EASTERN CO
Form 10-Q
July 28, 2006

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

FORM 10-Q

(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED July 1, 2006

OR

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

Commission File Number: 0-599

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

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

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

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

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

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

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

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

Class	Outstanding as of July 1, 2006
Common Stock, No par value	3,651,499

PART 1 - FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

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

ASSETS	July 1,
Current Assets	
Cash and cash equivalents	$ 2,7
Accounts receivable, less allowances: $294,000 - 2006; $295,000 - 2005	16,1
Inventories	23,6
Prepaid expenses and other assets	2,1
Deferred income taxes	7
Total Current Assets	45,3
Property, Plant and Equipment	45,0
Accumulated depreciation	(21,7
	23,2
Goodwill	10,6
Trademarks	1
Patents, technology, and licenses, less accumulated amortization	1,9
Interest rate swap asset	1
Intangible pension asset	7
Prepaid pension cost	7
	14,4
TOTAL ASSETS	$ 83,0
LIABILITIES AND SHAREHOLDERS' EQUITY	
Current Liabilities	
Accounts payable	$ 6,7
Accrued compensation	1,2
Other accrued expenses	3,3
Current portion of long-term debt	3,4
Total Current Liabilities	14,7
Deferred income taxes	9
Long-term debt, less current portion	10,7
Accrued post-retirement benefits	1,9
Accrued pension cost	6,3

Shareholders' Equity	
Preferred Stock, no par value: Authorized and unissued 2,000,000 shares	
Common Stock, no par value: Authorized: 25,000,000 shares	
Issued: 5,340,225 shares in 2006 and 5,328,417 shares in 2005	17,9
Treasury Stock: 1,688,726 shares	(16,6
Retained earnings	51,8
Accumulated other comprehensive income (loss):	
Foreign currency translation	1,0
Additional minimum pension liability, net of taxes	(6,0
Derivative financial instruments, net of taxes	1
Accumulated other comprehensive loss	(4,9
Total Shareholders' Equity	48,2
TOTAL LIBILITIES AND SHAREHOLDERS' EQUITY	$ 83,0

See accompanying notes.

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

	Six Months Ended		
	July 1, 2006	July 2, 2005	Jul
Net sales	$ 57,529,342	$ 53,688,878	$
Cost of products sold	(44,570,597)	(41,766,852)	(
Gross margin	12,958,745	11,922,026	
Selling and administrative expenses	(8,722,668)	(8,547,685)	
Operating profit	4,236,077	3,374,341	
Interest expense	(471,101)	(523,257)	
Other income	47,630	23,672	
Income before income taxes	3,812,606	2,874,756	
Income taxes	1,456,284	1,060,785	
Net income	$ 2,356,322	$ 1,813,971	$
Earnings per Share:			
Basic	$ .65	$ .50	
Diluted	$ .61	$ .47	
Cash dividends per share:	$ .23	$ .22	

See accompanying notes.

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

	Six Months Ended July 1, 2006	July 2, 2005	Jul
Net income	$ 2,356,322	$ 1,813,971	$
Other comprehensive income/(loss) -			
Change in foreign currency translation	200,957	(34,320)	
Change in fair value of derivative financial instruments, net of income taxes of:			
2006 - ($49,087) and ($17,925) respectively	86,557	-	
2005 - ($64,000) and ($23,000) respectively	-	96,417	
	287,514	62,097	
Comprehensive income	$ 2,643,836	$ 1,876,068	$

See accompanying notes.

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

	Six Months Ended July 1, 2006	July 2,
Operating Activities		
Net income	$ 2,356,322	$ 1,813
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,736,285	1,782
Provision for doubtful accounts	3,464	5
Deferred income taxes	-	192
Issuance of Common Stock for directors' fees	38,451	51
Changes in operating assets and liabilities:		
Accounts receivable	(1,289,683)	(1,815
Inventories	(2,870,071)	92
Prepaid expenses and other	213,018	208
Prepaid pension cost	78,656	(698

Other assets	(84,492)	(111
Accounts payable	1,434,903	752
Accrued compensation	(161,194)	(1,198
Other accrued expenses	(347,850)	(440
Net cash provided by operating activities	1,107,809	634
Investing Activities		
Purchases of property, plant and equipment	(2,364,583)	(920
Proceeds from sale of equipment	15,035	
Net cash used in investing activities	(2,349,548)	(920
Financing Activities		
Principal payments on long-term debt	(1,710,919)	(2,203
Proceeds from revolving credit loan	-	3,000
Proceeds from sales of Common Stock	203,700	
Dividends paid	(838,436)	(799
Net cash used in financing activities	(2,345,655)	(3
Effect of exchange rate changes on cash	(19,112)	6
Net change in cash and cash equivalents	(3,606,506)	(282
Cash and cash equivalents at beginning of period	6,345,947	4,420
Cash and cash equivalents at end of period	$ 2,739,441	$ 4,138

See accompanying notes.

THE EASTERN COMPANY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
JULY 1, 2006

Note A - Basis of Presentation

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

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

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

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

Note B - Earnings Per Share

The denominators used in the earnings per share computations follow:

	Six Months Ended	
	July 1, 2006	July 2, 2005
Basic:		
Denominator for basic earnings per share	3,646,915	3,635,546
Diluted:		
Weighted average shares outstanding	3,646,915	3,635,546
Dilutive stock options	223,587	240,690
Denominator for diluted earnings per share	3,870,502	3,876,236

Note C - Inventories

The components of inventories follow:

	July 1, 2006	December 31, 2005
Raw materials and component parts	$11,287,317	$ 9,917,792
Work in process	5,313,068	4,681,623
Finished Goods	7,013,249	6,168,334
	$23,613,634	$20,767,749

Note D - Segment Information

Segment financial information follows:

	SIX MONTHS ENDED	
	July 1, 2006	July 2, 2005

Revenues:			
Sales to unaffiliated customers:			
Industrial Hardware	$ 27,348,308	$ 26,837,746	$ 14,4
Security Products	23,505,178	21,233,164	11,8
Metal Products	6,675,856	5,617,968	3,3
	$ 57,529,342	$ 53,688,878	$ 29,6

Income Before Income Taxes:			
Industrial Hardware	$ 2,198,731	$ 2,646,857	$ 1,1
Security Products	2,421,964	1,885,274	1,2
Metal Products	(384,618)	(1,157,790)	(2
Operating Profit	4,236,077	3,374,341	2,2
Interest expense	(471,101)	(523,257)	(2
Other income	47,630	23,672	
	$ 3,812,606	$ 2,874,756	$ 1,9

Note E - Recent Accounting Pronouncements

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

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

	SIX MONTHS ENDED July 2, 2005	THREE MONTHS ENDED July 2, 2005
Net income, as reported	$1,813,971	$1,083,389
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards granted, net of related tax effects	(876)	(438)
Pro forma net income	$1,813,095	$1,082,951
Earnings per share:		
Basic-as reported	$0.50	$0.30
Basic-pro forma	$0.50	$0.30

Diluted-as reported	$0.47	$0.28
Diluted-pro forma	$0.47	$0.28

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

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

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

Note F - Debt

On March 8, 2006, the Company signed a capital lease in the amount of $68,948 with Citicorp Vendor Finance for the purchase of new lighting equipment at its Greenwald facility in Chester, Connecticut. The lease has a three year term at 0% interest rate. Payments under the lease are $1,915 per month.

Note G - Goodwill

The following is a roll-forward of goodwill from year-end 2005 to the end of the second quarter 2006:

Beginning balance - December 31, 2005	$ 10,641,532
Foreign exchange	49,748
Ending balance - July 1, 2006	$ 10,691,280

Note H - Retirement Benefit Plans

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

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

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

	Pension Benefits		
	Six Months Ended		Thre
	July 1, 2006	July 2, 2005	July 1, 20
Service cost	$ 800,332	$ 673,680	$ 398,8
Interest cost	1,166,466	1,113,211	545,8
Expected return on plan assets	(1,512,097)	(1,358,011)	(756,0
Net amortization and deferral	299,288	193,686	149,6
Net periodic benefit cost	$ 753,989	$ 622,566	$ 338,3

	Post-retirement Benefits		
	Six Months Ended		Thr
	July 1, 2006	July 2, 2005	July 1, 20
Service cost	$ 43,282	$ 43,358	$ 21,6
Interest cost	52,112	59,204	26,0
Expected return on plan assets	(43,252)	(39,594)	(21,6
Net amortization and deferral	(41,758)	(38,801)	(20,8
Net periodic benefit cost	$ 10,384	$ 24,167	$ 5,1

The Company's funding policy with respect to its qualified plans is to contribute at least the minimum amount required by applicable laws and regulations. For 2005, the Company was required to contribute $1,403,000 into its salaried plan ($600,000 contributed as of July 1, 2006) and $266,000 into one of its hourly plans ($208,000 contributed as of July 1, 2006). The Company will make the remaining contributions prior to filing its federal income tax return on September 15, 2006. The required contributions for 2006 have not yet been determined by the Company's actuaries. Any required contribution will be paid prior to filing its federal tax return on September 15, 2007.

The Company has a contributory savings plan under Section 401(k) of the Internal Revenue Code covering substantially all U.S. non-union employees. The plan allows participants to make voluntary contributions of up to 100% of their annual compensation on a pretax basis, subject to IRS limitations. The plan provides for contributions by the Company at its discretion. The Company made contributions of $43,910 and $86,153 in the second quarter and first six months of 2006, respectively, and $42,313 and $82,713 in the second quarter and first six months of 2005, respectively.

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

The following discussion is intended to highlight significant changes in the Company's financial position and results of operations for the twenty-six weeks ended July 1, 2006. The interim financial statements and this Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Consolidated Financial Statements and Notes thereto for the fiscal year ended December 31, 2005 and the related Management's Discussion and Analysis of Financial Condition and Results of Operations, both of which are contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

Certain statements set forth in this discussion and analysis of financial condition and results of operations are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. They use such words as "may," "will," "expect," "believe," "plan" and other similar terminology. These statements reflect management's current expectations regarding future events and operating performance and speak only as of the date of this release. These forward-looking statements involve a number of risks and uncertainties and actual future results and trends may differ materially depending on a variety of factors including changing customer preferences, lack of success of new products, loss of customers, competition, increased raw material prices, problems associated with foreign sourcing of parts and products, changes within our industry segments, in the overall economy, litigation and legislation. In addition, terrorist threats and the possible responses by the U.S. government, the effects on consumer demand, the financial

markets, the travel industry, the trucking industry and other conditions increase the uncertainty inherent in forward-looking statements. Forward-looking statements reflect the expectations of the Company at the time they are made, and investors should rely on them only as expressions of opinion about what may happen in the future and only at the time they are made. The Company undertakes no obligation to update any forward-looking statement. Although the Company believes it has an appropriate business strategy and the resources necessary for its operations, future revenue and margin trends cannot be reliably predicted and the Company may alter its business strategies to address changing conditions.

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

OVERVIEW

Net sales for the second quarter of 2006 increased 8% to $29.7 million from $27.4 million in the second quarter of 2005. Second quarter net income increased 12% to $1.2 million, or $0.31 per diluted share, from $1.1 million, or $0.28 per diluted share.

Net sales for the first six months of 2006 increased 7% to $57.5 million from $53.7 million in the first six months of 2005. Net income increased 30% to $2.4 million, or $0.61 per diluted share, from $1.8 million, or $0.47 per diluted share.

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

Cash flow from operations in the first six months of 2006 has improved compared to the same period in 2005. The Company's line of credit, along with controlling discretionary expenditures, should provide sufficient cash flow to enable the Company to meet all its existing obligations.

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

RESULTS OF OPERATIONS

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

	Three Months Ended July 1, 20		
	Industrial Hardware	Security Products	Metal Products
Net sales	100.0%	100.0%	100.0%
Cost of products sold	78.3%	72.6%	97.6%
Gross margin	21.7%	27.4%	2.4%
Selling and administrative expense	13.4%	16.8%	9.8%
Operating profit	8.3%	10.6%	-7.4%

	Three Months Ended July 2, 20		
	Industrial Hardware	Security Products	Metal Products
Net sales	100.0%	100.0%	100.0%
Cost of products sold	75.2%	72.1%	104.1%
Gross margin	24.8%	27.9%	-4.1%
Selling and administrative expense	15.0%	19.0%	12.1%
Operating profit	9.8%	8.9%	-16.2%

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

	Industrial Hardware	Security Products	Metal Products	Tota
Net sales	$ 651	$ 685	$ 912	$ 2,2
Volume	2.9%	5.4%	28.1%	6
Prices	0.0%	0.3%	0.0%	0
New Products	1.8%	0.4%	10.0%	2
	4.7%	6.1%	38.1%	8
Cost of products sold	$ 938	$ 551	$ 736	$ 2,2
	9.0%	6.8%	29.6%	10
Gross margin	$ (287)	$ 134	$ 176	$
	-8.4%	4.3%	179.8%	0
Selling and administrative expenses	$ (134)	$ (131)	$ 33	$ (2
	-6.4%	-6.2%	11.4%	-5
Operating profit	$ (153)	$ 265	$ 143	$ 2
	-11.4%	26.4%	37.0%	13

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

	Six Months Ended July 1, 200		
	Industrial Hardware	Security Products	Metal Products
Net sales	100.0%	100.0%	100.0%
Cost of products sold	77.2%	72.5%	96.0%
Gross margin	22.8%	27.5%	4.0%
Selling and administrative expense	14.8%	17.1%	9.7%
Operating profit	8.0%	10.4%	-5.7%

	Six Months Ended July 2, 20		
	Industrial Hardware	Security Products	Metal Products
Net sales	100.0%	100.0%	100.0%
Cost of products sold	75.1%	72.5%	110.6%
Gross margin	24.9%	27.5%	-10.6%
Selling and administrative expense	15.1%	18.6%	10.0%
Operating profit	9.8%	8.9%	-20.6%

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

	Industrial Hardware	Security Products	Metal Products	Tota
Net sales	$ 510	$ 2,272	$ 1,058	$ 3,8
Volume	-2.1%	9.7%	12.6%	4
Prices	0.0%	0.2%	0.6%	0
New Products	4.0%	0.7%	5.6%	2
	1.9%	10.7%	18.8%	7
Cost of products sold	$ 957	$ 1,651	$ 195	$ 2,8
	4.8%	10.7%	3.1%	6
Gross margin	$ (447)	$ 621	$ 863	$ 1,0
	-6.7%	10.7%	144.5%	8
Selling and administrative expenses	$ 2	$ 84	$ 89	$ 1
	0.0%	2.1%	15.9%	2
Operating profit	$ (449)	$ 537	$ 774	$ 8
	-16.9%	28.5%	66.8%	25

INDUSTRIAL HARDWARE SEGMENT

Net sales in the Industrial Hardware segment were up 5% in the second quarter and 2% in the first half of 2006 compared to the prior year periods. The sales increase was mainly the result of increased sales of hardware to the truck accessories and service body markets and new products, which more than offset decreased sales of "sleeper boxes" for the Class 8 trailer truck market compared to the same period in 2005. The Company expects the sales volume of "sleeper boxes" to improve as the year progresses. In addition, new products developed using our lightweight honeycomb composites included a mobile pickup mounted camper shell for emergency vehicle use and a mobile building door for military use. Other new products included a retro-fit kit for the military Humvee, a 3 point t-handle assembly and a star wheel rotary assembly for the truck accessory market, a hidden hinge and a remote magnet alarm for the service body market and an assortment of handles and latches used in many of the markets we sell to. All of the new products were developed internally for the variety of markets we serve.

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

Cost of products sold for the Industrial Hardware segment increased 9% in the second quarter and 5% in the first half of 2006 compared to the prior year periods. The increase in the cost of products sold is primarily the result of increases in sales volume, costs of raw materials, payroll and payroll related charges and utilities that were experienced during the periods.

Gross margin as a percent of net sales decreased from 25% to 22% in the second quarter and from 25% to 23% in the first half of 2006 compared to the prior year periods due to the higher manufacturing costs and changes in the mix of products sold.

Selling and administrative expenses for the second quarter decreased 6% compared to the prior year period due to decreases in advertising expenses, travel costs and payroll and payroll related charges. Selling and administrative expenses for the first half of 2006 were comparable to the prior year period.

SECURITY PRODUCTS SEGMENT

Net sales in the Security Products segment increased 6% in the second quarter and 11% in the first half of 2006 compared to 2005 periods. Sales volume in the second quarter of 2006 was up in all of the segments' operating units except for commercial laundry compared to the 2005 second quarter. Sales volume increases were experienced at all of the segment's operating units during the first six months of 2006 and in many of the markets we service including: automotive accessories, coin operated machines, gaming, electronics, enclosures and commercial laundry. Sales of new products focused on lock products such as the Super SesameeTM padlock, an electric car lock set, a remote keyless lock, and cash drawer bill hold down and till assemblies as well as various other items for the many markets we service.

Cost of products sold for the Security Products segment was up 7% in the second quarter and 11% in the first half of 2006 compared to the 2005 periods. Most of the increase in cost of products sold was the result of increased sales volume. Additional factors affecting this segment were increases in raw material costs, freight costs, payroll and payroll related charges and utilities.

Gross margin as a percentage of sales in the second quarter of 2006 decreased to 27% from 28% in the 2005 period due to higher manufacturing costs in the 2006 quarter. Gross margin as a percentage of sales was comparable at 27.5% for the first half of both 2006 and 2005.

Selling and administrative expenses decreased 6% in the second quarter and increased 2% in the first half of 2006 from 2005 levels. The decrease in the second quarter was due to lower travel and trade show expenses compared to the same period in 2005. The increase in the first half was due to higher payroll and payroll related charges and advertising expenses which exceeded reductions in travel and trade show expenses resulting in the overall increase in 2006.

METAL PRODUCTS SEGMENT

Net sales in the Metal Products segment were up 38% in the second quarter and 19% in the first half of 2006 as compared to the prior year periods. Sales of mining products were up 48% in the second quarter of 2006 compared to the second quarter of 2005 and sales of contract castings increased 7% from the prior year levels. Sales of mining products were up 21% in the first half of 2006 compared to the first six months of 2005 and sales of contract castings increased 12% from the comparable period in 2005. New product sales were primarily a new mine roof anchor for the Canadian mining market and a large flange nut. The Company expects the installation of the new automatic pouring system for ductile iron which was completed in July to increase efficiency in producing ductile iron castings and is continuing its marketing efforts for mine roof anchors in the China mining industry.

Cost of products sold increased 30% in the second quarter and 3% in the first half of 2006 compared to the same periods in 2005. The increase was mainly due to increases in sales volume, raw materials and payroll and payroll related charges.

Gross margin as a percentage of net sales increased from -4% to 2% in the second quarter of 2006 compared to the 2005 period and improved from -11% in the first half of 2005 to 4% for the first half of 2006. The improvement is primarily due to the increased sales volume and the mix of products produced.

Selling and administrative expenses were up 11% in the second quarter and up 16% the first half of 2006 compared to the same periods in 2005. The increases were related to increases in payroll and payroll related charges, advertising costs and travel expenses.

OTHER ITEMS

Interest expense decreased 16% in the second quarter and 10% in the first six months of 2006 compared to the prior year periods mainly due to the new swap contract associated with the loan agreement which was amended in August 2005 and lower debt balances.

Other income increased 10% in the second quarter and 101% from the first six months of 2005 to 2006 due to higher cash balances in the Company's cash management program, which resulted in higher interest income.

Income taxes increased in line with the higher earnings level. The effective tax rate in the second quarter of 2006 increased to 39% from the 2005 rate of 36%. The effective tax rate in the first six months of 2006 was 38% compared to 37% in the first six months of 2005. The increase in the effective tax rates in 2006 are the result of the Company deriving a higher percentage of its earnings from countries with higher effective tax rates.

LIQUIDITY AND SOURCES OF CAPITAL

The Company generated $1.1 million from operations for the first six months of 2006 compared to $635,000 for the same period in 2005. The change in cash flows was the result of improved earnings, the timing differences for collections of accounts receivable and payments of liabilities and changes in inventories. Cash flow from operations coupled with cash on hand at the beginning of the year were sufficient to fund capital expenditures, debt service, incentive payments, contributions to the Company's pension plans, and dividend payments.

Additions to property, plant and equipment were $2.4 million during the first six months of 2006 versus $920,000 for the comparable period in the prior year. Total capital expenditures for 2006 are expected to be in the range of $3.0 million to $4.0 million.

Total inventories as of July 1, 2006 were $23.6 million, compared to $20.8 million at year-end 2005. The inventory turnover ratio of 3.8 turns at the end of the second quarter was slightly lower than both the prior year second quarter and year-end 2005 ratio of 4.1 turns. The increase in inventory is a result of increased business in the United States, an increase in the level of ductile iron inventory in anticipation of the installation of the new auto-pour system in the Metal Products segment, and the ramping up of production at our facility in Shanghai, China. Accounts receivable increased by $1.3 million from year end 2005, primarily due to increased sales volume. The average days sales in accounts receivable for the second quarter of 2006 was 49 days compared to 48 days in the second quarter of 2005 and 49 days at year end 2005.

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

ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

ITEM 4 - CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

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

The Company believes that a controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. The Company's disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives, and the CEO and CFO have concluded that these controls and procedures are effective at the "reasonable assurance" level.

Changes in Internal Controls

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

PART II - OTHER INFORMATION

ITEM 1 - LEGAL PROCEEDINGS

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

ITEM 1A - RISK FACTORS

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

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

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

ITEM 3 - DEFAULTS UPON SENIOR SECURITIES

None

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

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

ITEM 5 - OTHER INFORMATION

None

ITEM 6 - EXHIBITS

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

32) Certifications pursuant to Rule 13a-14(b) and 18 USC 1350 as

adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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

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

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

SIGNATURES

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

THE EASTERN COMPANY
(Registrant)

DATE: July 28, 2006   /s/Leonard F. Leganza

Leonard F. Leganza
President and Chief Executive Officer

DATE: July 28, 2006   /s/John L. Sullivan III

John L. Sullivan III
Vice President, Secretary and Treasurer