

STEPAN CO  
Form 10-K/A  
March 22, 2007

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-K/A**  
**Amendment No. 1**  
\_\_\_\_\_

(MARK ONE)

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_

Commission File Number 1-4462

\_\_\_\_\_  
**STEPAN COMPANY**

(Exact name of registrant as specified in its charter)

\_\_\_\_\_

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**36-1823834**  
(I.R.S. Employer  
Identification Number)

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Edens and Winnetka Road, Northfield, Illinois  
(Address of principal executive offices)

60093  
(Zip Code)

Registrant's telephone number including area code: 847-446-7500

Securities registered pursuant to Section 12 (b) of the Act:

| Title of Each Class<br>Common Stock, \$1 par value | Name of Each Exchange<br>on Which Registered<br>New York Stock Exchange |
|--|---|
| 5 1/2% Convertible Preferred Stock, no par value   | Chicago Stock Exchange<br>New York Stock Exchange                       |
|  | Chicago Stock Exchange  |

Securities registered pursuant to Section 12 (g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act Yes  No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)

Yes  No

Aggregate market value at June 30, 2006, of voting stock held by nonaffiliates of the registrant: \$204,204,002\*

Number of shares outstanding of each of the issuer's classes of common stock as of February 28, 2007:

| Class                       | Outstanding at February 28, 2007 |
|-----------------------------|----------------------------------|
| Common Stock, \$1 par value | 9,238,521                        |

Documents Incorporated by Reference

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**Part of Form 10-K**  
Part III, Items 10-14

**Document Incorporated**  
Proxy Statement dated March 22, 2007

\* Based on reported ownership by all directors, officers and beneficial owners of more than 5% of registrant's voting stock. However, this determination does not constitute an admission of affiliate status for any of these holders.

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**EXPLANATORY NOTE**

Stepan Company (the Company) is filing this Amendment No. 1 on Form 10-K/A to correct for a typographical error in the Per Diluted Share amount in the 2006 first quarter column of the Selected Quarterly Financial Data table included in Item 8 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006, as filed with the U.S. Securities and Exchange Commission on March 8, 2007 (the Original Filing). The \$0.37 Per Diluted Share amount on page 88 of the Original Filing has been replaced with \$0.31 Per Diluted Share. This change is reflected on page 46 of this Form 10-K/A. No other information in the Original Filing is amended hereby. This Form 10-K/A continues to describe conditions as of the date of the Original Filing, and accordingly, the Company has not updated the disclosures contained herein to reflect events that occurred at a later date.

As required by Rule 12b-15 promulgated under the Securities Exchange Act of 1934, as amended, the Company's principal executive officer and principal financial officer are providing Rule 13a-14(a) certifications in connection with this Form 10-K/A (but otherwise identical to their prior certifications) and are also furnishing, but not filing, Rule 13a-14(b) certifications in connection with this Form 10-K/A (but otherwise identical to their prior certifications).

**Item 8. Financial Statements and Supplementary Data**

The following statements and data are included in this item:

Report of Independent Registered Public Accounting Firm

Consolidated Statements of Income (For years ended December 31, 2006, 2005 and 2004)

Consolidated Balance Sheets (December 31, 2006 and 2005)

Consolidated Statements of Cash Flow (For years ended December 31, 2006, 2005 and 2004)

Consolidated Statements of Stockholders' Equity (For years ended December 31, 2006, 2005 and 2004)

Notes to Consolidated Financial Statements

Selected Quarterly Financial Data

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders of

Stepan Company

Northfield, Illinois

We have audited the accompanying consolidated balance sheets of Stepan Company and subsidiaries (the "Company") as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). 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, such consolidated financial statements present fairly, in all material respects, the financial position of Stepan Company and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 2, 2007, expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ Deloitte & Touche LLP  
DELOITTE & TOUCHE LLP

Chicago, Illinois  
March 2, 2007

*Stepan Company**Consolidated Statements of Income**For the years ended December 31, 2006, 2005 and 2004*

| <i>(In thousands, except per share amounts)</i>                                   | <i>2006</i>         | <i>2005</i>         | <i>2004</i>       |
|---|---------------------|---------------------|-------------------|
| <b>Net Sales</b> (Note 1)   | <b>\$ 1,172,583</b> | <b>\$ 1,078,377</b> | <b>\$ 935,816</b> |
| Cost of Sales   | <b>1,046,797</b>    | 955,515             | 824,849           |
| <b>Gross Profit</b>   | <b>125,786</b>      | 122,862             | 110,967           |
| Operating Expenses:   |                     |                     |                   |
| Marketing   | <b>34,452</b>       | 32,467              | 29,615            |
| Administrative  | <b>45,844</b>       | 35,339              | 36,204            |
| Research, development and technical services (Note 1)                             | <b>29,637</b>       | 29,588              | 25,969            |
|   | <b>109,933</b>      | 97,394              | 91,788            |
| <b>Operating Income</b>   | <b>15,853</b>       | 25,468              | 19,179            |
| Other Income (Expense):   |                     |                     |                   |
| Interest, net (Note 5)  | <b>(8,885)</b>      | (7,801)             | (7,237)           |
| Income (Loss) from equity in joint venture (Note 1)                               | <b>(812)</b>        | (729)               | 2,320             |
| Other, net  | <b>1,233</b>        | 708                 | 371               |
|   | <b>(8,464)</b>      | (7,822)             | (4,546)           |
| <b>Income Before Provision for Income Taxes and Minority Interest</b>             | <b>7,389</b>        | 17,646              | 14,633            |
| Provision for income taxes (Note 7)   | <b>900</b>          | 4,170               | 4,320             |
| Minority interest (Note 1)  | <b>(181)</b>        | (53)                | (11)              |
| <b>Income Before Cumulative Effect of Change in Accounting Principle</b>          | <b>6,670</b>        | 13,529              | 10,324            |
| Cumulative effect of change in accounting principle, net of income taxes (Note 2) |                     | (370)               |                   |
| <b>Net Income</b>   | <b>\$ 6,670</b>     | \$ 13,159           | \$ 10,324         |
| Basic earnings per share of common stock (Note 16)                                |                     |                     |                   |
| Income before cumulative effect of change in accounting principle                 | <b>\$ 0.64</b>      | \$ 1.41             | \$ 1.06           |
| Cumulative effect of change in accounting principle                               | <b>\$</b>           | \$ (0.04)           | \$                |
| <b>Net Income Per Common Share</b>  | <b>\$ 0.64</b>      | \$ 1.37             | \$ 1.06           |
| Diluted earnings per share of common stock (Note 16)                              |                     |                     |                   |
| Income before cumulative effect of change in accounting principle                 | <b>\$ 0.63</b>      | \$ 1.39             | \$ 1.05           |
| Cumulative effect of change in accounting principle                               | <b>\$</b>           | \$ (0.04)           | \$                |
| <b>Net Income Per Common Share</b>  | <b>\$ 0.63</b>      | \$ 1.35             | \$ 1.05           |
| Shares Used to Compute Net Income Per Common Share (Note 16):                     |                     |                     |                   |
| Basic   | <b>9,133</b>        | 9,005               | 8,970             |
| Diluted   | <b>9,284</b>        | 9,725               | 9,038             |

*The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.*





*Stepan Company**Consolidated Balance Sheets**December 31, 2006 and 2005*

| <i>(Dollars in thousands)</i>   | <i>2006</i> | <i>2005</i> |
|---|-------------|-------------|
| <b>Assets</b>   |             |             |
| <b>Current Assets:</b>  |             |             |
| Cash and cash equivalents   | \$ 5,369    | \$ 16,641   |
| Receivables, less allowances of \$3,540 in 2006 and \$3,119 in 2005   | 160,525     | 149,922     |
| Inventories (Note 4)  | 82,837      | 76,399      |
| Deferred income taxes (Note 7)  | 10,362      | 8,239       |
| Other current assets  | 9,376       | 8,047       |
| Total current assets  | 268,469     | 259,248     |
| <b>Property, Plant and Equipment:</b>   |             |             |
| Land  | 10,792      | 10,125      |
| Buildings and improvements  | 101,230     | 94,188      |
| Machinery and equipment   | 722,616     | 685,832     |
| Construction in progress  | 25,072      | 16,214      |
|   | 859,710     | 806,359     |
| Less: accumulated depreciation  | 634,106     | 595,240     |
| Property, plant and equipment, net  | 225,604     | 211,119     |
| Goodwill, net (Note 3)  | 7,841       | 7,414       |
| Other intangible assets, net (Note 3)   | 7,360       | 8,775       |
| Other non-current assets  | 36,781      | 29,603      |
| Total assets  | \$ 546,055  | \$ 516,159  |
| <b>Liabilities and Stockholders Equity</b>  |             |             |
| <b>Current Liabilities:</b>   |             |             |
| Current maturities of long-term debt (Note 5)   | \$ 23,761   | \$ 16,777   |
| Accounts payable  | 108,084     | 102,264     |
| Accrued liabilities (Note 12)   | 48,650      | 43,863      |
| Total current liabilities   | 180,495     | 162,904     |
| Deferred income taxes (Note 7)  | 2,046       | 2,210       |
| Long-term debt, less current maturities (Note 5)  | 107,403     | 108,945     |
| Other non-current liabilities (Note 13)   | 74,574      | 74,361      |
| <b>Commitments and Contingencies</b> (Notes 6 and 14)   |             |             |
| Minority Interest (Note 1)  | 751         | 905         |
| <b>Stockholders Equity</b> (Note 8):  |             |             |
| 5 <sup>1</sup> / <sub>2</sub> percent convertible preferred stock, cumulative, voting, without par value; authorized 2,000,000 shares; issued and outstanding 572,854 shares in 2006 and 575,254 shares in 2005 | 14,321      | 14,381      |
|   | 10,343      | 10,143      |

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Common stock, \$1 par value; authorized 30,000,000 shares; issued 10,342,762 shares in 2006 and 10,142,853 shares in 2005

|  |                       |                |
|--|-----------------------|----------------|
| Additional paid-in capital   | <b>33,553</b>         | 26,812         |
| Accumulated other comprehensive loss (Note 1)  | <b>(14,292)</b>       | (23,867)       |
| Retained earnings (approximately \$32,219 unrestricted in 2006 and \$32,520 in 2005) | <b>161,184</b>        | 162,663        |
| Less: Treasury stock, at cost, 1,134,958 shares in 2006 and 1,102,309 shares in 2005 | <b>(24,323)</b>       | (23,298)       |
| <b>Stockholders' equity</b>  | <b>180,786</b>        | 166,834        |
| <br>Total liabilities and stockholders' equity                                       | <br><b>\$ 546,055</b> | <br>\$ 516,159 |

*The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.*

*Stepan Company**Consolidated Statements of Cash Flows**For the years ended December 31, 2006, 2005 and 2004*

| <i>(Dollars in thousands)</i>   | <i>2006</i> | <i>2005</i> | <i>2004</i> |
|---|-------------|-------------|-------------|
| <b>Cash Flows From Operating Activities</b>                                       |             |             |             |
| Net income  | \$ 6,670    | \$ 13,159   | \$ 10,324   |
| Adjustments to reconcile net income to net cash provided by operating activities: |             |             |             |
| Cumulative effect of accounting change  |             | 370         |             |
| Depreciation and amortization   | 38,384      | 38,769      | 39,169      |
| Deferred compensation   | 3,672       | 2,094       | 693         |
| Deferred income taxes   | (10,143)    | (5,406)     | (4,310)     |
| Other non-cash items  | 802         | (93)        | (1,420)     |
| Changes in assets and liabilities:  |             |             |             |
| Receivables, net  | (8,000)     | (19,145)    | (15,949)    |
| Inventories   | (4,613)     | (1,516)     | (4,009)     |
| Other current assets  | (1,091)     | 1,438       | (1,019)     |
| Accounts payable and accrued liabilities  | 7,759       | 8,884       | 20,677      |
| Pension liabilities   | (2,554)     | 4,057       | 698         |
| Environmental and legal liabilities   | 3,610       | (607)       | (1,398)     |
| Deferred revenues   | 5,017       | 38          | 503         |
| Excess tax benefit from stock options   | (685)       |             |             |
| Net Cash Provided By Operating Activities   | 38,828      | 42,042      | 43,959      |
| <b>Cash Flows From Investing Activities</b>                                       |             |             |             |
| Expenditures for property, plant and equipment                                    | (45,970)    | (41,519)    | (33,766)    |
| Dividend from Philippine joint venture, net of tax withholdings                   |             |             | 1,700       |
| Formation of China joint venture  |             |             | 945         |
| Other, net  | (2,524)     | 13          | 2,939       |
| Net Cash Used In Investing Activities   | (48,494)    | (41,506)    | (28,182)    |
| <b>Cash Flows From Financing Activities</b>                                       |             |             |             |
| Revolving debt and notes payable to banks, net                                    | 12,934      | (11,399)    | (481)       |
| Other debt borrowings   | 2,271       | 43,154      | 17,680      |
| Other debt repayments   | (12,474)    | (14,230)    | (23,908)    |
| Purchases of treasury stock, net  |             |             | (30)        |
| Dividends paid  | (8,149)     | (7,869)     | (7,731)     |
| Stock option exercises  | 3,297       | 534         | 718         |
| Excess tax benefit from stock options   | 685         |             |             |
| Other, net  | (315)       | (408)       | (335)       |
| Net Cash Provided By (Used In) Financing Activities                               | (1,751)     | 9,782       | (14,087)    |
| Effect of Exchange Rate Changes on Cash   | 145         | 62          | 336         |
| Net Increase (Decrease) in Cash and Cash Equivalents                              | (11,272)    | 10,380      | 2,026       |
| Cash and Cash Equivalents at Beginning of Year                                    | 16,641      | 6,261       | 4,235       |
| Cash and Cash Equivalents at End of Year  | \$ 5,369    | \$ 16,641   | \$ 6,261    |

**Supplemental Cash Flow Information**

|   |                 |           |          |
|---|-----------------|-----------|----------|
| Cash payments of income taxes, net of refunds | <b>\$ 7,037</b> | \$ 10,639 | \$ 8,359 |
| Cash payments of interest                     | <b>\$ 9,004</b> | \$ 7,670  | \$ 7,673 |

*The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.*

## Stepan Company

## Consolidated Statements of Stockholders' Equity

For the years ended December 31, 2006, 2005 and 2004

|   | Convertible        |                 | Additional         |                   | Accumulated                    |                      | Comprehensive<br>Income |
|---|--------------------|-----------------|--------------------|-------------------|--------------------------------|----------------------|-------------------------|
|   | Preferred<br>Stock | Common<br>Stock | Paid-in<br>Capital | Treasury<br>Stock | Other<br>Comprehensive<br>Loss | Retained<br>Earnings |                         |
| <i>(Dollars in thousands)</i>   |                    |                 |                    |                   |                                |                      |                         |
| <b>Balance January 1, 2004</b>  | \$ 14,552          | \$ 9,900        | \$ 22,277          | \$ (19,882)       | \$ (19,560)                    | \$ 154,780           |                         |
| Sale of 131,605 shares of common stock under stock option plan        |                    | 131             | 1,949              |                   |                                |                      |                         |
| Purchase of 72,774 shares of common stock, net of sales               |                    |                 |                    | (1,729)           |                                |                      |                         |
| Conversion of preferred stock to common stock                         | (15)               | 1               | 14                 |                   |                                |                      |                         |
| Net income  |                    |                 |                    |                   |                                | 10,324               | \$ 10,324               |
| Other comprehensive income/(loss):                                    |                    |                 |                    |                   |                                |                      |                         |
| Foreign currency translation adjustments                              |                    |                 |                    |                   | 4,974                          |                      | 4,974                   |
| Unrealized gain on securities (net of income taxes of \$161)          |                    |                 |                    |                   | 242                            |                      | 242                     |
| Minimum pension liability adjustment (net of income taxes of \$1,515) |                    |                 |                    |                   | (2,195)                        |                      | (2,195)                 |
| Comprehensive income  |                    |                 |                    |                   |                                |                      | \$ 13,345               |
| Cash dividends paid:  |                    |                 |                    |                   |                                |                      |                         |
| Preferred stock (\$1.375 per share)                                   |                    |                 |                    |                   |                                | (800)                |                         |
| Common stock (77.25¢ per share)                                       |                    |                 |                    |                   |                                | (6,931)              |                         |
| Non-qualified stock option income tax benefit                         |                    |                 | 209                |                   |                                |                      |                         |
| <b>Balance, December 31, 2004</b>                                     | 14,537             | 10,032          | 24,449             | (21,611)          | (16,539)                       | 157,373              |                         |
| Sale of 103,194 shares of common stock under stock option plan        |                    | 103             | 1,937              |                   |                                |                      |                         |
| Purchase of 62,864 shares of common stock, net of sales               |                    |                 |                    | (1,687)           |                                |                      |                         |
| Conversion of preferred stock to common stock                         | (156)              | 8               | 148                |                   |                                |                      |                         |
| Net income  |                    |                 |                    |                   |                                | 13,159               | \$ 13,159               |
| Other comprehensive income/(loss):                                    |                    |                 |                    |                   |                                |                      |                         |
| Foreign currency translation adjustments                              |                    |                 |                    |                   | (4,024)                        |                      | (4,024)                 |
| Unrealized gain on securities (net of income taxes of \$38)           |                    |                 |                    |                   | 60                             |                      | 60                      |
| Minimum pension liability adjustment (net of income taxes of \$1,920) |                    |                 |                    |                   | (3,364)                        |                      | (3,364)                 |
| Comprehensive income  |                    |                 |                    |                   |                                |                      | \$ 5,831                |
| Cash dividends paid:  |                    |                 |                    |                   |                                |                      |                         |
| Preferred stock (\$1.375 per share)                                   |                    |                 |                    |                   |                                | (796)                |                         |
| Common stock (78.50¢ per share)                                       |                    |                 |                    |                   |                                | (7,073)              |                         |
| Non-qualified stock option income tax benefit                         |                    |                 | 278                |                   |                                |                      |                         |
| <b>Balance, December 31, 2005</b>                                     | 14,381             | 10,143          | 26,812             | (23,298)          | (23,867)                       | 162,663              |                         |
| Sale of 197,171 shares of common stock under stock option plan        |                    | 197             | 3,973              |                   |                                |                      |                         |
| Purchase of 33,220 shares of common stock, net of sales               |                    |                 |                    | (1,037)           |                                |                      |                         |

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|  |           |           |           |             |             |            |
|--|-----------|-----------|-----------|-------------|-------------|------------|
| Conversion of preferred stock to common stock  | (60)      | 3         | 57        |             |             |            |
| Equity based compensation  |           |           | 420       |             |             |            |
| Deferred compensation  |           |           | 1,606     | 12          |             |            |
| Net income   |           |           |           |             | 6,670       | \$ 6,670   |
| Other comprehensive income:  |           |           |           |             |             |            |
| Foreign currency translation adjustments   |           |           |           | 5,805       |             | 5,805      |
| Unrealized gain on securities (net of income taxes of \$78)                            |           |           |           | 124         |             | 124        |
| Minimum pension liability adjustment (net of income taxes of \$3,035)                  |           |           |           | 4,199       |             | 4,199      |
| Comprehensive income   |           |           |           |             |             | \$ 16,798  |
| Defined benefit pension liability transition adjustment (net of income taxes of \$351) |           |           |           |             |             |            |
|  |           |           |           | (553)       |             |            |
| Cash dividends paid:   |           |           |           |             |             |            |
| Preferred stock (\$1.375 per share)  |           |           |           |             | (789)       |            |
| Common stock (80.50¢ per share)  |           |           |           |             | (7,360)     |            |
| Non-qualified stock option income tax benefit  |           |           | 685       |             |             |            |
| <b>Balance, December 31, 2006</b>  | \$ 14,321 | \$ 10,343 | \$ 33,553 | \$ (24,323) | \$ (14,292) | \$ 161,184 |

*The accompanying Notes to Consolidated Financial Statements are an integral part of these statements*

*Notes to Consolidated Financial Statements*

*For the years ended December 31, 2006, 2005 and 2004*

***1. Summary of Significant Accounting Policies***

**Nature of Operations**

Stepan Company (the Company) operations consist predominantly of the production and sale of specialty and intermediate chemicals, which are sold to other manufacturers for use in a variety of end products. Principal markets for all products are manufacturers of cleaning and washing compounds (including detergents, shampoos, fabric softeners, toothpastes and household cleaners), paints, cosmetics, food and beverages, agricultural products, plastics, furniture, automotive equipment, insulation and refrigeration.

**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its subsidiaries. The Company consolidates all wholly and majority-owned subsidiaries in which the Company exercises controlling influence. The equity method is used to account for investments in which the Company exercises significant but non-controlling influence. See Joint Ventures below. All significant intercompany balances and transactions have been eliminated in consolidation.

**Joint Ventures**

The Company is a partner in two joint ventures: Nanjing Stepan Jinling Chemical Limited Liability Company (Stepan China) in Nanjing, China, and Stepan Philippines Inc. in Bauan, Batangas, Philippines. Stepan China was formed to manufacture the Company's aromatic polyester polyols for China's domestic market. The Company and its partner own 55 percent and 45 percent, respectively, of the joint venture. The Company includes Stepan China's accounts in its consolidated financial statements, and the joint venture partner's interests in Stepan China's income and net assets are reported in the *Minority Interest* lines of the Consolidated Statements of Income and the Consolidated Balance Sheets, respectively. In 2004, Stepan China's financial statements were included in the Company's consolidated financial statements on a three-month lag basis. The reporting lag was reduced to one month in the third quarter of 2005 and was eliminated as of December 31, 2005. The impact of the additional months of activity on the Company's 2005 quarterly and annual consolidated financial statements was not significant.

Stepan Philippines Inc. owns and operates a manufacturing facility, which produces surfactants that are sold in the Philippines and Southeast Asia. The Company and its partner each hold a 50 percent interest in the joint venture. The Company's investment in Stepan Philippines Inc. is accounted for under the equity method and is included in the Other non-current assets caption on the Consolidated Balance Sheets. The Company's share of Stepan Philippines Inc.'s net earnings is included in the Income from Equity in Joint Venture line of the Consolidated Statements of Income.

#### **Cash and Cash Equivalents**

The Company considers all highly liquid investments with original maturities of three months or less from the date of purchase to be cash equivalents.

#### **Concentration of Credit Risks**

The Company grants credit to its customers who are widely distributed across the Americas, Europe and Asia. The Company does not have any one customer whose business represents more than 10 percent of the Company's consolidated revenue. There is no material concentration of credit risk.

#### **Inventories**

Inventories are valued at cost, which is not in excess of market value, and include material, labor and plant overhead costs. The last-in, first-out (LIFO) method is used to determine the cost of the Company's domestic inventories. The first-in, first-out (FIFO) method is used for all other inventories. Inventories priced at LIFO as of December 31, 2006 and 2005, amounted to 77 and 78 percent of total inventories, respectively.

#### **Property, Plant and Equipment**

Depreciation of physical properties is provided on a straight-line basis over the estimated useful lives of various assets. Lives used for calculating depreciation are generally 30 years for buildings and 15 years for building improvements. For assets classified as machinery and equipment, lives generally used for calculating depreciation expense are from ten to 15 years for manufacturing equipment, from five to ten years for furniture and fixtures, from three to five years for vehicles and from three to ten years for computer equipment and software. Manufacturing of chemicals is capital intensive with over 90 percent of the assets included in machinery and equipment representing manufacturing equipment. Major renewals and betterments are capitalized in the property accounts, while maintenance and repairs (\$27,940,000, \$28,114,000, and \$24,444,000 in 2006, 2005 and 2004, respectively), which do not renew or extend the life of the respective assets, are charged to operations currently. The cost of property retired or sold and the related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in income.

Included in the computer equipment and software component of machinery and equipment within property, plant and equipment are costs related to the acquisition and



development of internal-use software. Capitalized costs include external direct costs of materials and services consumed in obtaining and developing the software. For development projects where major internal resources are committed, payroll and payroll-related costs incurred during the application development phase of the project are also capitalized. The capitalized costs are amortized over the useful lives of the software, which are generally three to ten years. Costs incurred in the preliminary project phase are expensed.

Interest charges on borrowings applicable to major construction projects are capitalized.

Operating assets are written down to fair value whenever an impairment review indicates that the carrying value cannot be recovered on an undiscounted cash flow basis.

### **Revenue Recognition**

Revenue is recognized upon shipment of goods to customers, at which time title and risk of loss pass to the customer. For arrangements where the Company consigns product to a customer location, revenue is recognized when the customer uses the inventory. The Company records shipping and handling billed to a customer in a sales transaction as revenue. Costs incurred for shipping and handling are recorded in cost of sales. Volume discounts due to customers are estimated and recorded in the same period as the sales to which the discounts relate and reported as reductions of revenue in the Consolidated Statements of Income.

Cost of sales comprises raw material costs, including inbound freight expense to deliver the raw materials, manufacturing plant labor expenses and various manufacturing overhead expenses, which include utility, maintenance, operating supply, amortization and manufacturing asset depreciation expenses. Cost of sales also includes outbound freight expenses, purchasing and receiving costs, quality assurance expenses, inter-plant transfer costs and warehouse expenses.

Marketing expense comprises salary and the related fringe benefit expenses for marketing and sales personnel and operating costs, such as outside agent commissions, automobile rental and travel-related expenses, which support the sales and marketing functions. Bad debt charges and any depreciation expenses related to marketing assets (e.g. computers) are also classified as marketing expense.

Administrative expense comprises salary and the related fringe benefit expenses and operating costs for the Company's various administrative functions, which include information services, finance, legal, and human resources. Compensation expense related to the Company's deferred compensation plans and legal and environmental remediation expenses are also classified as administrative expense.

### **Environmental Expenditures**

Environmental expenditures that relate to current operations are expensed in cost of sales or capitalized as appropriate. Expenditures that mitigate or prevent environmental contamination and that benefit future operations are capitalized. Capitalized expenditures are depreciated generally utilizing a 10 year life. Expenditures that relate to an existing condition caused by past operations, and which do not contribute to current or future revenue generation, are expensed. Liabilities are recorded when environmental assessments and/or remedial efforts are probable and the cost or range of possible costs can be reasonably estimated. When no amount within the

range is a better estimate than any other amount, the minimum is accrued. Some of the factors on which the Company bases its estimates include information provided by feasibility studies, potentially responsible party negotiations and the development of remedial action plans. Because reported liabilities are recorded based on estimates, actual amounts could differ from those estimates. Legal costs related to environmental matters are expensed as incurred. See Note 14.

#### **Goodwill and Other Intangible Assets**

Intangible assets include patents, agreements not to compete, trademarks, customer lists and goodwill, all of which were acquired as part of business acquisitions. The Company separately identifies intangible assets other than goodwill and amortizes them in accordance with their useful lives, generally ranging from five to 15 years. Goodwill is not amortized. Goodwill is subject to annual tests for impairment. Intangible assets are tested for impairment when events indicate that an impairment may have occurred. At December 31, 2006, there was no impairment of goodwill or other intangible assets. For more details see Note 3.

#### **Research and Development Costs**

The Company's research and development costs are expensed as incurred. These expenses are aimed at discovery and commercialization of new knowledge with the intent that such effort will be useful in developing a new product or in bringing about a significant improvement to an existing product or process. Total expenses were \$18,850,000, \$18,292,000 and \$16,005,000 in 2006, 2005 and 2004, respectively. The balance of expenses reflected on the Consolidated Statements of Income relates to technical services, which include routine product testing, quality control and sales support service.

#### **Income Taxes**

The provision for income taxes includes federal, foreign, state and local income taxes currently payable and those deferred because of temporary differences between the financial statement and tax bases of assets and liabilities. Deferred tax assets or liabilities are computed based on the difference between the financial statement and income tax bases of assets and liabilities using enacted marginal tax rates. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized. Deferred income tax expenses or credits are based on the changes in the asset or liability from period to period. See Note 7.

#### **Translation of Foreign Currencies**

Assets and liabilities of consolidated foreign subsidiaries are translated into U.S. dollars at exchange rates in effect at year end. The resulting translation adjustments are included in stockholders' equity. Revenues and expenses for the consolidated foreign subsidiaries and equity income or losses for the Company's unconsolidated Philippines joint venture are translated at average exchange rates prevailing during the year. Gains or losses on foreign currency transactions are reflected in the "Other, net" caption of the Consolidated Statements of Income. The foreign exchange gains and losses recognized by year were \$64,000 gain in 2006, \$76,000 gain in 2005 and \$103,000 loss in 2004.

**Stock-Based Compensation**

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*, which replaced SFAS No. 123, *Accounting for Stock-Based Compensation*, and superseded Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. The accounting standard applies to new awards and to awards modified, repurchased or cancelled after the adoption date and to the unvested portion of awards outstanding as of the adoption date. SFAS No. 123(R) requires the fair value of all share-based payment transactions to be recognized in the financial statements. Prior to January 1, 2006, the Company used the intrinsic value method of APB Opinion No. 25, which resulted in the recognition of no stock-based compensation expense. The Company elected to adopt the new accounting standard using the modified prospective application method. Because prior period financial statements are not restated, financial results are not comparable as reported. The following table reconciles the actual net income and earnings per share results for the years ended December 31, 2005 and 2004, to pro forma results for the same periods, as if the Company had applied the fair value recognition provisions of SFAS No. 123 for periods prior to January 1, 2006. In December 2004, the Company's Board of Directors approved the immediate acceleration of the vesting periods for most of the stock options that were unvested at that time. As a result, there were very few unvested stock options outstanding throughout 2005, which accounts for the large decline in pro forma compensation expense from 2004 to 2005.

| (In thousands, except per share amounts)  | For the Years Ended<br>December 31 |           |
|---|------------------------------------|-----------|
|   | 2005                               | 2004      |
| Net income, as reported   | \$ 13,159                          | \$ 10,324 |
| Deduct: Total stock-based employee compensation expense determined under<br>fair value based method for all awards,<br>net of related tax effects | 30                                 | 1,517     |
| Net income, pro forma   | \$ 13,129                          | \$ 8,807  |
| Earnings per share:   |                                    |           |
| Basic as reported   | \$ 1.37                            | \$ 1.06   |
| Basic pro forma   | \$ 1.37                            | \$ 0.89   |
| Diluted as reported   | \$ 1.35                            | \$ 1.05   |
| Diluted pro forma   | \$ 1.35                            | \$ 0.89   |

See Note 9 for detailed information about the Company's stock-based compensation.

## Earnings Per Share

Basic earnings per share amounts are computed based on the weighted-average number of common shares outstanding. Net income used in computing basic earnings per share has been reduced by dividends paid to preferred stockholders. Diluted earnings per share amounts are based on the increased number of common shares that would be outstanding assuming the exercise of certain outstanding stock options (under the treasury stock method), the conversion of the convertible preferred stock, when such conversion would have the effect of reducing earnings per share, and directors' stock awards. See Note 16.

## Comprehensive Income

Comprehensive income includes net income and all other non-owner changes in equity that are not reported in net income. For the years ended December 31, 2006, 2005 and 2004, the Company's comprehensive income included net income, foreign currency translation gains and losses, unrealized gains and losses on investment securities and defined benefit pension liability adjustments. Comprehensive income is disclosed in the Consolidated Statements of Stockholders' Equity.

Accumulated other comprehensive loss as reported in the Consolidated Balance Sheets at December 31, 2006 and 2005, comprised the following:

| (Dollars in thousands)  | December 31 |             |
|---|-------------|-------------|
|   | 2006        | 2005        |
| Foreign currency translation gains/(losses)   | \$ 966      | (\$ 4,839)  |
| Unrealized gains on securities (net of income taxes of \$360 in 2006 and \$282 in 2005) | 550         | 426         |
| Defined benefit pension liability adjustments   |             |             |
| (net of income taxes of \$9,751 in 2006 and \$12,435 in 2005)                           | (15,808)    | (19,454)    |
| Total accumulated other comprehensive loss  | (\$ 14,292) | (\$ 23,867) |

## Segment Reporting

The Company reports financial and descriptive information about its reportable operating segments. Operating segments are components of the Company that have separate financial information that is regularly evaluated by the chief operating decision maker to assess segment performance and allocate resources. The Company discloses segment revenue, operating income, assets, capital expenditures and depreciation and amortization expenses. Enterprise-wide financial information about the revenues derived from the Company's products, the geographic locations in which the Company earns revenues and holds assets is also disclosed. See Note 15.

### **Derivative Instruments**

Derivative instruments are recognized on the balance sheet as either an asset or a liability measured at fair value. Changes in fair value are recognized currently in earnings or in other comprehensive income if specific hedge criteria are met. Special accounting for qualifying hedges allows a derivative instrument's gains and losses to offset related results on the hedged item in the statement of income, to the extent effective. If a transaction is designated to receive hedge accounting, the Company establishes at the inception of the hedge the method it will use for assessing the effectiveness of the hedge and the measurement approach for determining the ineffective aspect of the hedge.

The Company has limited derivative transactions. Company policy prohibits the use of financial instruments for trading or speculative purposes. The Company does, however, enter into forward contracts to minimize exposure related to rising natural gas prices. The Company may contract up to 100 percent of its forecasted natural gas requirements. Because the Company anticipates taking delivery of the gas for use in its manufacturing operations, the forward contracts qualify for the normal purchase exception of SFAS No. 133, as amended. As a result, the contracts are not accounted for as derivative instruments. The cost of the natural gas is charged to expense at the time the gas is delivered and used. To the extent forecasts are adjusted resulting in contracted volume exceeding forecasted volume, which is generally insignificant, the excess contracted volume is accounted for as a derivative instrument and, accordingly, marked to market through earnings at the applicable measurement date. At December 31, 2006, the Company had open forward contracts for the purchase of 0.7 million dekatherms of natural gas in 2007 at a cost of \$5,988,000.

The Company's foreign subsidiaries periodically use short-term forward exchange contracts to limit the exposure of certain foreign currency transactions and balances to fluctuating exchange rates. At December 31, 2006, the Company's French subsidiary had one forward contract for the January 2007 purchase of \$500,000.

### **Recent Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB Statement No. 109, *Accounting for Income Taxes*. The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken, in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties accounting in interim periods, disclosure and transition. The interpretation is effective for fiscal years beginning after December 15, 2006. The Company continues to evaluate the impact of adopting FIN 48. At this point, the Company does not believe that the adoption of FIN 48 will have a material effect on its financial position, cash flows and results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement defines fair value, provides a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The guidance in the new standard is applicable in circumstances where other accounting pronouncements mandate or permit fair value measurements. SFAS No. 157, which is effective for financial

statements issued for fiscal years beginning after November 15, 2007, does not require any new fair value measurements. The Company is in the process of determining the effect that adoption of SFAS No. 157 will have on its financial position, cash flows and results of operations.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. This statement amends certain requirements set forth in previous pension and postretirement accounting standards. SFAS No. 158 requires that the overfunded or underfunded status of a defined benefit postretirement plan be recognized as an asset or liability in the statement of financial position. Changes in the funded status are to be recognized in comprehensive income. This requirement is effective for fiscal years ending after December 15, 2006. Adoption of SFAS No. 158 did not have an effect on the Company's results of operations or cash flows. Furthermore, the adoption of the new standard did not have a significant effect on the Company's financial position. See Note 11. In addition to the foregoing requirement, SFAS No. 158 mandates, with limited exceptions, that the funded status of a defined benefit postretirement plan be measured as of the date of an entity's year-end statement of financial position. The Company already complies with this requirement.

In September 2006, the SEC released Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB No. 108 provides guidance regarding the methodology for quantifying and evaluating the materiality of financial statement misstatements. SAB No. 108 is effective for fiscal years ending after November 15, 2006. Application of the guidance in SAB No. 108 did not have a material effect on the Company's financial position, cash flows or results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 expands the scope of what entities may carry at fair value by offering an irrevocable option to record many types of financial assets and liabilities at fair value. Changes in fair value would be recorded in an entity's income statement. This accounting standard also establishes presentation and disclosure requirements that are intended to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective for the Company on January 1, 2008. Earlier application is permitted under certain circumstances. The Company will begin to assess the impact, if any, that the adoption of SFAS No. 159 will have on its financial position, cash flows and results of operations.

## **2. Asset Retirement Obligations**

The Company adopted FIN 47, *Accounting for Conditional Asset Retirement Obligations*, effective December 31, 2005. As a result, the Company recorded a liability for the eventual, future disposal of asbestos at the Company's various locations. The asset retirement obligation reflects the special handling and disposal of asbestos as set forth by the regulations of the various countries in which the Company operates. The asbestos is primarily used to insulate storage and processing tanks, reactors, boilers and infrastructure assets, such as flooring, walls and ceilings. The impact of adopting FIN 47 was a non-cash after-tax charge of \$370,000 against income for 2005. In accordance with the guidance of FIN 47, the charge for the cumulative effect of initially applying the interpretation was reported as a change in accounting principle in the Consolidated

Statements of Income. The effect on 2005 operating income was not material. The asset retirement obligation was \$539,000 and \$604,000 at December 31, 2006 and 2005, respectively.

Below is a reconciliation of the January 1, 2006, and December 31, 2006, carrying values of the Company's asset retirement obligations:

|   |               |
|---|---------------|
| <b>(In thousands)</b>                           |               |
| Asset retirement obligation, January 1          | \$ 604        |
| Liabilities incurred in 2006                    |               |
| Liabilities settled in 2006                     | (88)          |
| Accretion expense                               | 23            |
| <b>Asset retirement obligation, December 31</b> | <b>\$ 539</b> |

### 3. Goodwill and Other Intangible Assets

The Company's net carrying values of goodwill were \$7,841,000 and \$7,414,000 as of December 31, 2006 and December 31, 2005, respectively. The entire amount of goodwill relates to the surfactants reportable segment. The change in net carrying value resulted from the effects of currency translation.

The following table reflects the components of all other intangible assets, which all have finite lives, as of December 31, 2006 and 2005. The changes in the intangible assets' carrying amounts, except non-compete agreements, were due to the effects of currency translation.

| <b>(In thousands)</b>           | <b>Gross Carrying Amount</b> |                  | <b>Accumulated Amortization</b> |                  |
|---------------------------------|------------------------------|------------------|---------------------------------|------------------|
|                                 | <b>December 31 2006</b>      | <b>2005</b>      | <b>December 31 2006</b>         | <b>2005</b>      |
| <b>Other Intangible Assets:</b> |                              |                  |                                 |                  |
| Patents                         | \$ 2,000                     | \$ 2,000         | \$ 1,133                        | \$ 1,000         |
| Trademarks                      | 5,510                        | 5,512            | 3,279                           | 2,916            |
| Customer lists                  | 4,806                        | 4,660            | 4,155                           | 3,655            |
| Know-how <sup>(a)</sup>         | 8,484                        | 8,457            | 4,873                           | 4,283            |
| Non-compete agreements          |                              | 2,381            |                                 | 2,381            |
| <b>Total</b>                    | <b>\$ 20,800</b>             | <b>\$ 23,010</b> | <b>\$ 13,440</b>                | <b>\$ 14,235</b> |

- (a) Know-how includes intellectual property rights covering proprietary information, written formulae, trade secrets or secret processes, inventions and developmental products (whether patentable or not), discoveries, improvements, compositions, manufacturing processes, manuals, specifications and technical data.

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Aggregate amortization expense for the years ended December 31, 2006 and 2005, was \$1,509,000 and \$1,696,000, respectively. Estimated amortization expense for identifiable intangibles assets for each of the five succeeding fiscal years is as follows:

| <b>(In thousands)</b>   |          |
|-------------------------|----------|
| For year ended 12/31/07 | \$ 1,243 |
| For year ended 12/31/08 | \$ 1,139 |
| For year ended 12/31/09 | \$ 1,116 |
| For year ended 12/31/10 | \$ 1,111 |
| For year ended 12/31/11 | \$ 1,111 |

**4. Inventories**

The composition of inventories is as follows:

| <b>(Dollars in thousands)</b> | <b>December 31</b> |                  |
|-------------------------------|--------------------|------------------|
|                               | <b>2006</b>        | <b>2005</b>      |
| Finished products             | \$ 56,128          | \$ 48,154        |
| Raw materials                 | 26,709             | 28,245           |
| <b>Total inventories</b>      | <b>\$ 82,837</b>   | <b>\$ 76,399</b> |

If the first-in, first-out (FIFO) inventory valuation method had been used for all inventories, inventory balances would have been approximately \$24,555,000 and \$21,259,000 higher than reported at December 31, 2006, and December 31, 2005, respectively.

**5. Debt**

Debt comprises the following:

| <b>(Dollars in thousands)</b>             | <b>Maturity Dates</b> | <b>December 31</b> |                   |
|---|-----------------------|--------------------|-------------------|
|   |                       | <b>2006</b>        | <b>2005</b>       |
| Unsecured private placement notes         |                       |                    |                   |
| 5.69%                                     | 2012-2018             | \$ 40,000          | \$ 40,000         |
| 6.86%                                     | 2009-2015             | 30,000             | 30,000            |
| 6.59%                                     | 2007-2012             | 16,364             | 19,091            |
| 7.77%                                     | 2007-2008             | 5,455              | 8,182             |
| Unsecured U.S. bank debt                  | 2011                  | 9,400              |                   |
| Debt of foreign subsidiaries              |                       |                    |                   |
| Secured bank term loans, foreign Currency | 2007-2010             | 18,737             | 22,315            |
| Other, foreign currency                   | 2007-2015             | 11,208             | 6,134             |
| <b>Total Debt</b>                         |                       | <b>131,164</b>     | <b>125,722</b>    |
| Less current maturities                   |                       | 23,761             | 16,777            |
| <b>Long-term debt</b>                     |                       | <b>\$ 107,403</b>  | <b>\$ 108,945</b> |



During 2006, the Company negotiated a new, committed \$60,000,000 revolving credit agreement, with a term of five years, and simultaneously cancelled a similar agreement that would have expired in 2007. As of December 31, 2006, the Company had borrowings totaling \$9,400,000 on this new loan agreement. During 2006, the Company borrowed under this agreement at varying rates, which averaged 5.91 percent. The revolving credit agreement requires a facility fee on the total commitment that is based on the Company's leverage ratio. Periodically, the company had other borrowings under notes payable to U.S. banks for which there were no outstanding balances at December 31, 2006 or 2005.

The debt of foreign subsidiaries consists mostly of bank term loans to Stepan Europe, Stepan Mexico and to the Company's China joint venture, all in local currencies. The European bank term loans have scheduled maturities through 2010 and bear interest at 90-day EURIBOR plus 1.8 percent. The Mexican bank term loan has scheduled maturities through 2009, and bears interest at 10.35 percent. The China joint venture has bank term loans totaling \$2,562,000 that mature through 2008 and short-term loans totaling \$1,793,000, both in local currency, with interest averaging 5.79 percent. The Company guarantees its pro rata share (55 percent) of the China joint venture's bank debt. Other foreign currency debt is composed primarily of borrowings under uncommitted lines of credit to the Company's European subsidiaries. Except for the debt of the Company's China joint venture, the foreign debt that is currently outstanding is secured by the assets of the respective entities but is not guaranteed by the U.S. parent.

The various loan agreements contain provisions, which, among others, require maintenance of certain financial ratios and place limitations on additional debt, investments and payment of dividends. The Company is in compliance with its U.S. loan agreements as of December 31, 2006. Unrestricted retained earnings were \$32,219,000 and \$32,520,000 at December 31, 2006 and 2005, respectively.

Due to European severance costs and changes to French pension accounting standards, the Company's French subsidiary was out of compliance with its loan agreements as of December 31, 2006. The Company obtained a compliance waiver from its French banks.

Debt at December 31, 2006, matures as follows: \$23,761,000 in 2007; \$12,615,000 in 2008; \$10,744,000 in 2009; \$7,733,000 in 2010; \$16,420,000 in 2011 and \$59,891,000 after 2011.

The fair value of the Company's fixed-rate debt at December 31, 2006, including current maturities, was estimated to be \$94,162,000 compared to a carrying value of \$92,801,000.

Net interest expense for the years ended December 31 was composed of the following:

| <i>(Dollars in Thousands)</i> | 2006            | 2005     | 2004     |
|-------------------------------|-----------------|----------|----------|
| Interest Expense              | \$ 9,063        | \$ 8,065 | \$ 7,567 |
| Interest Income               | (178)           | (115)    | (157)    |
|                               | <b>8,885</b>    | 7,950    | 7,410    |
| Capitalized Interest          |                 | (149)    | (173)    |
| Interest, Net                 | <b>\$ 8,885</b> | \$ 7,801 | \$ 7,237 |

The Company maintains standby letters of credit under its workers' compensation insurance agreements and for other purposes as needed from time to time. The insurance letters of credit are renewed annually and amended to the amounts required by the insurance agreements. As of December 31, 2006, the Company had a total of \$1,411,000 in outstanding standby letters of credit.

### 6. Leased Properties

The Company leases certain property and equipment (primarily transportation equipment, buildings and land) under operating leases, which are denominated in local currencies. Total rental expense was \$4,545,000, \$3,987,000, and \$3,936,000 in 2006, 2005 and 2004, respectively.

Consolidated Company minimum future rental payments under operating leases with terms in excess of one year as of December 31, 2006, are:

| <i>(Dollars in thousands)</i>               | <i>Year</i>        | <i>Amount</i>    |
|---|--------------------|------------------|
|   | 2007               | \$ 3,117         |
|   | 2008               | 2,863            |
|   | 2009               | 2,165            |
|   | 2010               | 1,950            |
|   | 2011               | 1,456            |
|   | Subsequent to 2011 | 7,893            |
| <b>Total minimum future rental payments</b> |                    | <b>\$ 19,444</b> |

In January 2005, the Company's Brazilian subsidiary entered into an agreement to purchase a subsidiary of a multinational cleaning products company for a minimal purchase price. The purchase contract included a 10-year capital lease agreement under which \$463,000 was paid for the first 24 months with gross remaining payments due of \$2,136,000. At the end of the lease agreement, all of the relevant assets will be transferred and assigned to the Company. The assets and liabilities under the capital lease were recorded at the present value of the minimum lease payments. The leased assets are recorded under the property, plant and equipment caption of the Condensed Consolidated Balance Sheet. The capital lease liability is recorded under the other non-current liabilities caption of the Condensed Consolidated Balance Sheet. The amortization of the assets held under the capital lease is included in depreciation expense for 2006. Following is a summary of property held under the capital lease:

| <i>(Dollars in thousands)</i>  | <b>December 31, 2006</b> |
|--------------------------------|--------------------------|
| Machinery and equipment        | \$ 961                   |
| Building                       | 301                      |
| Land                           | 99                       |
|                                | 1,361                    |
| Less: Accumulated depreciation | (217)                    |
| <b>Total property, net</b>     | <b>\$ 1,144</b>          |

The minimum future lease payments under the capital lease as of December 31, 2006, for each of the next five years and in the aggregate are:

| <i>(Dollars in thousands)</i>                | <i>Year</i>        | <i>Amount</i> |
|--|--------------------|---------------|
|  | 2007               | \$ 267        |
|  | 2008               | 267           |
|  | 2009               | 267           |
|  | 2010               | 267           |
|  | 2011               | 267           |
|  | Subsequent to 2011 | 801           |
| Total minimum lease payments                 |                    | \$ 2,136      |
| Less: Amount representing interest           |                    | (976)         |
| Capital lease liability at December 31, 2006 |                    | \$ 1,160      |

### 7. Income Taxes

The provisions for taxes on income and the related income before taxes are as follows:

| <i>(Dollars in thousands)</i>                    | <i>2006</i> | <i>2005</i> | <i>2004</i> |
|--|-------------|-------------|-------------|
| <b>Taxes on Income</b>                           |             |             |             |
| Federal  |             |             |             |
| Current  | \$ 4,765    | \$ 6,153    | \$ 5,912    |
| Deferred   | (4,931)     | (4,483)     | (2,477)     |
| State  |             |             |             |
| Current  | 1,175       | 821         | 707         |
| Deferred   | (1,325)     | (543)       | (558)       |
| Foreign  |             |             |             |
| Current  | 5,789       | 2,602       | 2,011       |
| Deferred   | (4,573)     | (380)       | (1,275)     |
| Total  | \$ 900      | \$ 4,170    | \$ 4,320    |
| <b>Income before Taxes and Minority Interest</b> |             |             |             |
| Domestic   | \$ 353      | \$ 7,673    | \$ 12,212   |
| Foreign  | 7,036       | 9,973       | 2,421       |
| Total  | \$ 7,389    | \$ 17,646   | \$ 14,633   |

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The variations between the effective and statutory U.S. federal income tax rates are summarized as follows:

| <i>(Dollars in thousands)</i>   | 2006          |             | 2005            |             | 2004            |             |
|---|---------------|-------------|-----------------|-------------|-----------------|-------------|
|   | <i>Amount</i> | <i>%</i>    | <i>Amount</i>   | <i>%</i>    | <i>Amount</i>   | <i>%</i>    |
| Federal income tax provision at statutory tax rate                          | \$ 2,586      | 35.0        | \$ 6,176        | 35.0        | \$ 5,122        | 35.0        |
| State tax provision (benefit) on income less applicable federal tax benefit | (98)          | (1.3)       | 181             | 1.0         | 97              | 0.7         |
| Foreign income taxed at different rates <sup>(a)</sup>                      | (1,246)       | (16.9)      | (1,270)         | (7.2)       | (112)           | (0.8)       |
| Effect of equity in foreign joint venture                                   | 452           | 6.1         | 440             | 2.5         | (555)           | (3.8)       |
| Domestic production activities deduction                                    | (134)         | (1.8)       | (223)           | (1.3)       |                 |             |
| Repatriation of foreign earnings  |               |             | 485             | 2.7         | 700             | 4.8         |
| Charitable contribution of intellectual property                            |               |             |                 |             | (980)           | (6.7)       |
| U.S. tax credits <sup>(b)</sup>   | (1,964)       | (26.6)      | (1,899)         | (10.8)      | (265)           | (1.8)       |
| Non-deductible expenses and other items, net <sup>(c)</sup>                 | 1,304         | 17.7        | 280             | 1.7         | 313             | 2.1         |
| <b>Total income tax provision</b>   | <b>\$ 900</b> | <b>12.2</b> | <b>\$ 4,170</b> | <b>23.6</b> | <b>\$ 4,320</b> | <b>29.5</b> |

(a) Includes the effect of changes in valuation allowances for foreign entities of \$885,000, or 11.5 percent, in 2006.

(b) During 2006, the Company generated biodiesel credits of \$1,601,000 compared to \$1,430,000 in 2005. There were no biodiesel credits in 2004.

(c) 2006 includes \$560,000 for the tax effect on the gross up of pre-tax earnings due to biodiesel credits, \$398,000 in adjustments for federal income tax contingencies and \$346,000 for the tax effects on various non-deductible expenses.

At December 31, the tax effect of significant temporary differences representing deferred tax assets and liabilities is as follows:

| <i>(Dollars in thousands)</i>                                 | <i>2006</i>       | <i>2005</i>       |
|---|-------------------|-------------------|
| <b>Deferred Tax Liabilities:</b>                              |                   |                   |
| Depreciation  | \$ (25,754)       | \$ (29,460)       |
| Safe harbor leases  |                   | (235)             |
| Deferred Tax Liabilities                                      | \$ (25,754)       | \$ (29,695)       |
| <b>Deferred Tax Assets:</b>                                   |                   |                   |
| Pensions  | \$ 10,098         | \$ 12,445         |
| State income tax accrual                                      | (40)              | (114)             |
| Deferred revenue  | 2,490             | 1,085             |
| Other accruals and reserves                                   | 4,508             | 3,325             |
| Amortization of intangibles                                   | 342               | 430               |
| Inventories   | 1,445             | 672               |
| Legal and environmental accruals                              | 10,090            | 8,805             |
| Deferred compensation   | 10,365            | 9,020             |
| Bad debt and rebate reserves                                  | 1,699             | 1,686             |
| Subsidiaries net operating loss carryforwards                 | 2,846             | 3,154             |
| Tax credits   | 746               | 596               |
| Other   | 4                 | 4                 |
| Deferred Tax Assets   | \$ 44,593         | \$ 41,108         |
| <b>Valuation Allowance</b>                                    | <b>\$ (1,458)</b> | <b>\$ (2,459)</b> |
| <b>Net Deferred Tax Assets</b>                                | <b>\$ 17,381</b>  | <b>\$ 8,954</b>   |
| <b>Reconciliation to Consolidated Balance Sheet:</b>          |                   |                   |
| Current deferred tax assets                                   | \$ 10,362         | \$ 8,239          |
| Non-current deferred tax assets (in other non-current assets) | 9,065             | 3,222             |
| Current deferred tax liabilities (in accrued liabilities)     |                   | (297)             |
| Non-current deferred tax liabilities                          | (2,046)           | (2,210)           |
| <b>Net Deferred Tax Assets</b>                                | <b>\$ 17,381</b>  | <b>\$ 8,954</b>   |

Undistributed earnings of foreign subsidiaries and related companies that are deemed to be permanently reinvested amounted to \$51,226,000 at December 31, 2006 compared to \$45,226,000 at December 31, 2005. In general, the Company reinvests earnings of foreign subsidiaries in their operations indefinitely. However, the Company will repatriate earnings from a subsidiary where excess cash has accumulated and it is advantageous for tax or foreign exchange reasons. Because of the probable availability of foreign tax credits, it is not practicable to estimate the amount, if any, of the deferred tax liability on earnings reinvested indefinitely.

Tax loss carryforwards at December 31, 2006, amounted to \$7,800,000 compared with \$8,329,000 at the end of 2005. All of the tax loss carryforwards have an indefinite carryforward period. Tax credit carryforwards at December 31, 2006, amounted to \$746,000 compared to \$596,000. Of the tax credit carryforwards, \$746,000 expires in 2015.

At December 31, 2006, the Company had valuation allowances of \$1,458,000, which were attributable to the tax loss carryforwards in Germany and Brazil. At December 31, 2005, the Company had valuation allowances of \$2,459,000, which were attributable to the tax loss carryforwards in Germany and Brazil.

The Company's wholly owned subsidiary in Germany recorded sufficient earnings during 2006, to allow the Company to utilize tax loss carryforwards in the amount of \$410,000 for which a valuation allowance had previously been recorded. In addition, \$475,000 of Germany's valuation allowance was released due to anticipated increased future earnings. This adjustment more accurately reflects the Company's estimate using the more likely than not test for the valuation allowance.

Due to a favorable tax law change in Mexico the Company benefited from a tax reduction of \$635,000 during 2006. A transitional tax rule and election available under the law change impacts how inventories and cost of goods sold are recognized for tax purposes. In order to utilize the benefit of the law change in Mexico, the favorable election was made during 2006.

The reserve for tax contingencies related to issues in the U.S. and foreign locations was \$1,857,000 at December 31, 2006 compared to \$870,000 at December 31, 2005. This balance is the Company's best estimate of the potential liability for tax contingencies. The increase in the tax contingency reserve was primarily due to revised estimates of possible tax exposures in state and foreign jurisdictions. Inherent uncertainties exist in estimates of tax contingencies due to changes in tax law; both legislated and concluded through the various jurisdictions' tax court systems. It is the opinion of the Company's management that the possibility is remote that costs ultimately incurred in excess of those accrued, if any, will have a material adverse impact on the Company's financial statements.

In June of 2006, the FASB issued FIN 48, *Accounting for Uncertainty in Income Taxes*, effective for fiscal years beginning after December 15, 2006. This Interpretation is intended to clarify the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, *Accounting of Income Taxes*, by prescribing a more-likely-than-not threshold to recognize any benefit of a tax position taken or expected to be taken in a tax return. Tax positions that meet the recognition threshold are reported at the largest amount that is more-likely-than-not to be realized. FIN 48 revised disclosure requirements and introduces a prescriptive, annual, tabular roll-forward of the unrecognized tax benefits. Companies are required to assess all material open positions in all tax jurisdictions and determine the appropriate amount of tax benefits that are recognizable under FIN 48. The Company continues to evaluate the impact of adopting FIN 48. At this point, the Company does not believe that the adoption of FIN 48 will have a material effect on its financial position, cash flows and results of operations.

#### **8. Stockholders' Equity**

The Company's preferred stock is convertible at the option of the holder at any time (unless previously redeemed) into shares of common stock at a conversion of 1.14175 shares of common stock for each share of preferred stock. Dividends on preferred stock accrue at a rate of \$1.375 per share per annum, which are cumulative from the date of original issue. The Company may not declare and pay any dividend or make any distribution of assets (other than dividends or other distribution payable in shares of common stock) or redeem, purchase or otherwise acquire, shares

of common stock, unless all accumulated and unpaid preferred dividends have been paid or are contemporaneously declared and paid. The preferred stock is subject to optional redemption by the Company, in whole or in part, at any time, at a redemption price of \$25 per share plus accrued and unpaid dividends thereon to the date fixed for redemption. Preferred stock is entitled to 1.14175 votes per share on all matters submitted to stockholders for action and votes together with the common stock as a single class, except as otherwise provided by law or the Certificate of Incorporation of the Company. There is no mandatory redemption or sinking fund obligation with respect to the preferred stock.

At December 31, 2006 and 2005, treasury stock consisted of 1,134,958 and 1,102,309 shares of common stock, respectively.

### ***9. Stock-based Compensation***

On December 31, 2006, the Company had stock options outstanding under its 1992 Stock Option Plan (1992 Plan) and stock options and stock awards outstanding under its 2000 Stock Option Plan (2000 Plan) and its 2006 Incentive Compensation Plan (2006 Plan). The 2006 Plan was approved by shareholders at the Company's annual shareholder meeting held on April 25, 2006. Stock options and stock awards are granted to executives, key employees and outside directors. No further options or awards may be granted under the 1992 Plan or the 2000 Plan. The 2006 Plan authorizes the award of 1,000,000 shares of the Company's common stock for stock options, stock appreciation rights and stock awards. The compensation cost that was charged against income for all plans was \$420,000 for the year ended December 31, 2006. No stock-based compensation was charged against income for the years ended December 31, 2005 and 2004, as the Company did not begin recognizing fair value stock-based compensation expense in its financial statements until January 1, 2006, with the adoption of SFAS No. 123(R). The total income tax benefit recognized in the income statement for share-based compensation arrangements was \$93,000 for the same period. The following provides information regarding the stock option and stock award grants.

#### *Stock Options*

Under all plans, stock option awards are granted with an exercise price equal to the market price of the Company's stock at the date of grant. The market price is defined as the average of the opening and closing prices for Company common stock on the grant date as reported in the New York Stock Exchange Composite Transactions. The option awards generally vest based on two years of continuous service and have 8- to 10-year contractual terms. The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model incorporating the assumptions noted in the following table. Expected volatility is based on the historical volatility of the Company's stock. The Company also uses historical data to estimate the expected term of options granted. The risk-free rate is the U.S. Treasury note rate that corresponds to the expected option term at the date of grant.

|                         | For the Years Ended December 31 |           |           |
|-------------------------|---------------------------------|-----------|-----------|
|                         | 2006                            | 2005      | 2004      |
| Expected dividend yield | 3.00%                           | 2.80%     | 2.80%     |
| Expected volatility     | 23.15%                          | 23.10%    | 22.70%    |
| Expected life           | 7.9 years                       | 7.5 years | 7.5 years |
| Risk-free interest rate | 4.77%                           | 4.15%     | 3.95%     |

A summary of option activity under the Company's stock option plans for the year ended December 31, 2006, is presented below:

|   | Shares    | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value (\$'000) |
|---|-----------|---------------------------------|---|------------------------------------|
|   |           |                                 |   |                                    |
| <b>Options</b>                                  |           |                                 |   |                                    |
| Outstanding at January 1, 2006                  | 1,340,719 | \$ 23.89                        |   |                                    |
| Granted   | 106,995   | 26.50                           |   |                                    |
| Exercised                                       | (197,171) | 21.15                           |   |                                    |
| Forfeited or expired                            | (32,727)  | 24.02                           |   |                                    |
| Outstanding at December 31, 2006                | 1,217,816 | 24.57                           | 4.91  | \$ 8,652                           |
| Vested or expected to vest at December 31, 2006 | 1,214,456 | 24.56                           | 4.90  | \$ 8,634                           |
| Exercisable at December 31, 2006                | 1,114,321 | 24.38                           | 4.53  | \$ 8,118                           |

The weighted-average grant-date fair values of options granted during the years ended December 31, 2006, 2005 and 2004 were \$6.45, \$5.01 and \$5.58, respectively. The total intrinsic values of options exercised during the years ended December 31, 2006, 2005, and 2004 were \$1,805,000, \$712,000, and \$1,076,000, respectively.

As of December 31, 2006, there was \$370,000 of total unrecognized compensation cost related to unvested stock options granted under the Company's stock option plans. That cost is expected to be recognized over a weighted-average period of 1.15 years.

Cash received from stock option exercises under the Company's stock option plans for the years ended December 31, 2006, 2005, and 2004 was \$3,297,000, \$534,000 and \$718,000, respectively. The actual tax benefit realized for the tax deductions from stock option exercises totaled \$685,000, \$278,000, and \$209,000 for the years ended December 31, 2006, 2005, and 2004, respectively.

#### Stock Awards

In February 2006, the Company granted, to employees, stock awards under the 2000 Stock Option Plan. These are the only such awards granted under the plan. The stock awards vest only upon the Company's achievement of certain levels of consolidated net income and return on invested capital by the end of the specified measurement period, in this case December 31, 2008. The number of Company shares of common stock ultimately distributed, if any, is contingent upon the level of consolidated net income and return on invested capital attained. The fair value



of stock awards equals the grant-date market price of the Company's common stock, discounted for the estimated amount of dividends that would not be received during the measurement period. Compensation expense is recorded each reporting period based on the probable number of awards that will ultimately vest given the projected level of consolidated net income and return on invested capital. If at the end of the measurement period the performance objectives are not met, no compensation cost is recognized and any compensation expense recorded in prior periods will be reversed. Compensation cost is currently computed based on management's assessment that the minimum level of the performance objectives will be achieved by the end of the measurement period.

A summary of stock award activity for the year ended December 31, 2006, is presented below:

|                               | Weighted-Average Grant Date |            |
|-------------------------------|-----------------------------|------------|
|                               | Shares                      | Fair Value |
| Unvested Stock Awards         |                             |            |
| Unvested at January 1, 2006   |                             |            |
| Granted                       | 84,000                      | \$ 23.97   |
| Vested                        |                             |            |
| Forfeited                     | 2,000                       | \$ 23.93   |
| Unvested at December 31, 2006 | 82,000                      | \$ 23.97   |

As of December 31, 2006, under the current Company assumption as to the number of stock award shares that will probably vest at the measurement period ended December 31, 2008, there was \$314,000 of unrecognized compensation cost related to unvested stock awards. That cost is expected to be recognized over a period of 2.0 years. No stock award shares vested during the year ended December 31, 2006.

In general, it is the Company's policy to issue new shares of its common stock upon the exercise of stock options or the vesting of stock awards.

#### ***10. Deferred Compensation and Related Investments***

The Company sponsors deferred compensation plans that allow management to defer receipt of their bonuses and outside directors to defer receipt of their fees until retirement or departure from the Company or as elected. The deferred amounts are invested in mutual funds or Company common stock. The compensation expense and related deferred compensation obligation to the participants who elect deferral are recorded when the underlying compensation is earned. The deferred obligation may increase or decrease based on the performance results of investment options—a limited selection of mutual funds or Company common stock—chosen by the plan participants. The Company maintains at least enough Company common stock in treasury to cover the equivalent number of common stock shares resulting from participants electing the Company common stock investment option, which periodically requires the Company to purchase its common shares from the open market. When plan distributions are made to retired/departed participants, such distributions are made, in cash or shares of Stepan Company common stock at the option of the participant, in amounts equivalent to the payment date value of the investment choices made by the participant. Since the deferred compensation obligations

may be settled in cash, each reporting period the Company must record any appreciation in the value of the participant's plan balances as additional compensation expense. Conversely, declines in the market value of the investment choices made by the participant reduce compensation expense in the periods that the market value declines. The resulting increases and reductions of compensation expense are recorded in the Administrative expense line of the Consolidated Statements of Income. The additional compensation expense resulting from the appreciation of the market value and earnings of the selected investment options was \$3,672,000 in 2006, \$2,094,000 in 2005 and \$693,000 in 2004. The Company's deferred compensation liability was \$24,069,000 and \$22,118,000 at December 31, 2006 and 2005, respectively.

In December 2006, the Company, with prior Board of Director approval, adopted an amended and restated management incentive plan. The amendment provided participants with an irrevocable 2006 election to transfer all or a portion of their deferred compensation accounts that were attributable to pre-2007 bonuses to an alternate Company common stock investment option. The number of share equivalents credited to the participants' accounts for this option was based on the December 31, 2006, closing price of the Company's common stock. The share equivalents transferred to the alternate investment option can be distributed (upon a participant's retirement or departure from the Company) only in shares of Stepan Company common stock (i.e., there can be no cash settlements of these amounts). Furthermore, such amounts cannot be transferred to the plan's other investment options. As a result of the irrevocable 2006 election, the share equivalent amounts transferred to the participants' deferred compensation accounts were treated as equity instruments, and on December 31, 2006, \$1,542,000 was reclassified from the deferred compensation liability to additional paid-in capital in the Stockholders' Equity section of the Consolidated Balance Sheets. In addition to the irrevocable 2006 election noted above, the amended plan rules also mandate that all future deferrals of bonuses to the Company common stock investment option will all be directed to the alternate Company common stock investment option. The Company implemented this plan change to reduce some of the deferred compensation plan expense volatility as expense treatment is not required for future fluctuations in the value of these shares.

The Company purchases shares of mutual funds in accordance with the mutual fund investment selections made by the participants. Such investments are classified as available-for-sale and included in Other non-current assets in the Consolidated Balance Sheets. These investments are recorded at cost when purchased and adjusted to their fair market values at the end of each reporting period with unrealized gains and losses recorded as direct adjustments to stockholders' equity in Accumulated other comprehensive loss. If the accumulated unrealized loss for a particular mutual fund is considered other-than-temporary, the loss is reclassified out of Accumulated other comprehensive loss and recorded as an impairment loss in the Consolidated Statements of Income. The fair value of the affected mutual fund would then become its new cost basis for future gain/loss computations. Impairment losses, realized gains and losses from sales of mutual funds, dividend income and capital gains distributions are recorded in the Other, net caption under the Other Income (Expense) section of the Consolidated Statements of Income. The Company uses the average cost method to determine investment gains and losses.

The aggregate fair value of the mutual fund investments and gross unrealized gains or losses related to such investments at December 31, 2006 and 2005, were as follows:

| <i>(Dollars in thousands)</i> | 2006      | 2005      |
|-------------------------------|-----------|-----------|
| Aggregate fair value          | \$ 13,648 | \$ 10,836 |
| Gross unrealized gains        | 911       | 733       |
| Gross unrealized losses       | 1         | 25        |

The following table displays additional information about the mutual fund investments with gross unrealized losses at December 31, 2006 and 2005:

| <i>(Dollars in thousands)</i> | Length of Time in Loss Position |                      |                              |                      | Total    |                      |
|-------------------------------|---------------------------------|----------------------|------------------------------|----------------------|----------|----------------------|
|                               | Less than 12 Months<br>Fair     | Unrealized<br>Losses | 12 Months or Greater<br>Fair | Unrealized<br>Losses | Fair     | Unrealized<br>Losses |
| December 31, 2006             | \$ 473                          | \$ 1                 | \$ 473                       | \$ 1                 | \$ 473   | \$ 1                 |
| December 31, 2005             | \$ 2,942                        | \$ 17                | \$ 241                       | \$ 8                 | \$ 3,183 | \$ 25                |

Dividend income and realized gains and losses from sales of mutual fund investments recorded in the Consolidated Statements of Income and unrealized gains and losses recorded directly to stockholders equity for the years ended December 31, 2006, 2005 and 2004, were as follows:

| <i>(Dollars in thousands)</i>   | For the Years Ended<br>December 31 |        |        |
|---------------------------------|------------------------------------|--------|--------|
|                                 | 2006                               | 2005   | 2004   |
| Dividend income                 | \$ 1,026                           | \$ 424 | \$ 471 |
| Realized gains/(losses)         | 143                                | 208    | 2      |
| Unrealized gains (net of taxes) | 124                                | 60     | 242    |

There were no impairment losses recorded in 2006, 2005 or 2004.

### *11. Post Retirement Benefit Plans*

#### Defined Benefit Plans

The Company has funded non-contributory defined benefit plans covering substantially all U.S. employees and two unfunded non-qualified defined benefit pension plans (a supplemental executive plan and an outside directors plan). There is also a funded defined benefit plan for the Company's United Kingdom subsidiary. The benefits under these plans are based primarily on years of service and compensation levels. The Company generally funds the qualified pension plans up to the maximum amount deductible for income tax purposes.

Throughout the first half of 2006, amendments were made to four of the Company's defined benefit pension plans: the U.S. funded salaried defined benefit pension plan, the non-qualified unfunded supplemental executive defined benefit pension plan, the Maywood, New

Jersey, hourly defined benefit pension plan and the Stepan United Kingdom (UK) defined benefit pension plan. The amendments, which were similar for all four plans, took effect on July 1, 2006. The Company froze the defined benefit pension plans at June 30, 2006, and, as a result, accruals for service benefits ceased as of that date. Benefits earned through June 30, 2006, are available to participants when they retire, in accordance with the terms of the plans. The noted defined benefit pension plans were replaced with Company contributions to participants defined contribution accounts equal to a fixed percent of base salary. This change had no impact on current retirees or former employees with vested benefits or employees who terminated or retired by June 30, 2006. The Company will continue to recognize pension expense and cash funding obligations for the frozen defined benefit plans over the remaining lives of the pension liabilities. The Company also continues to recognize pension expense for the frozen unfunded supplemental executive defined benefit plan. Details of the effects of the pension plan amendments follow.

#### **U.S. Salaried and Supplemental Executive Defined Benefit Pension Plans**

In February 2006, the Company's Board of Directors approved amendments to the Company's U.S. funded salaried defined benefit pension plan and its non-qualified unfunded supplemental executive defined benefit pension. As a result of the announced pension plan amendments, the Company remeasured the obligations and assets of the salaried and supplemental executive defined benefit pension plans at February 14, 2006. The assumptions used in the remeasurement of the pension plan obligations were the same as those used in the December 31, 2005, measurement. The effects of the plan amendments were reductions of \$14,310,000 and \$493,000 in the projected benefit obligations for the salaried and supplemental executive defined benefit pension plans, respectively. In addition, the amendments triggered an \$111,000 curtailment loss that was recognized as a component of the net periodic benefit cost recorded for the three-month period ended March 31, 2006.

#### **Maywood, New Jersey, Hourly Defined Benefit Pension Plan**

In April 2006, the hourly workers at the Company's Maywood, New Jersey, plant ratified a new union contract, which resulted in amendments to the hourly defined benefit pension plan. The Company remeasured the obligations and assets of the Maywood hourly defined benefit pension plan at April 18, 2006. With the exception of the discount rate, which was increased from 5.75 percent to 6.25 percent, the assumptions used in the remeasurement of the pension plan obligations were the same as those used in the December 31, 2005, measurement. The amendment triggered a \$281,000 curtailment loss that was recognized as a component of the net periodic benefit cost recorded for the three-month period ended June 30, 2006.

#### **Stepan UK Defined Benefit Pension Plan**

In June 2006, Stepan UK pension plan trustees approved amendments to the Stepan UK defined benefit pension plan. As a result, the plan obligations and assets were remeasured at June 5, 2006. The discount rate used to measure the plan obligations was updated to a current rate of 5.00 percent compared to 4.70 percent used to measure plan obligations at December 31, 2005. The effect of the plan amendments was a \$1,816,000 reduction in the projected benefit obligations of the Stepan UK defined benefit pension plan. No curtailment gain or loss was triggered as a result of the remeasurement.

In December 2006, the Company adopted SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Post Retirement Plans*. The following table displays the incremental effect of applying the new accounting standard on the individual lines of the consolidated balance sheet at December 31, 2006:

|                                      | <b>Before</b>         |                    |  | <b>After</b>          |  |
|--------------------------------------|-----------------------|--------------------|--|-----------------------|--|
|                                      | <b>Application of</b> |                    |  | <b>Application of</b> |  |
|                                      | <b>SFAS No.</b>       |                    |  | <b>SFAS No.</b>       |  |
| <i>(Dollars in thousands)</i>        | <b>158</b>            | <b>Adjustments</b> |  | <b>158</b>            |  |
| Other non-current assets             | \$ 37,369             | \$ (588)           |  | \$ 36,781             |  |
| Total assets                         | 546,643               | (588)              |  | 546,055               |  |
| Accrued liabilities                  | 53,262                | (4,612)            |  | 48,650                |  |
| Other non-current liabilities        | 69,997                | 4,577              |  | 74,574                |  |
| Accumulated other comprehensive loss | (13,739)              | (553)              |  | (14,292)              |  |
| Total stockholders' equity           | 181,339               | (553)              |  | 180,786               |  |

**Obligations and Funded Status at December 31**

| <i>(Dollars in thousands)</i>           | United States |            | United Kingdom |           |
|---|---------------|------------|----------------|-----------|
|   | 2006          | 2005       | 2006           | 2005      |
| <b>Change in benefit obligation</b>     |               |            |                |           |
| Benefit obligation at beginning of year | \$ 118,958    | \$ 105,862 | \$ 17,423      | \$ 14,768 |
| Service cost                            | 1,806         | 3,617      | 409            | 665       |
| Interest cost                           | 6,056         | 5,952      | 865            | 729       |
| Plan participant contributions          |               |            | 141            | 282       |
| Actuarial (gain) / loss                 | (2,834)       | 6,803      | (477)          | 2,921     |
| Curtailement                            | (14,803)      | (295)      | (1,816)        |           |
| Benefits paid                           | (3,105)       | (2,981)    | (267)          | (178)     |
| Foreign exchange impact                 |               |            | 2,387          | (1,764)   |
| Benefit obligation at end of year       | \$ 106,078    | \$ 118,958 | \$ 18,665      | \$ 17,423 |

| <i>(Dollars in thousands)</i>                  | United States |             | United Kingdom |            |
|--|---------------|-------------|----------------|------------|
|  | 2006          | 2005        | 2006           | 2005       |
| <b>Change in plan assets</b>                   |               |             |                |            |
| Fair value of plan assets at beginning of year | \$ 73,798     | \$ 70,025   | \$ 10,912      | \$ 9,772   |
| Actual return on plan assets                   | 9,730         | 4,959       | 1,047          | 1,883      |
| Employer contributions                         | 5,896         | 1,795       | 483            | 284        |
| Plan participant contributions                 |               |             | 141            | 282        |
| Benefits paid                                  | (3,105)       | (2,981)     | (267)          | (178)      |
| Foreign exchange impact                        |               |             | 1,502          | (1,131)    |
| Fair value of plan assets at end of year       | \$ 86,319     | \$ 73,798   | \$ 13,818      | \$ 10,912  |
| Funded status                                  | \$ (19,759)   | \$ (45,160) | \$ (4,847)     | \$ (6,511) |
| Unrecognized net actuarial loss                |               | 44,895      |                | 3,997      |
| Unrecognized prior service cost                |               | 1,551       |                |            |
| Net amount recognized                          | \$ (19,759)   | \$ 1,286    | \$ (4,847)     | \$ (2,514) |

The amounts recognized in the Consolidated Balance Sheets at December 31, 2006, consist of

| <i>(Dollars in thousands)</i> | United States | United Kingdom |
|-------------------------------|---------------|----------------|
| Current liability             | \$ (297)      | \$             |
| Non-current liability         | (19,462)      | (4,847)        |
| Net amount recognized         | \$ (19,759)   | \$ (4,847)     |

The amounts recognized in accumulated other comprehensive income at December 31, 2006, consist of

| <i>(Dollars in thousands)</i> | United States | United Kingdom |
|-------------------------------|---------------|----------------|
| Net actuarial loss            | \$ 22,786     | \$ 1,835       |
| Prior service cost            | 938           |                |

|                       |    |        |    |       |
|-----------------------|----|--------|----|-------|
| Net amount recognized | \$ | 23,724 | \$ | 1,835 |
|-----------------------|----|--------|----|-------|

The amounts recognized in the Consolidated Balance Sheets at December 31, 2005, consist of

| <i>(Dollars in thousands)</i>          | United States | United Kingdom |
|--|---------------|----------------|
| Accrued benefit cost                   | \$ (29,741)   | \$ (5,058)     |
| Intangible asset                       | 1,682         |                |
| Accumulated other comprehensive income | 29,345        | 2,544          |
| Net amount recognized                  | \$ 1,286      | \$ (2,514)     |

Below is information for pension plans with accumulated benefit obligations in excess of plan assets at December 31:

| <i>(Dollars in thousands)</i>  | United States |            | United Kingdom |           |
|--------------------------------|---------------|------------|----------------|-----------|
|                                | 2006          | 2005       | 2006           | 2005      |
| Projected benefit obligation   | \$ 106,078    | \$ 118,958 | \$ 18,665      | \$ 17,423 |
| Accumulated benefit obligation | 106,078       | 103,539    | 18,665         | 15,970    |
| Fair value of plan assets      | 86,319        | 73,798     | 13,818         | 10,912    |



**Components of Net Periodic Benefit Cost and Other Amounts Recognized in Other Comprehensive Income**

Net periodic pension costs for the years ended December 31, 2006, 2005 and 2004 were as follows:

| <i>(Dollars in thousands)</i>      | United States   |                 |                 | United Kingdom |               |               |
|------------------------------------|-----------------|-----------------|-----------------|----------------|---------------|---------------|
|                                    | 2006            | 2005            | 2004            | 2006           | 2005          | 2004          |
| Service cost                       | \$ 1,806        | \$ 3,617        | \$ 3,411        | \$ 409         | \$ 665        | \$ 601        |
| Interest cost                      | 6,056           | 5,952           | 5,643           | 865            | 729           | 676           |
| Expected return on plan assets     | (6,693)         | (6,575)         | (6,592)         | (789)          | (620)         | (584)         |
| Amortization of prior service cost | 221             | 355             | 380             |                |               |               |
| Amortization of net loss           | 1,435           | 1,952           | 1,162           | 85             | 61            | 75            |
| Curtailment loss                   | 392             |                 |                 |                |               |               |
| <b>Net periodic benefit cost</b>   | <b>\$ 3,217</b> | <b>\$ 5,301</b> | <b>\$ 4,004</b> | <b>\$ 570</b>  | <b>\$ 835</b> | <b>\$ 768</b> |

Other changes in plan assets and benefit obligations recognized in other comprehensive income for the years ended December 31, 2006, 2005 and 2004 were as follows:

| <i>(Dollars in thousands)</i>          | United States |          |          | United Kingdom |          |          |
|--|---------------|----------|----------|----------------|----------|----------|
|  | 2006          | 2005     | 2004     | 2006           | 2005     | 2004     |
| Change in additional minimum liability | \$ (6,525)    | \$ 3,804 | \$ 4,065 | \$ (709)       | \$ 1,479 | \$ (355) |

The estimated amounts that will be amortized from accumulated other comprehensive income into net periodic benefit cost in 2007 are as follows:

| <i>(Dollars in thousands)</i> | United States   | United Kingdom |
|-------------------------------|-----------------|----------------|
| Net actuarial loss            | \$ 1,233        | \$             |
| Prior service cost            | 197             |                |
| <b>Total</b>                  | <b>\$ 1,430</b> | <b>\$</b>      |

**Estimated Future Benefit Payments**

| <i>(Dollars in thousands)</i> | United States | United Kingdom |
|-------------------------------|---------------|----------------|
| 2007                          | \$ 3,990      | \$ 39          |
| 2008                          | 4,413         | 92             |
| 2009                          | 4,820         | 94             |
| 2010                          | 5,210         | 96             |
| 2011                          | 5,591         | 129            |
| 2012 - 2016                   | 34,232        | 1,508          |

## Assumptions

The weighted-average assumptions used to determine benefit obligations at December 31 were as follows:

|                               | United States |       | United Kingdom |       |
|-------------------------------|---------------|-------|----------------|-------|
|                               | 2006          | 2005  | 2006           | 2005  |
| Discount rate                 | 6.00%         | 5.75% | 5.10%          | 4.70% |
| Rate of compensation increase |               | 4.01% |                | 4.70% |

The weighted-average assumptions used to determine net periodic benefit costs for years ended December 31 were as follows:

| <i>(Dollars in thousands)</i>            | United States |       |       | United Kingdom |       |       |
|--|---------------|-------|-------|----------------|-------|-------|
|  | 2006          | 2005  | 2004  | 2006           | 2005  | 2004  |
| Discount rate                            | 5.75%         | 5.75% | 6.00% | 4.90%          | 5.20% | 5.40% |
| Expected long-term return on plan assets | 8.50%         | 8.50% | 8.50% | 6.50%          | 7.20% | 6.80% |
| Rate of compensation increase            | 4.01%         | 4.01% | 4.01% | 4.70%          | 4.70% | 4.70% |

## Investment Strategies and Policies

### U.S. Plans

Plan assets are invested using active investment strategies, as compared to passive or index investing. An investment consulting firm hires and monitors underlying investment management firms for each asset category. Managers within each asset category cover a range of investment styles and approaches and are combined in a way that controls for capitalization and style biases (for equities), and interest rate risk (for fixed income, or bonds) versus benchmark indexes, while focusing primarily on stock and bond selection to improve returns. International equities use the same capitalization and style biases, but do so for non-US companies from developed countries. Real estate uses private core real estate strategies, which provide stable and high levels of current income and enhanced core strategies, which seek slightly higher returns emphasizing appreciation. Absolute return investments produces low volatility returns with a low correlation to traditional assets by combining individual hedge funds that can generate positive returns in a variety of markets.

Risk is controlled through diversification among multiple asset categories, managers, styles, and securities. The investment management firm recommends asset allocations based on the Company's plan needs and benchmark data for similar plans. The asset allocation targets are approved by the Company's Plan Committee. Risk is further controlled both at the manager and asset category level by assigning targets for risk versus investment returns. Real estate uses guidelines for advisor allocation, investment size, geographic diversification and leverage. Absolute return investments invest in multiple funds using one of five different strategies. The investment manager and evaluates performance by the underlying managers against these targets.

Allowable investment categories include:

**Equities:** Common stocks of large, medium, and small companies, including both U.S. and non-U.S. based companies. The long-term target allocation for equities, excluding Company stock, is 51 percent.

**Fixed Income (Debt):** Bonds or notes issued or guaranteed by the U.S. government, and to a lesser extent, by non-U.S. governments, or by their agencies or branches, mortgage backed securities, including collateralized mortgage obligations, corporate bonds and dollar-denominated debt securities issued in the U.S. by non-U.S. banks and corporations. Up to 15 percent of the fixed income assets may be in debt securities that are below investment grade. The target allocation for fixed income is 26 percent.

**Real Estate:** Private real estate funds using office, apartment, industrial, retail, and other property types. No greater than 40 percent can be invested with any advisor, no more than 33 percent in any fund, no greater than 33 percent in any of eight U.S. regions, and portfolio leverage is limited to 30 percent. The target allocation for real estate is four percent.

**Absolute Return Investments (Hedge Funds):** Utilizes fund of funds approach using long/short, market neutral, event-driven, convertible arbitrage, and fixed income arbitrage strategies. The target allocation for absolute return is four percent.

**Employer Securities:** The retirement Plans also hold shares of the Company's common and preferred stock, which are purchased or sold by the trustee from time to time, as directed by the Plan Committee. The Plans did not purchase or sell employer securities during 2006 or 2005. The target allocation for employer securities is 15 percent.

In addition to these primary investment types, excess cash may be invested in futures in order to efficiently achieve more fully invested portfolio positions. Otherwise, a small number of investment managers make limited use of derivatives, including futures contracts, options on futures and interest rate swaps in place of direct investment in securities to efficiently achieve equivalent market positions. Derivatives are not used to leverage portfolios.

#### ***U.K. Plan***

The objective of the U.K. defined benefit pension fund investment strategy is to maximize the long term rate of return on plan assets within a medium level of risk in order to minimize the cost of providing pension benefits. To that end, the plan assets are invested in an actively managed pooled fund that diversifies its holdings among equity securities, debt securities, property and cash. Although there are no formal target allocations for the plan assets, the fund will generally be heavily invested in equity securities. Equity securities are selected from U.K., European, U.S. and emerging market companies. Bonds comprise both U.K. government notes and bonds of U.K. and other countries' corporate notes. There are no specific prohibited investments, but the current managed fund will not allocate assets to derivatives or other financial hedging instruments. Plan trustees meet regularly with the fund manager to assess the fund's performance.

**Plan Assets**

The Company's asset allocations for its pension plans at December 31, 2006 and 2005, by asset category, were as follow:

| Asset Category                 | United States |             | United Kingdom |             |
|--------------------------------|---------------|-------------|----------------|-------------|
|                                | 2006          | 2005        | 2006           | 2005        |
| Equity securities              | 67%           | 66%         | 84%            | 85%         |
| Fixed income (debt) securities | 26%           | 26%         | 11%            | 8%          |
| Real estate securities         | 4%            | 4%          |                |             |
| Absolute return securities     | 3%            | 4%          |                |             |
| Other                          |               |             | 5%             | 7%          |
| <b>Total</b>                   | <b>100%</b>   | <b>100%</b> | <b>100%</b>    | <b>100%</b> |

Equity securities for the U.S. plans include the Company's common stock in the amounts of \$13,161,000 (15 percent of total plan assets) and \$11,175,000 (15 percent of total plan assets) at December 31, 2006 and 2005, respectively.

**Long-term Rate of Return for Plan Assets*****U.S. Plans***

The overall expected long-term rate of return on assets of 8.5 percent is based on plan asset allocation, capital markets forecasts and expected benefits of active investment management. For fixed income, the expected return is based on a long-term risk-free return assumed to be 6.0 percent for U.S. government securities, plus an additional 0.5 percent reflecting the risk premium for corporate bonds in the portfolio, for an overall average return of 6.5 percent. For equities, a 3.0 percent premium is added to the 6.0 percent risk-free rate for an expected return of 9.0 percent. For real estate, the expected return is 7.0 percent. For absolute return, the expected return is 7.7 percent.

The overall investment return forecast reflects the target allocations and the capital markets forecasts for each asset category, plus a premium for active asset management expected over the long-term.

***U.K. Plan***

The overall expected long term return on plan assets is a weighted average of the expected long term returns for equity securities, debt securities and other assets. The redemption yield at the measurement date on U.K. government fixed interest bonds and the yield on corporate bonds are used as proxies for the return on the debt portfolio. Weighting by the relative proportion of each

within the actual portfolio leads to the expected return on debt securities. For equities, a premium of three percent added to the risk-free rate. The holding of other assets is less significant. An overall expected return in line with U.K. bank base interest rates is adopted.

### Cash Flows

The Company expects to contribute approximately \$4,185,000 to its funded U.S. qualified defined benefit pension plans in 2007. The Company also expects to pay \$297,000 in 2007 related to its unfunded non-qualified pension plans. Stepan UK expects to contribute approximately \$427,000 to its funded defined benefit pension plan in 2007.

### Defined Contribution Plans

In July 2006, the Company established funded qualified defined contribution plans covering the employees affected by the freezes of the U.S. salaried, Maywood hourly and United Kingdom defined benefit pension plans. The U.S. plans have a fixed Company contribution rate of four percent of base salaries. No employee contribution is required. In addition to the fixed contributions, the Company makes additional discretionary transition contributions to partially compensate certain U.S. participants for the anticipated loss in benefits resulting from freezing the defined benefit plans. The transition contributions will be made through 2010. The United Kingdom plan requires employee and Company contributions of 6.15 percent and 7.5 percent of base salaries, respectively. Defined contribution pension plan expense was \$2,232,000 for the year ended December 31, 2006, of which \$857,400 related to the U.S. transition contributions. There was no comparable expense in 2005 or 2004.

The Company also sponsors a funded qualified profit sharing plan for its U.S. salaried employees and for some hourly employees. Company contributions are determined each year using a formula that is tied to Company profits. The contributions are allocated to participants' accounts on the basis of the participants' base earnings. Profit sharing expense was \$800,000 and \$865,000 for the years ended December 31, 2006 and 2005, respectively. There was no profit sharing expense in 2004.

### 12. Accrued Liabilities

The composition of accrued liabilities is as follows:

| <i>(Dollars in thousands)</i> | December 31 |           |
|-------------------------------|-------------|-----------|
|                               | 2006        | 2005      |
| Accrued payroll and benefits  | \$ 18,907   | \$ 22,389 |
| Accrued customer discounts    | 6,403       | 7,284     |
| Other accrued liabilities     | 23,340      | 14,190    |
| Total accrued liabilities     | \$ 48,650   | \$ 43,863 |

**13. Other Non-Current Liabilities**

The composition of other non-current liabilities is as follows:

| <i>(Dollars in thousands)</i>       | December 31      |                  |
|-------------------------------------|------------------|------------------|
|                                     | 2006             | 2005             |
| Deferred revenue                    | \$ 6,068         | \$ 1,185         |
| Environmental and legal matters     | 17,408           | 17,337           |
| Deferred compensation liability     | 23,369           | 21,369           |
| Pension liability                   | 24,309           | 31,162           |
| Other non-current liabilities       | 3,420            | 3,308            |
| Total other non-current liabilities | <b>\$ 74,574</b> | <b>\$ 74,361</b> |

**14. Contingencies**

There are a variety of legal proceedings pending or threatened against the Company. Some of these proceedings may result in fines, penalties, judgments or costs being assessed against the Company at some future time. The Company's operations are subject to extensive local, state and federal regulations, including the U.S. Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA) and the Superfund amendments of 1986 ( Superfund ). Over the years, the Company has received requests for information related to or has been named by the government as a PRP at 22 waste disposal sites where clean up costs have been or may be incurred under CERCLA and similar state statutes. In addition, damages are being claimed against the Company in general liability actions for alleged personal injury or property damage in the case of some disposal and plant sites. The Company believes that it has made adequate provisions for the costs it may incur with respect to these sites.

The Company has estimated a range of possible environmental and legal losses from \$13.8 million to \$42.9 million at December 31, 2006. At December 31, 2006, the Company's accrued liability for such losses, which represents the Company's best estimate within the estimated range of possible environmental and legal losses, was \$22.1 million compared to \$18.6 million at December 31, 2005.

For certain sites, estimates cannot be made of the total costs of compliance, or the Company's share of such costs; accordingly, the Company is unable to predict the effect thereof on the Company's financial position, cash flows and results of operations. Management believes that in the event of one or more adverse determinations in any annual or interim period, the impact on the Company's cash flows and results of operations for those periods could be material. However, based upon the Company's present belief as to its relative involvement at these sites, other viable entities' responsibilities for cleanup, and the extended period over which any costs would be incurred, the Company believes that these matters, individually and in the aggregate, will not have a material effect on the Company's financial position.

Following are summaries of the material contingencies at December 31, 2006:

***Maywood, New Jersey, Site***

The Company's property in Maywood, New Jersey and property formerly owned by the Company adjacent to its current site and other nearby properties (Maywood site) were listed on the National Priorities List in September 1993 pursuant to the provisions of CERCLA because of certain alleged chemical contamination. Pursuant to an Administrative Order on Consent entered into between USEPA and the Company for property formerly owned by the Company, and the issuance of an order by USEPA to the Company for property currently owned by the Company, the Company completed a Remedial Investigation Feasibility Study (RI/FS) in 1994. The Company submitted the Draft Final FS for Soil and Source Areas (Operable Unit 1) in September 2002. In addition, the Company submitted the Draft Final FS for Groundwater (Operable Unit 2) in June 2003. The Company is awaiting the issuance of a Record of Decision (ROD) from USEPA relating to the Maywood site and the proposed chemical remediation. The final ROD will be issued sometime after a public comment period.

Also, the New Jersey Department of Environmental Protection (NJDEP) filed a complaint against the Company and other entities on February 6, 2006, alleging that the defendants discharged hazardous substances at the Maywood site and at neighboring properties not part of the Maywood site resulting in damage to natural resources and the incurrence of response costs. The complaint was amended and removed to federal court but was remanded to state court on September 22, 2006.

The Company believes it has adequate reserves for claims associated with the Maywood site, and has recorded a liability for the estimated probable costs it expects to incur at the Maywood site related to remediation of chemical contamination. However, depending on the results of the ongoing discussions with USEPA, the final cost of such remediation could differ from the current estimates.

In addition, under the terms of a settlement agreement reached on November 12, 2004, the United States Department of Justice and the Company agreed to fulfill the terms of a Cooperative Agreement reached in 1985 under which the United States will take title to and responsibility for radioactive waste removal at the Maywood site, including past and future remediation costs incurred by the United States.

***Ewan, D Imperio and Lightman Drum Company Sites***

During the mid-1970's, Jerome Lightman and the Lightman Drum Company allegedly disposed of hazardous substances at several sites in New Jersey. The Company has been named as a potentially responsible party (PRP) in the case *United States v. Lightman* (1:92-cv-4710 D.N.J.), which involves the D Imperio Superfund Site and the Ewan Superfund Site, both located in New Jersey. The Company has reached an agreement in principal with respect to the past costs and future allocation percentage in said litigation for costs related to the D Imperio Superfund Site, including costs to comply with USEPA's Unilateral Administrative Orders, as well as for the past costs and allocation percentage at the Ewan Superfund Site. Such agreement in principal is subject to additional approvals, including final execution of a settlement agreement in the first half of 2007. On a related matter, if the aforementioned litigation is settled, the Company, as a

condition of settlement, will dismiss its appeal currently pending in the United States Third Circuit Court of Appeals objecting to the lodging of a partial consent decree in favor of the United States Government in this litigation. Under the partial consent decree, the government recovered past costs at the D Imperio Superfund Site from all PRPs including the Company. The Company paid its assessed share but will not seek to recover the sums it paid if the settlement is finalized. The Company believes that a resolution of its liability for this litigation will not have a material impact on the financial position, results of operations or cash flows of the Company.

Regarding the D Imperio Superfund Site, USEPA previously indicated it would seek penalty claims against the Company based on the Company's alleged noncompliance with the Modified Unilateral Administrative Order issued in January 2000 (Order). In December 2004, the Company entered into a Consent Decree with USEPA, which resolves USEPA's claims asserted against the Company for the alleged noncompliance with the Order. The settlement amount paid pursuant to the Consent Decree did not have a material impact on the financial position, results of operations or cash flows of the Company. In addition, the Company received notice from the NJDEP dated March 21, 2001, that NJDEP will pursue cost recovery against the alleged responsible parties, including the Company, in connection with the D Imperio Superfund Site. The NJDEP's claims include costs related to remediation of the D Imperio Superfund Site in the amount of \$434,406 (as of November 3, 2000) and alleged natural resource damages in the amount of \$529,584. The NJDEP settled such claims against the alleged responsible parties, resulting in the Company paying its portion (\$83,061) in July 2002.

In addition to the Ewan and D Imperio Superfund Sites, the Company received a Section 104(e) Request for Information from USEPA dated March 21, 2000, regarding the Lightman Drum Company Site located in Winslow Township, New Jersey. The Company responded to this request on May 18, 2000. In addition, the Company received a Notice of Potential Liability and Request to Perform RI/FS dated June 30, 2000, from USEPA. The Company has decided that it will participate in the performance of the RI/FS as a member of the Lightman Yard PRP Group. Due to the addition of other PRPs, the Company allocation percentage has decreased.

However, the allocation has not yet been finalized by the Lightman Yard PRP Group. In the fourth quarter of 2005, the Company paid a third assessment in the amount of \$42,280.

The Company believes that based on current information it has adequate reserves for the Jerome Lightman-related environmental sites.

#### ***Wilmington Site***

The Company is currently contractually obligated to contribute to the response costs associated with the Company's formerly-owned site at 51 Eames Street, Wilmington, Massachusetts. Remediation at this site is being managed by its current owner to whom the Company sold the property in 1980. Under the agreement, once total site remediation costs exceed certain levels, the Company is obligated to contribute up to five percent of future response costs associated with this site with no limitation on the ultimate amount of contributions. To date, the Company has paid the current owner \$1.2 million for the Company's portion of environmental response costs through the third quarter of 2006 (the current owner of the site bills the Company one calendar quarter in arrears). At December 31, 2006, the Company has increased its reserve from \$0.7 million to \$1.1 million for current and future claims associated with this site. Depending on the ultimate cost of the remediation at this site, the amount for which the Company is liable could differ from the current estimates.



In addition, the Company received a Notice of Potential Liability letter from USEPA dated January 12, 2006, regarding this site. The Company's response was filed on January 31, 2006. The Company then received a special notice letter from USEPA dated June 19, 2006, advising the Company and the other PRPs at the site, that they have 45 days to begin negotiations with USEPA to conduct certain response actions, including an RI/FS at the site. The PRPs responded to USEPA on August 25, 2006, that they will agree to participate in such negotiations in order to reach an agreement on the performance of an RI/FS for the site. The PRPs are awaiting a response from USEPA.

The Company and other prior owners also entered into an agreement in April 2004 waiving certain statute of limitations defenses for claims which may be filed by the Town of Wilmington, Massachusetts, in connection with this site. While the Company has denied any liability for any such claims, the Company agreed to this waiver while the parties continue to discuss the resolution of any potential claim, which may be filed.

On February 15, 2007, the Company executed a settlement agreement with 19 plaintiffs regarding alleged personal injury claims they asserted against the Company and other prior owners regarding this site. The plaintiffs' attorney executed the settlement on behalf of his clients. The agreement is expected to be submitted to the court for approval during March. As a result of this settlement, the Company recorded a fourth quarter charge of \$3.0 million for this settlement.

The Company believes that based on current information it has adequate reserves for the claims related to this site.

### ***15. Segment Reporting***

The Company has three reportable segments: surfactants, polymers and specialty products. Each segment provides distinct products and requires separate management due to unique markets, technologies and production processes. Surfactants are used in a variety of consumer and industrial cleaning compounds as well as in agricultural products, lubricating ingredients, biodiesel and other specialized applications. Polymers generates its revenues from the sale of phthalic anhydride, polyols and polyurethane systems used in plastics, building materials and refrigeration systems. Specialty products sell chemicals used in food, flavoring and pharmaceutical applications.

The Company evaluates the performance of its segments and allocates resources based on operating income before interest income/expense, other income/expense items and income tax provisions. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies.

Effective January 1, 2005, the Company changed the components of its segment operating income to reflect a change in the information now used by the chief operating decision makers in reviewing segment results. In 2005, the Company began charging corporate manufacturing expenses, which are corporate support expenses for engineering, purchasing and transportation, against the reportable segments' operating income. In prior years, these expenses were charged to unallocated corporate expense.

Segment data for the three years ended December 31, 2006, 2005 and 2004, are as follows:

| <i>(Dollars in thousands)</i>          | <i>Surfactants</i> | <i>Polymers</i> | <i>Specialty Products</i> | <i>Segment Totals</i> |
|--|--------------------|-----------------|---------------------------|-----------------------|
| <b>2006</b>                            |                    |                 |                           |                       |
| Net sales                              | \$ 880,327         | \$ 264,167      | \$ 28,089                 | \$ 1,172,583          |
| Operating income                       | 21,249             | 26,106          | 3,225                     | 50,580                |
| Assets                                 | 393,399            | 99,057          | 24,099                    | 516,555               |
| Capital expenditures                   | 32,526             | 8,181           | 4,967                     | 45,674                |
| Depreciation and amortization expenses | 29,216             | 5,948           | 1,281                     | 36,445                |
| <b>2005</b>                            |                    |                 |                           |                       |
| Net sales                              | \$ 823,603         | \$ 228,457      | \$ 26,317                 | \$ 1,078,377          |
| Operating income                       | 20,084             | 26,652          | 5,257                     | 51,993                |
| Assets                                 | 366,843            | 86,957          | 21,698                    | 475,498               |
| Capital expenditures                   | 26,651             | 13,056          | 1,536                     | 41,243                |
| Depreciation and amortization expenses | 29,426             | 5,523           | 1,810                     | 36,759                |
| <b>2004</b>                            |                    |                 |                           |                       |
| Net sales                              | \$ 709,487         | \$ 199,235      | \$ 27,094                 | \$ 935,816            |
| Operating income                       | 24,871             | 22,549          | 6,618                     | 54,038                |
| Assets                                 | 358,223            | 78,602          | 18,635                    | 455,460               |
| Capital expenditures                   | 27,212             | 5,274           | 807                       | 33,293                |
| Depreciation and amortization expenses | 29,263             | 6,145           | 1,303                     | 36,711                |

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Below are reconciliations of segment data to the consolidated financial statements:

| <i>(Dollars in thousands)</i>  | 2006              | 2005              | 2004              |
|--|-------------------|-------------------|-------------------|
| Operating income segment totals                                      | \$ 50,580         | \$ 51,993         | \$ 54,038         |
| Unallocated corporate expenses                                       | (34,727)          | (26,525)          | (27,528)          |
| Unallocated corporate manufacturing expenses                         |                   |                   | (7,331)           |
| Interest expense   | (8,885)           | (7,801)           | (7,237)           |
| Income (Loss) from equity in joint venture                           | (812)             | (729)             | 2,320             |
| Other, net   | 1,233             | 708               | 371               |
| <b>Consolidated income before income taxes and minority interest</b> | <b>\$ 7,389</b>   | <b>\$ 17,646</b>  | <b>\$ 14,633</b>  |
| Assets segment totals  | \$ 516,555        | \$ 475,498        | \$ 455,460        |
| Unallocated corporate assets   | 29,500            | 40,661            | 37,316            |
| <b>Consolidated assets</b>   | <b>\$ 546,055</b> | <b>\$ 516,159</b> | <b>\$ 492,776</b> |
| Capital expenditures segment totals                                  | \$ 45,674         | \$ 41,243         | \$ 33,293         |
| Unallocated corporate expenditures                                   | 296               | 276               | 473               |
| <b>Consolidated capital expenditures</b>                             | <b>\$ 45,970</b>  | <b>\$ 41,519</b>  | <b>\$ 33,766</b>  |
| Depreciation and amortization expenses segment totals                | \$ 36,445         | \$ 36,759         | \$ 36,711         |
| Unallocated corporate depreciation expenses                          | 1,939             | 2,010             | 2,458             |
| <b>Consolidated depreciation and amortization expenses</b>           | <b>\$ 38,384</b>  | <b>\$ 38,769</b>  | <b>\$ 39,169</b>  |

Company-wide geographic data for the years ended December 31, 2006, 2005 and 2004, are as follows (net sales attributed to countries based on selling location):

| <i>(Dollars in thousands)</i> | 2006                | 2005                | 2004              |
|-------------------------------|---------------------|---------------------|-------------------|
| Net sales                     |                     |                     |                   |
| United States                 | \$ 801,017          | \$ 751,962          | \$ 646,523        |
| France                        | 126,615             | 113,856             | 107,536           |
| United Kingdom                | 90,981              | 84,775              | 78,100            |
| All other countries           | 153,970             | 127,784             | 103,657           |
| <b>Total</b>                  | <b>\$ 1,172,583</b> | <b>\$ 1,078,377</b> | <b>\$ 935,816</b> |
| Long-lived assets             |                     |                     |                   |
| United States                 | \$ 153,244          | \$ 150,061          | \$ 147,199        |
| United Kingdom                | 30,478              | 27,381              | 30,247            |
| Germany                       | 13,899              | 12,886              | 15,964            |
| All other countries           | 43,184              | 36,980              | 33,798            |
| <b>Total</b>                  | <b>\$ 240,805</b>   | <b>\$ 227,308</b>   | <b>\$ 227,208</b> |



**16. Earnings Per Share**

Below is the computation of basic and diluted earnings per share for the years ended December 31, 2006, 2005 and 2004:

| <i>(In thousands, except per share amounts)</i>   | 2006     | 2005      | 2004      |
|---|----------|-----------|-----------|
| <b>Computation of Basic Earnings per Share</b>  |          |           |           |
| Income before cumulative effect of change in accounting principle                                 | \$ 6,670 | \$ 13,529 | \$ 10,324 |
| Deduct dividends on preferred stock   | 789      | 796       | 800       |
| Income applicable to common stock   | \$ 5,881 | \$ 12,733 | \$ 9,524  |
| Weighted-average number of shares outstanding   | 9,133    | 9,005     | 8,970     |
| Basic earnings per share  | \$ 0.64  | \$ 1.41   | \$ 1.06   |
| <b>Computation of Diluted Earnings per Share</b>  |          |           |           |
| Income before cumulative effect of change in accounting principle                                 | \$ 6,670 | \$ 13,529 | \$ 10,324 |
| Deduct dividends on preferred stock   | 789      |           | 800       |
| Income applicable to common stock <sup>(1)</sup>  | \$ 5,881 | \$ 13,529 | \$ 9,524  |
| Weighted-average number of shares outstanding   | 9,133    | 9,005     | 8,970     |
| Add net shares from assumed exercise of options (under treasury stock method)                     | 151      | 59        | 68        |
| Add weighted-average shares from assumed conversion of convertible preferred stock <sup>(2)</sup> |          | 661       |           |
| Shares applicable to diluted earnings   | 9,284    | 9,725     | 9,038     |
| Diluted earnings per share  | \$ 0.63  | \$ 1.39   | \$ 1.05   |

(1) Options to purchase 135,298, 150,770 and 496,972 shares of common stock were not included in the computation of diluted earnings per share for 2006, 2005 and 2004, respectively, because the options' exercise prices were greater than the average market price for the common stock and their effect would have been antidilutive.

(2) The assumed conversions of 572,854 and 581,482 shares of convertible preferred stock for 2006 and 2004 were antidilutive, and accordingly, were excluded from the diluted earnings per share calculations.

**17. Claims Settlement Income**

During the quarter ended March 31, 2006, the Company reached a \$900,000 settlement agreement with its electricity provider for lost profits and expenses incurred by the Company as a result of a 2005 unplanned electric outage precipitated by an undersized transformer installed by the electricity provider. The settlement income was recorded as a reduction of Cost of Sales in the Condensed Consolidated Statements of Income and was allocated to the polymers (\$667,000) and surfactants (\$233,000) segments.

On September 1, 2004, a fire at the production facility of the Company's United Kingdom subsidiary, which is included in the surfactants segment, destroyed drying equipment used to manufacture powdered laundry detergent. Because property insurance covered the loss of the equipment, the write-off of the remaining book value of the asset, net of insurance proceeds, had no effect on earnings for the year ended December 31, 2004. In 2005, insurance proceeds related to the fire, amounting to \$1,585,000 for property damage and \$887,000 for business interruption, were received and recorded as reductions of Cost of Sales in the Condensed Consolidated Statements of Income.

#### ***18. Severance Cost***

In the fourth quarter of 2006, the Company incurred \$2,766,000 of severance expenses related to an announced plan to restructure the business functions within its European surfactants organization. The restructuring is an effort to create operational efficiencies and reduce costs by eliminating functional redundancies. The severance expenses were charged to administrative expense for the Company's surfactants segment. Restructuring activities are expected to be completed in the first quarter of 2007, and it is anticipated that no further significant expenses will be incurred.

#### ***19. Related Party Receivable***

At December 31, 2006, the Other non-current assets classification of the Company's consolidated balance sheet included a \$1,415,000 receivable due from Stepan Philippines Inc. (SPI), a joint venture in which the Company holds a 50 percent ownership interest. The receivable is primarily for technology royalties due the Company pursuant to a royalty agreement between the Company and SPI. The receivable balance was \$1,066,000 at December 31, 2005, and was included in the Receivables classification in the current asset section of the Company's consolidated balance sheet at that time. Payments from SPI to the Company as collection on this receivable are generally made based on SPI having free cash flow, which presently is limited due to SPI's capital expenditures associated with its recent plant expansion.

#### ***20. Statement of Cash Flows***

Non-cash investing and financing activities for the years ended December 31, 2006, 2005 and 2004, included the receipt of shares of the Company's common stock tendered in lieu of cash by employees exercising stock options. The tendered shares, which were owned by employees for more than six months, had values of \$1,037,000 in 2006 (33,220 shares), \$1,687,000 in 2005 (62,864 shares) and \$1,700,000 in 2004 (71,591 shares) and were recorded as treasury stock.

Non-cash investing and financing activities for the year ended December 31, 2005, included a \$680,000 capital lease obligation entered into by the Company's Brazilian subsidiary.

## Selected Quarterly Financial Data

*(Dollars in thousands, except per share data)**Unaudited*

| <i>Quarter</i>  | <i>2006</i>  |               |              |                         |              |
|---|--------------|---------------|--------------|-------------------------|--------------|
|   | <i>First</i> | <i>Second</i> | <i>Third</i> | <i>Fourth</i>           | <i>Year</i>  |
| Net Sales   | \$ 289,612   | \$ 292,033    | \$ 302,773   | \$ 288,165              | \$ 1,172,583 |
| Gross Profit  | 32,334       | 33,244        | 35,896       | 24,312                  | 125,786      |
| Interest, net   | (2,061)      | (2,179)       | (2,333)      | (2,312)                 | (8,885)      |
| Income (Loss) Before Income Taxes and Minority Interest | 4,165        | 4,404         | 9,118        | (10,298) <sup>(a)</sup> | 7,389        |
| Net Income (Loss)                                       | 3,049        | 3,077         | 6,091        | (5,547)                 | 6,670        |
| Per Diluted Share                                       | 0.31         | 0.31          | 0.61         | (0.63)                  | 0.63         |

| <i>Quarter</i>   | <i>2005</i>  |               |              |               |              |
|--|--------------|---------------|--------------|---------------|--------------|
|  | <i>First</i> | <i>Second</i> | <i>Third</i> | <i>Fourth</i> | <i>Year</i>  |
| Net Sales  | \$ 264,252   | \$ 278,353    | \$ 265,717   | \$ 270,055    | \$ 1,078,377 |
| Gross Profit   | 29,816       | 34,703        | 32,719       | 25,624        | 122,862      |
| Interest, net  | (1,799)      | (2,006)       | (1,994)      | (2,002)       | (7,801)      |
| Income (Loss) Before Income Taxes and Minority Interest                  | 4,947        | 9,186         | 5,819        | (2,306)       | 17,646       |
| Income (Loss) Before Cumulative Effect of Change in Accounting Principle | 3,244        | 6,177         | 4,166        | (58)          | 13,529       |
| Per Diluted Share  | 0.33         | 0.64          | 0.43         | (0.03)        | 1.39         |
| Net Income (Loss)  | 3,244        | 6,177         | 4,166        | (428)         | 13,159       |
| Per Diluted Share  | 0.33         | 0.64          | 0.43         | (0.07)        | 1.35         |

(a) Includes a legal settlement charge of \$3.0 million and Stepan Europe severance expense of \$2.8 million.

**SIGNATURES**

**Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.**

STEPAN COMPANY

By: /s/ James E. Hurlbutt  
James E. Hurlbutt  
Vice President - Finance

March 22, 2007



**EXHIBIT INDEX**

- (31.1) Certification of President and Chief Executive Officer
- (31.2) Certification of Vice President Finance (Principal Financial Officer)
- (32) Certification of President and Chief Executive Officer (Principal Executive Officer) and Vice President Finance (Principal Financial Officer) pursuant to Section 906 of the Sarbanes-Oxley Act of 2002