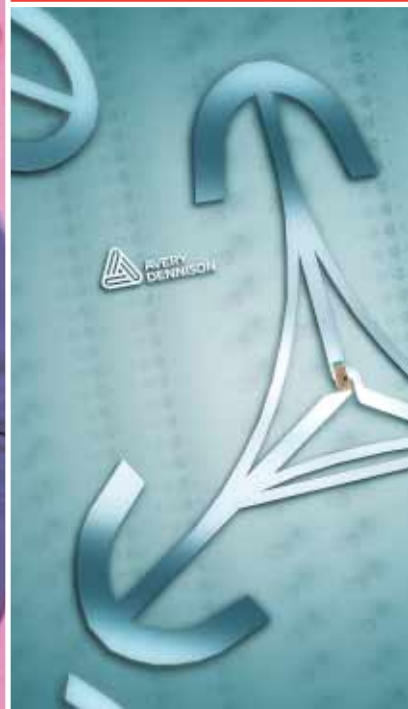




A DEMONSTRABLE DIFFERENCE



Annual Report 2006



FINANCIAL OVERVIEW

(Dollars in millions, except per share amounts)	2006	2005	2004
Net sales from continuing operations	\$5,575.9	\$5,473.5	\$5,317.0
Net income from continuing operations	\$ 352.5	\$ 291.8	\$ 281.0
Net income from continuing operations, as a percent of sales	6.3	5.3	5.3
Net income from continuing operations per common share, assuming dilution	\$ 3.51	\$ 2.90	\$ 2.79
Net income	\$ 367.2	\$ 226.4	\$ 279.7
Net income, as a percent of sales	6.6	4.1	5.3
Net income per common share, assuming dilution	\$ 3.66	\$ 2.25	\$ 2.78
Dividends per common share	1.57	1.53	1.49
Capital expenditures	153.2	171.6	205.7
Return on average shareholders' equity (percent)	22.5	14.6	19.9

FRONT COVER

- 1

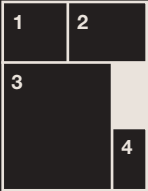
Fasson® clear pressure-sensitive label materials, manufactured by Fasson Roll North America, are taking beverage labeling to new levels of sophistication.
- 2

Jet aircraft light up the skies when decorated with Avery Graphics™ Aircraft film, manufactured by Graphics and Reflective Products.
- 3

Ready to make a statement? Avery® T-Shirt Transfer products — manufactured by Office and Consumer Products — have a unique image transfer system that enables consumers to personalize clothing and other fabrics.
- 4

From inventory tracking to supply chain management, Avery Dennison™ RFID inlays make it possible to find the right item at the right place and time.

Front



BACK COVER

- 1

Fasson® pressure-sensitive papers, manufactured by Materials South America, provide a premium look and labeling versatility for Argentine wines.
- 2

U.S. mail is functional — and fun — thanks to self-adhesive stamps such as DC® Comics Super Heroes, produced by Security Printing.
- 3

Fasson® clear pressure-sensitive label materials, manufactured by Roll Materials Asia Pacific, help attract consumers to health and beauty products.
- 4

Retail Information Services' eco-friendly jacquard woven labels offer natural labeling alternatives in either a blend of natural and conventional yarns or 100% natural yarn fibers.
- 5

France's postal service decorates many of its vehicles with Avery Graphics™ transparent films, manufactured by Graphics and Reflective Products.
- 6

Fasson Roll North America's new resealable film helps satisfy the appetite of customers such as KRAFT® Foods for innovative packaging solutions.
- 7

Manufactured by Performance Polymers, Avery Dennison's clear in-mold label film with its unique "no-label" look gives consumer products added shelf appeal.
- 8

Peeling and applying professional-looking labels is easy, thanks to Avery® Easy Peel Mailing Labels from Office and Consumer Products.

Back



**SERVICE. EXCELLENCE.  
INNOVATION. TEAMWORK.  
COMMUNITY. INTEGRITY.  
IN 2006, OUR EMPLOYEES  
EXEMPLIFIED THESE VALUES  
AND MADE A DEMONSTRABLE  
DIFFERENCE IN THE BUSINESSES  
OF OUR CUSTOMERS.  
OUR PRODUCTS AND SERVICES  
ENABLED OUR CUSTOMERS TO  
SERVE THEIR CLIENTS AND GROW  
THEIR BUSINESSES IN EVERY  
CORNER OF THE WORLD.**



**Kent Kresa**  
Chairman of the Board

**Dean A. Scarborough**  
President and Chief Executive Officer

## DEAR FELLOW SHAREHOLDERS:

**WE ARE PLEASED TO REPORT THAT 2006 WAS ANOTHER SUCCESSFUL YEAR FOR AVERY DENNISON. WE MADE SUBSTANTIAL PROGRESS IN ACHIEVING OUR VISION OF BEING RECOGNIZED AS THE BEST COATING AND CONVERTING COMPANY IN THE WORLD BY HELPING OUR CUSTOMERS GROW THEIR BUSINESSES.**

We continued to expand our presence in emerging markets, where high demand for our products drove significant growth. We began to regain some market share in our North American pressure-sensitive materials business in the second half of the year, although soft market demand negatively impacted our revenue growth.

Sales of our high-margin printable media products in the Office and Consumer Products segment grew in 2006, as a direct result of increased marketing and product renovation programs. This is a solid improvement from the slow decline we experienced in the previous year.

Our Retail Information Services (RIS) business also delivered solid top-line growth from new products such as heat transfer, as well as solid expansion in Asia.

We undertook a major business realignment in 2006 that spanned all geographies and businesses with the goal of simplifying processes and improving efficiencies. We met our objectives, achieving close to \$100 million of annualized savings, while reshaping our organizations to be more responsive to customers.

We were pleased with the conclusion of the investigations by the Department of Justice and the European Commission into competitive practices in the label stock industry. Both of these investigations were closed with no action.

### FINANCIAL HIGHLIGHTS

- Reported sales from continuing operations grew 2 percent to \$5.6 billion in 2006
- Net income from continuing operations grew 21 percent to \$352.5 million in 2006

#### **MOVING FORWARD**

Last year set the foundation for our Company to focus more on top-line growth, as well as executing our margin improvement programs.

#### **WE UNDERTOOK A MAJOR BUSINESS REALIGNMENT IN 2006 THAT SPANNED ALL GEOGRAPHIES AND BUSINESSES WITH THE GOAL OF SIMPLIFYING PROCESSES AND IMPROVING EFFICIENCIES.**

We continue to invest aggressively in emerging markets. The developing economies of Asia, Latin America and Eastern Europe represent approximately 25 percent of our sales, which have grown in the mid-teens. In 2007, we will open several new facilities in China and India. Growth is accelerating in India, where we will add facilities for both Retail Information Services and Pressure-sensitive Materials. Every Avery Dennison business will have a footprint in India by the end of the year.

In addition, we recently opened the Philip M. Neal Asia Pacific Research Center in China. This state-of-the-art facility is focused on helping our customers grow even faster in this region.

We added to our RFID capability with the purchase of an important technology to produce customized RFID products in smaller volumes. RFID sales began to increase in the fourth quarter of 2006. We will continue our investment program, expanding our geographic reach and our new products capability in this promising new market. Our channel access and manufacturing platforms are strong advantages in this market.

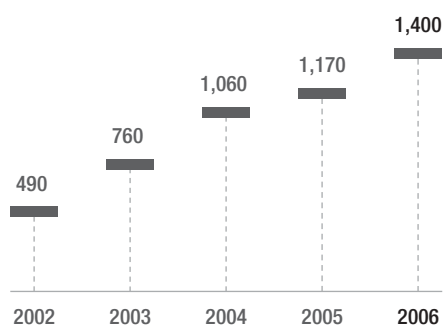
Retail Information Services is poised to deliver solid growth. RIS has benefited from strategic competitive advantages, including fulfillment and consistency of brand image and data for retailers and branded apparel manufacturers. We will add new facilities in Asia and introduce several new products for interior labeling.

#### **WE CONTINUE TO INVEST AGGRESSIVELY IN EMERGING MARKETS... EVERY AVERY DENNISON BUSINESS WILL HAVE A FOOTPRINT IN INDIA BY THE END OF THE YEAR.**



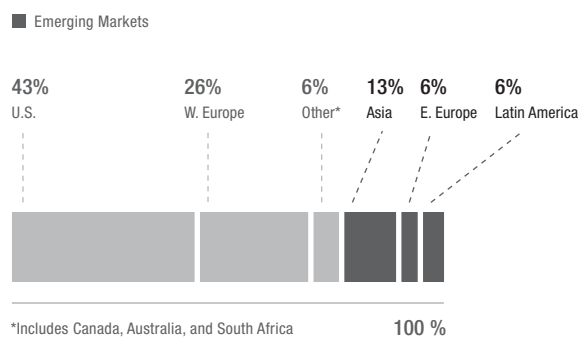
## EMERGING MARKET SALES

(DOLLARS IN MILLIONS)



## 2006 REVENUE BY REGION

(BEFORE INTERGEOGRAPHIC ELIMINATIONS)



We are investing in a new clear-on-clear coating line in our Pressure-sensitive Materials business to support the rapidly growing demand for clear film-based beer labels. Our share gain program is set to deliver moderate top-line growth in pressure-sensitive materials during 2007. Our service and new product platforms are enhanced by scale as we leverage our market-leading share position.

Our Specialty Tape business is introducing many new product platforms, ranging from new elastic side panels for disposable diapers to new materials that adhere to low-surface-energy substrates and products that minimize noise and vibrations. These platforms were developed under our successful Horizons growth program—most of these innovations produced in our Avery Research Center.

### CONTINUED MARGIN EXPANSION

We will continue to create a number of programs to reach our long-term goal of an 11 percent operating margin. Our Enterprise Lean Sigma initiative is at the core of our efforts, as employees continually find ways to simplify and streamline processes, while improving quality and service for our customers. During the fourth quarter of 2006, we announced another round of productivity measures to deliver \$11 million to \$13 million in savings in 2008.

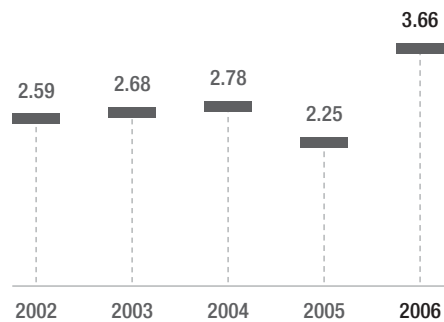
### OUR SERVICE AND NEW PRODUCT PLATFORMS ARE ENHANCED BY SCALE AS WE LEVERAGE OUR MARKET-LEADING SHARE POSITION.

### LOOKING AHEAD WITH CONFIDENCE

As a \$5.6 billion global company, Avery Dennison is an industry leader with clear competitive advantages in developed and emerging markets. Our strengths include: global scale; a strong share position for our core roll materials business; a strong Avery brand and consumer awareness in the office supply category; and an advantageous position in the Retail Information Services business. Our service and delivery platforms,

## EARNINGS PER SHARE

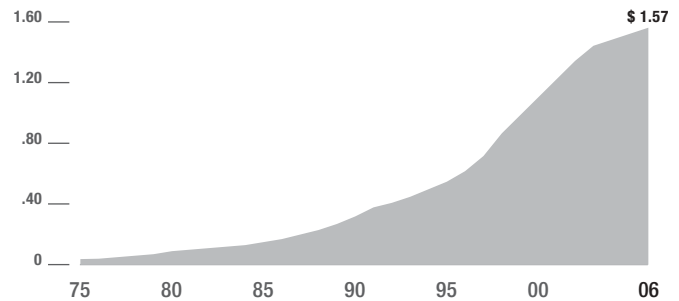
(DOLLARS)



## 31 CONSECUTIVE YEARS OF DIVIDEND INCREASES

(DOLLARS)

12.8% compound annual growth rate



coupled with our size and worldwide reach, make us the fastest provider of innovative products in our relevant markets.

We have an experienced team of leaders who are guided by our vision, values and operating principles. With more than half of our top senior management team born outside the U.S., we know how to operate in the 49 countries in which we do business. Knowing how to operate locally, while leveraging our worldwide values and resources, is a key advantage for us in markets outside the U.S.

The year 2007 marks the 100th birthday of the Company's founder, R. Stanton Avery. From the inception of Avery Dennison in 1935, Stan emphasized the importance of providing innovative products and services, and operating our business in an honest and forthright manner. Those of us who had the privilege of working with Stan know how much emphasis he placed on being a good corporate citizen and an excellent employer. Avery Dennison has implemented a number of programs to help employees understand the importance of the values and vision that guide all of us in this Company.

To our shareholders, we appreciate your support of the Company over the past year. To our employees, we offer our deepest thanks for your hard work in demonstrating the Avery Dennison difference through a year of change, renewal and progress.

Sincerely,

**DEAN A. SCARBOROUGH**  
President and Chief Executive Officer

**KENT KRESA**  
Chairman of the Board

March 1, 2007



## SERVICE

From pre-season collaboration to rigorous testing to unique retail information solutions, Avery Dennison helps Carter's turn the process of appealing to consumers into child's play.





## THE DIFFERENCE:

# CUSTOMER FOCUS

## RETAIL INFORMATION SERVICES + CARTER'S

Quality. Comfort. Innovation. Trust. These traits have made Carter's the number one baby and children's clothing brand in the U.S. today.

Avery Dennison Retail Information Services focuses on these same attributes to help make Carter's products stand out in stores.

Key to the successful 15-year relationship has been close collaboration to develop brand identification solutions that properly convey the benefits of Carter's products.

One example is Avery Dennison™ ComfortTag™ labels that are literally part of the fabric. This proprietary solution enabled Carter's to offer not only one of the first—but also the softest—tagless label on the market, an important feature for parents with infants and toddlers.

“Working with Avery Dennison gives us creative freedom to explore new ideas,” says Robin Polsley, vice president of creative marketing. “No matter what we come up with, we're confident that Avery Dennison will listen and deliver.”



## EXCELLENCE

Avery Dennison worked closely with two European design firms to provide compelling graphic solutions that would attract attention to ABN AMRO's winning entry in the highly competitive Volvo Ocean Race.

## THE DIFFERENCE:

# BRAND ENHANCEMENT

## GRAPHIC AND REFLECTIVE PRODUCTS + STUDIO BAS VAN DER HEIDE/KUBIK EUROPE

The prestigious offshore Volvo Ocean Race brings fame to its victor and visibility to its sponsors.

So when Dutch bank ABN AMRO wanted world-class graphics to attract attention to its entry, it hired two Dutch firms that worked closely with Avery Dennison to make sure that executing their designs would be smooth sailing.

The bank commissioned Studio Bas van der Heide to create a striking sail design that magazines would want to feature on their covers. To determine the boat design that would communicate the bank's brand most effectively, the studio thoroughly researched camera angles from sea and air. Studio Bas van der Heide then turned to Avery Dennison to supply Avery Graphics™ films, knowing they would be cost-effective,

easy to color-match, fast to apply and simple to correct as needed, no matter what the weather conditions.

In addition, ABN AMRO selected Kubik Europe to develop brand-enhancing designs for its corporate pavilion in each port. Kubik Europe worked closely with Avery Dennison to navigate potential challenges in delivering consistent, high-quality graphics in a variety of harsh marine settings.

"Avery Dennison was able to produce the right product for every idea we came up with," says Hajo Reinders, managing director, Kubik Europe. "During the campaign, we needed everything from small stickers and large graphics for ABN AMRO's head office to applications for branding offices and restaurants."

THE DIFFERENCE:

# LIMITLESS THINKING

## RFID DIVISION + KIMBERLY-CLARK

Kimberly-Clark has been a pioneer in radio frequency identification (RFID) since April 2004 when it became the first U.S. company to ship RFID-tagged products to Wal-Mart.

The company recognized that RFID technology could help it ship the right product in the right amount to the right customer at the right time.

But Kimberly-Clark also knew it needed to find the right supplier to provide the sophisticated inlays that are at the heart of RFID tags.

The company selected Avery Dennison—not only for the reliability and quality of its inlays, but also for its wide range of RFID resources and technical skills.

Those resources proved particularly helpful in the development and operation of Kimberly-Clark's RFID research lab—one of the most rigorous in the industry for testing RFID product performance. Avery Dennison not only supplied equipment, but also technical advice and support for the center.

"RFID is an evolving technology," says Mike O'Shea, director, Auto-ID Sensing Technology, Global Sciences and Technology. "Successful implementation requires a strong relationship with partners like Avery Dennison, who can contribute to the process and develop new solutions as we move forward."





## INNOVATION

Together, Avery Dennison and Kimberly-Clark have been pioneers in developing and using sophisticated RFID tags to track products and make sure they are delivered to the right place at the right time.





## TEAMWORK

Leveraging their complementary capabilities and global scale has enabled Brady Corporation and Avery Dennison to develop and supply standard labeling solutions that meet the needs of local customers in highly specialized markets around the world.



## THE DIFFERENCE:

# GLOBAL SCALE

## ROLL MATERIALS + BRADY CORPORATION

Brady Corporation spans the world. With 55 plants worldwide, this leading industrial label manufacturer is close to its customers, wherever they are. To meet the high-performance needs of the industrial, electronics, electrical, safety and other specialized markets, Brady wants suppliers that can be there right beside it.

Avery Dennison fits the bill. The two companies began working together a number of years ago because Brady wanted high-quality roll materials that would complement its coating capabilities and be readily available to its facilities around the world.

That win-win relationship continues today. For example, Avery Dennison and Brady recently co-developed materials that meet new European

compliance standards for waste and use of hazardous substances in electronic and electrical equipment. This has allowed Brady to have standard products supplied locally for use in different regions.

Avery Dennison also provides high-intensity prismatic reflective material that Brady's utility business converts to multilingual signs. These signs warn people in their own language about danger zones such as power lines and excavation projects.

"Avery Dennison's size, scope and global reach—coupled with our in-house technology—help us to take advantage of global market opportunities and meet the needs of various niche markets," says Matt Williamson, president, Brady Americas.

## THE DIFFERENCE:

# PRODUCTIVE PARTNERSHIPS

## OFFICE PRODUCTS NORTH AMERICA + LC INDUSTRIES

LC Industries has a unique vision: to provide meaningful jobs for the blind. Established in 1936, this \$200 million, non-profit company is today the largest U.S. employer of the blind.

LC Industries sells more than 800 items it manufactures or distributes in centers on military bases and in other locations across the U.S. One of its best-selling products is Avery-brand heavyweight document protectors.

This item exemplifies Avery Dennison's commitment to provide products that meet LC Industries' unique needs. In 2006, LC Industries employed eight blind people in its Louisville facility to package the

easy-to-separate Avery-brand bulk document protectors into 425,000 co-branded boxes.

Avery Dennison also ships new Avery-brand products to LC Industries early so that its customers can be among the first to benefit from the latest print-enabling products and tools.

"The blind suffer from an unemployment rate of nearly 70 percent," says William Hudson, president, LC Industries. "Avery Dennison has always respected and understood our vision, and worked hard to develop solutions that help our employees prosper and our company grow."





## COMMUNITY

Avery Dennison's close partnership with LC Industries, the largest employer of the blind in the U.S., produces visible results for both companies. Demand for Avery-brand products on military bases across the U.S. creates job opportunities and sales for LC Industries and growth for Avery Dennison.



**THE DIFFERENCE:**

# **THE AVERY DENNISON DIFFERENCE**

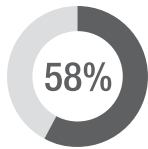
For more than 70 years, we have strived to provide unique products, outstanding service and strategic advantage for our customers. That tradition continued in 2006 as we worked to leverage our global scale, expertise and limitless thinking to help our customers grow their businesses.

We also began a journey to make our business simpler and more responsive. Our goal? To achieve the best of both worlds—decentralized and close to our

customers on the front end and more efficient and centralized in our support functions—so that we can provide even greater value for our customers, employees and shareholders in 2007 and beyond.

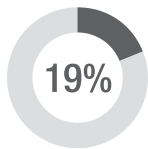
Our focus will remain on demonstrating new ways to make a meaningful difference to our customers. Our objective will be, as it always has been, to anticipate their needs and create innovative solutions to fulfill them. Because when they succeed, we succeed.

## OUR BUSINESSES AT A GLANCE



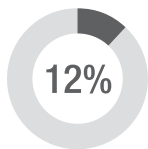
### **Pressure-sensitive Materials**

Pressure-sensitive Materials consists of Fasson-brand roll materials, graphics and reflective materials, performance polymers and engineered films. Roll materials are used in brand identity, barcode labeling systems, product identification and other applications by label converters and consumer products package designers and manufacturers. Graphics and reflective materials are used in wide-format digital printing, sign-making, traditional screen printing and offset printing to serve the graphic arts, vehicle marking, transportation and highway-safety industries. Performance polymers are an extensive line of water-based and solvent-based pressure-sensitive adhesives used in film and paper labels, graphic films, specialty automotive and industrial tapes, and protective films for windows and consumer goods. Locations: North America, Europe, Latin America, Asia Pacific and South Africa.



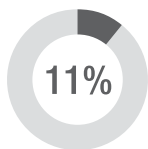
### **Office and Consumer Products**

Office and Consumer Products manufactures a wide range of products for office, home and school including Avery-brand self-adhesive labels, content and template software, binders, sheet protectors, dividers and index makers, writing instruments, cell phone labels, T-shirt transfers, security badge systems and do-it-yourself business cards. Locations: North America, Europe, Latin America and Asia Pacific.



### **Retail Information Services**

Retail Information Services designs, manufactures and sells a variety of price marking and brand identification products for retailers, apparel manufacturers, distributors and industrial customers worldwide. These include woven and printed labels, heat transfers, graphic tags, patches, integrated tags, price tickets, custom hard and soft goods packaging, RFID carton and item tags, electronic article surveillance (EAS) tags, barcode printers, software solutions, molded plastic fastening and application devices, as well as service bureau printing applications for supply chain and security management. Locations: North America, Europe, Latin America, Asia Pacific and South Africa.



### **Other Specialty Converting Businesses**

This group consists of several different businesses. The Specialty Tape business produces technically advanced pressure-sensitive tapes that are used by industrial fabricators, original equipment manufacturers, medical device manufacturers and in disposable diaper products. The Industrial and Automotive Products business manufactures high-quality materials such as decorative automotive interior films and long-life paint replacement films. The Security Printing business manufactures self-adhesive postage stamps and battery labels. The RFID business provides sophisticated RFID label inlays to converters who supply pressure-sensitive RFID labels for diverse end-user markets. Locations: North America, Europe, Latin America and Asia Pacific.



## FIVE-YEAR SUMMARY

(Dollars in millions, except per share amounts)	5-Year Compound Growth Rate	2006 <sup>(1)</sup>		2005 <sup>(2)</sup>		2004 <sup>(3)</sup>		2003 <sup>(4)</sup>		2002 <sup>(5)</sup>			
		Dollars	%	Dollars	%	Dollars	%	Dollars	%	Dollars	%		
<b>For the Year<sup>(6)</sup></b>													
Net sales	8.4%	\$ 5,575.9	100.0	\$ 5,473.5	100.0	\$ 5,317.0	100.0	\$ 4,736.8	100.0	\$ 4,127.5	100.0		
Gross profit	6.7	1,528.4	27.4	1,476.2	27.0	1,426.6	26.8	1,319.2	27.9	1,209.1	29.3		
Marketing, general and administrative expense	7.4	1,011.1	18.1	987.9	18.0	957.4	18.0	891.6	18.8	775.5	18.8		
Interest expense	1.7	55.5	1.0	57.9	1.1	58.7	1.1	58.6	1.2	44.7	1.1		
Income from continuing operations before taxes	4.0	425.6	7.6	366.8	6.7	375.3	7.1	338.5	7.1	361.1	8.7		
Taxes on income	(8.2)	73.1	1.3	75.0	1.4	94.3	1.8	93.4	2.0	106.9	2.6		
Income from continuing operations	8.3	352.5	6.3	291.8	5.3	281.0	5.3	245.1	5.2	254.2	6.2		
Income (loss) from discontinued operations, net of tax	N/A	14.7	N/A	(65.4)	N/A	(1.3)	N/A	22.8	N/A	3.0	N/A		
Net income	8.6	367.2	6.6	226.4	4.1	279.7	5.3	267.9	5.7	257.2	6.2		
		5-Year Compound Growth Rate		2006		2005		2004		2003		2002	
<b>Per Share Information</b>													
Income per common share from continuing operations				7.8%	\$ 3.53	\$ 2.91	\$ 2.81	\$ 2.47	\$ 2.58				
Income per common share from continuing operations, assuming dilution				7.9	3.51	2.90	2.79	2.45	2.56				
Net income per common share				8.1	3.68	2.26	2.80	2.70	2.61				
Net income per common share, assuming dilution				8.2	3.66	2.25	2.78	2.68	2.59				
Dividends per common share				5.0	1.57	1.53	1.49	1.45	1.35				
Average common shares outstanding				.4	99.8	100.1	99.9	99.4	98.5				
Average common shares outstanding, assuming dilution				.4	100.4	100.5	100.5	100.0	99.4				
Book value at fiscal year end				12.5	\$ 17.10	\$ 15.16	\$ 15.47	\$ 13.24	\$ 10.64				
Market price at fiscal year end				3.9	67.93	55.27	59.97	54.71	59.05				
Market price range					55.09 to 69.11	50.30 to 62.53	54.90 to 65.78	47.75 to 63.51	52.86 to 69.49				
<b>At Year End</b>													
Working capital					\$ (43.4)	\$ 31.0	\$ 151.8	\$ (56.8)	\$ (92.4)				
Property, plant and equipment, net					1,309.4	1,295.7	1,374.4	1,287.1	1,178.1				
Total assets					4,293.6	4,203.9	4,399.3	4,118.1	3,656.3				
Long-term debt					501.6	723.0	1,007.2	887.7	837.2				
Total debt					968.0	1,087.7	1,211.7	1,180.3	1,144.2				
Shareholders' equity					1,680.5	1,511.9	1,548.7	1,318.7	1,056.4				
Number of employees					22,700	22,600	21,400	20,300	20,500				
<b>Other Information</b>													
Depreciation expense <sup>(7)</sup>					\$ 153.8	\$ 154.2	\$ 145.8	\$ 141.9	\$ 122.5				
Research and development expense <sup>(7)</sup>					87.9	85.4	81.8	74.3	74.0				
Effective tax rate <sup>(7)</sup>					17.2%	20.4%	25.1%	27.6%	29.6%				
Total debt as a percent of total capital					36.5	41.8	43.9	47.2	52.0				
Return on average shareholders' equity (percent)					22.5	14.6	19.9	22.3	25.7				
Return on average total capital (percent)					15.6	10.1	12.1	12.4	13.9				

(1) Results for 2006 include net pretax charges of \$36.2 for restructuring costs, asset impairment and lease cancellation charges, environmental remediation and other items, partially offset by gain on sale of investment and assets. Additionally, results for 2006 include a tax benefit of \$14.9 due to capital losses arising from the sale of discontinued operations and a pretax gain on the sale of discontinued operations of \$1.3.

(2) Results for 2005 include a net pretax charge of \$63.6 for restructuring costs, asset impairment and lease cancellation charges and legal accrual related to a patent lawsuit, partially offset by gain on sale of assets. Additionally, results for 2005 include impairment charges for goodwill and intangible assets of \$74.4 associated with the expected divestiture of a business.

(3) Results for 2004 include a pretax charge of \$35.2 for restructuring costs, asset impairment and lease cancellation charges. Results for 2004 reflect a 53-week period.

(4) Results for 2003 include a net pretax charge of \$30.5 for restructuring costs, asset impairment and lease cancellation charges and net losses associated with several product line divestitures, partially offset by a gain from the settlement of a lawsuit. Additionally, results for 2003 include a pretax gain on sale of discontinued operations of \$25.5.

(5) Results for 2002 include a pretax charge for asset impairment and lease cancellation charges of \$21.4, as well as a pretax charge of \$10.7 related to severance.

(6) Certain amounts for prior years were reclassified to conform with the current year presentation.

(7) Amounts related to continuing operations.



# MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

## ORGANIZATION OF INFORMATION

Management's Discussion and Analysis provides a narrative concerning our financial performance and condition that should be read in conjunction with the accompanying financial statements. It includes the following sections:

• Definition of Terms .....	19
• Overview and Outlook .....	19
• Analysis of Results of Operations .....	22
• Results of Operations by Segment .....	24
• Financial Condition .....	26
• Uses and Limitations of Non-GAAP Measures .....	31
• Related Party Transactions .....	31
• Critical Accounting Policies and Estimates .....	31
• Recent Accounting Requirements .....	34
• Safe Harbor Statement .....	34
• Market-Sensitive Instruments and Risk Management .....	35

## DEFINITION OF TERMS

Our discussion of financial results includes several non-GAAP measures to provide additional information concerning Avery Dennison Corporation's ("the Company's") performance. These non-GAAP financial measures are not in accordance with, nor are they a substitute for, GAAP financial measures. The non-GAAP financial measures are intended to supplement the presentation of our financial results that are prepared in accordance with GAAP. (Refer to "Uses and Limitations of Non-GAAP Measures.")

We use the following terms:

- *Organic sales growth* refers to the change in sales excluding the estimated impact of currency translation, acquisitions and divestitures;
- *Core unit volume* refers to a measure of sales performance that excludes the estimated impact of currency translation, acquisitions and divestitures, as well as changes in product mix and pricing;
- *Segment operating income* refers to income before interest and taxes;
- *Free cash flow* refers to cash flow from operations, less payments for capital expenditures, software and other deferred charges; and
- *Working capital from continuing operations* refers to working capital excluding short-term debt, current assets and current liabilities of held-for-sale businesses.

While our segment structure remained the same as reported in the prior year, in 2006, we transferred our business media division from the Retail Information Services segment into other specialty converting businesses, to align with a change in our internal reporting structure. Prior year amounts included herein have been reclassified to conform to the current year presentation.

*As a result of the sale of our raised reflective pavement marker business during 2006 (discussed below in "Acquisitions and Divestitures"), the discussions which follow generally reflect summary results from our continuing operations unless otherwise noted. However, the net income and net income per share discussions include the impact of discontinued operations.*

## OVERVIEW AND OUTLOOK

### Overview

#### Sales

Our sales from continuing operations increased 2% in 2006 compared to growth of 3% in 2005, reflecting the factors summarized in the following table.

Estimated change in sales due to:	2006	2005	2004
Core unit volume	2%	(1)%	8%
Pricing & product mix	1	2	(1)
Organic sales growth	3%	1%	7%
Foreign currency translation	-	2	5
Divestitures, net of acquisitions	(1)	-	-
Reported sales growth	2%	3%	12%

Organic sales growth in 2006 reflected increases in most of our businesses outside of the U.S., particularly in the emerging markets of Asia, Eastern Europe and Latin America.

In the U.S., sales were approximately even with the prior year. In our North American roll materials business, reduced market share during the first quarter of 2006 (reflecting share loss related to price increases implemented in 2005 and early 2006, to offset higher raw material costs), as well as generally slow market conditions, were offset by some share gain during the second half of 2006. The benefit from growth of Avery-brand products and a strong back-to-school season in our Office and Consumer Products segment in the U.S. was offset by the loss of sales from exiting certain low-margin private label business in that segment.

Organic sales growth in 2005 reflected favorable changes in pricing and product mix, primarily due to the impact of selling price increases implemented to offset higher raw material costs. This benefit was partially offset by a decrease in core unit volume in 2005, reflecting the following factors:

- Loss of market share in our North American roll materials business following our implementation of selling price increases during 2005, to offset higher raw material costs
- The impact of an extra week in the 2004 fiscal year

- Accelerated purchases by Office and Consumer Products customers in advance of our 2005 selling price increases, which shifted sales into the fourth quarter of 2004.

#### Net Income

Net income increased \$141 million in 2006 compared to 2005.

Positive factors affecting the change in net income included:

- Higher sales
- Reduced restructuring and asset impairment charges in 2006 compared to 2005 (which included asset impairment charges related to discontinued operations)
- Cost savings from productivity improvement initiatives across all segments and corporate, including restructuring actions taken in 2006 and late 2005
- Tax benefit and gain on divestiture of a business
- Benefit of a lower effective tax rate on continuing operations

Negative factors affecting the change in net income included:

- Stock-based compensation and other employee-related costs
- Transition costs associated with 2006 restructuring actions
- Increased investment in information technology and marketing
- Accrual for environmental remediation costs

#### Summary Results by Segment

(In millions)	Net Sales		Operating Income	
	2006	2005	2006	2005
Pressure-sensitive Materials	\$ 3,236.3	\$ 3,114.5	\$ 301.2	\$ 258.1
Office and Consumer Products	1,072.0	1,136.1	179.0	168.0
Retail Information Services	667.7	630.4	45.0	37.7
Other specialty converting businesses	599.9	592.5	17.2	14.1
Corporate expense	—	—	(61.3)	(53.2)
Interest expense	—	—	(55.5)	(57.9)
Total from continuing operations	\$ 5,575.9	\$ 5,473.5	\$ 425.6	\$ 366.8

#### Pressure-sensitive Materials (58% of net sales)

Our Pressure-sensitive Materials segment reported a 4% increase in sales in 2006 compared to 2005. Organic sales growth was approximately 3%, reflecting growth in our roll materials and graphics and reflective businesses in Asia, Europe and Latin America.

Operating income for this segment increased 17% in 2006, reflecting higher sales and cost savings from restructuring and productivity improvement initiatives. Operating income for this segment included restructuring costs and asset impairments in both 2006 and 2005 and transition costs in 2006.

#### Office and Consumer Products (19% of net sales)

Our Office and Consumer Products segment reported a 6% decrease in sales in 2006 compared to 2005. On an organic basis, sales declined approximately 1%, reflecting the loss of sales from exiting certain low-margin private label business and decreased volume in Europe. These declines were partially offset by growth in North America for Avery-brand products, a strong back-to-school season, and accelerated purchases by customers in advance of our 2007 selling price increases for certain product lines.

Operating income for this segment increased 7% in 2006, including the benefit from cost savings from productivity improvement and restructuring initiatives. Operating income for this segment included restructuring costs, asset impairments and transition costs in both 2006 and 2005.

#### Retail Information Services (12% of net sales)

The Retail Information Services segment reported a 6% increase in sales in 2006 compared to 2005. Organic sales growth was approximately 5%, reflecting continued growth of the business in Asia, Latin America and Europe.

Operating income for this segment increased 19% in 2006, reflecting higher sales and cost savings from restructuring and productivity improvement initiatives. Operating income for this segment included restructuring costs, asset impairments and transition costs in 2006 and 2005.

#### Other specialty converting businesses (11% of net sales)

Other specialty converting businesses reported a 1% increase in sales in 2006 compared to 2005. Organic sales growth was approximately 2%, reflecting solid growth in our specialty tape business, partially offset by weakness in other businesses.

Operating income for these businesses increased 22% in 2006, reflecting sales growth and cost savings from restructuring and productivity improvement initiatives. Operating income for these businesses included restructuring costs and asset impairments in both 2006 and 2005.

#### Organic Sales Growth by Region

We estimate organic sales growth (decline) in major regions of operation as follows:

	2006	2005	2004
U.S.	—	(3)%	5%
Europe	3%	3%	5%
Asia	13%	13%	26%
Latin America	11%	4%	19%

As discussed above, sales in the U.S. were approximately even with the prior year, due to slow market conditions in our Pressure-sensitive Materials segment, the impact of prior year share loss in our roll materials business, and loss of sales from exiting low-margin private label business in our Office and Consumer Products segment.

Organic growth in Europe reflected strong growth in the east and modest growth in the west.

Growth in our Asian and Latin American businesses was due to continued market expansion.

### Cost Reduction Actions

(Dollars in millions)	Accrued Expenses	Headcount Reduction
Q4 2005 restructuring	\$ 41.1	700
2006 restructuring	23.5	450
Total Q4 2005–2006 restructuring actions	\$ 64.6	1,150
Q4 2006 charges related to 2007 actions	\$ 5.1	140

During late 2005 and 2006, we implemented cost reduction actions related to restructuring, which have improved our global operating efficiencies and are expected to result in annualized pre-tax savings of \$90 million to \$100 million. We estimate that approximately \$50 million of these savings (net of transition costs) were achieved in 2006, with the balance to benefit 2007. These restructuring actions resulted in headcount reductions of approximately 1,150 positions, which impacted all of our segments and geographic regions and were completed in 2006. We are reinvesting some of the savings in future growth opportunities.

Additional restructuring actions were identified during the fourth quarter of 2006. These actions are expected to be completed during 2007, with savings expected to benefit 2008.

In 2005, we also incurred charges related to the planned divestitures of several low-margin businesses and product lines, as discussed in "Divestitures and Acquisitions."

Restructuring charges associated with severance and asset impairments recorded during 2004 were related to the completion of the integration of the 2002 acquisition of Jackstädt into our other existing businesses. We closed a manufacturing facility in France during the first quarter of 2004 and a manufacturing facility in Italy during the second quarter of 2004.

Refer to Note 10, "Cost Reduction Actions," to the Consolidated Financial Statements for further detail.

### Effective Rate of Taxes on Income

The effective tax rate was 17.2% for the full year 2006 compared with 20.4% for the full year 2005.

Our effective tax rate in both years included benefits from:

- Changes in the geographic mix of income
- Continued improvements in our global tax structure
- Several favorable global tax audit settlements and the closure of certain tax years
- Release of certain valuation allowances

In 2005, these benefits were partially offset by incremental expense associated with the repatriation of accumulated foreign earnings under the American Jobs Creation Act of 2004.

### Free Cash Flow

Free cash flow, which is a non-GAAP measure, is used as a measure of funds available for other corporate purposes, such as dividends, debt reduction, acquisitions, and repurchase of common stock. Refer to "Uses and Limitations of Non-GAAP Measures."

(In millions)	2006	2005	2004
Net cash provided by operating activities	\$ 510.8	\$ 441.6	\$ 516.9
Purchase of property, plant and equipment	(161.9)	(162.5)	(178.9)
Purchase of software and other deferred charges	(33.4)	(25.8)	(21.8)
Free cash flow	\$ 315.5	\$ 253.3	\$ 316.2

The increase in free cash flow in 2006 of \$62 million reflects changes in assets and liabilities and higher net income compared to 2005. See "Analysis of Results of Operations" and "Liquidity" below for more information.

### Divestitures and Acquisitions

In December 2005, we announced our plan to sell our raised reflective pavement marker business, which had sales of approximately \$23 million in 2005. The divestiture of this business was completed during the second quarter of 2006 and resulted in a tax benefit due to capital losses arising from the sale of the business. The results of this business have been accounted for as discontinued operations for the years presented herein. This business was previously included in the Pressure-sensitive Materials segment.

In December 2005, we also announced the divestiture of two product lines. These divestitures were completed in the first quarter of 2006. The first product line, which was included in the Office and Consumer Products segment, had estimated sales of \$60 million in 2005, with minimal impact to income from operations. The second product line, which was included in other specialty converting businesses, had annual sales of approximately \$10 million in 2005, with minimal impact to income from operations. As part of these divestitures, in 2005, we recorded severance and other employee-related charges of approximately \$6 million and asset impairments of approximately \$9 million. These charges were included in the "Other Expense, net" line of our Consolidated Statement of Income, as noted in "Cost Reduction Actions" above.

During the third quarter of 2004, we acquired Rinke Etiketten ("Rinke"), a privately held company in Germany. The incremental impact of this acquisition on our net sales was approximately \$9 million during 2004, with an additional impact of approximately \$18 million in 2005. This business is included in our Retail Information Services segment.

### Investigations and Legal Proceedings

On October 19, 2006, we were notified by the U.S. Department of Justice's Antitrust Division ("DOJ") that the DOJ had decided to close its criminal investigation (initiated in April 2003) into competitive practices in the label stock industry without further action.

On November 15, 2006, we announced that we had been notified by the European Commission ("EC") that the EC had closed its investigation (initiated in May 2004) into competitive activities in the label stock industry with no action.

In July 2004, we were notified by the Competition Law Division of the Department of Justice of Canada that it was seeking information in connection with a label stock investigation. In August 2005, we were notified by the Australian Competition and Consumer Commission that it was seeking information in connection with a label stock investigation. We are cooperating with these investigations.

We are a named defendant in purported class actions in the U.S. seeking treble damages and other relief for alleged unlawful competitive practices, which were filed after the announcement of the DOJ investigation. We are also a named defendant in a purported class action in the U.S. seeking damages and other relief for alleged disclosure and fiduciary duty violations pertaining to alleged unlawful competitive practices. We have discovered instances of conduct by certain employees in China that potentially violate the U.S. Foreign Corrupt Practices Act, and we have reported that conduct to authorities in the U.S. Accordingly, we expect that fines or other penalties may be incurred.

We are unable to predict the effect of these matters at this time, although the effect could be adverse and material. These and other matters are reported in Note 8, "Contingencies," to the Consolidated Financial Statements.

### Outlook

In 2007, we expect low to mid single-digit revenue growth, including a modest positive effect from foreign currency translation. Our revenue expectations are subject to changes in economic and market conditions.

We anticipate continued benefit from our productivity improvement initiatives. In particular, we estimate that our restructuring and business realignment efforts will reduce costs by an additional \$45 million compared to 2006. However, we plan to reinvest some of the savings from these productivity improvements in growth initiatives. This reinvestment includes incremental spending of approximately \$12 million to \$15 million related to investments in information technology.

We estimate that pretax interest expense will be approximately even with 2006, subject to changes in average debt outstanding.

We expect total restructuring and asset impairment charges in 2007 will be lower than the charges taken in 2006.

We anticipate an increase in our annual effective tax rate for 2007, subject to changes in tax laws and the geographic mix of income, with potentially wide variances from quarter to quarter.

Reflecting these assumptions, we expect an increase in annual earnings and free cash flow in comparison with 2006. Additionally, the effect of share repurchase will benefit earnings per share in 2007.

We expect capital expenditures in 2007 to be approximately \$160 million to \$165 million, or approximately \$210 million to \$225 million including software investments, funded through operating cash flows. Major capital projects in 2007 include expansion in China and India, serving both our materials and retail information services businesses. Major software investments relate to customer service and standardization initiatives.

### ANALYSIS OF RESULTS OF OPERATIONS

#### Income from Continuing Operations Before Taxes:

(In millions)	2006	2005	2004
Net sales	\$ 5,575.9	\$ 5,473.5	\$ 5,317.0
Cost of products sold	4,047.5	3,997.3	3,890.4
Gross profit	1,528.4	1,476.2	1,426.6
Marketing, general and administrative expense	1,011.1	987.9	957.4
Interest expense	55.5	57.9	58.7
Other expense, net	36.2	63.6	35.2
Income from continuing operations before taxes	\$ 425.6	\$ 366.8	\$ 375.3
As a Percent of Sales:	%	%	%
Gross profit (margin)	27.4	27.0	26.8
Marketing, general and administrative expense	18.1	18.0	18.0
Income from continuing operations before taxes	7.6	6.7	7.1

#### Sales

Sales increased 2% in 2006 compared to an increase of 3% in 2005. Organic sales growth was approximately 3% in 2006 compared to approximately 1% in 2005. Organic sales growth in 2006 reflected increases in most of our businesses in Asia, Europe and Latin America. Organic growth in Europe reflected strong growth in the east and modest growth in the west. Growth in our Asian and Latin American businesses was due to continued market expansion.

On an organic basis, sales in the U.S. were approximately even in 2006, compared to a decrease of approximately 3% in 2005. In our North American roll materials business, reduced market share during the first quarter of 2006 (reflecting share loss related to price increases implemented in 2005 and early 2006 to offset higher raw material costs), as well as generally slow market conditions, were offset by some share gain during the second half of 2006. The benefit from growth of Avery-brand products and a strong back-to-school season in our Office and Consumer Products segment in the U.S. was offset by the loss of sales from exiting certain low-margin private label business (approximate impact of \$22 million) in that segment.

Sales growth in 2005 was negatively impacted by an extra week in the 2004 fiscal year and accelerated purchases by Office and



Consumer Products customers in advance of 2005 selling price increases, both of which contributed to higher growth in 2004. Combined, the accelerated purchases and extra week in 2004 represented an estimated \$60 million to \$70 million of the change in sales between 2005 and 2004. The loss of market share in our North American roll materials business also affected sales growth in 2005.

Foreign currency translation had a favorable impact on the change in sales of approximately \$21 million in 2006 compared to approximately \$77 million in 2005.

Product line divestitures, net of incremental sales from acquisitions, reduced sales by approximately \$54 million in 2006. Incremental sales from acquisitions, net of divestitures, contributed approximately \$19 million in 2005.

### Gross Profit

Gross profit margin in both 2006 and 2005 benefited from our ongoing productivity improvement and cost reduction actions.

In 2006, these benefits were partially offset by:

- Unfavorable segment mix (faster growth in segments with lower gross profit margin as a percent of sales)
- Energy-related cost inflation (approximately \$9 million)
- Change in the last-in, first-out ("LIFO") inventory reserves (approximately \$9 million); refer to "Critical Accounting Policies and Estimates"
- Transition costs associated with restructuring (approximately \$9 million)

In 2005, these benefits were partially offset by:

- Unfavorable segment mix
- Raw material inflation in excess of selling price increases
- Higher costs related to our radio frequency identification ("RFID") business (approximately \$9 million)

In 2006, we reclassified shipping and handling costs to "Cost of products sold" to align our businesses around a standard accounting policy. In 2005, several of our businesses included these costs in marketing, general and administrative expenses (approximately \$143 million for 2006, \$145 million for 2005 and \$148 million for 2004); previous results included herein have been reclassified for comparability to the current year.

### Marketing, General and Administrative Expenses

Marketing, general and administrative expense as a percent of sales in 2006 and 2005 reflected the benefit of productivity improvement initiatives and cost reduction actions.

In 2006, these benefits were offset by:

- Recognition of stock option expense (approximately \$21 million)
- Increased spending on information systems and marketing (approximately \$19 million)

- Increase in pension, medical and other employee-related costs (approximately \$12 million)

In 2005, these benefits were offset by:

- Higher pension and medical expenses (approximately \$14 million)
- Impact of foreign currency translation (approximately \$11 million)
- Additional spending on the development of our RFID business (approximately \$8 million), as well as other long-term growth initiatives
- Additional spending associated with acquisitions (approximately \$6 million)

### Interest Expense

Interest expense decreased in 2006 and 2005. The decreases were due to a reduction in debt outstanding, partially offset by an increase in interest rates.

### Other Expense

(In millions, pretax)	2006	2005	2004
Restructuring costs	\$ 21.1	\$ 37.5	\$ 23.6
Asset impairment & lease cancellation charges	8.7	28.1	11.6
Other	6.4	(2.0)	—
Other expense, net	\$ 36.2	\$ 63.6	\$ 35.2

In 2006 and 2005, "Other expense, net," consisted of charges for restructuring, including severance and other employee-related costs and asset impairment charges related to cost reduction actions and divestitures, as well as other items discussed below.

During late 2005 and 2006, we implemented cost reduction actions related to restructuring which have improved our global operating efficiencies and are expected to result in annualized pretax savings of \$90 million to \$100 million. We estimate that approximately \$50 million of these savings (net of transition costs) have been achieved in 2006. These restructuring actions resulted in a headcount reduction of approximately 1,150 positions, which impacted all of our segments and geographic regions, and were completed in 2006. We are reinvesting some of the savings in future growth opportunities. Refer to Note 10, "Cost Reduction Actions," to the Consolidated Financial Statements for more information.

The other items included in "Other expense, net," in 2006 included:

- Accrual for environmental remediation costs (\$13 million); refer to the Environmental section of "Financial Condition" below
- Costs related to a patent lawsuit and a divestiture (\$.8 million)
- Gain on sale of assets (\$5.3 million)
- Gain on curtailment and settlement of a pension obligation (\$1.6 million)
- Gain on sale of an investment (\$10.5 million), partially offset by a charitable contribution to the Avery Dennison Foundation (\$10 million)

In 2005, other items included in "Other expense, net," consisted of the gain on the sale of assets, partially offset by costs related to a patent lawsuit.

In 2004, "Other expense, net," consisted of charges for productivity improvement actions, primarily related to the completion of the Jackstädt integration actions.

#### Net Income:

(In millions, except per share amounts)	2006	2005	2004
Income from continuing operations			
before taxes	\$ 425.6	\$ 366.8	\$ 375.3
Taxes on income	73.1	75.0	94.3
Income from continuing operations	352.5	291.8	281.0
Income (loss) from discontinued operations, net of tax	14.7	(65.4)	(1.3)
Net income	\$ 367.2	\$ 226.4	\$ 279.7
Net income per common share	\$ 3.68	\$ 2.26	\$ 2.80
Net income per common share, assuming dilution	\$ 3.66	\$ 2.25	\$ 2.78
Net income as a percent of sales	6.6%	4.1%	5.3%
Effective tax rate from continuing operations	17.2%	20.4%	25.1%

#### Taxes on Income

Our 2006 effective tax rate included the benefit of changes in the geographic mix of income and continued improvements in our global tax structure, as well as the following:

- Net benefit from several favorable global tax audit settlements (approximately \$8.1 million)
- Release of certain valuation allowances (approximately \$5.2 million)

Our 2005 effective tax rate included the benefit of changes in the geographic mix of income and continued improvements in our global tax structure, as well as the following:

- Release of certain valuation allowances (approximately \$15.6 million)
- Net benefit from several favorable global tax audit settlements (approximately \$9 million)

In 2005, these benefits were partially offset by the incremental expense of \$13.5 million associated with the repatriation of accumulated foreign earnings under the American Jobs Creation Act of 2004.

#### Income (Loss) from Discontinued Operations

Income (loss) from discontinued operations includes the divestiture of our raised reflective pavement markers business as noted in the Overview section above. The divestiture of this business was completed during 2006 and resulted in a tax benefit (\$14.9 million) due to capital losses arising from the sale of the business and a gain on sale of \$1.3 million.

Based on our estimated value of the raised reflective pavement markers business in 2005, we concluded that associated goodwill and intangible assets from our acquisition of this business were

impaired. The resulting pretax impairment charge was approximately \$74 million in 2005.

Income from discontinued operations included net sales of approximately \$7 million in 2006, \$23 million in 2005 and \$24 million in 2004.

Refer to the Discontinued Operations section of Note 1, "Summary of Significant Accounting Policies," to the Consolidated Financial Statements for more information.

#### RESULTS OF OPERATIONS BY SEGMENT

##### Pressure-sensitive Materials Segment

(In millions)	2006	2005	2004
Net sales including intersegment sales	\$ 3,397.8	\$ 3,277.7	\$ 3,154.1
Less intersegment sales	(161.5)	(163.2)	(169.3)
Net sales	\$ 3,236.3	\$ 3,114.5	\$ 2,984.8
Operating income <sup>(1)</sup>	301.2	258.1	221.4
<sup>(1)</sup> Includes restructuring, asset impairment & lease cancellation charges and accrual for patent lawsuit, net of gain on sales of assets			
	\$ 9.3	\$ 23.0	\$ 34.4

##### Net Sales

Sales in our Pressure-sensitive Materials segment increased 4% in both 2006 and 2005. Organic sales growth was approximately 3% in 2006 and 2% in 2005.

Organic sales growth in 2006 reflected growth in our roll materials and graphics and reflective businesses in Asia, Latin America, and Europe. Organic growth in 2005 reflected the positive impact of pricing and product mix, resulting from increased selling prices implemented to offset higher raw material costs. The extra week in the 2004 fiscal year contributed to slower growth in 2005.

In our North American roll materials business, 2005 sales declined on an organic basis at a low single-digit rate, while 2006 sales were even with the prior year. The loss of market share following our implementation of selling price increases in 2005 and early 2006 contributed to this decline. Both years were also affected by generally slow market conditions. Some share gain during the second half of 2006 offset these factors.

Our roll materials business in Europe experienced low single-digit organic sales growth in 2006, reflecting strong growth in the east. In 2005, this business experienced high single-digit organic sales growth reflecting solid growth in the west and stronger growth in the east.

Market expansion contributed to double-digit organic sales growth in the roll materials business in Asia in both 2006 and 2005. The roll materials business in Latin America experienced high single-digit organic sales growth in 2006, resulting from market expansion. In 2005, this region experienced low single-digit organic sales growth due to market expansion and selling price increases,

partially offset by loss of market share from selling price increases and loss of sales with a large customer.

Our graphics and reflective business experienced mid single-digit organic sales growth in 2006, as strong international growth was partially offset by a decline in the U.S. On an organic basis, sales in this business were unchanged in 2005.

The changes in reported sales for the segment included a favorable impact of foreign currency translation of approximately \$15 million in 2006 and approximately \$58 million in 2005.

#### *Operating Income*

Increased operating income in 2006 and 2005 reflected higher sales and cost savings from restructuring and productivity improvement initiatives. Operating income for all years reflected restructuring, asset impairment and lease cancellation charges. In 2006, operating income was also impacted by transition costs associated with restructuring and stock option expense.

#### **Office and Consumer Products Segment**

(In millions)	2006	2005	2004
Net sales including			
intersegment sales	\$ 1,073.8	\$ 1,138.1	\$ 1,174.7
Less intersegment sales	(1.8)	(2.0)	(2.2)
Net sales	\$ 1,072.0	\$ 1,136.1	\$ 1,172.5
Operating income <sup>(1)</sup>	179.0	168.0	186.4

(1) Includes restructuring and asset impairment charges and net gain from product line divestiture	\$ (2.3)	\$ 21.8	\$ .5
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#### *Net Sales*

Sales in our Office and Consumer Products segment decreased 6% in 2006, while sales decreased 3% in 2005. The decline in reported sales in 2006 reflected the impact of a product line divestiture in Europe (approximately \$51 million). Foreign currency translation had a favorable impact on the change in reported sales of approximately \$1 million in 2006 and \$8 million in 2005.

On an organic basis, sales declined approximately 1% in 2006. The decline reflected the loss of sales from exiting certain low-margin private label business at the end of 2005 (approximately \$22 million), partially offset by growth in Avery-brand products, a strong back-to-school season in North America, and accelerated purchases by customers in late 2006 in advance of our 2007 selling price increases for certain product lines.

In 2005, sales on an organic basis declined 4%, reflecting a shift in volume to late 2004 (due to customers' accelerated purchases in advance of selling price increases effective January 1, 2005), as well as the benefit from an extra week in the 2004 fiscal year. Declines in core unit volume in 2005 were partially offset by increased selling prices, implemented to offset higher raw material costs.

#### *Operating Income*

Operating income in 2006 reflected cost savings from productivity improvement and restructuring actions, partially offset by associated transition costs, higher raw material and energy-related

costs, increased marketing costs, an increase in the LIFO reserve, and stock option expense.

Operating income in 2005 reflected charges related to restructuring, asset impairment and net losses associated with product line divestitures, partially offset by cost savings from restructuring and productivity initiatives. The selling price increases in 2005 offset the cumulative effect of raw material inflation over the 2004 to 2005 period.

#### **Retail Information Services Segment**

(In millions)	2006	2005	2004
Net sales including			
intersegment sales	\$ 671.1	\$ 637.1	\$ 599.5
Less intersegment sales	(3.4)	(6.7)	(6.8)
Net sales	\$ 667.7	\$ 630.4	\$ 592.7
Operating income <sup>(1)</sup>	45.0	37.7	43.4

(1) Includes restructuring, asset impairment & lease cancellation charges	\$ 11.2	\$ 7.5	\$ .3
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#### *Net Sales*

Sales in our Retail Information Services segment increased 6% in both 2006 and 2005. The increase in both years reflected continued growth of the business in Asia, Latin America and Europe, as well as incremental sales from acquisitions, net of product line divestitures. Organic sales growth was approximately 5% in 2006 and 2% in 2005.

The impact of acquisitions, net of product line divestitures, was approximately \$3 million in 2006 and \$21 million in 2005. Foreign currency translation contributed to the increase in sales by approximately \$3 million in 2006 and \$7 million in 2005.

#### *Operating Income*

Operating income in 2006 and 2005 benefited from productivity improvement actions, including the migration of production from Hong Kong to lower cost facilities in mainland China. Benefits from productivity initiatives were offset by increased spending for information systems, stock option expense and other incremental employee-related costs in 2006, and higher costs associated with growth initiatives in 2005. Operating income in both years included charges for restructuring, asset impairment, and lease cancellation.

#### **Other specialty converting businesses**

(In millions)	2006	2005	2004
Net sales including			
intersegment sales	\$ 614.3	\$ 607.7	\$ 585.8
Less intersegment sales	(14.4)	(15.2)	(18.8)
Net sales	\$ 599.9	\$ 592.5	\$ 567.0
Operating income <sup>(1)</sup>	17.2	14.1	39.9

(1) Includes restructuring and asset impairment charges	\$ 3.7	\$ 6.2	\$ -
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#### *Net Sales*

Sales in our other specialty converting businesses increased 1% in 2006 and 4% in 2005. A product line divestiture reduced reported sales by approximately \$7 million in 2006. Organic sales

growth was approximately 2% in 2006, reflecting solid growth in our specialty tape business, partially offset by weakness in other businesses. In 2005, organic sales growth of 4% reflected growth in most businesses.

Foreign currency translation had a favorable impact on the change in sales of approximately \$1 million in 2006 and \$4 million in 2005.

#### *Operating Income*

Operating income for these businesses increased in 2006, reflecting cost savings from restructuring and productivity improvement initiatives, partially offset by stock option expense. Operating income in both years included charges for restructuring and asset impairment.

The change in operating income in 2005 primarily reflected incremental costs related to the development of the RFID business.

### FINANCIAL CONDITION

#### *Liquidity*

##### **Cash Flow Provided by Operating Activities:**

(In millions)	2006	2005	2004
Net income	\$ 367.2	\$ 226.4	\$ 279.7
Depreciation and amortization	197.9	201.5	188.2
Income taxes (deferred and accrued)	1.8	(44.5)	31.2
Net (gain) loss on sale of assets and asset impairment	(7.8)	108.1	12.4
Trade accounts receivable	(2.3)	(43.9)	(1.4)
Other current assets	(45.6)	(4.3)	9.2
Inventories	(15.1)	(11.7)	(1.2)
Accounts payable and accrued liabilities	8.9	30.4	26.9
Long-term retirement benefits and other liabilities	(11.8)	(12.9)	(27.6)
Stock-based compensation	24.1	—	—
Other non-cash items, net	(6.5)	(7.5)	(.5)
Net cash provided by operating activities	\$ 510.8	\$ 441.6	\$ 516.9

For cash flow purposes, changes in assets and liabilities exclude the impact of foreign currency translation and the impact of acquisitions and divestitures and certain non-cash transactions (discussed in "Analysis of Selected Balance Sheet Accounts" below).

In 2006, cash flow provided by operating activities was negatively impacted by changes in working capital, as shown below:

#### *Uses of cash*

- Other current assets primarily reflected the timing of collection of value-added tax receivables in Europe
- Inventories reflected increased purchases to support higher sales and customer service initiatives

- Long-term retirement benefits and other liabilities reflected benefit payments partially offset by contributions of approximately \$39 million to our pension and postretirement health benefit plans

#### *Sources of cash*

- Accounts payable and accrued liabilities reflected the timing of payments and increased inventory

In 2005, cash flow provided by operating activities was negatively impacted by changes in working capital, as shown below:

#### *Uses of cash*

- Accounts receivable reflected higher sales and the timing of collections, partially offset by a decrease in the average days sales outstanding
- Income taxes reflected the timing of payments made, as well as the current year tax accrual
- Long-term retirement benefits and other liabilities reflected contributions of approximately \$46 million to our pension and post-retirement health benefit plans, partially offset by benefit payments
- Inventory reflected higher raw material purchases to support growth and business expansion

#### *Sources of cash*

- Accounts payable and accrued liabilities reflected the timing of payments and accruals, including accrual for restructuring charges

##### **Cash Flow Used in Investing Activities:**

(In millions)	2006	2005	2004
Purchase of property, plant and equipment	\$ (161.9)	\$ (162.5)	\$ (178.9)
Purchase of software and other deferred charges	(33.4)	(25.8)	(21.8)
Proceeds from sale of businesses and investments	35.4	—	—
Other, net	5.0	20.7	(16.2)
Net cash used in investing activities	\$ (154.9)	\$ (167.6)	\$ (216.9)

#### *Capital Spending*

Our major capital projects in 2006 included investments for expansion in China and India serving both our materials and retail information services businesses, as well as spending related to our new films coater in the U.S. Our major information technology projects in 2006 included system improvements for our Retail Information Services segment and our materials businesses.

#### *Proceeds from Sale of Businesses and Investments*

In 2006, we sold a long-term investment and divested both a product line in Europe and the raised reflective pavement marker business.



**Cash Flow Used in Financing Activities:**

(In millions)	2006	2005	2004
Net change of borrowings and payments of debt	\$ (140.1)	\$ (80.5)	\$ (119.1)
Dividends paid	(171.8)	(168.7)	(164.6)
Purchase of treasury stock	(157.7)	(40.9)	(.7)
Proceeds from exercise of stock options, net	54.1	11.1	19.1
Other	17.7	18.5	18.2
Net cash used in financing activities	\$ (397.8)	\$ (260.5)	\$ (247.1)

**Borrowings and Repayment of Debt**

At year end 2006, our borrowings outstanding under foreign short-term lines of credit were \$101.5 million (weighted-average interest rate of 9.6%), compared to \$108.3 million at year end 2005 (weighted-average interest rate of 6.6%).

Short-term variable rate commercial paper borrowings were \$154.4 million at December 30, 2006 (weighted-average interest rate of 5.0%) compared to \$255.3 million at December 31, 2005 (weighted-average interest rate of 2.3%).

We had medium-term notes of \$160 million outstanding at year end 2006 and 2005. In 2005, medium-term notes of \$73 million were paid on maturity. Outstanding medium-term notes have maturities from 2007 through 2025 and accrue interest at fixed rates ranging from 5.9% to 7.5%.

In August 2004, we issued \$150 million in floating rate senior notes due in 2007 under our 2001 shelf registration statement filed with the Securities and Exchange Commission ("SEC"). These notes are callable at par.

**Shareholders' Equity**

Our shareholders' equity was \$1.68 billion at year end 2006, compared to \$1.51 billion at year end 2005. Our annual dividend per share increased to \$1.57 in 2006 from \$1.53 in 2005.

**Share Repurchases**

On October 26, 2006, the Board of Directors authorized an additional 5 million shares of the Company's stock for our repurchase program, resulting in a total authorization of approximately 7.4 million shares of the Company's stock at that date. During the fourth quarter of 2006, we repurchased approximately 2.5 million shares. As of December 30, 2006, approximately 4.9 million shares were available for repurchase under the Board of Directors' authorization.

In the fourth quarter of 2005, we repurchased approximately .7 million shares under an agreement related to the L&E Packaging ("L&E") acquisition and recorded such amount to treasury stock. (See the Other section of "Contractual Obligations, Commitments and Off-Balance Sheet Arrangements" below for further details.)

**Analysis of Selected Balance Sheet Accounts****Long-lived Assets**

Goodwill increased \$43 million during 2006 primarily due to foreign currency translation (approximately \$32 million) and goodwill associated with an acquisition (approximately \$10 million).

Other intangibles resulting from business acquisitions decreased \$3 million during 2006 due to amortization expense recorded during 2006 (approximately \$11 million) partially offset by the impact of foreign currency translation (approximately \$6 million) and acquired intangibles associated with an acquisition (approximately \$2 million).

Other assets decreased approximately \$64 million during 2006 due primarily to a decrease in assets related to pension and postretirement benefits (approximately \$68 million). Refer to Note 6, "Pensions and Other Postretirement Benefits," to the Consolidated Financial Statements for more information on the change in accounting for pension and postretirement benefits as a result of the adoption of Statement of Financial Accounting Standards ("SFAS") No. 158.

**Other Shareholders' Equity Accounts**

The value of our employee stock benefit trusts increased \$51 million in 2006, due to an increase in the market value of shares held in the trusts (approximately \$122 million), partially offset by the issuance of shares under our stock and incentive plans (approximately \$71 million).

Accumulated other comprehensive loss increased by approximately \$39 million, due to foreign currency translation, partially offset by the after-tax impact of the adoption of SFAS No. 158 (approximately \$57 million). Refer to Note 6, "Pensions and Other Postretirement Benefits," to the Consolidated Financial Statements.

**Effect of Foreign Currency**

International operations generate approximately 55% of our net sales. Our future results are subject to changes in political and economic conditions and the impact of fluctuations in foreign currency exchange and interest rates. To reduce our income statement exposure to transactions in foreign currencies, we enter into foreign exchange forward, option and swap contracts, where available and appropriate.

**Impact of Foreign Currency Translation:**

(In millions)	2006	2005	2004
Change in net sales	\$ 21	\$ 77	\$ 207
Change in net income	2	2	8

While there was a benefit from foreign currency translation in 2006, this benefit was lower compared to prior years. The benefit to sales in 2006 primarily reflected a benefit from currencies in Canada, Brazil, Korea and China, partially offset by a negative impact of the Euro and currencies in South Africa and Australia. The impact of foreign currency fluctuations on net income is smaller than the impact on net sales, because our products are generally sourced in the currencies in which they are sold. As a

result, the impact of foreign exchange rates on sales is matched with a partially offsetting impact on reported expenses, thereby reducing the impact of foreign currency fluctuations on net income.

Our net income for 2005 and 2004 included translation gains and losses for operations in hyperinflationary economies, which included Turkey. For accounting purposes, operations are treated as being in a hyperinflationary economy, based on the cumulative inflation rate over the past three years. Operations in hyperinflationary economies consist of our operations in the Dominican Republic, which use the U.S. dollar as the functional currency. These operations were not significant to our consolidated financial position or results of operations. In 2006, Turkey was removed from hyperinflationary status.

#### Analysis of Selected Financial Ratios

We utilize certain financial ratios to assess our financial condition and operating performance, as discussed below.

#### Working Capital Ratio

Working capital (current assets minus current liabilities, excluding working capital of held-for-sale business), as a percent of net sales, decreased in 2006 primarily due to an increase in short-term debt. Working capital from continuing operations, as a percent of net sales, is shown below. We use this non-GAAP measure as a tool to assess our working capital requirements because it excludes the impact of fluctuations due to our financing activities. (Refer to "Uses and Limitations of Non-GAAP Measures.") The timing of financing activities is not necessarily related to our current operations and would tend to distort the working capital ratio from period to period. Our objective is to minimize our investment in working capital from operations by reducing this ratio, to maximize cash flow and return on investment.

#### Working capital from continuing operations:

(In millions)	2006	2005
(A) Working capital (current assets minus current liabilities; excludes working capital of held-for-sale businesses)	\$ (43.4)	\$ 31.0
Reconciling item:		
Short-term and current portion of long-term debt	466.4	364.7
(B) Working capital from continuing operations	\$ 423.0	\$ 395.7
(C) Net sales	\$ 5,575.9	\$ 5,473.5
Working capital, as a percent of net sales (A) ÷ (C)	(.8)%	.6%
Working capital from continuing operations, as a percent of net sales (B) ÷ (C)	7.6%	7.2%

As a percent of sales, working capital from continuing operations in 2006 weakened compared to 2005. In 2006, the change primarily reflected a decrease in cash and cash equivalents and income taxes payable. Working capital changes included the impact of currency.

#### Accounts Receivable Ratio

The average number of days sales outstanding was 58 days in 2006 and 2005, calculated using a four-quarter average accounts receivable balance divided by the average daily sales for the year.

#### Inventory Ratio

Average inventory turnover was 8.5 in 2006 compared to 8.8 in 2005, calculated using the annual cost of sales divided by a four-quarter average inventory balance. The decrease is due to higher average inventory levels, primarily to support customer service initiatives.

#### Debt Ratios

	Requirement	Year End	
		2006	2005
Total debt to total capital		36.5%	41.8%
<i>Debt covenant ratios:</i>			
Total debt to earnings before other expense, interest, taxes, depreciation and amortization	Not to exceed 3.5:1.0	1.4:1.0	1.6:1.0
Earnings before other expense, interest and taxes to interest	At least 3.5:1.0	9.3:1.0	8.4:1.0

The decrease in the total debt to total capital ratio in 2006 was due to a decrease in total debt outstanding and an increase in shareholders' equity.

Our various loan agreements in effect at year end require that we maintain specified ratios of consolidated debt and consolidated interest expense in relation to certain measures of income. We were in compliance with these covenants as shown in the table above.

The fair value of our debt is estimated based on the discounted amount of the related cash flows using the current rates offered to us for debt of the same remaining maturities. At year end, the fair value of our total debt, including short-term borrowings, was \$963 million in 2006 and \$1.1 billion in 2005.

#### Shareholders' Equity Ratios

	2006	2005	2004
Return on average shareholders' equity	22.5%	14.6%	19.9%
Return on average total capital	15.6	10.1	12.1

Increases in these ratios in 2006 compared to 2005 were primarily due to higher net income. These ratios are computed using actual net income and a five-quarter average denominator for equity and total debt accounts.

#### Capital Resources

Capital resources include cash flows from operations and debt financing. We maintain adequate financing arrangements at competitive rates. These financing arrangements consist of our commercial paper programs in the U.S. and Europe, committed and uncommitted bank lines of credit in the countries where we operate, callable commercial notes, and long-term debt, including medium-term notes.

#### Capital from Debt

Our total debt decreased approximately \$120 million in 2006 to \$968 million compared to year end 2005, reflecting payments of debt, partially offset by the impact of foreign currency translation.

In July 2004, we entered into a revolving credit agreement with ten domestic and foreign banks for a total commitment of \$525 million, expiring July 16, 2009. We use the financing available under this agreement as a commercial paper back-up facility and to finance other corporate requirements. There was no debt outstanding under this agreement as of year end 2006 and 2005.

In addition, we have a 364-day revolving credit facility with a foreign bank to provide up to Euro 30 million (\$39.6 million) in borrowings through July 31, 2007. With the approval of the bank, we may extend the revolving period and due date on an annual basis. Our intention is to negotiate an extension of this facility in 2007. Financing under this agreement is used to finance cash requirements of our European operations. As of year end 2006, \$26.3 million was outstanding under this agreement.

We had standby letters of credit outstanding of \$77.1 million and \$81.2 million at the end of 2006 and 2005, respectively.

Our uncommitted lines of credit were approximately \$359 million at year end 2006. Our uncommitted lines of credit do not have a commitment expiration date and may be cancelled by the banks or us at any time.

In the fourth quarter of 2004, we filed a shelf registration statement with the SEC to permit the issuance of up to \$500 million in debt and equity securities. Proceeds from the shelf offering may be used for general corporate purposes, including repaying, redeeming or repurchasing existing debt, and for working capital, capital expenditures and acquisitions. As of December 30, 2006, no securities had been issued under this registration statement.

Credit ratings are a significant factor in our ability to raise short-term and long-term financing. The credit ratings assigned to us also impact the interest rates on our commercial paper and other borrowings. When determining a credit rating, the rating agencies place significant weight on our competitive position, business outlook, consistency of cash flows, debt level and liquidity, geographic dispersion and management team.

#### Our credit ratings as of year end 2006:

	Short-term	Long-term	Outlook
Standard & Poor's Rating Service	A-2	A-	Negative
Moody's Investors Service	P2	A3	Stable

### Contractual Obligations, Commitments and Off-balance Sheet Arrangements

#### Contractual Obligations at Year End 2006:

(In millions)	Total	2007	Payments Due by Period				
			2008	2009	2010	2011	Thereafter
Short-term lines of credit	\$ 255.9	\$ 255.9	—	—	—	—	—
Long-term debt and capital leases	712.1	210.5	\$ 50.5	\$ .5	\$ .5	\$ .1	\$ 450.0
Interest on long-term debt <sup>(1)</sup>	400.1	35.6	27.3	24.6	24.6	24.6	263.4
Operating leases	201.3	50.8	41.5	27.1	18.6	15.7	47.6
Pension and postretirement benefit contributions	14.1	14.1	—	—	—	—	—
Total contractual obligations	\$ 1,583.5	\$ 566.9	\$ 119.3	\$ 52.2	\$ 43.7	\$ 40.4	\$ 761.0

(1) Interest on floating rate debt was estimated using the index rate in effect as of December 30, 2006.

We enter into operating leases primarily for office and warehouse space and equipment for electronic data processing and transportation. The terms of our leases do not impose significant restrictions or unusual obligations, except for the facility in Mentor, Ohio as noted below. The table above includes minimum annual rental commitments on operating leases having initial or remaining non-cancelable lease terms of one year or more.

On September 9, 2005, we completed the lease financing for a commercial facility (the "Facility") located in Mentor, Ohio, used primarily for the new headquarters and research center for our roll materials division. The Facility consists generally of land, buildings, equipment and office furnishings. We have leased the Facility under an operating lease arrangement, which contains a residual value guarantee of \$33.4 million. We do not expect the residual value of the Facility to be less than the amount guaranteed.

We did not include purchase obligations or open purchase orders at year end 2006 in the table of contractual obligations above, because it is impracticable for us to either obtain such information or provide a reasonable estimate due to the decentralized nature of our purchasing systems.

#### Investigations and Legal Proceedings

On October 19, 2006, we were notified by the DOJ that the DOJ had decided to close its criminal investigation (initiated in April 2003) into competitive practices in the label stock industry without further action.

On November 15, 2006, we announced that we had been notified by the EC that the EC had closed its investigation (initiated in May 2004) into the Company's competitive activities in the label stock industry, with no action.

In July 2004, we were notified by the Competition Law Division of the Department of Justice of Canada that it was seeking information in connection with a label stock investigation. In August 2005, we were notified by the Australian Competition and Consumer Commission that it was seeking information in connection with a label stock investigation. We are cooperating with these investigations.

We are a named defendant in purported class actions in the U.S. seeking treble damages and other relief for alleged unlawful competitive practices, which were filed after the announcement of the DOJ investigation. We are also a named defendant in a purported class action in the U.S. seeking damages and other relief for alleged disclosure and fiduciary duty violations pertaining to alleged unlawful competitive practices.

We are unable to predict the effect of these matters at this time, although the effect could be adverse and material. These matters are reported in Note 8, "Contingencies," to the Consolidated Financial Statements.

#### *Environmental*

We have been designated by the U.S. Environmental Protection Agency ("EPA") and/or other responsible state agencies as a potentially responsible party ("PRP") at fourteen waste disposal or waste recycling sites, which are the subject of separate investigations or proceedings concerning alleged soil and/or groundwater contamination and for which no settlement of our liability has been agreed upon. We are participating with other PRPs at such sites, and anticipate that our share of cleanup costs will be determined pursuant to remedial agreements to be entered into in the normal course of negotiations with the EPA or other governmental authorities.

We have accrued liabilities for these and certain other sites, including sites in which governmental agencies have designated us as a PRP, where it is probable that a loss will be incurred and the cost or amount of loss can be reasonably estimated. However, because of the uncertainties associated with environmental assessment and remediation activities, future expense to remediate the currently identified sites and any sites which could be identified in the future for cleanup could be higher than the liability currently accrued.

During the third quarter of 2006, we recognized an additional liability of \$13 million for estimated environmental remediation costs for a former operating facility, for which \$2 million had been accrued in the second quarter of 2006. The amount accrued represents the lower end of the current estimated range of \$15 million to \$17 million for costs expected to be incurred. We considered additional information provided by outside consultants in revising our previous estimates of expected costs. This estimate could change depending on various factors such as modification of currently planned remedial actions, change in site conditions, change in the estimated time to complete remediation, change in laws and regulations affecting remediation requirements and other factors.

Other amounts currently accrued are not significant to our consolidated financial position, and based upon current information, we believe that it is unlikely that the final resolution of these matters will significantly impact our consolidated financial position, results of operations or cash flows.

#### *Other*

In 2005, we contacted relevant authorities in the U.S. and reported the results of an internal investigation of potential violations of the U.S. Foreign Corrupt Practices Act. The transactions at issue were carried out by a small number of employees of our reflectives business in China, and involved, among other things, impermissible payments or attempted impermissible payments. The payments or attempted payments and the contracts associated with them appear to have been relatively minor in amount and of limited duration. Corrective and disciplinary actions have been taken. Sales of our reflectives business in China in 2005 were approximately \$7 million. Based on findings to date, no changes to our previously filed financial statements are warranted as a result of these matters. However, we expect that fines or other penalties may be incurred. While we are unable to predict the financial or operating impact of any such fines or penalties, we believe that our behavior in detecting, investigating, responding to and voluntarily disclosing these matters to authorities should be viewed favorably.

We and our subsidiaries are involved in various other lawsuits, claims and inquiries, most of which are routine to the nature of our business. Based upon current information, we believe that the resolution of these other matters will not materially affect us.

We provide for an estimate of costs that may be incurred under our basic limited warranty at the time product revenue is recognized. These costs primarily include materials and labor associated with the service or sale of products. Factors that affect our warranty liability include the number of units installed or sold, historical and anticipated rate of warranty claims on those units, cost per claim to satisfy our warranty obligation and availability of insurance coverage. As these factors are impacted by actual experience and future expectations, we assess the adequacy of the recorded warranty liability and adjust the amounts as necessary.

We participate in receivable financing programs, both domestically and internationally, with several financial institutions whereby we may request advances from these financial institutions. At December 30, 2006, we guaranteed approximately \$22 million of these advances.

We also guaranteed up to approximately \$22 million of certain of our foreign subsidiaries' obligations to their suppliers as of December 30, 2006.

In connection with the L&E acquisition in 2002, we issued approximately .7 million shares at \$63.08 per share. We also entered into an agreement with L&E whereby in the event the value of our common shares fell below the price of the shares that were issued to L&E (adjusted for dividends received), during the period



from January 1, 2005 through December 31, 2007, L&E had the option to exercise a true-up right. Upon exercise of this true-up right, we had the option to (1) pay the difference in value to L&E, in the form of (a) cash or (b) common shares, or (2) repurchase the shares at the issued share price, adjusted for dividends paid. The true-up obligation was reduced by any shares sold by L&E to third parties. During 2005, L&E sold 44,603 shares to third parties. On October 20, 2005, L&E notified us that it was exercising its true-up right under the agreement for the remaining approximately .7 million shares. We repurchased the remaining shares under the agreement for \$41 million in the fourth quarter of 2005.

#### USES AND LIMITATIONS OF NON-GAAP MEASURES

Our presented non-GAAP financial measures exclude the impact of certain events, activities or strategic decisions. The accounting effects of these events, activities or decisions, which are included in the GAAP measures, may make it difficult to assess the underlying performance of the Company in a single period. By excluding certain accounting effects, both positive and negative (for example, divestitures and acquisitions), from certain of our GAAP measures, management believes that it is providing meaningful supplemental information to facilitate an understanding of the Company's "core" or "underlying" operating results. These non-GAAP measures are used internally to evaluate trends in our underlying business, as well as to facilitate comparison to the results of competitors for a single period.

Limitations associated with the use of our non-GAAP measures include (1) the exclusion of foreign currency translation and the impact of acquisitions and divestitures from the calculation of organic sales growth; (2) the exclusion of mandatory debt service requirements, as well as the exclusion of other uses of the cash generated by operating activities that do not directly or immediately support the underlying business (such as discretionary debt reductions, dividends, share repurchase, acquisitions, etc.) for calculation of free cash flow; and (3) the exclusion of short-term debt from the calculation of working capital ratio from continuing operations. While some of the items the Company excludes from GAAP measures recur, these items tend to be disparate in amount and timing. Based upon feedback from investors and financial analysts, we believe that supplemental non-GAAP measures provide information that is useful to the assessment of the Company's performance and operating trends.

#### RELATED PARTY TRANSACTIONS

From time to time, we enter into transactions in the normal course of business with related parties. We believe that such transactions are at arm's length and for terms that would have been obtained from unaffiliated third parties.

One of our directors, Peter W. Mullin is the chairman, chief executive officer and a director of MC Insurance Services, Inc. ("MC"),

Mullin Insurance Services, Inc. ("MINC"), and PWM Insurance Services, Inc. ("PWM"), executive compensation and benefit consultants and insurance agents. Mr. Mullin is also the majority stockholder of MC, MINC and PWM (collectively referred to as the "Mullin Companies"). We paid premiums to insurance carriers for life insurance placed by the Mullin Companies in connection with several of our employee benefit plans. The Mullin Companies have advised us that they earned commissions from such insurance carriers for the placement and renewal of this insurance. Approximately 50% of these commissions were allocated to and used by MC Insurance Agency Services, LLC, and MullinTBG Insurance Agency Services (affiliates of MC) to administer benefit plans and provide benefit statements to participants under several of our employee benefit plans. The Mullin Companies own a minority interest in M Financial Holdings, Inc. ("MFH"). Substantially all of the life insurance policies, which we placed through the Mullin Companies in 2006 and prior years, are issued by insurance carriers that participate in reinsurance agreements entered into between these insurance carriers and M Life Insurance Company ("M Life"), a wholly-owned subsidiary of MFH. Reinsurance returns earned by M Life are determined annually by the insurance carriers and can be negative or positive, depending upon the results of M Life's aggregate reinsurance pool, which consists of the insured lives reinsured by M Life. The Mullin Companies have advised us that they participated in net reinsurance gains of M Life. None of these transactions were significant to our financial position or results of operations.

#### Summary of Related Party Activity:

(In millions)	2006	2005	2004
Mullin Companies commissions on our insurance premiums	\$ .5	\$ .9	\$ 1.1
Mr. Mullin's direct & indirect interest in these commissions	.4	.7	.8
Mullin Companies reinsurance gains (without risk of forfeiture) ascribed by M Life to our life insurance policies	.3	.2	.2
Mr. Mullin's direct & indirect interest in reinsurance gains (without risk of forfeiture)	.2	.1	.2
Mullin Companies reinsurance gains (subject to risk of forfeiture) ascribed by M Life to our life insurance policies	.6	1.5	—
Mr. Mullin's direct & indirect interest in reinsurance gains (subject to risk of forfeiture)	.4	1.1	—

#### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions for the reporting period and as of the financial statement date. These estimates and assumptions affect the reported

amounts of assets and liabilities, the disclosure of contingent liabilities and the reported amounts of revenue and expense. Actual results could differ from those estimates.

Critical accounting policies are those that are important to the portrayal of our financial condition and results, and which require us to make difficult, subjective and/or complex judgments. Critical accounting policies cover accounting matters that are inherently uncertain because the future resolution of such matters is unknown. We believe that critical accounting policies include accounting for revenue recognition, sales returns and allowances, accounts receivable allowances, inventory and inventory reserves, long-lived asset impairments, pensions and postretirement benefits, income taxes, stock-based compensation, restructuring and severance costs and litigation.

#### **Revenue Recognition**

Sales are recognized when persuasive evidence of an arrangement exists, pricing is determinable, and collection is reasonably assured. Furthermore, sales, provisions for estimated returns, and the cost of products sold are recorded at the time title transfers to customers and when the customers assume the risks and rewards of ownership. Sales terms are generally f.o.b. (free on board) shipping point or f.o.b. destination, depending upon local business customs. For most regions in which we operate, f.o.b. shipping point terms are utilized and sales are recorded at the time of shipment, because this is when title and risk of loss are transferred. In certain regions, notably in Europe, f.o.b. destination terms are generally utilized and sales are recorded when the products are delivered to the customer's delivery site, because this is when title and risk of loss are transferred. Actual product returns are charged against estimated sales return allowances.

Sales rebates and discounts are common practice in the industries in which we operate. Volume, promotional, price, cash and other discounts and customer incentives are accounted for as a reduction to gross sales. Rebates and discounts are recorded based upon estimates at the time products are sold. These estimates are based upon historical experience for similar programs and products. We review such rebates and discounts on an ongoing basis and accruals for rebates and discounts are adjusted, if necessary, as additional information becomes available.

#### **Sales Returns and Allowances**

Sales returns and allowances represent credits we grant to our customers (both affiliated and non-affiliated) for the return of unsatisfactory product or a negotiated allowance in lieu of return. We accrue for returns and allowances based upon the gross price of the products sold and historical experience for such products. We record these allowances based on the following factors: (i) customer specific allowances; and (ii) an estimated amount, based on our historical experience, for issues not yet identified.

#### **Accounts Receivable Allowances**

We are required to make judgments as to the collectibility of accounts receivable based on established aging policy, historical

experience and future expectations. The allowances for doubtful accounts represent allowances for customer trade accounts receivable that are estimated to be partially or entirely uncollectible. These allowances are used to reduce gross trade receivables to their net realizable value. We record these allowances based on estimates related to the following factors: (i) customer specific allowances; (ii) amounts based upon an aging schedule; and (iii) an estimated amount, based on our historical experience, for issues not yet identified. No single customer represented 10% or more of our net sales or trade receivables at year end 2006 and 2005. However, our ten largest customers at year end 2006 represented approximately 18% of trade accounts receivable and consisted of six customers of our Office and Consumer Products segment, three customers of our Pressure-sensitive Materials segment and one customer of both these segments. The financial position and operations of these customers are monitored on an ongoing basis.

#### **Inventory and Inventory Reserves**

Inventories are stated at the lower of cost or market value and are categorized as raw materials, work-in-progress or finished goods. Cost is determined using methods that approximate both the first-in, first-out ("FIFO") and last-in, first-out ("LIFO") methods. Inventories valued using the LIFO method comprised 29% and 32% of inventories before LIFO adjustment at year end 2006 and 2005, respectively. The Company's international operations are on the FIFO basis of inventory cost accounting. U.S. operations use both FIFO and LIFO. Our limited use of the LIFO valuation methodology reflects the tax-basis election in place at the time of previous acquisitions of businesses in the U.S.

Inventory reserves are recorded for damaged, obsolete, excess and slow-moving inventory. We use estimates to record these reserves. Slow-moving inventory is reviewed by category and may be partially or fully reserved for depending on the type of product and the length of time the product has been included in inventory.

#### **Long-lived Asset Impairments**

We record impairment charges when the carrying amounts of long-lived assets are determined not to be recoverable. Impairment is measured by assessing the usefulness of an asset or by comparing the carrying value of an asset to its fair value. Fair value is typically determined using quoted market prices, if available, or an estimate of undiscounted future cash flows expected to result from the use of the asset and its eventual disposition. The amount of impairment loss is calculated as the excess of the carrying value over the fair value. Changes in market conditions and management strategy have historically caused us to reassess the carrying amount of our long-lived assets.

#### **Pensions and Postretirement Benefits**

In December 2006, we adopted the provisions of SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)":

- a) Recognition of the funded status of the Company's defined benefit and postretirement benefit plan (with a corresponding reversal of minimum pension liability under SFAS No. 87)
- b) Recognition of the gains or losses, prior service costs or credits and transition assets or obligations remaining from the initial application of SFAS Nos. 87 and 106 as a component of accumulated other comprehensive income, net of tax
- c) Measurement of the defined benefit plan assets and obligations as of the Company's fiscal year end
- d) Disclosure of additional information about the effects of the amortization of gains or losses, prior service costs or credits, and transition assets or obligations (remaining from the initial application of SFAS Nos. 87 and 106) on net periodic benefit cost for the next fiscal year

Assumptions used in determining projected benefit obligations and the fair value of plan assets for our pension plan and other postretirement benefit plans are evaluated by management in consultation with outside actuaries. In the event we determine that changes are warranted in the assumptions used, such as the discount rate, expected long-term rate of return, or health care costs, future pension and postretirement benefit expenses could increase or decrease. Due to changing market conditions or changes in the participant population, the actuarial assumptions we use may differ from actual results, which could have a significant impact on our pension and postretirement liability and related cost.

#### *Discount Rate*

We, in consultation with our actuaries, annually review and determine the discount rates to be used in connection with our postretirement obligations. The assumed discount rate for each pension plan reflects market rates for high quality corporate bonds currently available. In the U.S., our discount rate is determined by evaluating several yield curves consisting of large populations of high quality corporate bonds. The projected pension benefit payment streams are then matched with the bond portfolios to determine a rate that reflects the liability duration unique to our plans.

#### *Long-term Return on Assets*

We determine the long-term rate of return assumption for plan assets by reviewing the historical and expected returns of both the equity and fixed income markets, taking into consideration that assets with higher volatility typically generate a greater return over the long run. Additionally, current market conditions, such as interest rates, are evaluated and peer data is reviewed to check for reasonability and appropriateness.

#### *Healthcare Cost Trend Rate*

Our practice is to fund the cost of postretirement benefits on a cash basis. For measurement purposes, a 9% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2007. This rate is expected to decrease to approximately 5% by 2011.

#### **Income Taxes**

Deferred tax assets and liabilities reflect temporary differences between the amounts of assets and liabilities for financial and tax reporting purposes. Such amounts are adjusted, as appropriate, to reflect changes in tax rates expected to be in effect when the temporary differences reverse. A valuation allowance is recorded to reduce our deferred tax assets to the amount that is more likely than not to be realized.

When establishing a valuation allowance, we consider future sources of income such as forecasted earnings, the mix of earnings in the jurisdictions in which we operate, and prudent and feasible tax planning. In the event we determine that we would not be able to realize our deferred tax assets in the future, the valuation adjustment to the deferred tax assets is charged to earnings in the period in which we make such a determination. Likewise, if later it is determined that it is more likely than not that the deferred tax assets would be realized, we would release the previously provided valuation allowance.

We calculate current and deferred tax provisions based on estimates and assumptions that could differ from the actual results reflected in income tax returns filed during the following years. Adjustments based on filed returns are recorded when identified in the subsequent years.

The amount of income taxes we pay is subject to ongoing audits by federal, state and foreign tax authorities. Our estimate of the potential outcome of any uncertain tax issue is subject to management's assessment of relevant risks, facts, and circumstances existing at that time. We believe that we have adequately provided for reasonably foreseeable outcomes related to these matters. However, our future results may include favorable or unfavorable adjustments to our estimated tax liabilities in the period the assessments are made or resolved, which may impact our effective tax rate on a quarterly basis.

#### **Stock-Based Compensation**

Effective January 1, 2006, we began recognizing expense for stock-based compensation to comply with the provisions of the reissued SFAS No. 123(R), using the modified prospective application transition method. As permitted by this transition method, results for the prior periods have not been restated. In addition, we continued to recognize compensation cost related to outstanding unvested awards as of December 31, 2005 under the original provisions of SFAS No. 123. Stock-based compensation expense for all awards granted after December 31, 2005 was based on the grant date fair value estimated in accordance with SFAS No. 123(R).

#### *Valuation of Stock Options*

Our stock-based compensation expense is the estimated fair value of options granted, amortized on a straight-line basis over the requisite service period. The fair value of each of our stock option awards is estimated on the date of grant using the Black-Scholes option-pricing model. This model requires input assumptions for our expected dividend yield, expected volatility, risk-free interest rate and the expected life of the options.

Expected dividend yield was based on the current annual dividend divided by the 12-month average monthly stock price prior to grant.

Expected volatility for options granted during 2006 was based on both historical and implied volatility. Expected volatility for options granted prior to 2006 was based on historical volatility of our stock price.

Risk-free rate was based on the average of the weekly T-Bond rate over the expected option term.

Expected term was determined based on historical experience under our stock option plans.

Forfeiture rate assumption was determined based on historical data of our stock option forfeitures over the last twelve years.

Certain of the assumptions used above are based on management's estimates. As such, if factors change and such factors require us to change our assumptions and estimates, our stock-based compensation expense could be significantly different in the future.

We have not capitalized costs associated with stock-based compensation.

#### *Accounting for Income Taxes for Stock-based Compensation*

We elected to use the short-cut method to calculate the historical pool of windfall tax benefits related to employee stock-based compensation awards.

#### **Restructuring and Severance Costs**

We account for restructuring costs including severance and other costs associated with exit or disposal activities following the guidance provided in SFAS No. 112, "Accounting for Post-employment Benefits," and SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." In the U.S., we have a severance pay plan ("Pay Plan"), which provides eligible employees with severance payments in the event of an involuntary termination due to qualifying cost reduction actions. We calculate severance pay using the severance benefit formula under the Pay Plan. Accordingly, we record provisions for such amounts and other related exit costs when they are probable and estimable as set forth under SFAS No. 112. In the absence of a Pay Plan, liability for severance and other employee-related costs are recognized when the liability is incurred and follow the guidance of SFAS No. 146.

#### **Litigation and Environmental**

We are currently involved in various lawsuits, claims and inquiries, most of which are routine to the nature of our business. In accordance with SFAS No. 5, "Accounting for Contingencies," we accrue estimates of the probable and estimable losses for the resolution of these claims. The ultimate resolution of these claims could affect future results of operations should our exposure be materially different from our earlier estimates or should liabilities be incurred that were not previously accrued.

#### RECENT ACCOUNTING REQUIREMENTS

During 2006, we adopted several accounting and financial disclosure requirements of the Financial Accounting Standards Board ("FASB"), Emerging Issues Task Force ("EITF") and Financial Interpretations by the staff of the FASB. The requirements with the most significant impact were the reissued SFAS No. 123(R), "Share-Based Payment," and SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)." (Refer to Note 1, "Summary of Significant Accounting Policies," to the Consolidated Financial Statements for more information.)

#### SAFE HARBOR STATEMENT

The matters discussed in this Management's Discussion and Analysis of Financial Condition and Results of Operations and other sections of this Annual Report contain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements, which are not statements of historical fact, may contain estimates, assumptions, projections and/or expectations regarding future events, which may or may not occur. Words such as "aim," "anticipate," "assume," "believe," "continue," "could," "estimate," "expect," "guidance," "intend," "may," "objective," "plan," "potential," "project," "seek," "shall," "should," "target," "will," "would," or variations thereof and other expressions, which refer to future events and trends, identify forward-looking statements. Such forward-looking statements, and financial or other business targets, are subject to certain risks and uncertainties, which could cause actual results to differ materially from expected results, performance or achievements of the Company expressed or implied by such forward-looking statements.

Certain of such risks and uncertainties are discussed in more detail in Part I, Item 1A, "Risk Factors," to the Company's Annual Report on Form 10-K for the year ended December 30, 2006, and include, but are not limited to, risks and uncertainties relating to investment in development activities and new production facilities, timely development and successful market acceptance of new products, fluctuations in cost and availability of raw materials, ability of the Company to achieve and sustain targeted cost reductions, impact of competitive products and pricing, business mix shift, credit risks, ability to obtain adequate financing arrangements, fluctuations in pension, insurance and employee benefit costs, successful integration of acquisitions, successful implementation of new manufacturing technologies and installation of manufacturing equipment, customer and supplier concentrations, financial condition and inventory strategies of customers, changes in customer order patterns, loss of significant contract(s) or customer(s), legal proceedings, including the Canadian Department of Justice and Australian Competition Consumer Commission investigations into industry competitive practices and any related proceedings or lawsuits pertaining to these investigations or to the



subject matter thereof or of the recently concluded investigations by the DOJ and the EC (including purported class actions seeking treble damages for alleged unlawful competitive practices, and a purported class action related to alleged disclosure and fiduciary duty violations pertaining to alleged unlawful competitive practices, which were filed after the announcement of the DOJ investigation), impact of potential violations of the U.S. Foreign Corrupt Practices Act based on issues in China, changes in governmental regulations, fluctuations in interest rates, fluctuations in foreign currency exchange rates and other risks associated with foreign operations, changes in economic or political conditions, acts of war, terrorism, natural disasters, impact of epidemiological events on the economy, the Company's customers and suppliers, and other factors.

The Company believes that the most significant risk factors that could affect its ability to achieve its stated financial expectations in the near-term include (1) the impact of economic conditions on underlying demand for the Company's products; (2) the impact of competitor's actions, including expansion in key markets, product offerings and pricing; (3) the impact of changes in raw material and energy-related costs and associated changes in selling prices; (4) potential adverse developments in legal proceedings and/or investigations regarding competitive activities, including possible fines, penalties, judgments or settlements; and (5) the ability of the Company to achieve and sustain targeted cost reductions.

The Company's forward-looking statements represent judgment only on the dates such statements were made. By making such forward-looking statements, the Company assumes no duty to update them to reflect new, changed or unanticipated events or circumstances, other than as may be required by law.

## MARKET-SENSITIVE INSTRUMENTS AND RISK MANAGEMENT

### *Risk Management*

We are exposed to the impact of changes in interest rates and foreign currency exchange rates.

Our policy is not to purchase or hold foreign currency, interest rate or commodity contracts for trading purposes.

Our objective in managing the exposure to foreign currency changes is to reduce the risk to our earnings and cash flow associated with foreign exchange rate changes. As a result, we enter into foreign exchange forward, option and swap contracts to reduce risks associated with the value of our existing foreign currency assets, liabilities, firm commitments and anticipated foreign revenues and costs, when available and appropriate. The gains and losses on these contracts are intended to offset changes in the related exposures. We do not hedge our foreign currency exposure in a manner that would entirely eliminate the effects of changes in foreign exchange rates on our consolidated net income.

Our objective in managing our exposure to interest rate changes is to reduce the impact of interest rate changes on earnings and cash flows. To achieve our objectives, we may periodically use interest rate contracts to manage net exposure to interest rate changes related to our borrowings. In connection with the issuance of the \$250 million 10-year senior notes in 2003, we settled a forward starting interest rate swap at a loss of approximately \$32.5 million. The loss is currently being amortized to interest expense over 10 years, which corresponds to the term of the related debt.

Additionally, we enter into certain natural gas futures contracts to reduce the risks associated with anticipated domestic natural gas used in manufacturing and operations. These amounts are not material to our financial statements.

In the normal course of operations, we also face other risks that are either nonfinancial or nonquantifiable. Such risks principally include changes in economic or political conditions, other risks associated with foreign operations, commodity price risk and litigation risk, which are not represented in the analyses that follow.

### *Foreign Exchange Value-At-Risk*

We use a Value-At-Risk ("VAR") model to determine the estimated maximum potential one-day loss in earnings associated with both our foreign exchange positions and contracts. This approach assumes that market rates or prices for foreign exchange positions and contracts are normally distributed. The VAR model estimates were made assuming normal market conditions. Firm commitments, accounts receivable and accounts payable denominated in foreign currencies, which certain of these instruments are intended to hedge, were included in the model. Forecasted transactions, which certain of these instruments are intended to hedge, were excluded from the model. The VAR was estimated using a variance-covariance methodology based on historical volatility for each currency. The volatility and correlation used in the calculation were based on two-year historical data obtained from one of our domestic banks. A 95% confidence level was used for a one-day time horizon.

The VAR model is a risk analysis tool and does not purport to represent actual losses in fair value that could be incurred by us, nor does it consider the potential effect of favorable changes in market factors.

The estimated maximum potential one-day loss in earnings for our foreign exchange positions and contracts was approximately \$5.5 million at year end 2006.

### *Interest Rate Sensitivity*

An assumed 40 basis point move in interest rates (10% of our weighted-average interest rate on floating rate debt) affecting our variable-rate borrowings would have had an immaterial effect on our 2006 earnings.

## CONSOLIDATED BALANCE SHEET

(Dollars in millions)	2006	2005
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 58.5	\$ 98.5
Trade accounts receivable, less allowances of \$58.9 and \$61.6 at year end 2006 and 2005, respectively	910.2	863.2
Inventories, net	471.8	439.7
Current deferred and refundable income taxes	95.2	78.1
Other current assets	119.7	78.8
Total current assets	1,655.4	1,558.3
Property, plant and equipment, net	1,309.4	1,295.7
Goodwill	715.9	673.1
Other intangibles resulting from business acquisitions, net	95.5	98.7
Non-current deferred and refundable income taxes	42.7	39.8
Other assets	474.7	538.3
	<b>\$ 4,293.6</b>	<b>\$ 4,203.9</b>
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Short-term and current portion of long-term debt	\$ 466.4	\$ 364.7
Accounts payable	630.1	577.9
Accrued payroll and employee benefits	179.4	161.7
Accrued trade rebates	142.8	145.9
Current deferred and payable income taxes	48.4	62.4
Other accrued liabilities	231.7	213.0
Total current liabilities	1,698.8	1,525.6
Long-term debt	501.6	723.0
Long-term retirement benefits and other liabilities	334.2	356.8
Non-current deferred income taxes	78.5	86.6
Commitments and contingencies (see Notes 7 and 8)		
Shareholders' equity:		
Common stock, \$1 par value, authorized – 400,000,000 shares at year end 2006 and 2005; issued – 124,126,624 shares at year end 2006 and 2005; outstanding – 98,313,102 shares and 99,727,160 shares at year end 2006 and 2005, respectively	124.1	124.1
Capital in excess of par value	881.5	729.5
Retained earnings	2,139.9	1,945.3
Cost of unallocated ESOP shares	(5.7)	(7.7)
Employee stock benefit trusts, 8,896,474 shares and 10,006,610 shares at year end 2006 and 2005, respectively	(602.5)	(552.0)
Treasury stock at cost, 16,887,048 shares and 14,362,854 shares at year end 2006 and 2005, respectively	(806.7)	(638.2)
Accumulated other comprehensive loss	(50.1)	(89.1)
Total shareholders' equity	1,680.5	1,511.9
	<b>\$ 4,293.6</b>	<b>\$ 4,203.9</b>

See Notes to Consolidated Financial Statements

## CONSOLIDATED STATEMENT OF INCOME

(In millions, except per share amounts)	2006	2005	2004 <sup>(1)</sup>
Net sales	\$ 5,575.9	\$ 5,473.5	\$ 5,317.0
Cost of products sold	4,047.5	3,997.3	3,890.4
Gross profit	1,528.4	1,476.2	1,426.6
Marketing, general and administrative expense	1,011.1	987.9	957.4
Interest expense	55.5	57.9	58.7
Other expense, net	36.2	63.6	35.2
Income from continuing operations before taxes	425.6	366.8	375.3
Taxes on income	73.1	75.0	94.3
Income from continuing operations	352.5	291.8	281.0
Income (loss) from discontinued operations, net of tax (including gain on disposal of \$1.3 and tax benefit of \$14.9 in 2006)	14.7	(65.4)	(1.3)
Net income	\$ 367.2	\$ 226.4	\$ 279.7
Per share amounts:			
Net income (loss) per common share:			
Continuing operations	\$ 3.53	\$ 2.91	\$ 2.81
Discontinued operations	.15	(.65)	(.01)
Net income per common share	\$ 3.68	\$ 2.26	\$ 2.80
Net income (loss) per common share, assuming dilution:			
Continuing operations	\$ 3.51	\$ 2.90	\$ 2.79
Discontinued operations	.15	(.65)	(.01)
Net income per common share, assuming dilution	\$ 3.66	\$ 2.25	\$ 2.78
Dividends	\$ 1.57	\$ 1.53	\$ 1.49
Average shares outstanding:			
Common shares	99.8	100.1	99.9
Common shares, assuming dilution	100.4	100.5	100.5
Common shares outstanding at year end	98.3	99.7	100.1

(1) Results for fiscal year 2004 reflect a 53-week period.

See Notes to Consolidated Financial Statements

## CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

(Dollars in millions, except per share amounts)	Common stock, \$1 par value	Capital in excess of par value	Retained earnings	Cost of unallocated ESOP shares	Employee stock benefit trusts	Treasury stock	Accumulated other comprehensive income (loss)	Total
<b>Fiscal year ended 2003</b>	\$ 124.1	\$ 703.7	\$ 1,772.5	\$ (11.6)	\$ (595.4)	\$ (597.0)	\$ (77.6)	\$ 1,318.7
Comprehensive income:								
Net income			279.7					279.7
Other comprehensive income:								
Foreign currency translation adjustment							87.9	87.9
Minimum pension liability adjustment, net of tax of \$14.6							(14.9)	(14.9)
Effective portion of gains or losses on cash flow hedges, net of tax of \$2.5							1.9	1.9
Other comprehensive income							74.9	74.9
Total comprehensive income								354.6
Repurchase of 9,641 shares for treasury, net of shares issued						(.6)		(.6)
Stock issued under option plans, including \$19.2 of tax and dividends paid on stock held in stock trusts		4.4			34.3			38.7
Dividends: \$1.49 per share			(164.6)					(164.6)
ESOP transactions, net				1.9				1.9
Employee stock benefit trusts market value adjustment		58.0			(58.0)			—
<b>Fiscal year ended 2004</b>	124.1	766.1	1,887.6	(9.7)	(619.1)	(597.6)	(2.7)	1,548.7
Comprehensive income:								
Net income			226.4					226.4
Other comprehensive income:								
Foreign currency translation adjustment							(90.6)	(90.6)
Minimum pension liability adjustment, net of tax of \$2.2							(.9)	(.9)
Effective portion of gains or losses on cash flow hedges, net of tax of \$(3.1)							5.1	5.1
Other comprehensive income							(86.4)	(86.4)
Total comprehensive income								140.0
Repurchase of 693,005 shares for treasury, net of shares issued						(40.6)		(40.6)
Stock issued under option plans, including \$18.8 of tax and dividends paid on stock held in stock trusts		11.3			19.2			30.5
Dividends: \$1.53 per share			(168.7)					(168.7)
ESOP transactions, net				2.0				2.0
Employee stock benefit trusts market value adjustment		(47.9)			47.9			—
<b>Fiscal year ended 2005</b>	124.1	729.5	1,945.3	(7.7)	(552.0)	(638.2)	(89.1)	1,511.9
Comprehensive income:								
Net income			367.2					367.2
Other comprehensive income:								
Foreign currency translation adjustment							101.0	101.0
Effective portion of gains or losses on cash flow hedges, net of tax of \$1.8							(3.1)	(3.1)
Minimum pension liability, net of tax of \$.6							(2.2)	(2.2)
Other comprehensive income							95.7	95.7
Total comprehensive income								462.9
Adjustment to initially adopt SFAS No. 158:								
Adjustment to minimum pension liability to initially apply SFAS No. 158, net of tax of \$(59.2)							114.0	114.0
Net actuarial loss, prior service cost and net transition obligation, net of tax of \$62.2							(170.8)	(170.8)
Effects of changing pension plan measurement date pursuant to SFAS No. 158:								
Service cost, interest cost, and expected return on plan assets for December 1 – December 30, 2006, net of tax			(.8)					(.8)
Amortization of prior service cost for December 1 – December 30, 2006, net of tax							.1	.1
Repurchase of 2,524,194 shares for treasury, net of shares issued						(168.5)		(168.5)
Stock issued under option plans, including \$22.7 of tax and dividends paid on stock held in stock trusts		30.4			71.1			101.5
Dividends: \$1.57 per share			(171.8)					(171.8)
ESOP transactions, net				2.0				2.0
Employee stock benefit trusts market value adjustment		121.6			(121.6)			—
<b>Fiscal year ended 2006</b>	\$ 124.1	\$ 881.5	\$ 2,139.9	\$ (5.7)	\$ (602.5)	\$ (806.7)	\$ (50.1)	\$ 1,680.5

See Notes to Consolidated Financial Statements



## CONSOLIDATED STATEMENT OF CASH FLOWS

(In millions)	2006	2005	2004 <sup>(1)</sup>
<b>Operating Activities</b>			
Net income	\$ 367.2	\$ 226.4	\$ 279.7
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	154.3	155.7	147.2
Amortization	43.6	45.8	41.0
Deferred taxes	(10.8)	(12.6)	93.1
Asset impairment and net (gain) loss on sale of assets of \$(13.9), \$7 and \$2.5 in 2006, 2005 and 2004, respectively	(7.8)	108.1	12.4
Stock-based compensation	24.1	—	—
Other non-cash items, net	(6.5)	(7.5)	(.5)
Changes in assets and liabilities, net of the effect of business acquisitions and divestitures:			
Trade accounts receivable	(2.3)	(43.9)	(1.4)
Inventories	(15.1)	(11.7)	(1.2)
Other current assets	(45.6)	(4.3)	9.2
Accounts payable and accrued liabilities	8.9	30.4	26.9
Taxes on income	12.6	(31.9)	(61.9)
Long-term retirement benefits and other liabilities	(11.8)	(12.9)	(27.6)
Net cash provided by operating activities	510.8	441.6	516.9
<b>Investing Activities</b>			
Purchase of property, plant and equipment	(161.9)	(162.5)	(178.9)
Purchase of software and other deferred charges	(33.4)	(25.8)	(21.8)
Payments for acquisitions	(13.4)	(2.8)	(15.0)
Proceeds from sale of assets	15.4	21.8	8.2
Proceeds from sale of businesses and investments	35.4	—	—
Other	3.0	1.7	(9.4)
Net cash used in investing activities	(154.9)	(167.6)	(216.9)
<b>Financing Activities</b>			
Net (decrease) increase in borrowings (maturities of 90 days or less)	(137.8)	58.2	(39.9)
Additional borrowings (maturities longer than 90 days)	—	76.2	302.8
Payments of debt (maturities longer than 90 days)	(2.3)	(214.9)	(382.0)
Dividends paid	(171.8)	(168.7)	(164.6)
Purchase of treasury stock	(157.7)	(40.9)	(.7)
Proceeds from exercise of stock options, net	54.1	11.1	19.1
Other	17.7	18.5	18.2
Net cash used in financing activities	(397.8)	(260.5)	(247.1)
Effect of foreign currency translation on cash balances	1.9	.2	2.4
(Decrease) increase in cash and cash equivalents	(40.0)	13.7	55.3
Cash and cash equivalents, beginning of year	98.5	84.8	29.5
Cash and cash equivalents, end of year	\$ 58.5	\$ 98.5	\$ 84.8

(1) Results for fiscal year 2004 reflect a 53-week period.

See Notes to Consolidated Financial Statements

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Nature of Operations

Avery Dennison Corporation (the "Company") is a worldwide manufacturer of pressure-sensitive materials, office products and a variety of tickets, tags and other converted products. The Company's end markets include consumer products and other retail items (including apparel), logistics and shipping, industrial and durable goods, office products, transportation, and medical/health care.

### Segment Reporting

During the fourth quarter of 2004, the Company reorganized its reporting segments to provide enhanced transparency of its operational results. The Company's segments are:

- Pressure-sensitive Materials – manufactures and sells pressure-sensitive roll label materials, films for graphic and reflective applications, performance polymers (largely adhesives used to manufacture pressure-sensitive materials), and extruded films
- Office and Consumer Products – manufactures and sells a variety of office and consumer products, including labels, binders, dividers, sheet protectors, and writing instruments
- Retail Information Services – designs, manufactures and sells a wide variety of price marking and brand identification products, including tickets, tags and labels, and related supplies and equipment

In addition to the reportable segments, the Company has other specialty converting businesses comprised of several businesses that produce specialty tapes and highly engineered labels, including radio-frequency identification labels ("RFID") and other converted products.

While the Company's segment structure remained the same as reported at year end 2005, in the second quarter of 2006, the Company transferred its business media division from the Retail Information Services segment into other specialty converting businesses, to align with a change in its internal reporting structure. Prior year amounts included herein have been reclassified to conform to the current year presentation.

In 2006, the Pressure-sensitive Materials segment contributed approximately 58% of the Company's total sales, while the Office and Consumer Products segment and the Retail Information Services segment contributed approximately 19% and 12%, respectively, of the Company's total sales. International operations generated approximately 55% of the Company's total sales in 2006. Refer to Note 12, "Segment Information," for further detail.

### Principles of Consolidation

The consolidated financial statements include the accounts of majority-owned subsidiaries. Intercompany accounts, transactions and profits are eliminated. Investments in certain affiliates (20% to 50% ownership) are accounted for by the equity method of accounting. Investments representing less than 20% ownership are accounted for by the cost method of accounting.

### Financial Presentation

Certain prior year amounts have been reclassified to conform with the current year presentation. In 2006, shipping and handling costs (approximately \$143 million for 2006, approximately \$145 million for 2005, and approximately \$148 million for 2004), which were previously classified in "Marketing, general and administrative expense" for the Office and Consumer Products segment, Retail Information Services segment, and most businesses included in the other specialty converting businesses, were reclassified into "Cost of products sold" to align the Company's businesses around a standard accounting policy.

### Discontinued Operations

In 2006, the Company completed the sale of its raised reflective pavement markers business, which was announced in December 2005. The results for this business were accounted for as discontinued operations in the consolidated financial statements for the years presented herein. The divestiture resulted in a tax benefit (\$14.9 million) due to capital losses arising from the sale of the business and a gain on sale of \$1.3 million. Based on the estimated value for this business, management concluded that associated goodwill and intangible assets from the acquisition of this business were impaired, resulting in a pretax charge of \$74.4 million in December 2005. This business was previously included in the Pressure-sensitive Materials segment.

Summarized, combined statement of income for discontinued operations:

(In millions)	2006	2005	2004
Net sales	\$ 7.2	\$ 22.8	\$ 23.9
Loss before taxes	\$ (1.3)	\$ (76.9)	\$ (1.9)
Taxes on income	.2	(11.5)	(.6)
Loss from operations, net of tax	(1.5)	(65.4)	(1.3)
Gain on sale of discontinued operations	1.3	–	–
Tax benefit from sale	(14.9)	–	–
Income (loss) from discontinued operations, net of tax	\$ 14.7	\$ (65.4)	\$ (1.3)

See also Note 11, "Taxes Based on Income."

Amortization expense on other intangible assets related to discontinued operations was \$2 million in 2005 and 2004.

Summarized, combined balance sheet for discontinued operations (classified as held-for-sale):

(In millions)	2005
Current assets	\$ 3.9
Property, plant and equipment, net	5.1
Other assets	2.9
Total non-current assets (included in "Other assets" in the Consolidated Balance Sheet)	8.0
Current liabilities	2.2
Non-current liabilities	.5

### Fiscal Year

The Company's 2006 and 2005 fiscal years reflected 52-week periods ending December 30, 2006 and December 31, 2005, respectively. Fiscal year 2004 reflected a 53-week period ending January 1, 2005. Normally, each fiscal year consists of 52 weeks, but every fifth or sixth fiscal year consists of 53 weeks.

### Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions for the reporting period and as of the financial statement date. These estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent liabilities and the reported amounts of revenue and expense. Actual results could differ from these estimates.

### Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, deposits in banks, and short-term investments with maturities of three months or less when purchased. The carrying amounts of these assets approximate fair value due to the short maturity of the instruments. Cash paid for interest and taxes was as follows:

(In millions)	2006	2005	2004
Interest, net of capitalized amounts	\$ 52.0	\$ 55.9	\$ 59.5
Income taxes, net of refunds	60.4	113.1	68.9

In 2006 and 2005, non-cash activities included accruals for capital expenditures of approximately \$18 million and \$27 million, respectively, due to the timing of payments. In 2005, fixed assets acquired through capital lease totaled approximately \$9 million. These assets were sold and leased back in 2006, under an operating lease. Additionally in 2006, non-cash activities included approximately \$11 million in purchases of treasury stock, which were completed in late 2006 but not settled until January 2007.

### Accounts Receivable

The Company records trade accounts receivable at the invoiced amount. The allowance for doubtful accounts represents allowances for trade accounts receivable that are estimated to be partially or entirely uncollectible. The customer complaint reserve

represents estimated sales returns and allowances. These allowances are used to reduce gross trade receivables to their net realizable values. In 2006 and 2005, the Company recorded expenses of \$31.8 million and \$28.2 million, respectively, related to the allowances for trade accounts receivable. The Company records these allowances based on estimates related to the following factors:

- Customer-specific allowances
- Amounts based upon an aging schedule
- An estimated amount, based on the Company's historical experience

No single customer represented 10% or more of the Company's net sales or trade receivables at year end 2006 and 2005. However, the ten largest customers at year end 2006 represented approximately 18% of trade accounts receivable and consisted of six customers of the Company's Office and Consumer Products segment, three customers of the Pressure-sensitive Materials segment and one customer of both these segments. The Company does not generally require its customers to provide collateral, but the financial position and operations of these customers are monitored on an ongoing basis.

### Inventories

Inventories are stated at the lower of cost or market value. Cost is determined using methods that approximate both the first-in, first-out ("FIFO") and last-in, first-out ("LIFO") methods. Inventories valued using the LIFO method comprised 29% and 32% of inventories before LIFO adjustment at year end 2006 and 2005, respectively. The Company's international operations are on the FIFO basis of inventory cost accounting. U.S. operations use both FIFO and LIFO. Inventories at year end were as follows:

(In millions)	2006	2005
Raw materials	\$ 157.6	\$ 132.8
Work-in-progress	118.4	101.6
Finished goods	220.9	220.9
Inventories at lower of FIFO cost or market (approximates replacement cost)	496.9	455.3
Less LIFO adjustment	(25.1)	(15.6)
Inventory, net (on blended FIFO and LIFO basis)	\$ 471.8	\$ 439.7

### Property, Plant and Equipment

Major classes of property, plant and equipment are stated at cost and were as follows:

(In millions)	2006	2005
Land	\$ 54.8	\$ 56.0
Buildings and improvements	626.8	623.2
Machinery and equipment	1,959.7	1,885.4
Construction-in-progress	134.3	113.5
Property, plant and equipment	2,775.6	2,678.1
Accumulated depreciation	(1,466.2)	(1,382.4)
Property, plant and equipment, net	\$ 1,309.4	\$ 1,295.7

Depreciation is generally computed using the straight-line method over the estimated useful lives of the assets ranging from five to fifty years for buildings and improvements and two to

fifteen years for machinery and equipment. Leasehold improvements are depreciated over the shorter of the useful life of the asset or the term of the associated leases. Maintenance and repair costs are expensed as incurred; renewals and betterments are capitalized. Upon the sale or retirement of assets, the accounts are relieved of the cost and the related accumulated depreciation, with any resulting gain or loss included in net income.

### Software

The Company capitalizes software costs in accordance with American Institute of Certified Public Accountants' Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," and these capitalized costs are included in "Other assets" in the Consolidated Balance Sheet. Capitalized software is amortized on a straight-line basis over the estimated useful life of the software, ranging from two to ten years. Capitalized software costs were as follows:

(In millions)	2006	2005
Cost	\$ 259.0	\$ 236.7
Accumulated amortization	(145.8)	(126.4)
	<u>\$ 113.2</u>	<u>\$ 110.3</u>

### Impairment of Long-lived Assets

Impairment charges are recorded when the carrying amounts of long-lived assets are determined not to be recoverable. Impairment is measured by assessing the usefulness of an asset or by comparing the carrying value of an asset to its fair value. Fair value is typically determined using quoted market prices, if available, or an estimate of future cash flows expected to result from the use of the asset and its eventual disposition. Historically, changes in market conditions and management strategy have caused the Company to reassess the carrying amount of its long-lived assets. Refer to the Discontinued Operations section of this note, as well as Note 10, "Cost Reduction Actions," for details of impairment charges recorded in 2006, 2005 and 2004.

### Goodwill and Other Intangibles Resulting from Business Acquisitions

The Company accounts for business combinations in accordance with Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations." Business combinations are accounted for by the purchase method, and the excess of the acquisition cost over the fair value of net tangible assets and identified intangible assets acquired is considered goodwill. As a result, the Company discloses goodwill separately from other intangible assets and has recorded no amortization of goodwill as of the beginning of fiscal 2002. Other acquisition intangibles are identified using the criteria included in this Statement, including trademarks and trade names, patented and other acquired technology, customer relationships and other intangibles.

The Company adopted SFAS No. 142, "Goodwill and Other Intangible Assets," at the beginning of fiscal 2002. The Company's reporting units for the purposes of performing the impairment tests

for goodwill and other intangible assets consist of office and consumer products; retail information services; roll materials; graphics and reflective; business media; industrial products; RFID; performance polymers; specialty tapes, performance films; and security printing. For the purposes of performing the required impairment tests, a present value (discounted cash flow) method was used to determine the fair value of the reporting units with goodwill. The Company performed its annual impairment test in the fourth quarter of 2006, with an assessment that no impairment had occurred. Other intangible assets deemed to have an indefinite life are tested for impairment by comparing the fair value of the asset to its carrying amount. The Company does not have other intangible assets with an indefinite life.

The Company's reporting units are composed of either a discrete business or an aggregation of businesses with similar economic characteristics. Certain factors, including the decision to divest an individual business within a reporting unit, may result in the need to perform an impairment test prior to the annual impairment test. In the event that an individual business within a reporting group is divested, goodwill is allocated to that business based on its fair value relative to its reporting unit, which could result in a gain or loss. If a divested business within a reporting unit has not been integrated with other businesses within that reporting unit, the net book value of the goodwill associated with the business to be divested would be included in the carrying amount of the business when determining the gain or loss on disposal.

See also Note 3, "Goodwill and Other Intangibles Resulting from Business Acquisitions."

### Foreign Currency Translation

Asset and liability accounts of international operations are translated into U.S. dollars at current rates. Revenues and expenses are translated at the weighted-average currency rate for the fiscal year. Translation gains and losses of subsidiaries operating in hyperinflationary economies are included in net income in the period incurred. Gains and losses resulting from foreign currency transactions are included in income in the period incurred. Gains and losses resulting from hedging the value of investments in certain international operations and from translation of balance sheet accounts are recorded directly as a component of other comprehensive income.

Transactions in foreign currencies and translation of financial statements of subsidiaries operating in hyperinflationary economies increased net income by \$1.3 million in 2006, and decreased net income by \$2.2 million in 2005 and \$5.3 million in 2004. In 2005 and 2004, operations in hyperinflationary economies consisted of the Company's operations in the Dominican Republic and Turkey, for which the translation gains and losses are included in net income for Turkey. The functional currency for the Dominican Republic is the U.S. dollar, therefore, no translation gains and losses were recognized in net income. In 2006, Turkey was removed from hyperinflationary status.



### Financial Instruments

For purposes of this section of Note 1 and Note 5, "Financial Instruments," the terms "cash flow hedge," "derivative instrument," "fair value," "fair value hedge," "financial instrument," "firm commitment," "ineffective," and "highly effective" are used as these terms are defined in SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended.

The Company enters into certain foreign exchange hedge contracts to reduce its risk from exchange rate fluctuations associated with receivables, payables, loans and firm commitments denominated in certain foreign currencies that arise primarily as a result of its operations outside the U.S. The Company enters into certain interest rate contracts to help manage its exposure to interest rate fluctuations. The Company also enters into certain natural gas futures contracts to hedge price fluctuations for a portion of its anticipated domestic purchases. The maximum length of time in which the Company hedges its exposure to the variability in future cash flows for forecasted transactions is generally 12 to 18 months.

On the date the Company enters into a derivative contract, it determines whether the derivative will be designated as a hedge. Those derivatives not designated as hedges are recorded on the balance sheet at fair value, with changes in the fair value recognized currently in earnings. Those derivatives designated as hedges are classified as either (1) a hedge of the fair value of a recognized asset or liability or an unrecognized firm commitment (a "fair value" hedge); or (2) a hedge of a forecasted transaction or the variability of cash flows that are to be received or paid in connection with a recognized asset or liability (a "cash flow" hedge). The Company generally does not purchase or hold any foreign currency, interest rate or commodity contracts for trading purposes.

The Company assesses, both at the inception of the hedge and on an ongoing basis, whether hedges are highly effective. If it is determined that a hedge is not highly effective, the Company prospectively discontinues hedge accounting. For cash flow hedges, the effective portion of the related gains and losses is recorded as a component of other comprehensive income, and the ineffective portion is reported currently in earnings. Amounts in accumulated other comprehensive income (loss) are reclassified into earnings in the same period during which the hedged forecasted transaction is consummated. In the event the anticipated transaction is no longer likely to occur, the Company recognizes the change in fair value of the instrument in current period earnings. Changes in fair value hedges are recognized in current period earnings. Changes in the fair value of underlying hedged items (such as recognized assets or liabilities) are also recognized in current period earnings and offset the changes in the fair value of the derivative.

In the Statement of Cash Flows, hedge transactions are classified in the same category as the item hedged, primarily in operating activities.

### Revenue Recognition

Sales are recognized when persuasive evidence of an arrangement exists, pricing is determinable, and collection is reasonably assured. Furthermore, sales, provisions for estimated returns, and the cost of products sold are recorded at the time title transfers to customers and when the customers assume the risks and rewards of ownership. Sales terms are generally f.o.b. (free on board) shipping point or f.o.b. destination, depending upon local business customs. For most regions in which we operate, f.o.b. shipping point terms are utilized and sales are recorded at the time of shipment, because this is when title and risk of loss are transferred. In certain regions, notably in Europe, f.o.b. destination terms are generally utilized and sales are recorded when the products are delivered to the customer's delivery site, because this is when title and risk of loss are transferred. Actual product returns are charged against estimated sales return allowances. Volume, promotional, price, cash and other discounts and customer incentives are accounted for as a reduction to gross sales.

### Shipping and Handling Costs

Shipping and handling costs consist primarily of transportation charges incurred to move finished goods to customers. These costs are included in "Cost of products sold." In 2006, shipping and handling costs which were previously classified in "Marketing, general and administrative expense" for the Office and Consumer Products segment, Retail Information Services segment, and most businesses included in the other specialty converting businesses, were reclassified to align the Company's businesses around a standard accounting policy (refer to the Financial Presentation section of this note).

### Advertising Costs

Advertising costs included in "Marketing, general and administrative expense" were \$16.2 million in 2006, \$14.1 million in 2005, and \$11.1 million in 2004. The Company's policy is to expense advertising costs as incurred.

### Research and Development

Research and development costs are related to research, design and testing of new products and applications and are expensed as incurred. Research and development expense was \$87.9 million in 2006, \$85.4 million in 2005 and \$81.8 million in 2004.

### Pensions and Postretirement Benefits

Assumptions used in determining projected benefit obligations and the fair value of plan assets for the Company's pension plan and other postretirement benefit plans are evaluated by management in consultation with outside actuaries. In the event that the Company determines that changes are warranted in the assumptions used, such as the discount rate, expected long-term rate of return, or health care costs, future pension and postretirement benefit expenses could increase or decrease. Due to changing market conditions or changes in the participant population, the actuarial assumptions that the Company uses may differ from actual results, which could have a significant impact on the

Company's pension and postretirement liability and related cost. Refer to Note 6, "Pensions and Other Postretirement Benefits," for further detail on such assumptions.

### Product Warranty

The Company provides for an estimate of costs that may be incurred under its basic limited warranty at the time product revenue is recognized. These costs primarily include materials and labor associated with the service or sale of the product. Factors that affect the Company's warranty liability include the number of units installed or sold, historical and anticipated rate of warranty claims on those units, cost per claim to satisfy the Company's warranty obligation and availability of insurance coverage. As these factors are impacted by actual experience and future expectations, the Company assesses the adequacy of its recorded warranty liability and adjusts the amounts as necessary.

Product warranty liabilities were as follows:

(In millions)	2006	2005	2004
Balance at beginning of year	\$ 2.5	\$ 1.9	\$ 2.2
Accruals for warranties issued	.7	1.9	1.9
Payments	(1.3)	(1.3)	(2.2)
Balance at end of year	\$ 1.9	\$ 2.5	\$ 1.9

### Stock-Based Compensation

The terms used in this section of Note 1 and Note 9, "Shareholders' Equity and Stock-Based Compensation," including "short-cut method" and "windfall tax benefit," are as defined in SFAS No. 123(R), "Share-Based Payment."

Prior to January 1, 2006, the Company accounted for stock options in accordance with Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," as permitted by SFAS No. 123, "Accounting for Stock-Based Compensation," as amended. Except for costs related to restricted stock units ("RSUs") and restricted stock, no stock-based compensation cost was recognized in net income prior to January 1, 2006.

Effective January 1, 2006, the Company began recognizing expense for stock options to comply with the provisions of the reissued SFAS No. 123(R), "Share-Based Payment," using the modified prospective application transition method. As permitted by this transition method, results for the prior periods have not been restated.

As of January 1, 2006, the Company elected to use the short-cut method to calculate the historical pool of windfall tax benefits related to employee stock-based compensation awards, in accordance with the provisions of SFAS No. 123(R).

#### Effect of Stock Options on Net Income

Net income for 2006 includes pretax stock option expense of \$20.9 million, or \$0.14 per share, assuming dilution. This expense was included in "Marketing, general and administrative expense" and was recorded in corporate expense and the Company's operating segments, as appropriate. No stock-based compensation cost was capitalized for the year ended December 30, 2006.

The provisions of SFAS No. 123(R) require that options granted to retirement-eligible employees be treated as though they were immediately vested; as a result, the pretax compensation expense related to such options (approximately \$5 million) was recognized during 2006 and is included in the compensation expense noted above.

The following illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock options granted under the Company's stock option plans during the 2005 and 2004 fiscal years.

(In millions, except per share amounts)	2005	2004
Net income, as reported	\$ 226.4	\$ 279.7
Compensation expense, net of tax	(15.7)	(18.7)
Net income, pro forma	\$ 210.7	\$ 261.0
Net income per share, as reported	\$ 2.26	\$ 2.80
Net income per share, assuming dilution, as reported	2.25	2.78
Pro forma net income per share	\$ 2.10	\$ 2.61
Pro forma net income per share, assuming dilution	2.09	2.60

See also Note 9, "Shareholders' Equity and Stock-Based Compensation."

### Environmental Expenditures

Environmental expenditures are generally expensed. However, environmental expenditures for newly acquired assets and those which extend or improve the economic useful life of existing assets are capitalized and amortized over the remaining asset life. The Company reviews, on a quarterly basis, its estimates of costs of compliance with environmental laws related to remediation and cleanup of various sites, including sites in which governmental agencies have designated the Company as a potentially responsible party. When it is probable that obligations have been incurred and where a minimum cost or a reasonable estimate of the cost of compliance or remediation can be determined, the applicable amount is accrued. Potential insurance reimbursements are not offset against potential liabilities, and such liabilities are not discounted.

In December 2005, the Company adopted FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations – an interpretation of FASB Statement No. 143." As a result, the Company recognized a liability for the fair value of conditional asset retirement obligations based on estimates determined through present value techniques. An asset retirement is 'conditional' when the timing and (or) method of settlement of the retirement obligation is conditional upon a future event that may or may not be within the control of the Company. Certain potential obligations have not been included in the Company's estimate, because the range of time over which the Company may settle the obligation or the method of settlement is unknown or cannot be reasonably estimated. The Company's estimated liability associated with asset retirement obligations was not significant as of December 30, 2006.

**Restructuring and Severance Costs**

The Company accounts for restructuring costs including severance and other costs associated with exit or disposal activities following the guidance provided in SFAS No. 112, "Accounting for Postemployment Benefits," and SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." In the U.S., the Company has a severance pay plan ("Pay Plan"), which provides eligible employees with severance payments in the event of an involuntary termination due to qualifying cost reduction actions. Severance pay is calculated by using a severance benefit formula under the Pay Plan. Accordingly, the provisions for such amounts and other related exit costs are recorded when they are probable and estimable as set forth under SFAS No. 112. In the absence of a Pay Plan, liability for severance and other employee-related costs are recognized when the liability is incurred and follow the guidance of SFAS No. 146. See also Note 10, "Cost Reduction Actions."

**Investment Tax Credits**

Investment tax credits are accounted for in the period earned in accordance with the flow-through method.

**Taxes on Income**

Deferred tax assets and liabilities reflect temporary differences between the amount of assets and liabilities for financial and tax reporting purposes. Such amounts are adjusted, as appropriate, to reflect changes in tax rates expected to be in effect when the temporary differences reverse. A valuation allowance is recorded to reduce the Company's deferred tax assets to the amount that is more likely than not to be realized.

When establishing a valuation allowance, the Company considers future sources of income such as forecasted earnings, the mix of earnings in the jurisdictions in which the Company operates, and prudent and feasible tax planning. In the event the Company determines that it would not be able to realize the deferred tax assets in the future, the valuation adjustment to the deferred tax assets is charged to earnings in the period in which the Company makes such a determination. Likewise, if later it is determined that it is more likely than not that the deferred tax assets would be realized, the Company would release the previously provided valuation allowance.

The Company calculates its current and deferred tax provision based on estimates and assumptions that could differ from the actual results reflected in income tax returns filed during the following years. Adjustments based on filed returns are recorded when identified in the subsequent years. Certain amounts have been reclassified to conform with the current year presentation.

See also Note 11, "Taxes Based on Income."

**Net Income Per Share**

Net income per common share amounts were computed as follows:

(In millions, except per share amounts)	2006	2005	2004
(A) Income from continuing operations	\$ 352.5	\$ 291.8	\$ 281.0
(B) Income (loss) from discontinued operations	14.7	(65.4)	(1.3)
(C) Net income available to common shareholders	\$ 367.2	\$ 226.4	\$ 279.7
(D) Weighted-average number of common shares outstanding	99.8	100.1	99.9
Dilutive shares (additional common shares issuable under employee stock options, RSUs and restricted stock, contingently issuable shares under an acquisition agreement in 2004, and nonvested shares under employee agreements in 2005 and 2004)	.6	.4	.6
(E) Weighted-average number of common shares outstanding, assuming dilution	100.4	100.5	100.5
Income from continuing operations per common share (A) ÷ (D)	\$ 3.53	\$ 2.91	\$ 2.81
Income (loss) from discontinued operations per common share (B) ÷ (D)	.15	(.65)	(.01)
Net income per common share (C) ÷ (D)	\$ 3.68	\$ 2.26	\$ 2.80
Income from continuing operations per common share, assuming dilution (A) ÷ (E)	\$ 3.51	\$ 2.90	\$ 2.79
Income (loss) from discontinued operations per common share, assuming dilution (B) ÷ (E)	.15	(.65)	(.01)
Net income per common share, assuming dilution (C) ÷ (E)	\$ 3.66	\$ 2.25	\$ 2.78

Certain employee stock options, RSUs and shares of restricted stock were not included in the computation of net income per common share, assuming dilution, because they would not have had a dilutive effect. The amount excluded from the computation was 4.6 million in 2006, 4.6 million in 2005, and 1.4 million in 2004. The amount excluded for 2006 reflected the impact of additional dilutive shares following the calculation of assumed proceeds under the treasury stock method, as prescribed by SFAS No. 123(R).

### Comprehensive Income

Comprehensive income includes net income, foreign currency translation adjustments, adjustments to the minimum pension liability, net of tax, adjustments related to the implementation of SFAS No. 158, net of tax, and the gains or losses on the effective portion of cash flow and firm commitment hedges, net of tax, that are currently presented as a component of shareholders' equity. The Company's total comprehensive income was \$462.9 million and \$140 million for 2006 and 2005, respectively.

The components of accumulated other comprehensive loss (net of tax, except for foreign currency translation) at year end were as follows:

(In millions)	2006	2005
Foreign currency translation adjustment	\$ 137.6	\$ 36.6
Minimum pension liability	—	(111.8)
Adjustment to initially apply SFAS No. 158	(170.8)	—
Effect of the change in measurement date	.1	—
Net loss on derivative instruments designated as cash flow and firm commitment hedges	(17.0)	(13.9)
Total accumulated other comprehensive loss	\$ (50.1)	\$ (89.1)

As a result of the Company's adoption of SFAS No. 158 in 2006, previous amounts related to minimum pension liability were reversed. Adjustments to initially apply SFAS No. 158 are reported as a new component of accumulated other comprehensive loss. The following details the changes in accumulated other comprehensive loss related to pensions and other postretirement benefits, net of tax, for 2006:

(In millions)	2006
Minimum pension liability as of December 31, 2005	\$ (111.8)
Minimum pension liability adjustment under SFAS No. 87	(2.2)
Adjustment to minimum pension liability to initially apply SFAS No. 158	114.0
Minimum pension liability as of December 30, 2006	—
Adjustment to initially apply SFAS No. 158	(170.8)
Effect of the change in measurement date	.1
Ending balance	\$ (170.7)

Cash flow and firm commitment hedging instrument activity in other comprehensive income (loss), net of tax, was as follows:

(In millions)	2006	2005
Beginning accumulated derivative loss	\$ (13.9)	\$ (19.0)
Net loss reclassified to earnings	5.5	2.6
Net change in the revaluation of hedging transactions	(8.6)	2.5
Ending accumulated derivative loss	\$ (17.0)	\$ (13.9)

In connection with the issuance of the \$250 million 10-year senior notes in January 2003, the Company settled a forward starting interest rate swap at a loss of approximately \$32.5 million. This

unrecognized loss is being amortized to interest expense over 10 years, which corresponds to the term of the related debt. The related interest expense recognized during 2006 and 2005 was approximately \$2.9 million and \$2.7 million, respectively. Refer to Note 4, "Debt," for further detail.

### Recent Accounting Requirements

#### SFAS No. 123(R) and Related Guidance

In October 2006, Financial Accounting Standards Board ("FASB") issued Staff Position ("FSP") No. FAS 123(R)-6, "Amendment of FASB Staff Position FAS 123(R)-1." This guidance addresses certain technical corrections of FAS 123(R). These corrections include (a) exempting nonpublic companies from disclosing the aggregate intrinsic value of outstanding fully vested share options (or share units) and those expected to vest; (b) revising the computation of the minimum compensation cost that must be recognized to comply with paragraph 142 of Statement 123(R); (c) indicating that at the date that awards are no longer probable of vesting, any previously recognized compensation cost should be reversed; and (d) amending the definition of *short-term inducement* to exclude an offer to settle an award. This FSP is applicable in the first reporting period beginning after October 20, 2006. The adoption of this guidance has not had a significant impact on the Company's financial results of operations and financial position.

In October 2006, the FASB issued FSP No. FAS 123(R)-5, "Amendment of FASB Staff Position FAS 123(R)-1." This guidance addresses the modification of an instrument in connection with an equity restructuring. If modifications to the instrument are made solely to reflect an equity restructuring that occurs when holders are no longer employees, no change in the recognition or measurement of those instruments will occur as long as there is no increase in the fair value of the award and all holders of the same class of equity instruments are treated in the same manner. This FSP is applicable in the first reporting period beginning after October 10, 2006. The adoption of this guidance has not had a significant impact on the Company's financial results of operations and financial position.

In February 2006, the FASB issued FSP No. FAS 123(R)-4, "Classification of Options and Similar Instruments Issued as Employee Compensation that Allow for Cash Settlement upon the Occurrence of a Contingent Event." This guidance clarifies that a cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control shall be classified as a liability only when it becomes probable that the event will occur. This guidance is not applicable to the Company.

In November 2005, the FASB issued FSP No. FAS 123(R)-3, "Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards." This guidance allows an alternative transition method of tax treatment for initial adoption of SFAS No. 123(R). In accordance with this guidance, the Company elected



to use the short-cut method to calculate the historical pool of wind-fall tax benefits related to employee stock-based compensation awards as of January 1, 2006.

In October 2005, the FASB issued FSP No. FAS 123(R)-2, "Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)," to address recent inquiries from constituents to provide guidance on the application of grant date as defined in SFAS 123 (revised 2004), "Share-Based Payment." Under this guidance, grant date occurs when a mutual understanding of the key terms and conditions of an award is presumed to exist at the date the award is approved if (a) the award is a unilateral grant; and (b) the key terms and conditions of the award are expected to be communicated to the recipient within a relatively short time period from the date of approval. The guidance in this FSP has been applied upon adoption of SFAS No. 123(R).

In August 2005, the FASB issued FSP No. FAS 123(R)-1, "Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R)." This FSP modifies the requirements of SFAS No. 123 (revised 2004), "Share-Based Payment," to include freestanding financial instruments originally subject to SFAS No. 123(R) even if the holder is no longer an employee. The guidance in this FSP has been applied upon adoption of SFAS No. 123(R).

In April 2005, the Securities and Exchange Commission ("SEC") delayed the effective date of the reissued SFAS No. 123(R), "Share-Based Payment," to the beginning of the first annual reporting period beginning after June 15, 2005. This Statement is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation," and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." This Statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services and requires that the cost resulting from all share-based payment transactions be recognized in the financial statements. The Company adopted the recognition provisions of this Statement in January 2006 and followed the guidance under modified prospective application. The recognition of the related stock option expense was approximately \$20.9 million, pretax, in 2006. Compensation expense of approximately \$3.2 million related to restricted stock units ("RSUs") and restricted stock was also recognized in 2006.

#### *Other Requirements*

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)." This Statement requires (a) the recognition of funded status of a defined benefit postretirement plan in the statement of financial position and changes in the funded status through comprehensive income; (b) as a component of other comprehensive income, the recognition of actuarial gains and losses and the prior service costs

and credits (net of tax) that arise during the period, but are not recognized in the income statement; (c) measurement of defined benefit plan assets and obligations as of the date of the employer's fiscal year end statement of financial position; and (d) disclosure of additional information about certain effects on net periodic benefit cost for the next fiscal year, that arise from delayed recognition of the gains and losses, prior service costs or credits, and transition assets or obligations. The provisions of this Statement are effective as of the end of fiscal years ending after December 15, 2006, except for the requirement to measure plan assets and obligations as of the date of the employer's fiscal year end statement of financial position, which is effective for fiscal years ending after December 15, 2008. The Company has adopted all provisions of SFAS No. 158, including changing the measurement date of the majority of the U.S. plans to coincide with the fiscal year end. The adoption of SFAS No. 158 has reduced total shareholders' equity by approximately \$57 million, net of tax, in 2006. The adoption of SFAS No. 158 has not affected the Company's results of operations as of December 30, 2006.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This Statement establishes a framework for measuring fair value in accordance with U.S. generally accepted accounting principles, and expands disclosure about fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company will adopt this Statement when applicable. The Company is currently evaluating the impact of this Statement on the financial results of operations and financial position.

In September 2006, the FASB issued FSP AUG AIR-1, "Accounting for Planned Major Maintenance Activities." This FSP prohibits the use of the accrue-in-advance method of accounting and directs that entities shall apply the same method of accounting for planned major maintenance activities in annual and interim financial reporting periods. The guidance in this FSP is effective for fiscal years beginning after December 15, 2006. The adoption of this guidance is not expected to have a significant impact on the Company's financial results of operations and financial position.

In September 2006, the SEC issued Staff Accounting Bulletin ("SAB") No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements." This SAB provides guidance on approaches to considering the effects of identified unadjusted errors on financial statements, and what steps shall be taken to correct previously filed reports. The guidance in this SAB is effective for fiscal years beginning after November 15, 2006, and registrants electing not to restate financial statements for fiscal years ending on or before November 15, 2006 should reflect the effects of initially applying this guidance in their annual financial statements covering the first fiscal year ending after November 15, 2006. There was no cumulative effect at the time the Company adopted this guidance.



In July 2006, the FASB issued Financial Interpretation (“FIN”) No. 48, “Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109,” which is a change in accounting for income taxes. FIN No. 48 specifies how tax benefits for uncertain tax positions are to be recognized, measured, and derecognized in financial statements; requires certain disclosures of uncertain tax matters; specifies how reserves for uncertain tax positions should be classified on the balance sheet; and provides transition and interim period guidance, among other provisions. FIN No. 48 is effective for fiscal years beginning after December 15, 2006 and as a result, is effective for the Company in the first quarter of 2007. The Company is currently evaluating the impact of FIN No. 48 on the consolidated results of operations and financial position.

In October 2005, the FASB issued FSP No. FAS 13-1, “Accounting for Rental Costs Incurred during a Construction Period.” This FSP clarifies that rental costs of operating leases that are incurred during a construction period should be recognized as rental expense. The guidance in this FSP was applied beginning in 2006. The adoption of this guidance has not had a significant impact on the Company’s financial results of operations and financial position.

In September 2005, the consensus of the Emerging Issues Task Force (“EITF”) Issue No. 04-13, “Accounting for Purchases and Sales of Inventory with the Same Counterparty,” was published. An entity may sell inventory to another entity in the same line of business from which it also purchases inventory. This Issue states that inventory purchases and sales transactions with the same counterparty that are entered into in contemplation of one another should be combined for purposes of applying APB Opinion No. 29. In addition, a nonmonetary exchange, whereby an entity transfers finished goods inventory in exchange for the receipt of raw materials or work-in-process inventory within the same line of business, is not an exchange transaction to facilitate sales to customers as described in APB Opinion No. 29, and, therefore, should be recognized by the entity at fair value. Other nonmonetary exchanges of inventory within the same line of business should be recognized at the carrying amount of the inventory transferred. This Issue was effective for new arrangements entered into, or modifications or renewals of existing arrangements, beginning in the first interim or annual reporting period beginning after March 15, 2006. The adoption of this guidance has not had a significant impact on the Company’s financial results of operations and financial position.

In June 2005, the consensus of EITF Issue No. 05-6, “Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination,” was published and was effective for the reporting period after ratification. This Issue addresses the amortization

period for leasehold improvements acquired in a business combination or placed in service after lease inception. The adoption of this Issue has not had a significant impact on the Company’s financial results of operations and financial position.

In June 2005, the consensus of EITF Issue No. 05-5, “Accounting for Early Retirement or Postemployment Programs with Specific Features (Such as Terms Specified in Altersteilzeit Early Retirement Arrangements),” was published. This Issue addresses how an employer should account for the bonus feature and additional contributions into the German government pension scheme (collectively, the additional compensation) under a Type II Altersteilzeit (“ATZ”) arrangement, and the government subsidy under Type I and Type II ATZ arrangements. The consensus in this Issue was applicable beginning in fiscal year 2006. The adoption of this Issue has not had a significant impact on the Company’s financial results of operations and financial position.

In May 2005, the FASB issued SFAS No. 154, “Accounting Changes and Error Corrections – a replacement of APB Opinion No. 20 and FASB Statement No. 3.” This Statement requires retrospective application to prior periods’ financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. This Statement is effective for fiscal year 2006. In 2006, the Company changed its accounting treatment for shipping and handling costs as described in the Shipping and Handling Costs section of this note, and retrospectively applied this change by reclassifying shipping and handling costs for previously reported financial statements for comparability to the current period as required by SFAS No. 154. The provisions of SFAS No. 154 were not applicable to the adoption of SFAS No. 123(R) and SFAS No. 158, since there are specific transition provisions within those statements.

#### **Related Party Transactions**

From time to time, the Company enters into transactions in the normal course of business with related parties. Management believes that such transactions are at arm’s length and for terms that would have been obtained from unaffiliated third parties. One of the Company’s directors, Peter W. Mullin, is the chairman, chief executive officer and a director of MC Insurance Services, Inc. (“MC”), Mullin Insurance Services, Inc. (“MINC”), and PWM Insurance Services, Inc. (“PWM”), executive compensation and benefit consultants and insurance agents. Mr. Mullin is also the majority stockholder of MC, MINC and PWM (collectively referred to as the “Mullin Companies”). The Company paid premiums to insurance carriers for life insurance placed by the Mullin Companies in connection with several of the Company’s employee

benefit plans. The Mullin Companies have advised the Company that MC, MINC and PWM earned commissions from such insurance carriers for the placement and renewal of this insurance, for which Mr. Mullin had direct and indirect interests related to these commissions. Approximately 50% of these commissions were allocated to and used by MC Insurance Agency Services, LLC and MullinTBG Insurance Agency Services (affiliates of MC) to administer benefit plans and provide benefit statements to participants under several of the Company's employee benefit plans. The Mullin Companies own a minority interest in M Financial Holdings, Inc. ("MFH"). Substantially all of the life insurance policies, which the Company placed through the Mullin Companies, are issued by insurance carriers that participate in reinsurance agreements entered into between these insurance carriers and M Life Insurance Company ("M Life"), a wholly-owned subsidiary of MFH. Reinsurance returns earned by M Life are determined annually by the insurance carriers and can be negative or positive, depending upon the results of M Life's aggregate reinsurance pool, which consists of the insured lives reinsured by M Life. The Mullin Companies have advised the Company that they participated in net reinsurance gains of M Life. None of these transactions were significant to the financial position or results of operations of the Company.

**Summary of Related Party Activity:**

(In millions)	2006	2005	2004
Mullin Companies commissions on the Company's insurance premiums	\$ .5	\$ .9	\$ 1.1
Mr. Mullin's direct & indirect interest in these commissions	.4	.7	.8
Mullin Companies reinsurance gains (without risk of forfeiture) ascribed by M Life to the Company's life insurance policies	.3	.2	.2
Mr. Mullin's direct & indirect interest in reinsurance gains (without risk of forfeiture)	.2	.1	.2
Mullin Companies reinsurance gains (subject to risk of forfeiture) ascribed by M Life to the Company's life insurance policies	.6	1.5	—
Mr. Mullin's direct & indirect interest in reinsurance gains (subject to risk of forfeiture)	.4	1.1	—

**NOTE 2. ACQUISITIONS**

The aggregate cost of acquired companies was approximately \$13 million in 2006 and \$3 million in 2005. Goodwill resulting from these business acquisitions was approximately \$10 million in 2006 and \$1 million in 2005. Intangibles resulting from these business acquisitions were approximately \$2 million in 2006. The goodwill from these acquisitions is not expected to be deductible for U.S. tax purposes. These amounts of goodwill and intangibles do not include acquisition adjustments in the subsequent years following acquisition. Acquisitions during 2006 and 2005 were not significant to the consolidated financial position of the Company. Pro forma results for acquisitions in 2006 and 2005 are not presented, as the acquired businesses did not have a significant impact on the Company's results of operations for those years.

In 2004, the Company completed the acquisition of several small private companies, including Rinke Etiketten ("Rinke"), based in Germany, at a total cost of approximately \$15 million. Goodwill recognized for these transactions amounted to \$13.2 million and identified amortizable intangible assets amounted to \$1.8 million. This goodwill is not expected to be deductible for U.S. tax purposes. The final allocation of identifiable intangible assets and fixed assets for Rinke was assessed by a third-party valuation expert and completed during 2005. The results of operations for these companies have been included in the Company's Retail Information Services segment as of the acquisition dates.

In connection with the L&E Packaging ("L&E") acquisition in 2002, the Company issued 743,108 shares at \$63.08 per share. The Company also entered into an agreement with L&E whereby in the event the value of the Company's common shares fell below the price of the shares that were issued to L&E (adjusted for dividends received), during the period from January 1, 2005 through December 31, 2007, L&E had the option to exercise a true-up right. Upon exercise of this true-up right, the Company had the option to (1) pay the difference in value to L&E, in the form of (a) cash or (b) common shares, or (2) repurchase the shares at the issued share price, adjusted for dividends paid. The true-up obligation was reduced by any shares sold by L&E to third parties. During 2005, L&E sold 44,603 shares to third parties. On October 20, 2005, L&E notified the Company that L&E was exercising its true-up right under the agreement for the remaining 698,505 shares. The Company repurchased the remaining shares under the agreement for approximately \$41 million in the fourth quarter of 2005 and recorded such amount to treasury stock.

### NOTE 3. GOODWILL AND OTHER INTANGIBLES RESULTING FROM BUSINESS ACQUISITIONS

Changes in the net carrying amount of goodwill from continuing operations for 2006 and 2005, by reportable segment, are as follows:

(In millions)	Pressure-sensitive Materials	Office and Consumer Products	Retail Information Services	Other specialty converting businesses	Total
Balance as of January 1, 2005	\$ 334.6	\$ 170.4	\$ 205.3	\$ .3	\$ 710.6
Goodwill acquired during the period	–	–	1.1	–	1.1
Acquisition adjustments <sup>(1)</sup>	–	–	(2.7)	–	(2.7)
Translation adjustments	(21.0)	(12.5)	(2.4)	–	(35.9)
Balance as of December 31, 2005	313.6	157.9	201.3	.3	673.1
Transfer of business <sup>(2)</sup>	–	–	(3.1)	3.1	–
Goodwill acquired during the period	–	–	–	10.4	10.4
Acquisition adjustments <sup>(3)</sup>	–	–	.3	–	.3
Translation adjustments	18.8	11.2	2.0	.1	32.1
Balance as of December 30, 2006	\$ 332.4	\$ 169.1	\$ 200.5	\$ 13.9	\$ 715.9

(1) Acquisition adjustments in 2005 consisted of purchase price allocation of the Rinke acquisition and resolution of claims associated with RVL Packaging, Inc.

(2) Transfer of business refers to the transfer of the business media division from Retail Information Services to other specialty converting businesses to align with a change in the Company's internal reporting structure.

(3) Acquisition adjustments in 2006 consisted of purchase price allocation of a small acquisition in 2005.

The following table sets forth the Company's other intangible assets resulting from business acquisitions at December 30, 2006 and December 31, 2005, which continue to be amortized:

	2006			2005		
(In millions)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Amortizable other intangible assets:						
Customer relationships	\$ 93.0	\$ 25.1	\$ 67.9	\$ 85.7	\$ 19.0	\$ 66.7
Trade names and trademarks	43.2	33.6	9.6	40.1	25.6	14.5
Patented and other acquired technology	28.3	11.0	17.3	26.4	9.6	16.8
Other intangibles	4.8	4.1	.7	4.4	3.7	.7
Total	\$ 169.3	\$ 73.8	\$ 95.5	\$ 156.6	\$ 57.9	\$ 98.7

Amortization expense on other intangible assets resulting from business acquisitions was \$11.1 million for 2006, \$12 million for 2005, and \$11.8 million for 2004. The weighted-average amortization periods from the date of acquisition for intangible assets resulting from business acquisitions are twenty-two years for customer relationships, twelve years for trade names and trademarks, eighteen years for patented and other acquired technology, six years for other intangibles and eighteen years in total. As of December 30, 2006, the weighted-average remaining useful life of the acquired intangible assets are sixteen years for customer relationships, six years for trade names and trademarks, eleven years for patented and other acquired technology, two years for other intangibles and twelve years in total. Based on current information, estimated amortization expense for acquired intangible assets for each of the next five fiscal years is expected to be approximately \$8 million, \$7 million, \$6 million, \$6 million and \$6 million, respectively.

### NOTE 4. DEBT

Long-term debt and its respective weighted-average interest rates at December 30, 2006 consisted of the following:

(In millions)	2006	2005
Medium-term notes		
Series 1995 at 7.5% – due 2015 through 2025	\$ 50.0	\$ 50.0
Series 1997 at 6.6% – due 2007	60.0	60.0
Series 1998 at 5.9% – due 2008	50.0	50.0
Senior notes due 2013 at 4.9%	250.0	250.0
Senior notes due 2033 at 6.0%	150.0	150.0
Senior notes due 2007 at a floating rate of 5.6%	150.0	150.0
Other long-term borrowings	2.1	14.1
Less amount classified as current	(210.5)	(1.1)
	\$ 501.6	\$ 723.0

The Company's medium-term notes have maturities from 2007 through 2025 and accrue interest at fixed rates.

Maturities of long-term debt during the years 2007 through 2011 are \$210.5 million (classified as current), \$50.5 million, \$.5 million, \$.5 million and \$.1 million, respectively, with \$450 million maturing thereafter.

In the fourth quarter of 2004, the Company filed a shelf registration statement with the SEC to permit the issuance of up to \$500 million in debt and equity securities. Proceeds from the shelf offering may be used for general corporate purposes, including repaying, redeeming or repurchasing existing debt, and for working capital, capital expenditures and acquisitions. As of December 30, 2006, no securities have been issued under this registration statement.

Short-term variable rate commercial paper borrowings were \$154.4 million at December 30, 2006 (weighted-average interest rate of 5.0%) and \$255.3 million at December 31, 2005 (weighted-average interest rate of 2.3%). The change in outstanding commercial paper was due to positive cash flow from operations.

In July 2004, the Company entered into a revolving credit agreement with 10 domestic and foreign banks for a total commitment of \$525 million, expiring July 16, 2009. Financing available under the agreement is used as a commercial paper back-up facility and is also available to finance other corporate requirements. There was no debt outstanding under this agreement as of year end 2006 and 2005.

At December 30, 2006, the Company had \$101.5 million of borrowings outstanding under foreign short-term lines of credit with a weighted-average interest rate of 9.6%.

Included in the borrowings at December 30, 2006 was \$26.3 million outstanding under a 364-day revolving credit facility in which a foreign bank provides the Company up to Euro 30 million (\$39.6 million) through July 31, 2007. The Company may annually extend the revolving period and due date with the approval of the bank. The Company intends to negotiate an extension of this facility in 2007. Financing under this agreement is used to finance cash requirements of the Company's European operations.

Uncommitted lines of credit were \$358.9 million at year end 2006. The Company's uncommitted lines of credit do not have a commitment expiration date, and may be cancelled at any time by the Company or the banks.

At December 30, 2006, the Company had available short-term financing arrangements totaling \$297 million.

Commitment fees relating to the financing arrangements are not significant.

The Company's total interest costs in 2006, 2005 and 2004 were \$60.5 million, \$62.8 million, and \$61.8 million, respectively, of which \$5 million, \$4.9 million, and \$3.1 million, respectively, were capitalized as part of the cost of assets.

The terms of various loan agreements in effect at year end require that the Company maintain specified ratios on debt and interest expense in relation to certain measures of income. Under the loan agreements, the ratio of debt to earnings before other expense (see Note 10, "Cost Reduction Actions"), interest, taxes, depreciation and amortization may not exceed 3.5 to 1.0. The Company's ratio at year end 2006 was 1.4 to 1.0. Earnings before other expense, interest and taxes, as a ratio to interest, may not be less than 3.5 to 1.0. The Company's ratio at year end 2006 was 9.3 to 1.0.

The fair value of the Company's debt is estimated based on the discounted amount of future cash flows using the current rates offered to the Company for debt of the same remaining maturities. At year end 2006 and 2005, the fair value of the Company's total debt, including short-term borrowings, was \$963 million and \$1.1 billion, respectively.

The Company had standby letters of credit outstanding of \$77.1 million and \$81.2 million at the end of 2006 and 2005, respectively. The aggregate contract amount of outstanding standby letters of credit approximated fair value.

## NOTE 5. FINANCIAL INSTRUMENTS

During 2006, the amount recognized in earnings related to cash flow hedges that were ineffective was not significant. The aggregate reclassification from other comprehensive income to earnings for settlement or ineffectiveness was a net loss of \$5.5 million and \$2.6 million during 2006 and 2005, respectively. A net loss of approximately \$8.3 million is expected to be reclassified from other comprehensive income to earnings within the next 12 months.

In connection with the issuance of the \$250 million 10-year senior notes in January 2003, the Company settled a forward starting interest rate swap at a loss of \$32.5 million. This loss is being amortized to interest expense over a 10-year period, which corresponds to the term of the related debt.

The carrying value of the foreign exchange forward and natural gas futures contracts approximated the fair value, which, based on quoted market prices of comparable instruments, was a net liability of \$4.9 million at December 2006 and a net asset of \$2.6 million at December 2005.

The carrying value of the foreign exchange option contracts, based on quoted market prices of comparable instruments, was a net asset of \$.1 million at the end of 2006 and 2005. The carrying value of the foreign exchange option contracts approximated the fair market value.

The counterparties to foreign exchange and natural gas forward, option and swap contracts consist primarily of major international financial institutions. The Company centrally monitors its positions and the financial strength of its counterparties. Therefore, although the Company may be exposed to losses in the event of nonperformance by these counterparties, it does not anticipate such losses.

## NOTE 6. PENSIONS AND OTHER POSTRETIREMENT BENEFITS

### Adoption of SFAS No. 158

In the fourth quarter of 2006, the Company adopted the following provisions of SFAS No. 158:

- Recognition of the funded status of the Company's defined benefit and postretirement benefit plans (with a corresponding reversal of additional minimum pension liability ("AML") under SFAS No. 87)
- Recognition as a component of accumulated other comprehensive income, net of tax, the gains or losses, prior service costs or credits and transition assets or obligations remaining from the initial application of SFAS Nos. 87 and 106
- Measurement of the defined benefit plan assets and obligations as of the Company's fiscal year end
- Disclosure of additional information about the effects of the amortization of gains or losses, prior service costs or credits, and transition assets or obligations (remaining from the initial application of SFAS Nos. 87 and 106) on net periodic benefit cost for the next fiscal year

The above recognition and disclosure provisions are discussed in detail below.

### Defined Benefit Plans

The Company sponsors a number of defined benefit plans (the "Plan") covering substantially all U.S. employees, employees in certain other countries and non-employee directors. It is the Company's policy to make contributions to the Plan that are sufficient to meet the minimum funding requirements of applicable laws and regulations, plus additional amounts, if any, as management determines to be appropriate. Plan assets are generally invested in diversified portfolios that consist primarily of equity and fixed income securities. Benefits payable to employees are based primarily on years of service and employees' pay during their employment with the Company. Certain benefits provided by one of the Company's U.S. defined benefit plans may be paid, in part, from an employee stock ownership plan. While the Company has not expressed any intent to terminate the Plan, the Company may do so at any time.

### Measurement Date

In accordance with the measurement date provisions of SFAS No. 158, the Company changed its measurement date for the majority of its U.S. plans from a November 30 measurement date to Company's fiscal year end, which is December 30 for 2006.

The plan assets and benefit obligations were remeasured by recognizing the revised net periodic benefit cost prorated from November 30, 2006 to December 30, 2006. The impact of such remeasurement (\$.7 million) affected the Company's retained earnings and accumulated other comprehensive loss.

For the Company's international plans, the Company uses a fiscal year end measurement date.

### Postretirement Health Benefits

The Company provides postretirement health benefits to certain U.S. retired employees up to the age of 65 under a cost-sharing arrangement, and provides supplemental Medicare benefits to certain U.S. retirees over the age of 65. The Company's policy is to fund the cost of the postretirement benefits on a cash basis. The Company uses a fiscal year end measurement date for its postretirement health benefit plan. While the Company has not expressed any intent to terminate postretirement health benefits, the Company may do so at any time.

### Plan Assets

Assets of the Company's U.S. plans are invested in a diversified portfolio that consists primarily of equity and fixed income securities. Furthermore, equity investments are diversified across U.S. and non-U.S. stocks, including growth, value and small and large capitalization stocks. The Company's target plan asset investment allocation in the U.S is 75% in equity securities and 25% in fixed income securities, subject to periodic fluctuations in the respective asset classes above. The Plan assets include investments in the Company's stock, which totaled approximately 630,000 shares as of December 30, 2006. This amount, however, does not include any shares that may be held in index funds.

Assets of the Company's international plans are invested in accordance with local accepted practice, with asset allocations and investments varying by country and plan. Investments utilized by the various plans include equity securities, fixed income securities, real estate and insurance contracts.

The weighted-average asset allocations for the Company's pension plans at year end 2006 and 2005, by asset category are as follows:

	2006		2005	
	U.S.	Int'l	U.S.	Int'l
Equity securities	80%	57%	84%	61%
Fixed income securities	20	33	16	36
Real estate and insurance contracts	—	10	—	3
Total	100%	100%	100%	100%



**Plan Assumptions***Discount Rate*

The Company, in consultation with its actuaries, annually reviews and determines the discount rates to be used in connection with its postretirement obligations. The assumed discount rate for each pension plan reflects market rates for high quality corporate bonds currently available. In the U.S., the Company's discount rate was determined by evaluating several yield curves consisting of large populations of high quality corporate bonds. The projected pension benefit payment streams were then matched with the bond portfolios to determine a rate that reflected the liability duration unique to the Company's plans.

*Long-term Return on Assets*

The Company determines the long-term rate of return assumption for plan assets by reviewing the historical and expected returns of both the equity and fixed income markets, taking into consideration that assets with higher volatility typically generate a

greater return over the long run. Additionally, current market conditions, such as interest rates, are evaluated and peer data is reviewed to check for reasonability and appropriateness.

*Healthcare Cost Trend Rate*

For measurement purposes, a 9% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2007. This rate is expected to decrease to approximately 5% by 2011.

A one-percentage-point change in assumed health care cost trend rates would have the following effects:

(In millions)	One-percentage-point increase	One-percentage-point decrease
Effect on total of service and interest cost components	\$ .08	\$ (.09)
Effect on postretirement benefit obligation	.95	(1.13)

**Plan Balance Sheet Reconciliations**

The following provides a reconciliation of benefit obligations, plan assets and funded status of the plans:

(In millions)	Pension Benefits				U.S. Postretirement Health Benefits	
	2006		2005		2006	2005
	U.S.	Int'l	U.S.	Int'l		
<b>Change in projected benefit obligation:</b>						
Projected benefit obligation at beginning of year	\$ 513.7	\$ 415.7	\$ 468.7	\$ 407.9	\$ 34.1	\$ 41.6
Service cost	19.2	13.3	19.3	11.5	.9	1.7
Interest cost	29.7	19.6	27.6	18.7	1.7	2.5
Participant contribution	—	3.1	—	3.4	—	—
Amendments	—	—	2.8	—	—	(14.0)
Actuarial loss (gain)	24.2	13.9	20.2	34.1	(.4)	6.1
Plan transfer <sup>(1)</sup>	3.5	—	1.1	—	—	—
Benefits paid	(33.1)	(15.1)	(26.0)	(11.4)	(3.3)	(3.8)
Special termination benefits	—	.1	—	—	—	—
Net transfer in <sup>(2)</sup>	—	8.5	—	—	—	—
Pension curtailment	—	(1.8)	—	(.2)	—	—
Foreign currency translation	—	49.9	—	(48.3)	—	—
Projected benefit obligation at end of year	\$ 557.2	\$ 507.2	\$ 513.7	\$ 415.7	\$ 33.0	\$ 34.1
Accumulated benefit obligation at end of year	\$ 523.6	\$ 475.8	\$ 504.2	\$ 399.4		

(1) Plan transfer represents transfer from the Company's savings plan.

(2) Net transfer in represents valuation of additional pension plans.

(In millions)	Pension Benefits				U.S. Postretirement Health Benefits	
	2006		2005		2006	2005
	U.S.	Int'l	U.S.	Int'l		
<b>Change in plan assets:</b>						
Fair value of plan assets at beginning of year	\$ 520.7	\$ 330.8	\$ 476.4	\$ 319.3	\$ –	\$ –
Actual return on plan assets	83.3	48.6	42.8	42.2	–	–
Plan transfer <sup>(1)</sup>	3.5	–	1.1	–	–	–
Employer contribution	27.5	7.9	26.4	15.6	3.3	3.8
Participant contribution	–	3.1	–	3.4	–	–
Benefits paid	(33.1)	(15.1)	(26.0)	(11.4)	(3.3)	(3.8)
Net transfer in <sup>(2)</sup>	–	.4	–	–	–	–
Foreign currency translation	–	40.3	–	(38.3)	–	–
Fair value of plan assets at end of year	\$ 601.9	\$ 416.0	\$ 520.7	\$ 330.8	\$ –	\$ –
<b>Funded status of the plans:</b>						
Plan assets in excess of (less than) benefit obligation	\$ 44.7	\$ (91.2)	\$ 7.0	\$ (84.9)	\$ (33.0)	\$ (34.1)

(1) Plan transfer represents transfer from the Company's savings plan.

(2) Net transfer in represents valuation of additional pension plans.

	Pension Benefits						U.S. Postretirement Health Benefits		
	2006		2005		2004		2006	2005	2004
	U.S.	Int'l	U.S.	Int'l	U.S.	Int'l			
<b>Weighted-average assumptions used for determining year end obligations:</b>									
Discount rate	5.90%	4.67%	5.75%	4.49%	6.00%	4.91%	5.75%	5.50%	5.75%
Rate of increase in future compensation levels	3.59	2.90	3.59	2.79	3.61	2.68	–	–	–

The projected benefit obligation and fair value of plan assets for pension plans with projected benefit obligations in excess of plan assets for both the U.S. and international plans were \$627.6 million and \$471.1 million, respectively, at year end 2006 and \$555.3 million and \$382.9 million, respectively, at year end 2005.

The accumulated benefit obligation and fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets for the U.S. and international plans were \$298.2 million and \$160.9 million, respectively, at year end 2006 and \$531.9 million and \$375.8 million, respectively, at year end 2005.

The pretax amounts recognized in "Accumulated Other Comprehensive Income" in the Company's balance sheet after the adoption of SFAS No. 158 consist of:

(in millions)	Pension Benefits		U.S. Postretirement Health Benefits
	2006		2006
	U.S.	Int'l	
Net actuarial loss	\$ 103.4	\$ 120.3	\$ 21.8
Prior service cost (credit)	8.5	6.1	(24.0)
Net transition asset	–	(3.3)	–
Net amount recognized	\$ 111.9	\$ 123.1	\$ (2.2)

The following table summarizes the effects of required changes in the AML as of December 30, 2006, as well as the impact of the initial adoption of SFAS No. 158 on the Company's balance sheet:

(In millions)	Before AML and SFAS No. 158 Adjustments	AML Adjustments	SFAS No. 158 Adjustments	After AML and SFAS No.158 Adjustments
Non-current pension assets	\$ 174.2	\$ (1.4)	\$ (62.9)	\$ 109.9
Deferred income taxes	6.6	.6	2.9 <sup>(1)</sup>	10.1
Total assets	\$ 180.8	\$ (.8)	\$ (60.0)	\$ 120.0
Current pension liabilities	\$ –	\$ –	\$ 8.3	\$ 8.3
Non-current pension liabilities	190.4	1.4	(10.8)	181.0
Total liabilities	\$ 190.4	\$ 1.4	\$ (2.5)	\$ 189.3
Accumulated other comprehensive loss, net of tax	\$ 111.8	\$ 2.2	\$ 56.7	\$ 170.7
Retained earnings	–	–	.8	.8
Shareholders' equity	\$ 111.8	\$ 2.2	\$ 57.5	\$ 171.5

(1) Net of valuation allowances of approximately \$17.8.

The amount in non-current pension assets represents the net assets of the Company's overfunded plans, which consist of one U.S. plan and a number of international plans. The amounts in current and non-current pension liabilities represent the net obligation of the Company's underfunded plans, which consist of several U.S. plans and international plans.

#### Plan Income Statement Reconciliations

The following table sets forth the components of net periodic benefit cost (income):

(In millions)	Pension Benefits						U.S. Postretirement Health Benefits		
	2006		2005		2004		2006	2005	2004
	U.S.	Int'l	U.S.	Int'l	U.S.	Int'l			
<b>Components of net periodic benefit cost (income):</b>									
Service cost	\$ 19.2	\$ 13.3	\$ 19.3	\$ 11.5	\$ 16.8	\$ 10.4	\$ .9	\$ 1.7	\$ 1.4
Interest cost	29.7	19.6	27.6	18.7	25.5	18.2	1.7	2.5	2.1
Expected return on plan assets	(46.8)	(19.9)	(44.0)	(20.9)	(42.4)	(21.2)	–	–	–
Recognized net actuarial loss (gain)	8.0	6.6	5.2	3.7	3.5	2.5	1.4	1.6	.7
Amortization of prior service cost	1.9	.6	1.9	.6	.1	.2	(1.9)	(.9)	(.9)
Amortization of transition obligation or asset	–	(1.3)	(.3)	(1.3)	(.5)	(1.3)	–	–	–
Special termination benefit recognized	–	.1	–	–	–	–	–	–	–
Recognized gain on curtailment and settlement of obligation <sup>(1)</sup>	–	(1.9)	–	(.1)	–	.8	–	–	–
Net periodic benefit cost	\$ 12.0	\$ 17.1	\$ 9.7	\$ 12.2	\$ 3.0	\$ 9.6	\$ 2.1	\$ 4.9	\$ 3.3

(1) Recognized gain in 2006 relates to the divestiture of the Company's filing business in Europe.

	Pension Benefits						U.S. Postretirement Health Benefits		
	2006		2005		2004		2006	2005	2004
	U.S.	Int'l	U.S.	Int'l	U.S.	Int'l			
<b>Weighted-average assumptions used for determining net periodic cost:</b>									
Discount rate	5.75%	4.49%	6.00%	4.91%	6.25%	5.31%	5.50%	5.75%	6.25%
Expected long-term rate of return on plan assets	8.75	5.77	8.75	6.32	9.00	6.48	–	–	–
Rate of increase in future compensation levels	3.59	2.79	3.61	2.68	3.62	2.54	–	–	–

**Plan Contributions**

In 2007, the Company expects to contribute a minimum of \$2.6 million and \$8.3 million to its U.S. pension plans and international pension plans, respectively, and approximately \$3.2 million to its postretirement benefit plan.

**Future Benefit Payments**

Benefit payments, which reflect expected future services, are as follows:

(In millions)	Pension Benefits		U.S. Postretirement Health Benefits
	U.S.	Int'l	
2007	\$ 31.4	\$ 16.6	\$ 3.2
2008	32.1	15.4	3.2
2009	32.9	17.3	2.9
2010	33.6	18.8	2.7
2011	34.1	18.9	2.9
2012–2015	178.1	112.7	13.3

**Estimated Amortization Amounts in Accumulated Other Comprehensive Income**

The Company's estimates of fiscal year 2007 amortization of amounts included in accumulated other comprehensive income are as follows:

(In millions)	Pension Benefits		U.S. Postretirement Health Benefits
	2006	2006	
	U.S.	Int'l	
Net actuarial loss	\$ 7.6	\$ 7.9	\$ 1.4
Prior service cost (credit)	1.9	.7	(1.9)
Net transition asset	–	(1.1)	–
Net amount to be recognized	\$ 9.5	\$ 7.5	\$ (.5)

**Defined Contribution Plans**

The Company sponsors various defined contribution plans worldwide, with the largest plan being the Avery Dennison Corporation Employee Savings Plan ("Savings Plan" – a 401(k) savings plan covering its U.S. employees). The Company matches participant contributions to the Savings Plan based on a formula within the plan. The Savings Plan has a leveraged employee stock ownership plan ("ESOP") feature, which allows the plan to borrow funds to purchase shares of the Company's common stock at market prices. Savings Plan expense consists primarily of stock contributions from the ESOP to participant accounts.

ESOP expense is accounted for under the cost of shares allocated method. Net ESOP expense for 2006, 2005 and 2004 was \$.4 million, \$1.2 million, and \$.7 million, respectively. Company contributions to pay interest or principal on ESOP borrowings were \$2.5 million, \$1.7 million, and \$1.1 million in 2006, 2005 and 2004, respectively.

Interest costs incurred by the ESOP for 2006, 2005 and 2004 were \$.7 million, \$.6 million, and \$.3 million, respectively. Dividends on unallocated ESOP shares used for debt service were \$.9 million, \$1.1 million, and \$1.3 million for 2006, 2005 and 2004, respectively.

The cost of shares allocated to the ESOP for 2006, 2005 and 2004 was \$2.2 million, \$2.3 million, and \$2.1 million, respectively. Of the total shares held by the ESOP, 1.8 million shares were allocated and .5 million shares were unallocated at year end 2006, and 2.5 million shares were allocated and .6 million shares were unallocated at year end 2005.

**Other Retirement Plans**

The Company has deferred compensation plans which permit eligible employees and directors to defer a portion of their compensation. The deferred compensation, together with certain Company contributions, earns specified and variable rates of return. As of year end 2006 and 2005, the Company had accrued \$151.0 million and \$157.3 million, respectively, for its obligations under these plans. These obligations are funded by corporate-owned life insurance contracts and standby letters of credit. As of year end 2006 and 2005, these obligations were secured by standby letters of credit of \$61.0 million and \$64.5 million, respectively. The Company's expense, which includes Company contributions and interest expense, was \$12.0 million, \$6.9 million, and \$13.8 million for 2006, 2005 and 2004, respectively. A portion of the interest on certain Company contributions may be forfeited by participants if employment is terminated before age 55 other than by reason of death, disability or retirement.

To assist in the funding of these plans, the Company purchases corporate-owned life insurance contracts. Proceeds from the insurance policies are payable to the Company upon the death of the participant. The cash surrender value of these policies, net of outstanding loans, included in "Other assets" in the Consolidated Balance Sheet, was \$173.9 million and \$160.6 million at year end 2006 and 2005, respectively.

**NOTE 7. COMMITMENTS**

Minimum annual rental commitments on operating leases having initial or remaining noncancellable lease terms of one year or more are as follows:

Year	(In millions)
2007	\$ 50.8
2008	41.5
2009	27.1
2010	18.6
2011	15.7
Thereafter	47.6
Total minimum lease payments	\$ 201.3

Operating leases relate primarily to office and warehouse space, and equipment for electronic data processing and transportation. The terms of these leases do not impose significant restrictions or unusual obligations, except as noted below. There are no significant capital leases.

On September 9, 2005, the Company completed the lease financing for a commercial facility (the "Facility") located in Mentor, Ohio, used primarily for the new headquarters and research center for the Company's roll materials division. The Facility consists generally of land, buildings, equipment and office furnishings. The Company has leased the Facility under an operating lease arrangement, which contains a residual value guarantee of \$33.4 million. The Company does not expect the residual value of the Facility to be less than the amount guaranteed.

Rent expense for 2006, 2005 and 2004 was \$74 million, \$74 million, and \$66 million, respectively.

#### NOTE 8. CONTINGENCIES

##### Investigations and Legal Proceedings

On October 19, 2006, the U.S. Department of Justice notified the Company that the U.S. Department of Justice had decided to close its criminal investigation (initiated in April 2003) into competitive practices in the label stock industry without further action as described below.

On November 15, 2006, the Company announced that it had been notified that the European Commission ("EC") had closed its investigation (initiated in May 2004) into the Company's competitive activities in the label stock industry, with no action, as described below.

On April 14, 2003, the Company announced that it had been advised that the U.S. Department of Justice was challenging the proposed merger of UPM-Kymmene ("UPM") and the Morgan Adhesives ("MACtac") division of Bemis Co., Inc. ("Bemis") on the basis of its belief that in certain aspects of the label stock industry "the competitors have sought to coordinate rather than compete." The Company also announced that it had been notified that the U.S. Department of Justice had initiated a criminal investigation into competitive practices in the label stock industry.

On April 15, 2003, the U.S. Department of Justice filed a complaint in the U.S. District Court for the Northern District of Illinois seeking to enjoin the proposed merger ("DOJ Merger Complaint"). The DOJ Merger Complaint, which set forth the U.S. Department of Justice's theory of its case, included references not only to the parties to the merger, but also to an unnamed "Leading Producer" of North American label stock, which is the Company. The DOJ Merger Complaint asserted that "UPM and the Leading Producer have already attempted to limit competition between themselves, as

reflected in written and oral communications to each other through high level executives regarding explicit anticompetitive understandings, although the extent to which these efforts have succeeded is not entirely clear to the United States at the present time."

In connection with the U.S. Department of Justice's investigation into the proposed merger, the Company produced documents and provided testimony by Messrs. Neal, Scarborough and Simcic (then CEO, President and Group Vice President – Roll Materials Worldwide, respectively). On July 25, 2003, the United States District Court for the Northern District of Illinois entered an order enjoining the proposed merger. UPM and Bemis thereafter agreed to terminate the merger agreement. The court's decision incorporated a stipulation by the U.S. Department of Justice that the paper label industry is competitive.

On April 24, 2003, Sentry Business Products, Inc. filed a purported class action in the United States District Court for the Northern District of Illinois against the Company, UPM, Bemis and certain of their subsidiaries seeking treble damages and other relief for alleged unlawful competitive practices, essentially repeating the underlying allegations of the DOJ Merger Complaint. Ten similar complaints were filed in various federal district courts. In November 2003, the cases were transferred to the United States District Court for the Middle District of Pennsylvania and consolidated for pretrial purposes. Plaintiffs filed a consolidated complaint on February 16, 2004, which the Company answered on March 31, 2004. On April 14, 2004, the court separated the proceedings as to class certification and merits discovery, and limited the initial phase of discovery to the issue of the appropriateness of class certification. On January 4, 2006, plaintiffs filed an amended complaint. On January 20, 2006, the Company filed an answer to the amended complaint. The Company intends to defend these matters vigorously.

On May 6, 2003, Sekuk Global Enterprises filed a purported stockholder class action in the United States District Court for the Central District of California against the Company and Messrs. Neal, O'Bryant and Skovran (then CEO, CFO and Controller, respectively) seeking damages and other relief for alleged disclosure violations pertaining to alleged unlawful competitive practices. Subsequently, another similar action was filed in the same court. On September 24, 2003, the court appointed a lead plaintiff, approved lead and liaison counsel and ordered the two actions consolidated as the "In Re Avery Dennison Corporation Securities Litigation." Pursuant to court order and the parties' stipulation, plaintiff filed a consolidated complaint in mid-February 2004. The court approved a briefing schedule for defendants' motion to dismiss the consolidated complaint, with a contemplated hearing date in June 2004. In January 2004, the parties stipulated to stay the consolidated action, including the proposed



briefing schedule, pending the outcome of the government investigation of alleged anticompetitive conduct by the Company. The court has approved the parties' stipulation to stay the consolidated actions. On January 12, 2007, the plaintiffs filed a notice of voluntary dismissal of the case without prejudice. On January 17, 2007, the Court entered an order dismissing the case.

On May 21, 2003, The Harman Press filed in the Superior Court for the County of Los Angeles, California, a purported class action on behalf of indirect purchasers of label stock against the Company, UPM and UPM's subsidiary Raflatrac ("Raflatrac"), seeking treble damages and other relief for alleged unlawful competitive practices, essentially repeating the underlying allegations of the DOJ Merger Complaint. Three similar complaints were filed in various California courts. In November 2003, on petition from the parties, the California Judicial Council ordered the cases be coordinated for pretrial purposes. The cases were assigned to a coordination trial judge in the Superior Court for the City and County of San Francisco on March 30, 2004. A further similar complaint was filed in the Superior Court for Maricopa County, Arizona on November 6, 2003. Plaintiffs voluntarily dismissed the Arizona complaint without prejudice on October 4, 2004. On January 21, 2005, American International Distribution Corporation filed a purported class action on behalf of indirect purchasers in the Superior Court for Chittenden County, Vermont. Similar actions were filed by Webtego on February 16, 2005, in the Court of Common Pleas for Cuyahoga County, Ohio; by D.R. Ward Construction Co. on February 17, 2005, in the Superior Court for Maricopa County, Arizona; by Richard Wrobel, on February 16, 2005, in the District Court of Johnson County, Kansas; and by Chad and Terry Muzzey, on February 16, 2005 in the District Court of Scotts Bluff County, Nebraska. On February 17, 2005, Judy Benson filed a purported multi-state class action on behalf of indirect purchasers in the Circuit Court for Cocke County, Tennessee. On October 7, 2005, Webtego voluntarily dismissed its complaint. On February 16, 2006, D.R. Ward voluntarily dismissed its complaint. The Company intends to defend the remaining matters vigorously.

On August 15, 2003, the U.S. Department of Justice issued a subpoena to the Company in connection with its criminal investigation into competitive practices in the label stock industry. The Company produced documents and provided testimony in response to the subpoena.

On May 25, 2004, officials from the EC, assisted by officials from national competition authorities, launched unannounced inspections of and obtained documents from the Company's pressure-sensitive materials facilities in the Netherlands and Germany. The investigation apparently sought evidence of unlawful anticompetitive activities affecting the European paper and forestry products sector, including the label stock market. The Company cooperated with the investigation.

Based on published press reports, certain other European producers of paper and forestry products received similar visits from European authorities. One such producer, UPM, stated that it had decided to disclose to competition authorities "any conduct that has not comported with applicable competition laws," and that it had received conditional immunity in the European Union ("EU") and Canada with respect to certain conduct it has previously disclosed to them, contingent on full cooperation. In February 2006, UPM announced that the U.S. Department of Justice had agreed not to prosecute UPM in connection with the label stock investigation, and, further, that UPM had received conditional immunity in jurisdictions in addition to the EU and Canada.

On July 9, 2004, the Competition Law Division of the Department of Justice of Canada notified the Company that it was seeking information from the Company in connection with a label stock investigation. The Company is cooperating with the investigation.

On May 18, 2005, Ronald E. Dancer filed a purported class action in the United States District Court for the Central District of California against the Company, Mr. Neal, Karyn Rodriguez (VP and Treasurer) and James Bochinski (then VP, Compensation and Benefits), for alleged breaches of fiduciary duty under the Employee Retirement Income Security Act to the Company's Employee Savings Plan and Plan participants. The plaintiff alleges, among other things, that permitting investment in and retention of Company Common Stock under the Plan was imprudent because of alleged anticompetitive activities by the Company, and that failure to disclose such activities to the Plan and participants was unlawful. Plaintiff seeks an order compelling defendants to compensate the Plan for any losses and other relief. The parties stipulated to transfer the case to the judge in the consolidated case, "In Re Avery Dennison Corporation Securities Litigation" referenced above, and the court has approved the parties' stipulation to stay the matter pending the outcome of the government investigation of alleged anticompetitive conduct by the Company. The Company intends to defend this matter vigorously.

On August 18, 2005, the Australian Competition and Consumer Commission notified two of the Company's subsidiaries, Avery Dennison Material Pty Limited and Avery Dennison Australia Pty Ltd, that it was seeking information in connection with a label stock investigation. The Company is cooperating with the investigation.

On October 19, 2006, the U.S. Department of Justice notified the Company that the U.S. Department of Justice had decided to close its criminal investigation (initiated in April 2003) into competitive practices in the label stock industry without further action.

On November 15, 2006, the Company announced that it had been notified that the European Commission ("EC") had closed its investigation (initiated in May 2004) into the Company's competitive activities in the label stock industry, with no action.

The Board of Directors created an ad hoc committee comprised of independent directors to oversee the foregoing matters.

The Company is unable to predict the effect of these matters at this time, although the effect could be adverse and material.

#### **Environmental**

The Company has been designated by the U.S. Environmental Protection Agency ("EPA") and/or other responsible state agencies as a potentially responsible party ("PRP") at fourteen waste disposal or waste recycling sites, which are the subject of separate investigations or proceedings concerning alleged soil and/or groundwater contamination and for which no settlement of the Company's liability has been agreed. The Company is participating with other PRPs at such sites, and anticipates that its share of cleanup costs will be determined pursuant to remedial agreements entered into in the normal course of negotiations with the EPA or other governmental authorities.

The Company has accrued liabilities for these and certain other sites, including sites in which governmental agencies have designated the Company as a PRP, where it is probable that a loss will be incurred and the cost or amount of loss can be reasonably estimated. However, because of the uncertainties associated with environmental assessment and remediation activities, future expense to remediate the currently identified sites and any sites which could be identified in the future for cleanup could be higher than the liability currently accrued.

During the third quarter of 2006, the Company recognized an additional liability of \$13 million for estimated environmental remediation costs for a former operating facility, for which \$2 million had been accrued in the second quarter of 2006. The amount accrued represents the lower end of the current estimated range of \$15 million to \$17 million for costs expected to be incurred. Management considered additional information provided by outside consultants in revising its previous estimates of expected costs. This estimate could change depending on various factors such as modification of currently planned remedial actions, changes in the site conditions, a change in the estimated time to complete remediation, changes in laws and regulations affecting remediation requirements and other factors.

Other amounts currently accrued are not significant to the consolidated financial position of the Company and, based upon current information, management believes it is unlikely that the final resolution of these matters will significantly impact the Company's consolidated financial position, results of operations or cash flows.

#### **Other**

In 2005, the Company contacted relevant authorities in the U.S. and reported on the results of an internal investigation of potential violations of the U.S. Foreign Corrupt Practices Act. The transactions at issue were carried out by a small number of employees of the Company's reflectives business in China, and involved, among other things, impermissible payments or attempted impermissible payments. The payments or attempted payments and the contracts associated with them appear to have been relatively

minor in amount and of limited duration. Corrective and disciplinary actions have been taken. Sales of the Company's reflectives business in China in 2005 were approximately \$7 million. Based on findings to date, no changes to the Company's previously filed financial statements are warranted as a result of these matters. However, the Company expects that fines or other penalties could be incurred. While the Company is unable to predict the financial or operating impact of any such fines or penalties, it believes that its behavior in detecting, investigating, responding to and voluntarily disclosing these matters to authorities should be viewed favorably.

The Company and its subsidiaries are involved in various other lawsuits, claims and inquiries, most of which are routine to the nature of the business. Based upon current information, management believes that the resolution of these other matters will not materially affect the Company's financial position.

The Company participates in receivable financing programs, both domestically and internationally, with several financial institutions whereby advances may be requested from these financial institutions. Such advances are guaranteed by the Company. At December 30, 2006, the Company had guaranteed approximately \$22 million.

The Company guaranteed up to approximately \$22 million of certain foreign subsidiaries' obligations to their suppliers as of December 30, 2006.

#### **NOTE 9. SHAREHOLDERS' EQUITY AND STOCK-BASED COMPENSATION**

##### **Common Stock and Common Stock Repurchase Program**

The Company's Certificate of Incorporation authorizes five million shares of \$1 par value preferred stock (none outstanding), with respect to which the Board of Directors may fix the series and terms of issuance, and 400 million shares of \$1 par value voting common stock.

In December 1997, the Company redeemed the outstanding preferred stock purchase rights and issued new preferred stock purchase rights, declaring a dividend of one such right on each outstanding share of common stock, and since such time, the Company has issued such rights with each share of common stock that has been subsequently issued. When exercisable, each new right will entitle its holder to buy one one-hundredth of a share of Series A Junior Participating Preferred Stock at a price of \$150 per one one-hundredth of a share until October 31, 2007. The rights will become exercisable if a person acquires 20% or more of the Company's common stock or makes an offer, the consummation of which will result in the person's owning 20% or more of the Company's common stock. In the event the Company is acquired in a merger, each right entitles the holder to purchase common stock of the acquiring company having a market value of twice the exercise price of the right. Likewise, if a person or group acquires 20% or more of the Company's common stock, each right entitles the holder to purchase the Company's common stock with a market value equal to twice the exercise price of the right. The rights may

be redeemed by the Company at a price of one cent per right at any time prior to a person's or group's acquiring 20% of the Company's common stock. The 20% threshold may be reduced by the Company to as low as 10% at any time prior to a person's acquiring a percent of Company stock equal to the lowered threshold.

The Board of Directors previously authorized the issuance of up to 18 million shares to be used for the issuance of stock options and the funding of other Company obligations arising from various employee benefit plans. The remaining shares available are held in the Company's Employee Stock Benefit Trust ("ESBT"). The ESBT common stock is carried at market value with changes in share price from prior reporting periods reflected as an adjustment to capital in excess of par value.

On October 26, 2006, the Board of Directors authorized the repurchase of an additional 5 million shares of the Company's outstanding common stock, resulting in a total authorization of approximately 7.4 million shares at that date. The repurchased shares may be reissued under the Company's stock option and incentive plans or used for other corporate purposes. As of December 30, 2006, approximately 4.9 million shares were available for repurchase under the Board of Directors' authorization.

#### Stock Option and Incentive Plans

The Company maintains various stock option and incentive plans. Under these plans, stock options granted to directors and employees may be granted at no less than 100% of the fair market value of the Company's common stock on the date of the grant. Options generally vest ratably over a two-year period for directors, and over a four-year period for employees. Prior to fiscal year 2005, options for certain officers may cliff-vest over a 3- to 9.75-year period based on the Company's performance. Unexercised options expire ten years from the date of grant. All stock options granted under these plans had an exercise price equal to the fair market value of the underlying common stock on the date of grant.

The Company's stock-based compensation expense is the estimated fair value of options granted, amortized on a straight-line

basis over the requisite service period. The fair value of the Company's stock option awards is estimated as of the date of grant using the Black-Scholes option-pricing model. This model requires input assumptions for the Company's expected dividend yield, expected volatility, risk-free interest rate and the expected life of the options.

*Expected dividend yield* was based on the current annual dividend divided by the 12-month average monthly stock price prior to grant.

*Expected volatility* for options granted during 2006 was based on both historical and implied volatility. Expected volatility for options granted prior to 2006 was based on historical volatility of the Company's stock price.

*Risk-free rate* was based on the average of the weekly T-Bond rate over the expected option term of 5.8 years.

*Expected term* was determined based on historical experience under the Company's stock option plan.

*Forfeiture rate* assumption of 5% was determined based on historical data of the Company's stock option forfeitures during the last twelve years.

The weighted-average fair value per share of options granted during 2006 was \$15.50, compared to \$12.64 for the year ended 2005 and \$11.18 for the year ended 2004.

The underlying assumptions used were as follows:

	2006	2005	2004
Risk-free interest rate	4.74%	4.11%	3.86%
Expected stock price volatility	22.51	20.55	19.81
Expected dividend yield	2.58	2.67	3.01
Expected option term	5.8 years	7 years	7 years

As permitted by SFAS No. 123(R), underlying assumptions used for stock options granted prior to January 1, 2006 were retained.

The following table sets forth stock option information relative to the Company's stock option plans during 2006:

	Number of options (in thousands)	Weighted-average exercise price	Weighted-average contractual life (in years)	Aggregate intrinsic value (in millions)
Outstanding at December 31, 2005	10,853.2	\$ 56.32	6.90	—
Granted	1,494.1	67.68	—	—
Exercised	(1,217.5)	50.11	—	—
Forfeited or expired	(941.4)	59.12	—	—
Outstanding at December 30, 2006	10,188.4	\$ 58.47	6.67	\$ 100.2
Options vested and expected to vest at December 30, 2006	9,188.1	58.27	6.54	92.1
Options exercisable at December 30, 2006	5,030.4	\$ 55.64	5.01	\$ 62.6

The total intrinsic value of stock options exercised during 2006 was \$16.8 million and cash received by the Company from the exercise of these stock options was \$54.1 million. The windfall tax benefit realized by the Company from these exercised options was \$3.7 million. The intrinsic value of the stock options is based on the amount by which the market value of the underlying stock exceeds the exercise price of the option.

The following table provides a summary of the Company's stock option plans for the last three years:

	2006		2005		2004	
	Number of options (in thousands)	Weighted-average exercise price	Number of options (in thousands)	Weighted-average exercise price	Number of options (in thousands)	Weighted-average exercise price
Outstanding at beginning of year	10,853.2	\$ 56.32	9,503.7	\$ 55.18	7,951.9	\$ 52.66
Granted	1,494.1	67.68	1,856.8	59.23	2,381.7	59.22
Exercised	(1,217.5)	50.11	(304.0)	36.95	(586.5)	36.02
Forfeited or expired	(941.4)	59.12	(203.3)	58.79	(243.4)	58.38
Outstanding at year end	10,188.4	\$ 58.47	10,853.2	\$ 56.32	9,503.7	\$ 55.18

The following table summarizes the Company's unvested stock options during 2006:

	Number of options (in thousands)	Weighted-average exercise price
Unvested options outstanding at December 31, 2005	5,607.0	\$ 58.99
Granted	1,494.1	67.68
Vested	(1,065.8)	59.58
Forfeited	(877.3)	59.96
Unvested options outstanding at December 30, 2006	5,158.0	\$ 61.22

As of December 30, 2006, the Company had approximately \$39 million of unrecognized compensation cost related to unvested stock option awards granted under the Company's plans. This cost is expected to be recognized over the weighted-average remaining requisite service period for these awards of approximately 4 years.

The following table summarizes information on stock options outstanding and exercisable at December 30, 2006:

	Options outstanding			Options exercisable	
	Number outstanding (in thousands)	Weighted- average remaining contractual life (in years)	Weighted- average exercise price	Number exercisable (in thousands)	Weighted- average exercise price
Range of exercise prices					
\$ 38.31 to 50.72	1,033.0	2.15	\$ 45.66	1,031.7	\$ 45.66
51.13 to 59.47	6,501.4	6.83	57.63	3,211.1	56.90
59.65 to 67.80	2,654.0	8.04	65.49	787.6	63.58
\$ 38.31 to 67.80	10,188.4	6.67	\$ 58.47	5,030.4	\$ 55.64

#### Restricted Stock Units and Restricted Stock Grants

In December 2005, the Compensation and Executive Personnel Committee of the Board of Directors approved the award of RSUs, which were issued under the Company's stock option and incentive plan. In 2006 and 2005, RSUs were granted to two groups of employees. These RSUs include dividend equivalents in the form of additional RSUs, which are equivalent to the amount of the dividend paid or property distributed on a single share of common stock multiplied by the number of RSUs in the employee's account. Vesting for the two groups of RSUs is as follows:

- A vesting period of 3 years provided that a certain performance objective is met at the end of the third year after the year of the award. If the performance objective is not achieved at the end of the third year, the same unvested RSUs will be subject to meeting the performance objective at the end of the fourth year, and if not achieved at the end of the fourth year, then the fifth year following the year of grant, or
- A vesting period of 2 or 3 years, provided that employment continues for 2 or 3 years after the date of the award

For both groups, if the above vesting conditions are not met, the RSUs will be forfeited.

The following table summarizes information about awarded RSUs:

	Number of RSUs (in thousands)	Weighted-average grant-date fair value
Outstanding at December 31, 2005	93.5	\$ 59.47
Granted	87.3	67.80
Forfeited or expired	(10.5)	59.47
Outstanding at December 30, 2006	170.3	\$ 63.74

The total compensation expense related to RSUs and restricted stock is amortized on a straight-line basis over the requisite service period.

During 2006, the pretax compensation expense related to RSUs was \$2.9 million, or \$.02 per share, assuming dilution.

During 2005, the Company also awarded 30,000 shares of restricted stock, which vest in two equal increments: the first in 2009; the second in 2012. Pretax compensation expense for this award was \$.3 million in 2006 and \$.2 million in 2005.

As of December 30, 2006, the Company has approximately \$8.1 million of unrecognized compensation cost related to unvested RSUs and restricted stock. This cost is expected to be recognized over the remaining requisite service period for these awards (weighted average remaining service period of approximately 2 years for RSUs and 4 years for restricted stock).

#### NOTE 10. COST REDUCTION ACTIONS

Severance charges recorded under the restructuring actions below are included in "Other accrued liabilities" in the Consolidated Balance Sheet. Severance and related costs represent cash paid or to be paid to employees terminated under these actions. Asset impairments are based on the estimated market value of the assets. Charges below are included in "Other expense, net" in the Consolidated Statement of Income.

#### 2006

In 2006, the Company continued its cost reduction efforts that were initiated in late 2005 and implemented additional actions, resulting in a further headcount reduction of approximately 590 positions, as well as the impairment of certain assets. At December 30, 2006, approximately 155 employees impacted by these actions remain with the Company, and are expected to leave in 2007. Pretax charges related to these actions totaled \$29.3 million, including severance and related costs of \$21.1 million, impairment of fixed assets and buildings of \$6.9 million and lease cancellation charges of \$1.3 million. The table below details the accruals and payments related to these actions:

(In millions)	Pressure-sensitive Materials Segment	Office and Consumer Products Segment	Retail Information Services Segment	Other specialty converting businesses	Corporate	Total
<b>Severance and other employee costs</b>						
Accrual at April 1, 2006	\$ 2.6	\$ .8	\$ 2.0	\$ —	\$ —	\$ 5.4
Accrual at July 1, 2006	2.0	—	2.0	.7	—	4.7
Accrual at September 30, 2006	.8	—	3.6	.1	—	4.5
Accrual at December 30, 2006	1.9	1.5	1.8	1.3	—	6.5
Total accruals for 2006 actions	7.3	2.3	9.4	2.1	—	21.1
Payments	(4.5)	(.8)	(5.3)	(1.4)	—	(12.0)
Balance at December 30, 2006	\$ 2.8	\$ 1.5	\$ 4.1	\$ .7	\$ —	\$ 9.1
<b>Asset Impairments</b>						
Buildings	\$ .6	\$ —	\$ —	\$ —	\$ 1.3	\$ 1.9
Machinery and equipment	1.7	.7	.5	1.6	.5	5.0
<b>Other</b>						
Lease cancellations	—	—	1.3	—	—	1.3
	\$ 2.3	\$ .7	\$ 1.8	\$ 1.6	\$ 1.8	\$ 8.2



**Fourth Quarter 2005**

In the fourth quarter of 2005, the Company recorded a pretax charge of \$55.5 million associated with restructuring actions (\$41.1 million), as well as expected product line divestitures (\$14.4 million). These actions were part of the Company's cost reduction efforts, which are expected to improve the Company's global operating efficiencies. The charge included severance and related costs of \$32.9 million related to the elimination of approximately 850 positions worldwide. Final payments to the terminated employees will be made during 2007. At December 30, 2006, approximately 85 employees impacted by these actions remain with the Company, and are expected to leave in 2007. Also included in the charge was \$22.6 million related to asset impairment, lease cancellation costs and other associated costs. The table below details the payments related to this program:

(In millions)	Pressure-sensitive Materials Segment	Office and Consumer Products Segment	Retail Information Services Segment	Other specialty converting businesses	Corporate	Total
<b>Severance and other employee costs</b>						
Beginning balance	\$ 15.1	\$ 6.8	\$ 5.6	\$ 2.5	\$ 2.9	\$ 32.9
Payments	(2.5)	(1.4)	(.4)	(1.0)	—	(5.3)
Balance at December 31, 2005	12.6	5.4	5.2	1.5	2.9	27.6
Payments	(9.1)	(5.4)	(3.0)	(1.5)	(1.4)	(20.4)
Balance at December 30, 2006	\$ 3.5	\$ —	\$ 2.2	\$ —	\$ 1.5	\$ 7.2
<b>Asset Impairments</b>						
Buildings	\$ 2.4	\$ —	\$ —	\$ —	\$ .8	\$ 3.2
Machinery and equipment	.1	10.7	.7	2.9	1.3	15.7
Capitalized software	—	—	—	—	2.5	2.5
<b>Other</b>						
Lease cancellations	—	—	.8	—	—	.8
Other costs	—	—	.4	—	—	.4
	\$ 2.5	\$ 10.7	\$ 1.9	\$ 2.9	\$ 4.6	\$ 22.6

**Second Quarter 2005**

In the second quarter of 2005, the Company recorded a pretax charge of \$2.1 million relating to asset impairments (\$1.4 million) and restructuring costs (\$.7 million). The asset impairment charges represented impairment of a building for \$.7 million in other specialty converting businesses and write-off of machinery and equipment for \$.7 million in the Pressure-sensitive Materials segment.

**First Quarter 2005**

In the first quarter of 2005, the Company recorded a pretax charge of \$6.7 million relating to restructuring costs and asset impairment charges, partially offset by a gain on sale of assets of \$3.4 million. The charge included severance and related costs of \$4 million related to the elimination of approximately 170 positions in the Office and Consumer Products segment as a result of the Company's closure of the Gainesville, Georgia label converting plant. As of December 30, 2006, all employees impacted by these actions had left the Company and final payments were made. Also included in the charge was \$2.7 million related to impairment of buildings and land in the Pressure-sensitive Materials segment.

**Second Quarter 2004**

In the second quarter of 2004, the Company recorded a pretax charge of \$13.8 million relating to restructuring costs, asset impairments and planned disposition of property, plant and equipment, and lease cancellation costs primarily associated with the completion of the Company's integration of the Jackstädt GmbH ("Jackstädt") acquisition in the Company's Pressure-sensitive Materials segment, as well as cost reduction actions in the Office and Consumer Products and Retail Information Services segments. The charge included severance and related costs of \$7.7 million related to approximately 195 positions worldwide. All employees impacted by these actions had left the Company in 2005 and final payments were made in 2006. Also included in the charge was \$6.1 million related to asset impairments and disposition of property, plant and equipment, lease cancellation costs and other associated costs in the Pressure-sensitive Materials segment.

**First Quarter 2004**

In the first quarter of 2004, the Company recorded a pretax charge of \$21.4 million relating to restructuring costs and asset impairment charges as part of the Company's integration of the Jackstädt acquisition in the Company's Pressure-sensitive Materials segment. The charge included severance and related costs of \$15.9 million, involving the elimination of approximately 210 positions. All employees impacted by these actions had left the Company in 2004 and final payments were made in 2006. Also included in the charge was \$2.9 million related to impairment of software and \$2.6 million related to impairment and planned disposition of machinery and equipment.

**NOTE 11. TAXES BASED ON INCOME**

Taxes based on income were as follows:

(In millions)	2006	2005	2004
Current:			
U.S. federal tax	\$ (4.5)	\$ 33.5	\$ 35.7
State taxes	4.7	3.0	6.0
International taxes	73.8	29.7	65.0
	74.0	66.2	106.7
Deferred:			
U.S. federal tax	8.8	(11.8)	8.7
State taxes	.8	(5.2)	2.7
International taxes	(25.2)	14.3	(24.4)
	(15.6)	(2.7)	(13.0)
Taxes on income	\$ 58.4	\$ 63.5	\$ 93.7

The principal items accounting for the difference in taxes as computed at the U.S. statutory rate, and as recorded, were as follows:

(In millions)	2006	2005	2004
Computed tax at 35% of income from continuing operations before taxes	\$ 149.0	\$ 128.3	\$ 131.4
Increase (decrease) in taxes resulting from:			
State taxes, net of federal tax benefit	3.4	(3.0)	6.9
Foreign earnings taxed at different rates	(54.7)	(31.4)	(41.7)
Valuation allowance	(5.2)	(15.6)	15.3
Jobs Act repatriation of earnings	.1	13.5	—
Tax credits	(4.9)	(6.4)	(6.6)
Tax contingencies and audit settlements	(8.1)	(9.0)	(7.9)
Other items, net	(6.5)	(1.4)	(3.1)
Taxes on income from continuing operations	73.1	75.0	94.3
Taxes on income from and gain on sale of discontinued operations	(14.7)	(11.5)	(.6)
Taxes on income	\$ 58.4	\$ 63.5	\$ 93.7

Consolidated income before taxes for U.S. and international operations was as follows:

(In millions)	2006	2005	2004
U.S.	\$ 107.4	\$ 99.5	\$ 168.3
International	318.2	267.3	207.0
Income from continuing operations before taxes	425.6	366.8	375.3
Income (loss) from discontinued operations before taxes	—	(76.9)	(1.9)
Income before taxes	\$ 425.6	\$ 289.9	\$ 373.4

U.S. income taxes have not been provided on certain undistributed earnings of international subsidiaries of approximately \$1.16 billion and \$924 million at years ended 2006 and 2005, respectively, because such earnings are considered to be reinvested indefinitely outside the U.S., except for the one-time repatriation of earnings in 2005, provided for by the American Jobs Creation Act of 2004 ("Jobs Act").

The Jobs Act, enacted on October 22, 2004, provided for a temporary 85% dividends-received deduction on certain foreign earnings repatriated before December 31, 2005. The deduction resulted in an approximate 5.25% federal tax rate on the repatriated earnings. During the third quarter of 2005, the Company's Chief Executive Officer and Board of Directors approved a domestic reinvestment plan as required by the Jobs Act to repatriate \$344 million of foreign earnings in fiscal 2005. The repatriation of earnings took place in the fourth quarter of 2005, and resulted in a one-time incremental expense of \$13.5 million.

The effective tax rate on continuing operations includes the benefit from the release of certain valuation allowances. The net impact of valuation allowance changes is \$5.2 million and \$15.6 million for years ended 2006 and 2005, respectively. Included in the effective tax rate on continuing operations is the net benefit from several favorable global tax audit settlements and closure of certain tax years, in the amount of \$8.1 million and \$9 million for years ended 2006 and 2005, respectively.

The income from discontinued operations in 2006 includes a \$14.9 million tax benefit from the divestiture of the raised reflective pavement marker business. This tax benefit resulted from the capital loss recognized from the sale of the business, which was a stock sale. The capital loss will be offset against capital gains recognized in 2006 related to the sale of an investment, as well as carried back to capital gains recognized in previous years, as allowable.

The amount of income taxes the Company pays is subject to ongoing audits by taxing jurisdictions around the world. The Company's estimate of the potential outcome of any uncertain tax issue is subject to management's assessment of relevant risks, facts, and circumstances existing at that time. The Company believes that it has adequately provided for reasonably foreseeable outcomes related to these matters. However, the Company's future results may include favorable or unfavorable adjustments to its estimated tax liabilities in the period the assessments are made or resolved, which may impact the Company's effective tax rate. The Company is currently subject to tax examinations by federal, state and foreign tax authorities.

Deferred income taxes reflect the temporary differences between the amounts at which assets and liabilities are recorded for financial reporting purposes and the amounts utilized for tax purposes. The primary components of the temporary differences that gave rise to the Company's deferred tax assets and liabilities were as follows:

(In millions)	2006	2005
Accrued expenses not currently deductible	\$ 42.1	\$ 34.1
Net operating losses and foreign tax credit carryforwards	69.4	60.1
Capital loss carryforward	3.6	—
Postretirement and postemployment benefits	49.6	50.3
Pension costs	18.3	9.3
Inventory reserves	8.2	12.4
Other	4.4	6.1
Valuation allowance	(67.5)	(53.2)
Total deferred tax assets	128.1	119.1
Depreciation and amortization	(127.7)	(134.3)
Total deferred tax liabilities	(127.7)	(134.3)
Total net deferred tax assets (liabilities)		
from continuing operations	\$ .4	\$ (15.2)
Net deferred tax assets from discontinued operations	—	2.6
Total net deferred tax assets (liabilities)	\$ .4	\$ (12.6)

Operating loss carryforwards of foreign subsidiaries for 2006 and 2005 are \$175 million and \$143.7 million, respectively. Credit carryforwards for 2006 and 2005 related to foreign investment tax credits totaled \$3.5 million and \$3.1 million, respectively. California research credit carryforward for 2006 and 2005 totaled \$4.2 million and \$3.9 million, respectively. Net operating losses, if unused, of \$19.4 million will expire by 2011, and \$44.1 million will expire after 2011. Net operating losses of \$111.5 million can be carried forward

indefinitely. The foreign investment tax credit carryforwards begin to expire in 2013. The California research credit can be carried forward indefinitely. The Company has established a valuation allowance for the net operating loss and credit carryforwards not expected to be utilized. The valuation allowance for 2006 and 2005 is \$67.5 million and \$53.2 million, respectively. The increase in 2006 is primarily attributable to the \$17.8 million deferred tax asset and related valuation allowance resulting from the adoption of SFAS No. 158.

The Company has been granted tax holidays in several jurisdictions including China, Thailand and Bangladesh. The tax holidays expire between 2007 and 2015. These tax holidays have reduced the Company's consolidated effective tax rate on continuing operations by less than 1% in 2006 and 2005.

In July 2006, the FASB issued Financial Interpretation ("FIN") No. 48, "Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109," which is a change in accounting for income taxes. FIN No. 48 specifies how tax benefits from uncertain tax positions are to be recognized, measured, and derecognized in financial statements; requires certain disclosures of uncertain tax matters; specifies how reserves for uncertain tax positions should be classified on the balance sheet; and provides transition and interim period guidance, among other provisions. FIN No. 48 is effective for fiscal years beginning after December 15, 2006 and as a result, is effective for the Company in the first quarter of 2007. The Company is currently evaluating the impact of FIN No. 48 on the consolidated results of operations and financial position.

#### NOTE 12. SEGMENT INFORMATION

The accounting policies of the segments are described in Note 1, "Summary of Significant Accounting Policies." Intersegment sales are recorded at or near market prices and are eliminated in determining consolidated sales. The Company evaluates performance based on income from operations before interest expense and taxes. General corporate expenses are also excluded from the computation of income from operations for the segments.

The Company does not disclose total assets by operating segment since the Company does not produce and review such information internally. The Company does not disclose revenues from external customers for each product because it is impracticable to do so. As the Company's reporting structure is not organized by country, results by individual country are not provided because it is impracticable to do so.

Financial information by reportable segment and other businesses from continuing operations is set forth below:

(In millions)	2006 <sup>(1)</sup>	2005 <sup>(2)</sup>	2004 <sup>(3)</sup>
<b>Net sales to unaffiliated customers:</b>			
Pressure-sensitive Materials	\$ 3,236.3	\$ 3,114.5	\$ 2,984.8
Office and Consumer Products	1,072.0	1,136.1	1,172.5
Retail Information Services	667.7	630.4	592.7
Other specialty converting businesses	599.9	592.5	567.0
Net sales to unaffiliated customers	\$ 5,575.9	\$ 5,473.5	\$ 5,317.0

#### Intersegment sales:

Pressure-sensitive Materials	\$ 161.5	\$ 163.2	\$ 169.3
Office and Consumer Products	1.8	2.0	2.2
Retail Information Services	3.4	6.7	6.8
Other specialty converting businesses	14.4	15.2	18.8
Eliminations	(181.1)	(187.1)	(197.1)
Intersegment sales	\$ -	\$ -	\$ -

#### Income from continuing operations before taxes:

Pressure-sensitive Materials	\$ 301.2	\$ 258.1	\$ 221.4
Office and Consumer Products	179.0	168.0	186.4
Retail Information Services	45.0	37.7	43.4
Other specialty converting businesses	17.2	14.1	39.9
Corporate expense	(61.3)	(53.2)	(57.1)
Interest expense	(55.5)	(57.9)	(58.7)
Income from continuing operations before taxes	\$ 425.6	\$ 366.8	\$ 375.3

#### Capital expenditures:

Pressure-sensitive Materials	\$ 75.8	\$ 74.1	\$ 115.1
Office and Consumer Products	13.6	24.8	19.6
Retail Information Services	25.6	31.7	36.5
Other specialty converting businesses	36.1	38.5	31.1
Corporate	2.1	2.3	1.6
Discontinued operations	-	.2	1.8
Capital expenditures <sup>(4)</sup>	\$ 153.2	\$ 171.6	\$ 205.7

#### Depreciation expense:

Pressure-sensitive Materials	\$ 88.2	\$ 86.2	\$ 80.7
Office and Consumer Products	20.7	24.6	25.3
Retail Information Services	17.8	16.3	14.3
Other specialty converting businesses	23.1	21.1	18.9
Corporate	4.0	6.0	6.6
Discontinued operations	.5	1.5	1.4
Depreciation expense	\$ 154.3	\$ 155.7	\$ 147.2

(1) Results for 2006 include "Other expense, net" totaling \$36.2, which consists of restructuring costs, asset impairment and lease cancellation charges of \$29.8, environmental remediation costs of \$13, costs of \$.4 related to a divestiture, accrual related to a patent lawsuit of \$.4 and charitable contribution of \$10 to the Avery Dennison Foundation, partially offset by gain on sale of investment of \$(10.5), gain on sale of assets of \$(5.3) and gain on curtailment and settlement of a pension obligation of \$(1.6). Of the \$36.2 total, the Pressure-sensitive Materials segment recorded \$9.3, the Office and Consumer Products segment recorded \$(2.3), the Retail Information Services segment recorded \$11.2, the other specialty converting businesses recorded \$3.7 and Corporate recorded \$14.3. See Note 10, "Cost Reduction Actions," for further information.

(2) Results for 2005 include "Other expense, net" totaling \$63.6, which consists of restructuring costs, asset impairment and lease cancellation charges of \$65.6, legal accrual related to a patent lawsuit of \$3.8, partially offset by gain on sale of assets of \$(5.8). Of the \$63.6 total, the Pressure-sensitive Materials segment recorded \$23, the Office and Consumer Products segment recorded \$21.8, the Retail Information Services segment recorded \$7.5, the other specialty converting businesses recorded \$6.2 and Corporate recorded \$5.1. See Note 10, "Cost Reduction Actions," for further information.

(3) Results for 2004 include "Other expense" totaling \$35.2, which consists of restructuring costs, asset impairment and lease cancellation charges, of which the Pressure-sensitive Materials segment recorded \$34.4, the Office and Consumer Products segment recorded \$.5 and the Retail Information Services segment recorded \$.3. See Note 10, "Cost Reduction Actions," for further information.

(4) Capital expenditures accrued but not paid were approximately \$18 million in 2006, \$27 million in 2005 and \$27 million in 2004. Capital expenditures refer to purchases of property, plant and equipment.

Financial information relating to the Company's continuing operations by geographic area is set forth below:

(In millions)	2006	2005	2004
<b>Net sales to unaffiliated customers:</b>			
U.S.	\$ 2,333.8	\$ 2,346.8	\$ 2,416.2
Europe	1,798.8	1,805.5	1,710.7
Asia	748.7	650.6	559.7
Latin America	332.4	288.9	255.0
Other international	362.2	381.7	375.4
Net sales	\$ 5,575.9	\$ 5,473.5	\$ 5,317.0
<b>Property, plant and equipment, net:</b>			
U.S.	\$ 562.5	\$ 580.6	\$ 599.6
International	746.9	715.1	774.8
Property, plant and equipment, net	\$ 1,309.4	\$ 1,295.7	\$ 1,374.4

Revenues are attributed to geographic areas based on the location to which the product is shipped. Export sales from the United States to unaffiliated customers are not a material factor in the Company's business.

NOTE 13. QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

(In millions, except per share data)	First Quarter <sup>(1)</sup>	Second Quarter <sup>(2)</sup>	Third Quarter <sup>(3)</sup>	Fourth Quarter <sup>(4)</sup>
<b>2006</b>				
Net sales from continuing operations	\$ 1,337.2	\$ 1,409.7	\$ 1,417.6	\$ 1,411.4
Gross profit from continuing operations	355.2	393.0	390.7	389.5
Net income	68.7	112.0	85.0	101.5
Net income per common share	.69	1.12	.85	1.02
Net income per common share, assuming dilution	.69	1.12	.85	1.01
<b>2005</b>				
Net sales from continuing operations	\$ 1,342.8	\$ 1,411.7	\$ 1,355.0	\$ 1,364.0
Gross profit from continuing operations	351.9	388.1	357.6	378.6
Net income	57.7	89.4	86.2	(6.9)
Net income per common share	.58	.89	.86	(.07)
Net income per common share, assuming dilution	.57	.89	.86	(.07)

(1) Results in the first quarter 2006 include pretax other expense totaling \$7.6 consisting of \$7.2 of restructuring costs and asset impairment charges and \$.4 for legal accrual related to a patent lawsuit.

Results in the first quarter 2005 include a \$6.7 pretax charge for restructuring costs and asset impairment charges, partially offset by a gain on sale of assets of \$3.4.

(2) Results in the second quarter 2006 include pretax net other expense totaling \$4 consisting of restructuring costs and asset impairment charges of \$6.1, charitable contribution of \$10 to the Avery Dennison Foundation, partially offset by gain on sale of investment of \$(10.5), and gain on curtailment and settlement of a pension obligation of \$(1.6).

Results in the second quarter 2005 include a \$2.1 pretax charge for restructuring costs and asset impairment charges.

(3) Results in the third quarter 2006 include pretax other expense of \$19.5, which consists of environmental remediation costs of \$13, restructuring costs and asset impairment charges of \$6.1, and costs of \$.4 related to a divestiture.

Results in the third quarter 2005 include a \$1.3 pretax charge for asset impairment charges.

(4) Results in the fourth quarter 2006 include pretax net other expense totaling \$5.1 consisting of restructuring costs, asset impairment and lease cancellation charges of \$10.4, partially offset by gain on sale of assets of \$(5.3).

Results in the fourth quarter 2005 include a \$55.5 pretax charge for restructuring costs, asset impairment and lease cancellation charges, and legal accrual related to a patent lawsuit of \$3.8, partially offset by a gain on sale of assets of \$2.4.



## STATEMENT OF MANAGEMENT RESPONSIBILITY FOR FINANCIAL STATEMENTS

The consolidated financial statements and accompanying information were prepared by and are the responsibility of management. The statements were prepared in conformity with accounting principles generally accepted in the United States of America and, as such, include amounts that are based on management's best estimates and judgments.

Oversight of management's financial reporting and internal accounting control responsibilities is exercised by the Board of Directors, through an Audit Committee, which consists solely of outside directors (see page 70). The Committee meets periodically with financial management, internal auditors and the independent registered public accounting firm to obtain reasonable assurance that each is meeting its responsibilities and to discuss matters concerning auditing, internal accounting control and financial reporting. The independent registered public accounting firm and the Company's internal audit department have free access to meet with the Audit Committee without management's presence.

## MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of management, including the chief executive officer and chief financial officer, the Company conducted an evaluation of the effectiveness of internal control over financial reporting based on the framework in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on the Company's evaluation under the framework in *Internal Control – Integrated Framework*, management has concluded that internal control over financial reporting was effective as of December 30, 2006. Management's assessment of the effectiveness of internal control over financial reporting as of December 30, 2006 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included herein.



Dean A. Scarborough  
President and  
Chief Executive Officer



Daniel R. O'Bryant  
Executive Vice President, Finance  
and Chief Financial Officer

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of Avery Dennison Corporation:

We have completed integrated audits of Avery Dennison Corporation's consolidated financial statements and of its internal control over financial reporting as of December 30, 2006 in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

### *Consolidated financial statements*

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, shareholders' equity, and cash flows present fairly, in all material respects, the financial position of Avery Dennison Corporation and its subsidiaries at December 30, 2006 and December 31, 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 30, 2006 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1 and Note 9, the Company changed the manner in which it accounts for stock-based compensation in 2006. As discussed in Note 6, the Company changed the manner in which it accounts for pensions and other postretirement benefits in 2006.

### *Internal control over financial reporting*

Also, in our opinion, management's assessment, included in the accompanying "Management's Report on Internal Control Over Financial Reporting," that the Company maintained effective internal control over financial reporting as of December 30, 2006 based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 30, 2006, based on criteria established in *Internal Control – Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.



PricewaterhouseCoopers LLP  
Los Angeles, California  
February 22, 2007

## DIRECTORS AND OFFICERS

### BOARD OF DIRECTORS

**Kent Kresa** <sup>2,3,4</sup>

Chairman of the Board,  
Avery Dennison Corporation  
Chairman Emeritus, Northrop  
Grumman Corporation,  
an aeronautical and defense  
systems manufacturer  
*Board member since 1999*

**Dean A. Scarborough**

President and  
Chief Executive Officer,  
Avery Dennison Corporation  
*Board member since 2000*

**Richard M. Ferry** <sup>1,3,5</sup>

Founder Chairman,  
Korn/Ferry International,  
an international executive  
search firm  
*Board member since 1985*

**Peter W. Mullin** <sup>3</sup>

Chairman, Mullin TBG,  
an executive compensation,  
benefit planning and corporate  
insurance consulting firm  
*Board member since 1988*

**David E. I. Pyott** <sup>1,5</sup>

Chairman of the Board and  
Chief Executive Officer,  
Allergan, Inc.,  
a global health care company  
*Board member since 1999*

**Peter K. Barker** <sup>1,2,3</sup>

Retired Partner, Goldman  
Sachs & Company,  
an investment banking firm  
*Board member since 2003*

**Julia A. Stewart** <sup>1,4,5</sup>

Chairman of the Board and  
Chief Executive Officer,  
IHOP Corporation,  
a restaurant chain  
*Board member since 2003*

**John T. Cardis** <sup>2,3,4</sup>

Retired Partner, Deloitte &  
Touche USA LLP,  
an audit, tax, consulting and  
financial advisory services firm  
*Board member since 2004*

**Rolf Börjesson** <sup>3,4,5</sup>

Chairman, Rexam PLC,  
a consumer packaging and  
beverage can manufacturer  
*Board member since 2005*

**Patrick T. Siewert** <sup>3,4</sup>

Senior Advisor,  
Coca-Cola Company,  
a worldwide  
beverage company  
*Board member since 2005*

**Directors Emeriti (nonvoting)****Charles D. Miller**

Retired Chairman and Chief  
Executive Officer,  
Avery Dennison Corporation

**H. Russell Smith**

Retired Chairman of the  
Executive Committee,  
Avery Dennison Corporation

- 1 – Member of Compensation and  
Executive Personnel Committee
- 2 – Member of Audit Committee
- 3 – Member of Finance Committee
- 4 – Member of Ethics and Conflict of  
Interest Committee
- 5 – Member of Nominating and  
Governance Committee

### CORPORATE OFFICERS

**Dean A. Scarborough**

President and  
Chief Executive Officer

**Robert G. van  
Schoonenberg**

Executive Vice President,  
General Counsel and Secretary

**Daniel R. O'Bryant**

Executive Vice President,  
Finance, and Chief  
Financial Officer

**Christian A. Simcic**

Group Vice President,  
Roll Materials

**Sandra Beach Lin**

Group Vice President,  
Specialty Materials and  
Converting

**Timothy S. Clyde**

Group Vice President,  
Office Products

**Robert M. Malchione**

Senior Vice President,  
Corporate Strategy  
and Technology

**J. Terry Schuler**

Senior Vice President,  
Human Resources

**Diane B. Dixon**

Senior Vice President,  
Corporate Communications  
and Advertising

**Stephen A. Mynott**

Vice President,  
Global Operations

**Mitchell R. Butier**

Vice President and  
Controller

**David N. Edwards**

Vice President and  
Chief Technology Officer

**Karyn E. Rodriguez**

Vice President and  
Treasurer

**Ahmed Rubaie**

Vice President,  
Internal Audit and Tax

**Kenneth A. Wolinsky**

Vice President and  
Chief Information Officer

## DIVISION OFFICERS

### ***Pressure-sensitive Materials***

**John L. Collins**  
Vice President, Sales,  
Fasson Roll North America

**Angelo Depietri**  
Vice President and  
General Manager,  
Materials and Office Products  
South America

**Georges Gravanis**  
Vice President, Sales  
Roll Materials Europe

**Kamran Kian**  
Vice President,  
Global Operations,  
Roll Materials

**Dagang Li**  
Vice President and  
General Manager,  
Roll Materials Greater China

**David R. Martin**  
Vice President and  
General Manager,  
Materials Australia and  
New Zealand

**John C. Quinn**  
Vice President and  
General Manager,  
Roll Materials Asia Pacific

**Donald W. Stoebe**  
Vice President and  
General Manager,  
Roll Materials Europe

**John M. Wurzburger**  
Vice President and  
General Manager,  
Fasson Roll North America

### ***Office and Consumer Products***

**Timothy G. Bond**  
Vice President and  
General Manager,  
Office Products North America

**Andy Cooper**  
Vice President and  
General Manager,  
Office Products Asia Pacific

**Hans-Guenther Klenk**  
Vice President and  
General Manager,  
Office Products Europe

### ***Retail Information Services***

**Terrence L. Hemmelgarn**  
Vice President and  
General Manager,  
Retail Information Services

**David E. Herring**  
Vice President and  
General Manager, Fastener,  
Retail Information Services

**Michael S. Johansen**  
Vice President and  
General Manager,  
Retail Information Services  
Asia Pacific

**Kim P. Macaulay**  
Vice President, Marketing,  
Information and Brand  
Management Services,  
Retail Information Services

### ***Other Specialty Converting Businesses***

**Robert B. Cornick**  
Vice President and  
General Manager,  
RFID

**William M. Goldsmith**  
Vice President and  
General Manager,  
Performance Films

**Martina L. McIsaac**  
Vice President and  
General Manager,  
Performance Polymers

**Mathew S. Mellis**  
Vice President and  
General Manager,  
Specialty Converting

**Ferdinand R. Pranch**  
Vice President and  
General Manager,  
Graphics and  
Reflective Products

**Helen M. Saunders**  
Global Commercial  
Vice President,  
Graphics and  
Reflective Products

**Kevin E. Young**  
Vice President and  
General Manager,  
Specialty Tape

## CORPORATE INFORMATION

### Counsel

Latham & Watkins LLP  
Los Angeles, California

### Independent Registered Public Accounting Firm

PricewaterhouseCoopers LLP  
Los Angeles, California

### Transfer Agent – Registrar

Computershare Trust Co., N.A.  
P. O. Box 43023  
Providence, RI 02940-3023  
(877) 498-8861  
(800) 952-9245 (hearing impaired number)  
www.computershare.com

### Annual Meeting

The Annual Meeting of Shareholders will be held at 1:30 p.m. on April 26, 2007, in the Conference Center of the Avery Dennison Miller Corporate Center, 150 North Orange Grove Boulevard, Pasadena, California.

### The DirectSERVICE™ Investment Program

Shareholders of record may reinvest their cash dividends in additional shares of Avery Dennison common stock at market price. Investors may also invest optional cash payments of up to \$12,500 per month in Avery Dennison common stock at market price. Avery Dennison investors not yet participating in the program, as well as brokers and custodians who hold Avery Dennison common stock for clients, may obtain a copy of the program by writing to The DirectSERVICE™ Investment Program, c/o Computershare (include a reference to Avery Dennison in the correspondence), P.O. Box 43081, Providence, RI 02940-3081, or calling (877) 498-8861, or logging onto their Web site at <http://www.computershare.com>.

### Direct Deposit of Dividends

Avery Dennison shareholders may deposit quarterly dividend checks directly into their checking or savings accounts. For more information, call Avery Dennison's transfer agent and registrar, Computershare Trust Co., Inc., at (800) 870-2340.

### Other Information

The Company is including, as Exhibits 31.1 and 31.2 to its Annual Report on Form 10-K for fiscal year 2006 filing with the Securities and Exchange Commission ("SEC"), certificates of the Chief Executive Officer and Chief Financial Officer of the Company pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, and the Company submitted to the New York Stock Exchange ("NYSE"), the Company's annual written affirmation on May 8, 2006, along with the Chief Executive Officer's certificate that he is

not aware of any violation by the Company of NYSE's Corporate Governance listing standards.

A copy of the Company's Annual Report on Form 10-K, as filed with the SEC, will be furnished to shareholders and interested investors free of charge upon written request to the Secretary of the Corporation. Copies may also be obtained from the Company's web site, [www.averydennison.com](http://www.averydennison.com), in the "Investors" section.

### Corporate Headquarters

Avery Dennison Corporation  
Miller Corporate Center  
150 North Orange Grove Boulevard  
Pasadena, California 91103  
Phone: (626) 304-2000  
Fax: (626) 792-7312

Mailing Address:  
P.O. Box 7090  
Pasadena, California 91109-7090

### Stock and Dividend Data

Common shares of Avery Dennison are listed on the NYSE.  
Ticker symbol: AVY

	2006		2005	
	High	Low	High	Low
<b>Market Price</b>				
First Quarter	\$ 61.54	\$ 56.33	\$ 62.53	\$ 56.10
Second Quarter	63.46	55.09	61.48	51.35
Third Quarter	61.97	56.95	56.92	51.98
Fourth Quarter	69.11	60.10	59.44	50.30

Prices shown represent closing prices on the NYSE

	2006	2005
<b>Dividends Per Common Share</b>		
First Quarter	\$ .39	\$ .38
Second Quarter	.39	.38
Third Quarter	.39	.38
Fourth Quarter	.40	.39
Total	\$ 1.57	\$ 1.53

Number of shareholders of record as of year end	9,556	10,216
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Frappuccino is a registered trademark of Starbucks Corporation. Used with permission. All rights reserved.

All other brands and product names are trademarks of their respective owners.



## MORE INFORMATION

### About Avery Dennison

Learn more about our Company  
at [www.averydennison.com](http://www.averydennison.com)

### Investor information

Obtain stock quotes, financial releases and more  
at [www.investors.averydennison.com](http://www.investors.averydennison.com)  
Send inquiries via e-mail to [investorcom@averydennison.com](mailto:investorcom@averydennison.com)

### Fasson-brand products

Discover why customers value our innovative materials solutions  
at [www.fasson.com](http://www.fasson.com)

### Career opportunities

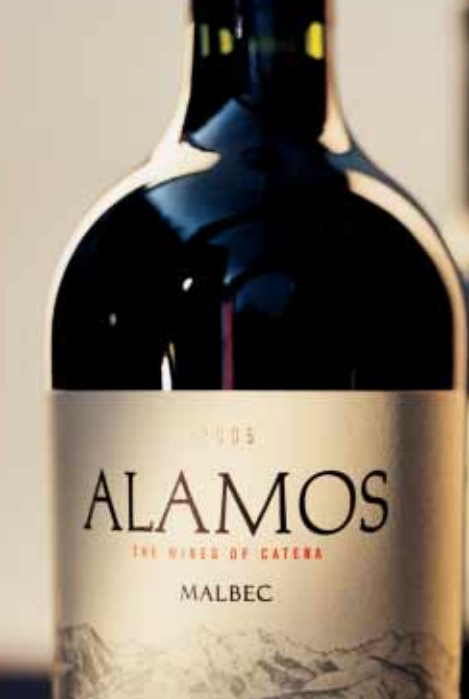
See how our employees make a world of difference  
and learn how to join our team  
at [www.averydennison.com/careers](http://www.averydennison.com/careers)

### Avery-brand office and consumer products


Call our Consumer Service Center at (800) 462-8379.

Explore a variety of useful products such as templates and software, plus creative solutions for virtually any task—including mailings, meetings and special events—at [www.avery.com](http://www.avery.com)

The screenshot displays the Avery website homepage. At the top, a red banner reads "Great results begin with Avery!". Below this is a navigation bar with links: Home, Site Map, Products, Ideas, Software/Templates, Design & Print Online, and Worldwide Contacts. The main content area is divided into several sections. On the left, there's a "Quick Search" bar with a "go" button and a "Points of Interest" section listing "Sign Kits", "Quick Peel Label Peeler", "Photo ID System", "Great Results Newsletter", "Business Resource Center", and "Home Corner". The central part features a large graphic for "Avery Mailing Solution Center" with images of "Avery Wizard" software and "Easy Peel White Mailing Labels". To the right, a "Product Catalog" lists various product types: Labels, Dividers, Cards, Binders, Highlighters, Signs, Photo ID, Media Labels, Printable Crafts, and a "View More" link. At the bottom, there are sections for "Featured Demo" (Avery Wizard) and "Templates & Software".



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150 North Orange Grove Boulevard  
Pasadena, California 91103  
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**EVERY  
DENNISON**

