

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 June 30, 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

The number of shares of the registrant's common stock, par value \$.01 per share, outstanding as of August 15, 2005 was 100.

AEARO COMPANY I

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PART I-FINANCIAL INFORMATION

Item 1. Financial Statements

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

	June 30, 2005	September 30, 2004
	<u>(Unaudited)</u>	
CURRENT ASSETS:		
Cash and cash equivalents	\$ 16,019	\$ 27,724
Accounts receivable (net of allowance for doubtful accounts of \$1,463 and \$1,358, respectively)	60,553	54,159
Inventories	44,424	40,849
Deferred and prepaid expenses	5,602	4,146
Total current assets	<u>126,598</u>	<u>126,878</u>
LONG TERM ASSETS:		
Property, plant and equipment, net	51,317	54,750
Other intangible assets, net	182,050	185,855
Other assets	13,403	15,144
Goodwill	116,596	133,745
Total assets	<u>\$ 489,964</u>	<u>\$ 516,372</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)

	June 30, 2005	September 30, 2004
	(Unaudited)	
CURRENT LIABILITIES:		
Current portion of long-term debt	\$ 3,455	\$ 1,639
Accounts payable and accrued liabilities	55,684	46,730
Accrued interest	3,067	6,996
Accrued income taxes	1,947	1,648
Total current liabilities	64,153	57,013
LONG TERM LIABILITIES:		
Long-term debt	298,299	302,842
Deferred income taxes	40,587	59,699
Other liabilities	14,169	14,726
Total liabilities	417,208	434,280
STOCKHOLDER'S EQUITY:		
Common stock, \$.01 par value—		
Authorized—100 shares		
Issued and outstanding—100 shares	-	-
Paid in capital	101,640	101,610
Accumulated deficit	(26,848)	(19,415)
Accumulated other comprehensive loss	(2,036)	(103)
Total stockholder's equity	72,756	82,092
Total liabilities and stockholder's equity	\$ 489,964	\$ 516,372

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 June 30,		Nine Months Ended June 30,	Three Months Ended June 30,	Six Months Ended March 31,
	2005	2004	2005	2004	2004
	Successor		Successor		Predecessor
Net sales	\$ 113,198	\$ 97,126	\$ 313,437	\$ 97,126	\$ 169,579
Cost of sales	<u>58,124</u>	<u>68,144</u>	<u>159,757</u>	<u>68,144</u>	<u>89,056</u>
Gross profit	55,074	28,982	153,680	28,982	80,523
Selling and administrative	34,172	28,149	98,583	28,149	56,835
Research and technical services	2,234	1,966	6,665	1,966	3,623
Amortization	1,313	101	3,928	101	242
Other (income) charges, net	(512)	1,690	(200)	1,690	(506)
Restructuring	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>(1,091)</u>
Operating income (loss)	17,867	(2,924)	44,704	(2,924)	21,420
Interest expense, net	<u>5,856</u>	<u>10,292</u>	<u>16,785</u>	<u>10,292</u>	<u>10,836</u>
Income (loss) before provision for income taxes	12,011	(13,216)	27,919	(13,216)	10,584
Provision for income taxes	<u>1,569</u>	<u>1,031</u>	<u>358</u>	<u>1,031</u>	<u>2,020</u>
Net income (loss)	<u>\$ 10,442</u>	<u>\$ (14,247)</u>	<u>\$ 27,561</u>	<u>\$ (14,247)</u>	<u>\$ 8,564</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)

<u>Successor</u>	Common Stock		Paid In	Accumulated	Accumulated Other Comprehensive	Total	Comprehensive Income (Loss)
	Shares	Amount	Capital	Deficit	Loss		
Balance, October 1, 2004	100	\$ -	\$ 101,610	\$ (19,415)	\$ (103)	\$ 82,092	
Net income	-	-	-	27,561	-	27,561	\$ 27,561
Dividend to parent				(34,994)		(34,994)	-
Foreign currency translation adjustment	-	-	-	-	(1,689)	(1,689)	(1,689)
Unrealized loss on derivative instruments	-	-	-	-	(244)	(244)	(244)
Vesting of restricted stock	-	-	30		-	30	-
Comprehensive income	-	-	-	-	-	-	\$ 25,628
Balance, June 30, 2005	<u>100</u>	<u>\$ -</u>	<u>\$ 101,640</u>	<u>\$ (26,848)</u>	<u>\$ (2,036)</u>	<u>\$ 72,756</u>	

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

AEARO COMPANY I AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

(In Thousands)

(Unaudited)

	Nine Months Ended June 30, 2005	Three Months Ended June 30 2004	Six Months Ended March 31, 2004
CASH FLOWS FROM OPERATING ACTIVITIES:	Successor		Predecessor
Net income (loss)	\$ 27,561	\$ (14,247)	\$ 8,564
Adjustments to reconcile net income (loss) to cash provided by operating activities—			
Depreciation	8,131	3,006	5,931
Amortization of intangible assets	3,928	101	242
Amortization of deferred financing costs	1,068	4,234	2,026
Inventory purchase accounting adjustment	--	17,067	--
Deferred income taxes	(3,310)	(7)	--
Stock based compensation	30	10	
Restructuring	--	--	(1,091)
Loss on disposal of assets	3		682
Changes in assets and liabilities—			
Accounts receivable	(6,755)	(2,242)	(1,113)
Inventories	(4,166)	2	(3,464)
Accrued income taxes	432	522	(1,453)
Accrued interest	(3,928)	767	3
Accounts payable and accrued liabilities	7,107	2,667	(3,224)
Prepaid expenses and other assets	427	986	633
Other liabilities	1,012	928	1,299
Net cash provided by operating activities	<u>31,540</u>	<u>13,794</u>	<u>9,035</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Additions to property, plant and equipment	(5,404)	(2,810)	(5,006)
Proceeds provided by disposals of property, plant and equipment	64	--	12
Net cash used by investing activities	<u>(5,340)</u>	<u>(2,810)</u>	<u>(4,994)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Distribution to shareholder to effect the merger	--	(86,852)	--
Repayment of old credit facility	--	(78,333)	--
Repayment of 12.5% senior subordinated notes	--	(98,000)	--
Proceeds from 8.25 senior subordinated notes	--	175,000	--
Debt issue costs	--	(10,408)	
Dividend to parent	(34,994)	(14,305)	--
Proceeds from (repayment of) revolving credit facility, net	--	(15,600)	3,950
Proceeds from (repayment of) term loans	(961)	125,000	(8,949)
Repayment of capital lease obligations	(200)	(61)	(122)
Repayment of long term debt	(273)	(26)	(119)
Net cash used for financing activities	<u>(36,428)</u>	<u>(3,585)</u>	<u>(5,240)</u>
EFFECT OF EXCHANGE RATE ON CASH	<u>(1,477)</u>	<u>(858)</u>	<u>(789)</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(11,705)	6,541	(1,988)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	<u>27,724</u>	<u>5,313</u>	<u>7,301</u>
CASH AND CASH EQUIVALENTS, END OF PERIOD	<u>\$ 16,019</u>	<u>\$ 11,854</u>	<u>\$ 5,313</u>
CASH PAID FOR:			
Interest	<u>\$ 19,977</u>	<u>\$ 4,787</u>	<u>\$ 8,862</u>
Income taxes	<u>\$ 3,674</u>	<u>\$ 552</u>	<u>\$ 3,254</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
JUNE 30, 2005

(Unaudited)

1) 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 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, Merger 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.

On March 10, 2004, Aearo Corporation ("Parent"), the Company's parent, entered into a merger agreement ("Merger Agreement") with AC Safety Holding Corp. and its subsidiary, AC Safety Acquisition Corp. that closed on April 7, 2004 (the "Merger"). Pursuant to the terms of the Merger Agreement, on April 7, 2004 ("Acquisition Date"), AC Safety Acquisition Corp. merged with and into Aearo Corporation with Aearo Corporation surviving the Merger as a wholly-owned subsidiary of AC Safety Holding Corp. The aggregate purchase price was approximately \$409.3 million, including fees and expenses. The Merger was financed with approximately \$303.7 million of debt as discussed in Note 6, \$3.7 million of which was assumed, \$4.3 million of cash and \$101.3 million of equity. The Company continues to be wholly-owned by Aearo Corporation after the Merger. The purpose of the Merger was to effect a change of control from Aearo Corporation to the Company's ultimate parent AC Safety Holding Corp.

Approximately \$87.0 million of proceeds from the Merger was distributed to our Parent and used to pay the shareholders of the Parent to effect the merger transaction. An additional \$14.3 million distributed to our Parent was used to pay the outstanding debt of the Parent as of April 7, 2004.

The Merger was a business combination under SFAS No. 141, "Business Combinations," and the purchase price paid for our Parent reflects the push down of 100% of the purchase price resulting from the Merger. Accordingly, the results of operations subsequent to the Acquisition Date are presented on a different basis of accounting than the results of operations prior to the Acquisition Date, and, therefore are not directly comparable. The sale was accounted for as if it had occurred on March 31, 2004, as management determined that results of operations were not significant and no material transactions occurred during the period from April 1, 2004 to April 7, 2004. The periods prior to April 7, 2004, are referred to as predecessor financial statements and the periods after April 7, 2004, are referred to as successor financial statements.

The purchase price is allocated to the Company's tangible and intangible assets and liabilities based upon estimated fair values as of the date of the Merger. The adjustment made to deferred tax liabilities and goodwill in fiscal 2005 reflect the adjustment of the purchase price

allocation to identifiable intangible assets and the related deferred tax liabilities for differences between book and tax basis of those assets as a result of finalizing the tax basis of certain assets. The purchase price has been allocated as follows (dollars in thousands):

Working capital	\$ 77,357
Fixed assets	55,139
Other assets and liabilities	16,073
Deferred tax liabilities	(45,258)
Finite lived intangible asset	74,104
Indefinite lived intangible assets	114,300
Goodwill	<u>117,629</u>
Purchase price	<u>\$ 409,344</u>

Goodwill resulting from the Merger is not deductible for income tax purposes.

3) Significant Accounting Policies

Use of Estimates. The preparation of the 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 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 June 30, 2005 and 2004 were \$0.9 million and \$0.4 million, respectively. The amount of co-operative advertising charged to selling and administrative expenses for the nine months ended June 30, 2005 and six months ended March 31, 2004 were \$2.0 million and \$0.9 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 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. At September 30, 2004, the Company's deferred tax asset for domestic net operating losses was partially offset by a valuation allowance of \$7.5 million. During the three month period ended March 31, 2005, management determined that based on current domestic operating results, it is more likely than not that domestic net operating losses will be realized and consequently reversed the \$7.5 million valuation allowance.

The Company is included in the consolidated tax return filed by AC Safety Holding Corp. 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 Intangibles", goodwill and intangible assets that have indefinite useful lives are not amortized but are tested at least annually for impairment. The Company will test its goodwill and indefinite lived intangible assets as of September 30, 2005. 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, 2004 and June 30, 2005, resulting from the Merger (dollars in thousands):

<u>September 30, 2004</u>	<u>Gross</u> <u>Amount</u>	<u>Accumulated</u> <u>Amortization</u>	<u>Additions</u>	<u>Carrying</u> <u>Amount</u>
Trademarks	\$ 114,300	\$ --	\$ --	\$ 114,300
Customer relationship list	73,000	(2,433)	--	70,567
Patents	719	(122)	82	679
Other	385	(76)	--	309
Total Intangibles	<u>\$ 188,404</u>	<u>\$ (2,631)</u>	<u>\$ 82</u>	<u>\$ 185,855</u>

<u>June 30, 2005 (Unaudited)</u>	<u>Gross</u> <u>Amount</u>	<u>Accumulated</u> <u>Amortization</u>	<u>Additions</u>	<u>Carrying</u> <u>Amount</u>
Trademarks	\$ 114,300	\$ --	\$ --	\$ 114,300
Customer Relationship List	73,000	(6,083)	--	66,917
Patents	802	(316)	122	608
Other	385	(160)	--	225
Total Intangibles	<u>\$ 188,487</u>	<u>\$ (6,559)</u>	<u>\$ 122</u>	<u>\$ 182,050</u>

Estimate of Aggregate Amortization Expense (dollars in thousands):

Year ending September 30, 2005	\$ 5,241
Year ending September 30, 2006	5,225
Year ending September 30, 2007	5,114
Year ending September 30, 2008	4,904
Year ending September 30, 2009	4,913

The following presents the allocation of goodwill resulting from the Merger and the changes in the carrying amount of goodwill for the nine months ended June 30, 2005 (dollars in thousands):

	<u>Nine Months</u> <u>Ended</u> <u>June 30,</u> <u>2005</u>
Beginning balance	\$ 133,745
Allocation adjustment	(15,491)
Translation adjustment	<u>(1,658)</u>
Ending balance	<u>\$ 116,596</u>

The allocation adjustment in fiscal 2005 reflects the adjustment of the purchase price allocation to identifiable intangible assets and the related deferred tax liabilities for differences between book and tax bases of those assets as a result of finalizing the tax basis of certain assets.

Stock-based Compensation. The Company accounts for stock-based compensation under the recognition and measurement principles of Accounting Principals Board (“APB”) No. 25, “Accounting for Stock Issued to Employees”. 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 June 30,		Nine Months Ended June 30	Three Months Ended June 30,	Six Months Ended March 31,
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2004</u>
	Successor		Successor		Predecessor
Net income (loss) as reported	\$ 10,442	\$ (14,247)	\$ 27,561	\$ (14,247)	\$ 8,564
Stock based compensation expense recorded under APB No. 25, net of tax	10	--	30	10	--
Stock-based compensation expense determined under the fair value method, net of tax	(44)	--	(127)	(10)	(67)
Proforma net income (loss)	<u>\$ 10,408</u>	<u>\$ (14,247)</u>	<u>\$ 27,464</u>	<u>\$ (14,247)</u>	<u>\$ 8,497</u>

Accounting for Derivative Instruments and Hedging Activities. SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" 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 has formally documented its hedging relationships, including identification of the hedging instruments and the hedge items, as well as its risk management objectives and strategies for undertaking each hedge transaction. From time to time the Company enters into foreign currency exchange contracts and interest rate swap agreements, which are derivatives as defined by SFAS No. 133. The Company enters into forward foreign currency contracts to mitigate the effects of changes in foreign currency rates on profitability and enters into interest rate swap agreements to hedge its variable interest rate risk. These derivatives are cash flow hedges. For all qualifying and highly effective cash flow hedges, the changes in the fair value of the derivatives are recorded in other comprehensive income. Amounts accumulated in other comprehensive income will be reclassified to earnings when the related product sales affect earnings for forward foreign currency contracts or when related interest payments affect earnings for interest rate swaps. During the three month period ended June 30, 2005, the Company entered into three new forward foreign currency contracts that will protect the Company against exchange rate movement during fiscal year 2006. As result of the new forward currency contracts, the Company has recorded a derivative payable of \$0.4 million at June 30, 2005. For the three month periods ended June 30, 2005 and 2004, the Company had no gains or losses resulting from the exercise of forward foreign currency contracts. For the nine and six month periods ended June 30, 2005 and March 31, 2004, the Company reclassified into earnings net losses of \$0 million and \$0.5 million, respectively resulting from the exercise of forward foreign currency contracts. All forward foreign currency contracts were determined to be highly effective whereby no ineffectiveness was recorded in earnings.

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 did not elect hedge accounting treatment for the interest rate cap as defined under SFAS No. 133, and, as a result, any fair value adjustment was charged directly to other charges (income), net. There was \$0.1 million of expense charges to earnings for the period ended, June 30, 2004 for the change in the fair value of the interest rate cap.

The Company also executes 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 other charges (income), net. The impact on earnings was a gain of approximately \$ 0.3 million and \$ 0.1 million for the three and nine month periods ended June 30, 2005, respectively, compared to net loss of \$ 0.3 million and \$0.4 million, respectively for the three and six month periods ended June 30, 2004 and March 31, 2004, respectively.

On June 30, 2005, the FASB issued Derivatives Implementation Group (“DIG”) B39, “Application of Paragraph 13(b) to Call Options That are Exercisable Only by the Debtor”, which provides an explicit scope exception to the provisions of paragraph 13(b) of SFAS No. 133 when the right to accelerate a repayment can only be exercise by the debtor (issuer/borrower). The Company has adopted DIG B39 as of April 1, 2005. Prior to the adoption of DIG B39, the Company determined under the provisions of DIG B16, “Calls and Puts in Debt Instruments”, that the embedded call option in the Company’s Senior Subordinated Notes was not clearly and closely related to the debt host contract and therefore required bifurcation. The carrying values of the derivative asset and liability were \$2.0 million at September 30, 2004. Prior to the adoption of DIG B39, the Company had recorded \$0.2 million loss in other (income) charges, net for the mark to market revaluation of the embedded call option and \$0.2 million for the reduction of interest due to the amortization of the corresponding liability during 2005. Upon the adoption of DIG B39, the Company reversed a derivative asset of approximately \$1.8 million and the corresponding liability that was previously recorded.

4) Other Comprehensive Income

The following table presents the reclassification amounts related to unrealized holding gains and losses presented in the statement of stockholder’s equity for the three month periods ended June 30, 2005 and 2004 and the nine and six month periods ended June 30, 2005 and March 31, 2004, respectively (dollars in thousands):

	Three Months Ended June 30,		Nine Months Ended June 30		Three Months Ended June 30,		Six Months Ended March 31,	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2004</u>	
	Successor		Successor		Successor		Predecessor	
Unrealized holding losses on derivatives during the period	\$ (244)	\$ (138)	\$ (244)	\$ (138)	\$ (244)	\$ (138)		\$ (133)
Less: reclassification adjustment for gains (losses) included in the statements of operations	<u>--</u>	<u>25</u>	<u>--</u>	<u>25</u>	<u>--</u>	<u>25</u>		<u>523</u>
Total	<u>\$ (244)</u>	<u>\$ (113)</u>	<u>\$ (244)</u>	<u>\$ (113)</u>	<u>\$ (244)</u>	<u>\$ (113)</u>		<u>\$ 390</u>

5) Inventories

Inventories consist of the following (dollars in thousands):

	June 30, 2005	September 30, 2004
	(Unaudited)	
Raw materials	\$ 11,029	\$ 9,302
Work in process	9,415	12,087
Finished goods	23,980	19,460
	<u>\$ 44,424</u>	<u>\$ 40,849</u>

Inventories, which include materials, labor and manufacturing overhead, are stated at the lower of cost or market, cost being 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 the Acquisition Date, the Company's debt has been negatively impacted by \$0.3 million related to the fluctuation of the Euro relative to the U.S dollar as of June 30, 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 were approximately \$123.8 million and \$126.0 million at June 30, 2005 and September 30, 2004, respectively. There were no amounts outstanding under the Revolving Credit Facility at June 30, 2005 and September 30, 2004 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 \$1.4 million and \$1.6 million of letters of credit outstanding at September 30, 2004 and June 30, 2005, respectively. 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 June 30, 2005.

On April 28, 2005, the Company amended its credit agreement to allow the Company to make, prior to September 30, 2005, up to \$35 million of cash distributions to Aearo Corporation, its parent corporation for the purpose of paying cash dividends to AC Safety Holding Corp., its parent, to be used by AC Safety Holding Corp. 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.

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. In addition, under the terms of the Merger Agreement with AC Safety Acquisition Corp., Aearo Corporation agreed to make the annual payment to Cabot for a minimum of seven years from the Acquisition 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 2003 and 2004, the Company settled 259 claims in which it was named as a defendant for an average settlement amount of \$24.36 in silica claims and \$83.24 in asbestos claims, while an additional 200 claims were dismissed without any payment (43.6% of cases closed), because the Company was not a proper defendant or did not make the product in question. As of September 30, 2004, the number of open claims where the Company was named as a defendant in silica and asbestos related matters was 11,087 and 4,282, respectively. For the nine months ended June 30, 2005, the increases in number of claims where the Company was named as a defendant in silica and asbestos related matters was 2,122 and 1,010 respectively. The 1,010 new asbestos claims include 114 claims that allege

exposure from clothing, which the Company never manufactured. One claim was settled for \$17.85 where the Company was named as a defendant in silica related matters during the nine months ended June 30, 2005. No claims were settled where the Company was named as a defendant in asbestos related matters during the nine months ended June 30, 2005. As of June 30, 2005, the number of open claims where the Company was named as a defendant in silica and asbestos related matters was 12,739 and 4,095, 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 Aearo has some risk of legal liability as a successor (“Additional Claims”). During the nine months ended June 30, 2005, Aearo paid a total of \$1.67 million for settlement, administrative and defense costs resulting in the settlement of 4,325 silica and asbestos claims that were settled between October 1, 2002 and September 30, 2004 involving both claims in which Aearo was named as a defendant and Additional Claims. During the period October 1, 2004 to June 30, 2005 Aearo paid a total of \$164.72 for three additional claims that were settled during that time period and paid a total of \$0.4 million for administrative and defense costs involving both claims in which Aearo was named as a defendant and Additional Claims. In addition, Aearo 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 Aearo.

The above information was based on data provided by Simon Peragine Smith, an outside law firm which tracks numbers 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 Aearo participates and through which all of its settlements have been handled in the relevant years. Also, between October 1, 2004 and June 30, 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 Aearo.

At June 30, 2005 and September 30, 2004, the Company has recorded liabilities of approximately \$4.6 million and \$5.4 million, respectively, which represents reasonable estimates of its probable liabilities for product liabilities substantially related to asbestos and silica-related claims as determined by the Company in consultation with an independent consultant. The \$0.8 million reduction in the reserve, net of new accruals which added to the reserve, since September 30, 2004 is primarily attributed to the payment of \$1.67 million, as referenced above, to pay costs attributed to settlement, administrative and defense costs that had been reached over the prior two year time period. 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 2009 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.

Net Sales by Business Segment (dollars in thousands):

	Three Months Ended June 30,		Nine Months Ended June 30	Three Months Ended June 30,	Six Months Ended March 31,
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2004</u>
	Successor		Successor		Predecessor
Safety Products	\$ 86,161	\$ 73,966	\$ 235,926	\$ 73,966	\$ 127,964
Safety Prescription Eyewear	10,493	10,126	29,706	10,126	20,337
Specialty Composites	<u>16,544</u>	<u>13,034</u>	<u>47,805</u>	<u>13,034</u>	<u>21,278</u>
Total	<u>\$113,198</u>	<u>\$ 97,126</u>	<u>\$ 313,437</u>	<u>\$ 97,126</u>	<u>\$ 169,579</u>

Inter-segment sales from the Specialty Composites segment to the Safety Products segment totaled \$1.1 million and \$0.7 million for the three months ended June 30, 2005 and 2004, respectively. Inter-segment sales from the Specialty Composites segment to the Safety Products segment totaled \$3.1 million and \$1.5 million for the nine and six months ended June 30, 2005 and March 31, 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 (loss) before income taxes (dollars in thousands):

	Three Months Ended June 30,		Nine Months Ended June 30	Three Months Ended June 30,	Six Months Ended March 31,
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2004</u>
	Successor		Successor		Predecessor
Safety Products	\$ 18,526	\$ 16,122	\$ 46,374	\$ 16,122	\$ 23,704
Safety Prescription Eyewear	275	37	(66)	37	(57)
Specialty Composites	<u>3,504</u>	<u>2,623</u>	<u>10,455</u>	<u>2,623</u>	<u>2,855</u>
Segment profit	22,305	18,782	56,763	18,782	26,502
Depreciation	3,125	3,006	8,131	3,006	5,931
Amortization of intangibles	1,313	101	3,928	101	242
Inventory purchase accounting	--	17,067	--	17,067	--
Bond call premium	--	1,532	--	1,532	--
Restructuring	--	--	--	--	(1,091)
Interest	<u>5,856</u>	<u>10,292</u>	<u>16,785</u>	<u>10,292</u>	<u>10,836</u>
Income (loss) before income taxes	<u>12,011</u>	<u>\$ (13,216)</u>	<u>\$ 27,919</u>	<u>\$ (13,216)</u>	<u>\$ 10,584</u>

Segment profit is defined as operating income (loss) before depreciation, amortization, interest expense 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 June 30, 2004 and 2005, and the nine and six month periods ended June 30, 2005 and March 31, 2004, respectively (dollars in thousands):

	Three Months Ended June 30,		Nine Months Ended June 30	Three Months Ended June 30,	Six Months Ended March 31,
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2004</u>
	Successor		Successor		Predecessor
Service cost	\$ 364	\$ 335	\$ 1,089	\$ 335	\$ 669
Interest cost	206	186	618	186	371
Expected return on plan assets	(184)	(167)	(552)	(167)	(332)
Amortization of prior service cost	<u>--</u>	<u>2</u>	<u>--</u>	<u>2</u>	<u>5</u>
Total	<u>\$ 386</u>	<u>\$ 356</u>	<u>\$ 1,155</u>	<u>\$ 356</u>	<u>\$ 713</u>

The Company previously disclosed in its Annual Report on Form 10-K for the year ended September 30, 2004, that it expected to contribute \$1.2 million to its pension plan in 2005. As of June 30, 2005, the Company has not made any contributions to its pension plan and plans to contribute a revised amount of \$1.8 million in the fourth quarter of fiscal 2005.

10) Dividend

On May 5, 2005, the Company's Board of Directors declared and paid a cash dividend to the Company's parent, Aearo Corporation, the sole holder of common stock, of approximately \$35 million. Aearo Corporation then paid a cash dividend to AC Safety Holding Corp., the Company's ultimate parent, who used the proceeds to make a partial redemption of its preferred stock. The Company used available cash to fund the dividend.

11) 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).

Consolidated Statement of Operations (Unaudited) Nine Months Ended June 30, 2005

	Successor					
	<u>Aearo</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	\$ 234,381	\$ --	\$ 114,004	\$ (34,948)	\$	\$ 313,437
Cost of sales	<u>132,127</u>	<u>--</u>	<u>62,454</u>	<u>(34,824)</u>	<u>--</u>	<u>159,757</u>
Gross profit	102,254	--	51,550	(124)	--	153,680
Selling and administrative	71,843	2,871	23,869	--	--	98,583
Research and technical services.....	4,186	--	2,479	--	--	6,665
Amortization	2,774	194	960	--	--	3,928
Other charges (income), net.....	<u>13,686</u>	<u>(20,911)</u>	<u>7,025</u>	<u>--</u>	<u>--</u>	<u>(200)</u>
Operating income (loss).....	9,765	17,846	17,217	(124)	--	44,704
Interest expense (income).....	<u>16,374</u>	<u>(2,172)</u>	<u>2,583</u>	<u>--</u>	<u>--</u>	<u>16,785</u>
Income (loss) before income taxes	(6,609)	20,018	14,634	(124)	--	27,919
Income tax provision (benefit).....	(11,984)	8,232	4,110	--	--	358
Equity in subsidiaries' earnings.....	<u>22,310</u>	<u>10,524</u>	<u>--</u>	<u>(32,834)</u>	<u>--</u>	<u>--</u>
Net income	<u>\$ 27,685</u>	<u>\$ 22,310</u>	<u>\$ 10,524</u>	<u>\$ (32,958)</u>	<u>\$</u>	<u>\$ 27,561</u>

Consolidated Statement of Operations (Unaudited)
Three Months Ended June 30, 2004

	Successor				
	Aearo	Guarantor	Non-	Eliminations	Consolidated
	Company I	Subsidiaries	Guarantor Subsidiaries		
Net sales	\$ 72,522	\$ --	\$ 35,388	\$ (10,784)	\$ 97,126
Cost of sales	<u>52,065</u>	<u>--</u>	<u>26,893</u>	<u>(10,814)</u>	<u>68,144</u>
Gross profit	20,457	--	8,495	30	28,982
Selling and administrative	20,797	344	7,008	--	28,149
Research and technical services.....	1,251	--	715	--	1,966
Amortization	83	18	--	--	101
Other charges (income), net.....	<u>5,582</u>	<u>(6,743)</u>	<u>2,851</u>	<u>--</u>	<u>1,690</u>
Operating income.....	(7,256)	6,381	(2,079)	30	(2,924)
Interest expense (income), net	<u>10,152</u>	<u>(399)</u>	<u>539</u>	<u>--</u>	<u>10,292</u>
Income (loss) before income taxes	(17,408)	6,780	(2,618)	30	(13,216)
Income tax provision (benefit).....	(2,875)	2,700	1,206	--	1,031
Equity in subsidiaries' earnings.....	<u>256</u>	<u>(3,824)</u>	<u>--</u>	<u>3,568</u>	<u>--</u>
Net income (loss)	<u>\$ (14,277)</u>	<u>\$ 256</u>	<u>\$ (3,824)</u>	<u>\$ 3,598</u>	<u>\$ (14,247)</u>

Consolidated Statement of Operations (Unaudited)
Six Months Ended March 31, 2004

	Predecessor				
	Aearo	Guarantor	Non-	Eliminations	Consolidated
	Company I	Subsidiaries	Guarantor Subsidiaries		
Net sales	\$ 122,913	\$ --	\$ 65,030	\$ (18,364)	\$ 169,579
Cost of sales	<u>71,142</u>	<u>--</u>	<u>36,348</u>	<u>(18,434)</u>	<u>89,056</u>
Gross profit	51,771	--	28,682	70	80,523
Selling and administrative	42,612	674	13,549	--	56,835
Research and technical services.....	2,351	--	1,272	--	3,623
Amortization	168	74	--	--	242
Other charges (income), net.....	6,815	(12,283)	4,962	--	(506)
Restructuring charges (income).....	<u>(1,091)</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>(1,091)</u>
Operating income.....	916	11,535	8,899	70	21,420
Interest expense (income), net	<u>10,117</u>	<u>(983)</u>	<u>1,702</u>	<u>--</u>	<u>10,836</u>
Income (loss) before income taxes	(9,201)	12,518	7,197	70	10,584
Income tax provision (benefit).....	(4,642)	5,022	1,640	--	2,020
Equity in subsidiaries' earnings.....	<u>13,053</u>	<u>5,557</u>	<u>--</u>	<u>(18,610)</u>	<u>--</u>
Net income	<u>\$ 8,494</u>	<u>\$ 13,053</u>	<u>\$ 5,557</u>	<u>\$ (18,540)</u>	<u>\$ 8,564</u>

Consolidated Statement of Operations (Unaudited)
Three Months Ended June 30, 2005

	Successor				
	<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>		
Net sales	\$ 86,049	\$ --	\$ 40,402	\$ (13,253)	\$ 113,198
Cost of Sales	<u>48,648</u>	<u>--</u>	<u>22,657</u>	<u>(13,181)</u>	<u>58,124</u>
Gross profit	37,401	--	17,745	(72)	55,074
Selling and administrative	25,628	344	8,200	--	34,172
Research and technical services.....	1,401	--	833	--	2,234
Amortization	923	70	320	--	1,313
Other charges (income), net.....	<u>5,134</u>	<u>(7,547)</u>	<u>1,901</u>	<u>--</u>	<u>(512)</u>
Operating income	4,315	7,133	6,491	(72)	17,867
Interest expense (income)	<u>5,687</u>	<u>(531)</u>	<u>700</u>	<u>--</u>	<u>5,856</u>
Income (loss) before income taxes	(1,372)	7,664	5,791	(72)	12,011
Income tax provision (benefit).....	(2,313)	3,140	742	--	1,569
Equity in subsidiaries' earnings.....	<u>9,573</u>	<u>5,049</u>	<u>--</u>	<u>(14,622)</u>	<u>--</u>
Net income.....	<u>\$ 10,514</u>	<u>\$ 9,573</u>	<u>\$ 5,049</u>	<u>\$ (14,694)</u>	<u>\$ 10,442</u>

Consolidated Balance Sheet (Unaudited)
June 30, 2005

	<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>
Current Assets:					
Cash and cash equivalents	\$ 6,169	\$ 397	\$ 9,453	\$ --	\$ 16,019
Receivables, net	39,813	229	20,511	--	60,553
Inventories	33,091	--	11,766	(433)	44,424
Deferred and prepaid expenses.....	<u>4,533</u>	<u>--</u>	<u>1,069</u>	<u>--</u>	<u>5,602</u>
Total current assets	<u>83,606</u>	<u>626</u>	<u>42,799</u>	<u>(433)</u>	<u>126,598</u>
Long Term Assets:					
Property plant and equipment.....	37,349	--	13,968	--	51,317
Goodwill and other intangibles, net	90,228	122,243	86,175	--	298,646
Inter-company receivables (payables).....	(54,417)	94,199	(39,782)	--	--
Investment in subsidiaries	242,966	67,292	(664)	(309,594)	--
Other assets.....	<u>13,392</u>	<u>--</u>	<u>11</u>	<u>--</u>	<u>13,403</u>
Total assets	<u>\$ 413,124</u>	<u>\$ 284,360</u>	<u>\$ 102,507</u>	<u>\$ (310,027)</u>	<u>\$ 489,964</u>
Current Liabilities:					
Current portion of long term debt	\$ 3,455	\$ --	\$ --	\$ --	\$ 3,455
Accounts payable and accrued liabilities	40,675	435	14,574	--	55,684
Accrued interest.....	3,067	--	--	--	3,067
Income tax payables (receivables)	<u>2,012</u>	<u>(2,150)</u>	<u>2,085</u>	<u>--</u>	<u>1,947</u>
Total current liabilities.....	<u>49,209</u>	<u>(1,715)</u>	<u>16,659</u>	<u>--</u>	<u>64,153</u>
Long Term Liabilities:					
Long term debt	298,299	--	--	--	298,299
Deferred income taxes.....	3,719	23,860	13,008	--	40,587
Other liabilities	<u>14,169</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>14,169</u>
Total liabilities	<u>365,396</u>	<u>22,145</u>	<u>29,667</u>	<u>--</u>	<u>417,208</u>
Stockholder's Equity:					
Common	--	--	4,222	(4,222)	--
Paid in capital	101,640	267,796	41,865	(309,661)	101,640
Accumulated deficit.....	(54,445)	(8,638)	36,695	(460)	(26,848)
Accumulated other comprehensive income (loss)	<u>533</u>	<u>3,057</u>	<u>(9,942)</u>	<u>4,316</u>	<u>(2,036)</u>
Total stockholder's equity	<u>47,728</u>	<u>262,215</u>	<u>72,840</u>	<u>(310,027)</u>	<u>72,756</u>
Total liabilities and stockholder's equity.....	<u>\$ 413,124</u>	<u>\$ 284,360</u>	<u>\$ 102,507</u>	<u>\$ (310,027)</u>	<u>\$ 489,964</u>

Consolidated Balance Sheet
September 30, 2004

	<u>Aeero</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	\$ 18,309	\$ 140	\$ 9,275	\$ --	\$ 27,724
Receivables, net	34,823	--	19,336	--	54,159
Inventories	29,956	--	11,202	(309)	40,849
Deferred and prepaid expenses.....	<u>3,014</u>	<u>--</u>	<u>1,132</u>	<u>--</u>	<u>4,146</u>
Total current assets	<u>86,102</u>	<u>140</u>	<u>40,945</u>	<u>(309)</u>	<u>126,878</u>
Long Term Assets:					
Property plant and equipment.....	40,040	--	14,710	--	54,750
Goodwill and other intangibles, net	134,567	131,786	53,247	--	319,600
Inter-company receivables (payables).....	64,478	(12,147)	(52,331)	--	--
Investment in subsidiaries	154,350	40,981	(713)	(194,618)	--
Other assets	<u>15,133</u>	<u>--</u>	<u>11</u>	<u>--</u>	<u>15,144</u>
Total Assets.....	<u>\$ 494,670</u>	<u>\$ 160,760</u>	<u>\$ 55,869</u>	<u>\$ (194,927)</u>	<u>\$ 516,372</u>
Current Liabilities:					
Current portion of long term debt	\$ 1,618	\$ --	\$ 21	\$ --	\$ 1,639
Accounts payable and accrued liabilities	32,623	577	13,530	--	46,730
Accrued interest.....	6,996	--	--	--	6,996
Income tax payables (receivables)	<u>2,324</u>	<u>(2,317)</u>	<u>1,641</u>	<u>--</u>	<u>1,648</u>
Total current liabilities.....	<u>43,561</u>	<u>(1,740)</u>	<u>15,192</u>	<u>--</u>	<u>57,013</u>
Long Term Liabilities:					
Long term debt	302,662	--	180	--	302,842
Deferred income taxes.....	58,073	--	1,626	--	59,699
Other liabilities	<u>14,726</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>14,726</u>
Total liabilities	<u>419,022</u>	<u>(1,740)</u>	<u>16,998</u>	<u>--</u>	<u>434,280</u>
Stockholder's Equity:					
Common	--	--	7,396	(7,396)	--
Paid in capital	101,610	167,519	12,280	(179,799)	101,610
Accumulated deficit.....	(24,824)	(8,664)	26,168	(12,095)	(19,415)
Accumulated other comprehensive income (loss)	<u>(1,138)</u>	<u>3,645</u>	<u>(6,973)</u>	<u>4,363</u>	<u>(103)</u>
Total stockholder's equity	<u>75,648</u>	<u>162,500</u>	<u>38,871</u>	<u>(194,927)</u>	<u>82,092</u>
Total liabilities and stockholder's equity.....	<u>\$ 494,670</u>	<u>\$ 160,760</u>	<u>\$ 55,869</u>	<u>\$ (194,927)</u>	<u>\$ 516,372</u>

**Consolidating Statement of Cash Flows (Unaudited)
Nine Months Ended June 30, 2005**

	Successor			Consolidated
	<u>Aearo</u> <u>Company I</u>	<u>Guarantor</u> <u>Subsidiaries</u>	<u>Non-</u> <u>Guarantor</u> <u>Subsidiaries</u>	
Net cash provided by operating activities.....	\$ 16,140	\$ 12,605	\$ 2,795	\$ 31,540
Net cash used for investing activities	(3,508)	--	(1,832)	(5,340)
Net cash provided by (used for) financing activities.....	(24,768)	(11,660)	-	(36,428)
Effect of exchange rate on cash	<u>(4)</u>	<u>(688)</u>	<u>(785)</u>	<u>(1,477)</u>
Increase (decrease) in cash and cash equivalents	(12,140)	257	178	(11,705)
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>\$ 6,169</u>	<u>\$ 397</u>	<u>\$ 9,453</u>	<u>\$ 16,019</u>

**Consolidating Statement of Cash Flows (Unaudited)
Three Months Ended June 30, 2004**

	Predecessor			Consolidated
	<u>Aearo</u> <u>Company I</u>	<u>Guarantor</u> <u>Subsidiaries</u>	<u>Non-</u> <u>Guarantor</u> <u>Subsidiaries</u>	
Net cash provided by operating activities.....	\$ 5,096	\$ 5,352	\$ 3,346	\$ 13,794
Net cash used for investing activities	(2,196)	--	(614)	(2,810)
Net cash provided by (used for) financing activities.....	(2,814)	(5,796)	5,025	(3,585)
Effect of exchange rate on cash	<u>2,051</u>	<u>(210)</u>	<u>(2,699)</u>	<u>(858)</u>
Increase (decrease) in cash and cash equivalents	2,137	(654)	5,058	6,541
Cash and cash equivalents at the beginning of the period..	<u>893</u>	<u>751</u>	<u>3,669</u>	<u>5,313</u>
Cash and cash equivalents at the end of the period	<u>\$ 3,030</u>	<u>\$ 97</u>	<u>\$ 8,727</u>	<u>\$ 11,854</u>

Consolidating Statement of Cash Flows (Unaudited)
Six Months Ended March 31, 2004

	<u>Predecessor</u>			
	<u>Aearo</u>	<u>Guarantor</u>	<u>Non-</u> <u>Guarantor</u>	
	<u>Company I</u>	<u>Subsidiaries</u>	<u>Subsidiaries</u>	<u>Consolidated</u>
Net cash provided by (used for) operating activities.....	\$ (1,359)	\$ 6,407	\$ 3,987	\$ 9,035
Net cash used for investing activities	(3,326)	--	(1,668)	(4,994)
Net cash provided by (used for) financing activities.....	3,255	(6,840)	(1,655)	(5,240)
Effect of exchange rate on cash	<u>779</u>	<u>978</u>	<u>(2,546)</u>	<u>(789)</u>
Increase (decrease) in cash and cash equivalents	(651)	545	(1,882)	(1,988)
Cash and cash equivalents at the beginning of the period..	<u>1,544</u>	<u>206</u>	<u>5,551</u>	<u>7,301</u>
Cash and cash equivalents at the end of the period	<u>\$ 893</u>	<u>\$ 751</u>	<u>\$ 3,669</u>	<u>\$ 5,313</u>

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, 2004.

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.

Merger Agreement

On March 10, 2004, Aearo Corporation ("Parent"), the Company's parent, entered into a merger agreement ("Merger Agreement") with AC Safety Holding Corp. and its subsidiary, AC Safety Acquisition Corp. that closed on April 7, 2004 (the "Merger"). Pursuant to the terms of the Merger Agreement, on April 7, 2004 ("Acquisition Date"), AC Safety Acquisition Corp. merged with and into Aearo Corporation with Aearo Corporation surviving the Merger as a wholly-owned subsidiary of AC Safety Holding Corp. The aggregate purchase price was approximately \$409.3 million, including fees and expenses. The Merger was financed with approximately \$303.7 million of debt as discussed in Note 6, \$3.7 million of which was assumed, \$4.3 million of cash and \$101.3 million of equity. The Company continues to be wholly-owned by Aearo Corporation after the Merger. The purpose of the Merger was to effect a change of control from Aearo Corporation to the Company's ultimate parent AC Safety Holding Corp.

Approximately \$87.0 million of proceeds from the Merger was distributed to our Parent and used to pay the shareholders of the Parent to effect the merger transaction. An additional \$14.3 million distributed to our Parent was used to pay the outstanding debt of the Parent as of April 7, 2004.

The Merger was a business combination under SFAS No. 141, "Business Combinations," and the purchase price paid for our Parent was pushed down to the Company. Accordingly, the results of operations subsequent to the Acquisition Date are presented on a different basis of accounting than the results of operations prior to the Acquisition Date, and therefore, are not directly comparable. The sale was accounted for as if it had occurred on March 31, 2004, as management determined that results of operations were not significant and no material transactions occurred during the period from April 1, 2004 to April 7, 2004.

Results of Operations -- Three Months Ended June 30, 2005 Compared to Three Months Ended June 30, 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 June 30,</u>			
	<u>2005</u>	<u>%</u>	<u>2004</u>	<u>%</u>
Net sales:				
Safety Products	\$ 86,161	76.1	\$ 73,966	76.2
Safety Prescription Eyewear	10,493	9.3	10,126	10.4
Specialty Composites	<u>16,544</u>	<u>14.6</u>	<u>13,034</u>	<u>13.4</u>
Total net sales	113,198	100.0	97,126	100.0
Cost of sales	<u>58,124</u>	<u>51.3</u>	<u>68,144</u>	<u>70.2</u>
Gross profit	<u>55,074</u>	<u>48.7</u>	<u>28,982</u>	<u>29.8</u>
Operating expenses:				
Selling and administrative	34,172	30.1	28,149	29.0
Research and technical services	2,234	2.0	1,966	2.0
Amortization	1,313	1.2	101	0.1
Other charges (income), net	<u>(512)</u>	<u>(0.4)</u>	<u>1,690</u>	<u>1.7</u>
Total operating expense	37,207	32.9	31,906	32.8
Operating income (loss)	17,867	15.8	(2,924)	(3.0)
Interest expense, net	<u>5,856</u>	<u>5.2</u>	<u>10,292</u>	<u>10.6</u>
Income (loss) before income taxes	12,011	10.6	(13,216)	(13.6)
Provision for income taxes	<u>1,569</u>	<u>1.4</u>	<u>1,031</u>	<u>1.1</u>
Net income (loss)	<u>\$ 10,442</u>	<u>9.2</u>	<u>\$ (14,247)</u>	<u>(14.7)</u>

Net sales for the three months ended June 30, 2005 increased 16.6% to \$113.2 million from \$97.1 million in the three months ended June 30, 2004. The increase in net sales was primarily driven by organic growth in the Safety Products and Specialty Composites segments and foreign currency translation. The weakness of the U.S. dollar favorably impacted net sales by \$1.8 million. The Safety Products segment net sales for the three months ended June 30, 2005 increased 16.5% to \$86.2 million from \$74.0 million in the three months ended June 30, 2004. The increase in net sales resulted from a 14.2% increase in organic growth and a 2.3% increase due to foreign currency translation. Organic sales for the

Safety Products segment, defined as net sales less the impact of foreign currency translation and acquisitions, have increased for thirteen consecutive quarters, when compared to the same quarter of the prior year. The Company attributes this growth to 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 June 30, 2005 increased 3.6% to \$10.5 million from \$10.1 million for the three months ended June 30, 2004. The increase in net sales resulted from a 2.8% increase in organic growth and a 0.8% increase from foreign currency translation. Specialty Composites' net sales for the three months ended June 30, 2005 increased 26.9% to \$16.5 million from \$13.0 million in three months ended June 30, 2004. The increase was primarily driven by market share gains and an improving economy driving volume increases in the precision electronics, truck, aircraft and industrial markets. The Company tracks measures such as computer and electronic production data and truck build rates to gauge the momentum in the Specialty Composites segment, which has been experiencing positive sales trends in the last eight quarters.

Gross profit for the three months ended June 30, 2005 increased to \$55.1 million from \$29.0 million for the three months ended June 30, 2004. Gross profit in the three months ended June 30, 2004 was negatively impacted by the non-recurring charge of \$17.1 million resulting from the write-up in inventory required by SFAS No. 141 on the merger date and subsequent sale of such inventory. Excluding the effects of the SFAS No. 141 adjustment, gross profit as a percentage of net sales for the three months ended June 30, 2005 was 48.7% as compared to 47.4% for the three months ended June 30, 2004. The 130 basis point improvement in the gross profit percentage is primarily due to product mix and productivity, accounting for approximately 100 basis points, with the remainder due primarily to the 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 June 30, 2005 increased 20.0% to \$43.3 million from \$36.1 million in the three months ended June 30, 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. Volume and productivity improvements contributed approximately 16.9% of the increase in gross profit with foreign currency translation contributing the remaining 3.1% of the increase. The Safety Prescription Eyewear segment gross profit in the three months ended June 30, 2005 increased 0.4% to \$4.6 million from \$4.5 million in the three months ended June 30, 2004. The increase was primarily the result of a 3.6% improvement due to sales volume and a 3.2% reduction due to product mix. Specialty Composites' gross profit in the three months ended June 30, 2005 increased 33.3% to \$7.2 million from \$5.4 million in the three months ended June 30, 2004. The increase was primarily driven by market share gains and an improving economy driving volume increases in the precision electronics, truck, aircraft and industrial markets, aided by productivity and improved manufacturing absorption. Approximately 26.9% of the increase in the Specialty Composites gross profit was due to volume increases with the remaining 6.4% of the increase due to product mix.

Operating expenses for the three months ended June 30, 2005 increased 16.6% to \$37.2 million from \$31.9 million for the three months ended June 30, 2004. The increase in operating expenses was primarily driven by an increase in selling and administrative, amortization expense, restructuring and research and technical partially offset by other charges, net. Selling and administrative expenses included approximately \$2.1 million due to variable selling expenses such as freight, commissions, travel and marketing, \$1.5 million of legal and consulting fees related to strategic alternatives such as acquisitions and debt financing and a \$0.4 million increase due to foreign currency translation. In addition, in the three months ended June 30, 2004, the Company adjusted approximately \$1.0 million of

expenses incurred as a result of the merger due to the allocation of purchase price as required by SFAS No. 141. Selling and administrative expenses as a percentage of net sales increased to 30.1% for the three months ended June 30, 2005 as compared to 29.0% for the three months ended June 30, 2004. Amortization expense increased approximately \$1.2 million due to the allocation of purchase price to finite lived intangible assets required by SFAS No. 141 due to the Merger Agreement. Other charges (income), net included approximately \$0.5 million favorable impact of foreign currency transaction expenses in the three months ended June 30, 2005 as compared to \$1.7 million of expense in the three months ended June 30, 2004, which included approximately \$1.5 million of expense to call the Company's 12.5% senior subordinated notes to effect the Merger.

Interest expense, net, for the three months ended June 30, 2005 decreased to \$5.9 million from \$10.3 million for the three months ended June 30, 2004. Interest expense in the three months ended June 30, 2004 included approximately \$4.0 million of expense related to the write off of deferred financing fees and approximately \$1.0 million of incremental interest expense related to the redemption of the 12.5% senior subordinated notes as a result of the Merger.

The provision for income taxes for the three months ended June 30, 2005 increased to \$1.6 million from \$1.0 million for the three months ended June 30, 2004. The 2005 estimated annual effective income tax rate was lowered to 29.5% in the three months ended June 30, 2005, which reduced the provision for income taxes by \$1.6 million.

The following discussion provides a comparison of the results of operations for the successor company and that of the predecessor company for the nine months ended June 30, 2005 and 2004, respectively. The discussion is provided for comparative purposes only, but the value of such comparison may be limited. Material variances that are caused by the different basis of accounting have been disclosed where applicable.

Results of Operations
(Dollars in Thousands)

	<u>Nine Months Ended June 30,</u>			
	<u>2005 (1)</u>	<u>%</u>	<u>2004 (1)</u>	<u>%</u>
Net sales:	<u>Successor</u>		<u>Predecessor</u>	
Safety Products	\$ 235,926	75.3	\$ 201,930	75.7
Safety Prescription Eyewear	29,706	9.5	30,463	11.4
Specialty Composites	<u>47,805</u>	<u>15.2</u>	<u>34,312</u>	<u>12.9</u>
Total net sales	313,437	100.0	266,705	100.0
Cost of sales	<u>159,757</u>	<u>51.0</u>	<u>157,200</u>	<u>58.9</u>
Gross profit	<u>153,680</u>	<u>49.0</u>	<u>109,505</u>	<u>41.1</u>
Operating expenses:				
Selling and administrative	98,583	31.5	84,984	31.9
Research and technical services	6,665	2.1	5,589	2.1
Amortization	3,928	1.3	343	0.1
Other charges (income), net	(200)	(0.1)	1,184	0.4
Restructuring	<u>--</u>	<u>--</u>	<u>(1,091)</u>	<u>(0.4)</u>
Total operating expense	108,976	34.8	91,009	34.1
Operating income	44,704	14.2	18,496	6.9
Interest expense, net	<u>16,785</u>	<u>5.3</u>	<u>21,128</u>	<u>7.9</u>
Income (loss) before income taxes	27,919	8.9	(2,632)	(1.0)
Provision for income taxes	<u>358</u>	<u>0.1</u>	<u>3,051</u>	<u>1.1</u>
Net income (loss)	<u>\$ 27,561</u>	<u>8.8</u>	<u>\$ (5,683)</u>	<u>(2.1)</u>

(1) Reflects a new basis of accounting subsequent to April 7, 2004 due to the Merger.

Net sales for the nine months ended June 30, 2005 increased 17.5% to \$313.4 million from \$266.7 million in the nine months ended June 30, 2004. The increase in net sales was primarily driven by organic growth in the Safety Products and Specialty Composites segments and foreign currency translation. The weakness of the U.S. dollar favorably impacted net sales by \$7.0 million. The Safety Products segment net sales for the nine months ended June 30, 2005 increased 16.8% to \$235.9 million from \$201.9 million in the nine months ended June 30, 2004. The increase in net sales resulted from a 13.5% increase in organic growth and a 3.3% increase due to foreign currency translation. Organic sales for the Safety Products segment, defined as net sales less the impact of foreign currency translation and acquisitions, have increased for thirteen consecutive quarters, when compared to the same quarter of the prior year. The Company attributes this growth to 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 nine months ended June 30, 2005 decreased 2.5% to \$29.7 million from \$30.5 million for the nine months ended June 30, 2004. The decrease in net sales resulted from a 3.3% reduction in volume partially offset by 0.8% increase from foreign currency translation. Specialty Composites' net sales for the nine months ended June 30, 2005 increased 39.3% to \$47.8 million from \$34.3 million in nine months ended June 30, 2004. The increase was primarily driven by market share gains and

an improving economy driving volume increases in the precision electronics, truck, aircraft and industrial markets. The Company tracks measures such as computer and electronic production data and truck build rates to gauge the momentum in the Specialty Composites segment, which has been experiencing positive sales trends in the last eight quarters.

Gross profit for the nine months ended June 30, 2005 increased 40.3% to \$153.7 million from \$109.5 million for the nine months ended June 30, 2004. Gross profit in the nine months ended June 30, 2004 was negatively impacted by the non-recurring charge of \$17.1 million resulting from the write-up in inventory required by SFAS No. 141 on the merger date and subsequent sale of such inventory. Excluding the effects of the SFAS No. 141 adjustment, gross profit as a percentage of net sales for the nine months ended June 30, 2005 was 49.0% as compared to 47.5% for the nine months ended June 30, 2004. The 150 basis point improvement in the gross profit percentage is primarily due to product mix and productivity, accounting for approximately 120 basis points, with the remainder due primarily to the 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 nine months ended June 30, 2005 increased 20.9% to \$119.5 million from \$98.9 million in the nine months ended June 30, 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. Volume and productivity improvements contributed approximately 19.8% of the increase in gross profit with foreign currency translation contributing the remaining 1.0% of the increase. The Safety Prescription Eyewear segment gross profit in the nine months ended June 30 2005 decreased 6.3% to \$13.3 million from \$14.2 million in the nine months ended June 30, 2004. The decrease was primarily the result of a 2.5% reduction due to a decrease in sales volume and a 3.9% reduction due to product mix. Specialty Composites' gross profit in the nine months ended June 30, 2005 increased 52.9% to \$20.8 million from \$13.6 million in the nine months ended June 30, 2004. The increase was primarily driven by market share gains and an improving economy driving volume increases in the precision electronics, truck, aircraft and industrial markets, aided by productivity and improved manufacturing absorption. Approximately 39.3% of the increase in the Specialty Composites gross profit was due to volume increases with the remaining 14.3% of the increase due to product mix.

Operating expenses for the nine months ended June 30, 2005 increased 19.7% to \$109.0 million from \$91.0 million for the nine months ended June 30, 2004. The increase in operating expenses was primarily driven by an increase in selling and administrative, amortization expense, restructuring and research and technical partially offset by other charges, net. Selling and administrative expenses included approximately \$2.2 million due to performance based incentives related to the increase in sales volume, \$2.0 million related to variable marketing programs and travel, \$1.6 million due to foreign currency translation, \$1.8 million related to freight and distribution with the remaining increase consistent with the increase in sales volume. Selling and administrative expenses as a percentage of net sales improved to 31.5% for the nine months ended June 30, 2005 as compared to 31.9% for the nine months ended June 30, 2004. Amortization expense increased approximately \$3.6 million due to the allocation of purchase price to finite lived intangible assets required by SFAS No. 141 due to the Merger Agreement. The decrease in other charges, net was attributed to foreign currency transaction expenses in the nine months ended June 30, 2005 as compared to \$1.2 million of expense in the nine months ended June 30, 2004, which included approximately \$1.5 million of expense to call the Company's 12.5% senior subordinated notes to effect the merger. The restructuring provision adjustment of \$1.1 million of income in the nine months ended June 30, 2004 was the result of a change in estimate relating to non-cancelable leases.

Interest expense, net, for the nine months ended June 30, 2005 decreased to \$16.8 million from \$21.1 million for the nine months ended June 30, 2004. Interest expense in the nine months ended June 30, 2004 included approximately \$4.0 million of expense related to the write off of deferred financing fees and approximately \$1.0 million of incremental interest expense related to the redemption of the 12.5% senior subordinated notes as a result of the Merger.

The provision for income taxes for the nine months ended June 30, 2005 decreased to \$0.4 million from \$3.1 million for the nine months ended June 30, 2004. At September 30, 2004, the Company's net operating losses were partially offset by a valuation allowance of \$7.5 million. During the six month period ended March 31, 2005, management determined that based on current domestic operating results, it is more likely than not that domestic net operating losses will be realized and consequently reversed the \$7.5 million valuation allowance. The reversal of the valuation allowance reduced the expected annual effective tax rate.

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 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"). Since the Acquisition Date, the Company's debt has been negatively impacted by \$ 0.3 million related to the fluctuation of the Euro relative to the U.S dollar as of June 30, 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 were

approximately \$123.8 million and \$126.0 million at June 30, 2005 and September 30, 2004, respectively. There were no amounts outstanding under the Revolving Credit Facility at June 30, 2005 and September 30, 2004, 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 \$1.4 million and \$1.6 million of letters of credit outstanding at September 30, 2004 and June 30, 2005, respectively. 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 June 30, 2005.

On April 28, 2005, the Company amended its credit agreement to allow the Company to make, prior to September 30, 2005, up to \$35 million of cash distributions to Aearo Corporation, its parent corporation for the purpose of paying cash dividends to AC Safety Holding Corp., its parent, to be used by AC Safety Holding Corp. 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.

On May 5, 2005, the Company's Board of Directors declared a cash dividend of approximately \$35 million to be paid to the Company's parent, Aearo Corporation, the sole holder of common stock. On May 7, 2005 Aearo Corporation paid a cash dividend to AC Safety Holding Corp., the Company's ultimate parent, who used the proceeds to make a partial redemption of its preferred stock. The Company used available cash to fund the dividend.

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 \$5.4 million and \$7.8 million, respectively, for capital expenditures for the nine months ended June 30, 2005 and 2004, respectively. The Company anticipates it will spend approximately \$9.5 million for capital expenditures in its fiscal year ending September 30, 2005.

The Company's net cash provided by operating activities for the nine months ended June 30, 2005 totaled \$31.5 million as compared to \$22.8 million for the nine months ended June 30, 2004. The increase of \$8.7 million was primarily due to a \$10.9 million improvement in net income adjusted for non-cash charges (depreciation, amortization, deferred taxes and other), partially offset by a \$2.2 million reduction from the net changes in assets and liabilities.

Net cash used for investing activities was \$5.3 million for the nine months ended June 30, 2005 as compared to \$7.8 million for the nine months ended June 30, 2004. The decrease in net cash used by investing activities is primarily attributed to reduced spending for property, plant and equipment.

Net cash used for financing activities for the nine months ended June 30, 2005 was \$36.4 million compared with \$8.8 million for the nine months ended June 30, 2004. The change is primarily due to the cash dividend paid to our Parent as mentioned above.

The Company maintains a non-contributory defined benefit cash balance pension plan. The Company utilizes an outside actuarial firm to estimate 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. Over the 11 year period ended September 30, 2004, 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 9.3%. Considering this information and the potential for lower future returns, the Company selected an 8.0% rate of return on plan asset assumption. Actual asset returns for the Company's pension plan improved in the last two fiscal years after two years of negative returns. The estimated effect of a 1% change in the expected long-term rate of return on plan assets results in a \$0.1 million impact on annual pension expense. The discount rate was also unchanged at 6.0% for the year ended September 30, 2004. The Company bases the discount rate on the AA Corporate bond yields. The estimated impact of a 1% change in the discount rate results in a \$0.1 million impact on annual pension expense.

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 2004. The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid (in thousands of dollars):

Fiscal year 2005	\$ 1,121
Fiscal year 2006	466
Fiscal year 2007	618
Fiscal year 2008	830
Fiscal year 2009	1,214
Fiscal year 2010 – 2014	6,784

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. In addition, under the terms of the Merger Agreement with AC Safety Acquisition Corp., Aearo Corporation agreed to make the annual payment to Cabot for a minimum of seven years from the Acquisition 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 2003 and 2004, the Company settled 259 claims in which it was named as a defendant for an average settlement amount of \$24.36 in silica claims and \$83.24 in asbestos claims, while an additional 200 claims were dismissed without any payment (43.6% of cases closed), because the Company was not a proper defendant or did not make the product in question. As of September 30, 2004, the number of open claims where the Company was named as a defendant in silica and asbestos related matters was 11,087 and 4,282, respectively. For the nine months ended June 30, 2005, the increases in number of claims where the Company was named as a defendant in silica and asbestos related matters was 2,122 and 1,010 respectively. The 1,010 new asbestos claims include 114 claims that allege exposure from clothing, which the Company never manufactured. One claim was settled for \$17.85 where the Company was named as a defendant in silica related matters during the nine months ended June 30, 2005. No claims were settled where the Company was named as a defendant in asbestos related matters during the nine months ended June 30, 2005. As of June 30, 2005, the number of open claims where the Company was named as a defendant in silica and asbestos related matters was 12,739 and 4,095, 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 Aearo has some risk of legal liability as a successor ("Additional Claims"). During the nine months ended June 30, 2005, Aearo paid a total of \$1.67 million for settlement, administrative and defense costs resulting in the settlement of 4,325 silica and asbestos claims that were settled between October 1, 2002 and September 30, 2004 involving both claims in which Aearo was named as a defendant and Additional Claims. During the period October 1, 2004 to June 30, 2005 Aearo paid a total of \$164.72 for three additional claims that were settled during that time period and paid a total of \$0.4 million for administrative and defense costs involving both claims in which Aearo was named as a defendant and Additional Claims. In addition, Aearo 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 Aearo.

The above information was based on data provided by Simon Peragine Smith, an outside law firm which tracks numbers 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 Aearo participates and through which all of its settlements have been handled in the relevant years. Also, between October 1, 2004 and June 30, 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 Aearo.

At June 30, 2005 and September 30, 2004, the Company has recorded liabilities of approximately \$4.6 million and \$5.4 million, respectively, which represents reasonable estimates of its probable liabilities for product liabilities substantially related to asbestos and silica-related claims as determined by the Company in consultation with an independent consultant. The \$0.8 million reduction in the reserve, net of new accruals which added to the reserve, since September 30, 2004 is primarily attributed to the payment of \$1.67 million, as referenced above, to pay costs attributed to settlement, administrative and defense costs that had been reached over the prior two year time period. 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 2009 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 June 30, 2005:

	(1)		<u>2010 and</u>		
	<u>2005</u>	<u>2006-2007</u>	<u>2008-2009</u>	<u>after</u>	<u>Total</u>
Capital lease obligations	\$ 88	\$ 705	\$ 368	\$ 32	\$ 1,193
Operating lease obligations	905	5,711	4,972	5,434	17,022
Mortgage obligations	90	2,048	--	--	2,138
Purchase obligations	1,021	6,680	6,402	--	14,103
Respiratory commitment	100	800	800	800	2,500
Long term debt	<u>5,626</u>	<u>43,403</u>	<u>43,173</u>	<u>320,028</u>	<u>412,230</u>
Total	<u>\$ 7,830</u>	<u>\$ 59,347</u>	<u>\$ 55,715</u>	<u>\$ 326,294</u>	<u>\$ 449,186</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 \$4.7 million for taxes worldwide in fiscal 2004 and does not anticipate significant changes to its tax obligations in the future. The Company has approximately \$1.6 million of letters of credit outstanding as of June 30, 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.

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. The impact on results of operations was a gain of approximately \$ 0.3 million and \$ 0.1 million for the three and nine month periods ended June 30, 2005, respectively, compared to net loss of \$ 0.3 million and \$ 0.6 million, respectively for the three and nine month periods ended June 30, 2004. 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. During the three month period ended June 30, 2005, the Company entered into three new forward foreign currency contract derivatives that protect the Company against exchange rate movement during fiscal 2006. As result of the new forward currency contracts, the Company has recorded a derivative payable of \$0.4 million at June 30, 2005. For the three and nine month periods ended June 30, 2004, the Company reclassified into earnings net losses of \$0 million and \$0.5 million, respectively, resulting from the exercise of forward foreign currency 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 charges (income), net. There was a \$0.1 million impact on earnings for the nine-month period ending June 30, 2004.

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 June 30, 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 June 30, 2005, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II – OTHER INFORMATION

Item 6. Exhibits

(a) Exhibits

See Index of Exhibits on page 43 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: August 15, 2005

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.