TENNANT CO
Form 10-Q
August 08, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

[X] Quarterly Report Under Section 13 or 15 (d) of the Securities Exchange Act of 1934
For the quarterly period ended June 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 No. 1-16191

TENNANT COMPANY

(Exact Name of Registrant as Specified in Its Charter)

Minnesota	**410572550**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S Employer Identification No.)

701 North Lilac Drive
P.O. Box 1452
Minneapolis, Minnesota 55440
(Address of Principal Executive Offices, Including Zip Code)

763-540-1200
(Registrant s Telephone Number, Including Area Code)

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

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 o Accelerated filer x Non-accelerated filer o

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

The number of shares outstanding of Registrant s common stock, par value $.375 on July 28, 2006, was 18,606,441.

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ITEM 1 Financial Statements

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS (Unaudited)
(In thousands, except per share data)

	Three Months Ended June 30		Six Months Ended June 30	
	2006	**2005**	**2006**	**2005**
Net sales	$ 150,965	$ 137,119	$ 286,427	$ 263,077
Cost of sales	85,167	78,672	163,829	150,644
Gross profit	65,798	58,447	122,598	112,433
Operating expenses:				
Research and development	5,648	4,507	10,630	8,969
Selling and administrative	47,553	43,151	92,652	86,596
Total operating expenses	53,201	47,658	103,282	95,565
Profit from operations	12,597	10,789	19,316	16,868
Interest income, net	720	263	1,170	416
Other income (expense), net	102	(262)	135	(686)
Profit before income taxes	13,419	10,790	20,621	16,598
Income tax expense	4,266	4,092	7,032	6,357
Net earnings	$ 9,153	$ 6,698	$ 13,589	$ 10,241
Per share:				
Basic earnings	$ 0.49	$ 0.37	$ 0.73	$ 0.57
Diluted earnings	$ 0.48	$ 0.37	$ 0.72	$ 0.56
Dividends	$ 0.11	$ 0.11	$ 0.22	$ 0.22
Weighted average number of shares:				

	Three Months Ended June 30		Six Months Ended June 30	
Basic	18,496	17,983	18,499	18,004
Diluted	18,920	18,143	18,939	18,201

See accompanying Notes to Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)
(In thousands)

	June 30, 2006	December 31, 2005
ASSETS		
Cash and cash equivalents	$ 42,434	$ 41,287
Receivables, less allowances of $4,828 and $4,756, respectively	106,915	105,917
Inventories	55,658	52,666
Prepaid expenses	2,947	3,503
Deferred income taxes, current portion	8,143	8,228
Total current assets	216,097	211,601
Property, plant and equipment	230,248	221,620
Accumulated depreciation	155,395	149,032
Property, plant and equipment, net	74,853	72,588
Deferred income taxes, long-term portion	2,085	1,522
Goodwill	22,981	22,253
Other intangibles, net	1,529	1,502
Other assets	1,518	2,006
Total assets	$ 319,063	$ 311,472
LIABILITIES & SHAREHOLDERS EQUITY		
LIABILITIES		

	June 30, 2006	December 31, 2005
Current debt and collateralized borrowings	$ 2,288	$ 2,232
Accounts payable, accrued expenses and deferred revenues	75,876	86,733
Total current liabilities	78,164	88,965
Long-term debt	2,138	1,608
Employee-related benefits	27,877	27,797
Total long-term liabilities	30,015	29,405
Total liabilities	108,179	118,370
SHAREHOLDERS EQUITY		
Common stock	6,987	3,459
Additional paid-in capital	10,216	6,963
Retained earnings	198,756	189,221
Accumulated other comprehensive income (loss)	(1,206)	(2,931)
Receivable from ESOP	(3,869)	(3,610)
Total shareholders equity	210,884	193,102
Total liabilities and shareholders equity	$ 319,063	$ 311,472

See accompanying Notes to Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(In thousands)

	Six Months Ended June 30	
	2006	2005
CASH FLOWS RELATED TO OPERATING ACTIVITIES:		
Net earnings	$ 13,589	$ 10,241

	Six Months Ended June 30	
Adjustments to net earnings to arrive at operating cash flows:		
Depreciation and amortization	6,767	6,646
Deferred tax expense	(439)	1,369
Stock-based compensation expense	1,970	633
Provision for bad debt and returns	463	499
Changes in operating assets and liabilities:		
Accounts receivable	(1,531)	8,477
Inventories	(1,126)	(3,266)
Accounts payable, accrued expenses and deferred revenues	(10,489)	(2,150)
Other current/noncurrent assets and liabilities	1,264	(3,885)
Other, net	1,468	298
Net cash flows related to operating activities	11,936	18,862
CASH FLOWS RELATED TO INVESTING ACTIVITIES:		
Purchases of property, plant and equipment	(8,708)	(8,285)
Sales of short-term investments		6,050
Proceeds from disposals of property, plant and equipment	453	1,062
Net cash flows related to investing activities	(8,255)	(1,173)
CASH FLOWS RELATED TO FINANCING ACTIVITIES:		
Net change in short-term borrowings		(514)
Payment of long-term debt		(5,000)
Capital lease payments	(915)	
Tax benefit on stock plans	659	
Proceeds from issuance of common stock	4,407	727
Purchases of common stock	(2,586)	(3,222)
Dividends paid	(4,085)	(3,951)
Net cash flows related to financing activities	(2,520)	(11,960)
Effect of exchange rate changes on cash and cash equivalents	(14)	(269)
Net increase in cash and cash equivalents	1,147	5,460
Cash and cash equivalents at beginning of year	41,287	16,837
Cash and cash equivalents at end of period	$ 42,434	$ 22,297
SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES		
Capital expenditures funded through capital leases	$ 1,867	$ 1,552
Collateralized borrowings incurred for operating lease equipment	$ 75	$

See accompanying Notes to Condensed Consolidated Financial Statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
(In thousands, except per share data)

(1) Basis of Presentation

Tennant Company is referred to as Tennant, us, we, or our in these notes to the condensed consolidated financial statements.

In our opinion, the accompanying unaudited, condensed consolidated financial statements contain all adjustments (consisting of only normal recurring adjustments, except as noted elsewhere in the notes to the condensed consolidated financial statements) necessary to present fairly our financial position as of June 30, 2006, the results of our operations for the three and six months ended June 30, 2006 and 2005 and cash flows for the six months ended June 30, 2006 and 2005. These statements are condensed and, therefore, do not include all of the information and note disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. The statements should be read in conjunction with the consolidated financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2005. The results of operations for the three and six months ended June 30, 2006 are not necessarily indicative of the results to be expected for the full year.

New Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. The requirements are effective for fiscal years beginning after December 15, 2006. Although we are still evaluating the impact that the adoption of FIN 48 will have on our consolidated financial statements, we do not believe it will have a material impact.

(2) Stock Split

On April 26, 2006, the Board of Directors declared a two-for-one common stock split effective July 26, 2006. As a result of the stock split, shareholders of record received one additional common share for every share held at the close of business on July 12, 2006. Share and per share data in these consolidated financial statements and related notes have been retroactively adjusted to reflect the stock split. In connection with the stock split, we amended our articles of incorporation to increase the number of authorized shares of common stock to 60,000.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
(In thousands, except per share data)

(3) Inventories

Inventories are valued at the lower of cost or market. Inventories at June 30, 2006 and December 31, 2005 consisted of the following:

	June 30, 2006	December 31, 2005
Inventories carried at LIFO:		
Finished goods	$ 19,415	$ 17,642
Raw materials, production parts and work-in-process	36,410	35,539
LIFO reserve	(24,827)	(24,060)
Total LIFO inventories	30,998	29,121
Inventories carried at FIFO:		
Finished goods	5,801	5,259
Raw materials, production parts and work-in-process	18,859	18,286
Total FIFO inventories	24,660	23,545
Total inventories	$ 55,658	$ 52,666

The LIFO reserve approximates the difference between LIFO carrying cost and replacement cost.

(4) Supplemental Cash Flow Information

Income taxes paid during the six months ended June 30, 2006 and 2005 were $6,146 and $2,201, respectively. Interest costs paid during the six months ended June 30, 2006 and 2005 were $124 and $376, respectively.

(5) Accumulated Other Comprehensive Income (Loss)

We report accumulated other comprehensive income (loss) as a separate item in the shareholders equity section of the balance sheet. Comprehensive income (loss) is comprised of the net earnings and other comprehensive income (loss). For the three and six months ended June 30, 2006 and 2005, other comprehensive income (loss) consists of foreign currency translation adjustments. The reconciliations of net earnings to comprehensive income (loss) are as follows:

	Three Months Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
Net earnings	$ 9,153	$ 6,698	$ 13,589	$ 10,241
Foreign currency translation adjustments	1,330	(1,395)	1,725	(2,232)
Comprehensive income (loss)	$ 10,483	$ 5,303	$ 15,314	$ 8,009

	Three Months Ended June 30		Six Months Ended June 30	

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
(In thousands, except per share data)

(6) Earnings Per Share Computation

	Three Months Ended June 30		Six Months Ended June 30	
	2006	**2005**	**2006**	**2005**
Weighted average shares outstanding Basic	18,496	17,983	18,499	18,004
Dilutive share equivalents	424	160	440	197
Weighted average shares outstanding Diluted	18,920	18,143	18,939	18,201
Net earnings	$ 9,153	$ 6,698	$ 13,589	$ 10,241
Earnings per share Basic	$ 0.49	$ 0.37	$ 0.73	$ 0.57
Earnings per share Diluted	$ 0.48	$ 0.37	$ 0.72	$ 0.56
Antidilutive securities excluded from diluted earnings per share calculation	77	862	76	840

(7) Segment Reporting

We operate in one reportable segment that consists of the design, manufacture and sale of products used primarily in the maintenance of nonresidential surfaces. Our products are sold in North America, Europe, and other international markets including the Middle East, Asia, Japan, Latin America and Australia. The following table sets forth net sales by geographic area (net of intercompany sales):

	Three Months Ended June 30		Six Months Ended June 30	
	2006	**2005**	**2006**	**2005**
North America	$ 101,096	$ 92,527	$ 191,111	$ 175,262
Europe	35,076	30,688	67,396	61,450
Other International	14,793	13,904	27,920	26,365

	Three Months Ended June 30		Six Months Ended June 30	
Total	$ 150,965	$ 137,119	$ 286,427	$ 263,077

(8) Goodwill and Intangible Assets

The following table summarizes the activity during the six months ended June 30, 2006 for goodwill and other intangible assets:

	Goodwill	Other Intangibles
Balance, December 31, 2005	$ 22,253	$ 1,502
Amortization expense		(90)
Foreign currency fluctuations	728	117
Balance, June 30, 2006	$ 22,981	$ 1,529

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
(In thousands, except per share data)

(9) Stock-Based Compensation

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123(R), Share Based Payment Revised 2004 (SFAS No. 123(R)), using the modified prospective transition method. Under this method, stock-based employee compensation cost is recognized using the fair-value based method for all new awards granted after January 1, 2006. Compensation costs for unvested stock options and awards that were outstanding as of the adoption date are being recognized, beginning January 1, 2006, over the requisite service period based on the grant-date fair value of those options and awards as previously calculated under the pro-forma disclosures pursuant to Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS No. 123). As of June 30, 2006, we had six plans which are described in Note 13 of the 2005 Annual Report on Form 10-K. The 1999 Directors Restricted Plan, 1997 Directors Option Plan and 1999 Stock Incentive Plan currently allow for stock-based compensation grants as of June 30, 2006. A maximum of 4,700 shares can be awarded under these plans; 608 shares were available for issuance under current and future equity compensation awards as of June 30, 2006.

Stock Option and Stock Appreciation Right Awards

We determined the fair value of our stock option awards using the Black-Scholes option pricing model. The following weighted-average assumptions were used to value the stock options granted during the six months ended June 2006 and 2005:

	2006	2005

	2006	2005
Expected life in years	7	7
Risk-free interest rate	4.9%	3.9%
Expected volatility	26.9%	25.9%
Expected dividend yield	2.0%	2.2%
Weighted-average fair value	$ 7.87	$ 5.51

Stock options were granted for 29 and 12 shares during the six months ended June 30, 2006 and 2005, respectively.

The expected life selected for stock options granted during the six month period represents the period of time that the stock options are expected to be outstanding based on historical data of stock option holder exercise and termination behavior for similar grants. The risk-free interest rate for periods within the contractual life of the stock option is based on the U.S. Treasury rate over the expected life at the time of grant. Expected volatilities are based upon historical volatility of our stock over a period equal to the expected life of each stock option grant. Dividend yield is estimated over the expected life based on our dividend policy and historical dividends paid.

The total intrinsic value of stock options exercised during the six months ended June 30, 2006 and 2005 was $1,889 and $151, respectively. The total grant date fair value of stock options vested during the six months ended June 30, 2006 and 2005 was $988 and $2,045, respectively. At June 30, 2006, the aggregate intrinsic value of shares outstanding and exercisable was $9,201 and $8,753, respectively.

Employee stock option awards prior to 2005 include a reload feature for options granted to key employees. This feature allows employees to exercise options through a stock-for-stock exercise using mature shares and employees are granted a new stock option (reload option) equal to the number of shares of common stock used to satisfy both the exercise price of the option and the tax withholding requirements. The reload options granted have an exercise price equal to the fair market value of the common stock on the grant date. Stock options granted in conjunction with reloads vest immediately and have a term equal to the remaining life of the initial grant.

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New stock option awards granted during the first six months of 2006 vest one-third each year over a three-year period and have a ten-year contractual term. These grants do not contain a reload feature. Compensation expense equal to the grant date fair value is recognized for these awards over the vesting period. Compensation expense is fully recognized for reload stock options as of the reload date.

In addition to stock options, we also grant cash-settled stock appreciation rights to employees in certain foreign locations. Stock appreciation rights outstanding were 18 as of June 30, 2006 . No new stock appreciation rights were granted during the first six months of 2006.

Compensation expense related to stock options and stock appreciation rights was $480 for the six-month period ended

June 30, 2006. As of June 30, 2006, there was unrecognized compensation cost for unvested options and rights of $1,003 of which $418 is expected to be recognized during the remainder of 2006 and the remaining $585 during 2007, 2008 and 2009.

The following table summarizes activity related to stock options and stock appreciation rights under our employee and non-employee director equity compensation plans during the six months ended June 30, 2006:

	Outstanding	Weighted-Average Exercise Price
Outstanding at December 31, 2005	2,053	$ 19.15
Granted	29	25.95
Exercised	(247)	18.38
Forfeited	(23)	19.69
Expired	(36)	18.52
Outstanding at June 30, 2006	1,776	$ 19.36
Exercisable at June 30, 2006	1,567	$ 18.94

The following table summarizes information concerning outstanding and exercisable stock options and stock appreciation rights as of June 30, 2006:

Range of Exercise Prices Between	Number Outstanding	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
$10.05-12.54	5	0.2	$ 11.00	5	$ 11.00
12.55-15.04	36	2.4	13.85	36	13.85
15.05-17.54	650	5.0	16.51	650	16.51
17.55-20.04	258	3.2	18.09	246	18.07
20.05-22.54	567	5.5	21.31	483	21.40
22.55-25.04	184	6.5	23.87	84	23.91
$25.05-27.55	76	5.2	25.98	63	25.84
	1,776	5.0	$ 19.36	1,567	$ 18.94

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
(In thousands, except per share data)

Restricted Share Awards

The following table summarizes the activity during the six months ended June 30, 2006 for unvested restricted share awards:

	Unvested Shares	Weighted-Average Grant Date Fair Value
Unvested at December 31, 2005	19	$ 19.68
Granted	65	26.25
Vested	(1)	19.49
Forfeited	(2)	21.60
Unvested at June 30, 2006	81	$ 24.74

Restricted share awards typically have a two- or three-year vesting period from the effective date of grant. The total fair value of shares vested during the six months ended June 30, 2006 and 2005 was $27 and $699, respectively. Compensation expense related to restricted stock was $353 and $200 for the six-month periods ended June 30, 2006 and 2005, respectively. As of June 30, 2006, there was $1,183 of total unrecognized compensation cost related to unvested shares, of which $428 is expected to be recognized during the remainder of 2006, and the remaining $755 during 2007, 2008 and 2009.

Performance Share Awards

We also grant performance share awards to key employees as a part of our management compensation program. These awards are earned based upon achievement of certain financial performance targets. We determine the fair value of these awards as of the date of grant and recognize the expense over a three-year performance period. The compensation expense for these awards was $1,018 for the six months ended June 30, 2006.

During November 2005, we also granted a performance share award, which vests and is earned upon achieving certain total shareholder return targets over a five-year performance period. The maximum number of shares of common stock issuable upon payout of the award is 40. Compensation cost is based on the fair value of this award as of the date of grant and recognized over the derived requisite service period of three years. Compensation expense related to this award was $71 for the six-month period ended June 30, 2006. As of June 30, 2006, there was $342 of total unrecognized compensation cost related to this award, of which $71 is expected to be recognized during the remainder of 2006, and the remaining $271 during 2007 and 2008.

Share-Based Liabilities

As of June 30, 2006, we had $1,726 in total share-based liabilities recorded on our balance sheet. During the six-month period ended June 30, 2006, we paid out $1,739 related to 2005 share-based liability awards.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
(In thousands, except per share data)

Prior to the adoption of SFAS No. 123(R), we accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. As we adopted SFAS No. 123(R) using the modified prospective approach, prior period net earnings and basic and diluted earnings per share have not been restated. The pro forma effects of recognizing the estimated fair value of stock-based compensation as previously calculated under SFAS No. 123 for the six months ended June 30, 2005 are summarized below:

	Three Months Ended June 30 2005	Six Months Ended June 30 2005
Net earnings as reported	$ 6,698	$ 10,241
Add: Stock-based compensation cost determined under intrinsic value method included in net earnings, net of related tax effects	125	209
Deduct: Stock-based employee compensation expense determined under fair value-based method, net of related tax effects	(437)	(762)
Net earnings pro forma	$ 6,386	$ 9,688
Earnings per share:		
Basic as reported	$ 0.37	$ 0.57
Basic pro forma	$ 0.36	$ 0.54
Diluted as reported	$ 0.37	$ 0.56
Diluted pro forma	$ 0.35	$ 0.53

(10) Guarantees

We record a liability for warranty claims at the time of sale. The amount of the liability is based on the trend in the historical ratio of claims to sales, the historical length of time between the sale and resulting warranty claim, new product introductions and other factors. Warranty periods on machines generally range from one to four years. The changes in warranty reserve balances for the six months ended June 30, 2006 and 2005 were as follows:

	June 30, 2006	June 30, 2005

	June 30, 2006	June 30, 2005
Beginning balance	$ 6,146	$ 6,180
Additions charged to expense	3,804	4,164
Change in estimate	153	
Foreign currency fluctuations	95	(87)
Claims paid	(3,961)	(3,712)
Ending balance	$ 6,237	$ 6,545

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
(In thousands, except per share data)

Certain operating leases for vehicles contain residual value guarantee provisions, which would become due at the expiration of the operating lease agreement if the fair value of the leased vehicles is less than the guaranteed residual value. Of those leases that contain residual value guarantees, the aggregate residual value at lease expiration is approximately $10,500, of which we have guaranteed approximately $8,100. As of June 30, 2006, we have recorded a liability for the estimated end of term loss related to this residual value guarantee of $718 for certain vehicles within our fleet. Our fleet also contains vehicles we estimate will settle at a gain. Gains on these vehicles will be recognized at the end of the lease term.

(11) Retirement Benefit Plans

As of June 30, 2006, we had four defined benefit retirement plans and a postretirement medical plan, which are described in Note 9 of the 2005 Annual Report on Form 10-K.

We have contributed $60 and $158 during the second quarter and $119 and $387 for the first six months of 2006 to our pension benefit plans and to our postretirement medical benefit plan, respectively. We expect to contribute approximately $200 and $900 to our pension benefit plans and to our postretirement medical benefit plan in 2006, respectively.

The components of the net periodic cost for the three and six months ended June 30, 2006 and 2005 were as follows:

	Three Months Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
Pension Benefits:				
Service cost	$ 235	$ 301	$ 510	$ 602
Interest cost	564	525	1,122	1,050
	(738)	(733)	(1,477)	(1,466)

	Three Months Ended June 30		Six Months Ended June 30	
Expected return on plan assets				
Recognized actuarial (gain) loss	(23)	(44)	(4)	(88)
Amortization of transition obligation	32	(6)	26	(12)
Amortization of prior service cost	141	143	283	286
Foreign currency	173		173	
Net periodic cost	$ 384	$ 186	$ 633	$ 372
Postretirement Medical Benefits:				
Service cost	$ 45	$ 47	$ 75	$ 95
Interest cost	234	122	383	243
Recognized actuarial (gain) loss	37		37	
Amortization of prior service cost	(259)		(259)	
Net periodic cost	$ 57	$ 169	$ 236	$ 338

(12) Subsequent Events

In July 2006, we acquired Hofmans Machinefabriek, a manufacturer of outdoor cleaning equipment based in Schaijk, The Netherlands, for a purchase price of approximately $7,800 in cash, subject to certain post-closing adjustments.

ITEM 2 - Management s Discussion and Analysis of Financial Condition and Results of Operations

Overview

Tennant Company is a world leader in designing, manufacturing and marketing of solutions that help create a cleaner, safer world. We provide equipment, parts and consumables and floor coatings to contract cleaners, end-user businesses, healthcare facilities, schools and local, state and federal governments. We sell our products through our direct sales and service organization and a network of authorized distributors worldwide. Geographically, our customers are primarily located in North America, Europe and other international markets including the Middle East, Asia, Japan, Latin America and Australia. We strive to be an innovator in our industry through our commitment to understanding our customers needs and using our expertise to create innovative solutions.

On April 26, 2006, the Board of Directors declared a two-for-one common stock split effective July 26, 2006. As a result of the stock split, shareholders of record received one additional common share for every share held at the close of business on July 12, 2006. Share and per share data in Management s Discussion and Analysis of Financial Condition and Results of Operations have been retroactively adjusted to reflect the stock split.

Net earnings for the second quarter of 2006 were up 36.7% to $9.2 million, or $0.48 per diluted share, compared to the second quarter of 2005. Net earnings were impacted by:

- Growth in net sales of 10.1%.
- An increase in gross profit margin of 1.0 percentage point.
- A 10.2% increase in selling and administrative (S&A) expenses.
- An increase in interest income, net of $0.5 million.

Net earnings for the six months ended June 30, 2006 increased 32.7% to $13.6 million, or $0.72 per diluted share, compared to the same period in 2005. Net earnings were impacted by:

- Growth in net sales of 8.9%.
- A 7.0% increase in S&A expenses.
- An increase in interest income, net of $0.8 million.
- An increase in other income, net of $0.8 million.

During the first quarter of 2006, we adopted Financial Accounting Standards Board Statement No. 123 (Revised 2004), Share-Based Payment (SFAS No. 123(R)). SFAS No. 123(R) requires compensation costs relating to share-based payment transactions, including employee stock options, be recognized in the financial statements. We applied the modified prospective approach to transition in our adoption of this standard. The modified prospective approach uses the fair value-based accounting method for all employee awards granted, modified, or settled after the adoption date. Compensation cost related to the unvested portion of awards outstanding as of the adoption date is based on the grant-date fair value of those awards as calculated under the original provisions of SFAS No. 123. As a result of the adoption of SFAS No. 123(R), S&A expenses for the three and six months ended June 30, 2006 included an expense of $0.2 million ($0.1 million after-tax or $0.01 per diluted share) and an expense of $0.5 million ($0.3 million after-tax or $0.02 per diluted share), respectively, related to stock options.

During the fourth quarter of 2005, we launched initiatives to establish a manufacturing facility in China and rationalize our global manufacturing footprint. For the six months ended June 30, 2006, Tennant has spent approximately $1.0 million pretax, or $0.04 per diluted share, on these initiatives. We originally expected to incur $3.6 million pretax in costs associated with these initiatives, however, as of June 30, 2006, we expect to incur approximately $2.8 million pretax. The decrease is primarily due to a reduction in the expansion costs at the China manufacturing facility due to effective expense management as well as timing of certain China ramp-up expenses.

Historical Results

The following compares the historical results of operations for the three- and six-month periods ended June 30, 2006 and 2005 in dollars and as a percentage of net sales (dollars in thousands, except earnings per diluted share):

Three Months Ended June 30	Six Months Ended June 30
2006	