

FLANDERS CORP  
Form 10-K/A  
September 12, 2006

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

**FORM 10-K/A**  
**AMENDMENT NO.2**

(Mark One)

**Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the year ended December 31, 2005

or

**Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-27958

**FLANDERS CORPORATION**

(Exact name of registrant as specified in its charter)

North Carolina

13-3368271

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(State or other jurisdiction of incorporation or organization)

2399 26th Avenue North, St. Petersburg, FL

(Address of principal executive offices)

(IRS Employer ID Number)

33734

(Zip Code)

Registrant's telephone number, including area code: (727) 822-4411

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

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

Title of each class

Common Stock, \$.001 per share par value

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

Indicate by check mark 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 registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

YES

NO

As of June 30, 2005, the aggregate market value of the voting stock held by non-affiliates of the registrant was approximately \$158.6 million.

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

YES

NO

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

YES

NO

As of February 20, 2006, the number of shares outstanding of the registrant's common stock was 26,340,408 shares.

Documents incorporated into this report on Form 10-K by reference: None.

**Explanatory Note:**

This Amendment No.2 on Form 10-K amends in certain technical respects Item 9A - Controls and Procedures to separately state that as of December 31, 2005 our Chief Financial Officer and Chief Executive Officer concluded our disclosure controls and procedures were adequate and that no changes in our internal controls over financial reporting occurred during the year ended December 31, 2005 that materially affected or are likely to materially affect our internal control over financial reporting. Also includes, as an exhibit to the filing, a stock option agreement to John Hodson. All other information contained in this Annual Report on Form 10-K/A remains unchanged.

**FLANDERS CORPORATION**

**FORM 10-K**

**FOR THE YEAR ENDED DECEMBER 31, 2005**

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**PART I**

**Item 1.**

**Business**

**OVERVIEW**

We design, manufacture and market air filters and related products, and are focused on providing complete environmental filtration systems for end uses ranging from controlling contaminants in residences and commercial office buildings through specialized manufacturing environments for semiconductors, pharmaceuticals, chemical, biological, radiological and nuclear processing. Currently, we believe, based on available trade and industry data, that we are one of the largest domestic manufacturers of air filters that are utilized by many industries including those associated with commercial and residential heating, ventilation and air conditioning systems (commonly known as HVAC systems), semiconductor manufacturing, ultra-pure materials, chemical, biological, radiological and materials processing, biotechnology, pharmaceuticals, synthetics, nuclear power and nuclear materials processing. We also design and manufacture much of our own production equipment to automate our processes in order to decrease labor costs associated with our standard products. Additionally, we produce glass-based air filter media for many of our products. Our customers include Abbott Laboratories, The Home Depot, Inc., Motorola, Inc., Merck & Co., Inc., Upjohn Co., Wal-Mart Stores, Inc., Westinghouse Electric Corp., and several large computer chip manufacturers.

The majority of our revenues come from the sale of after-market replacement filters, since air filters are typically placed in equipment designed to last much longer than the filters.

**GENERAL DEVELOPMENT OF BUSINESS**

Flanders Corporation was originally incorporated on July 2, 1986 in the State of Nevada, but is currently incorporated in the State of North Carolina. Our principal executive offices are currently located at 2399 26<sup>th</sup> Avenue North, St. Petersburg, FL 33713. The Company's internet website address is [www.flanderscorp.com](http://www.flanderscorp.com). The information contained on our website is not part of our reports with the Securities and Exchange Commission and is not incorporated by reference into this report. The Company's annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K, and all amendments thereto, are available free of charge on the Company's website as soon as reasonably practicable after such reports are electronically filed with, or furnished to, the Securities and Exchange Commission.

**FORWARD-LOOKING STATEMENTS AND ASSOCIATED RISKS**

This annual report, including all documents incorporated herein by reference, includes certain forward-looking statements within the meaning of that term in Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934, including, among others, those statements preceded by, following or including the words believe, expect, anticipate or similar expressions. These forward-looking statements are based largely on the current expectations of management and are subject to a number of risks and uncertainties. Actual results could differ materially from these forward-looking statements. In addition to the other risks described in the Factors That May Affect Future Results discussion under Management's Discussion and Analysis of Financial Condition and Results of Operations in Part II of this annual report, important factors to consider in evaluating such forward-looking statements include risks associated with demand for our products, market acceptance, economic conditions, competitive products and pricing, difficulties in product development, commercialization and technology. In light of these risks and uncertainties, there can be no assurance that the events contemplated by the forward-looking statements contained in this annual report will, in fact, occur. Accordingly, readers should not place undue reliance on forward-looking statements. The forward-looking statements speak as of the date of this report and we do not undertake any obligation to revise or update the forward-looking statements.

## **STRATEGY**

We have embarked on a program to increase earnings, and hence shareholder value, by improving our operating efficiency. We are seeking to grow at rates in excess of our market's general rate of growth, primarily through the introduction of qualitatively superior new products to our major marketplaces through existing customers.

## **INTRODUCE NEW PRODUCTS**

In the last three years, we have focused our development efforts on products which address the actual technical requirements of maintaining clean air to promote health. Maintaining ultra-clean air in residential and commercial settings requires continuous and complete replacement of used air contaminated by contact with hair, skin, carpet, solvents, cigarette smoke and other common particle sources with air filtered through a combination of pre-filters, High Efficiency Particulate Air (commonly called HEPA) filtration, and odor removal, as well as controlling all air inlets. This typically requires upgraded and augmented blowers for central or zoned HVAC systems necessary to push air through more effective filters, additional filtration placed at building air inlets, and enough additional HVAC capacity to generate over-pressure so that the majority of air leaks push clean air out, rather than allow dirty air inside.

We have developed 5 new patents associated with our new nested filter concept during 2005. This concept will enable us to stack 4 filters into a space normally holding only 1 filter. This will provide labor savings associated with handling of inventory, storage space savings as well as significant freight savings. We expect to roll this product out into retail stores during the first quarter of 2006.



We have also been able to provide an upgrade path for government buildings, large commercial office buildings and other public venues wishing to utilize HEPA filtration as part of a program to harden buildings against bioterrorist attacks.

Most currently available air filters for commercial, industrial and residential use are primarily useful for protecting motors, coils and other mechanical components from airborne grease condensation and other contaminants which reduce the life and energy-efficiency of the HVAC equipment and have little or no effect on reducing airborne contamination which may be harmful to humans. In fact, standard pleated filters, even those with high-MERV ratings, offer no appreciable benefit in terms of better air quality for the inhabitants than the cheapest spun-glass filters. These pleated filters are accompanied by increased heating and cooling costs caused by the decreased amount of air flowing through the system, and decreased efficiency, which may be accompanied by more frequent equipment breakdowns as equipment is stressed by attempting to push higher volumes of air through tighter filters. Our new products are designed to offer end-users substantial and measurable benefits to health and productivity through substantially cleaner air, and are properly engineered to reduce detrimental effects on equipment life.

*Co-branding with major name-brands.* During the past four years, we have developed and co-marketed products which utilize, and are branded with, Church and Dwight's Arm&Hammer® products, and Reckit Benkiser's Lysol™. We believe the brand-name recognition associated with these products will enable us to gain entrance with major retailers who are not currently our customers or to increase the number of our products carried by current customers who only carry portions of our product line. We will continue to look for appropriately branded technologies which might produce similarly beneficial products and branding opportunities.

*Security Products for Government Buildings and Commercial Office Buildings.* We have adapted our containment control technology to be used in hardening government facilities, large commercial office buildings and public venues against anthrax attacks and other bioterrorist incidents. While these systems do not offer complete protection against bioterrorist attacks, any credible multi-layered defense requires HEPA filtration and related technologies adapted to the unique requirements of these facilities. Marketing for these products will include analysis and diagnostic services offered through our IAQ (Indoor Air Quality) Diagnostic Group, adapted sales literature, technical seminars and electronic multimedia presentations.

## **IMPROVE OPERATING EFFICIENCY**

*Centralize Overhead Functions.* During 2005, we continued our ongoing programs to centralize functions and eliminate duplication of efforts between subsidiaries in the following areas: purchasing, production planning, shipping coordination, accounting and personnel management, risk management and benefit plan administration.

*Complete Vertical and Systems Integration.* During the past five years, we have continued to complete the development and redesigning of numerous systems and products which were only partially completed when we acquired the companies which originally claimed to have fully developed them. These products include the automated machinery necessary for high-speed production of our pleated filters, acquired with Precisionaire, and the mass-production processes for bonded carbon high-mass zero-density products. Additionally, the glass technology previously purchased, was not as developed as the seller had represented, resulting in significant additional cost to develop this technology and the machines are still not producing at promised run rates. We are currently trying to address this issue which may require an additional acquisition or the expenditures of additional resources to meet or reach expected results. We have also completed systems integration efforts which were only partially in place when the companies were acquired, particularly including inventory shop-floor control, procurement oversight, and financial reporting systems at Precisionaire. We believe that complete dissemination and duplication of these products and systems throughout Flanders will result in further gains in operating efficiency and augment our bottom line. During 2006, we are planning to move from semi automated lines to fully automated production lines which is expected to significantly reduce our labor related costs and complete our vertical integration by acquisition of additional filter media manufacturing companies.

*Strategic Expansion* During 2004 Global Containment Systems, Inc. (GCS), a wholly owned subsidiary of Flanders Corporation, was formed. We plan to expand our operations into a 400,000 square foot facility in Aiken, SC. This facility will accommodate the requirements for various nuclear containment projects scheduled at the Westinghouse Savannah River Site in Aiken, SC as well as other projects scheduled worldwide over the next ten years. Expansion into South Carolina will provide a state of the art facility with room necessary to provide in place testing, integration, process control verification and final testing and final installation which is expected to provide GCS a unique position in this developing market. This expansion is currently on hold until the Mixed Oxide Fuel Project (MOX) contract is signed.

Additionally, during 2004, Flanders Complete Service Division (Flanders CSD), an air filtration service provider was formed. Flanders CSD will offer weekly, monthly and quarterly service contracts for clean room and glove box certification; commercial, industrial, retail and residential surveys; and complete filtration management including mold remediation and analysis. The company is currently negotiating several large contracts and if they are executed, the company expects to have national coverage by the end of 2006.

*Strategic Acquisitions.* We continue to search for opportunities to acquire new businesses, although our criteria for evaluating these businesses has moved toward acquiring raw material suppliers, distributors and regional resellers, and away from acquiring competing air filter manufacturers in the United States. We will continue to search for opportunities to acquire companies in Europe and the Pacific Rim to expand our technologies in these geographic areas. We are looking for potential acquisitions with the following characteristics: (i) dominant positions in local or regional markets, (ii) a stable customer base distinct from our existing customers, and (iii) a history of consistent and healthy earnings. Acquiring resellers and distributors with these characteristics allows us to increase operating margins by removing at least one layer of middlemen, and their compounding mark-ups and commissions from the sales and distribution process, allowing us to earn higher margins while maintaining competitive pricing with end users. At the present time, we do not have any binding agreements with respect to future acquisitions. However, we are currently considering the acquisition of a glass mat producer which would reduce our glass material cost and enable us to avoid the additional development costs to develop the glass technology that was previously purchased. Additionally, we are considering the acquisition of a trucking company that would enable us to reduce our transportation costs which are a significant cost of the filter industry. We are evaluating various air filter sales and

service organizations that may help us enter new markets that we do not currently enjoy.

*Optimization of Mature Products.* Now that we have completed the rationalization and consolidation of our product lines, we should be able to stabilize designs and complete efficiency studies on our manufacturing processes and supply chains which should enable us to duplicate our most successful processes across all plants.

## **INCREASE MARKET SHARE**

*Use Strategically Located Facilities Throughout the United States to Increase Market Share.* Through acquisition and the establishment of new plants, we have placed facilities within one day's over-the-road shipping to most major population centers in the United States. We believe this ability to regionalize production and distribution has improved our business in several ways: (i) decreased cost of products to customers by reducing the average distance between our plants and both our customers and our major raw materials suppliers, hence decreasing freight expenses; (ii) increased responsiveness by decreasing the average time required to ship products to customers; and (iii) increased our share of national accounts total business by having manufacturing facilities in closer proximity to customers regional distribution centers. The ability to service all major population centers with regional manufacturing centers is critical for our business, allowing us to compete on price against less broadly based competitors without sacrificing margins as well as the ability to respond more rapidly than most of our competition. We will continue to review the market for new locations for expansion.

*Continued Emphasis on Quality and Performance.* A continued emphasis on product quality and on-time shipments has allowed us to capture market share in serving several industries in recent years. We are expanding our NQA1 Quality Assurance Program.

*Utilize High Efficiency Production and Logistics Systems to Dominate Niche Markets.* During the past several years we have invested heavily in upgrading our production facilities, scheduling capacity, and logistics management capabilities. We intend to continue using these advantages to capture market share in niche markets with specialized products tailored to their exact requirements. Many end users with specialized air filtration needs are currently making do with standard products. It has been our experience that minor changes made to our standard products to meet specialized requirements may offer significant operational savings to these end users, although the actual filters cost more.

## **AIR FILTER MARKET BACKGROUND**

The air filtration market is mature, with market growth driven by a gradual trend toward higher efficiency filters for residential, commercial and industrial applications.

Management is of the belief that concerns about anthrax and other harmful microbes will accelerate this trend over the next five years as commercial buildings in large U.S. cities upgrade their ventilation systems to install more efficient filters. They forecast that the world market for air filters will grow to approximately \$5 billion in 2005, up from \$3.5 billion in 2000, with the United States being the largest market for air filters. Other growth drivers include an increasing propensity towards using higher-performance filters in commercial and residential spaces instead of current low-efficiency models, and the use of HEPA filters in new applications.

Management believes the forces driving the air filtration market are evolving, beginning in the past decade and continuing for the next several years, from preserving machinery and equipment to maintaining and or facilitating indoor air quality. In addition, we expect many technology industries to increase their reliance on air filters to remove microscopic and gaseous contaminants from sensitive manufacturing processes associated with semiconductor manufacturing, pharmaceutical production, ultra-pure materials manufacturing, nuclear power and materials processing, and biotechnology. Companies are devoting resources to air filtration products to enhance process efficiency and employee productivity.

Air filters are used in many different applications, including the following:

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*Commercial and Residential HVAC Systems.* Replacement filters are an essential requirement for the efficient operation of commercial and residential HVAC systems.

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*Residential air cleaners.* Stand-alone air cleaners which produce ultra-clean air in a defined area are also gaining in popularity among allergy sufferers and asthmatics, although follow-up sales of replacement filtration cartridges have been limited.

- 

*General Industrial.* Air filters are used in standard industrial settings to provide cleaner work environments; for example, auto makers use air filtration systems to remove oil mist contaminants from the air in their plants and industrial paint booth users utilize air filtration to remove paint particles from the air.

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*Semiconductors.* HEPA and carbon filters are necessary to meet the increasingly stringent manufacturing environment requirements of semiconductor manufacturers, where microscopic airborne contaminants can ruin microchips during production, having a large impact on manufacturing yield and profitability. Carbon filters are also being increasingly used to filter gaseous contaminants from semiconductor manufacturing areas.

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*Pharmaceuticals.* Pharmaceutical companies are increasingly using cleanrooms to prevent cross-contamination between different products and different lots of the same product being manufactured at the same facility. The increasing use of cultured microbes for drug production is also expected to increase demand for high-end containment environments.

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*Biotechnology.* Containment systems for the manipulation of viruses and bacteria using genetic engineering techniques are critical to the biotechnology industry.

•

*Nuclear Power and Materials Processing.* Filtration systems are necessary to radioactive containment procedures for all nuclear facilities, containment systems are necessary to provide shielding.

•

*Chemical, Biological and Radiological Safe Environments.* Filtration systems are necessary to provide a safe environment for those working in sensitive areas that may be subject to exposure to such substances.

## **RECENT TRENDS**

Recent trends in the air filter industry, as well as changes in laws and governmental regulations during the past five years, all encourage an increased awareness of the benefits of the use of air filtration products. Some of these trends and changes are:

*Security Initiatives to Counter Terrorist Threats.* We believe, initiatives to harden buildings against bioterrorist attacks and other security initiatives will result in many governmental and commercial facilities upgrading their HVAC systems to incorporate HEPA filters and other types of upgraded air control systems. We have seen orders increase in this area over the past quarter.

*Semiconductor Downturn and Economic Recovery.* Sales of air filtration products for semiconductor facilities, historically a major market, are expected to be slow again during 2006, with most analysts pushing recovery for this sector out until 2007. The strengthening economy is also having a positive effect on sales of all of our products.

*Indoor Air Quality and Health.* We believe there is an increase in public concern regarding the effects of indoor air quality on employee productivity and health, as well as an increase in interest in standards for detecting and solving IAQ problems. For example, the American Society of Heating Refrigeration and Air-Conditioning Engineers (ASHRAE) has recently established certain minimum standards for ventilation and indoor air quality for commercial

and industrial settings. The World Health Organization has recently been studying the effects of air quality on human health, including widely publicized epidemiological studies indicating that airborne contaminants kill more people than automobile accidents. We are seeing a greater interest in upgrading residential filtration systems as well as commercial systems to address both energy savings and better indoor quality.

*Lack of Legitimate Competing Products.* We believe there is an increase in public and regulatory frustration with spurious and misleading claims made by certain manufacturers in the air filtration industry. This trend is evidenced by recent rulings by the Federal Trade Commission disallowing claims of "cleaning the air in an entire room" made by several manufacturers of "area HEPA filtration systems" as well as medical benefits claimed by manufacturers of "passive electrostatic washable synthetic filters and other articles in consumer reports. We hope that as the public becomes more interested in real filtration products that we will see continued strength in this market.

*Hazardous Working Environments.* Several studies recognize that air quality in working facilities has an impact upon human health. OSHA regulations, in particular, have made IAQ a consideration in a wide variety of industries, ranging from those industries using spray-paint booths to those using automobile assembly lines. We are encouraged by the awareness and increased interest in improving indoor air quality in working environments.

*Sick Building Syndrome.* Sick Building Syndrome, which is characterized by lethargy, frequent headaches, eye irritation and fatigue, has recently been shown to be a valid concern and is a major design consideration in new and renovated commercial and industrial buildings. The identification of "sick" buildings, and solutions for mitigation, involve complex issues which need to be examined on a case-by-case basis by qualified engineers. Solutions typically include improving the HVAC and filtration systems of the affected buildings.

## **MARKETING**

Much of our marketing effort consists of personal visits to customers and distributors through an extensive tiered network of contract salespeople. Periodic visits are enhanced by mass mailings announcing new products, participation in trade shows for exposure and lead generation, technical articles and advertisements in trade periodicals, and newly redesigned catalogs containing all Flanders' products. During 2004, we realigned our product offerings into groups focused on: foremarket "high purity" sales, generally consisting of sales of products for new or upgraded facilities; retail sales, generally consisting of sales through retailers for use in residences and small businesses; air filter sales and service, generally consisting of sales to air filter service companies who maintain industrial and commercial HVAC systems; and after-market sales, generally consisting of sales to wholesalers and distributors for use by industrial end users; and containment sales, generally consisting of sales to government agencies or highly specialized industrial environments.

Besides developing new sales leads and contacts, we are also focused on increasing the effectiveness of our existing distributors and contract salesmen by allowing them to offer our products as a complete "single-source" for air filtration products.

During 2004 Global Containment Systems, Inc. (GCS) , a wholly owned subsidiary of Flanders Corporation, was formed. We plan to expand our operations into a 400,000 square foot facility in Aiken, SC. This facility will accommodate the requirements for various nuclear containment projects scheduled at the Westinghouse Savannah River Site in Aiken, SC as well as other projects scheduled worldwide over the next ten years. Expansion into South Carolina will provide a state of the art facility with room necessary to provide in place testing, integration, process control verification and final testing and final installation which is expected to provide GCS a unique position in this developing market. This expansion is currently on hold until the Mixed Oxide Fuel project (MOX) contract is signed.

Additionally, during 2004, Flanders Complete Service Division (Flanders CSD), an air filtration service provider was formed. Flanders CSD will offer weekly, monthly and quarterly service contracts for clean room and glove box certification; commercial, industrial, retail and residential surveys; and complete filtration management including mold remediation and analysis. The company is currently negotiating several large contracts and if they are executed, the company expects to have national coverage by the end of 2006..

## **PRODUCTS**

We design, manufacture and market a broad range of air filters and related products, including:

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Residential heating and air conditioning filters, typically sold through retailers under the Flanders~Precisionaire brand name.

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Residential air cleaners, developed in 2000, which offer different filtration types ranging from single-room HEPA units which clean the air in a room to near-cleanroom levels to in-duct electrostatic precipitators which remove large quantities of airborne contaminants from entire residences without negatively impacting the efficiency of HVAC systems.

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Industrial specialty filters which fall under specifications that are categorized by efficiency ratings established by ASHRAE and used in a wide variety of industries, including paint facilities, automobile factories, chemical treatment plants, mushroom farms, coal mines, oil refineries and power plants.

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Commercial and industrial filters for use in office and general manufacturing environments, typically sold through wholesalers and distributors.

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High Efficiency Particulate Air (HEPA) filters (at least 99.97% efficient to 99.999997% efficient) in various grades, for use in semiconductor facilities, nuclear containment vessels, disease containment facilities, and other critical applications.

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Absolute Isolation Barriers which are customized stand-alone units, typically manufactured of stainless steel, used in various industries which require absolute control over contaminants, atmospheric composition and containment.

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Carbon filters, both in bonded panels, various impregnated medias, and activated charcoal beds, used to remove gaseous contaminants, odors and toxic chemical vapors in various commercial and industrial applications.

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Specialized air filter housings for use in multi-stage filtration applications.

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Other related products, including ductwork and equipment cleaning chemicals, custom air handlers and specialized filter housings.

- 

Surface finishing filters for any paint booth or surface finishing application in the overall surface finishing market.

## **MANUFACTURING**

We manufacture air filters, housings, Absolute Isolation Barriers and related equipment at several facilities in the United States and Mexico, which range in size from 18,000 square feet to approximately 600,000 square feet. The major plants are:

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Ten separate manufacturing and warehousing facilities located in Washington, North Carolina (2 plants) ; Bartow, Florida; Terrell, Texas; Salt Lake City, Utah; Momence, Illinois; Smithfield, North Carolina; Tijuana, Mexico; Stafford, Texas; and Auburn, Pennsylvania, produce a broad range of HEPA, commercial, residential and industrial filters.

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Other facilities in Bath and Washington, North Carolina, Salt Lake City, Utah, and Stafford, Texas, manufacture HEGA filters, high-end containment environments, housings, custom filter assemblies and other custom filtration products and systems which require extensive custom design, production and lot tracking, including products used in



the production and containment of potentially dangerous biologically engineered microorganisms.

- 

Fifteen direct offices spread across the US that provide a distribution point as well as light manufacturing.

In addition, we design and manufacture much of our automated production equipment as well as the glass-based media used in many of our products.

Our manufacturing operations are subject to periodic inspection by regulatory authorities. Because of the nature of some of our products, these agencies include the Department of Energy, Department of Defense and other agencies responsible for overseeing sensitive technologies. One of the considerations in deciding which types of products each facility will manufacture is the segregation of highly-regulated products to a minimal number of facilities to reduce the overhead associated with regulatory monitoring and compliance.

Each of our manufacturing facilities utilizes testing and design strategies appropriate to the products manufactured. These range from standard statistical process quality controls for residential replacement filters to individual testing and certification with patented proprietary particle scanning technologies for each laminar-grade HEPA filter. We believe that our ability to comprehensively test and certify HEPA filters is a competitive advantage.

## **SOURCE AND AVAILABILITY OF RAW MATERIALS**

Our principal raw materials are cardboard, fiberglass fibers, recyclable waste-glass, extruded glass, sheet metal, extruded aluminum, stainless steel, various grades of mild rolled steel, adhesives, resins and wood. All of these raw materials are readily available in sufficient quantities from many suppliers.

## **COMPETITION**

The air filtration market is fragmented and highly competitive. There are many companies which compete in our market areas. We believe that the principal competitive factors in the air filtration business include product performance, name recognition, price, product knowledge, reputation, customized design, timely delivery and product maintenance. We believe that we compete favorably in all of these categories. Competitors include companies with resources, assets, financial strength and market share which may be greater than ours. Major competitors include

American Air Filter International, Camfil Farr Company, Donaldson Company, Inc. and Airguard Corporation.

## **PATENTS, TRADEMARKS AND LICENSES**

The Company and its subsidiaries currently holds approximately (30) Thirty patents relating to filtration technology including patents relating to HEPA filters and fabrication methods, filter leak testing methods, filter assembly, laminar flow cleanrooms, components of isolation barriers, and the baking soda impregnation method used in the manufacture of the Arm & Hammer® infused Filters.

In addition, the Company maintains twenty-five (25) trademark registrations including the following: FLANDERS®, PRECISIONAIRE®, EZ FLOW®, SMILIE®, AIRVELOPE®, CHANNEL-CEIL®, PUREFORM®, ECONO-CELL®, GAS-PAK®, PUREFRAME®, DIMPLE PLEAT®, BLU-JEL®, VLSI®, KWIK KUT®, SUPER-FLOW®, NATURALAIRE®, AIRPURE®, PURESEAL®, FLANDERS ABSOLUTE ISOLATION®, FLANDERS/CSC®, TECH-SORB®, NATURALAIRE FILTER FRAGRANCE®, AIRIA®, and BECAUSE WE KNOW AIR FORWARDS AND BACKWARDS®. The Company also has applied for federal trademark protection for the SWISSAIRE™ mark (Serial No. 76/475,934) for its new paintbooth product line. Although management believes that the patents and trademarks associated with our various product lines and subsidiaries are valuable, we do not consider any of them to be essential to our business.

The Company developed 5 new patents associated with its new nested filter concept during 2005. This concept will enable us to stack 4 filters into a space normally holding only 1 filter. This will provide labor savings associated with handling of inventory, storage space savings as well as significant freight savings. We expect to roll this product out into retail stores during the first quarter of 2006.

The Company currently holds a license for the intellectual property mark of Arm & Hammer® from Church & Dwight Company for labeling uses on our baking soda infused product line. The Company is party to a Royalty Agreement with Church & Dwight for the use of said mark which management believes to be a reasonable and necessary agreement that is in the best interest of the Company. Furthermore, the Company holds a license for the intellectual property mark of Lysol™ from Reckitt Benckiser, Inc. for labeling uses on our new line of antimicrobial-treated filter product line. The Company is party to a Royalty Agreement with Reckitt Benckiser for the use of the Lysol™ mark which management believes to be a reasonable and necessary agreement that is in the best interest of the Company.

## **CUSTOMERS**

We are not dependent upon any single customer. One customer, Wal-Mart Stores, Inc., accounted for 15%, 15% and 17% of net sales during 2005, 2004 and 2003, respectively. The Home Depot, Inc., accounted for 15%, 16% and 17%

of net sales during 2005, 2004 and 2003, respectively. No other single customer accounted for 10% or more of net sales during the past three years. Other significant customers include Abbott Laboratories, Motorola, Inc., Intel Corporation, Merck & Co., Inc., Upjohn Co., Westinghouse Electric Corp., and several U.S. government agencies.

## **BACKLOG**

We had approximately \$26.0 million of firm backlog on December 31, 2005, compared to \$25.9 million on December 31, 2004. Firm backlog includes orders received and not yet begun and the unfinished, unbilled portion of special orders. Orders are typically not cancelable without penalty, except for certain stable filter supply contracts to nuclear facilities operated by the United States government. Backlog varies from week to week, based on the timing and mix of orders received. The difference in backlog between December 31, 2005 and 2004 is not considered to be meaningful, and is within the normal range of week-to-week variation. All backlog at December 31, 2005, is expected to be shipped by the end of the second quarter of 2006.

## **EMPLOYEES**

The Company employed 2,743 full-time employees on December 31, 2005; 2,463 in manufacturing, 19 in development and technical staff, 79 in sales and marketing, and the remaining 182 in support staff and administration.

None of these are represented by a union. The Company believes that its relationship with its employees is satisfactory.

## **GOVERNMENT REGULATION**

Although we believe our operations are in material compliance with applicable environmental laws and regulations, risks of significant costs and liabilities are inherent in manufacturing operations, and we cannot assure that significant costs and liabilities will not be incurred. Moreover, it is possible that other developments, such as increasingly strict environmental laws and regulations and enforcement policies, and claims for damages to property or persons resulting from our operations, could result in substantial costs and liabilities to us. We believe that changes in environmental laws and regulations will not have a material adverse effect on our financial position, results of operations or cash flows in the near term.

We are also subject to the requirements of OSHA and comparable state statutes. We believe we are in material compliance with OSHA and state requirements, including general industry standards, record keeping requirements and monitoring of occupational exposures. In general, we expect to increase our expenditures to comply with stricter industry and regulatory safety standards such as those described above. Although such expenditures cannot be accurately estimated at this time, we do not believe that they will have future material adverse effect on our financial position, results of operations or cash flows.

## SEASONALITY

Historically, our business has been seasonal, with a substantial percentage of sales occurring during the second and third quarters of each year. However, during 2005 we have begun to see a potential change in this historical pattern.

We believe that increased energy costs have encouraged not only the home owner, but industrial and commercial operations to begin to realize the benefits of timely filter replacement. This resulted in higher than usual fourth quarter sales. We believe that this will continue in future years. In addition, demand for our general commercial and industrial products appears to be highly influenced by the weather, with higher sales generally associated with extremes of either hot or cold weather, and lower sales generally associated with temperate weather. Because of these seasonal and weather-related demand fluctuations, quarter-to-quarter performance may not be a good predictor of future results.

## EXPORT SALES

We sell products to end users outside of the United States through domestic specialty cleanroom contractors. These sales are counted as domestic sales. We also sell products through foreign distributors, primarily in Europe, and through Flanders International, Ltd., a wholly-owned subsidiary located in Singapore which sells to customers in the Pacific Rim. Sales through foreign distributors and Flanders International amounted to less than 5% of net sales for each of the last three fiscal years. Assets held outside the United States are negligible.

## Item 2.

### Properties

The following table lists our principal facilities. Management believes that these properties are adequate for its current operational needs. We may, at some point, relocate, reorganize or consolidate various facilities for reasons of operating efficiencies or may open new plants to take advantage of perceived new economic opportunities. We are of the opinion that all properties are well maintained and appropriately insured.

<u>Principal Facility</u>	<u>Location</u>	<u>Approximate Floor</u>	<u>Monthly</u>	<u>Lease/Type</u>
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		<u>Space (sq. ft.)</u>	<u>Payment</u>	
Manufacturing and office facility	Washington, North Carolina	285,000	N/A	Owned
Manufacturing, service and office facility	Bath, North Carolina	46,000	N/A	Owned
Manufacturing plant	Bartow, Florida	175,000	N/A	Owned
Warehouse	Bartow, Florida	60,000	\$15,671	Leased
Manufacturing plant	Terrell, Texas	168,000	\$23,980 <sup>1</sup>	Owned
Manufacturing plant	Auburn, Pennsylvania	92,000	\$5,857 <sup>2</sup>	Owned
Office space and headquarters	St. Petersburg, Florida	18,000	N/A	Owned
Manufacturing plant	Momence, Illinois	211,000	\$135,584 <sup>3</sup>	Owned
Sales office and warehouse	Singapore	3,800	\$2,100	Leased
Manufacturing and warehouse	Smithfield, North Carolina	415,000	\$79,816	Leased <sup>4</sup>
Manufacturing plant	Smithfield, North Carolina	474,000	\$11,981 <sup>5</sup>	Owned
Manufacturing and office facility	Stafford, Texas	18,000	N/A	Owned
Manufacturing plant	Salt Lake City, Utah	192,000	N/A	Owned
Manufacturing plant and office facility	San Diego, California	96,000	\$49,914	Leased
Manufacturing plant	Tijuana, Mexico	127,000 <sup>6</sup>	\$46,651	Leased
Direct Sales Office	Phoenix, Arizona	22,000	\$6,697	Leased
Direct Sales Office	Santa Fe Springs, California	20,000	\$8,650	Leased
Direct Sales Office	Hayward, California	10,000	\$5,900	Leased
Direct Sales Office	Salt Lake City, Utah	15,000	\$3,139	Leased
Direct Sales Office	Sanford, North Carolina	1,000	\$950	Leased
Direct Sales Office & Warehouse	Kent, Washington	12,500	\$5,640	Leased
Manufacturing plant	Washington, North Carolina	110,000	12,500	Leased
	Philadelphia, Pennsylvania	26,000	16,000	Leased

Direct Sales Office &  
Warehouse

Direct Sales Office & Cerritos, California Warehouse	21,735	11,270	Leased
Direct Sales Office & Tucker, Georgia Warehouse	34,600	16,000	Leased
Direct Sales Office & Raleigh, North Carolina Warehouse	24,000	14,000	Leased
Direct Sales Office & Las Vegas, Nevada Warehouse	10,106	8,006	Leased

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<sup>1</sup>Property encumbered by a mortgage on which monthly payments are made.

<sup>2</sup>Property encumbered by a mortgage on which monthly payments are made.

<sup>3</sup>Property is pledged as security for an Economic Development Revenue Bond with a face value of \$6,000,000. The obligation is paid quarterly rather than monthly by paying a portion of principal and interest on the entire amount. The payment shown above is for the entire fourth quarter of 2005.

<sup>4</sup>The property and building is owned by a partnership consisting of two of the Company's officers and directors.

<sup>5</sup>The property is used as security for a two Industrial Revenue Bonds with face value of \$4,500,000 and \$4,000,000. Monthly payments are for interest only on the bonds, and vary from month to month based on the interest rate during the period.

<sup>6</sup>The Tijuana plant has 2 temporary buildings measuring 45,000 sq. ft. and 40,000 sq. ft.

Item 3.

Legal Proceedings

The Company is involved in a dispute with Liberty Mutual, a former workers' compensation administrator and stop-loss insurer for some of the Company's subsidiaries. The administrator has alleged that they are entitled to be reimbursed for certain costs incurred in administering various insurance claims. The Company has counter-sued,

claiming that the administrator acted in bad faith, was negligent in its duties as administrator of our claims, that it made payments on our behalf which were specifically disallowed, that they refused to follow instructions given to them by us, that they failed to meet minimal acceptable standards for administering claims, and that such failures constituted a material dereliction of their responsibilities as administrator, as well as other claims related to malfeasance and negligence. In addition, Liberty Mutual charged certain administrative fees over and above the actual costs incurred which the Company is contesting. The amount and probability of any payment or settlement is unknown at this time. Among the issues being considered is the ripeness of our counterclaim as well as the matter of currently unresolved workers' compensation claims whose estimate of potential loss may change as a result of this litigation. While management believes it has reserved an adequate amount for settlement of these claims, there is no guarantee that the Company's actual liability will not exceed its current estimate. Accordingly, these matters, if resolved in a manner different from management's estimate, could have a material effect on operating results or cash flows in the future.

We have settled our lawsuit with Conap (U.S. District Court for the Eastern District of North Carolina, Case No. 4-99-CV-93-H(3)) a supplier of urethane sealant used in some of our HEPA filtration products. The settlement amount we received is included in other income.

From time to time, the Company is a party as plaintiff or defendant to various legal proceedings related to our normal business operations. In the opinion of management, although the outcome of any legal proceeding cannot be predicted with certainty, the ultimate liability of the Company in connection with its legal proceedings will not have a material adverse effect on the Company's financial position, but could be material to the results of operations in any one future accounting period. The Company makes appropriate reserves for litigation, even if not material. Defense costs are expensed as incurred.

#### **Item 4.**

##### **Submission of Matters to a Vote of Security Holders**

The Company held its annual meeting of shareholders on December 15, 2005. During the meeting, holders of 24,569,082 shares, representing ninety-three percent (93%) of the 26,310,551 shares outstanding on the record date, attended either in person or by proxy. Holders in excess of 90% of the totals vote cast voted for the election of members to the Board of Directors for Robert R. Amerson, Steven K. Clark, William Mitchum, Jr., Robert Kelly Barnhill, Sr., David M. Mock, and Peter Fredericks. As a result of the meeting, Messrs. Amerson, Clark, Mitchum, Barnhill, Mock, and Fredericks were elected for an additional one-year term as directors.

## **PART II**

**Item 5.****Market for Registrant's Common Equity and Related Stockholder Matters****PRICE RANGE OF COMMON STOCK**

The Company's common stock is listed on the Nasdaq National Market System under the symbol FLDR. The following table sets forth, for the periods indicated, the high and low sale prices of the Company's common stock as reported by the Nasdaq National Market System. Such quotations do not include retail mark-ups, mark-downs, or other fees or commissions.

	High	Low
<b>2005</b>		
Fourth Quarter ended December 31, 2005	\$	\$
	12.46	9.81
Third Quarter ended September 30, 2005	\$	\$
	14.09	8.85
Second Quarter ended June 30, 2005	\$	\$
	11.67	7.77
First Quarter ended March 31, 2005	\$	\$
	11.43	8.55
<b>2004</b>		
Fourth Quarter ended December 31, 2004	\$	\$
	10.17	8.17
Third Quarter ended September 30, 2004	\$	\$
	10.47	8.36
Second Quarter ended June 30, 2004	\$	\$
	9.99	6.12
First Quarter ended March 31, 2004	\$	\$
	7.26	5.21



**2003**

Fourth Quarter ended December 31, 2003	\$	\$
	7.01	4.45
Third Quarter ended September 30, 2003	\$	\$
	6.05	2.71
Second Quarter ended June 30, 2003	\$	\$
	2.95	2.09
First Quarter ended March 31, 2003	\$	\$
	2.23	1.43

**EQUITY COMPENSATION PLAN INFORMATION**

The following table provides information about our Equity Compensation Plans.

Plan Category	Number of securities to be issued upon exercise of outstanding options	Weighted average price of outstanding options	Number of securities remaining available for future issuance
Long Term Incentive plan approved by security holders	1,535,000	\$8.56	183,000
Long Term Incentive plan not approved by security holders			
Directors and Officers plan approved by security holders	257,000	\$7.10	40,000
Directors and Officers plan not approved by security holders			
Other equity compensation plan approved by security holders	4,000,000	\$5.00	
Other equity compensation plan not approved by security holders			

**APPROXIMATE NUMBER OF EQUITY SECURITYHOLDERS**

On February 13, 2006, Flanders' common stock closed at \$11.14. As of February 13, 2006, there were approximately 141 holders of record of the Company's common stock. The Company estimates there are approximately 3 beneficial owners (holders of more than 5% of the common stock) of the Company's common stock.

## **DIVIDENDS**

We have not declared or paid cash dividends on our common stock. Currently, we retain any future earnings, except those used to repurchase stock, to finance the growth and development of the business, however, we are currently considering paying cash dividends in the future. The Board of Directors may decide to declare a dividend, based upon its evaluation of our earnings, financial position, capital requirements and any other factors the Board of Directors may consider to be relevant. Under the terms of our revolving credit line we cannot pay dividends without the prior written consent of the bank. The Company also has a stock repurchase program that is currently subject to restriction under the Company's line of credit facility. See Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources and Notes to Consolidated Financial Statements - Note G.

## **SALES OF UNREGISTERED SECURITIES**

The Company did not sell any unregistered securities during 2005, 2004 or 2003.

## **Item 6.**

### **Selected Financial Data**

The following financial data is derived from, and should be read in conjunction with, the Consolidated Financial Statements and notes thereto. Information concerning significant trends in the financial condition and results of operations is contained in Management's Discussion and Analysis of Financial Condition and Results of Operations.

### **SELECTED HISTORICAL OPERATIONS DATA** (In thousands, except per share data)

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Year Ended December 31,

	2005	2004	2003	2002	2001
	\$	\$	\$	\$	\$
Net sales	229,276	199,933	182,780	184,211	189,077
Gross profit	52,917	48,288	43,271	40,821	39,782
Operating expenses	35,297	33,569	32,112	29,591	36,311
Operating income from continuing operations	17,620	14,719	11,159	11,230	3,471
Earnings from continuing operations before income taxes	17,245	14,351	11,251	7,740	1,489
Provision for income taxes	4,739	4,581	3,505	3,001	930
Earnings from continuing operations	12,506	9,770	7,746	4,739	559
Loss from discontinued operations					(175)
Cumulative effect of accounting change				(27,681)	
		\$	\$	\$	\$
Net earnings (loss)	12,506	9,770	7,746	(22,942)	384
Earnings per share from continuing operations					
	\$	\$	\$	\$	\$
Basic	0.48	0.37	0.30	0.18	0.02
	\$	\$	\$	\$	\$
Diluted	0.45	0.36	0.29	0.18	0.02
Net earnings (loss) per share					
	\$	\$	\$	\$	\$
Basic	0.48	0.37	0.30	(0.88)	0.01
	\$	\$	\$	\$	\$
Diluted	0.45	0.36	0.29	(0.88)	0.01
Weighted average common shares outstanding					
Basic	26,309	26,201	26,033	26,033	26,036
Diluted	27,807	27,289	26,428	26,033	26,038

**SELECTED HISTORICAL BALANCE SHEET DATA** (In thousands)

December 31,

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	2005	2004	2003	2002	2001
Working capital	\$ 60,595	\$ 54,212	\$ 45,547	\$ 41,389	\$ 14,603
Total assets	172,216	159,670	145,415	141,671	180,255
Long-term obligations <sup>1</sup>	27,293	23,059	26,290	35,475	52,045
Total shareholders' equity	105,534	93,161	80,709	72,928	96,879

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Long-term obligations include long-term notes payable, long-term debt, including current maturities, convertible debt, and committed capital.

**Item 7.**

**Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion should be read in conjunction with Item 6 Selected Financial Data and our Consolidated Financial Statements, all included herein. The information set forth in this Management's Discussion and Analysis of Financial Condition and Results of Operations includes forward-looking statements that involve risks and uncertainties. Many factors, including but not limited to those discussed below under Factors That May Affect Future Results could cause actual results to differ materially from those contained in these forward-looking statements.

**OVERVIEW**

Flanders is a full-range air filtration product company engaged in designing, manufacturing and marketing air filtration products and certain related products and services. Our focus has evolved from expansion through acquisition to increasing the quality and efficiency of our high-volume replacement filtration products, and using these benefits to compete more effectively in the marketplace. We also design and manufacture much of our own production equipment as well as glass-based media for many of our air filtration products.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The following discussion and analysis is based upon our consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of our financial statements requires management to make estimates and assumptions that affect the reported amounts of revenues and expenses, and assets and liabilities during the periods reported. Estimates are used when accounting for certain items such as revenues, allowances for returns, early payment discounts, customer discounts, doubtful accounts, employee compensation programs, depreciation and amortization periods, taxes, inventory values, insurance programs, and valuations of investments, goodwill, other intangible assets and long-lived assets. We base our estimates on historical experience, where applicable, and other assumptions that we believe are reasonable under the circumstances. Actual results may differ from our estimates under different assumptions or conditions. We believe that the following critical accounting policies affect our more significant judgments and estimates used in preparation of our consolidated financial statements.

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We base our estimates on the aging of our accounts receivable balances and our historical write-off experience, net of recoveries. If the financial condition of our customers were to deteriorate, additional allowances may be required.

We value our inventories at the lower of cost or market. We write down inventory balances for estimated obsolescence or unmarketable inventory equal to the difference between the cost of the inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

Estimates of our insurance costs are developed by management's evaluation of the likelihood and probable amount of potential claims based on historical experience and evaluation of each claim. Changes in the key assumptions may occur in the future, which would result in changes to related insurance costs.

Goodwill is reviewed for possible impairment at least annually or more frequently upon the occurrence of an event or when circumstances indicate that the Company's carrying amount is greater than the fair value. In accordance with SFAS 142, the Company examined goodwill for impairment and determined that the Company's carrying amount did not exceed the fair value, thus, there was no impairment.

Generally, sales are recognized when shipments are made to customers. Rebates, allowances for damaged goods and other advertising and marketing program rebates are accrued pursuant to contractual provisions and included in accrued expenses. An insignificant amount of our revenues fall under the percentage-of-completion method of accounting used for long-term contracts. Under this method, sales and gross profit are recognized as work is performed based on the relationship between actual costs incurred and total estimated costs at completion. Sales and gross profit are adjusted prospectively for revisions in estimated total contract costs and contract values. Estimated losses are recorded when identified.

**RESULTS OF OPERATIONS** (thousands omitted, except per share amounts)**2005 Compared to 2004**

The following table summarizes the Company's results of operations as a percentage of net sales for 2005 and 2004.

	2005		2004	
Net sales	\$		\$	
	229,276	100.0%	199,933	100.0%
Gross profit				
	52,917	23.1	48,288	24.2
Operating expenses				
	35,297	15.4	33,569	16.8
Operating income				
	17,620	7.7	14,719	7.4
Nonoperating expense				
	(375)	(.2)	(368)	(.2)
Earnings before income taxes				
	17,245	7.5	14,351	7.2
Provision for income taxes				
	4,739	2.1	4,581	2.3
Net earnings			\$	
	12,506	5.5	9,770	4.9

*Net Sales:* Net sales for 2005 increased by \$29,343 or 14.7%, to \$229,276, from \$199,933 for 2004. The increase in net sales was due to our success in increasing our market share across generally all lines of our business.

*Gross Profit:* Gross profit for 2005 increased \$4,629 or 9.6%, to \$52,917 which made up 23.1% of net sales, from \$48,288 for 2004, which made up 24.2% of net sales. The gross profit increase was principally due to a higher sales volume while the decrease in gross profit percentage was primarily attributable to increases in direct labor,

transportation, raw material costs , and initial costs associated with new product offerings .

*Operating Expenses:* Operating expenses for 2005 increased \$1,728, or 5.1%, to \$35,297, from \$33,569 in 2004. The increase in operating expenses was primarily caused by a higher sales volume in 2005 .. Operating expenses as a percentage of sales decreased in 2005 to 15.4% from 16.8% due primarily to the higher sales volume covering certain fixed overhead costs..

*Nonoperating expense:* Nonoperating expense increased approximately \$7 to (\$375) of expense for 2005, compared to (\$368) in 2004. The increase was due to a n increase in interest expense of \$95 partially offset by an increase in other income of \$88.

*Provision for Income Taxes:* Our effective state and federal tax rate, adjusted for the effect of certain credits and adjustments, was approximately 38% and 39% for 2005 and 2004, respectively.

## 2004 Compared to 2003

The following table summarizes the Company's results of operations as a percentage of net sales for 2003 and 2002 (dollar amounts in thousands).

	2004		2003	
	\$		\$	
Net sales	199,933	100.0%	182,780	100.0%
Gross profit	48,288	24.2	43,271	23.7
Operating expenses	33,569	16.8	32,112	17.6
Operating income	14,719	7.4	11,159	6.1
Nonoperating expense	(368)	(.2)	92	.1

Earnings before income taxes	14,351	7.2	11,251	6.2
Provision for income taxes	4,581	2.3	3,505	1.9
	\$		\$	
Net earnings	9,770	4.9	7,746	4.2

*Net Sales:* Net sales for 2004 increased by \$17,153 or 9.4%, to \$199,933, from \$182,780 for 2003. The increase in net sales was due to our success in increasing our market share across generally all lines of our business.

*Gross Profit:* Gross profit for 2004 increased \$5,017 or 11.6%, to \$48,288 which made up 24.2% of net sales, from \$43,271 for 2003, which made up 23.7% of net sales. The gross profit increase was principally due to a higher sales volume and cost reductions attributable to:

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Reductions in raw material expenses due to in-house production of various raw materials.

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Reductions in direct labor force headcount and better utilization of our automated equipment.

*Operating Expenses:* Operating expenses for 2004 increased \$1,457, or 4.5%, to \$33,569, from \$32,112 in 2003. The increase in operating expenses was primarily caused by a higher sales volume in 2004. Operating expenses as a percentage of sales decreased in 2004 to 16.8% from 17.6% due primarily to a reduction of bad debt expense from 2003 of approximately \$3.5 million in 2003 to \$2.0 million in 2004.

*Nonoperating income (expense):* Nonoperating income (expense) decreased approximately \$460 to (\$368) of expense for 2004, compared to \$92 of income in 2003. The decrease was due to a reduction of other income partially offset by a reduction of interest expense of approximately \$300.

*Provision for Income Taxes:* Our effective state and federal tax rate, adjusted for the effect of certain one-time credits and adjustments, was approximately 38% and 39% for 2004 and 2003, respectively.



## EFFECTS OF INFLATION

The Company's business and operations have not been materially affected by inflation during the periods for which financial information is presented.

## LIQUIDITY AND CAPITAL RESOURCES (dollar amounts in thousands)

Working capital was \$60,595 at December 31, 2005, compared to \$54,212 at December 31, 2004. This included cash and cash equivalents of \$695 and \$1,886 at December 31, 2005 and 2004, respectively. The primary reason for the increase in working capital was the net earnings of the company partially offset by amounts used for acquisitions and to purchase equipment.

Trade receivables increased \$8,599, or 20.7% at December 31, 2005 from \$41,547 at December 31, 2004. The increase in accounts receivable is attributable to increased sales volume and the aging of various accounts along with the timing differences in shipments and payments received.

Continuing operations generated \$7,274 of cash in 2005, compared to \$8,150 of cash in 2004. The decrease in cash flows was primarily related to increases in receivables partially offset by higher operating income. Investing activities for continuing operations consumed \$11,080 of cash during 2005, compared to consuming \$7,137 during 2004. The increase in cash used in investing activities was primarily attributable to the acquisitions of companies in 2005. Financing activities provided \$2,615 of cash in 2005 consisting primarily of proceeds from long-term debt and consumed \$225 of cash in 2004, consisting primarily of payments on long-term debt.

On October 17, 2002, we signed agreements for a new credit facility with Fleet Capital Corporation, which replaced and repaid our previous \$30 million revolving credit facility. The new \$40 million facility consists of a \$7 million term loan and a \$33 million revolving credit line, both of which expire on October 17, 2007. The term loan bears interest, at our option, at either (i) LIBOR plus between 2.5% and 3%, dependent on the Company's fixed charge coverage during the prior twelve months; or (ii) the greater of the Federal Funds Effective Rate plus 0.5% or Fleet's base rate, plus between 0.5% and 1%, dependent on the Company's fixed charge coverage during the prior twelve months. The \$33 million revolving credit facility bears interest at 0.25% less than the term loan. Up to \$11 million of the revolving credit facility may be used to issue letters of credit. The facility is collateralized by substantially all of the Company's assets. The line of credit agreement requires maintenance of certain financial ratios, and restricts capital expenditures, dividends and share repurchases. Unless this credit facility is renewed, it will expire on October 17, 2007. There are no prepayment penalties on any of the credit facilities with Fleet Capital Corporation.

In connection with the amended working capital credit facility and notes payable to a regional development authority and bank, the Company has agreed to certain restrictive covenants which include, among other things, restricting capital expenditures to less than \$9,000 for 2005 and \$3,250 per year, thereafter, not paying dividends or repurchasing its stock without prior written consent, and maintenance of certain financial ratios at all times including: a minimum current ratio, minimum tangible net worth, a maximum ratio of total liabilities to tangible net worth and a minimum fixed charge coverage ratio.

As of December 31, 2005 we had the following fixed obligations and commitments

<b>Year ended December 31,</b>	<b>Operating leases</b>	<b>Capital leases</b>	<b>Long-term debt</b>	<b>Other long-term obligations</b>
2005	1,526	538	3,023	
2006	960	582	1,646	
2007	590	520	1,953	
2008	513	609	357	
2009	470	313	372	
Thereafter	0	0	17,380	1,388

We believe that our cash on hand, cash generated by operations, and cash available from our existing credit facilities is sufficient to meet the capital demands of our current operations during the 2006 fiscal year. Any major increases in sales, particularly in new products, may require substantial capital investment for the manufacture of filtration products. Failure to obtain sufficient capital could materially adversely impact our growth potential.

We are currently considering paying cash dividends in the future to holders of our common stock. Under the terms of our revolving credit line we cannot pay dividends without the prior written consent of the bank.

In 1998, the Board of Directors authorized the repurchase of up to two million shares of our common stock, which repurchase was completed in September 2000. On September 22, 2000, the Board of Directors authorized the repurchase of up to an additional two million shares of common stock through open market or negotiated transactions. Further repurchases under this program are restricted under our current line of credit agreement, and require prior consent of Fleet Capital Corporation. As of February 13, 2005, approximately 557,000 shares had been repurchased in the open market under this authorization.

## Outlook

During 2004 Global Containment Systems, Inc. (GCS) , a wholly owned subsidiary of Flanders Corporation, was formed. GCS will expand its operations into a 400,000 square foot facility in Aiken, SC. This facility will accommodate the requirements for various nuclear containment projects scheduled at the Westinghouse Savannah River Site in Aiken, SC as well as other projects scheduled worldwide over the next ten years. The expansion into South Carolina will provide a state of the art facility with room necessary to provide in place testing, integration, process control verification and final testing and final installation which is expected to provide GCS a unique position in this developing market.

Additionally, during 2004, Flanders Complete Service Division (Flanders CSD), an air filtration service provider was formed. Flanders CSD will offer weekly, monthly and quarterly service contracts for clean room and glove box certification; commercial, industrial, retail and residential surveys; and complete filtration Management including mold remediation and analysis. The company is currently negotiating several large contracts and if they are executed, the company expects to have national coverage by the end of 2006.

During the past three years, we have captured additional market share among big box retailers like The Home Depot and Wal-Mart, capitalizing on our ability to service national accounts from regional distribution centers and our improved on-time delivery performance. We anticipate additional market gains among these types of retailers during the next two years and are introducing new products focused on their marketing and end-user requirements. Sales to these retail outlets, while seasonal, also tend to follow progress in the overall economy. Additional gains in market share in this market may not have a significant impact on revenues without some recovery in the overall U.S. economy. Additionally, significant revenue enhancement to these customers is largely dependent upon the success of the new products we are introducing to this marketplace.

During the past three years, we introduced air filtration products which use the Arm&Hammer® brand name. We have recently completed development of antimicrobial air filtration products using the Lysol™ brand name. These products are expected to contribute to our expansion in the retail marketplace, but the extent to which they will do so, and their impact on the bottom line, is currently indeterminable.

We have adapted our biocontainment products for use as part of a system for hardening government buildings, commercial office complexes and public venues against airborne bioweapons such as anthrax and smallpox. There is currently an increase of interest in these products over the past quarter. Any interest towards hardening these types of facilities against airborne bioweapons could have a significant impact on our business.

Sales of air filtration products for semiconductor facilities, historically a major market, are expected to be slow again during 2006, with most analysts pushing recovery for this sector out until 2007. However, the strengthening economy is also having a positive effect on sales of all our products.

We have collected data that indicates that residential filter users replace their filters, on average, approximately one and a half times per year. Manufacturers of residential furnace and air conditioning systems recommend that these filters be changed every month. A minor trend toward increased maintenance of these residential heating and cooling systems could have a positive impact on our business.

Our most common products, in terms of both unit and dollar volume, are residential throw-away spun-glass filters, which usually sell for prices under \$1.00. Any increase in consumer concern regarding air pollution, airborne pollens, allergens, and other residential airborne contaminants could result in replacement of some of these products with higher value products. Our higher value products include our NaturalAire® higher-efficiency filters for residential use, and our Lysol™ and Arm&Hammer® co-branded products, with associated sales prices typically over \$5.00 each. Any such trend would have a beneficial effect on our business.

We believe there is currently a gradually increasing public awareness of the issues surrounding indoor air quality and that this trend will continue for the next several years. We also believe there is an increase in public concern regarding the effects of indoor air quality on employee productivity, as well as an increase in interest by standards-making bodies in creating specifications and techniques for detecting, defining and solving indoor air quality problems. We further believe there will be an increase in interest in our Absolute Isolation Barriers in the future because these products may be used in both semiconductor and pharmaceutical manufacturing plants to prevent cross-contamination between different lots and different processes being performed at the same facility. These products also increase production yields in many applications.

Currently, the largest domestic market for air filtration products is for mid-range ASHRAE-rated products and HVAC systems, typically used in commercial and industrial buildings. To date, our penetration of this market has been relatively small. We believe our ability to offer a one stop supply of air filtration products to HVAC distributors and wholesalers may increase our share of this market. We also believe that our recently developed modular air handlers and environmental tobacco smoke systems will enable us to expand sales to these customers. We intend our new products to serve as high profile entrants with distributors and manufacturers representatives, who can then be motivated to carry our complete product line.

We have continually looked for cost reductions in our products. During the past five years, we have continued to complete the development and redesigning of numerous systems and products which were only partially completed when we acquired the companies which originally claimed to have fully developed them. These products include the automated machinery necessary for high-speed production of our pleated filters, acquired with Precisionaire, and the mass-production processes for bonded carbon high-mass zero-density products. During 2006, we are expecting to move from semi automated lines to fully automated production lines which is expected to significantly reduce our labor related costs

This Outlook section, and other portions of this document, include certain forward-looking statements within the meaning of that term in Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934, including, among others, those statements preceded by, following or including the words believe, expect, intend, anticipate or similar expressions. These forward-looking statements are based largely on the current

expectations of management and are subject to a number of assumptions, risks and uncertainties. Our actual results could differ materially from these forward-looking statements. Important factors to consider in evaluating such forward-looking statements include those discussed below under the heading **Factors That May Affect Future Results** as well as:

- the shortage of reliable market data regarding the air filtration market,
- changes in external competitive market factors or in our internal budgeting process which might impact trends in our results of operations,
- anticipated working capital or other cash requirements,
- changes in our business strategy or an inability to execute our strategy due to unanticipated changes in the market,
- product obsolescence due to the development of new technologies, and
- various competitive factors that may prevent us from competing successfully in the marketplace.

In light of these risks and uncertainties, there can be no assurance that the events contemplated by the forward-looking statements contained in this Form 10-K will in fact occur.

### **Factors That May Affect Future Results**

#### *Failure to Manage Future Growth Could Adversely Impact Our Business Due to the Strain on Our Management, Financial and Other Resources*

If our business expands in the future, the additional growth will place burdens on management to manage such growth while maintaining profitability. Our ability to compete effectively and manage future growth depends on our ability to:

- recruit, train and manage our work force, particularly in the areas of corporate management, accounting, research and development and operations,
- manage production and inventory levels to meet product demand,
- manage and improve production quality,
- expand both the range of customers and the geographic scope of our customer base, and
- improve financial and management controls, reporting systems and procedures.

Any failure to manage growth effectively could have a material adverse effect on our business, financial condition and results of operations.

*Any Delay in Procuring Financing for New Products or Failure to Adequately Ramp-Up Production Capacity to Meet Demand Could Adversely Impact Our Business Due to Strain on Financial Resources.*

During 2006 and 2007, we plan to introduce and market various products which, if successful, may require additional financing and/or capital. This financing may need to be available on short notice. Any failure to obtain such financing, or delay in financing, could cause the failure of the new products due to inability to deliver on time, and could adversely impact relationships with current major accounts. In addition, delays in an untried supply chain, new production chains, and other delays common to the launch of a new product line could also adversely impact the success of the products, as well as current relationships with major accounts.

*Our Business May Suffer If Our Competitive Strategy is Not Successful*

Our continued success depends on our ability to compete in an industry that is highly competitive. This competition may increase as new competitors enter the market. Several of our competitors may have longer operating histories and greater financial, marketing and other resources than we do. Additionally, our competitors may introduce new

products or enhancements to products that could cause a decline in sales or loss of market acceptance of our existing products. Under our current competitive strategy, we endeavor to remain competitive by:

- increasing our market share,
- expanding our market through the introduction of new products which require periodic replacement, and
- improving operating efficiencies.

Although our executive management team continues to review and monitor our strategic plans, we have no assurance that we will be able to follow our current strategy or that this strategy will be successful.

*Our Market Share May Not Continue to Increase if We are Unable to Acquire Additional Synergistic Businesses*

In the past several years, we have significantly increased our market share by acquiring synergistic businesses. Although we intend to continue to increase our market share in this manner, we have no assurance that future acquisition opportunities will be available, and do not anticipate that future acquisitions will be of a size which would result in immediate significant increases in the size of our business. Additionally, in the future we may not have access to the substantial debt or equity financing to finance potential acquisitions. Moreover, these types of transactions may result in potentially dilutive issuances of equity securities, the incurrence of additional debt and other acquisition-related expenses, all of which could adversely affect our profitability or cash flows. Our strategy of growth through acquisition also exposes us to the potential risks inherent in assessing the value, strengths, weaknesses, and potential profitability of acquisition candidates and in integrating the operations of acquired companies. We do not currently have any binding agreements with respect to future acquisitions.

*Our Business May Suffer if Our Strategy to Increase the Size and Customer Base of the Air Filtration Market is Unsuccessful*

We are developing new products as part of our strategy to increase the size and customer base of the air filtration market. We have no assurance that this strategy will be successful. We have no guarantee that any new products we develop will gain acceptance in the marketplace, or that these products will be successful. Additionally, we have no assurance we will be able to recoup the expenditures associated with the development of these products. To succeed in this area we must:

- increase public awareness of the issues surrounding indoor air quality,
- adequately address the unknown requirements of the potential customer base,
- develop new products that are competitive in terms of price, performance and quality, and
- avoid significant increases in current expenditure levels in development, marketing and consumer education.

*We May Experience Critical Equipment Failure Which Could Have a Material Adverse Effect on Our Business*

If we experience extended periods of downtime due to the malfunction or failure of our automated production equipment, our business, financial condition and operations may suffer. We design and manufacture much of the automated production equipment used in our facilities. We also use other technologically advanced equipment for which manufacturers may have limited production capability or service experience. If we are unable to quickly repair our equipment or quickly obtain new equipment or parts from outside manufacturers, we could experience extended periods of downtime in the event of malfunction or equipment failure.

*Our Plan to Centralize Overhead Functions May Not Produce the Anticipated Benefits to Our Operating Results*

We are currently completing the implementation of plans to centralize overhead functions and eliminate duplication of efforts between our subsidiaries in the following areas:

- purchasing,
- production planning,
-



shipping coordination,

- 

marketing,

- 

accounting,

- 

personnel management,

- 

risk management, and

- 

benefit plan administration.

We have no assurance that cutting overhead in this fashion will have the anticipated benefits to our operating results. Additionally, we have no assurance that these reorganizations will not significantly disrupt the operations of the affected subsidiaries.

*Our Success Depends on Our Ability to Retain and Attract Key Personnel*

Our success and future operating results depend in part upon our ability to retain our executives and key personnel, many of whom would be difficult to replace. Our success also depends on our ability to attract highly qualified engineering, manufacturing, technical, sales and support personnel for our operations. Competition for such personnel, particularly qualified engineers, is intense, and there can be no assurance that we will be successful in attracting or retaining such personnel. Our failure to attract or retain such persons could have a material adverse effect on our business, financial condition and results of operations.

*Our Current Distribution Channels May be Unavailable if Our Manufacturers' Representatives Decide to Work Primarily With One of Our Competitors*

We provide our manufacturers' representatives with the ability to offer a full product line of air filtration products to existing and new customers. Some of our competitors offer similar arrangements. We do not have exclusive relationships with all of our representatives. Consequently, if our representatives decide to work primarily with one of

our competitors, our current distribution channels, and hence, our sales, could be significantly reduced.

*Management Controls a Significant Percentage of Our Stock*

As of December 31, 2005, our directors and executive officers beneficially held approximately 53.72% of our outstanding common stock. As a result, such shareholders effectively control or significantly influence all matters requiring shareholder approval. These matters include the election of directors and approval of significant corporate transactions. Such concentration of ownership may also have the effect of delaying or preventing a change in control that may otherwise be advantageous to the non-affiliated shareholders.

*We May be Required to Issue Stock in the Future That Will Dilute the Value of Our Existing Stock*

We have granted options to purchase a total of 5,792,000 shares of common stock to various parties with exercise prices ranging from \$1.50 to \$11.10 per share. The majority of these options are currently exercisable. Additionally, if the option holders exercise their options, the interests of current shareholders may be diluted.

*Our Shareholders May Not Realize Certain Opportunities Because of Our Charter Provisions and North Carolina Law*

Our Articles of Incorporation and Bylaws contain provisions that are designed to provide our Board of Directors with time to consider whether a hostile takeover offer is in our best interest and the best interests of our shareholders. These provisions may discourage potential acquisition proposals and could delay or prevent a change of control in our business. Additionally, we are subject to the Control Shares Acquisition Act of the State of North Carolina. This act provides that any person who acquires control shares of a publicly held North Carolina corporation will not have voting rights with respect to the acquired shares unless a majority of the disinterested shareholders of the corporation vote to grant such rights. This could deprive shareholders of opportunities to realize takeover premiums for their shares or other advantages that large accumulations of stock would typically provide.

*Our Business Can be Significantly Affected by Environmental Laws*

The constantly changing body of environmental laws and regulations may significantly influence our business and products. These laws and regulations require that various environmental standards be met and impose liability for the failure to comply with such standards. While we endeavor at each of our facilities to assure compliance with environmental laws and regulations, and are currently not aware of any ongoing issues of this nature, we cannot be certain that our operations or activities, or historical operations by others at our locations, will not result in civil or

criminal enforcement actions or private actions that could have a materially adverse effect on our business. We have, in the past, and may, in the future, purchase or lease properties with unresolved potential violations of federal or state environmental regulations. In these transactions, we have been successful in obtaining sufficient indemnification and mitigating the impact of the issues without recognizing significant expenses associated with litigation and cleanup.

However, purchasing or leasing these properties requires us to weigh the cost of resolving these issues and the likelihood of litigation against the potential economic and business benefits of the transaction. If we fail to correctly identify, resolve and obtain indemnification against these risks, they could have a material adverse impact on our financial position.

Because of the foregoing factors, as well as other variables affecting our operating results, past financial performance should not be considered a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

#### **Item 7A.**

##### **Quantitative and Qualitative Disclosures About Market Risk** (dollar amounts in thousands)

We are exposed to various market risks, primarily changes in interest rates. Market risk is the potential loss arising from adverse change in market rates and prices, such as foreign currency exchange and interest rates. For Flanders, these exposures are primarily related to changes in interest rates. We do not hold any derivatives or other financial instruments for trading or speculative purposes.

The fair value of the Company's total long-term debt, including capital leases and current maturities of long-term debt, at December 31, 2005 was \$27,293. Market risk was estimated as the potential decrease (increase) in future earnings and cash flows resulting from a hypothetical 10% increase (decrease) in the Company's estimated weighted average borrowing rate at December 31, 2005. Although most of the interest on the Company's debt is indexed to a market rate, there would be no material effect on the future earnings or cash flows related to the Company's total debt for such a hypothetical change.

We have only a limited involvement with derivative financial instruments. We have two interest-rate swap agreements to hedge against the potential impact on earnings from increases in market interest rates of two variable rate bonds. Under the interest rate swap agreements, we receive or make payments on a monthly basis, based on the differential between 5.14% and a tax exempt interest rate as determined by a remarketing agent. This interest rate swap is accounted for as a cash flow hedge in accordance with SFAS 133 and SFAS 138. Gains or losses related to inefficiencies of the cash flow hedge were included in net income during the period related to hedge ineffectiveness. The tax affected fair market value of the interest rate swap of \$833 is included in Accumulated other comprehensive loss on the balance sheet. The interest rate swap contracts expire in 2013 and 2015.

The Company's financial position is not materially affected by fluctuations in currencies against the U.S. dollar, since assets held outside the United States are negligible. Risks due to changes in foreign currency exchange rates are negligible, as the preponderance of our foreign sales occur over short periods of time or are demarcated in U.S. dollars.

## **Item 8.**

### **Financial Statements and Supplementary Data**

Beginning at page F-1.

## **Item 9A. Controls and Procedures**

### ***Evaluation of Disclosure Controls and Procedures***

Our management carried out an evaluation, under the supervision and with the participation of our President and Chief Executive Officer and our Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of our year ended December 31, 2005 pursuant to Exchange Act Rule 13a-15(b). Based upon that evaluation, our President and Chief Executive Officer and our Chief Financial Officer concluded that, as of the end of our year ended December 31, 2005, our disclosure controls and procedures were effective.

The term "disclosure controls and procedures," as defined under the Exchange Act, means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer 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 Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

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

There have been no changes in our internal control over financial reporting that occurred during the year ended December 31, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### ***MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING***

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined in Exchange Act Rule 13a-15(f). Our management has assessed the effectiveness of our internal control over financial reporting as of December 31, 2005. Management's evaluation was based on criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework*. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that:

- (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect our transactions and dispositions of our assets;
- (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and board of directors; and
- (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on our financial statements.

Because of its inherent limitations, internal control over financial reporting determined to be effective can provide only reasonable assurance with respect to financial statement preparation and may not prevent or detect all misstatements. Also, 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.

Based on the COSO criteria and our management's evaluation, our management believes our internal control over financial reporting as of December 31, 2005 was effective.

Our independent registered public accounting firm, Pender Newkirk & Co., LLC, has audited the financial statements included in this Annual Report on Form 10-K and has issued an attestation report on management's assessment of our internal control over financial reporting as well as on the effectiveness of our internal control over financial reporting. This report appears in this Annual Report on Form 10-K.

### ***Important Considerations***

The effectiveness of our disclosure controls and procedures and our internal control over financial reporting is subject to various inherent limitations, including cost limitations, judgments used in decision making, assumptions about the likelihood of future events, the soundness of our systems, the possibility of human error, and the risk of fraud. Moreover, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions and the risk that the degree of compliance with policies or procedures may deteriorate over time. Because of these limitations, there can be no assurance that any system of disclosure controls and procedures or internal control over financial reporting will be successful in preventing all errors or fraud or in making all material information known in a timely manner to the appropriate levels of management.

## **PART III**

**Item 10.**

**Directors and Executive Officers of the Registrant**

**IDENTIFICATION OF DIRECTORS AND EXECUTIVE OFFICERS**

Set forth below is information regarding (i) the current directors of the Company, who will serve until the next annual meeting of shareholders or until their successors are elected or appointed and qualified, and (ii) the current executive officers of the Company, who are elected to serve at the discretion of the Board of Directors.

Name

Age

Title

Steven K. Clark

53

Chief Executive Officer and Director

James L. Buddy Mercer

61

Vice President Operations

John W. Hodson

43

Chief Financial Officer

Robert Amerson

55

Chairman of the Board

Robert Kelly Barnhill, Sr.

66

Independent Director

William D. Mitchum, Jr.

58

Independent Director

David M. Mock

53

Independent Director

Peter Fredericks

47

Independent Director

**Steven K. Clark.** Mr. Clark was the Chief Financial officer and Director from December 1995 through December of 2004. He became the Chief Executive officer in December 2004. Mr. Clark acted as a consultant from November, 1995 through December, 1995. From July 1992 through October 1995, he was the Chief Financial Officer of Daw Technologies, Inc., a specialty cleanroom contractor and customer of the Company. Prior to this he was a senior partner of Miller and Clark, an accounting and management services firm. Mr. Clark spent four years with Price Waterhouse, and an additional four years with Arthur Andersen, both accounting firms. He has Bachelor of Arts degrees in Accounting and Political Science and a Master of Business Administration Degree, all from the University of Utah.

**James L. Buddy Mercer.** Mr. Mercer has been Vice President Operations for the Company since December 2001. He has direct responsibility for all plant manufacturing operations. Prior to December 2001, beginning in 1998, he was a

general manager for Precisionaire, a subsidiary of the Company. From 1967 through 1997, Mr. Mercer worked at Purolator Air Products, a competitor, working in several positions, up through plant manager.

**John W. Hodson.** Mr. Hodson has been the Chief Financial Officer of Precisionaire, Inc. and several other Flanders Subsidiaries since October 1999. He became the Chief Financial Officer of Flanders Corporation in December of 2004. He has direct responsibility for overseeing the Corporate accounting department, the financial reporting process and the day to day financial operations of the company. From 1986 through October 1999 he worked primarily as a public accountant for various CPA firms including Price Waterhouse and several smaller firms. He is a Certified Public Accountant in the states of Florida and North Carolina and has a Bachelor of Science degree in Accounting from the University of Central Florida.

**Robert Amerson.** Mr. Amerson has been President and Chief Executive Officer of the Company since 1987 but retired from these positions in December of 2004 and now Mr. Amerson is the Chairman of the Board of Directors. He has held a director position since 1988. Mr. Amerson has a Bachelor of Science degree in Business Administration from Atlantic Christian College.

**Robert Kelly Barnhill, Sr.** Mr. Barnhill was appointed as a director in December of 2004. Mr. Barnhill is President of Hendrix-Barnhill Co. Inc., a licensed contractor specializing in the construction of public utilities. Mr. Barnhill has served on the Board of Governors of Greenville Country Club and is the former President of the University City Kiwanis Club. Mr. Barnhill also served as the Pitt County Commissioner and currently serves on the North Carolina Licensing Board for General Contractors, the North Carolina State Engineering Foundation, and is the Vice Chairman of the Pitt Memorial Hospital Foundation. Mr. Barnhill received his degree in Civil Engineering from the North Carolina State University.

**William D. Mitchum, Jr.** Mr. Mitchum was appointed as a director in December of 2004. Mr. Mitchum is the President and Chief Executive Officer of Mercer Glass Co., Inc., duties he has held since 1981. Prior to this he was the Executive Vice President of Hardware Suppliers of America, Inc. and Eastern Millwork. Mr. Mitchum has served as Director of Local Board BB&T and Local Board First Union National. He is currently Director of Regional Advisory Board Wachovia Bank. Mr. Mitchum received his Bachelor of Science and MBA degrees from East Carolina University.

**David M. Mock.** Mr. Mock was appointed as a Director in August 2003 and affirmed by the shareholders in December 2003. Mr. Mock is a general partner with GMG Capital Partner, a New York-based investment firm, which he co-founded in 1997. Prior to joining GMS/GMG Partners, Mr. Mock was a private investor pursuing an investment strategy similar to that of GMG. Mr. Mock is currently Chairman of the Board of Captus Networks as



well as serving as Director or Executive Officer to several other companies including Alloptic, Inc., Forum Systems, and Connecting Point, Inc. Mr. Mock holds an Bachelor of Arts Degree in Accounting from the University of Utah and is considered an audit committee financial expert.

**Peter Fredericks.** Mr. Fredericks has been an independent director since April 2002. Mr. Fredericks is a private equity investor, and has been involved in business management, equity investment, and consulting since 1982. Mr. Fredericks' experience includes working as a strategy consultant with the Boston Consulting Group. Mr. Fredericks received his Bachelor of Arts degree in Economics with distinction from Stanford University, his Masters in Business Administration from Harvard University, where he was a Baker Scholar, and his Ph.D. from the Vienna University of Economics and Business Administration.

## Item 11.

### Executive Compensation

#### SUMMARY COMPENSATION TABLE

The following table sets forth the aggregate cash compensation paid by the Company for services rendered during the last three years to the Company's Chief Executive Officer and to each of the Company's other executive officers whose annual salary, bonus and other compensation exceeded \$100,000 in 2005.

Name and Principal Position	Year	Annual Compensation			Long-Term Compensation		
		Salary (\$)	Bonus (\$)	Other Annual Compensation (\$)	Awards Restricted Stock Award(s) (\$)	Securities Underlying Options/SARs (#)	Payouts LTIP Payouts (\$)
Steven K. Clark Chief Executive Officer	2005 <sup>1</sup>	328,846		9,574		500,000	
	2004	250,000		11,041		500,000	
	2003	254,808		1,587			
Robert Amerson	2005 <sup>1</sup>	328,846					
	2004	259,615					

Chairman of the Board of Directors	2003	246,672		
John W. Hodson	2005	107,346	4,431	30,000
Chief Financial Officer	2004	107,154	4,050	40,000
James B. Buddy Mercer	2005	118,247		
Vice President Operations	2004	118,247		40,000
	2003	120,521		80,000

1

Mr. Amerson and Mr. Clark each had an annual salary of \$350,000, plus a possible bonus each year, under their respective Employment Agreements, as amended.

**AGGREGATED OPTION/SAR EXERCISES IN LAST FISCAL YEAR**

**AND FISCAL YEAR-END OPTION/SAR VALUES**

The following table sets forth the aggregate number and value of stock options and SARs at year end by the Company's Chief Executive Officer and by each of the Company's other executive officers whose annual salary, bonus and other compensation exceeds \$100,000.

Name	Shares Acquired On Exercise (#)	Value Realized (\$)	Number of Securities Underlying Unexercised Options/SARs at Fiscal Year-End (#)	Value of Unexercised In-the-Money Options/SARs at Fiscal Year-End
			Exercisable/Unexercisable	Exercisable/Unexercisable
		\$	3,000,000 /	16,630,000 /

Steven K. Clark

		\$
	\$ 2,000,000 /	14,320,000 /
Robert R. Amerson		\$
	\$ 120,000 /	766,000 /
John W. Hodson	40,000	336,000
	\$ 40,000 /	210,200 /
James L. Buddy Mercer	80,000	721,600

## COMPENSATION OF DIRECTORS

Directors who are Company employees receive no additional or special remuneration for serving as Directors. The Company's non-employee Directors are paid \$500 plus out-of-pocket expenses for each meeting of the Board of Directors. After being a Director for at least six months, each non-employee Director receives an automatic option to purchase 5,000 shares of the Company's common stock on the first business day at the beginning of the following year. Each current non-employee Director serving also received an option to purchase 50,000 shares of common stock upon their appointment to the Board.

## EMPLOYMENT AGREEMENTS

Messrs. Amerson and Clark have employment agreements effective as of December 15, 1995 ( "Employment Agreements" ). The Employment Agreements, as amended, provide for an annual base salary of \$350,000 for both Mr. Amerson and Mr. Clark and terminate in 2010. The Employment Agreements also provide that the executive shall be entitled to the following termination payments: (i) 100% of his current base salary if the employment is terminated as a result of his death or disability; (ii) up to 200% of his current base salary if the employment is terminated by the Company for any reason other than death, disability or for cause, or (iii) up to 250% of the executive's gross income during the year preceding his termination if the Employment Agreement is terminated by the executive for good reason or by the Company for any reason other than death, disability or cause and the termination occurs within two years after a change of control of the Company has occurred.

Messr. Hodson has a three year employment contract dated January 1, 2005. The employment contract provides for an annual base salary of 100K and a discretionary bonus. The Employment Agreement also provides for 200% of his base salary upon termination by the company for any reason other than death or disability.

## **OTHER INFORMATION REGARDING THE BOARD OF DIRECTORS**

### Board Meetings and Committees

During 2005, the Board of Directors met four times and also executed various consent resolutions and written actions in lieu of meetings. Additionally, all directors were present, either in person or by proxy, at the Fiscal 2004 Annual Meeting of the Shareholders held in December of 2005.

The Board of Directors currently has an Audit Committee and a Compensation Committee. The Audit Committee reviews the results and scope of the audit and other services provided by the Company's independent auditors, reviews and evaluates the Company's internal audit and control functions, monitors transactions between the Company and its employees, officers and directors, and completes other functions as required by the Public Company Accounting Reform and Investor Protection Act (the Sarbanes-Oxley Act) passed in 2002. David Mock is considered the audit committee financial expert. The Compensation Committee administers the Company's equity incentive plans and designates compensation levels for executive officers and directors of the Company. The Audit Committee met four times during 2005. The Compensation Committee met one time during 2005.

Currently, the Audit Committee consists of Messrs. Mock, Fredericks, Barnhill, and Mitchum, with Mr. Mock serving as Chair. The Compensation Committee consists of Messrs. Fredericks, Mock, Clark and Amerson. Mr. Fredericks serves as Chair and Mr. Clark and Mr. Amerson serve as non-voting advisory members.

### Long-Term Incentive Plan

During 1996, the Company adopted the Long Term Incentive Plan (LTI Plan) to assist the Company in securing and retaining key employees and consultants. The LTI Plan authorizes grants of incentive stock options, nonqualified stock options, stock appreciation rights (SARs), restricted stock performance shares and dividend equivalents to officers and key employees of the Company and outside consultants to the Company. There are 1,987,000 shares of Common Stock reserved for award under the LTI Plan. During 2005, 2004 and 2003, the Company awarded options to purchase 665,000, 630,000 and 145,000 shares of Common Stock under the LTI Plan, respectively.

The LTI Plan is administered by the Compensation Committee. The Compensation Committee determines the total number and type of awards granted in any year, the number and selection of employees or consultants to receive awards, the number and type of awards granted to each grantee and the other terms and provisions of the awards, subject to the limitations set forth in the LTI Plan.

*Stock Option Grants.* The Compensation Committee has the authority to select individuals who are to receive options under the LTI Plan and to specify the terms and conditions of each option so granted (incentive or nonqualified), the exercise price (which must be at least equal to the fair market value of the common stock on the date of grant with respect to incentive stock options), the vesting provisions and the option term. Unless otherwise provided by the Compensation Committee, any option granted under the LTI Plan expires the earlier of five years from the date of grant or, three months after the optionee's termination of service with the Company if the termination of employment is attributable to (i) disability, (ii) retirement, or (iii) any other reason, or 15 months after the optionee's death. As of December 31, 2005, there are 1,535,000 options outstanding under the LTI Plan.

*Stock Appreciation Rights.* The Compensation Committee may grant SARs separately or in tandem with a stock option award. A SAR is an incentive award that permits the holder to receive (per share covered thereby) an equal amount by which the fair market value of a share of common stock on the date of exercise exceeds the fair market value of such share on the date the SAR was granted. Under the LTI Plan, the Company may pay such amount in cash, in common stock or a combination of both. Unless otherwise provided by the Compensation Committee at the time of grant, the provisions of the LTI Plan relating to the termination of employment of a holder of a stock option will apply equally, to the extent applicable, to the holder of a SAR. A SAR granted in tandem with a related option will generally have the same terms and provisions as the related option with respect to exercisability. A SAR granted separately will have such terms as the Compensation Committee may determine, subject to the provisions of the LTI Plan. As of December 31, 2005, no SARs are outstanding under the LTI Plan.

*Performance Shares.* The Compensation Committee is authorized under the LTI Plan to grant performance shares to selected employees. Performance shares are rights granted to employees to receive cash, stock, or other property, the payment of which is contingent upon achieving certain performance goals established by the Compensation Committee. As of December 31, 2005, no performance shares are outstanding under the LTI Plan.

*Restricted Stock Awards.* The Compensation Committee is authorized under the LTI Plan to issue shares of restricted common stock to eligible participants on such terms and conditions and subject to such restrictions, if any, outstanding under the LTI Plan. As of December 31, 2005, no restricted shares have been awarded under the LTI Plan.

*Dividend Equivalents.* The Compensation Committee may also grant dividend equivalent rights to participants subject to such terms and conditions as may be selected by the Compensation Committee. Dividend equivalent rights entitle the holder to receive payments equal to dividends with respect to all or a portion of the number of shares of stock subject to an option award or SARs, as determined by the Committee. As of December 31, 2005, no dividend equivalents are outstanding under the LTI Plan.

*Section 16(a) Beneficial Ownership Reporting Compliance.* Section 16(a) of the Securities Exchange Act of 1934 requires the Company's officers and directors, and persons who own more than ten percent of a registered class of the Company's equity securities, to file reports of ownership and changes in ownership with the Securities and Exchange Commission. Officers and directors are required by SEC regulation to furnish the Company with copies of all Section 16(a) forms filed. Based solely upon review of copies of such forms, or written representations that there were no unreported holdings or transactions, the Company believes that for the fiscal year ending December 31, 2005 all Section 16(a) filing requirements applicable to its officers and directors were complied with on a timely basis.

**Item 12.**

**Security Ownership of Certain Beneficial Owners and Management**

The following table sets forth all individuals known by the Company to beneficially own 5% or more of the Company's common stock, and all officers and directors of the registrant, with the amount and percentage of stock beneficially owned, as of December 31, 2005. Except as indicated in the following footnotes, each listed beneficial owner has sole voting and investment power over the shares of common stock held in their names.

Name and Address of Beneficial Owner	Shares of Common Stock Beneficially Owned	Percentage of Outstanding Shares of Common Stock <sup>(1)</sup>
Robert R. Amerson <sup>(2)</sup>  531 Flanders Filters Road  Washington, NC 27889	7,565,870	28.75%
Steven K. Clark <sup>(3)</sup>  2399 26th Avenue North  Saint Petersburg, Florida 33713	5,515,183	20.96%
John W. Hodson <sup>(4)</sup>	175,000	*

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William D. Mitchum, Jr. <sup>(5)</sup>	55,000	*
David Mock <sup>(6)</sup>	87,700	*
James L. Buddy Mercer <sup>(7)</sup>	120,000	*
Robert Kelly Barnhill, Sr. <sup>(8)</sup>	55,000	*
Peter Fredericks <sup>(9)</sup>	72,810	*

Caxton Associates, LLC	1,382,493	5.25%
------------------------	-----------	-------

Princeton Plaza Bldg 2

731 Alexander Rd

Princeton, NJ 08540

Officers and Directors as a group	14,136,563	53.72%
-----------------------------------	------------	--------

(8 persons) <sup>(2), (3), (4), (5), (6), (7), (8), (9)</sup>

\*

Represents less than 1% of the total issued and outstanding shares of common stock.

(1)

Applicable percentage of ownership is based on 26,317,354 shares of common stock outstanding as of December 31, 2005, together with all applicable options for unissued securities for such shareholders exercisable within 60 days. Shares of common stock subject to options exercisable within 60 days are deemed outstanding for computing the percentage ownership of the person holding such options, but are not deemed outstanding for computing the percentage of any other person.

(2)

Includes 1,000,000 shares which are subject to an option to purchase such shares from the Company at \$2.50 per share. These options expire in 2009. Also includes 1,000,000 shares which are subject to an option to purchase such shares from the Company at \$7.50 per share. These options expire in 2011. These options expire in 2011.

(3)

Includes 1,000,000 shares which are subject to an option to purchase such shares from the Company at \$2.50 per share. These options expire in 2009. Also includes 1,000,000 shares which are subject to an option to purchase such

shares from the Company at \$7.50 per share. These options expire in 2011. Also includes 500,000 shares which are subject to an option to purchase such shares from the Company at \$11.10 per share. These options expire in 2010.

(4)

Includes 10,000 shares which are subject to an option to purchase such shares from the Company at \$2.40 per share. These options expire in 2006. Also includes 40,000 shares which are subject to an option to purchase such shares from the Company at \$1.50 per share. These options expire in 2007. Also includes 20,000 shares which are subject to an option to purchase such shares from the Company at \$5.00 per share. These options expire in 2008. Also includes 20,000 shares which are subject to an option to purchase such shares from the Company at \$2.52 per share. These options expire in 2008. Also includes 20,000 shares which are subject to an option to purchase such shares from the Company at \$5.21 share. These options expire in 2009. Also includes 20,000 shares which are subject to an option to purchase such shares from the Company at \$8.60 per share. These options expire in 2009. Also includes 30,000 shares which are subject to an option to purchase such shares from the Company at \$11.10 per share. These options expire in 2010.

(5)

Includes 55,000 shares which are subject to an option to purchase such shares from the Company at \$11.01 per share. These options expire in 2010.

(6)

Includes 50,000 shares which are subject to an option to purchase such shares from the Company at \$4.37 per share. These options expire in 2008. Also includes 5,000 shares which are subject to an option to purchase such shares from the Company at \$11.01 per share. These options expire in 2010.

(7)

Includes 60,000 shares which are subject to an option to purchase such shares from the Company at \$2.52 per share. Also includes 20,000 shares which are subject to an option to purchase such shares from the Company at \$5.00 per share. These options expire in 2008. Also includes 20,000 shares which are subject to an option to purchase such shares from the Company at \$5.21 per share. Also includes 20,000 shares which are subject to an option to purchase such shares from the Company at \$8.60 per share. These options expire in 2009.

(8)

Includes 55,000 shares which are subject to an option to purchase such shares from the Company at \$11.01 per share. These options expire in 2010.



(9)

Includes 27,000 shares which are subject to an option to purchase such shares from the Company at \$1.74 per share. These options expire in 2007. Also includes 5,000 shares which are subject to an option to purchase such shares from the Company at \$1.77 per share. These options expire in 2008. Also includes 5,000 shares which are subject to an option to purchase such shares from the Company at \$6.49 per share. These options expire in 2009. Also includes 5,000 shares which are subject to an option to purchase such shares from the Company at \$11.01 per share. These options expire in 2010.

### **Item 13.**

#### **Certain Relationships and Related Transactions** (dollar amounts in thousands)

At December 31, 2005, Steven K. Clark owed the Company \$4,877 of principal and accrued interest which he previously borrowed to make certain payments under an indemnity agreement he entered into with the Company, to exercise options and to purchase certain shares. This debt is evidenced by a note which bears interest at LIBOR plus 1%, and is due in full on December 31, 2010, or on demand by the Company if he terminates employment, and is secured by common stock.

At December 31, 2005, Robert R. Amerson owed the Company \$2,872 of principal and accrued interest, which he previously borrowed, the majority of which was used to settle claims, to make certain payments under an indemnity agreement he entered into with the Company, to purchase certain shares and for other unspecified reasons. This debt is evidenced by a note which bears interest at LIBOR plus 1%, and is due in full on December 31, 2010, or on demand by the Company if he terminates employment, and is secured by common stock.

On January 2, 2001, the Company purchased and leased back \$797 in manufacturing equipment from Superior Diecutting, Inc., a vendor 50% owned by two officer and directors. The Company also loaned this supplier \$500, secured by a building and used to pay off an existing mortgage, and \$400 to repay a credit line secured by inventory, receivables and other current assets. The Company made payments of \$10,951 and \$6,933 in 2005 and 2004, respectively, to this supplier for purchases of raw materials. At December 31, 2005 and 2004, the Company owed a total of \$3,873 and \$2,591, respectively, to this vendor. At December 31, 2005, Superior Diecutting, Inc. owed the Company \$1,499. The accounts and operations of this related entity have been consolidated, thus, the financial effects of these transactions have been eliminated in consolidation.

The Company made payments totaling \$1,067 and \$1,041 in 2005 and 2004, respectively, to Wal-Pat II, a real estate Limited Liability Company which leases property to the Company. Wal-Pat II is owned by Robert R. Amerson and Steven K. Clark (fifty percent each). At December 31, 2005, the Company owed a total of \$0 to Wal-Pat II. As of February 1, 2006 the company entered into four new lease agreements for buildings owned by Wal-Pat II with monthly payments totaling \$58.

**Item 15.**

**Principal Accountant Fees and Services** (dollar amounts in thousands)

*Audit Related Fees*

Our principal accountants billed us an aggregate of \$266 and \$217 in fees and expenses for professional services rendered in connection with the audits of our financial statements for the calendar years ended December 31, 2005 and 2004, respectively, and reviews of the financial statements included in our quarterly reports on Form 10-Q during such calendar years.

Our principal accountants did not bill us any additional fees that are not disclosed under audit fees in each of the last two calendar years for assurance and related services that are reasonably related to the performance of our audit or review of our financial statements.

*Tax Fees*

Our principal accountants billed us an aggregate of \$61 and \$76 in fees and expenses for tax compliance, tax advice and tax planning during calendar years ended December 31, 2005 and 2004, respectively.

*All Other Fees*

Our principal accountants billed us an aggregate of \$34 and \$27 in fees and expenses during calendar years ended December 31, 2005 and 2004, respectively, for products and services other than those products and services described above. These services consist of the following:

- Audit of profit sharing plan and discussions regarding Sarbanes Oxley 404.

*Audit Committee Pre-Approval Process, Policies and Procedures*

The appointment of Pender Newkirk & Co., LLP was approved by our Audit Committee and full Board of Directors. Our principal auditors have performed their audit procedures in accordance with pre-approved policies and procedures established by our Audit Committee. Our principal auditors have informed our Audit Committee of the scope and nature of each service provided. With respect to the provisions of services other than audit, review, or attest services, our principal accountants brought such services to the attention of our Audit Committee, or one or more members of our Audit Committee for the members of our Board of Directors to whom authority to grant such approval had been delegated by the Audit Committee, prior to commencing such services. Such services primarily consisted of tax related services.

### **Code of Ethics for Senior Financial Officers**

The code of ethics established by the Company for its Senior Financial Officers is required to be signed by each such officer, is maintained on file by the Company, and incorporates the following:

Senior Financial Officers hold an important and elevated role in corporate governance. While members of the management team, they are uniquely capable and empowered to ensure that all stakeholder's interests are appropriately balanced, protected and preserved. This Code provides principles to which Flanders Corporation Officers are expected to adhere and advocate. They embody rules regarding individual and peer responsibilities, as well as responsibilities to employers, the public and other stakeholders. Our Senior Financial Officers agree by their signature below that they will:

1.

Act with honesty and integrity, avoiding actual or apparent conflicts of interest in personal and professional relationships.

2.

Will make reasonable efforts to comply with rules and regulations of federal, state, provincial and local governments, and other appropriate private and public regulatory agencies as known to them and will make reasonable efforts to maintain or obtain a professional level of knowledge of applicable rules and regulations.

3.

Act in good faith, responsibly, with due care, competence and diligence, without misrepresenting material facts or allowing one's independent judgment to be subordinated.

4.

Respect the confidentiality of information acquired in the course of one's work except when authorized or otherwise legally obligated to disclose. Confidential information acquired in the course of one's work will not be used for personal advantage.

## **PART IV**

### **Item 16.**

#### **Exhibits, Financial Statement Schedules and Reports on Form 8-K**

The following constitutes a list of Financial Statements, Financial Statement Schedules and Exhibits used in this report.

(a)(1)

Financial Statements: Financial Statements are included beginning at page F-1 as follows:

Report of Independent Registered Public Accounting Firm

F-2

Consolidated Balance Sheets at December 31, 2005 and 2004

F-5

Consolidated Statements of Operations for the years ended December 31, 2005, 2004 and 2003

F-6

Consolidated Statements of Stockholders' Equity for the years ended December 31, 2005, 2004 and 2003

F-7

Consolidated Statements of Cash Flows for the years ended December 31, 2005, 2004 and 2003

F-8

Notes to Consolidated Financial Statements

F-10

(a)(2)

Financial Statement Schedules

Report of Independent Registered Public Accounting Firm on schedule

F-30

Schedule II. Valuation and Qualifying Accounts

F-31

All schedules not listed have been omitted because they are not applicable or the information has been otherwise supplied in the Registrant's financial statements and schedules.

(a)(3)

Exhibits:

3.1

Articles of Incorporation for Flanders Corporation, filed with the Form 8-A dated March 8, 1996, incorporated herein by reference.

3.2

Bylaws of Flanders Corporation, filed with the Form 8-A dated March 8, 1996, incorporated herein by reference.

10.1

Loan and Security Agreement, dated October 9, 2002, by and among Fleet Capital Corporation, Flanders Corporation, Flanders/Precisionaire Corp., Flanders Filters, Inc., Flanders/CSC Corporation, Precisionaire, Inc., Precisionaire of Utah, Inc., Eco-Air Products, Inc., Air Seal Filter Housings, Inc. and Flanders Realty Corp., filed with the Form 8-K/A dated October 21, 2002.

10.2

First Amendment to Loan and Security Agreement, dated October 18, 2002, by and among Flanders Corporation, Flanders/Precisionaire Corp., Flanders Filters, Inc., Flanders/CSC Corporation, Precisionaire, Inc., Precisionaire of Utah, Inc., Eco-Air Products, Inc., Air Seal Filter Housings, Inc., Flanders Realty Corp. and Fleet Capital Corporation, filed with the Form 8-K/A dated October 21, 2002.

10.3

Second Amendment to Loan and Security Agreement, dated November 19, 2002, by and among Flanders Corporation, Flanders/Precisionaire Corp., Flanders Filters, Inc., Flanders/CSC Corporation, Precisionaire, Inc., Precisionaire of Utah, Inc., Eco-Air Products, Inc., Air Seal Filter Housings, Inc., Flanders Realty Corp. and Fleet Capital Corporation, filed with the Form 8-K/A dated October 21, 2002.

10.3.1

Third Amendment to Loan and Security Agreement, dated September 6, 2003 by and among Flanders Corporation, Flanders/Precisionaire Corp., Flanders Filters, Inc., Flanders/CSC Corporation, Precisionaire, Inc., Precisionaire of Utah, Inc., Eco-Air Products, Inc., Air Seal Filter Housings, Inc., Flanders Realty Corp. and Fleet Capital Corporation.

10.3.2

Fourth Amendment to Loan and Security Agreement, dated December 8, 2003, by and among Flanders Corporation, Flanders/Precisionaire Corp., Flanders Filters, Inc., Flanders/CSC Corporation, Precisionaire, Inc., Precisionaire of Utah, Inc., Eco-Air Products, Inc., Air Seal Filter Housings, Inc., Flanders Realty Corp. and Fleet Capital Corporation.

10.4

Support Agreement and Guaranty dated October 18, 2002, between Fleet Capital Corporation and Steven K. Clark, filed with the Form 8-K/A dated October 21, 2002.

10.5

Support Agreement and Guaranty dated October 18, 2002, between Fleet Capital Corporation and Robert Amerson, filed with the Form 8-K/A dated October 21, 2002.

10.6

Continuing Guaranty Agreement dated October 18, 2002, between Fleet Capital Corporation and Superior Diecutting, Inc., filed with the Form 8-K/A dated October 21, 2002.

10.7

Amended and Restated Continuing Guaranty dated November 26, 2002, between Fleet Capital Corporation and Superior Diecutting, Inc., filed with the Form 8-K/A dated October 21, 2002.

10.8

Loan Agreement between Will-Kankakee Regional Development Authority and Flanders Corporation dated December 15, 1997, filed with the December 31, 1997 Form 10-K, and incorporated herein by reference.

10.9

Loan Agreement between Flanders Corporation and the Johnston County Industrial Facilities and Pollution Control Financing Authority, dated April 1, 1998, filed with the Form 10-Q dated March 31, 1998, and incorporated herein by reference.

10.10

Loan Agreement between Flanders Corporation and the Johnston County Industrial Facilities and Pollution Control Financing Authority, dated March 1, 2000, filed with the Form 10-K dated December 31, 1999, and incorporated herein by reference.

10.11

Flanders Corporation 1996 Director Option Plan, filed with the Form 10-K dated December 31, 1995, and incorporated herein by reference.

10.12

Employment Agreement between Elite Acquisitions, Inc., Flanders Filters, Inc., and Steven K. Clark, filed with the December 31, 1995 Form 10-K, incorporated herein by reference.

10.13

Amendment to Employment Agreement between Elite Acquisitions, Inc., Flanders Filters, Inc., and Steven K. Clark, filed with Form S-1 dated October 21, 1996 (Reg. No. 333-14655) and incorporated herein by reference.

10.14

Amendment to Employment Agreement between Elite Acquisitions, Inc., Flanders Filters, Inc., and Steven K. Clark, filed with the Form 10-K dated December 31, 1997 and incorporated herein by reference.

10.15

Amendment to Employment Agreement between Elite Acquisitions, Inc., Flanders Filters, Inc., and Steven K. Clark, filed with the Form 10-K dated December 31, 1999, and incorporated herein by reference.

10.16

Employment Agreement between Elite Acquisitions, Inc., Flanders Filters, Inc. and Robert R. Amerson, filed with the December 31, 1995 Form 10-K, incorporated herein by reference.

10.17

Amendment to Employment Agreement between Elite Acquisitions, Inc., Flanders Filters, Inc., and Robert R. Amerson, filed with Form S-1 dated October 21, 1996 (Reg. No. 333-14655) and incorporated herein by reference.

10.18

Amendment to Employment Agreement between Elite Acquisitions, Inc., Flanders Filters, Inc., and Robert R. Amerson, filed with the Form 10-K dated December 31, 1997 and incorporated herein by reference.

10.19

Amendment to Employment Agreement between Elite Acquisitions, Inc., Flanders Filters, Inc., and Robert R. Amerson, filed with the Form 10-K dated December 31, 1999, and incorporated herein by reference.

10.20

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Stock Option Agreement between Flanders Corporation and Robert R. Amerson dated February 22, 1996, filed with Form S-8 on July 21, 1997, incorporated herein by reference.

10.21

Amendment to Stock Option Agreement between Flanders Corporation and Robert R. Amerson dated December 22, 1999, filed with the Form 10-K dated December 31, 1999, and incorporated herein by reference.

10.22

Stock Option Agreement between Flanders Corporation and Robert R. Amerson dated November 7, 2001, filed with Form 10-K for December 31, 2001, incorporated herein by reference.

10.23

Stock Option Agreement between Flanders Corporation and Steven K. Clark dated February 22, 1996, filed with Form S-8 on July 21, 1997, incorporated herein by reference.

10.24

Amendment to Stock Option Agreement between Flanders Corporation and Steven K. Clark dated December 22, 1999, filed with the Form 10-K dated December 31, 1999, and incorporated herein by reference.

10.25

Stock Option Agreement between Flanders Corporation and Steven K. Clark dated November 7, 2001, filed with Form 10-K dated December 31, 2001, incorporated by reference.

10.26

Note Agreement between Steven K. Clark and Flanders Corporation, dated April 24, 1999, filed with the Form 10-K dated December 31, 1999, and incorporated herein by reference.

10.27

Note Agreement between Robert R. Amerson and Flanders Corporation, dated April 24, 1999, filed with the Form 10-K dated December 31, 1999, and incorporated herein by reference.

10.28

Stock Option Agreement between Flanders Corporation and Steven K. Clark dated August 24, 2004, filed with Form 10-K dated December 31, 2004, incorporated by reference.

10.29

Stock Option Agreement between Flanders Corporation and Steven K. Clark dated December 7, 2005, filed with Form 10-K dated December 31, 2005, incorporated by reference.

10.30



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Stock Option Agreement between Flanders Corporation and John Hodson dated December 7, 2005, filed with Form 10-K dated December 31, 2005, incorporated by reference.

21

Subsidiaries of the Registrant.

23.1

Consent of Pender Newkirk LLP for incorporation by reference of their report into Form S-8 filed on July 21, 1997, filed herewith.

23.2

Consent of Grant Thornton LLP for incorporation by reference of their report into Form S-8 filed on July 21, 1997, filed herewith.

24

Power of Attorney (included on Signature page of this report).

32

Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of The Sarbanes-Oxley Act of 2002.

(b)

Form 8-K dated January 4, 2005

Form 8-K dated January 20, 2005

Form 8-K dated January 27, 2005

Form 8-K dated February 16, 2005

Form 8-K dated April 20, 2005

Form 8-K dated July 18, 2005

Form 8-K dated August 15, 2005

Form 8-K dated September 13, 2005

Form 8-K dated October 19, 2005

(c)

Financial Statement Schedules: See (a) (2) above.

**SIGNATURES**

Pursuant to the requirements of Section 13 of 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.

Dated this 13th day of February, 2006.

FLANDERS CORPORATION

By /s/ Steven K. Clark

Steven K. Clark

President, Chief Executive Officer,

and Director

By /s/ John W. Hodson

John W. Hodson

Chief Financial Officer

KNOW ALL PERSONS BY THESE PRESENTS that each person whose signature appears below constitutes and appoints Steven K. Clark, his attorney-in-fact, to sign any amendments to this report, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Commission, hereby ratifying and confirming all the said attorney-in-fact may lawfully do or cause to be done by virtue hereof.

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 and on the dates indicated.

Signature	Title	Date
<u>/s/</u> _____	President, Chief Executive Officer	_____
	And Director	
Steven K. Clark		
	Chief Financial Officer	_____
<u>/s/</u> _____		
John W. Hodson		
	Director	_____
<u>/s/</u> _____		
William Mitchum, Jr.		
	Director	_____

Robert Kelly Barnhill, Sr.

/s/ \_\_\_\_\_

Director

\_\_\_\_\_

David M. Mock

**FLANDERS CORPORATION**

**CONSOLIDATED FINANCIAL STATEMENTS**

**Report of Independent Registered Public Accounting Firm**

Board of Directors

Flanders Corporation and Subsidiaries

St. Petersburg, Florida

We have audited the accompanying consolidated balance sheets of Flanders Corporation and Subsidiaries (the Company ) as of December 31, 2005 and December 31, 2004 and the related consolidated statements of operations, stockholders' equity, and cash flows for the three years ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable

basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2005 and December 31, 2004 and the results of its operations and its cash flows for the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America

We have also audited, in accordance with the standards of the Public Company Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 10, 2006 expressed an unqualified opinion thereon.

Pender Newkirk & Company, LLP

Certified Public Accountants

Tampa, Florida

February 10, 2006

## **MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-(f) promulgated under the Exchange Act as a process designed by, or under the supervision of, the Company's principal executive and principal financial officers and effected by the Company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company;
  
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and
  
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its 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.

The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2005. In making this assessment, the Company's management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework.

Based on our assessment, management believes that, as of December 31, 2005, the Company's internal control over financial reporting is effective based on those criteria.

The Company's independent auditors have issued an audit report on our assessment of the Company's internal control over financial reporting.

**Report of Independent Registered Public Accounting Firm**

Board of Directors

Flanders Corporation and Subsidiaries

St. Petersburg, Florida

We have audited management's assessment, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting included in Item 9A, that Flanders Corporation and subsidiaries (the Company) maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.



Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, 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.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the balance sheets of the Company as of December 31, 2005 and 2004, and the related statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2005 and our report dated February 10, 2006 expressed an unqualified opinion thereon.

Pender Newkirk & Company, LLP

Certified Public Accountants

Tampa, Florida

February 10, 2006

## CONSOLIDATED BALANCE SHEETS

December 31,

(In thousands, except per share data)

ASSETS	2005	2004
Current assets	\$	\$
Cash and cash equivalents	695	1,886

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Receivables:		
Trade, less allowance for doubtful accounts: \$4,018 in 2005 and \$3,300 in 2004	50,146	41,547
Other	637	240
Inventories	39,418	39,539
Deferred taxes	3,260	2,875
Other current assets	1,673	1,019
	<b>Total current assets</b>	<b>95,829</b>
Related party receivables	395	374
Property and equipment, net	67,618	67,356
Intangible assets, net	5,800	888
Other assets	2,574	3,946
	\$	\$
	172,216	159,670
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities		
	\$	\$
Current maturities of long-term debt and capital lease obligations	3,561	2,553
Accounts payable	13,436	15,595
Accrued expenses	18,237	14,746
	<b>Total current liabilities</b>	<b>35,234</b>
Long-term capital lease obligations, less current maturities	2,023	2,368
Long-term debt, less current maturities	21,709	18,138
Long-term liabilities, other	1,392	1,729
Deferred taxes	6,324	11,380
Commitments and contingencies		
Stockholders equity		
Preferred stock, \$.001 par value, 10,000 shares authorized; none issued		
Common stock, \$.001 par value; 50,000 shares authorized; issued and outstanding: 26,317	26	26
Additional paid-in capital	90,758	90,758
Notes receivable secured by common shares	(6,987)	(6,650)
Accumulated other comprehensive loss	(833)	(1,037)
Retained earnings	22,570	10,064
	105,534	93,161
	\$	\$
	172,216	159,670

**CONSOLIDATED STATEMENTS OF OPERATIONS****Year Ended December 31,**

(In thousands, except per share data)

	<b>2005</b>	<b>2004</b>	<b>2003</b>
	\$	\$	\$
Net sales	229,276	199,933	182,780
Cost of goods sold	176,359	151,645	139,509
Gross profit	52,917	48,288	43,271
Operating expenses	35,297	33,569	32,112
Operating income	17,620	14,719	11,159
Non operating income (expense)			
Other income, net	1,297	1,209	1,970
Interest expense	(1,672)	(1,577)	(1,878)
	(375)	(368)	92
Earnings from operations before income taxes	17,245	14,351	11,251
Provision for income taxes	4,739	4,581	3,505
	\$	\$	\$
Net earnings	12,506	9,770	7,746
Net earnings per share			
	\$	\$	\$
Basic	0.48	0.37	.30
	\$	\$	\$
Diluted	0.45	0.36	.29
Weighted average common shares outstanding			
Basic	26,309	26,201	26,033

Diluted	27,807	27,289	26,428
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## CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

Years Ended December 31, 2005, 2004 and 2003

(In thousands)

	Common Stock	Additional Paid-In Capital	Notes Receivable	Accumulated Other Comprehensive Loss	Retained Earnings	Total
<b>Balance, January 1, 2003</b>	26	90,331	(8,695)	(1,294)	(7,440)	72,928
Accrued interest on notes receivable secured by common shares			(333)			(333)
Purchase and retirement of 63 shares of common stock	(1)	(188)			(12)	(201)
Issuance of 106 shares of common stock upon exercise of options	1	384				385
Comprehensive loss						
Net earnings					7,746	7,746
Gain on cash flow hedges				184		184
Total comprehensive earnings, net of tax						7,930
	\$	\$	\$	\$	\$	\$
<b>Balance, December 31, 2003</b>	26	90,527	(9,028) (309)	(1,110)	294	80,709 (309)

Accrued interest on notes receivable secured by common shares						
Proceeds from notes receivable secured by common shares			2,687			2,687
Purchase and retirement of 19 shares of common stock		(88)				(88)
Issuance of 238 shares of common stock upon exercise						
of options	1	319				319
Comprehensive earnings						
Net earnings					9,770	9,770
Gain on cash flow hedges				73		73
Total comprehensive earnings, net of tax						9,843
		\$	\$	\$	\$	\$
<b>Balance, December 31, 2004</b>	26	90,758	(6,650)	(1,037)	10,064	93,161
Accrued interest on notes receivable secured by common shares			(337)			(337)
Purchase and retirement of 4 shares of common stock		(46)				(46)
Issuance of 18 shares of common stock upon exercise						
of options		46				46
Comprehensive earnings						
Net earnings					12,506	12,506
Gain on cash flow hedges				204		204
Total Comprehensive earnings,						
net of tax						12,710
<b>Balance, December 31, 2005</b>	\$	\$	\$	\$	\$	\$
	26	90,758	(6,987)	(833)	22,570	105,534

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

## Year Ended December 31,

(In thousands)

	2005	2004	2003
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
	\$	\$	\$
Earnings from continuing operations	12,506	9,770	7,746
Adjustments to reconcile earnings from continuing operations to net cash provided by operating activities:			
Depreciation and amortization	8,527	8,165	7,990
Provision for doubtful accounts and notes	2,094	2,039	3,466
Provision for obsolete inventory	85	69	208
Loss on sale of property and equipment	123	138	200
Deferred taxes	(5,581)	1,377	1,094
Minority interest	216	0	0
Accrued interest on notes receivable secured by common shares	(337)	(309)	(333)
Change in working capital components:			
Receivables	(8,845)	(10,882)	(4,882)
Inventories	1,302	(6,527)	(6,147)
Other current assets	(550)	181	(391)
Accounts payable	(5,685)	4,093	(2,296)
Accrued expenses	3,419	(350)	5,438
Income taxes (net)	0	386	220
Net cash provided by operating activities	7,274	8,150	12,313
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Acquisitions, net of cash acquired	(2,939)		
Purchase of property and equipment	(8,136)	(7,563)	(5,264)
Purchase of technology	(451)		
Proceeds from sale of property and equipment	195	172	142
Proceeds from sale of assets			
Proceeds from (disbursements on) notes receivables	(21)	(13)	70
Decrease in other assets	272	267	42
Net cash used in investing activities	(11,080)	(7,137)	(5,010)

- Continued -

**CONSOLIDATED STATEMENTS OF CASH FLOWS** Continued**Years Ended December 31,**

(In thousands)

	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Net (payments on) proceeds from revolving credit agreement	5,458	(654)	(6,799)
Principal payments on long-term borrowings	(2,843)	(2,576)	(2,528)
Payment of debt issuance costs		(1)	(51)
Proceeds from exercise of options		319	367
Proceeds from notes receivable secured by common shares		2,687	
Net cash provided by (used) in financing activities	2,615	(225)	(9,011)
Net increase (decrease) in cash and cash equivalents	(1,191)	788	(1,708)
<b>CASH AND CASH EQUIVALENTS</b>			
Beginning of year	1,886	1,098	2,806
	\$	\$	\$
End of year	695	1,886	1,098
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b>			
Interest paid, net of \$116, \$39 and \$26 interest capitalized to property and equipment for 2005, 2004 and 2003, respectively:	\$	\$	\$
	1,656	1,614	1,954
	\$	\$	\$
Income taxes paid/(received)	6,910	4,044	525
<b>SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES</b>			
	\$	\$	\$
Purchase and retirement of common stock		88	
Sale of assets in exchange for notes receivable	\$	\$	\$

			2
	\$	\$	\$
Capital lease obligation incurred for property and equipment			143
	\$	\$	\$
Accounts receivable in exchange for notes receivable		3,395	149

## ACQUISITION OF COMPANIES

	\$	\$	\$
Working Capital surplus (deficit) acquired, net of cash and cash equivalents received	(1,187)		
	\$	\$	\$
Fair value of other assets acquired, principally property and equipment	614		
	\$	\$	\$
Goodwill	4,601		
	\$	\$	\$
Minority interest	220		
	\$	\$	\$
Long-term debt assumed	(1,302)		

## FLANDERS CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share amounts)



**Note A. Nature of Business and Summary of Significant Accounting Policies**

The nature of the business and a summary of the significant accounting policies consistently applied in the preparation of the accompanying consolidated financial statements follows.

1. Nature of business

The Company designs, manufactures and sells air filters and related products. It is focused on providing complete environmental filtration systems for end uses ranging from controlling contaminants in residences and commercial office buildings through specialized manufacturing environments for semiconductors and pharmaceuticals. The Company also designs and manufactures much of its own production equipment to automate processes to decrease labor costs associated with its standard products. The Company also produces glass-based air filter media for many of its products. The vast majority of the Company's current revenues come from the sale of after-market replacement filters, since air filters are typically placed in equipment designed to last much longer than the filters.

The Company sells some products for end users outside of the United States through domestic specialty clean room contractors. These sales are accounted for as domestic sales. The Company also sells products through foreign distributors, primarily in Europe, and through a wholly-owned subsidiary, which sells to customers in the Pacific Rim. Sales through foreign distributors and its wholly owned foreign subsidiary total less than 5% of net sales. Assets held outside the United States are negligible.

2.

Principles of consolidation

The consolidated financial statements include the accounts and operations of the Company and its subsidiaries, all of which are wholly-owned except for Superior Diecutting, Inc. of which 50% is owned by two officers and directors and 50% is owned by other shareholders unrelated to the Company or any of its officers and directors.

3.

Significant customers

Net sales for the years ended December 31, 2005, 2004 and 2003 included sales to the following major customers, together with the receivables due from those customers:

	Amount of Net Sales			Trade Receivable Balance	
	2005	2004	2003	As of December 31,	
				2005	2004
Customer A	\$	\$	\$	\$	\$
	33,905	29,149	30,715	6,562	5,132
Customer B	\$	\$	\$	\$	\$
	34,432	31,581	30,770	9,194	9,320

4.

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**FLANDERS CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share amounts)

**Note A. Nature of Business and Summary of Significant Accounting Policies** Continued

5

Cash and cash equivalents

The Company maintains its cash in bank deposit accounts, which at times, exceed federally insured limits. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents. For purposes of reporting cash flows, the Company considers all cash accounts which are not subject to withdrawal restrictions or designated for equipment acquisitions and certificates of deposit which have an original maturity of three months or less when purchased to be cash equivalents.

6.

Accounts Receivable

The Company provides an allowance for losses on trade receivables based on a review of the current status of existing receivables and management's evaluation of periodic aging of accounts. The Company charges off accounts receivable against the allowance for losses when an account is deemed to be uncollectible. It is the Company's policy to accrue interest on past due receivables. The provision for doubtful accounts and notes was \$2,094, \$2,039, and \$3,466 for the years ended December 31, 2005, 2004 and 2003, respectively.

7.

Fair value of financial instruments

The carrying amount of cash equivalents, trade receivables and trade payables approximates fair value at December 31, 2005 and 2004 because of the short maturity of these instruments. Based on the borrowing rates currently available to the Company for bank loans with similar maturities and similar collateral requirements, the fair value of notes payable and long-term debt approximates the carrying amounts at December 31, 2005 and 2004.

8.

Inventories

Inventories are valued at lower of cost (first-in, first-out method) or market.

9.

Comprehensive income

FAS 130, Reporting Comprehensive Income, requires disclosure of comprehensive income in addition to the existing income statement. Other comprehensive income (loss) is defined as the change in equity during a period, from transactions and other events, excluding changes resulting from investments by owners (e.g., supplemental stock offerings) and distributions to owners (e.g., dividends). An analysis of the changes in the components of accumulated comprehensive income is presented in the statement of changes in stockholders' equity.

10.

Derivative financial instruments

Effective January 1, 2001, the Company adopted Statement of Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133) as amended by SFAS 138, Accounting for Certain Derivative Instruments and Hedging Activities -- an Amendment to FASB Statement No. 133. SFAS 133 and SFAS 138 established new accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. All derivatives, whether designated in hedging relationships or not, are required to be recorded on the balance sheet at fair value. If the derivative is a cash flow hedge, the effective portions of changes in the fair value of the derivative are recorded in other comprehensive income and are recognized in the income statement when the hedged item affects earnings. Ineffective portions of changes in the fair value of cash flow hedges are recognized in earnings.

**Note A. Nature of Business and Summary of Significant Accounting Policies** Continued

The Company has only limited involvement with derivative financial instruments. The Company has two interest rate swap agreements to hedge against the potential impact on earnings from increases in market interest rates of two variable rate bonds. Under the interest rate swap agreements, the Company receives or makes payments on a monthly basis, based on the differential between 5.14% and a tax exempt interest rate as determined by a remarketing agent. This interest rate swap is accounted for as a cash flow hedge in accordance with SFAS 133 and SFAS 138. The tax

effected fair market value of the interest rate swap of \$833 and \$1,037 is included in accumulated other comprehensive loss at December 31, 2005 and 2004, respectively. The interest rate swap contracts expire in 2013 and 2015.

11.

Goodwill

As of January 1, 2002, the Company adopted Statement of Financial Accounting Standard (SFAS) No. 142, Goodwill and Other Intangible Assets (SFAS 142). SFAS 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. Thus, effective January 1, 2002, the Company has ceased amortization of goodwill, including goodwill recorded in past business combinations. The Company does not have any intangible assets with indefinite lives other than goodwill.

SFAS 142 requires that goodwill be tested for impairment annually, or more frequently if circumstances indicate potential impairment, by comparing the fair value of the asset to its carrying amount. Such testing requires, as an initial step, that each of the Company's reporting units, as defined in SFAS 142, be identified and that the Company's assets and liabilities, including the existing goodwill and intangible assets, be assigned to those reporting units. The Company has determined it has only one reporting unit.

12.

Trademarks and trade names

Trademarks and trade names are being amortized on a straight line basis over 17 years. At each balance sheet date, the Company evaluates the value of trademarks and trade names for impairment. Based upon its most recent analysis, the Company believes that no impairment of trademarks and trade names exists at December 31, 2005.

13.

Property and equipment

Property and equipment are stated at cost. Depreciation is computed by the straight-line method over estimated useful lives. Amortization of property and equipment held under capital leases is included in depreciation expense. The carrying amount of all long-lived assets is evaluated periodically to determine if adjustment to the depreciation and amortization period or the unamortized balance is warranted. Based upon its most recent analysis, the Company believes that no impairment of property and equipment exists at December 31, 2005.

14.

Debt issuance costs

The costs related to the issuance of debt are capitalized and amortized on a straight-line basis over the term of the related debt, which approximates the effective interest method.

15.

Revenue recognition

Generally, sales are recognized when shipments are made to customers. Rebates, allowances for damaged goods and other advertising and marketing program rebates, are accrued pursuant to contractual provisions and included in accrued expenses. An insignificant amount of our revenues fall under the percentage-of-completion method of accounting used for long-term contracts. Under this method, sales and gross profit are recognized as work is performed based on the relationship between actual costs incurred and total estimated costs at completion. Sales and gross profit are adjusted prospectively for revisions in estimated total contract costs and contract values. Estimated losses are recorded when identified.

**Note A.**

**Nature of Business and Summary of Significant Accounting Policies** Continued

16.

Income taxes

Deferred taxes are provided on the liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carry forwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

17.

Earnings per share

Basic EPS is calculated by dividing earnings available to common shareholders by the weighted average number of common shares outstanding during each period. Diluted EPS is similarly calculated, except that the denominator includes common shares that may be issued subject to existing rights with dilutive potential, except when their inclusion would be antidilutive.

**FLANDERS CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share amounts)

**Note A. Nature of Business and Summary of Significant Accounting Policies** Continued

18.

Stock Options

At December 31, 2005, the Company has three stock-based compensation plans. The Company accounts for those plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* and related Interpretations. No stock-based compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

2005

2004

2003

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Net earnings (loss), as reported	\$	\$	\$
	12,506	9,770	7,746
Deduct: Total stock-based compensation expense determined under fair value based methods for all awards, net of taxes	(4,112)	(2,454)	(562)
Pro forma net earnings (loss)	\$	\$	\$
	8,394	7,316	7,184
Basic earnings (loss) per share:			
As reported	\$	\$	\$
	.48	.37	.30
Pro forma	\$	\$	\$
	.32	.28	.28
Diluted earnings (loss) per share			
As reported	\$	\$	\$
	.45	.36	.29
Pro forma	\$	\$	\$
	.30	.27	.27

19.

Outbound shipping expenses

Outbound shipping expenses are included in operating expenses, not in cost of goods sold. Outbound shipping expenses were \$9,455, \$8,224, and \$6,724 for the years ending December 31, 2005, 2004 and 2003, respectively.

20.

Advertising



The costs of advertising are expensed as incurred. Advertising expense was \$2,543, \$2,422, and \$2,001 for the years ending December 31, 2005, 2004 and 2003, respectively.

21.

Reclassifications

Certain account balances for 2004 and 2003 have been reclassified with no effect on net earnings or retained earnings to be consistent with the classification adopted for the year ended December 31, 2005.

**FLANDERS CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share amounts)

**Note A.**

**Nature of Business and Summary of Significant Accounting Policies** Continued

22.

Impact of Recently Issued Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board (FASB) issued Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51 (the Interpretation). The Interpretation requires the consolidation of variable interest entities in which an enterprise absorbs a majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both, as a result of ownership, contractual, or other financial interests in the entity. Currently, entities are generally consolidated by an enterprise

that has controlling financial interest through ownership of a majority voting interest in the entity. The Interpretation was originally immediately effective for variable interest entities created after January 31, 2003, and effective in the fourth quarter of the Company's fiscal 2003 for those created prior to February 1, 2003. However, in October 2003, the FASB deferred the effective date for those variable interest entities created prior to February 1, 2003, until the Company's first quarter of fiscal 2004. The Company has substantially completed the process of evaluating this interpretation and believes its adoption will not have a material impact on its consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. This statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. This statement is effective for financial instruments entered into or modified after May 31, 2003 and pre-existing instruments as of the beginning of the first interim period that commences after June 15, 2003, except for mandatorily redeemable financial instruments. Mandatorily redeemable financial instruments are subject to the provisions of this statement beginning on January 1, 2004. We have not entered into or modified any financial instruments subsequent to May 31, 2003 affected by this statement. We do not expect the adoption of this statement will have a material impact on our financial condition or results of operations.

In November 2004, the Financial Accounting Standards Board issued statement of Financial Accounting Standard No. 151, "Inventory Costs". The new Statement amends Accounting Research Bulletin No. 43, Chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material. This Statement requires that those items be recognized as current-period charges and requires that allocation of fixed production overheads to the cost of conversion be based on the normal capacity of the production facilities. This statement is effective for fiscal years beginning after June 15, 2005. We do not expect adoption of this statement to have a material impact on our financial condition or results of operations.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment. This Statement replaces FASB Statement No. 123 and supersedes APB Opinion No. 25. Statement No. 123(R) will require the fair value of all stock option awards issued to employees to be recorded as an expense over the related vesting period. The Statement also requires the recognition of compensation expense for the fair value of any unvested stock option awards outstanding at the date of adoption. We are evaluating these new rules, but expect no material impact upon adoption relating to outstanding options since a majority of the awards under the existing incentive stock option plan will be fully vested prior to the effective date of the revised rules.

In May 2005, The Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 154, Accounting Changes and Error Corrections. The Statement applies to all voluntary changes in accounting principle and to changes required by an accounting pronouncement that do not include explicit transition provisions. SFAS No. 154 requires that changes in accounting principle be retroactively applied, instead of including the cumulative effect in the income statement. The correction of an error will continue to require financial statement restatement. A change in accounting estimate will continue to be accounted for in the period of change and in subsequent periods, if necessary. SFAS No. 154 is effective for fiscal years beginning after December 31, 2005. We do not expect the adoption of this Statement to have a material impact on our financial condition or results of operations.

**Note B. Inventories**

Inventories consist of the following at December 31:

	<b>2005</b>	<b>2004</b>
	\$	\$
Finished goods	19,497	19,233
Work in progress	3,183	2,630
Raw materials	18,214	19,068
	40,894	40,931
Less allowances	1,476	1,392
	\$	\$
	39,418	39,539

**Note C. Other Assets**

Other assets consist of the following at December 31:

	<b>2005</b>	<b>2004</b>
	\$	\$
Real estate held for sale	52	52
Notes receivable	1,181	2,607
Deposits	343	238
Deferred expenses	598	649
Investment, at cost	400	400
	\$	\$
	2,574	3,946

Notes receivable consists of the following at December 31,

	<b>2005</b>	<b>2004</b>
	\$	\$

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Note receivable, which is interest free for first year and 9% per annum thereafter, with a second year interest free if \$450 is paid during the first year. \$4 due each week beginning July 1, 2004.	524	912
Senior note receivable, which is interest free for first year and 5% per annum thereafter. \$6.5 due each month beginning January 31, 2005.	429	500
Junior note receivable, which is interest free. \$5 due each quarter beginning March 31, 2005.	285	300
Note receivable due in full by June 30, 2011.	0	1,000
Various other notes receivable	322	360
Less: Current portion of notes receivable	(379)	(465)
Total	\$	\$
	1,181	2,607

**FLANDERS CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share amounts)

**Note D. Intangible Assets**

Intangible assets consist of the following at December 31:

	<b>2005</b>	<b>2004</b>
	\$	\$
Goodwill	4,682	0

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	\$	\$
Trademarks and trade names, net of accumulated amortization of \$1,042 and \$820 in 2005 and 2004, respectively	1,118	888
	\$	\$
	5,800	888

Amortization expense was \$141, \$179 and \$133 in 2005, 2004 and 2003, respectively. Estimated amortization expense for each of the ensuing years through December 31, 2010 is as follows:

2006	\$
	216
2007	\$
	128
2008	\$
	128
2009	\$
	103
2010	\$
	91

**Note E. Property and Equipment**

Property and equipment and estimated useful lives consist of the following at December 31:

	<b>2005</b>	<b>2004</b>	<b>Estimated Useful Lives</b>
	\$	\$	
Land	1,905	1,635	
Buildings	40,225	40,153	15-40 years
Machinery and equipment	70,644	66,404	5 -15 years
Office equipment	10,281	9,866	5-7 years

Vehicles	2,145	1,351	5 years
Construction in progress	5,916	2,914	
	131,116	122,323	
Less accumulated depreciation	63,498	54,967	
	\$	\$	
	67,618	67,356	

Total depreciation expense charged to operations totaled \$8,170, \$7,771, and \$7,614 for 2005, 2004 and 2003, respectively.

**FLANDERS CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share amounts)

**Note F. Accrued Expenses**

Accrued expenses at December 31, 2005 and 2004 were as follows:

	<u>2005</u>	<u>2004</u>
Income tax payable	\$	\$
	3,063	975
Bank overdraft	\$	
	3,303	2,631

Other accrued expenses	\$	
	11,871	11,140
	\$	\$
	18,237	14,746

**Note G. Pledged Assets and Debt**

A summary of the Company's debt, and collateral pledged thereon, consists of the following at December 31:

	2005	2004
<b>Long-term debt:</b>		
LIBOR (4.8% at December 31, 2005) plus 1.75 to 2.25% revolving line of credit; interest rate dependent on fixed charge coverage*.	\$ 5,458	\$ 0
LIBOR plus 2.5 to 3.0% term note agreement; interest rate dependent on fixed charge coverage*.	2,567	3,967
LIBOR plus 2.25% note (mortgage) payable to a bank, due in monthly payments of \$14 including interest through October 2007, at which time all unpaid principal is due, collateralized by certain land, building and improvements.	1,952	2,118
Prime plus 0.25 percent (7.25% at December 31, 2005) notes payable to a mortgage company due in monthly payments of \$30 including interest through January 2006, at which time all unpaid principal is due, collateralized by a deed of trust on land and buildings.	24	303
6.5 percent note payable to a regional development authority, due in varying quarterly installments, plus interest, through December 2017, collateralized by a security agreement and financing statement on real and personal property.	4,445	4,685
Note payable to a bank with interest at prime plus 0.25 percent, with rate adjusted annually (7.25% at December 31, 2005), due in monthly payments of \$7 including interest through June 2017 subject to a call option in June 2007, collateralized by a deed of trust on real property.	648	684
Industrial revenue bond with a variable tax exempt interest rate as determined by a remarketing agent, with rate effectively fixed at 5.14% by an interest-rate swap, collateralized by a \$4,000 letter of credit that expires April 1, 2015.	4,000	4,000
Industrial revenue bond with a variable tax exempt interest rate as determined by a remarketing agent, with rate effectively fixed at 5.14% by an interest-rate swap, collateralized by a \$4,500 letter of credit that expires April 1, 2013.	4,500	4,500
Note payable with no interest to be paid in full by July 2007	158	0

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Prime plus 1.5 percent revolving line of credit up to \$600.	586	0
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Note payable to a bank with interest at prime plus 2.50 percent (7.25% at December 31, 2005), due in 5 regular payments of \$7 and one irregular payment of \$383 due in May 2006, collateralized by certain assets.	394	0
--	-----	---

Various obligations under capital lease agreements	2,561	2,802
	\$	\$
	27,293	23,059

**Note G. Pledged Assets and Debts** Continued

Less current maturities	3,561	2,553
	23,732	20,506

Less long-term capital lease obligations, less current maturities	2,023	2,368
	\$ 21,709	\$ 18,138

Aggregate maturities required on long-term debt and capital lease obligations as of December 31, 2005 are due in future years as follows:

Year Ending December 31,	\$
2006	3,561
2007	2,228
2008	2,473
2009	966
2010	685
Later years	17,380
	\$
	27,293

\*



Our current revolving credit agreement with a bank provides a maximum line of credit of \$33 million (subject to availability) and bears interest at either (i) LIBOR plus between 1.75% and 2.25%, dependent on the Company's fixed charge coverage during the prior twelve months; or (ii) the greater of the Federal Funds Effective Rate plus 0.5% or the bank's base rate, plus between 0.5% and 1%, dependent on the Company's fixed charge coverage during the prior twelve months. Up to \$11 million of this credit facility may be used to issue letters of credit of which the Company has two letters of credit associated with its industrial revenue bonds and two associated with its workers compensation policy. The revolving credit agreement is part of a combined facility with a bank that also includes a \$7 million facility to guarantee letters of credit, and a term loan at an interest rate 0.75% higher than the revolving facility. The term loan is due in monthly principal payments of \$116 plus interest. Both the line of credit and term loan are due in 2007. The combined facility is collateralized by substantially all of the Company's assets, requires maintenance of certain financial ratios, and restricts capital expenditures, payment of dividends and share repurchases.

**Note H. Leases**

The Company leases certain facilities and equipment under long-term non-cancelable operating leases, which may be renewed in the ordinary course of business, including a building lease with a related party. The Company leases certain manufacturing and warehousing space under a capital lease with an original term of ten years with two consecutive ten-year renewal options. Leased capital assets are included in property and equipment as follows at December 31:

	<b>2005</b>	<b>2004</b>
	\$	\$

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Buildings	3,700	3,700
Machinery and equipment	490	439
Office equipment	204	358
Accumulated depreciation	(997)	(907)
	\$	\$
	3,397	3,590

Future minimum payments, by year and in aggregate, under capital leases and operating leases consist of the following at December 31, 2005:

Year Ending December 31,

	Capital leases	Operating leases
	\$	\$
2006	736	1,526
2007	733	960
2008	622	590
2009	661	513
2010	319	470
Later years	0	0
	\$	\$
Total minimum lease payments	3,071	4,059
Less amount representing interest	510	
Present value of net minimum payments	2,561	
Current portion	538	
	\$	
Long-term portion	2,023	

Total rent expense charged to operations was approximately \$3,539, \$3,360, and \$3,255 for 2005, 2004 and 2003, respectively.

**FLANDERS CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share amounts)

**Note I. Income Taxes**

The Company's provision (benefit) for income taxes is as follows for the years ended December 31:

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Current:			
	\$	\$	\$
Federal	8,834	3,449	2,164
State	757	296	185
Foreign	34	150	62
	9,625	3,895	2,411
Deferred:			
Federal	(4,500)	632	1,008
State	(386)	54	86
	(4,886)	686	1,094
Total provision	\$	\$	\$

	4,739	4,581	3,505
--	-------	-------	-------

The income tax provision for continuing operations differs from the amount of tax determined by applying the Federal statutory rate as follows:

	<b>2005</b>	<b>2004</b>	<b>2003</b>
	\$	\$	\$
Income tax provision at statutory rate:	6,036	5,068	3,938
Increase (decrease) in income taxes due to:			
Nondeductible expenses	28	19	22
State income taxes net	683	561	334
Credits and adjustments	(2,008)	(1,067)	(789)
	\$	\$	\$
	4,739	4,581	3,505

## FLANDERS CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share amounts)

#### Note I. Income Taxes Continued

Net deferred tax assets and liabilities were comprised of the following:

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	<b>2005</b>	<b>2004</b>
Deferred tax assets:		
	\$	\$
Accounts receivable allowance	906	870
Inventory allowance and capitalization	1,340	1,177
Accrued expenses	573	579
Deferred expenses	41	40
Other Reserves		
State credits	400	209
	\$	\$
	3,260	2,875
Deferred tax liabilities:		
	\$	\$
Property and equipment	(10,744)	(13,592)
Interest rate swap	555	692
State net operating loss carry forwards	299	222
State credits	3,566	1,298
	\$	\$
	(6,324)	(11,380)

The components giving rise to the net deferred tax assets and liabilities described above have been included in the accompanying consolidated balance sheets at December 31 as:

	<b>2005</b>	<b>2004</b>
	\$	\$
Current assets	3,260	2,875
Noncurrent liabilities	(6,324)	(11,380)
	\$	\$
	(3,064)	(8,505)

**Note J. Commitments and Contingencies**

1.

Employment Agreements

Messrs. Amerson and Clark have employment agreements effective as of December 15, 1995 ( Employment Agreements ). The Employment Agreements, as amended, provide for an annual base salary of \$350 for both Mr. Amerson and Mr. Clark and terminate in 2010. The Employment Agreements also provide that the executive shall be entitled to the following termination payments: (i) 100% of his current base salary if the employment is terminated as a result of his death or disability; (ii) up to 200% of his current base salary if the employment is terminated by the Company for any reason other than death, disability or for cause, or (iii) up to 250% of the executive s gross income during the year preceding his termination if the Employment Agreement is terminated by the executive for good reason or by the Company for any reason other than death, disability or cause and the termination occurs within two years after a change of control of the Company has occurred.

Messr. Hodson has a three year employment contract dated January 1, 2005. The employment contract provides for an annual base salary of 100K and a discretionary bonus. The Employment Agreement also provides for 200% of his base salary upon termination by the company for any reason other than death or disability.

**FLANDERS CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share amounts)

2.

### Litigation

The Company is involved in a dispute with Liberty Mutual, a former workers' compensation administrator and stop-loss insurer for some of the Company's subsidiaries. The administrator has alleged that they are entitled to be reimbursed for certain costs incurred in administering various insurance claims. The Company has counter-sued, claiming that the administrator acted in bad faith, was negligent in its duties as administrator of our claims, that it made payments on our behalf which were specifically disallowed, that they refused to follow instructions given to them by us, that they failed to meet minimal acceptable standards for administering claims, and that such failures constituted a material dereliction of their responsibilities as administrator, as well as other claims related to malfeasance and negligence. In addition, Liberty Mutual charged certain administrative fees over and above the actual costs incurred which the Company is contesting. The amount and probability of any payment or settlement is unknown at this time. Among the issues being considered is the ripeness of our counterclaim as well as the matter of currently unresolved workers' compensation claims whose estimate of potential loss may change as a result of this litigation. While management believes it has reserved an adequate amount for settlement of these claims, there is no guarantee that the Company's actual liability will not exceed its current estimate. Accordingly, these matters, if resolved in a manner different from management's estimate, could have a material effect on operating results or cash flows in the future.

We have settled our lawsuit with Conap (U.S. District Court for the Eastern District of North Carolina, Case No. 4-99-CV-93-H(3)) a supplier of urethane sealant used in some of our HEPA filtration products. The settlement amount we received is included in other income.

From time to time, the Company is a party as plaintiff or defendant to various legal proceedings related to our normal business operations. In the opinion of management, although the outcome of any legal proceeding cannot be predicted with certainty, the ultimate liability of the Company in connection with its legal proceedings will not have a material adverse effect on the Company's financial position, but could be material to the results of operations in any one future accounting period. The Company makes appropriate reserves for litigation, even if not material. Defense costs are expensed as incurred.

3.

### Self-Insurance

During all periods presented, workers' compensation claims incurred by employees were fully insured through a high deductible policy with a policy year ending each May. The deductible per employee was \$500 in 2005 and \$350 in 2004, with no limit in the aggregate. The Company continuously monitors and estimates the estimated costs of claims incurred based on historical loss information and other information provided by its carrier's claims management

personnel. Included in the liabilities in the accompanying balance sheets are accrued workers' compensation expenses of approximately \$669 and \$659 as of December 31, 2005 and 2004, respectively.

The Company provides medical benefits to its employees under a self-insured program. Through June 30, 2002, the Company paid for 100% of an employee's health costs as the services were incurred. In July 2002, the Company changed the program that provides medical benefits to its employees once certain deductibles are met. The benefits to the employees are limited to \$35 per year with a \$1,000 lifetime benefit. The Company estimates the amount of incurred but unreported claims based on historical information. Included in the liabilities in the accompanying balance sheets are estimated accrued health insurance expenses of approximately \$212 and \$232 as of December 31, 2005 and 2004, respectively. The employer's portion of claims charged to operations totaled approximately \$971, \$893 and \$919 for 2005, 2004 and 2003, respectively.

## **FLANDERS CORPORATION AND SUBSIDIARIES**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share amounts)

4.

#### License and Royalty Agreements

The Company has secured licensing and royalty agreements with two companies allowing the Company to use their trade names and brands on its products. Costs associated with these agreements are expensed as incurred.

#### **Note K. Employee Benefit Plans**



The Company has a defined contribution 401(k) salary reduction plan intended to qualify under section 401(a) of the Internal Revenue Code of 1986 ( Salary Savings Plan ). The Salary Savings Plan allows eligible employees, as defined in the plan document, to defer up to fifteen percent of their eligible compensation, with the Company contributing an amount determined at the discretion of the Company s Board of Directors. The Company contributed approximately \$97, \$90 and \$89 to the Salary Savings Plan for the years ended December 31, 2005, 2004 and 2003, respectively.

During 1996, the Company adopted the Long Term Incentive Plan ( LTI Plan ) to assist the Company in securing and retaining key employees and consultants. The LTI Plan authorizes grants of incentive stock options, nonqualified stock options, stock appreciation rights ( SARs ), restricted stock performance shares and dividend equivalents to officers, key employees of the Company and outside consultants to the Company. There are 1,987,000 shares of Common Stock reserved for award under the LTI Plan. During 2005, 2004 and 2003, the Company awarded options to purchase 670,000, 645,000 and 145,000 shares of Common Stock under the LTI Plan, respectively.

During 1996, the Company also adopted the 1996 Director Option Plan which provides for the grant of 50,000 stock options to outside directors of the Company who were elected or appointed after February 1, 1996, and who were not existing directors on the effective date of the plan. Each such outside director who is serving as a director on January 1 of each calendar year will automatically be granted an option to acquire up to 5,000 shares of Common Stock on such date, assuming such outside director had been serving for at least six months prior to the date of grant. The Company has reserved 500,000 shares of its Common Stock for issuance under the 1996 Director Option Plan that expires in 2006. During 2005, 2004 and 2003, the Company awarded options to purchase 125,000, 15,000 and 80,000 shares, respectively, of Common Stock under the 1996 Director Option Plan.

## **FLANDERS CORPORATION AND SUBSIDIARIES**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share amounts)

#### **Note L. Related Party Transactions and Balances**

At December 31, 2005 and 2004, the Company had notes receivable secured by common stock classified as contra-equity of \$6,987 and \$6,650, respectively, due from various directors, officers, shareholders and employees, with interest thereon at LIBOR plus 1%, maturing at various dates to December 2010, of which \$6,987 is callable on demand by the Company if the officers or employees terminate employment with the Company.

During November 2000, the Company entered into a five-year operating lease whereby the Company was leasing 138,000 square feet of building owned by two officers of and directors of the Company (fifty percent each). In September 2002, the lease was amended as the Company occupied 224,000 square feet of building. Then, by November 2002, the Company occupied 399,000 square feet of a building. The Company made payments of \$1,067, \$1,041 and \$1,030 in 2005, 2004 and 2003, respectively. As of February 1, 2006 the company entered into four new lease agreements for buildings owned by Wal-Pat II with monthly payments totaling \$58. The Company believes these leases are at prevailing market rates.

On January 2, 2001, the Company purchased and leased back \$797 in manufacturing equipment from Superior Diecutting, Inc., a vendor 50% owned by two officer and directors. The Company also loaned this supplier \$500, secured by a building and used to pay off an existing mortgage, and \$400 to repay a credit line secured by inventory, receivables and other current assets. The Company made payments of \$10,951, \$6,933 and \$3,738 in 2005, 2004 and 2003, respectively, to this supplier for purchases of raw materials. At December 31, 2005 and 2004, the Company owed a total of \$3,873 and \$2,591, respectively, to this vendor. At December 31, 2005, Superior Diecutting, Inc. owed the Company \$1,499 due to the Company purchasing inventory on behalf of Superior Diecutting, Inc. The accounts and operations of this related entity have been consolidated, thus, the financial effects of these transactions have been eliminated in consolidation.

## **FLANDERS CORPORATION AND SUBSIDIARIES**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share amounts)

**Note M. Stock Options and Warrants**

During 2005, the Company granted options to purchase: 670,000 shares of common stock under its LTI Plan at exercise prices between \$8.85 - \$11.10 per share; 125,000 shares of common stock under its 1996 Director Option Plan at a weighted average exercise price of \$10.64 per share. All options granted during 2005 were non-qualified fixed price options.

The following table summarizes the activity related to all Company stock options and warrants for 2005, 2004 and 2003:

	Shares (In thousands)		Exercise Price		Weighted Average	
	Stock		per Share		Exercise Price	
	Warrants	Options	Warrants	Options	Warrants	Options
Outstanding at January 1, 2003	4,599		1.50	7.50	4.76	
Granted	225		1.65	5.00	3.51	
Exercised	(106)		1.65	3.94	3.45	
Canceled or expired	(183)		1.50	5.38	4.44	
Outstanding at December 31, 2003	4,535		1.50	7.50	4.75	
Granted	660		5.21	8.60	8.14	
Exercised	(177)		1.65	6.49	2.18	
Canceled or expired	(3)		4.75	4.75	4.75	
Outstanding at December 31, 2004	5,015		1.50	8.60	5.28	
Granted	795		8.85	11.10	10.75	
Exercised	(18)		1.74	1.74	2.54	
Canceled or expired						
Outstanding at December 31, 2005	5,792		1.50	11.10	6.04	
Exercisable at December 31, 2005	5,652		1.50	11.10	6.10	
Exercisable at December 31, 2004	4,835		1.74	8.60	5.36	
Exercisable at December 31, 2003	4,350		1.65	7.50	4.95	

The warrants and options expire at various dates ranging from November 2006 to December 2010. A further summary of information related to options outstanding at December 31, 2005 is as follows:

Range of Exercise Prices	Number Outstanding / Exercisable	Weighted Average Remaining Contractual Life (Years)	Weighted Average
			Exercise Price Outstanding / Exercisable
\$1.50 to 2.40	87 / 87	1.42	\$1.87 / 1.87
\$2.50 to 4.37	2,210 / 2,130	3.81	\$2.58 / 2.58
\$5.00 to 6.49	150 / 90	3.02	\$5.17 / 5.28
\$7.50 to 11.10	3,345 / 3,345	5.23	\$8.47 / 8.47

As permitted under accounting principles generally accepted in the United States of America, grants to employees under the LTI Plan and other grants to employees of options are accounted for following APB Opinion No. 25 and related Interpretations. Accordingly, no compensation cost has been recognized for grants to employees under the LTI Plan, since all options granted had an exercise price at or above the quoted market price of the Company's common stock on the date of grant.

## FLANDERS CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share amounts)

#### Note M. Stock Options and Warrants Continued

Had compensation cost for the option plans been determined based on the grant date fair values of awards using the Black-Scholes option pricing model, reported net earnings (loss) and earnings (loss) per common share would have been changed to the pro forma amounts shown below for the years ended December 31:

	2005	2004	2003
Net earnings (loss):	\$	\$	\$
As reported	12,506	9,770	7,746
	\$	\$	\$
Pro forma	8,394	7,316	7,185
Basic earnings (loss) per share:	\$	\$	\$
As reported	.48	.37	0.30
	\$	\$	\$
Pro forma	.32	.28	0.28
Diluted earnings (loss) per share:	\$	\$	\$
As reported	.45	.36	0.29
	\$	\$	\$
Pro forma	.30	.27	0.27
Weighted average fair value per option of options	\$	\$	\$
Granted during the year	8.68	6.21	2.50

In determining the pro forma amounts above, the value of each grant is estimated at the grant date using the Black-Scholes option model with the following weighted average assumptions for options granted in 2005, 2004 and 2003: Dividend rate of 0%; risk-free interest rate of 4.38%, 3.63% and 3.38%, respectively; expected lives of 5 years; and expected price volatility of 110%, 102% and 92%, respectively.

#### Note N. Earnings per Share

The following table shows the shares (in thousands) used in computing net earnings per common share including dilutive potential common stock.

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Common shares outstanding at beginning of year	26,303	26,084	26,033
Net weighted average common shares issued and canceled during year	6	117	
Weighted average number of common shares used in basic EPS	26,309	26,201	26,033
Dilutive effect of stock options and warrants	1,498	1,089	395
Weighted average number of common shares and dilutive potential shares used in diluted EPS	27,807	27,290	26,428

As of December 31, 2005, 2004 and 2003, options and warrants to purchase 580,000, 0 and 2,000,000 shares, respectively, of the Company's common stock described in Note N were excluded from the computation of diluted EPS because the market price of the underlying stock was less than the exercise price.

## FLANDERS CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share amounts)

#### Note O. Quarterly Financial Data (Unaudited)

	<b>Quarters Ended</b>			
	<b>March 31,</b>	<b>June 30,</b>	<b>September 30,</b>	<b>December 31,</b>
	<b>2005</b>	<b>2005</b>	<b>2005</b>	<b>2005</b>
Net sales	\$ 49,795	\$ 55,548	\$ 63,364	\$ 60,569
Gross profit	\$ 11,013	\$ 13,631	\$ 14,569	\$ 13,704
Operating income	\$ 3,620	\$ 5,226	\$ 4,775	\$ 3,999
Net Earnings	\$	\$	\$	\$

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	2,460	3,464	3,708	2,874
Net Earnings per share:	\$	\$	\$	\$
Basic	.09	.13	.14	.12
Diluted	.09	.12	.13	.11
Common stock prices:				
High	\$	\$	\$	\$
	11.43	11.67	14.09	12.46
Low	8.55	7.77	8.85	9.81

	<b>March 31,</b>	<b>June 30,</b>	<b>September 30,</b>	<b>December 31,</b>
	<b>2004</b>	<b>2004</b>	<b>2004</b>	<b>2004</b>
Net sales	\$	\$	\$	\$
	45,354	47,138	54,785	52,656
Gross profit	\$	\$	\$	\$
	9,963	11,911	12,646	13,768
Operating income	\$	\$	\$	\$
	2,021	3,486	3,980	5,232
Net Earnings	\$	\$	\$	\$
	1,454	2,097	2,784	3,435
Net Earnings per share:	\$	\$	\$	\$
Basic	.06	.08	.11	.13
Diluted	.05	.08	.10	.13
Common stock prices:				
High	\$	\$	\$	\$
	7.26	9.99	10.47	10.17
Low	5.21	6.12	8.36	8.17

**FLANDERS CORPORATION**  
**FINANCIAL STATEMENT SCHEDULE**



**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTANTING FIRM  
ON SCHEDULE**

Board of Directors

Flanders Corporation

In connection with our audits of the consolidated financial statements of Flanders Corporation and Subsidiaries referred to in our report dated February 10, 2006, which is included in the Company's Annual Report of Form 10-K for the year ended December 31, 2005, we have also audited Schedule II for each of the three years in the period ended December 31, 2005. In our opinion, this schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ Pender Newkirk & Company, LLP

Pender Newkirk & Company, LLC

Certified Public Accountants

Tampa, Florida

February 10, 2006

**FLANDERS CORPORATION AND SUBSIDIARIES**  
**SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS**  
**Years Ended December 31, 2005, 2004 and 2003**

	Balance at Beginning of Period	Additions Charged to Cost and Expense	Deductions	Balance at End of Period
For the year ended December 31, 2005	\$	\$	\$	\$
Allowance for doubtful accounts	3,300	2,094	(1,376) <sup>(1)</sup>	4,018
Allowance for inventory	1,392	85		1,477

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	\$	\$	\$	\$
Total	4,692	2,179	(1,376)	5,495
For the year ended December 31, 2004				
	\$	\$	\$	\$
Allowance for doubtful accounts	2,949	1,875	(1,524) <sup>(1)</sup>	3,300
Allowance for inventory	1,323	69		1,392
	\$	\$	\$	\$
Total	4,272	1,944	(1,524)	4,692
For the year ended December 31, 2003				
	\$	\$	\$	\$
Allowance for doubtful accounts	2,240	3,151	(2,442) <sup>(1)</sup>	2,949
Allowance for inventory	1,115	208		1,323
	\$	\$	\$	\$
Total	3,355	3,359	(2,442)	4,272

(1)

Uncollected receivables written-off, net of recoveries.