

As of September 2, 2006, the company had recorded \$3,475 as its best probable estimate of aggregate liabilities for costs of environmental investigation and remediation, inclusive of the accrual related to the Sorocaba facility described above. These estimates are based primarily upon internal or third-party environmental studies, assessments as to the company's responsibility, the extent of the contamination and the nature of required remedial actions. The company's current assessment of the probable liabilities and associated expenses related to environmental matters is based on the facts and circumstances known at this time. Recorded liabilities are adjusted as further information develops or circumstances change. Based upon currently available information, management does not believe that any such lawsuits, proceedings and investigations, individually or in aggregate, will have a material adverse effect on the company's long-term financial condition. However, adverse developments could negatively impact the company's results of operations or cash flows in one or more future quarters.

**Product Liability:** As a participant in the chemical and construction products industries, the company faces an inherent risk of exposure to claims in the event that the failure, use or misuse of its products results in or is alleged to result in property damage and/or bodily injury. From time to time and in the ordinary course of business, the company is a party to, or a target of, lawsuits, claims, investigations and proceedings, including product liability, contract, patent and intellectual property, antitrust and employment matters.

A subsidiary of the company is a defendant in numerous exterior insulated finish systems ( EIFS ) related lawsuits. As of September 2, 2006, the company's subsidiary was a defendant in approximately 36 lawsuits and claims related primarily to single-family homes. The EIFS product was used primarily in the residential construction market in the southeastern United States. Some of the lawsuits and claims involve EIFS in commercial or multi-family structures. Lawsuits and claims related to this product seek



monetary relief for water intrusion-related property damages. The company has insurance coverage for certain years with respect to this product line. During the quarter ended June 3, 2006, the company entered into agreements to settle numerous EIFS-related lawsuits and claims, including a lawsuit involving up to 186 homes. In total, the company paid \$5,000 in settlement of these lawsuits and claims, of which insurers have paid \$733 and are expected to pay an additional \$892. As of September 2, 2006, the company had recorded \$1,730 for the probable liabilities and \$1,725 for insurance recoveries, including the \$892 referred to above, for all remaining EIFS-related lawsuits and claims. The company continually reevaluates these amounts.

Based on currently available information, management does not believe that the ultimate outcome of any pending legal proceedings and claims related to this product line, individually or in aggregate, will have a material adverse effect on the company's long-term financial condition. However, adverse developments could negatively impact the company's results of operations or cash flows in one or more future quarters. Given the numerous uncertainties surrounding litigation and the projection of future events, such as the number of new claims to be filed each year and the average cost of disposing of each such claim, the actual costs could be higher or lower than the current estimated reserves or insurance recoveries.

The company and/or its subsidiaries have been named as defendants in lawsuits in which plaintiffs have alleged injury due to products containing asbestos manufactured by the company more than 20 years ago. The plaintiffs generally bring these lawsuits against multiple defendants and seek damages (both actual and punitive) in very large amounts. In many of these cases, the plaintiffs are unable to demonstrate that they have suffered any compensable injuries or that the injuries suffered were the result of exposure to products manufactured by the company or its subsidiaries. The company is typically dismissed as a defendant in these cases without payment. If the plaintiff establishes that compensable injury occurred as a result of exposure to the company's products, the case is generally settled for an amount that reflects the seriousness of the injury, the number and solvency of other defendants in the case, and the jurisdiction in which the case has been brought.

As a result of bankruptcy filings by numerous defendants in asbestos-related litigation and the prospect of national and state legislative reform relating to such litigation, the rate at which plaintiffs filed asbestos-related lawsuits against various companies (including the company) increased in 2001, 2002 and the first half of 2003. In the second half of 2003 and throughout 2004 and 2005, the rate of these filings declined significantly. However, the company currently expects that asbestos-related lawsuits will continue to be filed against the company in the future.

A significant portion of the defense costs and settlements relating to asbestos-related litigation involving the company continues to be paid by third parties, including indemnification pursuant to the provisions of a 1976 agreement under which the company acquired a business from a third party. Historically, this third party routinely defended all cases tendered to it and paid settlement amounts resulting from those cases. In the 1990s, the third party sporadically reserved its rights, but continued to defend and settle all asbestos-related claims tendered to it by the company. In 2002, the third party rejected the tender of certain cases by the company and indicated it would seek contributions from the company for past defense costs, settlements and judgments. However, this third party has continued to defend and pay settlement amounts, under a reservation of rights, in most of the asbestos cases tendered to the third party by the company.

In addition to the indemnification arrangements with third parties, the company has insurance policies that generally provide coverage for asbestos liabilities (including defense costs). Historically, insurers have paid a significant portion of the defense costs and settlements in asbestos-related litigation involving the company. However, certain of the company's insurers are insolvent. During 2005, the company and a number of its insurers entered into a cost-sharing agreement that provides for the allocation of defense costs, settlements and judgments among these insurers and the company in certain asbestos-related lawsuits. Under this agreement, the company is required to fund a share of settlements and judgments allocable to years in which the responsible insurer is insolvent. The cost-sharing agreement applies only to the asbestos litigation involving the company that is not covered by the third-party indemnification arrangements.

In 2004, the company and a group of other defendants (including the third party obligated to indemnify the company against certain asbestos-related claims) entered into negotiations with a group of plaintiffs to settle certain asbestos-related lawsuits. As previously reported and accounted for during the third quarter of 2004, the company agreed to contribute approximately \$3,522 towards the settlement to be paid in these cases in exchange for a full release of claims by the plaintiffs. Of this amount, the company's insurers have agreed to pay approximately \$1,236. The company and its insurers have transferred the required amounts into a trust established to disburse payments related to settlements. On December 1, 2005, \$3,085 was paid out of the trust under the settlement. As of September 2, 2006, the amount the company and its insurers have remaining to pay out of the trust is up to \$437. The company's remaining portion of this is up to \$284 and is recorded as restricted cash, which is included in other current assets. During the first nine months of 2006, the company accrued a total of \$605 for settlements of asbestos-related lawsuits. The company's insurers have paid or are expected to pay \$321 of this amount.

To the extent the company can reasonably estimate the amount of its probable liability for pending asbestos-related claims, the company establishes a financial provision and a corresponding receivable for insurance recoveries if certain criteria are met. As of September 2, 2006, the company had \$992 accrued for probable liabilities and \$504 for insurance recoveries related to asbestos claims. However, the company has concluded that it is not possible to estimate the cost of disposing of other asbestos-related claims (including claims that might be filed in the future) due to its inability to project future events. Future variables include the number of new claims filed, the average cost of disposing of such claims, the uncertainty of asbestos litigation, insurance coverage and indemnification agreement issues, and the continuing solvency of certain insurance companies.

Because of the uncertainties described above, the company cannot accurately estimate the cost of resolving pending and future asbestos-related claims against the company. Based on currently available information, the company does not believe that asbestos-related litigation, individually or in aggregate, will have a material adverse effect on the company's long-term financial condition. However, adverse developments in such litigation could negatively impact the company's results of operations or cash flows in one or more future quarters.

In addition to product liability claims discussed above, the company and its subsidiaries are involved in other claims or legal proceedings related to its products, which it believes are not out of the ordinary in a business of its type and size.

With respect to EIFS and asbestos claims, as well as all other litigation, the company cannot definitively estimate its potential liabilities. While the company is unable to predict the outcome of these matters, it does not believe, based upon currently available information, that the ultimate resolution of any pending matter, including the EIFS and asbestos litigation described above, individually or in aggregate, will have a material adverse effect on its long-term financial condition. However, adverse developments could negatively impact the company's results of operations or cash flows in one or more future quarters.

**Guarantees:** In July 2000, the Board of Directors adopted the Executive Stock Purchase Loan Program, designed to facilitate immediate and significant stock ownership by executives, especially new management employees. During certain designated periods between September 2000 and August 2001, eligible employees were allowed to purchase shares of company common stock in the open market. Under the program, the company arranged for a bank to provide full-recourse, personal loans to eligible employees electing to participate in the program. The loan interest rates were at the Applicable Federal Rate and matured over five years, with principal and interest due at that time. The loans were guaranteed by the company only in the event of the participant's default. The final loan was repaid in the second quarter of 2006.

**Note 10: Restructuring and Other Related Costs:**

The remaining liabilities accrued as part of prior years' restructuring plans were \$116 and \$343 as of September 2, 2006 and December 3, 2005, respectively. Details of the activity for fiscal 2006 are as follows:

|  |        |
|--|--------|
| Total liabilities at December 3, 2005    | \$ 343 |
| Currency change effect                   | 6      |
| Cash payments                            | (233)  |
|  | <hr/>  |
| Total liabilities at September 2, 2006   | 116    |
| Long-term portion of liabilities         | (39)   |
|  | <hr/>  |
| Current liabilities at September 2, 2006 | \$ 77  |
|  | <hr/>  |

**Note 11: Operating Segments**

Management evaluates the performance of its operating segments based on operating income which is defined as gross profit less SG&A expenses and excluding the gains (losses) on sales of assets. Corporate expenses are fully allocated to the operating segments. Segment data for the quarter follows:

|                     | 13 Weeks Ended    |          |           |                 |          |           |
|---------------------|-------------------|----------|-----------|-----------------|----------|-----------|
|                     | September 2, 2006 |          |           | August 27, 2005 |          |           |
|                     | Inter-            |          | Operating | Inter-          |          | Operating |
|                     | Trade             | Segment  |           | Trade           | Segment  |           |
|                     | Revenue           | Revenue  | Income    | Revenue         | Revenue  | Income    |
| Global Adhesives    | \$ 247,543        | \$ 5,019 | \$ 23,469 | \$ 248,299      | \$ 3,522 | \$ 16,036 |
| Full-Valu/Specialty | 141,406           | 830      | 11,131    | 109,792         | 525      | 8,086     |
|                     | <hr/>             |          | <hr/>     | <hr/>           |          | <hr/>     |
| Total               | \$ 388,949        |          | \$ 34,600 | \$ 358,091      |          | \$ 24,122 |
|                     | <hr/>             |          | <hr/>     | <hr/>           |          | <hr/>     |

|  | 39 Weeks Ended    |         |           |                 |         |           |
|--|-------------------|---------|-----------|-----------------|---------|-----------|
|  | September 2, 2006 |         |           | August 27, 2005 |         |           |
|  | Trade             | Inter-  | Operating | Trade           | Inter-  | Operating |
|  | Revenue           | Segment |           | Revenue         | Segment |           |
|  | Revenue           | Income  | Revenue   | Income          | Income  |           |
|  | <hr/>             | <hr/>   | <hr/>     | <hr/>           | <hr/>   | <hr/>     |

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|                     | <u>Revenue</u>    |                   |                   | <u>Revenue</u>    |                   |                   |
|---------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| Global Adhesives    | \$ 746,537        | \$ 7,757          | \$ 63,503         | \$ 772,123        | \$ 6,705          | \$ 36,652         |
| Full-Valu/Specialty | 379,205           | 1,367             | 25,707            | 326,880           | 873               | 18,903            |
|                     | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Total               | \$ 1,125,742      |                   | \$ 89,210         | \$ 1,099,003      |                   | \$ 55,555         |
|                     | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

**Reconciliation of Operating Income to Income before Income Taxes, Minority Interests and Income from Equity Investments:**

|  | <u>13 Weeks Ended</u> |                   | <u>39 Weeks Ended</u> |                   |
|--|-----------------------|-------------------|-----------------------|-------------------|
|  | <u>September 2,</u>   | <u>August 27,</u> | <u>September 2,</u>   | <u>August 27,</u> |
|  | <u>2006</u>           | <u>2005</u>       | <u>2006</u>           | <u>2005</u>       |
| Operating income   | \$ 34,600             | \$ 24,122         | \$ 89,210             | \$ 55,555         |
| Gains (losses) from sales of assets  | (14)                  | 278               | 831                   | 7,076             |
| Interest expense   | (4,575)               | (2,942)           | (12,285)              | (9,166)           |
| Other income (expense), net  | 274                   | (25)              | 280                   | (839)             |
|  | <u>          </u>     | <u>          </u> | <u>          </u>     | <u>          </u> |
| Income before income taxes, minority interests, and income from equity investments | \$ 30,285             | \$ 21,433         | \$ 78,036             | \$ 52,626         |
|  | <u>          </u>     | <u>          </u> | <u>          </u>     | <u>          </u> |

**Note 12: Subsequent Event**

On September 5, 2006, the company acquired Carolina Polymers' polymer and adhesive technology for the multi-wall bag industry. The company acquired inventory, accounts receivable, personal property, intellectual property and customer lists. No other assets or liabilities were purchased. The total initial cash payment was \$4,950 and was funded through existing cash. Carolina Polymers is also entitled to an earn-out of up to \$1,700 based on the company's shipment volume from September 5, 2006 to September 5, 2007. The acquisition will be recorded in the Global Adhesives operating segment.

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

**Overview**

The Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) should be read in conjunction with the MD&A included in the company's Annual Report on Form 10-K for the year ended December 3, 2005 for important background information related to the company's business.

Net income of \$24.2 million in the third quarter of 2006 was 55.7 percent higher than the net income of \$15.5 million in the third quarter of 2005. The net income increase resulted primarily from management's continuing emphasis on repositioning its product portfolio to a more profitable mix of business. Productivity gains and an ongoing focus on process improvements also contributed to the profitability improvement. The gross profit margin of 28.4 percent was 1.1 percentage points above last year's margin of 27.3 percent. Net earnings per share, on a diluted basis, was \$0.40 in the third quarter of 2006 as compared to \$0.26 in the third quarter of 2005.

On June 9, 2006 the company acquired the insulating glass sealant business of Henkel KGaA. The results for the third quarter of 2006 include twelve weeks of the Henkel operations.

Effective December 4, 2005, the company adopted the fair value recognition provisions of SFAS 123R, *Share-Based Payments* (SFAS 123R) using the modified prospective transition method, and therefore has not restated prior periods' results. All share-based compensation expense is recorded as selling, general and administrative expense. Total share-based compensation expense recorded in the third quarter and nine months year-to-date of 2006 was \$1.6 million (\$1.0 million, net of tax) and \$4.5 million (\$2.8 million, net of tax), respectively. Included in these amounts are \$0.8 million (\$0.5 million, net of tax) and \$2.7 million (\$1.6 million, net of tax) of share-based compensation expense for the third quarter and nine months year-to-date 2006, respectively, which represent additional expense recorded as a result of adopting SFAS 123R. Share-based compensation expense recorded for the third quarter and nine months year-to-date for 2005 was \$0.7 million (\$0.4 million, net of tax) and \$1.8 million (\$1.1 million, net of tax), respectively. These amounts would have been \$1.7 million (\$1.0 million, net of tax) and \$4.7 million (\$2.9 million, net of tax) for the third quarter and nine months year-to-date 2005, respectively, had the company recognized share-based expense in the Consolidated Statements of Income under SFAS 123, *Accounting for Stock-Based Compensation* (SFAS 123). Unrecognized compensation expense from unvested share-based awards was \$9.8 million as of September 2, 2006 and is expected to be recognized over a weighted-average period of 2.4 years. See Note 3 for more details.

**Critical Accounting Policies and Significant Estimates**

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Management's discussion and analysis of its results of operations and financial condition are based upon consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. Management believes the critical accounting policies and areas that require the most significant judgments and estimates to be used in the preparation of the consolidated financial statements are pension and other postretirement plan assumptions; goodwill recoverability; product, environmental and other litigation liabilities; and income tax accounting. Except with respect to changes in the manner in which we account for share-based compensation, as discussed below, there have been no material changes to the critical accounting policies as discussed in greater detail in the Management's Discussion and Analysis of Financial Condition and Results of Operations contained in the company's Annual Report on Form 10-K for the fiscal year ended December 3, 2005.

**Share-based Compensation:** The company has granted stock options, restricted stock and deferred compensation awards to certain employees and non-employee directors. The company recognizes compensation expense for all share-based payments granted after December 3, 2005 and prior to but not yet vested as of December 3, 2005, in accordance with SFAS 123R. Under the fair value recognition provisions of SFAS 123R, the company recognizes share-based compensation net of an estimated forfeiture rate and only recognizes compensation cost for those shares expected to vest on a straight-line basis over the requisite service period of the award (normally the vesting period). Prior to SFAS 123R adoption, the company accounted for share-based payments under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ) and accordingly, only recognized compensation expense for restricted stock awards, which had a grant date intrinsic value.

Determining the appropriate fair value model and calculating the fair value of share-based payment awards require the input of highly subjective assumptions, including the expected life of the share-based payment awards and stock price volatility. The company uses the Black-Scholes model to value its stock option awards. Management believes that future volatility will not materially differ from its historical volatility. Thus, the company uses the historical volatility of the company's common stock over the expected life of the award. The assumptions used in calculating the fair value of share-based payment awards represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change and management uses different assumptions, share-based compensation expense could be materially different in the future. In addition, the company is required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If the actual forfeiture rate is materially different from the estimate, share-based compensation expense could be significantly different from what has been recorded in the current period. See Note 3 to the Consolidated Financial Statements for a further discussion on share-based compensation.

**Pension and Other Postretirement Plan Assumptions:** In August 2006, the company began a process to diversify its U.S. Pension asset portfolio. As of September 2, 2006, approximately 25 percent of the reinvestment process was complete. At the end of this process, 100 percent of the portfolio will be reinvested with each reinvestment reflecting a target asset allocation of approximately 80 percent equities and 20 percent fixed income securities. This process is expected to be completed by May 31, 2008. Management will assess the impact of the asset reallocation on the expected return on assets assumption for fiscal 2007, which is based on the company's August 31, 2006 measurement date.

### **Results of Operations**

**Net Revenue:** Net revenue in the third quarter of 2006 of \$388.9 million was \$30.9 million or 8.6 percent above the net revenue of \$358.1 million in the third quarter of 2005. The net revenue increase was driven by the net effect of acquisitions and divestitures, which contributed an increase of \$30 million or 8.4 percent to the net revenue variance compared to last year. The impact on net revenue from foreign currency translation was a positive 1.4 percent as compared to the third quarter of 2005. Increases in selling prices accounted for a net revenue increase of 5.8 percent in the third quarter while sales volume, excluding acquisitions and divestitures, decreased 7.0 percent. The volume decreases and selling price increases were consistent with the company's strategy to reposition its product portfolio.

Through nine months of 2006, net revenue of \$1,125.7 million increased \$26.7 million or 2.4 percent over the first nine months of 2005. The net impact of acquisitions and divestitures accounted for net revenue increases of 2.9 percent while the currency effects accounted for decreases of 0.6 percent. Increases in selling prices contributed a positive 6.7 percent to the net revenue variance to last year and decreases in sales volume accounted for a negative impact of 6.6 percent.

**Cost of Sales:** The cost of sales of \$278.6 million in the third quarter of 2006 was \$18.1 million or 6.9 percent higher than the cost of sales in the third quarter of 2005. The cost of sales from businesses acquired added approximately \$24 million to the third quarter of 2006 as compared to last year. Raw material costs continued to increase in the third quarter of 2006 as oil prices hit record levels during the quarter. Lower sales volume combined with process improvements resulting from the company's Lean

Six Sigma<sup>SM</sup> initiatives helped mitigate the impact of the higher raw material prices. Through nine months of 2006, the cost of sales of \$805.9 million was \$5.3 million or 0.7 percent less than the first nine months of 2005. Similar to the third quarter, reduced sales volume and productivity improvements mitigated the impact from increases in raw material costs.

As a percent of net revenue, the cost of sales in both the third quarter and first nine months of 2006 was 71.6. In 2005, the cost of sales as a percent of net revenue was 72.7 percent in the third quarter and 73.8 percent for the first nine months.

**Gross Profit Margin:** The gross profit margin was 28.4 percent in the third quarter of 2006 and 27.3 percent in the third quarter of 2005. A shift in mix to more profitable products, selling price increases, productivity improvements and cost reductions in the manufacturing operations all contributed to the improved margin.

For the first nine months of 2006 the gross profit margin was 28.4 percent as compared to 26.2 percent for the first nine months of 2005.

**Selling, General and Administrative (SG&A) Expenses:** SG&A expenses of \$75.7 million in the third quarter of 2006 were \$2.3 million or 3.1 percent higher than in the third quarter of 2005. The SG&A expenses from businesses acquired during 2006 were \$5.3 million in the third quarter. The expensing of stock options in accordance with SFAS 123R added \$0.8 million in the third quarter of 2006. SG&A decreases resulted from lower payroll-related costs due to reduced headcount as well as process improvements resulting from the company's Lean Six Sigma<sup>SM</sup> initiatives.

Through the first nine months of 2006 SG&A expenses of \$230.7 million were \$1.6 million or 0.7 percent less than the first nine months of 2005. Expense increases related to businesses acquired, stock options and pension costs were more than offset by savings related to reduced headcount, lower depreciation expense and reduction in expenses resulting from the 2005 formation of the joint venture in Japan with Sekisui Chemical.

**Gains (Losses) from Sales of Assets:** Gains (losses) from sales of assets were losses of \$14 thousand in the third quarter of 2006 and gains of \$0.3 million in the third quarter of 2005. Last year's gains resulted primarily from the sale of a vacant property in Australia. Through nine months of 2006 the gains (losses) from sales of assets were \$0.8 million with the most significant transaction being the sale of a small adhesives product line and associated assets in the first quarter of this year. Through nine months of 2005, the gains (losses) from sales of assets were gains of \$7.1 million. Included in this figure was a \$4.7 million gain related to the sale of a 20 percent equity interest in the company's China operations to Sekisui Chemical. In addition to the China-related gain, last year's first nine months included a \$1.7 million gain on the sale of a European facility that had been closed as part of a previous restructuring initiative.

**Other Income (Expense), Net:** Other income (expense), net was income of \$0.3 million in the third quarter of 2006 and expense of \$25 thousand in the third quarter of 2005. Through nine months of 2006 other income (expense), net was income of \$0.3 million as compared to expense of \$0.8 million in 2005. Interest income increased \$1.2 million in the first nine months of 2006 as compared to last year primarily due to the higher average cash and cash equivalents balance in 2006 versus 2005.

**Interest Expense:** Interest expense of \$4.6 million in the third quarter of 2006 increased \$1.6 million from the third quarter of 2005. The increased debt related to the Roanoke acquisition in the second quarter of 2006 resulted in the higher interest expense in 2006. Through nine months, interest expense of \$12.3 million in 2006 was \$3.1 million more than the \$9.2 million in 2005.

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**Income Taxes:** The effective tax rate was 24.6 percent in the third quarter of 2006 and 32.0 percent in the third quarter of 2005. During the third quarter of 2006, the rate was lowered from 30.0 percent at the end of the second quarter of 2006 to 29.0 percent. The lower rate in 2006 was primarily due to the changes in geographic mix of pretax earnings generation. In addition, the third quarter of 2006 included a credit to income tax expense of \$0.9 million related to favorable settlements on tax audits. Through nine months of 2006 the effective tax rate was 27.9 percent as compared to 32.3 percent for the first nine months of 2005.

**Minority Interests in (Income) Loss of Subsidiaries:** Minority interests in (income) loss of subsidiaries was an expense of \$0.3 million in the third quarter of 2006 and income of \$0.3 million in the third quarter of 2005. The 2006 expense was the result of the profitability of the company's North American automotive joint venture of which it owns 70 percent and the Chinese adhesives business of which it owns 80 percent. The minority interest income in 2005 resulted from losses at the automotive joint venture. Through nine months of 2006 the minority interests was an expense of \$1.0 million and in the first nine months of 2005 was income of \$0.8 million.

**Income from Equity Investments:** Income from equity investments was \$1.6 million in the third quarter and \$3.7 million in the first nine months of 2006 as compared to \$0.7 million and \$1.8 million for the same periods of 2005, respectively. The increases in 2006 as compared to 2005 were due to the improved performance of the company's 30 percent ownership in a European automotive joint venture and its 40 percent ownership in the Japanese joint venture with Sekisui Chemical. 2006 included nine months of results from the Japanese joint venture while 2005 included only five months. The Japanese joint venture was formed on April 1, 2005.

**Net Income:** Net income of \$24.2 million in the third quarter of 2006 was 55.7 percent more than the net income of \$15.5 million in the third quarter of 2005. The diluted earnings per share improved to \$0.40 in the third quarter of 2006 from \$0.26 in the third quarter of 2005. The net income for the first nine months of 2006 of \$59.0 million increased 54.2 percent from the first nine months of 2005. The diluted earnings per share of \$0.99 in the first nine months of 2006 increased 50 percent from last year's diluted earnings per share of \$0.66.

### **Operating Segment Results**

*Note: Management evaluates the performance of its operating segments based on operating income which is defined as gross profit less SG&A expenses and excluding the gains/(losses) on sales of assets. Corporate expenses are fully allocated to the operating segments.*

**Global Adhesives:** Net revenue in the Global Adhesives operating segment of \$247.5 million in the third quarter of 2006 was 0.3 percent less than the net revenue of \$248.3 million in the third quarter of 2005. The net effect of lower sales volume and higher average selling prices accounted for a reduction in net revenue of 2.0 percent for the quarter as compared to last year. The impact from foreign currencies was a positive 2.0 percent as the euro strengthened in the third quarter of 2006 as compared to last year. Divestitures of certain product lines in previous quarters resulted in a net revenue decrease of 0.3 percent in the third quarter of 2006 as compared to last year. Management continues to focus on repositioning the Global Adhesives product portfolio to a more profitable mix. Through the first nine months of 2006 net revenue decreased 3.3 percent from the same period in 2005. The net effect from pricing, volume and sales mix was a negative 0.4 percent as compared to the first nine months of 2005. The effects of divestitures and the 2005 deconsolidation of the Japanese adhesive business was a negative 2.1 percent. The impact from currency fluctuations was a reduction in net revenue of 0.8 percent.

Operating income of \$23.5 million in the third quarter of 2006 was 46.3 percent higher than last year's operating income of \$16.0 million. Increases in average selling prices combined with efficiency improvements in the manufacturing areas resulting from Lean Six Sigma<sup>SM</sup> projects allowed the Global Adhesives segment to offset the effects of higher raw material costs and lower sales volume. Through nine months of 2006 the Global Adhesives operating income increased 73.3 percent from the first nine months of 2005. As a percent of net revenue, 2006 operating income was 9.5 percent in the third quarter and 8.5 percent in the first nine months. For the same periods of 2005 the operating income as a percent of net revenue was 6.5 percent and 4.7 percent, respectively.

**Full-Valu/Specialty:** Net revenue in the third quarter of 2006 for the Full-Valu/Specialty segment of \$141.4 million was 28.8 percent above the net revenue recorded in the third quarter of 2005 of \$109.8 million. The acquisitions made during 2006 added \$30.7 million or 28.0 percent to the 2006 net revenue. The net effect of selling price increases and volume decreases increased net revenue in the third quarter of 2006 by 0.5 percent as compared to last year while currency fluctuations accounted for a 0.3 percent increase. Through nine months of 2006, net revenue increased 16.0 percent as compared to last year with the acquisitions



contributing increases of 14.6 percent. The net impact of increases in selling prices and decreases in sales volume contributed 1.6 percent to the net revenue variance through nine months of 2006. Changes in currency rates resulted in a net revenue decrease of 0.2 percent as compared to the first nine months of 2005.

Operating income in the third quarter of 2006 of \$11.1 million was \$3.0 million or 37.7 percent higher than the third quarter of 2005. As a percent of net revenue the operating income was 7.9 percent in the third quarter of 2006 as compared to 7.4 percent in the third quarter of 2005. The increase in operating income was accomplished despite the costs incurred associated with the integration and transition of the two acquisitions. For the first nine months of 2006, operating income increased 36 percent as compared to the first nine months of 2005 to \$25.7 million. Savings from cost structure changes implemented in 2005, selling price increases and sales growth in key product lines all contributed to the 2006 operating income growth through the first nine months. As a percent of net revenue, operating income was 6.8 percent in the first nine months of 2006 and 5.8 percent in the first nine months of 2005.

### **Restructuring and Other Related Costs**

The remaining liabilities accrued as part of the 2002 restructuring plan were \$0.1 million and \$0.3 million as of September 2, 2006 and December 3, 2005, respectively. Details of the activity for fiscal 2006 are as follows:

(in thousands)

|  |        |
|--|--------|
| Total liabilities at December 3, 2005    | \$ 343 |
| Currency change effect                   | 6      |
| Cash payments                            | (233)  |
|  | <hr/>  |
| Total liabilities at September 2, 2006   | 116    |
| Long-term portion of liabilities         | (39)   |
|  | <hr/>  |
| Current liabilities at September 2, 2006 | \$ 77  |
|  | <hr/>  |

### **Liquidity and Capital Resources**

The company made two significant acquisitions in the first nine months of 2006. During the second quarter, the Roanoke acquisition was completed with a purchase price of approximately \$275 million. The Roanoke acquisition was funded with \$195 million of debt and approximately \$80 million of cash. In the third quarter of 2006 the company made an asset purchase of the insulating glass sealant business from Henkel KGaA for approximately \$34 million. The Henkel transaction was funded with cash on hand.

The company's capitalization ratio, defined as total debt divided by total debt plus total stockholders' equity was 29.8 percent as of September 2, 2006 as compared to 20.0 percent at December 3, 2005. Total debt was \$287.9 million as of September 2, 2006 as compared to \$146.8 million at December 3, 2005. Cash and cash equivalents were \$123.6 million as of September 2, 2006 and \$157.6 million at December 3, 2005.

**Cash Flows from Operating Activities:** Cash provided from operating activities was \$129.7 million in the first nine months of 2006 as compared to \$64.9 million in the first nine months of 2005. Improved profitability and a strong focus on working capital management were the

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main reasons for the increase in cash flows from operating activities. A key metric monitored by management is net working capital as a percentage of annualized net revenue (current quarter multiplied by four). Net working capital is defined as trade receivables, net of allowance for doubtful accounts plus inventory minus trade payables. That percentage was 14.5 percent at the end of the third quarter of 2006 versus 16.0 percent at year-end 2005 and 17.9 percent at the end of the third quarter of 2005. Increases in trade payables had the most significant impact on reducing the net working capital as a percentage of net revenue. Changes in payables resulted in a source of cash of \$18.8 million in the first nine months of 2006 as compared to a use of cash of \$20.7 million for the same period of 2005. This quarter's trade payables balance included a temporary increase of approximately \$8 million from an acquisition-related payable. Reductions in inventory days on hand also contributed to the improvement in the net working capital percentage.

**Cash Flows from Investing Activities:** Primarily due to the two acquisitions in 2006, investing activities resulted in a use of cash of \$319.2 million in the first nine months of 2006. The Roanoke acquisition accounted for approximately \$275 million and the acquisition of the insulated glass sealant business was approximately \$34 million. Purchases of property, plant and equipment of \$12.8 million were partially offset by approximately \$2.5 million of cash proceeds from the sales of businesses. The proceeds resulted primarily from the sale of a small adhesives product line which included a facility and certain other related assets. In the first nine months of 2005 investing activities resulted in a positive cash flow of \$8.9 million. The most significant transactions were the sale of an idle European manufacturing site that resulted in \$10.2 million of cash proceeds and the sale of a 20 percent interest in the China operations for \$8 million. Purchases of property, plant and equipment were \$17.9 million in the first nine months of 2005.

For the full year of 2006 purchases of property, plant and equipment are expected to approximate \$20 to \$25 million as compared to \$25.5 million for the full year of 2005.

**Cash Flows from Financing Activities:** Financing activities resulted in a source of cash of \$149.8 million in the first nine months of 2006 driven by the \$195 million of debt proceeds used to fund the Roanoke acquisition. Strong cash flow from operating activities allowed management to pay down \$30 million of the new debt during the third quarter of 2006. A \$25 million payment was also made in the second quarter of 2006 for the retirement of private placement debt. Cash generated from the exercise of stock options was \$15.0 million in the first nine months of 2006. For the same period in 2005, cash generated from stock options was \$7.4 million. Financing activity in the first nine months of 2005 resulted in cash used of \$26.1 million with the main transaction being the repayment of \$22 million of the company's 1994 private placement debt. Cash dividends paid were \$11.0 million in the first nine months of 2006 and \$10.4 million in the first nine months of 2005.

On June 19, 2006, the company entered into a term loan agreement for \$75 million with a consortium of financial institutions. The applicable interest rate is based on LIBOR plus 0.625 percent and is payable quarterly. Amounts due under the term loan will be paid in quarterly installments beginning in September 2010 and will mature on June 19, 2013. The company used the proceeds from the term loan to pay down a portion of its outstanding revolving credit agreement balance.

Management anticipates that cash flows from operating activities will again be positive in the fourth quarter and there will be sufficient cash to fund all fourth quarter cash requirements without the utilization of the line of credit. Management believes the company's ongoing operating cash flows will continue to provide sufficient amounts of cash to fund all other expected investments and capital expenditures.

### **Forward-Looking Statements and Risk Factors**

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. In this Quarterly Report on Form 10-Q, the company discusses expectations regarding future performance of the company which include anticipated financial performance, savings from restructuring and process initiatives, global economic conditions, liquidity requirements, the impact of litigation and environmental matters, the effect of new accounting pronouncements and one-time accounting charges and credits, and similar matters. This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements may be identified by the use of words like plan, expect, aim, believe, project, anticipate, intend, estimate, will, show (including the negative or variations thereof) and other expressions that indicate future events and trends. These plans and expectations are based upon certain underlying assumptions, including those mentioned with the specific statements. Such assumptions are in turn based upon internal estimates and analyses of current market conditions and trends, management plans and strategies, economic conditions and other factors. These plans and expectations and the assumptions underlying them are necessarily subject to risks and uncertainties inherent in projecting future conditions and results. Actual results could differ materially from expectations expressed in the forward-looking statements if one or more of the underlying assumptions and expectations proves to be inaccurate or is unrealized. In addition to the factors described in this report, Part II, Item 1A. Risk Factors in this report and Part I, Item 1A. Risk Factors in the company's Annual Report on Form 10-K for the fiscal year ended December 3, 2005, identify some of the important factors that could cause the



company's actual results to differ materially from those in any such forward-looking statements. This list of important factors does not include all such factors nor necessarily present them in order of importance. In order to comply with the terms of the safe harbor, the company has identified these important factors which could affect the company's financial performance and could cause the company's actual results for future periods to differ materially from the anticipated results or other expectations expressed in the forward-looking statements. Additionally, the variety of products sold by the company and the regions where the company does business makes it difficult to determine with certainty the increases or decreases in revenues resulting from changes in the volume of products sold, currency impact, changes in product mix and selling prices. However, management's best estimates of these changes as well as changes in other factors have been included. References to volume changes include volume, product mix and delivery charges, combined. These factors should be considered, together with any similar risk factors or other cautionary language, which may be made elsewhere in this Quarterly Report on Form 10-Q.

The company may refer to Part II, Item 1A. Risk Factors and this section of the Form 10-Q to identify risk factors related to other forward looking statements made in oral presentations, including investor conferences and/or webcasts open to the public.

This disclosure, including that under Forward-Looking Statements and Risk Factors, and other forward-looking statements and related disclosures made by the company in this report and elsewhere from time to time, represents management's best judgment as of the date the information is given. The company does not undertake responsibility for updating any of such information, whether as a result of new information, future events, or otherwise, except as required by law. Investors are advised, however, to consult any further public company disclosures (such as in filings with the Securities and Exchange Commission or in company press releases) on related subjects.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

**Market Risk:** The company is exposed to various market risks, including changes in interest rates, foreign currency rates and prices of raw materials. Market risk is the potential loss arising from adverse changes in market rates and prices, such as interest rates and foreign currency exchange rates.

**Interest Rate Risk:** Exposure to changes in interest rates result primarily from borrowing activities used to fund operations. Committed floating rate credit facilities are used to fund a portion of operations.

Management believes that probable near-term changes in interest rates would not materially affect financial condition, results of operations or cash flows. The annual impact on net income of a one-percentage point interest rate change on the outstanding balance of its variable rate debt as of September 2, 2006 would be approximately \$1.8 million.

**Foreign Exchange Risk:** As a result of being a global enterprise, there is exposure to market risks from changes in foreign currency exchange rates, which may adversely affect operating results and financial condition. Approximately 49 percent of net revenue was generated outside of the United States in the first nine months of 2006. Principal foreign currency exposures relate to the euro, British pound sterling, Japanese yen, Australian dollar, Canadian dollar, Argentine peso, Brazilian real and Chinese renminbi.

Management's objective is to balance, where possible, local currency denominated assets to local currency denominated liabilities to have a natural hedge and minimize foreign exchange impacts. The company enters into cross border transactions through importing and exporting goods to and from different countries and locations. These transactions generate foreign exchange risk as they create assets, liabilities and cash flows in currencies other than the local currency. This also applies to services provided and other cross border agreements among subsidiaries.

Management takes steps to minimize risks from foreign currency exchange rate fluctuations through normal operating and financing activities and, when deemed appropriate, through the use of derivative instruments. Management does not enter into any speculative positions with regard to derivative instruments.

From a sensitivity analysis viewpoint, based on the financial results of the first nine months of 2006, a hypothetical overall 10 percent change in the U.S. dollar would have resulted in a change in net income of approximately \$3.4 million.

**Raw Materials:** The principal raw materials used to manufacture products include resins, polymers, synthetic rubbers, vinyl acetate monomer and plasticizers. The company generally avoids sole source supplier arrangements for raw materials. While alternate supplies of most key raw materials are available, sustained strong economical growth in North America and China coupled with unplanned supplier production outages have led to strained supply-demand situations for several key feedstocks (such as ethylene and propylene), some of their derivatives, several polymers and other petroleum derivatives such as waxes.

Management's objective is to purchase raw materials that meet both its quality standards and production needs at the lowest total cost. Most raw materials are purchased on the open market or under contracts that limit the frequency but not the magnitude of price increases. In some cases, however, the risk of raw material price changes is managed by strategic sourcing agreements which limit price increases to increases in supplier feedstock costs, while requiring decreases as feedstock costs decline. The leverage of having substitute raw materials approved for use wherever possible is used to minimize the impact of possible price increases.

#### **Item 4. Controls and Procedures**

##### **(a) Controls and procedures**

As of the end of the period covered by this report, the company conducted an evaluation, under the supervision and with the participation of the company's chief executive officer and chief financial officer, of the company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934. Based on this evaluation, the chief executive officer and chief financial officer concluded that, as of September 2, 2006, the company's disclosure controls and procedures were effective to ensure that information required to be disclosed by the company in reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

##### **(b) Change in internal control over financial reporting**

There were no changes in the company's internal control over financial reporting during its most recently completed fiscal quarter that have materially affected or are reasonably likely to materially affect its internal control over financial reporting, as defined in Rule 13a-15(f) under the Exchange Act.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

**Environmental Matters.** From time to time, the company is identified as a potentially responsible party under the Comprehensive Environmental Response, Compensation and Liability Act ( CERCLA ) and/or similar state laws that impose liability for costs relating to the cleanup of contamination resulting from past spills, disposal or other release of hazardous substances. The company is also subject to similar laws in some of the countries where current and former plants are located. The company's environmental, health and safety department monitors compliance with all applicable laws on a global basis.

Currently the company is involved in various environmental investigations, clean-up activities and administrative proceedings and lawsuits. In many of these matters, the company has entered into participation agreements, consent decrees or tolling agreements. One of these environmental matters involves the investigation and remediation of environmental contamination at the company's Sorocaba, Brazil facility. Soil and water samples have been collected on and around the Sorocaba facility, and recent test results indicate that certain contaminants, including carbon tetrachloride and other solvents, may exist in the soil at the Sorocaba facility and in the groundwater at both the Sorocaba facility and some neighboring properties. The company is continuing to work with Brazilian regulatory authorities to

determine the necessary scope of remediation at the facility and the neighboring properties. As of September 2, 2006, \$2.1 million was recorded as a liability for expected investigation and remediation expenses remaining for this site. Once the full scope of any necessary remediation is determined, the company may be required to record additional liabilities related to investigation and remediation costs at the Sorocaba facility.

The company's management reviews the circumstances of each individual site, considering the number of parties involved, the level of potential liability or contribution of the company relative to the other parties, the nature and magnitude of the hazardous wastes involved, the method and extent of remediation, the estimated legal and consulting expense with respect to each site and the time period over which any costs would likely be incurred. The company accrues appropriate reserves for potential environmental liabilities, which are continually reviewed and adjusted as additional information becomes available. As of September 2, 2006, the company had reserved \$3.5 million, which represents its best estimate of probable liabilities with respect to environmental matters, inclusive of the accrual related to the Sorocaba facility as described above. However, the full extent of the company's future liability for environmental matters is difficult to predict because of uncertainty as to the cost of investigation and clean-up of the sites, the company's responsibility for such hazardous waste and the number of and financial condition of other potentially responsible parties.

From time to time, management becomes aware of compliance matters relating to, or receives notices from, federal, state or local entities regarding possible or alleged violations of environmental, health or safety laws and regulations. In some instances, these matters may become the subject of administrative proceedings or lawsuits and may involve monetary sanctions of \$0.1 million or more (exclusive of interest and litigation costs).

While uncertainties exist with respect to the amounts and timing of the company's ultimate environmental liabilities, based on currently available information, management does not believe that these matters, individually or in aggregate, will have a material adverse effect on the company's long-term financial condition. However, adverse developments could negatively impact the company's results of operations or cash flows in one or more future quarters.

**Other Legal Proceedings.** From time to time and in the ordinary course of business, the company is a party to, or a target of, lawsuits, claims, investigations and proceedings, including product liability, personal injury, asbestos, commercial contract, patent and intellectual property, antitrust, health and safety and employment matters. While the company is unable to predict the outcome of these matters, it does not believe, based upon currently available information, that the ultimate resolution of any pending matter, individually or in aggregate, including the EIFS and asbestos litigation described in the following paragraphs, will have a material adverse effect on the company's long-term financial condition. However, adverse developments could negatively impact the company's results of operations or cash flows in one or more future quarters.

A subsidiary of the company is a defendant in numerous exterior insulated finish systems ( EIFS ) related lawsuits. As of September 2, 2006, the company's subsidiary was a defendant in approximately 36 lawsuits and claims related primarily to single-family homes. The EIFS product was used primarily in the residential construction market in the southeastern United States. Some of the lawsuits and claims involve EIFS in commercial or multi-family structures. Lawsuits and claims related to this product line seek monetary relief for water intrusion-related property damages. The company has insurance coverage for certain years with respect to this product line. During the quarter ended June 3, 2006, the company entered into agreements to settle numerous EIFS-related lawsuits and claims, including a lawsuit involving up to 186 homes. In total, the company paid \$5.0 million in settlement of these lawsuits and claims, of which insurers have paid \$0.7 million and are expected to pay an additional \$0.9 million. As of September 2, 2006, the company had recorded \$1.7 million for the probable liabilities and \$1.7 million for insurance recoveries, including the \$0.9 million referred to above, for all remaining EIFS-related lawsuits and claims. The company continually reevaluates these amounts.

Based on currently available information, management does not believe that the ultimate outcome of any pending legal proceedings and claims related to this product line, individually or in aggregate, will have a material adverse effect on the company's long-term financial condition. However, adverse developments



could negatively impact the company's results of operations or cash flows in one or more future quarters. Given the numerous uncertainties surrounding litigation and the projection of future events, such as the number of new claims to be filed each year and the average cost of disposing of each such claim, the actual costs could be higher or lower than the current estimated reserves or insurance recoveries.

The company and/or its subsidiaries have been named as defendants in lawsuits in which plaintiffs have alleged injury due to products containing asbestos manufactured by the company more than 20 years ago. The plaintiffs generally bring these lawsuits against multiple defendants and seek damages (both actual and punitive) in very large amounts. In many cases, plaintiffs are unable to demonstrate that they have suffered any compensable injuries or that the injuries suffered were the result of exposure to products manufactured by the company or its subsidiaries. The company is typically dismissed as a defendant in these cases without payment. If the plaintiff establishes that compensable injury occurred as a result of exposure to the company's products, the case is generally settled for an amount that reflects the seriousness of the injury, the number and solvency of other defendants in the case, and the jurisdiction in which the case has been brought.

As a result of bankruptcy filings by numerous defendants in asbestos-related litigation and the prospect of national and state legislative reform relating to such litigation, the rate at which plaintiffs filed asbestos-related lawsuits against various companies (including the company) increased in 2001, 2002 and the first half of 2003. In the second half of 2003 and throughout 2004 and 2005, the rate of these filings declined significantly. However, the company expects that asbestos-related lawsuits will continue to be filed against the company in the future.

A significant portion of the defense costs and settlements relating to asbestos-related litigation involving the company continues to be paid by third parties, including indemnification pursuant to the provisions of a 1976 agreement under which the company acquired a business from a third party. Historically, this third party routinely defended all cases tendered to it and paid settlement amounts resulting from those cases. In the 1990s, the third party sporadically reserved its rights, but continued to defend and settle all asbestos-related claims tendered to it by the company. In 2002, the third party rejected the tender of certain cases by the company and indicated it would seek contributions from the company for past defense costs, settlements and judgments. However, this third party has continued to defend and pay settlement amounts, under a reservation of rights, in most of the asbestos cases tendered to the third party by the company.

In addition to the indemnification arrangements with third parties, the company has insurance policies that generally provide coverage for asbestos liabilities (including defense costs). Historically, insurers have paid a significant portion of the defense costs and settlements in asbestos-related litigation involving the company. However, certain of the company's insurers are insolvent. During 2005, the company and a number of its insurers entered into a cost-sharing agreement that provides for the allocation of defense costs, settlements and judgments among these insurers and the company in certain asbestos-related lawsuits. Under this agreement, the company is required to fund a share of settlements and judgments allocable to years in which the responsible insurer is insolvent. The cost-sharing agreement applies only to the asbestos litigation involving the company that is not covered by the third-party indemnification arrangements.

In 2004, the company and a group of other defendants (including the third party obligated to indemnify the company against certain asbestos-related claims) entered into negotiations with a group of plaintiffs to settle certain asbestos-related lawsuits. As previously reported and accounted for during the third quarter of 2004, the company agreed to contribute approximately \$3.5 million towards the settlement to be paid in these cases in exchange for a full release of claims by the plaintiffs. Of this amount, the company's insurers have agreed to pay approximately \$1.2 million. The company and its insurers have transferred the required amounts into a trust established to disburse payments related to settlements. On December 1, 2005, \$3.1 million was paid out of this trust under the settlement. As of September 2, 2006, the amount the company and its insurers have remaining to pay out of trust is up to \$0.4 million. The company's remaining portion of this is up to \$0.3 million and is recorded as restricted cash, which is included in other current assets. During the first nine months of 2006, the company accrued a total of \$0.6 million for settlements of asbestos-related lawsuits. The company's insurers have paid or are expected to pay \$0.3 million of this amount.

To the extent the company can reasonably estimate the amount of its probable liabilities for pending asbestos-related claims, the company establishes a financial provision and a corresponding receivable for insurance recoveries if certain criteria are met. As of September 2, 2006, the company had \$1.0 million accrued for probable liabilities and \$0.5 million for insurance recoveries related to asbestos claims. However, the company has concluded that it is not possible to estimate the cost of disposing of other asbestos-related claims (including claims that might be filed in the future) due to its inability to project future events. Future variables include the number of new claims filed, the average cost of disposing of such claims, the uncertainty of asbestos litigation, insurance coverage and indemnification agreement issues, and the continuing solvency of certain insurance companies.

Because of the uncertainties described above, the company cannot accurately estimate the cost of resolving pending and future asbestos-related claims against the company. Based on currently available information, the company does not believe that asbestos-related litigation, individually or in aggregate, will have a material adverse effect on the company's long-term financial condition. However, adverse developments in such litigation could negatively impact the company's results of operations or cash flows in one or more future quarters.

### Item 1A. Risk Factors

This Form 10-Q contains forward-looking statements concerning our future programs, products, expenses, revenue, liquidity and cash needs as well as our plans and strategies. These forward-looking statements are based on current expectations and the company assumes no obligation to update this information. Numerous factors could cause actual results to differ significantly from the results described in these forward-looking statements, including the risk factors identified under Part I, Item 1A. Risk Factors contained in the company's Annual Report on Form 10-K for the fiscal year ended December 3, 2005. There have been no material changes in the risk factors disclosed by the company under Part I, Item 1A. Risk Factors contained in the Annual Report on Form 10-K for the fiscal year ended December 3, 2005.

### Item 1B. Unresolved Staff Comments

None.

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

### Issuer Purchases of Equity Securities

Upon vesting of restricted stock awarded by the company to employees, shares are withheld to cover the employees' withholding taxes. Information on the company's purchases of equity securities during the quarter follows:

| Period | (a)                                       | (b)                                   | (c)  | (d)  |
|--------|---|---------------------------------------|--|--|
|        | Total<br>Number<br>of Shares<br>Purchased | Average<br>Price<br>Paid<br>per Share | Total Number<br>of Shares<br>Purchased as<br>Part of Publicly<br>Announced | Maximum<br>Number of<br>Shares that<br>May Yet Be<br>Purchased |
|        |   |                                       |  |  |

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|                |                   |       |          | <u>Plans or<br/>Programs</u> | <u>Under the<br/>Plans or<br/>Programs (at<br/>end of period)</u> |
|----------------|-------------------|-------|----------|------------------------------|---|
| June 4, 2006   | July 8, 2006      | 6,476 | \$ 23.39 |                              | N/A   |
| July 9, 2006   | August 5, 2006    | 830   | \$ 23.94 |                              | N/A   |
| August 6, 2006 | September 2, 2006 |       |          |                              | N/A   |

**Item 6.**

**Exhibits**

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- 3.1 Restated Articles of Incorporation of H.B. Fuller Company, as amended to date
- 12 Computation of Ratios
- 31.1 Form of 302 Certification - Albert P.L. Stroucken
- 31.2 Form of 302 Certification - John A. Feenan
- 32.1 Form of 906 Certification - Albert P.L. Stroucken
- 32.2 Form of 906 Certification - John A. Feenan

Lean Six Sigma<sup>SM</sup> is a registered service mark of The George Group Incorporated.

**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.

Dated: October 6, 2006

**H.B. Fuller Company**

/s/ John A. Feenan

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John A. Feenan  
Senior Vice President and  
Chief Financial Officer

**Exhibit Index**

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