

# Notes to Consolidated Financial Statements

Nippon Kayaku Co., Ltd. and Consolidated Subsidiaries  
May 31, 2005 and 2004

## Note 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 primary 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.

**Note 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 ¥108.11 = U.S.\$1, the approximate rate of exchange on May 31, 2005, 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.

**Note 3**

**Inventories**

Inventories at May 31, 2005 and 2004 consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Merchandise .....	¥ 3,325	¥ 3,715	\$ 30,755
Finished products .....	9,457	8,839	87,475
Semi-finished products and work in process .....	5,789	5,380	53,547
Raw materials and supplies.....	5,570	5,173	51,521
	<u>¥24,144</u>	<u>¥23,110</u>	<u>\$223,328</u>

**Note 4****Marketable and Investment Securities**

Information regarding marketable securities classified as other securities as of May 31, 2005 and 2004 were as follows:

**Marketable other securities**

	<b>May 31, 2005</b>					
	Millions of yen			Thousands of U.S. dollars		
	Acquisition cost	Carrying value	Unrealized gain (loss)	Acquisition cost	Carrying value	Unrealized gain (loss)
Securities whose carrying value exceeds their acquisition cost:						
Stock .....	¥2,788	¥ 8,276	¥5,488	\$25,788	\$ 76,551	\$50,763
Debt securities .....	-	-	-	-	-	-
Other .....	3,289	3,296	6	30,422	30,487	55
Subtotal .....	6,077	11,572	5,494	56,211	107,039	50,818
Securities whose acquisition cost exceeds their carrying value:						
Stock .....	152	130	(22)	1,405	1,202	(203)
Debt securities .....	-	-	-	-	-	-
Other .....	301	278	(22)	2,784	2,571	(203)
Subtotal .....	453	408	(44)	4,190	3,773	(406)
<b>Total .....</b>	<b>¥6,531</b>	<b>¥11,981</b>	<b>¥5,449</b>	<b>\$60,410</b>	<b>\$110,822</b>	<b>\$50,402</b>

	<b>May 31, 2004</b>		
	Millions of yen		
	Acquisition cost	Carrying value	Unrealized gain (loss)
Securities whose carrying value exceeds their acquisition cost:			
Stock .....	¥3,264	¥ 8,278	¥5,013
Debt securities .....	-	-	-
Other .....	2,587	2,593	5
Subtotal .....	5,851	10,871	5,019
Securities whose acquisition cost exceeds their carrying value:			
Stock .....	151	129	(22)
Debt securities .....	-	-	-
Other .....	2,004	1,982	(21)
Subtotal .....	2,156	2,112	(44)
<b>Total .....</b>	<b>¥8,008</b>	<b>¥12,983</b>	<b>¥4,975</b>

Sales of securities classified as other securities amounted to ¥1,117 million (\$10,332 thousand) as of May 31, 2005 with the aggregate gain of ¥640 million (\$5,919 thousand) and the aggregate loss of ¥3 million (\$27 thousand) for the year ended May 31, 2005.

**Note 5****Depreciation**

Depreciation for property, plant and equipment were ¥6,567 million (\$60,743 thousand) and ¥6,306 million for the years ended May 31, 2005 and 2004, respectively.

**Note 6****Short-Term Bank Loans and Long-Term Debt**

Short-term bank loans are unsecured and are generally represented by 60-day notes. The weighted average interest rates for the years ended May 31, 2005 and 2004 were approximately 2.85% and 2.14%, respectively.

The interest rates applicable to the long-term borrowings (except for current portion) at May 31, 2005 and 2004 average approximately 2.54% and 2.10%, respectively.

Long-term debt at May 31, 2005 and 2004 consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Bonds without collateral:			
2.47% bonds due 2005.....	–	¥ 3,000	–
Collateralized loans from banks, insurance companies, government agencies and other financial institutions, due through 2015 .....	¥ 3,526	2,572	\$ 32,614
Loans without collateral .....	8,806	6,978	81,454
	12,333	12,550	114,078
Less current portion.....	(2,547)	(4,041)	(23,559)
	<u>¥ 9,785</u>	<u>¥ 8,509</u>	<u>\$ 90,509</u>

The aggregate annual maturities of long-term debt subsequent to May 31, 2005 are as follows:

	Millions of yen	Thousands of U.S. dollars
<u>Year ending May 31,</u>		
2006.....	¥ 2,547	\$ 23,559
2007.....	2,958	27,361
2008.....	2,536	23,457
2009 and thereafter .....	4,291	39,691
	<u>¥12,333</u>	<u>\$114,078</u>

Assets pledged as collateral for long-term debt, other non-current liabilities and payables-trade at May 31, 2005 are summarized as follows:

	Millions of yen	Thousands of U.S. dollars
Receivables .....	¥ 100	\$ 924
Investment securities .....	313	2,895
Property, plant and equipment, at net book value.....	13,785	127,509
	<u>¥14,201</u>	<u>\$131,356</u>

**Note 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 2005 and 2004. 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 statements of income for the year ended May 31, 2005 and 2004 differed from the statutory tax rate for the following reasons:

	2004
Statutory tax rate .....	41.88%
Effect of:	
Expenses not deductible for income tax purposes .....	2.55
Dividend income deductible for income tax purposes .....	(3.19)
Inhabitants' tax based on individuals .....	1.08
Amortization of consolidation adjustments .....	0.52
Increase of valuation allowance .....	8.63
Tax credit for research and development cost .....	(4.51)
Tax credit for information and technology equipments .....	(1.65)
Other, net .....	(0.97)
Effective tax rate.....	<u>44.34%</u>

There is no significant difference between the normal effective statutory tax rate and the effective income tax rate reflected in the accompanying consolidated statements of income for the year ended May 31, 2005.

**Note 7****Income Taxes  
(continued)**

The significant components of deferred tax assets and liabilities as of May 31, 2005 and 2004 were as follows:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Deferred tax assets:			
Accrued retirement benefits .....	¥ 3,763	¥ 3,178	\$ 34,807
Accrued bonuses .....	1,243	1,278	11,497
Accrued enterprise tax .....	205	247	1,896
Allowance for sales rebate .....	102	143	943
Tax loss carried forward .....	1,532	1,284	14,170
Other .....	1,059	988	9,795
Total deferred tax assets .....	7,907	7,119	73,138
Valuation allowance .....	(1,794)	(1,534)	(16,594)
	6,113	5,585	56,544
Deferred tax liabilities:			
Adjustment of acquisition costs of fixed assets .....	(892)	(823)	(8,250)
Unrealized holding gains on other securities .....	(2,264)	(2,075)	(20,941)
Adjustments for book value relating to land of consolidated subsidiaries .....	(706)	(706)	(6,530)
Goodwill and other intangible assets .....	(414)	(456)	(3,829)
Other .....	(327)	(200)	(3,024)
Total deferred tax liabilities .....	(4,605)	(4,261)	(42,595)
Net deferred tax assets .....	¥ 1,508	¥ 1,323	\$ 13,948

**Note 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, 2005 and 2004 for the Company's and the consolidated subsidiaries' defined benefit plans:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Retirement benefit obligation .....	¥(24,062)	¥(22,728)	\$(222,569)
Plan assets at fair value .....	14,431	13,315	133,484
Unfunded retirement benefit obligation .....	(9,631)	(9,413)	(89,085)
Unrecognized actuarial gain or loss .....	4,447	5,231	41,134
Unrecognized past service cost .....	(1,783)	(2,271)	(16,492)
Net retirement benefit obligation .....	(6,968)	(6,453)	(64,452)
Prepaid pension cost .....	969	781	8,963
Accrued retirement benefits .....	¥ (7,937)	¥ (7,235)	\$ (73,415)

The components of retirement benefit expenses for the year ended May 31, 2005 and 2004 are outlined as follows:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Service cost .....	¥1,457	¥1,278	\$13,477
Interest cost .....	462	559	4,273
Expected return on plan assets .....	(170)	(78)	(1,572)
Amortization of actuarial gain or loss .....	707	684	6,539
Amortization of past service cost .....	(252)	(252)	(2,330)
Total .....	¥2,203	¥2,191	\$20,377

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

	May 31,	
	2005	2004
Discount rates .....	2.0% – 2.1%	2.1% – 2.5%
Expected rates of return on plan assets .....	1.0% – 2.1%	1.0% – 2.5%
Period for amortization of prior service liability .....	10 years	10 years
Period for recognition of actuarial gain or loss .....	10 years	10 years

Accrued retirement benefits include ¥482 million (\$4,458 thousand) for directors and corporate auditors of the Company and its domestic consolidated subsidiaries at May 31, 2005.

**Note 9**

**Research and Development Expenses**

Research and development expenses amounted to ¥9,498 million (\$8,854 thousand) and ¥8,554 million for the years ended May 31, 2005 and 2004, respectively.

**Note 10**

**Contingent Liabilities**

Contingent liabilities at May 31, 2005 were as follows:

	Millions of yen	Thousands of U.S. dollars
Notes receivable discounted .....	¥ 361	\$ 3,339
Guarantees of loan of unconsolidated subsidiary .....	27	249
Guarantees of loan of employees .....	2,278	21,071

**Note 11**

**Amounts per Share**

	Yen		U.S. dollars
	2005	2004	2005
For the year ended May 31:			
Net income:			
Primary .....	¥ 28.87	¥ 21.22	\$0.26
Cash dividends .....	11.70	11.00	0.10
At May 31:			
Net assets .....	570.31	550.12	5.27

**Note 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.

**Note 13**

**Leases**

Lease payments relating to finance lease transactions accounted for as operating leases amounted to ¥409 million (\$3,783 thousand) and ¥434 million for the years ended May 31, 2005 and 2004, respectively.

Future minimum lease payments (including the interest portion) subsequent to May 31, 2005 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
2006 .....	¥361	\$3,339
2007 and thereafter .....	507	4,689
	¥868	\$8,028

Lease income relating to finance leases accounted for as operating leases amounted to ¥51 million (\$471 thousand) and ¥51 million for the years ended May 31, 2005 and 2004, respectively.

Note 14

Segment Information

The Companies operate principally in four industry segments: functional chemicals, pharmaceuticals, fine chemicals and other businesses. The functional chemicals business involves the production and sales of inflators, functional materials, catalysts and electric materials. The fine chemicals business involves the production and sales of agro, color chemicals and explosives. Other businesses comprises real estate leasing business.

With its reorganization, effective on June 1, 2004, the Company has changed industry segmentation. The previous industry segment information has been reclassified to the current industry segment of the Company.

Industry segment information for the Companies as of or for the years ended May 31, 2005 and 2004 is summarized as follows:

2005							
Millions of yen							
	Functional chemicals business	Pharmaceuticals business	Fine chemicals business	Other businesses	Total	Eliminations	Consolidated
I. Sales and operating income:							
Sales to third parties.....	¥64,574	¥39,660	¥26,843	¥ 3,126	¥134,205	-	¥134,205
Intersegment .....	253	32	88	6	381	¥ (381)	-
Total .....	64,828	39,692	26,932	3,133	134,586	(381)	134,205
Operating expenses.....	57,680	34,832	25,045	1,650	119,209	4,829	124,039
Operating income.....	¥ 7,147	¥ 4,860	¥ 1,887	¥ 1,482	¥ 15,377	¥ (5,211)	¥ 10,166
II. Asset depreciation and capital expenditures:							
Total assets .....	¥64,247	¥40,248	¥29,293	¥16,991	¥150,780	¥30,583	¥181,364
Depreciation and amortization .....	3,189	1,794	1,395	729	7,108	500	7,609
Capital expenditures .....	3,675	706	986	22	5,391	1,946	7,337

2005							
Thousands of U.S. dollars							
	Functional chemicals business	Pharmaceuticals business	Fine chemicals business	Other businesses	Total	Eliminations	Consolidated
I. Sales and operating income:							
Sales to third parties.....	\$597,299	\$366,848	\$248,293	\$ 28,914	\$1,241,374	-	\$1,241,374
Intersegment .....	2,340	295	813	55	3,524	\$ (3,524)	-
Total .....	599,648	367,144	249,116	28,979	1,244,898	(3,524)	1,241,374
Operating expenses.....	533,530	322,190	231,662	15,262	1,102,663	44,667	1,147,340
Operating income.....	\$ 66,108	\$ 44,954	\$ 17,454	\$ 13,708	\$ 142,234	\$ (48,200)	\$ 94,033
II. Asset depreciation and capital expenditures:							
Total assets .....	\$594,274	\$372,287	\$270,955	\$157,163	\$1,394,690	\$282,887	\$1,677,587
Depreciation and amortization .....	29,497	16,594	12,903	6,743	65,747	4,624	70,382
Capital expenditures .....	33,993	6,530	9,120	203	49,865	18,000	67,866

2004							
Millions of yen							
	Functional chemicals business	Pharmaceuticals business	Fine chemicals business	Other businesses	Total	Eliminations	Consolidated
I. Sales and operating income:							
Sales to third parties.....	¥56,405	¥41,122	¥27,053	¥ 3,434	¥128,016	-	¥128,016
Intersegment .....	181	45	60	6	293	¥ (293)	-
Total .....	56,587	41,167	27,114	3,441	128,310	(293)	128,016
Operating expenses.....	49,679	35,864	25,343	2,032	112,919	4,999	117,919
Operating income.....	¥ 6,908	¥ 5,302	¥ 1,771	¥ 1,408	¥ 15,390	¥ (5,292)	¥ 10,097
II. Asset depreciation and capital expenditures:							
Total assets .....	¥63,397	¥39,270	¥30,261	¥17,259	¥150,189	¥29,633	¥179,823
Depreciation and amortization .....	2,695	1,804	1,456	810	6,767	376	7,144
Capital expenditures .....	4,519	3,891	1,226	69	9,706	338	10,045

Overseas sales, which include export sales of the Company and its consolidated subsidiaries, totaled ¥33,080 million (\$305,984 thousand) and ¥24,560 million, or 24.6% and 19.2% of the consolidated net sales for the years ended May 31, 2005 and 2004, respectively.

Note 15

Subsequent Event

(1) The following appropriations of retained earnings of the Company were approved at a meeting of the shareholders held on August 30, 2005:

	Millions of yen	Thousands of U.S. dollars
2004 year-end cash dividends (¥6.20 = \$0.057 per share) .....	¥1,127	\$10,424
Bonuses to directors .....	55	508

(2) On June 16, 2005, the Company sold its land to Sumitomo Realty & Development Co., Ltd. for ¥8.7 billion (\$80,473 thousand).

As a result, the Company is to record the gain of approximate ¥8.4 billion (\$77,698 thousand) for the fiscal year ending May 31, 2006.