

OM GROUP INC  
Form 10-Q  
September 23, 2005

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q  
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended June 30, 2005  
Commission File Number 001-12515  
OM GROUP, INC.  
(exact name of registrant as specified in its charter)**

Delaware  
(state or other jurisdiction of  
incorporation or organization)

52-1736882  
(I.R.S., Employer  
Identification Number)

127 Public Square  
1500 Key Tower  
Cleveland, Ohio 44114-1221  
(Address of principal executive offices)  
(zip code)  
(216) 781-0083

(Registrant's telephone number, including area code)

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 and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934)

Yes  No

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

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of June 30, 2005:

Common Stock, \$.01 Par Value 28,472,596 shares

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Item 1 Financial Statements**

**OM GROUP, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(Dollars in thousands, except share data)  
(Unaudited)

	<b>June 30, 2005</b>	<b>December 31, 2004</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 37,436	\$ 26,779
Restricted cash in escrow	74,000	
Accounts receivable, less allowances	139,642	161,346
Inventories	362,186	415,517
Advances to suppliers	13,614	32,498
Other	35,849	52,719
<i>Total Current Assets</i>	662,727	688,859
<b>PROPERTY, PLANT AND EQUIPMENT, AT COST</b>		
Land	4,814	4,982
Buildings and improvements	162,470	161,566
Machinery and equipment	501,212	493,930
Furniture and fixtures	17,259	17,130
	685,755	677,608
Less accumulated depreciation	310,176	287,796
	375,579	389,812
<b>OTHER ASSETS</b>		
Goodwill	179,710	181,871
Receivables from joint venture partner	29,379	29,379
Other	49,499	44,780
<b>TOTAL ASSETS</b>	<b>\$ 1,296,894</b>	<b>\$ 1,334,701</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Long-term debt in default	\$ 400,000	\$ 400,000
Current portion of long-term debt	5,750	5,750
Accounts payable	105,760	132,312
Accrued employee costs	20,555	17,062
Retained liabilities of businesses sold	16,675	21,837
Shareholder litigation accrual	74,000	74,000
Other	25,441	50,835

<i>Total Current Liabilities</i>	648,181	701,796
<b>LONG-TERM LIABILITIES</b>		
Long-term debt	22,062	24,683
Deferred income taxes	29,368	31,033
Shareholder litigation accrual	17,882	18,000
Minority interest	39,591	44,168
Other	34,059	27,989
<b>STOCKHOLDERS EQUITY</b>		
Preferred stock, \$.01 par value: Authorized 2,000,000 shares, no shares issued or outstanding		
Common stock, \$.01 par value: Authorized 60,000,000 shares; issued 28,533,831 shares in 2005 and 28,484,098 shares in 2004	285	285
Capital in excess of par value	500,218	498,250
Retained deficit	(8,201)	(32,080)
Treasury stock (61,235 shares in 2005 and 14,025 shares in 2004, at cost)	(2,226)	(710)
Accumulated other comprehensive income	15,675	21,287
<i>Total Stockholders Equity</i>	505,751	487,032
<b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>	<b>\$ 1,296,894</b>	<b>\$ 1,334,701</b>

*See accompanying notes to condensed consolidated financial statements (unaudited).*

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Item 1 Financial Statements**

**OM GROUP, INC.**  
**CONDENSED STATEMENTS OF CONSOLIDATED OPERATIONS**  
(Amounts in thousands, except per share data)  
(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2005	2004	2005	2004
Net sales	\$ 314,709	\$ 313,738	\$ 666,641	\$ 680,368
Cost of products sold	274,136	243,758	570,217	497,720
	40,573	69,980	96,424	182,648
Selling, general and administrative expenses	20,169	28,312	55,739	66,522
<b>INCOME FROM OPERATIONS</b>	20,404	41,668	40,685	116,126
<b>OTHER INCOME (EXPENSE)</b>				
Interest expense	(10,259)	(11,136)	(20,252)	(20,334)
Foreign exchange loss	(1,482)	(3,472)	(2,812)	(3,835)
Investment and other income, net	3,860	1,317	5,853	4,064
	(7,881)	(13,291)	(17,211)	(20,105)
<b>INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES AND MINORITY INTEREST</b>	12,523	28,377	23,474	96,021
Income tax expense	3,090	8,309	5,791	28,115
Minority interest	(1,041)	2,410	(4,571)	1,973
<b>INCOME FROM CONTINUING OPERATIONS</b>	10,474	17,658	22,254	65,933
<b>DISCONTINUED OPERATIONS</b>				
Income from operations, net of tax	841		1,625	
<b>NET INCOME</b>	\$ 11,315	\$ 17,658	\$ 23,879	\$ 65,933
Net income per common share basic				
Continuing operations	\$ 0.37	\$ 0.62	\$ 0.78	\$ 2.32
Discontinued operations	0.03		0.06	

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Net income	\$ 0.40	\$ 0.62	\$ 0.84	\$ 2.32
Net income per common share assuming dilution				
Continuing operations	\$ 0.37	\$ 0.62	\$ 0.78	\$ 2.31
Discontinued operations	0.03		0.06	
Net income	\$ 0.40	\$ 0.62	\$ 0.84	\$ 2.31
Weighted average shares outstanding				
Basic	28,473	28,470	28,463	28,470
Assuming dilution	28,519	28,562	28,545	28,586

*See accompanying notes to condensed consolidated financial statements (unaudited).*

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Item 1 Financial Statements**

**OM GROUP, INC.**  
**CONDENSED STATEMENTS OF CONSOLIDATED CASH FLOWS**  
**(Amounts in thousands)**  
**(Unaudited)**

	<b>Six Months Ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
<b>OPERATING ACTIVITIES</b>		
Income from continuing operations	\$ 22,254	\$ 65,933
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	24,640	25,321
Foreign exchange loss	2,812	3,835
Gain on sale of investments	(2,359)	
Minority interest	(4,571)	1,973
Income from equity method investment	(2,841)	(2,673)
Other non-cash items	(495)	7,825
Changes in operating assets and liabilities (a)	(20,219)	(91,363)
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>19,221</b>	<b>10,851</b>
<b>INVESTING ACTIVITIES</b>		
Expenditures for property, plant and equipment	(8,735)	(6,370)
Proceeds from sale of investments	4,534	
Acquisition of business		(6,715)
<b>NET CASH USED IN INVESTING ACTIVITIES</b>	<b>(4,201)</b>	<b>(13,085)</b>
<b>FINANCING ACTIVITIES</b>		
Payments of long-term debt and revolving line of credit	(52,747)	
Proceeds from the revolving line of credit	49,872	
Proceeds from exercise of stock options	117	
<b>NET CASH USED IN FINANCING ACTIVITIES</b>	<b>(2,758)</b>	
Effect of exchange rate changes on cash and cash equivalents	(1,605)	(1,118)
Increase (decrease) in cash and cash equivalents	10,657	(3,352)
Cash and cash equivalents at beginning of period	26,779	54,719
Cash and cash equivalents at end of period	\$ 37,436	\$ 51,367

*See accompanying notes to condensed consolidated financial statements (unaudited).*



- (a) Amount includes \$74.0 million paid into escrow during the second quarter of 2005 related to the settlement of the shareholder class action litigation. At June 30, 2005, such amount is classified separately as Restricted cash in escrow on the Condensed Consolidated Balance Sheet. The Restricted cash in escrow and corresponding Shareholder litigation accrual remained on the balance sheet until September 2005, when the settlement was approved by the Court and finalized.
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June 30, 2005

(Thousands of dollars, except as noted and per share amounts)

**Note A Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair financial presentation have been included. Past operating results are not necessarily indicative of the results which may occur in future periods, and the interim period results are not necessarily indicative of the results to be expected for the full year. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

**Note B Inventories**

Inventories consist of the following:

	June 30, 2005	December 31, 2004
Raw materials and supplies	\$ 227,283	\$ 248,536
Work in process	44,659	37,711
Finished goods	90,244	129,270
	\$ 362,186	\$ 415,517

**Note C Receivables from Joint Venture Partner**

In 2001 and 2002, the Company refinanced the capital contribution for the 25% minority shareholder in its joint venture in the Democratic Republic of Congo (DRC). At June 30, 2005 and December 31, 2004, the receivables from this partner were \$29.4 million. The receivables are secured by the partner's interest (book value of \$21.8 million at June 30, 2005 and \$24.5 million at December 31, 2004) in the joint venture and are due in full on December 31, 2008 (\$22.9 million) and December 31, 2010 (\$6.5 million). The \$22.9 million receivable bears interest at LIBOR plus 2.75% (5.96% at June 30, 2005) and the \$6.5 million receivable bears interest at 4.35%. The Company has recorded a full allowance against the interest due but not paid on the receivables. Dividends paid by the joint venture, if any, first serve to reduce the Company's receivable before any amounts are remitted to the joint venture partner.

**Note D Contingent Matters and Restricted Cash in Escrow**

In November 2002, the Company received notice that shareholder class action lawsuits were filed in the U.S. District Court for the Northern District of Ohio related to the decline in the Company's stock price after the third quarter 2002 earnings announcement. The lawsuits allege virtually identical claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 against the Company, certain executive officers and the members of the Board of Directors. Plaintiffs seek damages in an unspecified amount to compensate persons who purchased the Company's stock between November 2001 and October 2002 at allegedly inflated market prices. In July 2004, these lawsuits were amended to include the entire restatement period back to and including 1999, and to add the Company's independent auditors, Ernst & Young LLP, as a defendant. The Company and the lead plaintiff of the shareholder class action



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lawsuits have entered into a Stipulation and Agreement of Settlement (Agreement) dated June 6, 2005, which Agreement, as amended, was approved on September 8, 2005 by the U.S. District Court (Court) hearing the cases. The Company recorded a charge to administrative expense of \$82.5 million during the fourth quarter of 2003 related to these lawsuits.

In November 2002, the Company also received notice that shareholder derivative lawsuits had been filed in the U.S. District Court for the Northern District of Ohio against the members of the Company's Board of Directors and certain of its then executives. Derivative plaintiffs allege the directors and executives breached their fiduciary duties to the Company in connection with a decline in the Company's stock price after its third quarter 2002 earnings announcement by failing to institute sufficient financial controls to ensure that the Company and its employees complied with generally accepted accounting principles by writing down the value of the Company's cobalt inventory on or before December 31, 2001. Derivative plaintiffs seek a number of changes to the Company's accounting, financial and management structures and unspecified damages from the directors and executives to compensate the Company for costs incurred in, among other things, defending the aforementioned securities lawsuits. In July 2004, the derivative plaintiffs amended these lawsuits to include conduct allegedly related to the Company's decision to restate its earnings back to and including 1999. The Company has entered into an agreement in principle with the lead plaintiffs of the shareholder derivative lawsuits that outlines the general terms of the proposed settlement of these lawsuits subject to the satisfaction of various conditions and execution of a definitive agreement by the interested parties, including the individual defendants. The proposed settlement provides for the Company to issue 380,000 shares of its common stock in payment of attorneys' fees and costs incurred by plaintiffs counsel with respect to this litigation, and also requires the Company to implement various corporate governance changes. The Company recorded a charge to administrative expense of \$2.0 million during the fourth quarter of 2003 and an additional charge to administrative expense of \$7.5 million during the first quarter of 2004 related to these lawsuits.

At June 30, 2005 and December 31, 2004, the Company had an aggregate accrual of \$91.9 million and \$92.0 million, respectively, for the shareholder class action and shareholder derivative lawsuits. The settlements are anticipated to be payable \$74.0 million in cash and \$17.9 million in common stock. In April 2005, the Company paid \$74.0 million into an escrow account and in September 2005 the Company issued \$8.5 million of common stock in connection with settlement of the shareholder class action lawsuits. The \$74.0 million is classified as Restricted cash in escrow in the Condensed Consolidated Balance Sheet at June 30, 2005. The Restricted cash in escrow and corresponding Shareholder litigation accrual remained on the balance sheet until the Agreement was approved by the Court in September 2005. The cash is restricted for use under the terms of the Agreement solely by lead plaintiff's counsel to pay actual costs of notice and settlement administration. The Company had no ability under the Agreement to use the amount in escrow for any purpose.

The 380,000 shares to be issued in connection with the shareholder derivative litigation are marked-to-market through the statement of operations based on changes in the Company's stock price, as the liability is fixed in shares. During the second quarter of 2005, income of \$0.1 million was recognized.

Insurance proceeds are expected to be available for contribution to the resolution of the cases but the Company does not expect these lawsuits to be resolved within the limits of applicable insurance. As of September 15, 2005, insurance proceeds of approximately \$25 million have been received, representing both reimbursement of legal expenses in 2003, 2004 and 2005 related to the lawsuits (approximately \$17 million in total, including approximately \$3.0 million and \$2.0 million for the three months ended June 30, 2005 and 2004, respectively, and approximately \$4.9 million and \$4.0 million for the six months ended June 30, 2005 and 2004, respectively), as well as reimbursement of a portion of the settlement amount paid by the Company during 2005 (approximately \$8 million in the second quarter of 2005). Potential remaining insurance proceeds of up to approximately \$19 million are expected to be available and will be recognized when received.

The Company is a party to various other legal proceedings incidental to its business and is subject to a variety of environmental and pollution control laws and regulations in the jurisdictions in which it operates. As is the case with other companies in similar industries, the Company faces exposure from actual or potential claims and legal proceedings involving environmental matters.

A number of factors affect the cost of environmental remediation, including the determination of the extent of contamination, the length of time the remediation may require, the complexity of environmental regulations, and the continuing improvements in remediation techniques. Taking these factors into

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consideration, the Company has estimated the undiscounted costs of remediation, which will be incurred over several years. The Company accrues an amount consistent with the estimates of these costs when it is probable that a liability has been incurred. At June 30, 2005 and December 31, 2004 the Company has recorded environmental liabilities of \$7.5 million and \$9.5 million, respectively, primarily related to remediation and decommissioning at the Company's closed manufacturing sites in St. George, Utah, Newark, New Jersey, and Vasset, France. The Company has recorded \$4.3 million in other current liabilities and \$3.2 million in other long-term liabilities as of June 30, 2005.

Although it is difficult to quantify the potential impact of compliance with or liability under environmental protection laws, the Company believes that any amount it may be required to pay in connection with environmental matters, as well as other legal proceedings arising out of operations in the normal course of business, is not reasonably likely to exceed amounts accrued by an amount that would have a material adverse effect upon its financial condition, results of operations, or cash flows.

**Note E Pension and Other Postretirement Benefits**

The components of the Company's net periodic benefit expense (income) for its defined benefit pension plan and other postretirement benefits are shown below:

	Three months ended June 30,			
	Defined Benefit Pension Plan		Other Postretirement Benefits	
	2005	2004	2005	2004
Service cost	\$	\$	\$ 17	\$
Interest cost	305	216	63	50
Expected return on plan assets	(236)	(243)		
Other	54	8	10	(8)
Net periodic benefit expense (income)	\$ 123	\$ (19)	\$ 90	\$ 42
	Six months ended June 30,			
	Defined Benefit Pension Plan		Other Postretirement Benefits	
	2005	2004	2005	2004
Service cost	\$	\$	\$ 34	\$
Interest cost	610	432	126	100
Expected return on plan assets	(472)	(486)		
Curtailment	4,728			
Other	108	16	20	(16)
Net periodic benefit expense (income)	\$ 4,974	\$ (38)	\$ 180	\$ 84

The curtailment expense included in the above table relates to the termination of James P. Mooney's employment with the Company on January 11, 2005 as discussed in Note J.

The Medicare Prescription Drug, Improvement and Modernization Act ( Act ) was enacted on December 8, 2003. The Act introduces a prescription drug benefit under Medicare Part D, in addition to a federal subsidy to sponsors

of postretirement benefit plans that provide a prescription drug benefit that is at least actuarially equivalent to Medicare Part D. In May 2004, FASB Staff Position 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, was issued which provides guidance on accounting for the federal subsidy. The provisions of FASB 106-2 became effective for the Company as of July 1, 2004 and have been applied prospectively. The impact of adopting FASB 106-2 was not significant.

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**Table of Contents****Note F Earnings Per Share**

The following table sets forth the computation of basic and dilutive income from continuing operations per common share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Income from continuing operations	\$ 10,474	\$ 17,658	\$ 22,254	\$ 65,933
Weighted average shares outstanding	28,473	28,470	28,463	28,470
Dilutive effect of stock options and restricted stock	46	92	82	116
Weighted average shares outstanding assuming dilution	28,519	28,562	28,545	28,586
Basic income per common share from continuing operations	\$ 0.37	\$ 0.62	\$ 0.78	\$ 2.32
Dilutive income per common share from continuing operations	\$ 0.37	\$ 0.62	\$ 0.78	\$ 2.31

The following table sets forth the computation of basic and dilutive net income per common share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Net income	\$ 11,315	\$ 17,658	\$ 23,879	\$ 65,933
Weighted average shares outstanding	28,473	28,470	28,463	28,470
Dilutive effect of stock options and restricted stock	46	92	82	116
Weighted average shares outstanding assuming dilution	28,519	28,562	28,545	28,586
Basic net income per common share	\$ 0.40	\$ 0.62	\$ 0.84	\$ 2.32
Dilutive net income per common share	\$ 0.40	\$ 0.62	\$ 0.84	\$ 2.31

**Note G Comprehensive Income**

During the three months ended June 30, 2005 and 2004, total comprehensive income was \$3.6 million and \$11.7 million, respectively. Total comprehensive income for the six months ended June 30, 2005 and 2004 was \$18.3 million and \$60.0 million, respectively. Comprehensive income consists of net income, foreign currency translation adjustments and unrealized gains and losses on commodity hedging activity, net of income taxes.

**Note H Income Taxes**

The effective income tax rate for the three and six months ended June 30, 2005 was 24.7% versus 29.3% for the three and six months ended June 30, 2004. The effective income tax rate for all periods is lower than the statutory



rate in the United States due primarily to a higher proportion of earnings in jurisdictions having lower statutory tax rates (primarily Finland, which has a 26% and 29% statutory rate for 2005 and 2004, respectively) and a tax holiday from income taxes in Malaysia, both offset by losses

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in the United States with no corresponding tax benefit.

**Note I Debt and Other Financial Instruments**

Debt consists of the following:

	June 30, 2005	December 31, 2004
Senior Subordinated Notes	\$ 400,000	\$ 400,000
Note payable bank	20,125	23,000
Deferred gain on termination of fair value hedges	6,356	6,711
Fair value of interest rate swaps (fair value hedges)	1,331	722
	427,812	430,433
Current: Current portion	5,750	5,750
Long-term debt in default	400,000	400,000
Total long-term debt	\$ 22,062	\$ 24,683

The Senior Subordinated Notes (the Notes) bear interest at 9.25% and mature on December 15, 2011. The Company's domestic subsidiaries are the guarantors of the Notes. The delay by the Company in filing its Form 10-K for the year ended December 31, 2003 caused events of default under the indenture governing the Notes, and the Company reclassified the Notes from long-term to current as of March 31, 2004, which was the date the 2003 Form 10-K was due. The Company filed its 2003 Form 10-K on March 31, 2005 and filed its Form 10-Qs for each of the first three quarters of 2004 on June 10, 2005. The delay by the Company in filing its Form 10-K for the year ended December 31, 2004 and its Form 10-Q for the first quarter of 2005, resulted in new events of default under the indenture governing the Notes. Also, on August 17, 2005, the trustee for the Notes furnished a notice of default to the Company with respect to the delay by the Company in filing its Form 10-Q for the second quarter of 2005. Such delay would have become an event of default if the Form 10-Q for the second quarter of 2005 were not filed by October 16, 2005. However, the Company filed its 2004 Form 10-K on August 22, 2005 and is filing its Form 10-Qs for the first and second quarter of 2005 on September 23, 2005. On August 30, 2005, the trustee for the Notes furnished a letter to the Company that gave the Company until October 29, 2005 to furnish to the trustee an annual compliance certificate required under the indenture governing the Notes in order to avoid an event of default under that indenture. In the event the Company is unable to avoid an event of default, the noteholders, or the indenture trustee at the direction of the noteholders, would have the right but would not be obligated, to accelerate payment of these Notes. The Company cannot predict whether they would do so if an event of default were to occur. If any such acceleration were to occur, based on discussions with the Company's lead bank, the Company believes it would be able to refinance such obligation on a long-term basis. Further, because the noteholders had the right to accelerate payments of the Notes at the time of filing the Form 10-K for the year ended December 31, 2004, the report of the Company's independent registered public accounting firm dated August 19, 2005 contains an explanatory paragraph indicating conditions that raise substantial doubt about the Company's ability to continue as a going concern.

On August 7, 2003, the Company entered into a \$150 million Senior Secured Revolving Credit Facility with a group of lending institutions. The facility bears interest at a rate of LIBOR plus 2.00% to 3.00% or PRIME plus 0.25% to 1.25% and matures in August 2006. There were no borrowings under this facility at June 30, 2005. Because of the delay by the Company in filing required periodic reports with the SEC during 2004, the Company failed to comply with specific covenants in the related credit

agreement and events of default occurred under the credit agreement. Due to the filing of the Form 10-Qs for the first and second quarter of 2005 on September 23, 2005, the Company will no longer be in default and will be entitled to borrow under the credit agreement.

During December 2003, the Company borrowed \$22.9 million from a Belgium bank. This loan bore interest at a rate of LIBOR plus 2.75% and was scheduled to mature in December 2008. In November 2004, the Company refinanced this loan with a Finland bank, resulting in a new principal balance of \$23.0 million. The refinanced loan has an interest rate of LIBOR plus 1.25% and is payable in 48 equal installments beginning in January 2005 and ending December 2008. Simultaneous to the initial borrowing, the proceeds were loaned by the Company to one of its DRC smelter joint venture partners.

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The loan receivable is recorded in Receivables from joint venture partner, bears interest at LIBOR plus 2.75% and matures in December 2008.

**Note J Termination Charge**

On January 11, 2005, James P. Mooney's employment with the Company was terminated and he ceased to be its Chief Executive Officer. During the first quarter of 2005, the Company recorded a charge of \$8.7 million related to his termination, in accordance with Mr. Mooney's employment agreement and a supplemental executive retirement plan. Such amount includes termination benefits based on salary, estimated bonus (as calculated per the provisions in the agreement) and certain benefits to be paid over the remaining term of the agreement, as well as the actuarially-determined present value of amounts to be paid under a supplemental executive retirement plan. The Company is examining its alternatives for recovery against Mr. Mooney, including claims for disgorgement under the Sarbanes-Oxley Act of 2002. Any such claims will be recognized when settled.

**Note K DRC Smelter Shut-down**

During the first quarter of 2005, the Company's joint venture in the DRC shut-down its smelter as scheduled for approximately four months for regular maintenance and production improvements. The impact of the shut-down reduced the Company's gross profit and income from continuing operations by approximately \$2.0 million and \$1.1 million, respectively, for the three months ended June 30, 2005, and approximately \$9.4 million and \$5.2 million, respectively, for the six months ended June 30, 2005. The smelter was re-opened in May of 2005.

**Note L Recently Issued Accounting Standards**

In November 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 151, Inventory Costs – An amendment of ARB No. 43 (SFAS 151). SFAS 151 clarifies that abnormal amounts of idle facility expense, freight, handling costs and spoilage should be expensed as incurred and not included in overhead. Further, SFAS 151 requires that allocation of fixed production overheads to conversion costs should be based on normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Companies must apply the standard prospectively. The adoption of SFAS 151 is not expected to have a material impact on the Company's results of operations or financial position.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised), Share-Based Payments (SFAS 123R). SFAS 123R is a revision of Statement of Financial Accounting Standards No. 123, Accounting for Stock Issued to Employees (APB 25). SFAS 123R requires that the cost of transactions involving share-based payments be recognized in the financial statements based on a fair-value-based measurement. SFAS 123R is effective for fiscal years beginning after June 15, 2005. The adoption of SFAS 123R is not expected to have a material impact on the Company's results of operations or financial position.

The American Jobs Creation Act of 2004 (AJCA) was enacted on October 22, 2004. The AJCA repeals an export incentive, creates a new deduction for qualified domestic manufacturing activities, and includes a special one-time deduction of 85 percent of certain foreign earnings repatriated to the U.S. In December 2004, the Financial Accounting Standards Board issued Staff Position No. FAS 109-1, Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 (FSP FAS 109-1). In accordance with FSP FAS 109-1, the Company will treat the deduction for qualified domestic manufacturing as a special deduction in future years as realized. The deduction for qualified domestic manufacturing activities did not impact the Company's consolidated financial statements in 2004 and for the first and second quarters of 2005. The Company has not yet completed its evaluation of the deduction for qualified domestic manufacturing activities on the Company's future effective tax rate. The phase-out of the export incentive is not expected to have a material impact on the Company's effective tax rate in the future. In December 2004, the Financial Accounting Standards Board issued Staff Position No. FAS 109-2, Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision with the American Jobs Creation Act of 2004, allowing companies additional time to evaluate



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the effect of the AJCA on plans for reinvestment or repatriation of foreign earnings. The Company is in the process of evaluating the effects of the repatriation provision; however, the Company does not expect the impact of repatriation of foreign earnings, if any, to have a material impact on the Company's results of operations or financial position.

**Note M Business Segment Information**

The Company operates in two business segments—Cobalt and Nickel. The Cobalt segment includes products manufactured using cobalt and other metals including copper, zinc, manganese and calcium. The Nickel segment includes nickel-based products. The Company's products are essential components in numerous complex chemical and industrial processes, and are used in many end markets, such as rechargeable batteries, coatings, custom catalysts, liquid detergents, lubricants and fuel additives, plastic stabilizers, polyester promoters and adhesion promoters for rubber tires, colorants, petroleum additives, magnetic media, metal finishing agents, cemented carbides for mining and machine tools, diamond tools used in construction, stainless steel, alloy and plating applications. The Company's products are sold in various forms such as solutions, crystals, powders, cathodes and briquettes. Corporate is comprised of general and administrative expense not allocated to the segments.

While the primary manufacturing sites are in Finland, the Company also has manufacturing and other facilities in Australia, North America, Europe and Asia-Pacific, and the Company markets its products worldwide. Further, approximately 25% of the Company's investment in property, plant and equipment is located in the Democratic Republic of Congo where the Company operates a smelter through a 55% owned joint venture.

These segments correspond to management's approach to aggregating products and business units, making operating decisions and assessing performance. The following table reflects the results of the segments.

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2005	2004	2005	2004
Net sales				
Cobalt	\$ 133,624	\$ 165,125	\$ 293,615	\$ 329,108
Nickel	192,581	166,292	400,542	389,173
Intercompany sales between segments:				
Cobalt	(175)	(617)	(484)	(1,783)
Nickel	(11,321)	(17,062)	(27,032)	(36,130)
<b>Total net sales</b>	<b>\$ 314,709</b>	<b>\$ 313,738</b>	<b>\$ 666,641</b>	<b>\$ 680,368</b>
Income (loss) from operations				
Cobalt	\$ 6,410	\$ 39,029	\$ 14,486	\$ 90,341
Nickel	14,457	14,459	43,481	58,460
Corporate expenses (a)	(463)	(11,820)	(17,282)	(32,675)
<b>Total income from operations</b>	<b>\$ 20,404</b>	<b>\$ 41,668</b>	<b>\$ 40,685</b>	<b>\$ 116,126</b>
Interest expense	(10,259)	(11,136)	(20,252)	(20,334)
Foreign exchange loss	(1,482)	(3,472)	(2,812)	(3,835)
Investment and other income, net	3,860	1,317	5,853	4,064

Income from continuing operations before income taxes and minority interest	\$ 12,523	\$ 28,377	\$ 23,474	\$ 96,021
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- (a) The amount for the three months ended June 30, 2005 is reduced by the net insurance proceeds of \$8.5 million received during the second quarter of 2005 related to the shareholder class action litigation. Before the impact of the insurance proceeds, corporate expenses were \$9.0 million for the three months ended June 30, 2005 which was lower than the three months ended June 30, 2004 amount due primarily to professional fees in 2004 associated with the audit committee investigation and restatement process. For the six months ended June 30, 2005 and 2004, corporate expenses decreased in 2005 due to

charges in 2004 of \$7.5 million related to the shareholder derivative lawsuits and \$2.8 million for executive compensation, and a charge of \$8.7 million related to the former chief executive officer's separation agreement in 2005 that was substantially offset by the income from the receipt of net insurance proceeds of \$8.5 million related to the shareholder class action lawsuits.

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**Table of Contents****Note N Guarantor and Non-Guarantor Subsidiary Information**

In December 2001, the Company issued \$400 million in aggregate principal amount of 9.25% Senior Subordinated Notes due 2011. These Notes are guaranteed by the Company's wholly-owned domestic subsidiaries. The guarantees are full, unconditional and joint and several.

The Company's foreign subsidiaries are not guarantors of these Notes. The Company, as presented below, represents OM Group, Inc. exclusive of its guarantor subsidiaries and its non-guarantor subsidiaries. Condensed consolidating financial information for the Company, the guarantor subsidiaries, and the non-guarantor subsidiaries is as follows:

<b>Balance Sheet Data</b>	<b>The Company</b>	<b>Combined Guarantor Subsidiaries</b>	<b>June 30, 2005</b>		<b>Total</b>
			<b>Combined Non-guarantor Subsidiaries</b>	<b>Eliminations</b>	
Current assets:					
Cash and cash equivalents	\$ 16,722	\$ 580	\$ 20,134	\$	\$ 37,436
Restricted cash in escrow	74,000				74,000
Accounts receivable	490,757	89,476	318,423	(759,014)	139,642
Inventories		47,117	315,069		362,186
Other assets		3,365	46,098		49,463
<b>Total current assets</b>	<b>581,479</b>	<b>140,538</b>	<b>699,724</b>	<b>(759,014)</b>	<b>662,727</b>
Property, plant and equipment net		34,220	341,359		375,579
Goodwill	75,830	68,908	34,972		179,710
Intercompany receivables	276,520		987,813	(1,264,333)	
Investment in subsidiaries	92,347		2,160,527	(2,252,874)	
Receivables from joint venture partner			29,379		29,379
Other assets	10,546	12,149	26,804		49,499
<b>Total assets</b>	<b>\$ 1,036,722</b>	<b>\$ 255,815</b>	<b>\$ 4,280,578</b>	<b>\$ (4,276,221)</b>	<b>\$ 1,296,894</b>
Current liabilities:					
Current portion of long-term debt	\$	\$	\$ 5,750	\$	\$ 5,750
Long-term debt in default	400,000				400,000
Accounts payable	423	94,955	341,266	(330,884)	105,760
Other accrued expenses	92,422	15,410	28,839		136,671
<b>Total current liabilities</b>	<b>492,845</b>	<b>110,365</b>	<b>375,855</b>	<b>(330,884)</b>	<b>648,181</b>
Long-term debt	7,687		14,375		22,062
Deferred income taxes	3,673		25,695		29,368
Other long-term liabilities and minority interest	26,766	19,918	44,848		91,532
Intercompany payables		457,897	1,210,344	(1,668,241)	

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Stockholders equity	505,751	(332,365)	2,609,461	(2,277,096)	505,751
Total liabilities and stockholders equity	\$ 1,036,722	\$ 255,815	\$ 4,280,578	\$ (4,276,221)	\$ 1,296,894

December 31, 2004

Balance Sheet Data	The Company	Combined		Eliminations	Total
		Guarantor Subsidiaries	Non-guarantor Subsidiaries		
Current assets:					
Cash and cash equivalents	\$ 8,533	\$ 1,197	\$ 17,049	\$	\$ 26,779
Accounts receivable	496,692	79,383	531,902	(946,631)	161,346
Inventories		58,450	357,067		415,517
Other assets		6,291	78,926		85,217
Total current assets	505,225	145,321	984,944	(946,631)	688,859
Property, plant and equipment net		35,542	354,270		389,812
Goodwill	75,830	68,908	37,133		181,871
Intercompany receivables	334,598		935,132	(1,269,730)	
Investment in subsidiaries	92,347		2,160,526	(2,252,873)	
Receivables from joint venture partner			29,379		29,379
Other assets	11,120	12,166	21,494		44,780
Total assets	\$ 1,019,120	\$ 261,937	\$ 4,522,878	\$ (4,469,234)	\$ 1,334,701
Current liabilities:					
Current portion of long-term debt	\$	\$	\$ 5,750	\$	\$ 5,750
Long-term debt in default	400,000				400,000
Accounts payable	100	76,262	571,394	(515,444)	132,312
Other accrued expenses	97,671	18,811	47,252		163,734
Total current liabilities	497,771	95,073	624,396	(515,444)	701,796
Long-term debt	7,433		17,250		24,683
Deferred income taxes			31,033		31,033
Other long-term liabilities and minority interest	26,884	14,157	49,116		90,157
Intercompany payables		497,038	1,189,735	(1,686,773)	
Stockholder s equity	487,032	(344,331)	2,611,348	(2,267,017)	487,032
	\$ 1,019,120	\$ 261,937	\$ 4,522,878	\$ (4,469,234)	\$ 1,334,701

Total liabilities & stockholder's  
equity

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<b>Income Statement Data</b>	<b>The Company</b>	<b>Three months ended June 30, 2005</b>			
		<b>Combined Guarantor Subsidiaries</b>	<b>Combined Non-guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Total</b>
Net sales	\$	\$ 59,246	\$ 353,706	\$ (98,243)	\$ 314,709
Cost of products sold		47,468	324,911	(98,243)	274,136
		11,778	28,795		40,573
Selling, general and administrative expenses		4,025	16,144		20,169
Income from operations		7,753	12,651		20,404
Interest expense	(9,805)	(2,200)	(12,508)	14,254	(10,259)
Foreign exchange loss		(14)	(1,468)		(1,482)
Investment and other income, net	2,499	251	15,364	(14,254)	3,860
Income (loss) from continuing operations before income taxes and minority interest	(7,306)	5,790	14,039		12,523
Income tax expense			3,090		3,090
Minority interest			(1,041)		(1,041)
Income (loss) from continuing operations	(7,306)	5,790	11,990		10,474
Income from discontinued operations, net of tax	841				841
Net income (loss)	\$ (6,465)	\$ 5,790	\$ 11,990	\$	\$ 11,315

<b>Income Statement Data</b>	<b>The Company</b>	<b>Three months ended June 30, 2004</b>			
		<b>Combined Guarantor Subsidiaries</b>	<b>Combined Non-guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Total</b>
Net sales	\$	\$ 56,387	\$ 408,950	\$ (151,599)	\$ 313,738
Cost of products sold		43,828	351,529	(151,599)	243,758
		12,559	57,421		69,980
Selling, general and administrative expenses		18,137	10,175		28,312
Income (loss) from operations		(5,578)	47,246		41,668
Interest expense	(10,293)	(1,569)	(12,834)	13,560	(11,136)
Foreign exchange loss	(31)		(3,441)		(3,472)
Investment and other income, net	1,893	192	12,792	(13,560)	1,317

Income (loss) from continuing operations before income taxes and minority interest	(8,431)	(6,955)	43,763		28,377
Income tax expense			8,309		8,309
Minority interest			2,410		2,410
Net income (loss)	\$ (8,431)	\$ (6,955)	\$ 33,044	\$	\$ 17,658

## Six months ended June 30, 2005

Income Statement Data	The Company	Six months ended June 30, 2005		Eliminations	Total
		Combined Guarantor Subsidiaries	Combined Non-guarantor Subsidiaries		
Net sales	\$	\$ 113,941	\$ 775,363	\$ (222,663)	\$ 666,641
Cost of products sold		94,880	698,000	(222,663)	570,217
		19,061	77,363		96,424
Selling, general and administrative expenses		27,806	27,933		55,739
Income (loss) from operations		(8,745)	49,430		40,685
Interest expense	(19,405)	(4,244)	(26,240)	29,637	(20,252)
Foreign exchange loss		(31)	(2,781)		(2,812)
Investment and other income, net	4,797	524	30,169	(29,637)	5,853
Income (loss) from continuing operations before income taxes and minority interest	(14,608)	(12,496)	50,578		23,474
Income tax expense			5,791		5,791
Minority interest			(4,571)		(4,571)
Income (loss) from continuing operations	(14,608)	(12,496)	49,358		22,254
Income from discontinued operations, net of tax	1,625				1,625
Net income (loss)	\$ (12,983)	\$ (12,496)	\$ 49,358	\$	\$ 23,879

## Six months ended June 30, 2004

Income Statement Data	The Company	Six months ended June 30, 2004		Eliminations	Total
		Combined Guarantor Subsidiaries	Combined Non-guarantor Subsidiaries		
Net sales	\$	\$ 108,572	\$ 865,689	\$ (293,893)	\$ 680,368
Cost of products sold		83,512	708,101	(293,893)	497,720
		25,060	157,588		182,648
Selling, general and administrative expenses		44,989	21,533		66,522

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Income (loss) from operations		(19,929)	136,055		116,126
Interest expense	(19,129)	(3,022)	(29,826)	31,643	(20,334)
Foreign exchange loss	(246)	(8)	(3,581)		(3,835)
Investment and other income, net	3,640	215	31,852	(31,643)	4,064
Income (loss) from continuing operations before income taxes and minority interest	(15,735)	(22,744)	134,500		96,021
Income tax expense			28,115		28,115
Minority interest			1,973		1,973
Net income (loss)	\$ (15,735)	\$ (22,744)	\$ 104,412	\$	\$ 65,933

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<b>Cash Flow Data</b>	<b>Six months ended June 30, 2005</b>				
	<b>The Company</b>	<b>Combined Guarantor Subsidiaries</b>	<b>Combined Non-guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Total</b>
Net cash provided by operating activities	\$ 8,072	\$ 273	\$ 10,876	\$	\$ 19,221
Investing activities:					
Expenditures for property, plant and equipment net		(890)	(7,845)		(8,735)
Proceeds from sale of investments			4,534		4,534
Net cash used in investing activities		(890)	(3,311)		(4,201)
Financing activities:					
Payments of long-term debt and revolving line of credit	(49,872)		(2,875)		(52,747)
Proceeds from the revolving line of credit	49,872				49,872
Proceeds from exercise of stock options	117				117
Net cash provided by (used in) financing activities	117		(2,875)		(2,758)
Effect of exchange rate changes on cash and cash equivalents			(1,605)		(1,605)
Increase (decrease) in cash and cash equivalents	8,189	(617)	3,085		10,657
Cash and cash equivalents at beginning of period	8,533	1,197	17,049		26,779
Cash and cash equivalents at end of period	\$ 16,722	\$ 580	\$ 20,134	\$	\$ 37,436

<b>Cash Flow Data</b>	<b>Six months ended June 30, 2004</b>				
	<b>The Company</b>	<b>Combined Guarantor Subsidiaries</b>	<b>Combined Non-guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Total</b>
Net cash provided by (used in) operating activities	\$ 6,969	\$ (1,647)	\$ 5,529	\$	\$ 10,851
Investing activities:					
		(985)	(5,385)		(6,370)

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Expenditures for property, plant and equipment net				
Acquisition of business	(6,715)			(6,715)
Net cash used in investing activities	(6,715)	(985)	(5,385)	(13,085)
Effect of exchange rate changes on cash and cash equivalents			(1,118)	(1,118)
Increase (decrease) in cash and cash equivalents	254	(2,632)	(974)	(3,352)
Cash and cash equivalents at beginning of period	8,839	4,553	41,327	54,719
Cash and cash equivalents at end of period	\$ 9,093	\$ 1,921	\$ 40,353	\$ 51,367

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**Table of Contents****Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations***Overview*

The Company is a leading, vertically integrated international producer and marketer of value-added, metal-based specialty chemicals and related materials, primarily from cobalt and nickel. The Company applies proprietary technology to unrefined cobalt and nickel raw materials to market more than 1,500 product offerings to approximately 3,300 customers in over 30 industries. The Company operates in two business segments—Cobalt and Nickel. The Company's business is critically connected to both the price and availability of raw materials, primarily cobalt and nickel. Since the Company has manufacturing and other facilities in Africa, North America, Europe and Asia-Pacific, and markets its products worldwide, fluctuations in currency prices may affect the Company's operating results. These factors are discussed in more detail in Management's Discussion and Analysis of Financial Condition and Results of Operations contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

*Three Months Ended June 30, 2005 Compared to Three Months Ended June 30, 2004*

Net sales for the three months ended June 30, 2005 were \$314.7 million, an increase of less than 1% versus \$313.7 million for the comparable period in 2004. Sales were favorably impacted by higher nickel metal prices in 2005, offset by the impact of lower cobalt metal prices and volumes. The average price of cobalt for the second quarter of 2005 was \$15.03 compared to \$24.91 for the second quarter of 2004. The average price of nickel for the second quarter of 2005 was \$7.44 compared to \$5.67 for the second quarter of 2004.

Gross profit decreased to \$40.6 million for the three-months ended June 30, 2005, versus \$70.0 million for the comparable period in 2004. The decrease in gross profit was principally due to lower selling prices as a result of the decrease in cobalt metal prices. Margins decreased due to the sale of cobalt finished goods manufactured using higher cost raw materials that were purchased before the overall decrease in metal prices, lower nickel sales volumes, lower of cost or market (LCM) charge of \$2.3 million in 2005 due to decreasing nickel metal prices at the end of the quarter, higher smelting and refining costs due to a new tolling agreement at the Company's nickel refinery in Finland, the scheduled maintenance shut-down of the DRC smelter (see Note K to the condensed consolidated financial statements included in this quarterly report), and the negative impact of currency exchange effects resulting from the stronger euro compared to the U.S. dollar.

Selling, general and administrative expenses (SG&A) decreased by \$8.1 million and as a percentage of sales to 6.4% in 2005 versus 9.0% for the comparable period in 2004. The decrease was due principally to the receipt of \$10.9 million of insurance proceeds related to the shareholder class action litigation, reduced by \$2.4 million of legal fees associated with the litigation. The amount of the settlement of these suits (\$82.5 million) was expensed in 2003.

Other expense net was \$7.9 million for the three months ended June 30, 2005, versus \$13.3 million for the comparable period in 2004. The decrease was due to lower foreign exchange losses in 2005 versus the comparable period in 2004, a gain of \$2.4 million in 2005 on the sale of an investment in equity securities, and lower interest expense in 2005 due to the favorable impact of interest rate swaps.

The effective income tax rate for the three months ended June 30, 2005 was 24.7% versus 29.3% for the comparable period in 2004. The effective rate for both periods was lower than the statutory rate in the United States due primarily to a higher proportion of earnings in jurisdictions having lower statutory tax rates (primarily Finland, which has a 26% and 29% statutory rate for 2005 and 2004, respectively) and a tax holiday from income taxes in Malaysia, partially offset by losses in the United States with no corresponding tax benefit.

Income from discontinued operations results from favorable translation adjustments of retained liabilities of businesses sold denominated in a foreign currency.

Net income was \$11.3 million, or \$0.40 per diluted share, for the three months ended June 30, 2005 versus \$17.7 million, or \$0.62 per diluted share, for the comparable period in 2004, due primarily to the aforementioned factors.

Cobalt

Net sales for the three months ended June 30, 2005 were \$133.6 million versus \$165.1 million for the comparable period in 2004. The decrease was due primarily to lower metal prices. Operating profit was \$6.4 million versus \$39.0 million for the comparable period in 2004. The

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decrease was due primarily to the sale of finished goods manufactured using higher cost raw materials that were purchased before the overall decrease in metal prices, lower metal selling prices, and the negative impact of a stronger euro against the U.S. dollar in 2005 compared to 2004.

The planned annual maintenance shutdown of the Company's cobalt refinery in Finland was completed on schedule during the second quarter of 2005 and the refinery has resumed normal production. The Company's joint venture in the DRC shut down its smelter as scheduled during January of 2005 for approximately four months for regular maintenance and production improvements. The smelter was re-opened in May of 2005.

### Nickel

Net sales for the three months ended June 30, 2005 were \$192.6 million versus \$166.3 million for the comparable period in 2004, due primarily to higher market prices for nickel. This increase was partially offset by slightly lower sales volumes due to lower availability of raw material feedstocks. Operating profit was \$14.5 million for each period. As a percentage of sales, operating profit in 2005 decreased to 7.5% from 8.7% in 2004, due primarily to higher smelting and refining costs due to a new tolling agreement at the Company's nickel refinery in Finland, an LCM charge of \$2.3 million due to decreasing nickel prices at the end of the quarter, lower volumes, and the impact of the stronger euro against the U.S. dollar in 2005 compared to 2004.

The planned annual maintenance shutdown of the company's Finland-based nickel refinery was completed on schedule during the second quarter of 2005 and the refinery has resumed normal production.

### Corporate expenses

Corporate expenses for the three months ended June 30, 2005 were \$0.5 million versus \$11.8 million for the comparable period in 2004. The amount in 2005 is reduced by the net insurance proceeds of \$8.5 million received during the second quarter related to the shareholder class action litigation. Before the impact of the insurance proceeds, corporate expenses in 2005 were \$9.0 million lower than the corresponding amount in 2004 due primarily to professional fees in 2004 associated with the audit committee investigation and restatement process.

### *Six Months Ended June 30, 2005 Compared to Six Months Ended June 30, 2004*

Net sales for the six months ended June 30, 2005 were \$666.6 million, a decrease of 2.0% versus \$680.4 million for the comparable period in 2004. The decrease in sales resulted principally from lower cobalt metal prices in 2005 versus 2004 and lower volumes, partially offset by the positive impact of higher nickel metal prices.

Gross profit decreased to \$96.4 million for the six month period ended June 30, 2005, versus \$182.6 million for the comparable period in 2004. The decrease in gross profit was principally due to lower selling prices as a result of the decrease in cobalt metal prices. Margins decreased due to the sale of cobalt finished goods manufactured using higher cost raw materials that were purchased before the overall decrease in cobalt metal prices, lower nickel sales volumes, a LCM charge of \$2.3 million in 2005 due to decreasing nickel metal prices at the end of the second quarter, higher smelting and refining costs due to a new tolling agreement at the Company's nickel refinery in Finland, the scheduled maintenance shut-down of the DRC smelter, and the negative impact of currency effects resulting from the stronger euro compared to the U.S. dollar.

Selling, general and administrative expenses decreased by \$10.8 million and as a percentage of sales to 8.4% in 2005 versus 9.8% in 2004. The decrease was principally due to 2004 charges to administrative expense of \$7.5 million related to the shareholder derivative lawsuits and \$2.8 million for executive compensation awards. The 2005 amount includes an \$8.7 million charge related to the former chief executive officer's separation agreement

and \$8.5 million of income related to the receipt of insurance proceeds related to the shareholder

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lawsuits.

Other expense net was \$17.2 million for the six months ended June 30, 2005, versus \$20.1 million for the comparable period in 2004. The decrease is due primarily to lower foreign exchange losses in 2005 versus the comparable period in 2004, and a gain of \$2.4 million in 2005 on the sale of an investment in equity securities.

The effective income tax rate for the six months ended June 30, 2005 was 24.7% versus 29.3% for the comparable period 2004. The effective tax rate for both periods was lower than the statutory rate in the United States due primarily to a higher proportion of earnings in jurisdictions having lower statutory tax rates (primarily Finland, which has a 26% and 29% statutory rate for 2005 and 2004, respectively) and a tax holiday from income taxes in Malaysia, partially offset by losses in the United States with no corresponding tax benefit.

Income from discontinued operations results from favorable translation adjustments of retained liabilities of businesses sold denominated in a foreign currency.

Net income was \$23.9 million, or \$0.84 per diluted share, for the six months ended June 30, 2005 versus \$65.9 million, or \$2.31 per diluted share, in 2004, due primarily to the aforementioned factors.

**Cobalt**

Net sales for the six months ended June 30, 2005 were \$293.6 million versus \$329.1 million for the comparable period in 2004. The decrease in sales was due primarily to lower cobalt metal prices compared to the prior year.

Operating profit for the period was \$14.5 million versus \$90.3 million for the comparable period in 2004. The decrease was due primarily to the sale of finished goods manufactured using higher cost raw materials that were purchased before the overall decrease in metal prices, lower metal selling prices, the scheduled maintenance shut-down of the smelter in the DRC in the first quarter of 2005, and the negative impact of a stronger euro against the U.S. dollar in 2005 compared to 2004.

**Nickel**

Net sales for the six months ended June 30, 2005 were \$400.5 million versus \$389.2 million for the comparable period in 2004, due primarily to higher metal market prices for nickel and improved volumes of nickel value-added products. This increase was partially offset by lower volumes of nickel metal products.

Operating profit for the six months ended June 30, 2005 was \$43.5 million versus \$58.5 million for the comparable period in 2004. The decline was due primarily to higher smelting and refining costs due to a new tolling agreement at the Finland nickel refinery, lower volumes, an LCM charge of \$2.3 million in 2005 due to decreasing nickel metal prices at the end of the second quarter, and the impact of the stronger euro compared to the U.S. dollar.

**Corporate expenses**

Corporate expenses for the six months ended June 30, 2005 were \$17.3 million versus \$32.7 million for the comparable period in 2004. The decrease was due principally to charges in 2004 of \$7.5 million related to the shareholder derivative lawsuits and \$2.8 million for executive compensation. Corporate expenses in 2005 include a charge of \$8.7 million related to the former chief executive officer's separation agreement, which was substantially offset by the income from the receipt of net insurance proceeds of \$8.5 million related to the shareholder class action lawsuits. Spending also decreased in 2005 due to higher professional fees in the comparable period in 2004 associated with the audit committee investigation and restatement process.



**Table of Contents****Liquidity and Capital Resources**

Operating activities provided cash of \$19.2 million during the six months ended June 30, 2005 versus providing cash of \$10.9 million for the comparable period in 2004. Income from continuing operations for the six months ended June 30, 2005 was \$22.3 million, which represents a decrease of \$43.6 million versus the comparable period in 2004, as a result of the factors discussed above. Accounts receivable at June 30, 2005 decreased \$21.7 million compared to December 31, 2004 primarily due to lower sales in the second quarter of 2005 compared to the fourth quarter of 2004. Inventories at June 30, 2005 decreased \$53.3 million compared to December 31, 2004 due primarily to lower cobalt metal prices and lower nickel inventory quantities. Advances to suppliers decreased \$18.9 million compared to December 31, 2004 due to the timing of the shipments of inventory at December 31, 2004 compared to June 30, 2005 that required prepayment to suppliers. Accounts payable decreased by \$26.6 million compared to the fourth quarter of 2004, which corresponds with lower inventory levels. Cash of \$74.0 million was paid into escrow during the second quarter of 2005 related to the settlement of the shareholder class action litigation. Such amount is classified separately as Restricted cash in escrow on the Condensed Consolidated Balance Sheet at June 30, 2005. The Company had no ability to use this amount in escrow for any purpose.

Capital expenditures for the six months ended June 30, 2005 and 2004 were \$8.7 million and \$6.4 million, respectively, primarily related to ongoing projects to maintain current operating levels.

During the second quarter of 2005, the Company received \$4.5 million from the sale of an investment in equity securities, and recognized a gain of \$2.4 million on the sale.

During the second quarter of 2005, the Company borrowed \$49.9 million against its revolving credit facility to fund a portion of the monies paid into escrow related to the shareholder class action litigation. Such borrowings were repaid during the quarter with cash provided by operations.

The Senior Subordinated Notes (the Notes) bear interest at 9.25% and mature on December 15, 2011. The Company's domestic subsidiaries are the guarantors of the Notes. The delay by the Company in filing its Form 10-K for the year ended December 31, 2003 caused events of default under the indenture governing the Notes, and the Company reclassified the Notes from long-term to current as of March 31, 2004, which was the date the 2003 Form 10-K was due. The Company filed its 2003 Form 10-K on March 31, 2005 and filed its Form 10-Qs for each of the first three quarters of 2004 on June 10, 2005. The delay by the Company in filing its Form 10-K for the year ended December 31, 2004 and its Form 10-Q for the first quarter of 2005, resulted in new events of default under the indenture governing the Notes. Also, on August 17, 2005, the trustee for the Notes furnished a notice of default to the Company with respect to the delay by the Company in filing its Form 10-Q for the second quarter of 2005. Such delay would have become an event of default if the Form 10-Q for the second quarter of 2005 were not filed by October 16, 2005. However, the Company filed its 2004 Form 10-K on August 22, 2005 and is filing its Form 10-Qs for the first and second quarter of 2005 on September 23, 2005. On August 30, 2005, the trustee for the Notes furnished a letter to the Company that gave the Company until October 29, 2005 to furnish to the trustee an annual compliance certificate required under the indenture governing the Notes in order to avoid an event of default under that indenture. In the event the Company is unable to avoid an event of default, the noteholders, or the indenture trustee at the direction of the noteholders, would have the right but would not be obligated, to accelerate payment of these Notes. The Company cannot predict whether they would do so if an event of default were to occur. If any such acceleration were to occur, based on discussions with the Company's lead bank, the Company believes it would be able to refinance such obligation on a long-term basis. Further, because the noteholders had the right to accelerate payments of the Notes at the time of filing the Form 10-K for the year ended December 31, 2004, the report of the Company's independent registered public accounting firm dated August 19, 2005 contains an explanatory paragraph indicating conditions that raise substantial doubt about the





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Company's ability to continue as a going concern.

On August 7, 2003, the Company entered into a \$150 million Senior Secured Revolving Credit Facility with a group of lending institutions. The facility bears interest at a rate of LIBOR plus 2.00% to 3.00% or PRIME plus 0.25% to 1.25% and matures in August 2006. There were no borrowings under this facility at June 30, 2005. Because of the delay by the Company in filing required periodic reports with the SEC during 2004, the Company failed to comply with specific covenants in the related credit agreement and events of default occurred under the credit agreement. Due to the filing of the Form 10-Qs for the first and second quarter of 2005 on September 23, 2005, the Company will no longer be in default and will be entitled to borrow under the credit agreement.

During December 2003, the Company borrowed \$22.9 million from a Belgium bank. This loan bore interest at a rate of LIBOR plus 2.75% and was scheduled to mature in December 2008. In November 2004, the Company refinanced this loan with a Finland bank, resulting in a new principal balance of \$23.0 million. The refinanced loan has an interest rate of LIBOR plus 1.25% and is payable in 48 equal installments beginning in January 2005 and ending December 2008. Simultaneous to the initial borrowing, the proceeds were loaned by the Company to one of its DRC smelter joint venture partners. The loan receivable is recorded in Receivables from joint venture partner, bears interest at LIBOR plus 2.75% and matures in December 2008.

The Company has generated sufficient cash from operations during 2005 to provide for its working capital, debt service and capital expenditure requirements. The Company believes that it will have sufficient cash provided by operations and available from its credit facility to provide for its working capital, debt service, litigation settlement and capital expenditure requirements for the remainder of 2005 and 2006.

The Company is a defendant in shareholder class action and derivative lawsuits alleging securities law violations relating to the decline in the Company's stock price following the third quarter 2002 earnings announcement. The status of such lawsuits is described in Note D to the condensed consolidated financial statements included in this quarterly report.

### **Critical Accounting Policies**

The condensed consolidated financial statements include the accounts of the company and all majority-owned subsidiaries. The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions in certain circumstances that affect amounts reported in the accompanying condensed consolidated financial statements and related footnotes. In preparing these condensed consolidated financial statements, management has made its best estimates and judgments of certain amounts included in the condensed consolidated financial statements, giving due consideration to materiality. Application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ from these estimates. During the first six months of 2005, there were no changes in the Company's critical accounting policies as disclosed in its Form 10-K filed for the year ended December 31, 2004.

### **Cautionary Statement for Safe Harbor Purposes**

The Company is making this statement in order to satisfy the "safe harbor" provisions contained in the Private Securities Litigation Reform Act of 1995. This report contains statements that the Company believes may be "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are not historical facts and generally can be identified by use of statements that include phrases such as believe, expect, anticipate, intend, plan, foresee or other words or phrases of similar import. Similarly, statements that describe the Company's objectives, plans or goals also are forward-looking statements.

These forward-looking statements are subject to risks and uncertainties that are difficult to predict, may be beyond the Company's control and could cause actual results to differ materially from

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those currently anticipated.

Important factors that may affect the Company's expectations, estimates or projections include:

the completion of the settlement of the derivative lawsuits filed against certain of the Company's former executives and certain of its current and former directors in a manner that is consistent with the agreement in principle reached with the lead plaintiffs in such lawsuits;

the speed and sustainability of price changes in cobalt and nickel;

the potential for lower of cost or market write-downs of the carrying value of inventory necessitated by decreases in the market prices of cobalt and nickel;

the availability of competitively priced supplies of raw materials, particularly cobalt and nickel;

the effect of the Company's inability to meet the SEC and NYSE filing obligations on a timely basis upon funding availability under the Company's credit facilities or upon debt obligations outstanding;

the effect of the Company not completing the documentation and testing of its internal controls over financial reporting such that management of the Company and its independent registered public accounting firm are unable to report as to such internal control over financial reporting;

the risk that new or modified internal controls, implemented in response to the 2004 investigation by the audit committee of the Company's board of directors and the Company's examination of its internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act, are not effective and need to be improved, resulting in additional expense;

the demand for metal-based specialty chemicals and products in the Company's markets;

the effect of fluctuations in currency exchange rates on the Company's international operations;

the effect of non-currency risks of investing and conducting operations in foreign countries, including political, social, economic and regulatory factors;

the outcome of the previously announced SEC Division of Enforcement review of the investigation conducted by the Company's audit committee; and

the general level of global economic activity and demand for the Company's products.

The Company does not assume any obligation to update these forward-looking statements.

**Item 3 Quantitative and Qualitative Disclosures About Market Risk**

A discussion of market risk exposures is included in Part II, Item 7a, "Quantitative and Qualitative Disclosure About Market Risk", of the Company's 2004 Annual Report on Form 10-K. The Company's exposure to market risk did not change materially between December 31, 2004 and June 30, 2005.

**Item 4 Controls and Procedures**

(a) Evaluation of Disclosure Controls and Procedures

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Management of the Company, under the supervision and with the participation of the chief executive officer, the former interim chief executive officer and the chief financial officer, carried out an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of June 30, 2005. As defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act), disclosure controls and procedures are controls and procedures designed to ensure that information required to be disclosed in reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported on a timely basis.

In August 2005, the Company received a material weakness letter from its independent registered public accounting firm indicating the Company maintained inadequate controls over the financial statement close process. These control deficiencies, which relate primarily to the Americas operating location, resulted in errors in the depreciation of fixed assets, amortization of intangible assets, deferral of costs, valuation of inventory, recording of accruals, revenue recognition, classification of certain assets and liabilities and elimination of intercompany profit in inventory. These errors resulted in adjustments to such accounts. When aggregated, these control deficiencies constitute a material weakness over the financial statement close process. Further, the Company maintained inadequate controls over the recording of income tax contingency reserves and deferred income tax assets, liabilities and the related valuation allowance. These control deficiencies resulted in adjustments to such accounts.

Based on their evaluation, the chief executive officer and the chief financial officer have concluded that the Company's disclosure controls and procedures were not effective as of June 30, 2005 in timely alerting them to material information relating to the Company and its subsidiaries that is required to be included in the Company's SEC filings.

**(b) Changes in Internal Controls**

As a result of the evaluation referenced above, and as part of the Company's continuing activities pursuant to the provisions of Section 404 of the Sarbanes-Oxley Act, the Company has made many changes that improve its internal control environment. Changes that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting, are summarized below:

The Company has changed its financial management to improve the quality of the team. Some of these changes include: (1) chief financial officer, (2) corporate controller, (3) group controllers for cobalt and nickel, (4) treasurer, (5) tax manager, (6) director of internal audit, (7) hiring of additional accounting staff at both the corporate and cobalt groups and (8) elimination of the information technologies team, replacing them with an outsourced, professionally managed company.

The Company is in the process of shifting all original accounting from corporate to the operating units. Two group controllers manage these operating unit accounting personnel and are primarily responsible for consolidated group accounting results. Corporate accounting is now a part of the oversight, review and consultation process. The shifting of the original accounting to the operating unit level has resulted in improved communication and interaction among the unit controllers, group controllers and corporate accounting.

The Company has implemented improved internal controls and efficiencies with respect to its monthly, quarterly and year-end financial statement close processes. Two key controls implemented are as follows: (1) formal quarterly meetings among the chief executive officer, chief financial officer, group vice presidents, corporate controller and group controllers are held to discuss all significant and/or judgmental issues, facts and circumstances as well as accounting treatment of each issue, and a summary of the issues and conclusions is then shared with the audit committee and the Company's independent registered public accounting firm; and (2) the group vice presidents and corporate and group controllers sign an internal representation letter each quarter regarding their respective results, which cascade up to the chief executive officer and chief financial officer certifications pursuant to

Sections 302 and 906 of the Sarbanes-Oxley Act.

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The Company has made improvements to its consolidation process, including enhanced operating unit reporting, improved chart of accounts, better use of the system for financial analysis, budget to actual variance analysis, tighter system security and placing responsibility with the operating unit controllers to reconcile intercompany accounts. With these changes in place, more tools are available for management's financial analysis.

A formal monthly financial calendar is in place and communicated to the operating unit controllers to establish responsibilities and due dates. The goal is a more consistent, timely closing process at the operating units, which will allow more time for analysis by the group controllers and corporate accounting.

The Company has developed revised monthly management reports to communicate more timely and relevant financial information to the entire management group (including operating units). The Company has made many improvements in this area during the last half of 2004 and first half of 2005, including continually challenging the specific content included in the report based on input from users, as well as involving unit controllers in validating the information provided.

The Company has made significant improvements to its information systems, the controls surrounding these systems and the users understanding of how they can be used to improve business processes. Daily transactional accuracy and thoroughness has improved significantly resulting in far less month end corrections and customer/vendor errors.

The Company created a worldwide whistleblower program managed by human resources, completely independent of its operating units and corporate.

The people, process and technology enhancements outlined above significantly overlap with continuing activities pursuant to the provisions of Section 404 of the Sarbanes-Oxley Act. During the fourth quarter of 2003, the Company engaged external assistance to work with management to identify internal control deficiencies and suggest remediation. Through the fourth quarter of 2004, the Company has spent approximately \$2 million on this external assistance. Although this process is not completed, it has resulted in more formalized, company-wide financial policies and procedures to standardize and improve processes and controls; improved procedures related to reconciliation of key accounts; improved segregation of duties; enhanced oversight and review by management; and access restrictions to critical systems.

By implementing the above actions, the Company believes that issues raised by the material weakness letter received from the independent registered public accounting firm have been or are in the process of being remediated.

## **Part II Other Information**

### **Item 1 Legal Proceedings**

The Company is a party to certain shareholder class action and derivative lawsuits related to the decline in the Company's stock price after the third quarter of 2002 earnings announcement. A description of this litigation, including material developments occurring during the period covered by this report, is included in Note D to the condensed consolidated financial statements included in this quarterly report.

### **Item 6 Exhibits**

(12) Computation of Ratio of Earnings to Fixed Charges

(31.1) Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

(31.2) Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

(32) Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

September 23, 2005

OM GROUP, INC.

/s/ R. Louis Schneeberger

R. Louis Schneeberger

Chief Financial Officer

(Duly authorized signatory of OM Group, Inc.)