

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

**FORM 10-Q**

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the quarterly period ended **October 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: 1-3203



**CHESAPEAKE CORPORATION**

(Exact name of registrant as specified in its charter)

**Virginia**

(State or other jurisdiction of incorporation or organization)

**54-0166880**

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

**1021 East Cary Street**

**Richmond, Virginia**

(Address of principal executive offices)

**23219**

Zip Code

Registrant's telephone number, including area code: **804-697-1000**

**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 ☒ 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 ☐

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

Number of shares of \$1.00 par value common stock outstanding as of November 6, 2006:  
19,824,932 shares.

**CHESAPEAKE CORPORATION**  
**FORM 10-Q**  
**FOR THE QUARTERLY PERIOD ENDED OCTOBER 1, 2006**  
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## PART I - FINANCIAL INFORMATION

### Item 1: Financial Statements

#### CHESAPEAKE CORPORATION AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF EARNINGS *(in millions, except per share data; unaudited)*

	Quarters Ended		Nine Months Ended	
	Oct. 1, 2006	Oct. 2, 2005	Oct. 1, 2006	Oct. 2, 2005
<b>Net sales</b>	\$ 247.9	\$ 244.8	\$ 737.4	\$ 759.9
<b>Costs and expenses:</b>				
Cost of products sold	206.8	201.4	612.9	625.3
Selling, general and administrative expenses	32.3	31.5	99.5	101.5
Restructuring expenses, asset impairments and other exit costs	1.6	3.3	7.7	3.3
(Gain) loss on divestiture	(4.1)	-	(3.1)	3.4
Other income, net	2.9	1.6	7.8	7.5
<b>Income from operations</b>	14.2	10.2	28.2	33.9
Interest expense, net	10.1	8.0	29.1	24.9
Loss on extinguishment of debt	-	0.5	0.6	0.5
<b>Income (loss) from continuing operations before taxes</b>	4.1	1.7	(1.5)	8.5
Income tax (benefit) expense	(1.3)	(0.1)	(2.4)	1.2
<b>Income from continuing operations</b>	5.4	1.8	0.9	7.3
<b>Discontinued operations:</b>				
Gain (loss) from discontinued operations, net of income tax of \$0.0 in each period presented	0.2	(0.6)	(4.4)	(2.2)
Loss on disposal of discontinued operations, net of income tax of \$0.0 in each period presented	(1.5)	-	(1.9)	(2.4)
<b>Net income (loss)</b>	\$ 4.1	\$ 1.2	\$ (5.4)	\$ 2.7
<b>Basic earnings per share:</b>				
Income from continuing operations	\$ 0.28	\$ 0.09	\$ 0.05	\$ 0.38
Discontinued operations	(0.07)	(0.03)	(0.33)	(0.24)
<b>Net income (loss)</b>	\$ 0.21	\$ 0.06	\$ (0.28)	\$ 0.14
<b>Diluted earnings per share:</b>				
Income from continuing operations	\$ 0.28	\$ 0.09	\$ 0.05	\$ 0.38
Discontinued operations	(0.07)	(0.03)	(0.33)	(0.24)
<b>Net income (loss)</b>	\$ 0.21	\$ 0.06	\$ (0.28)	\$ 0.14
<b>Weighted average number of common shares outstanding:</b>				
Basic	19.4	19.4	19.4	19.4
Diluted	19.4	19.4	19.4	19.4

*The accompanying Notes to Consolidated Financial Statements are an integral part of the financial statements.*

**CHESAPEAKE CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

*(in millions, except shares and per share amounts; unaudited)*

	Oct. 1, <u>2006</u>	Jan. 1, <u>2006</u>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 6.8	\$ 8.7
Accounts receivable (less allowance of \$3.7 and \$3.8)	148.7	134.8
<b>Inventories:</b>		
Finished goods	58.0	61.0
Work-in-process	19.5	19.7
Materials and supplies	29.0	27.8
<b>Total inventories</b>	<u>106.5</u>	<u>108.5</u>
Prepaid expenses and other current assets	18.0	26.1
Income taxes receivable	1.4	1.5
<b>Total current assets</b>	<u>281.4</u>	<u>279.6</u>
Property, plant and equipment, net	367.6	372.0
Goodwill	379.3	354.0
Other assets	113.1	117.4
<b>Total assets</b>	<u><u>\$ 1,141.4</u></u>	<u><u>\$ 1,123.0</u></u>

*The accompanying Notes to Consolidated Financial Statements are an integral part of the financial statements.*

**CHESAPEAKE CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**, continued  
*(in millions, except shares and per share amounts; unaudited)*

	Oct. 1, <u>2006</u>	Jan. 1, <u>2006</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 124.7	\$ 132.4
Accrued expenses	84.7	89.5
Income taxes payable	20.6	21.8
Current maturities of long-term debt	12.8	22.8
Dividends payable	-	4.3
	<u>242.8</u>	<u>270.8</u>
<b>Total current liabilities</b>	242.8	270.8
	<u>452.9</u>	<u>410.1</u>
Long-term debt	45.6	47.0
Environmental liabilities	71.3	75.8
Pensions and postretirement benefits	15.6	17.0
Deferred income taxes	11.7	7.0
Other long-term liabilities	<u>839.9</u>	<u>827.7</u>
<b>Total liabilities</b>	839.9	827.7
<b>Stockholders' equity:</b>		
Common stock, \$1 par value; authorized, 60 million shares; outstanding, 19.8 million shares and 19.6 million shares, respectively	19.8	19.6
Additional paid-in-capital	93.2	96.6
Unearned compensation	-	(3.9)
Accumulated other comprehensive loss (income)	8.5	(10.9)
Retained earnings	180.0	193.9
	<u>301.5</u>	<u>295.3</u>
<b>Total stockholders' equity</b>	301.5	295.3
<b>Total liabilities and stockholders' equity</b>	<u>\$ 1,141.4</u>	<u>\$ 1,123.0</u>

*The accompanying Notes to Consolidated Financial Statements are an integral part of the financial statements.*

**CHESAPEAKE CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
*(in millions; unaudited)*

	Nine Months Ended	
	<u>Oct. 1, 2006</u>	<u>Oct. 2, 2005</u>
<b>Operating activities:</b>		
Net (loss) income	\$ (5.4)	\$ 2.7
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	42.8	43.6
Deferred income taxes	(3.0)	(0.9)
Loss on extinguishment of debt	0.6	0.5
(Gain) loss on divestiture	(1.7)	6.4
Asset impairment	3.0	-
Pension expense	14.2	9.9
Gain on sales of property, plant and equipment	(2.8)	(1.3)
Changes in operating assets and liabilities, net of acquisitions and dispositions:		
Accounts receivable, net	(21.4)	(19.2)
Inventories	(1.4)	(13.2)
Other assets	5.7	4.2
Accounts payable	(4.9)	8.6
Accrued expenses	0.4	7.7
Income taxes payable and receivable, net	(2.1)	(2.2)
Contributions to defined benefit pension plans	(23.8)	(17.6)
Other	1.3	(0.7)
<b>Net cash provided by operating activities</b>	<u>1.5</u>	<u>28.5</u>
<b>Investing activities:</b>		
Acquisitions	-	(64.8)
Purchases of property, plant and equipment	(25.9)	(25.0)
Proceeds from sales of property, plant and equipment	5.0	4.3
Proceeds from divestiture, net of transaction costs	19.4	-
Other	-	0.1
<b>Net cash (used in) investing activities</b>	<u>(1.5)</u>	<u>(85.4)</u>
<b>Financing activities:</b>		
Net borrowings on lines of credit	31.3	113.9
Payments on long-term debt	(23.0)	(77.1)
Proceeds from long-term debt	3.6	3.1
Debt issue costs	(0.8)	-
Dividends paid	(12.9)	(12.8)
<b>Net cash (used in) provided by financing activities</b>	<u>(1.8)</u>	<u>27.1</u>
<b>Effect of exchange rate changes on cash and cash equivalents</b>	<u>(0.1)</u>	<u>(0.1)</u>
Decrease in cash and cash equivalents	(1.9)	(29.9)
Cash and cash equivalents at beginning of period	8.7	54.3
Cash and cash equivalents at end of period	<u>\$ 6.8</u>	<u>\$ 24.4</u>

*The accompanying Notes to Consolidated Financial Statements are an integral part of the financial statements.*

CHESAPEAKE CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (*unaudited*)

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation**

The consolidated interim financial statements of Chesapeake Corporation and subsidiaries included herein are unaudited. The January 1, 2006 consolidated balance sheet was derived from audited financial statements. As of July 31, 2006, we completed the sale of our French luxury packaging business and have accounted for this business as a discontinued operation (see Note 7). These statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") and, in accordance with those rules and regulations, we have condensed or omitted certain information and footnotes normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America ("GAAP"). We believe that the disclosures made are adequate for a fair presentation of results of our operations and financial position. In the opinion of management, the consolidated financial statements reflect all adjustments, all of a normal recurring nature, necessary to present fairly our consolidated financial position and results of operations for the interim periods presented herein. All significant intercompany accounts and transactions are eliminated. The preparation of consolidated financial statements in conformity with GAAP requires management to make extensive use of estimates and assumptions that affect the reported amounts and disclosures. Actual results could differ from these estimates.

Our fiscal year ends on the Sunday nearest to December 31.

These consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in our latest Annual Report on Form 10-K; additional details on our significant accounting policies are provided therein. The results of operations for the 2006 interim periods are not necessarily indicative of the results that may be expected for the full year.

In this report, unless the context requires otherwise, references to "we," "us," "our," "Chesapeake" or the "Company" are intended to mean Chesapeake Corporation and its consolidated subsidiaries.

**Share-Based Compensation**

*Adoption of SFAS No. 123(R)*

On January 2, 2006 the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)"), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and restricted stock awards, based on estimated fair values. SFAS No. 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning after January 1, 2006. In March 2005 the SEC issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS No. 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS No. 123(R).

The Company adopted SFAS No. 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 2, 2006, the first day of the Company's fiscal year ending December 31, 2006 ("fiscal 2006"). Under this method the share-based compensation cost recognized beginning January 2, 2006 includes compensation cost for (i) all share-based payments

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (*unaudited*)

granted prior to, but not vested as of, January 2, 2006 based on the grant date fair value originally estimated in accordance with the provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), and (ii) all share-based payments granted subsequent to January 1, 2006 based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). In accordance with the modified prospective transition method, the Company's Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123(R).

Prior to January 2, 2006 we accounted for share-based compensation plans in accordance with the provisions of APB 25 as permitted by SFAS No. 123. We elected to use the intrinsic value method of accounting for employee and director share-based compensation expense for our noncompensatory employee and director stock option awards and did not recognize compensation expense for the issuance of options with an exercise price equal to or greater than the market price of the underlying common stock at the date of grant. Had we elected to adopt the fair value approach as prescribed by SFAS No. 123, which charges earnings for the estimated fair value of stock options, our pro forma net income and pro forma earnings per share for the three and nine month periods ended October 2, 2005 would have been as follows:

(in millions, except per share data)

	Quarter <u>Ended</u>	Nine Months <u>Ended</u>
	Oct. 2, <u>2005</u>	Oct. 2, <u>2005</u>
Stock-based compensation expense, net of tax, included in net income as reported	\$ 0.1	\$ 0.6
Net income as reported	\$ 1.2	\$ 2.7
Additional stock-based compensation expense, net of tax	0.1	0.5
Pro forma net income	\$ 1.1	\$ 2.2
Earnings per share As reported:		
Basic	\$ 0.06	\$ 0.14
Diluted	0.06	0.14
Pro forma:		
Basic	\$ 0.06	\$ 0.11
Diluted	0.06	0.11

Based on changes in the probability assessment of achieving performance targets the Company recognized a share-based compensation benefit under SFAS No. 123(R) for the three month period ended October 1, 2006 of \$0.5 million. For the nine month period ended October 1, 2006 stock based compensation expense was \$0.6 million. Share-based compensation expense recognized under the provisions of APB 25 (primarily for restricted stock awards under our long-term incentive programs) during the nine month period ended October 2, 2005 was \$0.7 million (\$0.6 million after tax).

Prior to the adoption of SFAS No. 123(R) the Company presented the cash flow benefits for income tax deductions resulting from the exercise of stock options as operating cash flows in the statement of cash flows. Effective with the adoption of SFAS No. 123(R) the Company changed its cash flow presentation whereby tax benefits arising from tax deductions in excess of tax benefits recorded on the compensation costs recognized for such options (excess tax benefits) are now classified as financing



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cash flows. Also, effective with the adoption of SFAS No. 123(R), the amount previously classified within equity as "Unearned compensation" was charged to "Additional paid-in-capital." As permitted by SFAS No. 123(R) the Company elected to use the short cut method to calculate windfall tax benefits available as of the adoption date of SFAS No. 123(R).

*Stock Option and Award Plans*

The Company has four stock compensation plans for employees: the 2005 Incentive Plan, the 1997 Incentive Plan, the 1993 Incentive Plan and the 1987 Stock Option Plan. All four plans have been approved by our shareholders. The options outstanding as of October 1, 2006, were awarded under our 1993, 1997 and 2005 Incentive Plans. Up to 4,354,569 additional shares may be issued pursuant to all of the stock option and award plans; however, the Board of Directors has stated that all future grants will be made only from those shares available under the 2005 Incentive Plan, which had 1,476,013 additional shares available for issuance at October 1, 2006. Under the 2005 Incentive Plan we may grant stock options, stock appreciation rights ("SARs"), stock awards, performance shares or stock units, and may make incentive awards to our key employees and officers. As to employees the stock compensation plans are administered by the Executive Compensation Committee of the Board of Directors.

*Stock Options*

Stock options are generally granted with an exercise price equal to the market value of our common stock on the date of the grant, expire 10 years from the date they are granted and vest over a three-year service period. As permitted by SFAS No. 123 and SFAS No. 123(R) the fair values of the options were estimated using the Black-Scholes option-pricing model. The Black-Scholes weighted-average assumptions were as follows:

	<b>Nine months ended Oct. 1, 2006</b>		<b>Nine months ended Oct. 2, 2005</b>	
Weighted-average fair value of options at grant date	\$ 4.85		\$ 6.51	
Dividend yield	6.0	%	4.1	%
Risk-free interest rates	4.7	%	4.1	%
Volatility	57.4	%	44.6	%
Expected option term (years)	5.8		5.0	

As part of the annual valuation process the Company reassesses the appropriateness of the inputs into the Black-Scholes model used for option valuation. The Company establishes the risk-free interest rate using U.S. Treasury zero-coupon bonds with a remaining term equal to the expected option life assumed at the date of grant. The dividend yield is set based on the dividend rate approved by the Company's Board of Directors and the stock price on the grant date. The expected volatility assumption is set based primarily on historical volatility. The expected life assumption is set based on an analysis of past exercise behavior by option holders. In performing the option valuations the Company has not stratified option holders as exercise behavior has historically been consistent across all employee groups. The forfeiture rate used is based on historical experience. As required by SFAS No. 123(R) the Company will adjust the estimated forfeiture rate based upon actual experience.

The following schedule summarizes stock option activity for the nine months ended October 1, 2006:

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (*unaudited*)

	Number of Stock Options	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding January 1, 2006	1,474,545	\$27.40	4.8	
Granted	80,300	14.60	10.0	
Exercised	-	-	-	
Forfeited/expired	(84,320)	24.80	-	
	<u>1,470,525</u>	<u>26.85</u>	<u>3.9</u>	<u>-</u>
Outstanding October 1, 2006	1,470,525	26.85	3.9	-
Exercisable October 1, 2006	1,329,374	27.75	3.3	-

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the third quarter of 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on October 1, 2006. The amount of aggregate intrinsic value will change based on the fair market value of our stock.

Information about options outstanding at October 1, 2006, is summarized below:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted - Average Remaining Contractual Life (Years)	Weighted - Average Exercise Price	Number Exercisable	Weighted - Average Exercise Price
\$14.60 - \$19.22	160,336	7.8	\$16.24	80,136	\$17.87
\$19.23 - \$23.07	223,618	5.3	\$21.93	185,003	\$21.96
\$23.08 - \$26.91	212,334	3.9	\$25.18	189,998	\$25.05
\$26.92 - \$30.76	630,667	3.3	\$28.58	630,667	\$28.58
\$30.77 - \$34.60	130,317	0.9	\$33.05	130,317	\$33.05
\$34.61 - \$38.45	113,253	1.8	\$37.97	113,253	\$37.97
	<u>1,470,525</u>			<u>1,329,374</u>	

For the three months ended October 1, 2006 the total share-based compensation expense for stock options was \$0.2 million. The total income tax benefit recognized in net income related to this expense was \$0.1 million. For the nine months ended October 1, 2006 the total share-based compensation expense for stock options was \$0.5 million. The total income tax benefit recognized in net income related to this expense was \$0.2 million. As of October 1, 2006 there was \$0.7 million of total unrecognized compensation cost related to non-vested stock options. The cost is to be recognized over a weighted-average period of 2 years. There were no exercises of stock options during the nine months ended October 1, 2006.

CHESAPEAKE CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (*unaudited*)

*Non-employee Directors*

Chesapeake has a Directors' Deferred Compensation Plan that provides for annual grants of stock options to nonemployee directors. Up to 270,350 options for additional shares may be issued pursuant to the Directors' Plan; however, any future awards of stock options (or other equity compensation) to nonemployee directors will be made under the 2005 Incentive Plan. For the nine months ended October 1, 2006, there were no options and 11,875 shares granted to non-employee directors.

*Restricted Stock*

From time to time the Executive Compensation Committee of the Board of Directors (or, as to the CEO, the Committee of Independent Directors) will grant performance-based or service-based restricted stock to Chesapeake's officers and certain managers under Chesapeake's Incentive Plans. For the 2004-2006, 2005-2007 and 2006-2008 cycles of the long-term incentive program, the performance criteria established by the Executive Compensation Committee (and the Committee of Independent Directors, as to the CEO) for the vesting of restricted stock was the achievement of specific strategic goals for Chesapeake. If the performance targets are not achieved by the ends of the applicable cycles, the related shares will be forfeited.

The fair value of each share of restricted stock is based on the fair market value of the stock on the date of grant. The probability of achieving the performance criteria is assessed each quarter and compensation expense is adjusted accordingly. For liability classified awards, compensation expense is further adjusted based on the fair value of the award at the end of the reporting quarter. If performance goals are not met no compensation cost is recognized and any previously recognized compensation cost is reversed. The following schedule summarizes non-vested restricted stock activity for the nine months ended October 1, 2006:

	Shares	Weighted- Average Grant Date Value
Outstanding grants at January 1, 2006	245,856	\$24.75
New shares granted	186,100	17.36
Shares forfeited	(41,506)	18.55
Shares vested	(600)	19.64
Outstanding grants at October 1, 2006	389,850	\$25.90

As of October 1, 2006 there was \$1.5 million of total unrecognized compensation cost related to nonvested restricted stock. The cost is expected to be recognized over a weighted-average period of 2 years, assuming achievement of the performance criteria.

**New Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48 ("FIN 48"), *Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109, Accounting for Income Taxes*, which clarifies the accounting for uncertainty in income taxes. FIN 48 prescribes a 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. The Interpretation requires that the Company recognize in the financial statements the impact of a tax position, if that position is more likely than not to be sustained on audit, based on the technical merits of the position. FIN 48 also

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (*unaudited*)

provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure. The provisions of FIN 48 are effective beginning January 1, 2007 with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. We are currently evaluating the impact of adopting FIN 48 on the financial statements.

In September 2006 the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in accordance with GAAP and expands disclosures about fair value measurements. The provisions of SFAS No. 157 are effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We do not expect SFAS No. 157 to have a material impact on our financial statements.

In September 2006 the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans-an amendment of FASB Statements No. 87, 88, 106, and 132(R)* ("SFAS 158"), which requires an employer to recognize the over-funded or under-funded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity. This Statement also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. The provisions of SFAS 158 requires prospective application, and are effective as of December 31, 2006, except for the measurement date provisions, which are effective for fiscal years ending after December 15, 2008. Based on our unfunded obligation as of December 31, 2005, the adoption of SFAS 158 would reduce total stockholders' equity by approximately \$90.0 million, net of tax. The adoption of SFAS 158 will not affect our results of operations. By the time of adoption at December 31, 2006, plan performance and actuarial assumptions could have a significant impact on the actual amounts recorded. However, the Company does not believe the decrease in stockholders' equity will have a significant impact on the Company's financing covenants.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *"Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements"* ("SAB 108"). Due to diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006. We do not expect SAB 108 to have a significant impact on our financial statements.

## **NOTE 2. EARNINGS PER SHARE ("EPS")**

### **Calculation**

Basic EPS is calculated using the weighted-average number of outstanding common shares during each period. Diluted EPS is calculated using the weighted-average number of diluted outstanding common shares during each period. Diluted EPS reflects the potential dilution that could occur if securities are exercised or converted into common stock, or result in the issuance of common stock that would then share in earnings. The difference between the weighted-average shares used for the basic and diluted calculation is due to the number of shares for which "in-the-money" stock options are outstanding.

No dilutive shares were outstanding as of October 1, 2006 and there was not a material amount of dilutive shares outstanding as of October 2, 2005 for purposes of calculating diluted EPS. As of October

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1, 2006 and October 2, 2005, 1.5 million of potentially dilutive common shares were not included in the computation of diluted EPS because the effect would be antidilutive.

**NOTE 3. COMPREHENSIVE INCOME**

Comprehensive income (loss) is as follows:

	Quarters Ended		Nine Months Ended	
	Oct. 1, 2006	Oct. 2, 2005	Oct. 1, 2006	Oct. 2, 2005
Net income (loss)	\$ 4.1	\$ 1.2	\$ (5.4)	\$ 2.7
Foreign currency translation	(1.5)	(0.2)	22.5	(61.5)
Change in fair market value of derivatives, net of tax	1.6	(0.8)	2.7	(4.6)
Minimum pension liability, net of tax	(0.9)	0.2	(5.8)	4.9
Comprehensive income (loss)	<u>\$ 3.3</u>	<u>\$ 0.4</u>	<u>\$ 14.0</u>	<u>\$ (58.5)</u>

**NOTE 4. RESTRUCTURING AND OTHER EXIT COSTS**

During the fourth quarter of fiscal 2005 Chesapeake announced plans for a global cost savings program. The scope of this program is extensive and could ultimately involve a number of locations being either sold, closed or downsized. We also expect broad-based workforce reductions and a general reduction in overhead costs throughout the Company. Additionally, we are targeting specific improvements in operating processes. The cost of these initiatives is expected to range from \$30 million to \$40 million on a pre-tax basis, with the cash flow impact being less due to the sale of related real estate and assets. Full implementation of this program is expected by the end of fiscal 2007. The ultimate costs and timing of this program will be dependent on consultation and, in certain circumstances, negotiation with European works councils or other employee representatives. Costs associated with the program have been classified as "restructuring expenses, asset impairments and other exit costs" in the accompanying consolidated statements of earnings.

Charges recorded during the quarter and nine-month period ended October 1, 2006 were primarily recorded within the Paperboard Packaging segment, and are summarized as follows:

	Quarters Ended		Nine Months Ended	
	Oct. 1, 2006	Oct. 2, 2005	Oct. 1, 2006	Oct. 2, 2005
Employee-related costs	\$ 1.2	\$ 3.2	\$ 7.7	\$ 3.2
Asset impairment	-	-	3.0	-
Loss on asset sales, redeployment costs, and other exit costs	0.3	0.1	0.9	0.1
Total restructuring expenses, asset impairment and other exit costs	<u>1.5</u>	<u>3.3</u>	<u>11.6</u>	<u>3.3</u>
Restructuring expenses, asset impairments and other exit costs attributed to discontinued operations	0.1	-	(3.9)	-
Restructuring expenses, asset impairments and other exit costs attributed to continuing operations	<u>\$ 1.6</u>	<u>\$ 3.3</u>	<u>\$ 7.7</u>	<u>\$ 3.3</u>

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During the first quarter of fiscal 2006 we initiated the closure of our paperboard packaging carton operation at Bedford in the United Kingdom. Under the closure plan, production of products manufactured at the Bedford facility has been transferred to other Company sites in the United Kingdom. The closure, which was completed in the third quarter of fiscal 2006, resulted in 89 employee terminations. We recognized approximately \$2.0 million in employee-related costs during the first nine months of fiscal 2006 associated with this closure. In addition, we recognized a benefit of \$0.1 million related to Bedford plant asset disposals and redeployments. We do not expect to incur any significant additional costs related to asset disposals and redeployment costs related to this site during the remainder of fiscal 2006.

Closure activities associated with the previously reported closure of our paperboard packaging facility in Birmingham in the United Kingdom were substantially completed during the first quarter of fiscal 2006. Severance benefits were paid to the 190 affected employees during the fourth quarter of fiscal 2005 and the first nine months of fiscal 2006. During the first nine months of fiscal 2006, additional employee-related costs of \$0.4 million and plant asset redeployment and disposal costs of approximately \$0.7 million were incurred. In October 2006 we completed the sale of the facility for approximately \$4.7 million, which will be included in our fourth quarter 2006 results.

Under the global cost savings plan described above, the Company has recorded other employee-related costs of \$5.0 million during the first nine months of 2006 for broad-based workforce and overhead reductions.

The following table displays the activity and balances of the restructuring charges, asset impairments and other exit costs for fiscal 2006.

<i>(in millions)</i>	<b>Employee- Related Costs</b>	<b>Asset Impairments</b>	<b>Other Exit Costs</b>	<b>Total</b>
Balance January 1, 2006	\$6.9	\$-	\$-	\$6.9
New charges, continuing operations	7.0	-	0.7	7.7
New charges, discontinued operations	0.7	3.0	0.2	3.9
Cash payments	(11.9)	-	(1.2)	(13.1)
Asset impairments	-	(3.0)	-	(3.0)
Gain/(loss) on asset sales	-	-	0.7	0.7
Other non-cash items	0.4	-	0.2	0.6
Balance October 1, 2006	<u>3.1</u>	<u>-</u>	<u>0.6</u>	<u>3.7</u>

As previously disclosed we completed the sale of our French luxury packaging business ("CLP") to Sofavie on July 31, 2006. The historical operating results, as well as the loss on the sale of CLP, have been reflected as discontinued operations as of October 1, 2006 (including restructuring activities associated with our rigid box operation at Ezy-sur-Eure, France (the "Ezy" site), and the second quarter 2005 loss on sale of our French wine and spirits label operation at Bourgeot Etiqso Lesbats ("Bourgeot")). See Note 7 regarding discontinued operations.

## NOTE 5. GAIN (LOSS) ON DIVESTITURES

### *Lurgan:*

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On March 23, 2006 the Company completed the sale of its plastic packaging operation in Lurgan, Northern Ireland ("Lurgan") to a group led by existing management ("Buyer"). The cash proceeds on sale, net of transaction costs, approximated \$15 million. The Company also received a subordinated loan note of 1.25 million pounds Sterling (approximately \$2.2 million at the sale date). The loan note has been fully reserved by management given the Company's subordinated position and the extent of other acquisition indebtedness of the Buyer. The purchase and sale agreement includes customary warranties and indemnities related to the Company's operation of the business prior to the transaction closing date. The purchase and sale agreement also provides for an arrangement whereby the Company may achieve additional proceeds from the Buyer dependent upon the subsequent sale of certain real property conveyed with the operation.

The divestiture resulted in a pre-tax net gain of \$3.1 million (\$2.9 million after tax). The net gain of \$3.1 million includes a pre-tax loss of \$1.0 million on the sale recorded in the first quarter, and a pre-tax gain of \$4.1 million due to the receipt of additional proceeds (\$3.2 million) and recovery of a portion of the subordinated loan note (\$0.9 million) recorded in the third quarter. In connection with the divestiture, the Company made a contribution of approximately \$5.9 million to the non-U.S. defined benefit pension plan which covered the employees of the Lurgan facility.

***CPI:***

In connection with the 2001 divestiture of Consumer Promotions International, Inc. ("CPI"), a component of the Company's former Merchandising and Specialty Packaging segment, the Company provided seller financing for a portion of the proceeds through receipt of subordinated promissory notes. Included in the promissory notes were term notes of approximately \$5.0 million, which were recorded at fair value on the date of sale.

In July 2005 CPI informed the Company of its inability to continue interest payments under the term notes. Also, CPI provided the Company with updated financial information that indicated a significant deterioration in the operating results of CPI. These factors resulted in a change in our estimate as to the recovery of these notes. Due to the subordinated nature of our position as a creditor and the risks associated with pursuing recovery, we wrote down the value of these notes to zero in the second quarter of 2005. This loss of \$3.4 million has been classified as "loss on divestitures" in the accompanying consolidated statement of earnings. The Company subsequently recovered \$0.6 million in the fourth quarter of 2005 in full settlement of these notes.

**NOTE 6. GOODWILL AND INTANGIBLE ASSETS**

The following table sets forth the details of our goodwill balance:

<i>(in millions)</i>	<b>Paperboard Packaging</b>	<b>Plastic Packaging</b>	<b>Total</b>
Balance January 1, 2006	\$283.1	\$70.9	\$354.0
Goodwill acquired/purchase price adjustments	(0.7)	-	(0.7)
Divestitures	-	(5.6)	(5.6)
Foreign currency translation	25.6	6.0	31.6
Balance October 1, 2006	<u>\$308.0</u>	<u>\$71.3</u>	<u>\$379.3</u>

In connection with our March 2006 divestiture of Lurgan, \$5.6 million of goodwill was allocated to Lurgan based on the relative fair value of the divested business to the Plastic Packaging segment taken as a whole.

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In December 2005 we purchased the outstanding minority interest in our South African plastic packaging operations for approximately \$12.6 million, inclusive of capitalized transaction costs. We accounted for the acquisition under the purchase method as a step acquisition. The excess purchase price over the historical book value of the minority interest was provisionally allocated to goodwill. The allocation of goodwill is preliminary and may be revised as a result of further analysis of the fair values of assets purchased and liabilities assumed.

In connection with our September 2005 acquisition of Impaxx Pharmaceutical Packaging Group, Inc. ("Arlington Press"), a portion of the purchase price was ascribed to certain finite-lived intangible assets, primarily customer relationships. The cost and accumulated amortization of customer relationships as of October 1, 2006 were \$16.2 million and \$1.7 million, respectively. The cost and accumulated amortization of customer relationships as of January 1, 2006 were \$16.2 million and \$0.5 million, respectively. Amortization expense recorded during the first nine months of fiscal 2006 for customer relationships was \$1.2 million.

Amortization expense of our intangible assets for the next five fiscal years is estimated as follows (amounts in millions):

2006 (remaining 3 months)	\$0.4
2007	1.6
2008	1.6
2009	1.6
2010	1.6

## NOTE 7. DISCONTINUED OPERATIONS

Summarized results of discontinued operations are shown separately in the accompanying consolidated statements of earnings. Discontinued operations in fiscal 2006 primarily relate to the sale of CLP, which was included within our Paperboard Packaging segment, to Sofavie on July 31, 2006. The sale price was 500 thousand Euro (approximately \$640 thousand at the sale date). The sale resulted in a pre-tax and after-tax loss of \$1.5 million in the third quarter of 2006, which is included in "Loss on disposal of discontinued operations" in the accompanying consolidated statement of earnings. The financial position of the CLP business was not material to our consolidated financial position on July 31, 2006. CLP's historical operating results have been reclassified and presented within "Gain (loss) from discontinued operations" in the accompanying consolidated statements of earnings, as follows:

<i>(in millions)</i>	Quarters Ended		Nine Months Ended	
	Oct. 1, 2006	Oct. 2, 2005	Oct. 1, 2006	Oct. 2, 2005
Revenue	\$ 3.2	\$ 10.0	\$ 16.7	\$ 27.2
Pre-tax income (loss)	\$ 0.2	\$ (0.6)	\$ (4.4)	(2.2)

Discontinued operations in fiscal 2005 primarily represent reclassification of CLP historical operating results, which includes Bourgeot. On April 18, 2005, the Company completed the sale of the assets of Bourgeot to Autajon Group. The sale price was 1.16 million Euro (approximately \$1.5 million at the sale date). The Company incurred a pre-tax and after-tax, non-cash loss on sale of \$3.0 million in the



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second quarter of 2005, which is included in "Loss on disposal of discontinued operations" in the accompanying consolidated statements of earnings. Additionally, within discontinued operations for fiscal 2005 is a reduction of the liability for contractual obligations related to our former Merchandising and Specialty Packaging segment that was divested in 2001.

In accordance with Emerging Issues Task Force ("EITF") No. 87-24, interest has been allocated to CLP for both fiscal 2006 and 2005. Interest allocated did not have a significant impact on our results from continuing operations for both fiscal 2006 and 2005.

#### **NOTE 8. INCOME TAXES**

The comparability of our effective income tax rates is heavily influenced by the relationship of U.S. to non-U.S. pre-tax income (losses), by management's expectation as to recovery of our U.S. and certain foreign jurisdiction deferred income tax assets, and by the timing of settlement or resolution of income tax contingencies. The recognition of income tax benefits for U.S. deferred income tax assets is largely dependent on the magnitude and assumed reversal patterns of the Company's U.S. taxable temporary differences, principally related to our U.S. defined benefit pension arrangements. During fiscal 2005 we recognized deferred income tax benefits for our U.S. deferred income tax assets to the full extent of existing taxable temporary differences. For this reason, and given our inability to project future U.S. taxable income, we are no longer recognizing income tax benefits on U.S. tax losses incurred subsequent to January 1, 2006. Our fiscal 2006 effective income tax rate was also adversely affected by a capital gains tax in the first quarter of fiscal 2006 of approximately \$0.9 million on the transfer of assets in connection with the divestiture of the Lurgan operation (see Note 5). During the third quarter of 2006, the Company recorded a \$2.3 million income tax benefit as a result of management's reassessment of its valuation allowance for deferred income tax assets in France following the sale of CLP. The effective income tax rate for the nine-month period ended October 1, 2006 also included a benefit of \$1.8 million associated with the favorable settlement of income tax contingencies with U.K. tax authorities.

In October 2006, we reached a settlement with U.K. tax authorities regarding an income tax contingency, and will record an income tax benefit of \$1.5 million in the fourth quarter of 2006 related to this matter.

#### **NOTE 9. DEBT**

In the first quarter of fiscal 2006 we redeemed 5.0 million pounds Sterling principal amount of our 10.375 percent senior subordinated notes due 2011 at a premium and recognized a loss of \$0.6 million associated with the debt extinguishment.

In the first quarter of fiscal 2005 we paid \$38.8 million principal amount of loan note maturities and we redeemed, at par, the remaining \$18.2 million principal amount of our 7.2 percent notes which also matured during the first quarter. In the third quarter of 2005 we redeemed 2.9 million pounds Sterling principal amount of our 10.375 percent senior subordinated note due 2011 at a premium and recognized a loss of \$0.5 million associated with the debt extinguishment.

#### **NOTE 10. EMPLOYEE RETIREMENT AND POSTRETIREMENT BENEFITS**

The components of the net periodic benefit cost recognized during the quarters and nine month periods ended October 1, 2006 and October 2, 2005 were as follows:

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<i>(in millions)</i>	Pension Benefits				Postretirement Benefits Other Than Pensions	
	U.S. Plans		Non-U.S. Plans			
	Oct. 1, 2006	Oct. 2, 2005	Oct. 1, 2006	Oct. 2, 2005	Oct. 1, 2006	Oct. 2, 2005
Quarters Ended:						
Service cost	\$ -	\$ 0.1	\$ 1.8	\$ 1.4	\$ -	\$ -
Interest cost	0.9	0.9	5.5	4.7	0.2	0.3
Expected return on plan assets	(1.1)	(1.2)	(5.1)	(4.6)	-	-
Recognized actuarial loss	0.3	0.5	2.5	1.3	0.1	0.1
Net pension expense	\$ 0.1	\$ 0.3	\$ 4.7	\$ 2.8	\$ 0.3	\$ 0.4

<i>(in millions)</i>	Pension Benefits				Postretirement Benefits Other Than Pensions	
	U.S. Plans		Non-U.S. Plans			
	Oct. 1, 2006	Oct. 2, 2005	Oct. 1, 2006	Oct. 2, 2005	Oct. 1, 2006	Oct. 2, 2005
Nine Months Ended:						
Service cost	\$ -	\$ 0.4	\$ 5.3	\$ 4.4	\$ -	\$ -
Interest cost	2.7	2.8	16.0	14.8	0.6	0.7
Expected return on plan assets	(3.3)	(3.6)	(15.0)	(14.6)	-	-
Recognized actuarial loss	1.0	1.6	7.4	4.1	0.3	0.3
Curtailment loss	0.1	-	-	-	-	-
Net pension expense	\$ 0.5	\$ 1.2	\$ 13.7	\$ 8.7	\$ 0.9	\$ 1.0

In connection with the December 2005 freezing of benefits under certain of our U.S. defined benefit pension plans, we recorded a curtailment loss of \$0.1 million during the first quarter of fiscal 2006. As a result of permanently freezing benefits under these plans, we changed the amortization period for unrecognized actuarial losses for the affected plans, effective January 2, 2006, to the average remaining life expectancy of the participants.

## NOTE 11. COMMITMENTS AND CONTINGENCIES

### Environmental Matters

The costs of compliance with existing environmental regulations are not expected to have a material adverse effect on our financial position or results of operations.

The Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") and similar state "Superfund" laws impose liability, without regard to fault or to the legality of the original action, on certain classes of persons (referred to as potentially responsible parties or "PRPs") associated with a release or threat of a release of hazardous substances into the environment. Financial responsibility for the remediation and restoration of contaminated property and for natural resource damages can extend to previously owned or used properties, waterways and properties owned by third parties, as well as to properties currently owned and used by a company even if contamination is attributable entirely to prior owners. As discussed below the U.S. Environmental Protection Agency ("EPA") has given notice of its intent to list the Lower Fox River in Wisconsin on the National Priorities

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List under CERCLA and identified our subsidiary, Wisconsin Tissue Mills Inc., now WTM I Company ("WT"), as a PRP for the Lower Fox River site.

Except for the Fox River matter we have not been identified as a PRP at any other CERCLA-related sites. However, there can be no assurance that we will not be named as a PRP at any other sites in the future or that the costs associated with additional sites would not be material to our financial position or results of operations.

In June 1994 the U.S. Department of Interior, Fish and Wildlife Service ("FWS"), a federal natural resources trustee, notified WT that it had identified WT as a PRP for natural resources damage liability under CERCLA arising from alleged releases of polychlorinated biphenyls ("PCBs") in the Fox River and Green Bay System in Wisconsin from WT's former recycled tissue mill in Menasha, Wisconsin. In addition to WT six other companies (Appleton Papers, Inc., Fort Howard Corporation, P.H. Glatfelter Company ("Glatfelter"), NCR Corporation, Riverside Paper Corporation and U.S. Paper Mills Corporation) have been identified as PRPs for the Fox River site. The FWS and other governmental and tribal entities, including the State of Wisconsin ("Wisconsin"), allege that natural resources, including federal lands, state lands, endangered species, fish, birds, tribal lands or lands held by the U.S. in trust for various Indian tribes, have been exposed to PCBs that were released from facilities located along the Lower Fox River. On January 31, 1997 the FWS notified WT of its intent to file suit, subject to final approval by the U.S. Department of Justice ("DOJ"), against WT to recover alleged natural resource damages, but the FWS has not yet instituted such litigation. On June 18, 1997 the EPA announced that it was initiating the process of listing the Lower Fox River on the CERCLA National Priorities List of hazardous waste sites. On September 30, 2003 EPA and the Wisconsin Department of Natural Resources ("DNR"), in connection with the issuance of General Notice Letters under CERCLA to the PRPs requesting a good faith offer to conduct the remedial design for downstream portions of the Lower Fox River site, also notified Menasha Corporation and Sonoco Products Company that those companies were also considered potentially liable for the cost of response activities at the Lower Fox River site.

In January 2003 DNR and EPA released a Record of Decision (the "OU1-2 ROD") for Operable Units 1 and 2 ("OU1" and "OU2") of the Fox River site. OU1 is the reach of the river that is the farthest upstream and is immediately adjacent to the former WT mill. The OU1-2 ROD selects a remedy, consisting primarily of dredging, to remove substantially all sediment in OU1 with concentrations of PCBs of more than 1 part per million in order to achieve a surface weighted-average PCB concentration level ("SWAC") of not more than 0.25 parts per million. The OU1-2 ROD estimates the present-worth cost of the proposed remedy for OU1 is \$66.2 million. Present-worth cost as stated in the OU1-2 ROD means capital costs in undiscounted 2001 dollars and long-term operation, maintenance and monitoring costs discounted at 6 percent. This estimate is an engineering cost estimate and the OU1-2 ROD states that the actual project cost is expected to be within +50 percent to -30 percent of the estimate. The OU1-2 ROD estimates that the proposed dredging remedy for OU1 will be accomplished over a six-year period after commencement of dredging. For OU2, the reach of the river covering approximately 20 miles downstream from OU1, the OU1-2 ROD proposes a remedy of monitored natural recovery over a 40-year period. The OU1-2 ROD states that the present-worth cost of the proposed remedy for OU2 is an engineering cost estimate of \$9.9 million, based on estimated costs discounted at 6 percent.

On July 1, 2003 DNR and EPA announced that they had signed an agreement with WT under which WT will complete the design work for the sediment clean-up in OU1. On April 12, 2004, a Consent Decree (the "Consent Decree") regarding the remediation of OU1 by WT and Glatfelter was entered by a federal court. Under the terms of the Consent Decree, WT and Glatfelter agreed to perform appropriate remedial action in OU1 in accordance with the OU1-2 ROD under oversight by EPA and DNR. To fund the

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remedial action, WT and Glatfelter each paid \$25 million to an escrow account, and EPA and Wisconsin agreed to use their best efforts to obtain an additional \$10 million from another source to supplement the funding. Contributions and cooperation may also be obtained from local municipalities, and additional assistance may be sought from other potentially liable parties. As provided in the Consent Decree, WT has been reimbursed from the escrow account for \$2 million of OU1 design costs expended under the July 1, 2003, design agreement.

Upon completion of the remedial action for OU1 to the satisfaction of EPA and Wisconsin, WT and Glatfelter will receive covenants not to sue from EPA and Wisconsin for OU1, subject to conditions typical of settlements under CERCLA. We believe the required remedial action for OU1 can be completed with the expected funding provided under the Consent Decree assuming approval of alternative remedial actions that are environmentally appropriate but more cost effective than the remedial action selected in the OU1-2 ROD. If the funding provided through the Consent Decree is not adequate to pay for the required remedial action, WT and Glatfelter have the option, but not the obligation, to contribute additional funds to complete the remedial action. WT remains potentially liable for the additional costs necessary to achieve the performance standards for OU1 specified in the OU1-2 ROD.

Under the terms of the Consent Decree WT also paid EPA and the State of Wisconsin \$375,000 for past response costs, and paid \$1.5 million for natural resource damages ("NRD") for the Fox River site and \$150,000 for past NRD assessment costs. These payments have been credited toward WT's potential liability for response costs and NRD associated with the Fox River site as a whole. As discussed later in this section we believe that WT is entitled to substantial indemnification from a prior owner of WT with respect to these costs, and the prior owner has reimbursed WT for the payments made to date as required in the Consent Decree.

In July 2003 EPA and DNR announced a Record of Decision (the "OU3-5 ROD") for Operable Units 3, 4 and 5 ("OU3," "OU4" and "OU5," respectively), the remaining operable units for this site. The OU3-5 ROD requires primarily dredging and disposal of PCB contaminated sediments from OU3 and OU4 (the downstream portion of the river) and monitored natural recovery in OU5 (Green Bay). The OU3-5 ROD remedy for OU3 and OU4 provides for removal of substantially all sediment with concentrations of PCBs of more than 1 part per million in order to achieve a SWAC of not more than 0.25 parts per million. The OU3-5 ROD estimates the present-worth cost of the proposed remedy for OU3-5 is \$324 million. Present-worth cost as stated in the ROD means capital costs in undiscounted 2001 dollars and long-term operation, maintenance and monitoring costs discounted at 6 percent. This estimate is an engineering cost estimate, and the OU3-5 ROD states that the actual project cost is expected to be within +50 percent to -30 percent of the estimate.

Based on information available to us at this time we believe that the range of reasonable estimates of the remaining total cost of remediation and restoration for the Fox River site is \$280 million to \$1.59 billion. The low end of this range assumes costs estimated in the OU1-2 ROD and the OU3-5 ROD and takes into account the -30 percent engineering estimating factor. The upper end of the range assumes costs estimated by consultants for the PRPs and includes a +50 percent engineering estimating factor. The OU1-2 ROD indicates that OU1 active remediation and restoration is expected to take approximately six years, while the OU3-5 ROD indicates that active remediation and restoration is expected to take approximately seven years.

Based on current information and advice from our environmental consultants, we believe that the 1 part per million remedial action level, and the resulting aggressive effort to remove substantial amounts of PCB-contaminated sediments (most of which are buried under cleaner material or are otherwise unlikely

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to move) and dispose of the sediment off-site, as contemplated by the OU1-2 ROD and the OU3-5 ROD are excessive and would be environmentally detrimental and therefore inappropriate. The OU1-2 ROD includes provisions that a contingent remedy for OU1 consisting of a combination of dredging and capping may be implemented if certain conditions in the OU1-2 ROD are met and such remedy would provide the same level of protection to human health and the environment as the selected remedy. We believe that alternative remedies that are less intrusive than those selected in the OU1-2 ROD and the OU3-5 ROD are more environmentally appropriate, cost effective and responsible methods of managing the risks attributable to the sediment contamination. Any enforcement of a definitive remedial action plan may be subject to judicial review.

On October 25, 2000 the federal and tribal natural resources trustees released a Restoration and Compensation Determination Plan ("RCDP") presenting the federal and tribal trustees' planned approach for restoring injured federal and tribal natural resources and compensating the public for losses caused by the release of PCBs at the Fox River site. The RCDP states that the final natural resource damage claim (which is separate from, and in addition to, the remediation and restoration costs that will be associated with remedial action plans) will depend on the extent of PCB clean-up undertaken by EPA and DNR, but estimates past interim damages to be \$65 million, and, for illustrative purposes only, estimates additional costs of restoration to address present and future PCB damages in a range of \$111 million to \$268 million. To date Wisconsin has not issued any estimate of natural resource damages. We believe, based on the information currently available to us, that the estimate of natural resource damages in the RCDP represents the reasonably likely upper limit of the total natural resource damages. We believe that the alleged damages to natural resources are overstated in the RCDP and joined in the PRP group comments on the RCDP to that effect. No final assessment of natural resource damages has been issued.

Under CERCLA each PRP generally will be jointly and severally liable for the full amount of the remediation and restoration costs and natural resource damages, subject to a right of contribution from other PRPs. In practice PRPs generally negotiate among themselves to determine their respective contributions to any multi-party activities based upon factors including their respective contributions to the alleged contamination, equitable considerations and their ability to pay. In draft analyses by DNR and federal government consultants the volume of WT's PCB discharges into the Fox River has been estimated to range from 2.72 percent to 10 percent of the total discharges of PCBs. This range may not be indicative of the share of the cost of the remediation and restoration costs and natural resource damages that ultimately will be allocated to WT because of: inaccuracies or incompleteness of information about mill operations and discharges; inadequate consideration of the nature and location of various discharges of PCBs to the river, including discharges by persons other than the named PRPs and the relationship of those discharges to identified contamination; uncertainty of the geographic location of the remediation and restoration eventually performed; uncertainty about the ability of other PRPs to participate in paying the costs and damages; and uncertainty about the extent of responsibility of the manufacturers of the carbonless paper recycled by WT which contained the PCBs. We have evaluated the ability of other PRPs to participate in paying the remediation and restoration costs and natural resource damages based on our estimate of their reasonably possible shares of the liability and on public financial information indicating their ability to pay such shares. While we are unable to determine at this time what shares of the liability for the Fox River costs will be paid by the other identified PRPs (or other entities who are subsequently determined to have liability), based on information currently available to us and the analysis described above, we believe that most of the other PRPs have the ability to pay their reasonably possible shares of the liability.

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The ultimate cost to WT of remediation and restoration costs and natural resource damages related to the Fox River site and the time periods over which the costs and damages may be incurred cannot be predicted with certainty at this time due to uncertainties with respect to: what remediation and restoration will be implemented; the actual cost of that remediation and restoration; WT's share of any multi-party remediation and restoration costs and natural resource damages; the outcome of the federal and state natural resource damage assessments; the timing of any remediation and restoration; the evolving nature of remediation and restoration technologies and governmental regulations; controlling legal precedent; the extent to which contributions will be available from other parties; and the scope of potential recoveries from insurance carriers and prior owners of WT. While such costs and damages cannot be predicted with certainty at this time, we believe that WT's reasonably likely share of the ultimate remediation and restoration costs and natural resource damages associated with the Fox River site, including disbursement on behalf of WT of the remaining amount deposited by WT under the terms of the Consent Decree, may fall within the range of \$22 million to \$137 million, payable over a period of up to 40 years. In our estimate of the lower end of the range we have assumed remediation and restoration costs as estimated in the OU1-2 ROD and the OU3-5 ROD, and the low end of the governments' estimates of natural resource damages and WT's share of the aggregate liability. In our estimate of the upper end of the range we have assumed large-scale dredging at a higher cost than estimated in the OU1-2 ROD and the OU3-5 ROD, and that our share of the ultimate aggregate liability for all PRPs will be higher than we believe it will ultimately be determined to be. We have accrued an amount for the Fox River liability based on our estimate of the reasonably probable costs within the range as described above.

We believe that, pursuant to the terms of a stock purchase agreement between Chesapeake and Philip Morris Incorporated (now known as Philip Morris USA Inc., or "PM USA," a wholly owned subsidiary of Altria Group, Inc.), a former owner of WT, we are entitled to substantial indemnification from PM USA with respect to the liabilities related to this matter. Based on the terms of that indemnity we believe that the costs and damages within our estimated range of liability should be indemnified by PM USA. We understand, however, that PM USA is subject to certain risks (including litigation risk in cases relating to health concerns regarding the use of tobacco products). Accordingly, there can be no assurance that PM USA will be able to satisfy its indemnification obligations in the future. However, PM USA is currently meeting its indemnification obligations under the stock purchase agreement and, based on our review of currently available financial information, we believe that PM USA has the financial ability to continue to meet its indemnification obligations.

Pursuant to the Joint Venture Agreement with Georgia-Pacific Corporation for Georgia-Pacific Tissue, LLC, WT has retained liability for, and the third party indemnity rights associated with, the discharge of PCBs and other hazardous materials in the Fox River and Green Bay System. Based on currently available information we believe that if remediation and restoration are done in an environmentally appropriate, cost effective and responsible manner, and if natural resource damages are determined in a reasonable manner, the matter is unlikely to have a material adverse effect on our financial position or results of operations. However, because of the uncertainties described above, there can be no assurance that the ultimate liability with respect to the Lower Fox River site will not have a material adverse effect on our financial position or results of operations.

In the third quarter of 2006, we reviewed, and decreased, our estimate of our reasonably probable environmental costs based on remediation activities to date and other developments. Our accrued environmental liabilities totaled approximately \$55.5 million as of October 1, 2006, of which \$9.9

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million was considered short-term, and \$60.0 million as of January 1, 2006, of which \$13.0 million was considered short-term.

### **Legal and Other Commitments**

Chesapeake is a party to various other legal actions and tax audits which are ordinary and incidental to our business. While the outcome of environmental, tax and legal actions cannot be predicted with certainty, we believe the outcome of any of these proceedings, or all of them combined, will not have a material adverse effect on our consolidated financial position or results of operations.

The IRS has proposed certain adjustments relating to our tax treatment of our disposition of assets of WT in 1999 and issued a Notice of Deficiency based on those adjustments on May 25, 2006. After unsuccessful negotiations to resolve the matter, the Company filed a petition in the United States Tax Court in July seeking a determination that the alleged deficiency is in error. Pretrial proceedings are in progress and the Company intends to vigorously advocate its position in Tax Court. We have estimated our maximum potential exposure with respect to the matter to be approximately \$29 million; however, we continue to believe that our tax treatment of the transaction was appropriate and that we should prevail in this dispute with the IRS. Accordingly, no amount has been accrued for the proposed IRS adjustment.

### **Guarantees and Indemnifications**

We have entered into agreements for the sale of assets or businesses that contain provisions in which we agree to indemnify the buyers or third parties involved in the sale for certain liabilities or risks related to the sale. In these sale agreements we typically agree to indemnify the buyers or other involved third parties against a broadly-defined range of potential "losses" (typically including, but not limited to, claims, costs, damages, judgments, liabilities, fines or penalties, and attorneys' fees) arising from: (i) a breach of our representations or warranties in the sale agreement or ancillary documents; (ii) our failure to perform any of the covenants or obligations of the sale agreement or ancillary documents; and (iii) other liabilities expressly retained or assumed by us related to the sale. Most of our indemnity obligations under these sale agreements are: (i) limited to a maximum dollar value significantly less than the final purchase price; (ii) limited by time within which indemnification claims must be asserted (often between one and three years); and (iii) subject to a deductible or "basket." Many of the potential indemnification liabilities under these sale agreements are unknown, remote or highly contingent, and most are unlikely to ever require an indemnity payment. Furthermore, even in the event that an indemnification claim is asserted, liability for indemnification is subject to determination under the terms of the applicable sale agreement, and any payments may be limited or barred by a monetary cap, a time limitation or a deductible or basket. For these reasons we are unable to estimate the maximum potential amount of the potential future liability under the indemnity provisions of the sale agreements. However, we accrue for any potentially indemnifiable liability or risk under these sale agreements for which we believe a future payment is probable and a range of loss can be reasonably estimated. Other than the Fox River matter discussed in Environmental Matters above, as of October 1, 2006, we believe our liability under such indemnification obligations was immaterial.

In the ordinary course of our business we may enter into agreements for the supply of goods or services to customers that provide warranties to their customers on one or more of the following: (i) the quality of the goods and services supplied by us; (ii) the performance of the goods supplied by us; and (iii) our compliance with certain specifications and applicable laws and regulations in supplying the goods and

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services. Liability under such warranties often is limited to a maximum amount by the nature of the claim or by the time period within which a claim must be asserted. As of October 1, 2006 we believe our warranty obligations under such supply agreements were immaterial.

In the ordinary course of our business we may enter into service agreements with service providers in which we agree to indemnify the service provider against certain losses and liabilities arising from the service provider's performance of the agreement. Generally, such indemnification obligations do not apply in situations in which the service provider is grossly negligent, engages in willful misconduct or acts in bad faith. As of October 1, 2006 we believe our liability under such service agreements was immaterial.

In the ordinary course of our business, we may enter into supply agreements (such as those discussed above), service agreements (such as those discussed above), purchase agreements, leases, and other types of agreements in which we agree to indemnify the party or parties with whom we are contracting against certain losses and liabilities arising from, among other things: (i) our breach of the agreement or representations or warranties under the agreement; (ii) our failure to perform any of our obligations under the agreement; (iii) certain defined actions or omissions by us; and (iv) our failure to comply with certain laws, regulations, rules, policies, or specifications. As of October 1, 2006 we believe our liability under these agreements was immaterial.

#### **NOTE 12. SEGMENT DISCLOSURE**

We currently conduct our business in four operating segments: Plastic Packaging, Pharmaceutical and Healthcare Packaging ("Pharma"), Branded Products Packaging ("Branded Products") and Tobacco Packaging ("Tobacco"). The Pharma, Branded Products and Tobacco operating segments are aggregated into the Paperboard Packaging reportable segment. Our Paperboard Packaging segment designs and manufactures folding cartons, leaflets, labels and other primarily paper packaging products. The primary end-use markets for this segment are pharmaceutical and healthcare; branded products (such as alcoholic drinks, confectioneries, cosmetics and fragrances); and tobacco. The Plastic Packaging segment designs and manufactures plastic containers, bottles, preforms and closures. The primary end-use markets for this segment are agrochemicals and other specialty chemicals, and food and beverages. General corporate expenses are shown as Corporate.

Segments are determined by the "management approach" as described in SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. Management assesses continuing operations based on income from continuing operations before interest, loss on extinguishment of debt and taxes derived from similar groupings of products and services. The Company's segment operating income measure excludes gains (losses) on divestitures and restructuring expenses, asset impairments and other exit costs. On July 31, 2006 we completed the sale of CLP to Sofavie. The historical operating results as well as the loss on the sale of CLP have been reflected as discontinued operations as of October 1, 2006. See Note 7 regarding discontinued operations. In March 2006 we divested our plastic packaging operation in Lurgan, Northern Ireland (see Note 5).

There were no material intersegment sales during the third quarter and first nine months of fiscal 2006 or fiscal 2005. Segment identifiable assets are those that are directly used in segment operations. Corporate assets are cash, certain nontrade receivables and other assets.



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*(in millions)*

	<b>Third Quarter</b>		<b>Year to Date</b>	
	<b><u>2006</u></b>	<b><u>2005</u></b>	<b><u>2006</u></b>	<b><u>2005</u></b>
<b>Net sales from continuing operations:</b>				
Paperboard Packaging	\$ 214.4	\$ 202.1	\$ 622.3	\$ 620.0
Plastic Packaging	33.5	42.7	115.1	139.9
	<hr/>	<hr/>	<hr/>	<hr/>
	\$ 247.9	\$ 244.8	\$ 737.4	\$ 759.9
	<hr/>	<hr/>	<hr/>	<hr/>
<b>Segment operating income:</b>				
Paperboard Packaging	\$ 12.3	\$ 14.1	\$ 32.2	\$ 41.2
Plastic Packaging	2.7	3.4	11.9	12.3
Corporate	(3.3)	(4.0)	(11.3)	(12.9)
Restructuring expenses, asset impairments and other exit costs	(1.6)	(3.3)	(7.7)	(3.3)
Gain (loss) on divestiture	4.1	-	3.1	(3.4)
	<hr/>	<hr/>	<hr/>	<hr/>
Income from operations	\$ 14.2	\$ 10.2	\$ 28.2	\$ 33.9
	<hr/>	<hr/>	<hr/>	<hr/>
<b>Depreciation and amortization:</b>				
Paperboard Packaging	\$ 12.2	\$ 11.7	\$ 36.5	\$ 35.4
Plastic Packaging	1.8	2.3	6.0	7.2
Corporate	0.1	0.1	0.1	0.2
Discontinued operations	-	0.2	0.2	0.8
	<hr/>	<hr/>	<hr/>	<hr/>
	\$ 14.1	\$ 14.3	\$ 42.8	\$ 43.6
	<hr/>	<hr/>	<hr/>	<hr/>

*(in millions)*

	<b><u>Oct. 1, 2006</u></b>	<b><u>Jan. 1, 2006</u></b>
<b>Identifiable assets:</b>		
Paperboard Packaging	\$ 877.9	\$ 826.7
Plastic Packaging	158.3	184.2
Corporate	105.2	112.1
	<hr/>	<hr/>
	\$ 1,141.4	\$ 1,123.0
	<hr/>	<hr/>

## Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

### Overview

Consistent with our segment reporting in Note 12 to the Consolidated Financial Statements, segment operating income excludes any gains or losses related to divestitures and restructuring expenses, asset impairments and other exit costs. Excluding these amounts from our calculation of segment operating income is consistent with how our management reviews segment performance and, we believe, affords the reader consistent measures of our operating performance.

On July 31, 2006 we completed the sale of our French luxury packaging business ("CLP") to Sofavie. The historical operating results as well as the loss on the sale of CLP have been reflected as discontinued operations as of October 1, 2006. See Note 7 regarding discontinued operations.

The following table sets forth third quarter and year-to-date net sales from continuing operations and operating income by reportable business segment:

#### Sales and operating income by Segment

(in millions)

	Quarter Ended Oct. 1, 2006		Quarter Ended Oct. 2, 2005		Nine Months Ended Oct. 1, 2006		Nine Months Ended Oct. 2, 2005	
	Net Sales	Operating Income	Net Sales	Operating Income	Net Sales	Operating Income	Net Sales	Operating Income
Paperboard Packaging	\$ 214.4	\$ 12.3	\$ 202.1	\$ 14.1	\$ 622.3	\$ 32.2	\$ 620.0	\$ 41.2
Plastic Packaging	33.5	2.7	42.7	3.4	115.1	11.9	139.9	12.3
Corporate		(3.3)	-	(4.0)		(11.3)	-	(12.9)
Restructuring expenses, asset impairments and other exit costs		(1.6)		(3.3)		(7.7)		(3.3)
Gain (loss) on divestiture		4.1	-			3.1	-	(3.4)
Total	\$ 247.9	\$ 14.2	\$ 244.8	\$ 10.2	\$ 737.4	\$ 28.2	\$ 759.9	\$ 33.9

Net sales from continuing operations for the third quarter of fiscal 2006 were \$247.9 million, an increase of \$3.1 million, or 1 percent, from the comparable period in fiscal 2005. Excluding changes in foreign currency exchange rates, which increased net sales by \$8.8 million, net sales were down \$5.7 million, or 2 percent. The net impact of acquisitions and divestitures did not have a significant effect on the comparability of third quarter 2006 and 2005 consolidated net sales. Net sales from continuing operations for the first nine months of 2006 were \$737.4 million, a decrease of \$22.5 million, or 3 percent from the comparable period in 2005. Excluding changes in foreign currency exchange rates, which decreased net sales by \$12.1 million, sales were down 1 percent for the first nine months of fiscal 2006. Excluding the changes in foreign currency exchange rates and the effects of acquisitions and divestitures, net sales were down by \$19.4 million or 3 percent for the first nine months of fiscal 2006. The decrease in net sales for the third quarter and first nine months of fiscal 2006 resulted primarily from reduced sales within the tobacco and branded products paperboard packaging divisions, partially offset by increased sales in the Irish dairy market.

Gross margin, which is defined as net sales less cost of products sold, for the third quarter of fiscal 2006 was \$41.1 million, a decrease of \$2.3 million, or 5 percent, compared to \$43.4 million for the third quarter of fiscal 2005. Gross margin was \$124.5 million for the first nine months of 2006 compared to

gross margin of \$134.6 for the same period in 2005. As a percentage of sales, gross margin decreased slightly from 18 percent to 17 percent for both the third quarter and first nine months of fiscal 2006 versus fiscal 2005. The decrease in gross margin resulted primarily from reduced volumes and a less favorable product mix within certain markets in both the paperboard and plastic packaging segments.

Selling, general and administrative ("SG&A") expenses as a percentage of net sales for the third quarter and first nine months of fiscal 2006 and 2005 remained flat at 13 percent. Non-U.S. pension and other postretirement costs increased in the fiscal 2006 periods over fiscal 2005 levels, but were offset by cost savings under the Company's global cost savings program.

Operating income for the third quarter of fiscal 2006 was \$14.2 million compared to \$10.2 million for the third quarter of fiscal 2005. Operating income for the third quarter of 2006 included restructuring expenses and other exit costs of \$1.6 million related to our cost savings program and a gain of \$4.1 million related to the sale of our plastic packaging operation in Lurgan, Northern Ireland. Operating income for the third quarter of 2005 included restructuring expenses and other exit costs of \$3.3 million related to the our cost savings program. Changes in foreign currency exchange rates increased operating income by \$0.7 million for the third quarter of 2006 compared to the third quarter of 2005.

Operating income for the first nine months of 2006 was \$28.2 million compared to \$33.9 million for the first nine months of 2005. Operating income for the first nine months of 2006 included restructuring expenses and other exit costs of \$7.7 million related to the our cost savings program and a \$3.1 million gain on the divestiture of the our plastic packaging operation in Lurgan, Northern Ireland. Operating income for the first nine months of 2005 included restructuring expenses and other exit costs of \$3.3 million related to the our cost savings program and a loss of \$3.4 million related to the write-down of promissory notes received in connection with the divestiture of Consumer Promotions International, Inc., a component of our former Merchandising and Specialty Packaging segment. Changes in foreign currency exchange rates did not have a significant effect on operating income for the first nine months of 2006.

Net interest expense was \$10.1 million for the third quarter of fiscal 2006, an increase of \$2.1 million compared to the third quarter of fiscal 2005. Net interest expense was \$29.1 million for the first nine months of fiscal 2006 compared to \$24.9 million for the first nine months of fiscal 2005. Changes in foreign currency exchange rates did not have a significant impact on interest expense for the third quarter or the first nine months of 2006. The increase in net interest expense was primarily due to increased borrowing levels during fiscal 2006, principally as a result of the Arlington Press acquisition during the third quarter of 2005 and higher average interest rates on borrowings under our lines of credit during the first nine months of fiscal 2006.

During the first quarter of fiscal 2006, we recognized a pre-tax and after-tax loss of \$0.6 million, or \$0.03 per share, on the early redemption of 5.0 million pounds Sterling principal amount of our 10.375 percent senior subordinated notes due 2011. In the first quarter of fiscal 2005 we paid \$38.8 million principal amount of loan note maturities and we redeemed, at par, the remaining \$18.2 million principal amount of our 7.2 percent notes which also matured during the first quarter. In the third quarter of 2005 we redeemed 2.9 million pounds Sterling principal amount of our 10.375 percent senior subordinated notes due 2011 at a premium and recognized a loss of \$0.5 million associated with the debt extinguishment.

The comparability of our effective income tax rates is heavily influenced by the relationship of U.S. to non-U.S. pre-tax income (losses), by management's expectation as to recovery of our U.S. and certain

foreign jurisdiction deferred income tax assets, and by the timing of settlement or resolution of income tax contingencies. The recognition of income tax benefits for U.S. deferred income tax assets is largely dependent on the magnitude and assumed reversal patterns of the Company's U.S. taxable temporary differences, principally related to our U.S. defined benefit pension arrangements. During fiscal 2005 we recognized deferred income tax benefits for our U.S. deferred income tax assets to the full extent of existing taxable temporary differences. For this reason, and given our inability to project future U.S. taxable income, we are no longer recognizing income tax benefits on U.S. tax losses incurred subsequent to January 1, 2006. Our fiscal 2006 effective income tax rate was also adversely affected by a capital gains tax in the first quarter of fiscal 2006 of approximately \$0.9 million on the transfer of assets in connection with the divestiture of the Lurgan operation (see Note 5). During the third quarter of 2006, the Company recorded a \$2.3 million income tax benefit as a result of management's reassessment of its valuation allowance for deferred income tax assets in France following the sale of CLP. The effective income tax rate for the nine-month period ended October 1, 2006 also included a benefit of \$1.8 million associated with the favorable settlement of income tax contingencies with U.K. tax authorities.

Income from continuing operations for the third quarter of fiscal 2006 was \$5.4 million, or \$0.28 per diluted share, compared to income from continuing operations of \$1.8 million, or \$0.09 per diluted share, for the third quarter of fiscal 2005. Income from continuing operations for the first nine months of fiscal 2006 was \$0.9 million, or \$0.05 per diluted share, compared to income of \$7.3 million, or \$0.38 per diluted share, in the first nine months of fiscal 2005.

### **Share-Based Compensation**

On January 2, 2006 we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)"), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and restricted stock awards, based on estimated fair values. SFAS No. 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning after January 1, 2006. We adopted SFAS No. 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 2, 2006, the first day of the Company's fiscal year 2006. In accordance with the modified prospective transition method, our Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123(R).

Prior to January 2, 2006 we accounted for share-based compensation plans in accordance with the provisions of APB 25 as permitted by SFAS No. 123. We elected to use the intrinsic value method of accounting for employee and director share-based compensation expense for our noncompensatory employee and director stock option awards and did not recognize compensation expense for the issuance of options with an exercise price equal to or greater than the market price of the underlying common stock at the date of grant. Based on changes in the probability assessment of achieving performance targets the Company recognized a share based benefit under SFAS No. 123(R) for the quarter ended October 1, 2006 of \$0.5 million, net of \$0.2 million of share based compensation expense related to vesting of stock option awards. For the nine month period ended October 1, 2006, share-based compensation expense was \$0.6 million, of which \$0.5 million related to vesting of stock option awards. Share-based compensation expense recognized under the provisions of APB 25 (primarily for restricted stock awards under our long-term incentive plans) during the quarter and nine month periods ended October 2, 2005 were \$0.2 million and \$0.7 million, respectively.

## **Chesapeake's \$25-Million Cost Savings Program**

During the fourth quarter of fiscal 2005 Chesapeake announced plans for a \$25 million global cost savings program. The scope of this program is extensive and could ultimately involve a number of locations being either sold, closed or downsized. We also expect broad-based workforce reductions and a general reduction in overhead costs throughout the Company. Additionally, we are targeting specific improvements in operating processes. The cost of these initiatives is expected to range from \$30 million to \$40 million on a pre-tax basis, with the cash flow impact being less due to the sale of related real estate and assets. Full implementation of this program is expected by the end of fiscal 2007. The ultimate costs and timing of this program will be dependent on consultation and, in certain circumstances, negotiation with European works councils or employee representatives. Costs associated with the program have been classified as "restructuring expenses, asset impairments and other exit costs" in the accompanying consolidated statements of earnings. During the third quarter of fiscal 2006 we recorded restructuring costs, asset impairments and other exit costs of approximately \$1.6 million associated with this program and made cash payments under the program of approximately \$3.1 million. During the first nine months of fiscal 2006 we recorded restructuring costs, asset impairments and other exit costs of approximately \$11.6 million associated with this program, of which \$3.9 million is reported in discontinued operations following the sale of CLP. During the first nine months of fiscal 2006 we made cash payments of approximately \$13.1 million related to the cost savings program. (See Note 4.)

The scope of our \$25-million cost savings program also includes the sale of certain non-strategic or underperforming operations. During the first quarter of 2006, we completed the sale of our plastic packaging operation in Lurgan, Northern Ireland and during the third quarter of 2006, we completed the sale of CLP. Through the nine month period ended October 1, 2006, we have recovered \$22.0 million in sales proceeds related to these two operations and other assets divested under the program. (See Notes 5 and 7.)

## **Discontinued Operations**

Discontinued operations during 2006 primarily reflects the third quarter loss on sale, as well as historical operating results of, CLP. Discontinued operations during 2005 reflects the second quarter loss on sale of the assets of our French wine and spirits label operation, Bourgeot Etiquo Lesbats ("Bourgeot"), which was a component of the CLP business and has been reclassified from loss on divestiture. Also included in the 2005 discontinued operations is the reduction of a liability for certain contractual obligations related to our former Merchandising & Specialty Packaging segment and the historical operating results of CLP.

## **Net Income**

Including discontinued operations, net income for the third quarter of 2006 of \$4.1 million, or \$0.21 per share, compared to net income of \$1.2 million, or \$0.06 per share, for the third quarter of 2005. For the first nine months of 2006, we reported a net loss of \$5.4 million, or \$0.28 per share, compared to net income of \$2.7 million, or \$0.14 per share for the first nine months of 2005.

## Segment Information

### *Paperboard Packaging*

<i>(in millions)</i>	<u>2006</u>	<u>2005</u>	<u>Increase/ (Decrease)</u>	
			<u>\$</u>	<u>%</u>
Nine Months:				
Net sales	\$622.3	\$620.0	\$2.3	0.4
Segment operating income	32.2	41.2	(9.0)	(21.8)
Segment operating income margin %	5.2%	6.7%		

<i>(in millions)</i>	<u>2006</u>	<u>2005</u>	<u>Increase/ (Decrease)</u>	
			<u>\$</u>	<u>%</u>
Third Quarter:				
Net sales	\$214.4	\$202.1	\$12.3	6.1
Segment operating income	12.3	14.1	(1.8)	(12.8)
Segment operating income margin %	5.7%	7.0%		

Net sales for the Paperboard Packaging segment were \$214.4 million for the third quarter of fiscal 2006, an increase of \$12.3 million, or 6 percent, from the comparable period in fiscal 2005. Excluding changes in foreign currency exchange rates, which increased net sales by \$9.3 million, net sales were up 2 percent for the third quarter of 2006. Excluding changes in foreign currency exchange rates and the effects of acquisitions and divestitures, net sales decreased 3 percent for the quarter. Net sales for the Paperboard Packaging segment for the first nine months of fiscal 2006 were \$622.3 million, an increase of \$2.3 million compared to the first nine months of fiscal 2005. Excluding changes in foreign currency exchange rates, which decreased net sales by \$8.1 million, net sales were up 2 percent for the first nine months of 2006. Excluding changes in foreign currency exchange rates and the effects of acquisitions and divestitures, net sales declined \$22.1 million or 4 percent. The decrease in net sales during the third quarter and first nine months of fiscal 2006 was primarily due to lower sales of tobacco and branded products packaging.

Segment operating income for the Paperboard Packaging segment for the third quarter of fiscal 2006 was \$12.3 million, a decrease of \$1.8 million, or 13 percent, versus the comparable period in fiscal 2005. Excluding changes in foreign currency exchange rates, which increased segment operating income by \$0.5 million, segment operating income was down 16 percent for the third quarter of 2006. Segment operating income for the first nine months of fiscal 2006 was \$32.2 million, a decrease of \$9.0 million, or 22 percent, from the first nine months of fiscal 2005. Changes in foreign currency exchange rates did not have a significant effect on the comparability of Paperboard Packaging segment operating income for the first nine months of 2006 and 2005 Paperboard Packaging segment operating income. Increased pension expense and energy costs had an adverse impact during the third quarter and first nine months of fiscal 2006.

## Plastic Packaging

(in millions)		(Decrease)	
	2006	2005	
			\$ %
Nine Months:			
Net sales	\$115.1	\$139.9	\$(24.8) (17.7)
Segment operating income	11.9	12.3	(0.4) (3.3)
Segment operating income margin %	10.3%	8.8%	

(in millions)		(Decrease)	
	2006	2005	
			\$ %
Third Quarter:			
Net sales	\$33.5	\$42.7	\$(9.2) (21.5)
Segment operating income	2.7	3.4	(0.7) (20.6)
Segment operating income margin %	8.1%	8.0%	

Net sales for the Plastic Packaging segment for the third quarter of fiscal 2006 were \$33.5 million, a decrease of \$9.2 million, or 22 percent, from the comparable period in fiscal 2005. Excluding changes in foreign currency exchange rates, which decreased net sales by \$0.5 million, net sales were down 20 percent for the third quarter of 2006. Excluding the changes in foreign currency exchange rates and the effects of acquisitions and divestitures, net sales increased 5 percent for the quarter. This increase in net sales relative to the prior year was due primarily to increased sales in the Irish dairy market. Sales in other markets were relatively flat, as higher resin prices generally offset reduced volume.

Net sales for the Plastic Packaging segment were \$115.1 million for the first nine months of fiscal 2006, a decrease of \$24.8 million, or 18 percent, over the comparable period in fiscal 2005. Excluding changes in foreign currency exchange rates, which decreased net sales by \$4.0 million, net sales were down 15 percent for the first nine months of 2006. Excluding the changes in foreign currency exchange rates and the effects of divestitures, net sales increased 2% percent for the first nine months of 2006. The increase in net sales for the period was primarily attributable to increased sales in the Irish dairy market.

Segment operating income for the Plastic Packaging segment for the third quarter of fiscal 2006 was \$2.7 million, a decrease of \$0.7 million, or 21 percent, from the comparable period in fiscal 2005. The decrease in segment operating income was primarily due to lower operating earnings in the Company's beverage packaging operations primarily as a result of volume declines in South Africa. Segment operating income in the 2005 quarter was reduced by costs incurred in connection with the investigation of financial results at the Company's facility in Crewe, England. Changes in foreign currency exchange rates did not have a significant impact of the comparability of third quarter segment operating income. Segment operating income for the first nine months of fiscal 2006 was \$11.9 million, a decrease of \$0.4 million, or 3 percent, compared to the first nine months of fiscal 2005. Excluding changes in foreign currency exchange rates, which decreased segment operating income by \$0.4 million, segment operating income was flat for the first nine months of fiscal 2006 from the comparable period in 2005. Solid performances by the specialty chemicals, bulk container and dairy packaging operations were more than offset by a shortfall in operating earnings at some of our beverage packaging operations.

## **Liquidity and Financial Position**

Net cash provided by operating activities was \$1.5 million for the first nine months of fiscal 2006, compared to net cash provided by operating activities of \$28.5 million for the first nine months of fiscal 2005. The decrease primarily reflects spending under our global cost savings program, increased funding of our defined benefit pension plans, and an increase in working capital during the first nine months of fiscal 2006. Net cash used in operating activities for the first nine months of fiscal 2006 included spending under restructuring programs of \$13.1 million and increased contributions to our pension plans of approximately \$6.2 million.

Net cash used in investing activities in the first nine months of fiscal 2006 was \$1.5 million compared to net cash used in investing activities of \$85.4 million in the first nine months of fiscal 2005. Net cash used in investing activities during the first nine months of fiscal 2006 reflects the cash proceeds received on the divestiture of the plastic packaging operation in Lurgan, Northern Ireland operation and the sale of other fixed assets, offset by capital spending. Net cash used in investing activities during the first nine months of fiscal 2005 primarily reflects the acquisition of Arlington Press and capital spending. The Company's total capital spending was \$25.9 million for the first nine months of fiscal 2006 compared to \$25.0 million for the first nine months of fiscal 2005.

Net cash used in financing activities in the first nine months of fiscal 2006 was \$1.8 million, compared to net cash provided by financing activities of \$27.1 million in the first nine months of fiscal 2005. During the first nine months of fiscal 2006, we made debt repayments of \$23.0 million, which were more than offset by an increase in borrowings on our credit line of \$31.3 million. In the first quarter of fiscal 2005 we paid \$38.8 million principal amount of loan note maturities and we redeemed, at par, the remaining \$18.2 million principal amount of our 7.2 percent notes which also matured during the first quarter of 2005. We paid cash dividends of \$12.9 million, or \$0.66 per share, in the first nine months of fiscal 2006, and \$12.8 million, or \$0.66 per share, in the first nine months of fiscal 2005.

Our debt at October 1, 2006 was \$465.7 million, up \$32.8 million compared to January 1, 2006. Our debt-to-capital ratio was 60.7 percent as of October 1, 2006, compared to 59.4 percent at January 1, 2006. (Capital consists of debt and stockholders' equity.) The increase in debt and the change in the ratio from year-end 2005 to third quarter end 2006 was primarily due to increases in indebtedness to fund working capital and pre-funding associated with our Non-U.S. defined benefit pension plans.

We were in compliance with all of our debt covenants as of the end of the third quarter of fiscal 2006. We believe we will have adequate financial resources to support anticipated short-term and long-term capital needs and commitments.

## **Critical Accounting Policies**

Our consolidated financial statements have been prepared by management in accordance with GAAP. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and the reported amounts of revenue and expenses. We believe that the estimates, assumptions and judgments described in the section "Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies" of our most recent Annual Report on Form 10-K have the greatest potential impact on our financial statements, so we consider these to be our critical accounting policies. These policies include our accounting for: (a) goodwill and other long-lived asset valuations; (b) environmental and other contingencies; (c) pension



and other postretirement employee benefits; (d) deferred tax assets; and (e) restructuring and other exit costs. Because of the uncertainty inherent in these matters, reported results could have been materially different using a different set of assumptions and estimates for these critical accounting policies. We believe that the consistent application of these policies enables us to provide readers of our financial statements with useful and reliable information about our operating results and financial condition. There has been no significant change in these policies, or the estimates used in the application of the policies, since our 2005 fiscal year end.

## **Environmental**

See Note 11 to the Consolidated Financial Statements for additional information on environmental matters.

## **Seasonality**

Our Paperboard Packaging segment competes in several end-use markets, such as alcoholic drinks, confectioneries, cosmetics and fragrances, that are seasonal in nature. As a result, our Paperboard Packaging segment earnings stream is seasonal, with peak operational activity during the third and fourth quarters of the year. Our Plastic Packaging segment's markets include beverage and agrochemical markets in the southern hemisphere that are seasonal in nature. As a result, our Plastic Packaging segment earnings stream is also seasonal, with peak operational activity during the first and fourth quarters of the year.

## **New Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48 ("FIN 48"), *Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109, Accounting for Income Taxes*, which clarifies the accounting for uncertainty in income taxes. FIN 48 prescribes a 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. The Interpretation requires that the Company recognize in the financial statements the impact of a tax position, if that position is more likely than not to be sustained on audit, based on the technical merits of the position. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure. The provisions of FIN 48 are effective beginning January 1, 2007 with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. We are currently evaluating the impact of adopting FIN 48 on the financial statements.

In September 2006 the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in accordance with GAAP and expands disclosures about fair value measurements. The provisions of SFAS No. 157 are effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We do not expect SFAS No. 157 to have a material impact on our financial statements.

In September 2006 the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans-an amendment of FASB Statements No. 87, 88, 106, and 132(R) ("SFAS 158")*, which requires an employer to recognize the over-funded or under-funded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity. This Statement also requires an employer to

measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. The provisions of SFAS 158 requires prospective application, and are effective as of December 31, 2006, except for the measurement date provisions, which are effective for fiscal years ending after December 15, 2008. Based on our unfunded obligation as of December 31, 2005, the adoption of SFAS 158 would reduce total stockholders' equity by approximately \$90.0 million, net of tax. The adoption of SFAS 158 will not affect our results of operations. By the time of adoption at December 31, 2006, plan performance and actuarial assumptions could have a significant impact on the actual amounts recorded. However, the Company does not believe the decrease in stockholders' equity will have a significant impact on the Company's financing covenants.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *"Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements"* ("SAB 108"). Due to diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006. We do not expect SAB 108 to have a significant impact on our financial statements.

### **Forward-Looking Statements**

Forward-looking statements in the foregoing Management's Discussion and Analysis of Financial Condition and Results of Operations include statements that are identified by the use of words or phrases including, but not limited to, the following: "will likely result," "expected to," "will continue," "is anticipated," "estimated," "project," "believe," "expect" and words or phrases of similar import. Changes in the following important factors, among others, could cause our actual results to differ materially from those expressed in any such forward-looking statements: the Company's inability to realize the full extent of the expected savings or benefits from the \$25-million global cost savings program and to complete such activities in accordance with its planned timetable and within the expected cost range; competitive products and pricing; production costs, particularly for raw materials such as folding carton and plastics materials; fluctuations in demand; possible recessionary trends in United States and global economies; governmental policies and regulations; interest rates; fluctuations in currency translation rates; our ability to remain in compliance with our debt covenants; and other risks that are detailed from time to time in reports we file with the SEC.

### **Item 3. Quantitative and Qualitative Disclosure about Market Risk**

There are no material changes to the disclosure on this matter made in our Annual Report on Form 10-K for the year ended January 1, 2006.

### **Item 4. Controls and Procedures**

#### *Restatement*

As discussed in Note 1 to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended January 1, 2006 management of the Company has restated its consolidated financial statements for fiscal year 2004 (the fiscal year ended January 2, 2005) and fiscal year 2003 (the fiscal year ended December 28, 2003), as well as the quarterly consolidated financial statements for each of the interim periods of fiscal year 2005 (the fiscal year ended January 1, 2006) and fiscal year 2004 (the "Deferred Income Tax Restatement"). The determination to restate those

consolidated financial statements and other financial information was made in order to correct errors in the Company's accounting for deferred income taxes.

#### *Identification of Material Weakness*

As a result of the errors related to the Company's accounting for deferred income taxes, the Company concluded that it did not maintain effective controls over the completeness and accuracy of its accounting for deferred income tax assets, including the related deferred income tax valuation allowance and the income tax (benefit) expense accounts. Specifically, the Company did not maintain effective controls over the completeness and accuracy of its recovery analysis related to the valuation of its deferred income tax assets. This control deficiency resulted in the Deferred Income Tax Restatement discussed above and could result in a misstatement of deferred income tax assets and the related deferred income tax valuation allowance and income tax (benefit) expense that would result in a material misstatement to the annual or interim financial statements that would not be prevented or detected.

Accordingly, management has determined that this control deficiency constitutes a material weakness. A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

#### *Remediation of Material Weaknesses*

Management has researched and reviewed the detailed technical requirements related to the accounting for deferred tax asset valuation allowances and has revised its policy regarding the presumed reversal pattern of taxable temporary differences. Management has documented its conclusions so that they can continue to be applied consistently and appropriately in future periods. Management believes that implementation of this action has effectively remediated the material weakness described above.

#### *Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures*

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

An evaluation was performed under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of October 1, 2006. Based upon that evaluation our management, including our Chief Executive Officer and our Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of October 1, 2006.

#### *Changes in Internal Control over Financial Reporting*

The changes in the Company's internal controls over financial reporting described above as remediating the material weakness in controls surrounding the completeness and accuracy of deferred income tax assets were implemented during the quarter ended April 2, 2006. There was no change in the

Company's internal control over financial reporting during the third quarter of fiscal 2006 that materially affected, or is reasonably likely to materially affect, the internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings**

Reference is made to Note 11 of the Notes to Consolidated Financial Statements included herein.

### **Item 1A. Risk Factors**

Item 1A of our Annual Report on Form 10-K for the year ended January 1, 2006 describes some of the risks and uncertainties associated with our business. These risks and uncertainties have the potential to materially affect our results of operations and our financial condition. We do not believe that there have been any material changes to the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended January 1, 2006.

### **Item 6. Exhibits**

(a) Exhibits:

- 31.1 Certification of CEO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of CFO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32 Certifications of CEO and CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

## **SIGNATURE**

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.

CHESAPEAKE CORPORATION  
(Registrant)

Date: November 9, 2006

BY: /s/ Thomas G. Hayes  
Thomas G. Hayes  
Controller  
(Principal Accounting Officer)