

KATY INDUSTRIES INC  
Form 10-Q  
November 14, 2006

United States  
Securities and Exchange Commission  
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: September 30, 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 001-05558

Katy Industries, Inc.  
(Exact name of registrant as specified in its charter)

Delaware  
(State of Incorporation)

75-1277589  
(I.R.S. Employer Identification No.)

2461 South Clark Street, Suite 630, Arlington, Virginia 22202  
(Address of Principal Executive Offices) (Zip Code)

Registrant's telephone number, including area code: (703) 236-4300

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 (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

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Class  
Common Stock, \$1 Par Value

Outstanding at October 31, 2006  
7,957,377 Shares

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KATY INDUSTRIES, INC.  
 FORM 10-Q  
 September 30, 2006

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PART I - FINANCIAL INFORMATIONItem 1. Financial Statements

KATY INDUSTRIES, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED BALANCE SHEETS  
 (Amounts in Thousands)  
 (Unaudited)

ASSETS

	September 30, 2006	December 31, 2005
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 4,117	\$ 8,421
Accounts receivable, net	66,966	63,612
Inventories, net	60,247	62,799
Other current assets	4,376	3,600
Assets held for sale	12,152	-
<b>Total current assets</b>	<b>147,858</b>	<b>138,432</b>
<b>OTHER ASSETS:</b>		
Goodwill	665	665
Intangibles, net	6,481	6,946
Other	9,253	8,643
<b>Total other assets</b>	<b>16,399</b>	<b>16,254</b>
<b>PROPERTY AND EQUIPMENT</b>		
Land and improvements	336	1,732
Buildings and improvements	9,695	14,011
Machinery and equipment	119,206	140,514
	129,237	156,257
Less - Accumulated depreciation	(86,801)	(98,260)
<b>Property and equipment, net</b>	<b>42,436</b>	<b>57,997</b>
<b>Total assets</b>	<b>\$ 206,693</b>	<b>\$ 212,683</b>

See Notes to Condensed Consolidated Financial Statements.



KATY INDUSTRIES, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED BALANCE SHEETS  
 (Amounts in Thousands, Except Share Data)  
 (Unaudited)

LIABILITIES AND STOCKHOLDERS' EQUITY

	September 30, 2006	December 31, 2005
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 42,936	\$ 47,449
Accrued compensation	4,008	4,071
Accrued expenses	38,659	37,713
Current maturities of long-term debt	2,857	2,857
Revolving credit agreement	49,729	41,946
Liabilities held for sale	3,434	-
 Total current liabilities	 141,623	 134,036
 LONG-TERM DEBT, less current maturities	 9,510	 12,857
 OTHER LIABILITIES	 9,012	 10,497
 Total liabilities	 160,145	 157,390
 COMMITMENTS AND CONTINGENCIES (Note 9)	 -	 -
 <b>STOCKHOLDERS' EQUITY</b>		
15% Convertible Preferred Stock, \$100 par value, authorized 1,200,000 shares, issued and outstanding 1,131,551 shares, liquidation value \$113,155	108,256	108,256
Common stock, \$1 par value, authorized 35,000,000 shares, issued 9,822,304 shares	9,822	9,822
Additional paid-in capital	26,968	27,016
Accumulated other comprehensive income	3,362	3,158
Accumulated deficit	(79,900)	(70,415)
Treasury stock, at cost, 1,864,927 and 1,874,027 shares, respectively	(21,960)	(22,544)
 Total stockholders' equity	 46,548	 55,293
 Total liabilities and stockholders' equity	 \$ 206,693	 \$ 212,683

See Notes to Condensed Consolidated Financial Statements.





KATY INDUSTRIES, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
 FOR THE THREE MONTHS AND NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005  
 (Amounts in Thousands, Except Share and Per Share Data)  
 (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net sales	\$ 121,217	\$ 133,165	\$ 285,653	\$ 309,724
Cost of goods sold	104,912	116,402	246,468	273,460
Gross profit	16,305	16,763	39,185	36,264
Selling, general and administrative expenses	11,753	12,820	36,298	39,058
Severance, restructuring and related charges	738	254	1,591	892
Loss (gain) on sale of assets	49	(176)	103	(342)
Operating income (loss)	3,765	3,865	1,193	(3,344)
Interest expense	(1,715)	(1,457)	(5,198)	(4,031)
Other, net	42	215	466	203
Income (loss) from continuing operations before provision for income taxes	2,092	2,623	(3,539)	(7,172)
Provision for income taxes from continuing operations	553	304	1,211	722
Income (loss) from continuing operations	1,539	2,319	(4,750)	(7,894)
Loss from operations of discontinued businesses (net of tax)	(151)	(986)	(849)	(1,467)
Loss on sale of discontinued businesses (net of tax)	(3,200)	-	(3,130)	-
(Loss) income before cumulative effect of a change in accounting principle	(1,812)	1,333	(8,729)	(9,361)
Cumulative effect of a change in accounting principle (net of tax)	-	-	(756)	-
Net (loss) income	\$ (1,812)	\$ 1,333	\$ (9,485)	\$ (9,361)
(Loss) income per share of common stock - Basic:				

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Income (loss) from continuing operations	\$	0.19	\$	0.29	\$	(0.60)	\$	(0.99)
Discontinued operations		(0.42)		(0.12)		(0.50)		(0.19)
Cumulative effect of a change in accounting principle		-		-		(0.09)		-
Net (loss) income	\$	(0.23)	\$	0.17	\$	(1.19)	\$	(1.18)
(Loss) income per share of common stock - Diluted:								
Income (loss) from continuing operations	\$	0.06	\$	0.09	\$	(0.60)	\$	(0.99)
Discontinued operations		(0.13)		(0.04)		(0.50)		(0.19)
Cumulative effect of a change in accounting principle		-		-		(0.09)		-
Net (loss) income	\$	(0.07)	\$	0.05	\$	(1.19)	\$	(1.18)
Weighted average common shares outstanding (thousands):								
Basic		7,962		7,951		7,971		7,948
Diluted		26,825		26,880		7,971		7,948

See Notes to Condensed Consolidated Financial Statements.

KATY INDUSTRIES, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005  
 (Amounts in Thousands)  
 (Unaudited)

	2006	2005
Cash flows from operating activities:		
Net loss	\$ (9,485)	\$ (9,361)
Loss from operations of discontinued business	3,979	1,467
Loss from continuing operations	(5,506)	(7,894)
Cumulative effect of a change in accounting principle	756	-
Depreciation and amortization	6,578	6,733
Amortization of debt issuance costs	877	844
Stock option expense	486	1,953
Loss (gain) on sale of assets	103	(342)
	3,294	1,294
Changes in operating assets and liabilities:		
Accounts receivable	(8,589)	(12,343)
Inventories	(2,201)	3,580
Other assets	(490)	(1,279)
Accounts payable	3,449	16,191
Accrued expenses	3,414	1,085
Other, net	(3,478)	(926)
	(7,895)	6,308
Net cash (used in) provided by continuing operations	(4,601)	7,602
Net cash provided by (used in) discontinued operations	2,116	(461)
Net cash (used in) provided by operating activities	(2,485)	7,141
Cash flows from investing activities:		
Capital expenditures of continuing operations	(2,947)	(5,402)
Capital expenditures of discontinued operations	(78)	(383)
Acquisition of business, net of cash acquired	-	(1,115)
Collections of note receivable from sale of subsidiary	-	106
Proceeds from sale of discontinued operations, net	2,542	-
Proceeds from sale of assets	263	931
Net cash used in investing activities	(220)	(5,863)
Cash flows from financing activities:		
Net borrowings on revolving loans	7,418	1,045
Decrease in book overdraft	(5,031)	-
Repayments of term loans	(3,347)	(2,143)
Direct costs associated with debt facilities	(166)	(244)
Repurchases of common stock	(97)	-
Proceeds from the exercise of stock options	147	-

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Net cash used in financing activities		(1,076)		(1,342)
Effect of exchange rate changes on cash and cash equivalents		(523)		166
Net (decrease) increase in cash and cash equivalents		(4,304)		102
Cash and cash equivalents, beginning of period		8,421		8,525
Cash and cash equivalents, end of period	\$	4,117	\$	8,627
Supplemental disclosure of non-cash investing activities:				
Note receivable from sale of discontinued operations	\$	1,200	\$	-

See Notes to Condensed Consolidated Financial Statements.

KATY INDUSTRIES, INC. AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 SEPTEMBER 30, 2006  
 (Unaudited)

(1) Significant Accounting Policies

Consolidation Policy and Basis of Presentation

The condensed consolidated financial statements include the accounts of Katy Industries, Inc. and subsidiaries in which it has a greater than 50% interest, collectively “Katy” or the Company. All significant intercompany accounts, profits and transactions have been eliminated in consolidation. Investments in affiliates, which do not meet the criteria of a variable interest entity and are not majority owned or where the Company exercises significant influence, are reported using the equity method. The condensed consolidated financial statements at September 30, 2006 and December 31, 2005 and for the three and nine month periods ended September 30, 2006 and September 30, 2005 are unaudited and reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial condition and results of operations of the Company. Interim results may not be indicative of results to be realized for the entire year. The condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto, together with management’s discussion and analysis of financial condition and results of operations, contained in the Company’s Annual Report on Form 10-K for the year ended December 31, 2005. The year-end condensed balance sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States.

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.

Inventories

The components of inventories are as follows (amounts in thousands):

	September 30, 2006	December 31, 2005
Raw materials	\$ 16,246	\$ 23,314
Work in process	779	1,766
Finished goods	52,778	48,949
Excess and obsolete inventory reserve	(4,213)	(4,548)
LIFO reserve	(5,343)	(6,682)
	\$ 60,247	\$ 62,799

At September 30, 2006 and December 31, 2005, approximately 27% and 39%, respectively, of Katy’s inventories were accounted for using the last-in, first-out (“LIFO”) method of costing, while the remaining inventories were accounted for using the first-in, first-out (“FIFO”) method. Current cost, as determined using the FIFO method, exceeded LIFO

cost by \$5.3 million and \$6.7 million at September 30, 2006 and December 31, 2005, respectively. The reduction in the LIFO reserve primarily resulted from the sale of the Metal Truck Box business unit.

In November 2004, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 151, *Inventory Costs, an amendment of ARB No. 43, Chapter 4* (“SFAS No. 151”). SFAS No. 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and spoilage. In addition, SFAS No. 151 requires that allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. The provisions of SFAS No. 151 are effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Effective January 1, 2006, the Company adopted SFAS No. 151 which did not have a material impact on the results of operations and financial position.

Property, Plant and Equipment

Property and equipment are stated at cost and depreciated over their estimated useful lives: buildings (10-40 years) generally using the straight-line method; machinery and equipment (3-20 years) using straight-line or composite methods; tooling (5 years) using the straight-line method; and leasehold improvements using the straight-line method over the remaining lease period or useful life, if shorter. Costs for repair and maintenance of machinery and equipment are expensed as incurred, unless the result significantly increases the useful life or functionality of the asset, in which case capitalization is considered. Depreciation expense from continuing operations was \$2.0 million and \$6.1 million, and \$2.0 million and \$6.2 million for the three and nine month periods ended September 30, 2006 and 2005, respectively.

Katy adopted SFAS No. 143, *Accounting for Asset Retirement Obligations* (“SFAS No. 143”), on January 1, 2003. SFAS No. 143 requires that an asset retirement obligation associated with the retirement of a tangible long-lived asset be recognized as a liability in the period in which it is incurred or becomes determinable, with an associated increase in the carrying amount of the related long-term asset. The cost of the tangible asset, including the initially recognized asset retirement cost, is depreciated over the useful life of the asset. In accordance with SFAS No. 143, the Company has recorded as of September 30, 2006 an asset of \$0.8 million and related liability of \$1.1 million for retirement obligations associated with returning certain leased properties to the respective lessors upon the termination of the lease arrangements. A summary of the changes in asset retirement obligation since December 31, 2005 is included in the table below (amounts in thousands):

SFAS No. 143 Obligation at December 31, 2005	\$	1,068
Accretion expense		38
Changes in estimates, including timing		-
SFAS No. 143 Obligation at September 30, 2006	\$	1,106

Stock Options and Other Stock Awards

Prior to January 1, 2006, the Company accounted for stock options and other stock awards under the provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (“APB No. 25”), as allowed by SFAS No. 123, *Accounting for Stock-Based Compensation* (“SFAS No. 123”), as amended by SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure* (“SFAS No. 148”). APB No. 25 dictated a measurement date concept in the determination of compensation expense related to stock awards including stock options, restricted stock, and stock appreciation rights (“SARs”).

Katy’s outstanding stock options all had established measurement dates and therefore, fixed plan accounting was applied, generally resulting in no compensation expense for stock option awards. However, the Company issued stock appreciation rights, stock awards and restricted stock awards which were accounted for as variable stock compensation awards for which compensation (income) expense was recorded. Compensation income associated with stock appreciation rights was \$0.1 million and \$0.9 million for the three and nine month periods ended September 30, 2005, respectively. No compensation expense relative to restricted stock awards was recognized in the three and nine month periods ended September 30, 2005. Compensation (income) expense for stock awards and stock appreciation rights is recorded in selling, general and administrative expenses in the Condensed Consolidated Statements of Operations.

Effective January 1, 2006, the Company has adopted SFAS No. 123R, *Share-Based Payment* (“SFAS No. 123R”), using the modified prospective method. Under this method, compensation cost recognized during the nine month period ended September 30, 2006 includes: a) compensation cost for all stock options granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with SFAS No. 123R amortized over the options’ vesting period; b) compensation cost for stock appreciation rights granted prior to, but vested as of January

1, 2006, based on the January 1, 2006 fair value estimated in accordance with SFAS No. 123R; and c) compensation cost for stock appreciation rights granted prior to and vested as of September 30, 2006 based on the September 30, 2006 fair value estimated in accordance with SFAS No. 123R.



The following table shows total compensation expense (see Note 7 for descriptions of Stock Incentive Plans) included in the Condensed Consolidated Statements of Operations for the three and nine month periods ended September 30, 2006:

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Selling, general and administrative expense	\$ 354	\$ 381
Cumulative effect of a change in accounting principle	-	756
	\$ 354	\$ 1,137

The cumulative effect of a change in accounting principle reflects the compensation cost for stock appreciation rights granted prior to, but vested as of January 1, 2006, based on the January 1, 2006 fair value. Prior to the effective date, no compensation cost was accrued associated with SARs as all of these stock awards were out of the money. Pro forma results for the prior period have not been restated. As a result of adopting SFAS No. 123R on January 1, 2006, the Company's net loss for the three and nine month periods ended September 30, 2006 is approximately \$0.4 million and \$1.1 million higher, respectively, than had it continued to account for stock-based employee compensation under APB No. 25. Basic net loss per share for the three month period ended September 30, 2006 would have been \$0.18 had the Company not adopted SFAS No. 123R, compared to reported basic net loss per share of \$0.23. Diluted net loss per share for the three month period ended September 30, 2006 would have been \$0.05 had the Company not adopted SFAS No. 123R, compared to reported diluted net loss per share of \$0.07. Basic and diluted net loss per share for the nine month period ended September 30, 2006 would have been \$1.05 had the Company not adopted SFAS No. 123R, compared to reported basic and diluted net loss per share of \$1.19. The adoption of SFAS No. 123R had approximately \$0.7 million positive impact on cash flows from operations with the recognition of a liability for the outstanding and vested stock appreciation rights. The adoption of SFAS No. 123R had no impact on cash flows from financing.

The fair value for stock options was estimated at the date of grant using a Black-Scholes option pricing model. The Company used the simplified method, as allowed by Staff Accounting Bulletin ("SAB") No. 107, *Share-Based Payment*, for estimating the expected term equal to the average between the minimum and maximum lives expected for each award, ranging from 5.30 years to 6.50 years. In addition, the Company estimated volatility, ranging from 53.8% to 57.6%, by considering its historical stock volatility over a term comparable to the remaining expected life of each award. The risk-free interest rate, ranging from 3.98% to 4.48%, was the current yield available on U.S. treasury rates with issues with a remaining term equal in term to each award. The Company estimates forfeitures using historical results. Its estimates of forfeitures will be adjusted over the requisite service period based on the extent to which actual forfeitures differ, or are expected to differ, from their estimate.

The fair value for stock appreciation rights, a liability award, was estimated at the effective date of SFAS No. 123R and September 30, 2006 using a Black-Scholes option pricing model. The Company estimated the expected term equal to the average between the minimum and maximum lives expected for each award, ranging from 3.0 years to 5.8 years. In addition, the Company estimated volatility, ranging from 53.5% to 54.9%, by considering its historical stock volatility over a term comparable to the remaining expected life of each award. The risk-free interest rate, ranging from 4.57% to 4.60%, was the current yield available on U.S. treasury rates with issues with a remaining term equal in term of each award. The Company estimates forfeitures using historical results. Its estimates of forfeitures will be adjusted over the requisite service period based on the extent to which actual forfeitures differ, or are expected to differ, from their estimate.

The following table illustrates the effect on net income (loss) and net income (loss) per share had the Company applied the fair value recognition provisions of SFAS No. 123R to account for the Company's employee stock option awards for the three and nine month periods ended September 30, 2005 because these awards were not accounted for using the fair value recognition method during those periods. However, no impact was present on net income (loss) as all stock option awards were vested prior to the time period presented. For purposes of pro forma disclosure, the estimated fair value of the stock awards, as prescribed by SFAS No. 123, is amortized to expense over the vesting period:

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	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income (loss)	\$ 1,333	\$ (9,361)
Add: Stock-based employee compensation expense included in reported net income (loss), with no related tax effects	-	1,953
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, with no related tax effects	(120)	(134)
Pro forma net income (loss)	\$ 1,213	\$ (7,542)
Income (loss) per share - Basic:		
As reported	\$ 0.17	\$ (1.18)
Pro forma	\$ 0.15	\$ (0.95)
Income (loss) per share - Diluted:		
As reported	\$ 0.05	\$ (1.18)
Pro forma	\$ 0.05	\$ (0.95)

The historical pro forma impact of applying the fair value method prescribed by SFAS No. 123 is not representative of the impact that may be expected in the future due to changes resulting from additional grants and changes in assumptions such as volatility, interest rates, and the expected life used to estimate fair value of stock options and other stock awards. Note that the above pro forma disclosure was not presented for the three and nine month periods ended September 30, 2006 because all stock awards have been accounted for using the fair value recognition method under SFAS No. 123R for these periods.

Derivative Financial Instruments

Effective August 17, 2005, the Company entered into an interest rate swap agreement designed to limit exposure to increasing interest rates on its floating rate indebtedness. The differential to be paid or received is recognized as an adjustment of interest expense related to the debt upon settlement. In connection with the Company's adoption of SFAS No. 133, *Accounting for Derivative Financial Instruments and Hedging Activities* ("SFAS No. 133"), the Company is required to recognize all derivatives, such as interest rate swaps, on its balance sheet at fair value. As the derivative instrument held by the Company is classified as a hedge under SFAS No. 133, changes in the fair value of the derivative will be offset against the change in fair value of the hedged liability through earnings, or recognized in other comprehensive income until the hedged item is recognized in earnings. Hedge ineffectiveness associated with the swap will be reported by the Company in interest expense.

The agreement has an effective date of August 17, 2005 and a termination date of August 17, 2007 with a notional amount of \$25.0 million in the first year declining to \$15.0 million in the second year. The Company is hedging its variable LIBOR-based interest rate for a fixed interest rate of 4.49% for the term of the swap agreement to protect the Company from potential interest rate increases. The Company has designated its benchmark variable LIBOR-based interest rate on a portion of the Bank of America Credit Agreement as a hedged item under a cash flow hedge. In accordance with SFAS No. 133, the Company recorded an asset of \$0.1 million on its balance sheet at September 30, 2006, with changes in fair market value included in other comprehensive income.

The Company reported no gain or loss for the three and nine months ended September 30, 2006, as a result of any hedge ineffectiveness. Future changes in this swap arrangement, including termination of the agreement, may result in a reclassification of any gain or loss reported in other comprehensive income into earnings as an adjustment to interest expense.

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Details regarding the swap as of September 30, 2006 are as follows (amounts in thousands):

Notional Amount	Maturity	Rate Paid	Rate Received	Fair Value (2)
\$ 15,000	August 17, 2007	4.49%	LIBOR (1)	\$ 108

(1) LIBOR rate is determined on the 23rd of each month and continues up to and including the maturity date.

(2) The fair value is the mark-to-market value.

Comprehensive (Loss) Income

The components of comprehensive (loss) income are as follows (amounts in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net (loss) income	\$ (1,812)	\$ 1,333	\$ (9,485)	\$ (9,361)
Foreign currency translation (losses) gains	(593)	256	161	(1,188)
Unrealized (losses) gains on interest rate swap	(90) (683)	(38) 218	43 204	(38) (1,226)
Comprehensive (loss) income	\$ (2,495)	\$ 1,551	\$ (9,281)	\$ (10,587)

Earnings Per Share (EPS)

The Condensed Consolidated Financial Statements include basic and diluted earnings per share. Diluted per share information is calculated by also considering the impact of potential common stock on the weighted average shares outstanding. Potential common stock consists of (a) stock options "in the money" based on the average stock price for the respective period and (b) convertible preferred shares accounted for using the "if converted" basis, which assumes their conversion to common stock at a ratio of 16.6:1. The following table sets forth the computation of diluted earnings per share for the three months ended September 30, 2006 and 2005 (amounts in thousands):

	Three Months Ended September 30, 2006			Three Months Ended September 30, 2005		
	Income	Shares	Per-share amount	Income	Shares	Per-share amount
Basic EPS Net (loss) income	\$ (1,812)	7,962	\$ (0.23)	\$ 1,333	7,951	\$ 0.17
Effect of Dilutive Securities [a] Stock options		4			70	
Convertible preferred stock		18,859			18,859	

Diluted EPS      \$ (1,812)      26,825      \$ (0.07)      \$ 1,333      26,880      \$ 0.05

[a] For the nine months ended September 30, 2006 and 2005, the stock options and convertible preferred stock were not reflected as their effect on loss per share for the periods were anti-dilutive.

Reclassifications

Certain immaterial reclassifications were made to the 2005 financial statements in order to conform to the 2006 presentation. The Company in the fourth quarter of 2005 determined that certain items previously classified as severance, restructuring and related charges during the first three quarters of 2005 of \$1.1 million should have been classified as costs of goods sold (\$0.7 million) and selling, general and administrative expenses (\$0.4 million). For the three and nine months ended September 30, 2005, the Company reclassified \$0.4 million and \$0.7 million, respectively, from severance, restructuring and related charges to cost of goods sold. For the three and nine months ended September 30, 2005, the Company reclassified less than \$0.1 million and \$0.4 million, respectively, from severance, restructuring and related charges to selling, general and administrative expenses. These reclassifications did not impact the Company's reported net (loss) income, income (loss) from continuing operations or cash flows from operations. Additionally, the impact to the Company's reported gross profit in these quarters was not significant.

(2) New Accounting Pronouncements

In June 2006, the FASB issued FASB Interpretation (“FIN”) No. 48, *Accounting for Uncertainty in Income Taxes* (“FIN 48”), which describes a comprehensive model for the measurement, recognition, presentation and disclosure of uncertain tax positions in the financial statements. Under the interpretation, the financial statements will reflect expected future tax consequences of such positions presuming the tax authorities’ full knowledge of the position and all relevant facts, but without considering time values. For the Company, the provisions of FIN 48 are effective January 1, 2007. The Company is assessing the impact this interpretation may have in its future financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (“SFAS No. 157”). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. This standard does not require any new fair value measurements but provides guidance in determining fair value measurements presently used in the preparation of financial statements. For the Company, SFAS No. 157 is effective January 1, 2008. The Company is assessing the impact this standard may have in its future financial statements.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106 and 132(R)*. This new standard requires employers to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. For employers that have equity securities that trade in the public market, this new standard requires the recognition of the funded status of a defined benefit postretirement plan and requires disclosures as of the end of the fiscal year ending after December 15, 2006. The Company is currently evaluating the impact of adopting this standard in its financial statements.

(3) Intangible Assets

Following is detailed information regarding Katy’s intangible assets (amounts in thousands):

	September 30, 2006			December 31, 2005		
	Gross Amount	Accumulated Amortization	Net Carrying Amount	Gross Amount	Accumulated Amortization	Net Carrying Amount
Patents	\$ 1,477	\$ (1,032)	\$ 445	\$ 1,409	\$ (954)	\$ 455
Customer lists	10,445	(8,061)	2,384	10,643	(7,997)	2,646
Tradenames	5,539	(2,276)	3,263	5,498	(2,075)	3,423
Other	441	(52)	389	441	(19)	422
Total	\$ 17,902	\$ (11,421)	\$ 6,481	\$ 17,991	\$ (11,045)	\$ 6,946

All of Katy’s intangible assets are definite long-lived intangibles. Katy recorded amortization expense on intangible assets of \$0.2 million for both the three month periods ended September 30, 2006 and 2005, and \$0.5 million for both the nine month periods ended September 30, 2006 and 2005. Estimated aggregate future amortization expense related to intangible assets is as follows (amounts in thousands):

2006 (remainder)	\$ 128
2007	638
2008	624
2009	590
2010	542

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2011	506
Thereafter	3,453



#### (4) Savannah Energy Systems Company Partnership

In 1984, Savannah Energy Systems Company (“SESCO”), an indirect wholly owned subsidiary of Katy, entered into a series of contracts with the Resource Recovery Development Authority of the City of Savannah, Georgia (“the Authority”) to construct and operate a waste-to-energy facility. The facility would be owned and operated by SESCO solely for the purpose of processing and disposing of waste from the City of Savannah. In 1984, the Authority issued \$55.0 million of Industrial Revenue Bonds (“the IRBs”) and lent the proceeds to SESCO under the loan agreement for the acquisition and construction of the waste-to-energy facility. The funds required to repay the loan agreement come from the monthly disposal fee paid by the Authority under the service agreement for certain waste disposal services, a component of which is for debt service. The debt service component of the monthly fee is paid into a trust, outside of the Company’s control, which is then utilized to make the scheduled debt payments on the IRBs. The Authority is unconditionally obligated to pay the monthly fee whether or not the facility is operating unless SESCO and Katy are insolvent and the facility is deemed incapable of handling the required amount of waste.

SESCO has a legally enforceable right to offset amounts it owes to the Authority under the loan agreement (scheduled principal repayments) against amounts that are owed from the Authority under the service agreement. At September 30, 2006, no amounts were outstanding as a result of the sale of the partnership discussed further below. Accordingly, the amounts owed to and due from SESCO have been netted for financial reporting purposes and are not shown on the Condensed Consolidated Balance Sheets in accordance with FIN No. 39, *Offsetting of Amounts Related to Certain Contracts*.

On April 29, 2002, SESCO entered into a partnership agreement with Montenay Power Corporation and its affiliates (“Montenay”) that turned over the control of SESCO’s waste-to-energy facility to the partnership. The Company caused SESCO to enter into this agreement as a result of evaluations of SESCO’s business. First, Katy concluded that SESCO was not a core component of the Company’s long-term business strategy. Moreover, Katy did not feel it had the management expertise to deal with certain risks and uncertainties presented by the operation of SESCO’s business, given that SESCO was the Company’s only waste-to-energy facility. Katy had explored options for divesting SESCO for a number of years, and management felt that this transaction offered a reasonable strategy to exit this business.

The partnership, with Montenay’s leadership, assumed SESCO’s position in various contracts relating to the facility’s operation. Under the partnership agreement, SESCO contributed its assets and liabilities (except for its liability under the loan agreement with the Authority and the related receivable under the service agreement with the Authority) to the partnership. While SESCO had a 99% interest as a limited partner, profits and losses were allocated 1% to SESCO and 99% to Montenay. In addition, Montenay had the day to day responsibility for administration, operations, financing and other matters of the partnership. While the above partnership qualifies as a variable interest entity, the Company was not the primary beneficiary as defined by FIN No. 46, *Consolidation of Variable Interest Entities*, and accordingly, the partnership is not consolidated. SESCO did not meet the criteria as the primary beneficiary as Montenay receives 99% of all profits and losses, Montenay was required to finance the partnership, partners were not obligated to contribute additional capital, and Montenay had agreed to indemnify SESCO for any losses incurred due to a breach in the service agreement.

Katy agreed to pay Montenay \$6.6 million over the span of seven years under a note payable in return for Montenay assuming the risks associated with the partnership and its operation of the waste-to-energy facility. In the first quarter of 2002, the Company recognized a charge of \$6.0 million consisting of 1) the discounted value of the \$6.6 million note, 2) the carrying value of certain assets contributed to the partnership, consisting primarily of machinery spare parts, and 3) costs to close the transaction. It should be noted that all of SESCO’s long-lived assets were reduced to a zero value in 2001, so no additional impairment was required. On a going forward basis, Katy expected that income statement activity associated with its involvement in the partnership would not be material, and Katy’s Consolidated Balance Sheets would carry the liability mentioned above.

Certain amounts may have been due to SESCO upon expiration of the service agreement in 2008; also, Montenay may have purchased SESCO's interest in the partnership at that time. Katy did not record any amounts receivable or other assets relating to amounts that may have been received at the time the service agreement expired, given their uncertainty.

To induce the required parties to consent to the SESCO partnership transaction, SESCO retained its liability under the loan agreement. In connection with that liability, SESCO also retained its right to receive the debt service component of the monthly disposal fee. In addition to SESCO retaining its liabilities under the loan agreement, to induce the required parties to consent to the partnership transaction, Katy continued to guarantee the obligations of the partnership under the service agreement. The partnership was liable for liquidated damages under the service agreement if it failed to accept the minimum amount of waste or to meet other performance standards under the service agreement. Additionally, Montenay had agreed to indemnify Katy for any breach of the service agreement by the partnership.

On June 27, 2006, the Company and Montenay amended the partnership agreement in order to allow the Company to completely exit from the SESCO operations and related obligations. In addition, Montenay became the guarantor under the loan obligation for the IRBs. Montenay purchased the Company's limited partnership interest for \$0.1 million and a reduction of approximately \$0.6 million in the face amount due to Montenay as agreed upon in the original partnership agreement. In addition, Montenay removed the Company as the performance guarantor under the service agreement. As a result of the above transaction, the Company recorded \$0.4 million within loss from operations of discontinued businesses during the nine months ended September 30, 2006 given the reduction in the face amount due to Montenay as agreed upon in the original partnership agreement. In addition, the Company recorded a gain on the sale of the partnership interest of approximately \$0.1 million as reflected within loss on sale of discontinued businesses.

The table below schedules the remaining payments due to Montenay as of September 30, 2006 which are reflected in accrued expenses in the Condensed Consolidated Balance Sheets (amounts in thousands):

2006	\$ 400
2007	400
	\$ 800

##### (5) Indebtedness

Long-term debt consists of the following (amounts in thousands):

	September 30, 2006	December 31, 2005
Term loan payable under Bank of America Credit Agreement, interest based on LIBOR and Prime Rates (8.38% - 9.50%), due through 2009	\$ 12,367	\$ 15,714
Revolving loans payable under the Bank of America Credit Agreement, interest based on LIBOR and Prime Rates (8.13% - 9.25%)	49,729	41,946
Total debt	62,096	57,660
Less revolving loans, classified as current (see below)	(49,729)	(41,946)
Less current maturities	(2,857)	(2,857)
Long-term debt	\$ 9,510	\$ 12,857

Aggregate remaining scheduled maturities of the Term Loan as of September 30, 2006 are as follows (amounts in thousands):

2006	\$ 714
2007	2,857
2008	2,857
2009	5,939

On April 20, 2004, the Company completed a refinancing of its outstanding indebtedness (the "Refinancing") and entered into a new agreement with Bank of America Business Capital (formerly Fleet Capital Corporation) (the "Bank of America Credit Agreement"). Like the previous credit agreement with Fleet Capital Corporation, the Bank of America Credit Agreement is a \$110.0 million facility with a \$20.0 million term loan ("Term Loan") and a \$90.0 million revolving credit facility ("Revolving Credit Facility") with essentially the same terms as the previous credit agreement. The Bank of America Credit Agreement is an asset-based lending agreement and involves a syndicate of four banks, all of which participated in the syndicate from the previous credit agreement. The Bank of America Credit Agreement, and the additional borrowing ability under the Revolving Credit Facility obtained by incurring new term debt, results in three important benefits related to the Company's long-term strategy: (1) additional borrowing capacity to invest in capital expenditures and/or acquisitions key to the Company's strategic direction, (2) increased working capital flexibility to build inventory when necessary to accommodate lower cost outsourced finished goods inventory and (3) the ability to borrow locally in Canada and the United Kingdom and provide a natural hedge against currency fluctuations.

The Revolving Credit Facility has an expiration date of April 20, 2009 and its borrowing base is determined by eligible inventory and accounts receivable. The Term Loan also has a final maturity date of April 20, 2009 with quarterly payments of \$0.7 million. A final payment of \$5.2 million is scheduled to be paid in April 2009. The Term Loan is collateralized by the Company's property, plant and equipment.

The Company's borrowing base under the Bank of America Credit Agreement is reduced by the outstanding amount of standby and commercial letters of credit. Vendors, financial institutions and other parties with whom the Company conducts business may require letters of credit in the future that either (1) do not exist today or (2) would be at higher amounts than those that exist today. Currently, the Company's largest letters of credit relate to our casualty insurance programs. Letters of credit totaling \$8.4 million were outstanding at September 30, 2006, which reduced the unused borrowing availability under the Revolving Credit Facility.

All extensions of credit under the Bank of America Credit Agreement are collateralized by a first priority security interest in and lien upon the capital stock of each material domestic subsidiary (65% of the capital stock of each material foreign subsidiary), and all present and future assets and properties of Katy. Customary financial covenants and restrictions apply under the Bank of America Credit Agreement. Current margins of 275 basis points over applicable LIBOR rates for Revolving Credit Facility borrowings and 300 basis points over LIBOR for borrowings under the Term Loan reflect the highest spread under the Bank of America Credit Agreement, as amended. Additionally, margins on the Term Loan will drop an additional 25 basis points if the balance of the Term Loan is reduced below \$10.0 million. Interest accrues at higher margins on prime rates for swing loans, the amounts of which were nominal at September 30, 2006.

With the Sixth Amendment in the Bank of America Credit Agreement ("Sixth Amendment"), the Company's current debt covenants under the Bank of America Credit Agreement are as follows:

*Minimum Availability* - Eligible collateral must exceed the sum of the Company's outstanding borrowings and letters of credit under the Revolving Credit Facility by at least \$5.0 million from the effective date of the Sixth Amendment through September 29, 2006 and by at least \$7.5 million from September 30, 2006 until the date the Company delivers its financial statements for the first quarter of 2007 to its lenders.

*Fixed Charge Coverage Ratio* - The Company is required to maintain a Fixed Charge Coverage Ratio (as defined in the Bank of America Credit Agreement) of 1.1:1. Pursuant to the Sixth Amendment, this covenant was suspended and will be reinstated following the first quarter of 2007.

*Capital Expenditures* - For the year ended December 31, 2006, the Company is not to exceed \$12.0 million in capital expenditures. Subsequent to 2006, the Company is not to exceed \$15.0 million during a single fiscal year.

*Leverage Ratio* - The Third Amendment to the Bank of America Credit Agreement eliminated the Leverage Ratio (as defined in the Bank of America Credit Agreement) as a financial covenant. Following the first quarter of 2007, the Leverage Ratio will be utilized to determine the interest rate margin over the applicable LIBOR rate.

The Company believes that it will be able to comply with all covenants, as amended, throughout 2006. If the Company is unable to comply with the terms of the amended covenants, it could seek to obtain further amendments and pursue increased liquidity through additional debt financing and/or the sale of assets (see discussion above). It is possible, however, the Company may not be able to obtain further amendments from the lender under the Bank of America Credit Agreement or secure additional financing or liquidity through the sale of assets on favorable terms or at all.

For the three and nine months ended September 30, 2006 and 2005, the Company had amortization of debt issuance costs of \$0.3 million and \$0.9 million, and \$0.3 million and \$0.8 million, respectively. In addition, the Company incurred and expensed zero and \$0.2 million, and \$0.1 million and \$0.2 million associated with amending the Bank of America Credit Agreement, as discussed above, in the three and nine months ended September 30, 2006 and 2005, respectively.

The Revolving Credit Facility under the Bank of America Credit Agreement requires lockbox agreements which provide for all receipts to be swept daily to reduce borrowings outstanding. These agreements, combined with the existence of a material adverse effect (“MAE”) clause in the Bank of America Credit Agreement, caused the revolving credit facility to be classified as a current liability, per guidance in the Emerging Issues Task Force Issue No. 95-22, *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that Include Both a Subjective Acceleration Clause and a Lock-Box Arrangement*. The Company does not expect to repay, or be required to repay, within one year, the balance of the revolving credit facility classified as a current liability. The MAE clause, which is a fairly typical requirement in commercial credit agreements, allows the lenders to require the loan to become due if they determine there has been a material adverse effect on the Company’s operations, business, properties, assets, liabilities, condition, or prospects. The classification of the revolving credit facility as a current liability is a result only of the combination of the lockbox agreements and MAE clause. The Bank of America Credit Agreement does not expire or have a maturity date within one year, but rather has a final expiration date of April 20, 2009. The lender had not notified the Company of any indication of a MAE at September 30, 2006, and the Company was not in default of any provision of the Bank of America Credit Agreement at September 30, 2006.

All of the debt under the Bank of America Credit Agreement is re-priced to current rates at frequent intervals. Therefore, its fair value approximates its carrying value at September 30, 2006.

#### (6) Retirement Benefit Plans

Several of the Company’s subsidiaries have pension plans covering substantially all of their employees. These plans are noncontributory, defined benefit pension plans. The benefits to be paid under these plans are generally based on employees’ retirement age and years of service. The companies’ funding policies, subject to the minimum funding requirement of employee benefit and tax laws, are to contribute such amounts as determined on an actuarial basis to provide the plans with assets sufficient to meet the benefit obligations. Plan assets consist primarily of fixed income investments, corporate equities and government securities. The Company also provides certain health care and life insurance benefits for some of its retired employees. The post-retirement health plans are unfunded. Katy uses an annual measurement date of December 31 for the majority of its pension and other post-retirement benefit plans for all years presented. Information regarding the Company’s net periodic benefit cost for pension and other post-retirement benefit plans for the three and nine months ended September 30, 2006 and 2005, is as follows (amounts in thousands):

	Pension Benefits			
	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Components of net periodic benefit cost:				
Service cost	\$ 3	\$ 2	\$ 7	\$ 6
Interest cost	24	23	68	70
Expected return on plan assets	(24)	(25)	(68)	(77)
Amortization of net gain	16	20	44	59
Net periodic benefit cost	\$ 19	\$ 20	\$ 51	\$ 58

	Other Benefits			
	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Components of net periodic benefit cost:				
Interest cost	\$ 85	\$ 47	\$ 157	\$ 142
Amortization of prior service cost	66	15	94	45
Amortization of net gain	(8)	15	12	45
Net periodic benefit cost	\$ 143	\$ 77	\$ 263	\$ 232

Required contributions to the pension plans for 2006 are \$0.1 million. Katy made this required contribution during the first quarter of 2006.

#### (7) Stock Incentive Plans

##### Stock Options

At the 1995 Annual Meeting, the Company's stockholders approved the Long-Term Incentive Plan (the "1995 Incentive Plan") authorizing the issuance of up to 500,000 shares of Company common stock pursuant to the grant or exercise of stock options, including incentive stock options, nonqualified stock options, SARs, restricted stock, performance units or shares and other incentive awards to executives and certain key employees. The Compensation Committee of the Board of Directors administers the 1995 Incentive Plan and determines to whom awards may be granted and the type of award, as well as the number of shares of Company common stock to be covered by each award and the terms and conditions of such awards. The exercise price of stock options granted under the 1995 Incentive Plan cannot be less than 100 percent of the fair market value of such stock on the date of grant. In the event of a Change in Control of the Company, awards granted under the 1995 Incentive Plan are subject to substantially similar provisions to those described under the 1997 Incentive Plan. The definition of Change in Control of the Company under the 1995 Incentive Plan is substantially similar to the definition described under the 1997 Incentive Plan below.

At the 1995 Annual Meeting, the Company's stockholders approved the Non-Employee Directors Stock Option Plan (the "Directors Plan") authorizing the issuance of up to 200,000 shares of Company common stock pursuant to the grant or exercise of nonqualified stock options to outside directors. The Board of Directors administers the Directors Plan. The exercise price of stock options granted under the Directors Plan is equal to the fair market value of the Company's common stock on the date of grant. Stock options granted pursuant to the Directors Plan are immediately vested in full



on the date of grant and generally expire 10 years after the date of grant. This plan has expired as of December 31, 2005 and no further grants will be made.

At the 1998 Annual Meeting, the Company's stockholders approved the 1997 Long-Term Incentive Plan (the "1997 Incentive Plan"), authorizing the issuance of up to 875,000 shares of Company common stock pursuant to the grant or exercise of stock options, including incentive stock options, nonqualified stock options, SARs, restricted stock, performance units or shares and other incentive awards. The Compensation Committee of the Board of Directors administers the 1997 Incentive Plan and determines to whom awards may be granted and the type of award, as well as the number of shares of Company common stock to be covered by each award and the terms and conditions of such awards. The exercise price of stock options granted under the 1997 Incentive Plan cannot be less than 100 percent of the fair market value of such stock on the date of grant.

The 1997 Incentive Plan also provides that in the event of a Change in Control of the Company, as defined below, 1) any SARs and stock options outstanding as of the date of the Change in Control which are neither exercisable or vested will become fully exercisable and vested (the payment received upon the exercise of the SARs shall be equal to the excess of the fair market value of a share of the Company's Common Stock on the date of exercise over the grant date price multiplied by the number of SARs exercised); 2) the restrictions applicable to restricted stock will lapse and such restricted stock will become free of all restrictions and fully vested; and 3) all performance units or shares will be considered to be fully earned and any other restrictions will lapse, and such performance units or shares will be settled in cash or stock, as applicable, within 30 days following the effective date of the Change in Control. For purposes of subsection 3), the payout of awards subject to performance goals will be a pro rata portion of all targeted award opportunities associated with such awards based on the number of complete and partial calendar months within the performance period which had elapsed as of the effective date of the Change in Control. The Compensation Committee will also have the authority, subject to the limitations set forth in the 1997 Incentive Plan, to make any modifications to awards as determined by the Compensation Committee to be appropriate before the effective date of the Change in Control.

For purposes of the 1997 Incentive Plan, "Change in Control" of the Company means, and shall be deemed to have occurred upon, any of the following events: 1) any person (other than those persons in control of the Company as of the effective date of the 1997 Incentive Plan, a trustee or other fiduciary holding securities under an employee benefit plan of the Company or a corporation owned directly or indirectly by the stockholders of the Company in substantially the same proportions as their ownership of stock of the Company) becomes the beneficial owner, directly or indirectly, of securities of the Company representing 30 percent or more of the combined voting power of the Company's then outstanding securities; or 2) during any period of two consecutive years (not including any period prior to the effective date), the individuals who at the beginning of such period constitute the Board of Directors (and any new director, whose election by the Company's stockholders was approved by a vote of at least two-thirds of the directors then still in office who either were directors at the beginning of the period or whose election or nomination for election was so approved), cease for any reason to constitute a majority thereof, or 3) the stockholders of the Company approve: (a) a plan of complete liquidation of the Company; or (b) an agreement for the sale or disposition of all or substantially all the Company's assets; or (c) a merger, consolidation, or reorganization of the Company with or involving any other corporation, other than a merger, consolidation, or reorganization that would result in the voting securities of the Company outstanding immediately prior thereto continuing to represent at least 50 percent of the combined voting power of the voting securities of the Company (or such surviving entity) outstanding immediately after such merger, consolidation, or reorganization. The Company has determined that the Recapitalization did not result in such a Change in Control.

In March 2004, the Company's Board of Directors approved the vesting of all previously unvested stock options. The Company did not recognize any compensation expense upon this vesting of options because, based on the information available at that time, the Company did not have an expectation that the holders of the previously unvested options would terminate their employment with the Company prior to the original vesting period.

On June 28, 2001, the Company entered into an employment agreement with C. Michael Jacobi, its former President and Chief Executive Officer. To induce Mr. Jacobi to enter into the employment agreement, on June 28, 2001, the Compensation Committee of the Board of Directors approved the Katy Industries, Inc. 2001 Chief Executive Officer's Plan. Under this plan, Mr. Jacobi was granted 978,572 stock options. Mr. Jacobi was also granted 71,428 stock options under the Company's 1997 Incentive Plan. Upon Mr. Jacobi's retirement in May 2005, all but 300,000 of these options were cancelled. All of the remaining options are under the 2001 Chief Executive Officer's Plan. In the second quarter of 2005, Mr. Jacobi retired from the Company. Upon this event, the Company recognized \$2.0 million of non-cash compensation expense related to his 1,050,000 options using the intrinsic method of accounting under APB No. 25, because he would not have otherwise vested in these options but for the March 2004 accelerated vesting.



On September 4, 2001, the Company entered into an employment agreement with Amir Rosenthal, its Vice President, Chief Financial Officer, General Counsel and Secretary. To induce Mr. Rosenthal to enter into the employment agreement, on September 4, 2001, the Compensation Committee of the Board of Directors approved the Katy Industries, Inc. 2001 Chief Financial Officer's Plan. Under this plan, Mr. Rosenthal was granted 123,077 stock options. Mr. Rosenthal was also granted 76,923 stock options under the Company's 1995 Incentive Plan.

On June 1, 2005, the Company entered into an employment agreement with Anthony T. Castor III, its President and Chief Executive Officer. To induce Mr. Castor to enter into the employment agreement, on July 15, 2005, the Compensation Committee of the Board of Directors approved the Katy Industries, Inc. 2005 Chief Executive Officer's Plan. Under this plan, Mr. Castor was granted 750,000 stock options. These options vest evenly over a three-year period.

The following table summarizes stock option activity under each of the 1997 Incentive Plan, 1995 Incentive Plan, the Chief Executive Officer's Plan, the Chief Financial Officer's Plan and the Directors Plan:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2005	1,856,350	\$ 3.99		
Granted	-	\$ 0.00		
Exercised	(45,000)	\$ 3.26		
Expired	(6,000)	\$ 13.57		
Cancelled	(31,000)	\$ 5.12		
Outstanding at September 30, 2006	1,774,350	\$ 3.96	6.73 years	\$ 122
Vested and Exercisable at September 30, 2006	1,144,350	\$ 4.65	5.63 years	\$ 41

As of September 30, 2006, total unvested compensation expense associated with stock options amounted to \$0.4 million, and is being amortized on a straight-line basis over the respective option's vesting period. The weighted average period in which the above compensation cost will be recognized is 0.8 years as of September 30, 2006.

#### Stock Appreciation Rights

During 2002, a non-employee consultant was awarded 200,000 SARs under the 1997 Incentive Plan. As of December 31, 2005, these SARs were outstanding at an exercise price of \$6.00.

On November 21, 2002, the Board of Directors approved the 2002 Stock Appreciation Rights Plan (the "2002 SAR Plan"), authorizing the issuance of up to 1,000,000 SARs. Vesting of the SARs occurs ratably over three years from the date of issue. The 2002 SAR Plan provides limitations on redemption by holders, specifying that no more than 50% of the cumulative number of vested SARs held by an employee could be exercised in any one calendar year. The SARs expire ten years from the date of issue. The Board approved grants on November 22, 2002, of 717,175 SARs to 60

individuals with an exercise price of \$3.15, which equaled the market price of Katy's stock on the grant date. In addition, 50,000 SARs were granted to four individuals during 2003 with exercise prices ranging from \$3.01 through \$5.05. In 2004, 275,000 SARs were granted to fifteen individuals with exercise prices ranging from \$5.20 through \$6.45. No SARs were granted in 2005. At December 31, 2005, Katy had 671,781 SARs outstanding at a weighted average exercise price of \$4.16.

The 2002 SAR Plan also provides that in the event of a Change in Control of the Company, all outstanding SARs may become fully vested. In accordance with the 2002 SAR Plan, a “Change in Control” is deemed to have occurred upon any of the following events: 1) a sale of 100 percent of the Company’s outstanding capital stock, as may be outstanding from time to time; 2) a sale of all or substantially all of the Company’s operating subsidiaries or assets; or 3) a transaction or series of transactions in which any third party acquires an equity ownership in the Company greater than that held by KKTY Holding Company, L.L.C. and in which Kohlberg & Co., L.L.C. relinquishes its right to nominate a majority of the candidates for election to the Board of Directors.

The following table summarizes SARs activity under each of the 1997 Incentive Plan and the 2002 SAR Plan:

Non-Vested at December 31, 2005	85,115
Granted	26,000
Vested	(55,998)
Cancelled	(1,683)
Non-Vested at September 30, 2006	53,434
Total Outstanding at September 30, 2006	813,281

#### (8) Income Taxes

As of September 30, 2006 and December 31, 2005, the Company had deferred tax assets, net of deferred tax liabilities and valuation allowances, of \$1.0 million, respectively. Domestic net operating loss (“NOL”) carry forwards comprised \$34.8 million of the deferred tax assets. Katy’s history of operating losses in many of its taxing jurisdictions provides significant negative evidence with respect to the Company’s ability to generate future taxable income, a requirement in order to recognize deferred tax assets on the Condensed Consolidated Balance Sheets. For this reason, the Company was unable to conclude at September 30, 2006 and December 31, 2005 that NOLs and other deferred tax assets in the United States and certain unprofitable foreign jurisdictions would be utilized in the future. As a result, valuation allowances for these entities were recorded as of such dates for the full amount of deferred tax assets, net of the amount of deferred tax liabilities.

The provision for income taxes for the three and nine months ended September 30, 2006 and 2005 reflects current expense for state and foreign income taxes. Tax benefits were not recorded on the pre-tax net income (loss) for the three and nine months ended September 30, 2006 and 2005 as valuation allowances were recorded related to deferred tax assets created as a result of operating losses in the United States and certain foreign jurisdictions. As a result of accumulated operating losses in those jurisdictions, the Company has concluded that it was more likely than not that such benefits would not be realized.

#### (9) Commitments and Contingencies

##### *General Environmental Claims*

The Company and certain of its current and former direct and indirect corporate predecessors, subsidiaries and divisions are involved in remedial activities at certain present and former locations and have been identified by the United States Environmental Protection Agency (“EPA”), state environmental agencies and private parties as potentially responsible parties (“PRPs”) at a number of hazardous waste disposal sites under the Comprehensive Environmental Response, Compensation and Liability Act (“Superfund”) or equivalent state laws and, as such, may be liable for the cost of cleanup and other remedial activities at these sites. Responsibility for cleanup and other remedial activities at a Superfund site is typically shared among PRPs based on an allocation formula. Under the federal Superfund statute,

parties could be held jointly and severally liable, thus subjecting them to potential individual liability for the entire cost of cleanup at the site. Based on its estimate of allocation of liability among PRPs, the probability that other PRPs, many of whom are large, solvent, public companies, will fully pay the costs apportioned to them, currently available information concerning the scope of contamination, estimated remediation costs, estimated legal fees and other factors, the Company has recorded and accrued for environmental liabilities in amounts that it deems reasonable and believes that any liability with respect to these matters in excess of the accruals will not be material. The ultimate costs will depend on a number of factors and the amount currently accrued represents management's best current estimate of the total costs to be incurred. The Company expects this amount to be substantially paid over the next five to ten years.

*W.J. Smith Wood Preserving Company (“W.J. Smith”)*

The W. J. Smith matter originated in the 1980s when the United States and the State of Texas, through the Texas Water Commission, initiated environmental enforcement actions against W.J. Smith alleging that certain conditions on the W.J. Smith property (the “Property”) violated environmental laws. In order to resolve the enforcement actions, W.J. Smith engaged in a series of cleanup activities on the Property and implemented a groundwater monitoring program.

In 1993, the EPA initiated a proceeding under Section 7003 of the Resource Conservation and Recovery Act (“RCRA”) against W.J. Smith and Katy. The proceeding sought certain actions at the site and at certain off-site areas, as well as development and implementation of additional cleanup activities to mitigate off-site releases. In December 1995, W.J. Smith, Katy and the EPA agreed to resolve the proceeding through an Administrative Order on Consent under Section 7003 of RCRA. While the Company has completed the cleanup activities required by the Administrative Order on Consent under Section 7003 of RCRA, the Company still has further obligations with respect to this matter in the areas of groundwater and land treatment unit monitoring and closure as well as ongoing site operation and maintenance costs.

Since 1990, the Company has spent in excess of \$7.0 million undertaking cleanup and compliance activities in connection with this matter. While ultimate liability with respect to this matter is not easy to determine, the Company has recorded and accrued amounts that it deems reasonable for prospective liabilities with respect to this matter.

*Asbestos Claims*

A. The Company has been named as a defendant in ten lawsuits filed in state court in Alabama by a total of approximately 324 individual plaintiffs. There are over 100 defendants named in each case. In all ten cases, the Plaintiffs claim that they were exposed to asbestos in the course of their employment at a former U.S. Steel plant in Alabama and, as a result, contracted mesothelioma, asbestosis, lung cancer or other illness. They claim that they were exposed to asbestos in products in the plant which were manufactured by each defendant. In eight of the cases, Plaintiffs also assert wrongful death claims. The Company will vigorously defend the claims against it in these matters. The liability of the Company cannot be determined at this time.

B. Sterling Fluid Systems (USA) has tendered over 2,055 cases pending in Michigan, New Jersey, New York, Illinois, Nevada, Mississippi, Wyoming, Louisiana, Georgia, Massachusetts and California to the Company for defense and indemnification. With respect to one case, Sterling has demanded that Katy indemnify it for a \$200,000 settlement. Sterling bases its tender of the complaints on the provisions contained in a 1993 Purchase Agreement between the parties whereby Sterling purchased the LaBour Pump business and other assets from the Company. Sterling has not filed a lawsuit against Katy in connection with these matters.

The tendered complaints all purport to state claims against Sterling and its subsidiaries. The Company and its current subsidiaries are not named as defendants. The plaintiffs in the cases also allege that they were exposed to asbestos and products containing asbestos in the course of their employment. Each complaint names as defendants many manufacturers of products containing asbestos, apparently because plaintiffs came into contact with a variety of different products in the course of their employment. Plaintiffs’ claim that LaBour Pump and/or Sterling may have manufactured some of those products.

With respect to many of the tendered complaints, including the one settled by Sterling for \$200,000, the Company has taken the position that Sterling has waived its right to indemnity by failing to timely request it as required under the 1993 Purchase Agreement. With respect to the balance of the tendered complaints, the Company has elected not to assume the defense of Sterling in these matters.





C. LaBour Pump Company, a former subsidiary of the Company, has been named as a defendant in over 335 similar cases in New Jersey. These cases have also been tendered by Sterling. The Company has elected to defend these cases, many of which have been dismissed or settled for nominal sums.

While the ultimate liability of the Company related to the asbestos matters above cannot be determined at this time, the Company has recorded and accrued amounts that it deems reasonable for prospective liabilities with respect to this matter.

*Non-Environmental Litigation - Banco del Atlantico, S.A.*

*Banco del Atlantico, S.A. v. Woods Industries, Inc., et al. Civil Action No. L-96-139 (now 1:03-CV-1342-LJM-VSS, U.S. District Court, Southern District of Indiana).* In December 1996, Banco del Atlantico (“plaintiff”), a bank located in Mexico, filed a lawsuit in Texas against Woods Industries, Inc., a subsidiary of Katy, and against certain past and/or then present officers, directors and owners of Woods (collectively, “defendants”). The plaintiff alleges that it was defrauded into making loans to a Mexican corporation controlled by certain past officers and directors of Woods based upon fraudulent representations and purported guarantees. Based on these allegations, and others, the plaintiff originally asserted claims for alleged violations of the federal Racketeer Influenced and Corrupt Organizations Act (“RICO”); “money laundering” of the proceeds of the illegal enterprise; the Indiana RICO and Crime Victims Act; common law fraud and conspiracy; and fraudulent transfer. As discussed below, certain of the plaintiff’s claims were dismissed with prejudice by the Court. The plaintiff also seeks recovery upon certain alleged guarantees purportedly executed by Woods Wire Products, Inc., a predecessor company from which Woods purchased certain assets in 1993 (prior to Woods’s ownership by Katy, which began in December 1996). The primary legal theories under which the plaintiff seeks to hold Woods liable for its alleged damages are respondeat superior, conspiracy, successor liability, or a combination of the three.

The case was transferred from Texas to the Southern District of Indiana in 2003. In September 2004, the plaintiff and HSBC Mexico, S.A. (collectively, “plaintiffs”), who intervened in the litigation as an additional alleged owner of the claims against the defendants, filed a Second Amended Complaint. The defendants filed motions to dismiss the Second Amended Complaint on November 8, 2004. These motions sought dismissal of plaintiffs’ Second Amended Complaint on grounds of, among other things, failure to state a claim and forum non conveniens.

On August 11, 2005, the court granted significant aspects of Defendants’ motions to dismiss for failure to state a claim. Specifically, the Court dismissed *with prejudice* all of the federal and Indiana RICO claims asserted in the Second Amended Complaint against Woods. This ruling removes the treble damages exposure associated with the federal and Indiana RICO claims. Recently, the Court also denied the defendants’ renewed motion to dismiss for forum non conveniens. The sole claims now remaining against Woods are certain common law claims and claims under the Indiana Crime Victims Act. Fact discovery is continuing, and trial is scheduled for fall of 2007. Expert discovery is also ongoing.

The plaintiffs seek damages in excess of \$24.0 million, request that the Court void certain asset sales as purported “fraudulent transfers” (including the 1993 Woods Wire Products, Inc./Woods asset sale), and continue to claim that the Indiana Crime Victims Act entitles them to treble damages for some or all of their claims. Katy may have recourse against the former owners of Woods and others for, among other things, violations of covenants, representations and warranties under the purchase agreement through which Katy acquired Woods, and under state, federal and common law. Woods may also have indemnity claims against the former officers and directors. In addition, there is a dispute with the former owners of Woods regarding the final disposition of amounts withheld from the purchase price, which may be subject to further adjustment as a result of the claims by the plaintiff. The extent or limit of any such adjustment cannot be predicted at this time.

While the ultimate liability of the Company related to this matter cannot be determined at this time, the Company has recorded and accrued amounts that it deems reasonable for prospective liabilities with respect to this matter.

*Other Claims*

Katy also has a number of product liability and workers' compensation claims pending against it and its subsidiaries. Many of these claims are proceeding through the litigation process and the final outcome will not be known until a settlement is reached with the claimant or the case is adjudicated. The Company estimates that it can take up to 10 years from the date of the injury to reach a final outcome on certain claims. With respect to the product liability and workers' compensation claims, Katy has provided for its share of expected losses beyond the applicable insurance coverage, including those incurred but not reported to the Company or its insurance providers, which are developed using actuarial techniques. Such accruals are developed using currently available claim information, and represent management's best estimates. The ultimate cost of any individual claim can vary based upon, among other factors, the nature of the injury, the duration of the disability period, the length of the claim period, the jurisdiction of the claim and the nature of the final outcome.

Although management believes that the actions specified above in this section individually and in the aggregate are not likely to have outcomes that will have a material adverse effect on the Company's financial position, results of operations or cash flow, further costs could be significant and will be recorded as a charge to operations when, and if, current information dictates a change in management's estimates.

(10) Industry Segment Information

The Company is organized into two operating segments: Maintenance Products and Electrical Products. The activities of the Maintenance Products Group include the manufacture and distribution of a variety of commercial cleaning supplies and consumer home products. The Electrical Products Group is a marketer and distributor of consumer electrical corded products. For all periods presented, information for the Maintenance Products Group excludes amounts related to the United Kingdom consumer plastics and Metal Truck Box business units as the units are classified as discontinued operations as discussed further in Note 12. The following table sets forth information by segment (amounts in thousands):

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		Three months ended September 30,		Nine months ended September 30,	
		2006	2005	2006	2005
<b>Maintenance Products Group</b>					
Net external sales		\$ 55,942	\$ 56,621	\$ 160,787	\$ 164,799
Operating income (loss)		2,928	298	4,698	(4,254)
Operating margin (deficit)		5.2%	0.5%	2.9%	(2.6%)
Depreciation and amortization		1,899	1,881	5,831	5,719
Capital expenditures		896	2,604	2,356	5,151
<b>Electrical Products Group</b>					
Net external sales		\$ 65,275	\$ 76,544	\$ 124,866	\$ 144,925
Operating income		4,391	6,099	6,372	10,166
Operating margin		6.7%	8.0%	5.1%	7.0%
Depreciation and amortization		188	245	650	948
Capital expenditures		235	100	571	251
<b>Total</b>					
Net external sales	Operating segments	\$ 121,217	\$ 133,165	\$ 285,653	\$ 309,724
	Total	\$ 121,217	\$ 133,165	\$ 285,653	\$ 309,724
Operating income (loss)	Operating segments	\$ 7,319	\$ 6,397	\$ 11,070	\$ 5,912
	Unallocated corporate Severance, restructuring, and related charges	(2,767)	(2,454)	(8,183)	(8,706)
	(Loss) gain on sale of assets	(738)	(254)	(1,591)	(892)
	Total	(49)	176	(103)	342
	Total	\$ 3,765	\$ 3,865	\$ 1,193	\$ (3,344)
Depreciation and amortization	Operating segments	\$ 2,087	\$ 2,126	\$ 6,481	\$ 6,667
	Unallocated corporate	25	26	97	66
	Total	\$ 2,112	\$ 2,152	\$ 6,578	\$ 6,733
	-	\$ 1,131	\$ 2,704	\$ 2,927	\$ 5,402

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Capital expenditures	Operating segments				
	Unallocated				
	- corporate	7	-	20	-
	Discontinued				
	- operations	30	127	78	383
	Total	\$ 1,168	\$ 2,831	\$ 3,025	\$ 5,785
		September 30,	December 31,		
		2006	2005		
Total assets	Maintenance				
	- Products Group	\$ 102,016	\$ 108,012		
	Electrical Products				
	- Group	84,315	66,744		
	- Other [a]	14,369	27,391		
	Unallocated				
	- corporate	5,993	10,536		
	Total	\$ 206,693	\$ 212,683		

[a] Amounts shown as "Other" primarily represent items associated with Sahlman Holding Company, Inc., the Company's equity method investment, and United Kingdom consumer plastics business unit, which is classified as an asset held for sale. The amount on December 31, 2005 also includes the assets of the Metal Truck Box business unit.

(11) Severance, Restructuring and Related Charges

Over the past three years, the Company has initiated several cost reduction and facility consolidation initiatives, resulting in severance, restructuring and related charges. Key initiatives were the consolidation of the St. Louis, Missouri manufacturing/distribution facilities, shutdown of both Woods US and Woods Canada manufacturing as well as the consolidation of the Glit facilities. These initiatives resulted from the on-going strategic reassessment of the Company's various businesses as well as the markets in which they operate.

A summary of charges by major initiative is as follows (amounts in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Consolidation of St. Louis manufacturing/distribution facilities	\$ 704	\$ 146	\$ 1,403	\$ 100
Consolidation of Glit facilities	-	(23)	-	659
Consolidation of administrative functions for CCP	-	-	-	21
Shutdown of Woods Canada manufacturing	-	131	-	112
Corporate office relocation	34	-	188	-
Total severance, restructuring and related charges	\$ 738	\$ 254	\$ 1,591	\$ 892

Consolidation of St. Louis manufacturing/distribution facilities - In 2002, the Company committed to a plan to consolidate the manufacturing and distribution of the four Continental Commercial Products, LLC ("CCP") facilities in the St. Louis, Missouri area. Management believed that in order to implement a more competitive cost structure and combat competitive pricing pressure, the excess capacity at the Company's four plastic molding facilities in this area would need to be eliminated. This plan was expected to be completed by the end of 2003; however, charges have been incurred past 2003 due to changes in assumptions in non-cancelable lease accruals, including the buyout of the Warson Road (St. Louis, Missouri) lease and changes in sublet assumptions. Charges in 2006 were for an adjustment to the non-cancelable lease accrual at the Hazelwood, Missouri facility due to the execution of a sublease on the property, as well as changes in the amount of usable manufacturing space. Charges in 2005 were for an adjustment to the non-cancelable lease accrual at the Hazelwood facility due to a change in the amount of sublease rental income anticipated as well as miscellaneous charges for the termination of the Warson Road facility lease. Management believes that no further charges will be incurred for this activity. Following is a rollforward of restructuring liabilities by type for the consolidation of St. Louis manufacturing/distribution facilities (amounts in thousands):

	Total	One-time	Contract
		Termination Benefits [a]	Termination Costs [b]
Restructuring liabilities at December 31, 2005	\$ 1,845	\$ -	\$ 1,845
Additions	1,403	-	1,403
Payments	(601)	-	(601)
Restructuring liabilities at September 30, 2006	\$ 2,647	\$ -	\$ 2,647

Consolidation of Glit facilities - In 2002, the Company approved a plan to consolidate the manufacturing facilities of its Glit business unit in order to implement a more competitive cost structure. It was anticipated that this activity would begin in early 2003 and be completed by the end of the second quarter of 2004. Due to numerous operational issues, including management turnover and a small fire at the Wrens, Georgia facility, the completion of this consolidation was delayed. In 2005, the Company completed the closure of the Lawrence, Massachusetts facility and is expected to close the Pineville, North Carolina facility in the fourth quarter of 2006. In 2005, the Company recorded a charge related to severance for terminations at the Lawrence facility. Other than closure costs and severance for the Pineville facility, management does not anticipate any material charges beyond 2005. Following is a rollforward of restructuring liabilities by type for the consolidation of Glit facilities (amounts in thousands):



	Total	One-time Termination Benefits [a]	Contract Termination Costs [b]
Restructuring liabilities at December 31, 2005	\$ 505	\$ 255	\$ 250
Additions	-	-	-
Payments	(176)	(176)	-
Restructuring liabilities at September 30, 2006	\$ 329	\$ 79	\$ 250

**Consolidation of administrative functions for CCP** - In 2002, in order to streamline processes and eliminate duplicate functions, the Company initiated a plan to centralize certain administrative and back office functions into Bridgeton, Missouri from certain businesses within the Maintenance Products Group. This plan was anticipated to be completed in 2004 upon the transfer of functions from the Lawrence, Massachusetts facility (see Consolidation of Glit facilities above); however, the closure was delayed and subsequently contributed to the delay in this plan until completion in 2005. Katy has incurred primarily severance costs over the past three years for this integration of back office and administrative functions. The most significant project is the centralization of the customer service functions for the Continental, Glit, Wilen, and Disco business units. Charges in 2005 relate to costs associated with an accrual for idle space at the Company's facility in Atlanta. There was no activity for this initiative during the three and nine months ended September 30, 2006. The Company does not expect to incur any additional charges on this initiative.

**Shutdown of Woods US manufacturing** - During 2002, a major restructuring occurred at the Woods business unit. After significant study and research into different sourcing alternatives, Katy decided that Woods would source all of its products from Asia. In December 2002, Woods shut down all U.S. manufacturing facilities, which were in suburban Indianapolis and in southern Indiana. All 2005 activity reflects payments on the non-cancelable lease accrual. No charges were recorded in the three and nine months ended September 30, 2006 and 2005. Following is a rollforward of restructuring liabilities by type for the shutdown of Woods US manufacturing (amounts in thousands):

	Total	One-time Termination Benefits [a]	Contract Termination Costs [b]
Restructuring liabilities at December 31, 2005	\$ 195	\$ 20	\$ 175
Additions	-	-	-
Payments	(80)	(1)	(79)
Restructuring liabilities at September 30, 2006	\$ 115	\$ 19	\$ 96

**Shutdown of Woods Canada manufacturing** - In 2003, the Company approved a plan to shut down the manufacturing operation in Toronto, Ontario and source substantially all of its products from Asia. Management believed that this action was necessary in order to implement a more competitive cost structure to combat pricing pressure by producers in Asia. In connection with this shutdown, the Company also anticipated the sale and leaseback of this facility, which would provide additional liquidity. In December 2003, Woods Canada closed this manufacturing facility in Toronto, Ontario, but was unable to complete the sale/leaseback transaction at that time. Accordingly, the charge for the non-cancelable lease accrual was recorded in the first quarter of 2004, upon the completion of the sale/leaseback transaction. The idle capacity was a direct result of the elimination of the manufacturing function from this facility. A portion of the facility was available for sublease at the time the accrual was established. In 2005, a credit was recorded to finalize the severance paid over the past two years. Management believes that no more charges will be incurred for this activity, except for potential adjustments to non-cancelable lease liabilities. Following is a rollforward of restructuring liabilities by type for the shutdown of Woods Canada manufacturing (amounts in thousands):



	Total	One-time Termination Benefits [a]	Contract Termination Costs [b]
Restructuring liabilities at December 31, 2005	\$ 717	\$ -	\$ 717
Additions	-	-	-
Payments	(133)	-	(133)
Restructuring liabilities at September 30, 2006	\$ 584	\$ -	\$ 584

**Corporate office relocation** - In November 2005, the Company announced the closing of its corporate office in Middlebury, Connecticut, and the relocation of certain corporate functions to the CCP location in Bridgeton, Missouri, the outsourcing of other functions, and the move of the remaining functions to a new location in Arlington, Virginia. The amounts recorded in 2006 relate to severance for employees at the Middlebury office. Following is a rollforward of restructuring liabilities by type for the corporate office relocation (amounts in thousands):

	One-time Termination Benefits [a]
Restructuring liabilities at December 31, 2005	\$ 157
Additions	188
Payments	(345)
Restructuring liabilities at September 30, 2006	\$ -

The table below details activity in restructuring reserves since December 31, 2005 (amounts in thousands):

	Total	One-time Termination Benefits [a]	Contract Termination Costs [b]
Restructuring liabilities at December 31, 2005	\$ 3,419	\$ 432	\$ 2,987
Additions	1,591	188	1,403
Payments	(1,335)	(522)	(813)
Restructuring liabilities at September 30, 2006 [c]	\$ 3,675	\$ 98	\$ 3,577

[a] Includes severance, benefits, and other employee-related charges associated with the employee terminations.

[b] Includes charges related to non-cancelable lease liabilities for abandoned facilities, net of potential sub-lease revenue. Total maximum potential amount of lease loss, excluding any sub-lease rentals, is \$4.2 million as of September 30, 2006. The Company has included \$0.6 million as an offset for sub-lease rentals.

[c] Katy expects to substantially complete its current restructuring programs in 2006. The remaining severance, restructuring and related charges for these initiatives are expected to be approximately \$0.3 million.

The table below details activity in restructuring and related reserves by operating segment since December 31, 2005 (amounts in thousands):

	Total	Maintenance Products Group	Electrical Products Group	Corporate
Restructuring liabilities at December 31, 2005	\$ 3,419	\$ 2,350	\$ 912	\$ 157
Additions	1,591	1,403	-	188
Payments	(1,335)	(777)	(213)	(345)
Restructuring liabilities at September 30, 2006	\$ 3,675	\$ 2,976	\$ 699	\$ -

The table below summarizes the future obligations for severance, restructuring and other related charges by operating segment detailed above (amounts in thousands):

	Total	Maintenance Products Group	Electrical Products Group	Corporate
2006	\$ 853	\$ 680	\$ 173	\$ -
2007	745	498	247	-
2008	704	450	254	-
2009	452	427	25	-
2010	449	449	-	-
Thereafter	472	472	-	-
Total				
Payments	\$ 3,675	\$ 2,976	\$ 699	\$ -

#### (12) Discontinued Operations

On June 2, 2006, the Company sold certain assets of the Metal Truck Box business unit within the Maintenance Products Group for gross proceeds of \$3.6 million, including a \$1.2 million note receivable. These proceeds were used to pay off related portions of the Term Loan and the Revolving Credit Facility. The Company recorded a loss of \$30,000 in the second quarter of 2006 in connection with this sale. Management and the board of directors determined that this business is not a core component to the Company's long-term business strategy.

On June 27, 2006, the Company sold its limited partnership interest in a waste-to-energy facility ("SESCO") for gross proceeds of approximately \$0.1 million. These proceeds were used to reduce our outstanding borrowings under the Revolving Credit Facility. The Company recorded a gain of \$0.1 million in the second quarter of 2006 in connection with this sale. Management and the board of directors determined that SESCO was not a core component of the Company's long-term business strategy.

The Company did not separately identify the related assets and liabilities of the Metal Truck Box business unit and SESCO on the Condensed Consolidated Balance Sheets. Following is a summary of the major asset and liability categories for these discontinued operations:

	September 30, 2006	December 31, 2005
Current assets:		
Accounts receivable, net	\$ -	\$ 2,419
Inventories, net	-	3,422
Other current assets	-	5
	\$ -	\$ 5,846
Non-current assets:		
Intangibles, net	\$ -	\$ 166
Property and equipment, net	-	1,728
	\$ -	\$ 1,894
Current liabilities:		
Accounts payable	\$ -	\$ 1,741
Accrued compensation	-	530
Accrued expenses	1,195	1,219
	\$ 1,195	\$ 3,490
Other liabilities:	\$ -	\$ 1,486

On September 29, 2006, the Board of Directors of Katy approved managements' plan to sell the United Kingdom consumer plastics business. The Company has identified a potential purchaser and expects the sale will be completed in the fourth quarter of 2006; however, no definitive agreement has been reached and the Company may not meet its expectation. As a result, the net assets of this business have been classified as an asset held for sale on the Condensed Consolidated Balance Sheets in accordance with SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets* ("SFAS No. 144"). Accordingly, the carrying value of the business unit's net assets was adjusted to its fair value less costs to sell, amounting to \$8.7 million. Costs to sell include the incremental direct costs to complete the sale and represent costs such as broker commissions, legal and other closing costs. Costs to sell exclude future expected losses associated with the operations of the disposal group while held for sale. The ultimate sales price could change from current expectation. With the classification as an asset held for sale and its adjusted valuation, the Company incurred a \$3.2 million impairment charge as reflected in the loss on the sale of discontinued businesses within the Condensed Consolidated Statements of Operations during the three months ended September 30, 2006. Management's undiscounted cash flows used to previously support the account balances did not identify prior period adjustments.

In accordance with SFAS No. 144, the United Kingdom consumer plastics business will be classified as a discontinued operation as operations and cash flows will be eliminated from on-going operations with no significant continuing involvement in this business. Assets and liabilities held for sale, related to this discontinued operation, is comprised of the following assets and liabilities as of September 30, 2006:

Assets held for sale:	
Accounts receivable, net	\$ 3,494
Inventories, net	2,384
Other current assets	308
Property and equipment, net	7,107
Accumulated other comprehensive income	(1,141)
	\$ 12,152
Liabilities held for sale:	
Accounts payable	\$ 2,661
Accrued expenses	773
	\$ 3,434

The historical operating results of the United Kingdom consumer plastics business unit, the Metal Truck Box business unit and SESCO have been segregated as discontinued operations on the Condensed Consolidated Statements of Operations. Selected financial data for discontinued operations is summarized as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Net sales	\$ 4,473	\$ 7,392	\$ 19,115	\$ 24,556
Pre-tax loss	\$ (151)	\$ (986)	\$ (849)	\$ (1,467)
Pre-tax loss on sale of discontinued businesses	\$ (3,200)	\$ -	\$ (3,130)	\$ -

### (13) Acquisition

During the third quarter of 2005, CCP acquired substantially all of the assets and assumed certain liabilities of Washington International Non-Wovens, LLC (“WIN”), based in Washington, Georgia. The purchase price was approximately \$1.7 million, including \$0.6 million of assumed debt, and was allocated to the acquired net assets and intangible lease asset at their estimated fair values. The WIN acquisition is not material for purposes of presenting pro forma financial information. This acquired business is part of the Glit business unit in the Maintenance Products Group.

## Item 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management’s discussion and analysis of financial condition and results of operations (“MD&A”) is designed to provide a reader of these financial statements with a narrative from the perspective of the management of Katy Industries, Inc. (“Katy” or the “Company”) on Katy’s financial condition, results of operations, liquidity and other factors which may affect the Company’s future results. The MD&A in this quarterly report should be read in conjunction with the MD&A in Katy’s 2005 annual report on Form 10-K filed with the Securities and Exchange Commission on March 31, 2006 and as amended on October 18, 2006.

## RESULTS OF OPERATIONS

Three Months Ended September 30, 2006 versus Three Months Ended September 30, 2005

	2006		2005	
	(Amounts in Millions, Except Per Share Data)			
	\$	% to Sales	\$	% to Sales
Net sales	\$ 121.2	100.0	\$ 133.2	100.0
Cost of goods sold	104.9	86.6	116.4	87.4
Gross profit	16.3	13.4	16.8	12.6
Selling, general and administrative expenses	11.8	9.7	12.8	9.6
Severance, restructuring and related charges	0.7	0.6	0.3	0.2
Loss (gain) on sale of assets	-	0.0	(0.2)	(0.1)
Operating income	3.8	3.1	3.9	2.9
Interest expense	(1.7)		(1.5)	
Other, net	-		0.2	
Income from continuing operations before provision for income taxes	2.1		2.6	
Provision for income taxes from continuing operations	0.6		0.3	
Income from continuing operations	1.5		2.3	
Loss from operations of discontinued businesses (net of tax)	(0.1)		(1.0)	
Loss on sale of discontinued businesses (net of tax)	(3.2)		-	
(Loss) income before cumulative effect of a change in accounting principle	(1.8)		1.3	
Cumulative effect of a change in accounting principle	-		-	
Net (loss) income	\$ (1.8)		\$ 1.3	
(Loss) income per share of common stock - basic:				
Income from continuing operations	\$ 0.19		\$ 0.29	
Discontinued operations	(0.42)		(0.12)	
Cumulative effect of a change in accounting principle	-		-	
Net (loss) income	\$ (0.23)		\$ 0.17	

(Loss) income per share of common  
stock - diluted:

Income from continuing operations	\$	0.06	\$	0.09
Discontinued operations		(0.13)		(0.04)
Cumulative effect of a change in accounting principle		-		-
Net (loss) income	\$	(0.07)	\$	0.05

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## Overview

Our consolidated net sales for the three month period ended September 30, 2006 decreased \$12.0 million compared to the three month period ended September 30, 2005. The decline in net sales of 9% was comprised of lower volumes of 21% offset by higher pricing of 11% and favorable currency translation of 1%. Gross margins were 13.4% for the three month period ended September 30, 2006, an increase of 0.8 percentage points compared to the three month period ended September 30, 2005. In 2005, incremental operating costs incurred due to the delayed consolidation of the Glit facilities adversely impacted gross margin levels. In 2006, the lower volume impact was partially offset by the improvement in pricing. In addition, production efficiencies gained at our Glit facilities improved our margins. Selling, general and administrative expense ("SG&A") as a percentage of sales of 9.7% for the third quarter of 2006 was comparable to 9.6% for the third quarter of 2005. Operating income of \$3.8 million for the three month period ended September 30, 2006 was comparable to \$3.9 million of operating income for the prior period, mostly due to higher gross margins offsetting the lower net sales levels and higher severance and restructuring costs.

Overall, we reported a net loss of (\$1.8) million [(\$0.07) per diluted share] for the three month period ended September 30, 2006, versus net income of \$1.3 million [\$0.05 per diluted share] for the same period of 2005.

## Net Sales

### *Maintenance Products Group*

Net sales from the Maintenance Products Group decreased from \$56.6 million during the three month period ended September 30, 2005 to \$55.9 million during the three month period ended September 30, 2006. Overall, this decline of 1% was primarily due to lower sales volumes of 6% partially offset by higher pricing of 4% and favorable currency translation of 1%. Sales activity for the Contico business unit continues to be impacted by the reduced volumes which were partially offset by sales improvement in our core Continental business unit.

Higher pricing resulted from the implementation of selling price increases across the Maintenance Products Group, most of which took effect throughout 2005. The implementation of price increases was in response to the accelerating cost of our primary raw materials, packaging materials, utilities and freight.

### *Electrical Products Group*

The Electrical Products Group's sales decreased from \$76.5 million for the three month period ended September 30, 2005 to \$65.3 million for the three month period ended September 30, 2006. The sales decrease of 15% was primarily the result of lower volume of 33% partially offset by higher pricing of 17% and favorable currency translation of 1%. Lower volume resulted from the loss of certain product lines with certain customers. In addition, a milder hurricane season in the United States has resulted in lower volume requirements in 2006. Multiple selling price increases have been implemented since the beginning of 2004 to offset the rising cost of copper and PVC. We may continue to implement price increases; however, there can be no assurance that such increases, if implemented, will be accepted. In addition, sales at Woods Canada were favorably impacted by a stronger Canadian dollar versus the U.S. dollar in the third quarter of 2006 as compared to the same period in 2005.

Operating Income

Three months ended September 30,  
(Amounts in Millions)

<b>Operating income (loss)</b>	2006		2005		Change	
	\$	% Margin	\$	% Margin	\$	% Margin
Maintenance Products Group	\$ 2.9	5.2	\$ 0.3	0.5	\$ 2.6	4.7
Electrical Products Group	4.4	6.7	6.1	8.0	(1.7)	(1.3)
Unallocated corporate expense	(2.8)		(2.4)		(0.4)	
	4.5	3.8	4.0	3.0	0.5	0.8
Severance, restructuring and related charges	(0.7)		(0.3)		(0.4)	
(Loss) gain on sale of assets	-		0.2		(0.2)	
Operating income	\$ 3.8	3.1	\$ 3.9	2.9	\$ (0.1)	0.2

*Maintenance Products Group*

The Maintenance Products Group's operating income improved from \$0.3 million (0.5% of net sales) during the three month period ended September 30, 2005 to \$2.9 million (5.2% of net sales) for the three month period ended September 30, 2006. The improvement was primarily attributable to the production efficiencies gained within our Glit business unit. In addition, higher pricing resulting from the implementation of selling price increases across the Maintenance Products Group, most of which took effect throughout 2005, improved gross margins.

*Electrical Products Group*

The Electrical Products Group's operating income decreased from \$6.1 million (8.0% of net sales) for the three month period ended September 30, 2005 to \$4.4 million (6.7% of net sales) for the three month period ended September 30, 2006. The volume lost during the quarter as discussed above impacted the overall reduction in operating income. In addition, operating margins were negatively impacted from the change in material costs and the ability to recover from the customer.

*Corporate*

Corporate operating expenses increased from \$2.4 million in the three month period ended September 30, 2005 to \$2.8 million in three month period ended September 30, 2006 principally due to stock compensation, both stock options and stock appreciation rights.

*Severance, Restructuring and Related Charges*

Operating results for the Company during the three months ended September 30, 2006 and 2005 were impacted by severance, restructuring and related charges of \$0.7 million and \$0.3 million, respectively. Charges in 2006 related to costs associated with additional impairment for our Hazelwood facility as lower amount of space is required for the remaining manufacturing. Charges in 2005 primarily related to severance and facility closure costs associated with the

closure of one of our Glit facilities.

Other Items

Interest expense increased by \$0.3 million in the third quarter of 2006 compared to the same period of 2005, primarily as a result of higher interest rates in 2006 and higher levels of outstanding borrowings.

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The provision for income taxes for the three months ended September 30, 2006 and 2005 reflects a current expense for state income taxes and foreign income taxes. In both 2006 and 2005, tax benefits were not recorded in the U.S. (for federal and certain state income taxes) on pre-tax net income (loss) as a result of accumulated operating losses in the those jurisdictions, as we concluded that it was more likely than not that such benefits would not be realized. We recorded tax benefits for other foreign subsidiaries as we concluded that it was more likely than not that such benefits would be realized.

With the classification of the United Kingdom consumer plastics business unit as an asset held for sale, all activity associated with this business unit is classified as a discontinued operation. Included within the loss on sale of discontinued businesses is a \$3.2 million impairment charge upon the valuation of this business unit as an asset held for sale as discussed further in Note 12 of the Condensed Consolidated Financial Statements. Loss from operations of discontinued businesses includes activity from the United Kingdom consumer plastics business, plus the Metal Truck Box business unit and our SESCO partnership interest, which were both sold during the second quarter of 2006.

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Nine Months Ended September 30, 2006 versus Nine Months Ended September 30, 2005

	2006		2005	
	(Amounts in Millions, Except Per Share Data)			
	\$	% to Sales	\$	% to Sales
Net sales	\$ 285.7	100.0	\$ 309.7	100.0
Cost of goods sold	246.5	86.3	273.4	88.3
Gross profit	39.2	13.7	36.3	11.7
Selling, general and administrative expenses	36.3	12.7	39.1	12.6
Severance, restructuring and related charges	1.6	0.6	0.9	0.3
Loss (gain) on sale of assets	0.1	0.0	(0.4)	(0.1)
Operating income (loss)	1.2	0.4	(3.3)	(1.1)
Interest expense	(5.2)		(4.1)	
Other, net	0.5		0.2	
Loss from continuing operations before provision for income taxes	(3.5)		(7.2)	
Provision for income taxes from continuing operations	1.2		0.7	
Loss from continuing operations	(4.7)		(7.9)	
Loss from operations of discontinued businesses (net of tax)	(0.9)		(1.5)	
Loss on sale of discontinued businesses (net of tax)	(3.1)		-	
Loss before cumulative effect of a change in accounting principle	(8.7)		(9.4)	
Cumulative effect of a change in accounting principle (net of tax)	(0.8)		-	
Net loss	\$ (9.5)		\$ (9.4)	
Loss per share of common stock - basic:				
Loss from continuing operations	\$ (0.60)		\$ (0.99)	
Discontinued operations	(0.50)		(0.19)	
Cumulative effect of a change in accounting principle	(0.09)		-	
Net loss	\$ (1.19)		\$ (1.18)	
Loss per share of common stock - diluted:				
Loss from continuing operations	\$ (0.60)		\$ (0.99)	

Discontinued operations	(0.50)	(0.19)
Cumulative effect of a change in accounting principle	(0.09)	-
Net loss	\$ (1.19)	\$ (1.18)

### Overview

Our consolidated net sales for the nine month period ended September 30, 2006 decreased \$24.0 million compared to the nine month period ended September 30, 2005. The decline in net sales of 8% was comprised of lower volumes of 17% offset by higher pricing of 8% and favorable currency translation of 1%. Gross margins were 13.7% for the nine month period ended September 30, 2006; an increase of 2.0 percentage points compared to the nine month period ended September 30, 2005. In 2005, higher raw material costs and incremental operating costs incurred due to the delayed consolidation of the Glit facilities were partially offset by selling price increases and the favorable impact of restructuring and cost containment. In 2006, the lower volume impact was offset by the improvement in pricing and the production efficiencies being gained at our Glit business unit. SG&A as a percentage of sales for the first nine months of 2006 was 12.7% which was comparable to the first nine months of 2005. Operating income for the first nine months of 2006 improved to \$1.2 million from an operating loss of (\$3.3) million in 2005, mostly due to higher gross margins and reduced selling, general and administrative expense.

Overall, we reported a net loss of (\$9.5) million [(\$1.19) per share] for the nine month period ended September 30, 2006, versus a net loss of (\$9.4) million [(\$1.18) per share] for the same period of 2005.

Net Sales*Maintenance Products Group*

Net sales from the Maintenance Products Group decreased from \$164.8 million during the nine month period ended September 30, 2005 to \$160.8 million during the nine month period ended September 30, 2006. Overall, this decline of 2% was primarily due to lower volumes of 7% partially offset by higher pricing of 5%. Activity within the Contico and Glit business units were the primary reasons for the volume shortfall for the nine months ended September 30, 2006.

Higher pricing resulted from the implementation of selling price increases across the Maintenance Products Group, which took effect throughout the last half of 2005, with the most significant increases in the domestic business units. The implementation of price increases was in response to the accelerating cost of our primary raw materials, packaging materials, utilities and freight.

*Electrical Products Group*

The Electrical Products Group's sales decreased from \$144.9 million for the nine month period ended September 30, 2005 to \$124.9 million for the nine month period ended September 30, 2006. The sales reduction of 14% was primarily the result of lower volume of 28% partially offset by higher pricing of 13% and favorable currency translation of 1%. Volume in 2006 at Woods US was adversely impacted by the absence of 2005 non-recurring activity with one of its major customers which did not repeat in the first quarter of 2006. In addition, 2006 was adversely impacted by the loss of certain product lines with certain customers along with a milder hurricane season in the United States. Sales at Woods Canada were favorably impacted by a stronger Canadian dollar versus the U.S. dollar in the first half of 2006 as compared to the same period in 2005.

Operating Income

Nine months ended September 30,  
(Amounts in Millions)

<b>Operating income (loss)</b>	2006		2005		Change	
	\$	% Margin	\$	% Margin	\$	% Margin
Maintenance Products Group	\$ 4.7	2.9	\$ (4.3)	(2.6)	\$ 9.0	5.5
Electrical Products Group	6.4	5.1	10.2	7.0	(3.8)	(1.9)
Unallocated corporate expense	(8.2)		(8.7)		0.5	
	2.9	1.0	(2.8)	(0.9)	5.7	1.9
Severance, restructuring and related charges	(1.6)		(0.9)		(0.7)	
(Loss) gain on sale of assets	(0.1)		0.4		(0.5)	
Operating income (loss)	\$ 1.2	0.4	\$ (3.3)	(1.1)	\$ 4.5	1.5





### *Maintenance Products Group*

The Maintenance Products Group's operating income increased from an operating loss of (\$4.3) million (2.6% of net sales) during the nine month period ended September 30, 2005 to operating income of \$4.7 million (2.9% of net sales) for the nine month period ended September 30, 2006. The improvement was primarily attributable to production efficiencies gained at our Glit business unit gained over 2005 as well as higher pricing levels in 2006. In 2005, lower volumes and higher raw material costs adversely impacted our business units which sell plastic products. SG&A as a percentage of net sales in the first nine months of 2006 was slightly lower versus 2005 due mostly to cost containment measures.

### *Electrical Products Group*

The Electrical Products Group's operating income decreased from \$10.2 million (7.0% of net sales) for the nine month period ended September 30, 2005 to \$6.4 million (5.1% of net sales) for the nine month period ended September 30, 2006. The decrease in profitability was primarily due to the reduced volume levels at the Woods US business unit as discussed above. Gross margin performance in 2005 includes higher than historical one-time sales to a specific customer which resulted in a favorable gross margin in 2005. In addition, operating margins were negatively impacted, primarily during the third quarter, from the change in material costs and the ability to recover from the customer.

### *Corporate*

Corporate operating expenses decreased from \$8.7 million in the nine month period ended September 30, 2005 to \$8.2 million in the nine month period ended September 30, 2006 principally due to compensation cost associated with the acceleration of vesting of stock options in 2005 offset by higher health insurance costs in 2006.

### *Severance, Restructuring and Related Charges*

Operating results for the Company during the nine months ended September 30, 2006 and 2005 were negatively impacted by severance, restructuring and related charges of \$1.6 million and \$0.9 million, respectively. Charges in 2006 related to changes in lease assumptions for an abandoned facility (\$1.4 million) with the remaining charges primarily related to the relocation of the corporate headquarters. Charges in 2005 primarily related to severance and facility closure costs associated with the closure of one of our Glit facilities (\$0.7 million).

### Other Items

Interest expense increased by \$1.2 million in the first nine months of 2006 versus the same period of 2005, primarily as a result of higher interest rates and higher average borrowings in 2006 (principally due to increased working capital levels and lower financial performance in the second half of 2005). Other income, net for the nine months ended September 30, 2006 included a gain on foreign currency transactions.

The provision for income taxes for the nine months ended September 30, 2006 reflects current expense for state and foreign income taxes. In both 2006 and 2005, tax benefits were not recorded in the U.S. (for federal and certain state income taxes) and for certain foreign subsidiaries on pre-tax net losses as valuation allowances were recorded related to deferred tax assets created as a result of operating losses in the United States and certain foreign jurisdictions.

With the classification of the United Kingdom consumer plastics business unit as an asset held for sale, all activity associated with this business unit is classified as a discontinued operation. Included within the loss on sale of discontinued businesses is a \$3.2 million impairment charge upon the valuation of this business unit as an asset held for sale as discussed further in Note 12 of the Condensed Consolidated Financial Statements. Loss from operations of

discontinued businesses includes activity from the United Kingdom consumer plastics business, plus the Metal Truck Box business unit and our SESCO partnership interest, which were both sold during the second quarter of 2006 for a net gain of \$0.1 million. For the nine months ended September 30, 2006, the Company incurred a loss from operations of discontinued businesses of \$0.8 million compared to a loss from operations of discontinued businesses of \$1.5 million for the nine months ended September 30, 2005.

Effective January 1, 2006, the Company adopted SFAS No. 123R. As a result, a cumulative effect of this adoption of \$0.8 million was recognized associated with the fair value of all vested SARs. See Note 2 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for a discussion of the cumulative effect of a change in accounting principle.

## LIQUIDITY AND CAPITAL RESOURCES

We require funding for working capital needs and capital expenditures. We believe that our cash flow from operations and the use of available borrowings under the Bank of America Credit Agreement (as defined below) provide sufficient liquidity for our operations going forward. As of September 30, 2006, we had cash and cash equivalents of \$4.1 million versus cash and cash equivalents of \$8.4 million at December 31, 2005. Also as of September 30, 2006, we had outstanding borrowings of \$62.1 million [57% of total capitalization], under the Bank of America Credit Agreement, as defined below, with unused borrowing availability on the Revolving Credit Facility, as defined below, of \$22.3 million. As of December 31, 2005, we had outstanding borrowings of \$57.7 million [51% of total capitalization]. We used \$2.5 million of cash in operations during the nine months ended September 30, 2006 versus providing \$7.1 million of cash flow from operations during the nine months ended September 30, 2005. The use of cash flow in operations was primarily attributable to the pay down of accounts payable in the first quarter of 2006 as well as the on-going investment in inventory within our Electrical Products Group.

### Bank of America Credit Agreement

On April 20, 2004, we completed a refinancing of our outstanding indebtedness (the “Refinancing”) and entered into a new agreement with Bank of America Business Capital (formerly Fleet Capital Corporation) (the “Bank of America Credit Agreement”). Like the previous credit agreement with Fleet Capital Corporation, the Bank of America Credit Agreement is a \$110.0 million facility with a \$20.0 million term loan (“Term Loan”) and a \$90.0 million revolving credit facility (“Revolving Credit Facility”) with essentially the same terms as the previous credit agreement. The Bank of America Credit Agreement is an asset-based lending agreement and involves a syndicate of four banks, all of which participated in the syndicate from the previous credit agreement. The Bank of America Credit Agreement, and the additional borrowing ability under the Revolving Credit Facility obtained by incurring new term debt, results in three important benefits related to our long-term strategy: (1) additional borrowing capacity to invest in capital expenditures and/or acquisitions key to our strategic direction, (2) increased working capital flexibility to build inventory when necessary to accommodate lower cost outsourced finished goods inventory and (3) the ability to borrow locally in Canada and the United Kingdom and provide a natural hedge against currency fluctuations.

The Revolving Credit Facility has an expiration date of April 20, 2009 and its borrowing base is determined by eligible inventory and accounts receivable. The Term Loan also has a final maturity date of April 20, 2009 with quarterly payments of \$0.7 million. A final payment is scheduled to be paid in April 2009. The Term Loan is collateralized by our property, plant and equipment.

Our borrowing base under the Bank of America Credit Agreement is reduced by the outstanding amount of standby and commercial letters of credit. Vendors, financial institutions and other parties with whom we conduct business may require letters of credit in the future that either (1) do not exist today or (2) would be at higher amounts than those that exist today. Currently, our largest letters of credit relate to our casualty insurance programs. At September 30, 2006, total outstanding letters of credit were \$8.4 million.

All extensions of credit under the Bank of America Credit Agreement are collateralized by a first priority security interest in and lien upon the capital stock of each material domestic subsidiary (65% of the capital stock of each material foreign subsidiary), and all present and future assets and properties of Katy. Customary financial covenants and restrictions apply under the Bank of America Credit Agreement. Current margins of 275 basis points over

applicable LIBOR rates for Revolving Credit Facility borrowings and 300 basis points over LIBOR for borrowings under the Term Loan reflect the highest spread under the Bank of America Credit Agreement, as amended. Additionally, margins on the Term Loan will drop an additional 25 basis points if the balance of the Term Loan is reduced below \$10.0 million. Interest accrues at higher margins on prime rates for swing loans, the amounts of which were nominal at September 30, 2006.

With the Sixth Amendment in the Bank of America Credit Agreement (“Sixth Amendment”), the Company’s current debt covenants under the Bank of America Credit Agreement are as follows:

*Minimum Availability* - Eligible collateral must exceed the sum of our outstanding borrowings and letters of credit under the Revolving Credit Facility by at least \$5.0 million from the effective date of the Sixth Amendment through September 29, 2006 and by at least \$7.5 million from September 30, 2006 until the date we deliver our financial statements for the first quarter of 2007 to our lenders.

*Fixed Charge Coverage Ratio* - The Company is required to maintain a Fixed Charge Coverage Ratio (as defined in the Bank of America Credit Agreement) of 1.1:1. Pursuant to the Sixth Amendment, this covenant was suspended and will be reinstated following the first quarter of 2007.

*Capital Expenditures* - For the year ended December 31, 2006, the Company is not to exceed \$12.0 million in capital expenditures. Subsequent to 2006, the Company is not to exceed \$15.0 million during a single fiscal year.

*Leverage Ratio* - The Third Amendment to the Bank of America Credit Agreement eliminated the Leverage Ratio (as defined in the Bank of America Credit Agreement) as a financial covenant. Following the first quarter of 2007, the Leverage Ratio will be utilized to determine the interest rate margin over the applicable LIBOR rate.

If we are unable to comply with the terms of the amended covenants, we could seek to obtain further amendments or pursue increased liquidity through additional debt financing and/or the sale of assets. However, there is no guarantee that such financing could be obtained. The Company is in compliance with the Credit Agreement as of September 30, 2006 and believes that we will be able to comply with all covenants, as amended, throughout 2006.

For the three and nine months ended September 30, 2006 and 2005, the Company had amortization of debt issuance costs of \$0.3 million and \$0.9 million, and \$0.3 million and \$0.8 million, respectively. In addition, the Company incurred and expensed zero and \$0.2 million, and \$0.1 million and \$0.2 million associated with amending the Bank of America Credit Agreement, as discussed above, in the three and nine months ended September 30, 2006 and 2005, respectively.

The Revolving Credit Facility under the Bank of America Credit Agreement requires lockbox agreements which provide for all receipts to be swept daily to reduce borrowings outstanding. These agreements, combined with the existence of a MAE clause in the Bank of America Credit Agreement, caused the revolving credit facility to be classified as a current liability, per guidance in the Emerging Issues Task Force Issue No. 95-22, *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that Include Both a Subjective Acceleration Clause and a Lock-Box Arrangement*. We do not expect to repay, or be required to repay, within one year, the balance of the revolving credit facility classified as a current liability. The MAE clause, which is a fairly typical requirement in commercial credit agreements, allows the lenders to require the loan to become due if they determine there has been a material adverse effect on our operations, business, properties, assets, liabilities, condition, or prospects. The classification of the revolving credit facility as a current liability is a result only of the combination of the lockbox agreements and MAE clause. The Bank of America Credit Agreement does not expire or have a maturity date within one year, but rather has a final expiration date of April 20, 2009. The lender had not notified us of any indication of a MAE at September 30, 2006, and we were not in default of any provision of the Bank of America Credit Agreement at September 30, 2006.

#### Contractual Obligations

We have contractual obligations associated with our debt, operating lease agreements, severance and restructuring, and other obligations. Our obligations as of September 30, 2006, are summarized below (in thousands of dollars):



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Contractual Cash Obligations	Total	Due in less than 1 year	Due in 1-3 years	Due in 3-5 years	Due after 5 years
Revolving credit facility [a]	\$ 49,729	\$ 49,729	\$ -	\$ -	\$ -
Term loans	12,367	2,857	9,510	-	-
Interest on debt [b]	10,925	4,628	6,297	-	-
Operating leases [c]	24,072	7,709	11,413	4,171	779
Severance and restructuring [c]	1,919	953	543	372	51
SESCO payable to Montenay [d]	800	800	-	-	-
Post-retirement benefits [e]	5,376	834	1,421	1,080	2,041
<b>Total Contractual Obligations</b>	<b>\$ 105,188</b>	<b>\$ 67,510</b>	<b>\$ 29,184</b>	<b>\$ 5,623</b>	<b>\$ 2,871</b>

  

Other Commercial Commitments	Total	Due in less than 1 year	Due in 1-3 years	Due in 3-5 years	Due after 5 years
Commercial letters of credit	\$ 835	\$ 835	\$ -	\$ -	\$ -
Stand-by letters of credit	7,529	7,529	-	-	-
Guarantees [f]	-	-	-	-	-
<b>Total Commercial Commitments</b>	<b>\$ 8,364</b>	<b>\$ 8,364</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>

[a] As discussed in the Liquidity and Capital Resources section above and in Note 5 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q, the entire Revolving Credit Facility under the Bank of America Credit Agreement is classified as a current liability on the Condensed Consolidated Balance Sheets as a result of the combination in the Bank of America Credit Agreement of (i) lockbox agreements on Katy's depository bank accounts, and (ii) a subjective Material Adverse Effect (MAE) clause. The Revolving Credit Facility expires in April of 2009.

[b] Represents interest on the Revolving Credit Facility and Term Loan of the Bank of America Credit Agreement. Amounts assume interest accrues at the current rate in effect, including the effect of the impact of the increased margins through the end of the first quarter of 2007 pursuant to the Sixth Amendment. The amount also assumes the principal balance of the Revolving Credit Facility remains constant through its expiration date of April 20, 2009 and the principal balance of the Term Loan amortizes in accordance with the terms of the Bank of America Credit Agreement. Due to the variable nature of the Bank of America Credit Agreement, actual interest rates could differ from the assumptions above. In addition, actual borrowing levels could differ from the assumptions above due to liquidity needs.

[c] Future non-cancelable lease rentals are included in the line entitled "Operating leases," which includes obligations associated with restructuring activities. The Condensed Consolidated Balance Sheet at September 30, 2006 includes \$3.6 million in discounted liabilities associated with non-cancelable operating lease rentals, net of estimated sub-lease revenues, related to facilities that have been abandoned as a result of restructuring and consolidation activities.

[d] Amount owed to Montenay as a result of the SESCO partnership, discussed in Note 4 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q. This obligation is

classified in the Condensed Consolidated Balance Sheets in accrued expenses within Current Liabilities, recorded on a discounted basis.

[e] Benefits consist of post-retirement medical obligations to retirees of former subsidiaries of Katy, as well as deferred compensation plan liabilities to former officers of the Company.

[f] As discussed in Note 4 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q, SESCO, an indirect wholly-owned subsidiary of Katy, was party to a partnership that operated a waste-to-energy facility, and had certain contractual obligations, for which Katy provided certain guarantees. If the partnership was not able to perform its obligations under the contracts, under certain circumstances SESCO and Katy could have been subject to damages equal to the amount of Industrial Revenue Bonds ("IRBs") outstanding (which financed construction of the facility) less amounts held by the partnership in debt service reserve funds. As of September 30, 2006, none of the IRBs remained outstanding (see Note 4 to Condensed Consolidated Financial Statements).



For items noted as [d] and [f], on June 27, 2006, the Company and Montenay amended the partnership agreement in order to allow the Company to completely exit from the SESCO operations and related obligations. In addition, Montenay became the guarantor under the loan obligation for the IRBs. Montenay purchased the Company's limited partnership interest for \$75 thousand and a reduction of approximately \$0.6 million in the face amount due to Montenay as agreed upon in the original partnership agreement. In addition, Montenay removed the Company as the performance guarantor under the service agreement. As a result of the above transaction, the Company recorded \$0.4 million within loss from operations of discontinued businesses during the nine months ended September 30, 2006 given the reduction in the face amount due to Montenay as agreed upon in the original partnership agreement. In addition, the Company recorded a gain on the sale of the partnership interest of approximately \$0.1 million as reflected within loss on sale of discontinued businesses.

#### Off-balance Sheet Arrangements

See Note 4 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for a discussion of SESCO.

#### Cash Flow

Liquidity was adversely impacted during the first nine months of 2006 as a result of higher operating cash requirements. We used \$2.5 million of operating cash compared to providing operating cash of \$7.1 million during the first nine months of 2005. Debt obligations at September 30, 2006 increased \$4.1 million from December 31, 2005, primarily the result of higher working capital offset by proceeds received from the sale of the Metal Truck Box business unit.

#### *Operating Activities*

Cash flow provided by operating activities before changes in operating assets was \$3.3 million in the first nine months of 2006 versus cash flow provided by operating activities before changes in operating assets of \$1.3 million in the first nine months of 2005. While we had net losses in both periods, these amounts included non-cash items such as depreciation, amortization and amortization of debt issuance costs. We used \$7.9 million of cash related to operating assets and liabilities during the nine months ended September 30, 2006 versus cash provided related to operating assets and liabilities of \$6.3 million during the nine months ended September 30, 2005. Our operating cash flow was adversely impacted in 2006 by the pay down of accounts payable during the first quarter of 2006 along with our seasonal investment into inventory within our Electrical Products Group.

#### *Investing Activities*

Capital expenditures totaled \$3.0 million during the nine months ended September 30, 2006 as compared to \$5.8 million during the nine months ended September 30, 2005. Anticipated capital expenditures in 2006 are expected to be slightly lower than in 2005. In addition, the Company received \$2.5 million in cash proceeds from the sale of the Metal Truck Box business unit and the SESCO partnership interest.

#### *Financing Activities*

Overall, debt increased \$4.1 million during the nine months ended September 30, 2006 versus a decrease of \$1.1 million during the nine months ended September 30, 2005, primarily relating to the changes in working capital during those periods. Direct debt costs totaling \$0.2 million and \$0.2 million in the first nine months of 2006 and 2005, respectively, primarily represents a fee paid to our lenders in connection with the amendments made to the Bank of America Credit Agreement.



## SEVERANCE, RESTRUCTURING AND RELATED CHARGES

Over the past three years, the Company has initiated several cost reduction and facility consolidation initiatives, resulting in severance, restructuring and related charges. Key initiatives were the consolidation of the St. Louis manufacturing/distribution facilities, shutdown of both Woods US and Woods Canada manufacturing as well as the consolidation of the Glit facilities. These initiatives resulted from the on-going strategic reassessment of our various businesses as well as the markets in which they operate.

A summary of charges by major initiative is as follows (amounts in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Consolidation of St. Louis manufacturing/distribution facilities	\$ 704	\$ 146	\$ 1,403	\$ 100
Consolidation of Glit facilities	-	(23)	-	659
Consolidation of administrative functions for CCP	-	-	-	21
Shutdown of Woods Canada manufacturing	-	131	-	112
Corporate office relocation	34	-	188	-
Total severance, restructuring and related charges	\$ 738	\$ 254	\$ 1,591	\$ 892

The impact of actions in connection with the above initiatives on the Company's reportable segments (before tax) is as follows (amounts in thousands):

	Total Expected Cost	Total Provision to Date
Maintenance Products Group	\$ 22,646	\$ 22,396
Electrical Products Group	12,776	12,776
Corporate	12,323	12,261
	\$ 47,745	\$ 47,433

A rollforward of all restructuring and related reserves since December 31, 2005 is as follows (amounts in thousands):

	Total	One-time Termination Benefits [a]	Contract Termination Costs [b]
Restructuring liabilities at December 31, 2005	\$ 3,419	\$ 432	\$ 2,987
Additions	1,591	188	1,403
Payments	(1,335)	(522)	(813)
Restructuring liabilities at September 30, 2006 [c]	\$ 3,675	\$ 98	\$ 3,577

[a] Includes severance, benefits, and other employee-related charges associated with the employee terminations.

[b] Includes charges related to non-cancelable lease liabilities for abandoned facilities, net of estimated sub-lease revenue. Total maximum potential amount of lease loss, excluding any sublease rentals, is \$4.2 million as of September 30, 2006. We have included \$0.6 million as an offset for sublease rentals.

[c] Katy expects to substantially complete its current restructuring programs in 2006. The remaining severance, restructuring and related charges for these initiatives are expected to be approximately \$0.3 million.

Since 2001, the Company has been focused on a number of restructuring and cost reduction initiatives, resulting in severance, restructuring and related charges. With these changes, we anticipated cost savings from reduced headcount, higher utilized facilities and divested non-core operations. However, anticipated cost savings have been impacted from such factors as material price increases, competitive markets and inefficiencies incurred from consolidation of facilities. See Note 11 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for a discussion of severance, restructuring and related charges.

## OUTLOOK FOR 2006

We experienced strong sales performance during 2005 from the Woods US retail electrical corded products business, offset by lower volumes in our Contico and Glit business units. Price increases were passed along to our Woods US customers during 2005 as a result of the rise in copper prices in the last two years and we have implemented additional price increases in 2006; however, not as quickly as material prices increased. We anticipate a reduction in net sales from Woods US, as experienced in the first half of 2006, due to customers moving more of their purchases directly to Asian manufacturers. We have implemented price increases primarily in the last half of 2005 for the Continental, Container and Contico business units in response to higher raw material costs. However, in the Contico business, we face the continuing challenge of passing through price increases to offset these higher costs, and sales volumes have been and are likely to continue to be negatively impacted as a result of raising prices.

We expect that the quality, shipping and production issues present at our Glit facilities in 2005 have improved and will continue to improve throughout 2006. We believe the Glit business unit will improve its quality level and cost control in its Wrens operations and as they consolidate the Pineville, North Carolina operation into the Wrens, Georgia facility. This consolidation is expected to occur in the fourth quarter of 2006 and will result in improved profitability of our Glit business. In addition, we believe the disruption to our Glit operations over the last two years resulted in the loss of certain customers. Currently, we do not anticipate additional lost sales for the rest of 2006.

Cost of goods sold is subject to variability in the prices for certain raw materials, most significantly thermoplastic resins used in the manufacture of plastic products for the Continental and Contico businesses. Prices of plastic resins, such as polyethylene and polypropylene, have increased steadily from the latter half of 2002 through 2005. Management has observed that the prices of plastic resins are driven to an extent by prices for crude oil and natural gas, in addition to other factors specific to the supply and demand of the resins themselves. Resin prices for 2006 are expected to remain stable as experienced to date in 2006. We are equally exposed to price changes for copper at our Woods US and Woods Canada business units. Prices for copper increased in late 2003 and have continued through the first nine months of 2006. We have not employed an active hedging program related to our commodity price risk, but are employing other strategies for managing this risk, including contracting for a certain percentage of resin needs through supply agreements and opportunistic spot purchases. We have experienced cost increases in the prices of primary raw materials used in our products and inflation on other costs such as packaging materials, utilities and freight. In a climate of rising raw material costs (and especially in 2005), we experience difficulty in raising prices to shift these higher costs to our consumer customers for our plastic and copper products. Our future earnings may be negatively impacted to the extent further increases in costs for raw materials cannot be recovered or offset through higher selling prices. We cannot predict the direction our raw material prices will take during 2006 and beyond.

Since the Recapitalization, our management has executed a number of restructuring and cost reduction initiatives, including the consolidation of facilities, divestiture of non-core operations, selling, general and administrative (SG&A) cost rationalization and organizational changes. In the future, we continue to expect to benefit from various profit enhancing strategies such as process improvements (including Lean Manufacturing and Six Sigma), value engineering products, improved sourcing/purchasing and lean administration.

SG&A expenses were comparable as a percentage of sales in 2005 versus 2004 and should remain stable as a percentage of sales in 2006. We have completed the process of transferring back-office functions of our Wilen, Glit and Disco business units from Georgia to Bridgeton, Missouri, the headquarters of CCP. We will continue to evaluate the possibility of further consolidation of administrative processes.

Interest rates rose in 2005 and we expect rates to increase slightly in 2006. Ultimately, we cannot predict the future levels of interest rates. With the execution of the Sixth Amendment under the Bank of America Credit Agreement, the Company will have the interest rate margins on all of our outstanding borrowings and letters of credit set at the largest margins set forth in the Bank of America Credit Agreement. Interest rate margins will return to levels set forth in the Bank of America Credit Agreement subsequent to the delivery of our financial statements for the first quarter of 2007 to our lenders.

Given our history of operating losses, along with guidance provided by the accounting literature covering accounting for income taxes, we are unable to conclude it is more likely than not that we will be able to generate future taxable income sufficient to realize the benefits of domestic deferred tax assets carried on our books. Therefore, except for our profitable foreign subsidiaries, a full valuation allowance on the net deferred tax asset position was recorded at December 31, 2005 and 2004, and we do not expect to record the benefit of any deferred tax assets that may be generated in 2006. We will continue to record current expense associated with federal, foreign and state income taxes.

In 2005, our financial performance benefited from favorable currency translation as the Canadian dollar and the British sterling strengthened throughout the year against the U.S. dollar. While we cannot predict the ultimate direction of exchange rates, we do not expect to see the same favorable impact on our financial performance in 2006.

We expect our working capital levels to remain constant as a percentage of sales. However, inventory carrying values may be impacted by higher material costs. Cash flow will be used in 2006 for capital expenditures and payments due under our Term Loan as well as the settlement of previously established restructuring accruals. The majority of these accruals relate to non-cancelable lease obligations for abandoned facilities. These accruals do not create incremental cash obligations in that we are obligated to make the associated payments whether we occupy the facilities or not. The amount we will ultimately pay out under these accruals is dependent on our ability to successfully sublet all or a portion of the abandoned facilities.

On March 9, 2006, in anticipation of not achieving the minimum Fixed Charge Coverage Ratio as of the end of each quarter of 2006, we obtained the Sixth Amendment to the Bank of America Credit Agreement. The Sixth Amendment adjusts the Minimum Availability such that our eligible collateral must exceed the sum of our outstanding borrowings and letters of credit under the Revolving Credit Facility by at least \$5.0 million from the effective date of the Sixth Amendment through September 29, 2006 and by at least \$7.5 million from September 30, 2006 until the date we deliver our financial statements for the first quarter of 2007 to our lenders. Subsequent to the delivery of the financial statements for the first quarter of 2007, the Sixth Amendment reestablishes the minimum Fixed Charge Coverage Ratio as originally set forth in the Bank of America Credit Agreement. The Sixth Amendment also reduces the maximum allowable capital expenditures for 2006 from \$15.0 million to \$12.0 million, and increases the interest rate margins on all of our outstanding borrowings and letters of credit to the largest margins set forth in the Bank of America Credit Agreement. Interest rate margins will return to levels set forth in the Bank of America Credit Agreement subsequent to the delivery of our financial statements for the first quarter of 2007 to our lenders.

If we are unable to comply with the terms of the amended covenants, we could seek to obtain further amendments and pursue increased liquidity through additional debt financing and/or the sale of assets. We believe that given our strong working capital base, additional liquidity could be obtained through additional debt financing, if necessary. However, there is no guarantee that such financing could be obtained. The Company believes that we will be able to comply with all covenants, as amended, throughout 2006. In addition, we are continually evaluating alternatives relating to the sale of excess assets and divestitures of certain of our business units. Asset sales and business divestitures present opportunities to provide additional liquidity by de-leveraging our financial position.

Cautionary Statement Pursuant to Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995

This report and the information incorporated by reference in this report contain various “forward-looking statements” as defined in Section 27A of the Securities Act of 1933 and Section 21E of the Exchange Act of 1934, as amended. The forward-looking statements are based on the beliefs of our management, as well as assumptions made by, and information currently available to, our management. We have based these forward-looking statements on current expectations and projections about future events and trends affecting the financial condition of our business. These forward-looking statements are subject to risks and uncertainties that may lead to results that differ materially from those expressed in any forward-looking statement made by us or on our behalf, including, among other things:



- Increases in the cost of, or in some cases continuation of, the current price levels of plastic resins, copper, paper board packaging, and other raw materials.
  - Our inability to reduce product costs, including manufacturing, sourcing, freight, and other product costs.
- Greater reliance on third parties for our finished goods as we increase the portion of our manufacturing that is outsourced.
  - Our inability to reduce administrative costs through consolidation of functions and systems improvements.
    - Our inability to execute our systems integration plan.
      - Our inability to successfully integrate our operations as a result of the facility consolidations.
- Our inability to achieve product price increases, especially as they relate to potentially higher raw material costs.
- The potential impact of losing lines of business at large mass merchant retailers in the discount and do-it-yourself markets.
  - Competition from foreign competitors.
    - The potential impact of rising interest rates on our LIBOR-based Bank of America Credit Agreement.
      - Our inability to meet covenants associated with the Bank of America Credit Agreement.
      - The potential impact of rising costs for insurance for properties and various forms of liabilities.
      - The potential impact of changes in foreign currency exchange rates related to our foreign operations.
- Labor issues, including union activities that require an increase in production costs or lead to a strike, thus impairing production and decreasing sales. We are also subject to labor relations issues at entities involved in our supply chain, including both suppliers and those involved in transportation and shipping.
- Changes in significant laws and government regulations affecting environmental compliance and income taxes.

Words and phrases such as “expects,” “estimates,” “will,” “intends,” “plans,” “believes,” “should,” “anticipates,” and “thinks” are intended to identify forward-looking statements. The results referred to in forward-looking statements may differ materially from actual results because they involve estimates, assumptions and uncertainties. Forward-looking statements included herein are as of the date hereof and we undertake no obligation to revise or update such statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. All forward-looking statements should be viewed with caution.

## ENVIRONMENTAL AND OTHER CONTINGENCIES

See Note 9 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for a discussion of environmental and other contingencies.

## RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

See Note 2 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for a discussion of recently issued accounting pronouncements.

## CRITICAL ACCOUNTING POLICIES

We disclosed details regarding certain of our critical accounting policies in the Management's Discussion and Analysis section of our Annual Report on Form 10-K for the year ended December 31, 2005 (Part II, Item 7). There have been no changes to policies as of September 30, 2006, except for the adoption of SFAS No. 123R.

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"), which describes a comprehensive model for the measurement, recognition, presentation and disclosure of uncertain tax positions in the financial statements. Under the interpretation, the financial statements will reflect expected future tax consequences of such positions presuming the tax authorities' full knowledge of the position and all relevant facts, but without considering time values. The Company is assessing the impact this interpretation may have in its future financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ("SFAS No. 157"). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. This standard does not require any new fair value measurements but provides guidance in determining fair value measurements presently used in the preparation of financial statements. For the Company, SFAS No. 157 is effective January 1, 2008. The Company is assessing the impact this standard may have in its future financial statements.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106 and 132(R)*. This new standard requires employers to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. For employers that have equity securities that trade in the public market, this new standard requires the recognition of the funded status of a defined benefit postretirement plan and requires disclosures as of the end of the fiscal year ending after December 15, 2006. The Company is currently evaluating the impact of adopting this standard in its financial statements.

## Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

### Interest Rate Risk

Our exposure to market risk associated with changes in interest rates relates primarily to our debt obligations. Accordingly, effective August 17, 2005, we entered into a two-year interest rate swap agreement on a notional amount of \$25.0 million in the first year and \$15.0 million in the second year. The fixed interest rate under the swap at September 30, 2006 and over the life of the agreement is 4.49%. Our interest obligations on outstanding debt at September 30, 2006 were indexed from short-term LIBOR. As a result of the current rising interest rate environment and the increase in the interest rate margins on our borrowings as a result of the Sixth Amendment to the Bank of America Credit

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Agreement, our exposures to interest rate risks could be material to our financial position or results of operations. For example, a 1% increase in the interest rate of the Bank of America Credit would increase our annual interest expense by approximately \$0.4 million.

### Foreign Exchange Risk

We are exposed to fluctuations in the Euro, British pound, Canadian dollar and Chinese Renminbi. Some of our subsidiaries make significant U.S. dollar purchases from Asian suppliers, particularly in China. An adverse change in foreign currency exchange rates of Asian countries could result in an increase in the cost of purchases. We do not currently hedge foreign currency transaction or translation exposures. Our net investment in foreign subsidiaries translated into U.S. dollars at September 30, 2006 is \$22.6 million. A 10% change in foreign currency exchange rates would amount to \$2.3 million change in our net investment in foreign subsidiaries at September 30, 2006.

### Commodity Price Risk

We have not employed an active hedging program related to our commodity price risk, but are employing other strategies for managing this risk, including contracting for a certain percentage of resin needs through supply agreements and opportunistic spot purchases. See Management's Discussion and Analysis of Financial Condition and Results of Operations - Outlook for 2006 in Part I, Item 2 of this Quarterly Report on Form 10-Q, for further discussion of our exposure to increasing raw material costs.

## Item 4. CONTROLS AND PROCEDURES

### (a) Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our filings with the Securities and Exchange Commission ("SEC") is reported within the time periods specified in the SEC's rules, and that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. We also have investments in certain unconsolidated entities. The oversight of these entities includes an assessment of controls over the recording of related amounts in the consolidated financial statements, including controls over the selection of accounting methods, the recognition of equity method income and losses, and the determination, valuation, and recording of assets in our investment account balances.

Pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934, Katy carried out an evaluation, under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (pursuant to Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period of our report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our principal executive officer and primary financial officer, as appropriate, to allow timely decisions regarding required disclosure.

### (b) Change in Internal Controls

There have been no changes in Katy's internal control over financial reporting during the quarter ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect Katy's internal control over financial reporting.

As noted in our Annual Report on Form 10-K for the year ended December 31, 2004, our Glit facility in Wrens, Georgia lacks a perpetual inventory system and relies on quarterly physicals to value inventory. Throughout 2004, we adjusted our material cost of sales estimate (for preparation of non-quarter-end interim financial statements) to reflect rising material cost of sales.



Also during 2004 and 2005, the Wrens facility experienced significant personnel turnover, consolidation of other operations (consistent with our strategy of consolidating our abrasives operations into the Wrens facility), and manufacturing disruption events such as the production interruption caused by the air handling system fire in October 2004. Management determined that key inventory processes, such as receiving, production reporting, scrap, and shipping, required improvement.

In light of the above developments, our management requested that our independent auditor, PricewaterhouseCoopers LLP (“PwC”), perform a comprehensive analysis of the Wrens inventory process controls. As part of the analysis, PwC conducted, in the Spring of 2005, an on-site review of the operations and inventory-related process controls of the Wrens facility as well as related certain back-office processes conducted in St. Louis, Missouri.

The PwC review concluded that inventory process controls were inadequate. Among the inadequacies identified were those relating to shipping and receiving controls, bills of material and routings, security measures, and systems implementation (we are in the process of re-implementing a new ERP system). As a result of its review, PwC recommended that we take certain corrective actions, including the establishment of a perpetual inventory system. In response to each of PwC’s detailed recommendations, management developed an itemized corrective action plan which was discussed with our Audit Committee, Board of Directors and PwC. We believe that the action plan developed by our management will correct the inadequacies in our internal control over financial reporting as they relate to our inventory process at our Wrens facility. We also believe that despite these inadequacies, the quarterly physical inventory process at this facility has provided us with an accurate inventory valuation.

The following is a summary of the specific actions that have been taken to correct the internal control deficiencies and related status as of September 30, 2006:

- Implementation of short term corrective actions in shipping and receiving - Revised shipping, receiving, physical inventory, period end cut-off and returned goods procedures have been issued. Training to reinforce the importance of the physical verification was provided to all appropriate material handlers. Products loaded for shipment are now verified against system generated bill of ladings. A receiving log was implemented in the first quarter of 2005 and is reviewed at least weekly by the distribution manager.
- Establishment of improved interim recording of raw material usage - The shop floor module in PRMS (the facility’s ERP system) was activated on July 1, 2005. Large raw material variances continue to be reviewed and/or isolated by work order to allow bill of material (“BOM”) corrections as required. Miscellaneous inventory transactions are being downloaded and reviewed at least weekly by cost accounting. In 2005, a supplemental system was also re-implemented to allow the daily review of costed non-woven production runs to identify process or material variances. The output of this system yields a daily cost per yard of non-woven material produced, as well as an average cost per yard over multiple batches/runs. This information was used as a reference point and allowed material cost verifications with PRMS formula BOMs. During the third quarter of 2006, the Company discontinued the supplemental system given the higher level of accuracy being obtained from the shop floor module in PRMS.
- Reestablishment of a monthly physical inventory until the PRMS perpetual inventory process is re-implemented - This location’s monthly physical inventory was reinstated for the February 2005 accounting close. We continue taking a monthly physical inventory throughout 2005 and 2006. Over the past year, overall accuracy, based on inventory value, continues to significantly improve.
  - Establishment of security measures to mitigate the risk of theft - All employees were issued parking permits to help identify on-site traffic of non-employees. A security camera system was installed and became operational in June 2005. Cameras provide monitoring of key plant areas by both security personnel and key managers.

- Improvement in bill of material and routing accuracy - In July 2005, a BOM accuracy project was completed which encompassed the review of the most significant BOMs across all product lines. Efforts are now ongoing to review remaining BOMs, prioritizing based on sales volumes and comparative analysis with other BOMs of like material/sizes. All remaining significant BOMs, based on volume levels, were updated by February 1, 2006.

- Proper staffing and planning of PRMS re-implementation - The PRMS re-implementation was completed at the end of July 2005. The Material Planning and Scheduling module of PRMS was completed in the fourth quarter of 2005. The total re-implementation was facilitated by a consultant with expertise with both PRMS and ERP system implementation across varied industries.
- Establishment of procedures for production reporting and inventory transactions - Detailed procedures for reporting of production in PRMS have been issued. The implementation of scanning for inventory transactions was completed in August and documented procedures were completed in September, 2005. Any additional procedures will be finalized and documented when they are validated.
- Activation of PRMS production and inventory system - The system was fully activated on February 1, 2006 which allows the accumulation and reporting of transactions, maintenance of perpetual inventory records, and the calculation of standard cost and related variances. The system will continue to operate in parallel with the monthly physical inventory until all significant variances will be identified and corrected.

The implementation of our action plan is an ongoing process. Although we believe that we have made significant progress in the items noted above, we have not yet fully implemented certain of the PwC recommendations, including the establishment and validation, to an appropriate accuracy level, of a perpetual inventory system. Accordingly, we are unable to conclude as of September 30, 2006 that our inventory process controls at our Wrens facility are adequate without the monthly physical inventory counts. In our Annual Report for the year ended December 31, 2005, we believed that the activation of the PRMS production and inventory system would allow the Company to rely on the adequacy of internal controls (without the monthly physical inventory counts) at our Wrens, Georgia facility by the end of the second quarter of 2006. The Company now believes that it will not be able to eliminate the monthly physical inventory counts as an inventory process control until the fourth quarter of 2006.



**PART II - OTHER INFORMATION**

**Item 1. LEGAL PROCEEDINGS**

Except as otherwise noted in Note 9 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q, during the quarter for which this report is filed, there have been no material developments in previously reported legal proceedings, and no other cases or legal proceedings, other than ordinary routine litigation incidental to the Company's business and other nonmaterial proceedings, were brought against the Company.

**Item 1A. RISK FACTORS**

We are affected by risks specific to us as well as factors that affect all businesses operating in a global market. The significant factors known to us that could materially adversely affect our business, financial condition, or operating results are described in our most recently filed Annual Report on Form 10-K (Item 1A of Part I). There has been no material change in those risk factors.

**Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

On April 20, 2003, the Company announced a plan to spend up to \$5.0 million to repurchase shares of its common stock. In 2004, 12,000 shares of common stock were repurchased on the open market for approximately \$75 thousand under this plan, while in 2003, 482,800 shares of common stock were repurchased on the open market for approximately \$2.5 million. The Company suspended further purchases under the plan on May 10, 2004. On December 5, 2005, we announced the resumption of the plan. During 2005, the Company purchased 3,200 shares of common stock on the open market for less than \$0.1 million. During the three and nine months ended September 30, 2006, the Company purchased 8,900 and 35,900 shares of common stock on the open market for less than \$0.1 million.

**Item 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

**Item 5. OTHER INFORMATION**

None.

**Item 6. EXHIBITS**

**Exhibit  
Number**

**Exhibit Title**

- |      |  |   |
|------|--|---|
| 31.1 | CEO Certification pursuant to Securities Exchange Act Rule 13a-14, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. | * |
| 31.2 | CFO Certification pursuant to Securities Exchange Act Rule 13a-14, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. | * |

- 32.1 CEO Certification required by 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. \*#
- 32.2 CFO Certification required by 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. \*#

\* Indicates filed herewith.

# These certifications are being furnished solely to accompany this report pursuant to 18 U.S.C. 1350, and are not being filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and are not to be incorporated by reference into any filing of Katy Industries, Inc. whether made before or after the date hereof, regardless of any general incorporation language in such filing.

Signatures

Pursuant to the requirements 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.

KATY INDUSTRIES, INC.

Registrant

DATE: November 14, 2006

By /s/ Anthony T. Castor III

Anthony T. Castor III

President and Chief Executive Officer

By /s/ Amir Rosenthal

Amir Rosenthal

Vice President, Chief Financial Officer,

General Counsel and Secretary