

Notes to Consolidated Financial Statements

Nippon Kayaku Co., Ltd. and Consolidated Subsidiaries
May 31, 2006 and 2005

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 Corporate Law 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 method 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 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.

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 gains or losses 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 ¥112.26 = U.S.\$1, the approximate rate of exchange on May 31, 2006, 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

**Accounting
Changes**

Accounting Standard for Impairment of fixed assets

Effective June 1, 2005, the Company and its domestic consolidated subsidiaries adopted a new accounting standard for impairment of fixed assets ("Opinion Concerning the Establishment of Accounting Standard for Impairment of Fixed Assets" issued by the Business Accounting Council on August 9, 2002) and the "Implementation Guidance on the Accounting Standard for Impairment of Fixed Assets" (Accounting Standard Implementation Guidance No. 6 issued on October 31, 2003).

The effect of the adoption of this standard was to decrease income before income taxes and minority interest by ¥192 million (\$1,710 thousand) for the year ended May 31, 2006.

Accounting Standard for Bonuses to directors

Effective June 1, 2005, the Company and certain domestic consolidated subsidiaries adopted a new accounting standard for Bonuses to directors ("Accounting Standard for Bonuses to directors" issued by the Business Accounting Council on November 29, 2005).

The effect of the adoption of this standard was to decrease operating income and income before income taxes and minority interests by ¥145 million (\$1,291 thousand) for the year ended May 31, 2006.

Note 4**Inventories**

Inventories at May 31, 2006 and 2005 consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Merchandise	¥ 3,595	¥ 3,325	\$ 32,023
Finished products	10,452	9,457	93,105
Semi-finished products and work in process	6,230	5,789	55,496
Raw materials and supplies.....	6,370	5,570	56,743
	¥26,649	¥24,144	\$237,386

Note 5**Marketable and Investment Securities**

Information regarding marketable securities classified as other securities as of May 31, 2006 and 2005 were as follows:

Marketable other securities

	May 31, 2006					
	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.....	¥2,867	¥11,555	¥8,688	\$25,538	\$102,930	\$77,391
Debt securities	—	—	—	—	—	—
Other.....	1,803	1,804	0	16,060	16,069	0
Subtotal	4,670	13,359	8,688	41,599	119,000	77,391
Securities whose acquisition cost exceeds their carrying value:						
Stock.....	1,070	1,051	(18)	9,531	9,362	(160)
Debt securities	—	—	—	—	—	—
Other.....	1,459	1,449	(9)	12,996	12,907	(80)
Subtotal	2,530	2,501	(28)	22,536	22,278	(249)
Total	¥7,200	¥15,861	¥8,660	\$64,136	\$141,288	\$77,142

	May 31, 2005		
	Millions of yen		
	Acquisition cost	Carrying value	Unrealized gain (loss)
Securities whose carrying value exceeds their acquisition cost:			
Stock.....	¥2,788	¥ 8,276	¥5,488
Debt securities	—	—	—
Other.....	3,289	3,296	6
Subtotal	6,077	11,572	5,494
Securities whose acquisition cost exceeds their carrying value:			
Stock.....	152	130	(22)
Debt securities	—	—	—
Other.....	301	278	(22)
Subtotal	453	408	(44)
Total	¥6,531	¥11,981	¥5,449

Sales of securities classified as other securities amounted to ¥337 million (\$3,001 thousand) as of May 31, 2006 with the aggregate gain of ¥9 million (\$80 thousand) and the aggregate loss of ¥1 million (\$8 thousand) for the year ended May 31, 2006.

Note 6**Depreciation**

Depreciation of property, plant and equipment were ¥6,756 million (\$60,181 thousand) and ¥6,567 million for the years ended May 31, 2006 and 2005, respectively.

Note 7

**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, 2006 and 2005 were approximately 3.17% and 2.85%, respectively.

The interest rates applicable to the long-term borrowings (except for current portion) at May 31, 2006 and 2005 average approximately 2.61% and 2.54%, respectively.

Long-term debt at May 31, 2006 and 2005 consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Collateralized loans from banks, insurance companies, government agencies and other financial institutions, due through 2015	¥ 1,806	¥ 3,526	\$ 16,087
Loans without collateral	8,314	8,806	74,060
	10,120	12,333	90,147
Less current portion	(2,944)	(2,547)	(26,224)
	¥ 7,175	¥ 9,785	\$ 63,914

The aggregate annual maturities of long-term debt subsequent to May 31, 2006 are as follows:

	Millions of yen	Thousands of U.S. dollars
Year ending May 31,		
2007	¥ 2,944	\$26,224
2008	2,712	24,158
2009	1,941	17,290
2010 and thereafter	2,522	22,465
	¥10,120	\$90,147

Assets pledged as collateral for long-term debt, other non-current liabilities and payables-trade at May 31, 2006 are summarized as follows:

	Millions of yen	Thousands of U.S. dollars
Investment securities	¥ 184	\$ 1,639
Property, plant and equipment, at net book value	10,744	95,706
	¥10,929	\$97,354

Note 8

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 rate of 40.69% in 2006 and 2005. Income taxes of the foreign consolidated subsidiaries are based generally on the tax rates applicable in their countries of incorporation.

There was no significant difference between the normal effective statutory income tax rate and the effective income tax rate reflected in the accompanying consolidated statements of income for the year ended May 31, 2006 and 2005.

Note 8**Income Taxes**
(continued)

The significant components of deferred tax assets and liabilities as of May 31, 2006 and 2005 were as follows:

	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Deferred tax assets:			
Accrued retirement benefits	¥ 2,294	¥ 3,763	\$ 20,434
Accrued bonuses	1,352	1,243	12,043
Accrued enterprise tax	178	205	1,585
Allowance for sales rebate	141	102	1,256
Tax loss carried forward	1,971	1,532	17,557
Other	1,200	1,059	10,689
Total deferred tax assets	7,140	7,907	63,602
Valuation allowance	(2,169)	(1,794)	(19,321)
	4,971	6,113	44,281
Deferred tax liabilities:			
Adjustment of acquisition costs of fixed assets	(2,505)	(892)	(22,314)
Special reserve for adjustment of acquisition costs of fixed assets	(1,006)	—	(8,961)
Unrealized holding gains on other securities	(3,572)	(2,264)	(31,818)
Adjustments on book value relating to land of consolidated subsidiaries	(706)	(706)	(6,288)
Goodwill and other intangible assets	(420)	(414)	(3,741)
Other	(392)	(327)	(3,491)
Total deferred tax liabilities	(8,602)	(4,605)	(76,625)
Net deferred tax assets (liabilities)	¥(3,630)	¥ 1,508	\$(32,335)

Note 9**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, 2006 and 2005 for the Company's and the consolidated subsidiaries' defined benefit plans:

	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Retirement benefit obligation	¥(25,579)	¥(24,062)	\$(227,854)
Plan assets at fair value	24,700	14,431	220,024
Unfunded retirement benefit obligation	(878)	(9,631)	(7,821)
Unrecognized actuarial gain or loss	(331)	4,447	(2,948)
Unrecognized past service cost	(1,351)	(1,783)	(12,034)
Net retirement benefit obligation	(2,561)	(6,968)	(22,813)
Prepaid pension cost	5,463	969	48,663
Accrued retirement benefits	¥ (8,025)	¥ (7,937)	\$(71,485)

The components of retirement benefit expenses for the year ended May 31, 2006 and 2005 are outlined as follows:

	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Service cost	¥1,428	¥1,457	\$12,720
Interest cost	492	462	4,382
Expected return on plan assets	(187)	(170)	(1,665)
Amortization of actuarial gain or loss	662	707	5,897
Amortization of past service cost	(206)	(252)	(1,835)
Total	¥2,189	¥2,203	\$19,499

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

	May 31,	
	2006	2005
Discount rates.....	2.0% – 2.1%	2.0% – 2.1%
Expected rates of return on plan assets.....	1.0% – 2.1%	1.0% – 2.1%
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 included ¥61 million (\$543 thousand) for directors and corporate auditors of the Company and its domestic consolidated subsidiaries at May 31, 2006.

Note 10

Research and Development Expenses

Research and development expenses amounted to ¥10,419 million (\$92,811 thousand) and ¥9,498 million for the years ended May 31, 2006 and 2005, respectively.

Note 11

Contingent Liabilities

Contingent liabilities at May 31, 2006 were as follows:

	Millions of yen		Thousands of U.S. dollars
Notes receivable discounted	¥ 256		\$ 2,280
Guarantees of loan of employees	2,154		19,187

Note 12

Amounts per Share

	Yen		U.S. dollars
	2006	2005	2006
For the year ended May 31:			
Net income:			
Primary	¥ 52.92	¥ 28.87	\$0.47
Cash dividends	20.00	11.70	0.17
At May 31:			
Net assets	634.51	570.31	5.65

Note 13

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 14

Leases

Lease payments relating to finance lease transactions accounted for as operating leases amounted to ¥385 million (\$3,429 thousand) and ¥409 million for the years ended May 31, 2006 and 2005, respectively.

Future minimum lease payments (including the interest portion) subsequent to May 31, 2006 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
2007	¥323		\$2,877
2008 and thereafter	405		3,607
	¥728		\$6,484

Lease income relating to finance leases accounted for as operating leases amounted to ¥51 million (\$454 thousand) and ¥51 million for the years ended May 31, 2006 and 2005, respectively.

Note 15
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.

Industry segment information for the Companies as of or for the years ended May 31, 2006 and 2005 is summarized as follows:

2006							
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	¥73,133	¥39,774	¥24,028	¥ 3,089	¥140,026	-	¥140,026
Intersegment	86	8	64	8	167	¥ (167)	-
Total	73,219	39,783	24,093	3,097	140,194	(167)	140,026
Operating expenses.....	63,042	34,283	22,208	1,571	121,106	5,700	126,806
Operating income	¥10,177	¥ 5,499	¥ 1,884	¥ 1,526	¥ 19,087	¥ (5,867)	¥ 13,219
II. Asset depreciation and capital expenditures:							
Total assets	¥83,041	¥39,667	¥28,500	¥16,992	¥168,202	¥37,106	¥205,308
Depreciation and amortization	3,689	1,614	1,175	661	7,141	567	7,708
Loss on impairment of fixed assets.....	-	-	-	-	-	192	192
Capital expenditures	9,334	2,230	1,324	33	12,923	878	13,802

2006							
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	\$651,460	\$354,302	\$214,038	\$ 27,516	\$1,247,336	-	\$1,247,336
Intersegment	766	71	570	71	1,487	\$ (1,487)	-
Total	652,226	354,382	214,617	27,587	1,248,833	(1,487)	1,247,336
Operating expenses.....	561,571	305,389	197,826	13,994	1,078,799	50,774	1,129,574
Operating income	\$ 90,655	\$ 48,984	\$ 16,782	\$ 13,593	\$ 170,024	\$ (52,262)	\$ 117,753
II. Asset depreciation and capital expenditures:							
Total assets	\$739,720	\$353,349	\$253,874	\$151,362	\$1,498,325	\$330,536	\$1,828,861
Depreciation and amortization	32,861	14,377	10,466	5,888	63,611	5,050	68,662
Loss on impairment of fixed assets.....	-	-	-	-	-	1,710	1,710
Capital expenditures	83,146	19,864	11,794	293	115,116	7,821	122,946

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

Overseas sales, which include export sales of the Company and its consolidated subsidiaries, totaled ¥42,280 million (\$376,625 thousand) and ¥33,080 million, or 30.2% and 24.6% of the consolidated net sales for the years ended May 31, 2006 and 2005, respectively.

Note 16
Subsequent Events

The following appropriations of retained earnings of the Company were approved at a meeting of the shareholders held on August 30, 2006:

	Millions of yen	Thousands of U.S. dollars
2006 year-end cash dividends (¥14.50 = \$0.129 per share)	¥2,636	\$23,481