K2 INC
Form 10-Q
August 08, 2006

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT

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

For the quarterly period ended June 30, 2006

Commission File No. 1-4290

K2 INC.

(Exact name of registrant as specified in its charter)

Delaware	**95-2077125**
(State of Incorporation)	**(I.R.S. Employer Identification No.)**

5818 El Camino Real

Carlsbad, California	**92008**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code (760) 494-1000

Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report:

Not applicable

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

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

Large Accelerated Filer ¨ Accelerated Filer x Non-Accelerated Filer ¨

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

At August 3, 2006 there were 47,099,720 shares of Common Stock ($1.00 par value) outstanding.

PART - 1 FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS
CONSOLIDATED CONDENSED STATEMENTS OF INCOME (Unaudited)

(Thousands, except per share figures)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
Net sales	$ 301,142	$ 301,425	$ 649,213	$ 619,716
Cost of products sold	198,577	201,667	434,093	417,139
Gross profit	102,565	99,758	215,120	202,577
Selling expenses	57,683	54,502	119,558	113,217
General and administrative expenses	35,703	36,910	73,776	71,003
Operating income	9,179	8,346	21,786	18,357
Interest expense	6,736	7,285	14,569	14,538
Other income, net	(783)	(1,117)	(1,535)	(1,838)
Income before income taxes	3,226	2,178	8,752	5,657
Provision for income taxes	1,083	725	2,967	1,880
Net income	$ 2,143	$ 1,453	$ 5,785	$ 3,777
Basic earnings per share:				
Net income	$ 0.05	$ 0.03	$ 0.12	$ 0.08
Diluted earnings per share:				
Net income	$ 0.05	$ 0.03	$ 0.12	$ 0.08
Basic shares outstanding	47,016	46,216	46,916	46,196
Diluted shares outstanding	47,604	47,373	47,555	47,430

See notes to consolidated condensed financial statements

CONSOLIDATED CONDENSED BALANCE SHEETS

	June 30, 2006 (unaudited)	December 31, 2005
	(Thousands, except share data)	
Assets		
Current Assets		
Cash and cash equivalents	$ 11,652	$ 11,797
Accounts receivable, less allowances for doubtful accounts of $17,929 (2006) and $15,922 (2005)	276,776	380,442
Inventories, net	383,264	359,028
Deferred income taxes	2,258	5,044
Prepaid expenses and other current assets	25,516	21,905
Total current assets	699,466	778,216
Property, plant and equipment	305,721	295,202
Less allowance for depreciation and amortization	164,782	151,147
	140,939	144,055
Other Assets		
Goodwill	109,557	107,027
Tradenames	117,001	117,001
Other intangible assets, net	18,282	19,988
Other	23,696	24,289
Total Assets	$ 1,108,941	$ 1,190,576
Liabilities and Shareholders Equity		
Current Liabilities		
Bank loans	$ 22,770	$ 24,296
Accounts payable	72,459	93,470
Income taxes payable	27,787	31,946
Accrued payroll and related	39,434	40,555
Other accruals	82,310	85,256
Current portion of long-term debt	2,933	33,265
Total current liabilities	247,693	308,788
Long-term pension liabilities	26,758	26,758
Long-term debt	242,027	280,717
Deferred income taxes	21,286	21,286
Convertible debentures	99,237	99,003
Shareholders Equity		
Preferred Stock, $1 par value, authorized 12,500,000 shares, none issued		
Common Stock, $1 par value, authorized 110,000,000 shares in 2006 and 2005, issued shares - 47,834,342 in 2006 and 47,663,227 in 2005	47,834	47,663
Additional paid-in capital	505,527	503,624
Retained deficit	(59,218)	(65,003)
Treasury shares at cost, 763,140 shares in 2006 and 2005	(9,360)	(9,360)
Accumulated other comprehensive loss	(12,843)	(22,900)
Total Shareholders Equity	471,940	454,024
Total Liabilities and Shareholders Equity	$ 1,108,941	$ 1,190,576

See notes to consolidated condensed financial statements

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS (Unaudited)

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
	(Thousands)	
Operating Activities		
Net Income	$ 5,785	$ 3,777
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sale of operating facility	(1,504)	
Depreciation and amortization	17,791	17,278
Non-cash share-based compensation charges	989	360
Deferred taxes	2,736	1,415
Changes in current assets and current liabilities	54,362	18,652
Net cash provided by operating activities	80,159	41,482
Investing Activities		
Property, plant and equipment expenditures	(11,680)	(17,308)
Proceeds from sale of property, plant and equipment	5,386	872
Purchase of businesses, net of cash acquired	(2,813)	(15,094)
Other items, net	(2,391)	3,098
Net cash used in investing activities	(11,498)	(28,432)
Financing Activities		
Borrowings under long-term debt	530,052	548,000
Payments of long-term debt	(598,840)	(540,525)
Net decrease in short-term bank loans	(1,526)	(24,473)
Exercise of stock options	1,085	397
Net cash used in financing activities	(69,229)	(16,601)
Effects of foreign exchange rates on cash and cash equivalents	423	(632)
Net decrease in cash and cash equivalents	(145)	(4,183)
Cash and cash equivalents at beginning of year	11,797	25,633
Cash and cash equivalents at end of period	$ 11,652	$ 21,450

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

June 30, 2006

NOTE 1 Basis of Presentation

The accompanying unaudited consolidated condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six month period ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

The consolidated condensed balance sheet at December 31, 2005 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

K2 Inc. (K2) reports its financial statements using a 52/53 week year with a 13 week quarter ending on the closest Sunday to the end of March, June, September and December. Fiscal year 2006 includes 53 weeks versus 52 weeks in 2005 fiscal year, and the first quarter 2006 includes 14 weeks versus 13 weeks in the first quarter 2005. For purposes of the consolidated financial statements, the end of each quarter is stated as of March 31, June 30, September 30 and December 31, respectively.

The interim financial statements should be read in connection with the financial statements in K2 Inc. s Annual Report on Form 10-K for the year ended December 31, 2005.

Certain prior year amounts have been reclassified to conform to the current year presentation.

NOTE 2 Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This Interpretation is effective for fiscal years beginning after December 15, 2006. K2 is currently assessing the impact of this Interpretation on its financial position and results of operations.

In February 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 155, *Accounting for Hybrid Financial Instruments* . SFAS No. 155 amends SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* and SFAS No. 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities-a replacement of FASB Statement No. 125* . SFAS No. 155 permits the fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 2 Recent Accounting Pronouncements (Continued)

and clarifies that both interest-only and principal-only strips are not subject to the provision of SFAS No. 133. Further, SFAS No. 155 establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding versus those that are embedded derivatives. Other provisions relate to matters of concentration of credit risk and application of certain provisions to special purpose entities. The effective date for the provisions of SFAS No. 155 is for those instruments acquired or issued after the beginning of our fiscal year 2007. K2 believes that SFAS No. 155 should not have a material impact on its financial position or results of operations.

NOTE 3 Share-Based Compensation

Under K2 s 2006, 2005, 2004, 1999 and 1994 Long-Term Incentive Plans (2006 Plan, 2005 Plan, 2004 Plan, 1999 Plan and 1994 Plan, respectively), stock options may be granted to eligible directors and key employees of K2 and its subsidiaries at not less than 100% of the market value of the shares on the dates of grant. As defined in the 2006 Plan, 2005 Plan and 2004 Plan (collectively, the Plans), share-based awards include awards of shares of stock that are subject to certain restrictions (Restricted Stock) and a fixed or variable right to acquire stock, which may or may not be subject to restriction (Restricted Stock Units). These Plans also provide for the issuance of Restricted Stock, Restricted Stock Units and other share-based awards that are subject to performance objectives (Performance Award). The 2006, 2005, 2004, 1999 and 1994 Plans permit the granting of options for terms not to exceed ten years from date of grant. The options are exercisable on such terms as may be established at the dates of grant and generally vest over three years. Pursuant to the 1994 Plan document, no additional awards may be granted under the 1994 Plan after December 31, 2004.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 3 Share-Based Compensation (Continued)

Stock Option Activity

Options granted, exercised, expired and forfeited under the 2006 Plan, 2005 Plan, 2004 Plan, 1999 Plan and 1994 Plan and options assumed from acquisitions for the first six months of fiscal year 2006 are as follows:

	Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Options outstanding at December 31, 2005	4,237,332	$ 11.60	6.76	
Granted	5,000	10.08		
Exercised	(49,820)	7.99		
Expired	(39,046)	14.92		
Options outstanding at March 31, 2006	4,153,466	$ 11.61	6.57	
Granted	647,000	11.15		
Exercised	(90,355)	7.60		
Forfeited	(1,500)	11.15		
Expired	(176,496)	14.80		
Options outstanding at June 30, 2006	4,532,115	$ 11.50	6.93	$ 5,056,584
Options vested and expected to vest at June 30, 2006	4,508,782	$ 11.50	0.29	$ 5,056,382
Options exercisable at June 30, 2006	3,870,615	$ 11.56	6.42	$ 5,049,934

The weighted-average grant-date fair value of options granted during the three months ended June 30, 2006 and 2005 was $5.17 and $6.70, respectively. The weighted-average grant-date fair value of options granted during the six months ended June 30, 2006 and 2005 was $5.17 and $6.70, respectively. Intrinsic value is defined as the difference between the relevant current market value of the common stock and the grant price for options with exercise prices less than the market values on such dates. The total intrinsic value of options exercised during the three months ended June 30, 2006 and 2005 was approximately $419,000 and $173,000, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2006 and 2005 was approximately $595,000 and $333,000, respectively. Cash received from stock options exercised during the six months ended June 30, 2006 was $1.1 million and the actual tax benefit realized from these exercises was zero.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 3 Share-Based Compensation (Continued)

Options are granted at an exercise price equal to the fair market value at the date of grant. Information regarding stock options outstanding as of June 30, 2006 is as follows:

	Options Outstanding			Options Exercisable	
Price Range	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Shares	Weighted Average Exercise Price
\$2.39 - \$7.13	508,213	\$ 6.47	4.07 years	508,213	\$ 6.47
\$7.25 - \$7.30	53,322	7.28	5.09 years	53,322	7.28
\$7.45 - \$7.45	492,500	7.45	6.75 years	492,500	7.45
\$7.50 - \$10.63	343,128	8.40	3.82 years	333,128	8.35
\$11.15 - \$11.15	645,500	11.15	9.89 years		
\$11.25 - \$12.50	148,600	11.29	2.71 years	148,600	11.29
\$12.51 - \$12.51	916,500	12.51	8.82 years	916,500	12.51
\$12.82 - \$13.25	119,304	13.16	5.12 years	113,304	13.16
\$13.69 - \$13.69	1,023,500	13.69	7.88 years	1,023,500	13.69
\$13.83 - \$65.00	281,548	21.15	3.07 years	281,548	21.15
Total	4,532,115	\$ 11.50	6.93 years	3,870,615	\$ 11.56

Restricted Stock

A summary of the status of the Company s restricted stock issued under the Plans for the first six months of fiscal year 2006 is as follows:

	Shares	Weighted Average Grant Date Fair Value
Restricted stock outstanding at December 31, 2005	192,000	\$ 13.23
Vested	(26,668)	13.35
Restricted stock outstanding at March 31, 2006	165,332	13.21
Vested	(4,000)	12.51
Restricted stock outstanding at June 30, 2006	161,332	\$ 13.23

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 3 Share-Based Compensation (Continued)

Restricted Stock Units

A summary of the status of the Company s restricted stock units issued, including performance awards, under the Plans for the first six months of fiscal year 2006 is as follows:

	Shares	Weighted Average Purchase Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Restricted stock units outstanding at December 31, 2005				
Awarded	229,122			
Forfeited	(500)			
Restricted stock units outstanding at June 30, 2006	228,622		1.75	$ 2,501,125
Restricted stock units vested and expected to vest at June 30, 2006	228,122		1.75	$ 2,501,125
Restricted stock units exercisable (vested and deferred) at June 30, 2006				$

Adoption of SFAS No. 123 (revised 2004)

On January 1, 2006, K2 adopted SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123R), which requires K2 to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost is recognized in the consolidated statement of operations over the period during which an employee is required to provide service in exchange for the award the requisite service period. No compensation cost is recognized for equity instruments for which employees do not render the requisite service. The grant-date fair value of employee share options and similar instruments is estimated using option-pricing models adjusted for the unique characteristics of those instruments. SFAS No. 123R eliminates the use of Accounting Principles Board (APB) Opinion No. 25 *Accounting for Stock Issued to Employees,* and the option for pro forma disclosure in accordance with SFAS No. 123 *Accounting for Stock-Based Compensation.*

SFAS No. 123R permits public companies to adopt its requirements using one of the two following methods: (1) a modified prospective method in which compensation cost is recognized beginning with the effective date based on both (a) the requirements of SFAS No. 123R for all share-based payments granted after the effective date and (b) the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that remain unvested on the effective date; or (2) a modified retrospective method which includes the requirements of the modified prospective method described above, but also permits companies to restate prior periods

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 3 Share-Based Compensation (Continued)

based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures, either (a) for all prior periods presented or (b) prior interim periods of the year of adoption. K2 adopted SFAS No. 123R using the modified-prospective method and therefore prior periods are not restated.

SFAS No. 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a cash flow from financing activities, rather than a cash flow from operating activities as required under previous guidance. This requirement may reduce operating cash flows and increases net financing cash flows in periods after adoption.

The Company recognized the following share-based compensation expense during the three months and six months ended June 30, 2006. (Thousands, except per share data):

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Stock options		
General and administrative expenses	$ 74	$ 350
Cost of goods sold	40	40
Selling expenses	4	4
Restricted stock		
General and administrative expenses	237	476
Restricted stock units		
General and administrative expenses	119	119
Total	474	989
Income tax benefit	(174)	(362)
Share-based compensation expense, net of taxes	$ 300	$ 627
Effect of share-based compensation expense on net income per share:		
Basic	$ (0.01)	$ (0.01)
Diluted	$ (0.01)	$ (0.01)

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 3 Share-Based Compensation (Continued)

The following table summarizes the approximate unrecognized compensation cost for the share-based compensation awards and the weighted average remaining years over which the cost will be recognized:

	Total Unrecognized Compensation Cost (thousands)	Weighted Average Remaining Years
Stock options	$ 3,194	2.04
Restricted stock	1,547	1.75
Restricted stock units	2,436	1.02
Total	$ 7,177	1.76

Prior to the adoption of SFAS No. 123R, K2 measured compensation cost for its employee share-based compensation plans using the intrinsic value method prescribed by APB Opinion No. 25 and related interpretations and provided pro forma net income and pro forma net income per share disclosures for employee stock option grants made as if the fair-value-based method defined in SFAS No. 123 had been applied. Compensation cost for stock options issued to employees was recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price.

The following table illustrates the effect on net income and net income per share as if the Company had applied the fair-value-based method as defined in SFAS No. 123 to share-based compensation during the three and six months ended June 30, 2005. (Thousands, except per share data).

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income as reported	$ 1,453	$ 3,777
Add: Total share-based compensation expense included in net income, net of taxes	277	360
Less: Total share-based compensation expense determined under fair value based method for all awards, net of taxes	(9,146)	(9,891)
Net income, adjusted	$ (7,416)	$ (5,754)
Earnings per share:		
Basic - as reported	$ 0.03	$ 0.08
Basic - pro forma	$ (0.16)	$ (0.12)
Diluted - as reported	$ 0.03	$ 0.08
Diluted - pro forma	$ (0.16)	$ (0.12)

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 3 Share-Based Compensation (Continued)

On May 17, 2005, the Compensation Committee of the Board of Directors of K2 approved the acceleration of vesting of certain unvested and out-of-the-money stock options previously awarded to employees and officers under the K2 stock option plans. An option was considered out-of-the-money if the stated exercise price was greater than $11.94 per share, the closing price of K2 s common stock on May 17, 2005, which was the last trading day before approval of the acceleration. Outstanding unvested options that had an exercise price equal to or less than $11.94 on May 17, 2005, will continue to vest under the terms of the original option agreements. As a result of this action, options to purchase approximately 2.1 million shares of K2 s common stock that would otherwise have vested over the next three years became fully vested. The options have a range of exercise prices of $12.51 to $14.30 and a weighted average exercise price of $13.14. Options held by non-employee directors were not affected. In addition, the Compensation Committee imposed a holding period that will require that all affected executive officers of the Company not sell shares acquired through the exercise of an accelerated option (other than shares needed to cover the exercise price and satisfying withholding taxes) prior to the earlier of the date on which exercise would have been permitted under the options original vesting terms or, if earlier, the executive officer s last day of employment. The decision to accelerate the vesting of these options was made to reduce future compensation expense that was and is expected to be recorded in conjunction with SFAS No. 123R.

Determining Fair Value

Valuation and Amortization Method. K2 has elected to use the Black-Scholes option valuation model (single option approach) to calculate the fair value of employee stock option grants. For options with graded vesting, the option grant is treated as a single award and compensation cost is recognized on a straight-line basis over the vesting period of the entire award, ensuring that compensation cost is at least equal to the cumulative amount of vesting at the end of each reporting period.

Expected Term. The expected term of options granted represents the period of time that the option is expected to be outstanding. K2 estimates the expected term of the option grants based on historical exercise patterns that are believed to be representative of future behavior as well as other various factors. When and if applicable, K2 uses separate groups of employees that have similar historical exercise behavior for valuation purposes.

Expected Volatility. K2 estimates its volatility using its historical share price performance over the expected life of the options, which management believes is materially indicative of expectations about expected future volatility.

Risk-Free Interest Rate. K2 uses risk-free interest rates in the Black-Scholes option valuation model that are based on U.S. Treasury zero-coupon issues with a remaining term equal to the expected life of the options.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 3 Share-Based Compensation (Continued)

Dividend Rate. K2 does not issue dividends on its common stock and does not anticipate paying any cash dividends in the foreseeable future. Therefore, K2 uses an expected dividend yield of zero in the Black-Scholes option valuation model.

Forfeitures. SFAS No. 123R requires companies to estimate forfeitures at the time of grant and revise those estimates in subsequent reporting periods if actual forfeitures differ from those estimates. K2 uses historical data to estimate pre-vesting option forfeitures and record share-based compensation expense only for those awards that are expected to vest. For purposes of calculating pro forma information under SFAS 123 for periods prior to the date of adoption of SFAS No. 123R, K2 accounted for forfeitures as they occurred.

The following weighted average assumptions were used to estimate the fair value of options granted during the three and six months ended June 30, 2006 and 2005:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
Risk free interest rate	4.98%	3.60%	4.98%	3.60%
Expected life of options	5 years	5 years	5 years	5 years
Expected volatility	45.5%	40.9%	45.5%	40.9%
Expected dividend yield				

NOTE 4 Inventories

The components of inventories consisted of the following:

	June 30, 2006	December 31, 2005
	(Thousands)	
Finished goods	$ 281,378	$ 266,340
Work in process	15,124	18,796
Raw materials	86,762	73,892
	$ 383,264	$ 359,028

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 5 Acquisitions

During the 2006 second quarter, K2 completed the acquisition of substantially all of the assets of both Xtools, LLC, a business engaged in the design, selling and distribution of fishing accessories and TrakSports USA Inc., a business engaged in the design, selling and distribution of skis. The purchase price for these assets was paid in cash. The results of the operations of these two companies were included in the consolidated financial statements of K2 beginning with the date of the applicable acquisition.

During the 2005 second quarter, K2 completed the acquisition of substantially all of the assets of both Hodgman, Inc., a business engaged in the design, selling and distribution of hunting and fishing waders, and the stock of JRC Products Limited, a business engaged in the design, selling and distribution of fishing tackle products. The purchase price for these assets was paid in cash. The results of the operations of these two companies were included in the consolidated financial statements of K2 beginning with the date of the applicable acquisition.

Those two transactions completed during the 2005 second quarter were accounted for under the purchase method of accounting, and accordingly the purchased assets and liabilities were recorded at their estimated fair values at the date of the acquisition. The combined purchase price allocation for the two acquisitions resulted in an excess of the purchase price over net tangible assets acquired of approximately $7.0 million.

The excess amounts of the two transactions were allocated to intangible assets with finite and indefinite lives including: customer relationships and patents of $0.1 million with an average life of 2.0 years; tradenames with an indefinite life not subject to amortization of $2.9 million; and goodwill not subject to amortization of $4.0 million.

At June 30, 2006, there was approximately $2.4 million of cash and 29,175 shares of K2 common stock held in escrow or due for payment relating to certain acquisitions. The cash and shares will be released from escrow during 2006 through 2008 subject to final agreement between K2 and the selling parties. The cash and shares in escrow as well as future cash payments due have been reflected in the purchase price of the related acquisitions. Shares held in escrow are reflected in the calculation of diluted earnings per share for the periods presented.

Pursuant to the acquisitions made by K2 during 2005, 2004 and 2003, K2 approved restructuring and exit plans related to the closure of certain facilities of the acquired companies. In accordance with Emerging Issues Task Force (EITF) 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination,* K2 established reserves for employee severance, employee relocation costs and lease termination costs totaling approximately $0.6 million, $11.0 million and $5.1 million, during 2005, 2004 and 2003, respectively. These reserves were recognized as assumed liabilities of the acquired companies. The reserves established were not individually significant to any of K2 s acquisitions during 2005, 2004 or 2003.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 5 Acquisitions (Continued)

The following table summarizes the activity in 2005 and the first six months of 2006:

	Employee Severance	Employee Relocation	Subtotal (Thousands)	Lease Termination Costs	Total
Balance at December 31, 2004	$ 6,990	$ 368	$ 7,358	$ 5,197	$ 12,555
Reserves established in conjunction with acquisitions	205		205	422	627
Adjustments to reserve estimates (reflected as an adjustment of the cost of the acquired companies)	(2,644)		(2,644)	(1,582)	(4,226)
Utilized in 2005:	(3,205)	(125)	(3,330)	(1,906)	(5,236)
Balance at December 31, 2005	1,346	243	1,589	2,131	3,720
Utilized in 2006:	(1,213)	(12)	(1,225)	(837)	(2,062)
Balance at June 30, 2006	$ 133	$ 231	$ 364	$ 1,294	$ 1,658

K2 believes that the remaining reserves for restructuring are adequate to complete its restructuring and exit plans.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 6 Intangible Assets and Goodwill

The components of intangible assets and goodwill consisted of the following:

	Weighted Average Useful Life	June 30, 2006 Gross Amount	Accumulated Amortization	Net Book Value	December 31, 2005 Gross Amount	Accumulated Amortization	Impairment Charge (a)	Net Book Value
					(Thousands)			
Intangibles subject to amortization:								
Patents	7.9 years	$ 16,517	$ 5,682	$ 10,835	$ 16,164	$ 4,729	$	$ 11,435
Customer contracts/relationships	8.2 years	8,215	3,252	4,963	8,215	2,689		5,526
Licensing agreements	7.4 years	2,795	1,605	1,190	2,795	1,357		1,438
Trademarks	7.1 years	955	355	600	955	279		676
Non-compete agreements	4.1 years	1,572	878	694	1,574	661		913
Order backlog and other	0.2 years				1,560	1,560		
		30,054	11,772	18,282	31,263	11,275		19,988
Intangibles not subject to amortization: (by segment)								
Tradename								
Marine and Outdoor		3,252		3,252	3,252			3,252
Action Sports		48,292		48,292	55,259		6,967	48,292
Team Sports		43,857		43,857	65,718		21,861	43,857
Apparel and Footwear		21,600		21,600	21,600			21,600
Goodwill								
Marine and Outdoor		28,426		28,426	26,959			26,959
Action Sports		1,070		1,070	101,104		101,104	
Team Sports					123,222		123,222	
Apparel and Footwear		80,061		80,061	80,068			80,068
		226,558		226,558	477,182		253,154	224,028
Total intangibles and goodwill		$ 256,612	$ 11,772	$ 244,840	$ 508,445	$ 11,275	$ 253,154	$ 244,016

(a) Non-cash intangible impairment charges as a result of annual testing in accordance with SFAS No. 142 Goodwill and Other Intangible Assets (SFAS No. 142).

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 6 Intangible Assets and Goodwill (Continued)

The table below shows the activity in intangibles subject to and not subject to amortization for the six months ended June 30, 2006.

	December 31, 2005 Net Book Value	Purchase Price Allocations (a)	Other Activity (b) (Thousands)	Amortization	June 30, 2006 Net Book Value
Intangibles subject to amortization:					
Patents	$ 11,435	$	$ 353	$ (953)	$ 10,835
Customer contracts/relationships	5,526			(563)	4,963
Licensing agreements	1,438			(248)	1,190
Trademarks	676			(76)	600
Non-compete agreements	913		(2)	(217)	694
	19,988		351	(2,057)	18,282
Intangibles not subject to amortization: (by segment)					
Tradename					
Marine and Outdoor	3,252				3,252
Action Sports	48,292				48,292
Team Sports	43,857				43,857
Apparel and Footwear	21,600				21,600
Goodwill					
Marine and Outdoor	26,959	1,135	332		28,426
Action Sports		1,070			1,070
Apparel and Footwear	80,068	(7)			80,061
	224,028	2,198	332		226,558
Total intangibles and goodwill	$ 244,016	$ 2,198	$ 683	$ (2,057)	$ 244,840

(a) Amounts in this column represent the allocation of purchase price to intangibles in accordance with SFAS No. 141 *Business Combinations* and adjustments to the preliminary purchase price allocations.

(b) Amounts in this column represent either additions to intangibles not related to purchased intangibles or the effects of foreign currency translation.

Amortization expense for intangibles subject to amortization was approximately $2.1 million for the six months ended June 30, 2006. Amortization expense of purchased intangible assets subject to amortization is estimated to be approximately $3.5 million during the fiscal year ending December 31, 2006, $3.3 million during 2007, $3.2 million during 2008, $2.0 million during 2009 and $1.4 million during 2010.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 7 Warranties

K2 records the estimated cost of product warranties at the time sales are recognized. K2 estimates warranty obligation by reference to historical product warranty return rates, material usage and service delivery costs incurred in correcting the product. Should actual product warranty return rates, material usage or service delivery costs differ from the historical rates, revisions to the estimated warranty liability would be required.

The following activity related to product warranty liabilities:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
(Unaudited)	(Thousands)		(Thousands)	
Beginning Balance	$ 9,089	$ 9,324	$ 9,089	$ 9,691
Charged to costs and expenses	2,053	2,428	4,207	4,654
From acquisitions	300		300	
Amounts charged to reserve	(1,925)	(2,379)	(4,079)	(4,972)
Ending Balance	$ 9,517	$ 9,373	$ 9,517	$ 9,373

NOTE 8 Borrowings and Other Financial Instruments

At June 30, 2006, K2 s principal long-term borrowing facility was a $250 million revolving Credit Facility (Facility) expiring on February 21, 2011 with several banks and other financial institutions. The Facility is expandable to $350 million subject to certain conditions. The Facility has a $100 million limit for the issuance of letters of credit. Borrowings under the Facility are secured by all of K2 s assets in the United States, Canada and England. Actual borrowing availability under the Facility is based on K2 s trade receivable and inventory levels in the United States, Canada and England, subject to eligibility criteria and defined advance rates. Borrowings under the Facility are subject to an interest rate grid, and as of June 30, 2006 bear a rate equal to the prime rate, or a LIBOR interest rate plus 1.375%, and the Facility had an unused commitment fee of 0.25% per year. The Facility includes various covenants, including requirements that K2 maintain a minimum debt service coverage ratio if the unused availability drops below $37.5 million, as well as limiting annual capital expenditures, indebtedness, dividends and certain investment activities.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 8 Borrowings and Other Financial Instruments (Continued)

At June 30, 2006, borrowings of $27.1 million were outstanding under the Facility bearing an average interest rate of 6.73%. At June 30, 2006, there were also letters of credit outstanding under the Facility of $11.6 million (consisting of $8.2 million of standby letters of credit and $3.4 million of trade letters of credit expiring over the next 12 months). Pursuant to the terms of the Facility, an additional $190.8 million was available for borrowing at June 30, 2006.

At June 30, 2006, K2 had $25 million of 7.25% convertible subordinated debentures (7.25% Debentures) due March 2010. The 7.25% Debentures are convertible into 2,097,315 shares of K2 common stock at a conversion price of $11.92 per share. Pursuant to the agreement for these debentures, the note holders received warrants to purchase 243,260 and 524,329 additional shares of K2 s common stock at exercise prices of $13.143 and $11.92 per share, respectively, exercisable within the three and five year period ended February 14, 2006 and February 14, 2008, respectively (the Warrants). The Warrants that were exercisable within the three year period ended February 14, 2006 expired unexercised. K2 assigned a total fair market value of $2.3 million to the Warrants. At June 30, 2006, the aggregate unamortized fair market value of $0.8 million is reflected as a reduction of the face amount of the 7.25% Debentures on K2 s balance sheet which is being amortized to interest expense using the effective interest method through the exercise periods, thereby increasing the carrying value of the debentures.

At June 30, 2006, K2 had $75 million of 5.00% convertible senior debentures (5% Debentures) due June 2010. The 5% Debentures are convertible into 5,706,458 shares of K2 common stock at a conversion price of $13.143 per share. The debentures are redeemable by K2 in whole or in part at K2 s option on or after June 15, 2008 at a redemption price of 101.429% beginning on June 15, 2008 and ending on June 14, 2009, and at 100.714% beginning on June 15, 2009 and ending on June 14, 2010.

At June 30, 2006, K2 also had $200 million of 7.375% senior, unsecured notes (Senior Notes) due July 1, 2014. The Senior Notes are redeemable by K2 in whole or in part at K2 s option at any time prior to July 1, 2009 at a price equal to 100% of the principal amount plus accrued and unpaid interest plus a make-whole premium as defined in the indenture. Thereafter, K2 may redeem all or a portion of the notes at the redemption prices set forth in the indenture. The Senior Notes include various incurrence covenants, including limitations on indebtedness, restricted payments and sales of assets.

At June 30, 2006, K2 also had $40.7 million outstanding under various foreign lending arrangements.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 9 Pension Plans

Domestic plan

K2 sponsors a non-contributory defined benefit pension plan that covers approximately 750 of its domestic employees. Benefits are generally based on years of service and the employee s highest average compensation for five consecutive years during the years of credited service. Benefit formulas for prior service vary for different divisions. Contributions are intended to provide for benefits attributable to service to date and service expected to be provided in the future. K2 funds this plan in accordance with the Employee Retirement Income Security Act of 1974.

Effective August 31, 2004, the K2 Pension Plan was amended to freeze the accrual of future benefits for almost all of the employees. This resulted in active participants no longer accruing benefits under the plan. Participants will remain eligible to receive benefits they have earned under the plan through August 31, 2004 when they retire. New employees will not be eligible to accrue any benefit under the plan. Only a small group of about 20 employees subject to a collective bargaining agreement will continue to accrue a benefit until September 16, 2006.

K2 also has a pension plan which covered certain employees of the Simplex Building Products division which K2 sold in 2000 (the Simplex UAW Pension Plan). This plan was merged with the K2 Pension Plan as of December 31, 2005.

The components of domestic net periodic pension cost consisted of the following:

	Domestic Plan Three Months Ended June 30,		Domestic Plan Six Months Ended June 30,	
	2006	2005	2006	2005
	(Thousands)			
Service cost	$ 38	$ 25	$ 76	$ 50
Interest cost	1,007	1,010	2,014	2,020
Expected return on assets	(981)	(1,034)	(1,962)	(2,068)
Actuarial loss	215	162	430	324
Total net periodic benefit cost	$ 279	$ 163	$ 558	$ 326

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 9 Pension Plans (Continued)

The increase in the net periodic benefit cost for the three and six months ended June 30, 2006 as compared to the three and six months ended June 30, 2005 is due to lower than expected asset returns during 2005; a change in expected return on assets for 2006 from 8.25% to 7.75%; lower expected contributions in 2006 compared to 2005, and a change in discount rate from 5.75% to 5.67%. These increases were partially offset by a decrease due to demographic and miscellaneous changes. K2 estimates a required cash contribution of approximately $61,000 to the plan in 2006. During the six months ended June 30, 2006, K2 made contributions totaling approximately $37,000 to the domestic plan.

Foreign plans

In addition to the plans discussed above, K2 also had five smaller defined benefit plans in the United Kingdom and in Germany (foreign plans). Four of the foreign plans are in Germany and are attributable to the acquisitions of Völkl and Marker on July 7, 2004. K2 recorded pension expense for the plans in Germany beginning with the date of the acquisitions.

	Foreign Pension Plans Three Months Ended June 30,		Foreign Pension Plans Six Months Ended June 30,	
	2006	2005	2006	2005
	(Thousands)			
Net periodic benefit cost				
Service cost	$ 101	$ 77	$ 202	$ 154
Interest cost	201	216	402	431
Expected return on plan assets	(132)	(117)	(264)	(233)
Amortization of net loss	6		12	
Net periodic benefit cost	$ 176	$ 176	$ 352	$ 352

Pension expense for the three and six months ended June 30, 2006 for the foreign plans remained fairly consistent with the three months and six months ended June 30, 2005. K2 estimates a required cash contribution of approximately $1.2 million to the foreign plans in 2006. During the six months ended June 30, 2006, K2 made contributions totaling approximately $0.8 million to the foreign plans.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 10 Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss are as follows:

	Currency Translation Adjustments	Additional Minimum Pension Liability	Derivative Financial Instruments	Total
		(Thousands)		
Balance at December 31, 2005	$ (9,182)	$ (13,470)	$ (248)	$ (22,900)
Currency translation adjustment	9,749			9,749
Reclassification adjustment for amounts recognized in cost of sales			497	497
Change in fair value of derivatives, net of $31 in taxes			(189)	(189)
Balance at June 30, 2006	$ 567	$ (13,470)	$ 60	$ (12,843)

Total comprehensive income (loss) was $10.2 million and ($5.7) million for the three months ended June 30, 2006 and 2005, respectively. Total comprehensive income (loss) was $15.8 million and ($8.0) million for the six months ended June 30, 2006 and 2005, respectively. Total comprehensive income includes the net change in accumulated other comprehensive loss for the period.

Adjustments resulting from translating foreign functional currency financial statements into U.S. dollars are included in the foreign currency translation adjustment in the above table. The currency translation gain for the six months ended June 30, 2006 is the result of the weakening of the U.S. dollar against foreign currencies during the period, mainly the Euro.

NOTE 11 Earnings Per Share Data

Basic earnings per share (EPS) is determined by dividing net income or loss by the weighted average number of shares outstanding during the period. Diluted EPS reflects the potential dilutive effects of stock options, restricted stock, restricted stock units, shares held in escrow and warrants, using the treasury stock method, and of the convertible debentures using the if converted method.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 11 Earnings Per Share Data (Continued)

Options to purchase 4,532,115 and 4,450,291 shares of K2 common stock were outstanding at June 30, 2006 and 2005, respectively. At June 30, 2006, there were also 161,332 shares of nonvested restricted stock, 228,622 shares of nonvested restricted stock units and 29,175 shares held in escrow relating to certain acquisitions. At June 30, 2005, there were 230,000 shares of nonvested restricted stock and 612,466 shares held in escrow relating to certain acquisitions. At June 30, 2006 and 2005, shares of common stock issuable upon conversion of the $100 million of convertible debentures totaling 7,803,775 and warrants to purchase 524,329 and 767,589, respectively, of shares of common stock were outstanding.

For the three months ended June 30, 2006 and 2005, approximately 2,730,000 and 2,167,000 stock options, respectively, were excluded since their inclusion would have been antidilutive. For the three months ended June 30, 2006, approximately 53,000 shares of nonvested restricted stock were excluded since their inclusion would have been antidilutive. For the three months ended June 30, 2006 there were approximately 84,000 shares of nonvested restricted stock units excluded since they were contingently issuable shares whose performance condition had not been satisfied as of June 30, 2006. For the three months ended June 30, 2006, approximately 374,521 warrants were also excluded as their inclusion would have been antidilutive. For the three months ended June 30, 2006 and 2005, 29,175 and 612,466 shares of K2 common stock held in escrow, respectively, were included in the calculation of diluted earnings per share.

For the six months ended June 30, 2006 and 2005, approximately 2,638,000 and 1,500,000 stock options, respectively, were excluded since their inclusion would have been antidilutive. For the six months ended June 30, 2006, approximately 438,055 warrants were also excluded as their inclusion would have been antidilutive. For the six months ended June 30, 2006 there were approximately 40,000 shares of nonvested restricted stock units excluded since they were contingently issuable shares whose performance condition had not been satisfied as of June 30, 2006. For the six months ended June 30, 2006 and 2005, 63,214 and 616,672 shares of K2 common stock held in escrow, respectively, were included in the calculation of diluted earnings per share.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 11 Earnings Per Share Data (Continued)

The table below outlines the determination of the number of diluted shares of common stock used in the calculation of diluted EPS as well as the calculation of diluted EPS for the periods presented:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(Thousands, except per share amounts)			
Determination of diluted number of shares:				
Average common shares outstanding	47,016	46,216	46,916	46,196
Assumed conversion of dilutive stock options, restricted stock, restricted stock units, warrants and shares in escrow	588	1,157	639	1,234
Diluted average common shares outstanding	47,604	47,373	47,555	47,430
Calculation of diluted earnings per share:				
Net income	$ 2,143	$ 1,453	$ 5,785	$ 3,777
Diluted earnings per share (a)	$ 0.05	$ 0.03	$ 0.12	$ 0.08

(a) Diluted earnings per share is calculated by dividing net income by diluted average common shares outstanding for the respective period.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 12 Segment Information

Under SFAS No. 131 *Disclosures about Segments of an Enterprise and Related Information (SFAS No.131),* K2 classifies its business into the following four segments based on similar product types and distribution channels: Marine and Outdoor, Team Sports, Action Sports and Apparel and Footwear.

The Marine and Outdoor segment includes *Shakespeare* fishing tackle and monofilament products as well as *Stearns* outdoor products. The Team Sports segment includes baseball and softball products, K2 Licensed Products and paintball products. The Action Sports segment includes skis, snowboards, snowshoes and in-line skates. The Apparel and Footwear segment includes *Marmot* and *Ex Officio* products as well as skateboard shoes and related apparel. During 2005, the paintball business declined significantly. In order to improve efficiency, K2 reorganized the paintball business to operate more in line with how the components of the Team Sports segment operates with increased emphasis on the mass merchant and large sporting goods retailer distribution. Upon completion of the reorganization in the first quarter of 2006, K2 has adjusted its segment reporting to include paintball products in the Team Sports segment versus the Action Sports segment where it was previously reported. The segment information for the 2005 period has been restated to reflect this reclassification.

The segment information presented below is for the three months ended June 30:

	Net Sales to Unaffiliated Customers		Intersegment Sales		Operating Profit (Loss)	
	2006	2005	2006	2005	2006	2005
			(Millions)			
Marine and Outdoor	$ 128.8	$ 130.4	$ 46.2	$ 36.7	$ 19.6	$ 20.1
Team Sports	96.5	89.3		0.1	4.4	0.9
Action Sports	37.5	44.1	4.8	2.3	(10.5)	(9.9)
Apparel and Footwear	38.3	37.6	0.8	0.2	0.4	3.0
Total segment data	$ 301.1	$ 301.4	$ 51.8	$ 39.3	13.9	14.1
Corporate expenses, net					(4.0)	(4.6)
Interest expense					(6.7)	(7.3)
Income before provision for income taxes					$ 3.2	$ 2.2

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 12 Segment Information (Continued)

The segment information presented below is for the six months ended June 30:

	Net Sales to Unaffiliated Customers		Intersegment Sales		Operating Profit (Loss)	
	2006	2005	2006	2005	2006	2005
	(Millions)					
Marine and Outdoor	$ 252.0	$ 242.8	$ 86.6	$ 69.9	$ 35.8	$ 36.1
Team Sports	229.0	197.5		0.1	17.3	8.9
Action Sports	93.6	108.9	5.7	4.9	(21.3)	(21.4)
Apparel and Footwear	74.6	70.5	2.3	1.0	(1.4)	3.9
Total segment data	$ 649.2	$ 619.7	$ 94.6	$ 75.9	30.4	27.5
Corporate expenses, net					(7.0)	(7.3)
Interest expense					(14.6)	(14.5)
Income before provision for income taxes					$ 8.8	$ 5.7

NOTE 13 Contingencies

K2 has not experienced any substantial difficulty in obtaining raw materials, parts or finished goods inventory for its sporting goods or other recreational products and industrial business. Many components and finished products, however, are manufactured or assembled abroad (particularly in the People s Republic of China) and therefore could be subject to interruption as a result of local unrest, currency exchange fluctuations, increased tariffs, trade difficulties natural disasters and other factors. A single supplier manufactures major portions of K2 s in-line skates. K2 believes alternate sources for these products could be found, although at potentially increased costs.

K2 currently is a party to various legal proceedings, including those noted below. While management presently believes that the ultimate outcome of these proceedings, individually and in the aggregate, will not have a material adverse effect on our business, financial position, results of operations or prospects, litigation and related matters are subject to inherent uncertainties, and unfavorable rulings could occur. An unfavorable ruling could include money damages or, in cases for which injunctive relief is sought, an injunction prohibiting K2 from selling one or more products. Were an unfavorable ruling to occur, there exists the possibility of a material adverse impact on the business, financial position or results of operations for the period in which the ruling occurs or future periods. K2 maintains product liability, general liability and excess liability insurance coverage. However, no assurances can be given that such insurance will continue to be available at an acceptable cost to K2 or that such coverage will be sufficient to cover one or more large claims, or that the insurers will not successfully disclaim coverage as to a pending or future claim.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 13 Contingencies (Continued)

Environmental

K2 is one of several named potentially responsible parties (PRP) in three Environmental Protection Agency matters involving discharge of hazardous materials at old waste sites in South Carolina and Michigan. Although environmental laws technically impose joint and several liability upon each PRP at each site, the extent of K2 s required financial contribution to the cleanup of these sites is expected to be limited based upon the number and financial strength of the other named PRP s and the volume and types of waste involved which might be attributable to K2.

Environmental and related remediation costs are difficult to quantify for a number of reasons including the number of parties involved, the difficulty in determining the extent of the contamination, the length of time remediation may require, the complexity of environmental regulation and the continuing advancement of remediation technology. K2 accrues for liabilities of this nature when it is probable a liability has been incurred and the amount can be reasonably estimated. At June 30, 2006 and December 31, 2005, K2 had recorded an estimated liability of approximately $800,000 for environmental liabilities. The estimates are based on K2 s share of the costs to remediate as provided by the PRP s consultants and in connection with a consent decree entered into in November 2004. The ultimate outcome of these matters cannot be predicted with certainty, however, and taking into consideration the recorded reserves, management does not believe these matters will have a material adverse effect on K2 s business, financial position, results of operations or prospects.

EIFS Litigation and Claims

From 1988 through 2000, K2, through a former division, manufactured and sold an exterior wall covering product for application by contractors on commercial and residential buildings, referred to as exterior insulated finish systems (EIFS). In June 2000, K2 sold the assets of this division to Tyco International (US) Inc. and affiliates, including any liabilities for EIFS manufactured and installed after the sale date. K2 has not been in this building products business since June 2000. Since 1995, K2 has been a party to over 500 claims or lawsuits with a majority of the claims originating from the southeastern United States, with other claims and lawsuits from over 20 states. As of June 30, 2006, K2 continues to be a defendant or co-defendant in approximately 40 single family residential EIFS cases, the majority of which are pending in Alabama and Texas. K2 is also defending EIFS lawsuits involving commercial structures, townhouses, and condominiums. The vast majority of K2 s EIFS lawsuits seek monetary relief for water intrusion related property damages, although some claims in certain lawsuits allege personal injuries from exposure to mold.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 13 Contingencies (Continued)

To date, all litigation costs and settlements related to the EIFS claims and lawsuits against K2 have been paid by insurers, with the exception of immaterial deductibles and one partial payment by K2, for which adequate reserves were made at the time of the sale of the EIFS business, although such insurance carriers have issued reservation of rights letters in respect of certain claims and lawsuits. A reservation of rights letter refers to the notice provided by our insurers that, while our insurers have determined that the applicable insurance policy would cover for the applicable lawsuits, the insurers preserve or reserve their right to withdraw from defense commitment on one or more claims if it is determined that one or more of the claims do not trigger coverage under the applicable insurance policy. Although K2 s experience with respect to EIFS claims is still evolving and it is possible that future claims and payments may vary from management s current expectations, K2 believes that its third party insurance will be adequate to cover the anticipated costs of all remaining EIFS litigation.

In September 2000, 98 home owners filed suit in the district court Montgomery County, Texas against the builder of the homes, Life Forms Homes, Inc., the EIFS applicator, Fresh Coat, Inc., the EIFS distributor, Griesenbeck Architectural Products, and K2. The allegations included claims of misrepresentation, common law indemnity and violation of the Texas Deceptive Trade Practices Act (DTPA). In this litigation, Life Forms, Fresh Coat, Inc., and Griesenbeck Architectural Products, Inc. filed cross-claims against K2 under the same theories.

K2 timely tendered this case to its insurance carrier, which originally defended this lawsuit under a reservation of rights letter. In April 2004, K2 and its insurer negotiated an agreement which resulted in its insurer providing full indemnity up to applicable policy limits for all claims arising out of this litigation. In exchange for the indemnity, K2 s insurer assumed full control over the litigation and settlement negotiations. The claims by the 98 home owners were eventually settled by K2 s insurer. On November 4, 2005, the related claims against K2 by Life Forms, Fresh Coat, and Griesenbeck were tried and resulted in a jury verdict of approximately $42 million, of which $6.8 million was for knowingly and intentionally violating the DTPA. K2 s insurer has advised that it plans to appeal this verdict. Based on the agreement with its insurer to indemnify K2 on all claims as well as adequate insurance coverage and management s assessments of K2 s arguments that may be made on behalf of K2 on appeal, K2 does not believe this verdict will have a material adverse effect on its business, financial condition, results of operations or prospects.

While, to date, none of these EIFS proceedings have required that K2 incur substantial costs, there can be no guarantee of insurance coverage. Current and future EIFS proceedings could result in substantial costs to K2. Although K2 carries what it believes is adequate general, product and excess liability insurance, K2 cannot assure that its insurance coverage will be adequate for all future payments, that the insured amounts will cover all future claims in excess of deductibles or that all amounts will be covered by insurance in respect of all judgments.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 13 Contingencies (Continued)

Intellectual Property

In January 2004, Rawlings was sued by a licensee in the U.S. District Court for the District of Maine in connection with a license agreement pursuant to which the licensee was granted an exclusive license to use certain Rawlings trademarks for the manufacture and sale of team and personal sporting-equipment bags this lawsuit was later transferred to the U.S. District Court for the Eastern District of Missouri. In February 2004, Rawlings gave the licensee notice that it was terminating the license agreement and sued the licensee in the Missouri District Court, in which Rawlings alleged, among other things, that the licensee breached the license agreement by failing to use its best efforts . This license agreement was in place prior to the March 26, 2003 acquisition of Rawlings by K2 Inc. Accordingly, as a pre-acquisition contingency, K2 established a $3.0 million liability as part of its purchase price allocation of Rawlings and added $0.5 million to the liability in the fourth quarter 2004 through expense to the income statement.

On April 29, 2005, a jury awarded the licensee (1) $4.1 million for a claim of lost profits for the next ten years on sales of equipment bags, plus the value of inventory of such bags (the 10-Year Lost Profits Verdict), (2) $2.1 million for lost profits of equipment bags beginning ten years from the date of the breach of the agreement through forever (the Speculative Profits Verdict) and (3) $2.5 million for K2 s alleged tortious interference with the licensee s business expectations (the Tortious Interference Verdict) between Rawlings and the licensee. The Missouri District Court ruled that the licensee was not permitted to bring certain claims to the jury. Following trial, the licensee was awarded approximately $0.5 million in attorney s fees and costs pursuant to a motion. Following the verdict, K2 established in the second quarter of 2005 an additional $1.2 million in liabilities for a total of approximately $4.7 million in liabilities related to this litigation, including estimated legal fees and costs of licensee s attorneys.

On May 19, 2005, K2 and Rawlings, as the case may be, have filed a motion for new trial with respect to the 10-Year Lost Profits Verdict and a motion for judgment notwithstanding the verdict with respect to the Speculative Profits Verdict and the Tortious Interference Verdict. On July 27, 2005, the Missouri District (1) denied Rawlings motion for a new trial in respect of the $4.1 million 10-Year Lost Profits Verdict, (2) granted Rawlings motion for judgment notwithstanding the verdict with respect to the $2.1 million Speculative Profits Verdict and (3) denied K2 s motion for judgment notwithstanding the verdict for the $2.5 million Tortious Interference Verdict. Accordingly, there is currently a judgment against K2 and Rawlings for approximately $6.8 million, including post judgment interest.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 13 Contingencies (Continued)

K2 and Rawlings, as the case may be, intend to vigorously prosecute an appeal. K2 believes, in part based on advice and estimates from outside counsel as follows: that certain portions of the Missouri District Court s decision are not supported by facts or law; that there are meritorious arguments to be raised during the appeals process because of, among other things, a lack of evidence to support certain aspects of the verdict; and that K2 s aggregate exposure including attorney s fees and costs of license is approximately $4.7 million. In connection with its appeal, K2 was required by Missouri law to post bond in the amount of approximately $6.8 million. In the event that K2 and Rawlings are unsuccessful in their appeal and the amount of the judgment, including the fees and costs of attorneys for the licensee, is greater than $4.7 million, or the outcome of a total liability greater than $4.7 million becomes probable and estimable, K2 will be required to record an expense in the period in which the matter is finalized. However, this expense could be higher if the appeals court rules in favor of the licensee for certain claims on which it is expected that licensee will appeal. The appeal process is expected to be completed in the range of one to two years.

In connection with K2 s acquisition of substantially all of the assets of Miken Composites, LLC, a business engaged in the design, selling and distribution of composite softball bats and softball-related products and accessories in the fourth quarter 2004, K2 assumed the post-acquisition damages, if any, relating to a patent lawsuit in the U.S. District Court for the District of Minnesota. In this patent lawsuit, Miken Composites, L.L.C. v. Wilson Sporting Goods Co., Miken commenced an action in April 2002 seeking a declaration that a line of softball bats manufactured by Miken does not infringe a particular patent owned by Wilson. In response, Wilson counterclaimed for patent infringement seeking compensatory damages and a permanent injunction against Miken as the manufacturer and distributor of the allegedly infringing bats.

In July 2004, the Minnesota Court issued an order interpreting certain of Wilson s claims concerning its patent. Based on this ruling, Miken moved for summary judgment. On March 17, 2005, before any ruling on the summary judgment motion, the Minnesota Court entered an order to stay the patent case pending resolution of a related appeal in federal court of *Wilson Sporting Goods Co. v. Hillerich & Bradsby Co.* This case involves the same Wilson patent as in *Miken Composites, L.L.C. v. Wilson Sporting Goods Co*.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 13 Contingencies (Continued)

The outcome of this matter will depend primarily upon contested facts, and cannot be accurately predicted. Although each of K2 and Miken believes that Miken has meritorious defenses to Wilson s counterclaims, in the event that Miken is unsuccessful in the declaratory judgment and counterclaim actions, it is expected that Wilson would seek to pursue K2 for alleged acts of infringement arising after the acquisition of Miken s assets by K2. It is further expected, that Wilson would seek the same remedies against K2 that it is currently seeking against Miken, namely compensatory damages and an injunction against the manufacture and sale of allegedly infringing bats. In such event, K2 would, among other things, be required to record an expense in the period when the loss resulting from the resolution of the matter is probable and estimable. The litigation process for this case, including any appeals, is estimated to be in the range of two to three years.

NOTE 14 Supplemental Guarantor Information

Obligations to pay principal and interest on K2 s Senior Notes are guaranteed by K2 s existing and future wholly-owned U.S. subsidiaries. Separate financial statements of the guarantors are not provided, as subsidiary guarantors are 100% owned by K2 and guarantees are full, unconditional, and joint and several. The non-guarantor subsidiaries are K2 s consolidated non-U.S. subsidiaries. Supplemental condensed consolidating financial information of the K2 s guarantors and non-guarantors is presented below.

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 14 Supplemental Guarantor Information (Continued)

	Three Months Ended June 30, 2006				
	K2 Inc.	Guarantor Subsidiaries	Non-guarantor Subsidiaries	Eliminating Entries	Consolidated K2 Inc.
Net sales	$	$ 243,099	$ 109,804	$ (51,761)	$ 301,142
Cost of products sold		161,216	86,706	(49,345)	198,577
Gross profit		81,883	23,098	(2,416)	102,565
Selling expenses		37,131	20,552		57,683
General and administrative expenses	7,377	19,144	9,182		35,703
Operating income (loss)	(7,377)	25,608	(6,636)	(2,416)	9,179
Income in consolidated subsidiaries	15,627			(15,627)	
Other income, net	(6)	(154)	(623)		(783)
Interest expense	6,113	(54)	677		6,736
Income (loss) before income taxes	2,143	25,816	(6,690)	(18,043)	3,226
Income taxes		682	401		1,083
Net income (loss)	$ 2,143	$ 25,134	$ (7,091)	$ (18,043)	$ 2,143

	Three Months Ended June 30, 2005				
	K2 Inc.	Guarantor Subsidiaries	Non-guarantor Subsidiaries	Eliminating Entries	Consolidated K2 Inc.
Net sales	$	$ 243,786	$ 96,935	$ (39,296)	$ 301,425
Cost of products sold		164,830	75,358	(38,521)	201,667
Gross profit		78,956	21,577	(775)	99,758
Selling expenses		38,754	15,748		54,502
General and administrative expenses	8,161	20,467	8,282		36,910
Operating income (loss)	(8,161)	19,735	(2,453)	(775)	8,346
Income in consolidated subsidiaries	15,294			(15,294)	
Other income, net	(15)	(765)	(337)		(1,117)
Interest expense	5,695	49	1,541		7,285
Income (loss) before income taxes	1,453	20,451	(3,657)	(16,069)	2,178
Income taxes		1,762	(1,037)		725
Net income (loss)	$ 1,453	$ 18,689	$ (2,620)	$ (16,069)	$ 1,453

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 14 Supplemental Guarantor Information (Continued)

	Six Months Ended June 30, 2006				
	K2 Inc.	Guarantor Subsidiaries	Non-guarantor Subsidiaries	Eliminating Entries	Consolidated K2 Inc.
Net sales	$	$ 534,335	$ 209,500	$ (94,622)	$ 649,213
Cost of products sold		360,390	164,671	(90,968)	434,093
Gross profit		173,945	44,829	(3,654)	215,120
Selling expenses		84,328	35,230		119,558
General and administrative expenses	15,925	42,318	15,533		73,776
Operating income (loss)	(15,925)	47,299	(5,934)	(3,654)	21,786
Income in consolidated subsidiaries	34,870			(34,870)	
Other income, net	(15)	(582)	(938)		(1,535)
Interest expense	13,175	2	1,392		14,569
Income (loss) before income taxes	5,785	47,879	(6,388)	(38,524)	8,752
Income taxes		1,686	1,281		2,967
Net income (loss)	$ 5,785	$ 46,193	$ (7,669)	$ (38,524)	$ 5,785

	Six Months Ended June 30, 2005				
	K2 Inc.	Guarantor Subsidiaries	Non-guarantor Subsidiaries	Eliminating Entries	Consolidated K2 Inc.
Net sales	$	$ 492,638	$ 202,997	$ (75,919)	$ 619,716
Cost of products sold		334,119	156,741	(73,721)	417,139
Gross profit		158,519	46,256	(2,198)	202,577
Selling expenses		80,590	32,627		113,217
General and administrative expenses	15,121	40,700	15,182		71,003
Operating income (loss)	(15,121)	37,229	(1,553)	(2,198)	18,357
Income in consolidated subsidiaries	30,518			(30,518)	
Other income, net	(821)	(564)	(453)		(1,838)
Interest expense	12,441	202	1,895		14,538
Income (loss) before income taxes	3,777	37,591	(2,995)	(32,716)	5,657
Income taxes		2,451	(571)		1,880
Net income (loss)	$ 3,777	$ 35,140	$ (2,424)	$ (32,716)	$ 3,777

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 14 Supplemental Guarantor Information (Continued)

Condensed Consolidating Balance Sheets (Unaudited)

(Thousands)

	As of June 30, 2006				
	K2 Inc.	Guarantor Subsidiaries	Non-guarantor Subsidiaries	Eliminating Entries	Consolidated K2 Inc.
Assets					
Current Assets					
Cash and cash equivalents	$ 54	$ 1,336	$ 10,262	$	$ 11,652
Accounts receivable, net	6,966	223,554	118,111	(71,855)	276,776
Inventories, net		243,696	139,568		383,264
Deferred income taxes	2,769	(1,016)	505		2,258
Prepaid expenses and other current assets	3,595	6,246	15,675		25,516
Total current assets	13,384	473,816	284,121	(71,855)	699,466
Property, plant and equipment	10,472	162,975	132,274		305,721
Less allowance for depreciation and amortization	1,700	107,251	55,831		164,782
	8,772	55,724	76,443		140,939
Advances to affiliates	48,012	392,401	51,040	(491,453)	
Investment in subsidiaries	860,811			(860,811)	
Intangible assets, net	228,737	10,342	5,761		244,840
Other	18,115	2,647	2,934		23,696
Total Assets	$ 1,177,831	$ 934,930	$ 420,299	$ (1,424,119)	$ 1,108,941
Liabilities and Shareholders Equity					
Current Liabilities					
Bank loans	$	$	$ 22,770	$	$ 22,770
Accounts payable	1,598	79,611	63,105	(71,855)	72,459
Accrued liabilities	54,429	58,228	36,874		149,531
Current portion of long-term debt			2,933		2,933
Total current liabilities	56,027	137,839	125,682	(71,855)	247,693
Long-term pension liabilities	20,381		6,377		26,758
Long-term debt	227,059		14,968		242,027
Deferred income taxes	21,286				21,286
Advances from affiliates	281,901	76,355	133,197	(491,453)	
Convertible debentures	99,237				99,237
Interdivisional equity		720,736	140,075	(860,811)	
Shareholders equity	471,940				471,940
Total Liabilities and Shareholders Equity	$ 1,177,831	$ 934,930	$ 420,299	$ (1,424,119)	$ 1,108,941

K2 INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)

June 30, 2006

NOTE 14 Supplemental Guarantor Information (Continued)

Condensed Consolidating Balance Sheets

(Thousands)

	As of December 31, 2005				
	K2 Inc.	Guarantor Subsidiaries	Non-guarantor Subsidiaries	Eliminating Entries	Consolidated K2 Inc.
Assets					
Current Assets					
Cash and cash equivalents	$ 2,575	$ 1,594	$ 7,628	$	$ 11,797
Accounts receivable, net	43,700	251,483	158,596	(73,337)	380,442
Inventories, net		259,257	99,771		359,028
Deferred income taxes	4,083		961		5,044
Prepaid expenses and other current assets	3,481	4,699	13,725		21,905
Total current assets	53,839	517,033	280,681	(73,337)	778,216
Property, plant and equipment	13,294	159,807	122,101		295,202
Less allowance for depreciation and amortization	1,478	101,820	47,849		151,147
	11,816	57,987	74,252		144,055
Advances to affiliates	1,002	380,406	73,432	(454,840)	
Investment in subsidiaries	841,857			(841,857)	
Intangible assets, net	228,581	10,265	5,170		244,016
Other	18,731	3,458	2,100		24,289
Total Assets	$ 1,155,826	$ 969,149	$ 435,635	$ (1,370,034)	$ 1,190,576
Liabilities and Shareholders Equity					
Current Liabilities					
Bank loans	$	$	$ 24,296	$	$ 24,296
Accounts payable	33,911	85,758			