

Edgar Filing: HERCULES INC - Form 10-Q

HERCULES INC  
Form 10-Q  
May 15, 2003

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 March 31, 2003  
Commission file number 1-496

HERCULES INCORPORATED

A Delaware corporation  
I.R.S. Employer Identification No. 51-0023450  
Hercules Plaza  
1313 North Market Street  
Wilmington, Delaware 19894-0001  
Telephone: 302-594-5000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes: ☒ No: ☐

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

Yes: ☒ No: ☐

As of April 30, 2003, 109,914,973 shares of registrant's common stock were outstanding.

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

HERCULES INCORPORATED  
CONSOLIDATED STATEMENT OF OPERATIONS

(Dollars in millions, except per share)

	(Unaudited) Three Months March 31 ----- 2003 -----
Net sales	\$ 441
Cost of sales (Note 7)	281
Selling, general and administrative expenses	90

# Edgar Filing: HERCULES INC - Form 10-Q

Research and development	10
Intangible asset amortization (Note 5)	2
Other operating (income) expense, net (Note 8)	(1)
	-----
Profit from operations	59
Interest and debt expense	19
Preferred security distributions of subsidiary trusts	15
Other expense, net (Note 9)	4
	-----
Income (loss) before income taxes and equity income (loss)	21
Provision for income taxes	8
	-----
Income (loss) before equity income (loss)	13
Equity income (loss) of affiliated companies, net of tax	--
	-----
Net income (loss) from continuing operations before discontinued operations and cumulative effect of changes in accounting principle	13
Net loss on discontinued operations, net of tax (Note 4)	--
	-----
Net income (loss) before cumulative effect of changes in accounting principle	13
Cumulative effect of changes in accounting principle, net of tax (Notes 5 and 13)	(28)
	-----
Net loss	\$ (15)
	=====
Basic and diluted earnings (loss) per share (Note 6)	
Continuing operations	\$ 0.12
Discontinued operations	\$ --
Cumulative effect of changes in accounting principle	\$ (0.26)
Net loss	\$ (0.14)
Weighted-average number of shares - basic (millions)	109.5
Weighted-average number of shares - diluted (millions)	109.7

See accompanying notes to consolidated financial statements.

2

## HERCULES INCORPORATED CONSOLIDATED BALANCE SHEET

(Dollars in millions)	(Unaudited) March 31, 2003	December 31, 2002
	-----	-----
ASSETS		
Current assets		
Cash and cash equivalents	\$ 218	\$ 209
Restricted cash (Note 11)	125	125
Accounts and notes receivable (net of allowance for doubtful accounts of \$12 million)	368	360
Inventories		

# Edgar Filing: HERCULES INC - Form 10-Q

Finished products	91	88
Materials, supplies, and work in process	86	79
Deferred income taxes	39	46
	-----	-----
Total current assets	927	907
Property, plant, and equipment	1,949	1,925
Accumulated depreciation and amortization	(1,286)	(1,262)
	-----	-----
Net property, plant, and equipment	663	663
Intangible assets, net (Note 5)	196	198
Goodwill, net (Note 5)	477	468
Deferred income taxes	20	15
Other assets	414	442
	-----	-----
Total assets	\$ 2,697	\$ 2,693
	=====	=====
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities		
Accounts payable	\$ 167	\$ 176
Accrued expenses	273	295
Short-term debt (Note 11)	145	145
	-----	-----
Total current liabilities	585	616
Long-term debt (Note 11)	733	738
Deferred income taxes	71	80
Postretirement benefits and other liabilities	792	758
Commitments and contingencies (Note 14)	--	--
Company-obligated preferred securities of subsidiary trusts (Note 12)	625	624
Stockholders' deficit		
Series preferred stock	--	--
Common stock (shares issued: 2003 - 159,984,444; 2002 - 159,984,444)	83	83
Additional paid-in capital	667	682
Unearned compensation	(89)	(93)
Accumulated other comprehensive losses	(434)	(454)
Retained earnings	1,468	1,483
	-----	-----
	1,695	1,701
Reacquired stock, at cost (shares: 2003 - 50,061,718; 2002 - 50,615,487)	(1,804)	(1,824)
	-----	-----
Total stockholders' deficit	(109)	(123)
	-----	-----
Total liabilities and stockholders' deficit	\$ 2,697	\$ 2,693
	=====	=====

See accompanying notes to consolidated financial statements.

# Edgar Filing: HERCULES INC - Form 10-Q

Three Mo

200

Net cash provided by (used in) operating activities of continuing operations

\$

## CASH FLOW FROM INVESTING ACTIVITIES:

Capital expenditures

Proceeds of investment and fixed asset disposals

Other, net

Net cash (used in) provided by investing activities of continuing operations

## CASH FLOW FROM FINANCING ACTIVITIES:

Long-term debt proceeds

Long-term debt repayments

Change in short-term debt

Common stock issued

Net cash used in financing activities of continuing operations

Net cash provided by discontinued operations

Effect of exchange rate changes on cash

Net increase (decrease) in cash and cash equivalents

Cash and cash equivalents - beginning of period

Cash and cash equivalents - end of period

\$

## SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Cash paid during the period for:

Interest

Preferred security distributions of subsidiary trusts

Income taxes

Non-cash investing and financing activities:

Incentive and other employee benefit stock plan

\$

See accompanying notes to consolidated financial statements.

HERCULES INCORPORATED

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)

(Dollars in millions)

(Unaudited)  
Three Months Ended  
March 31,

2003 2002

Net loss	\$ (15)	\$ (580)
Foreign currency translation	20	(55)

# Edgar Filing: HERCULES INC - Form 10-Q

Comprehensive income (loss)	----- \$ 5 =====	----- \$ (635) =====
-----------------------------	------------------------	----------------------------

See accompanying notes to consolidated financial statements.

5

## HERCULES INCORPORATED NOTES TO FINANCIAL STATEMENTS (UNAUDITED)

1. These condensed consolidated financial statements and the notes to the consolidated financial statements of Hercules Incorporated ("Hercules" or the "Company") are unaudited as of and for the three months ended March 31, 2003 and 2002, but in the opinion of management include all adjustments necessary to present fairly in all material respects Hercules' financial position and results of operations for the interim periods. These condensed consolidated financial statements should be read in conjunction with the accounting policies, financial statements and notes included in Hercules' Annual Report on Form 10-K for the year ended December 31, 2002. Certain prior period amounts have been reclassified to conform to the current period presentation.

### 2. Stock-based Compensation

Compensation costs attributable to stock option and similar plans are recognized based on any excess of the quoted market price of the stock on the date of grant over the amount the employee is required to pay to acquire the stock (the intrinsic-value method under Accounting Principles Board Opinion 25 ("APB 25")). Such amount, if any, is accrued over the related vesting period, as appropriate. Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123") and the related amendments in Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" ("SFAS 148") require companies electing to continue to use the intrinsic-value method to make pro forma disclosures of net income and earnings per share as if the fair value based method of accounting had been applied.

Pursuant to the disclosure requirements of SFAS 123, as amended by SFAS 148, the following table presents the pro forma effect on net loss and loss per share assuming the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation.

(Dollars in millions, except per share)	Three Months Ended March 31,	
	2003	2002
Net loss, as reported	\$ (15)	\$ (580)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax	2	3
Pro forma net loss	\$ (17)	\$ (583)
Loss per share:		

## Edgar Filing: HERCULES INC - Form 10-Q

Basic - as reported	\$ (0.14)	\$ (5.32)
	=====	=====
Basic - pro forma	\$ (0.16)	\$ (5.35)
	=====	=====
Diluted - as reported	\$ (0.14)	\$ (5.32)
	=====	=====
Diluted - pro forma	\$ (0.16)	\$ (5.35)
	=====	=====

### 3. Recent Accounting Pronouncements

In January 2003, the FASB issued FASB Interpretation No. 46, "Consolidation of Certain Variable Interest Entities" ("FIN 46") ("VIEs"), which is an interpretation of Accounting Research Bulletin No. 51, "Consolidated Financial Statements" ("ARB 51"). FIN 46 addresses the application of ARB 51 to VIEs, and generally would require that assets, liabilities and results of the activity of a VIE be consolidated into the financial statements of the enterprise that is considered the primary beneficiary. The provisions of FIN 46 apply on a prospective basis to VIEs created after January 31, 2003 and become effective after June 30, 2003 for VIEs the Company had prior to January 31, 2003. The Company currently has two joint-venture VIEs that are presently accounted for using the equity method of accounting. These entities serve as strategic global marketers of the Company's bicomponent fibers. The assets and liabilities of these entities are not consolidated within the Company's financial statements. There are no assets of the Company that serve as collateral for the VIEs and the creditors of the VIEs have no recourse to the general credit of the Company.

In April 2003, the FASB issued Statement of Financial Accounting Standards No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" ("SFAS 149"). SFAS 149 incorporates provisions

6

that were clarified by the Derivatives Implementation Group. The provisions of SFAS 149 should be applied prospectively to contracts entered into after June 30, 2003. The Company does not believe this statement will have a material effect on its financial statements.

### 4. Discontinued Operations

On April 29, 2002, the Company completed the sale of the BetzDearborn Water Treatment Business (the "Water Treatment Business") to GE Specialty Materials, a unit of General Electric Company. The sale price was \$1.8 billion in cash, resulting in net after-tax proceeds of approximately \$1.7 billion. The Company used the net proceeds to prepay debt under its senior credit facility and ESOP credit facility (see Note 11). Pursuant to Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144") as adopted on January 1, 2002, the Water Treatment Business has been treated as a discontinued operation as of February 12, 2002 and accordingly, all financial information has been restated. The loss from discontinued operations for the three months ended March 31, 2002 includes an after-tax loss on the disposal of the business of \$230 million.

The Paper Process Chemicals Business, representing approximately one-third of the business of BetzDearborn Inc. when it was originally acquired in 1998, was fully integrated into and continues to be reported within Pulp and Paper.

## Edgar Filing: HERCULES INC - Form 10-Q

Summarized below are the results of operations of the Water Treatment Business for the three months ended March 31, 2002.

(Dollars in millions)	Three Months Ended March 31, 2002
	-----
Net sales	\$ 192
Profit from operations	33
Income before income taxes	35
Tax provision	14
	-----
Income from operations	21
Loss from disposal of business, including a provision for income taxes of \$51 million	(230)
	-----
Loss from discontinued operations	\$ (209)
	=====

Summarized below is the net cash flow provided by discontinued operations for the three months ended March 31, 2002.

(Dollars in millions)	Three Months Ended March 31, 2002
	-----
Net cash provided by operations	\$ 9
Capital expenditures	(2)
	-----
Net cash flow from discontinued operations	\$ 7
	=====

The major classes of assets and liabilities included in the consolidated balance sheet at the time of disposal were as follows:

(Dollars in millions)			
ASSETS		LIABILITIES	
Accounts receivable, net	\$ 160	Accounts payable	\$ 57
Inventory	76	Accrued expenses	46
Fixed assets	216	Deferred income taxes	171
Goodwill and other intangible assets	1,419	Other liabilities	6
			-----
Other assets	43		\$ 280
	-----		=====
	\$ 1,914		
	=====		

## Edgar Filing: HERCULES INC - Form 10-Q

### 5. Goodwill and Other Intangible Assets

Effective January 1, 2002, Hercules adopted the provisions of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"). Hercules identified the following reporting units: BetzDearborn, Pulp and Paper, Aqualon, FiberVisions and Pinova. In connection with Hercules' transitional review, recorded goodwill was determined to be impaired in the BetzDearborn and FiberVisions reporting units. In the first quarter of 2002, Hercules completed its transitional impairment review of the identified reporting units and recognized after-tax impairment losses of \$262 million in the BetzDearborn reporting unit and \$87 million in the FiberVisions reporting unit as a cumulative effect of a change in accounting principle. In addition, an after-tax impairment loss of \$19 million was recognized in the first quarter of 2002 relating to the Company's equity investment in CP Kelco, which had an impairment under SFAS 142. Pursuant to SFAS 142, the Company is required to perform an annual assessment of its reporting units for impairment. The annual assessment was performed as of November 30, 2002 and indicated no additional impairment to the Company's goodwill was warranted.

Accumulated amortization for goodwill upon adoption of SFAS 142 was \$185 million. The following table shows changes in the carrying amount of goodwill by operating segment for the three months ended March 31, 2003.

(Dollars in millions)	Performance Products -----	Engineered Materials and Additives -----	Total -----
Balance at December 31, 2002	\$ 383	\$ 85	\$ 468
Foreign currency translation	9	--	9
	-----	-----	-----
Balance at March 31, 2003	\$ 392	\$ 85	\$ 477
	=====	=====	=====

The following table provides information regarding the Company's other intangible assets with finite lives:

(Dollars in millions)	Customer Relationships -----	Trademarks & Tradenames -----	Other Intangibles -----	Total -----
Gross Carrying Amount				
Balance, December 31, 2002	\$ 89	\$ 70	\$ 95	\$ 254
Balance, March 31, 2003	89	70	95	254
Accumulated Amortization				
Balance, December 31, 2002	\$ 11	\$ 7	\$ 38	\$ 56
Balance, March 31, 2003	11	8	39	58

Total amortization expense for each of the three month periods ended March 31, 2003 and 2002 for other intangible assets was \$2 million and \$4 million, respectively, of which \$2 million was included in income from continuing operations for each of the three months ended March 31, 2003 and 2002. Estimated amortization expense for 2003 and the five succeeding fiscal years is \$9 million per year for 2003 and 2004 and \$8 million per year from 2005 through 2008.



# Edgar Filing: HERCULES INC - Form 10-Q

8

## 6. Earnings (Loss) Per Share

The following table shows the amounts used in computing earnings (loss) per share and the effect on net income (loss) and the weighted-average number of shares of dilutive potential common stock:

(Dollars in millions, except per share)	Three Months Ended March 31,	
	2003	2002
	Income (loss)	Earnings (loss) per share (Loss)
BASIC AND DILUTED:		
Continuing operations	\$ 13	\$ 0.12
Discontinued operations	--	--
Cumulative effect of changes in accounting principle	(28)	(0.26)
Net loss	\$ (15)	\$ (0.14)
Weighted-average number of shares - basic (millions)	109.5	109.0
Weighted-average number of shares - diluted (millions)	109.7	109.0

For the three months ended March 31, 2003 and 2002, the Company had convertible subordinated debentures which are convertible into approximately 0.2 million shares of common stock. However, the common stock shares into which these debentures are convertible have not been included in the dilutive share calculation for the three months ended March 31, 2002 because the impact of their inclusion would be anti-dilutive. The dilutive effect of the convertible debentures was included in the calculation for the three months ended March 31, 2003.

## 7. Depreciation Expense

Cost of sales and selling, general and administrative expenses include depreciation expense related to continuing operations of \$17 million and \$18 million for the three months ended March 31, 2003 and 2002, respectively.

## 8. Other Operating (Income) Expense, Net

Other operating (income) expense, net, for the three months ended March 31, 2003 and 2002 includes additional charges for severance benefits of \$2 million and \$4 million, respectively, associated with the comprehensive cost reduction and work process redesign program announced in September 2001 (see Note 10). The Company also recognized a \$3 million gain in the three months ended March 31, 2003 related to a favorable legal settlement. The Company recognized approximately \$1 million in environmental charges in the three months ended March 31, 2002.

## 9. Other Expense, Net

Other expense, net, for the three months ended March 31, 2003 and 2002 includes \$1 million and \$2 million, respectively, in net charges for asbestos-related costs (see Note 14), \$1 million and \$2 million, respectively, in bank charges and other charges of approximately \$3 million and \$1 million,

## Edgar Filing: HERCULES INC - Form 10-Q

respectively. Interest income of \$1 million was recognized in both periods. In addition, the three months ended March 31, 2002 included approximately \$1 million for litigation costs, a \$1 million foreign currency loss and a gain from the sale of assets of \$2 million. Litigation costs and asset sales primarily relate to former operations of the Company.

### 10. Restructuring

The consolidated balance sheet reflects liabilities for employee severance benefits and other exit costs of \$14 million and \$36 million at March 31, 2003 and 2002, respectively. During 2001, management authorized and committed to a plan to reduce the workforce as part of the comprehensive cost reduction and work process redesign program. Through December 31, 2002, the Company incurred charges related to this restructuring of \$76 million, which includes charges of \$68 million for employee termination benefits and \$8 million for exit costs related to facility closures. During the three months ended March 31, 2003, the accrual for severance benefits recognized in accordance with Statement of Financial Accounting Standards No. 112, "Employers' Accounting for Postemployment Benefits," increased by approximately \$2 million. Under this plan, approximately 1,364 employees have left or will leave the Company, of which approximately 1,260 employees were terminated through March 31, 2003. Approximately 46 employees were terminated during the three months ended March 31, 2003. The employees under the plan that have not been terminated will be terminated by December 31, 2003. The plan includes reductions throughout the Company with the majority of them from support functions.

Cash payments during the three months ended March 31, 2003 were \$10 million for severance benefits and other exit costs. Severance benefits paid during the quarter include the continuing benefit streams of previously

9

terminated employees as well as those terminated in the current period. Severance benefits were paid in accordance with the Company's standard severance pay plans, or in accordance with local practices outside the United States.

A reconciliation of activity with respect to the liabilities established for these plans is as follows:

(Dollars in millions)	March 31, 2003 -----	December 31, 2002 -----
Balance at beginning of year	\$ 22	\$ 43
Additional termination benefits and other exit costs	2	25
Cash payments	(10)	(39)
Reversals against goodwill	--	(3)
Reversals against earnings	--	(2)
Transferred with discontinued operations	--	(2)
	-----	-----
Balance at end of period	\$ 14 =====	\$ 22 =====

The balance at the end of the period represents severance benefits and other exit costs of which \$12 million pertains to the 2001 restructuring plan and \$2 million pertains to a prior year plan. The Company expects cash payments relating to these plans to be made over the next two years.

## Edgar Filing: HERCULES INC - Form 10-Q

Effective January 1, 2003, the Company adopted Statement of Financial Accounting Standards No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" ("SFAS 146"). SFAS 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs in a Restructuring)." SFAS 146 defines the timing of the recognition of costs associated with exit or disposal activities, the types of costs that may be recognized and the methodology for calculating the fair value of such costs. In the first quarter of 2003, the Company did not recognize any costs associated with exit or disposal activities pursuant to SFAS 146.

### 11. Debt

A summary of short-term and long-term debt follows:

(Dollars in millions)	March 31, 2003 -----	December 31, 2002 -----
SHORT-TERM:		
Banks	\$    --	\$     1
Current maturities of long-term debt	145	144
	-----	-----
	\$   145	\$   145
	=====	=====

Bank borrowings represent primarily foreign overdraft facilities and short-term lines of credit, which are generally payable on demand with interest at various rates. At March 31, 2003, the Company had \$15 million of unused short-term lines of credit that may be drawn as needed. There were no short-term lines of credit in use at March 31, 2003.

10

(Dollars in millions)	March 31, 2003 -----	December 31, 2002 -----
LONG-TERM:		
6.60% notes due 2027	\$   100	\$   100
6.625% notes due 2003	125	125
11.125% senior notes due 2007	400	400
8% convertible subordinated debentures due 2010	3	3
Term notes at various rates from 4.07% to 8.56% due in varying amounts through 2006	47	50
Term B loan due 2007	199	200
Other	4	4
	-----	-----
	878	882
Current maturities of long-term debt	(145)	(144)
	-----	-----
Net long-term debt	\$   733	\$   738
	=====	=====

## Edgar Filing: HERCULES INC - Form 10-Q

On December 20, 2002, the Company completed the refinancing of its existing senior credit facility with a new senior credit facility. The new senior credit facility consists of a four year \$125 million revolving credit agreement and a \$200 million term B loan due May 2007. In addition, the Company has the option of borrowing an additional \$50 million to \$150 million on terms identical to the term B loan. The incremental term loan will remain available until the earlier of December 20, 2005 or the repayment of the \$200 million term B loan. In conjunction with the execution of the credit agreement, \$125 million of the proceeds of the term B loan was placed into an escrow account to pay the principal amount of the 6.625% notes in June 2003. The escrow funds have been recognized as restricted cash on the Consolidated Balance Sheet. The term B loan bears interest at LIBOR + 3.25%. The revolving credit agreement bears interest at LIBOR plus an applicable margin, currently 2.75%, which is determinable based on the Company's leverage ratio. Interest rates are reset for one, two, three or six month periods at the Company's option.

The new senior credit facility is secured by liens on the Company's assets (including real, personal and intellectual properties) and is guaranteed by substantially all of the Company's current and future wholly-owned domestic subsidiaries.

As of March 31, 2003, \$58 million of the \$125 million revolver was available for use. The Company had outstanding letters of credit associated with the credit facility of \$67 million at March 31, 2003.

The Company's new senior credit facility requires quarterly compliance with certain financial covenants, including a debt/EBITDA ratio ("leverage ratio") and an interest coverage ratio and establishes limitations on the permitted amount of annual capital expenditures.

### 12. Company-obligated Preferred Securities of Subsidiary Trusts

Company-obligated Preferred Securities of Subsidiary Trusts consists of:

(Dollars in millions)	March 31, 2003 -----	December 31, 2002 -----
9.42% Trust Originated Preferred Securities	\$ 363	\$ 363
6 1/2% CRESTS Units	262	261
	-----	-----
	\$ 625	\$ 624
	=====	=====

### 13. Asset Retirement Obligations

Effective January 1, 2003, the Company adopted Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations" ("SFAS 143"). SFAS 143, which was issued in June 2001, establishes accounting and reporting standards for the recognition and measurement of legal obligations associated with the retirement of tangible long-lived assets. SFAS 143 requires that the fair value of an asset retirement obligation be recorded when incurred. Included within the scope of SFAS 143 are environmental remediation liabilities that resulted from the normal operation of a long-lived asset. The Company has a number of environmental remediation liabilities associated with current and former operations that were incurred during the course of normal operations. The most significant differences in the measurement of these obligations under SFAS 143 are outlined below:

# Edgar Filing: HERCULES INC - Form 10-Q

11

RECORDING OF FULL OBLIGATION: SFAS 143 requires that the fair value of an asset retirement obligation be recorded when it is incurred if a reasonable estimate of fair value can be made. Under SFAS 143, uncertainties (probability) in the amount and timing of settlement are incorporated into the fair value measure of the recognized liability, whereas under Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies," and FASB Interpretation 14, "Reasonable Estimation of the Amount of a Loss," uncertainties are considered in determining recognition of a liability.

PRESENT VALUE OF OBLIGATION: SFAS 143 requires that the fair value of the asset retirement obligation be discounted using a credit adjusted risk-free rate.

CAPITALIZATION OF COSTS RELATED TO ENVIRONMENTAL CONTAMINATION: SFAS 143 requires capitalization of costs as a component of fixed assets to the extent there is a corresponding operating asset. EITF 90-8, "Capitalization of Costs to Treat Environmental Contamination," permitted capitalization of environmental remediation costs incurred in preparing a property for sale.

With the adoption of SFAS 143, the Company recorded an increase to its environmental remediation liabilities of \$28 million with a corresponding increase to property, plant, and equipment of \$2 million and a decrease in capitalized environmental remediation costs of \$18 million, resulting in an after-tax charge of \$28 million (\$44 million on a pre-tax basis), or \$0.26 per share, as a cumulative effect of a change in accounting principle.

The following table provides a reconciliation of the changes in the asset retirement obligations during the period.

	SFAS 143 Adoption				
	Balance January 1, 2003	Cumulative Effect Adjustment	Capitalized Retirement Obligations	Liabilities (Incurred) Settled	Accretion
Capitalized remediation costs	\$ 18	\$ (18)	\$ --	\$ --	\$ --
Environmental Remediation					
Liabilities:					
SFAS 143 ARO sites	(85)	(26)	(2)	2	--
Non-SFAS 143 sites	(3)	--	--	(1)	--
	-----	-----	-----	-----	-----
	\$ (70)	\$ (44)	\$ (2)	\$ 1	\$ --
	=====	=====	=====	=====	=====

The accretion the Company recognized during the quarter was rounded to zero.

## 14. Commitments and Contingencies

### GUARANTEES

In November 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect

## Edgar Filing: HERCULES INC - Form 10-Q

Guarantees of Indebtedness of Others" ("FIN 45"). The initial recognition and measurement provisions of FIN 45 were applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The Company applied the initial recognition and measurement provisions on a prospective basis effective January 1, 2003. FIN 45 modifies existing disclosure requirements for most guarantees and requires that at the time a company issues a guarantee, the company must recognize an initial liability for the fair value of the obligation it assumes under that guarantee. The Company adopted the disclosure requirements of FIN 45 as of December 31, 2002. Disclosure about each group of similar guarantees is provided below:

### INDEMNIFICATIONS

In connection with the sale of Company assets and businesses, the Company has indemnified respective buyers against certain liabilities that may arise in connection with the sale transactions and business activities prior to the ultimate closing of the sale. The terms of these indemnifications typically pertain to environmental, tax, employee and/or product related matters. If the indemnified party were to incur a liability or have a liability increase as a result of a successful claim, pursuant to the terms of the indemnification, the Company would be required to protect, defend, and/or indemnify the buyer. These indemnifications are generally subject to threshold amounts, specified claim periods and/or other restrictions. The carrying amount recorded for all indemnifications as of March 31, 2003 was \$110 million.

In addition, in connection with these transactions, the Company has generally provided indemnifications on

12

general corporate matters such as ownership of the relevant assets, the power and corporate authority to enter into transactions and the satisfaction of liabilities not assumed by the buyer. These indemnifications generally have indefinite terms.

Although it is reasonably possible that future payments may exceed amounts accrued, due to the nature of indemnified items, it is not possible to make a reasonable estimate of the maximum potential loss or range of loss. Generally, there are no specific recourse provisions. Approximately \$1 million in cash is held in escrow or collateral to cover certain indemnifications related to the sale of a business in 2001.

In addition, the Company provides certain indemnifications in the ordinary course of business such as product, patent and performance warranties in connection with the manufacture, distribution and sale of its products and services. Due to the nature of these indemnities, it is not possible to make a reasonable estimate of the maximum potential loss or range of loss.

### DEBT OBLIGATIONS

The Company has directly guaranteed various debt obligations under agreements with third parties related to subsidiaries and affiliates, and/or other unaffiliated companies. At March 31, 2003, the Company had directly guaranteed \$23 million of such obligations. This represents the maximum principal amount of potential future payments that the Company could be required to make under the guarantees. Any applicable interest and expenses would generally be added to the amount of the obligations.

Directly guaranteed obligations include approximately \$8 million of outstanding obligations which are recorded as debt in the Company's Consolidated Financial Statements. Existing guarantees for subsidiaries and affiliates arose

## Edgar Filing: HERCULES INC - Form 10-Q

from liquidity needs in normal operations. The Company will be required to perform on these guarantees in the event of default by the guaranteed party.

### INTERCOMPANY GUARANTEES

The Company and its subsidiaries have intercompany guarantees between and among themselves which aggregate approximately \$165 million as of March 31, 2003. These guarantees relate to intercompany loans used to facilitate normal business operations. All of the \$165 million has been eliminated from the Company's Consolidated Financial Statements.

### ENVIRONMENTAL

In the ordinary course of its business, the Company is subject to numerous environmental laws and regulations covering compliance matters or imposing liability for the costs of, and damages resulting from, cleaning up sites, past spills, disposals and other releases of hazardous substances. Changes in these laws and regulations may have a material adverse effect on the Company's financial position and results of operations. Any failure by the Company to adequately comply with such laws and regulations could subject the Company to significant future liabilities.

Hercules has been identified as a potentially responsible party ("PRP") by U.S. federal and state authorities, or by private parties seeking contribution, for the cost of environmental investigation and/or cleanup at numerous sites. The range of the reasonably possible share of costs for the investigation and cleanup of current and former operating sites, and other locations where the Company may have a known liability is between \$115 million and \$225 million. The actual costs will depend upon numerous factors, including the number of parties found responsible at each environmental site and their ability to pay; the actual methods of remediation required or agreed to; outcomes of negotiations with regulatory authorities; outcomes of litigation; changes in environmental laws and regulations; technological developments; and the years and timing of remedial activity required, which could range from 0 to 30.

Hercules becomes aware of sites in which it may be named a PRP in investigatory and/or remedial activities through correspondence from the U.S. Environmental Protection Agency ("EPA") or other government agencies or from previously named PRPs, who either request information or notify the Company of its potential liability. The Company has established procedures for identifying environmental issues at its plant sites. In addition to environmental audit programs, the Company has environmental coordinators who are familiar with environmental laws and regulations and act as a resource for identifying environmental issues.

United States, et al. v. Vertac Corporation, et al., USDC No. LR-C-80-109 and LR-C-80-110 (E.D. Ark.)

This case, a cost-recovery action based upon the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA", or the Superfund statute), as well as other statutes, has been pending since 1980, and involves liability for costs expended and to be expended in connection with the investigation and remediation of the Vertac Chemical Company ("Vertac") site in Jacksonville, Arkansas. Hercules owned and operated the site from December 1961 until 1971. The site was used for the manufacture of certain herbicides and, at the order of the United

States, Agent Orange. In 1971, the site was leased to Vertac's predecessor. In 1976, Hercules sold the site to Vertac. The site was abandoned by Vertac in

## Edgar Filing: HERCULES INC - Form 10-Q

1987, and Vertac was subsequently placed into receivership. Both prior to and following the abandonment of the site, the EPA and the Arkansas Department of Pollution Control and Ecology ("ADPC&E") were involved in the investigation and remediation of contamination at and around the site. Pursuant to several orders issued pursuant to CERCLA, Hercules actively participated in many of these activities. The cleanup is essentially complete, except for certain on-going maintenance and monitoring activities. This litigation primarily concerns the responsibility and allocation of liability for the costs incurred in connection with these activities.

Although the case initially involved many parties, as a result of various United States District Court rulings and decisions, as well as a trial, Hercules and Uniroyal were held jointly and severally liable for the approximately \$100 million in costs allegedly incurred by the EPA, as well as costs to be incurred in the future. That decision was made final by the District Court on September 13, 1999. Both Hercules and Uniroyal timely appealed that judgment to the United States Court of Appeals for the Eighth Circuit.

On February 8, 2000, the District Court issued a final judgment on the allocation between Hercules and Uniroyal finding Uniroyal liable for 2.6 percent and Hercules liable for 97.4 percent of the costs at issue. Hercules timely appealed that judgment. Oral argument on both appeals was held before the Eighth Circuit on June 12, 2000. On April 10, 2001, the United States Court of Appeals for the Eighth Circuit issued an opinion in the consolidated appeals described above. In that opinion, the Appeals Court reversed the District Court's decision which had held Hercules jointly and severally liable for costs incurred and to be incurred at the Jacksonville site, and remanded the case back to the District Court for several determinations, including a determination of whether the harms at the site giving rise to the government's claims were divisible. The Appeals Court also vacated the District Court's allocation decision holding Hercules liable for 97.4 percent of the costs at issue, ordering that these issues be revisited following further proceedings with respect to divisibility. Finally, the Appeals Court affirmed the judgment of liability against Uniroyal.

The trial on remand commenced on October 8, 2001, continued through October 19, 2001, resumed on December 11, 2001 and concluded on December 14, 2001. At the trial, the Company presented both facts and law to the District Court in support of its belief that the Company should not be liable under CERCLA for some or all of the costs incurred by the government in connection with the site because those harms are divisible. The District Court has not yet rendered its decision. Should the Company prevail on remand, any liability to the government will be either eliminated or reduced from the prior judgment.

Hercules Incorporated v. Aetna Casualty & Surety Company, et al., Del. Super., C.A. No. 92C-10-105 and 90C-FE-195-1-CV (consolidated).

In 1992, Hercules brought suit against its insurance carriers for past and future costs for cleanup of certain environmental sites. In April 1998, the trial regarding insurance recovery for the Jacksonville, Arkansas, site (see discussion above) was completed. The jury returned a "Special Verdict Form" with findings that, in conjunction with the Court's other opinions, were used by the Court to enter a judgment in August 1999. The judgment determined the amount of Hercules' recovery for past cleanup expenditures and stated that Hercules is entitled to similar coverage for costs incurred since September 30, 1997 and in the future. Hercules has not included any insurance recovery in the estimated range of costs above. Since entry of the Court's August 1999 order, Hercules has entered into settlement agreements with several of its insurance carriers and has recovered certain settlement monies. The terms of those settlements and the amounts recovered are confidential. On August 15, 2001, the Delaware Supreme Court issued a decision in Hercules Incorporated v. Aetna Casualty & Surety Company, et al., Del. Super., C.A. No. 92C-10-105 and 90C-FE-195-1-CV (consolidated). In its decision, the Delaware Supreme Court affirmed the trial



## Edgar Filing: HERCULES INC - Form 10-Q

court in part, reversed the trial court in part and remanded the case for further proceedings. The specific basis upon which the Delaware Supreme Court reversed the trial court was the trial court's application of pro rata allocation to determine the extent of the insurers' liability. Following settlements with two additional insurers, the terms of which are confidential, Hercules decided not to pursue this litigation against the remaining defendants. This matter was dismissed with prejudice on or about February 3, 2003.

The Allegany Ballistics Laboratory ("ABL") is a government-owned facility which was operated by Hercules from 1945 to 1995 under contract with the United States Department of the Navy. The Navy has notified Hercules that they would like to negotiate with Hercules with respect to certain environmental liabilities which, the Navy alleges, are attributable to Hercules' past operations at ABL. The Navy alleges that, pursuant to CERCLA, it has spent a total of \$24.8 million and expects to spend an additional \$60 million over the next 10 years. The Company is currently investigating the Navy's allegations, including the basis of the Navy's claims, and whether the contracts with the government pursuant to which the Company operated ABL may insulate the Company from some or all of the amounts

14

sought. At this time, however, the Company cannot reasonably estimate its liability, if any, with respect to ABL and, accordingly, has not included this site in the range of its environmental liabilities reported above.

At March 31, 2003, the accrued liability for environmental remediation was \$115 million. The extent of liability is evaluated quarterly based on currently available information, including the progress of remedial investigations at each site and the current status of negotiations with regulatory authorities regarding the method and extent of apportionment of costs among other PRPs. While it is not feasible to predict the outcome of all pending suits and claims, the ultimate resolution of these environmental matters could have a material effect upon the results of operations and the financial position of Hercules, and the resolution of any of these matters during a specific period could have a material effect on the quarterly or annual results of that period.

### LITIGATION

The Company is a defendant in numerous asbestos-related personal injury lawsuits and claims which typically arise from alleged exposure to asbestos fibers from resin encapsulated pipe and tank products which were sold by one of the Company's former subsidiaries to a limited industrial market ("products claims"). The Company is also a defendant in lawsuits alleging exposure to asbestos at facilities formerly or presently owned or operated by the Company ("premises claims"). Claims are received and settled or otherwise resolved on an on-going basis. In late December 1999, the Company entered into a settlement agreement to resolve the majority of the claims then pending. In connection with that settlement, the Company also entered into an agreement with several of the insurance carriers which sold that former subsidiary primary and first level excess insurance policies. Under the terms of that agreement, the majority of the amounts paid to resolve those products claims were insured, subject to the limits of the insurance coverage provided by those policies. The terms of both settlement agreements are confidential.

Since entering into those agreements, the Company has continued to receive and settle or otherwise resolve claims on an on-going basis. Between January 1, 2002 and December 31, 2002, the Company received approximately 11,000 new claims, approximately half of which were included in "consolidated" complaints naming anywhere from one hundred to thousands of plaintiffs and a large number of defendants, but providing little information connecting any specific

## Edgar Filing: HERCULES INC - Form 10-Q

plaintiff's alleged injuries to any specific defendant's products or premises. It is the Company's belief that a significant majority of these "consolidated" claims will be dismissed for no payment. During that same time period, the Company also received approximately 13,000 other new claims, most of which were included in "consolidated" complaints, which have either been dismissed without payment or are in the process of being dismissed without payment, but with plaintiffs retaining the right to re-file should they be able to establish exposure to an asbestos-containing product for which the Company bears liability. Between January 1, 2003 and March 31, 2003, the Company received approximately 6,380 new claims, of which approximately 4,040 claims were included in "consolidated" complaints. The Company is continuing to evaluate whether the claims experience of 2002 and the first quarter of 2003, which represents a significant increase over prior years, is an anomaly or a new trend.

With respect to total claims pending, as of March 31, 2003, there were approximately 21,180 unresolved claims, of which approximately 1,055 were premises claims. There were also approximately 2,220 unpaid claims which have been settled or are subject to the terms of a settlement agreement. In addition, as of March 31, 2003, there were approximately 13,340 claims (including the 13,000 claims noted in the above paragraph) which have been dismissed without payment or are in the process of being dismissed without payment.

The Company anticipates that the primary and first level excess insurance policies referenced above will likely exhaust over the next 1 to 2 months, assuming that the rate of settlements and payments remains relatively consistent with the Company's past experience. Nonetheless, based on the current number of claims pending, the amounts the Company anticipates paying to resolve those claims which are not dismissed or otherwise resolved without payment, and anticipated future claims, the Company believes that it and its former subsidiary together have sufficient additional insurance to cover the majority of its current and estimated future asbestos-related liabilities, as discussed in the paragraph below.

The foregoing is based on the Company's assumption that the number of future claims filed per year and claim resolution payments will vary considerably from year-to-year and by plaintiff, disease, venue, and other circumstances, but will, when taken as a whole, remain relatively consistent with the Company's experience to date and will decline as the population of potential future claimants expires due to non-asbestos-related causes. It is also based on the preliminary results of the study discussed below, the Company's evaluation of potentially available insurance coverage and its review of the relevant case law. However, the Company recognizes that the number of future claims filed per year and claim resolution payments could greatly exceed those reflected by its past experience and contemplated by the study referenced below, that the Company's belief of the range of its reasonably possible financial exposure could

change as the study referenced below continues, that its evaluation of potentially available insurance coverage may change depending upon numerous variables including risks inherent in litigation and the risk that one or more insurance carriers may refuse or be unable to meet its obligations to the Company, and that conclusions resulting from its review of relevant case law may be impacted by future court decisions or changes in the law.

The Company is seeking defense and indemnity payments or an agreement to pay from those carriers responsible for excess coverage whose levels of coverage have been or will soon be reached. Although those excess carriers have not yet agreed to defend or indemnify it, the Company believes that it is likely that

## Edgar Filing: HERCULES INC - Form 10-Q

they will ultimately agree to do so, and that the majority of its estimated future asbestos-related costs will ultimately be paid or reimbursed by those carriers. However, if the Company is not able to reach satisfactory agreements with those carriers prior to exhaustion of the primary and first level excess insurance policies now covering the majority of its current asbestos-related claims, then, beginning as early as the second quarter of 2003, the Company might be required to completely fund these matters while it seeks reimbursement from its carriers. In order to maximize the likelihood of obtaining insurance payments for these liabilities, on November 27, 2002, the Company initiated litigation against its excess insurance carriers in a matter captioned Hercules Incorporated v. OneBeacon, et al., Civil Action No. 02C-11-237 (SCD), Superior Court of Delaware, New Castle County. Notwithstanding the filing of this litigation, the Company is continuing settlement discussions with several of its key insurers.

The Company has commissioned a study of its asbestos-related liabilities. That study, which is in progress and will continue over the next several quarters, is being conducted by Professor Eric Stallard, who is a Research Professor of Demographic Studies at a major national university and a Member of the American Academy of Actuaries. Professor Stallard is a consultant with broad experience in estimating such liabilities. Based on the initial findings of that study, the Company estimates that its reasonably possible financial exposure for these matters ranges from \$200 million to \$500 million. Due to inherent uncertainties in estimating the timing and amounts of future payments, this range does not include the effects of inflation and has not been discounted for the time value of money. In addition, the range of financial exposures set forth above does not include estimates for future legal costs. It is the Company's policy to expense these costs as incurred. As stated above, the Company presently believes that the majority of this range of financial exposures will ultimately be funded by insurance proceeds. Cash payments related to this exposure are expected to be made over an extended number of years and actual payments, when made, could be for amounts in excess of the range due to potential future changes in estimates as well as the effects of inflation.

Due to the dynamic nature of asbestos litigation and the present uncertainty concerning the participation of its excess insurance carriers, the Company's estimates are inherently uncertain, and these matters may present significantly greater financial exposures than presently anticipated. In addition, the asbestos study referenced in the above paragraph is continuing, and further analysis combined with new data received in the future could result in a material modification of the range of reasonably possible financial exposure set forth above. As a result of all of the foregoing, the Company's liability with respect to asbestos-related matters could exceed present estimates and may require a material change in the accrued liability for these matters within the next twelve months. If the Company's liability does exceed amounts recorded in the balance sheet, the Company presently believes that the majority of any additional liability it may reasonably anticipate will be paid or reimbursed by its insurance carriers.

The initial findings of the study referenced above identify a range of the Company's reasonably possible financial exposure for these matters. The Company is not presently able to specify its best estimate of its liability within that range. The Company recorded a gross accrual of \$225 million for present and future potential asbestos claims before anticipated insurance recoveries resulting in a net charge of \$65 million related to these matters in the period ended September 30, 2002. At March 31, 2003, the Company has a remaining accrual of \$205 million for the gross liability. The Company believes that it is probable that \$126 million of the \$205 million accrual will be funded by or recovered from insurance carriers. At March 31, 2003, the consolidated balance sheet reflects a current insurance receivable of \$7 million and a long-term insurance receivable of \$119 million. The Company, in conjunction with outside advisors, will continue to study its asbestos-related exposures, insurance

## Edgar Filing: HERCULES INC - Form 10-Q

recovery expectations, and reserves on an on-going basis, and make adjustments as appropriate.

In June 1998, Hercules and David T. Smith Jr., a former Hercules employee and plant manager at the Brunswick plant, along with Georgia-Pacific Corporation and AlliedSignal Inc., were sued in Georgia State Court by 423 plaintiffs for alleged personal injuries and property damage. This litigation is captioned Coley, et al. v. Hercules Incorporated, et al., No. 98 VSO 140933 B (Fulton County, Georgia). Plaintiffs allege they were damaged by the discharge of hazardous waste from the companies' plants. On February 11, 2000, the Georgia State Court dismissed Georgia-Pacific Corporation and AlliedSignal Inc., without prejudice. In September 2000, David T. Smith Jr., was dismissed by the Georgia State Court with prejudice. On July 18, 2000, the Company was served with a complaint in a

16

case captioned Erica Nicole Sullivan, et al. v. Hercules Incorporated and David T. Smith, Jr., Civil Action File No. 00-1-05463-99 (Cobb County, Georgia). Based on the allegations contained in the complaint, this matter is very similar to the Coley litigation, and is brought on behalf of approximately 700 plaintiffs for alleged personal injury and property damage arising from the discharge of hazardous waste from Hercules' plant. The Company has reached an agreement in principle to settle the claims of all but six of these plaintiffs for an amount which is confidential, but which is not material to the financial condition of the Company.

In August 1999, the Company was sued in an action styled as Cape Composites, Inc. v. Mitsubishi Rayon Co., Ltd., Case No. 99-08260 (U.S. District Court, Central District of California), one of a series of similar purported class action lawsuits brought on behalf of purchasers (excluding government purchasers) of carbon fiber and carbon prepreg in the United States from the named defendants from January 1, 1993 through January 31, 1999. The lawsuits were brought following published reports of a Los Angeles federal grand jury investigation of the carbon fiber and carbon prepreg industries. In these lawsuits, plaintiffs allege violations of Section 1 of the Sherman Antitrust Act for alleged price fixing. In September 1999, these lawsuits were consolidated by the Court into a case captioned Thomas & Thomas Rodmakers v. Newport Adhesives and Composites, Case No. CV-99-07796-GHK (CTx) (U.S. District Court, Central District of California), with all related cases ordered dismissed. This lawsuit is proceeding through discovery and motion practice. On May 2, 2002, the Court granted plaintiffs' Motion to Certify Class. The Company is named in connection with its former Composites Products Division, which was sold to Hexcel Corporation in 1996, and has denied liability and will vigorously defend this action.

Since September 2001, Hercules, along with the other defendants in the Thomas & Thomas Rodmakers action referred to above, has been sued in nine California state court purported class actions brought on behalf of indirect purchasers of carbon fiber. In January 2002, these were consolidated into a case captioned Carbon Fiber Cases I, II, and III, Judicial Council Coordination Proceeding Nos. 4212, 4216 and 4222, Superior Court of California, County of San Francisco. These actions all allege violations of the California Business and Professions Code relating to alleged price fixing of carbon fiber and unfair competition. The Company denies liability and will vigorously defend each of these actions.

In June 2002, a purported class action was filed in Massachusetts under the caption Saul M. Ostroff, et al. v. Newport Adhesives, et al., Civil Action No. 02-2385, Superior Court of Middlesex County. This matter is a purported class action brought on behalf of consumers who purchased merchandise

## Edgar Filing: HERCULES INC - Form 10-Q

manufactured with carbon fiber, and alleges the same types of price fixing activities alleged in the actions described in the above two paragraphs. In October 2002, the Company was notified that Horizon Sports Technologies had "opted out" of the federal antitrust class action described above (Thomas & Thomas Rodmakers) and filed its own suit against Hercules and the other defendants in that action (Horizon Sports Technologies, Inc. v. Newport Adhesives and Composites, Inc., et al., Case No. CV02-8126 FMC (RNEX), U.S. District Court, Central District of California, Western Division).

Further, in April 2002, a related "Qui Tam" action was unsealed by the U.S. District Court for the Southern District of California. That action is captioned Randall M. Beck, et al. v. Boeing Defense and Space Group, Inc., et al., (Civil Action No. 99 CV 1557 JM JAH), was filed under seal in 1999, and is a "False Claims" action brought pursuant to the False Claims Act (31 U.S.C. Section 729 et seq.). In that action, the relators, in the name of the United States Government, allege the same price fixing activities which are the subject of the above-described actions. The relators then allege that those alleged price fixing activities resulted in inflated prices being charged by the defendant carbon fiber manufacturers to the defendant defense contractors, who, in turn, submitted claims for payment to the United States Government under various government contracts. It is alleged that those claims for payment were "false claims" because the prices charged for the carbon fiber and carbon prepreg were "fixed" contrary to the laws of the United States. The Company denies liability and will vigorously defend each of these actions.

In connection with the grand jury investigation noted above in the paragraph describing the Cape Composites litigation, in January 2000, the United States Department of Justice ("DOJ"), Antitrust Division, served a grand jury subpoena duces tecum upon Hercules. The Company has been advised that it is one of several manufacturers of carbon fiber and carbon prepreg that have been served with such a subpoena.

On September 28, 2000, the Company sold its Food Gums Division to CP Kelco ApS, a joint venture that the Company entered into with Lehman Brothers Merchant Banking Partners II, L.P. CP Kelco also acquired the biogums business of Pharmacia Corporation (formerly Monsanto Company). In April 2001, CP Kelco U.S., Inc., a wholly-owned subsidiary of CP Kelco ApS sued Pharmacia (CP Kelco U.S., Inc. v. Pharmacia Corporation U.S. District Court for the District of Delaware, Case No. 01-240-RRM), alleging federal securities fraud, common law fraud, breach of warranties and representations, and equitable fraud. In essence, the lawsuit alleges that Pharmacia misrepresented the value of the biogums business, resulting in damages to CP Kelco U.S., including the devaluation of CP Kelco U.S.'s

17

senior debt by the securities markets. In June 2001, Pharmacia filed a third-party complaint against the Company and Lehman. That complaint seeks contribution and indemnification from the Company and Lehman, jointly and severally, for any damages that may be awarded to CP Kelco U.S. in its action against Pharmacia. The Company filed a Motion for Judgement on the Pleadings, which was granted by the Magistrate Judge on September 19, 2002. In March 2003, the Magistrate Judge's ruling was adopted by the District Court judge. Prior to a trial on the case-in-chief, the District Court dismissed the Company from the case, subject to Pharmacia's right to appeal. On April 28, 2003, a jury trial began on the case-in-chief among CP Kelco, Lehman and Pharmacia. After the commencement of jury deliberations, the parties reached a settlement. The terms of the settlement are confidential. Given the settlement of the case-in-chief, the Company believes that the District Court's earlier dismissal of the Company would be upheld, if appealed.

## Edgar Filing: HERCULES INC - Form 10-Q

In November 2002, an action for declaratory judgment was filed in the U.S. District Court for the District of Delaware under the caption of Atofina Chemicals, Inc. and Atofina v. Hercules Incorporated (Civil Action No. 02-1613). In this action, Atofina seeks a declaration from the court regarding its liability for certain damages sought by the Company as compensation for injuries arising from the actions of Atofina, Akzo Nobel Chemicals and Clariant (including its successor in interest, Hoechst Celanese) in fixing the prices of monochloroacetic acid and sodium monochloroacetate from 1995 to 2000. The Company in response has counter-claimed against the entities identified above and affiliated companies for damages and injunctive relief. The matter is still in the pleadings stage with discovery to follow. The Company has settled with one of the parties. The terms of the settlement are confidential.

By Order dated May 6, 2003, the U.S. District Court for the Middle District of Louisiana remanded to the 18th Judicial District Court for the Parish of Iberville, Louisiana, a total of nine (9) consolidated lawsuits, including two (2) lawsuits in which the Company is a defendant. These two lawsuits are Jerry Oldham, et al. v. The State of Louisiana, et al., Civil Action No. 55,160, 18th Judicial District Court, Parish of Iberville, Louisiana and John Capone, et al. v. The State of Louisiana, et al., Civil Action No. 56,048C, 18th Judicial District Court, Parish of Iberville, Louisiana, were served on the Company in September 2002 and October 2002, respectively. The Oldham case is a purported class action comprised of approximately 2,000 plaintiffs, and the Capone case is a consolidated action by approximately 44 plaintiffs. Both actions assert claims against the State of Louisiana, the Company, American PetroFina, Hercofina, Ashland Oil, International Minerals and Chemicals, Allemania Chemical, Ashland Chemical and the Parish of Iberville. The purported class members and plaintiffs, who claim to have worked or lived at or around the Georgia Gulf plant in Iberville Parish, allege injury and fear of future illness from the consumption of contaminated water and, specifically, elevated levels of arsenic in that water. As to the Company, plaintiffs allege that the Company, itself, and then as part of a joint venture, operated a nearby plant and, as part of those operations, used a groundwater injection well to dispose of various wastes, and that those wastes contaminated the potable water supply at Georgia Gulf. On October 17, 2002, the Company removed these matters to federal court. In January 2003, the U.S. District Court for the Middle District of Louisiana consolidated the Capone and Oldham matters with other lawsuits in which the Company is not a party. Plaintiffs sought remand which, as noted above, was granted by Order dated May 6, 2003. Discovery is now beginning. The Company denies any liability and intends to vigorously defend these matters.

On January 31, 2003, the Court granted a Motion for Class Certification in a lawsuit captioned Douglas C. Smith, Individually and on Behalf of All Others Similarly Situated v. Hercules Incorporated and Thomas Gossage, CA No. 01C-08-291 WCC, Superior Court of Delaware, New Castle County. This lawsuit, which was filed on August 31, 2001, on behalf of Mr. Smith and a class of approximately 130 present and former Hercules employees, seeks payments under the "Integration Synergies Incentive Compensation Plan" (the "Plan"), a program put into place by the Company following its acquisition of BetzDearborn Inc. in October 1998. The goal of the Plan was to provide certain financial incentives to specific employees who were deemed to have significant impact on the integration of BetzDearborn Inc. into Hercules Incorporated. The amount to be paid under the Plan was tied to the successful achievement of "synergies," which were defined as the annualized reduction of expenses or improvement of profits realized as a result of the integration of BetzDearborn Inc. into Hercules. The lawsuit essentially alleges that the payments made under the Plan were not adequate and that the Company breached the terms of the Plan. The lawsuit seeks payments of between \$25 million and \$30 million, although the Company does not believe that any payments are owed to the class members. In February 2003, plaintiffs agreed to dismiss Thomas Gossage from the lawsuit. Discovery is ongoing. The Company denies any liability to the plaintiffs and is vigorously defending this action.

## Edgar Filing: HERCULES INC - Form 10-Q

At March 31, 2003, the consolidated balance sheet reflects a current liability of approximately \$27 million and a long-term liability of approximately \$184 million for litigation and claims. These amounts represent management's best estimate of the probable and reasonably estimable losses related to litigation or claims. The extent of the liability and recovery is evaluated quarterly. While it is not feasible to predict the outcome of all pending suits and claims, the ultimate resolution of these matters could have a material effect upon the financial position of Hercules, and the

18

resolution of any of the matters during a specific period could have a material effect on the quarterly or annual operating results for that period.

### 15. Segment Information

The table below reflects Net sales and Profit from operations for the three months ended March 31, 2003 and 2002.

(Dollars in millions)	Three Months Ended March 31,	
	2003	2002
Net sales:		
Performance Products	\$ 356	\$ 327
Engineered Materials and Additives	85	75
	-----	-----
Consolidated	\$ 441	\$ 402
	=====	=====
Profit from operations:		
Performance Products	\$ 56	\$ 58
Engineered Materials and Additives	2	3
Reconciling Items (a)	1	(7)
	-----	-----
Consolidated	\$ 59	\$ 54
	=====	=====

- (a) Reconciling Items for the three months ended March 31, 2003 include severance charges and income recognized as a result of a favorable legal settlement. Reconciling items for the three months ended March 31, 2002 include restructuring charges, environmental costs and other corporate costs not allocated to the businesses.

### 16. Financial Information of Guarantor Subsidiaries

The following condensed consolidating financial information for the Company presents the financial information of Hercules, the guarantor subsidiaries and the non-guarantor subsidiaries based on the Company's understanding of the Securities and Exchange Commission's interpretation and application of Rule 3-10 under the Securities and Exchange Commission's Regulation S-X. The financial information may not necessarily be indicative of

## Edgar Filing: HERCULES INC - Form 10-Q

results of operations or financial position had the guarantor subsidiaries or non-guarantor subsidiaries operated as independent entities.

In this presentation, Hercules consists of the parent company's operations. Guarantor subsidiaries and non-guarantor subsidiaries of Hercules are reported on an equity basis.

19

### Condensed Consolidating Statement of Operations Three Months Ended March 31, 2003

	(Unaudited) (Dollars in millions)		
	Unconsolidated		
	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries
Net sales	\$ 129	\$ 107	\$ 2
Cost of sales	83	76	1
Selling, general, and administrative expenses	28	15	
Research and development	5	4	
Intangible asset amortization	2	--	
Other operating (income) expense, net	(2)	--	
Profit (loss) from operations	13	12	
Interest and debt expense (income), net	45	(15)	
Preferred security distributions of subsidiary trusts	--	--	
Other expense, net	1	2	
(Loss) income before income taxes and equity income (loss)	(33)	25	
(Benefit) provision for income taxes	(11)	9	
Equity loss of affiliated companies	--	--	
Equity income (loss) from consolidated subsidiaries	35	2	
Net income (loss) from continuing operations before discontinued operations and cumulative effect of changes in accounting principle	13	18	
Net (loss) income from discontinued operations, net of tax	--	--	
Net income (loss) before cumulative effect of changes in accounting principle	13	18	
Cumulative effect of changes in accounting principle, net of tax	(28)	--	
Net (loss) income	\$ (15)	\$ 18	\$



# Edgar Filing: HERCULES INC - Form 10-Q

20

## Condensed Consolidating Statement of Operations Three Months Ended March 31, 2002

	(Unaudited) (Dollars in millions)		
	Unconsolidated		
	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries
Net sales	\$ 133	\$ 115	\$ 2
Cost of sales	84	81	1
Selling, general, and administrative expenses	20	26	
Research and development	5	4	
Intangible asset amortization	1	1	
Other operating (income) expense, net	(1)	4	
Profit (loss) from operations	24	(1)	
Interest and debt expense (income), net	68	(23)	
Preferred security distributions of subsidiary trusts	--	--	
Other expense, net	1	1	
Loss (income) before income taxes and equity income (loss)	(45)	21	
(Benefit) provision for income taxes	(11)	8	
Equity loss of affiliated companies	--	--	
Equity income (loss) from consolidated subsidiaries	31	15	
Net (loss) income from continuing operations before discontinued operations and cumulative effect of changes in accounting principle	(3)	28	
Net (loss) income from discontinued operations, net of tax	(209)	12	
Net (loss) income before cumulative effect of changes in accounting principle	(212)	40	
Cumulative effect of changes in accounting principle, net of tax	(368)	--	
Net (loss) income	\$ (580)	\$ 40	\$

21

## Condensed Consolidating Balance Sheet March 31, 2003

Edgar Filing: HERCULES INC - Form 10-Q

	(Unaudited) (Dollars in millions)		
	Unconsolidated		
	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries
<hr/>			
ASSETS			
Current assets			
Cash and cash equivalents	\$ 106	\$ 6	\$ 1
Restricted cash	125	--	--
Accounts and notes receivable, net	90	66	2
Intercompany receivables	80	25	--
Inventories	49	55	--
Deferred income taxes	20	17	--
	<hr/>	<hr/>	<hr/>
Total current assets	470	169	4
Property, plant, and equipment, net	173	162	3
Investments in subsidiaries	2,351	69	--
Goodwill and other intangible assets, net	232	90	3
Deferred income taxes	122	--	--
Other assets	344	13	--
	<hr/>	<hr/>	<hr/>
Total assets	\$ 3,692	\$ 503	\$ 1,2
	=====	=====	=====
LIABILITIES AND STOCKHOLDERS' DEFICIT			
Current liabilities			
Accounts payable	\$ 49	\$ 17	\$ 1
Accrued expenses	91	125	--
Intercompany payables	8	71	--
Short-term debt	127	--	--
	<hr/>	<hr/>	<hr/>
Total current liabilities	275	213	2
Long-term debt	700	--	--
Deferred income taxes	--	117	--
Postretirement benefits and other liabilities	655	71	--
Company-obligated preferred securities of subsidiary trusts	--	--	6
Intercompany notes payable/(receivable)	2,171	(1,050)	(1,1
Stockholders' deficit	(109)	1,152	1,3
	<hr/>	<hr/>	<hr/>
Total liabilities and stockholders' deficit	\$ 3,692	\$ 503	\$ 1,2
	=====	=====	=====

Condensed Consolidating Statement of Cash Flows  
Three Months Ended March 31, 2003

(Unaudited)  
(Dollars in millions)  
Unconsolidated

Edgar Filing: HERCULES INC - Form 10-Q

	Parent	Guarantor Subsidiaries	Non-Guar Subsidiaries
	-----	-----	-----
NET CASH (USED IN) PROVIDED BY OPERATIONS	\$ (36)	\$ 15	\$
CASH FLOW FROM INVESTING ACTIVITIES:			
Capital expenditures	(2)	(2)	
Proceeds of investment and fixed asset disposals	--	--	
Other, net	--	--	
	-----	-----	-----
Net cash used in investing activities	(2)	(2)	
	-----	-----	-----
CASH FLOW FROM FINANCING ACTIVITIES:			
Long-term debt repayments	(1)	--	
Change in short-term debt	--	--	
Change in intercompany, noncurrent	9	(14)	
Common stock issued	5	--	
	-----	-----	-----
Net cash provided by (used in) financing activities	13	(14)	
Effect of exchange rate changes on cash	--	--	
	-----	-----	-----
Net (decrease) increase in cash and cash equivalents	(25)	(1)	
Cash and cash equivalents at beginning of period	131	7	
	-----	-----	-----
Cash and cash equivalents at end of period	\$ 106	\$ 6	\$ 1
	=====	=====	=====

23

Condensed Consolidating Statement of Cash Flows  
Three Months Ended March 31, 2002

	(Unaudited) (Dollars in millions) Unconsolidated		
	Parent	Guarantor Subsidiaries	Non-Guar Subsidiaries
	-----	-----	-----
NET CASH (USED IN) PROVIDED BY OPERATING ACTIVITIES OF CONTINUING OPERATIONS	\$ (17)	\$ 32	\$ (
CASH FLOW FROM INVESTING ACTIVITIES:			
Capital expenditures	(2)	(1)	
Proceeds of investment and fixed asset disposals	8	2	
Other, net	--	(3)	
	-----	-----	-----
Net cash provided by (used in) investing activities of continuing operations	6	(2)	
	-----	-----	-----
CASH FLOW FROM FINANCING ACTIVITIES:			
Long-term debt proceeds	155	--	
Long-term debt repayments	(105)	--	

# Edgar Filing: HERCULES INC - Form 10-Q

Change in short-term debt	--	--	
Change in intercompany, noncurrent	(46)	29	
Common stock issued	2	--	
	-----	-----	-----
Net cash provided by (used in) financing activities of continuing operations	6	29	(
Net cash flow (used in) provided by discontinued operations	--	(67)	
Effect of exchange rate changes on cash	--	--	
	-----	-----	-----
Net decrease in cash and cash equivalents	(5)	(8)	(
Cash and cash equivalents at beginning of period	8	12	
	-----	-----	-----
Cash and cash equivalents at end of period	\$ 3	\$ 4	\$
	=====	=====	=====

24

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Within the following discussion, unless otherwise stated, "quarter" and "three-month period" refer to the first quarter of 2003 and the three months ended March 31, 2003. All comparisons are with the corresponding period in the previous year, unless otherwise stated.

The Company operates through two reportable segments and four divisions: Performance Products (Pulp and Paper, Aqualon) and Engineered Materials and Additives (FiberVisions, Pinova).

The table below reflects Net sales and Profit from operations for the quarters ended March 31, 2003 and 2002. Substantially all reconciling items have been allocated to the segments. The reconciling items primarily include corporate expenses.

(Dollars in millions)	Three Months Ended March 31,	
	2003	2002
	-----	-----
Net sales:		
Performance Products	\$ 356	\$ 327
Engineered Materials and Additives	85	75
	-----	-----
Consolidated	\$ 441	\$ 402
	=====	=====
Profit from operations:		
Performance Products	\$ 56	\$ 58
Engineered Materials and Additives	2	3
Reconciling Items (a)	1	(7)
	-----	-----
Consolidated	\$ 59	\$ 54
	=====	=====

## Edgar Filing: HERCULES INC - Form 10-Q

- (a) Reconciling Items for the three months ended March 31, 2003 include severance charges and income recognized as a result of a favorable legal settlement. Reconciling items for the three months ended March 31, 2002 include restructuring charges, environmental costs and other corporate costs not allocated to the businesses.

Consolidated net sales were \$441 million for the quarter, an increase of \$39 million, or 10%. Compared to the first quarter 2002, prices were flat while volume/mix had a 3% positive impact and rate of exchange had a 7% positive impact. Volumes improved 7% versus the prior year. Regionally, net sales improved 2% in North America, 24% in Europe and 15% in Asia Pacific and declined 12% in Latin America. European sales were higher primarily due to the positive impact of the weaker dollar versus the euro. Profit from operations improved \$5 million, or 9%. The improvement in profit from operations was driven by higher volumes, the positive impact of the weaker dollar versus the euro and reductions in the Company's fixed cost structure pursuant to the comprehensive cost reduction and work process redesign program (see Note 10) commenced in 2001; offsetting these amounts were higher raw material and energy costs, higher insurance expenses and higher pension and postretirement costs. Profit from operations benefited from income recognized as a result of a favorable legal settlement as well as lower environmental and severance charges versus the prior year.

In the Performance Products segment, net sales grew \$29 million, or 9%, and profit from operations declined \$2 million, or 3%. In the Pulp and Paper Division, net sales growth resulted from 7% higher volumes as a result of the supply agreement with G.E. Betz. These volumes were recorded as intercompany sales prior to the divestiture of the Water Treatment Business. Profit from operations in the three-month period was negatively impacted by higher energy and raw material costs and higher pension expenses offset by lower selling, general and administrative expenses. Demand in the North American and European markets was weaker than expected with extended shutdowns at a number of paper mills. In addition, weather conditions in the southeastern United States affected wood chip supply and slowed production with a number of the Company's customers. Aqualon experienced 12% net sales growth and a 6% improvement in profit from operations in the quarter versus the prior year quarter. These improvements were largely driven by 4% higher volumes and the positive effect of rate of exchange. Volume improvements were driven largely by improved oilfield demand as rig counts were up worldwide versus the prior year. Profit from operations was negatively impacted by higher pension expenses.

25

In the Engineered Materials and Additives segment, net sales increased \$10 million, or 13%, and profit from operations declined \$1 million, or 33%. FiberVisions net sales increased 26% as a result of the positive rate of exchange effect, 14% higher volumes and the contractual customer pass through of higher polymer costs. Profit from operations was flat for the quarter. Higher volumes, resulting from increased demand for fibers in wipes and baby diapers, were offset by higher polymer costs. FiberVisions can recover approximately 75% of the higher polymer costs with a four to eight week lag depending on the terms of the customer contract. Conversely, when polymer prices begin to decline, the lag results in margin recovery. Net sales in Pinova experienced a 12% decline as a result of 5% lower volumes and changes in product/mix. Pinova's decreased volumes were due to lost sales from competitive pricing in the chewing gum market. Profit from operations decreased \$1 million as a result of the lower volumes and higher pension expenses.

Interest and debt expense, and preferred security distributions of subsidiary trusts decreased \$17 million for the quarter, primarily due to lower outstanding debt balances, reflecting the application of proceeds from the sale

## Edgar Filing: HERCULES INC - Form 10-Q

of the Water Treatment Business on April 29, 2002.

The effective tax rate for the quarter for continuing operations was 38% versus 200% for the same period 2002. The rate for the 2002 quarter was unfavorably impacted by the mix of earnings and losses by geographic region. The anticipated full year 2003 tax rate is approximately 38%.

### DISCONTINUED OPERATIONS

On April 29, 2002, Hercules completed the sale of the Water Treatment Business to GE Specialty Materials, a unit of General Electric Company (see Note 4). The sale price was \$1.8 billion in cash, resulting in net after-tax proceeds of approximately \$1.7 billion. The Company used the net proceeds to prepay debt under its senior credit facility and ESOP credit facility. Pursuant to SFAS 144, the Water Treatment Business has been treated as a discontinued operation as of February 12, 2002, and accordingly, all financial information has been restated. The loss from discontinued operations for the three months ended March 31, 2002 includes an after-tax loss on the disposal of the business of \$230 million.

The Paper Process Chemicals Business, representing approximately one-third of the business of BetzDearborn Inc. when it was originally acquired in 1998, was fully integrated into and continues to be reported within Pulp and Paper.

### FINANCIAL CONDITION

Liquidity and Financial Resources: Net cash provided by continuing operations was \$12 million for the three-month period compared to cash used by continuing operations of \$15 million in the first quarter 2002. The current ratio has increased to 1.60 at March 31, 2003, compared with 1.47 at December 31, 2002. The quick ratio has increased to 1.30 at March 31, 2003 from 1.20 at December 31, 2002.

As of March 31, 2003, the Company had \$58 million available under its \$125 million revolving credit agreement and \$15 million of unused short-term lines of credit. The Company had outstanding letters of credit associated with the credit facility of \$67 million at March 31, 2003. The Company expects to meet short-term cash requirements from current available cash, operating cash flow and availability under lines of credit.

Capital expenditures are expected to be between \$45 million and \$58 million during 2003. On April 28, 2003, the Company announced capacity expansion plans for the Natrosol(R) HEC (Hydroxyethylcellulose) and Natrosol(R) Plus product lines. The expansion, which will be staged at Aqualon's production facilities in New Jersey, Virginia and The Netherlands, is expected to begin in the fourth quarter 2003 and to be completed by the end of 2004. The expansion and upgrades are designed to increase annual capacity by 10,000 tons and have the added capability to produce new products now under development.

Capital Structure and Commitments: Total capitalization (stockholders' (deficit) equity, company-obligated preferred securities of subsidiary trusts and debt) remained flat at \$1.4 billion at March 31, 2003 from year-end 2002. The ratio of debt-to-total capitalization decreased to 63% at March 31, 2003 from 64% at December 31, 2002. In June 2003, the \$125 million 6.625% notes will mature. The Company has placed \$125 million in proceeds from the term B loan into an escrow account to pay the 6.625% notes. The escrow funds have been recognized as restricted cash on the Consolidated Balance Sheet.

### 2003 OUTLOOK

The Company has experienced higher pension, health care, insurance, energy and raw material costs than anticipated. Energy and natural gas price spikes caused a number of raw material prices to increase as suppliers used the

## Edgar Filing: HERCULES INC - Form 10-Q

opportunity to improve

26

margins. It also caused some structural changes and reductions in capacity. The Company expects raw material prices to remain up for some period of time.

More specifically, producers of materials derived from the chlor-alkalai, ethylene and natural gas chains are passing through increases in commodity prices. A combination of market tightness due to capacity consolidation, Venezuelan production interruptions and the war in Iraq affected many downstream products. Solvents, surfactants and a number of other raw materials came under pressure in the first quarter as all suppliers announced price increases. In general, realized increases were well below announced price increases.

The Company raised prices across all four divisions, the effects of which are expected to be realized beginning in the second quarter. The U.S. dollar continues to weaken versus the euro.

In Pulp and Paper, production is expected to remain sluggish in the near-term. In April, Pulp and Paper announced price increases across several product lines to offset rising raw material and energy costs. However, the environment continues to be very difficult and requires delivery of total cost savings to customers through new product and application technology. Over the long-term, Pulp and Paper is forecasting production growth for the global paper industry to be consistent with historical trends.

In Aqualon, market conditions continue to be weak, but slightly ahead of last year. However, Aqualon has seen increases in the oilfield-related businesses.

FiberVisions anticipates no benefit from any economic upturn in 2003. First quarter 2003 volume increases are due to new product introduction, pipeline fill, some gain in market share and strong customer market share.

In Pinova, market conditions remain unchanged.

### CRITICAL ACCOUNTING POLICIES

Effective January 1, 2003, the Company adopted SFAS 143 (see Note 13). Adoption of SFAS 143 resulted in the Company increasing the recorded liabilities for environmental remediation obligations. The actual costs for environmental remediation obligations will depend on numerous factors, including the actual methods of remediation required or agreed to, outcomes of negotiations with regulatory authorities, outcomes of litigation, changes in environmental laws and regulations, technological developments, and the years and timing of remedial activity required. SFAS 143 introduced additional variables into the measurement of these obligations, including probability weighting of expected cash flows, present value and assumptions regarding interest rates. Revisions to either the timing or amount of estimated cash flows, as well as the passage of time, will result in changes to the recorded liability.

### RECENT EVENTS

On March 20, 2003, the Hercules Shareholders' Committee for New Management filed a preliminary proxy statement with the SEC announcing that it will solicit proxies to elect four candidates to the Board of Directors of Hercules Incorporated at the upcoming 2003 Annual Meeting. The Committee is comprised of International Specialty Products Inc., a privately-held international specialty chemicals company, four current members of the Hercules Board and the Committee's four nominees for election to the Board of Directors at this year's

## Edgar Filing: HERCULES INC - Form 10-Q

annual meeting. Since the initial filing, the Committee has filed several amendments to the preliminary proxy statement, as well as definitive additional soliciting materials.

### RISK FACTORS

Market Risk - Fluctuations in interest and foreign currency exchange rates affect the Company's financial position and results of operations. The Company uses several strategies from time to time to actively hedge interest rate and foreign currency exchange rate exposure and minimize the effect of such fluctuations on reported earnings and cash flow. Sensitivity of the Company's financial instruments to selected changes in market rates and prices which are reasonably possible are described below. Market values are the present value of projected future cash flows based on the market rates and prices chosen. The market values for interest rate risk are calculated by utilizing a third-party software model that utilizes standard pricing models to determine the present value of the instruments based on the market conditions as of the valuation date.

The Company's derivative and other financial instruments subject to interest rate risk at March 31, 2003 consist of debt instruments, pension benefit obligations and pension plan assets invested in fixed rate securities. The debt instruments had a net market value at March 31, 2003 of \$1.46 billion. The sensitivity analysis assumes an

27

instantaneous 100-basis point move in interest rates from their current levels, with all other variables held constant. A 100-basis point increase in interest rates at March 31, 2003 would result in a \$61 million decrease in the net market value of the liability. A 100-basis point decrease in interest rates at March 31, 2003 would result in a \$78 million increase in the net market value of the liability.

The Company's financial instruments subject to foreign currency exchange risk consist of foreign currency forward contracts and represent a net liability position of \$0.6 million at March 31, 2003. The following sensitivity analysis assumes an instantaneous 10% change in foreign currency exchange rates, with all other variables held constant. A 10% strengthening of the U.S. dollar versus other currencies at March 31, 2003 would result in a \$1.1 million increase in the net liability position, while a 10% weakening of the dollar versus other currencies would result in a \$1.1 million decrease in the net liability position resulting in a net asset position.

Foreign exchange forward and option contracts have been used to hedge the Company's firm and anticipated foreign currency cash flows. Thus, there is either an asset or cash flow exposure related to all the financial instruments in the above sensitivity analysis for which the impact of a movement in foreign exchange rates would be in the opposite direction and substantially equal to the impact on the instruments in the analysis. There are presently no significant restrictions on the remittance of funds generated by the Company's operations outside the United States.

The Company has not designated any derivative as a hedge instrument under Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, and accordingly, changes in the fair value of derivatives are recorded each period in earnings.

The assets and liabilities associated with the Company's defined benefit pension plans are subject to interest rate and market risk. At March 31, 2003, the accumulated pension benefit obligation ("ABO") of the U.S. defined benefit



## Edgar Filing: HERCULES INC - Form 10-Q

plan was \$1,227 million based on a discount rate of 6.75%. The fair value of the U.S. defined benefit plan assets at March 31, 2003 was \$923 million. The assets of the U.S. defined benefit plan are invested as follows: \$427 million in domestic corporate equity securities, \$166 million in international corporate equity securities, \$317 million in fixed income securities and \$13 million in other investments. The Company has used an 8.75% assumed rate of return on plan assets for the U.S. plans effective January 1, 2003. A 100-basis point decrease or increase in the discount rate has approximately a plus or minus \$130 million impact on the ABO. A 100-basis point decrease or increase in the assumed rate of return has approximately a plus or minus \$12 million impact on the U.S. pension expense estimated for 2003.

**Environmental Litigation** - Hercules has been identified by U.S. federal and state authorities as a "potentially responsible party" for environmental cleanup at numerous sites. The estimated range of reasonably possible costs for remediation is between \$115 million and \$225 million. The Company does not anticipate that its financial condition will be materially affected by environmental remediation costs in excess of amounts accrued, although quarterly or annual operating results could be materially affected (see Note 14).

Environmental remediation expenses are funded from internal sources of cash. Such expenses are not expected to have a significant effect on the Company's ongoing liquidity. Environmental cleanup costs, including capital expenditures for ongoing operations, are a normal, recurring part of operations and are not significant in relation to total operating costs or cash flows.

**Other Litigation** - Hercules is a defendant in numerous lawsuits that arise out of, and are incidental to, the conduct of its business. These suits concern issues such as product liability, contract disputes, employee-related matters, patent infringement, environmental proceedings, property damage and personal injury matters. The Company is a defendant in numerous asbestos-related personal injury lawsuits and claims which typically arise from alleged exposure to asbestos fibers from resin-encapsulated pipe and tank products which were sold by one of the Company's former subsidiaries to a limited industrial market ("products claims"). The Company is also a defendant in lawsuits alleging exposure to asbestos at facilities formerly or presently owned or operated by the Company ("premises claims"). The Company's estimated liability and insurance recoveries are based on numerous assumptions regarding the number of future claims, the cost of settlements, potential insurance recoveries and other variables. While the Company believes its estimates are reasonable, there can be no assurance that these assumptions will prove to be correct and the Company's actual experience may differ materially over time. Since it is not feasible to predict the outcome of all pending suits and claims, the ultimate resolution of these matters could have a material effect upon the financial position of Hercules, and the resolution of any of the matters during a specific period could have a material effect on the quarterly or annual operating results for that period (see Note 14). The Company anticipates that its primary and first level excess insurance policies will likely exhaust over the next 1 to 2 months, assuming that the rate of settlements and payments remains relatively consistent with the Company's past experience. Nonetheless, based on the current number of claims pending, the amounts the Company anticipates paying to resolve those claims which are not dismissed or

otherwise resolved without payment, and anticipated future claims, the Company believes that it and its former subsidiary together have sufficient additional insurance to cover the majority of its current and estimated future asbestos-related liabilities.

## Edgar Filing: HERCULES INC - Form 10-Q

This quarterly report on Form 10-Q includes forward-looking statements, as defined in the Private Securities Litigation Reform Act of 1995, reflecting management's current analysis and expectations, based on what management believes to be reasonable assumptions. Forward-looking statements may involve known and unknown risks, uncertainties and other factors, which may cause the actual results to differ materially from those projected, stated or implied, depending on such factors as: ability to generate cash, ability to raise capital, ability to refinance, the result of the pursuit of strategic alternatives, ability to execute work process redesign and reduce costs, business climate, business performance, economic and competitive uncertainties, higher manufacturing costs, reduced level of customer orders, changes in strategies, risks in developing new products and technologies, environmental and safety regulations and clean-up costs, foreign exchange rates, the impact of changes in the value of pension fund assets and liabilities, changes in generally accepted accounting principles, legislative changes, adverse legal and regulatory developments, including increases in the number or financial exposures of claims, lawsuits, settlements or judgments, or the inability to eliminate or reduce such financial exposures by collecting indemnity payments from insurers, the impact of increased accruals and reserves for such exposures, and adverse changes in economic and political climates around the world, including terrorist activities and international hostilities. Accordingly, there can be no assurance that the Company will meet future results, performance or achievements expressed or implied by such forward-looking statements. As appropriate, additional factors are contained in other reports filed by the Company with the Securities and Exchange Commission. This paragraph is included to provide safe harbor for forward-looking statements, which are not generally required to be publicly revised as circumstances change, and which the Company does not intend to update.

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

For discussion of quantitative and qualitative disclosure about market risk, see "Risk Factors" under Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations.

### ITEM 4. CONTROLS AND PROCEDURES

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Vice President and Controller, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15 as of March 31, 2003. Based upon that evaluation, the Company's Chief Executive Officer and Vice President and Controller concluded that the Company's disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in Company reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to the date the Company carried out this evaluation.

## PART II - OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

## Edgar Filing: HERCULES INC - Form 10-Q

For information related to Legal Proceedings, see Notes to Financial Statements.

### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

#### (a) Exhibits

Please see the exhibits listed on the Exhibit Index.

#### (b) Reports on Form 8-K

Date of Report -----	Item No. -----	Financial Statements Included -----
February 13, 2003	5, 12	Yes

30

HERCULES INCORPORATED

### SIGNATURES

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

HERCULES INCORPORATED

By: /s/ Stuart C. Shears

-----  
Stuart C. Shears  
Vice President and Treasurer  
(Principal Financial Officer and duly  
authorized signatory)  
May 15, 2003

By: /s/ Fred G. Aanonsen

-----  
Fred G. Aanonsen  
Vice President and Controller  
(Principal Accounting Officer and duly  
authorized signatory)  
May 15, 2003

31

HERCULES INCORPORATED

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, William H. Joyce, Chairman and Chief Executive Officer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Hercules Incorporated;
2. Based on my knowledge, this quarterly report does not contain any untrue

## Edgar Filing: HERCULES INC - Form 10-Q

statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report.
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ William H. Joyce

-----  
William H. Joyce  
Chairman and Chief Executive Officer  
May 15, 2003

## Edgar Filing: HERCULES INC - Form 10-Q

HERCULES INCORPORATED

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Fred G. Aanonsen, Vice President and Controller, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Hercules Incorporated;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report.
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including

## Edgar Filing: HERCULES INC - Form 10-Q

any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ Fred G. Aanonsen

-----  
Fred G. Aanonsen  
Vice President and Controller  
May 15, 2003

33

HERCULES INCORPORATED

### EXHIBIT INDEX

NUMBER	DESCRIPTION
10-A*	Amended and Restated Hercules Incorporated Management Incentive Compensation Plan, dated February 21, 2003
10-B*	Hercules Deferred Compensation Plan, restated December 1995
10-C*	Employment Offer Letter - Fred G. Aanonsen, dated June 27, 2001
10-D*	Employment Offer Letter - Robert C. Flexon, dated May 12, 2000
10-E*	Hercules Executive Survivor Benefit Plan II dated January 1, 1987- Benefit structure is only applicable to one executive officer
99.1*	Certification of Chairman and Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
99.2*	Certification of Vice President and Controller Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* Filed herewith

34