KADANT INC
Form 10-K
March 16, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K

(mark one)

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2005

¨ 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 1-11406

KADANT INC.

(Exact name of registrant as specified in its charter)

Delaware	**52-1762325**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
One Acton Place, Suite 202	
Acton, Massachusetts	**01720**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (978) 776-2000

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on Which Registered**
Common Stock, $.01 par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference into Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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 in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨ Accelerated filer x 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 x

The aggregate market value of the voting and non-voting common equity held by nonaffiliates of the registrant as of July 2, 2005, was approximately $301,325,000.

As of March 1, 2006, the registrant had 13,576,764 shares of Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive proxy statement pursuant to Regulation 14A promulgated under the Securities Exchange Act of 1934, as amended, to be used in connection with the registrant s 2006 Annual Meeting of Shareholders are incorporated by reference into Part III of this Form 10-K.

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Kadant Inc.

Annual Report on Form 10-K

for the Fiscal Year Ended December 31, 2005

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Kadant Inc. **2005 Annual Report**

PART I

Forward-Looking Statements

This Annual Report on Form 10-K and the documents that we incorporate by reference in this Report include forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. These forward-looking statements are not statements of historical fact, and may include statements regarding possible or assumed future results of operations. Forward-looking statements are subject to risks and uncertainties and are based on the beliefs and assumptions of our management, using information currently available to our management. When we use words such as believes, expects, anticipates, intends, plans, estimates, should, likely, will, would, or similar expressions, we are making forward-looking statements.

Forward-looking statements are not guarantees of performance. They involve risks, uncertainties, and assumptions. Our future results of operations may differ materially from those expressed in the forward-looking statements. Many of the important factors that will determine these results and values are beyond our ability to control or predict. You should not put undue reliance on any forward-looking statements. We undertake no obligation to publicly update any forward-looking statement, whether as a result of new information, future events, or otherwise. For a discussion of important factors that may cause our actual results to differ materially from those suggested by the forward-looking statements, you should read carefully the section captioned Risk Factors in Part I, Item 1A, of this Report.

Item 1. Business

General Development of Business

The Company was incorporated in Delaware in November 1991 to be the successor-in-interest to several papermaking equipment businesses of Thermo Electron Corporation (Thermo Electron). In November 1992, we completed an initial public offering of a portion of our outstanding common stock. On July 12, 2001, the Company changed its name to Kadant Inc. from Thermo Fibertek Inc. In August 2001, Thermo Electron disposed of its remaining equity interest in Kadant by means of a stock dividend to its shareholders. In May 2003, we moved the listing of our common stock to the New York Stock Exchange, where it continues to trade under the symbol KAI.

The terms we, us, our, Registrant, or Company in this Report refer to Kadant Inc. and its consolidated subsidiaries.

Description of Our Business

We are a leading supplier of equipment used in the global papermaking and paper recycling industries and also a manufacturer of granules made from papermaking byproducts. Our continuing operations consist of one reportable operating segment, Pulp and Papermaking Systems, and two separate product lines: Fiber-based Products and Casting Products. In classifying operational entities into a particular segment, we considered how our management assesses performance and makes operating decisions, and aggregated businesses with similar economic characteristics, products and services, production processes, customers, and methods of distribution. In addition, prior to its sale, we operated a composite building products business (the composites business), which is presented as a discontinued operation in the accompanying consolidated financial statements. On October 21, 2005, our Kadant Composites LLC subsidiary sold substantially all of its assets, comprising the composites business, to LDI Composites Co. for approximately $11.1 million in cash and the assumption of $1.4 million of liabilities resulting in an immaterial gain on the sale. The sale price is subject to a post-closing adjustment.

Pulp and Papermaking Systems

Our Pulp and Papermaking Systems segment has a long and well-established history of developing, manufacturing, and marketing equipment for the global papermaking and paper recycling industries. Some of our businesses or their predecessor companies have been in operation for approximately 100 years. Our customer base includes major global paper manufacturers and, with our equipment found in most of the world s pulp and paper mills, we believe we have one of the largest installed bases of equipment in the pulp and paper industry. We manufacture our products in nine countries in Europe, North and South America, and Asia and license certain products for manufacture in South America and Asia.

On May 11, 2005, we acquired all the outstanding stock of The Johnson Corporation (Kadant Johnson), a leading supplier of fluid-handling systems and equipment, including steam and condensate systems, components, and controls. These products are used primarily in the dryer section of the papermaking process and during the production of corrugated boards, metals, plastics, rubber, textiles, and food. Kadant Johnson was a privately held company based in Three Rivers, Michigan, with approximately 575 employees and annual revenues of approximately $76 million in calendar 2004. The purchase price for the acquisition was approximately $101.5 million in cash, subject to a post-closing adjustment, and $4.7 million of acquisition-related costs. In addition to the consideration paid at closing, we issued a letter of credit to the sellers for $4.0 million related to certain tax assets of Kadant Johnson, the value of which we expect to realize. This amount is subject to adjustment based on The Johnson Corporation s final tax return for 2005, and is due over the next five years as follows: 15% per year in 2006, 2007, 2008 and 2009, and 40% in 2010. The parties also agreed to an earn-out provision, based on the achievement of certain revenue targets between the closing date of May 11, 2005 and July 1, 2006, which could increase the purchase price by up to $8.0 million. This contingent consideration will be accounted for as an increase in goodwill, if and when the revenue targets are achieved. Based on our current forecasts, we do not believe that a significant payout under the earn-out provision is likely.

On January 21, 2006, on behalf of our wholly foreign owned enterprise formed in China, we entered into an Asset Purchase Agreement with Jining Huayi Light Industry Machinery Co., Ltd. (Huayi) to acquire substantially all the assets of Huayi, a supplier of stock-preparation equipment in China, for approximately $20 million, subject to adjustment. We expect to finance the acquisition through a combination of cash and borrowings, in China or under our existing $25 million revolver, which is part of our credit facility entered into in May 2005. The closing of the acquisition is subject to customary closing conditions, including regulatory approvals and the approval of our board of directors and Huayi s board of directors and shareholders. The closing is expected to occur in the second quarter of 2006. Huayi s unaudited revenues were approximately $15.0 million in 2005.

Our Pulp and Papermaking Systems segment consists of the following product lines: stock-preparation systems and equipment, paper machine accessory equipment, water-management systems, and, since the May 2005 acquisition of Kadant Johnson, fluid-handling systems.

Stock-preparation systems and equipment

We develop, manufacture, and market complete custom-engineered systems and equipment, as well as standard individual components, for pulping, de-inking, screening, cleaning, and refining recycled and virgin fibers to prepare them for entry into the paper machine during the production of recycled paper. Our principal stock-preparation products include:

- Recycling and approach flow systems: Our equipment includes pulping, screening, cleaning, and de-inking systems that blend pulp mixtures and remove contaminants, such as ink, glue, metals, and other impurities, to prepare them for entry into the paper machine during the production of recycled paper.
- Virgin pulping process equipment: Our equipment includes pulp washing, evaporator, recausticizing, and condensate treatment systems used to remove lignin, concentrate and recycle process chemicals, and remove condensate gases.

Paper machine accessory equipment

We develop, manufacture, and market a wide range of doctor systems and related consumables that continuously clean papermaking rolls to keep paper machines running efficiently; doctor blades made of a variety of materials to perform functions including cleaning, creping, web removal, and application of coatings; and profiling systems that control moisture, web curl, and gloss during paper production. Our principal paper machine accessory products include:

- Doctor systems and holders: Our doctor systems clean papermaking rolls to maintain the efficient operation of paper machines by placing a blade against the roll at a constant and uniform pressure. A doctor system consists of the structure supporting the blade and the blade holder. A large paper machine may have as many as 100 doctor systems.
- Profiling systems: We offer profiling systems that control moisture, web curl, and gloss during paper production.
- Doctor blades: We manufacture doctor blades made of a variety of materials including metal, bi-metal, or synthetic materials that perform a variety of functions including cleaning, creping, web removal, or the application of coatings. A typical doctor blade has a life ranging from eight hours to two months, depending on the application.

Water-management systems

We develop, manufacture, and market water-management systems and equipment used to continuously clean paper machine fabrics, drain water from pulp mixtures, form the sheet or web, and filter the process water for reuse. Our principal water-management systems include:

- Shower and fabric-conditioning systems: Our shower and fabric-conditioning systems assist in the removal of contaminants that collect on paper machine fabrics used to convey the paper web through the forming, pressing, and drying sections of the paper machine. The average paper machine has between 3 and 12 fabrics. These fabrics can easily become contaminated with fiber, fillers, pitch, and dirt that can have a detrimental effect on paper machine performance and paper quality. Our shower and fabric-conditioning systems assist in the removal of these contaminants.
- Formation systems: We supply structures that drain, purify, and recycle process water from the pulp mixture during paper sheet and web formation.
- Water-filtration systems: We offer a variety of filtration systems and strainers that remove contaminants from process water before reuse and recover reusable fiber for recycling back into the pulp mixture.

Fluid-handling systems

We develop, manufacture and market rotary joints, precision unions, steam and condensate systems, components, and controls used primarily in the dryer section of the papermaking process and during the production of corrugated boxboard, metals, plastics, rubber, textiles, and food. Our principal fluid-handling systems include:

- Rotary joints: Our mechanical devices, used with rotating shafts, allow the transfer of pressurized fluid from a stationary source into and out of rotating machinery for heating, cooling, or the transfer of fluid power.
- Syphons: Our devices, installed primarily inside the rotating cylinders of paper machines, are used to force steam once it has cooled into a liquid state (condensate) out of the drying cylinders through rotary joints located on either end.
- Turbulator® tube bars: Our steel or stainless steel axial bars, installed on the inside of dryers, are used to induce turbulence in the condensate layer to improve the uniformity and rate of heat transfer (drying rate) of the dryers.

Engineered steam and condensate systems: Our systems control the flow of steam from the boiler to the paper drying cylinders, collect condensed steam, and return it to the boiler to improve energy-efficiency during the paper drying process.

Fiber-Based and Casting Products

Our Fiber-based Products business produces biodegradable, absorbent granules from papermaking byproducts for use primarily as carriers for agricultural, home lawn and garden, and professional lawn, turf and ornamental applications, as well as for oil and grease absorption. In addition, our Casting Products business manufactures grey and ductile iron castings.

Discontinued Operation

Prior to October 2005, we produced composite building products, including decking and railing systems and roof tiles, made from recycled fiber, plastic, and other material, which were marketed through distributors primarily to the building industry. On October 21, 2005, our Kadant Composites LLC subsidiary sold substantially all of its assets, comprising the composites business, to LDI Composites Co. (the Buyer) for approximately $11.1 million in cash and the assumption of $1.4 million of liabilities resulting in an immaterial gain on the sale. The sale price is subject to a post-closing adjustment.

As part of the sale transaction, Kadant Composites LLC retained the warranty obligations associated with products manufactured prior to the sale date. Kadant Composites LLC deposited $3.5 million of the sale proceeds into a special escrow fund to satisfy these warranty claims. This fund will be administered by the Buyer for five years or until the funds are exhausted, after which time Kadant Composites LLC will administer any remaining covered warranty claims. Based on the claims submitted to the Buyer for reimbursement through year-end 2005, the remaining balance in the special escrow fund would be reduced to approximately $2.3 million. Based on the claims activity and payments processed after year-end 2005, we anticipate that the special escrow fund will be utilized and Kadant Composites LLC will assume claims processing in 2006. As of December 31, 2005, the accrued warranty reserve associated with the composites business was $5.3 million. All future activity associated with this warranty reserve will continue to be classified in the results of the discontinued operation in our consolidated financial statements.

Research and Development

We develop a broad range of products for all facets of the markets we serve. We focus our research and development efforts on the technological advancement of our stock-preparation, paper machine accessory, fluid-handling, and water-management products.

Our research and development expenses from continuing operations were $4.9 million, $3.1 million, and $4.3 million in 2005*, 2004, and 2003, respectively.

Raw Materials

Raw materials, components, and supplies for our significant products are available either from a number of different suppliers or from alternative sources that we believe could be developed without a material adverse effect on our business.

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* Unless otherwise noted, references to 2005, 2004, and 2003 in this Annual Report on Form 10-K are for the fiscal years ended December 31, 2005, January 1, 2005, and January 3, 2004, respectively.

The raw material used in the manufacture of our fiber-based granules is obtained from two paper recycling mills. The mills have the exclusive right to supply papermaking byproducts to our existing granulation plant in Green Bay, Wisconsin, under a contract which expires in December 2007 and is renewable every two years by mutual agreement. Although we believe that our relationship with the mills is good, the mills may not agree to renew the contract upon its expiration. Due to manufacturing changes at the mills, we recently had some difficulty obtaining sufficient raw material to operate at optimal production levels. We are working with the mills to ensure a stable supply of raw material. To date, we have been able to meet all of our customer delivery requirements, but there can be no assurance that we will be able to meet future delivery requirements. If the mills were unable or unwilling to supply us sufficient fiber, we would be forced to find an alternative supplier for this raw material.

Patents, Licenses, and Trademarks

We protect our intellectual property rights by applying for and obtaining patents when appropriate. We also rely on technical know-how, trade secrets, and trademarks to maintain our competitive position.

Pulp and Papermaking Systems

We have numerous U.S. and foreign patents, including foreign counterparts to our U.S. patents, expiring on various dates ranging from 2006 to 2024. We maintain a worldwide network of licensees and cross-licensees of products with other companies serving the pulp, papermaking, converting, and paper recycling industries.

Fiber-Based Products

We currently hold several U.S. patents, expiring on various dates ranging from 2008 to 2021, related to various aspects of the processing of fiber-based granules and the use of these materials in the agricultural, professional turf, home lawn and garden, general absorption, oil and grease absorption, and catbox filler markets. We also have foreign counterparts to these U.S. patents in Canada.

Seasonal Influences

Pulp and Papermaking Systems

There are no material seasonal influences on this segment s sales of products and services.

Fiber-Based and Casting Products

Our fiber-based granular products business experiences fluctuations in sales, usually in the third quarter, when sales decline due to the seasonality of the agricultural and home lawn and garden markets.

Working Capital Requirements

There are no special inventory requirements or credit terms extended to customers that would have a material adverse effect on our working capital.

Dependency on a Single Customer

No single customer accounted for more than 10% of our consolidated revenues or more than 10% of the Pulp and Papermaking Systems segment s revenues in any of the past three years. Revenues from China were $29.2 million, $29.4 million, and $31.1 million in 2005, 2004, and 2003, respectively.

Backlog

Our backlog of firm orders for the Pulp and Papermaking Systems segment was $52.5 million and $34.2 million at year-end 2005 and 2004, respectively. We anticipate that substantially all of the backlog at December 31, 2005, will be shipped or completed during the next 12 months. Some of these orders may be canceled by the customer upon payment of a cancellation fee.

Competition

We face significant competition in each of our principal markets. We compete primarily on the basis of quality, price, service, technical expertise, and product performance and innovation. We believe the reputation that we have established for quality products and in-depth process knowledge provides us with a competitive advantage. In addition, a significant portion of our business is generated from our existing worldwide customer base. To maintain this base, we have emphasized technology, service, and a problem-solving relationship with our customers.

We are a leading supplier of stock-preparation equipment used for the preparation of recycled and virgin fibers in the production of recycled paper. Several major competitors supply various pieces of equipment for this process. Our principal competitors in this market are Voith Paper GmbH, Groupe Laperriere & Verrault Inc., Metso Corporation, and Maschinenfabrik Andritz AG. We compete in this market primarily on the basis of technical expertise, product innovation, and price. Other competitors specialize in segments within the white- and brown-paper markets.

We are a leading supplier of specialty accessory equipment for paper machines. Our principal global competitors in this market are Joh. Clouth GmbH & Co. KG and Metso Corporation. Because of the high capital costs of paper machines and the role of our accessories in maintaining the efficiency of these machines, we generally compete in this market on the basis of service, technical expertise, performance, and price.

We are a leading supplier of fluid-handling systems and equipment, offering global sales and service, application expertise, and an extensive rotary joint product line. There are numerous competitors in this market, including Deublin Company, Barco Company, Christian Maier GmbH & Co. KG, and Duff-Norton Company. In addition, due to the highly fragmented nature of the rotary joint market, we compete with numerous local competitors. We generally compete based on process knowledge, technical competency, product and service quality, and price.

Various competitors exist in the formation, shower and fabric-conditioning systems, and filtration systems markets. Principal competitors are IBS-Paper Performance Group in formation and shower and fabric conditioning systems and Asten/Johnson Foils in formation tables. In addition, a variety of smaller companies compete within the shower and fabric-conditioning systems and filtration systems markets. In each of these markets, we generally compete on the basis of process knowledge, application experience, product quality, service, and price.

Environmental Protection Regulations

We believe that our compliance with federal, state, and local environmental protection regulations will not have a material adverse effect on our capital expenditures, earnings, or competitive position.

Employees

As of December 31, 2005, we had approximately 1,400 employees worldwide.

Financial Information

Financial information concerning our segment and product lines is summarized in Part IV, Item 15, Exhibits and Financial Statement Schedules, Note 11, which begins on page F-1 of this Report.

Financial information about exports by domestic operations and about foreign operations is summarized in Part IV, Item 15, Exhibits and Financial Statement Schedules, Note 11, which begins on page F-1 of this Report.

Available Information

We file annual, quarterly, and current reports, proxy statements, and other documents with the Securities and Exchange Commission (SEC) under the Exchange Act. The public may read and copy any materials that we file with the SEC at the SEC s Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Also, the SEC maintains a website that contains reports, proxy and information statements, and other information regarding issuers, including us, that file electronically with the SEC. The public can obtain any documents that we file with the SEC at www.sec.gov. We also make available free of charge through our website at www.kadant.com our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to these Reports filed with or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, as soon as reasonably practicable after we electronically file these materials with, or furnish them to, the SEC. We are not including the information contained in our website as part of this Report nor are we incorporating the information on our website into this Report by reference.

Executive Officers of the Registrant

The following table summarizes certain information concerning individuals who are our executive officers as of March 1, 2006:

Name	Age	Present Title (Fiscal Year First Became Executive Officer)
William A. Rainville	64	Chairman of the Board, President, and Chief Executive Officer (1991)
Edward J. Sindoni	61	Executive Vice President and Chief Operating Officer (2006)
Thomas M. O Brien	54	Executive Vice President and Chief Financial Officer (1994)
Jonathan W. Painter	47	Executive Vice President (1997)
Edwin D. Healy	68	Vice President (2002)
Sandra L. Lambert	50	Vice President, General Counsel, and Secretary (2001)
Eric T. Langevin	43	Vice President (2006)
Rudolf A. Leerentveld	49	Vice President (2005)
Michael J. McKenney	44	Vice President, Finance and Chief Accounting Officer (2002)

Mr. Rainville has been president and chief executive officer since our incorporation in 1991, a member of our board of directors since 1992, and chairman of our board since 2001. Prior to our spinoff in 2001, Mr. Rainville also held various managerial positions with Thermo Electron, including chief operating officer, recycling and resource recovery, a position he held since 1998, and for more than five years prior to that, senior vice president. Prior to joining Thermo Electron, Mr. Rainville held positions at Drott Manufacturing, Paper Industry Engineering, and Sterling Pulp and Paper.

Mr. Sindoni was named an executive vice president and chief operating officer in March 2006 and is responsible for global operations. He served as a senior vice president from 2001 to 2006 with responsibility for our paper machine accessory equipment and water-management systems businesses. From 1992 to 2001, he served as a vice president. Prior to joining us in 1987, he had a 21-year career with the General Electric Company.

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Mr. O Brien has been an executive vice president since 1998 and our chief financial officer since 2001. He served as our treasurer from 2001 to February 2005 and also as vice president, finance, from 1991 to 1998. Prior to joining us, Mr. O Brien held various finance positions at Racal Interlan, Inc., Prime Computer, Compugraphic Corporation, and the General Electric Company.

Mr. Painter has been an executive vice president since 1997 and president of our composite building products business from 2001 until its sale in 2005. He served as our treasurer and treasurer of Thermo Electron from 1994 until 1997. Prior to 1994, Mr. Painter held various managerial positions with us and at Thermo Electron.

Mr. Healy has been a vice president since October 2002 and is responsible for our stock-preparation equipment business. He also served as the president of our Kadant Black Clawson Inc. subsidiary from 2000 to mid-2003. He held various managerial positions at Kadant Black Clawson following its acquisition in 1997 and before that, served as the president of our Fiberprep Inc. subsidiary from 1988 to 1997. Prior to joining us, Mr. Healy had a 29-year career with Bird, Escher, Wyss and its predecessor, Bird Machinery.

Ms. Lambert has been a vice president and our general counsel since 2001, and our secretary since our incorporation in 1991. Prior to joining us, she was a vice president and secretary of Thermo Electron since 1999 and 1990, respectively, and before that was a member of Thermo Electron s legal department.

Mr. Langevin was named a vice president in March 2006, with responsibility for our paper machine accessory equipment and water-management systems businesses. Mr. Langevin has been president of our Kadant Web Systems subsidiary since 2001, and before that served as its senior vice president and vice president of operations. Prior to that, Mr. Langevin managed several product groups and departments within Kadant Web Systems after joining us in 1986 as a product development engineer.

Mr. Leerentveld has been a vice president since June 2005 and has served as the president of our Kadant Johnson Inc. subsidiary, acquired in May 2005. Prior to its acquisition, Mr. Leerentveld served as president of The Johnson Corporation since 1998, and before that held various managerial positions within The Johnson Corporation; Feda, Inc.; and EDCS, International Investment Fund.

Mr. McKenney has been our vice president, finance and chief accounting officer since January 2002, and served as our corporate controller since 1997. Mr. McKenney was controller of Kadant AES, our division acquired from Albany International Inc., from 1993 to 1997. Prior to 1993, Mr. McKenney held various financial positions at Albany International.

Item 1A. Risk Factors

In connection with the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, we wish to caution readers that the following important factors, among others, in some cases have affected, and in the future could affect, our actual results and could cause our actual results in 2006 and beyond to differ materially from those expressed in any forward-looking statements made by us, or on our behalf.

Our business is dependent on the condition of the pulp and paper industry.

We sell products primarily to the pulp and paper industry, which is a cyclical industry. Generally, the financial condition of the global pulp and paper industry corresponds to the condition of the general economy, as well as to a number of other factors, including pulp and paper production capacity relative to demand. In recent years, the industry in certain geographic regions, notably North America, has been in a prolonged downcycle, resulting in depressed pulp and paper prices, decreased spending, mill closures, consolidations, and bankruptcies, all of which have adversely affected our business. As paper companies consolidate in response to market weakness, they frequently reduce capacity and postpone or even cancel capacity addition or expansion projects. These cyclical downturns can cause our sales to decline and adversely affect our profitability.

Our business is subject to economic, currency, political, and other risks associated with international sales and operations.

During 2005, approximately 60% of our sales were to customers outside the United States, principally in Europe and Asia. International revenues are subject to a number of risks, including the following:

- agreements may be difficult to enforce and receivables difficult to collect through a foreign country s legal system;
- foreign customers may have longer payment cycles;
- foreign countries may impose additional withholding taxes or otherwise tax our foreign income, impose tariffs, or adopt other restrictions on foreign trade; and
- the protection of intellectual property in foreign countries may be more difficult to enforce.

Although we seek to charge our customers in the same currency in which our operating costs are incurred, fluctuations in currency exchange rates may affect product demand and adversely affect the profitability in U.S. dollars of products we provide in international markets where payment for our products and services is made in their local currencies. Any of these factors could have a material adverse impact on our business and results of operations.

A significant portion of our international sales has, and may in the future, come from China. An increase in revenues, as well as our proposed acquisition of a manufacturing and assembly facility in China, will expose us to increased risk in the event of changes in the policies of the Chinese government, political unrest, unstable economic conditions, or other developments in China or in U.S.-China relations that are adverse to trade, including enactment of protectionist legislation or trade restrictions. Orders from customers in China, particularly for large systems that have been tailored to a customer s specific requirements, involve increased credit risk due to payment terms that are applicable to doing business in China. In addition, the timing of these orders is often difficult to predict.

We are subject to intense competition in all our markets.

We believe that the principal competitive factors affecting the markets for our products include quality, price, service, technical expertise, and product innovation. Our competitors include a number of large multinational corporations that may have substantially greater financial, marketing, and other resources than we do. As a result, they may be able to adapt more quickly to new or emerging technologies and changes in customer requirements, or to devote greater resources to the promotion and sale of their services and products. Competitors technologies may prove to be superior to ours. Our current products, those under development, and our ability to develop new technologies may not be sufficient to enable us to compete effectively. Competition, especially in China, could increase if new companies enter the market or if existing competitors expand their product lines or intensify efforts within existing product lines.

Our debt may adversely affect our cash flow and may restrict our investment opportunities.

On May 9, 2005, we entered into a Credit Agreement, consisting of a $60 million five-year term loan and a $25 million revolver. On May 11, 2005, we borrowed $60 million to fund the acquisition of Kadant Johnson under the term loan. We may also obtain additional long-term debt and working capital lines of credit to meet future financing needs, which would have the effect of increasing our total leverage.

Our leverage could have negative consequences, including:

- increasing our vulnerability to adverse economic and industry conditions,
- limiting our ability to obtain additional financing,
- limiting our ability to pay dividends on or repurchase our capital stock,
- limiting our ability to acquire new products and technologies through acquisitions or licensing, and
- limiting our flexibility in planning for, or reacting to, changes in our business and the industries in which we compete.

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Our indebtedness bears interest at floating rates pursuant to the terms of the Credit Agreement. As a result, our interest payment obligations on this indebtedness will increase if interest rates increase. To reduce the exposure to floating rates, we have converted 60% of the term loan to a fixed rate of interest through an interest rate swap.

Our ability to satisfy our obligations and to reduce our total debt depends on our future operating performance and on economic, financial, competitive, and other factors beyond our control. Our business may not generate sufficient cash flows to meet these obligations or to successfully execute our business strategy. If we are unable to service our debt and fund our business, we may be forced to reduce or delay capital expenditures or research and development expenditures, seek additional financing or equity capital, restructure or refinance our debt, or sell assets. We may not be able to obtain additional financing or refinance existing debt or sell assets on terms acceptable to us or at all.

Restrictions in our Credit Agreement may limit our activities.

Our Credit Agreement contains, and future debt instruments to which we may become subject may contain, restrictive covenants that limit our ability to engage in activities that could otherwise benefit us, including restrictions on our ability and the ability of our subsidiaries to:

- incur additional indebtedness,
- pay dividends on, redeem, or repurchase our capital stock,
- make investments,
- create liens,
- sell assets,
- enter into transactions with affiliates, and
- consolidate, merge, or transfer all or substantially all of our assets and the assets of our subsidiaries.

We are also required to meet specified financial ratios under the terms of our Credit Agreement. Our ability to comply with these financial restrictions and covenants is dependent on our future performance, which is subject to prevailing economic conditions and other factors, including factors that are beyond our control such as foreign exchange rates, interest rates, changes in technology, and changes in the level of competition.

Our failure to comply with any of these restrictions or covenants may result in an event of default under our Credit Agreement, which could permit acceleration of the debt under that instrument and require us to repay that debt before its scheduled due date.

If an event of default occurs, we may not have sufficient funds available to make the required payments under our indebtedness. If we are unable to repay amounts owed under our Credit Agreement, those lenders may be entitled to foreclose on and sell the collateral that secures our borrowings under the agreement.

Our Kadant Composites LLC subsidiary is responsible for certain continued warranty obligations associated with its former composites business, even though it has disposed of this business.

On October 21, 2005, Kadant Composites LLC sold its composites business. As part of the transaction, Kadant Composites LLC retained the warranty obligation associated with products manufactured prior to the sale date. Our consolidated results will continue to be impacted by these warranty obligations and we may be unable to accurately predict the potential liabilities related to these product warranties. In 2003 and 2004, Kadant Composites LLC experienced a significant increase in warranty claims and warranty expense related to its composite decking products including, but not limited to, contraction of certain deck boards and excessive oxidation that affects the integrity of the plastic used in some of its decking products. Included in the increased warranty expense was the cost of exchanging material held by its distributors with new material that, we believe, is not susceptible to this oxidation issue, and our best estimate of future potential costs related to valid claims arising from installed products. In 2005, Kadant Composites LLC experienced a higher-than-expected level of warranty claims associated with previously identified product issues. Although Kadant Composites LLC increased the warranty provisions accordingly, the reserve established may not be sufficient if Kadant

Composites LLC incurs warranty claims higher than anticipated. It is reasonably possible that the ultimate settlement of such warranty claims may exceed the amount of the warranty reserve. In addition, there can be no assurance that other problems will not develop. A continued high level of warranty claims or expenses would have an adverse impact on the warranty reserve and would adversely affect our consolidated results.

Our inability to successfully integrate Kadant Johnson into our business could have a material adverse effect on our business.

On May 11, 2005, we acquired Kadant Johnson. The integration of Kadant Johnson into our business will involve the merger of employees, products, and services over multiple U.S. and international locations. We may not be successful in integrating this business into our current structure, or in obtaining the anticipated cost savings or synergies from the acquisition. To meet our quarterly certification requirements and in anticipation of incorporating Kadant Johnson into our 2006 Sarbanes-Oxley compliance process, we will also be performing a detailed review of Kadant Johnson s internal control structure to ensure that its controls over financial reporting are consistent with our policies and procedures. Given the multi-location structure of the Kadant Johnson business, this review will take significant time and effort, similar to our Sarbanes-Oxley compliance efforts in 2004, and will involve significant cost. During this process, we may identify control deficiencies in addition to those disclosed elsewhere in this periodic report. Our ability to realize the value of the goodwill and other intangibles recorded for this acquisition will depend on the future cash flows of the Kadant Johnson business. If these future cash flows are below what we anticipated, we may incur future impairment losses associated with goodwill and intangibles, which could have a material adverse effect on our results of operations.

Our inability to successfully complete the acquisition of a manufacturing and assembly plant in China could adversely affect our business.

Our strategy includes the ability to manufacture components and equipment in low-cost regions such as China. We recently entered into an Asset Purchase Agreement to acquire a Chinese supplier of stock-preparation equipment. This acquisition is subject to a number of conditions, including the negotiation and signing of a definitive purchase agreement and satisfaction of customary conditions and regulatory approvals, and there is no assurance that we will be able to complete this acquisition on favorable terms or on a timely basis. Our inability to successfully complete the acquisition would delay the implementation of our strategy to manufacture parts and components for stock-preparation equipment in a low-cost region, and could adversely affect our ability to compete cost-effectively in Asia and other markets.

In anticipation of completing this acquisition, we have terminated our efforts to construct an assembly and manufacturing facility outside Beijing. We may not be able to recoup our expenses to date associated with the formation of our subsidiary to operate this facility, such as the design and construction of the facility, and other costs incurred in connection with this effort.

Our inability to successfully identify and complete acquisitions or successfully integrate any new or previous acquisitions could have a material adverse effect on our business.

Our strategy includes the acquisition of technologies and businesses that complement or augment our existing products and services. Promising acquisitions are difficult to identify and complete for a number of reasons, including competition among prospective buyers and the need for regulatory, including antitrust, approvals. We do incur costs from time to time associated with potential acquisitions, which are deferred during the due diligence phase. Future operating results could be negatively impacted in any quarter in which we determine that a potential acquisition will not close and such associated costs are expensed. Any acquisition we may complete may be made at a substantial premium over the fair value of the net assets of the acquired company. We may not be able to complete future acquisitions, integrate any acquired businesses successfully into our existing businesses, make such businesses profitable, or realize anticipated cost savings or synergies, if any, from these acquisitions. In addition, we have previously acquired several companies and businesses and, as a result, we have recorded significant goodwill and intangible assets on our balance sheet. Any future impairment losses identified will be recorded as reductions to operating income, which could have a material adverse effect on our results of operations. Our ability to realize the value of the goodwill and intangibles that we have recorded will depend on the future performance and cash flows of these businesses, which will depend, in part, on how well we have integrated these businesses.

Our inability to obtain the anticipated benefits from the restructuring of our Kadant Lamort subsidiary would have a negative effect on our future operating results.

In an effort to improve operating performance at our Kadant Lamort subsidiary in France, we approved a restructuring of that subsidiary on November 18, 2004. This restructuring is intended to strengthen Kadant Lamort s competitive position in the European paper industry. We accrued a restructuring charge of $9.2 million in the fourth quarter of 2004 for severance and other termination costs in connection with the workforce reduction. If we are unable to obtain the anticipated benefits from this restructuring, our future operating results would be negatively impacted.

Natural gas is a significant cost in the manufacture of our fiber-based granular products, and our results from operations will be adversely affected by continued high natural gas costs.

We use natural gas in the production of our fiber-based granular products the price of which increased dramatically at the end of 2005. We seek to manage our exposure to natural gas price fluctuations by entering into short-term forward contracts to purchase specified quantities of natural gas from a supplier. We may not be able to effectively manage our exposure to natural gas price fluctuations. Continued high costs of natural gas will adversely affect our consolidated results if we are unable to effectively manage our exposure or pass these costs on to customers in the form of surcharges.

We are dependent on two mills for the raw material used in our fiber-based granules, and we may not be able to obtain raw material on commercially reasonable terms.

We are dependent on two paper mills for the fiber used in the manufacture of our fiber-based granular products. These mills have the exclusive right to supply the papermaking byproducts used in the manufacturing process. Due to manufacturing changes at the mills, we recently had some difficulty obtaining sufficient raw material to operate at optimal production levels. We are working with the mills to ensure a stable supply of raw material. To date, we have been able to meet all of our customer delivery requirements, but there can be no assurance that we will be able to meet future delivery requirements. Although we believe our relationship with the mills is good, the mills could decide not to renew the contract when it expires at the end of 2007, or may not agree to renew on commercially reasonable terms. If the mills were unable or unwilling to supply us sufficient fiber, we would be forced to find an alternative supply for this raw material. We may be unable to find an alternative supply on commercially reasonable terms or could incur excessive transportation costs if an alternative supplier were found, which would increase our manufacturing costs and might prevent prices for our products from being competitive.

Our inability to protect our intellectual property could have a material adverse effect on our business. In addition, third parties may claim that we infringe their intellectual property, and we could suffer significant litigation or licensing expense as a result.

We place considerable emphasis on obtaining patent and trade secret protection for significant new technologies, products, and processes because of the length of time and expense associated with bringing new products through the development process and into the marketplace. Our success depends in part on our ability to develop patentable products and obtain and enforce patent protection for our products both in the United States and in other countries. We own numerous U.S. and foreign patents, and we intend to file additional applications, as appropriate, for patents covering our products. Patents may not be issued for any pending or future patent applications owned by or licensed to us, and the claims allowed under any issued patents may not be sufficiently broad to protect our technology. Any issued patents owned by or licensed to us may be challenged, invalidated, or circumvented, and the rights under these patents may not provide us with competitive advantages. A patent relating to our fiber-based granular products expired in the second quarter of 2004. As a result, we could be subject to increased competition in this market, which could have an adverse effect on this business. In addition, competitors may design around our technology or develop competing technologies. Intellectual property rights may also be unavailable or limited in some foreign countries, which could make it easier for competitors to capture increased market share. We could incur substantial costs to defend ourselves in suits brought against us or in suits in which we may assert our patent rights against others. An unfavorable outcome of any such litigation could have a material adverse effect on our business and results of operations. In addition, as our patents expire, we rely on trade secrets and proprietary know-how to protect our products. We cannot be sure the steps we have taken or will take in the future will be adequate to deter misappropriation of our proprietary information and intellectual property.

We seek to protect trade secrets and proprietary know-how, in part, through confidentiality agreements with our collaborators, employees, and consultants. These agreements may be breached, we may not have adequate remedies for any breach, and our trade secrets may otherwise become known or be independently developed by our competitors.

Third parties may assert claims against us to the effect that we are infringing on their intellectual property rights. We could incur substantial costs and diversion of management resources in defending these claims, which could have a material adverse effect on our business, financial condition, and results of operations. In addition, parties making these claims could secure a judgment awarding substantial damages, as well as injunctive or other equitable relief, which could effectively block our ability to make, use, sell, distribute, or market our products and services in the United States or abroad. In the event that a claim relating to intellectual property is asserted against us, or third parties not affiliated with us hold pending or issued patents that relate to our products or technology, we may seek licenses to such intellectual property or challenge those patents. However, we may be unable to obtain these licenses on commercially reasonable terms, if at all, and our challenge of the patents may be unsuccessful. Our failure to obtain the necessary licenses or other rights could prohibit the sale, manufacture, or distribution of our products and, therefore, could have a material adverse effect on our business, financial condition, and results of operations.

Fluctuations in our quarterly operating results may cause our stock price to decline.

Given the nature of the markets in which we participate and the effect of Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition, we may not be able to reliably predict future revenues and profitability, and unexpected changes may cause us to adjust our operations. A large proportion of our costs are fixed, due in part to our significant selling, research and development, and manufacturing costs. Thus, small declines in revenues could disproportionately affect our operating results. Other factors that could affect our quarterly operating results include:

- failure of our products to pass contractually agreed upon acceptance tests, which would delay or prohibit recognition of revenues under SAB No. 104;
- failure of a customer, particularly in China, to comply with an order s contractual obligations;
- adverse changes in demand for and market acceptance of our products;
- competitive pressures resulting in lower sales prices of our products;
- adverse changes in the pulp and paper industry;
- delays or problems in our introduction of new products;
- our competitors announcements of new products, services, or technological innovations;
- contractual liabilities incurred by us related to guarantees of our product performance;

- increased costs of raw materials or supplies, including the cost of energy; and
- changes in the timing of product orders.

Anti-takeover provisions in our charter documents, under Delaware law, and in our shareholder rights plan could prevent or delay transactions that our shareholders may favor.

Provisions of our charter and bylaws may discourage, delay, or prevent a merger or acquisition that our shareholders may consider favorable, including transactions in which shareholders might otherwise receive a premium for their shares. For example, these provisions:

- authorize the issuance of blank check preferred stock without any need for action by shareholders;
- provide for a classified board of directors with staggered three-year terms;
- require supermajority shareholder voting to effect various amendments to our charter and bylaws;
- eliminate the ability of our shareholders to call special meetings of shareholders;
- prohibit shareholder action by written consent; and
- establish advance notice requirements for nominations for election to our board of directors or for proposing matters that can be acted on by shareholders at shareholder meetings.

In addition, our board of directors has adopted a shareholder rights plan intended to protect shareholders in the event of an unfair or coercive offer to acquire our company and to provide our board of directors with adequate time to evaluate unsolicited offers. Preferred stock purchase rights have been distributed to our common shareholders pursuant to the rights plan. This rights plan may have anti-takeover effects. The rights plan will cause substantial dilution to a person or group that attempts to acquire us on terms that our board of directors does not believe are in our best interests and those of our shareholders and may discourage, delay, or prevent a merger or acquisition that shareholders may consider favorable, including transactions in which shareholders might otherwise receive a premium for their shares.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

We believe that our facilities are in good condition and are suitable and adequate for our present operations. We do not anticipate significant difficulty in obtaining lease renewals or alternate space as needed. The location and general character of our principal properties as of December 31, 2005, are as follows:

Pulp and Papermaking Systems

We own approximately 1,351,000 square feet and lease approximately 146,000 square feet, under leases expiring on various dates ranging from 2006 to 2011, of manufacturing, engineering, and office space. Our principal engineering and manufacturing facilities are located in Vitry-le-Francois, France; Auburn, Massachusetts; Theodore, Alabama; Queensbury, New York; Mason, Ohio; Three Rivers, Michigan; Guadalajara, Mexico; Summerstown, Ontario, Canada; Sao Paulo, Brazil; Weesp, The Netherlands; Bury, England; Hindas, Sweden; and Wuxi, China.

Other

We lease approximately 6,000 square feet in Acton, Massachusetts, for our corporate headquarters under a lease expiring in December 2006. We own approximately 26,000 square feet and lease approximately 15,000 square feet, under a lease expiring in January 2007, of manufacturing and office space located in Green Bay, Wisconsin. We also own 33,000 square feet of manufacturing and office space in Springport, Michigan.

Item 3. Legal Proceedings

Not applicable.

Item 4. Submission of Matters to a Vote of Security Holders

Not applicable.

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PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities.

Market Price of Common Stock

On May 14, 2003, our common stock began trading on the New York Stock Exchange under the symbol KAI. Prior to that date, our common stock was traded on the American Stock Exchange.

The following table sets forth the high and low sales prices of our common stock for 2005 and 2004, as reported in the consolidated transaction reporting system.

	2005		2004	
Quarter	**High**	**Low**	**High**	**Low**
First	$ 21.22	$ 18.15	$ 23.49	$ 19.17
Second	22.65	17.02	23.30	18.08
Third	23.18	18.27	23.15	17.72
Fourth	20.54	16.50	20.90	17.81

Holders of Common Stock

As of February 28, 2006, we had approximately 5,796 holders of record of our common stock. This does not include holdings in street or nominee name. The closing market price on the New York Stock Exchange for our common stock on February 28, 2006, was $18.89 per share.

Dividend Policy

We have never declared or paid cash dividends and we do not at this time expect to pay cash dividends in the foreseeable future because our policy has been to use earnings to finance expansion and growth. Payment of dividends will rest within the discretion of the board of directors and will depend upon, among other factors, our earnings, capital requirements, and financial condition. Our ability to pay dividends is further restricted by the terms of our Credit Agreement.

Issuer Purchases of Equity Securities

The following table provides information about purchases by us of our common stock during the fourth quarter of 2005:

Issuer Purchases of Equity Securities

Period		**Total Number of Shares Purchased**	**Average Price Paid per Share**	**Total Number of Shares Purchased as Part of Publicly Announced Plans (1)**	**Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans**
10/2/05	10/31/05				$ 11,623,747
11/1/05	11/30/05	204,000	$ 18.04	204,000	$ 7,944,105
12/1/05	12/31/05				$ 7,944,105
Total:		204,000	$ 18.04	204,000	

(1) On May 6, 2005, our board of directors authorized the repurchase of up to $15 million of our equity securities in the open market or in negotiated transactions for the period from May 18, 2005 through May 18, 2006. As of December 31, 2005, we had repurchased 1,200 shares of our common stock for $25 thousand in the second quarter of 2005, 171,500 shares of our common stock for $3.4 million in the third quarter of 2005, and 204,000 shares of our common stock for $3.7 million in the fourth quarter of 2005 under this authorization.

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Item 6. Selected Financial Data

(In thousands, except per share amounts)	2005	2004 (b)	2003 (a)	2002 (a,c,d)	2001(a,d,e)
Statement of Operations Data					
Revenues	$ 243,713	$ 194,966	$ 191,507	$ 177,113	$ 219,226
Income from Continuing Operations Before Cumulative Effect of Change in Accounting Principle	9,865	5,753	13,123	8,280	12,522
Loss from Discontinued Operation, Net of Tax	(2,988)	(5,099)	(1,306)	(2,326)	(2,540)
Income Before Cumulative Effect of Change in Accounting Principle	6,877	654	11,817	5,954	9,982
Cumulative Effect of Change in Accounting Principle, Net of Tax				(32,756)	
Net Income (Loss)	$ 6,877	$ 654	$ 11,817	$ (26,802)	$ 9,982
Basic Earnings (Loss) per Share:					
Continuing Operations Before Cumulative Effect of Change in Accounting Principle	$ .71	$ .41	$ .96	$ .64	$ 1.02
Discontinued Operation	(.21)	(.36)	(.09)	(.18)	(.21)
Cumulative Effect of Change in Accounting Principle				(2.53)	
Net Income (Loss)	$ .50	$ .05	$ .87	$ (2.07)	$ .81
Diluted Earnings (Loss) per Share:					
Continuing Operations Before Cumulative Effect of Change in Accounting Principle	$ .70	$ .40	$ .94	$ .63	$ 1.02
Discontinued Operation	(.21)	(.35)	(.09)	(.18)	(.21)
Cumulative Effect of Change in Accounting Principle				(2.49)	
Net Income (Loss)	$ .49	$ .05	$ .85	$ (2.04)	$ .81
Balance Sheet Data (f)					
Working Capital (g,h)	$ 75,446	$ 113,650	$ 114,935	$ 83,855	$ 167,451
Total Assets	355,811	285,237	271,713	231,517	367,654
Long-Term Obligations	46,500			580	119,267
Shareholders Investment	207,625	212,461	211,758	181,257	183,557

(a) Restated to reflect the composite building products business as a discontinued operation.
(b) Reflects $9.5 million of pre-tax restructuring and other costs.
(c) Reflects $2.4 million of pre-tax restructuring and other costs, the redemption and repurchase of $118.1 million of the Company s 41/2% subordinated convertible debentures, resulting in a pre-tax gain of $50.0 thousand, and cumulative effect of a change in accounting principle of $32.8 million associated with the adoption of Statement of Financial Accounting Standards No. 142.
(d) Annual results were revised to reclassify extraordinary gains from the Company s redemption and repurchase of its debentures in accordance with Statement of Financial Accounting Standards No. 145.
(e) Reflects $0.7 million of pre-tax restructuring costs and the repurchase of $34.9 million of the Company s 41/2% subordinated convertible debentures, resulting in a pre-tax gain of $1.1 million.
(f) Includes the composite building products business, which is reflected as a discontinued operation.
(g) Includes the 2001 redemption of common stock of a subsidiary for $13.1 million.
(h) Includes $7.4 million, $8.1 million, $12.2 million, $10.1 million, and $9.0 million in 2005, 2004, 2003, 2002, and 2001, respectively, associated with the discontinued operation.

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

Reference is made throughout this Management s Discussion and Analysis of Financial Condition and Results of Operations to Notes included in the Consolidated Financial Statements, beginning on page F-1 of this Report.

Overview

Industry Background

Our continuing operations are comprised of one reportable operating segment: Pulp and Papermaking Systems (Papermaking Systems), and two product lines, Fiber-based Products and Casting Products. Through our Pulp and Papermaking Systems segment, we develop, manufacture, and market a range of equipment and products for the domestic and international papermaking and paper recycling industries. We have a large, stable customer base that includes most of the world s major paper manufacturers. As a result, we have one of the largest installed bases of equipment in the pulp and paper industry. Our installed base provides us with a spare parts and consumables business that yields higher margins than our capital equipment business, and which, we believe, is less susceptible to the cyclical trends in the paper industry.

Through our Fiber-based Products line, we manufacture and sell granules derived from pulp fiber for use as carriers for agricultural, home lawn and garden, and professional lawn, turf and ornamental applications, as well as for oil and grease absorption. We also manufacture and sell grey and ductile iron castings through our Casting Products business.

Prior to the sale of the composites business, we produced composite building products, including decking and railing systems and roof tiles, made from recycled fiber, plastic, and other material, which were marketed through distributors primarily to the building industry. On October 21, 2005, our Kadant Composites LLC subsidiary (Kadant Composites LLC) sold substantially all of its assets, comprising the composites business, to LDI Composites Co. (the Buyer) for approximately $11.1 million in cash and the assumption of $1.4 million of liabilities resulting in an immaterial gain on sale. The sale price is subject to a post-closing adjustment.

As part of the sale transaction, Kadant Composites LLC retained the warranty obligations associated with products manufactured prior to the sale date. Kadant Composites LLC deposited $3.5 million of the sale proceeds into a special escrow fund to satisfy these warranty claims. This fund will be administered by the Buyer for five years or until the funds are exhausted, after which time Kadant Composites LLC will administer any remaining covered warranty claims. Based on the claims submitted to the Buyer for reimbursement through year-end 2005, the remaining balance in the special escrow fund would be reduced to approximately $2.3 million. Based on the claims activity and payments processed after year-end 2005, we anticipate that the special escrow fund will be utilized and Kadant Composites LLC will assume claims processing in 2006. As of December 31, 2005, the accrued warranty reserve associated with the composites business was $5.3 million. All future activity associated with this warranty reserve will continue to be classified in the results of the discontinued operation in the accompanying consolidated financial statements.

International Sales

During 2005, approximately 60% of our sales were to customers outside the United States, principally in Europe and Asia. We generally seek to charge our customers in the same currency in which our operating costs are incurred. However, our financial performance and competitive position can be affected by currency exchange rate fluctuations affecting the relationship between the U.S. dollar and foreign currencies. We seek to reduce our exposure to currency fluctuations through the use of forward currency exchange contracts. We may enter into forward contracts to hedge certain firm purchase and sale commitments denominated in currencies other than our subsidiaries functional currencies. These contracts hedge transactions principally denominated in U.S. dollars.

Application of Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of our consolidated financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that entail significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. We believe that our most critical accounting policies upon which our financial condition depends, and which involve the most complex or subjective decisions or assessments, are those described below. For a discussion on the application of these and other accounting policies, see Note 1 in the Notes to Consolidated Financial Statements.

Revenue Recognition. We enter into arrangements with customers that have multiple deliverables, such as equipment and installation, and we recognize revenues and profits on certain long-term contracts using the percentage-of-completion method of accounting.

Percentage-of-Completion. Revenues recorded under the percentage-of-completion method of accounting were $55.6 million in 2005, $43.7 million in 2004, and $49.3 million in 2003. The percentage of completion is determined by comparing the actual costs incurred to date to an estimate of total costs to be incurred on each contract. If a loss is indicated on any contract in process, a provision is made currently for the entire loss. Our contracts generally provide for billing of customers upon the attainment of certain milestones specified in each contract. Revenues earned on contracts in process in excess of billings are classified as unbilled contract costs and fees, and amounts billed in excess of revenues are classified as billings in excess of contract costs and fees. The complexity of the estimation process under the percentage-of-completion method affects the amounts reported in our consolidated financial statements. A number of internal and external factors affect our percentage-of-completion and cost of sales estimates, including labor rate and efficiency variances, estimates of warranty costs, estimated future material prices from vendors, and customer specification and testing requirements. In addition, we are exposed to the risk, primarily relating to our orders in China, that a customer will not comply with the order s contractual obligations to take delivery of the equipment. This risk is reduced somewhat by such customer s forfeiture of their deposit on the order. The contractual obligations relating to the order may be difficult to enforce through a foreign country s legal system, which could result in a significant credit exposure in the period or periods that were to be affected by the breach of contract. Although we make every effort to ensure the accuracy of our estimates in the application of this accounting policy, if our business conditions were to be different, or if we were to use different assumptions, it is possible that materially different amounts could be reported as revenues in our consolidated financial statements.

SAB No. 104. Under Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition, when the terms of sale include customer acceptance provisions, and compliance with those provisions cannot be demonstrated until customer acceptance, revenues are recognized upon such acceptance. When a sale arrangement involves multiple elements (e.g., installation), we consider the guidance in Emerging Issues Task Force (EITF) No. 00-21 Revenue Arrangements with Multiple Deliverables. Such transactions are evaluated to determine whether the deliverables in the arrangement represent separate units of accounting. If equipment and installation do not meet the separation criteria under EITF No. 00-21, revenues for products sold that require installation, for which the installation is essential to functionality or is not deemed inconsequential or perfunctory, are recognized upon completion of installation. Revenues for products sold where installation is not essential to functionality, and is deemed inconsequential or perfunctory, are recognized upon shipment, with estimated installation costs accrued. We provide a reserve for the estimated warranty and installation costs at the time revenue is recognized, as applicable. To the extent that installation becomes a significant component of our business in the future, the judgment associated with the determination of revenue recognition will increase. The complexity of all issues related to the assumptions, risks, and uncertainties inherent in the application of SAB No. 104 affects the amounts reported as revenues in our consolidated financial statements. Under SAB No. 104, we may not be able to reliably predict future revenues and profitability due to the difficulty of estimating when installation will be performed or when we will meet the contractually agreed upon performance tests, which can delay or prohibit recognition of revenues. The determination of when we install the equipment or fulfill the performance guarantees is largely dependent on our customers, their willingness to allow installation of the equipment or performance of the appropriate tests in a timely manner, and their cooperation in addressing possible problems that would impede achievement of the performance guarantee criteria. Unexpected changes in the timing related to the completion of installation or performance guarantees could cause our revenues and earnings to be significantly affected.

Inventories. We value our inventory at the lower of the actual cost (on a first-in, first-out; last-in, first-out; or weighted average basis) or market value and include materials, labor, and manufacturing overhead. We regularly review inventory quantities on hand and compare these amounts to historical and forecasted usage of and demand for each particular product or product line. We record a charge to cost of revenues for excess and obsolete inventory to reduce the carrying value of the inventories to net realizable value. Inventory writedowns have historically been within our expectations and the provisions established. A significant decrease in demand could result in an increase in the amount of excess inventory quantities on hand, resulting in a charge for the writedown of that inventory in that period. In addition, our estimates of future product usage or demand may prove to be inaccurate, resulting in an understated or overstated provision for excess and obsolete inventory. Therefore, although we make every effort to ensure the accuracy of our forecasts of future product usage and demand, any significant unanticipated changes in demand or technological developments could have a significant impact on the value of our inventory and our reported operating results.

Valuation of Goodwill and Intangible Assets. We evaluate the recoverability of goodwill and indefinite-lived intangible assets annually in the fourth quarter, or more frequently if events or changes in circumstances, such as a decline in sales, earnings, or cash flows, or material adverse changes in the business climate, indicate that the carrying value of an asset might be impaired. We completed our annual impairment tests in the fourth quarter of 2005 using estimates from our long-range forecasts. Intangible assets subject to amortization are evaluated for impairment if events or changes in circumstances indicate that the carrying value of an asset might be impaired. No adjustment was required to the carrying value of our goodwill or intangible assets based on the analysis performed.

Goodwill is considered to be impaired when the net book value of a reporting unit exceeds its estimated fair value. Fair values are primarily established using a discounted cash flow methodology (specifically, the income approach). The determination of discounted cash flows is based on our long-range forecasts. The revenue growth rates included in the forecasts are our best estimates based on current and anticipated market conditions, and the profit margin assumptions are projected based on current and anticipated cost structures. Our judgments and assumptions regarding the determination of the fair value of an intangible asset or goodwill associated with an acquired business could change as future events impact such fair values. Any future impairment loss could have a material adverse affect on our long-term assets and operating expenses in the period in which impairment is determined to exist.

Accounts Receivable. We exercise judgment in determining our allowance for bad debts, which is based on our historical collection experience, current trends, credit policies, specific customer collection issues, and accounts receivable aging categories. In determining this allowance, we look at historical writeoffs of our receivables. We also look at current trends in the credit quality of our customer base as well as changes in our credit policies. We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history and each customer s current creditworthiness. We continuously monitor collections and payments from our customers. In addition, in some instances we utilize letters of credit as a way to mitigate credit exposure. While actual bad debts have historically been within our expectations and the provisions established, we cannot guarantee that we will continue to experience the same rate of bad debts that we have in the past, especially in light of business conditions in the paper industry. A significant change in the liquidity or financial position of any of our customers could result in the uncollectibility of the related accounts receivable and could adversely affect our operating cash flows in that period.

Warranties. In the Papermaking Systems segment, we offer warranties of various durations to our customers depending upon the specific product and terms of the customer purchase agreement. We typically negotiate terms regarding warranty coverage and length of warranty depending on the products and their applications. Our standard mechanical warranties require us to repair or replace a defective product during the warranty period at no cost to the customer. We record an estimate for warranty-related costs at the time of sale based on our actual historical return rates and repair costs, as well as other analytical tools for estimating future warranty claims. These estimates are revised for variances between actual and expected claims rates. While our warranty costs have historically been within our expectations and the provisions established, we cannot guarantee that we will continue to experience the same warranty return rates or repair costs that we have in the past.

On October 21, 2005, Kadant Composites LLC sold its composites business, presented as a discontinued operation in the accompanying consolidated financial statements. As part of the transaction, Kadant Composites LLC retained the warranty obligation associated with products manufactured prior to the sale date. Our consolidated results will continue to be impacted by any adjustments to this warranty obligation, which will continue to be presented within the discontinued operation. This warranty obligation relates to a standard limited warranty provided to the original owner of our decking and roofing products, limited to repair or replacement of the defective product or a refund of the original purchase price. Prior to the sale of the composites business, we recorded an estimate for warranty-related costs at the time of sale based on our actual historical return rates and repair costs, as well as other analytical tools for estimating future warranty claims. These estimates are revised for variances between actual and expected claims rates. Our analysis of expected warranty claims rates includes detailed assumptions associated with potential product returns, including the type of product sold, temperatures at the location of installation, density of boards, and other factors. Certain assumptions, such as the effect of weather conditions and high temperatures on the product installed, include inherent uncertainties that are subject to fluctuation which could impact our future warranty provisions. Due to the highly subjective nature of these assumptions, we have recorded our best estimate of the cost of expected warranty claims. It is reasonably possible that the ultimate settlement of such claims may exceed the amount recorded, if we incur warranty return rates higher than we anticipated.

A significant increase in warranty return rates or costs to repair our products would lead to an increase in the warranty provision and could have a material adverse impact on our consolidated results for the period or periods in which such returns or additional costs occur.

Income Taxes. We estimate the degree to which tax assets and loss carryforwards will result in a benefit based on expected profitability by tax jurisdiction, and provide a valuation allowance for tax assets and loss carryforwards that we believe will more likely than not go unused. If it becomes more likely than not the tax asset or loss carryforward will be used, we would reverse the related valuation allowance. Our tax valuation allowance totaled $2.5 million at year-end 2005. Should our actual future taxable income by tax jurisdiction vary from our estimate, additional allowances or reversals thereof may be necessary.

We provide a liability for future income tax payments in the worldwide tax jurisdictions in which we operate. Should tax return positions that we expect are sustainable not be sustained upon audit, we could be required to record an incremental tax provision for such taxes. Should previously unrecognized tax benefits be sustained, a reduction in our tax provision would result.

Industry and Business Outlook

Our products are primarily sold to the pulp and paper industry. The paper industry had been in a prolonged downcycle for the past several years. While the performance of paper producers, especially in North America, has been gradually improving over the past year, the industry is continuing to experience sluggish demand. The profitability of paper producers is still being negatively affected by higher operating costs, especially higher energy costs. We believe paper companies remain cautious about increasing their capital and operating spending in the current market environment. We expect, however, if the market recovers, paper companies will increase their capital and operating spending, which would have a positive effect on paper company suppliers, such as Kadant, although the timing of such effect is difficult to predict. We continue to concentrate our efforts on several initiatives intended to improve our operating results, including: (i) integrating the Kadant Johnson acquisition, (ii) penetrating new markets outside the paper industry, (iii) completing our acquisition of a stock-preparation production plant in China, and (iv) increasing aftermarket sales. In addition, we continue to focus our efforts on managing our operating costs, capital expenditures, and working capital.

In an effort to improve operating performance at our Kadant Lamort subsidiary in France, we approved a restructuring of that subsidiary in 2004 intended to strengthen Kadant Lamort s competitive position in the European paper industry. We accrued a restructuring charge for severance and other termination costs in connection with the workforce reduction of $9.2 million in the fourth quarter of 2004. We completed the the restructuring actions in 2005 and as a result of these actions, we estimate that our Kadant Lamort subsidiary will be profitable in 2006.

We continue to pursue market opportunities outside North America. In the last several years, China has become a significant market for our stock-preparation equipment. To capitalize on this growing market, we plan to acquire a manufacturing and assembly facility in China for this equipment and related products, as well as for certain of our accessories and water-management products in the future. Revenues from China are primarily derived from large capital orders, the timing of which is often difficult to predict. Our customers in China have experienced delays in obtaining financing for their capital addition and expansion projects due to efforts by the Chinese government to control economic growth, which are reflected in a slowdown in financing approvals in China s banking system. This has caused delays in receiving orders and, as a result, will delay our recognizing revenue on these projects to periods later than originally anticipated. We plan to use our new facility in China as a base for increasing our aftermarket business, which we believe will be more predictable.

Our 2006 guidance reflects expected revenues and earnings per share from continuing operations, which excludes the results from our discontinued operation. For the first quarter of 2006, we expect to earn, from continuing operations, between $.17 to $.19 per diluted share, on revenues of $70 to $72 million. For the full year, we expect to earn from continuing operations between $1.15 to $1.25 per diluted share, on revenues of $290 to $300 million.

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Kadant Inc. **2005 Annual Report**

Results of Operations

2005 Compared to 2004

The following table sets forth our consolidated statement of operations expressed as a percentage of total revenue for the years ending December 31, 2005 and January 1, 2005.

	December 31, 2005	January 1, 2005
Revenues	100%	100%
Costs and Operating Expenses:		
Cost of revenues	61	61
Selling, general, and administrative expenses	31	29
Research and development expenses	2	1
Restructuring and other costs (income), net		5
	94	96
Operating Income	6	4
Interest Income (Expense), Net		
Income from Continuing Operations Before Income Taxes and Minority Interest	6	4
Provision for Income Taxes	2	1
Income from Continuing Operations	4	3
Loss from Discontinued Operation	(1)	(3)
Net Income	3%	%

Revenues

Revenues increased to $243.7 million in 2005 from $195.0 million in 2004, an increase of $48.7 million, or 25%. Revenues in 2005 include a $47.9 million, or 25%, increase from recently acquired Kadant Johnson, and the favorable effects of currency translation of $2.0 million, or 1%, due to a weaker U.S. dollar relative to most of the functional currencies in countries in which we operate.

Revenues from our Papermaking Systems segment and other businesses for the years ending December 31, 2005 and January 1, 2005 are as follows:

(In thousands)	December 31, 2005	January 1, 2005
Revenues:		
Pulp and Papermaking Systems	$ 232,615	$ 188,320
Other	11,098	6,646
	$ 243,713	$ 194,966

Pulp and Papermaking Systems. Revenues for the Papermaking Systems segment increased to $232.6 million in 2005 compared with $188.3 million in 2004, an increase of $44.3 million, or 24%. The increase in revenues in 2005 includes $45.5 million, or 24%, from recently acquired Kadant Johnson, which comprises our fluid-handling product line, and a 1% increase from the favorable effect of currency translation.

Revenues at the Papermaking Systems segment by product line were as follows:

(In millions)	2005	2004	Increase (Decrease)	Increase (Decrease) Excluding Effect of Currency Translation
Product Line:				
Accessories	$ 58.8	$ 62.7	$ (3.9)	$ (4.7)
Stock-Preparation Equipment	98.2	95.4	2.8	2.0
Fluid-Handling	45.5		45.5	45.5
Water-Management	28.3	28.8	(0.5)	(0.8)
Other	1.8	1.4	0.4	0.3
	$ 232.6	$ 188.3	$ 44.3	$ 42.3

Revenues from the segment s accessories product line decreased by $3.9 million, or 6%, in 2005, including a $0.8 million increase from the favorable effect of currency translation. Excluding the effect of currency translation, revenues from the segment s accessories product line decreased $4.7 million, or 7%, due to a $2.9 million, or 7%, decrease in sales in North America and a $1.8 million, or 8%, decrease in sales in Europe. The decrease in sales was due to weaker demand in both North America and Europe, as well as a significant amount of unscheduled downtime by one of our largest customers in the U.S.

Revenues from the segment s stock-preparation equipment product line increased by $2.8 million, or 3%, in 2005, including a $0.8 million increase from the favorable effect of currency translation. Excluding the effect of currency translation, revenues from the stock-preparation equipment product line increased $2.0 million, or 2%, due to a $5.8 million, or 16%, increase in sales in North America due to strong demand for our capital equipment, offset in part by a $4.1 million, or 12%, decrease in Europe due to weak demand.

Revenues from the recently acquired fluid-handling product line were $45.5 million in 2005.

Revenues from the segment s water-management product line decreased $0.5 million, or 2%, in 2005, including a $0.3 million increase from the favorable effect of currency translation. Excluding the effect of currency translation, revenues from the segment s water-management product line decreased by $0.8 million, or 3%, due primarily to a $1.3 million, or 22%, decrease in sales in Europe due to a decrease in large capital orders and lower levels of mill spending.

Other. Revenues from our Fiber-based Products business increased $2.0 million, or 29%, in 2005 to $8.6 million from $6.6 million in 2004 due to stronger sales of Biodac®, our line of biodegradable granular products. Revenues from our newly acquired Casting Products business were $2.5 million in 2005.

Gross Profit Margin

Gross profit margin for the years ending December 31, 2005 and January 1, 2005 were as follows:

	December 31, 2005	January 1, 2005
Gross Profit Margin:		
Pulp and Papermaking Systems	39%	39%
Other	28%	36%

39%	39%

Gross profit margin was 39% in 2005 and 2004. The gross profit margin at the Papermaking Systems segment remained constant at 39% in 2005 and 2004. The inclusion of the fluid-handling product line from May 2005 contributed to a 3% increase in gross profit margins in 2005, largely offset by lower margins at our stock-preparation product line in 2005. The lower margins at our stock-preparation product line in 2005 primarily resulted from a higher proportion of sales of lower-margin capital equipment in North America, which reduced gross margins by 1%, as well as lower gross profit margins in Europe at our Kadant Lamort subsidiary, which also reduced gross margins by 1%. The gross profit margin in Other decreased to 28% in 2005 from 36% in 2004 due to the inclusion of lower margins from the Casting Products business and lower margins in our Fiber-based granular product line due to an increase in the cost of natural gas used in the production of our fiber-based granules. We expect the gross profit margin in the Fiber-based granular product line to continue to be negatively affected by significantly higher costs of natural gas used in the manufacturing process.

Operating Expenses

Selling, general, and administrative expenses as a percentage of revenues were 31% and 29% in 2005 and 2004, respectively. Selling, general, and administrative expenses increased $18.3 million, or 32%, to $74.6 million in 2005 from $56.3 million in 2004. This increase included a $9.0 million, or 37%, increase in general and administrative expenses and a $9.3 million, or 29%, increase in selling expenses.

The increase in general and administrative expenses included $9.9 million of general and administrative expenses from recently acquired Kadant Johnson and a $1.0 million increase associated with a gain which lowered general and administrative expenses in 2004. The gain of $1.0 million in the first quarter of 2004 resulted from the renegotiation of a series of agreements with one of our licensees. These increases were offset in part by a $1.3 million decrease due to expense reductions at the Papermaking Systems segment, a $0.7 million decrease in severance costs associated with our European operations, and a $0.5 million decrease in bad debt expense.

The increase in selling expenses was due primarily to $9.1 million associated with recently acquired Kadant Johnson and a $0.4 million increase from the unfavorable effect of foreign currency translation.

Research and development expenses as a percentage of revenues were 2% and 1% in 2005 and 2004, respectively. Research and development expenses increased $1.8 million to $4.9 million in 2005 compared to $3.1 million in 2004 due to the inclusion of $1.0 million of research and development expenses associated with Kadant Johnson and a $0.8 million increase in research and development projects at the Papermaking Systems segment.

Restructuring and Other Costs (Income)

During 2005, we recorded restructuring income of $0.1 million, which included $0.2 million of restructuring costs and $0.3 million of curtailment gain. The restructuring costs of $0.2 million in 2005 included $0.1 million of income resulting from the reduction in the estimated restructuring costs associated with the Kadant Lamort restructuring initiated in 2004 and $0.3 million in restructuring costs associated with 2005 restructuring actions. The 2005 restructuring costs include $0.2 million of severance and associated costs related to the reduction of 14 full-time positions in the U.S. and $0.1 million for equipment relocation costs, both in our Papermaking Systems segment. We estimate annualized savings of $0.6 million in selling, general, and administrative expenses and $0.8 million in cost of revenues from these restructuring actions. The $0.3 million curtailment gain in 2005 resulted from a reduction in the accrued liability for Kadant Lamort s pension plan associated with the Kadant Lamort restructuring initiated in 2004.

During 2004, we recorded restructuring costs of $9.5 million, which were accounted for in accordance with Statement of Financial Accounting Standards (SFAS) No. 112. Restructuring costs of $9.2 million related to severance and other termination costs for 97 employees across all functions at the Papermaking Systems segment s Kadant Lamort subsidiary. These actions were taken in an effort to strengthen Kadant Lamort s competitive position in the European paper industry. In addition, we recorded restructuring costs of $0.3 million, related to severance costs for 11 employees at one of the Papermaking Systems segment s U.S. subsidiaries. We estimate annualized savings of $5.6 million ($3.6 million in cost of revenues and $2.0 million in selling, general, and administrative expenses) from these restructuring actions when fully implemented (see Note 8 to the consolidated financial statements).

Interest Income

Interest income was $1.5 million in 2005 and 2004. During 2005, the increase in interest income due to higher prevailing interest rates was largely offset by the decrease in average cash balances primarily resulting from the May 2005 acquisition of Kadant Johnson.

Interest Expense

Interest expense increased to $2.1 million in 2005 from $23 thousand in 2004 primarily due to interest expense associated with the $60.0 million in borrowings entered into in May 2005 to fund the Kadant Johnson acquisition.

Income Taxes

Our effective tax rate was 28% and 30% in 2005 and 2004, respectively. The 28% effective tax rate in 2005 included a 6% non-recurring tax benefit resulting from a payment of $0.9 million received from our former parent company under a tax agreement and a 1% non-recurring tax benefit resulting from a reduction of $0.1 million in tax reserves. The 30% effective tax rate in 2004 was lower than the statutory federal income tax rate primarily due to a reorganization of several of our foreign subsidiaries that resulted in a more tax-efficient corporate structure. We expect our effective tax rate to be approximately 35% in 2006.

Minority Interest

Minority interest expense in 2005 and 2004 represents minority investors share of earnings in our majority-owned subsidiaries.

Income from Continuing Operations

Income from continuing operations increased to $9.9 million in 2005 from $5.8 million in 2004, an increase of $4.1 million, or 71%. This increase includes a $1.9 million increase from the inclusion of Kadant Johnson and a $6.1 million increase due to the decrease in after-tax restructuring costs.

Loss from Discontinued Operation

On October 21, 2005, our Kadant Composites LLC subsidiary (Kadant Composites LLC) sold substantially all of its assets, comprising the composites business, to LDI Composites Co. As part of the sale transaction, Kadant Composites LLC retained the warranty obligations associated with products manufactured prior to the sale date. All future activity associated with this warranty reserve will continue to be classified in the results of the discontinued operation.

Loss from discontinued operation decreased to $3.0 million in 2005 from $5.1 million in 2004, a decrease of $2.1 million due primarily to a $1.2 million pre-tax decrease in warranty costs and a decrease in operating costs prior to the sale.

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Kadant Inc. **2005 Annual Report**

2004 Compared to 2003

The following table sets forth our consolidated statement of operations expressed as a percentage of total revenue for the years ending January 1, 2005 and January 3, 2004.

	January 1, 2005	January 3, 2004
Revenues	100%	100%
Costs and Operating Expenses:		
Cost of revenues	61	61
Selling, general, and administrative expenses	29	26
Research and development expenses	1	2
Restructuring and other costs (income), net	5	
	96	89
Operating Income	4	11
Interest Income (Expense), Net		
Income from Continuing Operations Before Income Taxes and Minority Interest	4	11
Provision for Income Taxes	1	4
Income from Continuing Operations	3	7
Loss from Discontinued Operation	(3)	(1)
Net Income	%	6%

Revenues

Revenues increased to $195.0 million in 2004 from $191.5 million in 2003, an increase of $3.5 million, or 2%. Revenues in 2004 include the favorable effects of currency translation of $7.5 million, or 4%, due to a weaker U.S. dollar relative to most of the functional currencies in countries in which we operate.

Revenues from our Papermaking Systems segment and other businesses for the years ending January 1, 2005 and January 3, 2004 are as follows:

(In thousands)	January 1, 2005	January 3, 2004
Revenues:		
Pulp and Papermaking Systems	$ 188,320	$ 185,708
Other	6,646	5,799
	$ 194,966	$ 191,507

Pulp and Papermaking Systems. Revenues for the Papermaking Systems segment increased to $188.3 million in 2004 compared with $185.7 million in 2003, an increase of $2.6 million, or 1%. The increase in revenues in 2004 includes a 4% increase from the favorable effect of currency translation.

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Revenues at the Papermaking Systems segment by product line were as follows:

(In millions)	2004	2003	Increase (Decrease)	Decrease Excluding Effect of Currency Translation
Product Line:				
Accessories	$ 62.7	$ 60.8	$ 1.9	$ (1.4)
Stock-Preparation Equipment	95.4	93.9	1.5	(2.1)
Water-Management	28.8	29.5	(0.7)	(1.3)
Other	1.4	1.5	(0.1)	(0.1)
	$ 188.3	$ 185.7	$ 2.6	$ (4.9)

Revenues from the segment s accessories product line increased by $1.9 million, or 3%, in 2004, including a $3.3 million increase from the favorable effect of currency translation. Excluding the effect of currency translation, revenues from the segment s accessories product line decreased $1.4 million, or 2%, due to a $3.3 million, or 14%, decrease in sales in Europe due to weaker demand partially offset by a $1.9 million, or 5%, increase in sales in North America. Revenues from the segment s stock-preparation equipment product line increased by $1.5 million, or 2%, in 2004, including a $3.6 million increase from the favorable effect of currency translation. Excluding the effect of currency translation, revenues from the stock-preparation equipment product line decreased $2.1 million, or 2%, due to a $2.4 million, or 7%, decrease in sales in Europe due to weaker demand. Revenues from the segment s water-management product line decreased $0.7 million, or 2%, in 2004, including a $0.6 million increase from the favorable effect of currency translation. Excluding the effect of currency translation, revenues from the segment s water-management product line decreased by $1.3 million, or 4%, due primarily to a $1.8 million, or 7%, decrease in sales in North America.

Other. Revenues from our Fiber-based Products business increased to $6.6 million in 2004 from $5.8 million in 2003, an increase of $0.8 million, or 15%, due to stronger sales of Biodac®, our line of biodegradable granular products.

Gross Profit Margin

Gross profit margin for the years ending January 1, 2005 and January 3, 2004 were as follows:

	January 1, 2005	January 3, 2004
Gross Profit Margin:		
Pulp and Papermaking Systems	39%	39%
Other	36%	37%
	39%	39%

Gross profit margin was 39% in 2004 and 2003. The gross profit margin at the Papermaking Systems segment remained constant at 39% in 2004 and 2003. The gross profit margin in Other decreased to 36% in 2004 from 37% in 2003 due to an increase in the cost of natural gas used in the production of our fiber-based granules.

Operating Expenses

Selling, general, and administrative expenses as a percentage of revenues were 29% and 26% in 2004 and 2003, respectively. Selling, general, and administrative expenses increased $5.9 million, or 12%, to $56.3 million in 2004 from $50.4 million in 2003. This increase included a $3.3 million, or 16%, increase in general and administrative expenses and a $2.6 million, or 9%, increase in selling expenses. The increase in general and

administrative expenses includes a $1.1 million increase in the costs associated with the implementation of the internal control requirements of the Sarbanes-Oxley Act, a $1.0 million increase in bad debt expense, which in part was due to recoveries of $0.3 million in 2003, a $0.7 million increase from the unfavorable effect of foreign currency translation at the Papermaking Systems segment, a $0.4 million increase in severance costs associated with our European operations, and a $0.4 million increase associated with several projects under way to further streamline our international organization. Also included in general and administrative expenses, offsetting the expenses noted above, was a gain of approximately $1.0 million in the first quarter of 2004, which resulted from renegotiating a series of agreements with one of our licensees. The increase in selling expenses includes a $1.4 million increase from the unfavorable effect of foreign currency translation.

Research and development expenses as a percentage of revenues were 1% and 2% in 2004 and 2003, respectively. Research and development expenses decreased $1.2 million to $3.1 million in 2004 compared to $4.3 million in 2003 due to the timing of research and development projects at the Papermaking Systems segment.

Restructuring and Other Costs (Income)

During 2004, we recorded restructuring costs of $9.5 million, which were accounted for in accordance with Statement of Financial Accounting Standards (SFAS) No. 112. Restructuring costs of $9.2 million related to severance and other termination costs for 97 employees across all functions at the Papermaking Systems segment s Kadant Lamort subsidiary. These actions were taken in an effort to strengthen Kadant Lamort s competitive position in the European paper industry. In addition, we recorded restructuring costs of $0.3 million related to severance costs for 11 employees at one of the Papermaking Systems segment s U.S. subsidiaries. We estimate annualized savings of $5.6 million ($3.6 million in cost of revenues and $2.0 million in selling, general, and administrative expenses) from these restructuring actions when fully implemented (see Note 8 to the consolidated financial statements).

During 2003, we recorded net restructuring and other income of $23 thousand. Restructuring costs of $0.6 million, which were accounted for in accordance with SFAS No. 112, related to severance costs for seven employees across all functions at the Papermaking Systems segment s Kadant Lamort subsidiary. These actions were taken in an effort to improve profitability and were in response to a continued weak market environment and reduced demand for our products. Annual savings from these actions, included primarily in cost of revenues, were approximately $0.4 million. We recorded a gain of $0.6 million from the sale of property, for approximately $0.9 million in cash, at the same subsidiary.

Interest Income

Interest income increased to $1.5 million in 2004 from $1.0 million in 2003 primarily due to higher prevailing interest rates.

Income Taxes

Our effective tax rate was 30% and 38% in 2004 and 2003, respectively. The 30% effective tax rate in 2004 was lower than the statutory federal income tax rate primarily due to a reorganization of several of our foreign subsidiaries that resulted in a more tax-efficient corporate structure. The 38% effective tax rate in 2003 exceeded the statutory federal income tax rate primarily due to the impact of state income taxes and nondeductible expenses.

Minority Interest

Minority interest expense in 2004 and 2003 represents minority investors share of earnings in our majority-owned subsidiaries.

Income from Continuing Operations

Income from continuing operations decreased to $5.8 million in 2004 from $13.1 million in 2003, a decrease of $7.3 million, or 56%, due primarily to the increase in pre-tax restructuring costs of $9.5 million in 2004 compared to 2003.

Loss from Discontinued Operation

Loss from discontinued operation increased to $5.1 million in 2004 from $1.3 million in 2003, an increase of $3.8 million primarily due to a $4.8 million pre-tax increase in warranty costs. We experienced a substantial increase in warranty claims in 2004 compared to 2003. The claims were associated with contraction of certain decking products and with a new problem concerning excessive oxidation that affected the integrity of the plastic used in some of our decking products. As a result of the increased claims and our estimate of future claims, we increased our warranty expense to $6.7 million in 2004 compared to $1.9 million in 2003. Included in the increased warranty expense is the cost of exchanging material held by our distributors with new material and our best estimate of costs related to future potential valid claims arising from the installed product.

Liquidity and Capital Resources

Consolidated working capital was $75.4 million at December 31, 2005, compared with $113.7 million at January 1, 2005. Included in working capital are cash and cash equivalents of $40.8 million at December 31, 2005, compared with $82.1 million at January 1, 2005. At December 31, 2005, $24.3 million of cash and cash equivalents was held by our foreign subsidiaries.

2005

Cash provided by operating activities was $17.7 million in 2005, including $19.1 million provided by continuing operations and $1.4 million used by the discontinued operation. The cash provided by operating activities in 2005 was primarily the result of $9.9 million of income from continuing operations, a non-cash charge of $6.9 million for depreciation and amortization expense, and a decrease in inventory of $4.4 million, offset in part by a decrease in accounts payable, which used cash of $4.5 million. The cash used by the discontinued operation of $1.4 million resulted primarily from the net loss of $3.0 million due primarily to the pre-tax warranty provision of $5.5 million and a decrease in accounts payable of $1.1 million due to payments made prior to the sale date. These items were offset in part by a decrease in accounts receivable due to collections made prior to the sale date, which provided cash of $1.2 million and an increase in other current liabilities of $1.8 million due primarily to an increase in payments owed to the Buyer as reimbursement for claims paid on behalf of Kadant Composites LLC.

Cash used for investing activities was $100.9 million in 2005, including $106.4 million used by continuing operations and $5.5 million provided by the discontinued operation. We used cash of $103.6 million in 2005 to acquire the stock of The Johnson Corporation. We used $3.2 million in 2005 to purchase property, plant, and equipment. We also used cash of $1.1 million in 2005 to acquire the remaining minority interest in one of our Kadant Johnson subsidiaries. The cash provided by discontinued operation of $5.5 million relates primarily to the unrestricted cash proceeds received from the sale of the majority of the assets of the discontinued operation.

Our financing activities provided cash of $50.1 million in 2005 related entirely to our continuing operations. In 2005, we received proceeds of $60.0 million from a term loan we entered into to fund a portion of the purchase price for Kadant Johnson. We also increased our short- and long-term obligations by $4.0 million, which represents additional consideration for Kadant Johnson to be paid over the next five years. During 2005, we purchased 486,400 shares of our common stock on the open market for $9.1 million and repaid $5.5 million of long-term obligations.

2004

Cash provided by operating activities was $13.2 million in 2004, including $12.9 million from continuing operations and $0.3 million from the discontinued operation. The cash provided by operating activities in 2004 was primarily the result of $5.8 million of income from continuing operations, a non-cash charge of $3.6 million for depreciation and amortization expense, and an increase in provision for warranty obligations of $2.7 million, offset in part by a decrease in accounts payable, which used cash of $2.6 million. The cash provided by the discontinued operation of $0.3 million relates primarily to a non-cash charge for depreciation and amortization expense of $0.9 million and an increase in other current liabilities which provided cash of $3.7 million due primarily to an increase in accrued warranty. In addition, a decrease in inventory provided cash of $1.4 million and an increase in accounts payable provided cash of $0.6 million. These items were offset in part by a net loss of $5.1 million due primarily to the pre-tax warranty provision of $6.7 million and an increase in accounts receivable of $1.1 million.

Cash used for investing activities was $3.5 million in 2004, including $3.2 million used by continuing operations and $0.3 million used by the discontinued operation. During 2004, we purchased property, plant, and equipment for $2.2 million and paid $1.9 million in acquisition-related costs for Kadant Johnson, offset in part by proceeds of $1.3 million received from the sale of property, plant, and equipment. The cash used by the discontinued operation of $0.3 million relates primarily to the purchase of property, plant, and equipment.

Our financing activities used cash of $5.4 million in 2004, related entirely to our continuing operations. During 2004, we purchased 509,000 shares of our common stock on the open market for $10.3 million and repaid $0.6 million of long-term obligations. In addition, in 2004 we received proceeds of $5.5 million from the issuance of common stock in connection with our employee stock option and stock purchase plans.

Additional Liquidity and Capital Resources

We completed our acquisition of Kadant Johnson on May 11, 2005 for $101.5 million in cash, subject to a post-closing adjustment, and $4.7 million of acquisition-related costs. In addition to the cash consideration, we issued a letter of credit to the sellers for $4.0 million, subject to adjustment, related to certain tax assets of Kadant Johnson, the value of which we expect to realize. The parties also agreed to an earn-out provision, based on the achievement of certain revenue targets between the closing date (May 11, 2005) and July 1, 2006, which could increase the purchase price by up to $8.0 million. Based on our current forecasts, we do not believe that a significant payout under the earn-out provision is likely.

To fund $60 million of the purchase price, we entered into a term loan and revolving credit facility (the Credit Agreement) effective as of May 9, 2005 in the aggregate principal amount of up to $85 million, including a $25 million revolver. The Credit Agreement includes a $60 million term loan, which is repayable in quarterly installments over a five-year period. The aggregate principal amount to be repaid each year is as follows: $9 million, $10.5 million, $13.5 million, $15 million, and $7.5 million in 2006, 2007, 2008, 2009, and 2010, respectively. Interest on the revolving loan and the term loan accrues and is payable quarterly in arrears at one of the following rates selected by us: (a) the prime rate plus an applicable margin initially set at 0% for 2005, and up to 0.25% thereafter or, (b) a eurocurrency rate plus an applicable margin initially set at 1% for 2005, and between 0.625% and 1.25% thereafter. The applicable margin is determined based upon our total debt to earnings before interest, taxes, depreciation and amortization (EBITDA) ratio, as defined in the Credit Agreement.

Our obligations under the Credit Agreement may be accelerated upon the occurrence of an event of default under the Credit Agreement, which include customary events of default including, without limitation, payment defaults, defaults in the performance of affirmative and negative covenants, the inaccuracy of representations or warranties, bankruptcy- and insolvency-related defaults, defaults relating to such matters as ERISA, uninsured judgments and the failure to pay certain indebtedness, and a change-of-control default.

In addition, the Credit Agreement contains negative covenants applicable to us and our subsidiaries, including financial covenants requiring us to comply with a maximum consolidated leverage ratio of 3.0, which is lowered to 2.5 in certain circumstances, and a minimum consolidated fixed charge coverage ratio of 1.5. Pursuant to an amendment to the Credit Agreement effective December 28, 2005, this maximum consolidated leverage ratio is increased to 2.75 in the quarter in which we complete the proposed acquisition of a manufacturer of stock preparation equipment in China and in the following quarter. In addition to the financial covenants, we are also required to comply with covenants related to restrictions on liens, indebtedness, fundamental changes, dispositions of property, making certain restricted payments (including dividends and stock repurchases), investments, transactions with affiliates, sale and leaseback transactions, swap agreements, changing our fiscal year, negative pledges, arrangements affecting subsidiary distributions, and entering into new lines of business. As of December 31, 2005, we were in compliance with these covenants.

The loans under the Credit Agreement are guaranteed by certain of our domestic subsidiaries and secured by a pledge of 65% of the stock of our first-tier foreign subsidiaries and our subsidiary guarantors pursuant to a guarantee and pledge agreement effective May 9, 2005 in favor of JPMorgan Chase Bank, N.A., as agent on behalf of the lenders.

In May 2004, our board of directors authorized the repurchase of up to $30.0 million of our equity securities in the open market or in negotiated transactions through May 18, 2005. We repurchased 460,400 and 109,700 shares of our common stock for $9.4 million and $2.0 million in 2004 and 2005, respectively, under this authorization. We also repurchased an additional 48,600 shares of our common stock for $0.9 million in 2004 under a previous authorization.

On May 6, 2005, our board of directors authorized the repurchase of up to $15.0 million of our equity securities in the open market or in negotiated transactions for the period from May 18, 2005 through May 18, 2006. As of December 31, 2005, we had repurchased 376,700 shares of our common stock for $7.1 million under this authorization.

On October 22, 2004, the American Jobs Creation Act of 2004 (the Act) was signed into law. The Act created a temporary incentive for U.S. multinationals to repatriate accumulated income earned outside the U.S. at an effective tax rate of 5.25%. After evaluating the effect of the law on our unremitted foreign earnings, we have determined that due to various factors, there is no benefit to us. Therefore, it will remain our practice to reinvest indefinitely the earnings of our international subsidiaries, except in instances in which we can remit such earnings without a significant associated tax cost. Through December 31, 2005, we have not provided U.S. income taxes on approximately $53.5 million of unremitted foreign earnings. We believe that any U.S. tax liability due upon remittance of such earnings would be immaterial due to the availability of U.S. foreign tax credits generated from such remittance. The related foreign tax withholding, which would be required if we remitted the foreign earnings to the U.S., would be approximately $2.3 million.

On January 21, 2006, on behalf of our wholly foreign owned enterprise formed in China, we entered into an Asset Purchase Agreement with Jining Huayi Light Industry Machinery Co., Ltd. (Huayi) to acquire substantially all the assets of Huayi, a supplier of stock-preparation equipment in China, for approximately $20 million, subject to adjustment. We expect to finance the acquisition through a combination of cash and borrowings, in China or under our existing $25 million revolver, which is part of our credit facility entered into in May 2005, with a consortium of banks with JPMorganChase Bank as administrative agent. The closing of the acquisition is subject to customary closing conditions, including regulatory approvals and the approval of our board of directors and Huayi s board of directors and shareholders. The closing is expected to occur in the second quarter of 2006.

On October 21, 2005, Kadant Composites LLC sold its composites business, presented as a discontinued operation in the accompanying consolidated financial statements. As part of the transaction, Kadant Composites LLC retained the warranty obligation associated with products manufactured prior to the sale date. At December 31, 2005, the warranty reserve for the composites business was $5.3 million. Our liquidity and consolidated results will continue to be impacted by future cash payments for warranty claims and any adjustments to this warranty obligation. Adjustments to our results for these items will continue to be classified within the results for the discontinued operation in our consolidated financial statements.

Although we currently have no material commitments for capital expenditures, we plan to make expenditures during 2006 for property, plant, and equipment of approximately $4.1 million.

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Contractual Obligations and Other Commercial Commitments

The following table summarizes the Company s known contractual obligations and commercial commitments to make future payments or other consideration pursuant to certain contracts as of December 31, 2005, as well as an estimate of the timing in which these obligations are expected to be satisfied. Detailed information concerning these obligations and commitments can be found in Notes 2, 7 and 8 to our consolidated financial statements.

	Payments Due by Period or Expiration of Commitment				
(In millions)	**Less than 1 Year**	**1-3 Years**	**4-5 Years**	**After 5 Years**	**Total**
Contractual Obligations: (a)					
Long-term debt obligations	$ 9.0	$ 24.0	$ 22.5	$	$ 55.5
Operating lease obligations	1.9	1.5	0.1		3.5
Kadant Johnson acquisition consideration (b)	0.6	1.2	2.2		4.0
Commercial Commitments: (c)					
Letters of credit	12.4	2.5			14.9
Total (d)	$ 23.9	$ 29.2	$ 24.8	$	$ 77.9

(a) We have purchase obligations related to the acquisition of raw material made in the ordinary course of business that may be terminated with minimal notice and are excluded from this analysis.

(b) In addition to the consideration paid at closing for Kadant Johnson, we issued a letter of credit to the sellers for $4.0 million related to certain tax assets of Kadant Johnson, the value of which we expect to realize. This amount is subject to adjustment based on The Johnson Corporation s final tax return for 2005. The table above excludes contingent consideration of $8.0 million associated with the Kadant Johnson acquisition. The parties agreed in the purchase agreement to an earn-out provision, based on the achievement of certain revenue targets between the closing date of May 11, 2005 and July 1, 2006, which could increase the purchase price by up to $8.0 million. Based on our current forecasts, we do not believe that a significant payout under the earn-out provision is likely.

(c) In the ordinary course of business, we are required to issue limited performance guarantees, which do not require letters of credit, relating to our equipment and systems. We typically limit our liability under these guarantees to amounts that would not exceed the value of the contract. We believe that we have adequate reserves for any potential liability in connection with such guarantees. These guarantees are not included in this table.

(d) This table excludes $4.8 million of accrued restructuring costs and $7.4 million of other long-term liabilities related primarily to pension plans, as these liabilities are not subject to fixed payment terms. We expect that the accrued restructuring costs will be paid in 2006.

Provisions in financial guarantees or commitments, debt or lease agreements, or other arrangements could trigger a requirement for an early payment, additional collateral support, amended terms, or acceleration of maturity.

We do not have special-purpose entities nor do we use off-balance-sheet financing arrangements.

In the future, our liquidity position will be primarily affected by the level of cash flows from operations and the amount of cash expended on debt repayments, capital projects, stock repurchases, or additional acquisitions, if any. We believe that our existing resources, together with the cash available from our credit facility and the cash we expect to generate from continuing operations, are sufficient to meet the capital requirements of our current operations for the foreseeable future.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risk from changes in interest rates and foreign currency exchange rates, which could affect our future results of operations and financial condition. We manage our exposure to these risks through our regular operating and financing activities. We entered into a receive-variable and pay-fixed swap agreement in 2005 to hedge a portion of our variable rate long-term debt. Additionally, we use short-term forward contracts to manage certain exposures to foreign currencies. We enter into forward foreign exchange contracts to hedge firm purchase and sale commitments denominated in currencies other than our subsidiaries local currencies. We do not engage in extensive foreign currency hedging activities; however, the purpose of our foreign currency hedging activities is to protect our local currency cash flows related to these commitments from fluctuations in foreign exchange rates. Our forward foreign exchange contracts principally hedge transactions denominated in U.S. dollars. Gains and losses arising from forward contracts are recognized as offsets to gains and losses resulting from the transactions being hedged. We do not use financial instruments for trading purposes.

Interest Rates

Our cash and cash equivalents are sensitive to changes in interest rates. Interest rate changes would result in a change in interest income due to the difference between the current interest rates on cash and cash equivalents and the variable rates to which these financial instruments may adjust in the future. A 10% decrease in year-end interest rates would have resulted in a negative impact on our net income of $0.1 million in both 2005 and 2004.

A portion of our outstanding debt of $55.5 million as of year-end 2005 is sensitive to changes in interest rates. We hedged $33.3 million of the debt with a receive-variable pay-fixed swap agreement. The fair value of the swap agreement is sensitive to changes in the 4-year Treasury bill rate. A 10% decrease in the year-end 4-year Treasury bill rate would have resulted in an increase of unrealized losses of $0.3 million as of year-end 2005. The remaining unhedged portion of the debt totaling $22.2 million as of year-end 2005 is sensitive to changes in interest rates. As of year-end 2005, the interest rate on the unhedged portion of the debt was based on LIBOR. A 10% increase in the year-end LIBOR rate would have resulted in a negative impact on our net income of $0.1 million in 2005.

Currency Exchange Rates

We generally view our investment in foreign subsidiaries in a functional currency other than our reporting currency as long-term. Our investment in foreign subsidiaries is sensitive to fluctuations in foreign currency exchange rates. The functional currencies of our foreign subsidiaries are principally denominated in euros, British pounds sterling, Mexican pesos, Canadian dollars, Chinese renminbi and Brazilian reals. The effect of changes in foreign exchange rates on our net investment in foreign subsidiaries is reflected in the accumulated other comprehensive items component of shareholders investment. A 10% depreciation in functional currencies at year-end 2005 and 2004, relative to the U.S. dollar, would have resulted in a reduction in shareholders investment of $6.7 million and $5.0 million, respectively.

The fair value of forward foreign exchange contracts is sensitive to fluctuations in foreign currency exchange rates. The fair value of forward foreign exchange contracts is the estimated amount that we would pay or receive upon termination of the contracts, taking into account the change in foreign currency exchange rates. A 10% depreciation in year-end 2005 and 2004 foreign currency exchange rates related to our contracts would have resulted in an increase in unrealized losses on forward foreign exchange contracts of $0.3 million in both 2005 and 2004. Since we use forward foreign exchange contracts as hedges of firm purchase and sale commitments, the unrealized gain or loss on forward foreign currency exchange contracts resulting from changes in foreign currency exchange rates would be offset by corresponding changes in the fair value of the hedged items.

Item 8. Financial Statements and Supplementary Data

This data is submitted as a separate section to this Report. See Item 15, Exhibits and Financial Statement Schedules.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2005. The term disclosure controls and procedures, as defined in Securities Exchange Act Rules 13a-15(e) and 15d-15(e), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by the company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported, within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based upon the evaluation of our disclosure controls and procedures as of December 31, 2005, our Chief Executive Officer and Chief Financial Officer concluded that as of December 31, 2005, our disclosure controls and procedures were effective at the reasonable assurance level.

Evaluation of Changes in Internal Controls over Financial Reporting

In May 2005 we acquired The Johnson Corporation (Kadant Johnson), a private company with internal control procedures that had not been designed for public company reporting. Prior to our acquisition, Kadant Johnson s independent certified public accountants identified material weaknesses in Kadant Johnson s controls over the inventory reserve calculation and financial close procedures. Kadant Johnson adjusted their inventory obsolescence reserve before the acquisition date by restating prior periods to increase their reserve in compliance with our policy and generally accepted accounting principles. In addition, we added internal control procedures to ensure that Kadant Johnson s disclosure controls, as they relate to Kadant s consolidated financial reporting, were adequate and in compliance with our policies and procedures. As a result, we made a number of changes to internal controls over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended) during 2005 including:

- reviewing and strengthening Kadant Johnson s tax accounting process,
- reviewing and strengthening Kadant Johnson s intercompany reconciliation process,
- enhancing the documentation relating to Kadant Johnson s reserve calculations for accounts receivable and warranties to comply with its policies, and
- accelerating and improving Kadant Johnson s financial close procedures.

Other than the changes resulting from our acquisition of Kadant Johnson outlined above, there have not been any changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended) during the fiscal quarter ended December 31, 2005 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Management s Report on Internal Control over Financial Reporting

We are continuing the process of evaluating Kadant Johnson s internal controls and, as of the date of this report, have not yet completed our evaluation. As permitted, we will be excluding this acquisition from our reporting under Section 404 of the Sarbanes-Oxley Act of 2002 at December 31, 2005.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Securities Exchange Act Rules 13a-15(f) and 15d-15(f). Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2005, excluding the internal controls at Kadant Johnson. In making this assessment, our management used the criteria set forth in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our assessment, management believes that, as of December 31, 2005 our internal control over financial reporting, excluding the internal controls at Kadant Johnson, is effective based on the criteria issued by COSO.

Because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our independent registered public accountants, Ernst & Young LLP, have issued an audit report on our assessment of our internal control over financial reporting, which is included herein on page F-3.

Item 9B. Other Information

Not applicable.

PART III

Item 10. Directors and Executive Officers of the Registrant

The information concerning directors is included under the heading Election of Directors in our 2006 proxy statement for our 2006 Annual Meeting of Shareholders and is incorporated in this Report by reference. The information concerning executive officers is included under the heading Executive Officers of the Registrant in Item 1 of Part I of this Report.

The information required under Item 405 of Regulation S-K is included under the heading Stock Ownership Section 16(a) Beneficial Ownership Reporting Compliance in our 2006 proxy statement and is incorporated in this Report by reference.

The information required under Item 406 of Regulation S-K is included under the heading Election of Directors Corporate Governance Code of Business Conduct and Ethics in our 2006 proxy statement and is incorporated in this Report by reference.

Item 11. Executive Compensation

This information is included under the heading Executive Compensation in our 2006 proxy statement and is incorporated in this Report by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Except for the information concerning equity compensation plans, this information is included under the heading Stock Ownership in our 2006 proxy statement and is incorporated in this Report by reference.

The following table provides information about the securities authorized for issuance under our equity compensation plans as of December 31, 2005:

Equity Compensation Plan Information

Plan Category	(a) Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants, and Rights	(b) Weighted-Average Exercise Price of Outstanding Options, Warrants, and Rights	(c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a))
Equity compensation plans approved by security holders	1,377,168(1)	$ 16.30(1)	486,439(2)
Equity compensation plans not approved by security holders (3)	322,204	$ 13.73	12,002
Total	1,699,372(1)	$ 15.82(1)	498,441(2)

(1) Excludes an aggregate of 263,950 shares of common stock issuable under our employees stock purchase plan in connection with current and future offering periods under the plan. Excludes 2,569 shares reserved for issuance pursuant to our deferred compensation plan for directors.

(2) Includes 263,950 shares of common stock issuable under our employees stock purchase plan in connection with current and future offering periods under the plan.

(3) The material features of our 2001 employee equity incentive plan are described in Part IV, Item 15, Exhibits and Financial Statement Schedules, Note 3, which begins on page F-1 of this Report.

Item 13. Certain Relationships and Related Transactions

This information is included under the heading Certain Relationships and Related Transactions in our 2006 proxy statement and is incorporated in this Report by reference.

Item 14. Principal Accountant Fees and Services

This information is included under the heading Independent Auditors in our 2006 proxy statement and is incorporated in this Report by reference.

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PART IV

Item 15. Exhibits and Financial Statement Schedules

The following documents are filed as part of this Report:

(1) Consolidated Financial Statements (see Index on Page F-1 of this Report):
Report of Independent Registered Public Accounting Firm on Consolidated Financial Statements and Schedule

Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting

Consolidated Statement of Operations

Consolidated Balance Sheet

Consolidated Statement of Cash Flows

Consolidated Statement of Comprehensive Income and Shareholders Investment

Notes to Consolidated Financial Statements

(2) Consolidated Financial Statement Schedule (see Index on Page F-1 of this Report):
Schedule II: Valuation and Qualifying Accounts

All other schedules are omitted because they are not applicable or not required, or because the required information is shown either in the consolidated financial statements or in the notes thereto.

(3) Exhibits filed herewith or incorporated in this Report by reference are set forth in the Exhibit Index on page 34. This list of exhibits identifies each management contract or compensatory plan or arrangement required to be filed as an exhibit to this Report.

Signatures

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: March 16, 2006

KADANT INC.

By: /s/ WILLIAM A. RAINVILLE

William A. Rainville

Chairman of the Board, Chief Executive Officer,

and President

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated, on March 16, 2006.

Signature	**Title**
By: /s/ WILLIAM A. RAINVILLE **William A. Rainville**	Chairman of the Board, Chief Executive Officer, and P