

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

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended December 31, 2005

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 333-116676

AEARO COMPANY I

(Exact name of registrant as specified in its charter)

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

13-3840356
(IRS Employer Identification No.)

5457 West 79th Street
Indianapolis, Indiana
(Address of principal executive offices)

46268
(Zip Code)

(317) 692-6666
(Registrant's telephone number, including area code)

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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

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

The number of shares of the registrant's common stock, par value \$.01 per share, outstanding as of February 14, 2006 was 100.

AEARO COMPANY I

TABLE OF CONTENTS

Form 10-Q for the Quarterly Period Ended December 31, 2005

PART I-FINANCIAL INFORMATION	4
Item 1. Financial Statements.....	4
Condensed Consolidated Balance Sheets - Assets	4
Condensed Consolidated Balance Sheets - Liabilities and Stockholder's Equity	5
Condensed Consolidated Statements of Operations	6
Condensed Consolidated Statement of Stockholder's Equity	7
Condensed Consolidated Statements of Cash Flow	8
Notes to Condensed Consolidated Financial Statements.....	9
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	25
Item 3. Quantitative and Qualitative Disclosures About Market Risk	34
Item 4. Controls and Procedures.....	36
II – OTHER INFORMATION.....	37
Item 6. Exhibits.....	37
SIGNATURES	38
EXHIBIT INDEX.....	39

Part I-Financial Information

Item 1. Financial Statements

AEARO COMPANY I AND SUBSIDIARIES
Condensed Consolidated Balance Sheets - Assets
(In Thousands)

	December 31, 2005	September 30, 2005
	<u>(Unaudited)</u>	
CURRENT ASSETS:		
Cash and cash equivalents	\$ 27,577	\$ 30,068
Accounts receivable (net of allowance for doubtful accounts of \$1,447 and \$1,381, respectively)	59,382	61,998
Inventories	54,161	48,132
Deferred and prepaid expenses	11,200	8,385
Total current assets	<u>152,320</u>	<u>148,583</u>
LONG TERM ASSETS:		
Property, plant and equipment, net	50,103	50,444
Goodwill and other intangible assets, net	286,562	288,674
Other assets	13,435	13,644
Total assets	<u>\$ 502,420</u>	<u>\$ 501,345</u>

The accompanying notes are an integral part of these condensed consolidated financial statements.

AEARO COMPANY I AND SUBSIDIARIES

Condensed Consolidated Balance Sheets - Liabilities and Stockholder's Equity (In Thousands, Except for Per Share and Share Amounts)

	December 31, 2005	September 30, 2005
	(Unaudited)	
CURRENT LIABILITIES:		
Current portion of long-term debt	\$ 3,404	\$ 3,432
Accounts payable and accrued liabilities	55,813	58,632
Accrued interest	3,115	6,678
Accrued income taxes	2,263	1,888
Total current liabilities	64,595	70,630
LONG TERM LIABILITIES:		
Long-term debt	296,472	297,625
Deferred income taxes	47,949	45,340
Due to Parent	1,293	1,161
Other liabilities	14,223	12,984
Total liabilities	424,532	427,740
STOCKHOLDER'S EQUITY:		
Common stock, \$.01 par value—		
Authorized—100 shares		
Issued and outstanding—100 shares	-	-
Additional paid in capital	101,750	101,750
Accumulated deficit	(20,977)	(26,820)
Accumulated other comprehensive loss	(2,885)	(1,325)
Total stockholder's equity	77,888	73,605
Total liabilities and stockholder's equity	\$ 502,420	\$ 501,345

The accompanying notes are an integral part of these condensed consolidated financial statements.

AEARO COMPANY I AND SUBSIDIARIES

Condensed Consolidated Statements of Operations

(In Thousands)

(Unaudited)

	Three Months Ended December 31,	
	2005	2004
Net sales	\$ 104,142	\$ 95,761
Cost of sales	<u>52,139</u>	<u>48,705</u>
Gross profit	52,003	47,056
Selling and administrative	32,603	31,731
Research and technical services	2,500	2,220
Amortization of intangible assets	1,302	1,318
Other (income) charges, net	<u>296</u>	<u>(68)</u>
Operating income	15,302	11,855
Interest expense, net	<u>5,688</u>	<u>5,241</u>
Income before provision for income taxes	9,614	6,614
Provision for income taxes	<u>3,771</u>	<u>1,596</u>
Net income	<u>\$ 5,843</u>	<u>\$ 5,018</u>

The accompanying notes are an integral part of these condensed consolidated financial statements.

AEARO COMPANY I AND SUBSIDIARIES

Condensed Consolidated Statement of Stockholder's Equity (In Thousands, Except Share Amounts)

	Common		Additional Paid In Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total	Comprehensive Income
	Shares	Amount					
Balance, October 1, 2005	100	\$ -	\$ 101,750	\$ (26,820)	\$ (1,325)	\$ 73,605	
Net income	-	-	-	5,843	-	5,843	\$ 5,843
Foreign currency translation adjustment			-	-	(1,149)	(1,149)	(1,149)
Unrealized loss on derivative instruments, net of tax			-	-	(304)	(304)	(304)
Net minimum pension liability adjustment, net of tax			-	-	(107)	(107)	(107)
Comprehensive income							<u>\$ 4,283</u>
Balance, December 31, 2005	<u>100</u>	<u>\$ -</u>	<u>\$ 101,750</u>	<u>\$ (20,977)</u>	<u>\$ (2,885)</u>	<u>\$ 77,888</u>	

The accompanying notes are an integral part of these condensed consolidated financial statements.

AEARO COMPANY I AND SUBSIDIARIES

Condensed Consolidated Statement of Cash Flow (In Thousands) (Unaudited)

	Three Months Ended December 31, <u>2005</u>	Three Months Ended December 31, <u>2004</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 5,843	\$ 5,018
Adjustments to reconcile net income to cash provided by operating activities—		
Depreciation	2,449	2,577
Amortization of intangible assets and deferred financing costs	1,620	1,660
Deferred income taxes	2,512	240
Other, net	11	67
Changes in assets and liabilities:		
Accounts receivable	2,246	3,027
Inventories	(6,315)	(1,060)
Income taxes payable	455	843
Accounts payable and accrued liabilities	(5,307)	(8,073)
Prepaid and deferred assets	(2,443)	(717)
Other assets	(494)	(1,211)
Other liabilities	<u>953</u>	<u>(1,008)</u>
Net cash provided by operating activities	<u>1,530</u>	<u>1,363</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to property, plant and equipment	(3,117)	(1,494)
Other	<u>3</u>	<u>1</u>
Net cash used for investing activities	<u>(3,114)</u>	<u>(1,493)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of term loan	(312)	(325)
Proceeds from notes payable to Parent	132	-
Repayment of capital lease obligations	(71)	(65)
Repayment of long term debt	<u>(25)</u>	<u>(224)</u>
Net cash used for financing activities	<u>(276)</u>	<u>(614)</u>
EFFECT OF EXCHANGE RATE ON CASH AND CASH EQUIVALENTS	<u>(631)</u>	<u>465</u>
DECREASE IN CASH AND CASH EQUIVALENTS	(2,491)	(279)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	<u>30,068</u>	<u>27,724</u>
CASH AND CASH EQUIVALENTS, END OF PERIOD	<u>\$ 27,577</u>	<u>\$ 27,445</u>
NON CASH INVESTING ACTIVITIES:		
Property, plant and equipment purchases	\$ 614	\$ -
CASH PAID FOR:		
Interest	<u>\$ 9,716</u>	<u>\$ 9,265</u>
Income taxes	<u>\$ 740</u>	<u>\$ 1,026</u>

The accompanying notes are an integral part of these condensed consolidated financial statements.

AEARO COMPANY I AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements
(Unaudited)

1) Condensed Consolidated Financial Statements

In the opinion of management, the accompanying unaudited condensed consolidated financial statements of Aearo Company I (the “Company”) contain all normal, recurring adjustments necessary to present fairly, in accordance with accounting principles generally accepted in the United States of America, the financial position, results of operations and cash flows for the interim periods presented. The results of operations for the interim periods shown in this report are not necessarily indicative of results for any future interim period or for the entire year. These condensed consolidated financial statements do not include all disclosures associated with annual financial statements, and accordingly, should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K.

2) Company Background and Basis of Presentation

The Company manufactures and sells products under the brand names AOSafety[®], E-A-R[®], Peltor[®] and SafeWaze[™]. These products are sold through three reportable segments, which are Safety Products, Safety Prescription Eyewear and Specialty Composites.

The Company is wholly-owned by Aearo Corporation, a subsidiary of Aearo Technologies Inc.

3) Significant Accounting Policies

Use of Estimates. The preparation of the condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Revenue Recognition and Allowance for Doubtful Accounts. The Company recognizes revenue when title and risk transfer to the customer, which is generally when the product is shipped to customers. At the time revenue is recognized, certain provisions may also be recorded including pricing discounts and incentives. The Company offers its customers three types of incentive programs: a sales rebate/volume discount program, a marketing incentive program and a co-operative advertising program. The sales rebate/volume discount program is based on achieved volume levels along with growth incentives over the prior year’s sales dollars. Rebate obligations are estimated based on current sales levels and are recorded as a reduction of revenue when sales to the customer make progress towards the required sales level. The marketing incentive program provides qualifying customers that achieve specified volume levels with funds to assist the customers with marketing the Company’s products. The funds provided to the qualifying customers are recorded as a reduction of revenue when sales to the customer make progress towards the required sales level. The co-operative advertising program provides funds to specific customers to advertise the Company’s products. The qualifying customers provide specific documentation of the advertising to the Company to assure that the benefit received is comparable to other arms length advertising expenditures undertaken by the Company. The amount of co-operative advertising charged to selling and administrative expenses for the three months ended December 31, 2005 and 2004 were \$0.7 million and \$0.5 million, respectively. An allowance for doubtful accounts is generally recorded based on a percentage of aged receivables. However, management judgment is involved with the final determination of the allowance based on several factors

including specific analysis of a customer's credit worthiness, historical bad debt experience, changes in payment history and general economic and market trends.

Foreign Currency Translation. Assets and liabilities of the Company's foreign subsidiaries are translated at period-end exchange rates. Income and expenses are translated at the approximate average exchange rate during the period. Foreign currency translation adjustments are recorded as a separate component of stockholder's equity.

Foreign Currency Transactions. Foreign currency gains and losses arising from transactions by the Company or any of the Company's subsidiaries are reflected in net income.

Cost of Goods Sold. Cost of goods sold includes all costs to manufacture the Company's products including raw materials, which include inbound freight and import duties, direct labor, plant supervision, maintenance labor and parts, quality control, receiving, purchasing, production planning, manufacturing supplies, scrap, rework, utilities, depreciation, property taxes, sales and use taxes and insurance.

Selling and Administrative Expenses. Selling and administrative expenses include salaries and benefits for selling, marketing, customer service, finance and human resources personnel, direct marketing expenses, trade show expenses, commissions, selling expenses, bad debts, advertising, travel and entertainment, office supplies, recruiting, relocation, legal expenses, accounting fees, consulting and warehousing and logistics expenses incurred after the point of manufacture.

Income Taxes. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using currently enacted tax rates. The Company is included in the consolidated tax return filed by Aearo Technologies Inc. All taxes are recorded as if separate, stand alone returns were filed.

Goodwill and Other Intangibles. Under the provisions of SFAS No. 142, "Goodwill and Other Intangible Assets", goodwill and intangible assets that have indefinite useful lives are not amortized but are tested at least annually for impairment. Intangible assets that have finite useful lives are amortized over their useful lives and reviewed for impairment at each reporting date.

The following presents a summary of other intangibles assets as of September 30, 2005 and December 31, 2005 (dollars in thousands):

<u>September 30, 2005</u>	<u>Gross</u> <u>Amount</u>	<u>Accumulated</u> <u>Amortization</u>	<u>Carrying</u> <u>Amount</u>
Trademarks	\$ 114,300	\$ --	\$ 114,300
Customer relationship list	73,000	(7,299)	65,701
Patents	963	(377)	586
Other	385	(185)	200
Total Intangibles	<u>\$ 188,648</u>	<u>\$ (7,861)</u>	<u>\$ 180,787</u>

<u>December 31, 2005</u>	<u>Gross</u> <u>Amount</u>	<u>Accumulated</u> <u>Amortization</u>	<u>Carrying</u> <u>Amount</u>
Trademarks	\$ 114,300	\$ --	\$ 114,300
Customer Relationship List	73,000	(8,515)	64,485
Patents	1,004	(437)	567
Other	<u>728</u>	<u>(210)</u>	<u>518</u>
Total Intangibles	<u>\$ 189,032</u>	<u>\$ (9,162)</u>	<u>\$ 179,870</u>

Estimate of Aggregate Amortization Expense (dollars in thousands):

Year ending September 30, 2006	\$ 5,310
Year ending September 30, 2007	5,294
Year ending September 30, 2008	5,183
Year ending September 30, 2009	4,973
Year ending September 30, 2010	4,980

The following presents the changes in the carrying amount of goodwill for the three months ended December 31, 2005 (dollars in thousands):

	<u>Three Months</u> <u>Ended</u> <u>December 31,</u> <u>2005</u>
Beginning balance	\$ 107,887
Translation adjustment	<u>(1,195)</u>
Ending balance	<u>\$ 106,692</u>

Stock-based Compensation. Certain employees are awarded stock options and restricted stock under the stock incentive plan of Aearo Technologies Inc. The Company accounts for stock-based compensation under the recognition and measurement principles of Accounting Principles Board (“APB”) Opinion No. 25, “Accounting for Stock Issued to Employees” and FASB Interpretation No. 44, “Accounting for Certain Transactions Involving Stock Compensation, an interpretation of APB No. 25. Accordingly, no compensation expense for stock options has been recognized as all options granted had an exercise price equal to or above the price of the underlying common stock on the grant date. The Company recognizes compensation expense related to restricted stock awards and amortizes the expense over the vesting period based on the estimated fair value of the stock at the date of grant.

The following table illustrates the effect on net income if the Company had applied the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" as amended by SFAS No. 148 "Accounting for Stock-Based Compensation – Transition and Disclosure," to stock-based employee compensation (dollars in thousands):

	Three Months Ended	
	December 31,	
	<u>2005</u>	<u>2004</u>
Net income as reported	\$ 5,843	\$ 5,018
Stock based compensation expense recorded under APB No. 25, net of tax	--	--
Stock-based compensation expense determined under the fair value method, net of tax	<u>(26)</u>	<u>(31)</u>
Proforma net income	<u>\$ 5,817</u>	<u>\$ 4,987</u>

Accounting for Derivative Instruments and Hedging Activities. The Company accounts for derivatives in accordance with the provisions of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", as amended and interpreted ("SFAS No. 133"). SFAS No. 133 requires that every derivative instrument be recorded in the balance sheet as either an asset or a liability measured at its fair value.

The Company's results of operations are subject to risks associated with operating in foreign countries, including fluctuations in currency exchange rates. While many of the Company's selling and distribution costs are denominated in Canadian and European currencies, a large portion of product costs are U.S. Dollar denominated. As a result, a decline in the value of the U.S. Dollar relative to other currencies can have a favorable impact on the profitability of the Company and an increase in the value of the U.S. Dollar relative to these other currencies can have a negative effect on the profitability of the Company. The Company's Swedish operations are also affected by changes in exchange rates relative to the Swedish Krona. A decline in the value of the Krona relative to other currencies can have a favorable impact on the profitability of the Company and an increase in the value of the Krona relative to other currencies can have a negative impact on the profitability of the Company.

To mitigate the effects of changes in foreign currency rates on results of operations and cash flows, the Company executes two hedging programs, one for transaction exposures, and the other for cash flow exposures in foreign operations. In order to implement the transaction hedging program, the Company utilizes forward foreign currency contracts for up to 30-day terms to protect against the adverse effects that exchange rate fluctuations may have on the foreign-currency-denominated trade activities (receivables, payables and cash) of foreign subsidiaries. These contracts have not been designated as hedges under SFAS No. 133 and, accordingly, the gains and losses on both the derivative and foreign-currency-denominated trade activities are recorded as transaction adjustments in results of operations. For the three months ended December 31, 2005 and 2004, the impact on results of operations for the hedging of trade activities was a net loss of \$0.6 million and \$0.1 million, respectively.

In regard to its cash flow hedging program, the Company complies with SFAS No. 133 which requires that derivative instruments be recorded in the balance sheet as either an asset or liability measured at its fair value. As of December 31, 2005, the Company has recorded a derivative payable of \$0.5 million. There was no forward foreign currency contracts designated as cash flow hedges during the three month period ended December 31, 2004. For

the three month period ended December 31, 2005 the Company reclassified a net loss of \$0.2 million into earnings as a result of the exercise of forward foreign contracts. All forward foreign currency contracts were determined to be highly effective whereby no ineffectiveness was recorded in earnings. In addition, the Company limits the foreign exchange impact on the balance sheet with debt denominated in Euros.

The Company is exposed to market risk from changes in interest rates. The Company, from time to time, will utilize interest rate instruments to reduce the impact of either increases or decreases in interest rates on its floating rate debt.

The Company had approximately \$30.5 million of variable rate debt protected under an interest rate cap arrangement, which expired December 31, 2004. The Company had not elected hedge accounting treatment for the interest rate cap as defined under SFAS No. 133 and, as a result, fair value adjustments were charged directly to other (income) charges, net. There was no impact on earnings for the three month period ending December 31, 2004. The Company had no interest rate derivatives outstanding for the three month period ended December 31, 2005.

The Company is of the opinion that it is well positioned to manage interest rate exposures in the short term. The Company continues to monitor interest rate movements and has mitigated the risks of potential interest rate fluctuations through the use of the aforementioned interest rate instruments.

New Accounting Pronouncements

In December 2004, the FASB enacted SFAS No. 123R, "Share-Based Payment" which replaces SFAS No. 123, "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS No. 123R requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our results of operations. The accounting provisions of SFAS No. 123R will be adopted by the Company beginning on January 1, 2006. The Company anticipates that this will impact net income by approximately \$0.1 million.

4) Other Comprehensive Income

The following table presents the reclassification amounts related to unrealized gains and losses presented in the statement of stockholder's equity for the three month periods ended December 31, 2005 and 2004, respectively (dollars in thousands):

	Three Months Ended	
	December 31,	
	<u>2005</u>	<u>2004</u>
Unrealized losses on derivatives during the period	\$ (477)	\$ --
Less: reclassification adjustment for gains (losses) included in the statements of operations	<u>(173)</u>	<u>--</u>
Total other comprehensive income (loss)	<u>\$ (304)</u>	<u>\$ --</u>

5) Inventories

Inventories consist of the following (dollars in thousands):

	<u>December 31,</u> <u>2005</u>	<u>September 30,</u> <u>2005</u>
Raw materials	\$ 13,108	\$ 10,816
Work in process	12,026	11,249
Finished goods	<u>29,027</u>	<u>26,067</u>
	<u>\$ 54,161</u>	<u>\$ 48,132</u>

Inventories, which include materials, labor and manufacturing overhead, are stated at the lower of cost or market, cost determined using the first-in, first-out method.

6) Debt

The Company's debt structure includes: (a) \$175.0 million of 8.25% Senior Subordinated Notes ("8.25% Notes") due 2012, which are publicly held and redeemable at the option of the Company, in whole or in part at various redemption prices, (b) up to an aggregate of \$175.0 million under its Credit Agreement with various banks comprised of (i) a secured term loan facility consisting of loans providing for up to \$125.0 million of term loans (collectively the "Term Loans") with a portion of the Term Loans denominated in Euros, (ii) a secured revolving credit facility ("Revolving Credit Facility") providing for up to \$50.0 million of revolving loans for general corporate purposes, and (iii) an uncommitted incremental term loan facility of up to \$75.0 million for acquisitions (collectively, the "Senior Bank Facilities"). Since April 7, 2004, when the Company's debt was issued, the Company's debt has been reduced by \$0.7 million related to the fluctuation of the Euro relative to the U.S. dollar as of December 31, 2005. The Company does not plan to take any measure to minimize the foreign exchange impact of its Euro denominated debt. The amounts outstanding on the Term Loans and Revolving Credit facility at December 31, 2005 were

approximately \$122.9 million and \$0.0 million, respectively. The Revolving Credit Facility provides for the issuance of letters of credit in an aggregate face amount of up to \$15.0 million. The Company had approximately \$1.6 million of letters of credit outstanding at both September 30, 2005 and December 31, 2005. The Term Loans amortize quarterly over a seven-year period. Amounts repaid or prepaid in respect of the Term Loans may not be re-borrowed. Loans and letters of credit under the Revolving Credit Facility will be available until the Revolving Loan Maturity Date, which is April 7, 2010. The Term Loans mature on April 7, 2011. Effective December 31, 2004, the Company received a 0.25% reduction in the interest rate paid on its Term Loans for meeting certain financial covenants. The Company was in compliance with all financial covenants and restrictions as of December 31, 2005.

On April 28, 2005, the Company amended its credit agreement to allow the Company to make, prior to September 30, 2005, a one-time payment of up to \$35 million of cash distributions, which was made to Aearo Corporation, its parent corporation for the purpose of paying cash dividends to Aearo Technologies Inc., its parent, to be used by Aearo Technologies Inc. primarily to redeem, pro rata, its outstanding preferred shares and to pay accrued dividends on the preferred shares. In addition, the amendment (i) modified the amount of the incremental Term Loan commitment from \$60.0 million to \$75.0 million (ii) eliminated the termination date for the incremental Term Loan commitment and (iii) allowed for incremental Term Loans in Euros.

The Company is permitted under its Credit Agreement to pay dividends to its parent, Aearo Corporation, for the purposes of paying cash interest, when due on its indebtedness as long as the Company satisfies certain requirements, or to pay expenses, up to \$1.0 million per fiscal year, that occur in the ordinary course of business. For the three months ended December 31, 2005, there is no cash interest due on Aearo Corporation's indebtedness and no expenses forecasted to occur in the ordinary course of business, therefore, the Company is prohibited from paying any dividends without approval from the members of its credit facility.

7) Commitments and Contingencies

Lease Commitments. The Company leases certain transportation vehicles, warehouse facilities, office space, and machinery and equipment under cancelable and non-cancelable leases, most of which expire within 10 years and may be renewed by the Company.

Contingencies. Various lawsuits and claims arise against the Company in the ordinary course of its business. Most of these lawsuits and claims are products liability matters that arise out of the use of safety eyewear and respiratory product lines manufactured by the Company as well as products purchased for resale.

The Company is a defendant in lawsuits by plaintiffs alleging that they suffer from respiratory medical conditions, such as asbestosis or silicosis, relating to exposure to asbestos and silica, and that such conditions result, in part, from the use of respirators that, allegedly, were negligently designed or manufactured. The defendants in these lawsuits are often numerous, and include, in addition to manufacturers and distributors of respirators, manufacturers, distributors and installers of sand (used in sand blasting), asbestos and asbestos-containing products. Many of these claims are covered by the Asset Transfer Agreement entered into on June 13, 1995 by the Company and Aearo Corporation, on the one hand, and Cabot Corporation and certain of its subsidiaries (the "Sellers"), on the other hand (the "1995 Asset Transfer Agreement"). In the 1995 Asset Transfer Agreement, so long as Aearo Corporation makes an annual payment of \$400,000 to Cabot, the Sellers agreed to retain, and Cabot and the Sellers agreed to defend and indemnify Aearo Corporation and its subsidiaries against, any liability or obligation relating to or otherwise arising under any proceeding or other claim against Aearo Corporation and its subsidiaries or Cabot or their

respective affiliates or other parties with whom any Seller directly or indirectly has a contractual liability sharing arrangement which sounds in product liability or related causes of action arising out of actual or alleged respiratory medical conditions caused or allegedly caused by the use of respirators or similar devices sold by Sellers or their predecessors (including American Optical Corporation and its predecessors) prior to July 11, 1995. To date, Aearo Corporation has elected to pay the annual fee and intends to continue to do so. As of April, 7, 2004, Aearo Corporation agreed to make the annual payment to Cabot for a minimum of seven years from that date. Aearo Corporation and its subsidiaries could potentially be liable for claims currently retained by Sellers if Aearo Corporation elects to cease paying the annual fee or if Cabot and the Sellers no longer are able to perform their obligations under the 1995 Asset Transfer Agreement. Cabot acknowledged in a stock purchase agreement that it and Aearo Corporation entered into on June 27, 2003 (providing for the sale by Cabot to Aearo Corporation of all of the common and preferred stock of Aearo Corporation owned by Cabot) that the foregoing provisions of the 1995 Asset Transfer Agreement remain in effect. The 1995 Asset Transfer Agreement does not apply to claims relating to the business of Eastern Safety Equipment, the stock of which the Company acquired in 1996.

In fiscal 2004 and 2005 the Company settled 3 claims in which it was named as a defendant for an average settlement amount of \$16.99 in silica claims and \$0.00 in asbestos claims, while an additional 2,152 claims were dismissed without any payment (99.9% of cases closed), because the Company was not a proper defendant or did not make the product in question. As of September 30, 2005, the number of open claims where the Company was named as a defendant in silica and asbestos related matters was 12,714 and 4,124, respectively. For the three months ended December 31, 2005, the increases in number of claims where the Company was named as a defendant in silica and asbestos related matters was 37 and 1 respectively. One claim was settled where the Company was named as a defendant in silica related matters and six claims were settled where the Company was named as a defendant in asbestos related matters during the three months ended December 31, 2005. None of these settled claims required a payment by the Company. As of December 31, 2005, the number of open claims where the Company was named as a defendant in silica and asbestos related matters was 12,080 and 4,104, respectively.

In addition to the above claims, the Company may agree to pay a share of the settlement and defense costs in particular cases even though the Company is not named as a defendant, because of agreements with prior owners of the brand and/or because of allegations that the Company has some risk of legal liability as a successor (“Additional Claims”). During the three months ended December 31, 2005 the Company did not make any settlement payments for Additional Claims. During that time period the Company paid a total of \$0.3 million for administrative and defense costs involving both claims in which the Company was named as a defendant and Additional Claims. In addition, the Company may receive the benefit of releases in some additional cases settled by the AO Defense Group regardless of whether any claim was made against the Company.

The above information was based on data compiled based on information relating to number of cases and settlements on behalf of the “AO Defense Group,” and is believed to be materially accurate. This information may be subject to future adjustment in light of new information becoming available. The AO Defense Group is a voluntary association of current and former manufacturers of the “AO Safety” brand of respirators and certain of their insurers in which the Company participates and through which all of its settlements have been handled in the relevant years. Also, for the three months ended December 31, 2005, there may have been claims settled by and fully funded by the insurers of Eastern Safety Equipment Co., Inc., a dissolved former subsidiary of the Company.

At December 31, 2005 and September 30, 2005, the Company has recorded liabilities of approximately \$5.3 million and \$5.1 million, respectively, which represents reasonable estimates of its probable liabilities for product liabilities substantially related to asbestos and silica-related claims. This reserve is re-evaluated periodically and additional charges or credits to results of operations may result as additional information becomes available. Various factors increase the difficulty in determining the Company's potential liability, if any, in such claims, including the fact that the defendants in these lawsuits are often numerous and the claims generally do not specify the amount of damages sought. Additionally, the bankruptcy filings of other companies with asbestos and silica-related litigation could increase the Company's cost over time. In light of these and other uncertainties inherent in making long-term projections, the Company has determined that the five-year period through fiscal 2010 is the most reasonable time period for projecting asbestos and silica-related claims and defense costs. It is possible that the Company may incur liabilities in an amount in excess of amounts currently reserved. However, taking into account currently available information, historical experience, and the 1995 Asset Transfer Agreement, but recognizing the inherent uncertainties in the projection of any future events, it is management's opinion that these suits or claims should not result in final judgments or settlements in excess of the Company's reserve that, in the aggregate, would have a material effect on the Company's financial condition, liquidity or results of operations.

8) Segment Reporting

The Company manufactures and sells products under the brand names AOSafety[®], E-A-R[®], Peltor[®] and SafeWaze[™]. These products are sold through three reportable segments, which are Safety Products, Safety Prescription Eyewear and Specialty Composites. The Safety Products segment manufactures and sells hearing protection devices, communication headsets, non-prescription safety eyewear, face shields, reusable and disposable respirators, hard hats, fall protection and first aid kits. The Safety Prescription Eyewear segment manufactures and sells prescription eyewear products that are designed to protect the eyes from the typical hazards encountered in the industrial work environment. The Company's Safety Prescription Eyewear segment purchases component parts (lenses and the majority of its frames) from various suppliers, grinds, shapes and applies coatings to the lenses in accordance with the customer's prescription, and then assembles the glasses using the customer's choice of frame. The Specialty Composites segment manufactures a wide array of energy-absorbing materials that are incorporated into other manufacturers' products to control noise, vibration and shock. The factors used for determining the Company's reportable segments were predominantly based on the nature and type of product sold.

During the three month period ended December 31, 2004, the Safety Product segment had gross sales of \$48.1 million of hearing protection products, \$15.1 million of eye, face and head protection products and \$11.2 million of other safety products, including fall protection products. During the three month period ended December 31, 2005, the Safety Product segment had gross sales of \$50.2 million of hearing protection products, \$17.5 million of eye, face and head protection products and \$12.8 million of other safety products, including fall protection products.

Net Sales by Business Segment (dollars in thousands):

	Three Months Ended	
	December 31,	
	<u>2005</u>	<u>2004</u>
Safety Products	\$ 76,580	\$ 71,153
Safety Prescription Eyewear	9,358	8,974
Specialty Composites	<u>18,204</u>	<u>15,634</u>
Total	<u>\$104,142</u>	<u>\$ 95,761</u>

Inter-segment sales from the Specialty Composites segment to the Safety Products segment totaled \$1.0 million and \$1.2 million for the three months ended December 31, 2005 and 2004, respectively. The inter-segment sales value is determined at fully absorbed inventory cost at standard rates plus 25%. The Company does not have a single customer in any of its three reportable segments that accounts for more than 10% of segment revenues in any of the periods presented.

Profit (loss) by business segment and reconciliation to income before income taxes (dollars in thousands):

	Three Months Ended	
	December 31,	
	<u>2005</u>	<u>2004</u>
Safety Products	\$ 14,580	\$ 12,214
Safety Prescription Eyewear	34	(325)
Specialty Composites	<u>4,439</u>	<u>3,861</u>
Segment profit	19,053	15,750
Depreciation	2,449	2,577
Amortization of intangibles	1,302	1,318
Interest expense, net	<u>5,688</u>	<u>5,241</u>
Income before income taxes	<u>\$ 9,614</u>	<u>\$ 6,614</u>

Segment profit is defined as operating income before depreciation, amortization, interest expense, net and income taxes and represents the measure used by the chief operating decision maker to assess segment performance and make decisions about the allocation of resources to business segments.

9) Pension

The following table presents the components of net periodic pension cost for the three month periods ended December 31, 2005 and 2004, respectively (dollars in thousands):

	Three Months Ended	
	December 31,	
	<u>2005</u>	<u>2004</u>
Service cost	\$ 384	\$ 364
Interest cost	217	206
Expected return on plan assets	(216)	(184)
Total	<u>\$ 385</u>	<u>\$ 386</u>

The Company previously disclosed in its Annual Report on Form 10-K for the year ended September 30, 2005, that it expected to contribute \$1.5 million to its pension plan in 2006. As of December 31, 2005, the Company has not made any contributions to its pension plan.

10) Summarized Financial Information

The Company's 8.25% Senior Subordinated Notes due 2012 are fully and unconditionally guaranteed, on a joint and several basis, by substantially all of the Company's wholly-owned domestic subsidiaries ("Subsidiary Guarantors"). The non-guarantor subsidiaries are the Company's foreign subsidiaries.

The following financial information illustrates the composition of the combined Subsidiary Guarantors. The Company believes that the separate, complete financial statements of the respective guarantors would not provide additional material information which would be useful in assessing the financial composition of the Subsidiary Guarantors (dollars in thousands).

Consolidating Statement of Operation Information Three Months Ended December 31, 2005

	<u>Acaro</u>	<u>Guarantor</u>	<u>Non-</u>		
	<u>Company I</u>	<u>Subsidiaries</u>	<u>Guarantor</u>	<u>Subsidiaries</u>	<u>Eliminations</u>
					<u>Consolidated</u>
Net sales	\$ 81,241	\$ --	\$ 35,146	\$ (12,245)	\$ 104,142
Cost of sales	<u>44,772</u>	<u>--</u>	<u>19,522</u>	<u>(12,155)</u>	<u>52,139</u>
Gross profit	36,469	--	15,624	(90)	52,003
Selling and administrative	24,315	265	8,023	--	32,603
Research and technical services	1,624	--	876	--	2,500
Amortization	922	60	320	--	1,302
Other charges (income), net	<u>4,236</u>	<u>(6,559)</u>	<u>2,619</u>	<u>--</u>	<u>296</u>
Operating income	5,372	6,234	3,786	(90)	15,302
Interest expense (income)	<u>5,553</u>	<u>(266)</u>	<u>401</u>	<u>--</u>	<u>5,688</u>
Income (loss) before income taxes	(181)	6,500	3,385	(90)	9,614
Income tax provision	144	2,608	1,019	--	3,771
Equity in subsidiaries' earnings	<u>6,258</u>	<u>2,366</u>	<u>--</u>	<u>(8,624)</u>	<u>--</u>
Net income	<u>\$ 5,933</u>	<u>\$ 6,258</u>	<u>\$ 2,366</u>	<u>\$ (8,714)</u>	<u>\$ 5,843</u>

**Consolidated Statement of Operations
Three Months Ended December 31, 2004**

	<u>Aearo</u>	<u>Guarantor</u>	<u>Non-</u> <u>Guarantor</u>		
	<u>Company I</u>	<u>Subsidiaries</u>	<u>Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
Net sales	\$ 71,699	\$ --	\$ 35,044	\$ (10,982)	\$ 95,761
Cost of sales	<u>40,434</u>	<u>--</u>	<u>19,245</u>	<u>(10,974)</u>	<u>48,705</u>
Gross profit	31,265	--	15,799	(8)	47,056
Selling and administrative	21,778	2,400	7,553	--	31,731
Research and technical services.....	1,343	--	877	--	2,220
Amortization	934	64	320	--	1,318
Other charges (income), net.....	<u>3,979</u>	<u>(6,459)</u>	<u>2,412</u>	<u>--</u>	<u>(68)</u>
Operating income.....	3,231	3,995	4,637	(8)	11,855
Interest expense (income)	<u>5,118</u>	<u>(347)</u>	<u>470</u>	<u>--</u>	<u>5,241</u>
Income (loss) before income taxes	(1,887)	4,342	4,167	(8)	6,614
Income tax provision (benefit).....	(1,778)	2,043	1,331	--	1,596
Equity in subsidiaries	<u>5,135</u>	<u>2,836</u>	<u>--</u>	<u>(7,971)</u>	<u>--</u>
Net income	<u>\$ 5,026</u>	<u>\$ 5,135</u>	<u>\$ 2,836</u>	<u>\$ (7,979)</u>	<u>\$ 5,018</u>

**Consolidating Balance Sheet Information
December 31, 2005**

	<u>Aearo</u>	<u>Guarantor</u>	<u>Non-</u> <u>Guarantor</u>	<u>Eliminations</u>	<u>Consolidated</u>
	<u>Company I</u>	<u>Subsidiaries</u>	<u>Subsidiaries</u>		
Current Assets:					
Cash and cash equivalents.....	\$ 17,675	\$ 567	\$ 9,335	\$ --	\$ 27,577
Receivables, net.....	41,069	--	18,313	--	59,382
Inventories.....	41,457	--	13,345	(641)	54,161
Deferred and prepaid expenses.....	<u>10,238</u>	<u>--</u>	<u>962</u>	<u>--</u>	<u>11,200</u>
Total current assets.....	<u>110,439</u>	<u>567</u>	<u>41,955</u>	<u>(641)</u>	<u>152,320</u>
Long Term Assets:					
Property plant and equipment.....	36,072	--	14,031	--	50,103
Goodwill and other intangibles, net.....	79,619	122,204	84,739	--	286,562
Investment in subsidiaries.....	234,706	67,292	(653)	(301,345)	--
Other assets.....	<u>13,424</u>	<u>--</u>	<u>11</u>	<u>--</u>	<u>13,435</u>
Total assets.....	<u>\$ 474,260</u>	<u>\$ 190,063</u>	<u>\$ 140,083</u>	<u>\$ (301,986)</u>	<u>\$ 502,420</u>
Current Liabilities:					
Current portion of long-term debt.....	\$ 3,404	\$ --	\$ --	\$ --	\$ 3,404
Accounts payable and accrued liabilities.....	40,191	401	15,221	--	55,813
Accrued interest.....	3,114	--	1	--	3,115
Income tax payables (receivables).....	<u>2,482</u>	<u>(2,613)</u>	<u>2,394</u>	<u>--</u>	<u>2,263</u>
Total current liabilities.....	<u>49,191</u>	<u>(2,212)</u>	<u>17,616</u>	<u>--</u>	<u>64,595</u>
Long Term Liabilities:					
Long-term debt.....	296,472	--	--	--	296,472
Deferred income taxes.....	10,441	23,859	13,649	--	47,949
Inter-company (receivables) payables.....	62,306	(92,996)	31,983	--	1,293
Other liabilities.....	<u>14,223</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>14,223</u>
Total liabilities.....	<u>432,633</u>	<u>(71,349)</u>	<u>63,248</u>	<u>--</u>	<u>424,532</u>
Stockholder's Equity:					
Common stock.....	--	--	4,223	(4,223)	--
Additional paid in capital.....	101,750	267,797	42,064	(309,861)	101,750
Accumulated deficit.....	(61,362)	(9,122)	42,012	7,495	(20,977)
Accumulated other comprehensive income (loss).....	<u>1,239</u>	<u>2,737</u>	<u>(11,464)</u>	<u>4,603</u>	<u>(2,885)</u>
Total stockholder's equity.....	<u>41,627</u>	<u>261,412</u>	<u>76,835</u>	<u>(301,986)</u>	<u>77,888</u>
Total liabilities and stockholder's equity.....	<u>\$ 474,260</u>	<u>\$ 190,063</u>	<u>\$ 140,083</u>	<u>\$ (301,986)</u>	<u>\$ 502,420</u>

Consolidating Balance Sheet Information
September 30, 2005

	<u>Aearo</u>	<u>Guarantor</u>	<u>Non-</u> <u>Guarantor</u>	<u>Eliminations</u>	<u>Consolidated</u>
	<u>Company I</u>	<u>Subsidiaries</u>	<u>Subsidiaries</u>		
Current Assets:					
Cash and cash equivalents	\$ 19,690	\$ 249	\$ 10,129	\$ --	\$ 30,068
Receivables, net	41,140	--	20,858	--	61,998
Inventories	36,969	--	11,532	(369)	48,132
Deferred and prepaid expenses.....	7,348	--	1,037	--	8,385
Total current assets	<u>105,147</u>	<u>249</u>	<u>43,556</u>	<u>(369)</u>	<u>148,583</u>
Long term assets:					
Property plan and equipment.....	36,425	--	14,019	--	50,444
Goodwill and other intangibles, net	80,540	122,224	85,910	--	288,674
Investment in subsidiaries	237,986	67,292	(670)	(304,608)	--
Other assets.....	13,171	--	11	462	13,644
Total Assets.....	<u>\$ 473,269</u>	<u>\$189,765</u>	<u>\$142,826</u>	<u>\$ (304,515)</u>	<u>\$ 501,345</u>
Current Liabilities:					
Current portion of long term debt	\$ 3,432	\$ --	\$ --	\$ --	\$ 3,432
Accounts payable and accrued liabilities	41,505	358	16,769	--	58,632
Accrued interest.....	6,678	--	--	--	6,678
Income tax payables (receivables)	2,892	(2,893)	1,889	--	1,888
Total current liabilities.....	<u>54,507</u>	<u>(2,535)</u>	<u>18,658</u>	<u>--</u>	<u>70,630</u>
Long Term Liabilities:					
Long term debt	297,625	--	--	--	297,625
Deferred income taxes.....	7,799	23,860	13,681	--	45,340
Inter-company (receivables) payables	59,473	(92,859)	34,547	--	1,161
Other liabilities	12,814	--	170	--	12,984
Total liabilities	<u>432,218</u>	<u>(71,534)</u>	<u>67,056</u>	<u>--</u>	<u>427,740</u>
Stockholder's Equity:					
Common Stock	--	--	4,223	(4,223)	--
Paid in capital	101,750	267,797	41,865	(309,662)	101,750
Accumulated deficit.....	(61,220)	(9,534)	39,424	4,510	(26,820)
Accumulated other comprehensive income (loss)	521	3,036	(9,742)	4,860	(1,325)
Total Stockholder's Equity	<u>41,051</u>	<u>261,299</u>	<u>75,770</u>	<u>(304,515)</u>	<u>73,605</u>
Total Liabilities and Stockholder's Equity	<u>\$ 473,269</u>	<u>\$ 189,765</u>	<u>\$ 142,826</u>	<u>\$ (304,515)</u>	<u>\$ 501,345</u>

**Consolidating Statement of Cash Flows Information
Three Months Ended December 31, 2005**

	<u>Aearo</u> <u>Company I</u>	<u>Guarantor</u> <u>Subsidiaries</u>	<u>Non-</u> <u>Guarantor</u> <u>Subsidiaries</u>	<u>Consolidated</u>
Net cash provided by (used for) operating activities.....	\$ (3,312)	\$ 4,096	\$ 746	\$ 1,530
Net cash used for investing activities	(1,518)	--	(1,596)	(3,114)
Net cash provided by (used for) financing activities.....	2,872	(3,480)	332	(276)
Effect of exchange rate on cash and cash equivalents.....	<u>(56)</u>	<u>(298)</u>	<u>(277)</u>	<u>(631)</u>
Increase (decrease) in cash and cash equivalents	(2,014)	318	(795)	(2,491)
Cash and cash equivalents at the beginning of the period..	<u>19,690</u>	<u>249</u>	<u>10,129</u>	<u>30,068</u>
Cash and cash equivalents at the end of the period	<u>\$ 17,676</u>	<u>\$ 567</u>	<u>\$ 9,334</u>	<u>\$ 27,577</u>

**Consolidating Statement of Cash Flows
Three Months Ended December 31, 2004**

	<u>Aearo</u> <u>Company I</u>	<u>Guarantor</u> <u>Subsidiaries</u>	<u>Non-</u> <u>Guarantor</u> <u>Subsidiaries</u>	<u>Consolidated</u>
Net cash provided by (used for) operating activities.....	\$ 1,262	\$ 780	\$ (679)	\$ 1,363
Net cash used for investing activities	(886)	--	(607)	(1,493)
Net cash provided by (used for) financing activities.....	2,706	(3,120)	(200)	(614)
Effect of exchange rate on cash and cash equivalents.....	<u>249</u>	<u>2,551</u>	<u>(2,335)</u>	<u>465</u>
Increase (decrease) in cash and cash equivalents	3,331	211	(3,821)	(279)
Cash and cash equivalents at the beginning of the period..	<u>18,309</u>	<u>140</u>	<u>9,275</u>	<u>27,724</u>
Cash and cash equivalents at the end of the period	<u>\$ 21,640</u>	<u>\$ 351</u>	<u>\$ 5,454</u>	<u>\$ 27,445</u>

11) Subsequent Events

On February 1, 2006, Aearo Technologies Inc., the ultimate parent of the Company, entered into an agreement and plan of merger (the “Merger Agreement”), pursuant to which Pacer Merger Company, will be merged (the “Merger”) with and into Aearo Technologies Inc., with Aearo Technologies Inc. surviving the merger as a wholly-owned subsidiary of Pacer Holding Company.

The consideration for the Merger is \$765 million, subject to adjustment as provided in the Merger Agreement. The closing of the Merger is subject to the satisfaction or waiver of customary conditions. The Merger Agreement contains customary representations, warranties and covenants. Until the closing of the Merger, Aearo Technologies Inc. has agreed that it and its subsidiaries, including the Company, will conduct their business in the ordinary course in substantially the same manner as presently conducted. The Merger Agreement may be terminated by mutual agreement of Aearo Technologies Inc. and Pacer Holding Company or by each of them if the Merger has not closed on or prior to the 90th day following February 1, 2006.

In connection with the transaction, the Company intends to make a tender offer to purchase for cash any and all of its outstanding \$175,000,000 aggregate principal amount of 8 ¼% senior subordinated notes due 2012.

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

This report contains forward-looking statements within the meaning of the federal securities laws. Statements that are not historical facts, including statements about the Company's beliefs and expectations, are forward-looking statements. Forward-looking statements included statements preceded by, followed by or that include the words "may," "could," "would," "should," "believe," "expect," "anticipate," "plan," "estimate," "target," "project," "intend," or similar expressions. These statements include, among others, statements regarding the Company's expected business outlook, anticipated financial and operating results, the Company's business strategy and means to implement the strategy, the Company's objectives, the amount and timing of future capital expenditures, future acquisitions, the likelihood of the Company's success in developing and introducing new products and expanding its business, the timing of the introduction of new and modified products or services, financing plans, working capital needs and sources of liquidity.

Forward-looking statements are only predictions and are not guarantees of performance. These statements are based on management's beliefs and assumptions, which in turn are based on currently available information. Important assumptions relating to the forward-looking statements include, among others, assumptions regarding demand for our products, the cost, timing and success of product upgrades and new product introductions, expected pricing levels, the timing and cost of planned capital expenditures and expected synergies relating to acquisitions. These assumptions could prove inaccurate. Forward-looking statements also involve risks and uncertainties, which could cause actual results to differ materially from those contained in any forward-looking statements. Many of these factors are beyond the Company's ability to control or predict. You should read this report in conjunction with the more detailed risks included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2005.

The Company believes these forward-looking statements are reasonable; however, undue reliance should not be placed on any forward-looking statements, which are based on current expectations. Further, forward-looking statements speak only as of the date they are made, and except as otherwise required by the federal securities laws, the Company undertakes no obligation to update any of them publicly in light of new information or future events.

Results of Operations -- Three Months Ended December 31, 2005 Compared to Three Months Ended December 31, 2004.

The following table sets forth the major components of the Company's consolidated statements of operations expressed as a percentage of net sales.

Results of Operations
(Dollars in Thousands)

	<u>Three Months Ended December 31,</u>			
	<u>2005</u>	<u>%</u>	<u>2004</u>	<u>%</u>
Net sales:				
Safety Products	\$76,580	73.5	\$71,153	74.3
Safety Prescription Eyewear	9,358	9.0	8,974	9.4
Specialty Composites	<u>18,204</u>	<u>17.5</u>	<u>15,634</u>	<u>16.3</u>
Total net sales	104,142	100.0	95,761	100.0
Cost of sales	<u>52,139</u>	<u>50.1</u>	<u>48,705</u>	<u>50.9</u>
Gross profit	<u>52,003</u>	<u>49.9</u>	<u>47,056</u>	<u>49.1</u>
Operating expenses:				
Selling and administrative	32,603	31.3	31,731	33.1
Research and technical services	2,500	2.4	2,220	2.3
Amortization	1,302	1.2	1,318	1.4
Other charges (income), net	<u>296</u>	<u>0.3</u>	<u>(68)</u>	<u>(0.1)</u>
Total operating expense	36,701	35.2	35,201	36.7
Operating income (loss)	15,302	14.7	11,855	12.4
Interest expense, net	<u>5,688</u>	<u>5.5</u>	<u>5,241</u>	<u>5.5</u>
Income (loss) before income taxes	9,614	9.2	6,614	6.9
Provision for income taxes	<u>3,771</u>	<u>3.6</u>	<u>1,596</u>	<u>1.7</u>
Net income (loss)	<u>\$ 5,843</u>	<u>5.6</u>	<u>\$ 5,018</u>	<u>5.2</u>

Net sales for the three months ended December 31, 2005 increased 8.8% to \$104.1 million from \$95.8 million in the three months ended December 31, 2004. The increase in net sales was primarily driven by organic growth in all of the Company's segments. The strengthening of the U.S. dollar unfavorably impacted net sales by \$1.7 million. The Safety Products segment net sales for the three months ended December 31, 2005 increased 7.6% to \$76.6 million from \$71.2 million in the three months ended December 31, 2004. The increase in net sales resulted from a 10.0% increase in organic growth and a 2.4% decrease due to foreign currency translation. Organic sales growth for the Safety Products segment, defined as the increase in net sales less the impact of foreign currency translation and acquisitions, have increased for fifteen consecutive quarters, when compared to the same quarter of the prior year. The Company attributes this growth to the strength of its brand names, an improved economy and its ability to successfully introduce new products into the markets it serves. The Safety Prescription Eyewear segment net sales for the three months ended December 31, 2005 increased 4.3% to \$9.4 million from \$9.0 million for the three months ended December 31, 2004. The increase in net sales resulted from a 3.7% increase in organic growth and a 0.6% increase from foreign currency translation. Specialty Composites' net sales for the three months ended December 31, 2005 increased 16.4% to \$18.2 million from \$15.6 million in three months ended December 31, 2004. The increase was primarily driven by Asian geographic market share gains in the precision electronics market, strong industry orders in both the Class 8 truck and the business jet markets and customer growth in the power generation markets.

Gross profit for the three months ended December 31, 2005 increased to \$52.0 million from \$47.1 million for the three months ended December 31, 2004. Gross profit in the three

months ended December 31, 2005 and the three months ended December 31, 2004 as a percentage of net sales was 49.9% and 49.1%, respectively. The 80 basis point improvement in the gross profit percentage is primarily due to productivity, the favorable impacts of higher manufacturing volumes in the Company's plants covering its manufacturing costs and the favorable impact of foreign currency translation. The Company's gross profit may not be comparable to the gross profit of other entities who record shipping and handling expenses as a component of cost of sales. The Safety Products segment gross profit in the three months ended December 31, 2005 increased 9.2% to \$39.6 million from \$36.2 million in the three months ended December 31, 2004. The increase in gross profit is primarily due to an improvement in sales volume due to an improved economy and the Company's ability to successfully introduce new products into the markets it serves, productivity improvements and the favorable impact of foreign currency translation. The Safety Products segment gross profit as a percentage of net sales in the three months ended December 31, 2005 and the three months ended December 31, 2004 was 51.6% and 50.9%, respectively. The Safety Prescription Eyewear segment gross profit in the three months ended December 31, 2005 increased 6.6% to \$4.3 million from \$4.1 million in the three months ended December 31, 2004. The Safety Prescription Eyewear segment gross profit as a percentage of net sales in the three months ended December 31, 2005 improved to 46.3% from 45.3% in the three months ended December 31, 2004. Specialty Composites' gross profit in the three months ended December 31, 2005 increased 19.9% to \$8.1 million from \$6.8 million in the three months ended December 31, 2004. The increase was primarily driven by higher volume resulting from Asian geographic market share gains in the precision electronics market, strong industry orders in both the Class 8 truck and the business jet markets and customer growth in the power generation markets. The Specialty Composites' segment gross profit as a percentage of net sales in the three months ended December 31, 2005 and the three months ended December 31, 2004 was 44.6% and 43.3%, respectively.

Operating expenses for the three months ended December 31, 2005 increased 4.3% to \$36.7 million from \$35.2 million for the three months ended December 31, 2004. The increase in operating expenses was primarily driven by an increase in selling and administrative, research and technical and other charges, net. The increase in selling and administrative expenses included approximately \$0.9 million due to variable selling expenses such as freight, commissions, travel and marketing, \$0.6 million of legal and other fees incurred for the effort related to the potential sale of the Company, and a \$0.6 million decrease due to foreign currency translation. Selling and administrative expenses as a percentage of net sales decreased to 31.3% for the three months ended December 31, 2005 as compared to 33.1% for the three months ended December 31, 2004. Other charges (income), net included approximately \$0.5 million unfavorable impact of foreign currency transaction expenses in the three months ended December 31, 2005 as compared to approximately \$0.1 million of expense in the three months ended December 31, 2004.

Interest expense, net, for the three months ended December 31, 2005 increased to \$5.7 million from \$5.2 million for the three months ended December 31, 2004. The increase was primarily due to the impact of increasing interest rates on the Company's variable rate debt.

The provision for income taxes for the three months ended December 31, 2005 increased to \$3.8 million from \$1.6 million for the three months ended December 31, 2004. For the quarter ended December 31, 2005, the Company's effective tax rate was approximately 39%. For the quarter ended December 31, 2004, the Company's effective rate was approximately 24%. The expected annual effective tax rate for fiscal 2005 was lower than fiscal 2006 due to true-ups for foreign taxes and post-merger net operating loss carryforwards and a reduction in the benefit received from the Extraterritorial Income Exclusion.

Effects of Changes in Exchange Rates

In general, the Company's results of operations are affected by changes in exchange rates. Subject to market conditions, the Company prices its products in Europe and Canada in local currency. While many of the Company's selling and distribution costs are also denominated in these currencies, a large portion of product costs are U.S. Dollar denominated. As a result, a decline in the value of the U.S. Dollar relative to other currencies can have a favorable impact on the profitability of the Company, and an increase in the value of the U.S. Dollar relative to these other currencies can have a negative effect on the profitability of the Company. The Company's Swedish operations are also affected by changes in exchange rates relative to the Swedish Krona. In contrast to the above, a decline in the value of the Krona relative to other currencies can have a favorable impact on the profitability of the Company and an increase in the value of the Krona relative to other currencies can have a negative impact on the profitability of the Company. The Company, from time to time, will utilize forward foreign currency contracts and other hedging instruments to mitigate the effects of changes in foreign currency rates on profitability.

Effects of Inflation

In recent years, inflation has been modest and has not had a material impact upon the results of the Company's operations.

Liquidity and Capital Resources

The Company's sources of funds have consisted primarily of operating cash flow and debt financing. The Company's uses of those funds consist principally of working capital, debt service, capital expenditures, dividends and acquisitions.

The Company's debt structure includes: (a) \$175.0 million of 8.25% Senior Subordinated Notes ("8.25% Notes") due 2012, which are publicly held and redeemable at the option of the Company, in whole or in part at various redemption prices, (b) up to an aggregate of \$175.0 million under its Credit Agreement with various banks comprised of (i) a secured term loan facility consisting of loans providing for up to \$125.0 million of term loans (collectively the "Term Loans") with a portion of the Term Loans denominated in Euros, (ii) a secured revolving credit facility ("Revolving Credit Facility") providing for up to \$50.0 million of revolving loans for general corporate purposes, and (iii) an uncommitted incremental term loan facility of up to \$75.0 million for acquisitions (collectively, the "Senior Bank Facilities"). The Company's debt, since the date issued, has been reduced by \$0.7 million related to the fluctuation of the Euro relative to the U.S. dollar as of December 31, 2005. The Company does not plan to take any measure to minimize the foreign exchange impact of its Euro denominated debt. The amounts outstanding on the Term Loans and Revolving Credit facility at December 31, 2005 were approximately \$122.9 million and \$0.0 million, respectively. The Revolving Credit Facility provides for the issuance of letters of credit in an aggregate face amount of up to \$15.0 million. The Company had approximately \$1.6 million of letters of credit outstanding at both September 30, 2005 and December 31, 2005. The Term Loans amortize quarterly over a seven-year period. Amounts repaid or prepaid in respect of the Term Loans may not be re-borrowed. Loans and letters of credit under the Revolving Credit Facility will be available until the Revolving Loan Maturity Date, which is April 7, 2010. The Term Loans mature on April 7, 2011. The Company was in compliance with all financial covenants and restrictions as of December 31, 2005.

On April 28, 2005, the Company amended its credit agreement to allow the Company to make, prior to September 30, 2005, a one-time payment of up to \$35 million of cash distributions, which was made, to Aearo Corporation, its parent corporation for the purpose of paying cash dividends to Aearo Technologies Inc., its parent, to be used by Aearo Technologies Inc. primarily to redeem, pro rata, its outstanding preferred shares and to pay

accrued dividends on the preferred shares. In addition, the amendment (i) modified the amount of the incremental Term Loan commitment from \$60.0 million to \$75.0 million (ii) eliminated the termination date for the incremental Term Loan commitment and (iii) allowed for incremental Term Loans in Euros.

The Company typically makes capital expenditures related primarily to the maintenance and improvement of manufacturing facilities. The Company's principal source of cash to fund these capital requirements is cash from operations. The Company spent \$3.1 million and \$1.5 million, respectively, for capital expenditures for the three months ended December 31, 2005 and 2004, respectively. The Company anticipates it will spend approximately \$13.0 million for capital expenditures in its fiscal year ending September 30, 2006.

The Company's net cash provided by operating activities for the three months ended December 31, 2005 totaled \$1.3 million as compared to \$1.4 million for the three months ended December 31, 2004. The decrease of \$0.1 million was primarily due to the \$3.0 million reduction from the net changes in assets and liabilities offset by a \$2.9 million improvement in net income.

Net cash used for investing activities was \$3.1 million for the three months ended December 31, 2005 as compared to \$1.5 million for the three months ended December 31, 2004. The increase in net cash used by investing activities is primarily attributed to increased spending for property, plant and equipment.

Net cash used for financing activities for the three months ended December 31, 2005 was \$0.3 million compared with \$0.6 million for the three months ended December 31, 2004. The change is primarily due to the lower level of debt repayments.

The Company maintains a non-contributory defined benefit cash balance pension plan. The Company estimates pension expense and funding based on various assumptions including the discount rate and the expected long-term rate of return on plan assets. To develop the expected long term rate of return on assets assumption, the Company considered historical returns and future expectations for returns for each asset class, as well as the target asset allocation of the pension portfolio. Based on Actuarial Standard of Practice No. 27 and interpretation of this standard, the FAS 87 long term rate of return on asset assumption must fall within a "best estimate range" – that is, a range of returns within which the actual return is more likely than not to fall. This "best estimate range" equates to a 20-year compound average return derived using a Portfolio Return calculator (PRC), reflecting the asset allocation of the trust with appropriate adjustments for investment, trading, management and administrative expenses that are paid from the trust. For purposes of determining the 25th to 75th percentile range, the PRC uses market assumptions with respect to each class to develop the probability distribution of returns. The independently developed rate of 8.00% falls within the 25th and 75th percentiles of 4.96% and 8.61%, respectively. Over the 12 year period ended September 30, 2005, the returns on the portfolio, assuming it was invested at the current target asset allocation in prior periods, would have been a compound annual average return of 9.1%. Considering this information and the potential for lower future returns due to the generally lower interest rate environment, the Company selected an 8.00% long term rate of return asset assumption.

The variability of asset returns and discount rates may have either a favorable or unfavorable impact on the Company's pension expense and the funded status of the pension plan. Under minimum funding rules, no additional pension contributions were required to be made in fiscal 2005. The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid (in thousands of dollars):

Fiscal year 2006

\$ 1,047

Fiscal year 2007	561
Fiscal year 2008	753
Fiscal year 2009	1,070
Fiscal year 2010	1,001
Fiscal year 2011 – 2015	7,108

The Company's business is affected by macroeconomic activity, mainly manufacturing output in developed nations. In addition, significant changes in product mix and volume can impact the Company's liquidity and capital resources in both the short and long term. As such, the Company's liquidity and capital resources are more likely to be impacted by macroeconomic factors. The Company believes that its disciplined approach to cost control, its diversification into consumer and other channels and the available capacity on its revolving credit facility will enable the Company to maintain adequate liquidity and capital resources in an economic downturn. The introduction of new products is likely to continue to favorably impact liquidity and capital resources in periods of economic growth although there are no assurances that these trends will continue in the future.

The Company has a substantial amount of indebtedness. The Company relies on internally generated funds, and to the extent necessary, on borrowings under the Revolving Credit Facility (subject to certain customary drawing conditions) to meet its liquidity needs. The Company anticipates that operating cash flow will be adequate to meet its operating, capital expenditures and debt service requirements for the next several years, although there can be no assurances that existing levels of sales and normalized profitability, and therefore cash flow, will be maintained.

Product Liability Claims

The Company is a defendant in lawsuits by plaintiffs alleging that they suffer from respiratory medical conditions, such as asbestosis or silicosis, relating to exposure to asbestos and silica, and that such conditions result, in part, from the use of respirators that, allegedly, were negligently designed or manufactured. The defendants in these lawsuits are often numerous, and include, in addition to manufacturers and distributors of respirators, manufacturers, distributors and installers of sand (used in sand blasting), asbestos and asbestos-containing products. Many of these claims are covered by the Asset Transfer Agreement entered into on June 13, 1995 by the Company and Aearo Corporation, on the one hand, and Cabot Corporation and certain of its subsidiaries (the "Sellers"), on the other hand (the "1995 Asset Transfer Agreement"). In the 1995 Asset Transfer Agreement, so long as Aearo Corporation makes an annual payment of \$400,000 to Cabot, the Sellers agreed to retain, and Cabot and the Sellers agreed to defend and indemnify Aearo Corporation and its subsidiaries against, any liability or obligation relating to or otherwise arising under any proceeding or other claim against Aearo Corporation and its subsidiaries or Cabot or their respective affiliates or other parties with whom any Seller directly or indirectly has a contractual liability sharing arrangement which sounds in product liability or related causes of action arising out of actual or alleged respiratory medical conditions caused or allegedly caused by the use of respirators or similar devices sold by Sellers or their predecessors (including American Optical Corporation and its predecessors) prior to July 11, 1995. To date, Aearo Corporation has elected to pay the annual fee and intends to continue to do so. As of April, 7, 2004, Aearo Corporation agreed to make the annual payment to Cabot for a minimum of seven years from that date. Aearo Corporation and its subsidiaries could potentially be liable for claims currently retained by Sellers if Aearo Corporation elects to cease paying the annual fee or if Cabot and the Sellers no longer are able to perform their obligations under the 1995 Asset Transfer Agreement. Cabot acknowledged in a stock purchase agreement that it and Aearo Corporation entered into on June 27, 2003 (providing for the sale by Cabot to Aearo Corporation of all of the common and preferred stock of Aearo

Corporation owned by Cabot) that the foregoing provisions of the 1995 Asset Transfer Agreement remain in effect. The 1995 Asset Transfer Agreement does not apply to claims relating to the business of Eastern Safety Equipment, the stock of which the Company acquired in 1996. Claims related to Eastern Safety Equipment have historically been covered by that company's insurers under a reservation of rights.

In fiscal 2004 and 2005 the Company settled 3 claims in which it was named as a defendant for an average settlement amount of \$16.99 in silica claims and \$0.00 in asbestos claims, while an additional 2,152 claims were dismissed without any payment (99.9% of cases closed), because the Company was not a proper defendant or did not make the product in question. As of September 30, 2005, the number of open claims where the Company was named as a defendant in silica and asbestos related matters was 12,714 and 4,124, respectively. For the three months ended December 31, 2005, the increases in number of claims where the Company was named as a defendant in silica and asbestos related matters was 37 and 1 respectively. One claim was settled where the Company was named as a defendant in silica related matters and six claims were settled where the Company was named as a defendant in asbestos related matters during the three months ended December 31, 2005. None of these settled claims required a payment by the Company. As of December 31, 2005, the number of open claims where the Company was named as a defendant in silica and asbestos related matters was 12,080 and 4,104, respectively.

In addition to the above claims, the Company may agree to pay a share of the settlement and defense costs in particular cases even though the Company is not named as a defendant because of agreements with prior owners of the brand and/or because of allegations that the Company has some risk of legal liability as a successor ("Additional Claims"). During the three month period ended December 31, 2005 the Company did not make any settlement payments for Additional Claims. During that time period the Company paid a total of \$0.3 million for administrative and defense costs involving both claims in which the Company was named as a defendant and Additional Claims. In addition, the Company may receive the benefit of releases in some additional cases settled by the AO Defense Group regardless of whether or not any claim was made against the Company.

The above information was based on data compiled based on information relating to number of cases and settlements on behalf of the "AO Defense Group," and is believed to be materially accurate. This information may be subject to future adjustment in light of new information becoming available. The AO Defense Group is a voluntary association of current and former manufacturers of the "AO Safety" brand of respirators and certain of their insurers in which the Company participates and through which all of its settlements have been handled in the relevant years. Also, for the three months ended December 31, 2005, there may have been claims settled by and fully funded by the insurers of Eastern Safety Equipment Co., Inc., a dissolved former subsidiary of the Company.

At December 31, 2005 and September 30, 2005, the Company has recorded liabilities of approximately \$5.3 million and \$5.1 million, respectively, which represents reasonable estimates of its probable liabilities for product liabilities substantially related to asbestos and silica-related claims. This reserve is re-evaluated periodically and additional charges or credits to results of operations may result as additional information becomes available. Various factors increase the difficulty in determining the Company's potential liability, if any, in such claims, including the fact that the defendants in these lawsuits are often numerous and the claims generally do not specify the amount of damages sought. Additionally, the bankruptcy filings of other companies with asbestos and silica-related litigation could increase the Company's cost over time. In light of these and other uncertainties inherent in making long-term projections, the Company has determined that the five-year period through fiscal 2010 is the most reasonable time period for projecting asbestos and silica-related claims and defense costs. It is possible that the Company may

incur liabilities in an amount in excess of amounts currently reserved. However, taking into account currently available information, historical experience, and the 1995 Asset Transfer Agreement, but recognizing the inherent uncertainties in the projection of any future events, it is management's opinion that these suits or claims should not result in final judgments or settlements in excess of the Company's reserve that, in the aggregate, would have a material effect on the Company's financial condition, liquidity or results of operations.

Contractual Obligations

The Company has the following minimum commitments under contractual obligations including purchase obligations by fiscal year, as defined by the U.S. Securities and Exchange Commission as of December 31, 2005:

	<u>2006(1)</u>	<u>2007-2008</u>	<u>2009-2010</u>	<u>2011 and</u> <u>after</u>	<u>Total</u>
Capital lease obligations	\$ 264	\$ 631	\$ 122	\$ --	\$ 1,017
Operating lease obligations	2,745	5,750	4,335	3,577	16,407
Mortgage obligations	1,988	--	--	--	1,988
Purchase obligations	2,710	6,647	3,201	--	12,558
Respiratory commitment	300	800	800	200	2,100
Long term debt	<u>16,137</u>	<u>47,209</u>	<u>46,352</u>	<u>322,232</u>	<u>431,930</u>
Total	<u>\$ 24,144</u>	<u>\$ 61,037</u>	<u>\$ 54,810</u>	<u>\$326,009</u>	<u>\$466,000</u>

(1) Amounts presented in the current fiscal year represent remaining payments for the fiscal year.

The amounts for long term debt above include both interest and principal payments. The Company paid approximately \$4.2 million for taxes worldwide in fiscal 2005 and does not anticipate significant changes to its tax obligations in the near future. The Company has approximately \$1.6 million of letters of credit outstanding as of December 31, 2005 and does not anticipate significant changes to its outstanding letters of credit in the future.

The Company plans to fund approximately \$1.5-\$2.2 million per year for pension obligations over the next 5 years. The above contribution level was determined after consideration of many factors such as the funded status of the plan, the long term rate of return on plan assets of 8%, the duration of plan liabilities, workforce characteristics and changes to plan features. The goal of the funding strategy is to achieve full funding while minimizing the year to year volatility of contribution payments.

Off-Balance Sheet Arrangements

The Company has no off-balance sheet arrangements or financing arrangements involving variable interest entities.

New Accounting Pronouncements

In December 2004, the FASB enacted SFAS No. 123R, "Share-Based Payment" which replaces SFAS No. 123, "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS No. 123R requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our results of operations. The accounting provisions of SFAS No. 123R will be adopted by the Company beginning on January 1, 2006. The Company anticipates that this will impact net income by approximately \$0.1 million.

Subsequent Events

On February 1, 2006, Aearo Technologies Inc., the ultimate parent of the Company, entered into an agreement and plan of merger (the “Merger Agreement”), pursuant to which Pacer Merger Company, will be merged (the “Merger”) with and into Aearo Technologies Inc., with Aearo Technologies Inc. surviving the merger as a wholly-owned subsidiary of Pacer Holding Company.

The consideration for the Merger is \$765 million, subject to adjustment as provided in the Merger Agreement. The closing of the Merger is subject to the satisfaction or waiver of customary conditions. The Merger Agreement contains customary representations, warranties and covenants. Until the closing of the Merger, Aearo Technologies Inc. has agreed that it and its subsidiaries, including the Company, will conduct their business in the ordinary course in substantially the same manner as presently conducted. The Merger Agreement may be terminated by mutual agreement of Aearo Technologies Inc. and Pacer Holding Company or by each of them if the Merger has not closed on or prior to the 90th day following February 1, 2006.

In connection with the transaction, the Company intends to make a tender offer to purchase for cash any and all of its outstanding \$175,000,000 aggregate principal amount of 8 ¼% senior subordinated notes due 2012.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company is exposed to market risks related to changes in foreign currencies, interest rates and commodity pricing. The Company uses derivatives to mitigate the impact of changes in foreign currencies and interest rates. All derivatives are for purposes other than trading. The Company accounts for derivatives pursuant to SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", as amended. The Company has formally documented its hedging relationships, including identification of hedging instruments and the hedge items, as well as its risk management objectives.

Foreign Currency Risk

The Company's results of operations are subject to risks associated with operating in foreign countries, including fluctuations in currency exchange rates. While many of the Company's selling and distribution costs are denominated in Canadian and European currencies, a large portion of product costs are U.S. Dollar denominated. As a result, a decline in the value of the U.S. Dollar relative to other currencies can have a favorable impact on the profitability of the Company and an increase in the value of the U.S. Dollar relative to these other currencies can have a negative effect on the profitability of the Company. The Company's Swedish operations are also affected by changes in exchange rates relative to the Swedish Krona. A decline in the value of the Krona relative to other currencies can have a favorable impact on the profitability of the Company and an increase in the value of the Krona relative to other currencies can have a negative impact on the profitability of the Company.

To mitigate the effects of changes in foreign currency rates on results of operations and cash flows, the Company executes two hedging programs, one for transaction exposures, and the other for cash flow exposures in foreign operations. In order to implement the transaction hedging program, the Company utilizes forward foreign currency contracts for up to 30-day terms to protect against the adverse effects that exchange rate fluctuations may have on the foreign-currency-denominated trade activities (receivables, payables and cash) of foreign subsidiaries. These contracts have not been designated as hedges under SFAS No. 133 and, accordingly, the gains and losses on both the derivative and foreign-currency-denominated trade activities are recorded as transaction adjustments in results of operations. For the three months ended December 31, 2005 and 2004, the impact on results of operations for the hedging of trade activities was a net loss of \$0.6 million and \$0.1 million, respectively.

In regard to its cash flow hedging program, the Company complies with SFAS No. 133 which requires that derivative instruments be recorded in the balance sheet as either an asset or liability measured at its fair value. As of December 31, 2005, the Company has recorded a derivative payable of \$0.5 million. There was no forward foreign currency contracts designated as cash flow hedges during the three month period ended December 31, 2004. For the three month period ended December 31, 2005 the Company reclassified a net loss of \$0.2 million into earnings as a result of the exercise of forward foreign contracts. All forward foreign currency contracts were determined to be highly effective whereby no ineffectiveness was recorded in earnings. In addition, the Company limits the foreign exchange impact on the balance sheet with debt denominated in Euros.

Interest Rates

The Company is exposed to market risk from changes in interest rates. The Company, from time to time, will utilize interest rate instruments to reduce the impact of either increases or decreases in interest rates on its floating rate debt.

The Company had approximately \$30.5 million of variable rate debt protected under an interest rate cap arrangement, which expired December 31, 2004. The Company had not

elected hedge accounting treatment for the interest rate cap as defined under SFAS No, 133 and, as a result, fair value adjustments were charged directly to other (income) charges, net. There was no impact on earnings for the three month period ending December 31, 2004. The Company had no interest rate derivatives outstanding for the three month period ended December 31, 2005.

The Company is of the opinion that it is well positioned to manage interest rate exposures in the short term. The Company continues to monitor interest rate movements and has mitigated the risks of potential interest rate fluctuations through the use of the aforementioned interest rate instruments.

Commodity Risk

The Company is subject to market risks with respect to industry pricing in paper and crude oil as it relates to various commodity items. The Company is also exposed to market risks for electricity, fuel oil and natural gas consumed in its operations. Items with potential risk of price volatility are paperboard, packaging films, nylons, resins, propylene, ethylene, plasticizer and freight. The Company manages pricing exposures on larger volume commodities such as polycarbonate, polyols and polyvinyl chloride via price negotiations utilizing alternative supplier competitive pricing. The Company sources some products and parts from Far East sources where resource availability, competition, and infrastructure stability has provided a favorable purchasing environment. The Company does not enter into derivative instruments to manage commodity risks.

Item 4. Controls and Procedures

Disclosure controls and procedures are defined by the Securities and Exchange Commission as those controls and other procedures that are designed to ensure that information required to be disclosed in the Company's filings under the Securities Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. The Company's Chief Executive Officer and Chief Financial Officer have evaluated the Company's disclosure controls and procedures as of December 31, 2005, and have determined that such disclosure controls and procedures are effective.

There has been no change in the Company's internal control over financial reporting during the quarter ended December 31, 2005, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

II – Other Information

Item 6. Exhibits

(a) Exhibits

See Index of Exhibits on page 39 hereof.

Signatures

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

Date: February 13, 2006

AEARO COMPANY I

/s/ Michael A. McLain

Michael A. McLain
Chairman and Chief Executive Officer
(Principal Executive Officer)

/s/ Jeffrey S. Kulka

Jeffrey S. Kulka
Senior Vice President, Chief Financial Officer and Secretary
(Principal Financial and Accounting Officer)

Exhibit Index

<u>EXHIBITS</u>	<u>DESCRIPTION</u>
31.1	Certification of Chief Executive Officer pursuant to Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**CERTIFICATION PURSUANT TO
RULE 15d-14(a) OF
THE SECURITIES EXCHANGE ACT OF 1934
AS ADOPTED PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Michael A. McLain., certify that:

1. I have reviewed this report on Form 10-Q of Aearo Company I;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations, and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 13, 2006

/s/ Michael A. McLain
Michael A. McLain
Chairman, President and Chief
Executive Officer

**CERTIFICATION PURSUANT TO
RULE 15d-14(a) OF
THE SECURITIES EXCHANGE ACT OF 1934
AS ADOPTED PURSUANT TO
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Jeffrey S. Kulka, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Aearo Company I;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations, and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 13, 2006

/s/ Jeffrey S. Kulka
Jeffrey S. Kulka
Senior Vice President, Chief Financial Officer
and Secretary

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Aearo Company I (the "Company"), on Form 10-Q for the period ended December 31, 2005, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Michael A. McLain, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Michael A. McLain
Michael A. McLain
Chairman, President
and Chief Executive Officer
February 13, 2006

A signed written statement required by Section 906 has been provided to Aearo Company I and will be retained by Aearo Company I and furnished to the Securities and Exchange Commission and its staff upon request.

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Aearo Company I (the "Company"), on Form 10-Q for the period ended December 31, 2005, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Jeffrey S. Kulka, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Jeffrey S. Kulka
Jeffrey S. Kulka
Senior Vice President,
Chief Financial Officer
and Secretary
February 13, 2006

A signed written statement required by Section 906 has been provided to Aearo Company I and will be retained by Aearo Company I and furnished to the Securities and Exchange Commission and its staff upon request.