

ANNUAL
REPORT
2006
Year ended May 31

Driving R&D and Growth – A Virtuous Circle

Since our founding in 1916, from a base in the fine chemicals business, the Nippon Kayaku Group has continued to expand into a broad range of new fields, including explosives, dyes, pharmaceuticals, agrochemicals, functional products, catalysts, and automobile safety parts to construct our current business foundation. We have succeeded in expanding through maximizing the use of our business resources and continually improving ourselves to meet the needs of the rapidly changing times.

The Nippon Kayaku Group has established information/communications, health care, and safety systems as the fields in which we will target our expansion, and we are working to further concentrate our business resources in these fields. In 2006, the 90th anniversary of our founding, we constructed the Integrated Research Laboratories, introduced a project system, and worked to create a fusion of the broad range of technologies we have developed in the Group. At the same time, we have actively pursued alliances with other companies. Based on a fair and honest business approach, the Nippon Kayaku Group is working to accelerate the pace of research and development, and to apply our strengths in global niche markets, in order to achieve continued growth.

Driving R&D and Growth – A Virtuous Circle

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* Company information after May 31, 2006 is disclosed as part of company information herein.

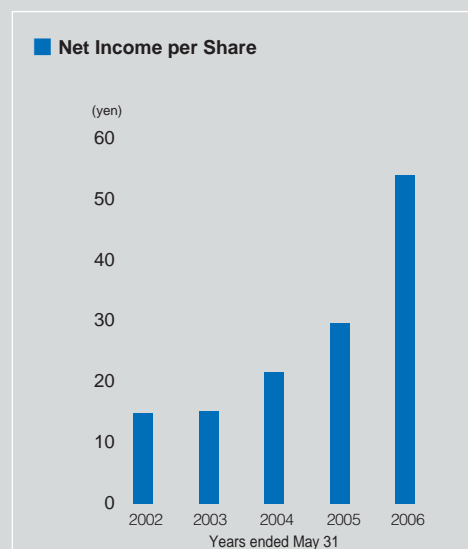
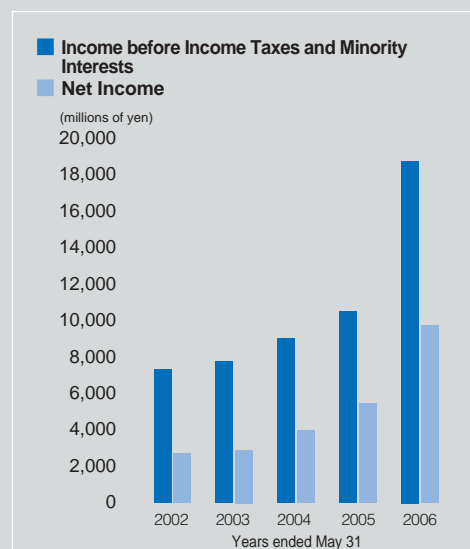
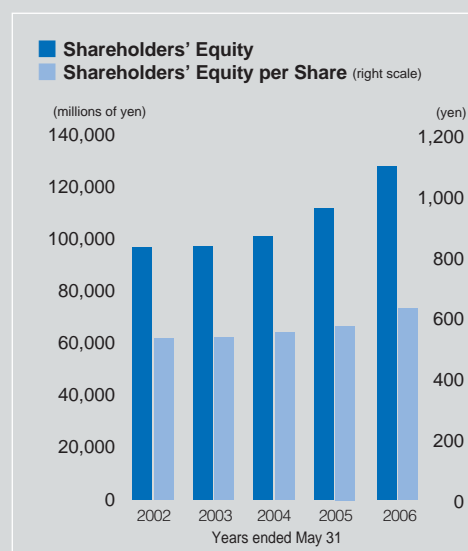
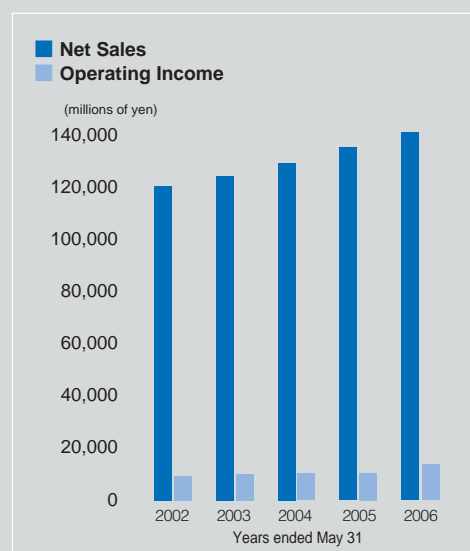
* Descriptions about future results imply uncertainty and risks, and do not guarantee realization of these results as such. There are possibilities that discrepancies will occur between goals and results due to such factors as changes in management environment.

Consolidated Financial Highlights

Millions of yen, except per share amounts

Years ended May 31	2006	2005	2004	2003	2002
Net Sales	140,026	134,205	128,016	123,431	119,435
Operating Income	13,219	10,166	10,097	9,697	9,384
Income before Income Taxes and Minority Interests	18,629	10,404	8,941	7,643	7,309
Net Income	9,641	5,315	3,926	2,780	2,630
Shareholders' Equity*	127,030	103,810	100,207	96,204	96,248
Shareholders' Equity per Share (Yen)	634.51	570.31	550.12	527.93	527.61
Net Income per Share (Yen)	52.92	28.87	21.22	14.92	14.42

* Shareholders' equity for years ended May 31, 2002, 2003, 2004, and 2005 does not include minority interests.



Message from the President

We have worked for a company-wide fusion of technology and human resources, in order to expand and grow our business in global niche markets.

Increased income and profits in the consolidated results for the year ended May 31, 2006

In the fiscal year ended May 31, 2006, net sales for the Nippon Kayaku Group were a new record of 140.026 billion yen, an increase of 5.821 billion yen from the previous fiscal year. Due to factors such as higher sales and cost-cutting measures, operating income increased by 3.053 billion yen to 13.219 billion yen. Net income increased by 4.325 billion yen to reach 9.641 billion yen, due in part to income from the sale of land at the former site of Yono company housing.

Looking at individual business areas, we see that in the functional chemicals business, sales were strong for products such as the epoxy resins used to encapsulate semiconductors, colors for inkjet printers, LCD display sealants, and plasma display films. In the safety systems business, sales of micro gas generators for seatbelt pretensioners were strong both in Japan and overseas. In the pharmaceuticals business, sales of new cancer-related products were strong, and we succeeded in cutting costs through a change to in-house production and other means. The fine chemicals business delivered profits at the same level as the previous year, due to strong sales of textile dyes.

Working for growth in global niche markets by selecting growth markets for concentrating resources, and by creating a fusion of technology and human resources

In the manufacturing industry, and the Nippon Kayaku Group in particular, because a long period of time is required for the creation of a new business or product, it is essential to have a clear vision for the mid- and long-term. Over the past few years, we have selected certain business areas and concentrated our resources in them. At the same time, we recognize that being involved in many business areas and forming an appropriate business group is an important strategy for growth. By working for a fusion of the fundamental technologies, patents, production technologies, and expertise we possess in each business area, we can generate new development, and accelerate the creation of the new businesses and products that only Nippon Kayaku is capable of.

The basic strategy of the Nippon Kayaku Group is to rapidly execute our business strategy for targeting niche markets by utilizing a fusion of technologies within and beyond our company. We have identified three growth fields: information/communications, health care, and safety systems. We intend to expand and grow our business in global niche markets by efficient business expansion that suits the size of our operations, and by creating a fusion of technologies from all different fields. Nippon Kayaku has positioned the functional chemicals business, which focuses on the information/communications and safety systems fields, and the pharmaceuticals business, which focuses on the health care field, as growth businesses, where



we are concentrating business resources and aiming for expansion and growth through rapid research and development. We have positioned the fine chemicals business as a stable income business, and are aiming to secure stable income by carrying out thorough cost-cutting and by introducing new products that meet market needs.

Introduction of the project system, aiming to cross compartmentalizing barriers and resolve issues rapidly


A company is continually exposed to fierce competition, and in order to emerge victorious from this competition the most important keys are accurately identifying the issues that need to be resolved, and rapidly resolving those issues. The conventional compartmentalized business organization is insufficient for this purpose, and for this reason we have introduced the project system to promote horizontal cooperation that is appropriate for the conduct of actual operations. By introducing this project system, we are aiming to be a company in which we can cross compartmentalizing organizational barriers to bring together team members from various divisions to be in charge of operations, and where these team members can share information, combine their expertise, and quickly carry out their work without hindrance.

Fulfilling social responsibilities, and working to maximize the value of our company

In order to fulfill our company's social responsibilities, we have placed the environment, safety, and quality at the core of Nippon Kayaku Group management, and have worked to strengthen our environmental safety management. In addition, we have strengthened our corporate governance and internal administration systems and are dedicating ourselves to total compliance. We are also engaged in timely and fair information disclosure, in order to improve the soundness and transparency of our management.

While we expect that the Japanese economy will continue its gradual expansion, there are also eventualities that can defy prediction, such as a possible slowdown in the U.S. economy or a spike in the price of oil. While the business environment surrounding the Nippon Kayaku Group is expected to remain a demanding one, we will work to maximize the value of our company in the future by following our basic strategy and achieving further expansion of our growth businesses.

October 1, 2006


Koichiro Shimada
President

SPECIAL FEATURE: RESEARCH AND DEVELOPMENT

April 2006: Opening of the Integrated Research Laboratories Working to Develop New Products Through a Fusion of Technology and Human Resources

In December 2005, Nippon Kayaku established the Research & Development Management Committee and the Research & Development Group, which serves as a comprehensive R&D organization spanning the entire company. In April 2006, in commemoration of the 90th anniversary of our founding, the Integrated Research Laboratories were opened. The purpose of these laboratories is to strengthen our R&D through a comprehensive, company-wide fusion of personnel and technology. Hidetoshi Kitazawa, director of the Research & Development Group, explains the background behind this event and the goals for Nippon Kayaku.



Hidetoshi Kitazawa
Director of the Research & Development Group
Representative Director, Senior Managing Director

Changes in Nippon Kayaku business

In 2006, Nippon Kayaku celebrated the 90th anniversary of the company's founding. During this long history, we have continued to expand our business while keeping pace with the changing times, and in doing so we have effected many changes in the structure of our business. Before the war and during the recovery period after it, our main focus was the explosives business, aimed at meeting the demand for energy. We then started our dyes business, pharmaceuticals business, agrochemicals business, and resins business. As the nation's economy grew, Japan was faced with the pressing need to make changes in order to adapt to the global economic environment, and there became intense technological reforms centered on such fields as IT and biotechnology. Under these conditions, we eventually positioned the functional chemicals business, related to electronic information and display materials such as cellular telephones, flat-screen televisions, DVD players, and ink-jet printers, as our central business. We also expanded our operations to include catalysts for the production of acrylic acid, optical functional films, and other products. Our business producing inflators, micro gas generators, and other automotive safety products began to grow as well. During this time, we continued to accumulate key intellectual assets, which centered primarily on the broad range of technology that supports these businesses.

Now, as globalization accelerates, needs are diversifying and unique and distinctive products are in demand. Moreover, the product cycle is extremely short, and customers are demanding even greater speed in product development. For these reasons, it has become nearly impossible to develop a product on the basis of one single technology, and it is necessary to create a combination of technologies.



The key is to develop products that satisfy customer needs, have creativity, and are highly marketable.

Reform of the R&D system

It was from this perspective that the structural reforms carried out by Nippon Kayaku in August 2004 reorganized the company to form a dynamic business organization able to rapidly meet market needs, aiming to apply a fusion of technologies to achieve growth in niche markets in three fields: information/communications, health care, and safety systems.

In addition, in December 2005 we established the Research & Development Management Committee and Research & Development Group, which serves as a comprehensive R&D organization spanning the entire company, in order to better make use of our company's collective strengths. As a result, we have reviewed our research and development system to strengthen company-wide R&D, working to resolve the following issues.

- (1) Strengthen the technology business by constructing a comprehensive R&D strategy and intellectual asset strategy which are in line with the company's business strategy and operation strategy.
- (2) Create new businesses and new products by promoting a fusion of technologies inside and beyond the company, including collaboration with industry, government, and universities, and by acquiring and incorporating leading-edge technologies.

- (3) Strengthen the next-generation fundamental technologies in order to construct technologies that will set us apart from other companies.

Establishment of the new Research & Development Management Committee

Nippon Kayaku has already carried out research and investment into each of these issues within the range of each business area. Indeed, these efforts were helpful in accelerating business research in each area; however, they were not effective in establishing a company-wide synergy, and there tended to be a lack of concentration in resource investment. As a result, the company eventually began to suffer from the effects of compartmentalization. For these reasons, we established the new Research & Development Management Committee, chaired by the company president, and created a mechanism for formulating company-wide strategy and policy for research and development.

The members of the Research & Development Management Committee include executive directors with official posts and the directors of research facilities, and the committee is tasked with discussing and formulating company-wide strategies and policies for research and development.

Establishment of the new Research & Development Group

In December 2005, we established the new Research & Development Group for the purpose of collecting and integrating business resources and R&D functions. This group combines

Fundamental Technologies and Growth Fields

Original Products

Explosives
Dyes, Chemicals
Pharmaceuticals
Agrochemicals
Resins

Fundamental Technologies

Materials technologies

Molecular & particle design
Functional design
Nanotechnology

Processing technologies

Explosives manufacturing
Dye manufacturing
Resin manufacturing
Dispersion processing
Film processing
Vapor-phase oxidation reactions
Pharmaceutical manufacturing
Agrochemicals formulation

System creation technologies

Control
Assembly

Evaluation technologies

Material & function evaluation
Hazard evaluation
Physiological & pharmacological activity evaluation
Safety & toxicity evaluation
Analysis



the Functional Chemicals R&D Laboratories, Pharmaceuticals Research Laboratories, Safety Systems Development Laboratories, and Agrochemicals Laboratories, together with the R&D Planning Division and Intellectual Property Division. At the same time, it provides a mechanism and operations for cooperation with business and marketing functions. The Functional Chemicals R&D Laboratories are responsible for development of functional

materials, electronic materials, colors and inks for inkjet printers, functional films, and vapor-phase oxidation catalysts, as well as development of products in new areas. The Pharmaceutical Research Laboratories carry out development in the medical pharmaceuticals field, centered on anti-cancer drugs, while the Safety Systems Development Laboratories carry out development of airbag inflators and micro gas generators for seatbelt pretensioners, and the Agrochemicals Laboratories develop chemical and biological pesticides. The R&D Planning Division operates company-wide research and development projects, such as R&D strategy planning and corporate themes. The Intellectual Property Division constructs intellectual property strategies for the entire company, and strengthens the company's information functions. Finally, the establishment of a new Pharmaceuticals Development Division in the Pharmaceuticals Group centralizes the organization for clinical development and provides links with the Pharmaceuticals

Research Laboratories, and is intended to generate rapid progress in development projects and post-marketing clinical trials.

Grand opening of the Integrated Research Laboratories, and the promotion of fusion and collaboration

As part of the activities commemorating the 90th anniversary since our founding, we completed construction of the Integrated Research Laboratories located in the Tokyo Business District, and the grand opening of this facility was held on April 12, 2006. For a long time, the Tokyo Business District has been home to our expanding pharmaceuticals research facilities, and with the completion of the Integrated Research Laboratories, researchers from a variety of fields will be gathered together under one roof. This opportunity for exchange promises to result in a productive fusion of technologies from the chemical, electrical, electronic, materials engineering, pharmaceutical, and other fields, leading to the development of new technologies that will eventually create new businesses. At the same time, these facilities are expected to function as a base for constructing a corporate culture of collaboration and fusion. In order to achieve an effective fusion of R&D management, the new Integrated Research Laboratories gathers the directors of the Functional Chemicals R&D Laboratories and Pharmaceuticals Research Laboratories, and their offices, in a single large room together with the R&D Planning Division and Intellectual Property Division.

Fundamental technologies and core product areas

The Nippon Kayaku fundamental technologies have their origins in the fine chemical technologies of explosives, dyes, and pharmaceuticals, which themselves are based upon this company's first lines of products. We then expanded the range of our technology, first adding agrochemicals to our business,

Core Product Clusters

Semiconductor encapsulation materials
Printed-circuit board materials
Adhesive, cohesive, and sealant materials

Functional colors
Recording materials
Functional films
Optical materials
Coating materials
MEMS materials
Vapor-phase oxidation catalysts

Pharmaceuticals (anti-cancer drugs)
Diagnostic agents
Automotive safety components
Agrochemicals
Dyes
Explosives

Growth Fields

Information/
communications

Health care

Safety systems

(New energy)

and then advancing into the field of epoxy resins used for the encapsulation of semiconductors. Based on the technology for synthesis of low molecular weight compounds, which was developed through our fine chemicals technology, we expanded our technology to cover the design and production of high molecular weight compounds by polymerization. In this way, we constructed the foundation of our fine chemicals business, which is the driving force behind our company. The technology for production of acrylic acid and methacrylic acid monomers, which are the raw materials for high molecular weight compounds, also led to the development of vapor-phase oxidation catalysts. In other areas, the application of explosive ignition technology led to the launch of our inflator business for automotive safety components, and our dye synthesis technology expanded to include the functional dye business, such as colors for inkjet printers, dyes for color filters used on digital cameras, and dyes for polarizing films used on LCD projectors. The current Nippon Kayaku fundamental technologies and core product clusters are as shown in the accompanying chart above.

In the future, we will work to strengthen and expand these technologies, while also working to create new fundamental technologies by fusing and combining all these technologies in our possession.

Operation of company-wide R&D themes and projects

In addition to the existing business-oriented R&D projects, we will also carry out R&D projects that involve the participation of all divisions throughout the company. Specifically, eight such projects are currently in progress (as the corporate themes: four projects related to functional chemicals, three projects related to pharmaceuticals, and one project related to explosives). The soonest among these are expected to generate business within the next 2 to 3 years. In addition, the Nanotech Project –

intended for the exchange of technologies and information related to nanotechnology throughout the company – has been in effect for the past several years. We will reinforce our support for this project, and apply it to the development of resin composites, ultra-fine particles, pharmaceuticals and formulation of agrochemicals, analysis technology, inorganic and organic hybrid materials, inflator gas generators, new catalysts, and other products.

Main R&D themes for developing the business that will support our company in the next generation

In the information/communications field, we are focusing on colors for commercial inkjet printers, micro electro-mechanical systems (MEMS)-related devices, high-performance resins such as polyimide and polyamide, high-performance optical films, and high-durability catalysts. In the health care field, we are focusing on the production of macromolecular micelle drug delivery systems (DDS), and in the safety systems field the focus is on the development of next-generation gas generators for automobile airbags and next-generation semiconductor bridge (SCB) squibs. Another growth field is the new energy area, where growth is expected and a number of Nippon Kayaku technologies can be applied to good use. We are proceeding with development, including collaboration with related companies and universities, aimed at commercialization of dye-sensitized solar cells, fuel cells, and other products that require a combination of multiple technologies, such as dyes, electrolytes, sealing materials, and adhesives.

In the future, we will work for a fusion of technology and human resources, targeting global niche markets where the size of Nippon Kayaku is an advantage, in order to increase the percentage of sales generated from new products, and to achieve continual growth for our business.

We are aiming at being the “number one and only one” in global niche markets through a fusion of technologies inside and beyond the company and the rapid introduction of new products, primarily in the information/communications field.



Keizo Shimomiya

Member of the Board
Managing Director
Director of Functional Chemicals Group

Further expanding our business through new products and new businesses

During the fiscal year ended May 31, 2006, the electronic materials business delivered strong performance, buoyed by growing demand for such items as liquid crystal televisions and plasma televisions, and other digital home electronic appliances, as well as for cellular telephones. However, severe business measures were required to secure profits, as material costs have risen due largely to the soaring price of oil. Consequently, we have focused efforts on correcting product prices, primarily in the functional materials business, and have engaged in company-wide cost-cutting efforts.

While a short-term corrective phase is anticipated, we have determined that the present growth trend will continue in the mid- to long-term. Nippon Kayaku will continue to position the information/communications field as a growth area for concentrating business resources. We will work to maintain a constant supply of new products to our customers, and are aiming to expand our business by identifying and developing new business areas that are consistent with technological and market trends.

Growing sales of environmentally friendly products in the functional materials business

Nippon Kayaku holds the global top market share for the epoxy resins used for the encapsulation of semiconductors. Our environmentally friendly epoxy resin called NC-3000, developed as a replacement for our earlier core product EOCN, has been recognized in fields extending beyond encapsulation materials, and sales are quickly growing in the printed wiring board (PWB) and other fields. For this reason, we carried out improvements to our supply system for this product.

For the resist ink resins, which are formed with RC resins as a base, we have shifted our research and development towards resins for flexible printed circuit (FPC), where a future large increase in demand is expected, and have introduced environmentally friendly products such as our epoxy resins into the market. Meanwhile, we have also worked to expand our group of resist monomers into the liquid crystal television and other flat panel display (FPD) areas. We are working to expand our business while developing new applications for RC resins.

We are also planning to expand our efforts aimed at the development of new applications, farther downstream in the process, for polyimide, polyamide, and other new resins. The focus is primarily on applications related to FPC.

In addition to its business of resist ink resins for PWBs, Kayaku Chemical (Wuxi) Co., Ltd. (KCW) in Wuxi, China has successfully begun production and sales of a range of coating resins for the rapidly expanding domestic market in China, and is delivering steadily improving performance. In the future, this company will work for greater business growth in the continually expanding Chinese market.

Strong performance by the electronic materials business, boosted by growth in the information/communications industries

We achieved a large-scale increase in sales of our colors for inkjet printers, thanks to an extremely well-conducted new-product development and marketing process. Aiming for further business expansion, we will also continue to develop a range of commercial and industrial inkjet inks in cooperation with printer and print head manufacturers.

Our range of films for flat panel display (FPD) has also shown a significant boost in sales. Our primary product, the front films for plasma televisions, is based on a fusion of two Nippon Kayaku fundamental technologies – dye technology and resin technology – and was developed and marketed in close connection with our customers. With the completion in August of a prototype and production line for our coating technology, we will accelerate the development of new products and work to expand our film business.

Despite difficult conditions in the market, other new products have been released successfully, including liquid crystal display (LCD) products, optics, and data storage products. DVD-related materials have been subject to fierce price competition as the market has expanded. However, extensive cost cutting and measures aimed at differentiating our products from the competition have allowed us to retain our top share of the market for recordable DVD-related materials.

Development is proceeding in two different systems (HD DVD and BR DVD) for next-generation DVDs. We are continuing to extend cooperation with the customers, and have begun marketing products that are compatible for both systems, respectively.

LCD sealants have also shown a strong increase in sales. In particular, as a result of the ever-increasing performance demands for the heat-curable sealants used in small- and mid-size panels, Nippon Kayaku has gained recognition for the superiority of our technology, allowing us to boost our market share. The adoption of our UV-curable resins by customers has been confirmed, and we expect full-scale growth in sales to begin in the near future.

Our consolidated subsidiary company Polatechno Co, Ltd., which primarily produces small- and mid-size polarizing films and optical materials for LCD projectors, is continuing to deliver strong performance. In particular, the inorganic polarizing film ProFlux™, produced by the U.S. company Moxtek Inc., has been adopted for use in high-definition rear projection televisions, with growing future sales expected.

Kayaku MicroChem Corporation, which is engaged in development and sales of resists for micro electro-mechanical systems (MEMS), has introduced new products and achieved strong sales. In addition, resist-coated wafers, which are silicon wafers with MEMS resist resin already applied, have been very well received by the customers.

Future growth expected in the catalyst business

We are engaged in the manufacture and sales of catalysts for the production of acrylic acid, which is used in the propylene direct-oxidation technology that was developed independently by our company. We are also engaged in the manufacture and sales of catalysts for the production of methacrylic acid, which is used in isobutylene direct-oxidation technology. The performance of our catalysts has been highly rated by customers throughout the world, and they are in use in a large number of plants that produce acrylic acid and methacrylic acid.

The market for super absorbent polymers (SAP), which are made of acrylic acids and used in disposable diapers and feminine hygiene products, is growing rapidly worldwide. As a result, a large number of new and expanded plants for the production of acrylic acids are planned in China and many other countries around the world. We are actively negotiating with these plants so that they will make use of catalysts from Nippon Kayaku.

Methacrylic acid is used as a raw material for acrylic plastic, and because of its superior transparency it has a great many uses, including in a range of displays, automobile tail lamps, large tanks at aquariums, and more recently as optical material in LCD televisions and projection televisions. There are growing opportunities for expansion of plants producing methacrylic acid.

Promoting a fusion of technologies inside and outside the company, and challenging ourselves to develop new technologies and businesses

Research themes at Nippon Kayaku are divided into the two categories of short- and mid-term themes, and long-term themes. Within each category, research is categorized as research directly related to business or else as research for the establishment of a technology base. After the system of responsibility has been made clear, we create a fusion of the technologies in our possession, and work for the creation of new products. We are also actively proceeding with joint research together with universities and other public research institutions, primarily for our long-term themes.

Nippon Kayaku always maintains a focus on the market when creating technology roadmaps and carrying out comprehensive R&D. We are actively engaged in joint development together with our customers because we believe that a cohesive exchange of information with customers is essential for research that is directly related to their business. Nippon Kayaku does not simply follow in the footsteps of existing technologies and business areas. Instead, we continuously challenge ourselves to develop new technologies and business areas. These efforts are not limited to our own company's technology, and we are actively involved in alliances and business ventures with other companies.

We are strengthening the production system for catalysts used in the manufacture of acrylic acid and methacrylic acid, in order to meet growing demand in Europe, America, and China

Sales for the Nippon Kayaku catalyst business in the year ended May 31, 2006 were 2.7 billion yen, an increase of 12% over the previous fiscal year. Overseas sales accounted for 2.1 billion yen of this amount. Due to factors such as the continuing double-digit growth in demand for acrylic acid and methacrylic acid in the China market, the worldwide supply situation is becoming tighter. In particular, growing demand for the super absorbent polymers (SAP) used in disposable diapers, as well as for acrylic ester, which is used in paints, adhesives, and other products, is putting a strain on supplies of acrylic acid. While our overseas sales are now centered on customers in Europe and America, we have also succeeded in obtaining orders in China. Using this as a foothold, we are planning to also expand sales in China, as well as in other markets such as India and Brazil.

Currently at the Nippon Kayaku Asa Plant, there are two lines of catalyst production equipment, with a total annual production capacity of 700 to 800 tons. This plant produces four types of catalysts, two each for the manufacturing process used for acrylic acid and methacrylic acid. With the growth in demand, this equipment is operating at near full capacity. For this reason, we are adding a production line with an annual production capacity of 500 tons, which is scheduled to begin operating at the start of 2007. With three production lines available, we will be able to reduce the loss that results from having to switch production among different types of catalysts. This will allow us to construct an optimized production system and maximize production efficiency. In addition, we are also considering expanding our business to catalysts other than those used for acrylic acid and methacrylic acid, by creating a fusion of our fundamental technologies with other technologies.

With large growth expected for sales of LCD panel materials, our consolidated subsidiary Polatechno has been listed on the JASDAQ Securities Exchange

On March 3, 2006, the Group company Polatechno Co., Ltd. was listed on the JASDAQ Securities Exchange in Japan. Polatechno was founded in 1991 as a joint venture established by Nippon Kayaku and Arisawa Manufacturing Co., Ltd. As one of the top dye manufacturers worldwide, Nippon Kayaku supplies a portion of the necessary materials to Polatechno, which in turn contracts testing and research to Nippon Kayaku.



Head office and plant of Polatechno

Polatechno manufactures and sells polarizing films, which are an essential component of LCD displays. Dye-type polarizing films are used on automobile instrument panels and many other fields, which require a high level of durability. Polatechno makes full use of its strengths in this field, and also manufactures the iodine-type polarizing films that are used in popular devices such as electronic dictionaries. This company has been successful by focusing on the niche market of small- and mid-size films, rather than on the market for large-size films used in LCD televisions, PCs, and other products, a market where major manufacturers are active. It also assembles polarizing films together with the surrounding materials to create and sell as projector components, and has achieved a strong market share in this area.

One field in which future growth is expected is the field of LCOS inorganic polarizing plate. LCOS is an LCD display that is expected to become the mainstream for LCD rear-projection televisions in the future. Polatechno manufactures and sells the ultra-high heat resistant inorganic polarizing plate used in these products. It is marketed under the brand name ProFlux™, and dominates the market.

Our Chinese consolidated subsidiary WPLC acquires ISO14001 international certification for environmental management systems

On April 25, 2006, Wuxi Polatechno Optics Co., Ltd. (WPLC) officially acquired ISO14001 international certification for environmental management systems. WPLC kicked off its efforts to gain this certification on July 21, 2005, and thanks to the combined efforts of all its staff, succeeded in acquiring the certification in just nine months.

The city of Wuxi, where WPLC is located, is located in the center of the Yangtze River delta in the southern part of Jiangsu Province, approximately 130 km from Shanghai, a region highly regarded for advanced commerce and industry. WPLC was established as a subsidiary of Polatechno Co., Ltd., for the assembly of projector materials. Polatechno Co., Ltd. is a Nippon Kayaku group company that maintains the No. 1 global market share for dye-type polarizing films used in LCD projectors and automobile LCD displays. While WPLC is an assembly company that produces a relatively small environmental burden, the fact that it has begun a PDCA (Plan-Do-Check-Action) cycle for continual improvements aimed at environmental protection is especially significant. Environmental protection activities such as saving energy and reducing waste materials are intended not only to reduce costs and strengthen the company structure, but also to heighten the company's value to society.



Plant of WPLC in Wuxi

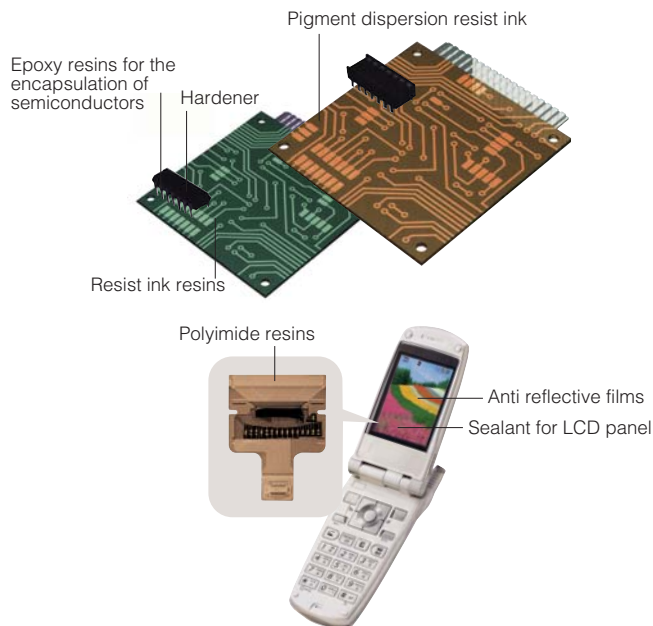
Business Areas

• Functional Products

We develop, manufacture and sell epoxy resins, UV-curing resins, and acrylic polymers.

Major products

- Epoxy resins (EOCN-1020, EPPN-500, NC-3000, BREN)
- Hardeners for epoxy resins (KAYAHARD)
- UV-curable resins (KAYARAD, KAYAMER, KAYACURE)
- Polyimide/Polyamide resins



• Electronics Materials

We develop, manufacture, and sell a broad range of electronics materials, optical functional films, optical disc materials, optical materials, and colors for inkjet printers.

Our consolidated subsidiary Polatechno Co., Ltd. manufactures and sells polarizing films and LCD projector components. Kayaku MicroChem Corporation imports and exports photo resists for micro-machines, etc.



• Catalysts

We are engaged in the development, manufacture, sales, and plant licensing business for acrylic acids, methacrylic acids and other catalysts used in manufacturing.



We are working to accelerate the fusion of knowledge and technology inside and outside the company, in order to achieve growth in the health care field, and in particular in areas related to cancer treatment.



Akira Mandai

Member of the Board
Managing Director
Director of Pharmaceuticals
Group

Applying nanotechnology to R&D for effective new anti-cancer drugs

The demand for effective cancer treatment will continue to increase in the future. In addition to demands for improving the utility of anti-cancer drugs that are currently on the market, there is also a strong demand for new anti-cancer drugs. Nippon Kayaku is actively investing business resources for the development of oncology products, and is continually working to strengthen its business base in this area. For the pharmaceuticals business in particular, in addition to our conventional research into cytotoxic anti-cancer drugs, we are creating a fusion of technologies from inside and outside the company, focusing on anti-cancer drug delivery system (DDS) pharmaceuticals, and working to accelerate the development. We are also actively engaged in alliances within and beyond our company.

For DDS pharmaceuticals in particular, we are engaged in the development of a DDS in which an anti-cancer drug is contained inside nano-size polymer micelles. DDS research is nearing a breakthrough point, as DDS technologies continue to incorporate nano-technology and information technology (IT). At Nippon Kayaku, we are aiming to expand our business by creating a fusion of technologies from inside and outside

the company, and are focusing our efforts on the development of anti-cancer drugs delivered by DDS which utilize polymer technology and nanotechnology.

Polymer micelles reach cancer cells passing through microscopic openings in the walls of the new blood vessels created by cancer tissues in order to acquire nutrients. Drug-carrying polymer micelles just 50 to 150 nanometers in diameter can pass through these openings to reach the tumor cells and deliver drugs directly. Achieving this specific delivery of anti-cancer drugs will allow the side effects of anti-cancer drugs to be reduced, and will deliver better results. Our Paclitaxel polymer micelle DDS (NK105) has completed Phase I clinical trials at the National Cancer Center, and we are proceeding with preparation for Phase II clinical trials. In addition, Phase I clinical trials were started in February 2006 at the National Cancer Center for another polymer micelle DDS (NK012) containing camptothecin active component, and are proceeding smoothly. We are also studying the possibility of applying this polymer micelle manufacturing technology to fields other than the anti-cancer drug field.

Strengthening our lineup of cancer-related products

Nippon Kayaku has accumulated a broad range of information related to the full spectrum of anti-cancer drug research, development, production, and sales. In order to apply this information in the best way to efficient business practices, we are not only researching and developing new drugs, but are also actively introducing new

products and proceeding with joint development to constantly strengthen our product lineup.

At present, Nippon Kayaku has marketed 20 anti-cancer drugs, two analgesics for cancer-related pain, and two cancer diagnostic agents. Development of new pharmaceuticals is especially focused on anti-cancer drugs, and we will continue to strengthen our product lineup in this important area.

Because combination therapy is most often used for cancer chemotherapy by medical institutions, we are engaged in providing and collecting information concerning not only our own products, but also concerning the administration, efficacy, and side effects of anti-cancer drugs in general. This allows us to collect a greater amount of information concerning anti-cancer drugs for research, production, and sales. Nippon Kayaku is continuing to provide information that is useful for actual cancer treatment, and also working to efficiently expand our business. For these purposes, a strong product lineup is essential and we are engaged in efforts to further improve it.

In 2004, we introduced ONCOVIN and EXAL from Eli Lilly Japan K.K., and in 2005 we introduced CALSED from Sumitomo Pharmaceuticals Co., Ltd. (currently Dainippon Sumitomo Pharma Co., Ltd.), GELPART from Yamanouchi Pharmaceuticals (currently Astellas Pharma Inc.), and EPIRUBICIN MERCK from Merck Hoei Ltd. We have also introduced the new anti-cancer drug NK408 from NeoPharm Inc. to combat brain tumors, and have been continuing clinical development. In 2006, we introduced the luteinizing hormone releasing hormone (LHRH) antagonist, OZARELIX from a Canadian company, Æterna Zentaris Inc., and began preparation of clinical development for treatment of prostate cancer. We also launched a generic anti-cancer drug, PACLITAXEL inj. NK, which was developed and is produced exclusively by us.

We will continue to actively pursue the introduction of new oncology products, and conduct extensive joint development, in order to strengthen our lineup of oncology products.

Strengthening our ability to provide oncology information and reinforcing our specialist medical representatives (MRs)

Cancer treatment today is generally conducted by a team, led by a medical expert and including pharmacists and nurses with advanced training and extensive practical experience.

It is therefore necessary to provide a broad range of information for them, and to react quickly to any and all new developments in oncology field. For this reason, Nippon Kayaku has strengthened drug information (DI) in the group, and is organizing lectures, seminars, and briefing sessions to answer these needs. We have also trained and dispatched cancer specialist MRs equipped with the ability to provide and collect information related to anti-cancer drugs in general.

Nippon Kayaku currently has 500-plus certified MRs. Of these, approximately 100 specialist MRs are assigned to the field of anti-cancer drugs to meet the growing demand in this field. To help them in their information-sensitive jobs, each MR is provided with a personal computer containing custom software developed by Nippon Kayaku. This software helps to strengthen the system that allows us to collect and provide information quickly. We have also constructed the MINK web system, which allows us to send information via the Internet directly to health care professionals who wish to receive it.

Reinforcement of facilities for production of high-potency active ingredients in order to expand integrated contract manufacturing which covers everything from API to pharmaceuticals

For many years, the Takasaki Plant has carried out integrated production of anti-cancer drugs that meet the strict standards of the FDA (US Food and Drug Administration), and we have constructed a complete system for GMP (Good Manufacturing Practices standards related to manufacturing control and quality control of pharmaceuticals) that covers every step from active pharmaceutical ingredients (API) to final dosage forms.

Making use of the vast amount of technology that we have acquired for the production of anti-cancer drugs, in the autumn of 2003 we began expanding our contract manufacturing business. We have since succeeded in constructing an integrated system for manufacturing pharmaceuticals that covers everything from the production of pharmaceutical intermediates and pharmaceutical API that combine original synthesis and bioscience technologies, to the production of injections that make extensive use of advanced sterile production technology. In particular, we are particularly skilled in the production of anti-cancer agents and other drugs that contain high-potency active ingredients. The production of high-potency active ingredients naturally requires thorough GMP, and also more advanced chemical hazard protection measures than for other pharmaceuticals. This necessitates special equipment, technology, and experience for management of the production process. For our primary anti-cancer drugs, we possess API and pharmaceutical production equipment that can be used to safely produce chemically hazardous medical compounds. In 2003, we installed additional multipurpose API production equipment for chemically hazardous drugs at the Takasaki Plant in Gunma Prefecture, Japan. In 2007, we will also establish an injection manufacturing plant that satisfies global standards, and construct a system for contract manufacture of high-potency active ingredients covering everything from API to injectables.

Application for expanding indication of RANDA, for use in treating asbestos-induced pleural mesothelioma

On June 28, 2006, Nippon Kayaku applied for supplemental approval of combination therapy using the anti-cancer drug RANDA (generic name: cisplatin), a drug used in the treatment of lung cancer, as effective in treating malignant pleural mesothelioma. Malignant pleural mesothelioma primarily occurs due to the inhalation of asbestos particles. Social interest in asbestos-related illnesses is increasing, with the passage of the Law Concerning Assistance for Health Effects of Asbestos, and the Partial Revisions to the Air Pollution Control Law and Other Laws for the Prevention of Health and Other Hazards Related to Asbestos. This combinant treatment was discussed at the First Discussion Conference for Problems in the Use of Unapproved Drugs, held by the Ministry of Health, Labor and Welfare on January 24, 2005. As this conference concluded that the early application of this treatment to national health care was essential, Nippon Kayaku made a supplemental application for approval. The number of deaths in Japan due to malignant pleural mesothelioma in 2004 was reported to be 833, and it is expected that this number will continue to increase, reaching a peak in 2030.

Release of the generic anti-cancer drug PACLITAXEL Inj. NK, bringing the anti-cancer drug lineup to 20



PACLITAXEL Inj. NK

On July 7, 2006, Nippon Kayaku released the generic anti-cancer drug Injectable PACLITAXEL Inj. NK (generic name: paclitaxel). PACLITAXEL Inj. NK is the third Nippon Kayaku generic anti-cancer drug, following Injectable CARBOMERCK 1% (generic name: carboplatin) and Injectable EPIRUBICIN Hydrochloride 10 mg/50 mg “MERCK” (generic name: epirubicin hydrochloride). These new drugs have boosted our anti-cancer drug lineup to 20 anti-cancer drugs.

PACLITAXEL inj. NK is the first generic anti-cancer drug released under the Nippon Kayaku brand, and in order to ensure quality we are producing it ourselves. In addition, we are constructing a system that will ensure that people feel secure when using our generic anti-cancer drugs. This system involves providing complete information for correct use of the drugs, mainly through approximately 100 specialist MRs who are equipped with knowledge concerning the full range of anti-

cancer drugs. We will continue to make use of the information and expertise that we have accumulated concerning the full spectrum of anti-cancer drug research, development, production, and sales, and will expand our business as a specialty & generic pharmaceutical manufacturer, focusing on the anti-cancer field.

Approval received for the manufacture and sale of CETROTIDE®, a drug that prevents early ovulation and is used for fertility treatment

On April 20, 2006, Nippon Kayaku received approval for the manufacture and sale of Injectable CETROTIDE® 3 mg/0.25 mg (generic name: cetrorelix acetate) for effective use in preventing early ovulation during controlled ovarian stimulation. The developmental rights for this drug are held by the German company Zentaris, and this drug has been approved and sold for the prevention of early ovulation in 92 countries, including the United States and countries in Europe.

In Japan, the drug was developed jointly by Shionogi & Co., Ltd. and Nippon Kayaku. It was agreed that we would import the drug from Zentaris and produce it, while Shionogi would carry out sales. Sales of this drug began in September 2006. In the future, we will continue to work under a system of close cooperation between Nippon Kayaku and Shionogi so that CETROTIDE® can contribute to health care in Japan in the field of fertility treatment, where a high level of expertise and special knowledge are required.

Release of GELPART, a medical material used to “starve” liver cancer

Nippon Kayaku has launched a medical material, GELPART, which is used in treating hepatocellular carcinoma. GELPART was introduced by Yamanouchi Pharmaceuticals Co., Ltd., the predecessor of Astellas Pharma Inc. In May 2005, we acquired the right to develop and sell GELPART in Japan from this company.

GELPART is composed of porous gelatin particles 1 mm or 2 mm in diameter, and is used for transcatheter arterial embolization, a type of treatment for patients with hepatocellular carcinoma. This treatment fills blood vessels that supply nutrients to hepatocellular carcinoma with porous gelatin particles, in effect “starving” the cancer tissue. To accomplish this, a catheter is routed through a blood vessel until it reaches a blood vessel that supplies nutrients to the cancer tissue. GELPART is then discharged through the catheter to close off the blood vessel. This interrupts the supply of nutrients and oxygen for a period of several days to several weeks, resulting in necrosis of the cancer cells. Special techniques are required in order to completely close off the blood vessels, and sales of this material were started primarily to specialist facilities.

Status of New Product Development by Stage

(as of October 1, 2006)

Stage	Development code Product name (Generic name)	Dosage form or route of administration	Therapeutic category (Indications)	Domestic developer	Characteristics/Others
				Origin	
NDA	SL-1100 (Filed in Dec. '03) (Estradiol)	Gel preparation	Estrogen (Climacteric disorder)	Joint dev. with Shiseido	First estradiol gel preparation in Japan. Approved in 61 countries.
				Besins International (France)	
Phase III	IMMUCYST PMCJ-9 (Connaught strain BCG)	Bladder instillation	Anti-cancer (for preventing recurrence of bladder cancer)	Own development	Extended indication
				Sanofi Pasteur (Canada)	
Phase II	NKT-01/ SPANIDIN (Gusperimus hydrochloride)	Injection	Immunosuppressant (Wegener's granulomatosis)	Own development	Developed overseas. Designated as an orphan drug (Mar. 2001) by the EMEA. Late phase II trial is currently in progress.
	Institute of Microbial Chemistry				
	NK211/HYCAMTIN® (Nogitecan hydrochloride)	Injection	Anti-cancer (Ovarian cancer)	Own development	Extended indication
	GSK				
NK911 (Micelle doxorubicin hydrochloride)	Injection	Anti-cancer (Pancreatic cancers)	Own development	Macromolecular micelle anti-cancer drug. Basic patent license obtained from Japan Science and Technology Corp. Development in other fields being considered.	
Tokyo Women's Medical University					
NS75A (Cetorelix acetate)	Injection	Anti-hormone (Hysteromyoma)	Joint dev. with Shionogi, Kayaku Zentaris	LHRH (hormone that stimulates secretion of pituitary gonadotropin) antagonist	
Zentaris (Germany)					
Phase I	NK408 (IL13-PE38QQR)	Injection	Anti-cancer (cerebral cancer)	Own development	New molecular targeted anti-cancer drug. Phase III in EU and US.
	NeoPharm (US)				
	NS75B (Cetorelix pamoate)	Injection (sustained release preparation)	Anti-hormone (Prostatic hypertrophy)	Joint dev. with Shionogi, Kayaku Zentaris	LHRH (hormone that stimulates secretion of pituitary gonadotropin) antagonist
	Zentaris (Germany)				
	NK105 (Micelle paclitaxel)	Injection	Anti-cancer (Solid cancers)	Own development	Macromolecular micelle anti-cancer drug
	Joint dev. with NanoCarrier				
NK314	Injection	Anti-cancer (Solid cancers)	Own development	New cytotoxic anti-cancer drug	
Own development					
NK012 (Micelle camptothecin analogue)	Injection	Anti-cancer (Solid cancers)	Own development	Macromolecular micelle anti-cancer drug	
Own development					
NK292	Oral preparation	Anti-cancer (Breast cancer)	Own development	New drug for treatment of breast cancer	

Major Products

The year in parentheses is when the product was first marketed.

Anti-Cancer and Cancer-Related Drugs

- PACLITAXEL Inj NK (2006)
- GELPART (2006)
- CALSED (2005) ①
- EPIRUBICIN (2005)
- IA CALL (2004) ②
- ONCOVIN (2004)
- EXAL (2004)
- CARBOMERCK (2003)
- IMMUCYST (2003) ③
- HYCAMTIN® (2003)
- MS-TWICELON (2001)
- COFORIN (1996)
- FARESTON (1995)
- ODYNE (1994)
- STARASID (1992)
- PINORUBIN (1988)
- LASTET (1987)
- BESTATIN (1987)
- RANDA (1984) ④
- PEPLEO (1981)
- BLEO (1969)



Immunosuppressants

- SPANIDIN (1994) ⑤



Cardiovascular Drugs

- MILLISROL for Coronary Infusion (2001)
- ADEHL (1999)
- MILLISTAPE (1998)
- NITROPEN TABLETS (1988)
- MILLISROL (1984) ⑥
- NITROGLYCERINE TABLETS (1953)



Neurological Drugs

- SALIGREN (2001)
- MUSCALM (1975)

Other Drugs

- ASTRIC DRY SYRUP (2002) ⑦



Diagnostic Agents

- LANA MAMMO CARD CEA (2002) ⑧
- LANA TP AUTO (2001)
- LANA 1,5AG AUTO LIQUID (2000)
- LANAZYME BFP PLATE (2000)
- LANAZYME ST-439 PLATE (1999)



We aim to further expand our business through the development of highly competitive products and global operations.



Yoshiyuki Ikeda

Member of the Board
Managing Director,
with Responsibility for Safety
Systems Division

Automotive safety products: Promising rapid growth globally

In developed societies where motorized traffic is extensive, demand is growing for collision protection for passengers and pedestrians in the case of accidents. We anticipate that in the future there will be increasingly varied paths of development for the automotive safety products that will meet these demands, and these products will be installed in an increasing number of vehicles. Growth in automobile production is expected to continue worldwide, centered among the so-called "BRICs" (Brazil, Russia, India, and China). Global production of passenger cars was approximately 62 million vehicles in 2005, and is forecast to reach approximately 78 million in 2014. From a global standpoint, with the success by Japanese automobile manufacturers in expanding to all corners of the world, much attention has been focused on Japanese automotive parts manufacturers for their efforts to enter and expand in local markets globally.

Our Safety Systems Division is currently riding this wave of expansion, and we are also working to grow our business by applying the expertise and trust we have developed over many years through business conducted with Japanese automobile manufacturers and Tier 1 manufacturers. For this purpose, our efforts are concentrated in the following three directions:

- Research and development of new products;
- Boosting competitiveness to increase our market share; and
- Focusing on global expansion of our business.

Strengthening R&D for the continual development and marketing of attractive new products

Applying our igniter and detonator technology, which is backed by our many years of experience, Nippon Kayaku has independently developed inflators for airbags and micro gas generators for seatbelt pretensioners. By reinforcing this special R&D strength, and by further streamlining operation of our research organization from a global perspective, we are developing and marketing new products with the performance, price, and quality that strongly appeal to customers. In 2004, we began to market a new thick-type disc inflator for the passenger seat, and we are working to create new applications for this product. Currently, we are aiming to quickly complete and market our compact inflator, now under development, for use in side-impact airbags.

For our highly rated micro gas generators, we are developing features that will make the squibs even more reliable. These will help to greatly increase the competitiveness of the micro gas generators that utilize these squibs. In keeping with the needs of the times, we are also proceeding with efforts to expand our range of lead-free and green products, to create a lineup of environmentally friendly products.

In addition, we are further increasing our efforts for the development of semiconductor bridge (SCB) squibs, aiming for their utilization in vehicles beginning in 2009, as well as a broad range of other new products.

Strengthening the competitiveness of existing products to increase market share and expand our business

As the automotive safety products market continues to expand, automotive parts manufacturers have shown greater concern over market share. Consequently, the competition has become extremely fierce. In order for us to survive, total cost awareness must penetrate all production, engineering, and management divisions. We must make ceaseless improvements to our products, processes, and distribution, and continually work for the efficient operation of our organization. The combined strength of the safety divisions and quality control divisions must be focused on achieving the highest level of competitiveness in the industry. This competitiveness will then lead to expansion of business.

Global operations to improve service to Japanese automobile manufacturers

In the safety systems business, we established Indet Safety Systems a.s. (ISS) in the Czech Republic in 1999, and LifeSparc Inc. (LS) in the U.S. in 2000. Together with our Himeji Plant (in Himeji, Hyogo Prefecture), we have been engaged in global production of squibs and micro gas generators. In early 2006, we established Nippon Kayaku CZ s.r.o. (NKCZ) in the Czech Republic, which is planning to start production of gas generating agents in mid 2007. In addition, in 2006 we established Kayaku Safety Systems (Huzhou) Co., Ltd. (KSH) in China, which will begin production of inflators and micro gas generators in mid 2007. In this way, we have constructed a global support system for Japanese automobile manufacturers as they expand overseas.

For the future, by constructing and utilizing the Internet, company intranets, and global databases, we are improving global communication, the distribution of responsibilities, and our many support services, and are striving to expand sales and increase the profit-earning capacity of our consolidated business.

Topics

Establishment of a company for the manufacture of automobile safety products in China, planning to start production in mid 2007

In addition to the global increase in automobile production, more and more automobiles, primarily luxury cars, are equipped with not only driver seat and passenger seat airbags, but also curtain airbags to protect occupants' heads, side airbags, and knee airbags. It is also expected that growing numbers of automobiles will be equipped with seatbelt pretensioners, which instantaneously wind up the seatbelt in the event of a collision. While the growth in these safety systems will continue to expand the market, increasingly fierce price competition has made the shift to production in China an urgent issue for our company. Nippon Kayaku has consequently established a new company, Kayaku Safety Systems (Huzhou) Co., Ltd. (KSH), located south of Shanghai, in Huzhou City, Zhejiang Province. This company will manufacture the inflators used to deploy airbags, and the micro gas generators that are part of seatbelt pretensioners. Plant construction and infrastructure preparation are currently under way, with full-scale production expected to begin in mid 2007.

Establishment of a company for the manufacture of inflator gas generating agents in the Czech Republic, planning to start production in mid 2007

Previously, the gas-generating agents that form the core of the Nippon Kayaku inflator business were manufactured only at the Himeji Plant. However we have decided to establish a new subsidiary company, Nippon Kayaku CZ (NKCZ) in the Czech Republic, which will have a plant with a production capacity equivalent to the Nippon Kayaku Himeji Plant (100 tons annually). Production is scheduled to begin in mid 2007. Because full-scale inflator production has not yet begun in the Czech Republic, initially the function of this new company will be to provide a stable supply of gas-generating agents to our Himeji plant. As inflator manufacturing increases and diversifies, products from this company will be delivered to an increasing number of destinations.

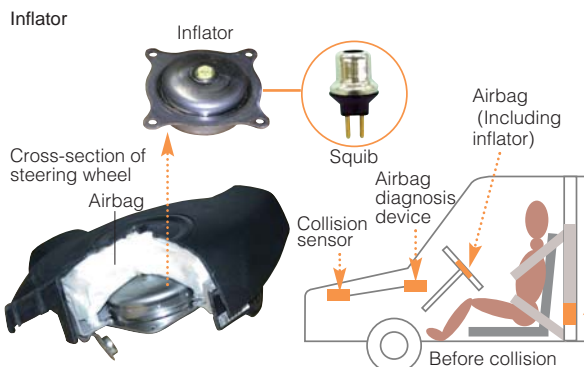
Mechanisms of Airbag and Seatbelt Pretensioner

Inflator Mechanism

An inflator is a device, incorporated in safety airbags, that generates gas to instantly inflate the bag when a vehicle collision occurs.

[Operating mechanism]

- (1) A sensor detects the collision, and an electrical signal is sent to the inflator.
- (2) The squib inside the inflator operates, igniting a gas-generating agent. The generated gas enters the airbag, instantly inflating it.

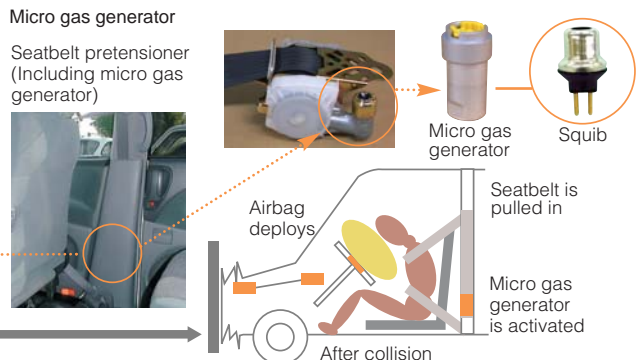


Micro Gas Generator Mechanism

The micro gas generator generates gas for the seatbelt pretensioner device, which winds up the seatbelt and instantly restrains the occupant's body when a vehicle collision occurs.

[Operating mechanism]

- (1) A sensor detects the collision, and an electrical signal is sent to the micro gas generator.
- (2) The squib inside the micro gas generator ignites the gas-generating agent. The generated gas pressure becomes the dynamic force that winds up the seatbelt.



Two years into our reforms, we are working to further accelerate the pace of change in order to stabilize profits.



Yoshiaki Fukushima

Member of the Board
Managing Director
Director of Fine Chemicals Group

Steady progress on reforms under harsh market conditions

As the trend toward reducing or eliminating the use of agrochemicals continues in the agrochemicals business, there has been a gradual decline in the amount of agrochemicals used. With no change in the trend toward relocation of color chemicals processing facilities overseas, the domestic market for the color chemicals business continues to shrink. In the explosives business, policies to restrict public works remain in effect, and the market has continued to decrease in size. These conditions have been exacerbated by new problems, such as a squeeze on profits resulting from high materials costs, attributable to the soaring price of oil, and rising import prices due to the increasing value of the Chinese yuan. Under these conditions, the Fine Chemicals Group is working to ensure survival through reforms which will alter the structure of our business. The fundamental strategy behind these reforms is to change our business operations in order to adapt to changes in the market. Specifically, for the agrochemicals business the key is the introduction of new active ingredients and new chemicals, and development of new domestic markets. For the color chemicals business, it is expanding into the Chinese market and other global markets, and for the explosives business it is to expand our business by increasing market share and developing new applications and products. We have already taken steps in these directions. Two years have passed since these reforms were started, and steady progress is being made. However, we must further accelerate the pace of these reforms, and make the changes more substantial.

In the agrochemicals business: Elimination of past debts and rapid marketing of new products in the future

Compared with the previous year, both sales and profits for the agrochemicals business showed large declines in the fiscal year ended May 31, 2006, and were significantly worse numerically. However the primary reason for these results is that we eliminated our past debts, and we were finally able to arrive at a starting point for carrying out true reforms. In the future, we will accelerate the development of new products that are developed in-house, carry out purchases of chemicals and ingredients, and become aggressively involved in M&A and other efforts in order to resolve the greatest issue for this business: the rapid introduction of new products to the market. In the fiscal year ending May 31, 2007, we are planning to market two new products: one new biological pesticide and one plant protection agent. In addition, we are engaged in other top-priority issues, including strengthening and expanding domestic sales and improving the profit structure, and ensuring that these changes are maintained and fully applied.

Higher income and profits for the color chemicals business, with future focus on infrastructure improvements for the China business

For the first time in several years, the color chemicals business achieved both higher income and higher profits, due to factors such as large growth in the China business where our main efforts

have been focused, strong growth in the Japan market, and the effects of cost-cutting measures. Our China subsidiaries Wuxi Advanced Kayaku Chemical Co., Ltd. (WAC) and Zhaoyuan Advanced Kayaku Chemical Co., Ltd. (ZAC) are continuing to deliver both higher production quantities and higher total sales year after year. In the future we will further accelerate the pace of expansion for our business in China. China sales have been increasing at an annual rate of 50% or more, and have reached the point where we are at last aiming for the 1.0 billion yen mark. At this opportunity, we are working faster to create a master plan for the new color chemicals business, focused on achieving profits through this color chemicals business in China. Achieving the goals in this master plan is essential, and we are hastening to complete the necessary infrastructure improvements.

Large increase in profits for the explosives business, with future efforts to focus on using new products to improve market share

The top two priorities for the explosives business have been the

following: achieving cost competitiveness, and developing unique products. To cut costs, we have reviewed our raw materials, and have also conducted complete reviews of items such as changes in production methods, and as a result have successfully achieved our target. In addition, the development division, which succeeded in developing the world's first granular emulsion explosive (Landex), has been involved in on-site use and application of this product, and has developed a safe and inexpensive method of blasting. It is currently on the way to achieving success in full-scale sales. As a result of efforts for reforms such as these, despite a slight decrease in sales, we achieved a large increase in profits. In the future, we will focus on increasing the market share for the new product Landex, and developing new applied products that utilize the technology we have accumulated and refined in the past.

Topics

Construction of new research laboratories at the Kashima Plant, in order to accelerate the pace of product development

In May 2006, Nippon Kayaku completed construction of new agrochemical business research laboratories, which will focus primarily on agrochemicals, within the Kashima Plant in Ibaraki Prefecture. The completion of these new facilities means integration of the Research & Development Division and the Production Division. In order to increase profits under the increasingly difficult conditions of the agrochemicals industry, we will change the pivot point of the agrochemicals business from development of agrochemical active ingredients to improvement and development of chemical products, making full use of the active ingredients our company possesses. Strengthening cooperation between the R&D Division and Production Division is critical for the purpose of improving the speed of product development. In addition, having these laboratories close to the plant has many advantages when conducting effectiveness tests.

Increasing the production capacity for synthetic textile dyes at the China group company Wuxi Advanced Kayaku Chemical Co., Ltd.

Nippon Kayaku took the lead in the Japanese synthetic dye industry with its entry into China, establishing a joint venture company in Zhaoyuan City, Shandong Province in 1995, and in Wuxi City, Jiangsu Province in 1996. Nippon Kayaku provided 75% of the investment in Zhaoyuan Advanced Kayaku Chemical Co., Ltd. (ZAC), which is located in Shandong Province, and produces fluorescent dyes, primarily for paper pulp. Nippon Kayaku provided 80% of the investment in Wuxi Advanced Kayaku Chemical Co., Ltd. (WAC), which is located in Jiangsu Province, and produces and sells disperse dyes and water-soluble dyes for textiles.

WAC has an annual production capacity of 1,800 tons, and the production equipment is approaching full capacity. For this reason, we have introduced new production equipment for water-soluble reactive dyes with an annual capacity of 2,000 tons, which is scheduled to begin operating in 2006. The reactive dye for which production capacity is being expanded is primarily used for cotton, and is named KAYACION. Plans are to sell half of this increased reactive dye production in China, and the remainder in Japan and other countries.

Business Areas

Agrochemicals

We manufacture and sell agrochemicals and similar products.

Major products

- DIAZINON
- MATRIC
- SAFROTIN
- EVISECT
- CYCLOSAL
- MCPB
- CHLOROPICRIN
- CUCUMERIS
- RATDEN
- SIMETRYN
- CHLORPIC-FLOW



Color Chemicals

We manufacture and sell textile dyes and dyes for paper pulp.

Major products

- KAYALON POLYESTER
- KAYACRYL-ED
- KAYACELON REACT
- KAYARUS
- KAYACION
- KAYAFECT
- KAYAPHOR LIQUID
- KAYASET



Explosives

We manufacture and sell explosives, black powder, and pyrotechnic products.

Major products

- Dynamite
- Slurried Explosives
- Ammonium Nitrate Fuel Oil Explosive (ANFO Explosive)
- Black Powder
- Electric Detonators



Corporate Governance

1. Basic concept of corporate governance

Nippon Kayaku understands that disclosing information to our shareholders and investors in a timely and fair manner is an important issue, as is strengthening check functions in order to ensure management transparency. Based on this understanding, we determined that a system based on decision-making by the board of directors, and corporate governance through an auditor system, is the most effective in terms of management functions.

2. Status of programs related to corporate governance

Under the above approach, we have introduced an executive director system to ensure our ability to react quickly to changes in the business environment and carry out flexible operations. We have also clearly separated our management decision-making and supervision functions from our operational functions, strengthening each of them to ensure correct decision-making and rapid operations.

• Board of directors

In order to rapidly carry out management decision-making, we reduced the number of directors to no more than 10, and are working to further strengthen our supervision functions so that all decisions regarding important issues in our operations are made based on the rules and policies of the board of directors, in accordance with laws and the articles of incorporation.

• Management conference

This conference discusses and receives reports concerning important items related to management and operations. After full discussion by the management conference members, these items are decided by the company president, who is the conference chairman.

• Executive directors committee

This committee is chaired by the company president, and is composed of the executive directors (up to 25) who are in charge of company operations, and who are appointed by the board of directors. It reports on the status of operations that are entrusted to it by the board of directors and president, as well as on other necessary items.

• Board of auditors

This board is composed of five auditors, three of whom are from outside the company. Based on the rules and policies of the board of auditors, it monitors and supervises the duties of the directors from an independent perspective.

In addition, we have established rules and policies for managerial authority, and have clarified the company business organization, business duties, and the authority and responsibilities of management and supervisory positions. We have constructed a system of responsibility, and are working to carry out systematic and efficient business operations.

3. Status of the internal administration system and risk management system

At a meeting of the board of directors on May 30, 2006, a basic policy for the construction of a system to ensure fair and appropriate operations was decided.

• Establishment of the Risk Management Division

Based on this policy, we have dedicated ourselves to ensuring that Nippon Kayaku operations are fair and appropriate, and on June 1, 2006 we established the Risk Management Division as the driving organization aimed at improving our internal administration system.

4. Director compensation system

In order to clarify the responsibilities of the directors and improve fairness and transparency, the director retirement bonus system, which had been largely based on seniority, was eliminated, and a new system of bonuses linked to consolidated performance was adopted. The new system for director compensation is now composed of a monthly salary and a performance-linked bonus.

5. Status of internal audits and audits by the board of auditors

In order to prevent improper acts or errors by directors and employees in the course of operations, and to contribute to operational improvements, the Audit Division has been established, independent of the board of auditors, as an internal organization for internal audits. Based on a yearly plan, this division conducts audits of operations, including those of Group companies.

Based on the audit policy and audit plans determined by the board of auditors, and on the division of audit responsibilities, the auditors attend meetings of the board of directors, monitor the status of operations, and use other means to monitor and supervise the business conduct of the directors from an independent perspective.

6. Relationship with outside auditors

Outside auditors attend meetings of the board of directors and other important meetings, express their opinions as needed, and hold regular discussion meetings with the representative directors in order to observe and understand our company's business policies. Outside auditors also receive general explanations concerning the contents of management meetings, auditor visits to business sites, and other information from the standing auditors.

7. Status of independent audits

We have concluded an agreement with the company Ernst & Young ShinNihon as an independent auditor, and we have submitted to independent audits.

Programs for the Environment, Safety, and Sustainability

Environmental safety management

We are making great efforts to become a “company that continuously contributes to mankind through products and technology that protect people’s lives and health, and support an enriched lifestyle.” To achieve this objective and meet the company’s social responsibilities, we actively engage in management that takes into consideration the aspects of “environment,” “safety,” and “health,” based on the concept of “Responsible Care.”*

*Responsible Care: An activity through which companies that manufacture or handle chemical substances actively take it upon themselves to implement measures that take into consideration the aspects of “environment,” “safety,” and “health” in each process, from chemical substance development, production, sale, and consumption, to end disposal. Since being developed in Canada in 1985, this important activity has spread throughout the world and is now being implemented in over 40 countries.

Environmental management system

In order to promote Responsible Care activities more efficiently and continuously improve them, the Nippon Kayaku Group has pursued the acquisition of international standard ISO14001 certification for its environmental management system. Currently, all six Nippon Kayaku plants, as well as group companies Polatechno Co., Ltd., Indet Safety Systems a.s., Kayaku Chemical (Wuxi) Co., Ltd., and Wuxi Polatechno Optics Co., Ltd. (WPLC), have acquired certification.

Environmental master plan targets and progress

Nippon Kayaku is engaging in activities according to a corporate-wide master plan that establishes targets for “reducing chemical substance emissions,” “reducing waste products,” and “preventing global warming.”

• Reducing chemical substance emissions and preventing pollution

We achieved the expressed target of “reducing the amount of dichloromethane emissions in the fiscal year ending May 31, 2006, by 85% from the level of the fiscal year ended May 31, 1996, to 10 tons or less.” This was due to improved effectiveness made possible by the exhaust gas treatment system that was introduced at the Kashima plant in the fiscal year ended May 31, 2005. In the future, we are further aiming at achieving optimum operation of an exhaust gas treatment system at the Fukuyama plant.

Also, in April 2005, we established a new target for reducing emissions of volatile organic compounds (VOC). Accordingly, in the fiscal year ended May 2006, VOC emissions were reduced to 70 tons, a 69-ton reduction from the fiscal year ended May 2005.



The Kashima plant received an incentive award from the Minister of Health, Labor and Welfare for “being particularly excellent in securing a safe workplace environment.”

• Reducing waste products

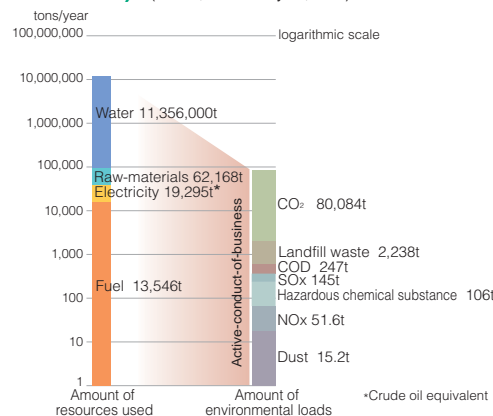
Aiming to form a recycling-oriented society, Nippon Kayaku has set targets of “generating no more waste products in the

fiscal year ending May 31, 2011, than were generated in the fiscal year ended May 31, 1997, and reducing landfill waste by 60%.” In this regard, we have already achieved those targets by reducing generated waste products by 40% and reducing landfill waste disposal by 71% in the fiscal year ended May 31, 2006. However, we are continuing to strive for further reductions.

• Preventing global warming

“In the fiscal year ending May 31, 2011, we will reduce carbon dioxide emissions of energy sources by 8.6% as compared to the fiscal year ended May 31, 1991 (April 2005 revision).” For this target, we achieved a reduction of 11.2% in the fiscal year ended May 31, 2006, thanks to the introduction, for instance, of city gas boilers. Taking into consideration future increases in production, we plan to take steps such as introducing co-generation equipment in order to achieve the target in the fiscal year ending May 31, 2011.

Resource input and environmental loads (non-consolidated) (June 1, 2005 – May 31, 2006)



Environmental accounting

Environmental accounting results for Nippon Kayaku (non-consolidated) for the fiscal year ended May 31, 2006, indicated that the cost of environmental protection was 2.21357 billion yen, and the effect of environmental protection was 81.61 million yen.

Development of environmentally friendly products

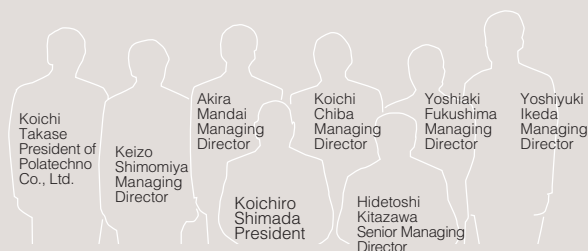
Throughout a product’s entire life cycle, from research and development to production, sale, and end disposal, the Nippon Kayaku Group evaluates and carefully considers the impact on the environment, health, and safety. Furthermore, we are concentrating on developing environmentally friendly products such as biological pesticides that do not harm people or livestock; UV- and EB-curable resin materials, which are widely used as resins for preventing “sick house” syndrome; and environmentally adaptive epoxy resins.

Relations with local communities

As part of its business activities, each of our plants throughout the nation concludes and respects agreements with the respective local communities concerning issues such as pollution prevention, water pollution prevention, green agreements, and mutual support in disasters.

Board of Directors/Auditors

As of October 1, 2006



Board of Directors

Koichiro Shimada
 Member of the Board
 President
 Representative Director

Hidetoshi Kitazawa
 Member of the Board
 Representative Director
 Senior Managing Director
 Director of Strategic Corporate Planning Group
 Director of Research & Development Group

Koichi Chiba
 Member of the Board
 Managing Director
 Director of Administration Group

Yoshiaki Fukushima
 Member of the Board
 Managing Director
 Director of Fine Chemicals Group

Akira Mandai
 Member of the Board
 Managing Director
 Director of Pharmaceuticals Group

Yoshiyuki Ikeda
 Member of the Board
 Managing Director,
 with Responsibility for Safety Systems Division

Keizo Shimomiya
 Member of the Board
 Managing Director
 Director of Functional Chemicals Group

Koichi Takase
 Member of the Board
 President, Representative Director of Polatechno Co., Ltd.

Auditors

Tasuku Oshima
 Standing Auditor

Yukihisa Asakawa
 Standing Auditor

Shoichi Saito
 Auditor

Yo Ota
 Auditor

Yasuharu Takamatsu
 Auditor

Consolidated Five-Year Summary

Nippon Kayaku Co., Ltd. and Consolidated Subsidiaries
Years Ended May 31

	2006	2005	2004	2003	2002
Results for the year (millions of yen)					
Net sales	¥140,026	¥134,205	¥128,016	¥123,431	¥119,435
Cost of sales	87,074	86,062	81,621	79,002	74,745
Selling, general and administrative expenses	39,731	37,976	36,297	34,730	35,305
Operating income	13,219	10,166	10,097	9,697	9,384
Income before income taxes and minority interests....	18,629	10,404	8,941	7,643	7,309
Net income	9,641	5,315	3,926	2,780	2,630
Amounts per share (yen)					
Net income	¥ 52.92	¥ 28.87	¥ 21.22	¥ 14.92	¥ 14.42
Cash dividend applicable to the year.....	20.00	11.70	11.00	11.00	11.00
Shareholders' equity	634.51	570.31	550.12	527.93	527.61
Year-end financial position (millions of yen)					
Current assets.....	¥108,644	¥ 92,716	¥ 93,651	¥ 99,223	¥ 96,099
Current liabilities	41,619	35,509	39,389	42,065	37,346
Working capital	67,025	57,207	54,262	57,158	58,753
Property, plant and equipment.....	62,754	57,533	57,069	58,009	58,683
Total assets.....	205,308	181,364	179,823	179,117	176,836
Total shareholders' equity *1	127,030	103,810	100,207	96,204	96,248
Year-end statistics					
Number of shares outstanding (thousands).....	182,503	182,503	182,503	182,503	182,503
Number of round-lot shareholders	18,268	18,770	19,756	20,367	21,010
Number of employees	4,300	4,049	3,934	3,679	3,552
Financial ratios					
Current ratio (times)	2.6	2.6	2.4	2.4	2.6
Equity ratio (%)	56.2	57.2	55.7	53.7	54.4
ROE (%)	8.8	5.2	4.0	2.9	2.8
ROA (%)	5.0	2.9	2.2	1.6	1.5
Sales by business segment *2 (millions of yen)					
Functional chemicals business.....	73,133	¥ 64,574	¥ 56,405		
Functional materials	16,407	15,448	15,942		
Electronic materials.....	40,476	36,181	30,410		
Catalysts	2,661	2,574	2,096		
Safety systems	13,587	10,370	7,955		
Pharmaceuticals business	39,774	39,660	41,122		
Fine chemicals business	24,028	26,843	27,053		
Agrochemicals	8,246	11,333	11,150		
Color chemicals	9,608	9,269	9,617		
Explosives.....	6,173	6,241	6,286		
Other businesses	3,089	3,126	3,434		

*1 Shareholders' equity for years ended May 31, 2002, 2003, 2004, and 2005 do not include minority interests.

*2 Business segments have changed from June 1, 2004. Sales by business segment for 2004 are reclassified to the current business segments.

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

Results of Operations

Business Overview

During the fiscal year ended May 31, 2006, Japan's economy experienced a moderate recovery and shifted toward a firm tone as an improvement in corporate earnings and expanded demand enabled capital investment to grow, and as an improvement in the employment situation led to improved household incomes and an increase in personal consumption.

The chemical products industry, centering on digital home electronics and other IT-related fields, was generally headed toward expansion. But conditions remained difficult as various factors affected the economy, including rising raw material costs due to a continuing rise in crude oil prices, and a drop in prices due to intensifying competition with neighboring countries.

In the pharmaceuticals industry, drug prices were revised in April 2006, the trend toward controlling the cost of medicines became even stronger, and global competition in the research, development, and sale of new drugs intensified. At the same time, the demand for generic pharmaceuticals grew as a fight for survival among companies unfolded.

In the midst of such conditions, the Nippon Kayaku Group has promoted structural reform based on the following priority policies: (1) the strengthening of business strategy, (2) the strengthening of company-wide research and development, and (3) the strengthening of the Administration Group and the support organization.

As a result and as electronic materials business shifted into robust form, the fiscal year ended May 31, 2006 produced more revenue and greater profit than the previous fiscal year.

Net sales

In the fiscal year ended May 31, 2006, net sales reached 140.026 billion yen, an increase of 5.821 billion yen (4.3%) from the previous fiscal year. Net sales for the entire Group were 140% of the net sales for the parent company alone.

Cost of Sales; Selling General, and Administrative Expenses

In the fiscal year ended May 31, 2006, the cost of sales was 87.074 billion yen, an increase of 1.012 billion yen (1.2%) from the previous fiscal year. It was down 1.9 percentage points from the previous fiscal year to 62.2% as a percentage with respect to net sales. Selling, general and administrative expenses in the fiscal year ended May 31, 2006 were 39.731 billion yen, an increase of 1.755 billion yen (4.6%) from the previous fiscal year.

Operating Income

In the fiscal year ended May 31, 2006, operating income was 13.219 billion yen, an increase of 3.053 billion yen from the previous fiscal year (30.0%). It was up 1.8 percentage points from the previous fiscal year to 9.4% as a percentage with respect to net sales.

Operating Performance by Business Segment

[Functional Chemicals Business]

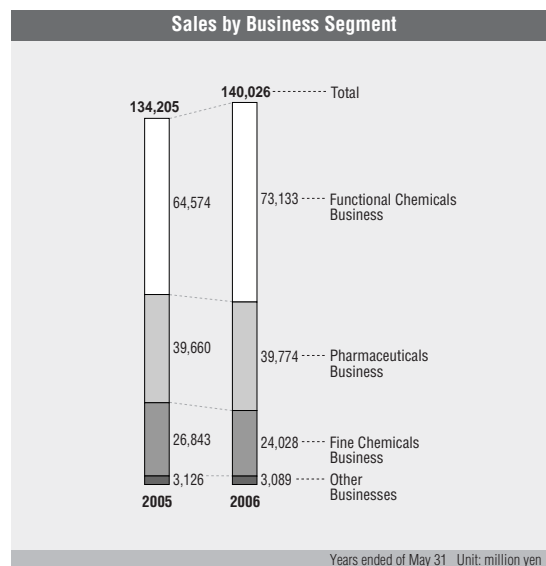
In the fiscal year ended May 31, 2006, sales for the functional chemicals business reached 73.133 billion yen, an increase of 8.558 billion yen (13.3%) from the previous fiscal year.

In the functional materials business, sales of epoxy resins for semiconductor encapsulation were strong, surpassing the previous year's sales.

In the electronic materials business, sales of products such as colors for inkjet printers, LCD sealants, and resins for optical disks went smoothly and were up from the previous fiscal year, while resins for lenses were down. In the area of optical films, products such as Polatechno's liquid crystal projector materials were slow in recovering, but sales of plasma display films went smoothly. Overall, sales in the electronic materials business were up from the previous fiscal year.

In the catalysts business, exports of catalysts for acrylic acid manufacturing went smoothly, surpassing sales from the previous fiscal year.

In the safety systems business, sales of airbag inflators were slightly weaker than the previous fiscal year, but



both domestic and export sales of micro gas generators for seatbelt pretensioners went smoothly and were up from the previous fiscal year. Overall, sales in the safety systems business were up from the previous fiscal year.

In the fiscal year ended May 31, 2006, overall operating income for the functional chemicals business was 10.177 billion yen, an increase of 3.029 billion yen (42.4%) from the previous fiscal year.

[Pharmaceuticals Business]

In the fiscal year ended May 31, 2006, sales for the pharmaceuticals business amounted to 39.774 billion yen, an increase of 114 million yen (0.3%) from the previous fiscal year.

Pharmaceutical products for the Japanese domestic market included new products "IA-CALL" (arterial-injection anti-cancer drug) and "EPIRUBICIN" (anti-cancer drug), as well as introduced-product "CALSED" (anti-cancer drug), which contributed to sales. Also, sales of "IMMUCYST Intravesical" (anti-cancer drug), "CARBOMERCK" (anti-cancer drug), and "SALIGREN Cap." (drug for treatment of dry mouth syndrome) went smoothly, surpassing the previous fiscal year. On the other hand, sales of "FARESTON Tab." (anti-cancer drug) and "MILLISROL Inj." (vasodilator) were down from the previous fiscal year.

In the area of exports, sales of BLEO (anti-cancer drug) were down, while sales of active pharmaceutical ingredients for ETOPOSIDE (anti-cancer drug) went smoothly. Overall, sales were up from the previous fiscal year.

As for active pharmaceutical ingredients, sales centering on contract manufacturing from API to pharmaceuticals went smoothly and were up from the previous fiscal year.

In the area of diagnostic agents, sales of "LANAZYME ST-439 plates" (breast cancer diagnostic agent) were strong and were up from the previous fiscal year.

In the fiscal year ended May 31, 2006, overall operating income for the pharmaceuticals business was 5.499 billion yen, an increase of 639 million yen (13.2%) from the previous fiscal year.

[Fine Chemicals Business]

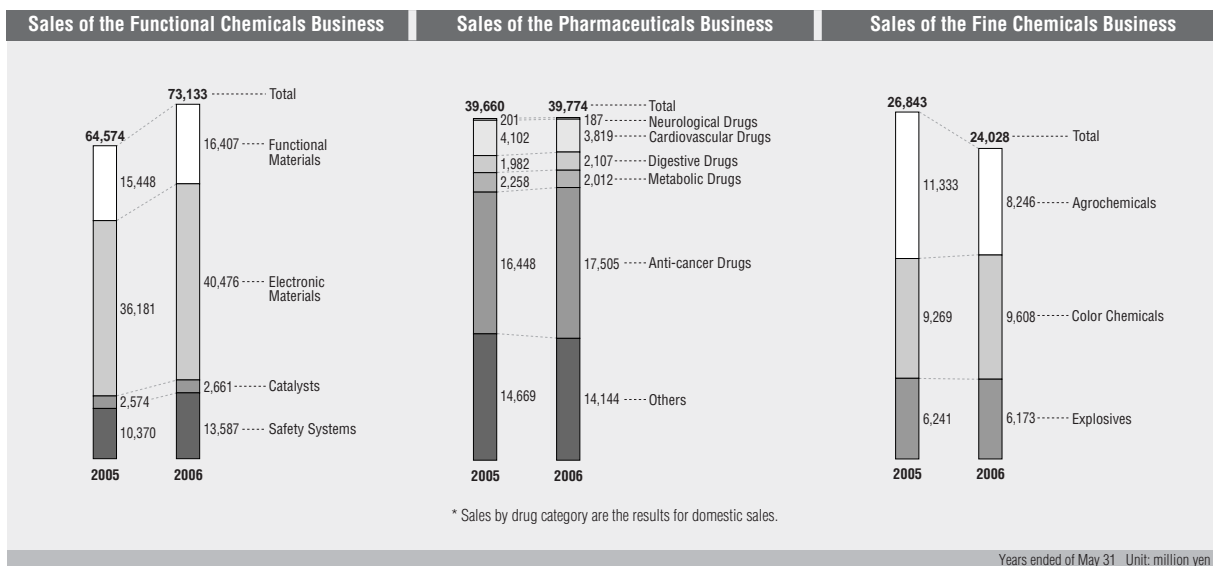
In the fiscal year ended May 31, 2006, sales for the fine chemicals business amounted to 24.028 billion yen, a decrease of 2.815 billion yen (10.5%) from the previous fiscal year.

In the agrochemicals business, exports remained at the same level as the previous fiscal year. But due to a change in the sales calculation method for domestic sales, overall sales were down from the previous fiscal year.

In the color chemicals business, exports of textile dyes were smooth and overall sales were up from the previous fiscal year.

In the explosives business, sales were down from the previous fiscal year, due to a decline in domestic demand.

In the fiscal year ended May 31, 2006, overall operating income for the fine chemicals business was 1.884 billion



yen, a decrease of 2 million yen (0.1%) from the previous fiscal year.

[Other Businesses]

In the fiscal year ended May 31, 2006, sales from other businesses amounted to 3.089 billion yen, a decrease of 37 million yen (1.2%) from the previous fiscal year.

Operating income was 1.526 billion yen, an increase of 44 million yen (3.0%) from the previous fiscal year.

Other Income and Expenses

In the fiscal year ended May 31, 2006, interest and dividends received amounted to 430 million yen, while interest paid was 430 million yen. Due in part to income from the sale of company housing, other (net) was income of 5.408 billion yen, an increase of 5.103 billion yen (1,673.1%) from the previous fiscal year.

Income before Income Taxes and Minority Interests

From the aforementioned results, income before income taxes and minority interests in the fiscal year ended May 31, 2006 was 18.629 billion yen, an increase of 8.224 billion yen (79.1%) from the previous fiscal year.

Corporate Tax

In the fiscal year ended May 31, 2006, corporate tax was 7.37 billion yen, an increase of 3.302 billion yen (81.2%) from the previous fiscal year.

Minority Interests

In the fiscal year ended May 31, 2006, minority interests amounted to 1.616 billion yen, an increase of 596 million yen (58.4%) from the previous fiscal year.

Net Income

In the fiscal year ended May 31, 2006, net income was 9.641 billion yen, an increase of 4.325 billion yen (81.4%) from the previous fiscal year. It improved 2.9 percentage points from the previous fiscal year to 6.9% as a percentage with respect to sales. In the fiscal year ended May 31, 2006, net income for the entire Group was 327% of the net income for the parent company alone. Net income per share was 52.92 yen.

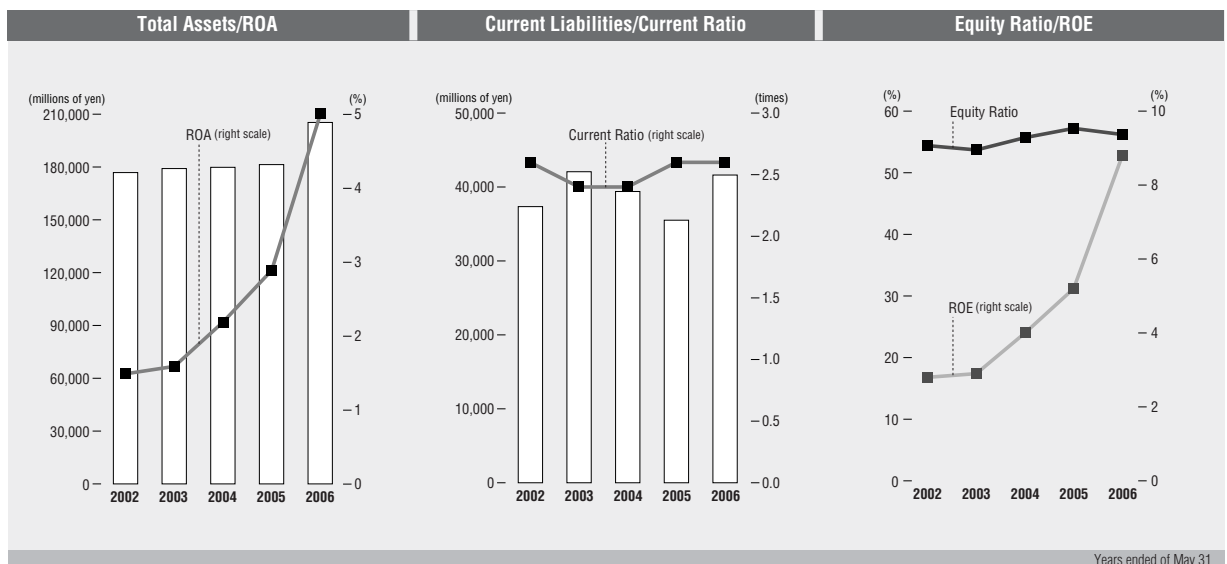
Financial Condition

Total Assets

As of the end of May 2006, total assets were 205.308 billion yen, an increase of 23.943 billion yen (13.2%) from the end of the previous fiscal year.

Current Assets

As of the end of May 2006, the balance of cash and cash equivalents was 21.424 billion yen, an increase of 4.233 billion yen (24.6%) from the end of the previous fiscal year. Time deposits were 42 million yen, an increase of 16 million yen (61.5%) from the end of the previous fiscal



year. Marketable securities were 5.497 billion yen. Trade receivables were 45.627 billion yen, a decrease of 896 million yen (1.9%) from the end of the previous fiscal year. Inventories were 26.649 billion yen, an increase of 2.505 million yen (10.4%) from the end of the previous fiscal year; and deferred tax assets were 2.167 billion yen, an increase of 157 million yen (7.8%) from the end of the previous fiscal year. Other current assets were 7.304 billion yen, an increase of 4.437 billion yen (154.8%) from the end of the previous fiscal year. As a result, total current assets were 108.644 billion yen, an increase of 15.928 billion yen (17.2%) from the end of the previous fiscal year.

Property, Plant, and Equipment; Investments and Other Assets

As of the end of May 2006, the value of property, plant, and equipment was 62.754 billion yen, an increase of 5.221 billion yen (9.1%) from the end of the previous fiscal year. Accumulated depreciation was 114.47 billion yen. The total value of intangible assets, investments and other assets was 33.909 billion yen, an increase of 2.794 billion yen (9.0%) from the end of the previous fiscal year.

Liabilities

As of the end of May 2006, current liabilities were 41.619 billion yen, an increase of 6.109 billion yen (17.2%) from the end of the previous fiscal year. Fixed liabilities were 36.659 billion yen, an increase of 1.421 billion yen (4.0%) from the previous fiscal year.

Shareholders' Equity

As of the end of May 2006, shareholders' equity was 127.03 billion yen and the equity ratio was 56.2%, a decrease of 1.0 percentage point from the previous fiscal year.

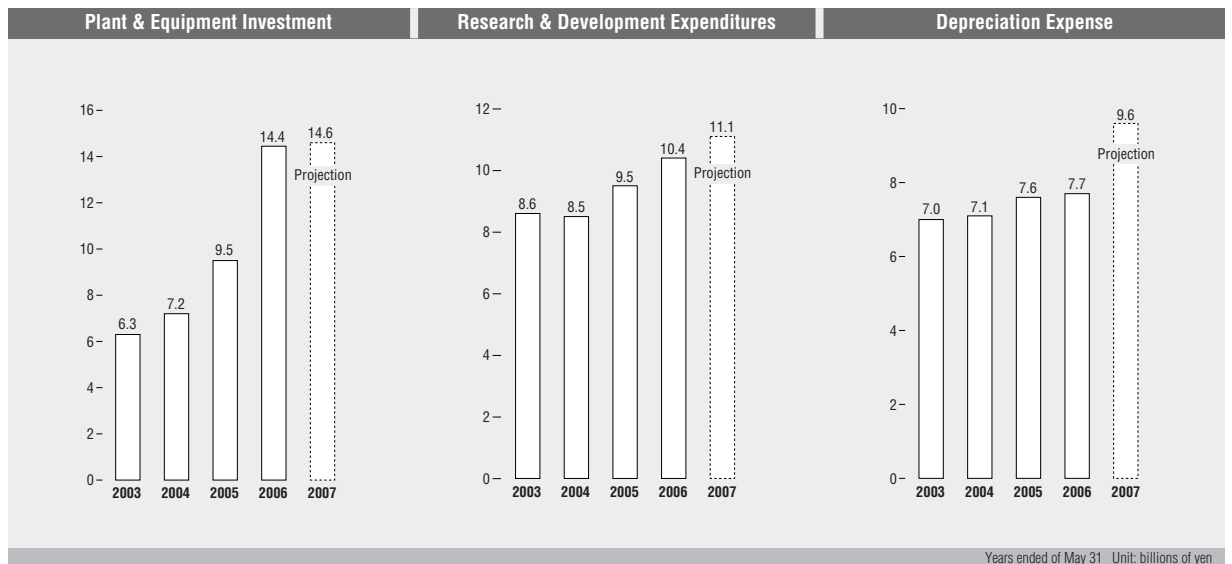
Cash Flows

Cash flows from operating activities decreased by 368 million yen from the previous fiscal year to 11.791 billion yen. This decrease was primarily caused by an increase in prepaid expenses.

Cash flows from investing activities indicated expenditures of 7.102 billion yen, a decrease in expenditures of 663 million yen from the previous fiscal year. This decrease was primarily caused by an increase in revenue from the sale of tangible fixed assets.

Cash flows from financing activities indicated an increase in revenue of 3.29 billion yen from the previous fiscal year, while expenditures reached 1.182 billion yen. This increase was primarily caused by revenue from an increase in consolidated subsidiaries' third-party allocation of shares.

As a result, the balance of cash and cash equivalents at the end of the year increased by 4.233 billion yen from the previous fiscal year, reaching 21.424 billion yen.



Consolidated Balance Sheets

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

	Millions of yen		Thousands of U.S. dollars (Note 2)
	2006	2005	2006
Assets			
Current assets:			
Cash and cash equivalents	¥ 21,424	¥ 17,191	\$ 190,842
Time deposits	42	26	374
Marketable securities (Note 5)	5,497	—	48,966
Trade receivables	45,627	46,523	406,440
Less allowance for doubtful receivables	(69)	(47)	(614)
Inventories (Note 4)	26,649	24,144	237,386
Deferred income taxes (Note 8)	2,167	2,010	19,303
Other current assets	7,304	2,866	65,063
Total current assets	108,644	92,716	967,789
Property, plant and equipment (Notes 6 and 7):	177,224	174,468	1,578,692
Less accumulated depreciation	(114,470)	(116,935)	(1,019,686)
Property, plant and equipment, net	62,754	57,533	559,005
Investments and other assets:			
Investment securities (Notes 5 and 7)	22,017	17,938	196,125
Goodwill	2,867	2,913	25,538
Deferred income taxes (Note 8)	252	894	2,244
Other assets	8,771	9,369	78,131
Total investments and other assets	33,909	31,115	302,057
Total assets	¥205,308	¥181,364	\$1,828,861

	Millions of yen		Thousands of U.S. dollars (Note 2)
	2006	2005	2006
Liabilities and shareholders' equity			
Current liabilities:			
Short-term bank loans (Note 7).....	¥ 1,923	¥ 2,203	\$ 17,129
Current portion of long-term debt (Note 7).....	2,944	2,547	26,224
Payables:			
Trade.....	16,580	16,460	147,692
Unconsolidated subsidiaries and affiliates.....	301	288	2,681
Construction.....	5,895	1,724	52,512
Other.....	6,622	3,467	58,988
Accrued expenses.....	4,948	4,759	44,076
Accrued income taxes (Note 8).....	1,276	2,189	11,366
Other current liabilities.....	1,125	1,868	10,021
Total current liabilities.....	41,619	35,509	370,737
Non-current liabilities:			
Long-term debt, less current portion (Note 7).....	7,175	9,785	63,914
Retirement benefits (Note 9).....	8,086	8,419	72,029
Other non-current liabilities.....	15,345	15,635	136,691
Deferred income taxes (Note 8).....	6,050	1,397	53,892
Total non-current liabilities.....	36,659	35,237	326,554
Total liabilities.....	78,278	70,746	697,292
Contingent liabilities (Note 11)			
Shareholders' equity (Notes 12 and 16):			
Common stock:			
Authorized – 700,000,000 shares			
Issued – 182,503,570 shares in 2006 and 2005.....	14,932	14,932	133,012
Additional paid-in capital.....	17,264	17,260	153,785
Retained earnings.....	77,201	68,109	687,698
Less treasury stock, at cost.....	(398)	(294)	(3,545)
Translation adjustments.....	1,158	571	10,315
Unrealized holding gains on other securities.....	5,216	3,231	46,463
Minority interests.....	11,653	6,805	103,803
Total shareholders' equity.....	127,030	110,615	1,131,569
Total liabilities and shareholders' equity.....	¥205,308	¥181,364	\$1,828,861

See accompanying notes to consolidated financial statements.

Consolidated Statements of Income and Retained Earnings

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

	Millions of yen		Thousands of U.S. dollars (Note 2)
	2006	2005	2006
Net sales.....	¥140,026	¥134,205	\$1,247,336
Cost of sales.....	87,074	86,062	775,645
Gross profit.....	52,951	48,142	471,681
Selling, general and administrative expenses.....	39,731	37,976	353,919
Operating income.....	13,219	10,166	117,753
Other income (expenses):			
Interest and dividend income.....	430	349	3,830
Interest expense.....	(430)	(416)	(3,830)
Other, net.....	5,408	305	48,173
	5,409	238	48,182
Income before income taxes and minority interests.....	18,629	10,404	165,945
Income taxes (Note 8):			
Current.....	3,622	4,455	32,264
Deferred.....	3,748	(387)	33,386
Minority interests.....	1,616	1,020	14,395
Net income (Note 12).....	9,641	5,315	85,880
Retained earnings at beginning of year.....	68,109	64,973	606,707
Increase resulting from consolidation of an additional subsidiary.....	80	—	712
Increase resulting from issuance of additional shares by a subsidiary.....	1,624	—	14,466
Decrease resulting from merger by a subsidiary.....	(60)	—	(534)
Bonuses to directors.....	(65)	(65)	(579)
Cash dividends paid.....	(2,128)	(2,002)	(18,955)
Decrease resulting from changes in scope of consolidation.....	—	(112)	0
Retained earnings at end of year.....	¥ 77,201	¥ 68,109	\$ 687,698

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

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

	Millions of yen		Thousands of U.S. dollars (Note 2)
	2006	2005	2006
Cash flows from operating activities			
Income before income taxes and minority interests	¥18,629	¥10,404	\$165,945
Adjustments to reconcile income before income taxes and minority interests to net cash provided by operating activities:			
Depreciation and amortization	7,708	7,609	68,662
Loss on impairment of fixed assets	192	–	1,710
Changes in reserves	(53)	592	(472)
Interest and dividend income	(430)	(349)	(3,830)
Interest expense	430	416	3,830
Equity in earnings of affiliates	(444)	(331)	(3,955)
Loss (gain) on disposal of property, plant and equipment, net	(4,939)	440	(43,996)
Loss (gain) on sales of investment securities, net	(7)	(636)	(62)
Changes in operating assets and liabilities:			
Notes and accounts receivable – trade	1,613	1,538	14,368
Inventories	(2,349)	(986)	(20,924)
Notes and accounts payable – trade	(758)	(659)	(6,752)
Payables – other	(138)	(475)	(1,229)
Other	(3,602)	(994)	(32,086)
Subtotal	15,848	16,566	141,172
Interest and dividends received	832	557	7,411
Interest paid	(354)	(417)	(3,153)
Income taxes paid	(4,535)	(4,545)	(40,397)
Net cash provided by operating activities	11,791	12,160	105,032
Cash flows from investing activities			
Purchases of time deposits, net	(2)	–	(17)
Purchase of marketable securities, net	(5,497)	1,002	(48,966)
Purchase of property, plant and equipment	(8,782)	(7,932)	(78,229)
Proceeds from sales of property, plant and equipment	8,099	1,480	72,145
Acquisition of goodwill and other intangible assets	(848)	(206)	(7,553)
Proceeds from sales (purchases) of investment securities, net	170	(277)	1,514
Purchase of investment securities of consolidated subsidiaries	(9)	(76)	(80)
Other	(230)	(1,755)	(2,048)
Net cash used in investing activities	(7,102)	(7,765)	(63,263)
Cash flows from financing activities			
Net change in short-term debt	(538)	1,049	(4,792)
Proceeds from long-term debt	945	1,826	8,417
Repayment of long-term debt	(3,392)	(1,848)	(30,215)
Repayment of construction cooperation fund	(234)	(234)	(2,084)
Redemption of corporate bond	–	(3,000)	0
Cash dividends paid	(2,119)	(2,009)	(18,875)
Increase due to issuance of additional shares by a consolidated subsidiary to third parties	4,524	–	40,299
Other	(368)	(257)	(3,278)
Net cash used in financing activities	(1,182)	(4,473)	(10,529)
Effect of exchange rate changes on cash and cash equivalents	211	82	1,879
Increase in cash and cash equivalents	3,718	3	33,119
Cash and cash equivalents at beginning of year	17,191	17,402	153,135
Decrease resulting from changes in scope of consolidation	–	(215)	0
Increase due to inclusion in consolidation	504	–	4,489
Increase due to merger by a subsidiary	11	–	97
Cash and cash equivalents at end of year	¥21,424	¥17,191	\$190,842

See accompanying notes to consolidated financial statements.

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
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
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



■ Certified Public Accountants
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■ Tel: 03 3503 1100
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Report of Independent Auditors

The Board of Directors
Nippon Kayaku Co., Ltd.

We have audited the accompanying consolidated balance sheets of Nippon Kayaku Co., Ltd. and consolidated subsidiaries as of May 31, 2006 and 2005, and the related consolidated statements of income and retained earnings, and cash flows for the years then ended, all expressed in yen. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in Japan. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Nippon Kayaku Co., Ltd. and consolidated subsidiaries at May 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in Japan.

The U.S. dollar amounts in the accompanying consolidated financial statements with respect to the year ended May 31, 2006 are presented solely for convenience. Our audit also included the translation of yen amounts into U.S. dollar amounts and, in our opinion, such translation has been made on the basis described in Note 2.

Additional information

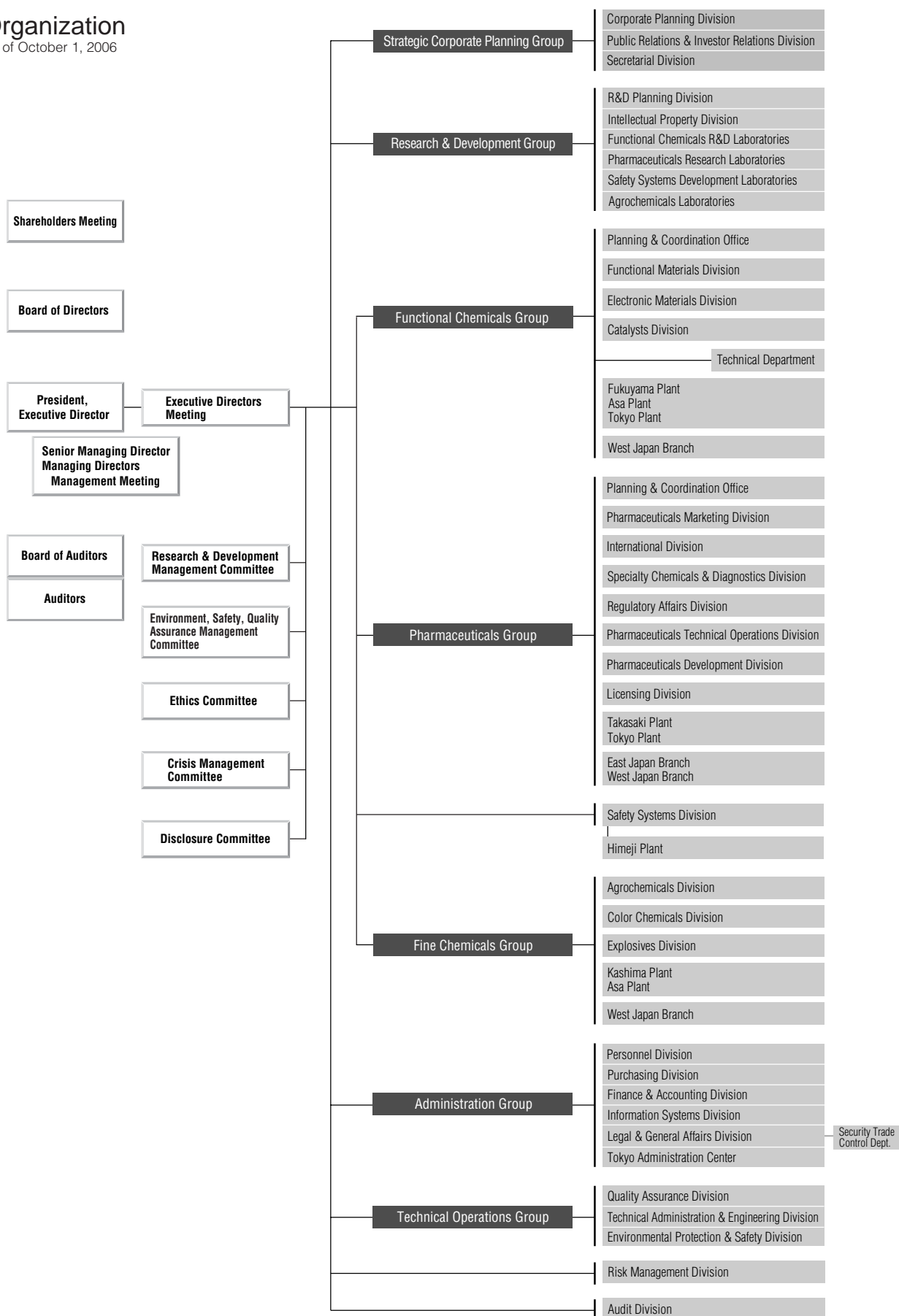
As discussed in Note 3, the Company has adopted new accounting standards for impairment of fixed assets and bonuses to directors.

Ernst & Young Shin Nihon

August 30, 2006

Organization

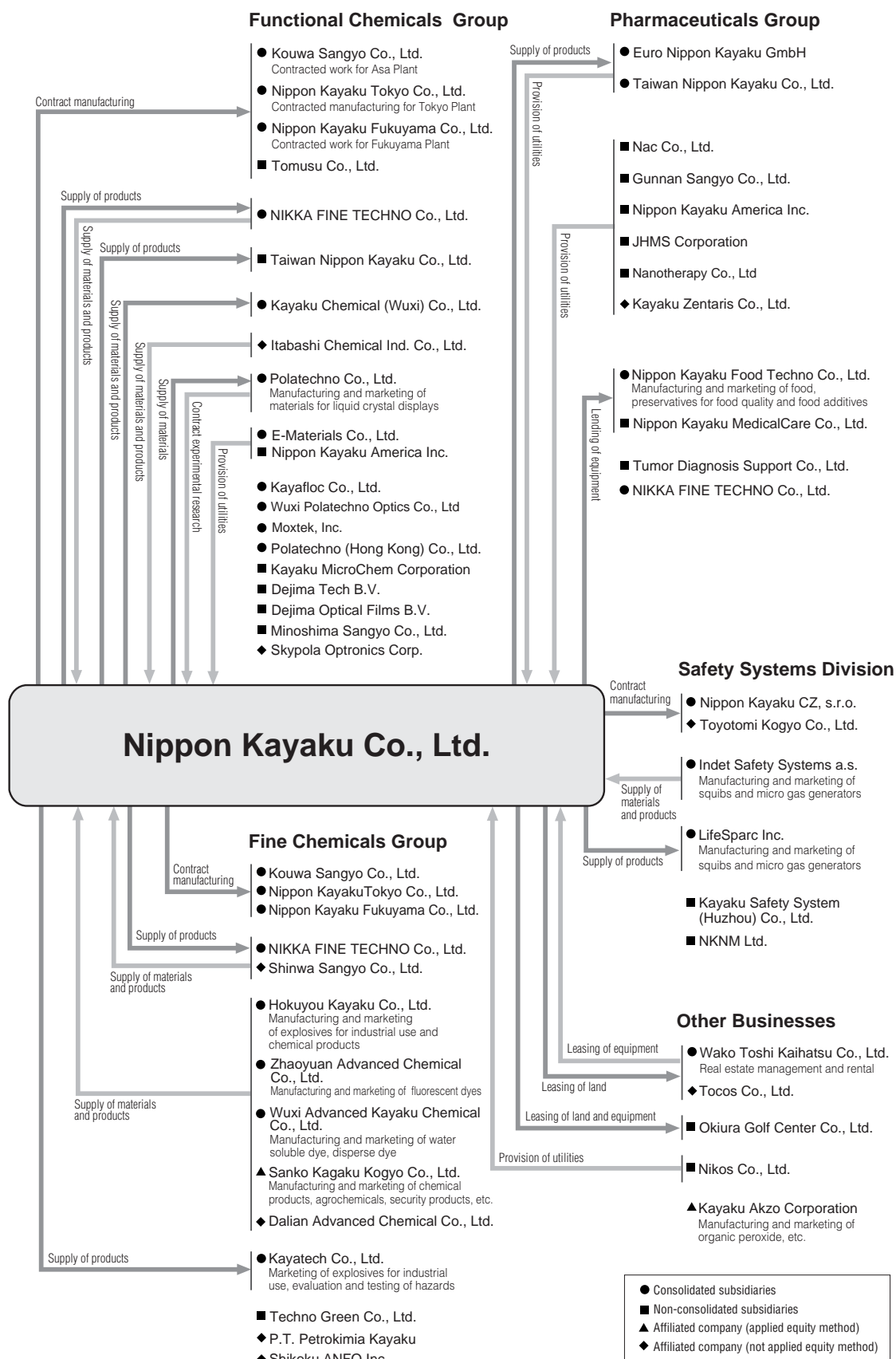
As of October 1, 2006



Group Companies

As of October 1, 2006

The Nippon Kayaku Group comprises Nippon Kayaku Co., Ltd., subsidiary companies, and affiliated companies. The outline of the placement of each company in the relevant business is as shown below.



Corporate Information

As of October 1, 2006

■ Business Name	Nippon Kayaku Co., Ltd.
■ Representative	Koichiro Shimada, President
■ Foundation	June 5, 1916
■ Head Office Address	Tokyo Fujimi Bldg., 11-2, Fujimi 1-chome, Chiyoda-ku, Tokyo 102-8172, Japan
■ Number of Employees	1,899 (non-consolidated), 4,300 (consolidated) (as of May 31, 2006)
■ Banks of Accounts	Bank of Tokyo-Mitsubishi UFJ, Mizuho Bank, Jyo Bank

■ Business Area

Functional Chemicals

Functional Materials Division	Epoxy resins, Epoxy resin curers, Combustion retardants for synthetic resins, UV-curing type resins, Polyimide/polyamide resins
Electronic Materials Division	Optical functional films, Optical disk materials, Optical materials, Functional Colors, Colors for inkjet printers, LCD projector components
Catalysts Division	Catalysts for the production of acrylic acid and methacrylic acid, Plant licensing business
Safety Systems Division	Airbag inflators, Micro gas generators for seatbelt pretensioners, Squibs

Pharmaceuticals

Anti-cancer agents, Neurological agents, Circulatory system agents, Digestive system agents, Metabolic agents, Antibiotics, Anti-inflammatory analgesic agents, Pharmaceutical API and intermediates, Food and food additives, Veterinary pharmaceuticals, Animal feedstuffs and feedstuff additives, Diagnostics

Fine Chemicals

Agrochemicals Division	Insecticides, Herbicides, Fungicides, Acaricide, Biological pesticides, Soil disinfectant, Animal repellents
Color Chemicals Division	Disperse dyes, Cationic dyes, Acidic dyes, Reactive dyes, Direct dyes, Sulphur dyes, Fluorescent dyes, Functional chemicals for textiles and paper, Special dyes for non-textile applications
Explosives Division	Industrial explosives, Black powder, Electric detonators, Non-electric detonators, Concrete crushers, Hazard evaluation test, Pyrotechnics

Others

Real estate leasing

■ Head Office and Domestic Offices

Head Office	Tokyo Fujimi Bldg., 11-2, Fujimi 1-chome, Chiyoda-ku, Tokyo 102-8172, Japan
East Japan Branch	Tokyo Fujimi Bldg., 11-2, Fujimi 1-chome, Chiyoda-ku, Tokyo 102-8172, Japan
West Japan Branch	Midosuji Honmachi Bldg., 5-7, honmachi 3-chome, Chuo-ku, Osaka-shi, Osaka 541-0053, Japan

■ Administration Group

Sapporo Office	Hiroyasu Bldg., 1-13-73, Minami 7-jyo Nishi, Chuo-ku, Sapporo-shi, Hokkaido 064-0807, Japan
Tokyo Office	Tokyo Fujimi Bldg., 11-2, Fujimi 1-chome, Chiyoda-ku, Tokyo 102-8172, Japan
Nagoya Office	Taiko Creacion Bldg., 19-11, Kikui 2-chome, Nishi-ku, Nagoya-shi, Aichi 451-0044, Japan
Osaka Office	Midosuji Honmachi Bldg., 5-7, honmachi 3-chome, Chuo-ku, Osaka-shi, Osaka 541-0053, Japan
Fukuoka Office	Nishitetsugion Bldg., 1-1, Gokushomachi, Hakata-ku, Fukuoka-shi, Fukuoka 812-0037, Japan
Tokyo Administration Center	31-12, Shimo 3-chome, Kita-ku, Tokyo 115-8588, Japan

■ Plants

Fukuyama Plant	126, Minookicho, Fukuyama-shi, Hiroshima 721-8567, Japan
Asa Plant	2300, Sanyoonoda-shi, Yamaguchi 757-8686, Japan
Takasaki Plant	239, Iwahanamachi, Takasaki-shi, Gunma 370-1208, Japan
Tokyo Plant	31-12, Shimo 3-chome, Kita-ku, Tokyo 115-8588, Japan
Himeji Plant	3903-39, Toyotomi, Toyotomicho, Himeji-shi, Hyogo 679-2123, Japan
Kashima Plant	6, Sunayama, Kamisu-shi, Ibaraki 314-0255, Japan

■ Laboratories

Functional Chemicals R&D Laboratories	31-12, Shimo 3-chome, Kita-ku, Tokyo 115-8588, Japan
Pharmaceuticals Research Laboratories	31-12, Shimo 3-chome, Kita-ku, Tokyo 115-8588, Japan
Safety Systems Development Laboratories	3903-39, Toyotomi, Toyotomicho, Himeji-shi, Hyogo 679-2123, Japan
Agrochemicals Laboratories	6, Sunayama, Kamisu-shi, Ibaraki 314-0255, Japan

Investor Information

As of May 31, 2006

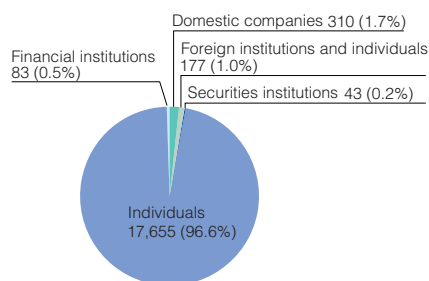
- Fiscal year June 1 to May 31
- Ordinary general meeting of shareholders Normally held in August in Tokyo.
- Record date Ordinary general meeting of shareholders: May 31
Year-end dividend: May 31
Interim dividend: November 30
- Stock exchange listing Tokyo stock exchanges
- Number of common stock Authorized: 700,000,000
Issued: 182,503,570
- Paid-in capital ¥14,932,922,842
- Number of shareholders 25,119

■ Major shareholders

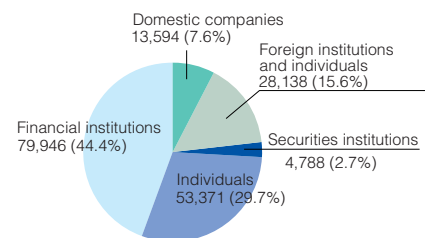
Shareholders	Number of shares held (unit: thousand)	Shareholding ratio
Japan Trustee Services Bank, Ltd. (Trust account)	13,976	7.65
The Master Trust Bank of Japan, Ltd. (Trust account)	13,770	7.54
Mizuho Bank, Ltd.	8,318	4.55
The Bank of Tokyo-Mitsubishi UFJ, Ltd.	5,788	3.17
Meiji Yasuda Life Insurance Company	5,102	2.79
The Joyo Bank, Ltd.	5,089	2.78
Kayavestor Club	4,778	2.61
Nippon Life Insurance Company	3,274	1.79
Employees' stock holding	2,581	1.41
Mistubishi UFJ Trust and Banking Corporation	2,394	1.31

■ Breakdown of shareholders

Number of round-lot shareholders
Total: 18,268



Number of shares held (unit: thousand shares)
Total: 179,837



- Transfer agent for common stock The Chuo Mitsui Trust and Banking Company, Limited
33-1, Shiba 3-chome, Minato-ku, Tokyo 105-8574, Japan

- Investor information Nippon Kayaku Co., Ltd
Public Relations & Investor Relations Division
Tokyo Fujimi Bldg., 11-2, Fujimi 1-chome, Chiyoda-ku,
Tokyo 102-8172 Japan
Phone: +81-3-3237-5046
Email: kouho@nipponkayaku.co.jp
URL: <http://www.nipponkayaku.co.jp/english/index.html>



Our company logo

This logo symbolizes Nippon Kayaku's company policies.
The space at the center represents the cosmos, world and expanses of the Earth.
The two soaring ellipses represent creativity and courage and the
two circles are the confidence between Nippon Kayaku, which
aspires to extraterrestrial space, and the public.



Head Office: Tokyo Fujimi Bldg., 11-2, Fujimi 1-chome, Chiyoda-ku, Tokyo 102-8172, Japan
<http://www.nipponkayaku.co.jp/>