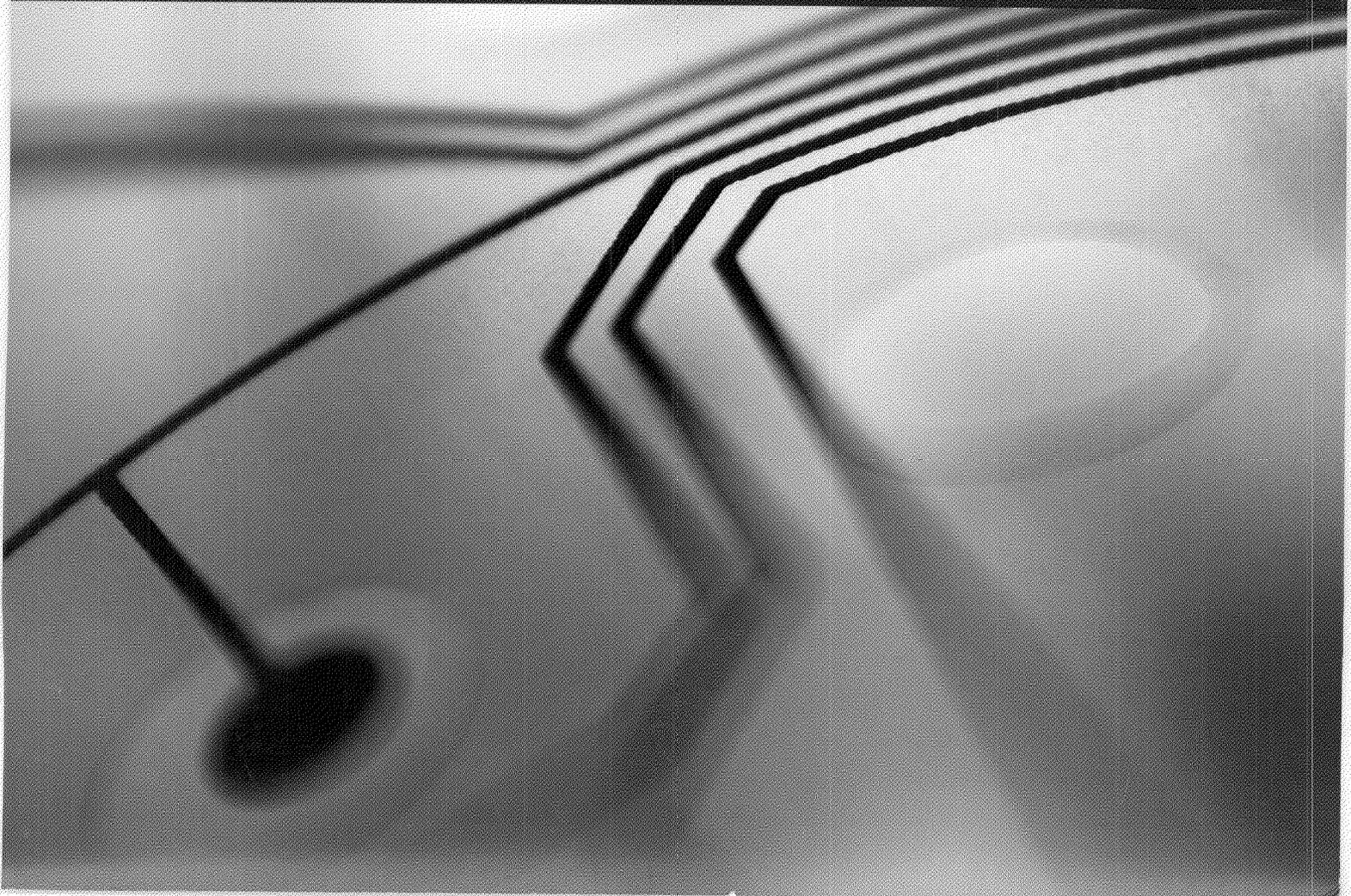


KMG 2012 ANNUAL REPORT



12028434

# A Consolidation process.



At KMG, our vision is clear: We strive to perfect the art and science of consolidation. We start by identifying the hidden value in businesses or product lines that others have overlooked. Our methodical integration and optimization processes ensure we remain focused on maximizing free cash flow and generating long-term shareholder value. While simple in theory, our formula for success requires focus, discipline and foresight to achieve.

2012

# A Consolidation approach to growth.

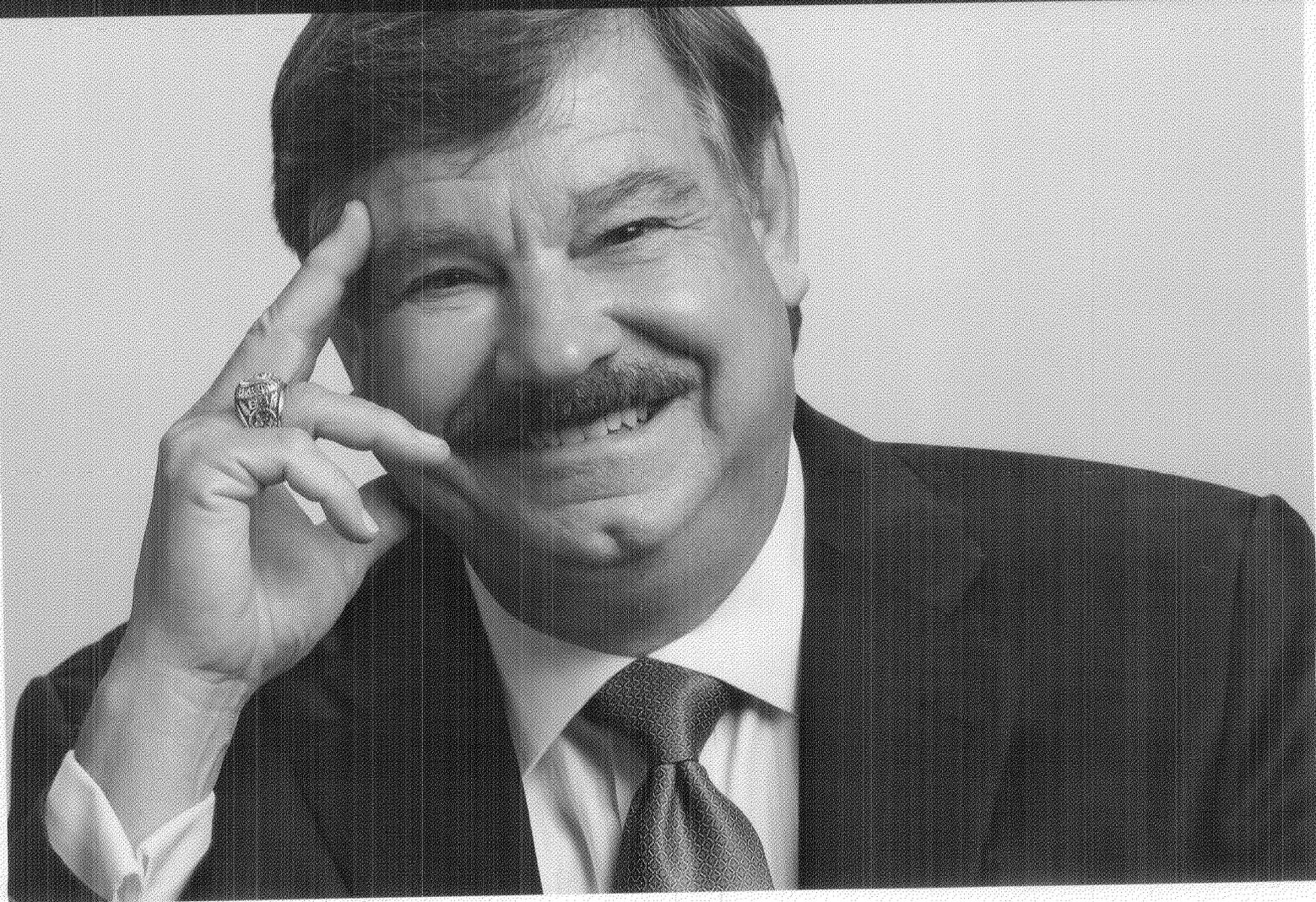
KMG's consolidation strategy represents the foundation of our corporate growth strategy. We seek out niche specialty chemical markets in which we will act as the primary catalyst for consolidation. From this advantageous position, we can capitalize on the full growth potential within a particular market.



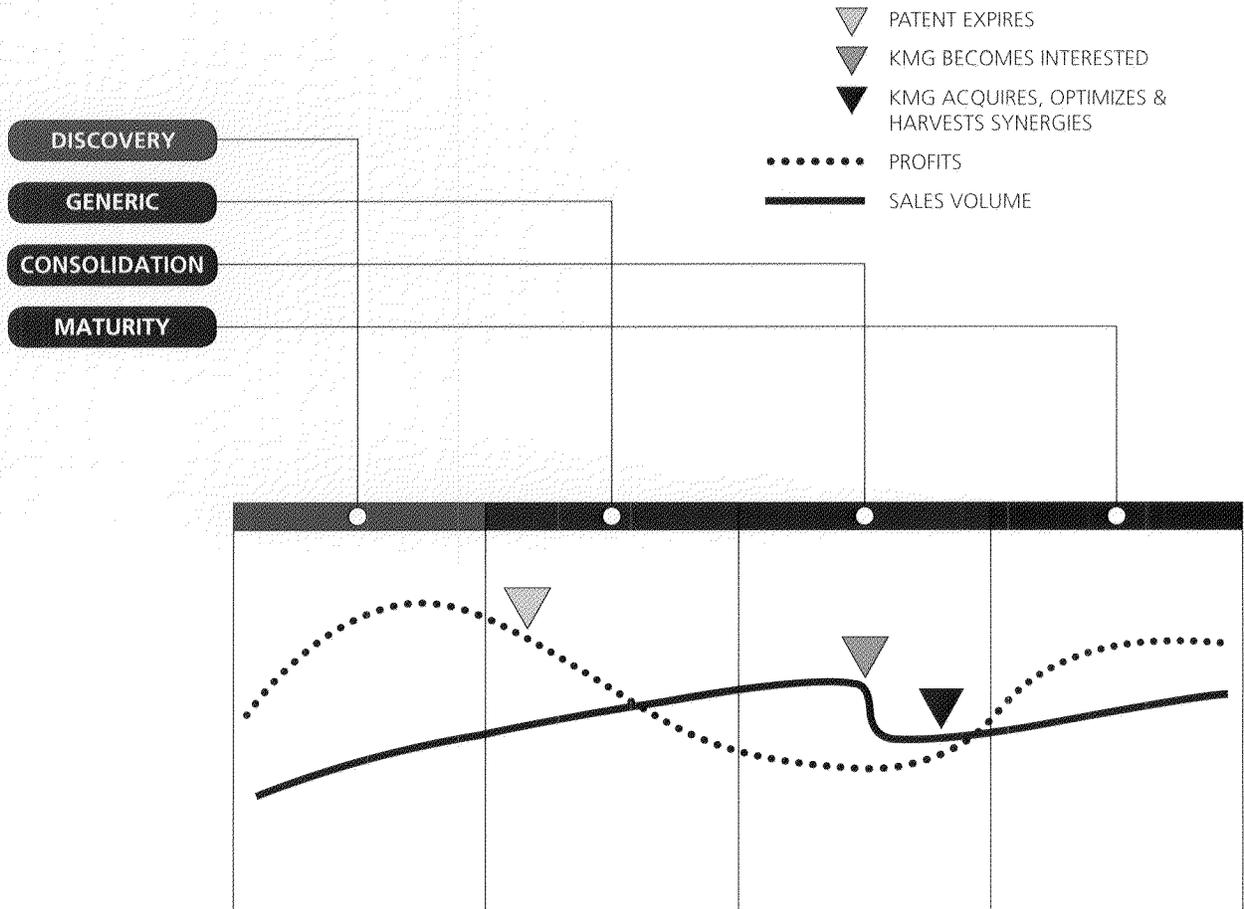
# A Consolidation vision.

**"KMG's vision is to perfect the art  
and science of consolidation."**

Neal Butler  
President and Chief Executive Officer



# KMG defines new markets.



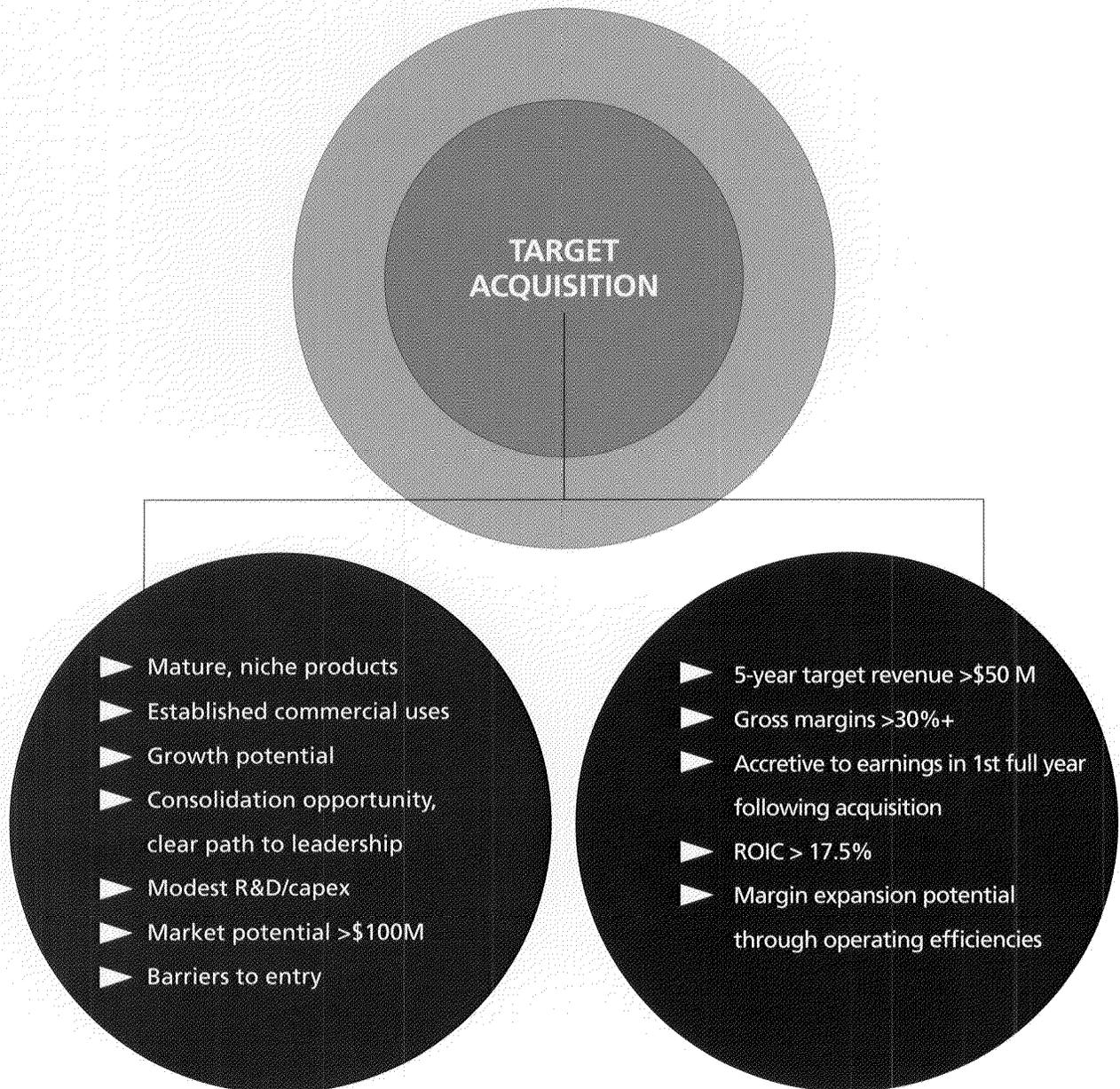
- VISION** Perfect the art and science of consolidation
- ASPIRATIONAL GOAL** Double revenue and EPS every five years
- STRATEGY**
  - ▶ Carve out newly defined segments
  - ▶ Supply unique products with high value applications
- ESTABLISH** Take a leading position through consolidation and organic growth
- MAXIMIZE**
  - ▶ Achieve higher economic returns
  - ▶ Generate supply- and demand-side synergies

# A Consolidation formula.

Although the highly fragmented nature of the specialty chemicals industry provides numerous opportunities for acquisitions, we methodically evaluate every potential target to ensure it meets our stringent requirements.

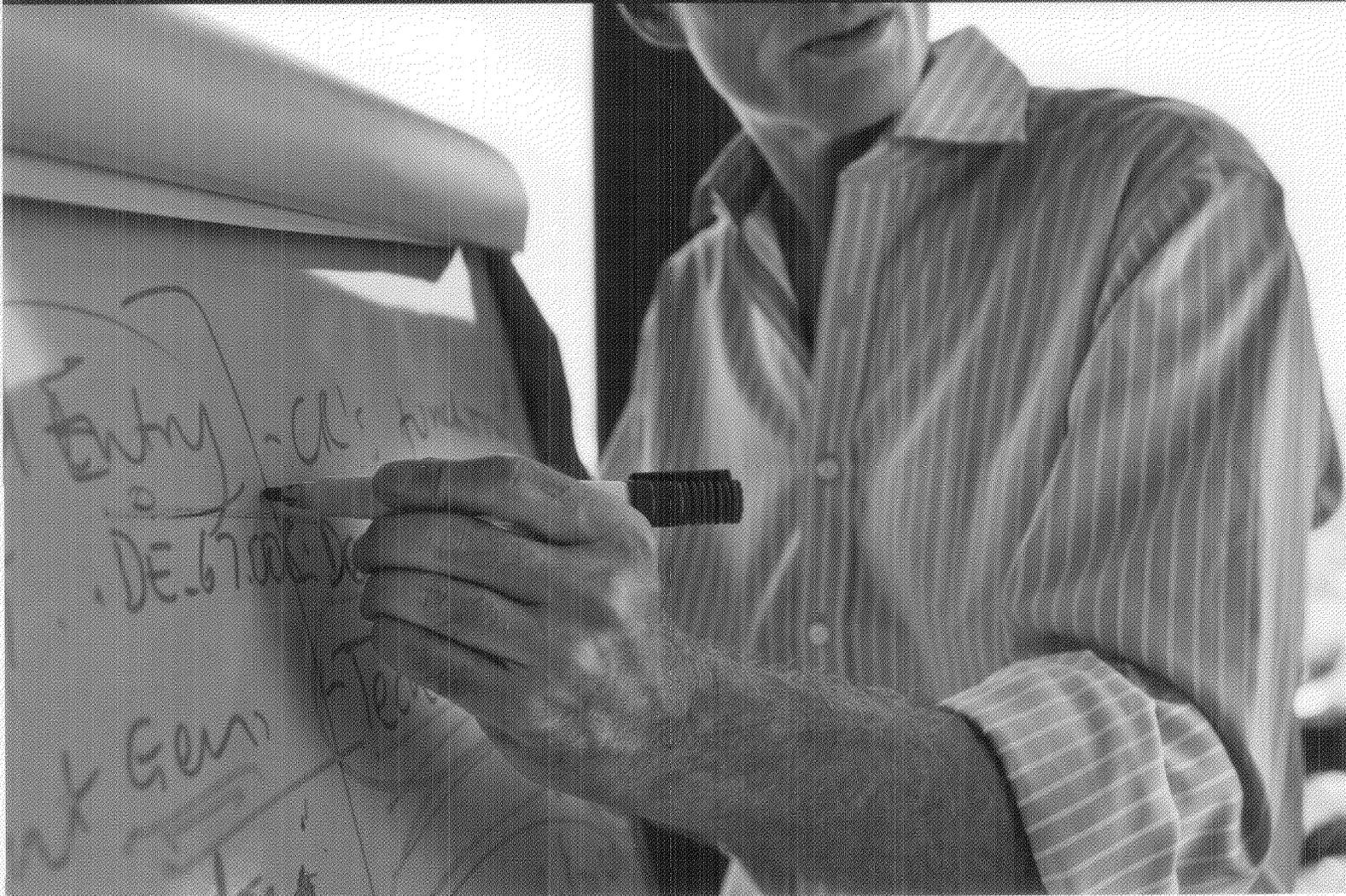


We carefully assess every target acquisition to make certain that it meets our rigorous standards for growth, profitability and market leadership potential.

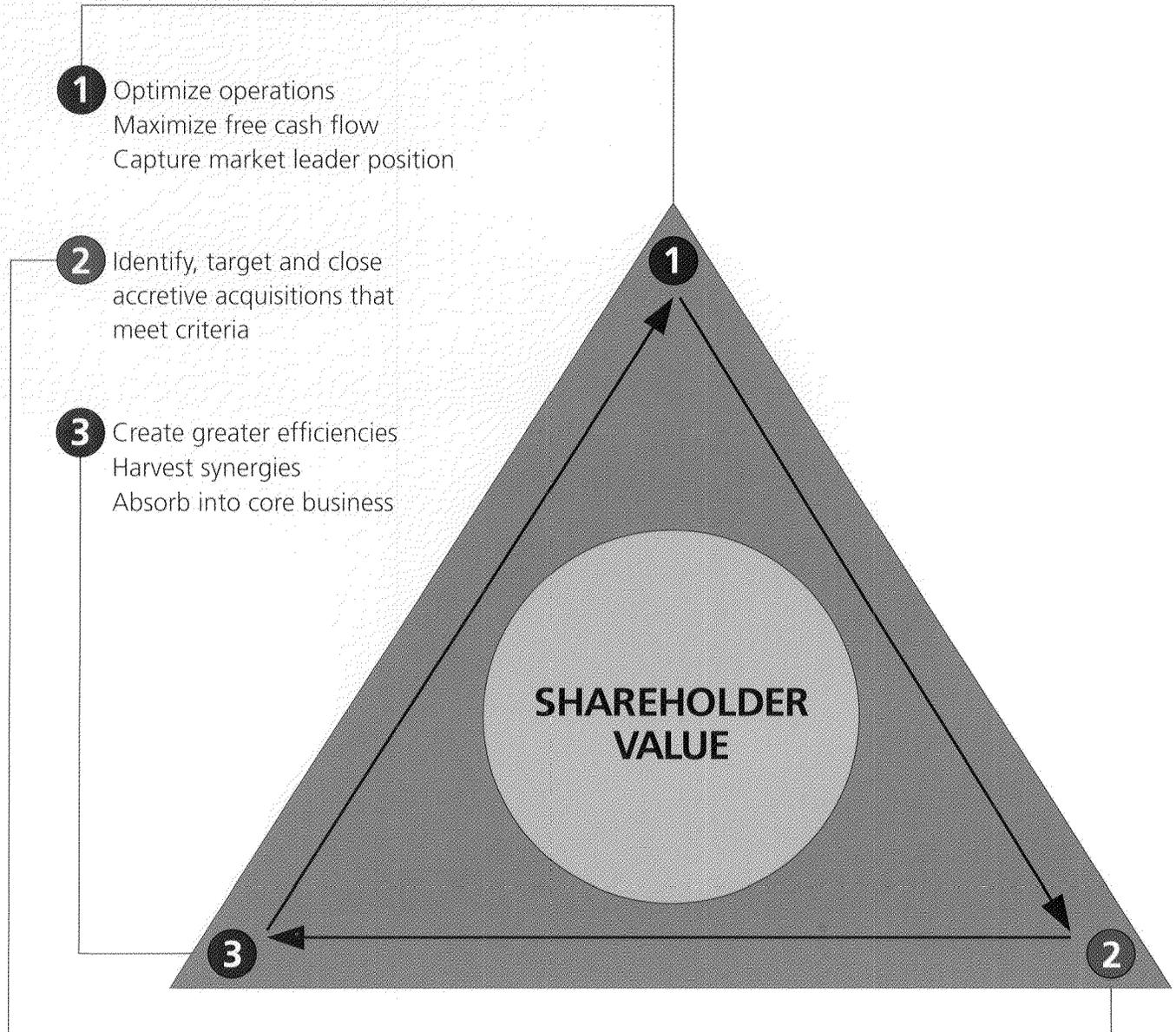


# A Consolidation core.

Through the efforts of our talented and dedicated employees, KMG has increased shareholders' equity by 89% over the past five years.

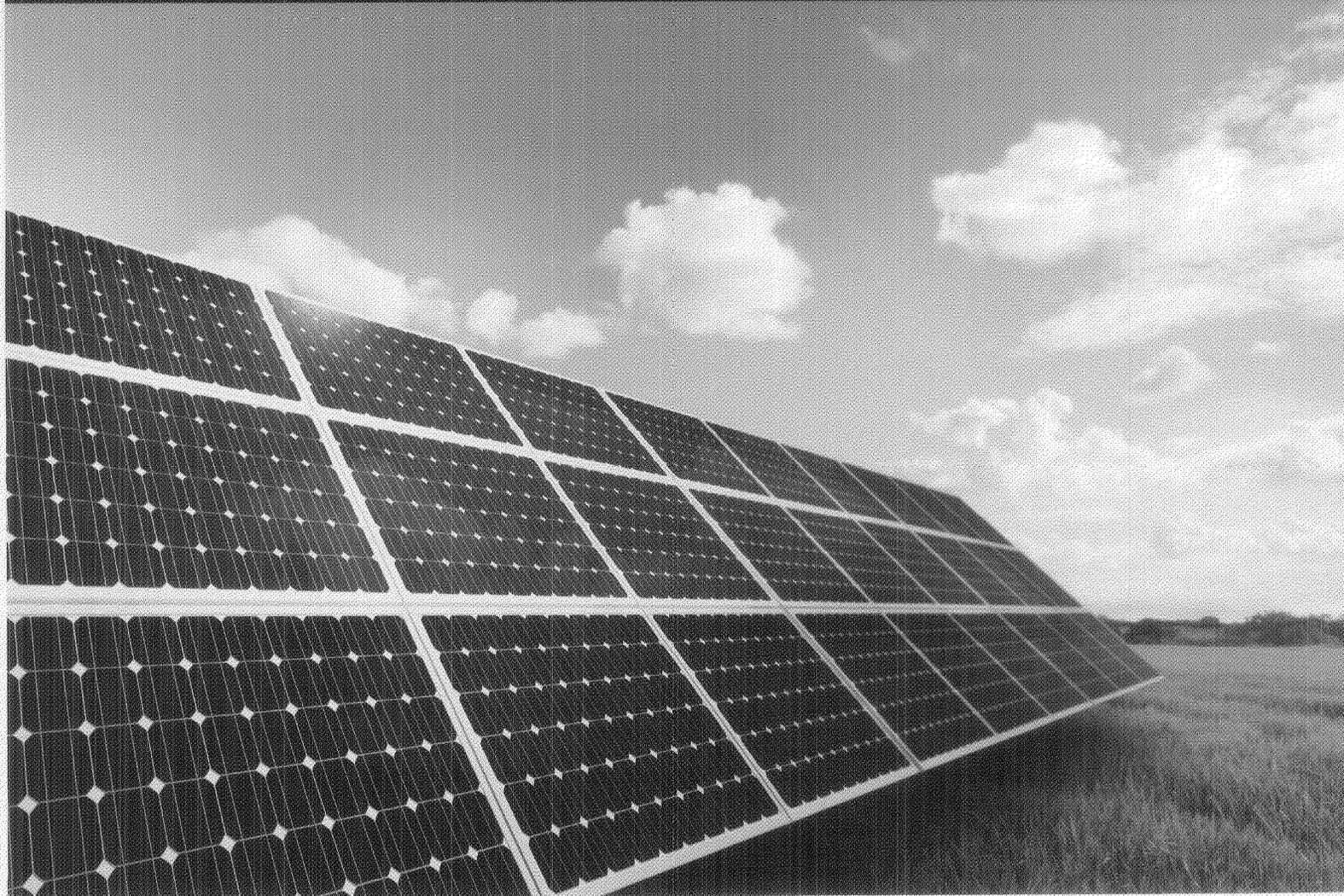


This process is the perpetual blueprint to execute our strategy and achieve our vision.



# A Consolidation commitment.

While the term has only recently become popular, sustainability is far from new a concept to KMG. We have long recognized that corporate responsibility is important to our business, our employees, our shareholders and the communities in which we operate.

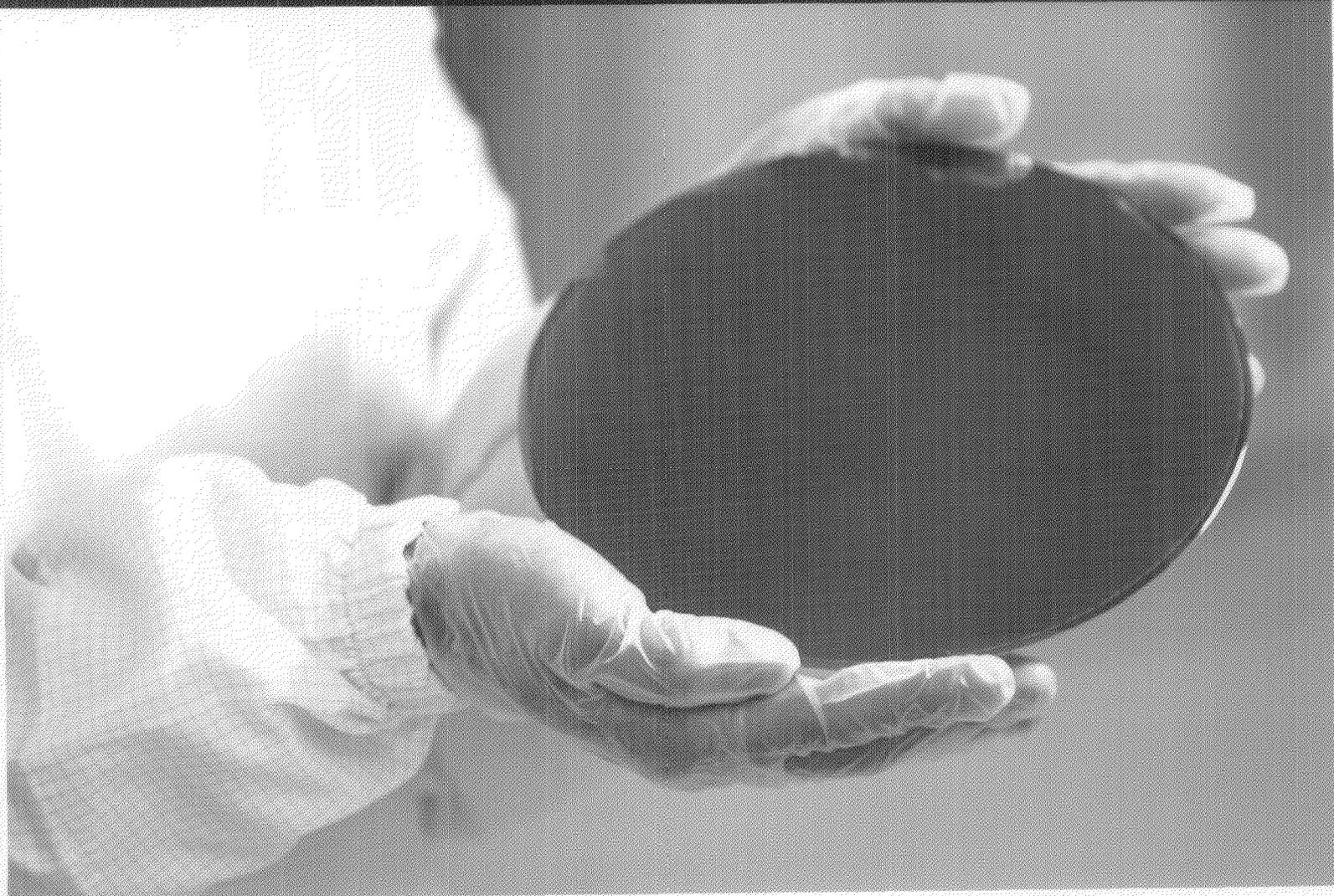


# Corporate Responsibility remains an integral component of our business strategy.



# Electronic Chemicals

We are a leading supplier of high-purity process chemicals primarily used in the manufacture of semiconductors. Our products include etchants and solvents that clean and etch silicon wafers. As semiconductor manufacturing process technology advances and incorporates ever-smaller transistors, the purity requirements of the chemicals used in the production of silicon wafers continue to increase. Our state-of-the-art facilities in North America and Europe can blend and package chemicals that meet the needs of semiconductor manufacturers producing the most technologically advanced silicon chips.



# Wood Treating Chemicals

Through our strategic consolidation process, KMG has grown to become the sole manufacturer of Penta in North America and the leading merchant supplier of creosote. Our industrial wood treating chemicals protect and prolong the useful lives of wooden railroad ties, utility poles, bridge timbers and marine pilings. Although far from glamorous, our wood treating products are critical to preserving the massive wooden infrastructure in the U.S., which includes over 700 million wooden railway ties and more than 40 million wooden utility poles. We continue to work diligently on maintaining our leading market positions and are constantly evaluating strategic initiatives to enhance this business, which generates high returns on capital and solid cash flow.



## Dear Fellow Shareholders,

I am pleased to report that fiscal 2012 was a successful year for KMG, although final results fell short of our expectations heading into the year. While we generated a 41% year/year increase in diluted earnings per share to \$1.20, overall results were dampened by approximately \$1.2 million in unexpected operating costs.

Despite a slower-than-expected start in the first half of the fiscal year, our Electronic Chemicals business enjoyed a strong year overall. The multi-faceted integration efforts within Electronic Chemicals fueled a significant increase in operating profitability, underscoring the benefits of our consolidation strategy.

Meanwhile, our Wood Treating Chemicals business continued to perform well and remains an important contributor to overall performance. Although the Wood Treating Chemicals business underperformed relative to our expectations in the second half of the year, we are confident that performance will recover in fiscal 2013.

### RECORD RESULTS FOR ELECTRONIC CHEMICALS

Electronic Chemicals segment revenues reached a record \$159 million in fiscal 2012, up 5% from fiscal 2011, despite the economic turmoil in Europe and softening in the U.S. economy. Our sales directly benefited from customer facility expansions as well as solid demand for high purity process chemicals required in the manufacture of the industry's most technologically advanced semiconductors.

Following the consolidation of our Electronic Chemicals' manufacturing plants in fiscal 2011, one of our primary goals this fiscal year was to realize the operational improvements and efficiencies stemming from a comprehensive continual improvement strategic initiative.

- From our two state-of-the-art Electronic Chemicals facilities in the U.S. – Pueblo, Colorado and Hollister, California – our consolidation efforts boosted capacity utilization, significantly enhancing manufacturing efficiency.
- We implemented a series of targeted pricing actions to effectively balance raw materials costs with selling prices for our high-purity acids and solvents. These pricing initiatives, coupled with manufacturing and operational improvements, fueled record operating income for Electronic Chemicals as operating margins (after corporate allocations) reached 8.4% for fiscal 2012.
- We also continued to make investments in order to satisfy our customers' growing quality and capacity requirements.

While we achieved substantial gains in fiscal 2012, we are confident there is room for further improvement within our Electronic Chemicals business, and we continue to identify and implement additional measures to enhance operating profitability.

### WOOD TREATING CHEMICALS A SOLID CONTRIBUTOR

Over the last several years, we have been successful in consolidating targeted components of our Wood Treating Chemicals business. In fiscal 2012, Wood Treating Chemicals sales were \$113 million, up from \$104 million in fiscal 2011. While raw material costs increased throughout the year, the operating profitability within this segment was essentially unchanged at 13.8% vs. 14.2% in fiscal 2011 due to select pricing actions implemented by the business unit coupled with various successful cost containment programs. Overall, the Wood Treating Chemicals business continued to generate attractive returns and cash flow.

For much of fiscal 2012, the Wood Treating Chemicals business benefited from strong volume growth given solid demand for treated railroad crossties and utility poles. While demand for our wood treating chemicals slowed in the fiscal fourth

# NYSE

On June 20, 2012, KMG transferred its stock exchange listing to the New York Stock Exchange. To mark the occasion, KMG executives and Directors rang the NYSE closing bell.



## KMG JOINS NYSE

quarter, partly due to competitive pressures in our markets, we remain confident in the outlook for this business. KMG's market-leading position, comprehensive supply chain capabilities, extensive supplier and customer relationships, and financial strength continue to provide significant competitive advantages.

## CUSTOMER FOCUS REMAINS A PRIORITY

In June, KMG began trading on the New York Stock Exchange (NYSE) under the symbol "KMG." We believe this move will help broaden KMG's visibility with investors, key suppliers, customers and peers. We are proud of this milestone in KMG's development and feel certain the NYSE's trading platform will best serve the long-term interests of current and future shareholders.

## A BRIGHT FUTURE

"Reliability to our customers" remains an important KMG Core Value. Each and every day, we strive to understand and meet the needs of our valued customers to ensure that KMG becomes a consistently dependable and trusted supplier. In fiscal 2012, we continued to invest in both our Electronic Chemicals and Wood Treating Chemicals businesses as we aim to strengthen customer loyalty to our products, people and performance.

As we enter fiscal 2013, we are excited about the opportunities that lie ahead. Our consolidation strategy continues to deliver, and our acquisition pipeline remains robust with identified opportunities in both Wood Treating Chemicals and Electronic Chemicals. Additionally, we remain active in pursuing accretive acquisitions in the establishment of a new market platform. I look forward to updating you, our shareholders, on KMG's progress throughout the year.

On behalf of KMG's management team and Board of Directors, I want to thank you for your continued support and faith in our ability to execute on strategy and grow shareholder value.

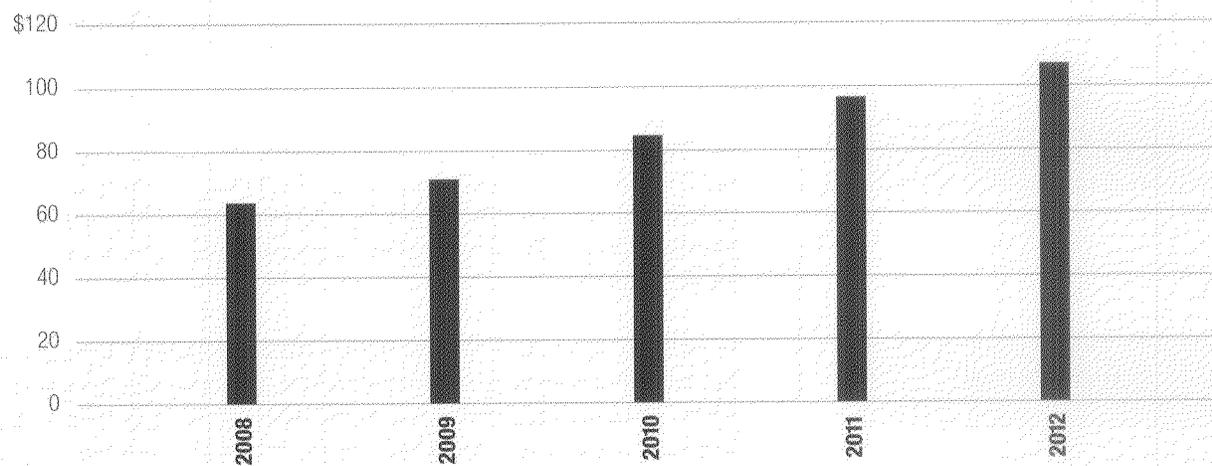
Sincerely,

**J. Neal Butler**  
President and Chief Executive Officer

## Financial Highlights

(in thousands, except per share)	2008	2009	2010	2011	2012
Net Sales	\$ 142,742	\$ 179,789	\$ 197,997	\$ 255,596	\$ 272,700
Gross Profit	\$ 42,136	\$ 60,208	\$ 66,723	\$ 68,060	\$ 77,065
Operating Income	\$ 10,426	\$ 20,292	\$ 26,731	\$ 17,022	\$ 25,437
Net Income	\$ 5,375	\$ 10,215	\$ 15,330	\$ 9,729	\$ 13,825
Earnings per Diluted Share	\$ 0.48	\$ 0.91	\$ 1.34	\$ 0.85	\$ 1.20
Weighted Average Diluted Shares Outstanding	11,232	11,230	11,422	11,489	11,528
Total Assets	\$ 155,978	\$ 143,508	\$ 176,021	\$ 185,378	\$ 167,690
Total Shareholders' Equity	\$ 63,687	\$ 70,977	\$ 84,778	\$ 96,530	\$ 106,767
Long-term Debt, Net of Current Portion	\$ 53,516	\$ 39,326	\$ 51,333	\$ 41,279	\$ 24,000
Depreciation and Amortization	\$ 5,665	\$ 6,168	\$ 6,711	\$ 7,354	\$ 7,018

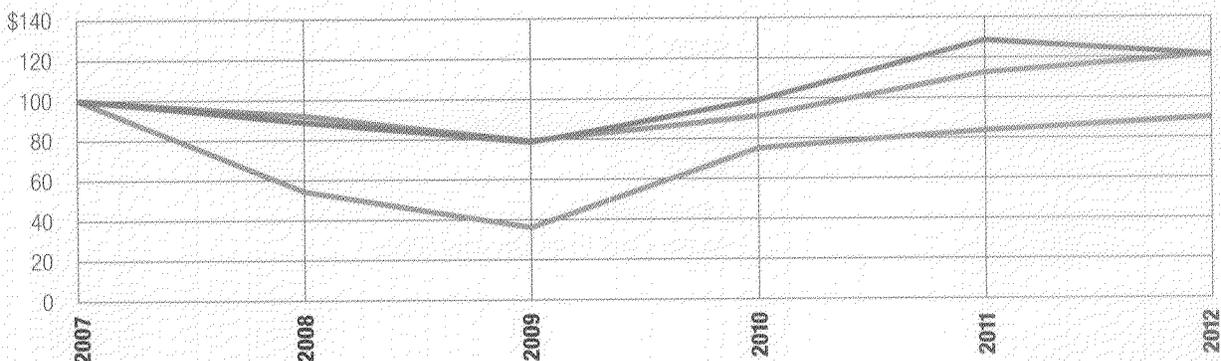
### SHAREHOLDERS' EQUITY FIVE-YEAR HISTORY (in millions)



### COMPARISON OF FIVE-YEAR CUMULATIVE TOTAL RETURN\*

Among KMG Chemicals, Inc., The NASDAQ Composite Index and the S&P Small Cap Specialty Chemicals Index.  
 \*\$100 invested in 2007 in stock or index including reinvestment of dividends. Fiscal year ended July 31.

■ KMG Chemicals, Inc.  
 ■ NASDAQ Composite  
 ■ S&P Small Cap Specialty Chemicals



UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

Form 10-K

(Mark one)

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

For the fiscal year ended July 31, 2012

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: 001-35577

Received SEC

**KMG CHEMICALS, INC.**

(Exact name of registrant as specified in its charter)

NOV 13 2012

Texas  
(State or other jurisdiction of  
incorporation or organization)

75-2640529  
Washington, DC 20549  
(I.R.S. Employer  
Identification No.)

9555 W. Sam Houston Parkway S., Suite 600  
Houston, Texas 77099

(Address of principal executive offices, including zip code)

(713) 600-3800

(Registrant's telephone number, including area code)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE EXCHANGE ACT:

Title of Each Class  
Common Stock, \$.01 par value

Name of each Exchange on which Registered  
The New York Stock Exchange

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE EXCHANGE ACT:

Title of Each Class

None

Name of each Exchange on which Registered

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulations S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

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

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant computed by reference to the closing price of \$18.41 on The Nasdaq Global Market as of the last business day of the Company's most recently completed second fiscal quarter (January 31, 2012) was \$144,276,000.

As of October 12, 2012, there were 11,412,400 shares of the registrant's common stock, par value \$0.01, per share outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

The proxy statement pertaining to our annual meeting of shareholders is incorporated by reference in Part III of this report.

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## PART I

### ITEM 1. BUSINESS

#### Company Overview

We manufacture, formulate and globally distribute specialty chemicals. We grow primarily by purchasing product lines and businesses that operate in segments of the specialty chemical industry that:

- provide an opportunity to obtain a significant share of the market segment through further acquisitions and organic growth;
- are of a size that larger industry participants generally find too small to be attractive;
- have niche products with well established and proven commercial uses;
- offer products that have moved well beyond their discovery phase and require little or no on-going research and development expenditures; and
- have significant barriers to entry.

We have acquired and currently operate businesses selling electronic chemicals and industrial wood treating chemicals. Our electronic chemicals segment provides high purity wet process chemicals to the semiconductor industry, primarily to clean and etch silicon wafers in the production of semiconductors. We are the leading supplier of high purity wet process chemicals to the semiconductor industry in the United States, and have a significant presence in Europe. Our wood treating chemicals, pentachlorophenol, or penta, and creosote, are sold to industrial customers who use these preservatives primarily to extend the useful life of utility poles and railroad crossties. We are the only supplier of penta in North America, and we are the principal supplier of creosote in the United States to wood treaters who do not produce their own creosote. On March 1, 2012, we discontinued our animal health business, when we sold most of the assets used in that segment to Bayer Healthcare, LLC.

For the twelve months ended July 31, 2012, we generated revenues of \$272.7 million and net income of \$13.8 million. On July 31, 2012, we had total long-term debt, net of current maturities, of \$24.0 million, cash and cash equivalents of \$1.6 million and total stockholders' equity of \$106.8 million.

#### Business Strategy

We seek to build profitability for our shareholders by discovering and exploiting opportunities that others overlook, while adhering to our core values: Safety First, Reliability to our Customers, Run Lean, Character Counts, Respect for Others and Excellence in Simplicity. To achieve that objective, our business strategies are:

- *Operate.* We seek to increase the profitability and maximize the cash flow and return on invested capital of our businesses by focusing on customer satisfaction, rational pricing policies, optimization of operating assets, efficient management of raw material purchasing and finished goods distribution, and maintaining a low overhead structure.
- *Acquire.* The cash flow generated by the businesses that we operate provides us with the ability to pursue further acquisitions in order to build on one of our existing segments, or to establish a new business platform for future growth. We screen through many market segments and acquisition candidates to find opportunities that exhibit the characteristics described above. We systematically approach identified acquisition candidates to attempt to structure an acquisition that meets our financial requirements. We typically do not spend a material sum of money on third party services in pursuit of an acquisition candidate until we feel the opportunity has a reasonable likelihood of meeting our financial requirements and of closing.
- *Integrate.* We have consistently been improving our ability as an organization to efficiently integrate progressively larger acquisitions. Our focus is to maintain reliable service to our customers during the integration period, identify and harvest the long-term synergies, and efficiently absorb acquisitions into our operations. An effective integration strategy sets the stage for optimized operations.

#### Business Segments

*Electronic Chemicals.* Our electronic chemicals business sells high purity wet process chemicals primarily to the semiconductor industry. High purity process chemicals are used to clean and etch silicon wafers in the production of semiconductors. The business was acquired in December 2007 from Air Products and Chemicals, Inc. ("Air Products"), and expanded with our purchase in March 2010 of the electronic chemicals business of General Chemical Performance Products LLP ("General Chemical"). Our products include sulfuric, phosphoric, nitric and hydrofluoric acids, ammonium hydroxide, hydrogen peroxide, isopropyl alcohol and various blends of chemicals. Our customers rely on us to provide products with very low levels of contaminants and particles, in some cases at less than 100 parts per trillion levels. To accomplish that objective, we purchase chemicals as raw materials from various suppliers, some of which are further purified. We are then responsible for their purity level, for analytical testing, blending and packaging, and

for distribution to our customers. Our products are sold in bulk and in containers, including bottles, drums and totes. This process is largely accomplished at our Pueblo, Colorado, Hollister, California and Milan, Italy facilities, although we currently contract with General Chemical to produce certain products for us at its facility. Our electronic chemicals business accounted for 58.5% of our net sales in fiscal year 2012, 59.3% in fiscal year 2011 and 56.6% in fiscal year 2010.

*Wood Treating Chemicals.* We supply penta and creosote to industrial customers who use these products to extend the useful life of wood, primarily utility poles and railroad crossties. Our penta products include penta blocks, solutions and hydrochloric acid, a byproduct of penta production. Penta is used primarily to treat utility poles, protecting them from insect damage and decay. We estimate that approximately two million treated utility poles are purchased each year by electric utility companies in the United States and that approximately 45% are treated with penta. We manufacture solid penta blocks at our facility in Matamoros, Mexico. We sell solid penta to our customers, or make it into a liquid solution of penta concentrate at our Matamoros, Mexico and Tuscaloosa, Alabama facilities. We sell penta products primarily in the southeastern and northwestern United States and in Canada. The hydrochloric acid we produce as a byproduct of penta production is sold in Mexico for use in the steel and oil well service industries. Creosote is a wood preservative used to treat utility poles and railroad crossties. Creosote is produced by the distillation of coal tar, a by-product of the transformation of coal into coke. In the last five years, production of wood crossties in North America has averaged 20.4 million ties annually. Almost all wood crossties are treated with creosote. We believe that less than 10% of utility poles are treated with creosote annually. We sell creosote to wood treaters throughout the United States. Our wood treating chemicals constituted about 41.4% of our net sales in fiscal year 2012, 40.7% in fiscal year 2011 and 43.4% in 2010.

## **Suppliers**

In electronic chemicals we rely on a variety of suppliers for our raw materials, some of which we purchase on open account and others which we purchase under supply contracts. The number of suppliers is often limited, particularly as to the specific grade of raw material required by us to supply high purity products to our customers. In particular, General Chemical operates their Bay Point, California facility under a manufacturing agreement with us to produce our principal source for hydrofluoric acid in North America. No assurance can be given that the loss of a supplier would not have a material adverse effect on our financial position or results of operations.

In our wood treating chemical segments, we depend on outside suppliers for all of the raw materials needed to produce our penta products, and are subject to fluctuations in the price of those materials. The principal raw materials used for our penta products are chlorine, phenol and co-solvent, each of which we purchase from a limited number of suppliers. We purchase almost all of the creosote we sell from two suppliers, Rütgers and Koppers. Our creosote supply agreements with each of them provide that we purchase an agreed minimum volume of creosote in each calendar year at a fluctuating, mutually agreed or formula-based price.

## **Customers**

We sell our products to approximately 400 customers. One of our electronic chemicals customers, Intel Corporation, accounted for 10% or more of our revenues in fiscal years 2012, 2011 and 2010. In addition, one of our creosote customers, Stella Jones Corporation, accounted for 10% or more of our revenues in fiscal years 2012 and 2011. No other customer accounted for 10% or more of our revenue in fiscal years 2012, 2011 and 2010. The loss of Intel or Stella Jones would have a material adverse effect on sales of our electronic chemicals and creosote products businesses, respectively. Assuming that the level of overall demand for wood preserving chemicals remained the same, we do not believe that the loss of any other customer of our wood treating segment would have a material adverse effect on sales of our wood treating chemicals.

## **Marketing**

We sell to our electronic chemicals customers through a combination of strategic account managers and account managers organized by geographic region. Our wood treating chemicals are sold in the United States through an internal sales force.

## **Geographical Information**

Sales made to customers in the United States were 84.0% of total revenues in fiscal year 2012, 85.7% in 2011 and 83.4% in 2010. Sales made outside of the United States were primarily electronic chemicals sold in Israel and Europe. As of the end of fiscal year 2012, our property, plant and equipment were allocated, based on net book value, 76.7% in the United States, 19.7% in Italy where one of our electronic chemical facilities is located and 3.6% in Mexico where our penta manufacturing facility is located.

## **Competition**

There are only a few firms competing with us in the sale of our products. We compete by selling our products at competitive prices and maintaining a strong commitment to product quality and customer service.

In electronic chemicals in North America, we believe that we have the largest market share, and our principal competitors include Honeywell, Kanto Corporation and Avantor (formerly Mallinckrodt Baker). Internationally, we compete in Europe primarily

with BASF, Honeywell and the OM Group. We believe that each has a more significant market share than we do in Europe. We do not participate materially in the market in Asia.

In our electronic chemicals business, our customers demand that each of their suppliers and each product used to make their semiconductors go through a rigorous qualification process. Once a customer has qualified one or more suppliers and their products for one of its fabrication facilities, there is often substantial reluctance to change that qualification.

The principal wood preserving chemicals for industrial users are penta, creosote and chromated copper arsenate, or CCA. We supply United States industrial users with both penta and creosote, but not CCA. We are the only manufacturer of penta in North America. Penta is used primarily to treat electric, telephone and other utility poles, to protect them from insect damage and decay. We estimate that approximately two million treated utility poles are purchased each year by utility companies in the United States. Of that amount, we estimate approximately 45% are treated with penta and that less than 10% are treated with creosote. The remaining poles are treated primarily with CCA. We provide the wood treating industry in the United States with most of its annual consumption of creosote not produced for internal use by Koppers and other creosote distillers.

Our wood treating chemicals must be registered prior to sale under United States law. See “Environmental and Safety Matters—Licenses, Permits and Product Registrations.” As a condition to registration, any company wishing to manufacture and sell these products must provide substantial scientific research and testing data regarding the chemistry and toxicology of the products to the U.S. Environmental Protection Agency (“EPA”). This data must be generated by the applicant, or the applicant must purchase access to the information from other data providers. We believe that the cost of satisfying the data submission requirement serves as an impediment to the entry of new competitors, particularly those with lesser financial resources. While we have no reason to believe that the product registration requirement will be materially modified, we cannot give any assurances as to the effect of such a discontinuation or modification on our competitive position.

## **Employees**

As of the end of fiscal year 2012, we had a total of 331 full-time employees. At our corporate offices in Houston, Texas, we employed 47 persons. At the end of the fiscal year, we had the following number of employees at our other facilities: 82 at Pueblo, Colorado, 39 at Hollister, California, 63 at Milan, Italy, 53 at Matamoros, Mexico, 6 at Tuscaloosa, Alabama, 12 at Elwood, Kansas, and the remainder of our employees worked from home or at the Bay Point, California facility of General Chemical. Sixteen of our employees in the United States are represented by a labor union, and 31 of our employees in Mexico are represented under an annual labor agreement that was last renewed in May 2012. Our employees in Italy are included in a national agreement covering all chemical workers in the country. We believe that we have good relations with our employees.

## **Environmental and Safety Matters**

Our operations are subject to extensive federal, state and local laws, regulations and ordinances in the United States and abroad relating to the generation, storage, handling, emission, disposal, transportation and discharge of certain materials, substances and waste into the environment, and various other health and safety matters. Governmental authorities have the power to enforce compliance with their regulations, and violators may be subject to civil, criminal and administrative penalties, injunctions or both. We must devote significant financial resources to ensure compliance, and we believe that we are in substantial compliance with all the applicable laws and regulations.

We anticipate that the regulation of our business operations under federal, state and local environmental regulations in the United States and abroad will increase and become more stringent over time. We cannot estimate the impact of increased and more stringent regulation on our operations, future capital expenditure requirements or the cost of compliance.

*United States Regulation; CERCLA.* The Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended, also known as “CERCLA” and the “Superfund” law, and comparable state laws generally impose joint and several liability for costs of investigation and remediation and for natural resource damages, without regard to fault or the legality of the original conduct, on certain classes of persons with respect to the release into the environment of substances designated under CERCLA as hazardous substances. These persons include the owner or operator of the site where the release occurred and companies that disposed or arranged for the disposal of the hazardous substance at the site. These liabilities can arise in association with the properties where operations were conducted, as well as in association with the disposal facilities where wastes were sent. Under CERCLA, such persons may be liable for the costs of cleaning up the hazardous substances that have been released into the environment, for damages to natural resources and for the costs of certain health studies. Many states have adopted comparable or more stringent state statutes. In the course of our operations, we generated materials that fall within CERCLA’s definition of hazardous substances. We may be the owner or operator of sites on which hazardous substances have been released and may have generated hazardous substances that have been transported to or otherwise released upon offsite facilities. We may be responsible under CERCLA for all or part of the costs to clean up facilities at which such substances have been released by previous owners or operators and offsite facilities to which our wastes were transported and for associated damages to natural resources.

*Resource Conservation and Recovery Act.* The Federal Resource Conservation and Recovery Act, as amended (“RCRA”) and comparable state laws, regulate the treatment, storage, disposal, remediation and transportation of wastes including those designated as “hazardous wastes.” The EPA and various state agencies have limited the disposal options for these wastes and impose numerous regulations upon the treatment, storage, disposal, remediation and transportation of those wastes. Our operations generate wastes that are subject to the RCRA and comparable state statutes. Furthermore, wastes generated by our operations that are currently exempt from treatment as hazardous wastes may be designated in the future as hazardous wastes under the RCRA or other applicable statutes and, therefore, may be subject to more rigorous and costly treatment, storage and disposal requirements. Governmental agencies (and in the case of civil suits, private parties in certain circumstances) can bring actions for failure to comply with RCRA regulations seeking administrative, civil or criminal penalties or injunctive relief, or actions seeking to compel us to abate a solid or hazardous waste situation that presents an imminent or substantial endangerment to health or the environment.

*Clean Water Act.* The Clean Water Act imposes restrictions and strict controls regarding the discharge of wastes and fill materials into waters of the United States. Under the Clean Water Act, and comparable state laws, the government (and in the case of civil suits, private parties in certain circumstances) can bring actions for failure to comply with Clean Water Act requirements and enforce compliance through civil, criminal and administrative penalties for unauthorized discharges of hazardous substances and of other pollutants. In the event of an unauthorized discharge of wastes, we may be liable for penalties and could be subject to injunctive relief.

*Clean Air Act.* The Clean Air Act (CAA), as amended, and comparable state and local laws and regulations restrict the emission of air pollutants from many sources and also impose various monitoring and reporting requirements. These laws and regulations may require us to obtain pre-approval for the construction or modification of certain projects or facilities expected to produce or significantly increase air emissions, obtain and strictly comply with air permit requirements or utilize specific equipment or technologies to control emissions. Governmental agencies (and in the case of civil suits, private parties in certain circumstances) can bring actions for failure to strictly comply with air pollution regulations or permits and generally enforce compliance through administrative, civil or criminal enforcement actions, resulting in fines, injunctive relief (which could include requiring us to forego construction, modification or operation of sources of air pollutants) and imprisonment. While we may be required to incur certain capital expenditures for air pollution control equipment or other air emissions-related issues, we do not believe that such requirements will have a material adverse effect on our operations.

*Greenhouse Gas Regulation.* More stringent laws and regulations relating to climate change and greenhouse gases (GHGs) may be adopted in the future and could cause us to incur material expenses in complying with them. The EPA has begun to regulate GHGs as pollutants under the CAA. By adopting rules regulating GHG emissions from motor vehicles, the EPA triggered requirements to permit GHG emissions from stationary sources under the Prevention of Significant Deterioration (PSD) and Title V permitting programs. The EPA has implemented the so-call “Tailoring Rule” requiring that the largest sources to first obtain permits for GHG emissions. There is still the possibility that federal legislation will be adopted to change the GHG permitting program put in place by the EPA, but to date, efforts at a comprehensive GHG legislative package (such as a cap and trade program) appear not to be moving forward in Congress. We may incur significant costs to control our emissions and comply with regulatory requirements associated with GHG permitting.

In addition to federal regulation, a number of states, individually and regionally, and localities also are considering or have implemented GHG regulatory programs. These potential regional and state initiatives may result in so-called cap-and-trade programs, under which overall GHG emissions are limited and GHG emissions are then allocated and sold, and possibly other regulatory requirements, that could result in our incurring material expenses to comply, e.g., by being required to purchase or to surrender allowances for GHGs resulting from our operations or otherwise being required to control or reduce emissions. It should be noted that some scientists have concluded that increasing concentrations of GHGs in the Earth’s atmosphere may produce climate changes that have significant physical effects, such as increased frequency and severity of storms, droughts, and floods and other climatic events; if any such effects were to occur, they could have an adverse effect on our assets and operations in locations vulnerable to such events.

*Occupational Safety.* Our operations are also governed by laws and regulations relating to workplace safety and worker health, principally the Occupational Safety and Health Act (OSHA) and its regulations. The OSHA hazard communication standard, the EPA’s community right-to-know regulations and similar state programs may require us to organize and/or disclose information about hazardous materials used or produced in our operations. We believe that we are in substantial compliance with these applicable requirements.

*Foreign Regulation.* Our Matamoros, Mexico and Milan, Italy facilities and operations are subject to various environmental laws, regulations and ordinances promulgated by governmental authorities of Mexico and Italy. Each country has laws and regulations concerning air and water emissions, hazardous waste treatment, storage and disposal, and workplace safety and worker health. Their respective regulatory authorities are given broad authority to enforce compliance with environmental, health and safety laws and regulations, and can require that operations be suspended pending completion of required remedial action.

*Licenses, Permits and Product Registrations.* Certain licenses, permits and product registrations are required for our products and operations in the United States, Mexico, Italy and other countries in which we do business. The licenses, permits and product registrations are subject to revocation, modification and renewal by governmental authorities. In the United States in particular, producers and distributors of chemicals such as penta and creosote are subject to registration and notification requirements under federal law (including under the Federal Insecticide, Fungicide and Rodenticide Act (“FIFRA”) and the Toxic Substances Control Act, and comparable state law) in order to sell those products in the United States. Compliance with these requirements has had, and in the future will continue to have, a material effect on our business, financial condition and results of operations. Under FIFRA, the registration system requires an ongoing submission to the EPA of substantial scientific research and testing data regarding the chemistry and toxicology of pesticide products by manufacturers. Under agreements with other industry participants, we sometimes share research and testing costs pertaining to our chemical products. We incurred expenses with respect to continuing operations of approximately \$802,000 in fiscal year 2012, \$760,000 in fiscal year 2011 and \$636,000 in fiscal year 2010 in connection with the research, testing and other expenses related to our participation in several industry task forces.

## **Available Information**

We make available free of charge on our Internet web site [www.kmgchemicals.com](http://www.kmgchemicals.com), our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and other filings pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and amendments to such filings, as soon as reasonably practicable after each are electronically filed with, or furnished to, the United States Securities and Exchange Commission (“SEC”). Information about our members of the Board of Directors, standing committee charters, and our Code of Business Conduct are also available, free of charge, through our website.

The SEC maintains a website that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC, available at [www.sec.gov](http://www.sec.gov). You may read and copy any materials we file with the SEC at the SEC’s Public Reference Room at 100 F Street, NE., Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Our stock trades under the ticker symbol “KMG” on the New York Stock Exchange. Except for portions of our proxy statement to be filed with the SEC, no information from either the SEC’s website or our website is incorporated herein by reference.

## **ITEM 1A. RISK FACTORS**

*You should carefully consider the risks described below, together with all of the other information included in this report. We believe the risks and uncertainties described below are the most significant we face. The occurrence of any of the following risks could materially harm our business, financial condition or results of operations. In that case, the trading price of our common stock could decline, and you may lose all or part of your investment.*

### **Risks Relating to Our Business**

*The industries in which we operate are competitive. This competition may prevent us from raising prices at the same pace as our costs increase, making it difficult for us to maintain existing business and win new business.*

We operate in competitive markets. Certain of our competitors have substantially greater financial and technical resources than we do. Additionally, new competitors may enter our markets. We may be required to reduce prices if our competitors reduce prices, or as a result of any other downward pressure on prices for our products and services, which could have an adverse effect on us. In electronic chemicals particularly, we compete with several international and North American companies. Our customers have regularly requested price decreases and maintaining or raising prices has been difficult over the past several years and will likely continue to be so in the near future. Competition in electronic chemicals is based on a number of factors, including price, freight economics, product quality and technical support. If we are unable to compete successfully, our financial condition and results of operations could be adversely affected.

*We may experience a reduced demand for our wood treating chemicals if the demand for the wood products on which those chemicals are used decreases, which may adversely affect our business, results of operations, cash flow and financial condition.*

Our wood treating chemicals, penta and creosote, are sold into mature markets. The principal consumers of our wood treating chemicals are industrial wood treating companies who use our products to protect wood utility poles and railroad crossties from insect damage and decay. Although these products are sold into relatively stable markets, the demand for treated wood generally increases or decreases with the financial strength and maintenance budgets of electric utilities and railroads. A significant decline in either utility pole or wood crosstie sales could have a material adverse effect on our business, financial condition and results of operations.

*The industries that we compete in are subject to economic downturns.*

An economic downturn in the electronic industry as a whole or other events (e.g., labor disruptions) resulting in significantly reduced production at the manufacturing plants of our customers, could have a material adverse impact on the results of our electronic

chemicals segment. Similarly, an economic downturn affecting utilities or major railroads could have a material adverse effect on demand for our wood treating chemicals.

***A significant portion of our revenue and operating income are concentrated in a small number of customers.***

We derive a significant portion of our revenues and operating income in our electronic chemicals and wood treating segments from sales of products to a small number of customers. As a result, the loss of Intel, Stella or another significant customer, or a material reduction of demand from one of those customers, could adversely affect our revenues and operating income.

***If we are unable to identify, fund and execute new acquisitions, we will not be able to execute a key element of our business strategy.***

Our strategy is to grow primarily by acquiring additional businesses and product lines. We cannot assure you that we will be able to identify, acquire or profitably manage additional businesses and product lines, or successfully integrate any acquired business or product line without substantial expenses, delays or other operational or financial difficulties. Financing for acquisitions may not be available, or may be available only at a cost or on terms and conditions that are unacceptable to us. Further, acquisitions may involve a number of special risks or effects, including diversion of management's attention, failure to retain key acquired personnel, unanticipated events or circumstances, legal liabilities, impairment of acquired intangible assets and other one-time or ongoing acquisition-related expenses. Some or all of these special risks or effects could have a material adverse effect on our financial and operating results. In addition, we cannot assure you that acquired businesses or product lines, if any, will achieve anticipated revenues and earnings.

The consideration we pay in connection with an acquisition also may affect our financial results. If we were to proceed with one or more significant acquisitions in which the consideration included cash, we could be required to use a substantial portion of our available cash or obtain debt or equity financing. To the extent that we issue shares of our capital stock or other rights to purchase shares of our common stock as consideration for an acquisition or in connection with the financing of an acquisition, including options or other rights, our existing common shareholders may be diluted, and our earnings per share may decrease.

***We may experience increased costs and production delays if suppliers fail to deliver materials or if prices increase for raw materials and other goods and services that we purchase from third parties.***

We purchase raw materials for our electronic chemicals business from a number of domestic and foreign suppliers. Although we believe that the raw materials we require in our electronic chemicals business will be available in sufficient supply on a competitive basis for the foreseeable future, continued increases in the cost of raw materials, including energy and other inputs used to make our products, could affect future sales volumes, prices and margins for our products. If a supplier should cease to deliver goods or services to us, we would in most cases find other sources. However, such a disruption could result in added cost and manufacturing delays. In addition, political instability, war, terrorism and other disruptions to international transit routes could adversely impact our ability to obtain key raw materials in a timely fashion, or at all.

***Increases in the price of our primary raw materials may decrease our profitability and adversely affect our liquidity, cash flow, financial condition and results of operations.***

The prices we pay for raw materials in our businesses have increased significantly in the last several years, and we have not always been able to pass those increases through to our customers fully and timely. In the future, we may be unable to pass on increases in our raw material costs, and raw material price increases may erode the profitability of our products by reducing our gross profit. Price increases for raw materials may also increase our working capital needs, which could adversely affect our liquidity and cash flow. For these reasons, we cannot assure you that raw material cost increases in our businesses would not have a material adverse effect on our financial condition and results of operations.

***We are dependent on a limited number of suppliers for certain key raw materials, the loss of any one of which could have a material adverse effect on our financial condition and results of operations.***

We depend on a limited number of suppliers for certain key raw materials needed by our businesses, such as sulfuric, hydrofluoric and nitric acids and creosote. Those suppliers are subject to a variety of operational and commercial constraints that can adversely impact our supply. If we were to lose suppliers for such key raw materials, we might have difficulty securing a replacement supplier at reasonable cost, and no assurance can be given that such loss would not have a material adverse effect on our financial condition and results of operations.

***Our profitability could be adversely affected by high petroleum prices.***

The profitability of our business, depends to a degree, upon the price of petroleum products, both as a component of transportation costs for delivery of products to our customers and as a raw material used to make our products, including penta solutions. High petroleum prices also affect the businesses of our customers. Our penta customers dissolve our product in petroleum to make a treating solution for utility poles. Unfavorable changes in petroleum prices or in other business and economic conditions

affecting our customers could reduce purchases of our products, and impose practical limits on our pricing. Any of these factors could lower our profit margins, and have a material adverse effect on our results of operations. We are unable to predict what the price of crude oil and petroleum-based products will be in the future. We may be unable to pass along to our customers the increased costs that result from higher petroleum prices.

***We will continue to pursue new acquisitions or joint ventures, and any such transaction could result in operating or management problems that adversely affect operating results. We remain subject to the ongoing risks of successfully integrating and managing the acquisitions and joint ventures that are completed.***

The acquisitions we make expose us to the risk of integrating that acquisition. An integration effort impacts various areas of our business, including our management, production facilities, information systems, accounting and financial reporting, and customer service. Disruption to any of these areas could materially harm our financial condition or results of operations.

We expect to continue to pursue new acquisitions or joint ventures, a pursuit which could consume substantial time and resources. The successful implementation of our operating strategy in current and future acquisitions and joint ventures may require substantial attention from our management team, which could divert management attention from existing businesses. The businesses acquired, or the joint ventures entered into, may not generate the cash flow and earnings, or yield the other benefits anticipated at the time of their acquisition or formation. The risks inherent in any such strategy could have an adverse impact on our results of operation or financial condition.

***Our ability to make payments on our debt will be contingent on our future operating performance, which will depend on a number of factors that are outside of our control.***

Our ability to make principal and interest payments on our debt is contingent on our future operating performance, which will depend on a number of factors, many of which are outside of our control. The degree to which we are leveraged could have other important negative consequences, including the following:

- we must dedicate a substantial portion of our cash flows from operations to the payment of our indebtedness, reducing the funds available for future working capital requirements, capital expenditures, acquisitions or other general corporate requirements;
- a significant portion of our borrowings are, and will continue to be, at variable rates of interest, which may result in higher interest expense in the event of increases in interest rates;
- we may be more vulnerable to a downturn in the segments in which we operate or a downturn in the economy in general;
- we may be limited in our flexibility to plan for, or react to, changes in our businesses and the segments in which we operate;
- we may be placed at a competitive disadvantage compared to our competitors that have less debt;
- we may be limited in our ability to react to unforeseen increases in certain costs and obligations arising in our businesses, including environmental liabilities;
- we may determine it to be necessary to dispose of certain assets or one or more of our businesses to reduce our debt; and
- our ability to borrow additional funds may be limited.

If we are unable to make scheduled debt payments or comply with the other provisions of our debt instruments, our lenders may be permitted under certain circumstances to accelerate the maturity of the indebtedness owed to them and exercise other remedies provided for in those instruments and under applicable law.

***Restrictions in our debt agreements could limit our growth and our ability to respond to changing conditions.***

Our debt agreements contain a number of significant covenants which affect our ability to take certain actions and restrict our ability to incur additional debt. These include covenants that prohibit certain acquisitions that are not approved by our lenders. In addition, our debt agreements require us to maintain certain financial ratios and satisfy certain financial condition tests, which may require us to take action to reduce our debt or take some other action to comply with them.

These restrictions could limit our ability to obtain future financings, make needed capital expenditures, withstand a future downturn in our business or the economy in general or otherwise conduct necessary corporate activities. We may also be prevented from taking advantage of business opportunities that arise because of the limitations that these restrictive covenants impose on us.

A breach of any of these covenants would result in a default under the applicable debt agreement. A default, if not waived, could result in acceleration of the debt outstanding under the agreement and in a default with respect to, and acceleration of, the debt outstanding under our other debt agreements. The accelerated debt would become immediately due and payable. If that should occur, we may not be able to pay all such debt or to borrow sufficient funds to refinance it. Even if new financing were then available, it may not be on terms that are acceptable to us.

***If our products are not re-registered by the EPA or are re-registered subject to new restrictions, our ability to sell our products may be curtailed or significantly limited.***

Our creosote and penta product registrations are under continuous review by the EPA under FIFRA. We have submitted and will submit a wide range of scientific data to support our U.S. registrations. To satisfy the registration review, we are required to demonstrate, among other things, that our products will not cause unreasonable adverse effects on human health or the environment when used according to approved label directions. In September 2008, the EPA announced that it had determined that creosote and penta were eligible for re-registration, but the EPA proposed new restrictions on the use of those products that will require some of our customers to incur substantial additional costs and to revise certain operating procedures. The EPA also required that creosote and penta registrants provide additional research and testing data respecting certain potential risks to human health or the environment as a further condition to continued re-registration. The EPA is also reviewing the risk profile of penta under its Integrated Risk Information System database. That review will establish a toxicological profile that may prompt the EPA to reconsider its risk assessment. We cannot assure you as to when or if the EPA will issue a final decision concluding that the conditions of re-registration for our creosote and penta products have been satisfied. Even if our products are re-registered by the EPA, we cannot assure you that our products will not be subject to further data submission requirements, or subject to use or labeling restrictions, that may have an adverse effect on our financial position and results of operations. The failure of our current or future-acquired products to be re-registered or to satisfy the registration review by the EPA, or the imposition of new use, labeling or other restrictions in connection with re-registration could have a material adverse effect on our financial condition and results of operations.

***Our products may be rendered obsolete or less attractive by changes in industry requirements or by supply-chain driven pressures to shift to environmentally preferable alternatives.***

Changes in regulatory, legislative and industry requirements, or changes driven by supply-chain pressures, may shift current customers away from products using penta, creosote or certain of our other products and toward alternative products that are believed to have fewer environmental effects. The EPA, foreign and state regulators, local governments, private environmental advocacy organizations and a number of large industrial companies have proposed or adopted policies designed to decrease the use of a variety of chemicals, including penta, creosote and others included in certain of our products. Our ability to anticipate changes in regulatory, legislative, and industry requirements, or changes driven by supply-chain pressures, will be a significant factor in our ability to remain competitive. Further, we may not be able to comply with changed or new regulatory or industrial standards that may be necessary for us to remain competitive.

We cannot assure you that the EPA, foreign and state regulators and local governments will not restrict the uses of penta, creosote or certain of our other products or ban the use of one or more of these products, or that the companies who use our products may decide to reduce significantly or cease the use of our products voluntarily. As a result, our products may become obsolete or less attractive to our customers.

***We may be unable to identify liabilities associated with the properties and businesses that may be acquired or obtain protection from sellers against them.***

The acquisition of properties and businesses requires assessment of a number of factors, including physical condition and potential environmental and other liabilities. Such assessments are inexact and inherently uncertain. The assessments made result from a due diligence review of the subject properties and businesses, but such a review may not reveal all existing or potential problems. We may not be able to obtain comprehensive contractual indemnities from the seller for liabilities that it created or that were created by any predecessor of the seller. We may be required to assume the risk of the physical or environmental condition of the properties and businesses in addition to the risk that the properties and businesses may not perform in accordance with expectations.

***We are dependent upon many critical systems and processes, many of which are dependent upon hardware that is concentrated in a limited number of locations. If a catastrophe were to occur at one or more of those locations, it could have a material adverse effect on our business.***

The business is dependent on certain critical systems, which support various aspects of our operations, from our computer network to our billing and customer service systems. The hardware supporting a large number of such systems is housed in a small number of locations. If one or more of these locations were to be subject to fire, natural disaster, terrorism, power loss, or other catastrophe, it could have a material adverse effect on our business. While we believe that we maintain reasonable disaster recovery programs, there can be no assurance that, despite these efforts, any disaster recovery, security and service continuity protection measures we may have or may take in the future will be sufficient.

In addition, we may be susceptible to acts of aggression on our critical operating system. "Cyber security" events such as computer viruses, electronic break-ins or other similar disruptive technological problems could also adversely affect our operations. Should such an event occur in the future, our insurance policies may not adequately compensate us for any losses that may occur due to any failures or interruptions in our computer systems and could affect our financial and operating results, causing disruptions in operations, damage of reputation, litigation, increased costs, or inaccurate information reported by our manufacturing facilities.

***Weather may impact adversely our ability to conduct business.***

Much of the creosote we sell is supplied from Europe, and we import that product through terminals in New Orleans, Louisiana and Savannah, Georgia. Our penta facility in Matamoros, Mexico, and several suppliers of raw materials for our electronic chemicals business are also located on or near the Gulf of Mexico. Thus, we are dependent on terminals and facilities located in coastal areas for a substantial portion of certain of the raw materials and creosote we use, the penta we make and for our electronic chemicals products. These terminals and facilities are vulnerable to hurricanes and other adverse weather conditions that have the potential to cause substantial damage and to interrupt operations. For example, in 2005 Hurricane Katrina closed our terminal in New Orleans, Louisiana temporarily and forced us to locate an interim substitute terminal. We cannot assure that adverse weather conditions will not affect our importation of creosote or the availability of penta and certain other raw materials in the future, the occurrence of which could have a material adverse effect on our financial condition and results of operations.

***The distribution and sale of our products is subject to prior governmental approvals and thereafter ongoing governmental regulation.***

Our products are subject to laws administered by federal, state and foreign governments, including regulations requiring registration, approval and labeling of our products. The labeling requirements restrict the use and type of application for our products. More stringent restrictions could make our products less desirable which would adversely affect our sales and profitability. All states where our products are used also require registration before they can be marketed or used in that state.

Governmental regulatory authorities have required, and may require in the future, that certain scientific testing and data production be provided on our products. Under FIFRA, the federal government requires registrants to submit a wide range of scientific data to support U.S. registrations. This requirement significantly increases our operating expenses, and we expect those expenses will continue in the future. Because scientific analyses are constantly improving, we cannot determine with certainty whether or not new or additional tests may be required by regulatory authorities. While Good Laboratory Practice standards specify the minimum practices and procedures which must be followed in order to ensure the quality and integrity of data related to these tests submitted to the EPA, there can be no assurance that the EPA will not request certain tests or studies be repeated. In addition, more stringent legislation or requirements may be imposed in the future. We can provide no assurance that our resources will be adequate to meet the costs of regulatory compliance or that the cost of such compliance will not adversely affect our profitability.

***The Registration Evaluation and Authorization of Chemicals (“REACH”) legislation may affect our ability to manufacture and sell certain products in the European Union.***

REACH, which was effective on June 1, 2007, requires chemical manufacturers and importers in the European Union to prove the safety of their products. As a result, we were required to pre-register certain products and file comprehensive reports, including testing data, on each chemical substance, and perform chemical safety assessments. Additionally, substances of high concern are subject to an authorization process. Authorization may result in restrictions on certain uses of products or even prohibitions on the manufacture or importation of products. The full registration requirements of REACH will be phased in over the next ten years. We will incur additional expense to cause the registration of our products under these regulations. REACH may also affect our ability to manufacture and sell certain products in the European Union.

***We are subject to extensive environmental laws and regulations and may incur costs that have a material adverse effect on our financial condition as a result of violations of or liabilities under environmental laws and regulations.***

Like other companies involved in environmentally sensitive businesses, our operations and properties are subject to extensive and stringent federal, state, local and foreign environmental laws and regulations, including those concerning, among other things:

- the treatment, storage and disposal of wastes;
- the investigation and remediation of contaminated soil and groundwater;
- the discharge of effluents into waterways;
- the emission of substances into the air; and
- other matters relating to environmental protection and various health and safety matters.

The EPA and other federal and state agencies, as well as comparable agencies in Mexico, Italy and in other countries where we sell our products, have the authority to promulgate regulations that could have a material adverse impact on our operations. These environmental laws and regulations may require permits for certain types of operations, require the installation of expensive pollution control equipment, place restrictions upon operations or impose substantial liability for pollution resulting from our operations. We expend substantial funds to minimize the discharge of hazardous materials in the environment and to comply with governmental regulations relating to protection of the environment. Compliance with environmental and health and safety laws and regulations has resulted in ongoing costs for us, and could restrict our ability to modify or expand our facilities or continue production, or require us to install costly pollution control equipment or incur significant expenses, including remediation costs. We have incurred, and expect to continue to incur, significant costs to comply with environmental and health and safety laws. Federal, state and foreign governmental

authorities may seek fines and penalties, as well as injunctive relief, for violation of the various laws and governmental regulations, and could, among other things, impose liability on us for cleaning up the damage resulting from a release of pesticides, hazardous materials or other chemicals into the environment.

***Our use of hazardous materials exposes us to potential liabilities.***

Our manufacturing and distribution of chemical products involves the controlled use of hazardous materials. Our operations, therefore, are subject to various associated risks, including chemical spills, discharges or releases of toxic or hazardous substances or gases, fires, mechanical failure, storage facility leaks and similar events. Our suppliers are subject to similar risks which may adversely impact the availability of raw materials. While we adapt our manufacturing and distribution processes to the environmental control standards of regulatory authorities, we cannot completely eliminate the risk of accidental contamination or injury from hazardous or regulated materials, including injury of our employees, individuals who handle our products or goods treated with our products, or others who claim to have been exposed to our products, nor can we completely eliminate the unanticipated interruption or suspension of operations at our facilities due to such events. We may be held liable for significant damages or fines in the event of contamination or injury, and such assessed damages or fines could have a material adverse effect on our financial performance and results of operations.

***Our business success depends significantly on the reliability and sufficiency of our manufacturing facilities.***

Our revenues depend significantly on the continued operation of our manufacturing facilities. The operation of our facilities involves risks, including the breakdown, failure, or substandard operation or performance of equipment, power outages, explosions, fires, earthquakes, natural disasters and other unscheduled downtime. The occurrence of material operational problems, the loss or shutdown of our facilities over an extended period of time due to these or other events could have a material adverse effect on our financial performance and operating results.

***Our business is subject to many operational risks for which we may not be adequately insured.***

We cannot assure you that we will not incur losses beyond the limits of, or outside the coverage of, our insurance policies. From time to time, various types of insurance for companies in the chemical industry have not been available on commercially acceptable terms or, in some cases, have been unavailable. In addition, we cannot assure you that in the future we will be able to maintain existing coverage or that our insurance premiums will not increase substantially.

We maintain limited insurance coverage for sudden and accidental environmental damages. We do not believe that insurance coverage for environmental damages that occur over time is available at a reasonable cost. Also, we do not believe that insurance coverage for the full potential liability that could be caused by sudden and accidental incidences is available at a reasonable cost. Accordingly, we may be subject to an uninsured or under-insured loss in such cases.

***Our business may be adversely affected by cyclical and seasonal effects.***

In general, the chemical industry is cyclical and demand for our wood treating products is somewhat seasonal. Many of our products are used in industries that are cyclical in nature. Changes affecting these industries can adversely affect our revenues and margins. Seasonal usage of our chemical products follows weather conditions, as well as customer marketing programs and requirements. Weather patterns can have an impact on our sales. There can be no assurance that we will adequately address any adverse seasonal effects.

***We depend on our senior management team and the loss of any member could adversely affect our operations.***

Our success is dependent on the management and leadership skills of our senior management team, including J. Neal Butler, our President and Chief Executive Officer, John V. Sobchak, our Chief Financial Officer, Roger C. Jackson, our General Counsel, and Ernest C. Kremling, our Vice President of Operations. While we have succession plans for these key positions, the loss of any member of our senior management team or an inability to attract, retain and maintain additional qualified personnel could prevent us from implementing our business strategy. We cannot assure you that we will be able to retain our existing senior management personnel or attract additional qualified personnel when needed.

***If we are unable to successfully negotiate with the labor unions representing our employees, we may experience a material work stoppage.***

About half of our full-time employees who work at our facilities in Matamoros, Mexico, and Hollister, California, and about a quarter of those who work in Milan, Italy are represented under a labor agreement. In Mexico the agreement is for two years, in Italy it is for one year and at Hollister, California it expires in April 2016. We cannot assure you that a new agreement will be reached at the end of each period without union action, or that a new agreement will be reached on terms satisfactory to us. An extended work stoppage, slowdown or other action by our employees could significantly disrupt our business. Future labor contracts may be on terms that result in higher labor costs to us, which also could adversely affect our results of operations.

***We are subject to narcotics gang disruption in Mexico and to possible risk of terrorist attacks, each of which could adversely affect our business.***

Our penta manufacturing facility is located in Matamoros, Mexico, an area where there has been significant violent crime involving narcotics gang warfare. Our penta operations could be disrupted or otherwise affected by narcotics gang activities in the Mexico border area where our facility is located. We are not insured against terrorist or narcotics gang attacks, and there can be no assurance that losses that could result from an attack on our facilities or personnel, railcars or tank trucks would not have a material adverse effect on our business, results of operations and financial condition. Since September 11, 2001, there has been concern that chemical manufacturing facilities and railcars carrying hazardous chemicals may be at an increased risk of terrorist attacks. Federal, state and local governments have begun a regulatory process that could lead to new regulations impacting the security of chemical industry facilities and the transportation of hazardous chemicals. Our business could be adversely impacted if a terrorist incident were to occur at any chemical facility or while a railcar or tank truck was transporting chemicals.

***We are subject to risks inherent in foreign operations, including changes in social, political and economic conditions.***

We have facilities in the United States, Mexico, and Italy, and generate a significant portion of our sales in foreign countries. Like other companies with foreign operations and sales, we are exposed to market risks relating to fluctuations in foreign currency exchange rates. At this time, the Euro is the functional currency of our operations in Italy. The Euro is currently under a great deal of stress, and it is not clear what the ultimate resolution will be of the current crisis. We are unable to predict either the actions that the governments may impose, if some countries determine to no longer use the Euros or if some countries began issuing currencies in addition to the Euro. We are also exposed to risks associated with changes in the laws and policies governing foreign investments in Mexico and Italy and, to a lesser extent, changes in United States laws and regulations relating to foreign trade and investment. While such changes in laws, regulations and conditions have not had a material adverse effect on our business or financial condition, we cannot assure you as to the future effect of any such changes.

## ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

## ITEM 2. PROPERTIES

We own or lease the following properties.

Location	Primary Use	Approximate Size	Owned/ Leased	Lease Expiration Date
Houston, Texas	Corporate Office	17,527 square feet	Leased	January 2017
Elwood, Kansas	Manufacture and Warehouse: Contract manufacturing for animal health products	14.9 acres	Owned	N/A
Matamoros, Mexico	Manufacture and Warehouse: Penta	13.0 acres	Owned	N/A
Tuscaloosa, Alabama	Formulation and Distribution: Penta	2.0 acres	Owned	N/A
Pueblo, Colorado	Manufacture and Warehouse: Electronic Chemicals	37.4 acres	Owned	N/A
Hollister, California	Manufacture and Warehouse: Electronic Chemicals	4.4 acres	Owned	N/A
Milan, Italy	Manufacture and Warehouse: Electronic Chemicals	7.3 acres	Owned	N/A

We manufacture and warehouse our electronic chemicals at our Pueblo, Colorado, Hollister, California and Milan, Italy facilities. Although we have sold our animal health products business, we manufacture and warehouse certain animal health products for Bayer under a transition services agreement at our Elwood, Kansas facility. We manufacture and warehouse penta products at our Matamoros, Mexico facility, and formulate and distribute penta solutions at our Tuscaloosa, Alabama facility. We believe that all of these properties are adequately insured, in good condition and suitable for their anticipated future use. We believe that if the lease for our corporate office is not renewed or is terminated, we can obtain other suitable facilities.

We also have two long-term bulk tank storage agreements with commercial terminal facilities where we store creosote for distribution, and have several storage agreements with commercial warehouses from which we distribute our electronic chemicals. Our bulk storage terminals are on the Mississippi River near New Orleans at Avondale, Louisiana and near Savannah, Georgia. The terminals are used primarily for creosote imported by us from Europe. If our tank storage agreements are not renewed or are terminated, we believe we can obtain other suitable facilities.

## ITEM 3. LEGAL PROCEEDINGS

The information set forth in Note 8 to the consolidated financial statements included in Item 8 of Part II of this report is incorporated herein by reference.

## ITEM 4. MINE SAFETY DISCLOSURES

None.

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUES PURCHASER OF EQUITY SECURITIES

Our common stock, par value \$.01 per share, is traded on The New York Stock Exchange (trading symbol KMG). As of October 12, 2012, there were 11,412,400 shares of Common Stock issued and outstanding held by approximately 500 shareholders of record, and more than 300 round lot holders. We moved our listing on June 20, 2012 to the New York Stock Exchange from the Nasdaq Global Market (trading symbol KMGB). The following table represents the high and low sale prices for our common stock as reported by the New York Stock Exchange and the Nasdaq Global Market for the fourth quarter of fiscal year 2012 and by the Nasdaq Global Market during the first, second and third quarters of fiscal year 2012 and in fiscal year 2011. The table also shows quarterly dividends we declared and paid during fiscal years 2012 and 2011.

	Common Stock Prices		Dividends Declared and Paid	
	High	Low	Per Share	Amount
Fiscal 2012				
First Quarter .....	\$ 16.93	\$ 11.82	\$ 0.025	\$ 283,000
Second Quarter .....	18.50	13.69	0.025	284,000
Third Quarter .....	19.48	17.00	0.03	341,000
Fourth Quarter .....	19.72	16.14	0.03	341,000
Fiscal 2011				
First Quarter .....	\$ 15.95	\$ 12.80	\$ 0.02	\$ 226,000
Second Quarter .....	17.68	13.80	0.02	226,000
Third Quarter .....	20.69	16.83	0.025	283,000
Fourth Quarter .....	20.60	16.21	0.025	283,000

We intend to pay out a reasonable share of cash from operations as dividends, consistent on average with the payout record of past years. We declared and paid a dividend in the first quarter of fiscal year 2013 of \$0.03 per share, or approximately \$342,000. The current quarterly dividend rate represents an annualized dividend of \$0.12 per share. The future payment of dividends, however, will be within the discretion of the Board of Directors and depends on our profitability, capital requirements, financial condition, growth, business opportunities and other factors which our Board of Directors may deem relevant. We repurchased no shares in fiscal years 2012 or 2011.

Our 2009 Long-Term Incentive Plan was submitted to the shareholders and approved at our annual meeting of shareholders on December 8, 2009. Our 2004 Long-Term Incentive Plan was adopted and approved by the shareholders in 2004. Our 1996 Stock Option Plan was adopted and approved by its shareholders in 1996. The 1996 Stock Option Plan terminated by expiration of its original term as of July 31, 2007, but options previously issued under the plan remain in effect.

The following information respecting our outstanding options, warrants and rights is provided as of July 31, 2012:

	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities available for future issuance under equity compensation plans (excluding securities reflected in column (a))
	(a)	(b)	(c)
Plan Category Equity compensation plans approved by security holders .....	180,000 <sup>(1)</sup>	\$ 4.13	579,108
Equity compensation plans not approved by security holders .....	—	—	—
Total .....	180,000	\$ 4.13	579,108

(1) Includes unvested options to purchase 30,000 shares of common stock.

## ITEM 6. SELECTED FINANCIAL DATA

The following table shows selected historical consolidated financial data for the five fiscal years ended July 31, 2012. The consolidated statements of income and cash flow data for each of the three fiscal years ended July 31, 2012, and the balance sheet data for the two fiscal years ended July 31, 2012, have been derived from our audited consolidated financial statements included elsewhere in this report. The consolidated statements of income and cash flow data for the two fiscal years ended July 31, 2009, and the balance sheet data for the three fiscal years ended July 31, 2010, has been derived from our audited consolidated financial statements. The data should be read in conjunction with our consolidated financial statements and notes to consolidated financial statements.

	Year Ended July 31,				
	2012	2011	2010	2009	2008
	(Amounts in thousands, except per share data)				
<b>Statement of Income Data <sup>(1)</sup></b>					
Net sales .....	\$ 272,700	\$ 255,596	\$ 197,997	\$ 179,789	\$ 142,742
Operating income .....	25,437	17,022	26,731	20,292	10,426
Income from continuing operations .....	14,315	9,418	15,177	9,889	4,988
Net income .....	13,825	9,729	15,330	10,215	5,375
Earnings per share from continuing operations-basic	\$ 1.26	\$ 0.83	\$ 1.36	\$ 0.89	\$ 0.45
Income/(loss) per share from discontinued operations-basic .....	(0.04)	0.03	0.01	0.03	0.04
Earnings per share-basic .....	<u>\$ 1.22</u>	<u>\$ 0.86</u>	<u>\$ 1.37</u>	<u>\$ 0.92</u>	<u>\$ 0.49</u>
Earnings per share from continuing operations-diluted	\$ 1.24	\$ 0.82	\$ 1.33	\$ 0.88	\$ 0.45
Income/(loss) per share from discontinued operations-diluted .....	(0.04)	0.03	0.01	0.03	0.03
Earnings per share-diluted .....	<u>\$ 1.20</u>	<u>\$ 0.85</u>	<u>\$ 1.34</u>	<u>\$ 0.91</u>	<u>\$ 0.48</u>
<b>Cash Flow Data <sup>(1)</sup></b>					
Net cash provided by operating activities .....	\$ 25,249	\$ 12,713	\$ 14,948	\$ 26,502	\$ 15,668
Net cash provided by (used in) investing activities .....	4,043	(8,007)	(29,677)	(6,268)	(75,540)
Net cash provided by (used in) financing activities .....	(29,275)	(7,823)	12,616	(15,442)	46,442
Payment of dividends .....	1,249	1,017	894	887	877
<b>Balance Sheet Data <sup>(1)</sup></b>					
Total assets .....	\$ 167,690	\$ 185,378	\$ 176,021	\$ 143,508	\$ 155,798
Long-term debt, net of current maturities .....	24,000	41,279	51,333	39,326	53,516
Total stockholders' equity .....	106,767	96,530	84,778	70,977	63,687

- (1) Our historical results are not necessarily indicative of results to be expected for any future period. The comparability of the data is affected by our acquisitions since fiscal 2008.
- (2) Certain reclassifications of prior year amounts have been made to conform to current year presentation. See Note 1 to the consolidated financial statements.

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the "Selected Financial Data" section of this report and our consolidated financial statements and the related notes and other financial information included elsewhere in this report. In addition to historical financial information, the following discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results and timing of selected events may differ materially from those anticipated in these forward-looking statements as a result of many factors, including those discussed under the section entitled "Risk Factors" and elsewhere in this report.

### Introduction

We manufacture, formulate and globally distribute specialty chemicals. We operate specialty chemical businesses selling electronic chemicals and industrial wood treating chemicals. Our electronic chemicals are sold to the semiconductor industry where they are used primarily to clean and etch silicon wafers in the production of semiconductors. Our wood treating chemicals, penta and creosote, are used by industrial customers primarily to extend the useful life of utility poles and railroad crossties.

In fiscal year 2012, approximately 58.5% of our revenues were from electronic chemicals and 41.4% were from industrial wood preservation chemicals.

Our results of operations are impacted by various competitive and other factors including:

- fluctuations in sales volumes;
- raw material pricing and availability;
- our ability to acquire and integrate new products and businesses; and
- the difference between prices received by us for our specialty chemical products and the costs to produce those products.

### Sale of the Animal Health Business

On March 1, 2012, we sold most of the assets of our animal health business to Bayer Healthcare, LLC for a purchase price of approximately \$10.2 million, including \$1.0 million held in escrow. The purchase price was paid in cash, subject to the escrow. We used the proceeds to reduce the amount outstanding on our revolving indebtedness. The escrowed amount is being held pending final acceptance by the EPA of certain studies being performed at its request on tetrachlorvinphos, the active ingredient used in Rabon products. The escrowed funds are to be released to us once the EPA has finally accepted the studies, the buyer has voluntarily canceled the products, or after five years. The escrowed funds are to be released to the buyer if the EPA cancels products to which the studies pertain before the funds are distributed to us. The sale included inventory, equipment and product registrations. We retained the real estate and building at our facility in Elwood, Kansas, and we will continue to operate it to manufacture products for the buyer under a transition services agreement that expires in February, 2013, subject to two six-month extensions.

### Results of Operations

#### Segment Data

Segment data is presented for our two segments for the three fiscal years ended July 31, 2012, 2011 and 2010. The segment data should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this report. Our animal health business was sold in March 2012, and results from that former segment are included in discontinued operations. Prior year information has been reclassified to conform to the current period presentation.

	Year Ended July 31,		
	2012	2011	2010
	(Amounts in thousands)		
Sales:			
Electronic chemicals.....	\$ 159,451	\$ 151,481	\$ 111,990
Wood treating.....	113,034	104,115	86,007
Total sales for reportable segments .....	<u>\$ 272,485</u>	<u>\$ 255,596</u>	<u>\$ 197,997</u>

## *Segment Sales*

In fiscal year 2012, net sales from electronic chemicals were \$159.5 million, an increase of \$8.0 million, or 5.3%, over net sales of \$151.5 million in fiscal year 2011. In fiscal year 2011, net sales in the electronic chemicals segment increased \$39.5 million, or 35.3%, over net sales of \$112.0 million in fiscal year 2010. In fiscal year 2012, the increase in net sales came from greater volume and from price increases implemented to recover higher raw material costs. In fiscal year 2011, the increase from the prior year was due to the effect of our March 2010 acquisition of the electronic chemicals business of General Chemical.

Net sales of wood treating chemicals increased by \$8.9 million, or 8.6%, to \$113.0 million in fiscal year 2012 from \$104.1 million in fiscal year 2011. Net sales of wood treating chemicals in fiscal year 2011 increased by \$18.1 million, or 21.1%, from \$86.0 million in fiscal year 2010. The increase in net sales of wood treating chemicals for each fiscal year was due to higher sales in both of our wood treating chemical product lines. The increase in fiscal year 2012 in wood treating products net sales came from price increases implemented to recover increased costs. The increase in fiscal year 2011 as compared with fiscal year 2010 came from a modest increase in volume to utility pole treaters and a significant increase in volume sold to crosstie treaters due to improved economic conditions. In the last five years, production of railroad crossties in North America has averaged 20.4 million ties annually.

## *Segment Income from Operations*

Income from operations of the electronic chemicals segment was \$13.4 million in fiscal year 2012, as compared to \$6.2 million in fiscal year 2011 and \$8.4 million in fiscal year 2010. Income from operations of electronic chemicals increased by \$7.2 million, or 115.8% in fiscal year 2012, as compared to the prior year period, and decreased \$2.2 million, or 25.9%, in fiscal year 2011 as compared to the prior year period.

The fiscal year 2012 improvement in income from operations in electronic chemicals was achieved despite corporate overhead allocated to the segment that was approximately \$1.3 million higher than the prior year. Approximately half of the \$7.2 million improvement came from improved efficiency in our supply chain operations. The balance of the improvement came from improved sales volume and, from manufacturing efficiency realized after the consolidation of manufacturing operations from the General Chemical acquisition. In fiscal year 2011, income from operations was adversely impacted by duplicative expenses associated with the integration of our March 2010 acquisition from General Chemical, and by rising raw material costs. We recognized an overall increase in net operating expenses of \$10.1 million in fiscal year 2011 as compared to fiscal year 2010. That change was mainly caused by an increase of \$8.3 million in freight, storage and handling expenses due to greater volume. That volume increase was primarily because we included results of operations from the General Chemical acquisition for the full fiscal year 2011. We also had approximately \$970,000 of higher selling expenses from higher employee costs relative to fiscal year 2010.

In fiscal year 2012, income from operations of the wood treating segment was \$15.6 million, as compared to \$14.8 million in fiscal year 2011 and \$23.0 million in fiscal year 2010. Income from operations for the wood treating segment increased by \$856,000, or 5.8%, in fiscal year 2012, and decreased by \$8.2 million, or 35.8%, in fiscal year 2011 as compared to the respective prior year period.

Income from operations in wood treating chemicals benefited in fiscal year 2012 from higher revenues, although there was a slight decline in operating margin. Overhead allocations to the segment increased by about \$1.1 million over the prior year. We also had higher costs in fiscal year 2012 of \$1.2 million for waste disposal attributable to the segment which were partially offset by a reduction in railcar cleaning and repair expenses of \$382,000. In fiscal year 2011, over 90% of the decline in income from operations in wood treating chemicals as compared to fiscal year 2010 was because of increased costs and a lower average price on our creosote products. During the first half of fiscal 2010, we benefited from a temporary disruption in the global creosote market that dramatically lowered our costs. Normal costs returned by the end of fiscal year 2010. In the same fiscal year, we entered into a long-term contract to sell creosote to our largest customer. Although this arrangement has had the effect of increasing creosote volume substantially, margins declined from the unusually high levels experienced in fiscal year 2010 to a more normal level in fiscal 2011.

## *Net Sales and Gross Profit*

### *Net Sales and Gross Profit for Fiscal Year 2012 vs. Fiscal Year 2011*

Net sales increased \$17.1 million, or 6.6% in fiscal year 2012 to \$272.7 million from \$255.6 million in fiscal year 2011. The increase came from increased sales of \$8.0 million from our electronic chemicals segment and \$8.9 million from our wood treating chemicals segment.

Gross profit increased in fiscal year 2012 by \$9.0 million, or 13.2% to \$77.1 million as compared to gross profit of \$68.1 million in fiscal year 2011. Approximately half of the improvement in gross profits was due to higher revenues, and half was due to improved gross profit margins. Gross profit as a percent of sales improved in fiscal year 2012 to 28.3% of sales as compared to 26.6% of sales in fiscal year 2011 primarily due to improved margins in our electronic chemicals segment, as we were able to implement pricing increases to recapture cost increases experienced in the prior fiscal year, and because we achieved improved manufacturing efficiency upon completion of our manufacturing consolidation.

Because other companies may include certain of the costs that we record in cost of sales in distribution expenses or selling, general and administrative expenses, and may include certain of the costs that we record in distribution expenses or selling, general and administrative expenses as cost of sales, our gross profit may not be comparable to that reported by other companies.

#### *Net Sales and Gross Profit for Fiscal Year 2011 vs. Fiscal Year 2010*

Net sales increased \$57.6 million, or 29.1%, in fiscal year 2011 to \$255.6 million from \$198.0 million in fiscal year 2010. The increase resulted from increased sales of \$39.5 million from our electronic chemicals segment and \$18.1 million from our wood treating chemicals segment. In electronic chemicals the increase came primarily from greater sales in North America. We acquired General Chemical's electronic chemicals business eight months into fiscal year 2010. The increase in sales in that segment in fiscal year 2011 was primarily due to having the benefit of that acquisition for the full year. In wood treating chemicals in fiscal year 2011, the increase came entirely from improved volume in creosote product sales.

Gross profit increased in fiscal year 2011 by \$1.3 million, or 2.0%, to \$68.1 million as compared to gross profit of \$66.7 million in fiscal year 2010. Gross profit increased primarily due to increased sales of electronic chemicals resulting from the acquisition of General Chemical's electronic chemicals business. The increase of approximately \$7.8 million in gross profit in fiscal year 2011 from the electronic chemicals segment was significantly offset by a decrease in gross profit in the wood treating segment in the fiscal year of \$6.5 million due to higher costs and lower average selling prices for creosote. Gross profit as a percent of sales declined in fiscal year 2011 to 26.6% of sales as compared to 33.7% of sales in fiscal year 2010. In electronic chemicals the gross profit percentage suffered from expenses of integrating the acquisition and from rising raw material costs.

A manufacturing agreement was entered into during fiscal year 2010 with General Chemical in connection with our acquisition of their electronic chemicals business. That agreement requires us to pay all of the direct costs of manufacturing associated with the production of electronic chemicals as General Chemical's Bay Point, California facility, and to pay a monthly fee set initially at \$117,000. We incurred those costs for four months in fiscal year 2010, but as our integration progressed the monthly fee was reduced to approximately \$68,000 by June 2011.

#### *Distribution and Selling, General and Administrative Expenses*

##### *Distribution and Selling, General and Administrative for Fiscal Year 2012 vs. Fiscal Year 2011*

Distribution expenses decreased to approximately \$26.8 million in fiscal year 2012 from \$28.8 million in fiscal year 2011, a decrease of about \$2.0 million, or 7.1%. The decrease in distribution expense resulted from efficiency improvements in our electronic chemicals segment supply chain costs from the completion of the integration of the General Chemical acquisition. Distribution expense was 9.8% of net sales in fiscal year 2012 and 11.3% in the prior year. The electronic chemicals segment incurs approximately three-quarters of our distribution expense. In electronic chemicals, distribution expense was 13.2% of net sales in fiscal year 2012 as compared to 16.0% in fiscal year 2011.

Selling, general and administrative expenses increased to \$24.9 million in fiscal year 2012 from \$22.2 million in fiscal year 2011, an increase of \$2.6 million, or 11.9%. As a percentage of net sales, those expenses were 9.1% and 8.7% in fiscal years 2012 and 2011, respectively. The increase in fiscal year 2012 over the prior year was primarily because of higher employee related costs of \$1.6 million and waste disposal costs of \$1.2 million for waste disposal at our Tuscaloosa facility and disposal of waste associated with cleaning rail cars in creosote service.

##### *Distribution and Selling, General and Administrative for Fiscal Year 2011 vs. Fiscal Year 2010*

Distribution expenses increased to \$28.8 million in fiscal year 2011 from \$19.1 million in fiscal year 2010, an increase of \$9.8 million, or 51.3%. Approximately \$8.3 million of the increase in distribution expense in fiscal year 2011 was from increased storage, handling and freight primarily in our electronic chemicals segment, in large part on increased volume attributable to the acquisition of the electronic chemicals business from General Chemical. Distribution expense was 11.3% of net sales in fiscal year 2011 and 9.6% in the prior year. In electronic chemicals, distribution expense was 16.0% of net sales in fiscal year 2011 as compared to 14.3% in fiscal year 2010.

Selling, general and administrative expenses increased to \$22.2 million in fiscal year 2011 from \$20.9 million in fiscal year 2010, an increase of \$1.3 million, or 6.1%. As a percentage of sales, those expenses were 8.7% and 10.6% in fiscal years 2011 and

2010, respectively. The increase in fiscal year 2011 over the prior year was primarily for increases in employee costs of \$674,000 and permits and licenses of \$345,000. Offsetting these increases, however, was a decrease of \$353,000 in integration costs.

Corporate expenses that were not allocated to any segment decreased by approximately \$706,000 in fiscal year 2011, as compared to the prior year period. The decrease was primarily in costs associated with our General Chemical acquisition in fiscal year 2010 which accounted for \$308,000 of the decrease, and because we had lower key man life insurance expenses of \$219,000, lower employee stock-based compensation expense of \$219,000 and lower director's fees and expenses of \$207,000.

#### *Interest Expense*

Interest expense was \$2.1 million in fiscal year 2012 and \$2.3 million in fiscal year 2011 and 2010. We increased borrowings under our credit facility to complete our acquisition of the electronic chemicals business of General Chemical in March 2010, and have subsequently reduced the amount of those borrowings.

#### *Income Taxes*

We had income tax expense from continuing operations of \$8.8 million, \$5.1 million and \$9.1 million in fiscal years 2012, 2011 and 2010, respectively. Our effective tax rate was 37.9% in fiscal year 2012, 35.0% in fiscal year 2011 and 37.5% in fiscal year 2010. In general, differences between these effective tax rates and the rate of 35.0% are primarily due to foreign and state income taxes, and the release of a valuation allowance on a deferred tax asset in fiscal year 2011.

#### *Discontinued Operations*

Discontinued operations reflected a net loss of \$490,000 and income of \$311,000 and \$153,000 for fiscal years 2012, 2011 and 2010, respectively. The sale of our animal health business was concluded in fiscal year 2012. The pre-tax gain on that sale was \$90,000. The results of operations of that business reflected a pre-tax loss of \$202,000 in fiscal year 2012, and pre-tax income of \$634,000 and \$247,000 in fiscal years 2011 and 2010, respectively, which are included in discontinued operations. We also incurred expense in fiscal years 2012 and 2011 of \$599,000 and \$120,000, respectively, in connection with the dismantling of the production facility related to the agricultural chemical segment that was discontinued in fiscal year 2008. Fiscal year 2012 also included expenses related to an accident at our Matamoros facility during the dismantlement of that facility.

### **Liquidity and Capital Resources**

#### *Cash Flows*

Net cash provided by operating activities was \$25.2 million in fiscal year 2012, \$12.7 million in fiscal year 2011 and \$14.9 million in fiscal year 2010.

In fiscal year 2012, net income adjusted for depreciation and amortization increased cash by \$20.8 million. Cash flows from operating activities were favorably impacted by a decrease in accounts receivable of \$6.8 million, primarily due to lower sales of creosote during the fourth quarter of fiscal year 2012 as compared to the prior year fourth fiscal quarter, and to a lesser extent because of the sale of the animal health business and currency translation adjustments of our Italian subsidiary's accounts receivable balance on lower currency exchange rates. Cash flows were also favorably impacted by an increase in accrued liabilities and a decrease in other receivables of \$1.9 million and \$2.2 million, respectively. The increase in accrued liabilities was mainly due to a higher employee incentive accrual of approximately \$1.1 million, while the decrease in other receivables included a reduction in income taxes receivable applied to the current period tax payments. Cash flows from operating activities were unfavorably impacted by a decrease in our trade accounts payable and an increase in inventories of \$2.8 million and \$5.5 million, respectively. The decrease in accounts payable was due primarily to the timing of payments on our creosote purchases and lower freight accruals, while the increase in inventories was attributable to our creosote inventories due to the combination of higher quantities, higher average cost and material in transit at the end of the current year. We also had higher inventories in our electronic chemicals segment due to increased raw material purchases at the end of fiscal year 2012. All results reported were net of the sale of our animal health business which reduced our working capital requirements.

In fiscal year 2011, net income adjusted for depreciation and amortization increased cash by \$17.2 million. Cash flows from operating activities were favorably impacted by an increase in accounts payable of \$3.8 million, primarily from the timing of payments for our creosote purchases and increased activity in our electronic chemicals segment related to increased production and sales volume. Cash flows from operating activities was unfavorably impacted by increases in our trade accounts receivables and inventories of \$5.9 million and \$2.2 million, respectively. The increase in accounts receivable was due to higher creosote sales, while the increase in inventories was attributable to our increased electronic chemicals business.

In fiscal year 2010, net income adjusted for depreciation and amortization increased cash by \$22.1 million. Approximately \$9.3 million of cash was used to fund an increase in trade accounts receivable, and of that increase approximately \$7.6 million was associated with the acquisition of the electronic chemicals business of General Chemical and the balance was due to increased sales

levels in the rest of the electronic chemicals business and year end increases in animal health receivables due to the timing of sales. Approximately \$3.5 million of cash was used as creosote inventories increased due to the timing of product shipments. That decrease in cash was offset by an increase of \$4.4 million in cash from increased accounts payable, of which \$2.1 million was associated with the acquisition of the electronic chemicals business of General Chemical and the balance was primarily due to the increase in electronic chemicals production.

Net cash provided by investing activities was \$4.0 million in fiscal year 2012 compared to cash used of \$8.0 million in fiscal year 2011 and \$29.7 million in fiscal year 2010. In fiscal year 2012, we made \$5.2 million of additions to property, plant and equipment, approximately \$4.3 million of which was for electronic chemicals production and distribution equipment. The remainder of our additions to property was capital expenditures for normal equipment and system upgrades and purchases at our different locations. We received \$10.2 million of proceeds for the sale of our animal health business during fiscal year 2012. In fiscal year 2011, we made \$8.3 million of additions to property, plant and equipment, approximately \$1.9 million of which was in connection with our integration efforts at our Hollister, California facility. We spent approximately \$4.6 million at our Pueblo facility primarily for the purchase of tank wagons, shipping containers and equipment related to our sulfuric acid business, and to a lesser extent for our integration efforts. The remainder of our additions to property was for normal capital expenditures. In fiscal year 2010, we acquired the electronic chemicals business of General Chemical using \$26.8 million in net cash, which included \$17.7 million of additions to property, plant and equipment and \$7.6 million of inventory. In that same year we made additions to property, plant and equipment of \$3.0 million, of which about \$1.7 million was for the purchase of shipping containers in our electronic chemicals business, our ongoing expansion project in Hollister, California and our Bay Point, California equipment upgrades.

In fiscal year 2012, net cash used in financing activities was \$29.3 million. We reduced our revolving facility by \$13.9 million and paid \$11.3 million to pay off our term loan. In fiscal year 2011, net cash used in financing activities was \$7.8 million. We reduced our revolving facility by \$2.1 million, reduced our term loan by \$8.0 million and also cleared the book overdraft that had been outstanding at July 31, 2011. In fiscal year 2010, net cash provided by financing activities was \$12.6 million, which included \$20.0 million of net borrowings on our revolving line to fund the acquisition of the electronic chemicals business of General Chemical, and principal payments on our term loan facility of \$7.0 million. We paid dividends of \$1.2 million in fiscal year 2012, \$1.0 million in fiscal year 2011 and \$894,000 in fiscal year 2010.

#### *Working Capital*

We have a revolving line of credit under an amended and restated credit agreement. At July 31, 2012, we had \$4.0 million outstanding under that revolving facility. Management believes that our current credit facility, combined with cash flows from operations, will adequately provide for our working capital needs for current operations for the next twelve months.

#### *Long Term Obligations*

To finance the acquisition of the electronic chemicals business in December 2007, we entered into an amended and restated credit agreement and a note purchase agreement with Wachovia Bank, National Association, a subsidiary of Wells Fargo & Co., Bank of America, N.A., The Prudential Insurance Company of America, and Pruco Life Insurance Company. The credit facility included a revolving loan facility and a term loan facility.

We amended the credit agreement in November 2011 by raising the maximum amount that may be borrowed under the revolving loan facility to \$60.0 million, extending the maturity to December 31, 2016, and allowing advances under the revolving loan facility without reference to a borrowing base restriction. The financial covenant for debt to capitalization was replaced by a current ratio minimum of 1.5 to 1.0. During the first quarter of fiscal year 2012 we paid off all outstanding advances under the credit facility's term loan commitment, and in the November 2011 amendment, that aspect of the facility was deleted.

Advances under the revolving loan mature December 31, 2016. The revolving loan bears interest at varying rate of LIBOR plus a margin based on our funded debt to EBITDA, as described below.

<u>Ratio of Funded Debt to EBITDA</u>	<u>Margin</u>
Equal to or greater than 3.0 to 1.0 .....	2.75%
Equal to or greater than 2.5 to 1.0, but less than 3.0 to 1.0 .....	2.50%
Equal to or greater than 2.0 to 1.0, but less than 2.5 to 1.0 .....	2.25%
Equal to or greater than 1.5 to 1.0, but less than 2.0 to 1.0 .....	2.00%
Less than 1.5 to 1.0 .....	1.75%

Advances outstanding under the revolving loan facility bear interest at 2.22% as of October 12, 2012 and 2.25% as of July 31, 2012. Before the term loan facility was paid off in October 2011 and removed from the credit facility, the term facility required principal payments of \$458,333 per month for the first 24 months, and then beginning in January 2010 principal payments became \$666,667 per month for the balance of the term prior to maturity. On March 2, 2012, we repaid the \$10.0 million principal

balance outstanding on the revolving loan facility from proceeds received from the sale of the animal health business. At October 12, 2012 and at July 31, 2012, \$4.0 million was outstanding on the revolving facility.

The financing for the acquisition of the electronic chemicals business in December 2007 included a \$20.0 million note purchase agreement we entered into with the Prudential Insurance Company of America. Advances under the note purchase agreement mature December 31, 2014, and bear interest at 7.43% per annum. Principal is payable at maturity. At October 12, 2012 and at July 31, 2012, \$20.0 million was outstanding under the note purchase agreement.

Loans under the amended and restated credit facility and the note purchase agreement are secured by our assets, including inventory, accounts receivable, equipment, intangible assets and real property. The credit facility and the note purchase agreement have restrictive covenants, including that we must maintain a fixed charge coverage ratio of 1.5 to 1.0, a ratio of funded debt to EBITDA of 3.0 to 1.0, and a current ratio of at least 1.5 to 1.0. For purposes of calculating these financial covenant ratios, we use pro forma EBITDA. On July 31, 2012, we were in compliance with all of our debt covenants.

#### *Environmental Expenditures*

Our capital expenditures and operating expenses for continuing operations for environmental matters, excluding testing, data submission and other costs associated with our product task force participation, were approximately \$2.2 million in fiscal year 2012, \$1.7 million in fiscal year 2011 and \$1.3 million in fiscal year 2010.

We expensed approximately \$802,000 for testing, data submission and other costs associated with our participation in product task forces for continuing operations in fiscal year 2012, and approximately \$760,000 and \$636,000 in fiscal years 2011 and 2010, respectively. We estimate that we will continue to incur additional testing, data submission and other costs for continuing operations of approximately \$756,000 in fiscal year 2013. Testing, data submission and other costs associated with the animal health business have been included in discontinued operations. Since environmental laws have traditionally become increasingly stringent, costs and expenses relating to environmental control and compliance may increase in the future. While we do not believe that the incremental cost of compliance with existing or future environmental laws and regulations will have a material adverse effect on our business, financial condition or results of operations, we cannot assure that costs of compliance will not exceed current estimates.

#### *Contractual Obligations*

Our obligations to make future payments under contracts as of July 31, 2012 are summarized in the following table (in thousands):

	Payments Due by Period (in thousands)			
	Total	1 Year	2-5 Years	More than 5 Years
Long-term debt .....	\$ 24,000	\$ —	\$ 24,000	\$ —
Estimated interest payments on debt <sup>(1)</sup> .....	3,508	1,527	1,981	—
Operating leases .....	6,131	2,294	3,549	288
Other long-term liabilities <sup>(2)</sup> .....	642	22	266	354
Purchase obligations <sup>(3)</sup> .....	266,543	86,081	165,538	14,924
Total .....	<u>\$ 300,824</u>	<u>\$ 89,924</u>	<u>\$ 195,334</u>	<u>\$ 15,566</u>

(1) Estimated payments are based on interest rates as of the end of July 2012.

(2) Post retirement benefit obligations for a supplemental executive retirement plan for one of our executives.

(3) Consists primarily of raw materials purchase contracts. These are typically not fixed prices arrangements. The prices are based on the prevailing prices.

## Outlook for Fiscal Year 2013

We anticipate another record year for net sales in fiscal year 2013, and continued growth of net earnings, absent a major disruption to the global economy. Operating margins improved significantly in the second half of fiscal year 2012, upon completion of final initiatives integrating our latest electronic chemicals acquisition. Operating efficiency is expected to incrementally improve during fiscal 2013. We anticipate healthy growth in the semiconductor sector during the second half of fiscal 2013, following a seasonal softening in chip production during the second fiscal quarter. Our wood treating chemicals business experienced increased competitive pressures in the rail tie market during the second half of fiscal 2012 from alternative treating processes that adversely impacted creosote demand. Driven by strong pole demand, we have seen a notable sales increase in our more profitable penta products line. Overall, we expect the bottom line contribution of wood treating chemicals will remain fairly steady on average through fiscal 2013.

We are actively pursuing several acquisition and related opportunities in both the electronic chemicals and wood treating chemicals markets. We are encouraged by the opportunities that we have seen, and by the ones before us. In addition to growing our two existing segments, we are also actively pursuing new platform opportunities to add to our business.

## Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements, such as financing or unconsolidated variable interest entities, other than operating leases.

## Recent Accounting Standards

We have considered all recently issued accounting standards updates and SEC rules and interpretive releases.

In July 2012, the Financial Accounting Standards Board (“FASB”) issued updated accounting guidance amending the method an entity uses to test indefinite-lived assets for impairment. Under previous guidance, an entity was required to test indefinite-lived assets for impairment on at least an annual basis, in two steps. First, an entity had to compare the fair value of the asset with its carrying amount. If the fair value of the asset was less than its carrying amount, then the second step of the test had to be performed to measure the amount of the impairment loss, if any. Under the updated guidance, an entity is not required to calculate the fair value of the asset, unless it determines that it is more likely than not that its fair value is less than its carrying amount. An entity has the option to first assess qualitative factors to determine whether it is more likely than not that the asset’s fair value is less than its carrying amount. Performing the two-step impairment test is unnecessary, when the asset’s fair value is determined to more likely than not be greater than its carrying amount. The updated guidance is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted, including for annual or interim indefinite-lived assets impairment tests performed prior to July 27, 2012, if an entity’s financial statements for the most recent annual period have not yet been issued. We early adopted the updated guidance for our annual impairment test for indefinite-lived assets performed as of July 31, 2012, which did not have a material impact on our financial statements. Based on our assessment, we determined that it was not more likely than not that the fair value of our indefinite-lived intangible assets was greater than the carrying amount, and that there would be no impairment of the assets.

## Critical Accounting Policies

Our consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements requires the use of estimates, judgments, and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the periods presented. The significant accounting principles that we believe are the most important to aid in fully understanding our financial results are the following:

*Revenue Recognition* — Our chemical products are sold in the open market and revenue is recognized when risk of loss and title to the products transfers to customers. In general, risk of loss transfers upon shipment to customers.

*Allowance for Doubtful Accounts* — We record an allowance for doubtful accounts to reduce accounts receivable where we believe accounts receivable may not be collected. A provision for bad debt expense recorded to selling, general and administrative expenses increases the allowance. Accounts receivable that are written off decrease the allowance. The amount of bad debt expense recorded each period and the resulting adequacy of the allowance at the end of each period are determined using a customer-by-customer analyses of accounts receivable balances each period and subjective assessments of future bad debt exposure. Historically, write offs of accounts receivable balances have been insignificant. The allowance was \$16,000 and \$414,000 at July 31, 2012 and 2011, respectively.

*Goodwill* — The carrying value of goodwill is reviewed at least annually, and if this review indicates that it will not be recoverable, our carrying value of goodwill will be adjusted to fair value. Based on an assessment of qualitative factors it was determined that there were no events or circumstances that would lead us to a determination that is more likely than not that the fair

value of the applicable reporting unit was less than the carrying value as of July 31, 2012 and 2011. Accordingly, we determined that as of July 31, 2012 and 2011, goodwill was not impaired. As a result, there was no change in the carrying value of goodwill of \$3.8 million as of July 31, 2012 and 2011.

*Impairment of Long-Lived Assets* — Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset or its disposition. The measurement of an impairment loss for long-lived assets, where management expects to hold and use the asset, are based on the asset's estimated fair value. Long-lived assets to be disposed of are reported at the lower of carrying amount or fair value.

*Income Taxes* — Deferred income taxes and liabilities are determined using the asset and liability method in accordance with accounting principles generally accepted in the United States of America. We have deferred tax assets that are reviewed periodically for recoverability. These assets are evaluated by using estimates of future taxable income streams. Valuations related to tax accruals and assets could be impacted by changes to tax codes, changes in the statutory tax rates and our future taxable income levels. A portion of the net deferred tax asset is related to net operating losses from a foreign subsidiary, which have no time expiration. As of July 31, 2012 we had no valuation allowance, as we concluded that it is more likely than not that the deferred tax asset related to the net operating losses of the foreign subsidiary will be realized based on pre-tax income realized for the last two years and projected earnings.

The Company's subsidiary in Italy is currently under examination for the period ended July 31, 2009. Adjustments were proposed by the taxing authority at the end of April 2011 that would result in approximately \$1.6 million (including interest and penalties) of additional liability, if all the adjustments are sustained. The Company is providing additional information and documentary evidence in response to the proposed adjustments, and intends to vigorously defend its tax positions. The ultimate outcome of this examination is subject to uncertainty and no amount has been recorded in the Company's consolidated financial statements

*Inventory Valuation* — We review inventories periodically to ensure the valuation of these assets is recorded at the lower of cost or market and to record an obsolescence reserve when inventory is considered unsellable. During the fiscal years ended July 31, 2012 and 2011, we recognized inventory valuation adjustments of \$371,000 and \$94,000, respectively. As of July 31, 2012 and 2011, we had recorded \$493,000 and \$333,000, respectively of reserves for inventory obsolescence.

## **Disclosure Regarding Forward Looking Statements**

We are including the following discussion to inform our existing and potential security holders generally of some of the risks and uncertainties that can affect us and to take advantage of the "safe harbor" protection for forward-looking statements that applicable federal securities law affords. From time to time, our management or persons acting on our behalf make forward-looking statements to inform existing and potential security holders about our company. These forward-looking statements include information about possible or assumed future results of our operations. All statements, other than statements of historical facts, included or incorporated by reference in this report that address activities, events or developments that we expect or anticipate may occur in the future, including such things as future capital expenditures, business strategy, competitive strengths, goals, growth of our business and operations, plans and references to future successes may be considered forward-looking statements. Also, when we use words such as "anticipate," "believe," "estimate," "intend," "plan," "project," "forecast," "may," "should," "budget," "goal," "expect," "probably" or similar expressions, we are making forward-looking statements. Many risks and uncertainties may impact the matters addressed in these forward-looking statements. Our forward-looking statements speak only as of the date made and we will not update forward-looking statements unless the securities laws require us to do so.

Some of the key factors which could cause our future financial results and performance to vary from those expected include:

- the loss of primary customers;
- our ability to implement productivity improvements, cost reduction initiatives or facilities expansions;
- market developments affecting, and other changes in, the demand for our products and the entry of new competitors or the introduction of new competing products;
- availability or increases in the price of energy, our primary raw materials and active ingredients;
- the timing of planned capital expenditures;
- our ability to identify, develop or acquire, and market additional product lines and businesses necessary to implement our business strategy and our ability to finance such acquisitions and development;
- the condition of the capital markets generally, which will be affected by interest rates, foreign currency fluctuations and general economic conditions;

- cost and other effects of legal and administrative proceedings, settlements, investigations and claims, including environmental liabilities which may not be covered by indemnity or insurance;
- the effects of weather, earthquakes, other natural disasters and terrorist attacks;
- the ability to obtain registration and re-registration of our products under applicable law;
- the political and economic climate in the foreign or domestic jurisdictions in which we conduct business; and
- other United States or foreign regulatory or legislative developments which affect the demand for our products generally or increase the environmental compliance cost for our products or impose liabilities on the manufacturers and distributors of such products.

The information contained in this report, including the information set forth under the heading “Risk Factors”, identifies additional factors that could cause our results or performance to differ materially from those we express in our forward-looking statements. Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of these assumptions and, therefore, the forward-looking statements based on these assumptions, could themselves prove to be inaccurate. In light of the significant uncertainties inherent in the forward-looking statements which are included in this report and the exhibits and other documents incorporated herein by reference, our inclusion of this information is not a representation by us or any other person that our objectives and plans will be achieved.

## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to certain market risks in the ordinary course of our business, arising primarily from changes in interest rates and to a lesser extent foreign currency exchange rate fluctuations. Generally we do not utilize derivative financial instruments or hedging transactions to manage that risk.

### **Interest Rate Sensitivity**

As of July 31, 2012, our fixed rate debt consisted of \$20.0 million of term notes with an interest rate of 7.43%, maturing on December 31, 2014.

Our variable rate debt as of July 31, 2012 consisted of a revolving loan advanced under our credit facility with an interest rate of 2.25% (2.0% plus LIBOR), maturing on December 31, 2016. On July 31, 2012, we had \$4.0 million borrowed on the revolving loan under that facility.

Based on the outstanding balance of our variable rate debt and applicable interest rate at July 31, 2012, taking into account anticipated principal payments, a 1.0% change in the interest rate as of July 31, 2012 would result in a change of approximately \$19,000 in annual interest expense.

### **Foreign Currency Exchange Rate Sensitivity**

We are exposed to fluctuations in foreign currency exchange rates from international operations in the electronic chemicals segment. Our international operations are centered in Europe, and use a different functional currency, the Euro, than the U.S. Dollar which is our consolidated reporting currency. Currency translation gains and losses result from the process of translating those operations from the functional currency into our reporting currency. Currency translation gains and losses have no impact on the consolidated statements of income and are recorded as accumulated other comprehensive income or loss within stockholders’ equity in our consolidated balance sheets. Assets and liabilities have been translated using exchange rates in effect at the balance sheet dates. Revenues and expenses have been translated using the average exchange rates during the period.

We recognized a foreign currency translation loss of \$3.1 million in fiscal year 2012 and a gain of \$2.1 million in fiscal year 2011, recorded as accumulated other comprehensive loss in the consolidated balance sheets. At July 31, 2012, the cumulative foreign currency translation loss reflected in accumulated other comprehensive loss was \$4.3 million.

Additionally we have limited exposure to certain transactions denominated in a currency other than the functional currency in our Italy operations. Accordingly, we recognize exchange gains or losses in our consolidated statement of operations from these transactions. We believe the impact of changes in foreign currency exchange rates do not have a material effect on our results of operations or cash flows.

## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

### Index to Consolidated Financial Statements

#### *Consolidated Financial Statements*

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders of  
KMG Chemicals, Inc.:

We have audited the accompanying consolidated balance sheet of KMG Chemicals, Inc. and subsidiaries (the Company) as of July 31, 2012, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for the year ended July 31, 2012. In connection with our audit of the consolidated financial statements, we also have audited financial statement schedule II. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of KMG Chemicals, Inc. and subsidiaries as of July 31, 2012, and the results of their operations and their cash flows for the year ended July 31, 2012, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedule II, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), KMG Chemicals, Inc.'s internal control over financial reporting as of July 31, 2012, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated October 15, 2012 expressed an unqualified opinion on the effectiveness of KMG Chemicals, Inc.'s internal control over financial reporting.

/s/ KPMG LLP  
Houston, Texas  
October 15, 2012

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of  
KMG Chemicals, Inc.:

We have audited the accompanying consolidated balance sheet of KMG Chemicals, Inc. (the "Company") as of July 31, 2011, and the related consolidated statements of income, comprehensive income, stockholders' equity and cash flows for each of the two years in the period ended July 31, 2011. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These consolidated financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and schedule based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the KMG Chemicals, Inc. as of July 31, 2011, and the consolidated results of their operations and their cash flows for each of the two years in the period ended July 31, 2011, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ UHY LLP

Houston, Texas  
October 14, 2011

Except for Note 12, as to which the date is October 15, 2012

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders  
KMG Chemicals, Inc.:

We have audited KMG Chemicals, Inc.'s internal control over financial reporting as of July 31, 2012, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). KMG Chemicals, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on KMG Chemicals, Inc.'s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, KMG Chemicals, Inc. maintained, in all material respects, effective internal control over financial reporting as of July 31, 2012, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of KMG Chemicals, Inc. and subsidiaries as of July 31, 2012, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for the year ended July 31, 2012, and our report dated October 15, 2012 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP  
Houston, Texas  
October 15, 2012

KMG CHEMICALS, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
AS OF JULY 31, 2012 AND 2011  
(In thousands, except for share and per share amounts)

	<b>2012</b>	<b>2011</b>
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents.....	\$ 1,633	\$ 1,826
Accounts receivable.....		
Trade, net of allowances of \$16 at July 31, 2012 and \$414 at July 31, 2011 .....	28,933	36,410
Other.....	960	3,148
Inventories, net .....	40,661	41,770
Current deferred tax assets .....	1,417	726
Prepaid expenses and other .....	2,057	2,126
Total current assets .....	75,661	86,006
Property, plant and equipment, net .....	68,026	71,826
Deferred tax assets .....	1,129	1,176
Goodwill .....	3,778	3,778
Intangible assets, net .....	14,980	19,493
Restricted cash.....	1,000	—
Other assets, net.....	3,116	3,099
Total assets .....	\$ 167,690	\$ 185,378
<b>Liabilities &amp; stockholders' equity</b>		
<b>Current liabilities</b>		
Accounts payable.....	\$ 21,855	\$ 24,899
Accrued liabilities.....	4,595	3,921
Book overdraft.....	—	2,852
Current deferred tax liabilities.....	—	7
Current maturities of long-term debt.....	—	8,000
Employee incentive accrual.....	2,227	1,103
Total current liabilities.....	28,677	40,782
Long-term debt, net of current maturities.....	24,000	41,279
Deferred tax liabilities.....	7,046	5,381
Other long-term liabilities .....	1,200	1,406
Total liabilities .....	60,923	88,848
<b>Commitments and contingencies</b>		
<b>Stockholders' equity</b>		
Preferred stock, \$.01 par value, 10,000,000 shares authorized, none issued .....	—	—
Common stock, \$.01 par value, 40,000,000 shares authorized, 11,405,808 shares issued and outstanding at July 31, 2012 and 11,318,941 shares issued and outstanding at July 31, 2011 .....	114	113
Additional paid-in capital.....	26,022	25,256
Accumulated other comprehensive loss .....	(4,339)	(1,233)
Retained earnings .....	84,970	72,394
Total stockholders' equity.....	106,767	96,530
Total liabilities and stockholders' equity.....	\$ 167,690	\$ 185,378

See accompanying notes to consolidated financial statements.

KMG CHEMICALS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
FOR THE YEARS ENDED JULY 31, 2012, 2011 AND 2010  
(In thousands, except per share amounts)

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Net sales.....	\$ 272,700	\$ 255,596	\$ 197,997
Cost of sales .....	195,635	187,536	131,274
Gross profit .....	<u>77,065</u>	<u>68,060</u>	<u>66,723</u>
Distribution expenses.....	26,770	28,821	19,054
Selling, general and administrative expenses .....	<u>24,858</u>	<u>22,217</u>	<u>20,938</u>
Operating income .....	<u>25,437</u>	<u>17,022</u>	<u>26,731</u>
Other income/(expense)			
Interest income .....	1	1	5
Interest expense .....	(2,100)	(2,336)	(2,252)
Other, net .....	<u>(269)</u>	<u>(208)</u>	<u>(211)</u>
Total other expense, net .....	<u>(2,368)</u>	<u>(2,543)</u>	<u>(2,458)</u>
Income from continuing operations before income taxes.....	<u>23,069</u>	<u>14,479</u>	<u>24,273</u>
Provision for income taxes.....	<u>(8,754)</u>	<u>(5,061)</u>	<u>(9,096)</u>
Income from continuing operations .....	<u>14,315</u>	<u>9,418</u>	<u>15,177</u>
Discontinued operations			
Income/(loss) from discontinued operations, before income taxes.....	(711)	514	247
Income tax benefit/(expense) .....	<u>221</u>	<u>(203)</u>	<u>(94)</u>
Income/(loss) from discontinued operations .....	<u>(490)</u>	<u>311</u>	<u>153</u>
Net income .....	<u>\$ 13,825</u>	<u>\$ 9,729</u>	<u>\$ 15,330</u>
Earnings per share			
Basic .....			
Income from continuing operations.....	\$ 1.26	\$ 0.83	\$ 1.36
Income/(loss) from discontinued operations .....	<u>(0.04)</u>	<u>0.03</u>	<u>0.01</u>
Net income.....	<u>\$ 1.22</u>	<u>\$ 0.86</u>	<u>\$ 1.37</u>
Diluted .....			
Income from continuing operations.....	\$ 1.24	\$ 0.82	\$ 1.33
Income/(loss) from discontinued operations .....	<u>(0.04)</u>	<u>0.03</u>	<u>0.01</u>
Net income.....	<u>\$ 1.20</u>	<u>\$ 0.85</u>	<u>\$ 1.34</u>
Weighted average shares outstanding			
Basic .....	11,363	11,309	11,183
Diluted .....	11,528	11,489	11,422

See accompanying notes to consolidated financial statements.

KMG CHEMICALS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
FOR THE YEARS ENDED JULY 31, 2012, 2011 AND 2010  
(In thousands)

	2012	2011	2010
Net income .....	\$ 13,825	\$ 9,729	\$ 15,330
Other comprehensive income/(loss)			
Foreign currency translation gain/(loss).....	(3,106)	2,102	(1,871)
Total other comprehensive income/(loss).....	(3,106)	2,102	(1,871)
Total comprehensive income.....	\$ 10,719	\$ 11,831	\$ 13,459

See accompanying notes to consolidated financial statements.

KMG CHEMICALS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
FOR THE YEARS ENDED JULY 31, 2012, 2011 AND 2010  
(In thousands)

	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income (loss)	Retained Earnings	Total Stockholders' Equity
	Shares Issued	Par Value				
BALANCE AT JULY 31, 2009 .....	11,101	\$ 111	\$ 23,084	\$ (1,464)	\$ 49,246	\$ 70,977
Cash dividends (\$0.08 per share).....					(894)	(894)
Stock options/warrants exercised.....	61		138			138
Restricted stock issued.....	67	1	(1)			—
Stock-based compensation expense.....			768			768
Tax benefit from stock-based awards .....			330			330
Net income .....					15,330	15,330
Loss on foreign currency translation.....				(1,871)		(1,871)
<b>BALANCE AT JULY 31, 2010 .....</b>	<b>11,229</b>	<b>\$ 112</b>	<b>\$ 24,319</b>	<b>\$ (3,335)</b>	<b>\$ 63,682</b>	<b>\$ 84,778</b>
Cash dividends (\$0.09 per share).....					(1,017)	(1,017)
Stock options/warrants exercised.....	50		200			200
Restricted stock issued.....	40	1	(1)			—
Stock-based compensation expense.....			542			542
Tax benefit from stock-based awards .....			196			196
Net income .....					9,729	9,729
Gain on foreign currency translation.....				2,102		2,102
<b>BALANCE AT JULY 31, 2011 .....</b>	<b>11,319</b>	<b>\$ 113</b>	<b>\$ 25,256</b>	<b>\$ (1,233)</b>	<b>\$ 72,394</b>	<b>\$ 96,530</b>
Cash dividends (\$0.11 per share).....					(1,249)	(1,249)
Stock options/warrants exercised.....	37		55			55
Restricted stock issued.....	50	1	(1)			—
Stock-based compensation expense.....			714			714
Tax benefit from stock-based awards .....			41			41
Other .....			(43)			(43)
Net income .....					13,825	13,825
Loss on foreign currency translation.....				(3,106)		(3,106)
<b>BALANCE AT JULY 31, 2012 .....</b>	<b>11,406</b>	<b>\$ 114</b>	<b>\$ 26,022</b>	<b>\$ (4,339)</b>	<b>\$ 84,970</b>	<b>\$ 106,767</b>

See accompanying notes to consolidated financial statements.

KMG CHEMICALS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE YEARS ENDED JULY 31, 2012, 2011 AND 2010  
(In thousands)

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Cash flows from operating activities			
Net income .....	\$ 13,825	\$ 9,729	\$ 15,330
Adjustments to reconcile net income to net cash provided by operating activities .....			
Depreciation and amortization .....	7,018	7,354	6,711
Amortization of loan costs included in interest expense .....	124	109	95
Stock-based compensation expense .....	714	542	768
Bad debt expense .....	—	154	63
Inventory valuation adjustment .....	371	(94)	(104)
Gain on sale of animal health business .....	(90)	—	—
(Gain)/loss on disposal of property .....	99	112	(13)
Deferred income tax expense .....	929	2,083	1,804
Tax benefit from stock-based awards .....	(41)	(196)	(330)
Changes in operating assets and liabilities, net of effects of acquisition .....			
Accounts receivable — trade .....	6,810	(5,909)	(9,293)
Accounts receivable — other .....	2,186	(1,370)	(1,084)
Inventories .....	(5,545)	(2,230)	(3,507)
Other current and non-current assets .....	(223)	(1,128)	(124)
Accounts payable .....	(2,801)	3,792	4,432
Accrued liabilities and other .....	1,873	(235)	200
Net cash provided by operating activities .....	<u>25,249</u>	<u>12,713</u>	<u>14,948</u>
Cash flows from investing activities			
Additions to property, plant and equipment .....	(5,193)	(8,268)	(3,015)
Cash used in connection with General Chemical acquisition .....	—	—	(26,784)
Proceeds from sale of animal health business .....	10,203	—	—
Proceeds from sale of property .....	33	60	17
Change in restricted cash .....	(1,000)	201	105
Net cash provided by/(used in) investing activities .....	<u>4,043</u>	<u>(8,007)</u>	<u>(29,677)</u>
Cash flows from financing activities			
Net borrowings/(payments) under revolving loan facility .....	(13,946)	(2,054)	20,000
Principal payments on borrowings on term loan .....	(11,333)	(8,000)	(6,958)
Proceeds from exercise of stock options and warrants .....	64	200	138
Tax benefit from stock-based awards .....	41	196	330
Book overdraft .....	(2,852)	2,852	—
Payment of dividends .....	(1,249)	(1,017)	(894)
Net cash provided by/(used in) financing activities .....	<u>(29,275)</u>	<u>(7,823)</u>	<u>12,616</u>
Effect of exchange rate changes on cash .....	(210)	215	(333)
Net decrease in cash and cash equivalents .....	(193)	(2,902)	(2,446)
Cash and cash equivalents at the beginning of year .....	1,826	4,728	7,174
Cash and cash equivalents at end of year .....	<u>\$ 1,633</u>	<u>\$ 1,826</u>	<u>\$ 4,728</u>
Supplemental disclosures of cash flow information			
Cash paid for interest .....	\$ 1,896	\$ 2,294	\$ 2,109
Cash paid for income taxes .....	\$ 5,009	\$ 4,387	\$ 10,427

See accompanying notes to consolidated financial statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**General** — KMG Chemicals, Inc. (the “Company”) is involved principally in the manufacture, formulation and distribution of specialty chemicals in carefully focused markets through its two wholly-owned subsidiaries, KMG Electronic Chemicals, Inc. (“KMG EC”) and KMG-Bernuth, Inc. (“KMG Bernuth”).

In its electronic chemicals business, the Company sells high purity wet process chemicals to the semiconductor industry, and in the wood treating chemicals business the Company sells two industrial wood treating chemicals, pentachlorophenol (“penta”) and creosote. The Company operates its electronic chemicals business through KMG EC in North America and through KMG Italia, S.r.l. (“KMG Italia”), a subsidiary of KMG EC, in Europe and elsewhere. That business has facilities in Pueblo, Colorado, Hollister, California and Milan, Italy. The Company manufactures penta at its plant in Matamoros, Mexico through KMG de Mexico (“KMEX”), a Mexican corporation which is a wholly-owned subsidiary of KMG Bernuth. The Company sells its penta products in the United States and Canada. The Company has two main suppliers of creosote, which it sells throughout the United States. The electronic chemicals and wood treating businesses constitute two reportable segments that the Company considers of equal importance. Although the electronic chemicals segment has net sales of 58.5% of the total net sales for reportable segments, the two segments have approximately equal income from operations. See Note 13.

**Principles of Consolidation** — The consolidated financial statements include the accounts of KMG Chemicals, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

**Use of Estimates** — The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (“GAAP”) 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 these estimates.

**Reclassifications** — Certain reclassifications of prior year amounts have been made to conform to current year presentation.

The consolidated balance sheet as of July 31, 2011 reflected a reclassification of certain accrued taxes payable to “Accounts receivable – other” to conform to the current period presentation. The current period presentation included a net receivable reflecting the offset of the respective tax receivable and tax payable associated with the same tax jurisdiction. This reclassification had no impact on the historical consolidated statements of income or retained earnings.

During the third quarter of fiscal year 2012, the Company sold its animal health business and the related results of operations are reported as discontinued operations in the consolidated statements of income. Previously reported amounts for each of the prior year periods presented have been adjusted for the effects of discontinued operations. See Note 12.

**Cash and Cash Equivalents** — The Company considers all investments with original maturities of three months or less when purchased to be cash equivalents. The Company reduces cash balances when checks are disbursed. Due to the time delay in checks clearing the banks, the Company reports a negative balance in its cash disbursement accounts as a current liability which is reflected as book overdraft in the consolidated balance sheets. The Company did not have a negative balance as of July 31, 2012.

**Restricted Cash** — Restricted cash includes cash balances which are legally or contractually restricted to use. The Company’s restricted cash as of July 31, 2012 includes proceeds that were placed in escrow in connection with the sale of the animal health business. See Note 12.

**Fair Value of Financial Instruments** — The carrying value of financial instruments, including cash and cash equivalents, accounts receivable, and accounts payable approximate fair value because of the relatively short maturity of these instruments. The fair value of the Company’s debt at July 31, 2012 and 2011 approximated its carrying value since the debt obligations bear interest at a rate consistent with market rates.

**Accounts Receivable** — The Company’s accounts receivable are primarily from wood-treating customers and from electronic chemical customers worldwide. The Company extends credit based on an evaluation of the customer’s financial condition, generally without requiring collateral. Exposure to losses on receivables is dependent on each customer’s financial condition. At July 31, 2012 there were two customers that represented approximately 12% and 17%, respectively, of the Company’s accounts receivable, and at July 31, 2011 there was one customer that represented approximately 13% of the Company’s accounts receivable.

The Company records an allowance for doubtful accounts to reduce accounts receivable when the Company believes an account may not be collected. A provision for bad debt expense is recorded to selling, general and administrative expenses. The amount of bad debt expense recorded each period and the resulting adequacy of the allowance at the end of each period are determined using a customer-by-customer analyses of accounts receivable balances each period and our assessment of future bad debt exposure.

Historically, write offs of accounts receivable balances have been insignificant. The allowance was \$16,000 and \$414,000 at July 31, 2012 and 2011, respectively.

**Inventories** — Inventories are valued at the lower of cost or market. For certain products, cost is generally determined using the first-in, first-out (“FIFO”) method. For certain other products the Company utilizes a weighted-average cost. The Company records inventory obsolescence as a reduction in its inventory when considered unsellable.

**Property, Plant, and Equipment** — Property, plant, and equipment are stated at cost less accumulated depreciation and amortization. Major renewals and betterments are capitalized. Repairs and maintenance costs are expensed as incurred.

Depreciation for equipment commences once placed in service, and depreciation for buildings and leasehold improvements commences once they are ready for their intended use. Depreciable life is determined through economic analysis. Depreciation for financial statement purposes is provided on the straight-line method.

The estimated useful lives of classes of assets are as follows:

Asset Class	Life (Years)
Building.....	15 to 30
Plant.....	10 to 18
Equipment.....	3 to 15
Leasehold improvements.....	remaining life of the lease

Depreciation expense was approximately \$6.5 million, \$6.3 million and \$5.6 million in fiscal years 2012, 2011 and 2010, respectively.

**Intangible Assets** — Identifiable intangible assets with a defined life are amortized using the straight-line method over the useful lives of the assets. Identifiable intangible assets of an indefinite life are not amortized. These assets are required to be tested for impairment at least annually. If this review indicates that impairment has occurred, the Company’s carrying value of intangibles will be adjusted to fair value. Based on an assessment of qualitative factors, in accordance with GAAP, it was determined that there were no events or circumstances that would lead the Company to a determination that is more likely than not that the fair value of the applicable assets was less than its carrying value as of July 31, 2012. Based on the impairment analysis performed as of July 31, 2012 and 2011 for intangible assets not subject to amortization, the Company concluded that an impairment charge was not necessary. It is the Company’s policy to expense costs as incurred in connection with the renewal or extension of its intangible assets.

**Goodwill** — The Company’s goodwill is associated with the wood treating chemicals segment. The carrying value of the Company’s goodwill is reviewed at least annually, and if this review indicates that it will not be recoverable the Company’s carrying value of goodwill will be adjusted to fair value. Based on an assessment of qualitative factors it was determined that there were no events or circumstances that would lead the Company to a determination that is more likely than not that the fair value of the applicable reporting unit was less than its carrying value as of July 31, 2012 and 2011. Accordingly, the Company determined that as of July 31, 2012 and 2011, goodwill was not impaired. As a result, there was no change in the carrying value of goodwill of \$3.8 million as of July 31, 2012 and 2011.

**Impairment of Long-Lived Assets** — Long-lived assets, including property, plant and equipment, and intangible assets with defined lives, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. If a trigger event indicates a possible impairment, the determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. The measurement of an impairment loss for long-lived assets, where management expects to hold and use the asset, are based on the asset’s estimated fair value. Long-lived assets to be disposed of are reported at the lower of carrying amount or fair value.

**Book Overdraft** — At July 31, 2011, the Company had a book overdraft of \$2.9 million that represented the amount in excess of the bank balance that was necessary to fund checks that were paid but not yet cleared. GAAP requires that the book overdrafts be classified as a current liability on the consolidated balance sheets. For purposes of reporting cash flows, the Company reports the book overdrafts as a financing activity. There was no book overdraft as of July 31, 2012.

**Revenue Recognition** — The Company’s chemical products are sold in the open market and revenue is recognized when risk of loss and title to the products transfers to customers. In general, risk of loss transfers upon shipment to customers.

**Cost of Sales** — Cost of sales includes inbound freight charges, purchasing and receiving costs, inspection costs and internal transfer costs. In the case of products manufactured by the Company, direct and indirect manufacturing costs (including depreciation and amortization) and associated plant administrative expenses are included as well as laid-in cost of raw materials consumed in the manufacturing process. We include depreciation on our property, plant and equipment in cost of sales.

**Distribution Expenses** — These expenses include outbound freight, storage and handling expenses and other miscellaneous costs associated with product storage, handling and distribution.

**Selling, General and Administrative Expenses** — These expenses include selling expenses, corporate headquarters' expenses, amortization of intangible assets and environmental regulatory support expenses.

**Advertising Costs** — Our policy is to expense advertising costs as they are incurred. Advertising costs were approximately \$347,000, \$608,000 and \$465,000 in fiscal years ended July 31, 2012, 2011 and 2010, respectively. These costs were primarily related to the animal health business which is reported as discontinued operations in the consolidated statements of income. See Note 12.

**Shipping and Handling Costs** — Shipping and handling costs are included in cost of sales and distribution expenses. Inbound freight charges and internal transfer costs are included in cost of sales. Product storage and handling costs and the cost of distributing products to the Company's customers are included in distribution expenses.

**Income Taxes** — The Company files a consolidated United States federal income tax return, and for financial reporting purposes, provides income taxes for the differences between the financial statement carrying amounts of assets and liabilities and their tax bases in accordance with Accounting Standards Codification ("ASC") Topic 740, "Accounting for Income Taxes."

**Earnings Per Share** — Basic earnings per common share amounts are calculated using the average number of common shares outstanding during each period. Diluted earnings per share assumes the issuance of restricted stock awards and the exercise of stock options having exercise prices less than the average market price during the period of the common stock, using the treasury stock method.

**Foreign Currency Translation** — The functional currency of the Company's Mexico operations is the U.S. Dollar. As a result, monetary assets and liabilities for KMEX are re-measured to U.S. dollars at current rates at the balance sheet dates, income statement items are re-measured at the average monthly exchange rates for the dates those items were recognized, and certain assets (including plant and production equipment) are re-measured at historical exchange rates. Foreign currency transaction gains and losses are included in the statement of operations as incurred along with gains and losses from currency re-measurement. These gains and losses were nominal in fiscal years 2012, 2011 and 2010.

The functional currency of the Company's KMG Italia subsidiary is the local currency (Euro). The translation adjustment resulting from currency translation of the local currency into the reporting currency (U.S. Dollar) is included as a separate component of stockholders' equity. The assets and liabilities have been translated from Euros into U.S. Dollars using exchange rates in effect at the balance sheet dates. Results of operations have been translated using the average exchange rates during the year. Foreign currency translation resulted in a translation adjustment of \$3.1 million and \$2.1 million in fiscal years 2012 and 2011, respectively, each of which are included in accumulated other comprehensive loss in the consolidated balance sheets.

**Stock-Based Compensation** — The Company's stock-based compensation expense is based on the fair value of the award measured on the date of grant. For stock option awards, the grant date fair value is measured using a Black-Scholes option valuation model. For stock awards, the Company's stock price on the date of the grant is used to measure grant date fair value. For awards of stock which are based on a fixed monetary value the grant date fair value is based on the monetary value. Stock-based compensation costs are recognized as an expense over the requisite service period of the award using the straight-line method.

## **Recent Accounting Standards**

The Company has considered all recently issued accounting standards updates and SEC rules and interpretive releases.

In July 2012, the Financial Accounting Standards Board ("FASB") issued updated accounting guidance amending the method an entity uses to test indefinite-lived assets for impairment. Under previous guidance, an entity was required to test indefinite-lived assets for impairment on at least an annual basis, in two steps. First, an entity had to compare the fair value of the asset with its carrying amount. If the fair value of the asset was less than its carrying amount, then the second step of the test had to be performed to measure the amount of the impairment loss, if any. Under the updated guidance, an entity is not required to calculate the fair value of an asset, unless it determines that it is more likely than not that its fair value is less than its carrying amount. An entity has the option to first assess qualitative factors to determine whether it is more likely than not that an asset's fair value is less than its carrying amount. Performing the two-step impairment test is unnecessary, when the asset's fair value is determined to more likely than not be greater than its carrying amount. The updated guidance is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted, including for annual or interim indefinite-lived assets impairment tests performed prior to July 27, 2012, if an entity's financial statements for the most recent annual period have not yet been issued. The Company early adopted the updated guidance for its annual impairment test for indefinite-lived assets performed as of July 31, 2012, which did not have a material impact on its financial statements. Based on the Company's assessment, it was determined that it was more likely than not that the fair value of the Company's indefinite-lived intangible assets was greater than the carrying amount based on our assessment and that there would be no impairment of the assets.

## 2. ACQUISITIONS

On March 29, 2010, the Company acquired certain assets of the electronic chemicals business of General Chemical Performance Products, LLC (“General Chemical”). The acquired business included products similar to the products of the Company’s then existing electronic chemicals business. The purpose of the acquisition was to expand the Company’s product line and increase market share.

The purchase included inventory, a 48,000 square foot manufacturing facility in Hollister, California and certain equipment at General Chemical’s Bay Point, California facility. The Company paid \$26.8 million in cash which was financed with available cash and borrowings under the Company’s revolving credit facility.

Acquisition-related costs that were included in selling, general and administrative expenses in the Company’s consolidated statements of income for the year ended July 31, 2010 were approximately \$398,000.

The following table sets forth pro forma results for the fiscal year ended July 31, 2010 had the acquisition occurred as of the beginning of the fiscal year. The pro forma results also include the effects of discontinued operations related to the animal health business which was sold in March 2012, described in Note 12. The unaudited pro forma financial information is not necessarily indicative of what the Company’s consolidated results of operations would have been had it completed the transaction as of the date indicated.

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

	<b>2010</b>
Revenues .....	\$ 226,216
Operating income .....	28,366
Net income .....	16,368
Earnings per share — basic .....	\$ 1.46

The Company recognized \$15.7 million of net sales and a net loss of \$318,000, net of income tax, and integration costs of \$663,000 related to the acquired business, in its consolidated statements of income for the fiscal year ended July 31, 2010. Depreciation included in the pro forma financial information is approximately \$230,000 per month for the year ended July 31, 2010.

## 3. INVENTORIES

Inventories are summarized as follows at July 31, 2012 and 2011 (in thousands):

	<b>2012</b>	<b>2011</b>
Raw materials and supplies .....	\$ 5,846	\$ 7,475
Work in process .....	896	1,034
Supplies .....	1,405	1,405
Finished products .....	33,007	32,189
Less reserve for inventory obsolescence .....	(493)	(333)
Inventories, net .....	\$ 40,661	\$ 41,770

## 4. PROPERTY, PLANT AND EQUIPMENT

Property, plant, and equipment and related accumulated depreciation and amortization are summarized as follows at July 31, 2012 and 2011 (in thousands):

	<b>2012</b>	<b>2011</b>
Land .....	\$ 9,034	\$ 10,081
Buildings and improvements .....	35,578	35,795
Equipment .....	45,924	44,098
Leasehold improvements .....	143	143
	90,679	90,117
Less accumulated depreciation and amortization .....	(28,824)	(24,388)
	61,855	65,729
Construction-in-progress .....	6,171	6,097
Property, plant and equipment, net .....	\$ 68,026	\$ 71,826

## 5. INCOME TAXES

The Company is subject to United States federal, state and foreign taxes on its operations. The geographical sources of income from continuing operations before income taxes for each of the three years ended July 31 (in thousands):

	<u>2012</u>	<u>2011</u>	<u>2010</u>
United States .....	\$ 21,789	\$ 13,716	\$ 22,342
Foreign.....	1,280	763	1,931
Income from continuing operations before income taxes .....	<u>\$ 23,069</u>	<u>\$ 14,479</u>	<u>\$ 24,273</u>

The components of income tax expense/(benefit) from continuing operations for the years ended July 31 consisted of the following (in thousands):

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Current:			
Federal .....	\$ 5,639	\$ 1,746	\$ 5,846
Foreign .....	686	513	487
State.....	1,071	719	959
	<u>7,396</u>	<u>2,978</u>	<u>7,292</u>
Deferred:			
Federal .....	1,441	2,546	1,625
Foreign .....	(104)	(648)	17
State.....	21	185	162
	<u>1,358</u>	<u>2,083</u>	<u>1,804</u>
Total .....	<u>\$ 8,754</u>	<u>\$ 5,061</u>	<u>\$ 9,096</u>

The Company allocated income tax benefits of \$221,000 and income tax expense of \$203,000 and \$94,000 to discontinued operations for the fiscal years ended July 31, 2012, 2011 and 2010, respectively.

Deferred income taxes are provided on all temporary differences between financial and taxable income. The following table presents the components of the Company's deferred tax assets and liabilities at July 31, 2012 and 2011 (in thousands):

	<u>2012</u>	<u>2011</u>
Deferred tax assets:		
Current deferred tax assets:		
Bad debt expense .....	\$ —	\$ 67
Inventory .....	780	737
Accrued liabilities .....	460	419
Accrued bonus .....	710	—
Other .....	27	—
Total current deferred tax assets.....	<u>\$ 1,977</u>	<u>\$ 1,223</u>
Non-current deferred tax assets		
Net operating loss .....	\$ 411	\$ 592
Difference in depreciable basis of property .....	745	701
Deferred compensation.....	690	553
Other .....	5	—
Total non-current deferred tax assets.....	<u>\$ 1,851</u>	<u>\$ 1,846</u>
Deferred tax liabilities:		
Current deferred tax liabilities:		
Prepaid assets.....	<u>\$ (560)</u>	<u>\$ (504)</u>
Non-current deferred tax liabilities:		
Difference in amortization basis of intangibles.....	\$ (2,440)	\$ (2,027)
Difference in depreciable basis of property .....	<u>(5,328)</u>	<u>(4,024)</u>
Total non-current deferred tax liabilities .....	<u>(7,768)</u>	<u>(6,051)</u>
Net current deferred tax asset.....	<u>\$ 1,417</u>	<u>\$ 719</u>
Net non-current deferred tax liability .....	<u>\$ (5,917)</u>	<u>\$ (4,205)</u>

The Company has concluded that it is more likely than not that the results of future operations will generate sufficient taxable income to realize its deferred tax assets.

The Company records provisions for uncertain tax provisions in accordance with ASC Topic 740, which clarified the accounting for income taxes by prescribing the minimum recognition threshold that a tax position is required to meet before being recognized in the financial statements. The Company recognizes interest and penalties related to uncertain tax positions in income tax expense. Based on an evaluation of tax years that remain open and subject to potential examination, the Company determined that it had no additional significant unrecognized tax benefits and no interest or penalties as of July 31, 2012, 2011 and 2010. The statute of limitations remains open for the fiscal years ended July 31, 2009 and forward for United States federal income taxes and fiscal year ended July 31, 2007 and forward for state tax jurisdictions. In Mexico, tax years subsequent to 2006, and in Italy, tax years beginning with our acquisition of the electronic chemicals business in December 2007, remain open and subject to examination.

The Company's subsidiary in Italy is currently under examination for the period ended July 31, 2009. Adjustments were proposed by the taxing authority at the end of April 2011 that would result in approximately \$1.6 million (including interest and penalties) of additional liability, if all the adjustments are sustained. The Company has provided additional information and documentary evidence in response to the proposed adjustments, and intends to vigorously defend its tax positions. Therefore, no amount has been recorded in the Company's consolidated financial statements

The Italian subsidiary has net operating losses carried forward of approximately \$1.5 million and \$2.1 million as of July 31, 2012 and 2011, respectively. The net operating losses are available to offset future income indefinitely.

Undistributed earnings of the Company's Mexico subsidiary amounted to approximately \$5.6 million at July 31, 2012. Those earnings are considered to be permanently reinvested. For the years ended July 31, 2012, the Company decided to implement an annual dividend policy plan for Mexico up to its current year earnings and profits. It is the Company's intention to continue to remain permanently invested in Mexico on its prior year cumulative undistributed earnings. In addition, the undistributed earnings of the Company's Italian subsidiary are considered to be permanently reinvested. Accordingly, no provision for United States income taxes have been provided with respect to the undistributed earnings. Upon repatriation of those earnings, in the form of dividends or otherwise, the Company will be subject to both United States income taxes (subject to an adjustment for foreign tax credits) and potential withholding taxes payable to the foreign country. Determination of the amount of unrecognized deferred United States income tax liability is not practicable due to the complexities associated with its hypothetical calculation.

The following table accounts for the differences between the actual tax provision, and the amounts obtained by applying the applicable statutory United States federal income tax rate of 35% to income from continuing operations before income taxes for each of the years ended July 31, 2012, 2011, and 2010, respectively (in thousands):

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Income taxes at the federal statutory rate.....	\$ 8,074	\$ 5,068	\$ 8,495
Effect of foreign operations .....	160	225	711
Change in valuation allowance.....	—	(627)	(882)
State income taxes, net of federal income tax effect.....	717	659	802
Other.....	(197)	(264)	(30)
Total .....	<u>\$ 8,754</u>	<u>\$ 5,061</u>	<u>\$ 9,096</u>

## 6. INTANGIBLE ASSETS

Intangible assets are summarized as follows (in thousands):

	Number of Years	July 31, 2012		
		Weighted Average Amortization Period	Original Cost	Accumulated Amortization
<b>Intangible assets subject to amortization</b>				
<b>(range of useful life):</b>				
Creosote supply contract (10 years).....	10.0	\$ 4,000	\$ (4,000)	\$ —
Electronic chemicals-related contracts (3-8 years) .....	3.8	1,164	(1,053)	111
Electronic chemicals-related trademarks and patents (10-15 years).....	12.0	117	(46)	71
Electronic chemicals— value of product qualifications (5 years).....	5.0	1,300	(606)	694
Total intangible assets subject to amortization .....	8.0	\$ 6,581	\$ (5,705)	876
<b>Intangible assets not subject to amortization:</b>				
Creosote product registrations.....				5,339
Penta product registrations .....				8,765
Total intangible assets not subject to amortization .....				14,104
Total intangible assets, net .....				\$ 14,980

	Number of Years	July 31, 2011		
		Weighted Average Amortization Period	Original Cost	Accumulated Amortization
<b>Intangible assets subject to amortization</b>				
<b>(range of useful life):</b>				
Creosote supply contract (10 years).....	10.0	\$ 4,000	\$ (3,955)	\$ 45
Electronic chemicals-related contracts (3-8 years) .....	3.8	1,164	(1,014)	150
Electronic chemicals-related trademarks and patents (10-15 years).....	12.0	117	(36)	81
Electronic chemicals—value of product qualifications (5 years).....	5.0	1,300	(347)	953
Discontinued operations.....	17.6	6,529	(2,369)	4,160
Total intangible assets subject to amortization .....	12.8	\$ 13,110	\$ (7,721)	5,389
<b>Intangible assets not subject to amortization:</b>				
Creosote product registrations.....				5,339
Penta product registrations .....				8,765
Total intangible assets not subject to amortization .....				14,104
Total intangible assets, net .....				\$ 19,493

Intangible assets subject to amortization are amortized over their estimated useful lives which are between three and 15 years. Amortization expense was approximately \$548,000, \$1.0 million and \$1.1 million for the fiscal years ended July 31, 2012, 2011 and 2010, respectively. The estimated amortization expense is projected to be approximately \$296,000, \$289,000, \$202,000, \$29,000 and \$29,000 for fiscal years 2013 through 2017, respectively.

## 7. LONG-TERM OBLIGATIONS

The Company's debt as of July 31, 2012 and July 31, 2011 consisted of the following (in thousands):

	<u>July 31, 2012</u>	<u>July 31, 2011</u>
Senior Secured Debt:		
Note Purchase Agreement, maturing on December 31, 2014, interest rate of 7.43% .....	\$ 20,000	\$ 20,000
Secured Debt: Term Loan Facility, maturing on December 31, 2012 (extinguished October 31, 2011).....	—	11,333
Revolving Loan Facility, maturing on December 31, 2016, variable interest rates based on LIBOR plus 2.00% (2.25% at July 31, 2012).....	4,000	17,946
Total debt.....	24,000	49,279
Current maturities of long-term debt .....	—	(8,000)
Long-term debt, net of current maturities .....	<u>\$ 24,000</u>	<u>\$ 41,279</u>

To finance the acquisition of the electronic chemicals business from Air Products in December 2007, the Company entered into an amended and restated credit agreement and a note purchase agreement with Wachovia Bank, National Association, a subsidiary of Wells Fargo & Co., Bank of America, N.A., The Prudential Insurance Company of America, and Pruco Life Insurance Company. The credit facility included a revolving loan facility and a term loan facility.

The Company amended those facilities in November 2011 to increase the amount that may be borrowed under the revolving loan facility to \$60.0 million, to extend the maturity to December 31, 2016, and to allow advances under the revolving loan facility without reference to a borrowing base restriction. The financial covenant for debt to capitalization was replaced by a current ratio minimum of 1.5 to 1.0. During the first quarter of fiscal year 2012, the Company paid off all outstanding advances under the credit facility's term loan commitment, and in the November 2011 amendment, that aspect of the facility was deleted.

Advances under the revolving loan mature December 31, 2016. The revolving loan bears interest at varying rate of LIBOR plus a margin based on our funded debt to earnings before interest, taxes, depreciation and amortization ("EBITDA").

<u>Ratio of Funded Debt to EBITDA</u>	<u>Margin</u>
Equal to or greater than 3.0 to 1.0 .....	2.75%
Equal to or greater than 2.5 to 1.0, but less than 3.0 to 1.0 .....	2.50%
Equal to or greater than 2.0 to 1.0, but less than 2.5 to 1.0 .....	2.25%
Equal to or greater than 1.5 to 1.0, but less than 2.0 to 1.0 .....	2.00%
Less than 1.5 to 1.0 .....	1.75%

Advances under the revolving loan bear interest at 2.25% as of July 31, 2012. Before the term loan facility was paid off in October 2011 and removed from the credit facility, the term facility required principal payments were \$458,333 per month for 24 months and then beginning January 2010 principal payments became \$666,667 per month for the balance of the term prior to maturity. The Company used the proceeds received on the sale of its animal health business to repay \$10.0 million of the balance on the revolving loan facility on March 2, 2012. The amount outstanding on the revolving loan facility was \$4.0 million at July 31, 2012.

In fiscal year 2008 the Company also entered into a \$20.0 million note purchase agreement with the Prudential Insurance Company of America. Advances under the note purchase agreement mature December 31, 2014, and bear interest at 7.43% per annum. Principal is payable at maturity. At July 31, 2012, \$20.0 million was outstanding under the note purchase agreement.

Loans under the amended and restated credit facility and the note purchase agreement are secured by the Company's assets, including inventory, accounts receivable, equipment, intangible assets, and real property. The credit facility and the note purchase agreement have restrictive covenants, including that the Company must maintain a fixed charge coverage ratio of 1.5 to 1.0, a ratio of funded debt to EBITDA of 3.0 to 1.0 and a fixed charge coverage ratio of at least 1.5 to 1.0. The Company is also obligated to maintain a debt to capitalization ratio of not more than 50%. For purposes of calculating these financial covenant ratios, the Company uses a pro forma EBITDA.

Principal payments due under long-term debt agreements for the fiscal years ended July 31 are as follows (in thousands):

	<u>Total</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>Thereafter</u>
Long-term debt .....	\$ 24,000	\$ —	\$ —	\$ 20,000	\$ —	\$ 4,000	\$ —

## 8. COMMITMENTS AND CONTINGENCIES

**Contractual Obligations** — The Company has non-cancelable operating leases for its office and warehouse facilities and certain transportation equipment and purchase obligations. Our obligations to make future payments under certain contractual obligations as of July 31, 2012 are summarized in the following table (in thousands):

	<u>Total</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>Thereafter</u>
Operating leases.....	\$ 6,131	\$ 2,294	\$ 1,864	\$ 681	\$ 603	\$ 401	\$ 288
Purchase obligations <sup>(1)</sup> .....	266,543	86,081	59,337	40,539	38,008	27,654	14,924
Total.....	<u>\$ 272,674</u>	<u>\$ 88,375</u>	<u>\$ 61,201</u>	<u>\$ 41,220</u>	<u>\$ 38,611</u>	<u>\$ 28,055</u>	<u>\$ 15,212</u>

(1) Consists primarily of raw materials purchase contracts. These are typically not fixed price arrangements. The prices are based on the prevailing market prices.

Rent expense relating to the operating leases was approximately \$2.3 million, \$2.0 million and \$2.0 million in fiscal years 2012, 2011 and 2010, respectively.

**Environmental** — The Company's operations are subject to extensive federal, state and local laws, regulations and ordinances in the United States and abroad relating to the generation, storage, handling, emission, transportation and discharge of certain materials, substances and waste into the environment, and various other health and safety matters. Governmental authorities have the power to enforce compliance with their regulations, and violators may be subject to fines, injunctions or both. The Company must devote substantial financial resources to ensure compliance, and it believes that it is in substantial compliance with all the applicable laws and regulations.

Certain licenses, permits and product registrations are required for the Company's products and operations in the United States, Mexico and other countries in which it does business. The licenses, permits and product registrations are subject to revocation, modification and renewal by governmental authorities. In the United States in particular, producers and distributors of chemicals such as penta and creosote are subject to registration and notification requirements under federal law (including under the Federal Insecticide Fungicide and Rodenticide Act ("FIFRA"), and comparable state law) in order to sell those products in the United States. Compliance with these requirements has had, and in the future will continue to have, a material effect on our business, financial condition and results of operations.

The Company incurred expenses in connection with FIFRA research and testing programs of approximately \$802,000, \$760,000 and \$636,000 in fiscal year 2012, 2011 and 2010, respectively. These costs are included in selling, general, and administrative expenses.

**Litigation and Other Contingencies** — The Company is subject to contingencies, including litigation relating to environmental laws and regulations, commercial disputes and other matters. Certain of these contingencies are discussed below. The ultimate resolution of these contingencies is subject to significant uncertainty, and should the Company fail to prevail in any of them or should several of them be resolved against the Company in the same reporting period, these matters could, individually or in the aggregate, be material to the consolidated financial statements. The ultimate outcome of these matters, however, cannot be determined at this time, nor can the amount of any potential loss be reasonably estimated, and as a result no amounts have been recorded in the Company's consolidated financial statements except where indicated.

The Company records legal costs associated with loss contingencies as expenses in the period in which they are incurred.

A lawsuit was filed against the Company's wholly-owned subsidiary, KMG de Mexico, relating to the title to the land on which its facility in Matamoros is located. The plaintiffs claim that their title to the land is superior to the person from whom our subsidiary bought the land. The plaintiffs are seeking to have our subsidiary's purchase overturned, and to recover the land and certain improvements or their value. The lawsuit was initially filed in 1998 in Matamoros, Mexico under *Adolfo Cazares Rosas, et al vs. KMG de Mexico and Guillermo Villarreal*. In January 2008, the case was sent by the appeals court back to the lower court to obtain additional factual information, and on April 20, 2009 the plaintiffs were required to re-file the case in the First Civil Court in Matamoros, Tamaulipas, Mexico as *Adolfo Cazares, Luis Escudero and Juan Cue vs. KMG de Mexico and Guillermo Villarreal*. In June 2011 the lower court ruled against KMG de Mexico, and held that the plaintiffs had superior title to the land, but that verdict was overturned on appeal in May 2012, and the case has been returned to the trial court for further action. The Company intends to continue to vigorously defend KMG de Mexico.

When the Company purchased assets from Air Products, Inc. ("Air Products") in December 2007, the Company agreed to be responsible for the applicable sales tax on the personal property that it purchased. The Colorado Department of Revenue audited the purchase, and in November 2009 issued a deficiency notice to Air Products for unpaid sales tax on the purchase of approximately \$819,000, before interest and penalties. The Company assumed the defense of the matter as allowed under its indemnity of Air Products. We classified certain property at our Pueblo facility as real property not subject to tax, rather than as personal property subject to sales tax. In fiscal year 2012, the Company recorded a reserve of approximately \$372,000 in the consolidated statements of income that the Company believes is adequate for the resolution of this matter, including taxes, penalties and interest.

The Company's subsidiary in Italy is currently under examination by the taxing authority there for the period ended July 31, 2009. Adjustments were proposed by the taxing authority at the end of April 2011 that would result in approximately \$1.6 million of additional income tax (including interest and penalties), if all the adjustments are sustained. We have provided additional information in response to the proposed adjustments, and intend to vigorously defend our tax positions. The ultimate outcome of this examination is subject to uncertainty and no amount has been recorded in our consolidated financial statements.

The Company is subject to federal, state, local and foreign laws and regulations and potential liabilities relating to the protection of the environment and human health and safety including, among other things, the cleanup of contaminated sites, the treatment, storage and disposal of wastes, the emission of substances into the air or waterways, and various health and safety matters. The Company expects to incur substantial costs for ongoing compliance with such laws and regulations. The Company may also face governmental or third-party claims, or otherwise incur costs, relating to cleanup of, or for injuries resulting from, contamination at sites associated with past and present operations. The Company accrues for environmental liabilities when a determination can be made that they are probable and reasonably estimable.

## **9. EMPLOYEE BENEFIT PLANS**

The Company has a defined contribution 401(k) plan covering substantially all of its U.S. employees. The Company makes matching contributions under this plan of up to 3% of the participant's compensation. Company contributions to the plan totaled approximately \$420,000, \$393,000 and \$313,000 in fiscal years 2012, 2011 and 2010, respectively.

In July 2001, the Company adopted a supplemental executive retirement plan. Only persons specifically designated by the Company may be participants in the plan. The plan is unfunded and amounts payable to participants are general obligations of the Company. The plan provides that a participant will be paid a supplemental retirement benefit for 10 years equal to a percentage of the participant's three-year average base salary at normal retirement. The benefit payable to participants is reduced by the equivalent actuarial value of the Company's other pension plan payments to the participant, if any, the Company's 401(k) plan and one-half social security benefits. Normal retirement is the earlier of age 65 and completion of 10 years credited service or age 60 with 30 years credited service. One executive has been designated as a participant. The Company recorded approximately \$54,000, \$33,000 and \$36,000 of expenses for fiscal years 2012, 2011 and 2010, respectively related to the plan. As of July 31, 2012, and 2011, the liability under this plan was approximately \$664,000 and \$610,000, respectively. Monthly payments of \$5,531 are scheduled to begin effective April 2013.

## 10. EARNINGS PER SHARE

Basic earnings per share have been computed by dividing net income by the weighted average shares outstanding. Diluted earnings per share have been computed by dividing net income by the weighted average shares outstanding plus potentially dilutive common shares. The following table presents information necessary to calculate basic and diluted earnings per share for periods indicated:

	Year Ended		
	2012	2011	2010
	(Amounts in thousands, except per share data)		
Income from continuing operations.....	\$ 14,315	\$ 9,418	\$ 15,177
Income/(loss) from discontinued operations .....	(490)	311	153
Net income.....	<u>\$ 13,825</u>	<u>\$ 9,729</u>	<u>\$ 15,330</u>
Weighted average shares outstanding — basic .....	11,363	11,309	11,183
Dilutive effect of options/warrants and stock awards .....	165	180	239
Weighted average shares outstanding — diluted.....	<u>11,528</u>	<u>11,489</u>	<u>11,422</u>
Basic earnings per share			
Basic earnings per share from continuing operations .....	\$ 1.26	\$ 0.83	\$ 1.36
Basic earnings per share on income/(loss) from discontinued operations.....	(0.04)	0.03	0.01
Basic earnings per share .....	<u>\$ 1.22</u>	<u>\$ 0.86</u>	<u>\$ 1.37</u>
Diluted earnings per share			
Diluted earnings per share from continuing operations .....	\$ 1.24	\$ 0.82	\$ 1.33
Diluted earnings per share on income/(loss) from discontinued operations.....	(0.04)	0.03	0.01
Diluted earnings per share .....	<u>\$ 1.20</u>	<u>\$ 0.85</u>	<u>\$ 1.34</u>

Outstanding stock-based awards are not included in the computation of diluted earnings per share under the treasury stock method, if including them would be anti-dilutive. There was an average of four thousand nine hundred seventy-two shares for the fiscal year ended 2012 and less than one thousand shares of potentially dilutive securities for the fiscal years ended 2011 and 2010, not included in the computation of diluted earnings per share.

## 11. STOCK-BASED COMPENSATION

### *Stock-Based Incentive Plans*

The Company adopted a 2009 Long-Term Incentive Plan (“2009 LTI Plan”) in October 2009, and it was approved by the shareholders at the annual meeting in December 2009. The Company adopted a 2004 Long-Term Incentive Plan (“2004 LTI Plan”) in October 2004, and it was approved by the shareholders at the annual meeting in November 2005 (the 2009 LTI Plan and the 2004 LTI Plan are referred to collectively as the “LTI Plans”). The Company adopted the 1996 Stock Option Plan (the “1996 Stock Plan”) in October, 1996, and it was approved by the Company’s shareholders in October, 1996.

The LTI Plans permit the granting of incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock, restricted stock units, performance awards, dividend equivalent rights, and other awards. They are administered by the Board of Directors or a committee appointed by the Board of Directors. The Board has designated the Compensation Committee as the administrator of the LTI Plans. Subject to the terms of the LTI Plans, the committee has the sole discretion to select the persons eligible to receive awards, the type and amount of incentives to be awarded, and the terms and conditions of awards. The committee also has the authority to interpret the LTI Plans, and establish and amend regulations necessary or appropriate for their administration. Any employee of the Company or a subsidiary of the Company or a director of the Company whose judgment, initiative, and efforts contributed or may be expected to contribute to the successful performance of the Company is eligible to participate. The maximum number of shares of the Company’s common stock that may be delivered pursuant to awards granted is 750,000 shares under the 2009 Long-Term Incentive Plan and 375,000 shares under the 2004 Long-Term Incentive Plan. Under the 2009 Long-Term Plan no executive officer may receive in any calendar year stock options or stock appreciation rights, or awards that are subject to the attainment of performance goals relating to more than 200,000 shares of common stock. Under the 2004 Long-Term Plan no executive officer may receive in any calendar year stock options or stock appreciation rights relating to more than 250,000 shares of common stock, or awards that are subject to the attainment of performance goals relating to more than 100,000 shares of common stock. At

July 31, 2012 there were approximately 490,512 shares and 88,596 shares available for future grants under the 2009 Long-Term Plan and 2004 Long-Term Plan, respectively.

The 1996 Stock Plan terminated by expiration of its original term on July 31, 2007. Options previously issued under the plan remain in effect. The 1996 Stock Plan is administered either by the Company's Board of Directors or by a committee of two or more non-employee directors. The Board designated the Compensation Committee as the administrator of the plan. Options are exercisable during the period specified in each option agreement and in accordance with a vesting schedule designated by the Board of Directors or the committee. Any option agreement may provide that options become immediately exercisable in the event of a change or threatened change in control of the Company and in the event of certain mergers and reorganizations of the Company. Options may be subject to early termination within a designated period following the option holder's cessation of service with the Company.

### **Accounting for Stock-Based Compensation**

The Company recognized stock-based compensation costs of approximately \$714,000, \$542,000 and \$768,000, respectively, for the fiscal years ended July 31, 2012, 2011 and 2010, and the related tax benefits of \$266,000, \$209,000 and \$292,000, respectively, for the fiscal years ended July 31, 2012, 2011 and 2010. Stock-based compensation costs are recorded as selling, general and administrative expenses in the consolidated statements of income. The Company accounts for stock-based compensation costs at fair value measured on the date of grant of the award using a Black-Scholes option valuation model for stock option awards. Grant date fair value for stock awards is measured using the Company's closing stock price on the date of grant of the stock awards where the award is based on a specific number of shares. For awards of stock which are granted based on a fixed monetary value the grant date fair value is based on the monetary value. Stock-based compensation costs are recognized as an expense over the requisite service period, generally the vesting period of the award, using the straight-line method.

As of July 31, 2012, there was approximately \$306,000 of unrecognized compensation costs that were related to outstanding stock awards expected to be recognized over a weighted-average period of 1.5 years.

A summary of activity for stock option and stock-awards is presented below.

### **Stock Options**

A summary of option activity associated with employee compensation for the fiscal year ended July 31, 2012 is presented below.

	Shares	Weighted-Average Exercise Price
Outstanding on August 1, 2011 .....	222,000	\$ 3.98
Granted .....	—	—
Exercised .....	(42,000)	3.32
Forfeited/Expired .....	—	—
Outstanding on July 31, 2012 .....	180,000	\$ 4.13

The following table summarizes information about stock options outstanding at July 31, 2012 that are fully vested (currently exercisable) and those that are expected to vest:

	Options Outstanding	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (years)	Aggregate Intrinsic Value (in thousands) <sup>(1)</sup>
Fully vested and currently exercisable .....	150,000	\$ 4.09	5.66	\$ 2,069
Expected to vest .....	30,000	4.37	11.11	405
Total outstanding stock options .....	180,000	\$ 4.13	6.57	\$ 2,474

(1) The aggregate intrinsic value is computed based on the closing price of the Company's stock on July 31, 2012.

No options were granted in fiscal years 2012, 2011 and 2010.

The total intrinsic value of options exercised in fiscal years 2012, 2011 and 2010 was approximately \$629,000, \$546,000 and \$934,000, respectively. The total fair value of shares vested was \$39,000, \$44,000 and \$44,000 for the fiscal years ended 2012, 2011 and 2010, respectively.

## Performance Shares

At August 1, 2011 there were 209,305 non-vested performance shares outstanding and during fiscal year 2012 there were 124,311 performance-based stock awards granted as Series 1 and 2 awards to certain executives and employees. Those shares represented the maximum award subject to certain performance measures as described below. There were 19,081 performance shares vested during fiscal year 2012. At July 31, 2012 there were 227,609 non-vested performance shares outstanding reflecting the maximum number of shares issuable under outstanding awards. The fair value of the fiscal year 2012 award was measured on the grant dates on October 11, 2011, October 28, 2011 and February 27, 2012 using the Company's closing stock price of \$14.16, \$15.30 and \$18.08, respectively. Stock-based compensation on the award is recognized on a straight-line basis over the requisite service period beginning on the date of grant through the end of the measurement period ending on July 31, 2014, based on the number of shares expected to vest at the end of the measurement period.

A summary of the performance based stock awards granted to certain executives as Series 1 and Series 2 awards in fiscal years 2012, 2011 and 2010 is detailed below.

Date of Grant	Series Award	Maximum Award (Shares)	Grant Date Fair Value	Measurement Period Ending	Actual or Expected Percentage of Vesting <sup>(1)</sup>	Actual Shares Vested or Shares Projected to Vest <sup>(1)</sup>
<b>Fiscal Year 2012 Award</b>						
2/27/2012 .....	Series 1	300	\$ 18.08	07/31/2014	20%	60
2/27/2012 .....	Series 2	200	\$ 18.08	07/31/2014	0%	—
		<u>500</u>				<u>60</u>
10/28/2011 .....	Series 1	15,300	\$ 15.30	07/31/2014	20%	3,060
10/28/2011 .....	Series 2	10,200	\$ 15.30	07/31/2014	0%	—
		<u>25,500</u>				<u>3,060</u>
10/11/2011 .....	Series 1	58,987	\$ 14.16	07/31/2014	20%	11,797
10/11/2011 .....	Series 2	39,324	\$ 14.16	07/31/2014	0%	—
		<u>98,311</u>				<u>11,797</u>
<b>Fiscal Year 2011 Award</b>						
12/7/2010 .....	Series 1	61,980	\$ 15.65	07/31/2013	30%	18,594
12/7/2010 .....	Series 2	41,318	\$ 15.65	07/31/2013	0%	—
		<u>103,298</u>				<u>18,594</u>
<b>Fiscal Year 2010 Award</b>						
3/17/2010 .....	Series 1	63,605	\$ 15.55	07/31/2012	30%	19,081
3/17/2010 .....	Series 2	42,402	\$ 15.55	07/31/2012	0%	—
		<u>106,007</u>				<u>19,081</u>
<b>Total</b> .....		<u><u>333,616</u></u>				<u><u>52,592</u></u>

(1) For performance shares granted in March 2010, the above table represents the actual percentage vesting and shares vested as of the end of the measurement period ended July 31, 2012. For the other performance share grants identified in the above table, the information set forth is the expected vesting percentage and the shares projected to vest.

Series 1: Vesting for the Series 1 awards is subject to a performance requirement composed of certain revenue growth objectives and average annual return on invested capital or equity objectives measured across a three-year period. These objectives are measured quarterly using the Company's budget, actual results and long-term projections. For the fiscal year 2012 and 2011 awards the expected percentage of vesting is based on performance through July 31, 2012 and reflects the percentage of shares projected to vest for the respective awards at the end of their measurement periods. For the Series 1 award for fiscal year 2010, the actual vesting was determined to be 30.0% at the end of the measurement period. Performance shares that have vested are normally issued within 75 days of the end of the fiscal year.

Series 2: Vesting for the Series 2 awards is subject to performance requirements pertaining to the growth rate in the Company's basic earnings per share over a three-year period. The achievement of performance requirements is measured quarterly using the Company's budget, actual results and long-term projections. For the fiscal year 2012 and 2011 awards the expected percentage of vesting is based on performance through July 31, 2012 and reflects the percentage of shares projected to vest for the respective awards at the end of their measurement periods. For the Series 2 award for fiscal year 2010, the actual vesting was determined to be zero at the end of the measurement period.

The weighted-average grant-date fair value of performance share awards outstanding at August 1, 2011 and July 31, 2012 was \$15.60 and \$15.10, respectively.

The total fair value of performance shares vested during fiscal years 2012, 2011 and 2010 was approximately \$297,000, \$63,000 and \$204,000, respectively.

### **Time-Based Shares**

A summary of activity for time-based stock awards for the fiscal year ended July 31, 2012 is presented below:

	Shares	Weighted-Average Grant-Date Fair Value
Non-vested on August 1, 2011 .....	24,939	\$ 16.03
Granted <sup>(1)</sup> .....	13,432	17.55
Vested <sup>(2)</sup> .....	(32,602)	16.26
Forfeited .....	—	—
Non-vested on July 31, 2012.....	5,769	\$ 15.65

- (1) Reflects 6,632 and 6,800 shares granted to non-employee directors on February 28, 2012 and May 23, 2012, respectively. The grants reflected service for the three month periods ended on each of the respective dates. The shares vested on the date of grant. The Company recognizes compensation expense related to the awards over the respective three month service period in accordance with GAAP.
- (2) During the fiscal year ended July 31, 2012 there were 33,453 shares vested. The number of shares presented here includes an adjustment of 851 shares which do not represent shares that vested during the fiscal year ended July 31, 2012. The adjustment was related to the fiscal year 2011 non-employee director stock grant, and reflects the difference between the number of shares reported as granted and the number of shares vested over the twelve month service period of the award ended November 30, 2011. The number of shares granted was calculated based on the aggregate monetary value of the award divided by the Company's closing stock price on the respective date of grant. The number of shares vested at the end of each of the three month service periods over the twelve month service period ending November 30, 2011 was based on the Company's closing stock price at the end of each of the three month periods.

The total fair value of shares vested during the fiscal year ended 2012, 2011 and 2010 was approximately \$545,000, \$374,000 and \$370,000, respectively.

## **12. DISCONTINUED OPERATIONS**

In fiscal year 2008 the Company discontinued operations of its herbicide product line that had comprised the agricultural chemical segment. During fiscal year 2011, the Company began dismantling the related equipment at its Matamoros, Mexico facility. In fiscal year 2012, two employees of the contractor hired to do the dismantling work were injured. The Company incurred costs in fiscal years 2012 and 2011 for equipment dismantlement, and in addition, the current year period included medical and other expenses associated with the accident. No dismantling expense was incurred in fiscal year 2010. The Company reported the costs in income (loss) from discontinued operations, before income taxes, which included \$599,000 and \$120,000 for the fiscal years ended July 31, 2012 and 2011, respectively.

On March 1, 2012, the Company sold its animal health business that had comprised the animal health segment to Bayer Healthcare LLC. The sale included inventory, equipment and product registrations. The Company retained the real estate and buildings at its facility in Elwood, Kansas. The Company sold the business for approximately \$10.2 million, including \$1.0 million in restricted cash held in escrow. The purchase price was paid in cash, subject to the escrow. The escrowed amount is to be held pending final acceptance by the United States Environmental Protection Agency ("EPA") of certain studies being performed at the request of the EPA on tetrachlorvinphos, the active ingredient used in Rabon products. The escrowed funds are to be released to the Company once the EPA has finally accepted the studies, the buyer has voluntarily canceled the products, or after five years. The escrowed funds are to be released to the buyer if the EPA cancels the products to which the studies pertain before the funds are distributed to the Company. Management believes that the EPA will accept the studies within five years.

The Company will continue to operate the facility in Elwood, Kansas to manufacture products for the buyer under a transition services agreement for one year, subject to two six-month extensions. The Company evaluated the transition services agreement and concluded that it did not represent significant continuing involvement or a continuation of activities by the Company in accordance with GAAP.

As of July 31, 2011 the components of assets and liabilities related to the discontinued operations of the animal health business included in the consolidated balance sheets were as follows (in thousands):

Inventories .....	\$ 5,401
Prepaid commissions.....	65
Total current assets .....	<u>5,466</u>
Property, plant and equipment, net.....	191
Intangible assets, net .....	4,160
Total assets .....	<u>\$ 9,817</u>

The Company recognized a gain on sale of approximately \$90,000 included in income (loss) from discontinued operations, before income taxes, in the Company's consolidated statements of income, calculated as follows in thousands.

Cash consideration .....	\$ 10,203
Less: net book value of assets sold as of February 29, 2012 and transaction costs .....	<u>(10,113)</u>
Total pre-tax gain.....	<u>\$ 90</u>

Animal health net sales and income before income tax reported in discontinued operations were as follows for the fiscal year ended July 31:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(Amounts in thousands)		
Revenue .....	\$ 5,643	\$ 10,760	\$ 10,631
Income (loss) before income taxes .....	(202)	634	247

### 13. SEGMENT INFORMATION

The Company previously had four reportable segments for electronic chemicals, penta, creosote and animal health. During the first quarter of fiscal year 2012, the Company re-evaluated the criteria used to determine operating segments and concluded that its two wood treating product lines met the criteria of a single operating segment. As a result, during the first quarter of fiscal year 2012, the composition of the Company's reportable segments was revised to reflect a change combining those two reportable segments. The Company sold its animal health business on March 1, 2012, and results of that former segment are now reported as discontinued operations. As a result, as of July 31, 2012 the Company has two reportable segments – electronic chemicals and wood treating. Prior year information has been reclassified to conform to the current period presentation.

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(Amounts in thousands)		
<b>Sales</b>			
Electronic chemicals.....	\$ 159,451	\$ 151,481	\$ 111,990
Wood treating.....	113,034	104,115	86,007
Total sales for reportable segments .....	<u>\$ 272,485</u>	<u>\$ 255,596</u>	<u>\$ 197,997</u>
<b>Depreciation and amortization</b>			
Electronic chemicals.....	\$ 5,933	\$ 5,607	\$ 4,784
Wood treating.....	504	814	894
Discontinued operations .....	342	664	766
Other — general corporate.....	239	269	267
Total consolidated depreciation and amortization .....	<u>\$ 7,018</u>	<u>\$ 7,354</u>	<u>\$ 6,711</u>
<b>Segment income from operations <sup>(1)</sup></b>			
Electronic chemicals.....	\$ 13,392	\$ 6,205	\$ 8,379
Wood treating.....	15,622	14,766	23,007
Total segment income from operations .....	<u>\$ 29,014</u>	<u>\$ 20,971</u>	<u>\$ 31,386</u>
<b>Capital expenditures</b>			
Electronic chemicals.....	\$ 4,493	\$ 7,359	\$ 29,066
Wood treating.....	393	354	482
Discontinued operations .....	—	17	64
Included in acquisition.....	—	—	(26,784)
Other — general corporate.....	307	538	187
Total capital expenditures.....	<u>\$ 5,193</u>	<u>\$ 8,268</u>	<u>\$ 3,015</u>
<b>Total assets</b>			
Electronic chemicals.....	\$ 111,144	\$ 114,929	
Wood treating.....	44,880	45,917	
Total assets for reportable segments.....	<u>\$ 156,024</u>	<u>\$ 160,846</u>	

(1) Segment income from operations includes allocated corporate overhead expenses.

Corporate overhead expenses allocated to segment income for the fiscal year ended July 31, 2012, 2011 and 2010 were as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(Amounts in thousands)		
Electronic chemicals.....	\$ 5,354	\$ 4,066	\$ 4,065
Wood treating.....	4,406	3,337	3,122
Total corporate overhead expense allocation .....	<u>\$ 9,760</u>	<u>\$ 7,403</u>	<u>\$ 7,187</u>

For fiscal year 2012 one customer in our electronic chemicals segment represented approximately 19% of the Company's net sales, and one customer in our wood treating segment represented approximately 12% of the Company's net sales. For fiscal years 2011 one customer in our electronic chemicals segment represented approximately 16% of the Company's net sales and one customer in our wood treating segment represented approximately 12% of the Company's net sales. For fiscal year 2010 sales to one customer in our electronic chemicals segment represented approximately 18% of the Company's net sales. No other customers accounted for 10% or more of the Company's net sales.

A reconciliation of total segment to consolidated amounts for fiscal years 2012, 2011 and 2010 is set forth in the table below.

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(Amounts in thousands)		
<b>Assets:</b>			
Total assets for reportable segments.....	\$ 156,024	\$ 160,846	
Total assets for discontinued operations <sup>(1)</sup> .....	467	10,461	
Other current assets .....	3,627	7,529	
Other assets .....	7,572	6,542	
Total assets .....	<u>\$ 167,690</u>	<u>\$ 185,378</u>	
<b>Sales:</b>			
Total sales for reportable segments .....	\$ 272,485	\$ 255,596	\$ 197,997
Other <sup>(2)</sup> .....	215	—	—
Net sales .....	<u>\$ 272,700</u>	<u>\$ 255,596</u>	<u>\$ 197,997</u>
<b>Segment income from operations:</b>			
Total segment income from operations <sup>(3)</sup> .....	\$ 29,014	\$ 20,971	\$ 31,386
Other corporate expense <sup>(3)</sup> .....	(3,577)	(3,949)	(4,655)
Operating income .....	25,437	17,022	26,731
Interest income .....	1	1	5
Interest expense .....	(2,100)	(2,336)	(2,252)
Other expense, net .....	(269)	(208)	(211)
Income from continuing operations before income taxes .....	<u>\$ 23,069</u>	<u>\$ 14,479</u>	<u>\$ 24,273</u>

#### Geographic Data

	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(Amounts in thousands)		
<b>Net sales:</b>			
United States .....	\$ 229,140	\$ 218,961	\$ 165,217
International .....	43,560	36,635	32,780
Net sales.....	<u>\$ 272,700</u>	<u>\$ 255,596</u>	<u>\$ 197,997</u>
<b>Property, plant and equipment, net:</b>			
United States .....	\$ 52,178	\$ 53,039	
International .....	15,848	18,787	
Property, plant and equipment, net .....	<u>\$ 68,026</u>	<u>\$ 71,826</u>	

- (1) Includes approximately \$467,000 and \$644,000 of deferred tax assets as of July 31, 2012 and 2011, respectively. For fiscal year ended 2011 the remainder of assets was related to the animal health business sold in March 2012.
- (2) Reflects fees from the transition services agreement in connection with the sale of the animal health business. See Note 12.
- (3) Other corporate expense primarily represents employee stock-based compensation expenses and those expenses associated with the Company's operation as a public entity such as board compensation, audit expense and fees related to the listing of our stock. The amounts presented include corporate overhead previously allocated to the animal health business. These amounts were not reallocated to the remaining segments.

#### 14. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

Quarterly results for the fiscal years ended July 31, 2012 and 2011 exclude the effect of discontinued operations, except for net income amounts. See note 12 for further detail on discontinued operations.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
(Amounts in thousands, except per share data)				
Year Ended July 31, 2012				
Net sales.....	\$ 71,539	\$ 66,975	\$ 66,579	\$ 67,607
Gross profit .....	18,675	17,141	20,606	20,643
Operating income .....	6,991	4,883	6,868	6,695
Income from continuing operations before income taxes .....	6,366	4,256	6,316	6,131
Net income .....	3,535	2,462	3,965	3,863
Earnings Per share: .....				
Income per share from continuing operations .....				
- basic .....	\$ 0.34	\$ 0.22	\$ 0.34	\$ 0.35
- diluted.....	0.34	0.22	0.33	0.34
Net income per share .....				
- basic .....	0.31	0.22	0.35	0.34
- diluted.....	0.31	0.21	0.34	0.33
Year Ended July 31, 2011				
Net sales.....	\$ 60,953	\$ 61,808	\$ 61,899	\$ 70,936
Gross profit .....	17,054	17,296	16,765	16,945
Operating income .....	5,846	4,524	4,141	2,511
Income from continuing operations before income taxes .....	5,303	3,685	3,620	1,871
Net income .....	3,516	2,424	2,607	1,182
Earnings Per share: .....				
Income per share from continuing operations .....				
- basic .....	\$ 0.33	\$ 0.20	\$ 0.21	\$ 0.09
- diluted.....	0.33	0.20	0.21	0.09
Net income per share .....				
- basic .....	0.31	0.21	0.23	0.10
- diluted.....	0.31	0.21	0.23	0.10

Earnings per share amounts are computed independently for each quarter presented. Therefore, the sum of the quarterly earnings per share may not equal annual earnings per share.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

## **ITEM 9A. CONTROLS AND PROCEDURES**

### **Disclosure Controls and Procedures**

The term “disclosure controls and procedures” is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934. This term refers to the controls and procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission. Our management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this annual report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of the end of the period covered by this annual report.

### **Management’s Report on Internal Control over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluations of effectiveness to future periods is subject to the risk that controls may become inadequate in the future period because of changes in conditions, in the degree of compliance with the policies, or because procedures may deteriorate.

Under the supervision and with the participation of our management, including our principal executive and principal financial officers, we conducted an assessment as of July 31, 2012 of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the “COSO Framework”). Based on this assessment, management concluded that its internal control over financial reporting was effective as of July 31, 2012.

Management’s assertion about the effectiveness of our internal control over financial reporting as of July 31, 2012, has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their report which appears herein.

### **Changes in Internal Control over Financial Reporting**

There were no changes to our internal control over financial reporting identified in conjunction with our management’s evaluation of such control that occurred during our fiscal quarter ended July 31, 2012 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **ITEM 9B. OTHER INFORMATION**

None.

## **PART III**

Pursuant to instruction G(3) to Form 10-K, the information required by Part III is incorporated by reference from our definitive proxy statement relating to our annual meeting of shareholders, which will be filed with the Securities and Exchange Commission within 120 days of the end of fiscal year 2012.

## PART IV

### ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 10-K

- (a) The financial statements and financial statement schedules filed as part of this report in Item 8 are listed in the Index to Financial Statements contained in that item.
- (b) The following documents are filed as exhibits. Documents marked with an asterisk (\*) are management contracts or compensatory plans, and portions of documents marked with a dagger (†) have been granted confidential treatment.
- 3.1 Restated and Amended Articles of Incorporation filed as Exhibit 3(i) to the company's filed as Exhibit 3(i) to the company's Form 10-QSB12G filed December 6, 1996, incorporated in this report.
  - 3.2 Bylaws filed as Exhibit 3(ii) to the company's Form 10-QSB12G filed December 6, 1996, incorporated in this report.
  - 3.3 Articles of Amendment to Restated and Amended Articles of Incorporation, filed December 11, 1997 filed as Exhibit 3 to the company's second quarter 1998 report on Form 10-QSB filed December 12, 1997, incorporated in this report.
  - 4.1 Form of Common Stock Certificate filed as Exhibit 4.1 to the company's Form 10-QSB12G filed December 6, 1996, incorporated in this report.
  - 10.1† Creosote Supply Agreement dated November 1, 1998 between Rütgers and the company filed as Exhibit 10.20 to the company's second quarter 1999 report on Form 10-QSB filed March 12, 1999, incorporated in this report.
  - 10.2\* 1996 Stock Option Plan filed as Exhibit 10.4 to the company's Form 10-QSB12G filed December 6, 1996, incorporated in this report.
  - 10.3\* Employment Agreement with John V. Sobchak dated June 26, 2001 filed as Exhibit 10.26 to the company's 2001 report on Form 10-K filed October 24, 2001, incorporated in this report.
  - 10.4\* Employment Agreement with Roger C. Jackson dated August 1, 2002 filed as Exhibit 10.31 to the company's 2003 report on Form 10-K filed October 23, 2003, incorporated in this report.
  - 10.5\* Employment Agreement with J. Neal Butler dated March 8, 2004 filed as Exhibit 10.18 to the company's 2004 report on Form 10-K filed October 15, 2004, and incorporated herein by reference.
  - 10.6\* Supplemental Executive Retirement Plan dated effective August 1, 2001 filed as Exhibit 10.27 to the company's 2001 report on Form 10-K filed October 24, 2001, incorporated in this report.
  - 10.7\* 2004 Long-Term Incentive Compensation Plan filed as Exhibit 10.21 to the company's report on Form 10-Q filed December 15, 2004, incorporated in this report.
  - 10.8\* Performance-Based Restricted Stock Agreement, Series 1 dated September 2, 2005 filed as Exhibit 10.28 to the company's report on Form 8-K filed September 7, 2005.
  - 10.9\* Performance-Based Restricted Stock Agreement, Series 2 dated September 2, 2005 filed as Exhibit 10.29 to the company's report on Form 8-K filed September 7, 2005.
  - 10.10† Sales Agreement with Koppers, Inc. dated May 8, 2007, filed as Exhibit 10.34 to the company's report on Form 10-Q filed June 5, 2007.
  - 10.11 Amended and Restated Credit Agreement with Wachovia Bank, National Association dated December 31, 2007 initially filed as Exhibit 10.39 to the company's report on Form 8-K filed January 7, 2008, and re-filed on March 12, 2010 to the company's report on Form 10-Q, and incorporated herein by this reference.
  - 10.12 Note Purchase Agreement with The Prudential Insurance Company of America dated December 31, 2007 filed as Exhibit 10.40 to the company's report on Form 8-K filed January 7, 2008, and incorporated herein by this reference.
  - 10.13† Agreement with Acme Chemical Marketing, LLC dated February 14, 2008 filed as Exhibit 10.41, to the company's report on Form 10-Q filed March 17, 2008, and incorporated herein.
  - 10.14\* Executive Severance Plan, dated October 10, 2008, by and between the Company and its Eligible Employees filed as Exhibit 10.42, to the company's report on Form 8-K filed October 13, 2008, and incorporated herein by this reference.

- 10.15 First Amendment to Amended and Restated Credit Agreement and Amended Pledge Agreement with Wachovia Bank, National Association dated effective January 30, 2009 filed as Exhibit 10.43, to the company's report on Form 10-Q filed on March 12, 2009, and incorporated herein by this reference.
  - 10.16 Amendment No. 1 to Note Purchase Agreement with The Prudential Insurance Company of America dated effective January 30, 2009 filed as Exhibit 10.44, to the company's report on Form 10-Q filed on March 12, 2009, and incorporated herein by this reference.
  - 10.17† Purchase Agreement dated December 31, 2007 with Intel Corporation filed as Exhibit 10.45 to the company's report on Form 8-K filed May 13, 2009, incorporated herein by this reference.
  - 10.18\* 2009 Long Term Incentive Plan of the Company, filed as Exhibit 10.46 to the company's report on Form 10-K filed October 14, 2009 and incorporated herein by this reference.
  - 10.19 Second Amendment to Amended and Restated Credit Agreement with Wachovia Bank, National Association dated March 18, 2010 filed as Exhibit 10.47, to the company's report on Form 8-K filed on March 30, 2010, and incorporated herein by this reference.
  - 10.20 Amendment No. 2 to Note Purchase Agreement and Limited Consent with The Prudential Insurance Company of America dated March 18, 2010 filed as Exhibit 10.48, to the company's report on Form 8-K filed on March 30, 2010, and incorporated herein by this reference.
  - 10.21 Third Amendment to Amended and Restated Credit Agreement with Wells Fargo Bank, National Association, Bank of America, N.A., The Prudential Insurance Company of America, and Pruco Life Insurance Company dated November 23, 2011 filed as Exhibit 10.49, to the company's report on Form 8-K filed on November 23, 2011, and incorporated herein by this reference.
  - 10.22 Amendment No. 3 to Note Purchase Agreement and limited consent with The Prudential Insurance Company of America, and Pruco Life Insurance Company dated November 30, 2011 filed as Exhibit 10.50, to the company's report on Form 8-K filed on November 23, 2011, and incorporated herein by this reference.
  - 21.1 Subsidiaries of the company.
  - 23.1 Consent of KPMG LLP.
  - 23.2 Consent of UHY LLP.
  - 31 Certificates under Section 302 the Sarbanes-Oxley Act of 2002 of the Chief Executive Officer and the Chief Financial Officer.
  - 32 Certificates under Section 906 of the Sarbanes-Oxley Act of 2002 of the Chief Executive Officer and the Chief Financial Officer.
- (c) Schedule II-Valuation and Qualifying Accounts and Reserves. All other schedules are omitted because they are not applicable or the required information is contained in the applicable financial statements of notes thereto.

**KMG Chemicals, Inc.**  
**Schedule II — Valuation and Qualifying Accounts**  
Fiscal years ended July 31, 2012, 2011 and 2010

Description	Balance at beginning of period	Charged to costs and expenses	Additions/ Deductions	Balance at end of period
Year ended July 31, 2012:				
Allowance for doubtful accounts.....	\$ 414,000	\$ —	\$ (398,000)	\$ 16,000
Inventory obsolescence .....	333,000	272,000	(112,000)	493,000
Valuation allowance on deferred tax assets.....	—	—	—	—
Year ended July 31, 2011:				
Allowance for doubtful accounts.....	\$ 260,000	\$ 154,000	\$ —	\$ 414,000
Inventory obsolescence .....	418,000	(34,000)	(51,000)	333,000
Valuation allowance on deferred tax assets.....	627,000	(627,000)	—	—
Year ended July 31, 2010:				
Allowance for doubtful accounts.....	\$ 595,000	\$ 63,000	\$ (398,000)	\$ 260,000
Inventory obsolescence .....	395,000	171,000	(148,000)	418,000
Valuation allowance on deferred tax assets.....	1,509,000	(882,000)	—	627,000

**SIGNATURES**

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

KMG CHEMICALS, INC.

By: /s/ J. Neal Butler Date: October 15, 2012  
J. Neal Butler, President, Chief Executive  
Officer and Director

Pursuant to the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

By: /s/ John V. Sobchak Date: October 15, 2012  
John V. Sobchak, Vice President and Chief  
Financial Officer

By: /s/ Jack M. North Date: October 15, 2012  
Jack M. North, Controller and  
Chief Accounting Officer

By: /s/ David L. Hatcher Date: October 15, 2012  
David L. Hatcher,  
Director and Chairman of the Board

By: /s/ Gerald G. Ermentrout Date: October 15, 2012  
Gerald G. Ermentrout, Director

By: /s/ Christopher T. Fraser Date: October 15, 2012  
Christopher T. Fraser, Director

By: /s/ George W. Gilman Date: October 15, 2012  
George W. Gilman, Director

By: /s/ John C. Hunter, III Date: October 15, 2012  
John C. Hunter, III, Director

By: /s/ Fred C. Leonard Date: October 15, 2012  
Fred C. Leonard III, Director

By: /s/ Stephen A. Thorington Date: October 15, 2012  
Stephen A. Thorington, Director

By: /s/ Karen A. Twitchell Date: October 15, 2012  
Karen A. Twitchell, Director

By: /s/ Richard L. Urbanowski Date: October 15, 2012  
Richard L. Urbanowski, Director

## SHAREHOLDER INFORMATION

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### TRANSFER AGENT AND REGISTRAR

Communications concerning the transfer of shares, lost certificates or changes of address for registered shares should be directed to the transfer agent:

**Securities Transfer Corporation**  
2591 Dallas Parkway, Suite 102, Frisco, Texas 75034  
Voice: 469.633.0101 Fax: 469.633.0088  
Email: info@stctransfer.com Website: www.stctransfer.com

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### DIRECT STOCK PURCHASE PLAN

The Company has a Direct Stock Purchase Plan (DSPP) for registered shareholders. Participants may invest in KMG common stock at current market prices without service fees or brokerage commissions and automatically reinvest KMG dividends into additional common shares. Participants may also use the plan to make gifts of KMG common stock, deposit existing stock certificates for safekeeping and sell KMG shares. Securities Transfer Corporation (STC) is the plan administrator. The DSPP prospectus can be obtained from KMG's website, [www.kmgchemicals.com](http://www.kmgchemicals.com), at STC's website, [www.stctransfer.com](http://www.stctransfer.com), or by calling 713.600.3800. This is not an offer to sell or a solicitation to buy securities, which are only offered by prospectus.

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### SHAREHOLDER SERVICES

KMG maintains an internal financial mailing list and can email you when news releases are distributed. To sign up, visit the website at [www.kmgchemicals.com](http://www.kmgchemicals.com) and click on Investor Relations. You can also request that certain financial information be mailed to you on a one-time basis, by contacting the corporate office.

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### CODE OF BUSINESS CONDUCT

KMG's Code of Business Conduct can be viewed and downloaded from the home page of the Company's website at [www.kmgchemicals.com](http://www.kmgchemicals.com). Copies are also available at no charge by contacting John V. Sobchak, Chief Financial Officer, at the address on the back cover.

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### FORM 10-K

Additional copies of the KMG Chemicals, Inc. Form 10-K, as filed with the Securities and Exchange Commission, can be downloaded from the Company website and are also available upon written request to the corporate offices.

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### INDEPENDENT ACCOUNTANTS

KPMG – Houston, Texas

#### Investor Inquiries on Company Activities

Inquiries about KMG are welcome by email, phone or letter. Please direct them to:

#### Investor Relations

Eric Glover, Investor Relations Manager

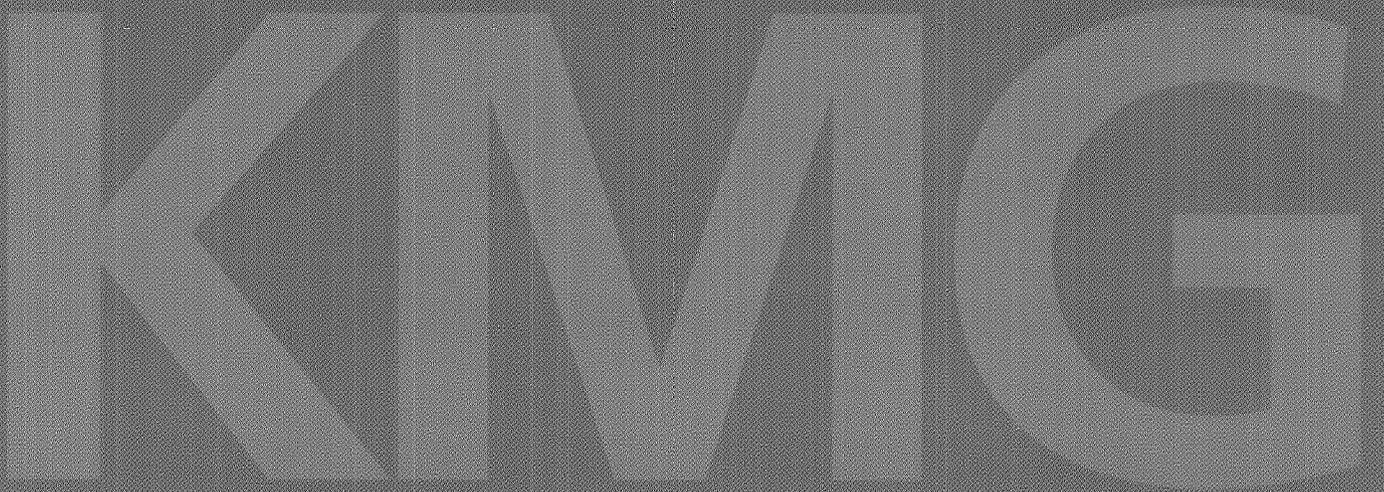
KMG Chemicals, Inc. 9555 West Sam Houston Parkway South, Suite 600 Houston, TX 77099  
Voice: 713.600.3865 Email: [eglover@kmgchemicals.com](mailto:eglover@kmgchemicals.com) Website: [www.kmgchemicals.com](http://www.kmgchemicals.com)

The information in this document includes certain forward-looking statements that are based upon assumptions that in the future may prove not to have been accurate and are subject to certain risks and uncertainties, including statements as to the future performance of the company. Although the company believes that the expectations reflected in its forward-looking statements are reasonable, it can give no assurance that such expectations or any of its forward-looking statements will prove to be correct. Factors that could cause results to differ include, but are not limited to, successful performance.

The logo consists of the letters 'KMG' in a bold, sans-serif font, enclosed within a square border.

KMG Chemicals, Inc.

9555 West Sam Houston Parkway South  
Suite 600 Houston, Texas 77099  
P 713.600.3800 F 713.600.3850  
NYSE: KMG  
[kmgchemicals.com](http://kmgchemicals.com)

A large, stylized, and semi-transparent version of the 'KMG' logo is centered at the bottom of the page. The letters are bold and blocky, with a slight shadow effect.