

SHERWIN WILLIAMS CO

Form 10-Q

October 25, 2006

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D. C. 20549  
FORM 10-Q**

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the 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 1-04851  
THE SHERWIN-WILLIAMS COMPANY**

(Exact name of registrant as specified in its charter)

OHIO

34-0526850

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

101 Prospect Avenue, N.W., Cleveland, Ohio

44115-1075

(Address of principal executive offices)

(Zip Code)

(216) 566-2000

(Registrant's telephone number including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

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

Common Stock, \$1.00 Par Value 134,822,846 shares as of September 30, 2006.



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Thousands of dollars, except per share data

|  | Three months ended September |              | Nine months ended September |              |
|--|------------------------------|--------------|-----------------------------|--------------|
|  | 2006                         | 2005         | 2006                        | 2005         |
| Net sales  | \$ 2,116,711                 | \$ 1,976,728 | \$ 6,015,209                | \$ 5,480,631 |
| Cost of goods sold                                 | 1,180,933                    | 1,136,983    | 3,371,432                   | 3,141,946    |
| Gross profit                                       | 935,778                      | 839,745      | 2,643,777                   | 2,338,685    |
| <i>Percent to net sales</i>                        | <i>44.2%</i>                 | <i>42.5%</i> | <i>44.0%</i>                | <i>42.7%</i> |
| Selling, general and administrative expenses       | 648,920                      | 602,517      | 1,888,067                   | 1,737,177    |
| <i>Percent to net sales</i>                        | <i>30.7%</i>                 | <i>30.5%</i> | <i>31.4%</i>                | <i>31.7%</i> |
| Interest expense                                   | 16,437                       | 12,092       | 50,624                      | 37,612       |
| Interest and net investment income                 | (6,127)                      | (1,329)      | (17,820)                    | (3,090)      |
| Other (income) expense net                         | (143)                        | 7,471        | 15,179                      | 20,781       |
| Income before income taxes and minority interest   | 276,691                      | 218,994      | 707,727                     | 546,205      |
| Income taxes                                       | 97,579                       | 66,970       | 230,352                     | 156,726      |
| Minority interest                                  |                              | 416          |                             | 1,356        |
| Net income   | \$ 179,112                   | \$ 151,608   | \$ 477,375                  | \$ 388,123   |
| Net income per common share:                       |                              |              |                             |              |
| Basic  | \$ 1.34                      | \$ 1.11      | \$ 3.56                     | \$ 2.82      |
| Diluted  | \$ 1.30                      | \$ 1.07      | \$ 3.46                     | \$ 2.73      |
| Average shares outstanding basic                   | 133,622,166                  | 136,911,347  | 134,196,870                 | 137,618,594  |
| Average shares and equivalents outstanding diluted | 137,375,111                  | 141,227,468  | 138,028,874                 | 141,972,327  |

See notes to condensed consolidated financial statements.

**Table of Contents****THE SHERWIN-WILLIAMS COMPANY AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS (UNAUDITED)**

Thousands of dollars

|   | <b>September<br/>30,<br/>2006</b> | December<br>31,<br>2005 | September<br>30,<br>2005 |
|---|-----------------------------------|-------------------------|--------------------------|
| <b>ASSETS</b>                               |                                   |                         |                          |
| Current assets:                             |                                   |                         |                          |
| Cash and cash equivalents                   | \$ 400,360                        | \$ 36,041               | \$ 29,836                |
| Accounts receivable, less allowance         | 1,015,139                         | 809,277                 | 956,109                  |
| Inventories:                                |                                   |                         |                          |
| Finished goods                              | 742,416                           | 686,913                 | 711,330                  |
| Work in process and raw materials           | 112,985                           | 121,631                 | 110,307                  |
|   | <b>855,401</b>                    | 808,544                 | 821,637                  |
| Deferred income taxes                       | 110,204                           | 107,739                 | 90,269                   |
| Other current assets                        | 163,958                           | 132,784                 | 150,564                  |
| Total current assets                        | <b>2,545,062</b>                  | 1,894,385               | 2,048,415                |
| Goodwill                                    | 887,175                           | 887,374                 | 908,411                  |
| Intangible assets                           | 280,352                           | 290,943                 | 295,539                  |
| Deferred pension assets                     | 417,416                           | 409,308                 | 434,745                  |
| Other assets                                | 159,007                           | 142,037                 | 150,561                  |
| Property, plant and equipment               | 2,006,087                         | 1,880,428               | 1,849,384                |
| Less allowances for depreciation            | 1,209,290                         | 1,135,280               | 1,111,613                |
|   | <b>796,797</b>                    | 745,148                 | 737,771                  |
| Total assets                                | <b>\$ 5,085,809</b>               | \$ 4,369,195            | \$ 4,575,442             |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                                   |                         |                          |
| Current liabilities:                        |                                   |                         |                          |
| Short-term borrowings                       | \$ 275,730                        | \$ 123,681              | \$ 282,629               |
| Accounts payable                            | 855,273                           | 719,977                 | 722,251                  |
| Compensation and taxes withheld             | 201,493                           | 224,760                 | 178,376                  |
| Accrued taxes                               | 158,493                           | 80,987                  | 138,909                  |
| Current portion of long-term debt           | 208,648                           | 10,493                  | 10,493                   |
| Other accruals                              | 412,475                           | 394,473                 | 374,662                  |
| Total current liabilities                   | <b>2,112,112</b>                  | 1,554,371               | 1,707,320                |
| Long-term debt                              | 298,755                           | 486,996                 | 487,313                  |
| Postretirement benefits other than pensions | 230,890                           | 226,526                 | 226,163                  |
| Other long-term liabilities                 | 381,890                           | 370,690                 | 401,577                  |

## Shareholders' equity:

Common stock \$1.00 par value:

134,822,846, 135,139,381 and 136,906,023 shares  
outstanding at September 30, 2006, December 31, 2005

and September 30, 2005, respectively

**221,590** 218,935 218,647

Preferred stock convertible, no par value:

460,681, 34,702 and 64,394 shares outstanding at

September 30, 2006, December 31, 2005 and

September 30, 2005, respectively

**460,681** 34,702 64,394

Unearned ESOP compensation

**(460,681)** (34,702) (64,394)

Other capital

**666,433** 570,394 528,388

Retained earnings

**3,420,229** 3,044,863 2,997,602

Treasury stock, at cost

**(2,040,582)** (1,890,040) (1,801,517)

Cumulative other comprehensive loss

**(205,508)** (213,540) (190,051)

Total shareholders' equity

**2,062,162** 1,730,612 1,753,069

Total liabilities and shareholders' equity

**\$ 5,085,809** \$ 4,369,195 \$ 4,575,442**See notes to condensed consolidated financial statements.**

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**Table of Contents****THE SHERWIN-WILLIAMS COMPANY AND SUBSIDIARIES  
CONDENSED STATEMENTS OF CONSOLIDATED CASH FLOWS (UNAUDITED)**

Thousands of dollars

|  | Nine months ended September<br>30, |               |
|--|------------------------------------|---------------|
|  | 2006                               | 2005          |
| <b>OPERATING ACTIVITIES</b>                                |                                    |               |
| Net income   | \$ 477,375                         | \$ 388,123    |
| Adjustments to reconcile net income to net operating cash: |                                    |               |
| Depreciation   | 90,714                             | 89,531        |
| Amortization of intangibles and other assets               | 16,881                             | 17,422        |
| Stock-based compensation expense                           | 17,743                             | 5,585         |
| Provisions for environmental-related matters               | 17,448                             | 12,279        |
| Defined benefit pension plans net credit                   | (1,127)                            | (3,674)       |
| Net increase in postretirement liability                   | 4,364                              | 4,188         |
| Other  | (3,985)                            | 7,142         |
| Change in working capital accounts net                     | (77,105)                           | (150,430)     |
| Costs incurred for environmental-related matters           | (8,283)                            | (5,819)       |
| Costs incurred for qualified exit costs                    | (1,968)                            | (582)         |
| Other  | 4,809                              | (395)         |
| <br>Net operating cash                                     | <br>536,866                        | <br>363,370   |
| <b>INVESTING ACTIVITIES</b>                                |                                    |               |
| Capital expenditures                                       | (144,368)                          | (103,023)     |
| Acquisitions of businesses                                 |                                    | (23,267)      |
| Increase in other investments                              | (26,473)                           | (19,787)      |
| Proceeds from sale of assets                               | 6,983                              | 10,876        |
| Other  | 2,061                              | (1,701)       |
| <br>Net investing cash                                     | <br>(161,797)                      | <br>(136,902) |
| <b>FINANCING ACTIVITIES</b>                                |                                    |               |
| Net increase in short-term borrowings                      | 150,123                            | 46,527        |
| Net increase (decrease) in long-term debt                  | 9,952                              | (1,505)       |
| Payments of cash dividends                                 | (102,009)                          | (85,714)      |
| Proceeds from stock options exercised                      | 61,237                             | 50,748        |
| Income tax effect of stock-based compensation              | 20,214                             |               |
| Treasury stock purchased                                   | (149,481)                          | (268,051)     |
| Other  | (1,325)                            | 15,254        |
| <br>Net financing cash                                     | <br>(11,289)                       | <br>(242,741) |
| <br>Effect of exchange rate changes on cash                | <br>539                            | <br>177       |



|  |                   |            |
|--|-------------------|------------|
| Net increase (decrease) in cash and cash equivalents | <b>364,319</b>    | (16,096)   |
| Cash and cash equivalents at beginning of year       | <b>36,041</b>     | 45,932     |
| <br>   |                   |            |
| Cash and cash equivalents at end of period           | <b>\$ 400,360</b> | \$ 29,836  |
| <br>   |                   |            |
| Income taxes paid                                    | <b>\$ 151,300</b> | \$ 112,956 |
| Interest paid  | <b>58,554</b>     | 46,012     |

**See notes to condensed consolidated financial statements.**

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**THE SHERWIN-WILLIAMS COMPANY AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)**

Periods ended September 30, 2006 and 2005

**Note A BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Form 10-K for the fiscal year ended December 31, 2005, as updated in the Company's Current Report on Form 8-K which was filed with the Securities and Exchange Commission (SEC) on April 18, 2006. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The consolidated results for the third quarter ended September 30, 2006 are not necessarily indicative of the results to be expected for the fiscal year ending December 31, 2006.

Minority interest reflects the minority shareholder's interest in the net income of Sherwin-Williams Kinlita Co., Ltd (Kinlita), disposed on September 29, 2005.

**Note B STOCK-BASED COMPENSATION**

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards (FAS) No. 123R, Share-Based Payment, utilizing the modified prospective method as described in FAS No. 123R. In the modified prospective method, compensation cost is recognized for all share-based payments granted after the effective date and for all unvested awards granted prior to the effective date. In accordance with FAS No. 123R, prior period amounts were not restated. FAS No. 123R also requires the tax benefits associated with these share-based payments to be classified as financing activities in the Condensed Statements of Consolidated Cash Flows, rather than as operating cash flows as required under previous regulations.

At September 30, 2006, the Company had two stock-based compensation plans and total unrecognized stock-based compensation expense of \$39.3 million that is expected to be recognized over a weighted-average period of 1.42 years. Total stock-based compensation expense, recognized in Selling, general and administrative expenses, aggregated \$6.3 million during the third quarter and \$17.7 million during the first nine months of 2006 compared to \$1.6 million during the third quarter of 2005 and \$5.6 million during the first nine months of 2005. The Company recognized a total income tax benefit of \$2.2 million during the third quarter and \$6.1 million during the first nine months of 2006 related to stock-based compensation expense compared to \$.6 million during the third quarter of 2005 and \$2.0 million during the first nine months of 2005. The recognition of total stock-based compensation expense impacted Basic net

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income per common share and Diluted net income per common share by \$.03 and \$.03, respectively, during the third quarter of 2006 and \$.09 and \$.08, respectively, during the first nine months of 2006.

Prior to the effective date, the stock-based compensation plans were accounted for under Accounting Principles Board Opinion (APBO) No. 25, Accounting for Stock Issued to Employees, and related interpretations. Pro-forma information regarding the impact of total stock-based compensation on net income and net income per share for prior periods is required by FAS No. 123R. Such pro-forma information, determined as if the Company had accounted for its stock-based compensation under the fair value method during the third quarter and first nine months of 2005, is illustrated in the following table:

|  | Three months<br>ended<br>September 30,<br>2005 | Nine months<br>ended<br>September 30,<br>2005 |
|--|--|---|
| (Thousands of dollars except per share data)   |  |   |
| Net income, as reported  | \$ 151,608                                     | \$ 388,123                                    |
| Add: Total stock-based compensation expense included in the determination of net income as reported, net of related tax effects  | 1,042  | 3,631   |
| Less: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects | (3,246)  | (8,661)                                       |
| <br>Pro forma net income   | <br>\$ 149,404                                 | <br>\$ 383,093                                |
| <br>Net income per common share:   |  |   |
| Basic as reported  | \$ 1.11  | \$ 2.82                                       |
| Basic pro-forma  | \$ 1.09  | \$ 2.78                                       |
| Diluted as reported  | \$ 1.07  | \$ 2.73                                       |
| Diluted pro-forma  | \$ 1.06  | \$ 2.71                                       |

The fair value of the Company's employee stock options was estimated at the date of grant using a Black-Scholes-Merton option-pricing model with the following weighted-average assumptions for all options granted during the first nine months:

|                                  | <b>FAS No.<br/>123R<br/>Expense<br/>2006</b> | FAS No.<br>123<br>Pro forma<br>2005 |
|----------------------------------|--|-------------------------------------|
| Risk-free interest rate          | <b>4.73%</b>                                 | 3.65%                               |
| Expected life of options         | <b>4.5 years</b>                             | 3.0 years                           |
| Expected dividend yield of stock | <b>2.25%</b>                                 | 2.28%                               |
| Expected volatility of stock     | <b>.243</b>                                  | .219                                |

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The risk-free interest rate is based upon the U.S. Treasury yield curve at the time of grant. The expected life of options was calculated using a Monte Carlo simulation model. Historical data was used to develop a post-vest termination rate of 4.77 percent, which was applied to the expected life of options calculation for the 2006 grants. The expected dividend yield of stock is the Company's best estimate of the expected future dividend yield. Expected volatility of stock was calculated using historical and implied volatilities. The Company applied an estimated forfeiture rate of 4.22 percent to the 2006 grants. This rate was calculated based upon historical activity and is an estimate of granted shares not expected to vest. If actual forfeitures differ from the expected rate, the Company may be required to make additional adjustments to compensation expense in future periods.

Cash received from option exercises totaled \$61.2 million and \$50.7 million during the first nine months of 2006 and 2005, respectively. The Company issues new shares upon exercise of stock options or granting of restricted stock.

**2006 Equity and Performance Incentive Plan**

At the Annual Meeting of Shareholders held on April 19, 2006, the shareholders approved the 2006 Equity and Performance Incentive Plan (Employee Plan) that replaced the 2003 Stock Plan and authorizes the Board of Directors, or a committee of the Board of Directors, to issue or transfer up to in the aggregate 10,000,000 shares of common stock, plus any shares relating to awards that expire, are forfeited or cancelled. The Company's Employee Plan permits the granting of stock options, restricted stock, appreciation rights, restricted stock units and performance shares and performance units to eligible employees. For more information on the Employee Plan, see the Company's Current Report on Form 8-K dated April 19, 2006. For a description of the 2003 Stock Plan's terms, see Note 11 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

Grants of restricted stock, which generally require four years of continuous employment from the date of grant before vesting and receiving the shares without restriction, have been awarded to certain officers and key employees under the 2003 Stock Plan. The number of shares to be received without restriction under this plan is based on the Company's achievement of specified financial goals relating to average return on average equity and earnings before interest, taxes, depreciation and amortization. During the first nine months of 2006, 1,500 shares of restricted stock vested and were delivered to certain officers and key employees under the 2003 Stock Plan and 4,000 shares were forfeited. During the first nine months of 2005, 191,500 shares of restricted stock vested and were delivered to certain officers and key employees under the 2003 Stock Plan and 135,250 shares were forfeited. At September 30, 2006, there were 1,148,600 shares of restricted stock granted to certain officers and key employees outstanding.

Unrecognized compensation expense with respect to restricted stock granted to eligible employees amounted to \$21.5 million and \$15.2 million at September 30, 2006 and 2005, respectively. The unrecognized compensation expense is being amortized on a straight-line basis over the four-year vesting period and is expected to be recognized over a weighted average period of 1.49 years.

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A summary of restricted stock granted to certain officers and key employees under the 2003 Stock Plan during the first nine months of 2006 and 2005 is as follows:

|  |                 |          |
|--|-----------------|----------|
| Shares granted   | <b>2006</b>     | 2005     |
|  | <b>294,975</b>  | 311,425  |
| Weighted-average fair value of restricted shares granted during the period | <b>\$ 47.11</b> | \$ 43.22 |

Grants of non-qualified and incentive stock options generally become exercisable to the extent of one-third of the optioned shares for each full year following the date of grant and generally expire ten years after the date of grant.

Unrecognized compensation expense with respect to stock options granted to eligible employees amounted to \$16.8 million and \$13.4 million at September 30, 2006 and 2005, respectively. The unrecognized compensation expense is being amortized on a straight-line basis over the three-year vesting period and is expected to be recognized over a weighted average period of 1.36 years.

The total intrinsic value of options exercised was \$54.9 million and \$42.4 million during the first nine months of 2006 and 2005, respectively.

A summary of the Company's non-qualified and incentive stock option activity and related information for the first nine months ended September 30, 2006 and 2005 is shown in the following table:

|  | <b>2006</b>        |                  |                  | <b>2005</b>     |                  |                  |
|--|--------------------|------------------|------------------|-----------------|------------------|------------------|
|  | <b>Optioned</b>    | <b>Weighted-</b> | <b>Aggregate</b> | <b>Optioned</b> | <b>Weighted-</b> | <b>Aggregate</b> |
|  | <b>Shares</b>      | <b>Average</b>   | <b>Intrinsic</b> | <b>Shares</b>   | <b>Average</b>   | <b>Intrinsic</b> |
|  |                    | <b>Exercise</b>  | <b>Value</b>     |                 | <b>Exercise</b>  | <b>Value</b>     |
|  |                    | <b>Price</b>     |                  |                 | <b>Price</b>     |                  |
| Outstanding beginning of year                                | <b>12,608,942</b>  | <b>\$ 31.09</b>  |                  | 13,286,833      | \$ 28.14         |                  |
| Granted  | <b>158,364</b>     | <b>48.10</b>     |                  | 235,500         | 45.28            |                  |
| Exercised  | <b>(2,347,335)</b> | <b>26.08</b>     |                  | (2,048,048)     | 24.68            |                  |
| Forfeited  | <b>(62,241)</b>    | <b>41.01</b>     |                  | (314,928)       | 33.58            |                  |
| Expired  | <b>(1,217)</b>     | <b>40.24</b>     |                  | (2,901)         | 27.15            |                  |
| Outstanding end of period                                    | <b>10,356,513</b>  | <b>\$ 32.42</b>  | <b>\$ 23.09</b>  | 11,156,456      | \$ 28.99         | \$ 14.73         |
| Exercisable at end of period                                 | <b>6,434,632</b>   |                  | <b>\$ 28.42</b>  |                 |                  |                  |
| Weighted-average fair value of options granted during period | <b>\$ 10.91</b>    |                  |                  |                 |                  |                  |
| Reserved for future grants                                   | <b>10,170,571</b>  |                  |                  |                 |                  |                  |

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Exercise prices for optioned shares outstanding as of September 30, 2006 ranged from \$17.91 to \$52.55. A summary of outstanding and exercisable options is as follows:

|  | Outstanding                               |  |                    | Exercisable                               |  |                    |
|--|---|--|--------------------|---|--|--------------------|
|  | Weighted-<br>Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Life (years) | Optioned<br>Shares | Weighted-<br>Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Life (years) | Optioned<br>Shares |
|  | 10,356,513                                | \$32.42  | 6.34               | 6,434,632                                 | \$27.09  | 5.07               |

**2006 Stock Plan for Nonemployee Directors**

At the Annual Meeting of Shareholders held on April 19, 2006, the shareholders approved the 2006 Stock Plan for Nonemployee Directors (Nonemployee Director Plan) that replaced the 1997 Stock Plan and authorizes the Board of Directors, or a committee of the Board of Directors, to issue or transfer up to in the aggregate 200,000 shares of common stock, plus any shares relating to awards that expire, are forfeited or are cancelled. The Company's Nonemployee Director Plan permits the granting of stock options, restricted stock, appreciation rights and restricted stock units to members of the Board of Directors who are not employees of the Company. At September 30, 2006, no shares have been granted under the Nonemployee Director Plan. For more information on the Nonemployee Director Plan, see the Company's Current Report on Form 8-K dated April 19, 2006. For a description of the 1997 Stock Plan's terms, see Note 11 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

Grants of restricted stock under the 1997 Stock Plan generally vest and are received without restriction to the extent of one-third of the granted shares for each year following the date of grant. During the first nine months of 2006 and 2005, 10,500 and 5,000 shares of restricted stock, respectively, vested under the 1997 Stock Plan. There were 32,500 shares of restricted stock granted to nonemployee Directors outstanding at September 30, 2006. Unrecognized compensation expense with respect to stock options granted to nonemployee Directors amounted to \$1.0 million and \$.7 million at September 30, 2006 and 2005, respectively. The unrecognized compensation expense is being amortized on a straight-line basis over the three-year vesting period and is expected to be recognized over a weighted average period of 1.10 years.

A summary of restricted stock granted to nonemployee Directors under the 1997 Stock Plan during the first nine months of 2006 and 2005 is as follows:

|  | 2006     | 2005     |
|--|----------|----------|
| Shares granted   | 16,500   | 15,000   |
| Weighted-average fair value of restricted shares granted during the period | \$ 47.56 | \$ 43.22 |

**Table of Contents****Note C DIVIDENDS**

Dividends paid on common stock during each of the first three quarters of 2006 and 2005 were \$.25 per common share and \$.205 per common share, respectively.

**Note D OTHER (INCOME) EXPENSE NET**

Items included in Other (income) expense net are as follows:

| (Thousands of dollars)                                     | Three months ended |          | Nine months ended |            |
|--|--------------------|----------|-------------------|------------|
|  | September 30,      |          | September 30,     |            |
|  | 2006               | 2005     | 2006              | 2005       |
| Dividend and royalty income                                | \$ (901)           | \$ (860) | \$ (2,676)        | \$ (2,402) |
| Net (income) expense of financing and investing activities | (203)              | 317      | (555)             | 2,164      |
| Loss on disposition of joint venture investment            |                    | 7,858    |                   | 7,858      |
| Foreign currency related (gains) losses                    | (459)              | 492      | 2,356             | 1,363      |
| Provisions for environmental matters net                   | 2,002              |          | 17,448            | 12,279     |
| Other income   | (1,269)            | (875)    | (3,819)           | (3,001)    |
| Other expense  | 687                | 539      | 2,425             | 2,520      |
|  | \$ (143)           | \$ 7,471 | \$ 15,179         | \$ 20,781  |

The net (income) expense of financing and investing activities represents the realized gains or losses associated with the disposal of fixed assets, the Company's investment in certain life insurance policies and financing fees.

The loss on disposition of joint venture investment relates to the disposal of the Company's majority ownership of Kinlita.

Provisions for environmental matters net represent site specific increases or decreases to environmental-related accruals as information becomes available upon which more accurate costs can be reasonably estimated and as additional accounting guidelines are issued. Environmental-related accruals are not offset by insurance proceeds and are recorded in accordance with Financial Accounting Standards Board (FASB) Interpretation No. 39. See Note K for further details on the Company's environmental-related activities.

Other income and other expense include items of revenue, gains, expenses and losses that are unrelated to the primary business purpose of the Company and adjustments to prior provisions for exit or disposal activities. Each individual item within these captions was immaterial; no single category of items exceeded \$1.0 million.

**Table of Contents****Note E EXIT OR DISPOSAL ACTIVITIES**

The Company recognizes liabilities associated with exit or disposal activities as incurred in accordance with FAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. Qualifying exit costs primarily include post-closure rent expenses, incremental post-closure costs and costs of employee terminations. Adjustments may be made to prior provisions for qualified exit costs if information becomes available upon which more accurate amounts can be reasonably estimated. Concurrently, property, plant and equipment is tested for impairment in accordance with FAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, and, if impairment exists, the carrying value of the related assets is reduced to estimated fair value. Additional impairment may be recorded for subsequent revisions in estimated fair value. No significant revisions occurred during the first three quarters of 2006. The following table summarizes the remaining liabilities associated with qualified exit costs at September 30, 2006 and the activity for the nine-month period then ended:

(Thousands of dollars)

| Exit Plan  | Balance at<br>December<br>31,<br>2005 | Actual<br>expenditures<br>charged to<br>accrual | Adjustments<br>to<br>prior<br>provisions<br>in Other<br>(income)<br>expense - net | Balance at<br>September<br>30,<br>2006 |
|--|---------------------------------------|---|---|--|
| Consumer Group manufacturing facilities<br>shutdown in 2005: |                                       |   |   |  |
| Severance and related costs                                  | \$ 922                                | \$ (927)  | \$ 5  | \$                                     |
| Other qualified exit costs                                   | 986                                   | (333)   | (533)   | 120                                    |
| Consumer Group manufacturing facility<br>shutdown in 2004:   |                                       |   |   |  |
| Other qualified exit costs                                   | 650                                   | (225)   |   | 425                                    |
| Qualified exit costs initiated prior to 2004                 | 12,883                                | (483)   |   | 12,400                                 |
| Totals   | \$ 15,441                             | \$ (1,968)                                      | \$ (528)  | \$ 12,945                              |

For further details on the Company's exit or disposal activities, see Note 5 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

**Note F PRODUCT WARRANTIES**

Changes in the Company's accrual for product warranty claims during the first three quarters of 2006 and 2005, including customer satisfaction settlements during the year, were as follows:



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| (Thousands of dollars)  | 2006      | 2005      |
|-------------------------|-----------|-----------|
| Balance at January 1    | \$ 23,003 | \$ 18,098 |
| Charges to expense      | 28,434    | 24,587    |
| Settlements             | (25,571)  | (22,341)  |
| Balance at September 30 | \$ 25,866 | \$ 20,344 |

For further details on the Company's accrual for product warranty claims, see Note 1 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

**Note G COMPREHENSIVE INCOME**

Comprehensive income is summarized as follows:

| (Thousands of dollars)   | Three months ended<br>September 30, |            | Nine months ended<br>September 30, |            |
|--|-------------------------------------|------------|------------------------------------|------------|
|  | 2006                                | 2005       | 2006                               | 2005       |
| Net income   | \$ 179,112                          | \$ 151,608 | \$ 477,375                         | \$ 388,123 |
| Foreign currency translation adjustments   | 1,659                               | 10,941     | 8,067                              | 19,375     |
| Marketable equity securities and derivative instruments used in cash flow hedges adjustments, net of taxes | (328)                               | 165        | (35)                               | 156        |
| Comprehensive income   | \$ 180,443                          | \$ 162,714 | \$ 485,407                         | \$ 407,654 |

**Note H NET INCOME PER COMMON SHARE**

| (Thousands of dollars except per share data)         | Three months ended<br>September 30, |             | Nine months ended September<br>30, |             |
|--|-------------------------------------|-------------|------------------------------------|-------------|
|  | 2006                                | 2005        | 2006                               | 2005        |
| Basic  |                                     |             |                                    |             |
| Average common shares outstanding                    | 133,622,166                         | 136,911,347 | 134,196,870                        | 137,618,594 |
| Net income   | \$ 179,112                          | \$ 151,608  | \$ 477,375                         | \$ 388,123  |
| Net income per common share                          | \$ 1.34                             | \$ 1.11     | \$ 3.56                            | \$ 2.82     |
| Diluted  |                                     |             |                                    |             |
| Average common shares outstanding                    | 133,622,166                         | 136,911,347 | 134,196,870                        | 137,618,594 |
| Non-vested restricted stock grants                   | 1,181,100                           | 886,225     | 1,147,385                          | 971,700     |
| Stock options and other contingently issuable shares | 2,571,845                           | 3,429,896   | 2,684,618                          | 3,382,033   |

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|   |                    |             |                    |             |
|---|--------------------|-------------|--------------------|-------------|
| Average common shares assuming dilution | <b>137,375,111</b> | 141,227,468 | <b>138,028,873</b> | 141,972,327 |
| Net income                              | \$ <b>179,112</b>  | \$ 151,608  | \$ <b>477,375</b>  | \$ 388,123  |
| Net income per common share             | \$ <b>1.30</b>     | \$ 1.07     | \$ <b>3.46</b>     | \$ 2.73     |

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**Table of Contents****Note I REPORTABLE SEGMENT INFORMATION**

The Company reports segment information in the same way that management internally organizes its business for assessing performance and making decisions regarding allocation of resources in accordance with FAS No. 131,

Disclosures about Segments of an Enterprise and Related Information. Effective January 1, 2006, the Company changed its reportable operating segments based on recent organizational changes in its management structure. The Company's reportable operating segments now are: Paint Stores Group, Consumer Group and Global Group. The Global Group Segment consists of certain business units with foreign or worldwide operations that were reported in the previous Paint Stores, Consumer, Automotive Finishes and International Coatings Segments. Amounts previously reported for the third quarter and first nine months of 2005 have been updated to reflect this change. See the Company's Current Report on Form 8-K dated April 18, 2006 and Exhibit 99.1 attached thereto which updates the Company's business segment information to reflect the changes in reportable operating segments for each calendar quarter of 2005 and each of the five years through the year ended December 31, 2005.

**Net External Sales/ Segment Profit (Loss)**

| (Thousands of dollars)                  | 2006               |                       | 2005               |                       |
|---|--------------------|-----------------------|--------------------|-----------------------|
|   | Net External Sales | Segment Profit (Loss) | Net External Sales | Segment Profit (Loss) |
| <b>Three months ended September 30:</b> |                    |                       |                    |                       |
| Paint Stores Group                      | \$ 1,347,720       | \$ 226,722            | \$ 1,231,034       | \$ 178,434            |
| Consumer Group                          | 354,967            | 60,273                | 360,244            | 54,112                |
| Global Group                            | 412,049            | 42,721                | 383,561            | 23,539                |
| Administrative                          | 1,975              | (53,025)              | 1,889              | (37,091)              |
| Consolidated totals                     | \$ 2,116,711       | \$ 276,691            | \$ 1,976,728       | \$ 218,994            |
| <b>Nine months ended September 30:</b>  |                    |                       |                    |                       |
| Paint Stores Group                      | \$ 3,732,128       | \$ 557,208            | \$ 3,295,253       | \$ 436,118            |
| Consumer Group                          | 1,085,814          | 193,270               | 1,101,084          | 171,605               |
| Global Group                            | 1,191,402          | 109,226               | 1,078,683          | 69,782                |
| Administrative                          | 5,865              | (151,977)             | 5,611              | (131,300)             |
| Consolidated totals                     | \$ 6,015,209       | \$ 707,727            | \$ 5,480,631       | \$ 546,205            |

**Intersegment Transfers**

| (Thousands of dollars) | Three months ended<br>September 30, |            | Nine months ended September<br>30, |              |
|------------------------|-------------------------------------|------------|------------------------------------|--------------|
|                        | 2006                                | 2005       | 2006                               | 2005         |
| Consumer Group         | \$ 456,869                          | \$ 430,155 | \$ 1,286,552                       | \$ 1,114,666 |
| Global Group           | 37,263                              | 32,739     | 106,963                            | 89,825       |
| Administrative         | 1,306                               | 1,264      | 3,760                              | 3,910        |
| Segment totals         | \$ 495,438                          | \$ 464,158 | \$ 1,397,275                       | \$ 1,208,401 |

Segment profit (loss) is total revenue, including intersegment transfers, less operating costs and expenses. Domestic intersegment transfers are accounted for at the approximate fully absorbed manufactured cost plus distribution costs. Foreign intersegment transfers are accounted for at values comparable to normal unaffiliated customer sales.

Administrative segment loss includes

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interest which is unrelated to certain financing activities of the Operating Segments, certain foreign currency transaction losses related to dollar-denominated debt and other financing activities, stock-based compensation expense and other adjustments.

Net external sales and segment profits of all consolidated foreign subsidiaries were \$214.1 million and \$21.3 million, respectively, for the third quarter of 2006, and \$203.8 million and \$11.1 million, respectively, for the third quarter of 2005. Net external sales and segment profits of these subsidiaries were \$611.1 million and \$50.6 million, respectively, for the first nine months of 2006, and \$555.8 million and \$27.9 million, respectively, for the first nine months of 2005. Long-lived assets of these subsidiaries totaled \$127.1 million and \$123.2 million at September 30, 2006 and 2005, respectively. Domestic operations account for the remaining net external sales, segment profits and long-lived assets. Administrative segment loss does not include any significant foreign operations. No single geographic area outside the United States was significant relative to consolidated net external sales or consolidated long-lived assets. Export sales and sales to any individual customer were each less than 10 percent of consolidated sales to unaffiliated customers during all periods presented.

**Note J HEALTH CARE, PENSION AND OTHER BENEFITS**

Shown below are the components of the Company's net periodic benefit (credit) cost for domestic defined benefit pension plans, foreign defined benefit pension plans and postretirement benefits other than pensions:

| (Thousands of dollars)                 | Domestic Defined<br>Benefit Pension Plans |            | Foreign Defined<br>Benefit Pension Plans |          | Postretirement<br>Benefits<br>Other than Pensions |          |
|--|---|------------|--|----------|---|----------|
|  | 2006                                      | 2005       | 2006                                     | 2005     | 2006  | 2005     |
| <b>Three months ended</b>              |   |            |  |          |   |          |
| <b>September 30:</b>                   |   |            |  |          |   |          |
| Net periodic benefit<br>(credit) cost: |   |            |  |          |   |          |
| Service cost                           | \$ 4,722                                  | \$ 4,316   | \$ 660                                   | \$ 587   | \$ 1,146  | \$ 1,111 |
| Interest cost                          | 3,697                                     | 3,406      | 750                                      | 673      | 4,020   | 4,345    |
| Expected return on assets              | (11,335)                                  | (11,003)   | (591)                                    | (503)    |   |          |
| Recognition of:                        |   |            |  |          |   |          |
| Unrecognized prior service<br>cost     | 151                                       | 154        | 15                                       | 15       | (158)   | (1,112)  |
| Unrecognized actuarial loss            | 1,244                                     | 781        | 340                                      | 303      | 860   | 1,265    |
| Net periodic benefit<br>(credit) cost  | \$ (1,521)                                | \$ (2,346) | \$ 1,174                                 | \$ 1,075 | \$ 5,868  | \$ 5,609 |
| <b>Nine months ended</b>               |   |            |  |          |   |          |
| <b>September 30:</b>                   |   |            |  |          |   |          |
| Net periodic benefit<br>(credit) cost: |   |            |  |          |   |          |
| Service cost                           | \$ 14,166                                 | \$ 12,946  | \$ 1,934                                 | \$ 1,836 | \$ 3,438  | \$ 3,333 |
| Interest cost                          | 11,091                                    | 10,220     | 2,194                                    | 2,097    | 12,060  | 13,035   |
| Expected return on assets              | (34,005)                                  | (33,009)   | (1,729)                                  | (1,554)  |   |          |
| Recognition of:                        |   |            |  |          |   |          |
| Unrecognized prior service<br>cost     | 453                                       | 464        | 45                                       | 53       | (474)   | (3,336)  |
| Unrecognized actuarial loss            | 3,732                                     | 2,345      | 992                                      | 928      | 2,580   | 3,795    |

|                                       |            |            |          |          |           |           |
|---------------------------------------|------------|------------|----------|----------|-----------|-----------|
| Net periodic benefit<br>(credit) cost | \$ (4,563) | \$ (7,034) | \$ 3,436 | \$ 3,360 | \$ 17,604 | \$ 16,827 |
|---------------------------------------|------------|------------|----------|----------|-----------|-----------|

For further details on the Company's health care, pension and other benefits, see Note 6 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

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**NOTE K OTHER LONG-TERM LIABILITIES**

The Company initially provides for estimated costs of environmental-related activities relating to its past operations and third-party sites for which commitments or clean-up plans have been developed and when such costs can be reasonably estimated based on industry standards and historical experience. These estimated costs are determined based on currently available facts regarding each site. If the best estimate of costs can only be identified as a range and no specific amount within that range can be determined more likely than any other amount within the range, the minimum of the range is provided. The unaccrued maximum of the estimated range of possible outcomes is \$144.0 million higher than the accrued amount at September 30, 2006. The Company continuously assesses its potential liability for investigation and remediation-related activities and adjusts its environmental-related accruals as information becomes available upon which more accurate costs can be reasonably estimated and as additional accounting guidelines are issued. Actual costs incurred may vary from these estimates due to the inherent uncertainties involved including, among others, the number and financial condition of parties involved with respect to any given site, the volumetric contribution which may be attributed to the Company relative to that attributed to other parties, the nature and magnitude of the wastes involved, the various technologies that can be used for remediation and the determination of acceptable remediation with respect to a particular site.

Included in Other long-term liabilities at September 30, 2006 and 2005 were accruals for extended environmental-related activities of \$135.9 million and \$124.2 million, respectively. Estimated costs of current investigation and remediation activities of \$33.5 million and \$24.9 million are included in Other accruals at September 30, 2006 and 2005, respectively.

Four of the Company's current and former manufacturing sites account for the majority of the accrual for environmental-related activities and the unaccrued maximum of the estimated range of possible outcomes at September 30, 2006. Included in the accruals of \$169.4 million at September 30, 2006 is \$111.3 million related directly to these four sites. In the aggregate unaccrued exposure of \$144.0 million at September 30, 2006, \$75.0 million relates to the four manufacturing sites. While environmental investigations and remedial actions are in different stages at these sites, additional investigations, remedial actions and monitoring will likely be required at each site.

Management cannot presently estimate the ultimate potential loss contingencies related to these sites or other less significant sites until such time as a substantial portion of the investigation at the sites is completed and remedial action plans are developed. In the event any future loss contingency significantly exceeds the current amount accrued, the recording of the ultimate liability may result in a material impact on net income for the annual or interim period during which the additional costs are accrued. Management does not believe that any potential liability ultimately attributed to the Company for its environmental-related matters will have a material adverse effect on the Company's financial condition, liquidity, or cash flow due to the extended period of time during which environmental investigation and remediation takes place. An estimate of the potential impact on the Company's operations cannot be made due to the aforementioned uncertainties.

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Management expects these contingent environmental-related liabilities to be resolved over an extended period of time. Management is unable to provide a more specific time frame due to the indefinite amount of time to conduct investigation activities at any site, the indefinite amount of time to obtain environmental agency approval, as necessary, with respect to investigation and remediation activities, and the indefinite amount of time necessary to conduct remediation activities.

For further details on the Company's Other long-term liabilities, see Note 8 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

**Note L IMPACT OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

In September of 2006, the FASB issued FAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FAS No. 87, 88, 106, and 132R. FAS No. 158 makes numerous changes to accounting for pension and postretirement benefit plans. The most significant change is that the funded status of all postretirement plans will be recorded on the balance sheet. The difference between a plan's funded status and its current balance sheet position will be recognized, net of taxes, as a component of Shareholders' equity. FAS No. 158 is effective for fiscal years ending after December 15, 2006. The Company will adopt the standard at December 31, 2006 and expects to recognize all actuarial losses and prior service costs and credits in Cumulative other comprehensive loss. Adoption of FAS No. 158 is not expected to have an impact on the Company's results of operations, cash flow or liquidity.

In September 2006, the FASB issued FAS No. 157, Fair Value Measurements. FAS No. 157 provides guidance for using fair value to measure assets and liabilities and only applies when other standards require or permit the fair value measurement of assets and liabilities. It does not expand the use of fair value measurement. FAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company will adopt this FAS as required and management is currently assessing the effect FAS No. 157 will have on the Company's results of operations, financial condition and liquidity.

In September 2006, the FASB issued Staff Position (FSP) AUG AIR-1, Accounting for Planned Major Maintenance Activities. FSP AUG AIR-1 addresses the accounting for planned major maintenance activities. Specifically, the FSP prohibits the practice of the accrue-in-advance method of accounting for planned major maintenance activities. FSP AUG AIR-1 is effective for fiscal years beginning after December 15, 2006. The Company will adopt the FSP as required and management does not expect FSP AUG AIR-1 to have an impact on the Company's results of operations, financial condition or liquidity.

In September 2006, the FASB ratified the Emerging Issues Task Force (EITF) consensus on EITF Issue No. 06-4, Accounting for Deferred Comp./Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. EITF Issue No. 06-4 indicates that an employer should recognize a liability for future post-employment benefits based on the substantive agreement with the employee. The EITF is effective for fiscal years beginning after



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December 15, 2007. The Company will adopt the EITF as required and management is currently assessing the effect EITF Issue No. 06-4 will have on the Company's results of operations, financial condition and liquidity.

In September 2006, the FASB ratified the EITF consensus on EITF Issue No. 06-5, Accounting For Purchases of Life Insurance Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance. EITF Issue No. 06-5 indicates that policyholders should consider the cash surrender value as well as any additional amounts included in the contractual terms of the policy. The EITF is effective for fiscal years beginning after December 15, 2006 and management does not expect the adoption of EITF Issue No. 06-5 to have an impact on the Company's results of operations, financial condition and liquidity.

In June 2006, the FASB issued Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. FIN 48 clarifies the recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company will adopt this interpretation as required and management is currently assessing the effect FIN 48 will have on the Company's results of operations, financial condition and liquidity.

In June 2006, the FASB ratified the EITF consensus on EITF Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation). EITF Issue No. 06-3 states that the classification of taxes as gross or net is an accounting policy decision that is dependent on type of tax and that similar taxes are to be presented in a similar manner. EITF Issue No. 06-3 is effective for reporting periods beginning after December 15, 2006. The Company will adopt this consensus as required, and adoption is not expected to have an impact on the Company's results of operations, financial condition or liquidity.

**Note M INCOME TAXES**

The effective tax rates were 35.3 percent and 32.6 percent for the third quarter and first nine months of 2006, respectively, and 30.6 percent and 28.7 percent for the third quarter and first nine months of 2005, respectively. The lower tax rate in 2005 when compared to 2006 was due to numerous favorable factors including the impact of the settlement of federal and state audit issues and tax benefits related to foreign operations.

**Note N DEBT**

See Note 7 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year-ended December 31, 2005 for a complete description of the Company's borrowing arrangements. The following represents significant changes that occurred to borrowings outstanding and terms of the arrangements during 2006.

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At September 30, 2006, borrowings outstanding under the domestic commercial paper program totaled \$246.5 million at an average rate of 5.63 percent. The nine-month increase in Short-term borrowings was due primarily to maintain short-term financial flexibility for the Company and support the seasonal increase in working capital.

On February 1, 2006, the Company sold or contributed certain of its accounts receivable to SWC Receivables Funding LLC (SWC), a consolidated wholly-owned subsidiary. SWC entered into an accounts receivable securitization borrowing facility with a third-party program agent. Under this program, SWC may borrow up to \$500.0 million and will secure such borrowings by granting a security interest in the accounts receivable, related security and the cash collections and proceeds of the receivables. At September 30, 2006, SWC had no borrowings outstanding under this program.

On April 17, 2006, the Company entered into an additional three-year credit agreement, which was amended on April 25, 2006 and May 8, 2006. This additional credit agreement gives the Company the right to borrow and to obtain the issuance, renewal, extension and increase of a letter of credit up to an aggregate availability of \$250.0 million. At September 30, 2006, there were no borrowings outstanding under the agreement.

On May 23, 2006, the Company entered into an additional five-year credit agreement. This additional credit agreement gives the Company the right to borrow and to obtain the issuance, renewal, extension and increase of a letter of credit up to an aggregate availability of \$100.0 million. The agreement was amended on July 24, 2006 to increase the aggregate availability to \$250.0 million. At September 30, 2006, there were no borrowings outstanding under the agreement.

**Note O RECLASSIFICATION**

Certain amounts in the 2005 financial statements have been reclassified to conform with the 2006 presentation.

**Note P LITIGATION**

In the course of its business, the Company is subject to a variety of claims and lawsuits, including litigation relating to product liability and warranty, personal injury, environmental, intellectual property, commercial, contractual and antitrust claims. The Company accrues for these contingencies consistent with the policy stated under Contingent Liabilities. However, because litigation is inherently subject to many uncertainties and the ultimate result of any present or future litigation is unpredictable, the Company's ultimate liability may result in costs that are significantly higher than currently accrued. In the event that the Company's loss contingency is ultimately determined to be significantly higher than currently accrued, the recording of the liability may result in a material impact on net income for the annual or interim period during which such liability is accrued. Additionally, due to the uncertainties involved, any potential liability determined to be attributable to the Company arising out of such litigation may have a material adverse effect on the Company's results of operations, liquidity or financial condition.

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*Lead Pigment and Lead-Based Paint Litigation*

The Company's past operations included the manufacture and sale of lead pigments and lead-based paints. The Company, along with other companies, is a defendant in a number of legal proceedings, including individual personal injury actions, purported class actions, a separate action brought by the State of Rhode Island, and actions brought by various counties, cities, school districts and other government-related entities, arising from the manufacture and sale of lead pigments and lead-based paints. The plaintiffs are seeking recovery based upon various legal theories, including negligence, strict liability, breach of warranty, negligent misrepresentations and omissions, fraudulent misrepresentations and omissions, concert of action, civil conspiracy, violations of unfair trade practice and consumer protection laws, enterprise liability, market share liability, public nuisance, unjust enrichment and other theories. The plaintiffs seek various damages and relief, including personal injury and property damage, costs relating to the detection and abatement of lead-based paint from buildings, costs associated with a public education campaign, medical monitoring costs and others. The Company is also a defendant in legal proceedings arising from the manufacture and sale of non-lead-based paints which seek recovery based upon various legal theories, including the failure to adequately warn of potential exposure to lead during surface preparation when using non-lead-based paint on surfaces previously painted with lead-based paint. The Company believes that the litigation brought to date is without merit or subject to meritorious defenses and is vigorously defending such litigation. The Company expects that additional lead pigment and lead-based paint litigation may be filed against the Company in the future asserting similar or different legal theories and seeking similar or different types of damages and relief.

Notwithstanding the Company's views on the merits, litigation is inherently subject to many uncertainties and the Company ultimately may not prevail. Adverse court rulings, such as the Rhode Island jury verdict and the Wisconsin State Supreme Court's July 2005 determination that Wisconsin's risk contribution theory applies in the lead pigment litigation (both discussed in more detail below), or determinations of liability, among other factors, could affect the lead pigment and lead-based paint litigation against the Company and encourage an increase in the number and nature of future claims and proceedings. In addition, from time to time, various legislation and administrative regulations have been enacted, promulgated or proposed to impose obligations on present and former manufacturers of lead pigments and lead-based paints respecting asserted health concerns associated with such products or to overturn the effect of court decisions in which the Company and other manufacturers have been successful.

Due to the uncertainties involved, management is unable to predict the outcome of the lead pigment and lead-based paint litigation, the number or nature of possible future claims and proceedings, or the effect that any legislation and/or administrative regulations may have on the litigation or against the Company. In addition, management cannot reasonably determine the scope or amount of the potential costs and liabilities related to such litigation, or resulting from any such legislation and regulations. The Company has not accrued any amounts for such litigation. Any potential liability that may result from such litigation or such legislation and regulations cannot reasonably be estimated. In the event any significant liability is determined to be attributable to the Company relating to such litigation, the recording of the liability may result

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in a material impact on net income for the annual or interim period during which such liability is accrued. Additionally, due to the uncertainties associated with the amount of any such liability and/or the nature of any other remedy which may be imposed in such litigation, any potential liability determined to be attributable to the Company arising out of such litigation may have a material adverse effect on the Company's results of operations, liquidity or financial condition. An estimate of the potential impact on the Company's results of operations, liquidity or financial condition cannot be made due to the aforementioned uncertainties.

*Rhode Island Lead Pigment Litigation*

During September 2002, a jury trial commenced in the first phase of an action brought by the State of Rhode Island against the Company and the other defendants. The sole issue before the court in this first phase was whether lead pigment in paint constitutes a public nuisance under Rhode Island law. In October 2002, the court declared a mistrial as the jury, which was split four to two in favor of the defendants, was unable to reach a unanimous decision. The State of Rhode Island retried the case and on February 22, 2006, the jury returned a verdict, finding that (i) the cumulative presence of lead pigment in paints and coatings on buildings in the State of Rhode Island constitutes a public nuisance, (ii) the Company, along with two other defendants, caused or substantially contributed to the creation of the public nuisance, and (iii) the Company and two other defendants should be ordered to abate the public nuisance. On February 28, 2006, the Court granted the defendants' motion to dismiss the punitive damages claim, finding insufficient evidence to support the State's request for punitive damages. Various post-trial motions and other matters remain before the Court. The Court has ruled that it will determine the scope and manner of the abatement remedy. The Court has not yet established a procedure or a time frame to make that determination. The Company intends to appeal the jury's verdict if the defendant's post-trial motions are not granted. This was the first legal proceeding against the Company to go to trial relating to the Company's lead pigment and lead-based paint litigation. The Company cannot reasonably determine the impact that the State of Rhode Island decision and determination of liability will have on the number or nature of present or future claims and proceedings against the Company or estimate the amount or range of ultimate loss that it may incur.

*Other Public Nuisance Claim Litigation*

The Company and other companies are defendants in other legal proceedings seeking recovery based on public nuisance liability theories including claims brought by the County of Santa Clara, California and other public entities in the State of California, the City of St. Louis, Missouri, the City of Milwaukee, Wisconsin, various cities and counties in the State of New Jersey, and several cities in the State of Ohio. The Santa Clara County, California proceeding was initiated in March 2000. The named plaintiffs are the County of Santa Clara, County of Santa Cruz, County of Solano, County of Alameda, County of Kern, City and County of San Francisco, San Francisco Housing Authority, San Francisco Unified School District, City of Oakland, Oakland Housing Authority, Oakland

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Redevelopment Agency and the Oakland Unified School District. The proceeding purports to be a class action on behalf of all public entities in the State of California except the State and its agencies. The plaintiffs' second amended complaint asserted claims for fraud and concealment, strict product liability/failure to warn, strict product liability/design defect, negligence, negligent breach of a special duty, public nuisance, private nuisance and violations of California's Business and Professions Code, and the third amended complaint alleges similar claims including a claim for public nuisance. Various asserted claims were resolved in favor of the defendants through pre-trial demurrers and motions to strike. In October 2003, the trial court granted the defendants' motion for summary judgment against the remaining counts on statute of limitation grounds. The plaintiffs appealed the trial court's decision and on March 3, 2006, the Court of Appeal, Sixth Appellate District, reversed in part the demurrers and summary judgment entered in favor of the Company and the other defendants. The Court of Appeal reversed the dismissal of the public nuisance claim for abatement brought by the cities of Santa Clara and Oakland and the City and County of San Francisco, and reversed summary judgment on all of the plaintiffs' fraud claim to the extent that the plaintiffs alleged that the defendants had made fraudulent statements or omissions minimizing the risks of low-level exposure to lead. The Court of Appeal further vacated the summary judgment holding that the statute of limitations barred the plaintiffs' strict liability and negligence claims, and held that those claims had not yet accrued because physical injury to the plaintiffs' property had not been alleged. The Court of Appeal affirmed the dismissal of the public nuisance claim for damages to the plaintiffs' properties, most aspects of the fraud claim, the trespass claim and the unfair business practice claim.

The City of St. Louis proceeding was initiated in January 2000. The City initially alleged claims for strict liability, negligence, fraudulent misrepresentation, negligent misrepresentation, concert of action, conspiracy, public nuisance, restitution and indemnity. Following various pre-trial proceedings during which many of the asserted claims were dismissed by the trial court or voluntarily dismissed by the City, on June 10, 2003, the City filed its fourth amended petition alleging a single count of public nuisance. Following further pre-trial proceedings, on January 18, 2006, the trial court granted the defendants' motion for summary judgment based on the City's lack of product identification evidence. On February 24, 2006, the City filed its notice of appeal to appeal the trial court's January 18, 2006 decision and a prior trial court decision.

The City of Milwaukee proceeding was initiated in April 2001 against Mautz Paint Co. and NL Industries, Inc. On November 7, 2001, the Company acquired certain assets of Mautz Paint Co. and agreed (under terms and conditions set forth in the purchase agreement) to defend and indemnify Mautz Paint Co. for its liability, if any, to the City of Milwaukee in this action. The City's complaint included claims for continuing public nuisance, restitution, conspiracy, negligence, strict liability, failure to warn and violation of Wisconsin's trade practices statute. Following various pre-trial proceedings during which several of the City's claims were dismissed by the court or voluntarily dismissed by the City, on August 13, 2003, the trial court granted defendants' motion for summary judgment on the remaining claims. The City appealed and, on November 9, 2004, the Wisconsin Court of Appeals reversed the trial court's decision and remanded the claims for public nuisance, conspiracy and restitution to the trial court. Discovery is currently proceeding in this matter and a previous trial date of January 8, 2007 has been postponed.

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In December 2001 and early 2002, a number of cities and counties in New Jersey individually initiated proceedings in the Superior Court of New Jersey against the Company and other companies asserting claims for fraud, public nuisance, civil conspiracy, unjust enrichment and indemnity. The New Jersey Supreme Court consolidated all of the cases and assigned them to the Superior Court in Middlesex County. By order dated November 4, 2002, the Superior Court granted the defendants' motion to dismiss all complaints. The plaintiffs appealed and, on August 17, 2005, the Appellate Division affirmed the dismissal of all claims except public nuisance. The Appellate Division reinstated the public nuisance claim in each case. On November 17, 2005, the New Jersey Supreme Court granted defendants' petition for certification to review the reinstatement of the public nuisance claims.

In September and October 2006, several cities in Ohio individually initiated proceedings in state court against the Company and other companies asserting claims for public nuisance, concert of action, unjust enrichment, indemnity and punitive damages. Also in September 2006, the Company initiated proceedings in the United States District Court, Southern District of Ohio, against certain of the Ohio cities which initiated the state court proceedings referred to in the preceding sentence and John Doe cities and public officials. The Company's proceeding seeks declaratory and injunctive relief to prevent the violation of the Company's federal constitutional rights in relation to such state court proceedings.

*Litigation Seeking Damages from Alleged Personal Injury*

The Company and other companies are defendants in a number of legal proceedings seeking monetary damages and other relief from alleged personal injuries. These proceedings include claims by children allegedly injured from ingestion of lead pigment or lead-containing paint, claims for damages allegedly incurred by the children's parents or guardians, and claims for damages allegedly incurred by professional painting contractors. These proceedings generally seek compensatory and punitive damages, and seek other relief including medical monitoring costs. These proceedings include purported claims by individuals, groups of individuals and class actions.

The plaintiff in *Thomas v. Lead Industries Association, et al.*, initiated an action against the Company, other alleged former lead pigment manufacturers and the Lead Industries Association in September 1999. The claims against the Company and the other defendants include strict liability, negligence, negligent misrepresentation and omissions, fraudulent misrepresentation and omissions, concert of action, civil conspiracy and enterprise liability. Implicit within these claims is the theory of risk contribution liability (Wisconsin's theory which is similar to market share liability) due to the plaintiff's inability to identify the manufacturer of any product that allegedly injured the plaintiff. Following various pre-trial proceedings during which certain of the plaintiff's claims were dismissed by the court, on March 10, 2003, the trial court granted the defendants' motion for summary judgment, dismissing the case with prejudice and awarding costs to each defendant. The plaintiff appealed and on June 14, 2004, the Wisconsin Court of Appeals affirmed the trial court's decision. On July 15, 2005, the Wisconsin Supreme Court reversed in part the trial court's decision and adopted a risk contribution theory to excuse the plaintiff's lack of evidence identifying any of the Company's or the other defendant's products as

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the cause of the alleged injury. The case has been remanded to the trial court and discovery is currently proceeding in this matter.

Wisconsin is the first jurisdiction to apply a theory of liability with respect to alleged personal injury (i.e.: risk contribution/market share liability) which does not require the plaintiff to identify the manufacturer of the product that allegedly injured the plaintiff in the lead pigment and lead-based paint litigation. Following the July 2005 decision by the Wisconsin Supreme Court to adopt a risk contribution theory in the lead pigment litigation, the Company is aware of five new proceedings which have been filed in Wisconsin courts against the Company and other companies seeking damages from alleged personal injury.

*Insurance Coverage Litigation*

On March 3, 2006, the Company filed a lawsuit in the Common Pleas Court, Cuyahoga County, Ohio against its liability insurers, including certain Underwriters at Lloyd's of London. The lawsuit seeks, among other things, (i) a declaration from the court that costs associated with the abatement of lead pigment in the State of Rhode Island, or any other jurisdiction, are covered under certain insurance policies issued to the Company and (ii) monetary damages for breach of contract and bad faith against the Lloyd's Underwriters for unjustified denial of coverage for the cost of complying with any final judgment requiring the Company to abate any alleged nuisance caused by the presence of lead pigment paint in buildings. This lawsuit was filed in response to a lawsuit filed by the Lloyd's Underwriters against the Company, two other defendants in the Rhode Island litigation and various insurance companies on February 23, 2006. The Lloyd's Underwriters' lawsuit asks a New York state court to determine that there is no indemnity insurance coverage for such abatement related costs, or, in the alternative, if such indemnity coverage is found to exist, the proper allocation of liability among the Lloyd's Underwriters, the defendants and the defendants' other insurance companies. An ultimate loss in the insurance coverage litigation would mean that insurance proceeds would be unavailable under the policies at issue to mitigate any ultimate abatement related costs and liabilities in Rhode Island and that insurance proceeds could be unavailable under the policies at issue to mitigate any ultimate abatement related costs and liabilities in other jurisdictions.

**Note Q STOCK PURCHASE PLAN AND PREFERRED STOCK**

On August 27, 2003, the Company issued 350,000 shares of preferred stock, no par value with cumulative quarterly dividends of ten dollars per share, for \$350.0 million to The Sherwin-Williams Company Employee Stock Purchase and Savings Plan (ESOP). The ESOP financed the acquisition of the preferred stock by borrowing \$350.0 million from the Company at the rate of 4.5 percent per annum. Each share of preferred stock was entitled to one vote upon all matters presented to the Company's shareholders and generally voted with the common stock together as one class. The preferred stock was held in an unallocated account by the ESOP until the value of compensation expense related to the Company's contributions was earned at which time contributions were credited to the members' accounts. The ESOP redeemed the remaining 34,702 shares of preferred stock for cash during the first two quarters of 2006.

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On August 1, 2006, the Company issued 500,000 shares of preferred stock, no par value with cumulative quarterly dividends of \$11.25 per share, for \$500.0 million to the ESOP. The ESOP financed the acquisition of the preferred stock by borrowing \$500.0 million from the Company at the rate of 5.5 percent per annum. This borrowing is payable over ten years in equal quarterly installments. Each share of preferred stock is entitled to one vote upon all matters presented to the Company's shareholders and generally votes with the common stock together as one class. The preferred stock is held in an unallocated suspense account by the ESOP until the value of compensation expense related to the Company's contributions is earned at which time contributions are credited to the members' accounts. The preferred stock is redeemable for cash and convertible into common stock at the option of the ESOP based on the relative fair value of the preferred and common stock at the time of conversion. The ESOP redeemed 39,319 shares of preferred stock for cash during the third quarter of 2006.



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**Item 2. MANAGEMENT'S DISCUSSION AND  
ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS**

**OVERVIEW**

Consolidated net sales increased 7.1 percent to \$2.12 billion in the third quarter of 2006 and 9.8 percent to \$6.02 billion in the first nine months of 2006 versus comparable periods in 2005. The net sales gains in the third quarter and first nine months were primarily a result of strong paint sales by stores open for more than twelve calendar months in the Paint Stores Group and by the Global Group. Consolidated net income increased 18.1 percent to \$179.1 million in the third quarter of 2006 and 23.0 percent to \$477.4 million in the first nine months versus comparable periods in 2005 due primarily to improved operations. Consolidated net income improved as a percent to net sales to 7.9 percent from 7.1 percent in the first nine months of 2006 versus comparable periods in 2005. Diluted net income per common share increased 21.5 percent in the third quarter to \$1.30 per share from \$1.07 per share in 2005 and 26.7 percent in the first nine months of 2006 to \$3.46 per share from \$2.73 per share a year ago. Effective January 1, 2006, the Company changed its reportable operating segments based on recent organizational changes in its management structure. The Company's reportable operating segments now are: Paint Stores Group, Consumer Group and Global Group. The Global Group Segment consists of certain business units with foreign or worldwide operations that were reported in the previous Paint Stores, Consumer, Automotive Finishes and International Coatings Segments. Historical business segment information has been updated to reflect this change in reportable operating segments.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The consolidated financial statements and accompanying footnotes included in this report have been prepared in accordance with accounting principles generally accepted in the United States with certain amounts based on management's best estimates and judgments. To determine appropriate carrying values of assets and liabilities that are not readily available from other sources, management uses assumptions based on historical results and other factors that they believe are reasonable. Actual results could differ from those estimates. Also, materially different amounts may result under materially different conditions or from using materially different assumptions. However, management currently believes that any materially different amounts resulting from materially different conditions or material changes in facts or circumstances are unlikely.

The Company adopted FAS No. 123R, Share-Based Payments, effective January 1, 2006, utilizing the modified prospective method as described in the standard. Under the modified prospective method, compensation cost is recognized for all share-based payments granted after the effective date and for all unvested awards granted prior to the effective date. Prior to adoption, the Company accounted for share-based payments under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. The Company recognized \$6.3 million in total stock-based compensation expense during the third quarter of 2006 and \$17.7 million

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during the first nine months of 2006. Total unrecognized stock-based compensation expense was \$39.3 million at September 30, 2006 and is expected to be recognized over a weighted-average period of 1.42 years. See Note B for more information on stock-based compensation.

There have been no significant changes in critical accounting policies or management estimates since the year ended December 31, 2005 other than the adoption of FAS No. 123R as described above. Changes in the Company's accruals for environmental remediation-related activities since the year ended December 31, 2005 are disclosed in Note K. A comprehensive discussion of the Company's critical accounting policies and management estimates is included in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2005, as updated in the Company's Current Report on Form 8-K which was filed with the Securities and Exchange Commission (SEC) on April 18, 2006.

**FINANCIAL CONDITION, LIQUIDITY AND CASH FLOW**

Cash and cash equivalents increased \$364.3 million during the first nine months of 2006, more than offsetting an increase of \$152.0 million in short-term borrowings, primarily to maintain short-term financial flexibility for the Company. In addition to the net increase of cash on-hand and short-term borrowings, capital expenditures of \$144.4 million, payments of cash dividends of \$102.0 million and treasury stock purchases of \$149.5 million were funded primarily by net cash from operations and proceeds from the exercise of stock options of \$61.2 million. Short-term borrowings related to the Company's domestic commercial paper program outstanding were \$246.5 million at an average rate of 5.63 percent at September 30, 2006. The Company had unused maximum borrowing availability of \$663.5 million at September 30, 2006 under the commercial paper program that is backed by the Company's revolving credit agreement.

During the first quarter of 2006, Moody's Investors Service downgraded the Company's debt rating from A2 to A3 and placed the Company's long-term ratings under review for further downgrade. Also during the first quarter, Standard & Poor's Ratings Services (S&P) placed the Company's ratings on CreditWatch with negative implications. On April 24, 2006, S&P lowered the Company's long-term corporate credit rating from A+ to A- and short-term corporate credit rating from A-1 to A-2 and kept the Company's ratings on CreditWatch with negative implications. These actions related to uncertainties surrounding the potential future cash payments resulting from the Rhode Island lead pigment litigation. The Company improved its financial flexibility by modifying existing borrowing arrangements and obtaining additional sources of funds through new borrowing facilities. See Note N for more information regarding debt.

Since September 30, 2005, cash generated by operations of \$890.2 million was used primarily for capital expenditures of \$184.4 million, treasury stock purchases of \$237.9 million, cash dividends of \$129.9 million and the retention of \$370.5 million of cash and cash equivalents.

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Capital expenditures during the first nine months of 2006 primarily represented expenditures associated with the construction of a new manufacturing facility in the Consumer Group and new store openings and normal equipment replacement in the Paint Stores Group.

During the third quarter of 2006, the Company purchased 1,700,000 shares of its common stock for treasury purposes through open market purchases, which brings the total number of shares purchased in 2006 to 2,950,000. The Company acquires shares of its common stock for general corporate purposes and, depending upon its cash position, financial flexibility requirements and market conditions, the Company may acquire additional shares of its common stock in the future. The Company had remaining authorization at September 30, 2006 to purchase 15,471,070 shares of its common stock.

At September 30, 2006, the Company's current ratio was 1.21, a decrease from the current ratio of 1.22 at December 31, 2005. The decrease in the current ratio was primarily due to increased short-term borrowings, the reclassification of \$197 million of Long-term debt, which is due in the first quarter of 2007 and the increase in Accounts payable which was mainly offset by the increase in Cash and cash equivalents.

**Contingent Liabilities**

Management believes that it properly valued the Company's assets and recorded all known liabilities that existed as of the balance sheet date for which a value was available or an amount could be reasonably estimated in accordance with all present accounting principles generally accepted in the United States. In addition, the Company may be subject to potential liabilities, as described in the following, which cannot be reasonably estimated due to the uncertainties involved.

In October 2005, a wholly-owned subsidiary of the Company acquired a 25 percent interest in Life Shield Engineered Systems, LLC (Life Shield) and became obligated to acquire an additional 24 percent interest in Life Shield in October 2007. Life Shield is a start-up company that develops and manufactures blast and fragment mitigating systems and ballistic resistant systems. The blast and fragment mitigating systems and ballistic resistant systems create a potentially higher level of product liability for the Company (as an owner of and raw material supplier to Life Shield and as the exclusive distributor of Life Shield's systems) than is normally associated with coatings and related products currently manufactured, distributed and sold by the Company.

Certain of Life Shield's technology has been designated as Qualified Anti-Terrorism Technology and granted a Designation under the Support Anti-terrorism by Fostering Effective Technologies Act of 2002 (SAFETY Act) and the regulations adopted pursuant to the SAFETY Act. Under the SAFETY Act, the potentially higher level of possible product liability for Life Shield relating to the technology granted the Designation is limited to \$6.0 million per occurrence in the event any such liability arises from an Act of Terrorism (as defined in the SAFETY Act). The limitation of liability provided for under the SAFETY Act does not apply to any technology not granted a designation or certification as a Qualified Anti-Terrorism Technology, nor in the event that any such liability arises from an act or event other than an Act of Terrorism. Life Shield maintains insurance for liabilities up to the \$6.0 million per occurrence limitation caused

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by failure of its products in the event of an Act of Terrorism. This commercial insurance is also expected to cover product liability claims asserted against the Company as the distributor of Life Shield's systems. The Company expects to seek Designation and Certification under the SAFETY Act for certain products supplied by the Company to Life Shield.

Management of the Company has reviewed the potential increased liabilities associated with Life Shield's systems and determined that potential liabilities arising from an Act of Terrorism that could ultimately affect the Company will be appropriately insured or limited by current regulations. However, due to the uncertainties involved in the future development, usage and application of Life Shield's systems, the number or nature of possible future claims and legal proceedings, or the affect that any change in legislation and/or administrative regulations may have on the limitations of potential liabilities, management cannot reasonably determine the scope or amount of any potential costs and liabilities for the Company related to Life Shield or to Life Shield's systems. Any potential liability for the Company that may result from Life Shield or Life Shield's systems cannot reasonably be estimated. However, based upon, among other things, the limitation of liability under the SAFETY Act in the event of an Act of Terrorism, management does not currently believe that the costs or potential liability ultimately determined to be attributable to the Company through its ownership of Life Shield, as a supplier to Life Shield or as a distributor of Life Shield's systems arising from the use of Life Shield's systems will have a material adverse effect on the Company's results of operations, liquidity or financial conditions.

**Litigation**

In the course of its business, the Company is subject to a variety of claims and lawsuits, including litigation relating to product liability and warranty, personal injury, environmental, intellectual property, commercial, contractual and antitrust claims. The Company accrues for these contingencies consistent with the policy stated under Contingent Liabilities. However, because litigation is inherently subject to many uncertainties and the ultimate result of any present or future litigation is unpredictable, the Company's ultimate liability may result in costs that are significantly higher than currently accrued. In the event that the Company's loss contingency is ultimately determined to be significantly higher than currently accrued, the recording of the liability may result in a material impact on net income for the annual or interim period during which such liability is accrued. Additionally, due to the uncertainties involved, any potential liability determined to be attributable to the Company arising out of such litigation may have a material adverse effect on the Company's results of operations, liquidity or financial condition.

*Lead Pigment and Lead-Based Paint Litigation*

The Company's past operations included the manufacture and sale of lead pigments and lead-based paints. The Company, along with other companies, is a defendant in a number of legal proceedings, including individual personal injury actions, purported class actions, a separate action brought by the State of Rhode Island, and actions brought by various counties, cities, school districts and other government-related entities, arising from the manufacture and sale of lead pigments and lead-based paints. The plaintiffs are seeking recovery based upon various legal theories, including negligence, strict liability, breach of warranty, negligent

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misrepresentations and omissions, fraudulent misrepresentations and omissions, concert of action, civil conspiracy, violations of unfair trade practice and consumer protection laws, enterprise liability, market share liability, public nuisance, unjust enrichment and other theories. The plaintiffs seek various damages and relief, including personal injury and property damage, costs relating to the detection and abatement of lead-based paint from buildings, costs associated with a public education campaign, medical monitoring costs and others. The Company is also a defendant in legal proceedings arising from the manufacture and sale of non-lead-based paints which seek recovery based upon various legal theories, including the failure to adequately warn of potential exposure to lead during surface preparation when using non-lead-based paint on surfaces previously painted with lead-based paint. The Company believes that the litigation brought to date is without merit or subject to meritorious defenses and is vigorously defending such litigation. The Company expects that additional lead pigment and lead-based paint litigation may be filed against the Company in the future asserting similar or different legal theories and seeking similar or different types of damages and relief.

Notwithstanding the Company's views on the merits, litigation is inherently subject to many uncertainties and the Company ultimately may not prevail. Adverse court rulings, such as the Rhode Island jury verdict and the Wisconsin State Supreme Court's July 2005 determination that Wisconsin's risk contribution theory applies in the lead pigment litigation (both discussed in more detail below), or determinations of liability, among other factors, could affect the lead pigment and lead-based paint litigation against the Company and encourage an increase in the number and nature of future claims and proceedings. In addition, from time to time, various legislation and administrative regulations have been enacted, promulgated or proposed to impose obligations on present and former manufacturers of lead pigments and lead-based paints respecting asserted health concerns associated with such products or to overturn the effect of court decisions in which the Company and other manufacturers have been successful.

Due to the uncertainties involved, management is unable to predict the outcome of the lead pigment and lead-based paint litigation, the number or nature of possible future claims and proceedings, or the effect that any legislation and/or administrative regulations may have on the litigation or against the Company. In addition, management cannot reasonably determine the scope or amount of the potential costs and liabilities related to such litigation, or resulting from any such legislation and regulations. The Company has not accrued any amounts for such litigation. Any potential liability that may result from such litigation or such legislation and regulations cannot reasonably be estimated. In the event any significant liability is determined to be attributable to the Company relating to such litigation, the recording of the liability may result in a material impact on net income for the annual or interim period during which such liability is accrued. Additionally, due to the uncertainties associated with the amount of any such liability and/or the nature of any other remedy which may be imposed in such litigation, any potential liability determined to be attributable to the Company arising out of such litigation may have a material adverse effect on the Company's results of operations, liquidity or financial condition. An estimate of the potential impact on the Company's results of operations, liquidity or financial condition cannot be made due to the aforementioned uncertainties.

*Rhode Island Lead Pigment Litigation*

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During September 2002, a jury trial commenced in the first phase of an action brought by the State of Rhode Island against the Company and the other defendants. The sole issue before the court in this first phase was whether lead pigment in paint constitutes a public nuisance under Rhode Island law. In October 2002, the court declared a mistrial as the jury, which was split four to two in favor of the defendants, was unable to reach a unanimous decision. The State of Rhode Island retried the case and on February 22, 2006, the jury returned a verdict, finding that (i) the cumulative presence of lead pigment in paints and coatings on buildings in the State of Rhode Island constitutes a public nuisance, (ii) the Company, along with two other defendants, caused or substantially contributed to the creation of the public nuisance, and (iii) the Company and two other defendants should be ordered to abate the public nuisance. On February 28, 2006, the Court granted the defendants' motion to dismiss the punitive damages claim, finding insufficient evidence to support the State's request for punitive damages. Various post-trial motions and other matters remain before the Court. The Court has ruled that it will determine the scope and manner of the abatement remedy. The Court has not yet established a procedure or a time frame to make that determination. The Company intends to appeal the jury's verdict if the defendant's post-trial motions are not granted.

This was the first legal proceeding against the Company to go to trial relating to the Company's lead pigment and lead-based paint litigation. The Company cannot reasonably determine the impact that the State of Rhode Island decision and determination of liability will have on the number or nature of present or future claims and proceedings against the Company or estimate the amount or range of ultimate loss that it may incur.

*Other Public Nuisance Claim Litigation*

The Company and other companies are defendants in other legal proceedings seeking recovery based on public nuisance liability theories including claims brought by the County of Santa Clara, California and other public entities in the State of California, the City of St. Louis, Missouri, the City of Milwaukee, Wisconsin, various cities and counties in the State of New Jersey, and several cities in the State of Ohio.

The Santa Clara County, California proceeding was initiated in March 2000. The named plaintiffs are the County of Santa Clara, County of Santa Cruz, County of Solano, County of Alameda, County of Kern, City and County of San Francisco, San Francisco Housing Authority, San Francisco Unified School District, City of Oakland, Oakland Housing Authority, Oakland Redevelopment Agency and the Oakland Unified School District. The proceeding purports to be a class action on behalf of all public entities in the State of California except the State and its agencies. The plaintiffs' second amended complaint asserted claims for fraud and concealment, strict product liability/failure to warn, strict product liability/design defect, negligence, negligent breach of a special duty, public nuisance, private nuisance and violations of California's Business and Professions Code, and the third amended complaint alleges similar claims including a claim for public nuisance. Various asserted claims were resolved in favor of the defendants through pre-trial demurrers and motions to strike. In October 2003, the trial court granted the defendants' motion for summary judgment against the remaining counts on statute of limitation grounds. The plaintiffs appealed the trial court's decision and on March 3, 2006, the Court of Appeal, Sixth Appellate District, reversed in part the demurrers and summary judgment entered in favor

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of the Company and the other defendants. The Court of Appeal reversed the dismissal of the public nuisance claim for abatement brought by the cities of Santa Clara and Oakland and the City and County of San Francisco, and reversed summary judgment on all of the plaintiffs' fraud claim to the extent that the plaintiffs alleged that the defendants had made fraudulent statements or omissions minimizing the risks of low-level exposure to lead. The Court of Appeal further vacated the summary judgment holding that the statute of limitations barred the plaintiffs' strict liability and negligence claims, and held that those claims had not yet accrued because physical injury to the plaintiffs' property had not been alleged. The Court of Appeal affirmed the dismissal of the public nuisance claim for damages to the plaintiffs' properties, most aspects of the fraud claim, the trespass claim and the unfair business practice claim. The City of St. Louis proceeding was initiated in January 2000. The City initially alleged claims for strict liability, negligence, fraudulent misrepresentation, negligent misrepresentation, concert of action, conspiracy, public nuisance, restitution and indemnity. Following various pre-trial proceedings during which many of the asserted claims were dismissed by the trial court or voluntarily dismissed by the City, on June 10, 2003, the City filed its fourth amended petition alleging a single count of public nuisance. Following further pre-trial proceedings, on January 18, 2006, the trial court granted the defendants' motion for summary judgment based on the City's lack of product identification evidence. On February 24, 2006, the City filed its notice of appeal to appeal the trial court's January 18, 2006 decision and a prior trial court decision.

The City of Milwaukee proceeding was initiated in April 2001 against Mautz Paint Co. and NL Industries, Inc. On November 7, 2001, the Company acquired certain assets of Mautz Paint Co. and agreed (under terms and conditions set forth in the purchase agreement) to defend and indemnify Mautz Paint Co. for its liability, if any, to the City of Milwaukee in this action. The City's complaint included claims for continuing public nuisance, restitution, conspiracy, negligence, strict liability, failure to warn and violation of Wisconsin's trade practices statute. Following various pre-trial proceedings during which several of the City's claims were dismissed by the court or voluntarily dismissed by the City, on August 13, 2003, the trial court granted defendants' motion for summary judgment on the remaining claims. The City appealed and, on November 9, 2004, the Wisconsin Court of Appeals reversed the trial court's decision and remanded the claims for public nuisance, conspiracy and restitution to the trial court. Discovery is currently proceeding in this matter and a previous trial date of January 8, 2007 has been postponed.

In December 2001 and early 2002, a number of cities and counties in New Jersey individually initiated proceedings in the Superior Court of New Jersey against the Company and other companies asserting claims for fraud, public nuisance, civil conspiracy, unjust enrichment and indemnity. The New Jersey Supreme Court consolidated all of the cases and assigned them to the Superior Court in Middlesex County. By order dated November 4, 2002, the Superior Court granted the defendants' motion to dismiss all complaints. The plaintiffs appealed and, on August 17, 2005, the Appellate Division affirmed the dismissal of all claims except public nuisance. The Appellate Division reinstated the public nuisance claim in each case. On November 17, 2005, the New Jersey Supreme Court granted defendants' petition for certification to review the reinstatement of the public nuisance claims.

In September and October 2006, several cities in Ohio individually initiated proceedings in state court against the Company and other companies asserting claims for public nuisance, concert of

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action, unjust enrichment, indemnity and punitive damages. Also in September 2006, the Company initiated proceedings in the United States District Court, Southern District of Ohio, against certain of the Ohio cities which initiated the state court proceedings referred to in the preceding sentence and John Doe cities and public officials. The Company's proceeding seeks declaratory and injunctive relief to prevent the violation of the Company's federal constitutional rights in relation to such state court proceedings.

*Litigation Seeking Damages from Alleged Personal Injury*

The Company and other companies are defendants in a number of legal proceedings seeking monetary damages and other relief from alleged personal injuries. These proceedings include claims by children allegedly injured from ingestion of lead pigment or lead-containing paint, claims for damages allegedly incurred by the children's parents or guardians, and claims for damages allegedly incurred by professional painting contractors. These proceedings generally seek compensatory and punitive damages, and seek other relief including medical monitoring costs. These proceedings include purported claims by individuals, groups of individuals and class actions.

The plaintiff in *Thomas v. Lead Industries Association, et al.*, initiated an action against the Company, other alleged former lead pigment manufacturers and the Lead Industries Association in September 1999. The claims against the Company and the other defendants include strict liability, negligence, negligent misrepresentation and omissions, fraudulent misrepresentation and omissions, concert of action, civil conspiracy and enterprise liability. Implicit within these claims is the theory of "risk contribution" liability (Wisconsin's theory which is similar to market share liability) due to the plaintiff's inability to identify the manufacturer of any product that allegedly injured the plaintiff. Following various pre-trial proceedings during which certain of the plaintiff's claims were dismissed by the court, on March 10, 2003, the trial court granted the defendants' motion for summary judgment, dismissing the case with prejudice and awarding costs to each defendant. The plaintiff appealed and on June 14, 2004, the Wisconsin Court of Appeals affirmed the trial court's decision. On July 15, 2005, the Wisconsin Supreme Court reversed in part the trial court's decision and adopted a risk contribution theory to excuse the plaintiff's lack of evidence identifying any of the Company's or the other defendant's products as the cause of the alleged injury. The case has been remanded to the trial court and discovery is currently proceeding in this matter.

Wisconsin is the first jurisdiction to apply a theory of liability with respect to alleged personal injury (i.e.: risk contribution/market share liability) which does not require the plaintiff to identify the manufacturer of the product that allegedly injured the plaintiff in the lead pigment and lead-based paint litigation. Following the July 2005 decision by the Wisconsin Supreme Court to adopt a risk contribution theory in the lead pigment litigation, the Company is aware of five new proceedings which have been filed in Wisconsin courts against the Company and other companies seeking damages from alleged personal injury.

*Insurance Coverage Litigation*

On March 3, 2006, the Company filed a lawsuit in the Common Pleas Court, Cuyahoga County, Ohio against its liability insurers, including certain Underwriters at Lloyd's of London. The lawsuit seeks, among other things, (i) a declaration from the court that costs associated with the



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abatement of lead pigment in the State of Rhode Island, or any other jurisdiction, are covered under certain insurance policies issued to the Company and (ii) monetary damages for breach of contract and bad faith against the Lloyd's Underwriters for unjustified denial of coverage for the cost of complying with any final judgment requiring the Company to abate any alleged nuisance caused by the presence of lead pigment paint in buildings. This lawsuit was filed in response to a lawsuit filed by the Lloyd's Underwriters against the Company, two other defendants in the Rhode Island litigation and various insurance companies on February 23, 2006. The Lloyd's Underwriters' lawsuit asks a New York state court to determine that there is no indemnity insurance coverage for such abatement related costs, or, in the alternative, if such indemnity coverage is found to exist, the proper allocation of liability among the Lloyd's Underwriters, the defendants and the defendants' other insurance companies. An ultimate loss in the insurance coverage litigation would mean that insurance proceeds would be unavailable under the policies at issue to mitigate any ultimate abatement related costs and liabilities in Rhode Island and that insurance proceeds could be unavailable under the policies at issue to mitigate any ultimate abatement related costs and liabilities in other jurisdictions.

**Environmental-Related Liabilities**

The operations of the Company, like those of other companies in the same industry, are subject to various federal, state and local environmental laws and regulations. These laws and regulations not only govern current operations and products, but also impose potential liability on the Company for past operations. Management expects environmental laws and regulations to impose increasingly stringent requirements upon the Company and the industry in the future. Management believes that the Company conducts its operations in compliance with applicable environmental laws and regulations and has implemented various programs designed to protect the environment and promote continued compliance.

Depreciation of capital expenditures and other expenses related to ongoing environmental compliance measures were included in the normal operating expenses of conducting business. The Company's capital expenditures, depreciation and other expenses related to ongoing environmental compliance measures were not material to the Company's financial condition, liquidity, cash flow or results of operations during the first nine months of 2006. Management does not expect that such capital expenditures, depreciation and other expenses will be material to the Company's financial condition, liquidity, cash flow or results of operations in 2006.

The Company is involved with environmental investigation and remediation activities at some of its current and former sites (including sites which were previously owned and/or operated by businesses acquired by the Company). In addition, the Company, together with other parties, has been designated a potentially responsible party under federal and state environmental protection laws for the investigation and remediation of environmental contamination and hazardous waste at a number of third-party sites, primarily Superfund sites. The Company may be similarly designated with respect to additional third-party sites in the future.

The Company accrues for estimated costs of investigation and remediation activities at its current, former and third party sites for which commitments or clean-up plans have been developed and when such costs can be reasonably estimated based on industry standards and professional judgment. These estimated costs are based on currently available facts regarding

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each site. The Company accrues a specific estimated amount when such an amount and a time frame in which the costs will be incurred can be reasonably determined. If the best estimate of costs can only be identified as a range and no specific amount within that range can be determined more likely than any other amount within the range, the minimum of the range is accrued by the Company in accordance with applicable accounting rules and interpretations. The Company continuously assesses its potential liability for investigation and remediation activities and adjusts its environmental-related accruals as information becomes available upon which more accurate costs can be reasonably estimated. At September 30, 2006 and 2005, the Company had accruals for environmental-related activities of \$169.4 million and \$149.1 million, respectively.

Due to the uncertainties surrounding environmental investigation and remediation activities, the Company's liability may result in costs that are significantly higher than currently accrued. If the Company's future loss contingency is ultimately determined to be at the maximum of the range of possible outcomes for every site for which costs can be reasonably estimated, the Company's aggregate accruals for environmental-related activities would be \$144.0 million higher than the accruals at September 30, 2006.

Four of the Company's current and former manufacturing sites, described below, accounted for the majority of the accruals for environmental-related activities and the unaccrued maximum of the estimated range of possible outcomes at September 30, 2006. Included in the accruals of \$169.4 million at September 30, 2006 was \$111.3 million related directly to these four sites. Of the aggregate unaccrued exposure of \$144.0 million at September 30, 2006, \$75.0 million related to the four manufacturing sites. While environmental investigations and remedial actions are in different stages at these sites, additional investigations, remedial actions and monitoring will likely be required at each site.

The first of the four sites is a former manufacturing facility in New Jersey that is in the early investigative stage of the environmental-related process. Although contamination exists at the site and adjacent areas, the extent and magnitude of the contamination has not yet been fully quantified. Due to the uncertainties of the scope and magnitude of contamination and the degree of remediation that may be necessary relating to this site, it is reasonably likely that further extensive investigation may be required and that extensive remedial actions may be necessary not only at the former manufacturing site but along an adjacent waterway. Depending on the extent of the additional investigation and remedial actions necessary, the ultimate liability for this site may exceed the amount currently accrued and the maximum of the range of reasonably possible outcomes currently estimated by management.

Two additional sites relate to a current manufacturing facility located in Illinois and a contiguous property. The environmental issues at these sites have been determined to be associated with historical operations of the Company. While the majority of the investigative work has been completed at these sites and some remedial actions taken, agreement on a proposed remedial action plan has not been obtained from the appropriate governmental agency.

The fourth site is a current manufacturing facility in California. Similar to the Illinois sites noted above, the environmental issues at this site have been determined to be associated with historical operations. The majority of the investigative activities have been completed at this site, some

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remedial actions have been taken and a proposed remedial action plan has been formulated but currently no clean up goals have been approved by the lead governmental agency. In both the Illinois and California sites, the potential liabilities relate to clean-up goals that have not yet been established and the degree of remedial actions that may be necessary to achieve these goals.

Management cannot presently estimate the ultimate potential loss contingencies related to these four sites or other less significant sites until such time as a substantial portion of the investigation at the sites is completed and remedial action plans are developed.

In accordance with FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* an interpretation of FASB Statement No. 143, the Company has identified certain conditional asset retirement obligations at various current manufacturing, distribution and store facilities. These obligations relate primarily to asbestos abatement and closures of hazardous waste containment devices. Using investigative, remediation and disposal methods that are currently available to the Company, the estimated cost of these obligations is not significant. In the event any future loss contingency significantly exceeds the current amount accrued, the recording of the ultimate liability may result in a material impact on net income for the annual or interim period during which the additional costs are accrued. Management does not believe that any potential liability ultimately attributed to the Company for its environmental-related matters will have a material adverse effect on the Company's financial condition, liquidity, or cash flow due to the extended period of time during which environmental investigation and remediation takes place. An estimate of the potential impact on the Company's operations cannot be made due to the aforementioned uncertainties.

Management expects these contingent environmental-related liabilities to be resolved over an extended period of time. Management is unable to provide a more specific time frame due to the indefinite amount of time to conduct investigation activities at any site, the indefinite amount of time to obtain governmental agency approval, as necessary, with respect to investigation and remediation activities, and the indefinite amount of time necessary to conduct remediation activities.

**Contractual Obligations and Commercial Commitments**

Short-term borrowings increased \$152.0 million to \$275.7 million at September 30, 2006 from \$123.7 million at December 31, 2005 primarily to maintain short-term financial flexibility for the Company and to help fund seasonal working capital needs. See the Financial Condition, Liquidity and Cash Flow section of this report for more information. There have been no other significant changes to the Company's contractual obligations and commercial commitments through the first nine months of 2006 as summarized in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2005, as updated in the Company's Current Report on Form 8-K which was filed with the SEC on April 18, 2006.

Changes to the Company's accrual for product warranty claims in the first nine months of 2006 are disclosed in Note F.

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Shown below are net sales and the percentage change for the third quarter and first nine months by reportable segment for 2006 and 2005:

(thousands of dollars)

|   | 2006                | Change | 2005         |
|---|---------------------|--------|--------------|
| <b>Three months ended September 30:</b> |                     |        |              |
| Paint Stores Group                      | <b>\$ 1,347,720</b> | 9.5%   | \$ 1,231,034 |
| Consumer Group                          | <b>354,967</b>      | -1.5%  | 360,244      |
| Global Group                            | <b>412,049</b>      | 7.4%   | 383,561      |
| Administrative                          | <b>1,975</b>        | 4.6%   | 1,889        |
|   | <b>\$ 2,116,711</b> | 7.1%   | \$ 1,976,728 |
| <b>Nine months ended September 30:</b>  |                     |        |              |
| Paint Stores Group                      | <b>\$ 3,732,128</b> | 13.3%  | \$ 3,295,253 |
| Consumer Group                          | <b>1,085,814</b>    | -1.4%  | 1,101,084    |
| Global Group                            | <b>1,191,402</b>    | 10.4%  | 1,078,683    |
| Administrative                          | <b>5,865</b>        | 4.5%   | 5,611        |
|   | <b>\$ 6,015,209</b> | 9.8%   | \$ 5,480,631 |

Consolidated net sales increased in the third quarter and the first nine months of 2006 due primarily to strong paint sales by stores open for more than twelve calendar months in the Paint Stores Group and by the Global Group. Net sales of all consolidated foreign subsidiaries were up 5.0 percent to \$214.1 million for the third quarter and up 9.9 percent to \$611.1 million for the first nine months of 2006 versus \$203.8 million and \$555.8 million for the respective comparable periods in 2005. All other net sales were up 7.3 percent to \$1.903 billion for the third quarter and up 9.7 percent to \$5.404 billion for the first nine months of 2006 versus \$1.773 billion and \$4.925 billion for the respective comparable periods in 2005.

Net sales in the Paint Stores Group increased due primarily to strong domestic architectural paint sales to contractors in the first half of 2006 that softened slightly in the third quarter and improved industrial maintenance product sales. Net sales from stores open for more than twelve calendar months increased 7.2 percent in the quarter and 11.1 percent in the first nine months. Total paint sales volume percentage increases were in the low single digits for the third quarter of 2006 and mid single digits for the first nine months over comparable periods in 2005. Sales of products other than paint increased 9.8 percent for the third quarter and 12.7 percent for the first nine months over comparable periods in 2005. A discussion of changes in volume versus pricing for such sales is not pertinent due to the wide assortment of general merchandise sold.

Net sales of the Consumer Group in the third quarter and the first nine months of 2006 decreased primarily due to lower sales volume to certain major retail customers as they continue to drive up inventory turns, sluggish retail sales at some other customers and the elimination of a portion of a paint program with a large retail customer that most significantly impacted the first half of 2006. Increased sales of products other than paint of 1.2 percent in the third quarter and 2.6 percent in the first nine months of 2006 over 2005 were more than offset by paint volume declines. The Global Group's third quarter net sales increased due primarily to paint and other coatings sales volume increases of 7.2 percent. Total paint and other coatings sales volume increased by 5.8 percent in the first nine months of 2006 over 2005. Kinlita, a Chinese joint venture disposed of at the end of the third quarter of 2005, represented \$7.1 million of sales for the third quarter and \$17.0 million in the first nine months of 2005. All but one of the worldwide

operations of the Global Group contributed to the volume increases in net sales. Favorable currency exchange rates increased net sales of this Segment by 1.8 percent in the quarter and 2.9 percent in the first nine months of 2006. Shown below is segment profit (loss) and the percent change for the third quarter and first nine months by reportable segment for 2006 and 2005:

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|   | 2006              | Change | 2005              |
|---|-------------------|--------|-------------------|
| <b>Three months ended September 30:</b> |                   |        |                   |
| Paint Stores Group                      | \$ 226,722        | 27.1%  | \$ 178,434        |
| Consumer Group                          | 60,273            | 11.4%  | 54,112            |
| Global Group                            | 42,721            | 81.5%  | 23,539            |
| Administrative                          | (53,025)          | -43.0% | (37,091)          |
|   | <b>\$ 276,691</b> | 26.3%  | <b>\$ 218,994</b> |
| <b>Nine months ended September 30:</b>  |                   |        |                   |
| Paint Stores Group                      | \$ 557,208        | 27.8%  | \$ 436,118        |
| Consumer Group                          | 193,270           | 12.6%  | 171,605           |
| Global Group                            | 109,226           | 56.5%  | 69,782            |
| Administrative                          | (151,977)         | -15.7% | (131,300)         |
|   | <b>\$ 707,727</b> | 29.6%  | <b>\$ 546,205</b> |

Consolidated segment profit was favorably impacted by a change in consolidated gross profit, which increased \$96.0 million and \$305.1 million in the third quarter and first nine months of 2006, respectively. As a percent of sales, consolidated gross profit increased to 44.2 percent in the quarter from 42.5 percent in the third quarter of 2005 and to 44.0 percent from 42.7 percent in the first nine months of 2005 primarily due to selling price increases, better factory utilization and fixed cost absorption relating to higher volumes. The Paint Stores Group's gross profit for the third quarter and first nine months of 2006 increased \$73.2 million and \$219.3 million, respectively, due primarily to the increases in paint sales volume and higher selling prices. The Consumer Group's third quarter gross profit increased from last year by \$6.2 million and \$24.1 million for the first nine months of 2006 over 2005 primarily due to better factory utilization and fixed cost absorption resulting from higher volume sales to the Paint Stores Group and selling price increases that were partially offset by raw material cost increases. The Global Group's gross profit for the third quarter and the first nine months of 2006 increased by \$16.6 million and \$59.7 million, respectively. Foreign exchange fluctuations increased gross profit by \$2.2 million for the third quarter and \$9.8 million for the first nine months of 2006. Increased paint and other coatings sales volume of 7.2 percent for the third quarter and 5.8 percent for the first nine months, increased selling prices and improved operating efficiencies related to additional manufacturing volume also contributed to the increase in gross profit for the Global Group.

Consolidated segment profit was also influenced by selling, general and administrative expenses (SG&A), which increased slightly as a percent to sales to 30.7 percent from 30.5 for the third quarter and decreased as a percent of sales to 31.4 percent from 31.7 percent for the first nine months of 2006 compared to 2005. In the Paint Stores Group, the SG&A percent of sales ratio decreased 1.0 percent for the third quarter of 2006 and 1.3 percent for the first nine months due to increased net sales. The effects of the increases in net sales were partially offset by increased spending due to the number of new store openings and variable costs associated with sales volume at the store level. The Consumer Group's SG&A spending increased less than 2.0 percent for both the third quarter and the first nine months of 2006 due to stringent spending guidelines for all expense categories and increased slightly for both periods as a percent of sales due to sales shortfalls. The Global Group's SG&A expenses as a percent of sales decreased slightly for both periods compared to last year as a result of increased net sales which were partially offset by higher expenses relating to more new branch openings and exchange rate fluctuations of \$1.4 million and \$6.2 million in the third quarter and first nine months of 2006, respectively.

Administrative expenses for the third quarter and the first nine months of 2006 were higher than the respective periods of 2005 due mainly to compensation and benefit related expenses not

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directly related to operating segments, including the additional expenses related to stock-based compensation recorded in 2006.

The effective tax rates were 35.3 percent and 32.6 percent for the third quarter and first nine months of 2006, respectively, and 30.6 percent and 28.7 percent for the third quarter and first nine months of 2005, respectively. The lower tax rate in 2005 when compared to 2006 was due to numerous factors including the impact of the settlement of federal and state audit issues and tax benefits related to foreign operations.

Net income increased \$27.5 million, or 18.1 percent in the third quarter of 2006 and \$89.3, or 23.0 percent, for the first nine months of 2006. Diluted net income per common share increased 21.5 percent to \$1.30 per share from \$1.07 per share in the third quarter of 2006 and 26.7 percent to \$3.46 per share from \$2.73 per share for the first nine months of 2006. The increase in diluted net income per common share of \$.73 for the first nine months of 2006 resulted primarily from improved operating performance partially offset by a higher effective tax rate and additional expenses related to stock-based compensation.

Management considers a measurement that is not in accordance with accounting principles generally accepted in the United States a useful measurement of the operational profitability of the Company. Some investment professionals also utilize such a measurement as an indicator of the value of profits and cash that are generated strictly from operating activities, putting aside working capital and certain other balance sheet changes. For this measurement, management increases net income for significant non-operating and non-cash expense items to arrive at an amount known as Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). The reader is cautioned that the following value for EBITDA should not be compared to other entities unknowingly. EBITDA should not be considered an alternative to net income or cash flows from operating activities as an indicator of operating performance or as a measure of liquidity. The reader should refer to the determination of net income and cash flows from operating activities in accordance with accounting principles generally accepted in the United States disclosed in the Statements of Consolidated Income and Statements of Consolidated Cash Flows. EBITDA as used by management is calculated as follows:

*(thousands of dollars)*

|                  | Three months ended |            | Nine months ended |            |
|------------------|--------------------|------------|-------------------|------------|
|                  | September 30,      |            | September 30,     |            |
|                  | 2006               | 2005       | 2006              | 2005       |
| Net income       | \$ 179,112         | \$ 151,608 | \$ 477,375        | \$ 388,123 |
| Interest expense | 16,437             | 12,092     | 50,624            | 37,612     |
| Income taxes     | 97,579             | 66,970     | 230,352           | 156,726    |
| Depreciation     | 30,875             | 30,597     | 90,714            | 89,531     |
| Amortization     | 5,622              | 5,296      | 16,881            | 17,422     |
| EBITDA           | \$ 329,625         | \$ 266,563 | \$ 865,946        | \$ 689,414 |



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**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION**

Certain statements contained in Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this report constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based upon management's current expectations, estimates, assumptions and beliefs concerning future events and conditions and may discuss, among other things, anticipated future performance (including sales and earnings), expected growth, future business plans and the costs and potential liability for environmental-related matters and the lead pigment and lead-based paint litigation. Any statement that is not historical in nature is a forward-looking statement and may be identified by the use of words and phrases such as expects, anticipates, believes, will, will result, will continue, plans to and similar expressions.

Readers are cautioned not to place undue reliance on any forward-looking statements. Forward-looking statements are necessarily subject to risks, uncertainties and other factors, many of which are outside the control of the Company, that could cause actual results to differ materially from such statements and from the Company's historical results and experience.

These risks, uncertainties and other factors include such things as: (a) general business conditions, strengths of retail and manufacturing economies and the growth in the coatings industry; (b) competitive factors, including pricing pressures and product innovation and quality; (c) changes in raw material and energy supplies and pricing; (d) changes in the Company's relationships with customers and suppliers; (e) the ability of the Company to attain cost savings from productivity initiatives; (f) the ability of the Company to successfully integrate past and future acquisitions into its existing operations, as well as the performance of the businesses acquired, including the acquisitions of KST Coatings Manufacturing, Inc., KST Coatings LLC, Uniflex LLC, Duron, Inc. and Paint Sundry Brands Corporation; (g) changes in general domestic economic conditions such as inflation rates, interest rates, tax rates, unemployment rates, higher labor and healthcare costs, recessions, and changing governmental policies, laws and regulations; (h) risks and uncertainties associated with the Company's expansion into and its operations in China, South America and other foreign markets, including general economic conditions, inflation rates, recessions, foreign currency exchange rates, foreign investment and repatriation restrictions, legal and regulatory constraints, civil unrest and other external economic and political factors; (i) the achievement of growth in developing markets, such as China, Mexico and South America; (j) increasingly stringent domestic and foreign governmental regulations including those affecting the environment; (k) inherent uncertainties involved in assessing the Company's potential liability for environmental-related activities; (l) other changes in governmental policies, laws and regulations, including changes in accounting policies and standards and taxation requirements (such as new tax laws and new or revised tax law interpretations); (m) the nature, cost, quantity and outcome of pending and future litigation and other claims, including the lead pigment and lead-based paint litigation, and the effect of any legislation and administrative regulations relating thereto; and (n) unusual weather conditions.

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Readers are cautioned that it is not possible to predict or identify all of the risks, uncertainties and other factors that may affect future results and that the above list should not be considered to be a complete list. Any forward-looking statement speaks only as of the date on which such statement is made, and the Company undertakes no obligation to update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

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**Item 3. QUANTITATIVE AND QUALITATIVE  
DISCLOSURES ABOUT MARKET RISK**

The Company is exposed to market risk associated with interest rates and value changes in foreign currencies. The Company utilizes derivative instruments as part of its overall financial risk management policy, but does not use derivative instruments for speculative or trading purposes. The Company has partially hedged risks associated with fixed interest rate debt by entering into various interest rate swap agreements. The Company does not believe that any potential loss related to interest rate exposure would have a material adverse effect on the Company's financial condition, results of operations or cash flows. The Company enters into foreign currency option and forward contracts to hedge against value changes in foreign currency. The Company believes it may experience continuing losses from foreign currency translation. However, the Company does not expect currency translation, transaction or hedging contract losses to have a material adverse effect on the Company's financial condition, results of operations or cash flows. There were no material changes in the Company's exposure to market risk since the disclosure included in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

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**Item 4. CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our Chairman and Chief Executive Officer and our Senior Vice President Finance and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 and Rule 15d-15 of the Securities Exchange Act of 1934, as amended (Exchange Act). Based upon that evaluation, our Chairman and Chief Executive Officer and our Senior Vice President Finance and Chief Financial Officer concluded that as of the end of the period covered by this report our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and accumulated and communicated to our management including our Chairman and Chief Executive Officer and our Senior Vice President Finance and Chief Financial Officer, to allow timely decisions regarding required disclosure. There were no changes in our internal control over financial reporting identified in connection with the evaluation that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings.**

For information with respect to certain legal proceedings and environmental-related matters, see the information included under the captions entitled Litigation and Environmental-Related Liabilities of Management's Discussion and Analysis of Financial Condition and Results of Operations and Notes K and P of the Notes to Condensed Consolidated Financial Statements, which is incorporated herein by reference.

**Item 2. Unregistered Sales of Securities and Use of Proceeds.**

A summary of the repurchase activity for the Company's third quarter is as follows:

| Period                                  | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price<br>Paid<br>Per<br>Share | Total Number<br>of Shares<br>Purchased as<br>Part of<br>Publicly<br>Announced<br>Plan | Maximum<br>Number of<br>Shares<br>That May Yet<br>Be<br>Purchased<br>Under<br>the Plan |
|---|---|--|---|--|
| July 1 – July 31                        |   |  |   |  |
| Share repurchase program <sup>(1)</sup> | 157,200                                   | \$ 49.26                                 | 157,200   | 17,013,870   |
| Employee transactions <sup>(2)</sup>    | 7,423                                     | \$ 50.18                                 |   | N/A  |
| August 1 – August 31                    |   |  |   |  |
| Share repurchase program <sup>(1)</sup> | 872,800                                   | \$ 50.28                                 | 872,800   | 16,141,070   |
| Employee transactions <sup>(2)</sup>    | 9,187                                     | \$ 50.69                                 |   | N/A  |
| September 1 – September 30              |   |  |   |  |
| Share repurchase program <sup>(1)</sup> | 670,000                                   | \$ 52.93                                 | 670,000   | 15,471,070   |
| Employee transactions <sup>(2)</sup>    | 2,700                                     | \$ 53.32                                 |   | N/A  |
| <b>Total</b>                            |   |  |   |  |
| Share repurchase program <sup>(1)</sup> | 1,700,000                                 | \$ 51.23                                 | 1,700,000   | 15,471,070   |
| Employee transactions <sup>(2)</sup>    | 19,310                                    | \$ 50.86                                 |   | N/A  |

(1) All shares were purchased through the Company's publicly announced share repurchase program. On October 21, 2005, the Board of Directors of the Company authorized the Company to purchase, in the

aggregate, 20.0 million shares of its common stock and rescinded the previous authorization limit. The Company had remaining authorization at September 30, 2006 to purchase 15,471,070 shares. There is no expiration date specified for the program. The Company intends to repurchase stock under the program in the future.

- (2) All shares were delivered to satisfy the exercise price and/or tax withholding obligations by employees who exercised stock options.

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Item 5. Other Information.

During the fiscal quarter ended September 30, 2006, the Audit Committee of the Board of Directors of the Company approved audit services to be performed by Ernst & Young LLP, the Company's independent registered public accounting firm. These audit services were approved within categories related to foreign subsidiary financial statements.

Item 6. Exhibits.

(a) Exhibits.

- 3 Amended and Restated Articles of Incorporation of the Company, as amended through July 26, 2006 (filed herewith).
- 4 Five Year Credit Agreement Amendment, dated as of July 24, 2006, by and among the Company, Citicorp USA, Inc., as administrative agent and issuing bank, the Lenders from time to time party thereto, and JPMorgan Chase Bank, N.A., as paying agent, filed as Exhibit 4 to the Company's Current Report of Form 8-K dated July 24, 2006, and incorporated herein by reference.
- 10(a) Form of Nonqualified Stock Option Award under The Sherwin-Williams Company 2006 Equity and Performance Incentive Plan, filed as Exhibit 10(a) to the Company's Current Report on Form 8-K dated July 19, 2006, and incorporated herein by reference.
- 10(b) Form of Incentive Stock Option Award under The Sherwin-Williams Company 2006 Equity and Performance Incentive Plan, filed as Exhibit 10(b) to the Company's Current Report on Form 8-K dated July 19, 2006, and incorporated herein by reference.
- 10(c) Form of Restricted Stock Grant under The Sherwin-Williams Company 2006 Equity and Performance Incentive Plan, filed as Exhibit 10(c) to the Company's Current Report on Form 8-K dated July 19, 2006, and incorporated herein by reference.
- 10(d) Form of Restricted Stock Grant under The Sherwin-Williams Company 2006 Stock Plan for Nonemployee Directors, filed as Exhibit 10(d) to the Company's Current Report on Form 8-K dated July 19, 2006, and incorporated herein by reference.
- 31(a) Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer (filed herewith).
- 31(b) Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer (filed herewith).

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32(a) Section 1350 Certification of Chief Executive Officer (filed herewith).

32(b) Section 1350 Certification of Chief Financial Officer (filed herewith).

**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 SHERWIN-WILLIAMS COMPANY

October 25, 2006

By: /s/ J.L. Ault  
J.L. Ault  
Vice President-Corporate Controller

October 25, 2006

By: /s/ L.E. Stellato  
L.E. Stellato  
Vice President, General Counsel and  
Secretary

**INDEX TO EXHIBITS**

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