

# Notes to Consolidated Financial Statements

Nippon Kayaku Co., Ltd. and Consolidated Subsidiaries  
May 31, 2004 and 2003

1

## *Basis of Consolidated Financial Statements*

### **a. Basis of Preparation**

The books and records of Nippon Kayaku Co., Ltd. (the "Company") and its consolidated domestic subsidiaries are maintained in the manner and form required or permitted under the Commercial Code of Japan and Japanese accounting practices. The books and records of overseas consolidated subsidiaries are maintained in conformity with the accounting principles and relevant legal requirements of their countries of domicile.

The accompanying consolidated financial statements of the Company and consolidated subsidiaries are prepared on the basis of accounting principles generally accepted in Japan, which are different in certain respects as to the application and disclosure requirements of International Financial Reporting Standards, and are compiled from the consolidated financial statements prepared by the Company as required by the Securities and Exchange Law of Japan.

In addition, the notes to the consolidated financial statements include information which is not required under accounting principles generally accepted in Japan but is presented herein as additional information.

As permitted by the Securities and Exchange Law of Japan, amounts of less than one million yen have been omitted. As a result, the totals shown in the accompanying consolidated financial statements (both in yen and in dollars) do not necessarily agree with the sums of the individual amounts.

Certain amounts previously reported have been reclassified to conform to the current year's presentation.

### **b. Basis of Consolidation**

The accompanying consolidated financial statements include the accounts of the Company and its significant subsidiaries controlled directly or indirectly by the Company (the "Companies"). Investment in companies over which the Company exercises significant influence in terms of their operating and financial policies have been included in the consolidated financial statements on an equity basis of accounting.

All significant intercompany balances and transactions have been eliminated in consolidation.

Investments in unconsolidated subsidiaries and affiliates not accounted for by the equity method are generally stated at cost.

The differences at the dates of acquisition between the cost and underlying net equity of the consolidated subsidiaries and companies accounted for by the equity method are being amortized by the straight-line method over a period of five years.

### **c. Foreign Currency Translation**

The revenue and expense accounts of the foreign subsidiaries are translated at the average exchange rates prevailing during the year.

The accounts of foreign consolidated subsidiaries, except for the components of shareholders' equity, are translated into yen at the rates of exchange in effect at the balance sheet date. The components of shareholders' equity are translated at their historical exchange rates. Translation differences arising from the translation of the financial statements of the foreign consolidated subsidiaries are presented as translation adjustments.

Monetary assets and liabilities denominated in foreign currencies of the Company and its domestic consolidated subsidiaries are translated into yen at the current rates except for those hedged by forward foreign exchange contracts, which are translated at the contracted rates.

Gains and losses arising from exchange differences are credited or charged to income in the year in which they are incurred.

### **d. Cash Equivalents**

The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

### **e. Securities**

Securities are classified into three categories: trading, held-to-maturity or other securities. Trading securities are carried at fair value and held-to-maturity securities are carried at amortized cost. Marketable securities classified as other securities are carried at fair value with changes in unrealized holding gain or loss, net of the applicable income taxes, included directly in shareholders' equity. Non-marketable securities classified as other securities are carried at cost. Cost of securities sold is determined by the moving average method.

**f. Inventories**

Inventories are stated at cost determined principally by the average method.

**g. Property, Plant and Equipment**

Property, plant and equipment is stated at cost except that the cost of certain assets has been reduced by certain capital gains in accordance with the Corporation Tax Law of Japan.

Depreciation is mainly computed by the declining-balance method, except that the straight-line method is applied to the buildings which were acquired after April 1, 1998 based on the estimated useful lives of the respective assets.

**h. Leases**

Finance lease transactions are primarily accounted for as operating leases except that lease agreements which stipulate transfer of ownership of the leased assets to the lessee are accounted for as finance leases.

**i. Retirement Benefits**

The Company and its domestic consolidated subsidiaries have defined benefit plans, i.e., welfare pension fund plans, tax-qualified pension plans and lump-sum payment plans, covering substantially all employees who are entitled to lump-sum or annuity payments, the amounts of which are determined by reference to their basic rates of pay, length of service, and the conditions under which termination occurs. Certain foreign subsidiaries have defined contribution plans.

Accrued employees' retirement benefits are provided mainly at an amount calculated based on the retirement benefit obligation and the fair value of the pension plan assets at the balance sheet dates, as adjusted for unrecognized actuarial gain or loss, and unrecognized past service cost. The retirement benefit obligation is attributed to each period by the straight-line method over the estimated years of service of the eligible employees. Actuarial gain and loss are amortized in the year following the year in which the gain or loss is recognized primarily by the straight-line method over periods of 10 years which are shorter than the average remaining years of service of the eligible employees. Past service cost is amortized primarily by the straight-line method over periods of 10 years which are shorter than the average remaining years of service of the eligible employees.

Directors and corporate auditors of the Company and its domestic consolidated subsidiaries are customarily entitled to lump-sum retirement payments under their respective unfunded retirement plan subject to the stockholders' approval. Provision for the retirement benefits for those officers has been made at estimated amount.

**j. Derivative Financial Instruments**

The Company has entered into derivative transactions in order to manage certain risks arising from adverse fluctuations in foreign currency exchange rates. Derivatives are carried at fair value with changes in unrealized gain or loss charged or credited to operations. Receivables and payables hedged by qualified derivatives are translated at the corresponding foreign exchange contract rates.

**2**

**U.S. Dollar Amounts**

The translation of yen amounts into U.S. dollar amounts is included solely for the convenience of readers outside Japan. The rate of ¥110.08 = U.S.\$1, the approximate rate of exchange on May 31, 2004, has been used. The inclusion of such amounts is not intended to imply that the yen amounts have been or could be readily converted, realized or settled in U.S. dollars at that or any other rate.

**3**

**Inventories**

Inventories at May 31, 2004 and 2003 consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Merchandise .....	¥ 3,715	¥ 3,659	\$ 33,748
Finished products .....	8,839	9,218	80,296
Semi-finished products and work in process .....	5,380	5,218	48,873
Raw materials and supplies .....	5,173	4,690	46,993
	<u>¥23,110</u>	<u>¥22,787</u>	<u>\$209,938</u>



Long-term debt at May 31, 2004 and 2003 consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Bonds without collateral:			
2.47% bonds due 2005 .....	¥ 3,000	¥ 3,000	\$ 27,252
Collateralized loans from banks, insurance companies, government agencies and other financial institutions, due through 2015 .....	2,572	3,139	23,364
Loans without collateral .....	6,978	4,240	63,390
	12,550	10,380	114,007
Less current portion .....	(4,041)	(2,565)	(36,709)
	¥ 8,509	¥ 7,814	\$ 77,298

The aggregate annual maturities of long-term debt subsequent to May 31, 2004 are as follows:

	Millions of yen	Thousands of U.S. dollars
Year ending May 31,		
2005 .....	¥ 4,041	\$ 36,709
2006 .....	2,195	19,940
2007 .....	2,128	19,331
2008 and thereafter .....	4,186	38,026
	¥12,550	\$114,007

Assets pledged as collateral for long-term debt, other non-current liabilities and payables-trade at May 31, 2004 are summarized as follows:

	Millions of yen	Thousands of U.S. dollars
Receivables .....	¥ 134	\$ 1,217
Investment securities .....	249	2,261
Property, plant and equipment, at net book value .....	13,286	120,694
	¥13,670	\$124,182

## 7

### Income Taxes

The Company and its domestic consolidated subsidiaries are subject to a number of taxes based on income which, in the aggregate, resulted in statutory tax rates of 41.88% in 2004 and 2003. Income taxes of the foreign consolidated subsidiaries are based generally on the tax rates applicable in their countries of incorporation.

The effective tax rate reflected in the accompanying consolidated statement of income for the year ended May 31, 2004 and 2003 differed from the statutory tax rate for the following reasons:

	2004	2003
Statutory tax rate.....	41.88%	41.88%
Effect of:		
Expenses not deductible for income tax purposes .....	2.55	3.00
Dividend income deductible for income tax purposes .....	(3.19)	-
Inhabitants' tax based on individuals.....	1.08	1.28
Amortization of consolidation adjustments .....	0.52	0.63
Increase of valuation allowance.....	8.63	-
Tax credit for research and development cost .....	(4.51)	-
Tax credit for information and technology equipments .....	(1.65)	-
Loss in consolidated subsidiaries .....	-	7.41
Effect of change in tax rate .....	-	0.96
Other, net .....	(0.97)	(0.89)
Effective tax rate .....	44.34%	54.27%

## 7

Income Taxes  
(continued)

The significant components of deferred tax assets and liabilities as of May 31, 2004 and 2003 were as follows:

	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Deferred tax assets:			
Accrued retirement benefits .....	¥3,178	¥2,549	\$28,869
Accrued bonuses .....	1,278	963	11,609
Write down on investment securities .....	—	48	—
Accrued enterprise tax .....	247	293	2,243
Allowance for sales rebate .....	143	136	1,299
Tax loss carried forward .....	1,284	892	11,664
Other .....	988	879	8,975
Total deferred tax assets .....	7,119	5,763	64,671
Valuation allowance .....	(1,534)	(917)	(13,935)
	5,585	4,846	50,735
Deferred tax liabilities:			
Adjustment of acquisition costs of fixed assets .....	(823)	(856)	(7,476)
Unrealized holding gains on other securities .....	(2,075)	(508)	(18,849)
Adjustments for book value relating to land of consolidated subsidiaries....	(706)	(706)	(6,413)
Goodwill and other intangible assets .....	(456)	—	(4,142)
Other .....	(200)	(98)	(1,816)
Total deferred tax liabilities .....	(4,261)	(2,169)	(38,708)
Net deferred tax assets.....	¥1,323	¥2,677	\$12,018

New legislation was enacted in March 2003 which changed the aggregate statutory tax rate from 41.88% to 40.69% effective the fiscal year beginning after May 31, 2004. The effect of this tax rate change was to decrease net deferred tax assets by ¥57 million at May 31, 2003, to increase income taxes-deferred by ¥73 million for the year ended May 31, 2003 and to increase unrealized holding gains of other securities by ¥15 million at May 31, 2003.

## 8

Retirement Benefit  
Plans

The following table sets forth the funded and accrued status of the plans, and the amounts recognized in the consolidated balance sheets as of May 31, 2004 and 2003 for the Company's and the consolidated subsidiaries' defined benefit plans:

	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Retirement benefit obligation .....	¥(22,728)	¥(21,647)	\$(206,468)
Plan assets at fair value .....	13,315	10,010	120,957
Unfunded retirement benefit obligation .....	(9,413)	(11,637)	(85,510)
Unrecognized actuarial gain or loss .....	5,231	6,030	47,519
Unrecognized past service cost .....	(2,271)	—	(20,630)
Net retirement benefit obligation.....	(6,453)	(5,606)	(58,621)
Prepaid pension cost .....	781	691	7,094
Accrued retirement benefits .....	¥ (7,235)	¥ (6,297)	\$ (65,724)

The components of retirement benefit expenses for the year ended May 31, 2004 and 2003 are outlined as follows:

	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Service cost .....	¥1,278	¥1,499	\$11,609
Interest cost .....	559	668	5,078
Expected return on plan assets .....	(78)	(224)	(708)
Amortization of actuarial gain or loss .....	684	362	6,213
Amortization of past service cost .....	(252)	—	(2,289)
Total .....	¥2,191	¥2,306	\$19,903

The assumptions used in accounting for the above plans were as follows:

	May 31,	
	2004	2003
Discount rates .....	2.1% – 2.5%	2.5% – 3.1%
Expected rates of return on plan assets .....	1.0% – 2.5%	2.5% – 3.1%
Period for amortization of prior service liability .....	10 years	–
Period for recognition of actuarial gain or loss .....	10 years	10 years

Accrued retirement benefits include ¥444 million (\$4,033 thousand) for directors and corporate auditors of the Company and its domestic consolidated subsidiaries at May 31, 2004.

**9**  
*Research and Development Expenses*

Research and development expenses amounted to ¥8,554 million (\$77,707 thousand) and ¥8,551 million for the years ended May 31, 2004 and 2003, respectively.

**10**  
*Contingent Liabilities*

Contingent liabilities at May 31, 2004 were as follows:

	Millions of yen	Thousands of U.S. dollars
	Notes receivable discounted .....	¥ 476
Guarantees of loan of unconsolidated subsidiary .....	30	272
Guarantees of loan of employees.....	2,326	21,130

**11**  
*Amounts per Share*

	Yen		U.S. dollars
	2004	2003	2004
For the year ended May 31:			
Net income:			
Primary .....	¥ 21.22	¥ 14.92	\$0.19
Cash dividends .....	11.00	11.00	0.09
At May 31:			
Net assets.....	550.12	527.93	4.99

**12**  
*Derivatives*

- (1) The Companies utilize forward foreign exchange contracts solely in order to hedge against the risk of fluctuations in foreign currency exchange rates and to stabilize their future cash flows relating to debts denominated in foreign currencies relating to their operations.
- (2) The Companies have entered into derivative transactions solely in order to hedge against certain risks in compliance with their internal policies. The Companies have not and do not utilize derivatives for speculative trading purposes.
- (3) The Companies are exposed to the risk of credit loss in the event of nonperformance by the counterparties to these derivative transactions, but consider the risk of any such loss to be minimal because the Companies enter into derivative transactions only with financial institutions which have high credit ratings.
- (4) The Companies enter into, monitor and manage their derivative positions based on their own internal policies.

**13**  
*Leases*

Lease payments relating to finance lease transactions accounted for as operating leases amounted to ¥434 million (\$3,942 thousand) and ¥447 million for the years ended May 31, 2004 and 2003, respectively.

Future minimum lease payments (including the interest portion) subsequent to May 31, 2004 relating to finance lease transactions accounted for as operating leases are summarized as follows:

Year ending May 31,	Millions of yen	Thousands of U.S. dollars
	2005 .....	¥373
2006 and thereafter .....	615	5,586
	¥988	\$8,975

Lease income relating to finance leases accounted for as operating leases amounted to ¥51 million (\$463 thousand) and ¥51 million for the years ended May 31, 2004 and 2003, respectively.

The Companies operate principally in four industry segments: pharmaceuticals, fine chemicals, agro & specialty chemicals and other businesses. The fine chemical business involves the production and sales of inflators, functional products, dyestuffs, explosives and catalysts, and other sophisticated chemical products. Other businesses comprise mainly real estate leasing business.

Industry segment information for the Companies as of or for the years ended May 31, 2004 and 2003 is summarized as follows:

2004							
Millions of yen							
	Pharmaceutical business	Fine chemical business	Agro & specialty chemical business	Other businesses	Total	Eliminations	Consolidated
I. Sales and operating income:							
Sales to third parties.....	¥34,266	¥69,088	¥21,226	¥ 3,434	¥128,016	-	¥128,016
Intersegment.....	19	56	1,518	6	1,602	¥ (1,602)	-
Total .....	34,285	69,145	22,745	3,441	129,618	(1,602)	128,016
Operating expenses .....	29,237	60,974	22,160	2,032	114,405	3,513	117,917
Operating income.....	¥ 5,048	¥ 8,170	¥ 585	¥ 1,408	¥ 15,213	¥ (5,115)	¥ 10,097
II. Asset depreciation and capital expenditures:							
Total assets.....	¥29,767	¥76,752	¥26,410	¥17,259	¥150,189	¥29,633	¥179,823
Depreciation and amortization .....	1,134	3,578	1,243	810	6,767	376	7,144
Capital expenditures .....	2,933	5,234	1,469	69	9,706	338	10,045

2004							
Thousands of U.S. dollars							
	Pharmaceutical business	Fine chemical business	Agro & specialty chemical business	Other businesses	Total	Eliminations	Consolidated
I. Sales and operating income:							
Sales to third parties.....	\$311,282	\$627,616	\$192,823	\$ 31,195	\$1,162,936	-	\$1,162,936
Intersegment.....	172	508	13,789	54	14,553	\$ (14,553)	-
Total .....	311,455	628,134	206,622	31,259	1,177,489	(14,553)	1,162,936
Operating expenses .....	265,597	553,906	201,308	18,459	1,039,289	31,913	1,071,193
Operating income.....	\$ 45,857	\$ 74,218	\$ 5,314	\$ 12,790	\$ 138,199	\$ (46,466)	\$ 91,724
II. Asset depreciation and capital expenditures:							
Total assets.....	\$270,412	\$697,238	\$239,916	\$156,785	\$1,364,362	\$269,195	\$1,633,566
Depreciation and amortization .....	10,301	32,503	11,291	7,358	61,473	3,415	64,898
Capital expenditures .....	26,644	47,547	13,344	626	88,172	3,070	91,251

2003							
Millions of yen							
	Pharmaceutical business	Fine chemical business	Agro & specialty chemical business	Other businesses	Total	Eliminations	Consolidated
I. Sales and operating income:							
Sales to third parties.....	¥35,111	¥63,637	¥21,248	¥ 3,434	¥123,431	-	¥123,431
Intersegment.....	-	74	2,114	11	2,199	¥ (2,199)	-
Total .....	35,111	63,711	23,362	3,445	125,630	(2,199)	123,431
Operating expenses .....	29,058	57,810	22,356	2,207	111,433	2,300	113,733
Operating income.....	¥ 6,052	¥ 5,901	¥ 1,005	¥ 1,237	¥ 14,197	¥ (4,499)	¥ 9,697
II. Asset depreciation and capital expenditures:							
Total assets.....	¥31,381	¥72,267	¥23,953	¥19,031	¥146,634	¥32,482	¥179,117
Depreciation and amortization .....	1,060	3,746	1,145	905	6,858	152	7,011
Capital expenditures .....	830	4,977	855	338	7,001	777	7,779

Overseas sales, which include export sales of the Company and its consolidated subsidiaries, totaled ¥24,560 million (\$223,110 thousand) and ¥20,175 million, or 19.2% and 16.3% of the consolidated net sales for the years ended May 31, 2004 and 2003, respectively.

The following appropriations of retained earnings of the Company were approved at a meeting of the shareholders held on August 27, 2004:

	Millions of yen	Thousands of U.S. dollars
2003 year-end cash dividends (¥5.50 = \$0.049 per share).....	¥1,001	\$9,093
Bonuses to directors.....	50	454