

FULLER H B CO
Form 10-K
February 15, 2007
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 2, 2006

OR

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

For the transition period from _____ to _____

Commission File No. **001-09225**

H.B. FULLER COMPANY

(Exact name of registrant as specified in its charter)

Minnesota
(State or other jurisdiction of
incorporation or organization)

1200 Willow Lake Boulevard, St. Paul, Minnesota
(Address of principal executive offices)

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

55110-5101
(Zip Code)

Edgar Filing: FULLER H B CO - Form 10-K

(Registrant's telephone number, including area code) (651) 236-5900

Securities registered pursuant to Section 12(b) of the Act:

(Title of each class)	(Name of each exchange on which registered)
Common Stock, par value \$1.00 per share	New York Stock Exchange
Common Stock Purchase Rights	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: none

(Title of class)

(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

Edgar Filing: FULLER H B CO - Form 10-K

The aggregate market value of the Common Stock, par value \$1.00 per share, held by non-affiliates of the registrant as of June 3, 2006 was approximately \$1,444,201,000 (based on the closing price of such stock as quoted on the New York Stock Exchange of \$24.49 on such date and adjusted for the July 2006 2-for-1 stock split).

The number of shares outstanding of the registrant's Common Stock, par value \$1.00 per share, was 60,561,265 as of January 31, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates information by reference to portions of the registrant's Proxy Statement for the Annual Meeting of Shareholders to be held on April 5, 2007.

Table of Contents

H.B. FULLER COMPANY

2006 Annual Report on Form 10-K

Table of Contents

PART I

Item 1.	<u>Business</u>	3
Item 1A.	<u>Risk Factors</u>	5
Item 1B.	<u>Unresolved Staff Comments</u>	6
Item 2.	<u>Properties</u>	7
Item 3.	<u>Legal Proceedings</u>	8
Item 4.	<u>Submission of Matters to a Vote of Security Holders</u>	11

PART II

Item 5.	<u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	13
Item 6.	<u>Selected Financial Data</u>	14
Item 7.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	15
Item 7A.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	42
Item 8.	<u>Financial Statements and Supplementary Data</u>	44
Item 9.	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	90
Item 9A.	<u>Controls and Procedures</u>	90
Item 9B.	<u>Other Information</u>	91

PART III

Item 10.	<u>Directors and Executive Officers of the Registrant</u>	92
Item 11.	<u>Executive Compensation</u>	92
Item 12.	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	92
Item 13.	<u>Certain Relationships and Related Transactions</u>	93
Item 14.	<u>Principal Accountant Fees and Services</u>	93

PART IV

Item 15.	<u>Exhibits and Financial Statement Schedules</u>	94
	<u>Signatures</u>	97

Table of Contents

PART I

Item 1. Business

H.B. Fuller Company and its subsidiaries manufacture and market adhesives and specialty chemical products globally, with sales operations in 31 countries in North America, Europe, Latin America and the Asia Pacific region. The business is reported in two operating segments. The Global Adhesives operating segment represents approximately 69 percent of global net revenue and is managed on a worldwide basis. The Full-Valu/Specialty operating segment represents approximately 31 percent of global net revenue.

Segment Information. The Global Adhesives operating segment produces and supplies industrial and performance adhesives products for applications in various markets, including assembly (woodworking, appliances, etc.), converting (packaging, corrugated, tape and label, tissue and towel, graphic arts, etc.), nonwoven (disposable diapers, feminine care and adult incontinence products), automotive and footwear.

The Full-Valu/Specialty operating segment produces and supplies specialty chemical product lines for ceramic tile applications, HVAC insulation, specialty products and consulting for packaging solutions, consumer products and products for the insulating glass market applications, as well as paint sold through a variety of distribution channels in Central America.

Management evaluates operating segment performance based on operating income which is defined as gross profit minus selling, general and administrative expenses (SG&A). Corporate expenses are fully allocated to the operating segments, except for \$12.3 million of charges in 2006 related to the Separation Agreement entered into with the former CEO on November 20, 2006. Corporate assets are not allocated to the segments. Inter-segment revenues are recorded at cost plus a minor markup for administrative costs.

Financial Information with respect to the company s segments and geographic areas is set forth in Note 14 to the Consolidated Financial Statements and is incorporated herein by reference.

Non-U.S. Operations. The principal markets, products and methods of distribution outside the United States vary with business practices of the country. Non-U.S. operations face varying degrees of economic and political risks. At the end of 2006, the company had sales offices and manufacturing plants in 15 countries outside the United States and satellite sales offices in another 15 countries.

Competition. The company sells a wide variety of products in numerous markets, each of which is highly competitive. Many competitors are part of large multi-national companies and may have more resources than the company. Any increase in competition may result in lost market share or reduced prices, which could result in reduced gross profit. This may impair the company s ability to grow or even to maintain current levels of revenues and earnings.

The principal competitive factors in the sale of adhesives and other specialty chemicals are product performance, customer service, technical service, quality and price.

Edgar Filing: FULLER H B CO - Form 10-K

Customers. Of the \$1,472.4 million net revenue to unaffiliated customers in 2006, \$779.6 million was sold through North American operations. No single customer accounted for more than 10 percent of consolidated net revenue.

Backlog. Orders for products are generally processed within one week. Therefore, no significant backlog of unfilled orders existed at December 2, 2006, December 3, 2005 or November 27, 2004.

Raw Materials. The principal raw materials used include resins, polymers, synthetic rubbers, vinyl acetate monomer and plasticizers. The company generally avoids sole source supplier arrangements for raw materials. While alternate supplies of most key raw materials are available, sustained strong economic growth in North

Table of Contents

America and China coupled with unplanned supplier production outages have led to strained supply-demand situations for several key feedstocks (such as ethylene and propylene), some of their derivatives, several polymers and other petroleum derivatives such as waxes.

The substitution of key raw materials requires the company to identify new supply sources, reformulate, retest and may require seeking re-approval from customers using those products.

The majority of the company's raw materials are petroleum/natural gas based derivatives. Under normal conditions, all of these raw materials are generally available on the open market. Prices and availability are subject to supply and demand market mechanisms. Higher crude oil and natural gas costs usually result in higher prices for raw materials, however, supply and demand pressures are also beginning to impact some markets.

The Latin American and Asia Pacific operations import many of their raw materials. Expanding the company's global supply base mandates a higher level of international procurement activity.

Patents, Trademarks and Licenses. Much of the technology used in manufacturing adhesives and other specialty chemicals is in the public domain. For technology not in the public domain, the company relies on trade secrets and patents when appropriate to protect its know-how. The company also licenses some patented technology from other sources. Management does not believe its business is materially dependent upon licenses or similar rights or on any single patent or group of related patents.

There are agreements with many employees to protect rights to technology and intellectual property. Confidentiality commitments also are routinely obtained from customers, suppliers and others to safeguard proprietary information.

The company owns numerous trademarks and service marks. Trademarks, such as Advantra[®], Adalis[®], Sesame[®], Protecto[®], TEC[®], Plasticola[®], Color Caulk[®], Amco Tool[®], AIM[™] Adhesive, Tile Perfect[®] and ChapCo[®] are important in marketing products. Most of the company's trademarks and service marks are registered.

Research and Development. The company continues to offer new and improved products. The primary emphasis has been on developing adhesives with applications across numerous markets. Research and development expenses were \$16.9 million, \$16.2 million and \$15.2 million in 2006, 2005, and 2004, respectively. These costs are included in selling, general and administrative expenses. While the company makes efforts to improve its technology, unexpected technological advances by new or existing competitors could materially affect its business in one or more markets.

Environmental, Health and Safety. The company undertakes to comply with applicable regulations relating to protection of the environment and workers' safety. Management regularly reviews and upgrades its environmental policies, practices and procedures and seeks improved production methods that minimize waste coming out of its facilities, particularly toxic waste, based on evolving societal standards and increased environmental understanding.

Edgar Filing: FULLER H B CO - Form 10-K

Environmental expenditures to comply with environmental regulations over the next two years are estimated to be approximately \$7.8 million, including approximately \$1.9 million of capital expenditures. See additional disclosure under Item 3. Legal Proceedings.

Employees. Approximately 3,700 individuals were employed on December 2, 2006, of which approximately 1,450 individuals were in the United States.

Available Information. For more information about the company, visit our website at:

<http://www.hbfuller.com>.

Table of Contents

The company files annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission (SEC) via EDGAR. The company's SEC filings are available to the public at our website as soon as reasonably practicable after they have been filed with or furnished to the SEC. You may also request a copy of these filings (other than an exhibit to a filing unless that exhibit is specifically incorporated by reference into that filing) at no cost, by writing to or telephoning the company at the following address: Office of the Corporate Secretary, H.B. Fuller Company, 1200 Willow Lake Boulevard, P.O. Box 64683, St. Paul, Minnesota 55164-0683, (651) 236-5825.

Item 1A. Risk Factors

This Form 10-K contains forward-looking statements concerning our future programs, products, expenses, revenue, liquidity and cash needs as well as our plans and strategies. These forward-looking statements are based on current expectations and the company assumes no obligation to update this information. Numerous factors could cause actual results to differ significantly from the results described in these forward-looking statements, including the following risk factors.

Competition: A wide variety of products are sold in numerous markets, each of which is highly competitive. The company's competitive position in the markets in which it participates is, in part, subject to external factors. For example, supply and demand for certain of the company's products is driven by end-use markets and worldwide capacities which, in turn, impact demand for and pricing of the company's products. Many of the company's direct competitors are part of large multi-national companies and may have more resources than the company. Any increase in competition may result in lost market share or reduced prices, which could result in reduced gross profit margins. This may impair the ability to grow or even to maintain current levels of revenues and earnings. While the company has an extensive customer base, loss of certain top customers could adversely affect the company's financial condition and results of operations until such business is replaced, and no assurances can be made that it would be able to regain or replace any lost customers.

Acquisitions: As part of its growth strategy, the company intends to pursue acquisitions of complementary businesses or products and joint ventures. The ability to grow through acquisitions or joint ventures depends upon the company's ability to identify, negotiate, complete and integrate suitable acquisitions or joint venture arrangements.

International: International operations could be adversely affected by changes in political and economic conditions, trade protection measures, restrictions on repatriation of earnings, differing intellectual property rights and changes in regulatory requirements that restrict the sales of products or increase costs. Also, changes in exchange rates between the U.S. dollar and other currencies could potentially result in increases or decreases in earnings and may adversely affect the value of the company's assets outside the United States. Although the company utilizes risk management tools, including hedging, as appropriate, to mitigate market fluctuations in foreign currencies, any changes in strategy in regard to risk management tools can also affect sales revenue, expenses and results of operations and there can be no assurance that such measures will result in cost savings or that all market fluctuation exposure will be eliminated.

Raw Materials: Raw materials needed to manufacture products are obtained from a number of suppliers. Many of these raw materials are petroleum-based derivatives, minerals and metals. Under normal market conditions, these materials are generally available on the open market from a variety of producers. From time to time, however, the prices and availability of these raw materials fluctuate, which could impair the ability to procure necessary materials, or increase the cost of manufacturing products. If the prices of raw materials increase, the company may be unable to pass these increases on to its customers and could experience reductions to its profit margins.

Litigation: The company's operations from time to time are parties to or targets of lawsuits, claims, investigations, and proceedings, including product liability, personal injury, asbestos, patent and intellectual property, commercial, contract, environmental, antitrust, health and safety, and employment

Table of Contents

matters, which are handled and defended in the ordinary course of business. While the company is unable to predict the outcome of these matters, it does not believe, based upon currently available information, that the ultimate resolution of any pending matter will have a material adverse effect on its long-term financial condition. However, adverse developments could negatively impact the company's results of operations or cash flows in one or more future quarters. See Item 3. Legal Proceedings for a discussion of current litigation.

Environmental: The company is subject to numerous environmental laws and regulations that impose various environmental controls on the company or otherwise relate to environmental protection, the sale and export of certain chemicals or hazardous materials, and various health and safety matters. Expenditures related to environmental matters have not had, and, based on currently available information, are not expected to have, a material adverse effect on the company's long-term financial condition. However, adverse developments could negatively impact the company's results of operations or cash flows in one or more future quarters. See Item 3. Legal Proceedings for a discussion of current environmental matters.

Additional factors which could affect future results include: (i) economic matters over which the company has no control, including changes in inflation, tax rates, and interest rates; (ii) changes in fiscal, governmental and other regulatory policies; (iii) the loss or insolvency of a major customer or distributor; (iv) natural or manmade disasters (including material acts of terrorism or hostilities that impact the company's markets); (v) loss of, or changes in, executive management; and (vi) changes in accounting standards which are adverse to the company. In addition, the company notes that its stock price can be affected by fluctuations in quarterly earnings.

Item 1B. Unresolved Staff Comments

None.

Table of Contents**Item 2. Properties**

Principal executive offices and central research facilities are located in the St. Paul, Minnesota area. Manufacturing operations are carried out at 19 plants located throughout the United States and at 17 plants located in 15 other countries. The Global Adhesives and Full-Valu/Specialty segments operate 11 and 8 plants, respectively in the United States and 14 and 3 plants, respectively outside the United States. In addition, numerous sales and service offices are located throughout the world. Management believes that the properties owned or leased are suitable and adequate for its business. Operating capacity varies by product, but additional production capacity is available for most product lines by increasing the number of shifts worked. The following is a list of the company's manufacturing plants as of December 2, 2006:

Global Adhesives	Manufacturing Sq Ft	Full-Valu/Specialty	Manufacturing Sq Ft
Non-U.S. :			
Argentina - Buenos Aires	10,367	Costa Rica - Alto de Ochomogo, Cartago	167,199
Australia - Dandenong South, VIC	71,280	Honduras - San Pedro Sula	23,346
Austria - Wels	66,500	Republic of Panama - Tocumen, Panama	30,588
Brazil - Sorocaba, SP ²	7,535		
Canada - Boucherville, QC	36,500		
Chile - Maipu, Santiago	64,099		
Republic of China - Huangpu Guangzhou ¹	68,380		
Colombia - Itagui, Antioquia ¹	7,800		
Costa Rica - Alajuela	4,993		
Germany - Lueneburg	64,249		
- Nienburg	139,248		
Italy - Borgolavezzaro, (No)	24,219		
Philippines - Laguna	10,759		
Portugal - Porto	90,193		
United Kingdom - Dukinfield, Cheshire	17,465		
Total Non-U.S.	683,587		221,133
U.S.:			
California - Roseville	82,202	Florida - Gainesville	6,800
Georgia - Covington	73,500	Georgia - Dalton	72,000
- Tucker	69,000	Illinois - Aurora	149,000
Kentucky - Paducah	252,500	- Palatine	55,000
Michigan - Farmington Heights ¹	26,000	Minnesota - Fridley	15,850
- Grand Rapids	65,689	New Jersey - Edison ¹	5,000
- Taylor	30,000	- Edison ²	37,000
Minnesota - Vadnais Heights	53,145	Texas - Houston	11,000
Missouri - St. Louis ²	21,000	Washington - Vancouver	35,768
Ohio - Blue Ash	102,000		
- Dayton ¹	220,000		
Texas - Mesquite	48,000		
Total U.S.	1,043,036		387,418
Total U.S. and Non-U.S.	1,726,623		608,551

¹ Leased Property

2 Idle Property

7

Table of Contents

Item 3. Legal Proceedings

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

Currently the company is involved in various environmental investigations, clean-up activities and administrative proceedings and lawsuits. In many of these matters, the company has entered into participation agreements, consent decrees or tolling agreements. One of these environmental matters involves the investigation and remediation of environmental contamination at the company's Sorocaba, Brazil facility. Soil and water samples have been collected on and around the Sorocaba facility, and test results indicate that certain contaminants, including carbon tetrachloride and other solvents, exist in the soil at the Sorocaba facility and in the groundwater at both the Sorocaba facility and some neighboring properties. The company is continuing to work with Brazilian regulatory authorities to determine the necessary scope of remediation at the facility and the neighboring properties. As of December 2, 2006, \$2.1 million was recorded as a liability for expected investigation and remediation expenses remaining for this site. Once the full scope of any necessary remediation is determined, the company may be required to record additional liabilities related to investigation and remediation costs at the Sorocaba facility.

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

The company's management reviews the circumstances of each individual site, considering the number of parties involved, the level of potential liability or contribution of the company relative to the other parties, the nature and magnitude of the hazardous substances involved, the method and extent of remediation, the estimated legal and consulting expense with respect to each site and the time period over which any costs would likely be incurred. To the extent the company can reasonably estimate the amount of its probable liabilities for environmental matters, the company establishes a financial provision if certain criteria are met. As of December 2, 2006, the company had reserved \$3.9 million, which represents its best estimate of probable liabilities with respect to environmental matters, inclusive of the accrual related to the Sorocaba facility as described above. However, the full extent of the company's future liability for environmental matters is difficult to predict because of uncertainty as to the cost of investigation and clean-up of the sites, the company's responsibility for such hazardous substances and the number of and financial condition of other potentially responsible parties.

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

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

Table of Contents

A subsidiary of the company is a defendant in numerous exterior insulated finish systems (EIFS) related lawsuits. As of December 2, 2006, the company's subsidiary was a defendant in approximately 29 lawsuits and claims related primarily to single-family homes. The EIFS product was used primarily in the residential construction market in the southeastern United States. Some of the lawsuits and claims involve EIFS in commercial or multi-family structures. Lawsuits and claims related to this product line seek monetary relief for water intrusion-related property damages. The company has insurance coverage for certain years with respect to this product line.

During the quarter ended June 3, 2006, the company entered into agreements to settle numerous EIFS-related lawsuits and claims, including a lawsuit involving up to 186 homes. In total, the company paid \$5.0 million in settlement of these lawsuits and claims, of which insurers have paid \$1.0 million and are expected to pay an additional \$0.6 million. As of December 2, 2006, the company had recorded \$1.7 million for the probable EIFS-related liabilities and \$1.2 million for insurance recoveries, including the \$0.6 million referred to above, for all remaining EIFS-related liabilities. The company continually reevaluates these amounts.

EIFS-related liabilities include amounts for pending lawsuits and claims as well as unasserted claims. The liabilities are recorded at management's best estimate of the outcome of the lawsuits and claims taking into consideration the facts and circumstances of the individual matters as well as past experience on similar matters. Amounts accrued for the unasserted claims are based primarily on historical experience. Because of the many uncertainties involved with litigation, management has concluded that it is not possible to estimate a range of loss, if any, that would exceed the accrual.

The rollforward of EIFS-related lawsuits and claims is as follows:

	Year Ended		
	December 2, 2006	Year Ended December 3, 2005	Year Ended November 27, 2004
Lawsuits and claims at beginning of year	75	94	93
New lawsuits and claims asserted	9	29	48
Lawsuits and claims settled	(55)	(40)	(44)
Lawsuits and claims dismissed		(8)	(3)
Lawsuits and claims at end of year	29	75	94

A summary of the aggregate costs and settlement amounts for EIFS-related lawsuits and claims is as follows:

	Year Ended December 2, 2006	Year Ended December 3, 2005	Year Ended November 27, 2004
(in thousands)			
Settlements reached	\$ 5,989	\$ 2,618	\$ 1,753
Defense costs incurred	\$ 2,507	\$ 3,324	\$ 2,832
Insurance payments received or expected to be received	\$ 3,492	\$ 2,276	\$ 1,578

Plaintiffs in EIFS cases generally seek to have their homes repaired or the EIFS replaced, and a dollar amount for the cost of repair or replacement is not ordinarily specified in the complaint. Although complaints in EIFS cases usually do not contain a specific amount of damages claimed, a complaint may assert that damages exceed a specified amount in order to meet jurisdictional requirements of the court in which the case is filed. Therefore, the Company does not believe it is meaningful to disclose the dollar amount of damages asserted in EIFS complaints.

Edgar Filing: FULLER H B CO - Form 10-K

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

Table of Contents

filed each year and the average cost of disposing of each such claim, the actual costs could be higher or lower than the current estimated reserves or insurance recoveries.

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

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

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

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

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

During the years ended December 2, 2006, December 3, 2005 and November 27, 2004 the Company settled five, twelve and ten asbestos-related lawsuits, respectively. The 2004 figure excludes the group settlement discussed above in the immediately preceding paragraph. The total amount of the settlements were \$0.6 million, \$0.7 million

Table of Contents

and \$0.4 million in 2006, 2005 and 2004, respectively. The company's insurers have paid or are expected to pay \$0.4 million, \$0.5 million and \$0.2 million of these settlement amounts in 2006, 2005 and 2004, respectively. In addition, as discussed above, in 2004 the Company agreed to contribute \$3.5 million to the group settlement. The Company's insurers have paid \$1.2 million of that settlement amount.

The Company does not believe that it would be meaningful to disclose the aggregate number of asbestos-related lawsuits filed against the Company, because relatively few of these lawsuits are known to involve exposure to asbestos-containing products made by the Company. Rather, the Company believes it is more meaningful to disclose the number of lawsuits that are settled.

To the extent the company can reasonably estimate the amount of its probable liabilities for pending asbestos-related claims, the company establishes a financial provision and a corresponding receivable for insurance recoveries if certain criteria are met. As of December 2, 2006, the company had \$1.2 million accrued for probable liabilities and \$0.6 million for insurance recoveries related to asbestos claims. However, the company has concluded that it is not possible to estimate the cost of disposing of other asbestos-related claims (including claims that might be filed in the future) due to its inability to project future events. Future variables include the number of new claims filed, the average cost of disposing of such claims, the uncertainty of asbestos litigation, insurance coverage and indemnification agreement issues, and the continuing solvency of certain insurance companies.

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

Item 4. Submission of Matters to a Vote of Security Holders

None in the quarter ended December 2, 2006.

Table of Contents**Executive Officers of the Registrant**

The following table shows the name, age and business experience for the past five years of the executive officers as of January 31, 2007. Unless otherwise noted, the positions described are positions with the company or its subsidiaries.

Name	Age	Positions	Period Served
Michele Volpi	42	President and Chief Executive Officer	December 2006-Present
		Group President, General Manager, Global Adhesives	
		Global SBU Manager, Assembly	December 2004-December 2006
		General Manager Marketing and Product Management of the Polymershapes Division, GE Plastics	June 2002-December 2004
			March 2001-June 2002
John A. Feenan	46	Senior Vice President and Chief Financial Officer	
		Senior Vice President and CFO, Jostens, Inc.	August 2003-Present
			2001-August 2003
Timothy J. Keenan	49	Vice President, General Counsel and Corporate Secretary	
		General Counsel and Corporate Secretary	December 2006-Present
		Deputy General Counsel, Assistant Corporate Secretary	December 2005-December 2006
		Senior Attorney and Assistant Secretary, International Multifoods Corporation	August 2004-December 2005
			1991-August 2004
Stephen J. Large	49	Group President, General Manager, Full-Valu/Specialty	
		Vice President and Chief Process Improvement Officer	July 2003-Present
		Vice President, Operations/Supply Chain	
			December 2002-July 2003
			May 2001-December 2002
James C. McCreary, Jr.	50	Vice President, Corporate Controller	November 2000-Present
Ann B. Parriott	48	Vice President, Human Resources	January 2006-Present

Edgar Filing: FULLER H B CO - Form 10-K

	Vice President, Applied Global Services, Applied Materials, Inc.	January 2004-December 2005
	Human Resources Manager, Intel Corporation	November 2002-October 2003
	People Systems Manager, Intel Corporation	June 2000-November 2002
Cheryl A. Reinitz	48 Vice President, Treasurer	December 2005-Present
	Director, Tax	July 2000-December 2005
Edwin J. Snyder	49 Vice President and Chief Process Improvement Officer	
	Vice President, Global Supply Chain Management	July 2003-Present
	Director of Sourcing and Supply Chain, Performance Polymers and Chemicals, Honeywell, Inc.	May 2002-July 2003
		December 1996-May 2002

The Board of Directors elects the executive officers annually.

Table of Contents**PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

The company's common stock is traded on the New York Stock Exchange under the symbol FUL. As of December 2, 2006, there were 2,794 common shareholders of record for the company's Common Stock. The following table shows the high and low sales price per share of the common stock and the dividends declared for the fiscal quarters. All amounts have been adjusted to reflect the July 2006 2-for-1 stock split.

	High and Low Sales Price				Dividends	
	2006		2005		(Per Share)	
	High	Low	High	Low	2006	2005
First quarter	\$ 20.96	\$ 15.60	\$ 14.65	\$ 12.63	\$ 0.06125	\$ 0.05750
Second quarter	28.00	19.94	16.18	13.17	0.06250	0.06125
Third quarter	25.08	18.11	18.06	15.86	0.06250	0.06125
Fourth quarter	28.25	18.50	17.09	13.65	0.06250	0.06125
Year	28.25	15.60	18.06	12.63	0.24875	0.24125

There are no significant contractual restrictions on the company's ability to declare or pay dividends.

The annual meeting of shareholders will be held on Thursday, April 5, 2007, at 2 p.m., central time, at the Science Museum of Minnesota, 120 West Kellogg Boulevard, St. Paul, MN. All shareholders are cordially invited to attend.

Issuer Purchases of Equity Securities

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

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
				(at end of period)
September 3, 2006 – October 7, 2006				N/A
October 8, 2006 – November 4, 2006				N/A
November 5, 2006 – December 2, 2006	53,314	\$ 25.91		N/A

Table of Contents**Item 6. Selected Financial Data**

(Dollars in thousands, except per share amounts)	Fiscal Years				
	2006 ^{1,2}	2005 ^{1,3}	2004 ¹	2003 ¹	2002 ¹
Net revenue	\$ 1,472,391	\$ 1,437,074	\$ 1,330,933	\$ 1,214,478	\$ 1,177,715
Income from continuing operations before cumulative effect of accounting change	\$ 80,948	\$ 56,719	\$ 29,775	\$ 36,176	\$ 25,258
Percent of net revenue	5.5	3.9	2.2	3.0	2.1
Total assets	\$ 1,478,471	\$ 1,107,557	\$ 1,135,359	\$ 1,007,588	\$ 961,439
Long-term debt, excluding current installments	\$ 224,000	\$ 112,001	\$ 138,149	\$ 161,047	\$ 161,763
Stockholders' equity	\$ 777,792	\$ 587,085	\$ 555,460	\$ 511,508	\$ 449,845
Per Common Share:					
Income from continuing operations before cumulative effect of accounting change:					
Basic	\$ 1.38	\$ 0.99	\$ 0.52	\$ 0.64	\$ 0.45
Diluted	\$ 1.35	\$ 0.97	\$ 0.51	\$ 0.63	\$ 0.44
Dividends declared and paid	\$ 0.2488	\$ 0.2413	\$ 0.2288	\$ 0.2238	\$ 0.2188
Book value	\$ 12.98	\$ 10.06	\$ 9.70	\$ 8.99	\$ 7.93
Number of employees	3,721	3,806	4,311	4,280	4,345

1 All amounts have been adjusted for: a) the July 2006 2-for-1 stock split (see Note 1 to the Consolidated Financial Statements) and b) removal of discontinued operations (see Note 2 to the Consolidated Financial Statements), c) reclassifications associated with the adoptions of SFAS 123R (see Note 3 to the Consolidated Financial Statements), which required certain share-based awards previously reported as liabilities and contra-equity accounts to be classified as additional paid in capital.

2 Amounts include the second quarter 2006 acquisition of Roanoke and the third quarter acquisition of Henkel KGaA's insulating glass sealant business (see Note 2 to the Consolidated Financial Statements).

3 53-week fiscal year.

Table of Contents

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

H.B. Fuller Company is a global manufacturer and marketer of adhesives and other specialty chemical products. The company is managed through two operating segments – Global Adhesives and Full-Valu/ Specialty.

Global Adhesives: The Global Adhesives segment produces and markets adhesives products for applications in a variety of markets on a global basis. The segment is managed primarily through four geographic regions, i.e. North America, Europe, Latin America and Asia Pacific. Each of the four regions manufactures and supplies products in the assembly, converting, nonwoven and footwear categories as described below. Through its global presence, the segment is able to supply product to large customers on a global basis. The automotive business is managed through the company's 70 percent-owned joint venture with a European company and markets its products primarily to the North American automotive industry.

Major categories and applications for the Global Adhesives products are described below:

Category	Description
Assembly	Hot melt, water-based, and thermoset adhesives and mastics. These products are used in the creation of abrasives, appliances, brushes, doors, electronics, filters, flooring, household and office furniture, kitchen cabinets, marine applications, medical devices, millwork, paint rollers, and sporting goods.
Converting	Hot melt and water-based products, which are vital to the production of bags and sacks, composite cans, corrugated cardboard, disposable paper goods, paperboard laminating, tape and labels, tissues and towels, and tubewinding.
Nonwoven	Hot melt adhesives used in disposable diapers, sanitary pads, and adult incontinence garments, as well as water-based and hot melt adhesives for disposable medical garments.
Footwear	Cleaners, primers, and adhesives for manufacturing footwear and leather goods.
Automotive	Adhesives and sealants for the North American automotive industry.

The Global Adhesives segment also includes certain strategic functions that are managed on a centralized basis at the operating segment level. These functions include, marketing, research and development, global accounts, process improvement, finance and human resources. Resources in the strategic functions are shared throughout the segment and are focused on maximizing the performance of the entire segment on a global basis. The marketing and research and development functions are responsible for the development, introduction and management of the segment's products. The global accounts function manages our relationships with customers that operate on a global basis. These customers represented 22 percent of the segment's net revenue in 2006. The process improvement group includes personnel that focus on revenue enhancement, cost reduction and pricing strategy. Finance and human resources establish global processes for their respective functions. These processes are executed by the individual segment components to ensure consistency in global information.

Table of Contents

Full-Valu/Specialty: The Full-Valu/Specialty segment provides customers with complete solutions that integrate products, services, knowledge, and capabilities. Key business categories of this segment are as follows:

Category	Description
Specialty	A portfolio of branded product lines, including:
Construction	
	<i>Foster® products</i> , which include mastics, coatings, sealants and adhesives for the thermal insulation, indoor air quality, asbestos abatement and HVAC markets.
	<i>TEC® products</i> , which include ceramic tile installation products, flooring adhesives, surface preparation products, exterior insulation finish systems and epoxy flooring for commercial and professional contractor markets.
	<i>Tile Perfect® products</i> , which includes pre-mixed grouts, mortars and other products largely targeted to the retail home improvement marketplace.
Insulating Glass	Offers products and expertise in the assembly of insulating glass and windows in North American, European and Asian markets.
Packaging Solutions	Provides consulting and innovative solutions for corrugated and folding carton packaging and engineered wood industries.
Paints	A portfolio of liquid paints brands for interior, exterior, architectural, automotive, marine and industrial applications in Central America. Brands include Protecto® and Glidden®.
Consumer	Within the Asia Pacific region, produces and markets adhesives, sealants and coatings for construction, craftsman and do-it-yourself markets. In Latin America, consumer sales consist of products such as glues used in schools.

The business components of the Full-Valu/Specialty segment are managed and integrated in such a way that allows them to leverage segment-wide resources and capabilities to create competitive advantages. These capabilities include branding, channel management and the capability to sell to large nation-wide retailers. Growth through acquisitions was critical to the Full-Valu/Specialty segment in 2006 as both the Roanoke and insulating glass business acquisitions, discussed below, were part of the Full-Valu/Specialty segment. Resources from within the Full-Valu/Specialty segment were allocated in 2006 to both the due diligence and integration of the two acquisitions as over \$300 million was invested for the two businesses combined.

Total Company: When reviewing the company's financial statements, it's important to understand how certain external factors impact the company. These factors include:

Changes in the prices of commodities, such as crude oil and natural gas

Global supply and demand of raw materials

Economic growth rates, especially in the United States and Europe, and

Currency exchange rates compared to the U.S. dollar

The company purchases thousands of raw materials, the majority of which are petroleum/natural gas derivatives. With over 70 percent of its cost of sales accounted for by raw materials, the company's financial results are extremely sensitive to changing costs in this area. In addition to the impact from commodity prices, supply and demand issues of raw materials also have a significant impact on the company's costs. As demand increases in high-growth areas, such as the Asia Pacific region, the supply of key raw materials may tighten, as they did in 2005, resulting in certain materials being put on allocation. Natural disasters, such as the hurricanes in the U.S. in 2005, also can have an impact as key raw material producers were shut down for extended periods of time. The company's centralized global sourcing group continually monitors areas such as capacity utilization figures, market supply and demand conditions, feedstock costs and inventory levels, as well as derivative and intermediate prices, which affect its raw materials.

Table of Contents

In 2006 the company generated 50 percent of its revenue in the U.S. and 25 percent in Europe. The pace of economic growth in these areas directly impacts certain industries to which the company supplies products. For example in the Global Adhesives segment, revenues from durable goods customers in areas such as appliances, furniture and automotive tend to fluctuate with the economic activity. In the Full-Valu/Specialty segment revenues tend to move with more specific economic indicators such as housing starts and other construction-related activity in the U.S.

The movement of foreign currency exchange rates as compared to the U.S. dollar impacts the translation of the foreign entities' financial statements into U.S. dollars. As foreign currencies strengthen against the dollar, the company's revenues and costs become higher as the foreign currency-denominated financial statements translate into more dollars. The fluctuation of the euro against the U.S. dollar has the most significant impact as compared to all other currencies. The impact of currency fluctuations on net revenue for the total year of 2006 was minimal as decreases in the first half of the year were offset by increases in the second half.

During 2006, the company continued with its strategy that began in 2005 to reposition its product lines to focus on more value-added solutions for the customers. The repositioning strategy relates primarily to the Global Adhesives segment. This has required the company to turn away certain low margin business that is based primarily on selling price. This strategy was the main reason for the gross profit margin to increase from 26.4 percent in 2005 to 28.5 percent in 2006.

There were several events/transactions that occurred in 2006 that had significant effects on the 2006 financial results, including the following (all of these are discussed in more detail in other areas of this report):

The acquisition in the second quarter of the Roanoke Companies Group (Roanoke) for approximately \$275 million. See Note 2 to the Consolidated Financial Statements for more details.

The acquisition of the insulating glass sealant business of Henkel KGaA in Germany in the third quarter for approximately \$34 million. See Note 2 to the Consolidated Financial Statements for more details.

Effective December 4, 2005, the company adopted the fair value recognition provisions of SFAS 123R, Share-Based Payments (SFAS 123R) using the modified prospective transition method, and therefore has not restated prior periods' results. All share-based compensation expense is recorded as selling, general and administrative expense. Total share-based compensation expense recorded in 2006 was \$13.2 million (\$8.1 million, net of tax), of which \$7.2 million related to modifications to the former CEO's share-based awards. Included in the \$13.2 million was \$3.6 million (\$2.2 million, net of tax) of share-based compensation expense for the year ended 2006, which represents additional expense recorded as a result of adopting SFAS 123R. Share-based compensation expense recorded for 2005 and 2004 was \$2.3 million (\$1.4 million, net of tax) and \$1.2 million (\$0.7 million, net of tax), respectively. These amounts for 2005 and 2004 would have been \$6.4 million (\$3.9 million, net of tax) and \$4.7 million (\$2.9 million, net of tax), respectively, had the company recognized share-based expense in the Consolidated Statements of Income under SFAS 123,

Accounting for Stock-Based Compensation (SFAS 123). Unrecognized compensation expense from unvested share-based awards was \$6.0 million as of December 2, 2006 and is expected to be recognized over a weighted-average period of 2.3 years. See Note 3 to the Consolidated Financial Statements for more details.

The resignation of Chairman and CEO Al Stroucken on December 1, 2006. The negotiated Separation Agreement resulted in pretax charges in the fourth quarter of 2006 of \$12.3 million (\$7.2 million, net of tax). See Notes 3, 4 and 10 of the Consolidated Financial Statements for more details. Lee Mitau, who has been a member of the company's board of directors since 1996 replaced Mr. Stroucken as Chairman. The new CEO is Michele Volpi who was the Group President of the Global Adhesives operating segment since 2004.

Edgar Filing: FULLER H B CO - Form 10-K

The sale of the company's powder coatings business component on December 1, 2006 to Valspar Corporation for approximately \$104 million. Over the past several years the company's focus in the

Table of Contents

Full-Valu/Specialty operating segment has become more centered on the construction and packaging industries. The powder coatings unit no longer fit the strategic direction of the segment. The transaction resulted in a pretax gain of \$68.9 million (\$50.3 million, net of tax) in the fourth quarter of 2006. The financial statements for all periods presented in this report reflect the results of the powder coatings business, including the gain on the sale, as discontinued operations. See Note 2 to the Consolidated Financial Statement for more details.

The company's financial results for 2006 were strong. Income from continuing operations of \$80.9 million was 43 percent above the 2005 income from continuing operations of \$56.7 million. The diluted earnings per share from continuing operations increased from \$0.97 per share in 2005 to \$1.35 per share in 2006, an increase of 39 percent. Several reasons for the improved profitability are discussed below in Results of Operations, but some of the most significant were the management of selling price increases in an environment of rising raw material costs, the product line repositioning strategy and improved cost structures through the utilization of the Lean Six SigmaSM methodology. Benefits realized in 2006 from Lean Six SigmaSM related initiatives were estimated at \$54 million, an estimated increase of nearly \$19 million as compared to 2005.

Lean Six SigmaSM methodology combines two powerful business improvement models—Lean, which focuses on the elimination of waste and Six Sigma, which is a customer-driven methodology focused on reducing variation in business processes. Projects and initiatives are run by individuals trained in project management disciplines that enable cross-functional teams of associates to make fact-based decisions and implement solutions on a companywide basis.

Free cash flow, defined as net cash provided by operating activities from continuing operations, less cash outlays for capital expenditures and dividends, was \$151.8 million in 2006, \$77.1 million in 2005 and \$62.6 million in 2004 and was calculated as follows:

(in thousands)	2006	2005	2004
Cash provided by operating activities from continuing operations	\$ 187,672	\$ 116,152	\$ 106,507
Purchased property, plant and equipment	(21,144)	(25,066)	(30,841)
Dividends paid	(14,752)	(13,961)	(13,074)
Free cash flow	\$ 151,776	\$ 77,125	\$ 62,592

The improvement in free cash flow in 2006 resulted primarily from the increased profitability as well as the continuing focus on working capital management. Management believes that free cash flow is more useful to shareholders as an indicator of cash flow generation than cash provided by operating activities from continuing operations, because it provides more insight into the company's ability to fund such things as debt reduction and acquisitions.

The company's fiscal year ends on the Saturday closest to November 30. Once in every five or six years, the fiscal year is 53 weeks instead of 52. Fiscal 2005 was a 53-week year. In reviewing the 2006 financial results as compared to 2005, the estimated impact of one less week in 2006 resulted in a decrease in net revenue of \$28 million or 2.0 percent and a decrease in net income of approximately \$2.1 million or \$0.04 per share.

2007 Outlook

As the company enters into 2007, the raw material environment continues to be uncertain. As previously mentioned, throughout 2005 and 2006, the company experienced a significant and continued increase in raw material costs. Record energy prices, tight supply, and natural disasters

Edgar Filing: FULLER H B CO - Form 10-K

combined to result in significant cost inflation. As the company looks forward to 2007, the company does not yet see a dramatic change in raw material costs.

Table of Contents

For example, the recent declines in ethylene have not yet fully translated into basic adhesives raw materials declines due to inventories, specific supply issues and intermediate derivatives pricing power. The company does, however, expect some minor cost reductions for certain ethylene based raw materials in the early part of 2007, but continues to face pressures in waxes, tackifying resins, and refined oils. Ethylene derivatives, such as EVA, VAM, and VAE, whose costs tend to move with these materials, account for 15 to 20 percent of the company's total raw material purchases. However, the company spends approximately twice as much on materials such as tackifying resins, waxes, oils, and solvents where ethylene and propylene developments have no effect on their costs. In addition, over 40 percent of the materials that are influenced by ethylene and propylene are purchased abroad where the cost development trends for ethylene and propylene are not favoring purchasers of the derivatives of these materials.

While the raw material panorama is uncertain and not easy to analyze given the thousands of raw materials that the company buys, the company intends to remain vigilant to take advantage of any potential raw material cost decreases. Managing selling prices in this uncertain raw material environment will continue to be a critical factor in the 2007 financial results.

The company has experienced declines in sales volume in both 2005 and 2006. Much of this volume decline was expected as management's strategy has been to focus on the product applications that provide the most value to both the customer and the company. Execution of the strategy has required the company to walk away from certain low profit volume. With manufacturing activity in North America showing signs of contracting as we move into 2007, sales volume growth will continue to be a challenge for the company in 2007. Recent figures on housing starts and auto sales from the U.S. automakers are two areas in particular that are in decline. Management believes the right long-term strategy is in place and therefore, is cautiously optimistic for organic sales growth in 2007.

The positive effects on the company's cost structures from utilizing Lean Six SigmaSM are expected to continue in 2007. Benefits will be realized in both the manufacturing operations and the SG&A expense areas. The ongoing focus on strict cost control will also continue in 2007. Pension expenses are expected to be lower in 2007 as compared to 2006 by \$3 to \$4 million dollars on a global basis. The primary reason for the expected decrease in pension expenses is the increase in discount rates used to calculate pension obligations. Higher discount rates result in lower pension obligations and in turn, lower pension expense. The company's balance sheet as of December 2, 2006 was strong with over \$255 million in cash and cash equivalents. Subsequent to fiscal year-end the company paid down \$62 million of debt, which will lower 2007 interest expense from the 2006 run rate. The strong balance sheet positions the company with borrowing capacity to support a significant level of merger and acquisition activity. Management continuously evaluates potential opportunities.

In 2007, the company will have the option to purchase an additional 10 percent ownership position in the joint venture company in Japan for \$12.0 million. Sekisui Chemical Corporation will also have the option to purchase an additional 10 percent ownership position in the company's China entities for \$4.0 million. Both Sekisui Chemical Corporation and the company are evaluating these potential options, but neither party has committed to exercising their respective option.

The company's new CEO, Michele Volpi, assumed his role on December 1, 2006. Mr. Volpi has been an integral part of the financial improvement made by the company over the last two years in his role as the Global Adhesives Group President. As with any leadership change, new ideas and initiatives are to be expected. The company has established an excellent financial foundation over the past two years. This allows Mr. Volpi to fully assess the organization before determining if any new initiatives are necessary and if so, when they should be implemented. No new initiatives have been announced as of the date of this filing.

Critical Accounting Policies and Significant Estimates

Edgar Filing: FULLER H B CO - Form 10-K

Management's discussion and analysis of its results of operations and financial condition are based upon consolidated financial statements, which have been prepared in accordance with accounting principles generally

Table of Contents

accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. Management believes the critical accounting policies and areas that require the most significant judgments and estimates to be used in the preparation of the consolidated financial statements are pension and other postretirement plan assumptions; goodwill recoverability; long-lived assets recoverability; conditional asset retirement obligation assumptions; share-based compensation accounting; product, environmental and other litigation liabilities; and income tax accounting.

Pension and Other Postretirement Plan Assumptions: The company sponsors defined-benefit pension plans in both U.S. and foreign entities. Also in the U.S. the company sponsors other postretirement plans for health care and life insurance costs. Expenses and liabilities for the pension plans and other postretirement plans are actuarially calculated. These calculations are based on management's assumptions related to the discount rate, expected return on assets, projected salary increases and healthcare cost trend rates. The annual measurement date for these assumptions is August 31. Note 10 to the Consolidated Financial Statements includes disclosure of these assumptions for both the non-U.S. and U.S. plans.

The discount rate assumption is tied to a long-term high quality bond index and is therefore subject to annual fluctuations. A lower discount rate increases the present value of the pension obligations, which results in higher pension expense. The discount rate in the U.S. was 6.0 percent at August 31, 2006 as compared to 5.50 percent at August 31, 2005 and 5.75 percent at August 31, 2004. A discount rate reduction of 0.5 percentage points increases pension and other postretirement plan expense approximately \$2.6 million (pretax). Discount rates for non-U.S. plans are determined in a manner consistent with the U.S. plan.

The expected return on assets assumption on the investment portfolios for the pension and other postretirement benefit plans is based on the long-term expected returns for the investment mix of assets currently in the portfolio. Because the rate of return is a long-term assumption, it generally does not change each year. Management uses historic return trends of the asset portfolio combined with recent market conditions to estimate the future rate of return. The current investment mix in the U.S. portfolios is primarily in U.S. equities. The company has used an expected return on assets assumption for the U.S. portfolio of 9.75 percent since 2002. This rate was used in calculating the expenses for 2004, 2005 and 2006. For 2007, the company will use a rate of 9.00 percent due to the reallocation of the portfolio assets to include a component of fixed income securities. A change of 0.5 percentage points for the expected return assumption will impact U.S. net pension and other postretirement plan expense (pretax) by approximately \$1.4 million. Expected return on asset assumptions for non-U.S. plans are determined in a manner consistent with the U.S. plan.

The projected salary increase assumption is based on historic trends and comparisons to the external market. Higher rates of increase result in higher pension expenses. As this rate is also a long-term expected rate, it is less likely to change on an annual basis. In the U.S., management has used the rate of 4.24 percent for 2006 and 4.02 percent in the prior three years.

Goodwill: Goodwill is the excess of cost of an acquired entity over the amounts assigned to assets acquired and liabilities assumed in a purchase business combination. As of December 2, 2006, the company's balance sheet included approximately \$195 million of goodwill. The goodwill is primarily included in the Full-Valu/Specialty operating segment.

SFAS No. 142, *Goodwill and Other Intangible Assets* requires the company to test goodwill for impairment annually or more often if circumstances or events indicate a change in the impairment status. Impairment testing compares the fair value of the reporting units that contain the goodwill to the net asset carrying value of the reporting unit to determine if impairment exists. The calculations confirmed that the fair value of the reporting units exceeded the net asset carrying values for all reporting units.

Edgar Filing: FULLER H B CO - Form 10-K

Management judgment is required in calculating the fair value of the reporting units. The calculation uses a discounted cash flow analysis that requires management to project financial performance and related cash flows.

Table of Contents

The projections are based on management's best estimate given recent financial performance, market trends, strategic plans and other available information. Future results will most likely differ from the projected results. However, based on the margin that fair value exceeded the net asset carrying value of the various reporting units, management does not anticipate a material impact on the company's financial results from differences in these assumptions.

Recoverability of Long-Lived Assets: The assessment of the recoverability of long-lived assets reflects management's assumptions and estimates. Factors that management must estimate when performing impairment tests include sales volume; prices; inflation, discount, currency exchange, and tax rates and capital spending. Significant management judgment is involved in estimating these factors, and they include inherent uncertainties. The measurement of the recoverability of these assets is dependent upon the accuracy of the assumptions used in making these estimates and how the estimates compare to the eventual future operating performance of the specific businesses to which the assets are attributed.

Judgments made by management related to the expected useful lives of long-lived assets and the ability to realize undiscounted cash flows in excess of the carrying amounts of such assets are affected by factors such as the ongoing maintenance and improvement of the assets, changes in economic conditions and changes in operating performance.

Conditional Asset Retirement Obligations: In accordance with Financial Accounting Standards Board Interpretation No. 47, Conditional Asset Retirement Obligations (FIN 47), the company has recognized conditional asset retirement obligations related to special handling of asbestos related materials in certain facilities. FIN 47 clarifies that the term conditional asset retirement obligation as used in SFAS No. 143, Accounting for Asset Retirement Obligations, refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and/or method of settlement. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation.

The company has identified certain facilities for which it has plans or expectations of plans to undertake a major renovation or demolition project that would require the removal of asbestos or has plans or expectation of plans to exit a facility. Once the probability of an action is determined, the company applies certain assumptions to determine the related liability and asset. These assumptions include the use of inflation rates, the use of credit adjusted risk-free discount rates and the reliance on third-party asbestos abatement specialists to estimate the costs to handle asbestos related materials. The recorded liability is required to be adjusted for changes resulting from the passage of time and/or revisions to the timing or the amount of the original estimate.

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

Determining the appropriate fair value model and calculating the fair value of share-based payment awards require the input of highly subjective assumptions, including the expected life of the share-based payment awards and stock price volatility. The company uses the Black-Scholes model to value its stock option awards. Management believes that future volatility will not materially differ from its historical volatility. Thus, the

Table of Contents

company uses the historical volatility of the company's common stock over the expected life of the award. The assumptions used in calculating the fair value of share-based payment awards represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change and management uses different assumptions, share-based compensation expense could be materially different in the future. In addition, the company is required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If the actual forfeiture rate is materially different from the estimate, share-based compensation expense could be significantly different from what has been recorded in the current period. See Note 3 to the Consolidated Financial Statements for a further discussion on share-based compensation.

Product, Environmental and Other Litigation Liabilities: As disclosed in Item 3 and in Note 1 and Note 12 to the Consolidated Financial Statements, the company is subject to various claims, lawsuits and other legal proceedings. Accruals for loss contingencies associated with these matters are made when it is determined that a liability is probable and the amount can be reasonably estimated. The assessment of the probable liabilities is based on the facts and circumstances known at the time that the financial statements are being prepared. For cases in which it is determined that a liability has been incurred but only a range for the potential loss exists, the minimum amount of the range is recorded and subsequently adjusted, as better information becomes available.

For cases in which insurance coverage is available, the gross amount of the estimated liabilities is accrued and a receivable is recorded for any probable estimated insurance recoveries. The company has recorded \$3.9 million for environmental investigation and remediation liabilities, including \$2.1 million for environmental remediation and monitoring activities at its Sorocaba, Brazil facility. In the EIFS litigation involving primarily single-family homes, \$1.7 million for the potential liabilities and \$1.2 million for potential insurance recoveries were accrued. The company also has accrued \$1.2 million for potential liabilities and \$0.6 million for potential insurance recoveries related to asbestos litigation. A complete discussion of environmental, product and other litigation liabilities is disclosed in Item 3 and Note 12 to the Consolidated Financial Statements.

Based upon currently available facts, management does not believe that the ultimate resolution of any pending legal proceeding, individually or in the aggregate, will have a material adverse effect on the company's long-term financial condition. However, adverse developments could negatively impact the company's results of operations or cash flows in one or more future quarters.

Income Tax Accounting: As part of the process of preparing the consolidated financial statements, management is required to estimate income taxes in each of the jurisdictions in which it operates. The process involves estimating actual current tax expense along with assessing temporary differences resulting from differing treatment of items for book and tax purposes. These temporary differences result in deferred tax assets and liabilities, which are included in the consolidated balance sheet. Management records a valuation allowance to reduce its deferred tax assets to the amount that is more likely than not to be realized. Management has considered future taxable income and ongoing tax planning strategies in assessing the need for the valuation allowance. Increases in the valuation allowance result in additional expense to be reflected within the tax provision in the consolidated statement of income. At December 2, 2006, the valuation allowance to reduce deferred tax assets totaled \$7.4 million.

Results of Operations: 2006 Compared to 2005 and 2004**Net Revenue:**

(In millions)	2006	2005	2004	2006 vs 2005	2005 vs 2004
Net revenue	\$ 1,472.4	\$ 1,437.1	\$ 1,330.9	2.5%	8.0%

Table of Contents

Net revenue in 2006 of \$1,472.4 million increased \$35.3 million or 2.5 percent from the 2005 net revenue of \$1,437.1 million. The 2005 net revenue was \$106.2 million or 8.0 percent above the net revenue of \$1,330.9 million in 2004. Management reviews variances in net revenue in terms of changes related to product pricing, sales volume, acquisitions/divestitures and changes in foreign currency exchange rates. The following table shows the net revenue variance analysis for the past two years:

() = Decrease	2006 vs 2005	2005 vs 2004
Product Pricing	6.9%	7.0%
Sales Volume	(8.8%)	1.2%
Acquisitions/Divestitures	4.5%	(1.5%)
Currency	(0.1%)	1.3%
Total	2.5%	8.0%

The impact on net revenue of having one less week in 2006 as compared to 2005 accounted for a net revenue decrease of approximately 2.0 percentage points and it was primarily related to volume. In comparing 2005 to 2004, the extra week in 2005 contributed an increase in net revenue of approximately 2.1 percent. The 2006 increase in selling prices and the decrease in sales volume is consistent with the company's continuing strategy to reposition its product lines to focus on areas that have the highest value to the customer and likewise generate the highest returns. The Global Adhesives and Full-Valu/Specialty segments had significant increases in net revenue due to increases in average selling prices in both 2006 and 2005 as compared to the respective prior year. The net revenue increase of 4.5 percent in 2006 resulting from acquisitions/divestitures was primarily due to the two significant acquisitions made during the year in the Full-Valu/Specialty segment.

Cost of Sales:

(In millions)	2006	2005	2004	2006 vs 2005	2005 vs 2004
Cost of sales	\$ 1,052.5	\$ 1,057.6	\$ 980.1	(0.5%)	7.9%
Percent of net revenue	71.5%	73.6%	73.6%		

The reduction in cost of sales in 2006 as compared to 2005 was due primarily to the 8.8 percent reduction in sales volume, which resulted in reduced raw material usage and lower labor costs in the manufacturing facilities. Improved productivity also had a positive impact on the 2006 cost of sales. These decreases were offset by the significant increase in raw material costs and also the cost of sales related to the acquisitions made during 2006. The acquisitions accounted for over \$60 million of cost of sales in 2006.

Throughout 2006 and 2005, the company experienced a significant and continued increase in raw material costs, which caused raw material prices to increase approximately 7 percent during 2006. Record energy prices, tight supply, and natural disasters combined to create significant cost inflation. The company reacted with the implementation of disciplined pricing processes, which are built to last, and demonstrated the ability to work with customers to recuperate sudden higher costs.

The company considers pricing and inventory levels of crude oil, natural gas, ethylene and propylene to be key indicators in managing its raw materials strategy. In addition to these indicators the company also considers general indicators such as GDP growth, consumer spending, general manufacturing activity and housing starts to help indicate the general health of the economic environment. As of December 2, 2006, the company believes that the general indicators are suggesting slower future growth than in the past, without a significant threat of recession. Should economic conditions begin to slow, the company's global sourcing organization will proactively re-negotiate affected raw material supply arrangements to improve its cost position.

In addition to the pricing actions mentioned above, the company increased its global strategic sourcing team process initiatives such as multi-sourcing, raw material arbitrage, contract re-negotiation and alternative

Table of Contents

technology leverage in 2006 to offset the inflationary impact by approximately \$23 million dollars in 2006. Similarly these types of initiatives offset between \$14 and \$15 million dollars of inflationary impact in 2005 and 2004.

Raw material cost increases were the predominant reason for the cost of sales increase in 2005 as compared to 2004. Energy prices increased throughout the year in response to higher demand combined with interruptions in supply. Supply interruptions were exacerbated by the hurricanes in the United States in August and September of 2005. The increases in raw materials were partially mitigated by reduced costs and improved efficiencies resulting from the company's Lean Six SigmaSM initiatives and overall cost controls in the manufacturing areas.

Gross Profit Margin:

(In millions)	2006	2005	2004	2006 vs 2005	2005 vs 2004
Gross Profit	\$ 419.9	\$ 379.5	\$ 350.8	10.6%	8.2%
Percent of net revenue	28.5%	26.4%	26.4%		

The gross profit margin was 28.5 percent in 2006 as compared to 26.4 percent in both 2005 and 2004. The improved margin in 2006 was attributed primarily to the company's strategy of repositioning its product lines to more value-added applications. A key component of this strategy is rigorous management of the company's selling prices. The 6.9 percent increase in net revenue in 2006 related to increases in selling prices reflects the success of the selling price management. In 2005 the gross profit margin was flat with 2004 as selling price increases were required to offset the impact of rapidly rising raw material costs.

Selling, General and Administrative (SG&A) Expenses:

(In millions)	2006	2005	2004	2006 vs 2005	2005 vs 2004
SG&A	\$ 304.5	\$ 300.2	\$ 292.2	1.4%	2.7%
Percent of net revenue	20.7%	20.9%	22.0%		

The 2006 expenses included \$12.3 million of charges associated with the CEO separation agreement that was entered into in the fourth quarter of 2006. These charges consisted of accelerated stock-based awards, additional SERP benefits and salary continuation benefits. These benefits were reduced by \$4.0 million from what he would have been entitled to had he continued to work through the end of his contract term, which ended on March 31, 2007. Also included in 2006 were over \$14 million of SG&A expenses resulting from the acquisitions made during the year and \$3.6 million from the expensing of stock options in accordance with the adoption of SFAS 123R. The 53rd week in 2005 added over \$5 million to the 2005 SG&A expenses. Reductions in SG&A expenses as compared to 2005 resulted from strict cost controls and productivity improvements resulting from Lean Six SigmaSM projects. The number of employees in SG&A functions at December 2, 2006 was 1,798 as compared to 1,880 at December 3, 2005. Included in the 2006 figure were 85 employees related to the businesses acquired during the year. Excluding the employees from businesses acquired, SG&A headcount decreased by 167 employees or 8.9 percent.

The \$8.0 million increase in SG&A expenses in 2005 as compared to 2004 was primarily due to the expenses incurred in the 53rd week, higher management incentive compensation and severance and other related costs resulting from the outsourcing of certain information technology functions. The contribution of the company's Japan adhesives business to the Sekisui-Fuller joint venture resulted in a reduction in SG&A expenses in 2005 of \$2.9 million as compared to 2004. Other SG&A expense reductions in 2005 were achieved through strict cost controls, headcount reductions and efficiencies resulting from Lean Six SigmaSM projects.

Table of Contents

As a percentage of net revenue, SG&A expenses were 20.7, 20.9 percent and 22.0 percent in 2006, 2005 and 2004, respectively. The charges in 2006 related to the former CEO's Separation Agreement added 0.8 percentage points to the 2006 SG&A percentage of net revenue.

Gains from Sales of Assets:

(In millions)	2006	2005	2004
Gains from sales of assets	\$ 1.1	\$ 7.2	\$ 0.4

The most significant transaction impacting gains from sales of assets in 2006 was the sale of a minor adhesives product line and associated assets in the first quarter of the year that resulted in a gain of \$0.6 million. The 2005 amount included a \$4.7 million gain that resulted from the sale of 20 percent of the company's China