QUAKER CHEMICAL CORP
Form 10-K
March 09, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2006

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission file number 001-12019

QUAKER CHEMICAL CORPORATION

(Exact name of Registrant as specified in its charter)

A Pennsylvania Corporation	**No. 23-0993790**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
One Quaker Park, 901 Hector Street, Conshohocken, Pennsylvania	**19428**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (610) 832-4000

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

Title of each class	Name of each Exchange on which registered
Common Stock, $1.00 par value	**New York Stock Exchange**
Stock Purchase Rights	**New York Stock Exchange**

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

None

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

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

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

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

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

Large accelerated filer ¨	Accelerated filer x	Non-accelerated filer ¨

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

State aggregate market value of common stock held by non-affiliates of the Registrant. (The aggregate market value is computed by reference to the last reported sale on the New York Stock Exchange on June 30, 2006): $184,494,293.

Indicate the number of shares outstanding of each of the Registrant s classes of common stock as of the latest practicable date: 10,020,588 shares of Common Stock, $1.00 Par Value, as of February 28, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s definitive Proxy Statement relating to the Annual Meeting of Shareholders to be held on May 9, 2007 are incorporated by reference into Part III.

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PART I

As used in this Report, the terms Quaker, the Company, we and our refer to Quaker Chemical Corporation, its subsidiaries, and associated companies, unless the context otherwise requires.

Item 1. *Business.*

General Description

Quaker develops, produces, and markets a broad range of formulated chemical specialty products for various heavy industrial and manufacturing applications and, in addition, offers and markets chemical management services (CMS). Quaker s principal products and services include: (i) rolling lubricants (used by manufacturers of steel in the hot and cold rolling of steel and by manufacturers of aluminum in the hot rolling of aluminum); (ii) corrosion preventives (used by steel and metalworking customers to protect metal during manufacture, storage, and shipment); (iii) metal finishing compounds (used to prepare metal surfaces for special treatments such as galvanizing and tin plating and to prepare metal for further processing); (iv) machining and grinding compounds (used by metalworking customers in cutting, shaping, and grinding metal parts which require special treatment to enable them to tolerate the manufacturing process, achieve closer tolerance and improve tool life); (v) forming compounds (used to facilitate the drawing and extrusion of metal products); (vi) hydraulic fluids (used by steel, metalworking, and other customers to operate hydraulically activated equipment); (vii) technology for the removal of hydrogen sulfide in various industrial applications; (viii) chemical milling maskants for the aerospace industry and temporary and permanent coatings for metal and concrete products; (ix) construction products such as flexible sealants and protective coatings for various applications; and (x) programs to provide chemical management services. Individual product lines representing more than 10% of consolidated revenues for any of the past three years are as follows:

	2006	2005	2004
Rolling lubricants	21.0%	21.3%	22.3%
Machining and grinding compounds	16.6%	16.4%	15.0%
Chemical management services	10.3%	11.7%	13.6%
Hydraulic fluids	10.8%	10.4%	10.1%
Corrosion preventives	10.6%	9.5%	9.8%

A substantial portion of Quaker s sales worldwide are made directly through its own employees and its CMS programs with the balance being handled through value-added resellers and agents. Quaker employees visit the plants of customers regularly and, through training and experience, identify production needs which can be resolved or alleviated either by adapting Quaker s existing products or by applying new formulations developed in Quaker s laboratories. Quaker makes little use of advertising but relies heavily upon its reputation in the markets which it serves. Generally, separate manufacturing facilities of a single customer are served by different personnel. As part of the Company s chemical management services, certain third-party product sales to customers are managed by the Company. Where the Company acts as a principal, revenues are recognized on a gross reporting basis at the selling price negotiated with the customers. Where the Company acts as an agent, such revenue is recorded using net reporting as service revenues, at the amount of the administrative fee earned by the Company for ordering the goods. Third party products transferred under arrangements resulting in net reporting totaled $62.8 million, $38.8 million, and $35.2 million for 2006, 2005 and 2004, respectively. The Company recognizes revenue in accordance with the terms of the underlying agreements, when title and risk of loss have been transferred, collectibility is reasonably assured, and pricing is fixed or determinable. This generally occurs for product sales when products are shipped to customers or, for consignment arrangements, upon usage by the customer and when services are performed. License fees and royalties are recognized in accordance with agreed-upon terms, when performance obligations are satisfied, the amount is fixed or determinable, and collectibility is reasonably assured, and are included in other income.

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Competition

The chemical specialty industry comprises a number of companies of similar size as well as companies larger and smaller than Quaker. Quaker cannot readily determine its precise position in every industry it serves. Based on information available to Quaker, however, it is estimated that Quaker holds a leading and significant global position (among a group in excess of 25 other suppliers) in the market for process fluids to produce sheet steel. It is also believed that Quaker holds significant global positions in the markets for process fluids in portions of the automotive and industrial markets. Many competitors are in fewer and more specialized product classifications or provide different levels of technical services in terms of specific formulations for individual customers. Competition in the industry is based primarily on the ability to provide products that meet the needs of the customer and render technical services and laboratory assistance to customers and, to a lesser extent, on price.

Major Customers and Markets

In 2006, Quaker s five largest customers (each composed of multiple subsidiaries or divisions with semi-autonomous purchasing authority) accounted for approximately 23% of its consolidated net sales with the largest customer (General Motors) accounting for approximately 6% of consolidated net sales. A significant portion of Quaker s revenues are realized from the sale of process fluids and services to manufacturers of steel, automobiles, appliances, and durable goods, and, therefore, Quaker is subject to the same business cycles as those experienced by these manufacturers and their customers. Furthermore, steel customers typically have limited manufacturing locations as compared to metalworking customers and generally use higher volumes of products at a single location. Accordingly, the loss or closure of a steel mill of a significant customer can have a material adverse effect on Quaker s business.

Raw Materials

Quaker uses over 1,000 raw materials, including mineral oils and derivatives, animal fats and derivatives, vegetable oils and derivatives, ethylene derivatives, solvents, surface active agents, chlorinated paraffinic compounds, and a wide variety of other organic and inorganic compounds. In 2006, only three raw material groups (mineral oil and derivatives, animal fats and derivatives, and vegetable oils and derivatives) each accounted for as much as 10% of the total cost of Quaker s raw material purchases. The price of mineral oil can be affected by the price of crude oil and refining capacity. Accordingly, significant fluctuations in the price of crude oil can have a material effect upon the Company s business. Many of the raw materials used by Quaker are commodity chemicals, and, therefore, Quaker s earnings can be affected by market changes in raw material prices. Quaker has multiple sources of supply for most materials, and management believes that the failure of any single supplier would not have a material adverse effect upon its business. Reference is made to the disclosure contained in Item 7A of this Report.

Patents and Trademarks

Quaker has a limited number of patents and patent applications, including patents issued, applied for, or acquired in the United States and in various foreign countries, some of which may prove to be material to its business. Principal reliance is placed upon Quaker s proprietary formulae and the application of its skills and experience to meet customer needs. Quaker s products are identified by trademarks that are registered throughout its marketing area.

Research and Development Laboratories

Quaker s research and development laboratories are directed primarily toward applied research and development since the nature of Quaker s business requires continual modification and improvement of formulations to provide chemical specialties to satisfy customer requirements. Research and development costs are expensed as incurred. Research and development expenses during 2006, 2005 and 2004 were $13.0 million, $14.2 million and $13.8 million, respectively.

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Quaker maintains quality control laboratory facilities in each of its manufacturing locations. In addition, Quaker maintains in Conshohocken, Pennsylvania, Placentia, California and Uithoorn, The Netherlands, laboratory facilities that are devoted primarily to applied research and development.

Most of Quaker s subsidiaries and associated companies also have laboratory facilities. Although not as complete as the Conshohocken or Uithoorn laboratories, these facilities are generally sufficient for the requirements of the customers being served. If problems are encountered which cannot be resolved by local laboratories, such problems may be referred to the laboratory staff in Conshohocken or Uithoorn.

Regulatory Matters

In order to facilitate compliance with applicable Federal, state, and local statutes and regulations relating to occupational health and safety and protection of the environment, the Company has an ongoing program of site assessment for the purpose of identifying capital expenditures or other actions that may be necessary to comply with such requirements. The program includes periodic inspections of each facility by Quaker and/or independent experts, as well as ongoing inspections and training by on-site personnel. Such inspections are addressed to operational matters, record keeping, reporting requirements, and capital improvements. In 2006, capital expenditures directed solely or primarily to regulatory compliance amounted to approximately $0.8 million compared to $0.7 million and $1.1 million in 2005 and 2004, respectively. In 2007, the Company expects to incur approximately $1.2 million for capital expenditures directed primarily to regulatory compliance. Incorporated by reference is the information regarding AC Products, Inc. contained in Note 18 of Notes to Consolidated Financial Statements included in Item 8 of this Report.

Number of Employees

On December 31, 2006, Quaker s consolidated companies had 1,287 full-time employees of whom 540 were employed by the parent company and its U.S. subsidiaries and 747 were employed by its non-U.S. subsidiaries. Associated companies of Quaker (in which it owns 50% or less) employed 159 people on December 31, 2006.

Product Classification

The Company s reportable segments are as follows:

(1) *Metalworking process chemicals* industrial process fluids for various heavy industrial and manufacturing applications.

(2) *Coatings* temporary and permanent coatings for metal and concrete products and chemical milling maskants.

(3) *Other chemical products* other various chemical products.

Incorporated by reference is the segment information contained in Note 13 of Notes to Consolidated Financial Statements included in Item 8 of this Report.

Non-U.S. Activities

Since significant revenues and earnings are generated by non-U.S. operations, Quaker s financial results are affected by currency fluctuations, particularly between the U.S. dollar, the E.U. euro, the Brazilian real, and the Chinese renminbi and the impact of those currency fluctuations on the underlying economies. Incorporated by reference is the foreign exchange risk information contained in Item 7A of this Report and the geographic information in Note 13 of Notes to Consolidated Financial Statements included in Item 8 of this Report.

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Quaker on the Internet

Financial results, news and other information about Quaker can be accessed from the Company s Web site at http://www.quakerchem.com. This site includes important information on products and services, financial reports, news releases, and career opportunities. The Company s periodic and current reports, including exhibits and supplemental schedules filed therewith, and amendments to those reports, filed with the Securities and Exchange Commission (SEC) are available on the Company s Web site, free of charge, as soon as reasonably practicable after they are electronically filed with or furnished to the SEC. Information that can be accessed through the Company s Web site is not incorporated by reference in this Report and accordingly you should not consider that information part of this Report.

Factors that May Affect Our Future Results

(Cautionary Statements under the Private Securities Litigation Reform Act of 1995)

Certain information included in this Report and other materials filed or to be filed by Quaker with the SEC (as well as information included in oral statements or other written statements made or to be made by us) contain or may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements can be identified by the fact that they do not relate strictly to historical or current facts. We have based these forward-looking statements on our current expectations about future events. These forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, anticipations, intentions, financial condition, results of operations, future performance and business, including:

- statements relating to our business strategy;
- our current and future results and plans; and
- statements that include the words may, could, should, would, believe, expect, anticipate, estimate, intend, plan or

Such statements include information relating to current and future business activities, operational matters, capital spending, and financing sources. From time to time, oral or written forward-looking statements are also included in Quaker s periodic reports on Forms 10-Q and 8-K, press releases, and other materials released to the public.

Any or all of the forward-looking statements in this Report, in Quaker s Annual Report to Shareholders for 2006, and in any other public statements we make may turn out to be wrong. This can occur as a result of inaccurate assumptions or as a consequence of known or unknown risks and uncertainties. Many factors discussed in this Report will be important in determining our future performance. Consequently, actual results may differ materially from those that might be anticipated from our forward-looking statements.

We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise. However, any further disclosures made on related subjects in Quaker s subsequent reports on Forms 10-K, 10-Q and 8-K should be consulted. These forward-looking statements are subject to risks, uncertainties and assumptions about us and our operations that are subject to change based on various important factors, some of which are beyond our control. A major risk is that the Company s demand is largely derived from the demand for its customers products, which subjects the Company to uncertainties related to downturns in a customer s business and unanticipated customer production shutdowns. Other major risks and uncertainties include, but are not limited to, significant increases in raw material costs, worldwide economic and political conditions, foreign currency fluctuations, and terrorist attacks such as those that occurred on September 11, 2001, each of which is discussed in greater detail in Item 1A of this Report. Furthermore, the Company is subject to the same business cycles as those experienced by steel, automobile, aircraft, appliance, and durable goods manufacturers. These risks, uncertainties, and possible inaccurate assumptions relevant to our business could cause our actual results to differ materially from expected and historical results. Other factors

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beyond those discussed in this Report could also adversely affect us. Therefore, we caution you not to place undue reliance on our forward-looking statements. This discussion is provided as permitted by the Private Securities Litigation Reform Act of 1995.

Item 1A. ***Risk Factors***

Changes to the industries and markets that Quaker serves could have a material adverse effect on the Company s liquidity, financial position and results of operations.

The chemical specialty industry comprises a number of companies of similar size as well as companies larger and smaller than Quaker. It is estimated that Quaker holds a leading global position in the markets for process fluids to produce sheet steel and in portions of the automotive and industrial markets. The industry is highly competitive, and a number of companies with significant financial resources and/or customer relationships compete with us to provide similar products and services. Our competitors may be positioned to offer more favorable pricing and service terms, resulting in reduced profitability and loss of market share for us. Historically, competition in the industry has been based primarily on the ability to provide products that meet the needs of the customer and render technical services and laboratory assistance to the customer and, to a lesser extent, on price. Success factors critical to the Company s business include successfully differentiating the Company s offering from its competition, operating efficiently and profitably as a globally integrated whole, and increasing market share and customer penetration through internally developed business programs and strategic acquisitions.

The business environment in which the Company operates remains challenging. The Company is subject to the same business cycles as those experienced by steel, automobile, aircraft, appliance, and durable goods manufacturers. A major risk is that the Company s demand is largely derived from the demand for its customers products, which subjects the Company to uncertainties related to downturns in our customers business and unanticipated customer production shutdowns or curtailments. Customer production within the steel and automotive industries has been recently slowing especially in the U.S., South American and European markets. This is further impacted by the loss of market share of certain of the Company s automotive customers in these markets. In addition, consolidation in the steel industry is concentrating sales among certain of the Company s key customers. The Company has limited ability to adjust its cost level contemporaneously with changes in sales and gross margins. Thus, a significant downturn in sales or gross margins due to weak end-user markets, loss of a significant customer, and/or rising raw material costs could have a material adverse effect on the Company s liquidity, financial position and results of operations.

Our business depends on attracting and retaining qualified management personnel.

The unanticipated departure of any key member of our management team could have an adverse effect on our business. Given the relative size of the Company and the breadth of its global operations, there are a limited number of qualified management personnel to assume the responsibilities of management level employees should there be management turnover. In addition, because of the specialized and technical nature of our business, our future performance is dependent on the continued service of, and our ability to attract and retain qualified management, commercial and technical personnel. Competition for such personnel is intense, and we may be unable to continue to attract or retain such personnel.

Inability to obtain sufficient price increases or contract concessions to offset increases in the costs of raw material could have a material adverse effect on the Company s liquidity, financial position and results of operations. Price increases implemented could result in the loss of sales.

Quaker uses over 1,000 raw materials, including mineral oils and derivatives, animal fats and derivatives, vegetable oils and derivatives, ethylene derivatives, solvents, surface active agents, chlorinated paraffinic compounds, and a wide variety of other organic and inorganic compounds. In 2006, three raw material groups (mineral oil and derivatives, animal fats and derivatives, and vegetable oils and derivatives) each accounted for

as much as 10% of the total cost of Quaker s raw material purchases. The price of mineral oil can be affected by the price of crude oil and refining capacity. In addition, many of the raw materials used by Quaker are commodity chemicals. Accordingly, Quaker s earnings can be affected by market changes in raw material prices.

Over the past three years, Quaker has experienced significant increases in its raw material costs, particularly crude-oil derivatives. For example, the price of crude oil averaged $66 per barrel in 2006 versus $57 in 2005 and $42 in 2004. In addition, refining capacity has also been constrained by various factors, which further contributed to higher raw material costs and negatively impacted margins. In response, the Company has aggressively pursued price increases to offset the increased raw material costs. Although the Company has been successful in recovering a substantial amount of the raw material cost increases, it has experienced competitive as well as contractual constraints limiting pricing actions. In addition, as a result of the Company s pricing actions, customers may become more likely to consider competitor s products, some of which may be available at a lower cost. Significant loss of customers could result in a material adverse effect on the Company s results of operations.

Bankruptcy of a significant customer could have a material adverse effect on our liquidity, financial position and results of operations.

During 2006, our five largest customers (each composed of multiple subsidiaries or divisions with semi-autonomous purchasing authority) together accounted for approximately 23% of our consolidated net sales with the largest customer (General Motors) accounting for approximately 6% of consolidated net sales.

A significant portion of Quaker s revenues is derived from sales to customers in the U.S. steel industry, where a number of bankruptcies occurred during recent years. In addition, certain large industrial customers have also experienced financial difficulty. As part of the bankruptcy process, the Company s pre-petition receivables may not be realized, customer manufacturing sites may be closed or contracts voided. The bankruptcy of a major customer could have a material adverse effect on the Company s liquidity, financial position and results of operations. Steel customers typically have limited manufacturing locations as compared to metalworking customers and generally use higher volumes of products at a single location. The loss or closure of a steel mill or other major customer site of a significant customer could have a material adverse effect on Quaker s business.

Failure to comply with any material provisions of our credit facility could have a material adverse effect on our liquidity, financial position and results of operations.

The Company maintains a $100.0 million unsecured credit facility (the Credit Facility) with a group of lenders, which can be increased to $125.0 million at the Company s request if lenders agree to increase their commitments and the Company satisfies certain conditions. The Credit Facility, which matures on September 30, 2010, provides the availability of revolving credit borrowings. In general, the borrowings under the Credit Facility bear interest at either a base rate or LIBOR rate plus a margin based on the Company s consolidated leverage ratio.

The Credit Facility contains limitations on capital expenditures, investments, acquisitions and liens, as well as default provisions customary for facilities of its type. While these covenants and restrictions are not currently considered to be overly restrictive, they could become more difficult to comply with as our business or financial conditions change. In addition, deterioration in the Company s results of operations or financial position could significantly increase borrowing costs.

Quaker is exposed to market rate risk for changes in interest rates, due to the variable interest rate applied to the Company s borrowings under its credit facilities. Accordingly, if interest rates rise significantly, the cost of debt to Quaker will increase, perhaps significantly, depending on the extent of Quaker s borrowings under the Credit Facility. At December 31, 2006, the Company had $79.2 million outstanding under its credit facilities. The Company has entered into interest rate swaps in order to fix a portion of its variable rate debt and mitigate the

risks associated with higher interest rates. The combined notional value of the swaps was $25.0 million at December 31, 2006. In February 2007, the Company completed a refinancing of its existing industrial development bonds to fix the interest rate of an additional $5.0 million of debt.

Failure to generate taxable income could have a material adverse effect on our financial position and results of operations.

At the end of 2006, the Company had net U.S. deferred tax assets totaling $15.5 million, excluding deferred tax assets relating to additional minimum pension liabilities. In addition, the Company has $5.1 million in operating loss carryforwards primarily related to certain of its foreign operations. The Company records valuation allowances when necessary to reduce its deferred tax assets to the amount that is more likely than not to be realized. The Company considers future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for a valuation allowance. However, in the event the Company were to determine that it would not be able to realize all or part of its net deferred tax assets in the future, an adjustment to the deferred tax asset would be a non-cash charge to income in the period such determination was made, which could have a material adverse effect on the Company s financial statements. The Company continues to closely monitor this situation as it relates to its net deferred tax assets and the assessment of valuation allowances. The Company is implementing actions that could positively impact taxable income.

Environmental laws and regulations and pending legal proceedings may materially and adversely affect the Company s liquidity, financial position and results of operations.

The Company is a party to proceedings, cases, and requests for information from, and negotiations with, various claimants and Federal and state agencies relating to various matters, including environmental matters. An adverse result in any such matters may materially and adversely affect the Company s liquidity, financial position and results of operations. Incorporated herein by reference is the information concerning pending asbestos-related litigation against an inactive subsidiary and amounts accrued associated with certain environmental investigatory and non-capital remediation costs in Note 18 of Notes to Consolidated Financial Statements which appears in Item 8 of this Report.

Ability to rapidly develop, manufacture and gain market acceptance of new and enhanced products required to maintain or expand our business.

We believe that our continued success depends on our ability to continuously develop and manufacture new products and product enhancements on a timely and cost-effective basis, in response to customers demands for higher performance process chemicals, coatings and other chemical products. Our competitors may develop new products or enhancements to their products that offer performance, features and lower prices that may render our products less competitive or obsolete and, as a consequence, we may lose business and/or significant market share. The development and commercialization of new products requires significant expenditures over an extended period of time, and some products that we seek to develop may never become profitable. In addition, we may not be able to develop and introduce products incorporating new technologies in a timely manner that will satisfy our customers future needs or achieve market acceptance.

The scope of our international operations subjects the Company to risks, including risks from changes in trade regulations, currency fluctuations, and political and economic instability.

Since significant revenues and earnings are generated by non-U.S. operations, Quaker s financial results are affected by currency fluctuations, particularly between the U.S. dollar, the E.U. euro, the Brazilian real, and the Chinese renminbi and the impact of those currency fluctuations on the underlying economies. During the past three years, sales by non-U.S. subsidiaries accounted for approximately 53% to 56% of the annual consolidated net sales. All of these operations use the local currency as their functional currency. The Company generally does not use financial instruments that expose it to significant risk involving foreign currency transactions; however,

the size of non-U.S. activities has a significant impact on reported operating results and attendant net assets. Therefore, as exchange rates vary, Quaker s results can be materially affected. Incorporated by reference is the foreign exchange risk information contained in Item 7A of this Report and the geographic information in Note 13 of Notes to Consolidated Financial Statements included in Item 8 of this Report.

Additional risks associated with the Company s international operations include but are not limited to the following:

- Changes in economic conditions from country to country,
- Changes in a country s political condition,
- Trade protection measures,
- Licensing and other legal requirements,
- Local tax issues,
- Longer payment cycles in certain foreign markets,
- Restrictions on the repatriation of our assets, including cash,
- Significant foreign and United States taxes on repatriated cash,
- The difficulties of staffing and managing dispersed international operations,
- Less protective foreign intellectual property laws, and
- Legal systems which may be less developed and predictable than those in the United States.

Terrorist attacks, or other acts of violence or war may affect the markets in which we operate and our profitability.

Terrorist attacks may negatively affect our operations. There can be no assurance that there will not be further terrorist attacks against the United States or United States businesses. Terrorist attacks or armed conflicts may directly impact our physical facilities or those of our suppliers or customers. Additional terrorist attacks may disrupt the global insurance and reinsurance industries with the result that we may not be able to obtain insurance at historical terms and levels for all of our facilities. Furthermore, additional attacks may make travel and the transportation of our supplies and products more difficult and more expensive and ultimately affect the sales of our products. The consequences of terrorist attacks or armed conflicts are unpredictable, and we may not be able to foresee events that could have an adverse effect on our business.

Item 1B. ***Unresolved Staff Comments.***

None.

Item 2. ***Properties.***

Quaker s corporate headquarters and a laboratory facility are located in Conshohocken, Pennsylvania. Quaker s other principal facilities are located in Detroit, Michigan; Middletown, Ohio; Placentia, California; Santa Fe Springs, California; Uithoorn, The Netherlands; Santa Perpetua de Mogoda, Spain; Rio de Janeiro, Brazil; Tradate, Italy; and Qingpu, China, which commenced operations in January 2007. All of the properties except Placentia, California and Santa Fe Springs, California are used by the metalworking segment. The Placentia, California and Santa Fe Springs, California properties are used by the coatings segment. With the exception of the Conshohocken, Placentia, Santa Fe Springs and Tradate sites, which are leased, all of these principal facilities are owned by Quaker and as of December 31, 2006 were mortgage free. Quaker also leases sales, laboratory, manufacturing, and warehouse facilities in other locations.

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Quaker s aforementioned principal facilities (excluding Conshohocken) consist of various manufacturing, administrative, warehouse, and laboratory buildings. Substantially all of the buildings (including Conshohocken) are of fire-resistant construction and are equipped with sprinkler systems. All facilities are primarily of masonry and/or steel construction and are adequate and suitable for Quaker s present operations. The Company has a program to identify needed capital improvements that are implemented as management considers necessary or desirable. Most locations have various numbers of raw material storage tanks ranging from 7 to 66 at each location with a capacity ranging from 1,000 to 82,000 gallons and processing or manufacturing vessels ranging in capacity from 15 to 16,000 gallons.

In January 2001, the Company contributed its Conshohocken, Pennsylvania property and buildings (the Site) into a real estate joint venture (the Venture) in exchange for a 50% interest in the Venture. The Venture did not assume any debt or other obligations of the Company and the Company did not guarantee nor was it obligated to pay any principal, interest or penalties on any of the Venture s indebtedness. The Venture renovated certain of the existing buildings at the Site, as well as built new office space. In December 2000, the Company entered into an agreement with the Venture to lease approximately 38% of the Site s available office space for a 15-year period commencing February 2002, with multiple renewal options. The Company believes the terms of this lease were no less favorable than the terms it would have obtained from an unaffiliated third party. In February 2005, the Venture sold its real estate assets to an unrelated third party, which resulted in $4.2 million of proceeds to the Company after payment of the Venture s obligations.

In 2005, the Company completed the sale of its Villeneuve, France site. Quaker had ceased manufacturing operations at this facility in March 2002. Production was consolidated into its facilities in Uithoorn, The Netherlands and Santa Perpetua de Mogoda, Spain. In November 2006, the Company s former Chinese joint venture partner purchased the Wuxi joint venture s manufacturing facility, with production scheduled to be transferred to the Company s Qingpu, China facility during 2007.

Each of Quaker s 50% or less owned non-U.S. associated companies owns or leases a plant and/or sales facilities in various locations.

Item 3. ***Legal Proceedings.***

The Company is a party to proceedings, cases, and requests for information from, and negotiations with, various claimants and Federal and state agencies relating to various matters, including environmental matters. Incorporated herein by reference is the information concerning pending asbestos-related litigation against an inactive subsidiary and amounts accrued associated with certain environmental investigatory and non-capital remediation costs in Note 18 of Notes to Consolidated Financial Statements, which appears in Item 8 of this Report. The Company is a party to other litigation which management currently believes will not have a material adverse effect on the Company s results of operations, cash flow, or financial condition.

Item 4. ***Submission of Matters to a Vote of Security Holders.***

No matters were submitted to a vote of security holders during the last quarter of the period covered by this Report.

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Item 4(a). ***Executive Officers of the Registrant.***

Set forth below are the executive officers of the Company. Each of the executive officers is elected annually to a one-year term.

Name, Age, and Present Position with the Company	Business Experience During Past Five Years and Period Served as an Officer
Ronald J. Naples, 61 Chairman of the Board and Chief Executive Officer, and Director	Mr. Naples has served in his current position since 1997.
Neal E. Murphy, 49 Vice President, Chief Financial Officer and Treasurer	Mr. Murphy was elected Vice President in July 2004 and was elected Chief Financial Officer and Treasurer in August 2004. Prior to joining the Company, he was Senior Vice President and Chief Financial Officer of International Specialty Products from February 2002 to July 2004.
Michael F. Barry, 48 Senior Vice President and Managing Director North America	Mr. Barry assumed his current position in January 2006. He was Senior Vice President and Global Industry Leader Metalworking and Coatings from July 2005 through December 2005. He was Vice President and Global Industry Leader Industrial Metalworking and Coatings from January 2004 through June 2005 and Vice President and Chief Financial Officer from 1998 to August 2004.
D. Jeffry Benoliel, 48 Vice President, Secretary and General Counsel	Mr. Benoliel has served in his current position since 2001.
José Luiz Bregolato, 61 Vice President and Managing Director South America	Mr. Bregolato has served in his current position since 1993.
Mark A. Featherstone, 45 Vice President and Global Controller	Mr. Featherstone was elected Vice President in March 2005, and has held the position of Global Controller since May 2001.
Mark Harris, 52 Senior Vice President Global Strategy and Marketing	Mr. Harris assumed his current position in January 2006. He was Senior Vice President and Global Industry Leader Steel from July 2005 through December 2005. He was Vice President and Global Industry Leader Steel from January 2001 through June 2005.
Jan F. Nieman, 46 Vice President and Managing Director Asia/Pacific	Mr. Nieman was elected Vice President in February 2005, and has held the position of Managing Director, Asia/Pacific since August 2003. He was also Global Business Unit Manager Value Added Resellers Metalworking, Quaker Chemical B.V., the Company s Dutch affiliate, from October 2000 to August 2003.
Wilbert Platzer, 45 Vice President and Managing Director Europe	Mr. Platzer assumed his current position in January 2006. He was Vice President Global Industrial Metalworking from July 2005 through December 2005. He was Vice President Worldwide Operations from January 2001 through June 2005.

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PART II

Item 5. ***Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.***

The Company s common stock is listed on the New York Stock Exchange (NYSE) under the trading symbol KWR. The following table sets forth, for the calendar quarters during the past two most recent fiscal years, the range of high and low sales prices for the common stock as reported on the NYSE composite tape (amounts rounded to the nearest penny), and the quarterly dividends declared and paid:

	Price Range				Dividends Declared		Dividends Paid	
	2006		2005					
	High	Low	High	Low	2006	2005	2006	2005
First quarter	$ 21.75	$ 18.90	$ 25.07	$ 20.03	$ 0.215	$ 0.215	$ 0.215	$ 0.215
Second quarter	21.94	16.70	22.00	17.30	0.215	0.215	0.215	0.215
Third quarter	20.29	18.04	19.11	16.57	0.215	0.215	0.215	0.215
Fourth quarter	22.49	18.25	19.34	15.80	0.215	0.215	0.215	0.215

As of January 17, 2007, there were 918 shareholders of record of the Company s common stock, its only outstanding class of equity securities.

Every holder of Quaker common stock is entitled to one vote or ten votes for each share held of record on any record date depending on how long each share has been held. As of January 17, 2007, 9,948,053 shares of Quaker common stock were issued and outstanding. Based on the information available to the Company, on January 17, 2007, the holders of 1,054,298 shares of Quaker common stock would have been entitled to cast ten votes for each share, or approximately 54% of the total votes that would have been entitled to be cast as of that record date and the holders of 8,893,755 shares of Quaker common stock would have been entitled to cast one vote for each share, or approximately 46% of the total votes that would have been entitled to be cast as of that date. The number of shares that are indicated as entitled to one vote includes those shares presumed to be entitled to only one vote. Because the holders of these shares may rebut this presumption, the total number of votes entitled to be cast as of January 17, 2007 could be more than 19,436,735.

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The following graph compares the cumulative total return (assuming reinvestment of dividends) from December 31, 2001 to December 31, 2006 for (i) Quaker s common stock, (ii) the S&P SmallCap 600 Stock Index (the SmallCap Index) and (iii) the S&P Chemicals (Specialty) Index-SmallCap (the Chemicals Index). The graph assumes the investment of $100 on December 31, 2001 in each of Quaker s common stock, the stocks comprising the SmallCap Index, and the stocks comprising the Chemicals Index.

COMPARISON OF CUMULATIVE FIVE YEAR TOTAL RETURN

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Item 6. ***Selected Financial Data.***

The following table sets forth selected financial information for the Company and its consolidated subsidiaries:

	2006	2005(1)	2004	2003	2002
	(In thousands, except per share amounts)				
Summary of Operations:					
Net sales	$ 460,451	$ 424,033	$ 400,695	$ 340,192	$ 274,521
Income before taxes, equity income and minority interest	18,440	6,615	17,457	24,118	24,318
Net income	11,667	1,688	8,974	14,833	14,297
Per share:					
Net income-basic	$ 1.19	$ 0.17	$ 0.93	$ 1.58	$ 1.56
Net income-diluted	$ 1.18	$ 0.17	$ 0.90	$ 1.52	$ 1.51
Dividends declared	0.86	0.86	0.86	0.84	0.84
Dividends paid	0.86	0.86	0.855	0.84	0.835
Financial Position:					
Working capital	$ 96,062	$ 79,105	$ 45,569	$ 37,137	$ 37,529
Total assets	357,382	331,995	324,893	289,467	213,858
Long-term debt	85,237	67,410	14,848	15,827	16,590
Shareholders equity	110,831	105,907	122,587	112,352	88,055

Following amounts in thousands

(1) The results of operation for 2005 include a net pre-tax charge for restructuring and related activities of $10,320, proceeds from the sale of real estate by the Company s real estate joint venture of $4,187, and a $1,000 tax charge associated with the repatriation of accumulated earnings of its foreign subsidiaries.

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Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations.***

Executive Summary

Quaker Chemical Corporation is a worldwide developer, producer, and marketer of chemical specialty products and a provider of chemical management services (CMS) for various heavy industrial and manufacturing applications around the globe, with significant sales to the steel and automotive industries. The improved 2006 results largely reflect the continued execution of the Company s actions taken throughout 2005 in response to its challenging business environment.

The revenue growth in 2006 was primarily due to increased selling prices, as well as higher volume in China. Higher selling prices, combined with improved CMS profitability, offset higher raw material and third-party finished product costs, resulting in significantly higher gross margin dollars with only a slight improvement in gross margin as a percentage of sales as compared to 2005. Raw material costs, primarily crude oil derivatives, continued to increase during 2006 compared to the prior year, mitigating pricing actions intended to improve gross margins as a percentage of sales. While oil prices have recently declined from a peak early in the third quarter of 2006, to date, the oil price reductions have not yet resulted in any significant reduction in raw material prices. Selling, general and administrative expenses for 2006 increased $4.6 million compared to 2005. Cost savings from restructuring efforts completed in 2005 enabled increased spending in higher growth areas, higher variable compensation and higher professional fees.

Earnings per diluted share of $1.18 represent a considerable improvement over the $0.17 for 2005. The principal factors impacting 2006 earnings included a 9% growth in revenues and improved performance from CMS. The Company s 2005 earnings included a $10.3 million pre-tax charge for restructuring and related activities and a $1.0 million tax charge attributable to the repatriation of accumulated earnings of its foreign subsidiaries, which were offset in part by $4.2 million of pre-tax income from the sale of property by the Company s real estate joint venture and lower minority interest primarily as a result of the Company s first quarter 2005 acquisition of the remaining 40% interest in its Brazilian affiliate. The Company s 2005 restructuring efforts are positively impacting the bottom line as resources have been shifted to higher growth areas like China, CMS and coatings. However, any improvements in gross margin as a percentage of sales will depend upon a sustained period of stable or declining raw material costs. The Company remains focused on pursing revenue opportunities, managing its raw material and other costs and pursuing pricing initiatives. Most recently, in the fourth quarter of 2006 the Company acquired the remaining minority interest in its China affiliate.

Notwithstanding the improved performance, the business environment in which the Company operates remains challenging. While demand in China is expected to continue to remain strong, volume in other markets was limited by customer end-market issues, including higher inventory levels in the U.S. steel industry and reduced vehicle sales experienced by some automotive customers, with indications that these conditions would continue for the foreseeable future. Raw material and third party product costs continue to remain higher as compared to the prior year. In certain instances, the Company faces competitive or contractual constraints limiting pricing actions to recover these higher costs.

Critical Accounting Policies and Estimates

Quaker s discussion and analysis of its financial condition and results of operations are based upon Quaker s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires Quaker to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, Quaker evaluates its estimates, including those related to customer sales incentives, product returns, bad debts, inventories, property, plant, and equipment, investments, intangible assets, income taxes, financing operations, restructuring, incentive compensation plans, pensions and other postretirement benefits, and contingencies and litigation. Quaker bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the

circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Quaker believes the following critical accounting policies describe the more significant judgments and estimates used in the preparation of its consolidated financial statements:

1. Accounts receivable and inventory reserves and exposures Quaker establishes allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. If the financial condition of Quaker s customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. As part of its terms of trade, Quaker may custom manufacture products for certain large customers and/or may ship product on a consignment basis. Further, a significant portion of Quaker s revenues is derived from sales to customers in the U.S. steel industry, where a number of bankruptcies have occurred during recent years. In recent years, certain large industrial customers have also experienced financial difficulty. When a bankruptcy occurs, Quaker must judge the amount of proceeds, if any, that may ultimately be received through the bankruptcy or liquidation process. These matters may increase the Company s exposure should a bankruptcy occur, and may require writedown or disposal of certain inventory due to its estimated obsolescence or limited marketability. Reserves for customers filing for bankruptcy protection are generally established at 75-100% of the amount outstanding at the filing date, dependent on the Company s evaluation of likely proceeds from the bankruptcy process. Large and/or financially distressed customers are generally reserved for on a specific review basis while a general reserve is established for other customers based on historical experience. The Company s consolidated allowance for doubtful accounts was $3.2 million and $4.1 million at December 31, 2006 and 2005, respectively. Further, the Company recorded provisions for doubtful accounts of $0.0 million, $1.2 million and $0.5 million in 2006, 2005 and 2004 respectively. An increase of 10% to the recorded provisions would have decreased the Company s pre-tax earnings by $0.0 million, $0.12 million and $0.05 million in 2006, 2005 and 2004, respectively.

2. Environmental and litigation reserves Accruals for environmental and litigation matters are recorded when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated. Accrued liabilities are exclusive of claims against third parties and are not discounted. Environmental costs and remediation costs are capitalized if the costs extend the life, increase the capacity or improve the safety or efficiency of the property from the date acquired or constructed, and/or mitigate or prevent contamination in the future. Estimates for accruals for environmental matters are based on a variety of potential technical solutions, governmental regulations and other factors, and are subject to a large range of potential costs for remediation and other actions. A considerable amount of judgment is required in determining the most likely estimate within the range, and the factors determining this judgment may vary over time. Similarly, reserves for litigation and similar matters are based on a range of potential outcomes and require considerable judgment in determining the most probable outcome. If no amount within the range is considered more probable than any other amount, the Company accrues the lowest amount in the range in accordance with generally accepted accounting principles. An inactive subsidiary of the Company is involved in asbestos litigation. If the Company ever concludes that it is probable it will be liable for any of the obligations of such subsidiary, then it will record the associated liabilities if they can be reasonably estimated. The Company will reassess this situation periodically in accordance with SFAS No. 5, Accounting for Contingencies. See Note 18 of Notes to Consolidated Financial Statements which appears in Item 8 of this Report.

3. Realizability of equity investments Quaker holds equity investments in various foreign companies, whereby it has the ability to influence, but not control, the operations of the entity and its future results. Quaker records an investment impairment charge when it believes an investment has experienced a decline in value that is other than temporary. Future adverse changes in market conditions, poor operating results of underlying investments, or devaluation of foreign currencies could result in losses or an inability to recover the carrying value of the investments that may not be reflected in an investment s current carrying value.

These factors may result in an impairment charge in the future. The carrying amount of the Company s equity investments at December 31, 2006 was $7.0 million and was comprised of three investments totaling $3.6 million, $2.3 million and $1.1 million, respectively.

4. Tax exposures and valuation allowances Quaker records expenses and liabilities for taxes based on estimates of amounts that will be ultimately determined to be deductible in tax returns filed in various jurisdictions. The filed tax returns are subject to audit, often several years subsequent to the date of the financial statements. Disputes or disagreements may arise during audits over the timing or validity of certain items or deductions, which may not be resolved for extended periods of time. Quaker establishes reserves for potential tax audit and other exposures as transactions occur and reviews these reserves on a regular basis; however, actual exposures and audit adjustments may vary from these estimates. Quaker also records valuation allowances when necessary to reduce its deferred tax assets to the amount that is more likely than not to be realized. While Quaker has considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event Quaker were to determine that it would be able to realize its deferred tax assets in the future in excess of its net recorded amount, an adjustment to the deferred tax asset would increase income in the period such determination was made. Likewise, should Quaker determine that it would not be able to realize all or part of its net deferred tax assets in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made which could have a material adverse impact on the Company s financial statements. U.S. income taxes have not been provided on the undistributed earnings of non-U.S. subsidiaries since it is the Company s intention to continue to reinvest these earnings in those subsidiaries for working capital needs and growth initiatives. U.S. and foreign income taxes that would be payable if such earnings were distributed may be lower than the amount computed at the U.S. statutory rate due to the availability of foreign tax credits.

5. Restructuring liabilities Restructuring charges may consist of charges for employee severance, rationalization of manufacturing facilities and other items. In 2001, Quaker recorded restructuring and other exit costs, including involuntary termination of certain employees, in accordance with the Financial Accounting Standards Board s (FASB) Emerging Issues Task Force (EITF) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). Certain of these items, particularly those involving impairment charges for assets to be sold or closed, require significant estimates and assumptions in terms of estimated sale proceeds, date of sale, transaction costs and other matters, and these estimates can change based on market conditions and other factors. In July 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, which nullified EITF Issue No. 94-3. The Company adopted the provisions of SFAS No. 146 effective for exit or disposal activities initiated after December 31, 2002. The principal difference between SFAS No. 146 and EITF 94-3 relates to its requirements for recognition of a liability for a cost associated with an exit or disposal activity. SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF 94-3, a liability for exit costs is recognized at the date of an entity s commitment to an exit plan.

6. Goodwill and other intangible assets Goodwill and other intangible assets are evaluated in accordance with SFAS No. 142, Goodwill and Other Intangible Assets. Intangible assets, which do not have indefinite lives, are recorded at fair value and amortized over a straight-line basis based on third party valuations of the assets. Goodwill and intangible assets, which have indefinite lives, are no longer amortized and are required to be assessed at least annually for impairment. The Company compares the assets fair value to their carrying value primarily based on future discounted cash flows in order to determine if an impairment charge is warranted. The estimates of future cash flows involve considerable management judgment and are based upon assumptions about expected future operating performance. Assumptions used in these forecasts are consistent with internal planning. The actual cash flows could differ from management s estimates due to changes in business conditions, operating performance, and economic conditions. The Company completed its annual impairment assessment as of the end of the third quarter 2006, and no impairment charge was warranted. The Company s consolidated goodwill and indefinite-lived intangible assets at December 31, 2006 and 2005 were $39.3 million and $36.0 million, respectively. The

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Company s assumption of weighted average cost of capital and estimated future net operating profit after tax (NOPAT) are particularly important in determining whether an impairment charge has been incurred. The Company currently uses a weighted average cost of capital of 12% and, at September 30, 2006, this assumption would have had to increase by more than 2.5 percentage points before any of the Company s reporting units would fail step one of the SFAS No. 142 impairment analysis. Further, at September 30, 2006, the Company s estimate of future NOPAT would have had to decrease by more than 17% before any of the Company s reporting units would be considered potentially impaired.

7. Postretirement benefits The Company provides certain pension and other postretirement benefits to employees and retirees. Independent actuaries, in accordance with accounting principles generally accepted in the United States, perform the required valuations to determine benefit expense and, if necessary, non-cash charges to equity for additional minimum pension liabilities. Critical assumptions used in the actuarial valuation include the weighted average discount rate, rates of increase in compensation levels, and expected long-term rates of return on assets. If different assumptions were used, additional pension expense or charges to equity might be required. For 2006, the Company incurred such a non-cash charge to equity of $9.3 million, in connection with the adoption of SFAS No. 158, Employers Accounting for Defined Benefit and Other Postretirement Plans. The Company s pension plan year-end is November 30, which serves as the measurement date. The following table highlights the potential impact on the Company s pre-tax earnings due to changes in assumptions with respect to the Company s pension plans, based on assets and liabilities at December 31, 2006:

	1/2 Percentage Point Increase			1/2 Percentage Point Decrease		
	Foreign	**Domestic**	**Total**	**Foreign**	**Domestic**	**Total**
			(Dollars in millions)			
Discount rate	$ (0.6)	$ (0.1)	$ (0.7)	$ 0.4	$ 0.1	$ 0.5
Expected rate of return on plan assets	$ (0.2)	$ (0.2)	$ (0.4)	$ 0.2	$ 0.2	$ 0.4

Recently Issued Accounting Standards

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing the recognition threshold a tax position is required to meet before being recognized in the financial statements. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effects, if any, of applying FIN 48 will be recorded as an adjustment to retained earnings as of the beginning of the period of adoption. The Company is currently evaluating the effect that the adoption of FIN 48 will have on its consolidated results of operations and financial condition and is not yet in a position to determine such effects.

In September 2006, the FASB issued FASB Staff Position (FSP) AUG AIR-1 Accounting for Planned Major Maintenance Activities (FSP AUG AIR-1). FSP AUG AIR-1 amends the guidance on the accounting for planned major maintenance activities; specifically, it precludes the use of the previously acceptable accrue in advance method. FSP AUG AIR-1 is effective for fiscal years beginning after December 15, 2006. The adoption of FSP AUG AIR-1 did not have a material effect on our consolidated financial position or results of operations.

In September 2006, the SEC staff issued Staff Accounting Bulletin (SAB) 108 Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 requires that public companies utilize a dual-approach to assessing the quantitative effects of financial misstatements. This dual approach includes both an income statement focused assessment and a balance sheet focused assessment. The guidance in SAB 108 must be applied to annual financial statements for fiscal years ending after November 15, 2006. The adoption of SAB 108 did not have a material effect on our consolidated financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 establishes a common definition for fair value to be applied to US GAAP guidance requiring use of fair

value, establishes a framework for measuring fair value, and expands disclosure about such fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact of SFAS No. 157 on its consolidated financial position and results of operations.

Liquidity and Capital Resources

Quaker s cash and cash equivalents remained at $16.1 million at December 31, 2006 and 2005. Operating and financing activities provided $8.2 million and $4.2 million, respectively, which were offset by $13.5 million of net cash used in investing activities.

Net cash flows provided by operating activities were $8.2 million in 2006 versus $11.6 million in 2005. The Company s higher net income was more than offset by the change in working capital accounts, increased net pension plan contributions and higher restructuring payments in 2006, as a result of the actions taken in the fourth quarter of 2005. The change in working capital accounts was largely driven by higher incentive compensation accruals in 2006 on higher earnings and the timing of accounts payable in the U.S. and Europe in the prior year.

Net cash flows used in investing activities were $13.5 million in 2006 compared to $8.8 million in 2005. The primary factors affecting the change in cash flows were higher capital expenditures in 2006 for expansion, primarily in Asia/Pacific, and lower payments related to acquisitions, and lower proceeds from the disposition of assets. In March 2005, the Company acquired the remaining 40% interest in its Brazilian joint venture for $6.7 million. In accordance with the purchase agreement, the Company made the first of four $1.0 million contingent annual payments in the first quarter of 2006. In addition, in the fourth quarter of 2006, the Company paid $0.6 million in connection with the acquisition of the remaining minority interest in its China joint venture. See also Note 14 of Notes to Consolidated Financial Statements. In the first quarter of 2005, the Company recorded a gain of $3.0 million in connection with the sale of real estate assets by the Company s real estate joint venture, discussed below. In 2005, the Company received $1.9 million of cash proceeds from the sale of its Villeneuve, France site.

In January 2001, the Company contributed its Conshohocken, Pennsylvania property and buildings (the Site) into a real estate joint venture (the Venture) in exchange for a 50% interest in the Venture. The Venture did not assume any debt or other obligations of the Company and the Company did not guarantee nor was it obligated to pay any principal, interest or penalties on any of the Venture s indebtedness. The Venture renovated certain of the existing buildings at the Site, as well as built new office space. In December 2000, the Company entered into an agreement with the Venture to lease approximately 38% of the Site s available office space for a 15-year period commencing February 2002, with multiple renewal options. The Company believes the terms of this lease were no less favorable than the terms it would have obtained from an unaffiliated third party. In February 2005, the Venture sold its real estate assets to an unrelated third party, which resulted in $4.2 million of proceeds to the Company after payment of the Venture s obligations. The proceeds include a gain of $3.0 million related to the sale by the Venture of its real estate holdings as well as $1.2 million of preferred distributions.

In December 2005, an inactive subsidiary of the Company reached a settlement agreement and release with one of its insurance carriers for $15.0 million. The proceeds of the settlement are restricted and can only be used to pay claims and costs of defense associated with this subsidiary s asbestos litigation. In accordance with the agreement, the subsidiary received $7.5 million cash in December 2005 and the remaining $7.5 million in December of 2006, which were deposited into an interest bearing account, which earned approximately $0.3 million in 2006, offset by $0.5 million of payments in 2006. The restrictions regarding the use of proceeds lapse after a period of 15 years. Due to the restricted nature of the proceeds, a corresponding deferred credit was established in Other non-current liabilities for an equal and offsetting amount, and will remain until the restrictions lapse or the funds are exhausted via payments of claims and costs of defense. See Notes 16, 17 and 18 of Notes to Consolidated Financial Statements.

Net cash flows provided by financing activities were $4.2 million in 2006 compared to a $14.9 million use of cash in 2005. The change was caused primarily by net borrowings in 2006 compared to net repayments in 2005. The borrowings in 2006 were used to fund the Company s working capital needs, construction of a new manufacturing

and research facility in China, and the fourth quarter 2006 acquisition of the remaining interest in the Company s China affiliate. The fourth quarter 2005 restructuring actions were funded during 2006. In addition, lower distributions were paid to the minority shareholders in 2006 due to the acquisition of minority shareholders interests. The prior year distributions to minority shareholders were driven in large part by a distribution made prior to the Company s acquisition of the remaining 40% interest in its Brazilian joint venture described above.

In September 2005, the Company prepaid its senior unsecured notes due in 2007. The total amount of principal prepaid was $8.6 million. In October 2005, the Company entered into a new syndicated multi-currency credit agreement that provides for financing in the United States and The Netherlands. This facility enabled the Company to consolidate the majority of its short-term debt into a longer-term facility. The new facility terminates on September 30, 2010. The new facility allows for revolving credit borrowings in a principal amount of up to $100.0 million, which can be increased to $125.0 million at the Company s request if lenders agree to increase their commitments and the Company satisfies certain conditions. In general, borrowings under the credit facility bear interest at either a base rate or LIBOR rate plus a margin based on the Company s consolidated leverage ratio. The provisions of the agreement require that the Company maintain certain financial ratios and covenants, all of which the Company was in compliance with as of December 31, 2006 and 2005. Under its most restrictive covenants, the Company could have borrowed an additional $18.8 million at December 31, 2006. At December 31, 2006 and 2005, the Company had approximately $79.2 million and $63.8 million outstanding on these credit lines at a weighted average borrowing rate of 5.69% and 4.42%, respectively. The Company has entered into interest rate swaps in order to fix a portion of its variable rate debt and mitigate the risks associated with higher interest rates. The combined notional value of the swaps was $25.0 million at December 31, 2006. In February 2007, the Company completed a refinancing of its existing industrial development bonds to fix the interest rate of an additional $5.0 million of debt.

The Company s net debt-to-total capital ratio was 40% at December 31, 2006, compared to 35% at December 31, 2005. In connection with the adoption of SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, the Company recorded a non-cash charge to Shareholders equity of $9.3 million, which negatively impacted the Company s net debt-to-total capital ratio by approximately two percentage points. The Company believes that in 2007 it is capable of supporting its operating requirements including pension plan contributions, payments of dividends to shareholders, possible acquisition and business opportunities, capital expenditures and possible resolution of contingencies, through internally generated funds supplemented with debt as needed.

The following table summarizes the Company s contractual obligations at December 31, 2006, and the effect such obligations are expected to have on its liquidity and cash flow in future periods. Pension and other postretirement plan contributions beyond 2007 are not determinable since the amount of any contribution is heavily dependent on the future economic environment and investment returns on pension trust assets. The timing of payments related to other long-term liabilities, which consist primarily of deferred compensation agreements, cannot be readily determined due to their uncertainty. Interest obligations on the Company s short and long-term debt are excluded as the majority of the Company s debt is subject to variable interest rates. (Amounts in millions)

	Payments due by period						
Contractual Obligations	**Total**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012 and beyond**
Short-term debt	$ 3.261	$ 3.261	$	$	$	$	$
Long-term debt	85.501	1.369	1.405	0.942	76.785		5.000
Capital lease obligations	1.717	0.446	0.407	0.338	0.508	0.018	
Non-cancelable operating leases	20.012	4.073	3.623	2.667	1.991	1.733	5.925
Purchase obligations	3.503	3.070	0.433				
Pension and other postretirement plan contributions	7.983	7.983					
Other long-term liabilities (primarily deferred compensation agreements)	8.553						8.553
Total contractual cash obligations	$ 130.530	$ 20.202	$ 5.868	$ 3.947	$ 79.284	$ 1.751	$ 19.478

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Operations

CMS Discussion

During 2003, the Company expanded its approach to its chemical management services (CMS) channel consistent with the Company s strategic imperative to sell customer solutions value not just fluids. Prior to this change, the Company effectively acted as an agent whereby it purchased chemicals from other companies and resold the product to the customer at little or no margin and earned a set management fee for providing this service. Therefore, the profit earned on the management fee was relatively secure as the entire cost of the products was passed on to the customer. The approach taken in 2003 was dramatically different. The Company began entering into new contracts under which it receives a set management fee and the costs that relate to those management fees were and are largely dependent on how well the Company controls product costs and achieves product conversions from other third-party suppliers to its own products. This approach came with new risks and opportunities, as the profit earned from the management fee is subject to movements in product costs as well as the Company s own performance. The Company believes this expanded approach is a way for Quaker to become an integral part of our customers operational efforts to improve manufacturing costs and to demonstrate value that the Company would not be able to demonstrate as purely a product provider.

Under this alternative pricing structure, the Company was awarded a series of multi-year CMS contracts primarily at General Motors Powertrain, DaimlerChrysler and Ford manufacturing sites in 2003, 2004, 2005 and 2006. This business was an important step in building the Company s share and leadership position in the automotive process fluids market and has positioned the Company well for penetration of CMS opportunities in other metalworking manufacturing sites. This alternative approach had a dramatic impact on the Company s revenue and margins. Under the traditional CMS approach, where the Company effectively acts as an agent, revenues and costs from these sales are reported on a net sales or pass-through basis. As discussed above, the alternative structure is different in that the Company s revenue received from the customer is a fee for products and services provided to the customer, which are indirectly related to the actual costs incurred. As a result, the Company recognizes in the alternative structure in reported revenues the gross revenue received from the CMS site customer, and in cost of goods sold, the third-party product purchases, which substantially offset each other until the Company achieves significant product conversions. As some contracts have been renewed or renegotiated, some of the contracts reverted to a pass through basis. Currently, the Company has a mix of contracts with both the traditional product pass through structure and fixed priced contracts covering all services and products. The Company s offerings will continue to include both approaches to CMS depending on customer requirements and business circumstances.

Comparison of 2006 with 2005

Net sales for 2006 were $460.5 million, up 8.6% from $424.0 million for 2005. The increase in net sales was attributable to higher sales prices and volume growth. Volume growth was mainly attributable to market share growth and increased demand in the U.S. and China offset by softening demand in Europe. Selling price increases were broadly implemented across all regions and market segments to offset significantly higher raw material costs.

Gross profit (net sales less cost of goods sold) as a percentage of sales was 31.0% for 2006, as compared to 30.6% for 2005. Higher selling prices and a stronger performance from the Company s CMS channel helped maintain margins notwithstanding continued increases in raw material prices, particularly crude oil derivatives.

Selling, general and administrative expenses (SG&A) for 2006 increased $4.6 million compared to 2005. Cost savings from restructuring efforts completed in 2005 enabled increased spending in higher growth areas, higher variable compensation, and higher professional fees. In addition, due to a legislative change, effective January 1, 2006, the Company recorded a pension gain in the first quarter of 2006 of $0.9 million relating to one of its European pension plans. SG&A as a percentage of sales decreased from 27.4% to 26.3%.

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In the first quarter of 2005, the Company incurred a net pre-tax charge of $1.2 million related to a reduction in its workforce. During the fourth quarter of 2005, the Company furthered this restructuring effort with the goal of significantly reducing operating costs in the U.S. and Europe. The fourth quarter program included involuntary terminations, a freeze of the Company s U.S. pension plan, and a voluntary early retirement offering to eligible U.S. employees. These actions resulted in a net pre-tax charge of $9.1 million.

The decrease in other income is largely due to $4.2 million of pre-tax gain relating to the Company s real estate joint venture recorded in 2005. The remainder of the decrease was the result of foreign exchange losses in 2006 compared to gains in 2005. The increase in net interest expense is attributable to higher average borrowings and higher interest rates.

The effective tax rate was 33.8% for 2006 compared to 50.4% in 2005, with the decrease primarily due to the tax charge taken in 2005 associated with the repatriation of accumulated foreign earnings.

At the end of 2006, the Company had net U.S. deferred tax assets totaling $15.5 million, excluding deferred tax assets relating to additional minimum pension liabilities. The Company records valuation allowances when necessary to reduce its deferred tax assets to the amount that is more likely than not to be realized. The Company considers future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for a valuation allowance. However, in the event the Company were to determine that it would not be able to realize all or part of its U.S. net deferred tax assets in the future, an adjustment to the deferred tax asset would be a non-cash charge to income in the period such determination were made, which could have a material adverse impact on the Company s financial statements. The continued upward pressure in the prices for the Company s crude-oil based raw materials has negatively impacted U.S. profitability. The Company continues to closely monitor this situation as it relates to its net deferred tax assets and the assessment of valuation allowances. The Company is continuing to evaluate alternatives that could positively impact taxable income.

The decrease in minority interest expense for the year is due to the acquisition of the remaining 40% interest in the Company s Brazilian affiliate in March of 2005, the fourth quarter 2006 acquisition of the remaining interest in the Company s China affiliate, and lower financial performance from most of the Company s minority affiliates.

Segment Reviews Comparison of 2006 with 2005

Metalworking Process Chemicals:

Metalworking Process Chemicals consist of industrial process fluids for various heavy industrial and manufacturing applications and represented approximately 92% of the Company s net sales in 2006. Net sales for this segment were up $32.0 million, or 8%, compared to 2005. Foreign currency translation positively impacted net sales by approximately 1%, driven by the Brazilian real to U.S. dollar exchange rate. The average Brazilian real to U.S. dollar rate was 0.46 in 2006 compared to 0.41 in 2005. Net sales were positively impacted by 4% growth in North America, 5% growth in Europe, 20% growth in Asia/Pacific and 2% growth in South America, all on a constant currency basis. The growth in net sales was attributable to both higher sales and volume growth. The majority of the volume growth came from increased demand in China, while price increases implemented across all regions helped to restore margins despite higher raw material costs. The $12.6 million increase in this segment s operating income compared to 2005 is largely reflective of the Company s pricing actions, improved performance from the Company s U.S. CMS channel, and savings generated from the Company s 2005 restructuring actions.

Coatings:

The Company s Coatings segment, which represented approximately 7% of the Company s net sales for 2006, contains products that provide temporary and permanent coatings for metal and concrete products and chemical milling maskants. Net sales for this segment were up $6.2 million, or 23% in 2006, compared with the

prior year. The increase in net sales was the result of increased demand for both coatings and chemical milling maskants to the aerospace industry. This segment s operating income increased $1.2 million, consistent with the noted volume increases.

Other Chemical Products:

Other Chemical Products, which represented approximately 1% of the Company s net sales for 2006, consists of sulfur removal products for industrial gas streams sold by the Company s Q2 Technologies joint venture. Net sales for 2006 decreased $1.8 million, or 47%, due to a variety of market conditions, including reduced demand in the hydrocarbon and wastewater markets. This segment s operating income decreased $0.4 million, as a result of the noted volume decreases.

Comparison of 2005 with 2004

Net sales for 2005 increased to $424.0 million, up 6% from $400.7 million for 2004. Approximately 4% of the increase was attributable to higher sales prices, while foreign exchange rate translation favorably impacted net sales by approximately 2%. Volume increases in Asia/Pacific were partially offset by softer demand in North America and Europe.

Gross profit as a percentage of sales declined from 32.7% in 2004 to 30.6% in 2005. Higher prices for the Company s raw materials, particularly crude oil derivatives, and higher third-party product purchase costs with respect to the Company s CMS contracts, exceeded the pace at which price increases could be implemented through the year. Unfavorable product and regional mix also contributed to the decline in gross profit percentage.

Selling, general and administrative expenses (SG&A) for 2005 increased $2.8 million or approximately 3% from 2004. Foreign exchange rate translation accounted for approximately half of the increase with the remainder attributable to inflation, investments in growth initiatives, and higher pension costs offset by other cost reduction efforts. SG&A as a percentage of sales decreased from 28.3% to 27.4%.

In the first quarter of 2005, the Company incurred a net pre-tax charge of $1.2 million related to a reduction in its workforce. During the fourth quarter of 2005, the Company furthered this restructuring effort with the goal of significantly reducing operating costs in the U.S. and Europe. The fourth quarter program included involuntary terminations, a freeze of the Company s U.S. pension plan, and a voluntary early retirement offering to eligible U.S. employees. These actions resulted in a net pre-tax charge of $9.1 million.

The increase in other income for 2005 was largely due to the $4.2 million of proceeds received from the sale by the Company s real estate joint venture of its holdings. The proceeds included a $3.0 million gain relating to the sale by the venture of its real estate holdings, as well as $1.2 million of preferred return distributions. Preferred distributions in 2004 totaled $0.9 million. Foreign exchange gains in 2005 also contributed to the increase in other income. The increase in net interest expense in 2005 was due to higher average borrowings and higher interest rates on the Company s debt.

The effective tax rate was 50.4% versus 31.5% in 2004. The increase was primarily due to the Company s election, in the fourth quarter of 2005, to repatriate substantial accumulated foreign earnings primarily to improve its global capital structure, which resulted in a $1.0 million charge in tax expense.

The $1.7 million decrease in minority interest in 2005 was primarily due to the Company s first quarter 2005 acquisition of the remaining 40% interest in its Brazilian affiliate.

Segment Reviews Comparison of 2005 with 2004

Metalworking Process Chemicals:

Metalworking Process Chemicals consists of industrial process fluids for various heavy industrial and manufacturing applications and represented approximately 93% of the Company s net sales in 2005. Net sales were up $23.0 million, or 6%, compared with 2004. Favorable currency translation represented approximately 2 percentage

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points of the growth in this segment, driven by the Brazilian real to U.S. dollar exchange rate. The average Brazilian real to U.S. dollar rate was 0.41 in 2005 compared to 0.34 in 2004. The remaining net sales increase of 4% was due to 35% growth in Asia/Pacific, 7.2% growth in South America, 1% growth in North America, partially offset by decreases in our European net sales, which were down 3%, all on a constant currency basis. The growth in net sales is primarily attributable to the pricing actions taken by the Company throughout 2004 and 2005 to help in offsetting the escalation in raw material costs. Volume increases in Asia/Pacific were offset by volume declines in the Company s North American and European regions. The $6.4 million decrease in this segment s operating income compared to 2004 is largely reflective of the pace at which raw material costs have escalated beyond the Company s pricing actions. This segment s operating income was also impacted by higher selling costs compared to the prior year.

Coatings:

The Company s Coatings segment, which represented approximately 6% of Company s net sales for 2005, contains products that provide temporary and permanent coatings for metal and concrete products and chemical milling maskants. Net sales for this segment were up $2.0 million, or 8%, in 2005, compared with the prior year, primarily due to higher chemical milling maskant sales to the aerospace industry. Operating income decreased by $0.1 million in 2005 compared to 2004 due to higher raw material and selling costs.

Other Chemical Products:

Other Chemical Products, which represented approximately 1% of net sales in 2005, consists of sulfur removal products for industrial gas streams sold by the Company s Q2 Technologies joint venture. Net sales for 2005 decreased $1.7 million or 31% due to a variety of market conditions, including special one-time sales to this segment s largest customer in 2004 affecting the yearly net sales comparison. This segment s operating income decreased by $0.4 million, consistent with the noted volume decreases and higher raw material costs.

Restructuring and Related Activities

In 2001, Quaker s management approved restructuring plans to realign the organization, primarily in Europe, and reduce operating costs (2001 Program). Included in the restructuring charges were provisions for severance of 53 employees. The charge comprised $2.807 million related to employee separations, $2.450 million related to facility rationalization charges, and $0.597 million related to abandoned acquisitions. In January of 2005, the last severance payment under the 2001 program was made and the Company reversed $0.117 million of unused restructuring accruals related to this program. In 2005, the Company completed the sale of its Villeneuve, France site for $1.907 million, which completed all actions contemplated by the 2001 Program. The Company reversed $0.159 million of unused restructuring accruals related to this program in the fourth quarter of 2005.

In 2003, Quaker s management approved a restructuring plan (2003 Program). Included in the 2003 restructuring charge were provisions for severance for 9 employees totaling $0.273 million. As of March 31, 2005, all severance payments were completed and the Company reversed $0.059 million of unused restructuring accruals related to this program, which completed all actions contemplated by the 2003 Program.

In 2004, Quaker s management approved a restructuring plan by announcing the consolidation of its administrative facilities in Hong Kong with its Shanghai headquarters (2004 Program). Included in the 2004 restructuring charge were severance provisions for 5 employees totaling $0.119 million and an asset impairment related to the Company s previous plans to implement its global ERP system at this location totaling $0.331 million. As of March 31, 2005, all severance payments were completed, which completed all actions contemplated by the 2004 Program.

In the first quarter of 2005, Quaker s management approved a restructuring plan (2005 1st Quarter Program). Included in the first quarter 2005 restructuring charge were provisions for severance for 16 employees totaling $1.408 million. At December 31, 2005, all severance payments were completed. The Company reversed $0.096 million of unused restructuring charges related to this program, which completed all actions contemplated by the 2005 1st Quarter Program.

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In the fourth quarter of 2005, Quaker s management approved a restructuring plan (2005 4th Quarter Program) with the goal of significantly reducing operating costs in the U.S. and Europe. The restructuring plan included involuntary terminations, a freeze of the Company s U.S. pension plan, and a voluntary early retirement window to certain U.S. employees, with enhanced pension and other postretirement benefits. Included in the restructuring charges were provisions for severance (voluntary and involuntary) of 55 employees. Restructuring and related charges of $9.344 million were recognized in the fourth quarter of 2005. The charge comprised $4.024 million related to severance for involuntary terminations, $1.017 million related to one-time payments for voluntary early retirement, $2.668 million related to the U.S. pension plan freeze, and $1.635 million for the enhanced pension and other postretirement benefits related to voluntary early retirement participants. The charges related to the U.S. pension plan freeze and the enhanced pension and postretirement benefits are not included in the following table, and are included as part of the accrued pension and other post retirement balances. See also Note 9 of Notes to Consolidated Financial Statements which appears in Item 8 of this Report. The Company completed the initiatives contemplated under this program during 2006.

	Employee Separations
2005 4th Quarter Program:	
Restructuring charges	$ 5.041
Payments	(1.006)
Currency translation and other	(0.002)
December 31, 2005 ending balance	4.033
Payments	(4.033)
December 31, 2006 ending balance	$ 0

Environmental Clean-up Activities

The Company is involved in environmental clean-up activities in connection with an existing plant location and former waste disposal sites. In April of 1992, the Company identified certain soil and groundwater contamination at AC Products, Inc. (ACP), a wholly owned subsidiary. Voluntarily in coordination with the Santa Ana California Regional Water Quality Board, ACP is remediating the contamination. The Company believes that the remaining potential-known liabilities associated with these matters range from approximately $1.5 million to $1.9 million, for which the Company has sufficient reserves. Notwithstanding the foregoing, the Company cannot be certain that liabilities in the form of remediation expenses, fines, penalties, and damages will not be incurred in excess of the amount reserved. See Note 18 of Notes to Consolidated Financial Statements which appears in Item 8 of this Report.

General

The Company generally does not use financial instruments that expose it to significant risk involving foreign currency transactions; however, the size of non-U.S. activities has a significant impact on reported operating results and the attendant net assets. During the past three years, sales by non-U.S. subsidiaries accounted for approximately 53% to 56% of the consolidated net annual sales. See Note 13 of Notes to Consolidated Financial Statements which appears in Item 8 of this Report.

Factors that May Affect Our Future Results

(Cautionary Statements Under the Private Securities Litigation Reform Act of 1995)

Certain information included in this Report and other materials filed or to be filed by Quaker with the SEC (as well as information included in oral statements or other written statements made or to be made by us) contain or may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as

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amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements can be identified by the fact that they do not relate strictly to historical or current facts. We have based these forward-looking statements on our current expectations about future events. These forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, anticipations, intentions, financial condition, results of operations, future performance and business, including:

statements relating to our business strategy;

our current and future results and plans; and

statements that include the words may, could, should, would, believe, expect, anticipate, estimate, intend, plan or

Such statements include information relating to current and future business activities, operational matters, capital spending, and financing sources. From time to time, oral or written forward-looking statements are also included in Quaker s periodic reports on Forms 10-Q and 8-K, press releases and other materials released to the public.

Any or all of the forward-looking statements in this report, in Quaker s Annual Report to Shareholders for 2006 and in any other public statements we make may turn out to be wrong. This can occur as a result of inaccurate assumptions or as a consequence of known or unknown risks and uncertainties. Many factors discussed in this Report will be important in determining our future performance. Consequently, actual results may differ materially from those that might be anticipated from our forward-looking statements.

We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise. However, any further disclosures made on related subjects in Quaker s subsequent reports on Forms 10-K, 10-Q and 8-K should be consulted. These forward-looking statements are subject to risks, uncertainties and assumptions about us and our operations that are subject to change based on various important factors, some of which are beyond our control. A major risk is that the Company s demand is largely derived from the demand for its customers products, which subjects the Company to uncertainties related to downturns in a customer s business and unanticipated customer production shutdowns. Other major risks and uncertainties include, but are not limited to, significant increases in raw material costs, worldwide economic and political conditions, foreign currency fluctuations, and terrorist attacks such as those that occurred on September 11, 2001, each of which is discussed in greater detail in Item 1A of this Report. Furthermore, the Company is subject to the same business cycles as those experienced by steel, automobile, aircraft, appliance, and durable goods manufacturers. These risks, uncertainties, and possible inaccurate assumptions relevant to our business could cause our actual results to differ materially from expected and historical results. Other factors beyond those discussed in this Report could also adversely affect us. Therefore, we caution you not to place undue reliance on our forward-looking statements. This discussion is provided as permitted by the Private Securities Litigation Reform Act of 1995.

Item 7A. ***Quantitative and Qualitative Disclosures About Market Risk.***

Quaker is exposed to the impact of interest rates, foreign currency fluctuations, changes in commodity prices, and credit risk.

Interest Rate Risk. Quaker s exposure to market rate risk for changes in interest rates relates primarily to its short and long-term debt. Most of Quaker s debt is negotiated at market rates. Accordingly, if interest rates rise significantly, the cost of debt to Quaker will increase. This can have an adverse effect on Quaker, depending on the extent of Quaker s borrowings. As of December 31, 2006, Quaker had approximately $79.2 million in borrowings under its credit facilities at a weighted average borrowing rate of approximately 5.69%. The Company uses derivative financial instruments primarily for the purposes of hedging exposures to fluctuations in interest rates. The Company does not enter into derivative contracts for trading or speculative purposes. In 2006

and 2005, the Company entered into five interest rate swaps in order to fix a portion of its variable rate debt. The swaps had a combined notional value of $25.0 million and $15.0 million and a fair value of $0.1 and $(0.1) million at December 31, 2006 and December 31, 2005, respectively. The counterparties to the swaps are major financial institutions. See the information included under the caption Derivatives in Note 1 of Notes to Consolidated Financial Statements which appears in Item 8 of this Report and is incorporated herein by reference. In February 2007, the Company completed a refinancing of its existing industrial development bonds to fix the interest rate of an additional $5.0 million of debt.

Foreign Exchange Risk. A significant portion of Quaker s revenues and earnings is generated by its foreign operations. These foreign operations also hold a significant portion of Quaker s assets and liabilities. All such operations use the local currency as their functional currency. Accordingly, Quaker s financial results are affected by risks typical of global business such as currency fluctuations, particularly between the U.S. dollar, the Brazilian real, the Chinese renminbi and the E.U. euro. As exchange rates vary, Quaker s results can be materially affected.

The Company generally does not use financial instruments that expose it to significant risk involving foreign currency transactions; however, the size of non-U.S. activities has a significant impact on reported operating results and the attendant net assets. During the past three years, sales by non-U.S. subsidiaries accounted for approximately 53% to 56% of consolidated net annual sales.

In addition, the Company often sources inventory among its worldwide operations. This practice can give rise to foreign exchange risk resulting from the varying cost of inventory to the receiving location as well as from the revaluation of intercompany balances. The Company mitigates this risk through local sourcing efforts.

Commodity Price Risk. Many of the raw materials used by Quaker are commodity chemicals, and, therefore, Quaker s earnings can be materially affected by market changes in raw material prices. In certain cases, Quaker has entered into fixed-price purchase contracts having a term of up to one year. These contracts provide for protection to Quaker if the price for the contracted raw materials rises, however, in certain limited circumstances, Quaker will not realize the benefit if such prices decline.

Credit Risk. Quaker establishes allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. If the financial condition of Quaker s customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. Downturns in the overall economic climate may also exacerbate specific customer financial issues. A significant portion of Quaker s revenues is derived from sales to customers in the U.S. steel industry, where a number of bankruptcies occurred during recent years. In recent years, certain large industrial customers have also experienced financial difficulty. When a bankruptcy occurs, Quaker must judge the amount of proceeds, if any, that may ultimately be received through the bankruptcy or liquidation process. In addition, as part of its terms of trade, Quaker may custom manufacture products for certain large customers and/or may ship product on a consignment basis. These practices may increase the Company s exposure should a bankruptcy occur, and may require writedown or disposal of certain inventory due to its estimated obsolescence or limited marketability. Customer returns of products or disputes may also result in similar issues related to the realizability of recorded accounts receivable or returned inventory.

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

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Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors

of Quaker Chemical Corporation:

We have completed integrated audits of Quaker Chemical Corporation s consolidated financial statements and of its internal control over financial reporting as of December 31, 2006, in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Quaker Chemical Corporation and its subsidiaries at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 9 and Note 11 to the consolidated financial statements, the Company changed the manner in which it accounts for defined benefit pension and other postretirement plans effective December 31, 2006 and the manner in which it accounts for share-based compensation in 2006.

Internal control over financial reporting

Also, in our opinion, management s assessment, included in Management s Report on Internal Control over Financial Reporting, appearing under Item 9A, that the Company maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the COSO. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management s assessment and on the effectiveness of the Company s internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting

includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

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

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

Philadelphia, PA

March 9, 2007

QUAKER CHEMICAL CORPORATION

CONSOLIDATED STATEMENT OF INCOME

	Year Ended December 31,		
	2006	2005	2004
	(In thousands, except per share amounts)		
Net sales	$ 460,451	$ 424,033	$ 400,695
Costs and expenses:			
Cost of goods sold	317,850	294,219	269,818
Selling, general, and administrative expenses	120,969	116,340	113,536
Restructuring and related activities, net		10,320	450
	438,819	420,879	383,804
Operating income	21,632	3,154	16,891
Other income, net	1,259	6,120	1,818
Interest expense	(5,520)	(3,681)	(2,363)
Interest income	1,069	1,022	1,111
Income before taxes, equity income and minority interest	18,440	6,615	17,457
Taxes on income	6,224	3,336	5,499
	12,216	3,279	11,958
Equity in net income of associated companies	773	618	890
Minority interest in net income of subsidiaries	(1,322)	(2,209)	(3,874)
Net income	$ 11,667	$ 1,688	$ 8,974
Per share data:			
Net income basic	$ 1.19	$ 0.17	$ 0.93
Net income diluted	$ 1.18	$ 0.17	$ 0.90
Weighted average shares outstanding:			
Basic	9,779	9,679	9,606
Diluted	9,854	9,816	9,969

See notes to consolidated financial statements.

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QUAKER CHEMICAL CORPORATION

CONSOLIDATED BALANCE SHEET

	December 31, 2006	December 31, 2005
	(In thousands, except par value and share amounts)	
ASSETS		
Current assets		
Cash and cash equivalents	$ 16,062	$ 16,121
Accounts receivable, net	107,340	93,943
Inventories	51,984	45,818
Deferred income taxes	4,379	4,439
Prepaid expenses and other current assets	6,476	5,672
Total current assets	186,241	165,993
Property, plant and equipment, net	60,927	56,897
Goodwill	38,740	35,418
Other intangible assets, net	8,330	8,703
Investments in associated companies	7,044	6,624
Deferred income taxes	28,573	24,385
Other assets	27,527	33,975
Total assets	$ 357,382	$ 331,995
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities		
Short-term borrowings and current portion of long-term debt	$ 4,950	$ 5,094
Accounts payable	54,212	50,832
Dividends payable	2,133	2,091
Accrued compensation	15,225	9,818
Other current liabilities	13,659	19,053
Total current liabilities	90,179	86,888
Long-term debt	85,237	67,410
Deferred income taxes	5,317	4,608
Accrued pension and postretirement benefits	38,430	38,210
Other non-current liabilities	23,353	22,363
Total liabilities	242,516	219,479
Minority interest in equity of subsidiaries	4,035	6,609
Commitments and contingencies		
Shareholders equity		
Common stock, $1 par value; authorized 30,000,000 shares; Issued: 2006-9,925,976, 2005-9,726,385 shares	9,926	9,726
Capital in excess of par value	5,466	3,574
Retained earnings	114,498	111,317
Accumulated other comprehensive loss	(19,059)	(18,710)
Total shareholders equity	110,831	105,907

Total liabilities and shareholders equity	$ 357,382	$ 331,995

See notes to consolidated financial statements.

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QUAKER CHEMICAL CORPORATION

CONSOLIDATED STATEMENT OF CASH FLOWS

	Year Ended December 31,		
	2006	2005	2004
		(In thousands)	
Cash flows from operating activities			
Net income	$ 11,667	$ 1,688	$ 8,974
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	10,136	9,163	8,610
Amortization	1,427	1,368	1,157
Equity in net income of associated companies, net of dividends	(348)	(384)	(602)
Minority interest in earnings of subsidiaries	1,322	2,209	3,874
Deferred income tax	404	(4,476)	(1,872)
Deferred compensation and other, net	(507)	(747)	(442)
Stock based compensation	857	771	452
Restructuring and related activities		6,018	450
Gain on sale of partnership assets		(2,989)	
(Gain) Loss on disposal of property, plant and equipment	34		(509)
Insurance settlement realized	(544)		
Pension and other postretirement benefits	(4,247)	(439)	(172)
Increase (decrease) in cash from changes in current assets and current liabilities, net of acquisitions:			
Accounts receivable	(8,947)	(9,600)	(6,254)
Inventories	(4,146)	(5,821)	(7,559)
Prepaid expenses and other current assets	(140)	161	(388)
Accounts payable and accrued liabilities	5,440	15,726	129
Change in restructuring liabilities	(4,033)	(2,798)	(558)
Estimated taxes on income	(192)	1,722	(1,596)
Net cash provided by operating activities	8,183	11,572	3,694
Cash flows from investing activities			
Capital expenditures	(12,379)	(6,989)	(8,643)
Payments related to acquisitions	(1,684)	(6,700)	
Proceeds from partnership disposition of assets		2,989	
Proceeds from disposition of assets	64	1,918	1,880
Insurance settlement received and interest earned	7,836	7,508	
Change in restricted cash, net	(7,292)	(7,508)	
Other, net			(75)
Net cash used in investing activities	(13,455)	(8,782)	(6,838)
Cash flows from financing activities			
Proceeds from short-term debt	1,897		
Net (decrease) increase in short-term borrowings	(3,384)	(52,703)	17,683
Proceeds from long-term debt	15,283	59,525	2,564
Repayment of long-term debt	(940)	(9,566)	(3,679)
Dividends paid	(8,444)	(8,340)	(8,241)
Stock options exercised, other	1,235	387	960
Distributions to minority shareholders	(1,490)	(4,198)	(1,956)
Net cash provided by (used in) financing activities	4,157	(14,895)	7,331

Effect of exchange rate changes on cash	1,056	(852)	2,976
Net (decrease) increase in cash and cash equivalents	(59)	(12,957)	7,163
Cash and cash equivalents at beginning of the period	16,121	29,078	21,915
Cash and cash equivalents at end of the period	$ 16,062	$ 16,121	$ 29,078
Supplemental cash flow disclosures			
Cash paid during the year for:			
Income taxes	$ 6,315	$ 5,584	$ 4,809
Interest	4,944	3,354	2,201
Non-cash activities:			
Restricted insurance receivable (See also Note 16 of Notes to Consolidated Financial Statements)	$ 7,500	$ 7,500	$

See notes to consolidated financial statements.

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QUAKER CHEMICAL CORPORATION

CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

	Common stock	Capital in excess of par value	Retained earnings	Unearned compensation	Accumulated other comprehensive income (loss)	Treasury stock	Total
	(In thousands, except per share amounts)						
Balance at December 31, 2003	$ 9,664	$ 2,181	$ 117,308	$ (621)	$ (15,406)	$ (774)	$ 112,352
Net income			8,974				8,974
Currency translation adjustments					8,959		8,959
Minimum pension liability					(1,052)		(1,052)
Unrealized gain on available-for-sale securities					159		159
Comprehensive income							17,040
Dividends ($0.86 per share)			(8,301)				(8,301)
Shares issued upon exercise of options	4	301				536	841
Shares issued for employee stock purchase plan	1	40				162	203
Equity-based compensation plans		110				76	186
Amortization of unearned compensation				266			266
Balance at December 31, 2004	9,669	2,632	117,981	(355)	(7,340)		122,587
Net income			1,688				1,688
Currency translation adjustments					(7,897)		(7,897)
Minimum pension liability					(3,449)		(3,449)
Current period changes in fair value of derivatives					(71)		(71)
Unrealized gain on available-for-sale securities					47		47
Comprehensive income							(9,682)
Dividends ($0.86 per share)			(8,352)				(8,352)
Shares issued upon exercise of options	33	273					306
Shares issued for employee stock purchase plan	17	260					277
Equity-based compensation plans	7	409					416
Amortization of unearned compensation				355			355
Balance at December 31, 2005	9,726	3,574	111,317		(18,710)		105,907
Net income			11,667				11,667
Currency translation adjustments					7,396		7,396
Minimum pension liability					1,250		1,250
Current period changes in fair value of derivatives					155		155
Unrealized gain on available-for-sale securities					143		143

Comprehensive income							20,611
Adjustment to initially apply FASB Statement No. 158					(9,293)		(9,293)
Dividends ($0.86 per share)			(8,486)				(8,486)
Shares issued upon exercise of options	104	942					1,046
Shares issued for employee stock purchase plan	11	178					189
Equity-based compensation plans	85	772					857
Balance at December 31, 2006	$ 9,926	$ 5,466	$ 114,498	$	$ (19,059)	$	$ 110,831

See notes to consolidated financial statements.

QUAKER CHEMICAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands except per share amounts)

Note 1 Significant Accounting Policies

Principles of consolidation: All majority-owned subsidiaries are included in the Company s consolidated financial statements, with appropriate elimination of intercompany balances and transactions. Investments in associated (less than majority-owned) companies are accounted for under the equity method. The Company s share of net income or losses of investments is included in the consolidated statement of income. The Company periodically reviews these investments for impairments and, if necessary, would adjust these investments to their fair value when a decline in market value is deemed to be other than temporary.

In January 2003, the Financial Accounting Standards Board (FASB), issued FASB Interpretation No. 46 (FIN 46), Consolidation of Certain Variable Interest Entities, (VIEs), which is an interpretation of Accounting Research Bulletin (ARB) No. 51, Consolidated Financial Statements. FIN 46, as revised by FIN 46 (revised December 2003), addresses the application of ARB No. 51 to VIEs, and generally would require that assets, liabilities and results of the activities of a VIE be consolidated into the financial statements of the enterprise that is considered the primary beneficiary. The consolidated financial statements include the accounts of the Company and all of its subsidiaries in which a controlling interest is maintained and would include any VIEs if the Company was the primary beneficiary pursuant to the provisions of FIN 46 (revised December 2003). The Company determined that its real estate joint venture, which was always accounted for under the equity method, was a VIE but that the Company was not the primary beneficiary. In February 2005, the Venture sold its real estate assets, which resulted in $4,187 of proceeds to the Company after payment of the partnership obligations. The proceeds included, a gain of $2,989 related to the sale by the Venture of its real estate holdings as well as $1,198 of preferred distributions. These proceeds are included in other income. See also Note 3 of Notes to Consolidated Financial Statements.

Translation of foreign currency: Assets and liabilities of non-U.S. subsidiaries and associated companies are translated into U.S. dollars at the respective rates of exchange prevailing at the end of the year. Income and expense accounts are translated at average exchange rates prevailing during the year. Translation adjustments resulting from this process are recorded directly in shareholders equity and will be included in income only upon sale or liquidation of the underlying investment. All non-U.S. subsidiaries use their local currency as its functional currency.

Cash and cash equivalents: The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents.

Inventories: Inventories are valued at the lower of cost or market value. Inventories are valued using the first-in, first-out (FIFO) method. See also Note 5 of Notes to Consolidated Financial Statements.

Long-lived assets: Property, plant and equipment are stated at cost. Depreciation is computed using the straight-line method on an individual asset basis over the following estimated useful lives: buildings and improvements, 10 to 45 years; and machinery and equipment, 3 to 15 years. The carrying value of long-lived assets is periodically evaluated whenever changes in circumstances or current events indicate the carrying amount of such assets may not be recoverable. An estimate of undiscounted cash flows produced by the asset, or the appropriate group of assets, is compared with the carrying value to determine whether an impairment exists. If necessary, the Company recognizes an impairment loss for the difference between the carrying amount of the assets and their estimated fair value. Fair value is based on current and anticipated future undiscounted cash flows. Upon sale or other dispositions of long-lived assets, the applicable amounts of asset cost and accumulated depreciation are removed from the accounts and the net amount, less proceeds from disposals is recorded to income. Expenditures for renewals and betterments, which increase the estimated useful life or capacity of the assets, are capitalized; expenditures for repairs and maintenance are expensed when incurred.

QUAKER CHEMICAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands except per share amounts)

Capitalized software: The Company applies the Accounting Standards Executive Committee Statement of Position (SOP) 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. This SOP requires the capitalization of certain costs incurred in connection with developing or obtaining software for internal use. In connection with the implementation of the Company s global transaction system, approximately $3,817 and $6,406 of net costs were capitalized at December 31, 2006 and 2005, respectively. These costs are amortized over a period of five years once the assets are placed into service.

Goodwill and other intangible assets: On January 1, 2002, the Company adopted SFAS No. 142, Goodwill and Other Intangible Assets. The standard requires that goodwill and indefinite-lived intangible assets no longer be amortized. In addition, goodwill and indefinite-lived intangible assets are tested for impairment at least annually. These tests will be performed more frequently if there are triggering events. Definite-lived intangible assets are amortized over their estimated useful lives, generally for periods ranging from 5 to 20 years. The Company continually evaluates the reasonableness of the useful lives of these assets. See also Note 15 of Notes to Consolidated Financial Statements.

Revenue recognition: The Company recognizes revenue in accordance with the terms of the underlying agreements, when title and risk of loss have been transferred, collectibility is reasonably assured, and pricing is fixed or determinable. This generally occurs for product sales when products are shipped to customers or, for consignment arrangements, upon usage by the customer and when services are performed. License fees and royalties are recognized in accordance with agreed-upon terms, when performance obligations are satisfied, the amount is fixed or determinable, and collectibility is reasonably assured, and are included in other income. As part of the Company s chemical management services, certain third-party product sales to customers are managed by the Company. Where the Company acts as a principal, revenues are recognized on a gross reporting basis at the selling price negotiated with customers. Where the Company acts as an agent, such revenue is recorded using net reporting as service revenues, at the amount of the administrative fee earned by the Company for ordering the goods. Third-party products transferred under arrangements resulting in net reporting totaled $62,777, $38,840 and $35,215 for 2006, 2005 and 2004, respectively.

Research and development costs: Research and development costs are expensed as incurred. Research and development expenses are included in selling, general and administrative expenses, and during 2006, 2005 and 2004 were $12,989, $14,148, and $13,808, respectively.

Concentration of credit risk: Financial instruments, which potentially subject the Company to a concentration of credit risk, principally consist of cash equivalents, short-term investments, and trade receivables. The Company invests temporary and excess funds in money market securities and financial instruments having maturities typically within 90 days. The Company has not experienced losses from the aforementioned investments. See also Note 4 of Notes to Consolidated Financial Statements.

Environmental liabilities and expenditures: Accruals for environmental matters are recorded when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated. If no amount in the range is considered more probable than any other amount, the Company records the lowest amount in the range in accordance with generally accepted accounting principles. Accrued liabilities are exclusive of claims against third parties and are not discounted. Environmental costs and remediation costs are capitalized if the costs extend the life, increase the capacity or improve safety or efficiency of the property from the date acquired or constructed, and/or mitigate or prevent contamination in the future.

Comprehensive income (loss): The Company presents comprehensive income (loss) in its Statement of Shareholders Equity. The components of accumulated other comprehensive loss at December 31, 2006 include: accumulated foreign currency translation adjustments of $1,848, minimum pension liability of $(21,300),

QUAKER CHEMICAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands except per share amounts)

unrealized holding gains on available-for-sale securities of $308, and the fair value of derivative instruments of $85. The components of accumulated other comprehensive loss at December 31, 2005 include: accumulated foreign currency translation adjustments of $(5,548) and minimum pension liability of $(13,257), unrealized holding gains on available-for-sale securities of $166, and the fair value of derivative instruments of $(71).

Income taxes: The provision for income taxes is determined using the asset and liability approach of accounting for income taxes. Under this approach, deferred taxes represent the future tax consequences expected to occur when the reported amounts of assets and liabilities are recovered or paid. The provision for income taxes represents income taxes paid or payable for the current year plus the change in deferred taxes during the year. Deferred taxes result from differences between the financial and tax bases of the Company s assets and liabilities and are adjusted for changes in tax rates and tax laws when changes are enacted. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized.

Derivatives: The Company uses derivative financial instruments primarily for purposes of hedging exposures to fluctuations in interest rates. The Company does not enter into derivative contracts for trading or speculative purposes. In accordance with SFAS 133, Accounting for Derivative Instruments and Hedging Activities, as amended and interpreted, all derivatives are recognized on the balance sheet at fair value. For derivative instruments designated as cash flow hedges, the effective portion of any hedge is reported in Accumulated Other Comprehensive Income (Loss) until it is cleared to earnings during the same period in which the hedged item affects earnings. The Company uses no derivative instruments designated as fair value hedges.

In 2006 and 2005, the Company entered into five interest rate swaps in order to fix a portion of its variable rate debt. The swaps had a combined notional value of $25,000 and $15,000 and a fair value of $85 and $(71) at December 31, 2006 and December 31, 2005, respectively. The counterparties to the swaps are major financial institutions.

Recently issued accounting standards:

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing the recognition threshold a tax position is required to meet before being recognized in the financial statements. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effects, if any, of applying FIN 48 will be recorded as an adjustment to retained earnings as of the beginning of the period of adoption. The Company is currently evaluating the effect that the adoption of FIN 48 will have on its consolidated results of operations and financial condition and is not yet in a position to determine such effects.

In September 2006, the FASB issued FASB Staff Position (FSP) AUG AIR-1 Accounting for Planned Major Maintenance Activities (FSP AUG AIR-1). FSP AUG AIR-1 amends the guidance on the accounting for planned major maintenance activities; specifically, it precludes the use of the previously acceptable accrue in advance method. FSP AUG AIR-1 is effective for fiscal years beginning after December 15, 2006. The adoption of FSP AUG AIR-1 did not have a material effect on our consolidated financial position or results of operations.

In September 2006, the SEC staff issued Staff Accounting Bulletin (SAB) 108 Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 requires that public companies utilize a dual-approach to assessing the quantitative effects of

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands except per share amounts)

financial misstatements. This dual approach includes both an income statement focused assessment and a balance sheet focused assessment. The guidance in SAB 108 must be applied to annual financial statements for fiscal years ending after November 15, 2006. The adoption of SAB 108 did not have a material effect on our consolidated financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 establishes a common definition for fair value to be applied to US GAAP guidance requiring use of fair value, establishes a framework for measuring fair value, and expands disclosure about such fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact of SFAS No. 157 on its consolidated financial position and results of operations.

Accounting estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosure of contingencies at the date of the financial statements and the reported amounts of net sales and expenses during the reporting period. Actual results could differ from such estimates.

Reclassifications: Certain reclassifications of prior years data have been made to improve comparability.

Note 2 Restructuring and Related Activities

In 2001, Quaker s management approved restructuring plans to realign the organization, primarily in Europe, and reduce operating costs (2001 Program). Included in the restructuring charges were provisions for severance of 53 employees. The charge comprised $2,807 related to employee separations, $2,450 related to facility rationalization charges, and $597 related to abandoned acquisitions. In January of 2005, the last severance payment under the 2001 program was made and the Company reversed $117 of unused restructuring accruals related to this program. In 2005, the Company completed the sale of its Villeneuve, France site for $1,907, which completed all actions contemplated by the 2001 Program. The Company reversed $159 of unused restructuring accruals related to this program in the fourth quarter of 2005.

In 2003, Quaker s management approved a restructuring plan (2003 Program). Included in the 2003 restructuring charge were provisions for severance for 9 employees totaling $273. As of March 31, 2005, all severance payments were completed and the Company reversed $59 of unused restructuring accruals related to this program, which completed all actions contemplated by the 2003 Program.

In 2004, Quaker s management approved a restructuring plan by announcing the consolidation of its administrative facilities in Hong Kong with its Shanghai headquarters (2004 Program). Included in the 2004 restructuring charge were severance provisions for 5 employees totaling $119 and an asset impairment related to the Company s previous plans to implement its global ERP system at this location totaling $331. As of March 31, 2005, all severance payments were completed, which completed all actions contemplated by the 2004 Program.

In the first quarter of 2005, Quaker s management approved a restructuring plan (2005 1st Quarter Program). Included in the first quarter 2005 restructuring charge were provisions for severance for 16 employees totaling $1,408. At December 31, 2005, all severance payments were completed. The Company reversed $96 of unused restructuring charges related to this program, which completed all actions contemplated by the 2005 1st Quarter Program.

In the fourth quarter of 2005, Quaker s management approved a restructuring plan (2005 4th Quarter Program) with the goal of significantly reducing operating costs in the U.S. and Europe. The restructuring plan

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands except per share amounts)

included involuntary terminations, a freeze of the Company s U.S. pension plan, a voluntary early retirement window to certain U.S. employees, with enhanced pension and other postretirement benefits. Included in the restructuring charges were provisions for severance (voluntary and involuntary) of 55 employees. Restructuring and related charges of $9,344 were recognized in the fourth quarter of 2005. The charge comprised $4,024 related to severance for involuntary terminations, $1,017 related to one-time payments for voluntary early retirement, $2,668 related to the U.S. pension plan freeze, and $1,635 for the enhanced pension and other postretirement benefits related to voluntary early retirement participants. The Company completed the initiatives contemplated under this program during 2006. The charges related to the U.S. pension plan freeze and the enhanced pension and other postretirement benefits are not included in the following table, and are included as part of the accrued pension and other postretirement balances. See also Note 9 of Notes to Consolidated Financial Statements.

Accrued restructuring balances, included in other current liabilities and assigned to the Metalworking segment, are as follows:

	Employee Separations
2005 4th Quarter Program:	
Restructuring charges	5,041
Payments	(1,006)
Currency translation and other	(2)
December 31, 2005 ending balance	4,033
Payments	(4,033)
December 31, 2006 ending balance	$ 0

Note 3 Investments in Associated Companies

Investments in associated (less than majority-owned) companies are accounted for under the equity method. Summarized financial information of the associated companies, in the aggregate, is as follows:

	December 31,	
	2006	**2005**
Current assets	$ 24,129	$ 22,063
Noncurrent assets	5,400	4,844
Current liabilities	13,062	11,153
Noncurrent liabilities	233	291

	Year Ended December 31,		
	2006	**2005**	**2004**
Net sales	$ 46,062	$ 44,507	$ 48,104
Gross margin	17,662	17,677	22,216
Operating income	3,920	3,430	5,440
Net income	1,574	1,202	2,194

In January 2001, the Company contributed its Conshohocken, Pennsylvania property and buildings (the Site) into a real estate joint venture (the Venture) in exchange for a 50% interest in the Venture. The Venture

QUAKER CHEMICAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands except per share amounts)

did not assume any debt or other obligations of the Company and the Company did not guarantee nor was it obligated to pay any principal, interest or penalties on any of the Venture s indebtedness. The Venture renovated certain of the existing buildings at the Site, as well as built new office space. In December 2000, the Company entered into an agreement with the Venture to lease approximately 38% of the Site s available office space for a 15-year period commencing February 2002, with multiple renewal options. The Company believes the terms of this lease were no less favorable than the terms it would have obtained from an unaffiliated third party. In February 2005, the Venture sold its real estate assets to an unrelated third party, which resulted in $4,187 of proceeds to the Company after payment of the Venture s obligations. The proceeds include a gain of $2,989 related to the sale by the Venture of its real estate holdings as well as $1,198 of preferred distributions. These proceeds are included in other income.

Note 4 Accounts Receivable and Allowance for Doubtful Accounts

Trade accounts receivable are recorded at the invoiced amount and generally do not bear interest. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable. We determine the allowance based on historical write-off experience by industry and regional economic data. Reserves for customers filing for bankruptcy protection are generally established at 75-100% of the amount owed at the filing date, dependent on the Company s evaluation of likely proceeds from the bankruptcy process. Large and/or financially distressed customers are generally reserved for on a specific review basis while a general reserve is established for other customers based on historical experience. We perform a formal review of our allowance for doubtful accounts quarterly. Account balances are charged off against the allowance when we feel it is probable the receivable will not be recovered. We do not have any off-balance-sheet credit exposure related to our customers. During 2006, the Company s five largest customers accounted for approximately 23% of its consolidated net sales with the largest customer (General Motors) accounting for approximately 6% of consolidated net sales.

At December 31, 2006 and 2005, the Company had gross trade accounts receivable totaling $110,525 and $98,009 with trade accounts receivable greater than 90 days past due of $5,565 and $11,725, respectively. Following are the changes in the allowance for doubtful accounts during the years ended December 31, 2006, 2005 and 2004.

	Balance at Beginning of Period	Charged to Costs and Expenses	Write-Offs Charged to Allowance	Effect of Exchange Rate Changes	Balance at End of Period
ALLOWANCE FOR DOUBTFUL ACCOUNTS					
Year ended December 31, 2006	$ 4,066	$	$ (961)	$ 80	$ 3,185
Year ended December 31, 2005	$ 6,773	$ 1,216	$ (3,828)	$ (95)	$ 4,066
Year ended December 31, 2004	$ 6,763	$ 500	$ (512)	$ 22	$ 6,773

Note 5 Inventories

Total inventories comprise:

	December 31, 2006	December 31, 2005
Raw materials and supplies	$ 21,589	$ 20,016
Work in process and finished goods	30,395	25,802
	$ 51,984	$ 45,818

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands except per share amounts)

Note 6 Property, Plant and Equipment

Property, plant and equipment comprise:

	December 31,	
	2006	2005
Land	$ 5,768	$ 5,391
Building and improvements	40,446	38,110
Machinery and equipment	104,427	94,223
Construction in progress	8,293	3,179
	158,934	140,903
Less accumulated depreciation	(98,007)	(84,006)
	$ 60,927	$ 56,897

The Company leases certain equipment under capital leases in Europe and the U.S., including its manufacturing facility in Tradate, Italy. Gross property, plant, and equipment includes $3,398 and $2,659 of capital leases with $672 and $345 of accumulated depreciation at December 31, 2006 and 2005, respectively. The following is a schedule by years of future minimum lease payments:

For the year ended December 31,	
2007	$ 446
2008	$ 407
2009	$ 338
2010	$ 508
2011	$ 18
2012 and beyond	$
Total net minimum lease payments	1,717
Less amount representing interest	(292)
Present value of net minimum lease payments	$ 1,425

Note 7 Asset Retirement Obligations

In June 2001, the FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations. SFAS No. 143 addresses accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated retirement costs. The Company adopted the standard as of January 1, 2003 and there was no material impact to the financial statements. In March 2005, the FASB issued its FASB Interpretation No. 47 (FIN 47), Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143. The interpretation clarifies that the term conditional asset retirement obligation (CARO) as used in SFAS 143, refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. A liability is recorded when there is enough information regarding the timing of the CARO to perform a probability weighted discounted cash flow analysis.

The Company s CARO s consist primarily of asbestos contained in certain manufacturing facilities and decommissioning costs related to its above-ground storage tanks. In the fourth quarter of 2005, due to a change in facts and circumstances at one of its manufacturing facilities, the Company determined enough information

QUAKER CHEMICAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands except per share amounts)

regarding the timing of cash flows was available to record a liability for $250. During 2006, the Company accrued interest on this liability, which is included in other non-current liabilities, of $15.

Note 8 Taxes on Income

Taxes on income consist of the following:

	Year Ended December 31,		
	2006	2005	2004
Current:			
Federal	$	$ (443)	$
State	21	20	
Foreign	5,799	8,235	7,371
	5,820	7,812	7,371
Deferred:			
Federal	792	(3,194)	(1,881)
Foreign	(388)	(1,282)	9
Total	$ 6,224	$ 3,336	$ 5,499

The components of earnings before income taxes were as follows:

	2006	2005	2004
Domestic	$ 395	$ (12,249)	$ (7,242)
Foreign	18,045	18,864	24,699
Total	$ 18,440	$ 6,615	$ 17,457

Domestic earnings before income taxes do not include foreign earnings that are included in U.S. taxable income. During the fourth quarter of 2005, the Company elected to repatriate substantial accumulated foreign earnings and implemented other tax planning strategies, which enabled the Company to utilize all domestic operating loss carryforwards, and improved its global capital structure. This repatriation was the primary reason for the increase in the Company s effective tax rate in 2005 and resulted in a net $1,000 charge to tax expense.

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QUAKER CHEMICAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands except per share amounts)

Total deferred tax assets and liabilities are composed of the following at December 31:

	2006		2005	
	Current	Non-current	Current	Non-current
Retirement benefits	$ 609	$ 10,918	$ 1,116	$ 7,948
Allowance for doubtful accounts	628		690	
Insurance and litigation reserves	826		800	
Postretirement benefits		2,634		2,744
Supplemental retirement benefits		1,460		1,347
Performance incentives	1,884	1,204	474	1,150
Equity-based compensation		332		
Alternative minimum tax carryforward		2,092		2,092
Restructuring charges			966	
Vacation pay	432		393	
Insurance settlement		5,176		5,253
Operating loss carryforward		5,098		3,527
Foreign tax credit		2,161		1,404
Deferred compensation		352		873
Other		45		48
	4,379	31,472	4,439	26,386
Valuation allowance		(2,899)		(2,001)
Total deferred income tax assets, net	$ 4,379	$ 28,573	$ 4,439	$ 24,385
Depreciation		$ 1,275		$ 1,203
Europe pension and other		4,042		3,405
Total deferred income tax liabilities		$ 5,317		$ 4,608

The following is a reconciliation of income taxes at the Federal statutory rate with income taxes recorded by the Company for the years ended December 31:

	2006	2005	2004
Income tax (benefit) provision at the Federal statutory tax rate	$ 6,454	$ 2,315	$ 6,110
State income tax provisions, net	13	13	
Non-deductible entertainment and business meal expense	136	151	176
Differences in tax rates on foreign earnings and remittances	(366)	3,777	(719)
Excess FTC utilization		(2,429)	
Settlement of tax contingencies		(446)	
Miscellaneous items, net	(13)	(45)	(68)
Taxes on income	$ 6,224	$ 3,336	$ 5,499

At December 31, 2006, the Company domestically had a net deferred tax asset of $15,515 inclusive of alternative minimum tax (AMT) credits of $2,092. Additionally, the Company has foreign tax credit carryovers of $2,161 which have the following expiration dates: $100 in 2012, $763 in 2013, $535 in 2014 and $763 in 2016. A full valuation allowance has been taken against these foreign tax credits. Finally, the Company has foreign tax loss carryforwards of $13,591 of which $2,013 expires in 2011; the remaining foreign tax losses have no expiration dates. A partial valuation allowance has been established with respect to the tax benefit of these losses for $738.

QUAKER CHEMICAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands except per share amounts)

U.S. income taxes have not been provided on the undistributed earnings of non-U.S. subsidiaries because it is the Company s intention to continue to reinvest these earnings in those subsidiaries to support growth initiatives. U.S. and foreign income taxes that would be payable if such earnings were distributed may be lower than the amount computed at the U.S. statutory rate due to the availability of tax credits. The amount of such undistributed earnings at December 31, 2006 was approximately $37,000. Any income tax liability which might result from ultimate remittance of these earnings is expected to be substantially offset by foreign tax credits.

Note 9 Pension and Other Postretirement Benefits

The Company maintains various noncontributory retirement plans, the largest of which is in the U.S., covering substantially all of its employees in the U.S. and certain other countries. The plans of the Company s subsidiaries in The Netherlands and in the United Kingdom are subject to the provisions of SFAS No. 87, Employers Accounting for Pensions. The plans of the remaining non-U.S. subsidiaries are, for the most part, either fully insured or integrated with the local governments plans and are not subject to the provisions of SFAS No. 87. The Company s U.S. pension plan year ends on November 30, which serves as the measurement date. The measurement date for the Company s postretirement benefits is December 31.

As part of the Company s 2005 fourth quarter restructuring program, the Company implemented a freeze of its U.S. pension plan for non-union employees and offered a voluntary early retirement window with enhanced pension and other postretirement benefits. The freeze of the Company s U.S. pension plan resulted in a plan curtailment charge of $2,668. The pension and other postretirement benefits enhancements resulted in special termination benefits charges of $1,205 and $430, respectively. See also Note 2 of Notes to Consolidated Financial Statements.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Post retirement Plans (SFAS No. 158). SFAS No. 158 requires that employers recognize on a prospective basis the funded status of their defined benefit pension and other postretirement plans on their consolidated balance sheet and recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost. SFAS No. 158 also requires additional disclosures in the notes to financial statements, which have been incorporated below.

The incremental effect of applying FASB Statement No. 158 on Individual Line Items in the Statement of Financial Position as of December 31, 2006, is as follows:

	Before Application of Statement 158	Adjustments	After Application of Statement 158
Deferred Income Taxes	$ 24,237	$ 4,336	$ 28,573
Other Assets	35,123	(7,596)	27,527
Total Assets	360,642	(3,260)	357,382
Other Current Liabilities	14,131	(472)	13,659
Accrued pension and post retirement benefits	31,925	6,505	38,430
Total Liabilities	236,483	6,033	242,516
Accumulated other comprehensive loss	(9,766)	(9,293)	(19,059)
Total shareholders equity	120,124	(9,293)	110,831

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QUAKER CHEMICAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands except per share amounts)

The following table shows the Company plans funded status reconciled with amounts reported in the consolidated balance sheet as of December 31:

	Pension Benefits						Other Postretirement Benefits	
	2006			2005			2006	2005
	Foreign	Domestic	Total	Foreign	Domestic	Total	Domestic	Domestic
Change in benefit obligation								
Benefit obligation at beginning of year	$ 44,464	$ 66,207	$ 110,671	$ 44,709	$ 60,967	$ 105,676	$ 10,902	$ 10,671
Service cost	2,025	586	2,611	2,025	1,735	3,760	15	20
Interest cost	1,920	3,575	5,495	1,898	3,394	5,292	551	581
Employee contributions	111		111	102		102		
Amendments		(111)	(111)					
Curtailment (gain)/loss	(2,748)		(2,748)		(1,938)	(1,938)		
Special termination benefits					1,205	1,205		430
Benefits paid	(1,132)	(5,756)	(6,888)	(717)	(3,831)	(4,548)	(1,153)	(1,159)
Plan expenses and premiums paid	(285)	(80)	(365)	(463)	(80)	(543)		
Actuarial (gain)/loss	(2,875)	1,537	(1,338)	2,646	4,755	7,401	(32)	359
Translation difference	5,159		5,159	(5,736)		(5,736)		
Benefit obligation at end of year	$ 46,639	$ 65,958	$ 112,597	$ 44,464	$ 66,207	$ 110,671	$ 10,283	$ 10,902
Change in plan assets								
Fair value of plan assets at beginning of year	$ 34,514	$ 37,873	$ 72,387	$ 36,020	$ 33,188	$ 69,208		