EASTERN CO
Form 10-Q
October 31, 2006

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

FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED September 30, 2006

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM to .

Commission File Number: 0-599

THE EASTERN COMPANY
(Exact name of registrant as specified in its charter)

Connecticut	06-0330020
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
112 Bridge Street, Naugatuck, Connecticut	06770
(Address of principal executive offices)	(Zip Code)

(203) 729-2255
(Registrant's telephone number, including area code)

Not applicable
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding as of September 30, 2006
Common Stock, No par value	5,478,446

PART 1 - FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

THE EASTERN COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

ASSETS	September 30
Current Assets	
Cash and cash equivalents	$ 2,312,
Accounts receivable, less allowances: $282,000 - 2006; $295,000 - 2005	18,933,
Inventories	25,570,
Prepaid expenses and other assets	2,808,
Deferred income taxes	715,
Total Current Assets	50,340,
Property, Plant and Equipment	46,068,
Accumulated depreciation	(22,632,
	23,436,
Goodwill	15,779,
Trademarks	133,
Patents, technology, and licenses, less accumulated amortization	1,950,
Interest rate swap asset	
Intangible pension asset	732,
Prepaid pension cost	755,
	19,351,
TOTAL ASSETS	$ 93,129,
LIABILITIES AND SHAREHOLDERS' EQUITY	
Current Liabilities	
Accounts payable	$ 9,574,
Accrued compensation	1,798,
Other accrued expenses	2,787,
Current portion of long-term debt	2,699,
Total Current Liabilities	16,860,
Deferred income taxes	883,
Long-term debt, less current portion	18,287,
Accrued post-retirement benefits	2,014,
Accrued pension cost	5,744,

Shareholders' Equity	
Preferred Stock, no par value: Authorized and unissued 2,000,000 shares	
Common Stock, no par value: Authorized: 25,000,000 shares	
Issued: 8,011,535 shares in 2006 and 7,992,626 shares in 2005	17,955,
Treasury Stock: 2,533,089 shares	(16,655,
Retained earnings	53,082,
Accumulated other comprehensive income (loss):	
Foreign currency translation	998,
Additional minimum pension liability, net of taxes	(6,042,
Derivative financial instruments, net of taxes	
Accumulated other comprehensive loss	(5,043,
Total Shareholders' Equity	49,338,
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 93,129,

See accompanying notes.

THE EASTERN COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Nine Months Ended		
	September 30, 2006	October 1, 2005	Septembe
Net sales	$ 88,735,730	$ 80,893,693	$ 31,
Cost of products sold	(69,165,262)	(62,865,242)	(24,
Gross margin	19,570,468	18,028,451	6,
Selling and administrative expenses	(13,145,284)	(12,454,214)	(4,
Operating profit	6,425,184	5,574,237	2,
Interest expense	(732,294)	(753,853)	(
Other income	132,337	45,445	
Income before income taxes	5,825,227	4,865,829	2,
Income taxes	1,801,738	1,795,491	
Net income	$ 4,023,489	$ 3,070,338	$ 1,
Earnings per Share:			
Basic	$ .74	$ .56	
Diluted	$ .69	$ .53	

Cash dividends per share:	$ .23	$ .22

See accompanying notes.

THE EASTERN COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

	Nine Months Ended September 30, 2006	October 1, 2005	Septemb
Net income	$ 4,023,489	$ 3,070,338	$ 1
Other comprehensive income/(loss) -			
Change in foreign currency translation	180,073	305,513	
Change in fair value of derivative financial instrument, net of income taxes of:			
2006 - $14,680 and ($34,407) respectively	26,339	-	
2005 - $54,377 and ($9,623) respectively	-	79,963	
Reclassification adjustment for termination of derivative financial instrument net of income taxes of ($26,477)	(46,623)	-	
	159,789	385,476	
Comprehensive income	$ 4,183,278	$ 3,455,814	$ 1

See accompanying notes.

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THE EASTERN COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Nine Months Ended September 30, 2006	October
Operating Activities		
Net income	$ 4,023,489	$ 3,0
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,649,880	2,6
Provision for doubtful accounts	14,385	
Deferred income taxes	-	1
Issuance of Common Stock for directors' fees	56,803	

Loss on sales of equipment and other assets	-	
Changes in operating assets and liabilities:		
Accounts receivable	(3,116,304)	(1,3
Inventories	(3,151,149)	2
Prepaid expenses and other	(420,103)	1
Prepaid pension cost	(557,307)	(6
Other assets	(117,572)	(1
Accounts payable	3,176,055	1
Accrued compensation	392,272	(9
Other accrued expenses	(571,254)	
Net cash provided by operating activities	2,379,195	3,3
Investing Activities		
Purchases of property, plant and equipment	(3,371,840)	(1,3
Business acquisition	(7,025,000)	
Proceeds from sale of equipment	15,035	
Net cash used in investing activities	(10,381,805)	(1,3
Financing Activities		
Principal payments on long-term debt	(15,191,389)	(2,2
Proceeds from issuance of long-term debt	20,000,000	
Proceeds from revolving credit loan	304,837	3,0
Proceeds from sales of Common Stock	203,700	
Dividends paid	(1,276,768)	(1,1
Net cash used in financing activities	4,040,380	(4
Effect of exchange rate changes on cash	(71,210)	
Net change in cash and cash equivalents	(4,033,440)	1,6
Cash and cash equivalents at beginning of period	6,345,947	4,4
Cash and cash equivalents at end of period	$ 2,312,507	$ 6,0

See accompanying notes.

THE EASTERN COMPANY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
SEPTEMBER 30, 2006

Note A - Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and footnotes required by generally accepted accounting principles in the United States for complete financial statements. Refer to the Company's consolidated financial statements and notes thereto included in its Form 10-K for the year ended December 31, 2005 for additional information.

The accompanying condensed consolidated financial statements are unaudited. However, in the opinion of management, all adjustments (consisting only of normal recurring accruals) necessary for a fair presentation of the results of operations for interim periods have been reflected therein. All intercompany accounts and transactions are eliminated. Operating results for interim periods are not necessarily indicative of the results that may be expected for the full year.

Certain prior period amounts have been reclassified to conform to the current period presentation. These reclassifications had no effect on previously reported net income.

The condensed consolidated balance sheet as of December 31, 2005 has been derived from the audited consolidated balance sheet at that date.

Note B - Subsequent Event

On September 28, 2006, the Company announced a three-for-two stock split of the Company's common shares. The record date was October 10, 2006, with the additional shares being issued on October 17, 2006. Fractional shares created as a result of this split were paid by cash. As the stock split occurred after the close of the Company's fiscal quarter and prior to the issuance of the financial statements, all share data and per share data in these financial statements and notes to financial statements reflect the effects of the stock split as if it occurred prior to the end of the fiscal quarter.

Note C - Earnings Per Share

The denominators used in the earnings per share computations follow:

	Nine Months Ended	
	September 30, 2006	October 1, 2005
Basic:		
Denominator for basic earnings per share	5,472,682	5,454,197
Diluted:		
Weighted average shares outstanding	5,472,682	5,454,197
Dilutive stock options	349,526	381,417
Denominator for diluted earnings per share	5,822,208	5,835,614

Note D - Inventories

The components of inventories follow:

	September 30, 2006	December 31, 2005
Raw materials and component parts	$12,222,685	$ 9,917,792
Work in process	5,753,356	4,681,623

Finished Goods	7,594,430	6,168,334
	$25,570,471	$20,767,749

Note E - Segment Information

Segment financial information follows:

	NINE MONTHS ENDED		
	September 30, 2006	October 1, 2005	Septembe
Revenues:			
Sales to unaffiliated customers:			
Industrial Hardware	$ 43,279,116	$ 39,878,367	$ 15
Security Products	36,034,888	32,889,979	12
Metal Products	9,421,726	8,125,347	2
	$ 88,735,730	$ 80,893,693	$ 31
Income Before Income Taxes:			
Industrial Hardware	$ 4,330,439	$ 3,784,671	$ 2
Security Products	3,502,032	3,463,352	1
Metal Products	(1,407,287)	(1,673,786)	(1
Operating Profit	6,425,184	5,574,237	2
Interest expense	(732,294)	(753,853)	
Other income	132,337	45,445	
	$ 5,825,227	$ 4,865,829	$ 2

Note F - Recent Accounting Pronouncements

The Company adopted FASB Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), Share-Based Payment, using the modified prospective method effective January 1, 2006. No stock options were granted in the first nine months of 2006 and, as all stock options outstanding at December 31, 2005 were fully vested, the adoption of SFAS No. 123(R) had no impact on the Company's consolidated financial statements.

The following table approximates the effect on net income and earnings per share if the Company had applied SFAS No. 123(R) for the periods ended October 1, 2005 and had adopted this statement on January 2, 2005:

	NINE MONTHS ENDED October 1, 2005	THREE MONTHS ENDED October 1, 2005

Net income, as reported	$3,070,338	$1,256,367
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards granted, net of related tax effects	(1,314)	(438)
Pro forma net income	$3,069,024	$1,255,929
Earnings per share:		
Basic-as reported	$0.56	$0.23
Basic-pro forma	$0.56	$0.23
Diluted-as reported	$0.53	$0.21
Diluted-pro forma	$0.53	$0.21

For the purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the stock options' vesting period ranging from 1 to 5 years. The pro forma effect on net income and related earnings per share may not be representative of future years' impact since the terms and conditions of new grants may vary from the current terms.

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Note F - Recent Accounting Pronouncements - continued

The Company adopted SFAS No. 151, Inventory Costs, an amendment of ARB No. 43, Chapter 4, effective January 1, 2006. The amendments made by SFAS No. 151 clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and require the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. The adoption of SFAS No. 151 did not have a material impact on the consolidated financial statements of the Company.

The Company adopted SFAS No. 154, Accounting Changes and Error Corrections--a replacement of APB Opinion No. 20 (Accounting Changes) and FASB Statement No. 3 (Reporting Accounting Changes in Interim Financial Statements), effective January 1, 2006. SFAS No. 154 provides guidance on accounting for and reporting of accounting changes and error corrections. It requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the specific period effects or the cumulative effect of the change. The adoption of SFAS No. 154 did not have a material impact on the Company's consolidated financial statements.

In June 2006, the FASB issued Interpretation No. 48 ("FIN 48") Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ("SFAS 109"). This interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS 109, Accounting for Income Taxes. FIN 48 details how companies should recognize, measure, present, and disclose uncertain tax positions that have been or are expected to be taken. As such, financial statements will reflect expected future tax consequences of uncertain tax positions presuming the taxing authorities' full knowledge of the position and all relevant facts. We are currently analyzing the effect of FIN 48 on our financial statements. FIN 48 is effective for fiscal years beginning after December 15, 2006.

In September 2006, the U.S. Securities and Exchange Commission staff issued Staff Accounting Bulletin No. 108 ("SAB 108"), Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 eliminates the diversity of practice surrounding how public companies quantify financial statement misstatements. It establishes an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of the company's financial statements and the related financial statement disclosures. We do not expect SAB 108 to have a material impact on our financial condition or results of operations. SAB 108 must be applied to annual financial statements for their first fiscal year ending after November 15, 2006.

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, Fair Value Measurements ("SFAS No. 157"). This standard clarifies the principle that fair value should be based on the assumptions that market participants would use when pricing an asset or liability. Additionally, it establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. We have not yet determined the impact that the implementation of SFAS No. 157 will have on our results of operations or financial condition. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007.

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) ("SFAS No. 158"). This standard requires employers to recognize the underfunded or overfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in the funded status in the year in which the changes occur through accumulated other comprehensive income. Additionally, SFAS No. 158 requires employers to measure the funded status of a plan as of the date of its year-end statement of financial position. We are currently evaluating the impact that the implementation of SFAS No. 158 will have on our financial statements. The new reporting requirements and related new footnote disclosure rules of SFAS No. 158 are effective for fiscal years ending after December 15, 2006. The new measurement date requirement applies for fiscal years ending after December 15, 2008.

Note G - Debt

On March 8, 2006, the Company signed a capital lease in the amount of $68,948 with Citicorp Vendor Finance for the purchase of new lighting equipment at its Greenwald facility in Chester, Connecticut. The lease has a three year term at 0% interest rate. Payments under the lease are $1,915 per month. The Company was required to make the initial payment in March 2006, but was not required to make another payment until the installation of the equipment was completed. As such, no additional payments have been made. The installation was completed in October 2006 and payments will commence in the fourth quarter of 2006.

On September 22, 2006, the Company amended the unsecured loan agreement ("Loan Agreement"), which includes a term portion and a revolving credit portion, with its lender, Bank of America, N.A. The amendment restructures and increases the balance of the term portion of the loan into a new seven (7) year loan in the amount of $20,000,000. The restructured term portion is payable in quarterly payments of $714,286 beginning January 2, 2007. The proceeds were used to repay in full the outstanding balance of its existing term loan, $12,625,000, and for the acquisition of Royal Lock.

In addition, the Company increased the maximum amount available under the revolving credit portion from $7,500,000 to $12,000,000 and renewed and extended the maturity date to September 22, 2009. The revolving credit portion has a variable quarterly commitment fee ranging from 0.10% to 0.25% based on operating results. As of September 30, 2006, the quarterly fee is 0.15% on the unused portion.

The interest rates on the term and the revolving credit portions of the Loan Agreement vary. The interest rates may vary based on the LIBOR rate plus a margin spread of 1.0% to 1.65% for the term portion and 1.0% to 1.6% for the revolving credit portion. The margin rate spread is based on operating results calculated on a rolling-four-quarter basis. On September 30, 2006, the interest rates on the term portion and the revolving credit portion of the Loan Agreement were 6.62% and 8.25%, respectively.

Also on September 22, 2006, the Company terminated its interest rate swap contract with the lender. At the time of termination, the notational amount was $9,468,750, which was equal to 75% of the outstanding balance of the Term Loan on that date. As a result of the termination, the Company received $73,100 which was included in other income during the third quarter.

Note H - Goodwill

The following is a roll-forward of goodwill:

Beginning balance - December 31, 2005	$ 10,641,532
Royal Lock Acquisition	5,088,828
Foreign exchange	49,357
Ending balance - September 30, 2006	$ 15,779,717

Note I - Retirement Benefit Plans

The Company has non-contributory defined benefit pension plans covering certain U.S. employees. Plan benefits are generally based upon age at retirement, years of service and, for its salaried plan, the level of compensation. The Company also sponsors unfunded nonqualified supplemental retirement plans that provide certain current and former officers with benefits in excess of limits imposed by federal tax law. The measurement date for the obligations disclosed below is September 30 of each year.

The Company also provides health care and life insurance for retired salaried employees in the United States who meet specific eligibility requirements.

Note I - Retirement Benefit Plans - continued

Significant disclosures relating to these benefit plans for the third quarter and first nine months of Fiscal 2006 and 2005 follow:

	Pension Benefits		
	Nine Months Ended		Thr
	Sept. 30, 2006	Oct. 1, 2005	Sept. 30, 2
Service cost	$ 1,200,496	$1,010,520	$ 400,1
Interest cost	1,749,696	1,669,817	583,2
Expected return on plan assets	(2,268,144)	(2,037,016)	(756,0
Net amortization and deferral	448,931	290,529	149,6
Net periodic benefit cost	$ 1,130,979	$ 933,850	$ 376,9

	Post-retirement Benefits		
	Nine Months Ended		Thr
	Sept. 30, 2006	Oct. 1, 2005	Sept. 30, 2
Service cost	$ 78,805	$ 65,036	$ 35,5
Interest cost	92,250	88,806	40,1
Expected return on plan assets	(57,452)	(59,391)	(14,2
Net amortization and deferral	(33,020)	(58,200)	8,7
Net periodic benefit cost	$ 80,583	$ 36,251	$ 70,1

The Company's funding policy with respect to its qualified plans is to contribute at least the minimum amount required by applicable laws and regulations. For 2005, the Company was required to contribute approximately $1.4 million into its salaried plan and approximately $266,000 into one of its hourly plans. The Company made all of the contributions prior to filing its federal income tax return on September 15, 2006. For 2006, the Company's is required to contribute approximately $1.8 million into its salaried plan and approximately $273,000 into one of its hourly plans. The contributions for 2006 will be made in 2007, prior to filing the Company's federal tax return on September 15, 2007.

The Company has a contributory savings plan under Section 401(k) of the Internal Revenue Code covering substantially all U.S. non-union employees. The plan allows participants to make voluntary contributions of up to 100% of their annual compensation on a pretax basis, subject to IRS limitations. The plan provides for contributions by the Company at its discretion. The Company made contributions of $41,326 and $127,581 in the third quarter and first nine months of 2006, respectively, and $39,614 and $122,327 in the third quarter and first nine months of 2005, respectively.

Note J - Business Acquisition

Effective September 25, 2006 the Company acquired certain assets of Royal Lock Corporation ("Royal") including accounts receivable, inventories, furniture, fixtures and equipment, intellectual property rights and rights existing under all sales and purchase agreements. Royal is a supplier of cam locks, switch locks, padlocks, latches, handles and specialty hardware parts. Its products are sold to numerous OEM's in several market segments, including automotive, recreational vehicles and furniture as well as electronics and fabricated metal parts producers. Royal will be included in the Security Products segment of the Company. The cost of the acquisition of Royal was $7,025,000, inclusive of transaction costs, plus the assumption of approximately $775,000 in current liabilities. The cost of the acquisition is subject to adjustment based on the final closing net book value and transaction costs.

The above acquisition has been accounted for using the purchase method. The acquired business is included in the consolidated operating results of the Company from the date of acquisition. The excess of the cost of the acquired business over the fair market value of the net assets acquired has been allocated to goodwill.

Neither the actual results nor the pro forma effects of the acquisition of Royal are material to the Company's financial statements.

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion is intended to highlight significant changes in the Company's financial position and results of operations for the thirty-nine weeks ended September 30, 2006. The interim financial statements and this Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Consolidated Financial Statements and Notes thereto for the fiscal year ended December 31, 2005 and the related Management's Discussion and Analysis of Financial Condition and Results of Operations, both of which are contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

Certain statements set forth in this discussion and analysis of financial condition and results of operations are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. They use such words as "may," "will," "expect," "believe," "plan" and other similar terminology. These statements reflect management's current expectations regarding future events and operating performance and speak only as of the date of this release. These forward-looking statements involve a number of risks and uncertainties and actual future results and trends may differ materially depending on a variety of factors including changing customer preferences, lack of success of new products, loss of customers, competition, increased raw material prices, problems associated with foreign sourcing of parts and products, changes within our industry segments, in the overall economy, litigation and legislation. In addition, terrorist threats and the possible responses by the U.S. government, the effects on consumer demand, the financial markets, the travel industry, the trucking industry and other conditions increase the uncertainty inherent in forward-looking statements. Forward-looking statements reflect the expectations of the Company at the time they are made, and investors should rely on them only as expressions of opinion about what may happen in the future and only at the time they are made. The Company undertakes no obligation to update any forward-looking statement. Although the Company believes it has an appropriate business strategy and the resources necessary for its operations, future revenue and margin trends cannot be reliably predicted and the Company may alter its business strategies to address changing conditions.

In addition, the Company makes estimates and assumptions that may materially affect reported amounts and disclosures. These relate to valuation allowances for accounts receivable and for excess and obsolete inventories, accruals for pensions and other postretirement benefits (including forecasted future cost increases and returns on plan assets), provisions for depreciation (estimating useful lives), and, on occasion, accruals for contingent losses.

Overview

Net sales for the third quarter of 2006 increased 15% to $31.2 million from $27.2 million in the third quarter of 2005. Third quarter net income increased 33% to $1.7 million, or $0.28 per diluted share, from $1.3 million, or $0.21 per diluted share.

Net sales for the first nine months of 2006 increased 10% to $88.7 million from $80.9 million in the first nine months of 2005. Net income increased 31% to $4.0 million, or $0.69 per diluted share, from $3.1 million, or $0.53 per diluted share.

Approximately $1.8 million of the sales increase in both the third quarter and nine month results was from the recent orders received from a military contractor for door latching components to be used in a project to retro-fit military Humvees. These orders should result in additional increased sales of approximately $30 million over the next two quarters.

Raw material prices have increased sharply during 2006, mainly in zinc, brass and stainless steel, which has had a negative impact on gross margins. The Company is recovering these increases from our customers, wherever possible. Currently, there is no indication that the Company will not be able to obtain supplies of all the materials that it requires.

Cash flow from operations in the first nine months of 2006 has fallen-off compared to the same period in 2005, mainly due to the working capital requirements of the military Humvee retro-fit program. The Company's line of credit, along with controlling discretionary expenditures, should provide sufficient cash flow to enable the Company to meet all its existing obligations.

A more detailed analysis of the Company's results of operations and financial condition follows:

Results of Operations

The following table shows, for the third quarter of 2006 and 2005, selected line items from the condensed consolidated statements of income as a percentage of net sales, by segment:

	Three Months Ended September 30,		
	Industrial Hardware	Security Products	Metal Products
Net sales	100.0%	100.0%	100.0%
Cost of products sold	73.6%	75.2%	125.5%
Gross margin	26.4%	24.8%	-25.5%

Selling and administrative expense	13.0%	16.1%	11.8%
Operating profit	13.4%	8.7%	-37.3%

	Three Months Ended October 1,		
	Industrial Hardware	Security Products	Metal Products
Net sales	100.0%	100.0%	100.0%
Cost of products sold	77.1%	70.9%	110.9%
Gross margin	22.9%	29.1%	-10.9%
Selling and administrative expense	14.2%	15.6%	9.7%
Operating profit	8.7%	13.5%	-20.6%

The following table shows the amount of change from the third quarter of 2005 to the third quarter of 2006 in sales, cost of products sold, gross margin, selling and administrative expenses and operating profit, by segment (dollars in thousands):

	Industrial Hardware	Security Products	Metal Products
Net sales	$ 2,890	$ 873	$ 239
Volume	2.9%	6.4%	4.8%
Prices	0.0%	-0.2%	0.3%
New Products	19.3%	1.3%	4.4%
	22.2%	7.5%	9.5%
Cost of products sold	$ 1,667	$ 1,164	$ 666
	16.6%	14.1%	24.0%
Gross margin	$ 1,223	$ (291)	$ (427)
	41.0%	-8.6%	-156.8%
Selling and administrativeexpenses	$ 229	$ 207	$ 80
	12.4%	11.4%	32.6%
Operating profit	$ 994	$ (498)	$ (507)
	87.4%	-31.6%	-98.2%

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The following table shows, for the first nine months of 2006 and 2005, selected line items from the condensed consolidated statements of income as a percentage of net sales, by segment:

	Nine Months Ended September 30,		
	Industrial Hardware	Security Products	Metal Products
Net sales	100.0%	100.0%	100.0%
Cost of products sold	75.9%	73.5%	104.6%
Gross margin	24.1%	26.5%	-4.6%
Selling and administrative expense	14.1%	16.8%	10.3%
Operating profit	10.0%	9.7%	-14.9%

	Nine Months Ended October 1,		
	Industrial Hardware	Security Products	Metal Products
Net sales	100.0%	100.0%	100.0%
Cost of products sold	75.7%	72.0%	110.7%
Gross margin	24.3%	28.0%	-10.7%
Selling and administrative expense	14.8%	17.5%	9.9%
Operating profit	9.5%	10.5%	-20.6%

The following table shows the amount of change from the first nine months of 2006 compared to the first nine months of 2005 in sales, cost of products sold, gross margin, selling and administrative expenses and operating profit, by segment (dollars in thousands):

	Industrial Hardware	Security Products	Metal Products
Net sales	$ 3,401	$ 3,145	$ 1,296
Volume	-0.5%	8.6%	10.3%
Prices	0.0%	0.1%	0.5%
New Products	9.0%	0.9%	5.2%
	8.5%	9.6%	16.0%
Cost of products sold	$ 2,625	$ 2,814	$ 861
	8.7%	11.9%	9.6%
Gross margin	$ 776	$ 331	$ 435

		8.0%		3.6%		50.1%
Selling and administrative expenses	$	230	$	292	$	169
		3.9%		5.1%		21.0%
Operating profit	$	546	$	39	$	266
		14.4%		1.1%		15.9%

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Industrial Hardware Segment

Net sales in the Industrial Hardware segment were up 22% in the third quarter and 9% in the first nine months of 2006 compared to the prior year periods. The sales increase was mainly the result of a new product for the military market used to retro-fit the military Humvees. Additionally, industrial hardware sales increases were experienced in the truck accessories and service body markets and new products. For the year to date period sales of "sleeper boxes" for the Class 8 trailer truck market decreased compared to the same period in 2005, however an increase in sales of these units was experienced in the third quarter of 2006 compared to the prior year period. The Company expects the sales volume of "sleeper boxes" to continue to improve during the fourth quarter. In addition, new products developed using our lightweight honeycomb composites included a mobile pickup mounted camper shell for emergency vehicle use and a mobile building door for military use. Other new products included the retro-fit kit for the military Humvee, a 3 point t-handle assembly and a star wheel rotary assembly for the truck accessory market, a hidden hinge and a remote magnet alarm for the service body market and an assortment of handles and latches used in many of the markets we sell to. All of the new products were developed internally for the variety of markets we serve.

Our Eastern Industrial (Shanghai) Ltd., manufacturing facility located in Shanghai, China continues to produce products for our U.S. affiliates and in the first nine months of 2006 also continued its expansion to increase its shipments of products to non-affiliated customers. This subsidiary will be instrumental in helping us to remain price competitive in North America and will open up the possibility to effectively pursue global markets.

Cost of products sold for the Industrial Hardware segment increased 17% in the third quarter and 9% in the first nine months of 2006 compared to the prior year periods. The change in the cost of products sold is primarily the result of sales volume increases, costs of raw materials, payroll and payroll related charges and utilities expenses that were experienced during the periods.

Gross margin as a percent of net sales in the third quarter increased from 23% in 2005 to 26% in 2006 and was comparable at 24% for the first nine months of both 2005 and 2006. The increase in the third quarter gross margin is due to higher sales volumes that resulted in more efficient utilization of production facilities.

Selling and administrative expenses for the third quarter increased 12% and 4% for nine months compared to the prior year periods due to increases in travel costs and payroll and payroll related charges.

Security Products Segment

Net sales in the Security Products segment increased 8% in the third quarter and

10% in the first nine months of 2006 compared to 2005 periods. Sales volume in the third quarter of 2006 was mainly due to increased sales of lock products compared to the third quarter of 2005. Sales volume increases were experienced at all of the segment's operating units during the first nine months of 2006 except for commercial laundry products when compared to the prior year. Sales increases were experienced in many of the markets we service including: automotive accessories, coin operated machines, gaming, electronics and enclosures. Sales of new products focused on lock products such as the Super SesameeTM padlock, an electric car lock set, a remote keyless lock, an L-handle used on a vehicle roof rack, and cash drawer bill hold down and till assemblies as well as various other items for the many markets we service. The acquisition of Royal Lock did not have a material impact on the third quarter or nine month financial statements because the acquisition was completed during the last week of the quarter.

Cost of products sold for the Security Products segment was up 14% in the third quarter and 12% in the first nine months of 2006 compared to the 2005 periods. Most of the change in cost of products sold was the result of increased sales volume. Additional factors affecting this segment were increases in raw material costs, freight costs, payroll and payroll related charges and utilities.

Gross margin as a percentage of sales in the third quarter of 2006 decreased to 25% from 29% in the 2005 period and for the nine month period to 27% from 28% due to higher manufacturing costs in the 2006 quarter.

Selling and administrative expenses increased 11% in the third quarter and 5% in the first nine months of 2006 from 2005 levels. The increases were due to higher payroll and payroll related charges and advertising expenses which exceeded reductions in travel and trade show expenses resulting in the overall increase in 2006.

Metal Products Segment

Net sales in the Metal Products segment were up 10% in the third quarter and 16% in the first nine months of 2006 as compared to the prior year periods. Sales of mining products were up 4% in the third quarter of 2006 compared to the third quarter of 2005 and sales of contract castings increased 16% from the prior year levels. Sales of both mining products and contract castings were up 16% in the first nine months of 2006 compared to the first nine months of 2005. New product sales were primarily a new mine roof anchor for the Canadian mining market and a large flange nut and a tall domenut for the U.S. mining market. While the Company expected the installation of the new automatic pouring system for ductile iron, which was substantially completed in July, to increase efficiency in producing ductile iron castings, debugging the new automatic pouring systems and the learning curve associated with the installation took longer than expected. The Company is also continuing its marketing efforts to sell mine roof anchors to the China mining industry.

Cost of products sold increased 24% in the third quarter and 10% in the first nine months of 2006 compared to the same periods in 2005. The change was mainly due to increases in sales volume, raw materials and payroll and payroll related charges. Additionally, the spike in the third quarter of 2006 was the result of production problems during the installation and start-up of the automatic pouring system which was installed during the quarter. The problems experienced have been resolved and should result in lower cost of sales resulting from anticipated improved production efficiency during the fourth quarter of 2006.

Gross margin as a percentage of net sales went from -11% to -26% in the third quarter of 2006 compared to the 2005 period and improved from -11% in the first nine months of 2005 to -5% for the first nine months of 2006. The decrease in the third quarter versus the prior year period was mainly due to the production problems experienced during the start-up of the new ductile iron automatic pouring system. The improvement in the nine month period over the prior year is primarily due to the increased sales volume and the mix of products produced.

Selling and administrative expenses were up 32% in the third quarter and up 21% for the first nine months of 2006 compared to the same periods in 2005. The increases were related to increases in payroll and payroll related charges, advertising expenses, travel expenses and expenses associated with negotiation of a union contract.

Other Items

Interest expense increased 13% in the third quarter and decreased 3% in the first nine months of 2006 compared to the prior year periods. The increase in the third quarter is due to the use of a portion of our revolving loan agreement for working capital needs, the higher level of debt associated with the loan agreement amendments in September 2006 and termination of the interest rate swap agreement. The decrease for the nine month period is due to lower average debt balances for the period compared to the first nine months of 2005.

Other income increased 289% in the third quarter and 191% from the first nine months of 2005 to 2006 due to higher cash balances in the Company's cash management program, which resulted in greater interest income, and termination of the swap agreement discussed in Note G to the financial statements.

Income taxes - the effective tax rate decreased in the third quarter of 2006 to 17% from the 2005 rate of 37% and for the first nine months of 2006 to 31% from 37% in the first nine months of 2005. The decrease in the effective tax rate in 2006 is the result of favorable tax provision adjustments. Without these tax adjustments, the effective tax rate would have approximated the prior year rate of 37%.

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Liquidity and Sources of Capital

The Company generated $2.4 million of cash from operations for the first nine months of 2006 compared to $3.4 million for the same period in 2005. The change in cash flows was mainly the result of timing differences for collections of accounts receivable and payments of liabilities and changes in inventories. Cash flow from operations coupled with cash on hand at the beginning of the year and draw-downs on the revolving loan were sufficient to fund capital expenditures, debt service, incentive payments, contributions to the Company's pension plans, and dividend payments. At the end of September 2006, the draw-down on the revolving loan was approximately $305,000. Additional borrowing under the amended loan agreement discussed in Note G to the financial statements was used to fund the acquisition of Royal Lock.

Additions to property, plant and equipment were $3.4 million during the first nine months of 2006 versus $1.3 million for the comparable period in the prior year. Total capital expenditures for 2006 are expected to be in the range of $3.5 million to $4.5 million.

Total inventories as of September 30, 2006 were $25.6 million, compared to $20.8 million at year-end 2005. The inventory turnover ratio of 3.6 turns at the end of the third quarter was slightly lower than both the prior year third quarter and year-end 2005 ratio of 4.1 turns. The increase in inventory is a result of the Royal Lock acquisition, increased business in the United States and at our facility in Shanghai, China and ramping up production for the Humvee retro-fit project. Accounts receivable increased by $4.1 million from year end 2005, primarily due to the Royal Lock acquisition as well as increased sales volume. The average days sales in accounts receivable for the third quarter of 2006 was 55 days compared to 47 days in the third quarter of 2005 and 49 days at year end 2005.

Cash flow from operating activities and funds available under the revolving credit portion of the Company's loan agreement are expected to be sufficient to cover future foreseeable working capital requirements.

ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to interest rate risk with respect to its unsecured Loan Agreement, which was amended during the third quarter, and provides for interest based on LIBOR plus a spread of up to 1.65%. The spread is determined by a comparison of the Company's operating performance with agreed-upon financial targets. Since the Company's performance depends to a large extent on the overall economy, the interest rate paid by the Company under its Loan Agreement is closely linked to the trend in the U.S. economy. The current interest rate spread is 1.25% on the term loan portion and on the revolving credit line portion of the Loan Agreement. Changes in LIBOR rates will also affect the Company's interest expense.

The balance of the term debt is subject to the volatility of short-term interest rates, where a 1% change in interest rates would cause a $189,000 increase or decrease in the Company's annual interest cost. The Company is currently evaluating the establishment of a new interest rate swap as a means of hedging future interest rate increases.

ITEM 4 - CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

An evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this report based on such evaluation.

The Company believes that a controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute

assurance that all control issues and instances of fraud, if any, within a company have been detected. The Company's disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives, and the CEO and CFO have concluded that these controls and procedures are effective at the "reasonable assurance" level.

Changes in Internal Controls

During the period covered by this report, there have been no significant changes in the Company's internal control over financial reporting or in other factors that have materially affected, or are reasonably likely to materially affect the Company's internal controls.

PART II - OTHER INFORMATION

ITEM 1 - LEGAL PROCEEDINGS

There are no material pending legal proceedings, other than ordinary routine litigation incidental to the Company's business, to which either the Company or any of its subsidiaries is a party or to which any of their property is the subject.

ITEM 1A - RISK FACTORS

There have been no material changes in risk factors from what was reported in the 2005 Annual Report on Form 10-K.

ITEM 2 - UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

There have been no sales of unregistered securities by the Company or purchases of registered equity securities by the Company during the period covered by this report.

ITEM 3 - DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 - SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

See the information set forth in Item 4 of the Form 10-Q of the Company for the quarterly period ended April 1, 2006.

ITEM 5 - OTHER INFORMATION

None

ITEM 6 - EXHIBITS

31) Certifications required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32) Certifications pursuant to Rule 13a-14(b) and 18 USC 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

99(1)) The Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2005 is incorporated herein by reference.

99(2)) Form 8-K filed on April 26, 2006 setting forth the press release reporting the Company's earnings for the quarter ended April 1, 2006 is incorporated herein by reference.

99(3)) Form 8-K filed on July 26, 2006 setting forth the press release reporting the Company's earnings for the quarter ended July 1, 2006 is incorporated herein by reference.

99(4)) Form 8-K filed on September 6, 2006 setting forth a purchase order for approximately $15.5 million is incorporated herein by reference.

99(5)) Form 8-K filed on September 25, 2006 setting forth the press release reporting the Acquisition of Royal Lock Corporation and the Amended Loan Agreement is incorporated herein by reference.

99(6)) Form 8-K filed on September 27, 2006 setting forth an addendum to a purchase order for an additional approximate $16 million is incorporated herein by reference.

99(7)) Form 8-K filed on September 28, 2006 setting forth the press release announcing a three-for-two stock split of the Company's common shares is incorporated herein by reference.

99(8)) Form 8-K filed on October 25, 2006 setting forth the press release reporting the Company's earnings for the quarter ended September 30, 2006 is incorporated herein by reference.

SIGNATURES

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

THE EASTERN COMPANY
(Registrant)

DATE: October 31, 2006 /s/Leonard F. Leganza

Leonard F. Leganza
President and Chief Executive Officer

DATE: October 31, 2006 /s/John L. Sullivan III

John L. Sullivan III
Vice President, Secretary and Treasurer