

STERLING FINANCIAL CORP /WA/
Form 11-K
June 25, 2004

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 11-K

(Mark One)

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

For the fiscal year ended December 31, 2003

OR

**TRANSITION REPORT PURSUANT TO SECTION 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____.

Commission File Number 0-20800

A. **Full title of the plan and the address of the plan, if different from that of the issuer named below:**

STERLING SAVINGS BANK
EMPLOYEE SAVINGS AND INVESTMENT PLAN AND TRUST

B. **Name of issuer of the securities held pursuant to the plan and the address of its principal executive office:**

Sterling Financial Corporation

**111 North Wall Street
Spokane, WA 99201**

REQUIRED INFORMATION

The following financial statements shall be furnished for the plan:

1. An audited statement of financial condition as of the end of the latest two fiscal years of the plan (or such lesser period as the plan has been in existence).

 2. An audited statement of income and changes in plan equity for each of the latest three fiscal years of the plan (or such lesser period as the plan as been in existence).

 3. The statements required by Items 1 and 2 shall be prepared in accordance with the applicable provisions of Article 6A of Regulation S-X (17 CFR 210.6A-01-.6A-05).

 4. In lieu of the requirements of Items 1-3 above, plans subject to ERISA may file plan financial statements and schedules prepared in accordance with the financial reporting requirements of ERISA. To the extent required by ERISA, the plan financial statements shall be examined by an independent accountant, except that the limited scope exemption contained in Section 103(a)(3)(C) of ERISA shall not be available.
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**Sterling Savings Bank
Employee Savings and Investment Plan and Trust**

INFORMATION TO BE INCLUDED IN THE REPORT:

1. Not applicable, see Item 4.
2. Not applicable, see Item 4.
3. Not applicable, see Item 4.
4. Financial statements and schedules prepared in accordance with the financial reporting requirements of ERISA.

Report of Independent Registered Public Accounting Firm

Financial Statements:

Statements of Net Assets Available for Benefits as of December 31, 2003 and 2002

Statement of Changes in Net Assets Available for Benefits for the Year Ended December 31, 2003

Summary of Accounting Policies

Notes to Financial Statements

Supplemental Schedules:

Schedule of Assets Held for Investment Purposes at End of Year

Schedule of Reportable Transactions for the Year Ended December 31, 2003

SIGNATURES

The Plan. Pursuant to the requirements of the Securities Exchange Act of 1934, the trustees (or other persons who administer the employee benefit plan) have duly caused this annual report to be signed on its behalf by the undersigned hereunto duly authorized.

**Sterling Savings Bank Employee Savings and Investment Plan
and Trust**
(Name of Plan)

June 25, 2004

/s/ William R. Basom

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(Date)

(Signature)

William R. Basom

Vice President, Treasurer and Principal Accounting Officer

Sterling Savings Bank
Employee Savings and Investment Plan and Trust
Index to Financial Statements and Supplemental Schedules

Report of Independent Registered Public Accounting Firm

Financial Statements:

Statements of Net Assets Available for Benefits as of December 31, 2003 and 2002

Statement of Changes in Net Assets Available for Benefits for the Year Ended December 31, 2003

Summary of Accounting Policies

Notes to Financial Statements

Supplemental Schedules:

Schedule of Assets Held for Investment Purposes at End of Year

Schedule of Reportable Transactions for the Year Ended December 31, 2003

Exhibit 23.1

Consent of Independent Registered Public Accounting Firm

**Sterling Savings Bank
Employee Savings and
Investment Plan and Trust
Financial Statements
and Supplemental Schedules
December 31, 2003**

Sterling Savings Bank
Employee Savings and Investment Plan and Trust
Index to Financial Statements and Supplemental Schedules

Report of Independent Registered Public Accounting Firm

Financial Statements:

Statements of Net Assets Available for Benefits as of December 31, 2003 and 2002

Statement of Changes in Net Assets Available for Benefits for the Year Ended December 31, 2003

Summary of Accounting Policies

Notes to Financial Statements

Supplemental Schedules:

Assets Held for Investment Purposes at End of Year

Reportable Transactions for the Year Ended December 31, 2003

Report of Independent Registered Public Accounting Firm

To the Participants and Administrative
Committee of the Sterling Savings Bank
Employee Savings and Investment Plan and Trust

We have audited the accompanying statements of net assets available for benefits of the Sterling Savings Bank Employee Savings and Investment Plan and Trust (the Plan) as of December 31, 2003 and 2002, and the related statement of changes in net assets available for benefits for the year ended December 31, 2003. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 2003 and 2002, and the changes in net assets available for benefits for the year ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

Our audits were performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules of assets held for investment purposes at end of year and reportable transactions for the year ended December 31, 2003, are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in our audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

/s/ BDO Seidman, LLP

June 10, 2004

Spokane, Washington

Sterling Savings Bank
Employee Savings and Investment Plan and Trust
Statements of Net Assets Available for Benefits
December 31, 2003 and 2002

	2003		2002
Assets			
Investments, at fair value:			
Mutual funds	\$ 9,957,165	\$	6,210,407
Common stock of Sterling Financial Corporation	16,095,687		7,764,890
Collective trust funds	3,613,154		2,160,677
Participant loans	175,393		101,290
	29,841,399		16,237,264
Cash and cash equivalents	203,292		16,156
Receivables:			
Employer contribution	0		30,875
Accrued interest	2,951		2,840
Net assets available for benefits	\$ 30,047,642	\$	16,287,135

See accompanying summary of accounting policies and notes to financial statements.

Sterling Savings Bank
Employee Savings and Investment Plan and Trust
Statement of Changes in Net Assets Available for Benefits
Year Ended December 31, 2003

	2003
Additions to net assets attributed to:	
Investment income:	
Interest	\$ 7,238
Dividends	1,119,146
Net appreciation in fair value of investments	9,090,604
	10,216,988
Contributions:	
Participants	3,307,179
Employer	909,396
Transfer of assets from another plan	194,324
	14,627,887
Deductions to net assets attributed to:	
Distributions and benefits paid to participants	845,170
Administrative expenses	22,210
	867,380
Total deductions	867,380
Net increase in net assets available for benefits	13,760,507
Net assets available for benefits:	
Beginning of year	16,287,135
End of year	\$ 30,047,642

See accompanying summary of accounting policies and notes to financial statements.

Sterling Savings Bank
Employee Savings and Investment Plan and Trust
Summary of Accounting Policies

Basis of Accounting

The financial statements of the Plan are prepared under the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America.

Investments

The Plan's investments are stated at fair value. Mutual funds are valued at quoted market prices which represent the value of shares held by the Plan at year end. The estimated value of the collective trust funds is determined based on the trustee's calculation of the aggregate quoted market price of the underlying investments adjusted for certain expenses. Sterling Financial Corporation common stock is valued at its quoted market price.

The Plan presents in the statement of changes in net assets available for benefits the net appreciation or depreciation in the fair value of its investments which consists of the realized gains or losses and the net unrealized appreciation or depreciation on those investments.

Purchases and sales of securities are recorded on a trade-date basis. Interest income is recorded on the accrual basis. Dividends are recorded on the ex-dividend date.

Benefit Payments

Benefits are recorded when paid.

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make significant estimates and assumptions that affect the reported amounts of net assets available for benefits and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of changes in net assets available for benefits during the reporting period. Actual results could differ from those estimates.

Risks and Uncertainties

The Plan provides for various investment options in combinations of stocks, mutual funds and other investment securities. Investment securities are exposed to various risks, such as interest rate, market and credit. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the value of investment securities, it is at least reasonably possible that changes in risks in the near term would materially affect participants' account balances and the amounts reported in the statements of net assets available for benefits and the

statement of changes in net assets available for benefits.

F-4

**Sterling Savings Bank
Employee Savings and Investment Plan and Trust
Notes to Financial Statements**

1. Description of Plan

The following description of the Sterling Savings Bank (Sterling or the Employer) Employee Savings and Investment Plan and Trust (the Plan) provides only general information. Participants should refer to the plan document for a more complete description of the Plan s provisions.

General

The Plan is a defined contribution plan, which became effective on July 1, 1985. Employees who have attained the age of 18 may enroll on the first day of the month following one calendar month of employment. The Plan is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), as amended.

Contributions

During the reporting period, participants could contribute from 1% to 20% of their compensation up to the statutory maximum through payroll deductions to the Plan. In 2004, subsequent to the reporting period, the 20% limit was increased to 75%.

Participants contributing to the Plan are entitled to an Employer matching contribution should Sterling elect to make one. Sterling s matching contribution for the year ended December 31, 2003 was 35% of the employee s contribution up to 10% of the participant s compensation. Additional amounts may be contributed at the option of Sterling as a profit sharing contribution. All Employer contributions are initially invested in the common stock of Sterling Financial Corporation. Participants who have been employed with Sterling for five years or more have the option of reallocating employer contributions into any of the Plan s other investment funds.

Investment Options

Participant contributions are invested in separate investment types as designated by the individual participants. Participants may elect to reallocate the amounts invested in each investment on any business day.

Participant Accounts

Separate accounts are maintained for each participant. Each participant s account is credited with the participant s contribution and an allocation of Sterling s contribution and Plan earnings. Allocations of Sterling s contribution and Plan earnings are based on participant account balances, as defined in the Plan document. The participant s benefit is limited to the benefit that has accumulated in the participant s account.

Vesting

A participant is 100% vested in their voluntary contributions plus actual earnings thereon. Company contributions and earnings thereon are subject to a vesting schedule of 50% after two years and 100% after three years of service.

Forfeitures

Forfeited invested accounts totaled \$28,789 and \$20,109 at December 31, 2003 and 2002, respectively. Forfeitures of Company contributions will reduce future matching contributions. Forfeitures in the amount of \$30,064 were used to offset employer's contributions for the year ended December 31, 2003.

Payment of Benefits

Distributions are made upon termination, death, disability or retirement. Participants or their beneficiaries will receive payment of benefits as follows: (a) balances of \$5,000 or less will be distributed in a lump sum, or (b) balances greater than \$5,000 will be distributed in various optional forms of distribution.

Participant Loans

Commencing March 2002 participants may borrow from their fund accounts up to a maximum of 50% of their vested account balance. However, participant loans can be no more than \$50,000 minus the participant's highest outstanding loan amount during the prior twelve months. The loans are secured by the vested balance in the participant's account and bear interest at the Federal Reserve prime rate plus 1%, calculated at the end of each month and applied to all loans funded during the next month. Principal and interest are paid ratably through regular payroll deductions over a period not to exceed five years.

Administrative Expenses

Both Sterling and Plan participants pay the costs of the Plan. Plan participants pay a portion of the trustee fee in the amount of \$25 per participant per year. Sterling pays the remaining portion of the trustee fee and all other professional fees.

2. Investments

The following table presents the fair value of investments, including those that represent 5% or more of the Plan's net assets at December 31, 2003 and 2002.

	2003	2002
Corporate Stocks:		
Common Stock of Sterling Financial Corporation	\$ 16,095,687	\$ 7,764,890
Collective Trust Funds:		
Merrill Lynch Retirement Preservation Trust	3,613,154	2,160,677
Mutual Funds:		
MFS Value Fund	2,075,319	28,985
MFS Capital Opportunity Fund	1,761,570	1,288,323
Delaware Group Trend Fund	1,746,155	1,108,205
Merrill Lynch S&P 500 Index	1,454,960	898,584
Alliance Premium Growth Fund	1,080,599	661,492
Merrill Lynch Bond Fund	669,011	0
American Balanced Fund	606,781	0
Merrill Lynch Global Allocation Fund	240,488	80,154
Van Kampen Emerging Growth Fund	175,485	79,453
Federated International Equity Fund	146,797	49,523
Federated Equity Fund	0	1,317,607
Mercury Total Return Bond Distributor	0	391,116
AIM Balanced Fund	0	306,965
Participant Loans	175,393	101,290
	\$ 29,841,399	\$ 16,237,264

During the year ended December 31, 2003, the Plan's investments (including gains and losses on investments bought and sold, as well as held during the year) appreciated (depreciated) in value as follows:

	2003
Mutual funds	\$ 1,801,244
Common stock of Sterling Financial Corporation	7,289,360
	\$ 9,090,604

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Investment in the Plan is participant-directed, except that the Employer's matching contributions are invested in Sterling Financial Corporation common stock. Participants at their discretion may also direct their investments to Sterling Financial Corporation common stock. Information about the net

F-7

assets in Sterling Financial Corporation common stock as of December 31, 2003 and 2002, and the change from 2002 to 2003 in non-participant directed investment balances are as follows:

	2003		2002
Net assets in Sterling Financial Corporation common stock:			
Non-participant directed	\$ 10,110,171	\$	4,825,968
Participant directed	5,985,516		2,938,922
Total	\$ 16,095,687	\$	7,764,890

Changes in non-participant directed net assets in Sterling Financial Corporation common stock for the years ended December 31:

	2003		2002
Contributions	\$ 909,396	\$	795,431
Interest and dividends	580,671		468,354
Net appreciation	4,470,707		839,147
Benefits paid to participants	(225,534)		(157,818)
Administrative expenses	(7,375)		(8,102)
Transfers to participant-directed investments	(443,662)		(57,081)
Total	\$ 5,284,203	\$	1,879,931

3. Plan Termination

Although it has not expressed an intent to do so, Sterling has the right to discontinue its contributions to the Plan at any time and to terminate the Plan subject to the provisions of ERISA. In the event of plan termination, participants' accounts will become fully vested and non forfeitable. All assets remaining in the Plan after payment of any expenses properly chargeable against the Plan shall be paid to participants in such a manner as the Plan administrator shall determine.

4. Tax Status

The Employer has not received a letter from the Internal Revenue Service (IRS) informing them the Plan is qualified and exempt under Section 401(k) of the Tax Reform Act of 1986, as amended. However, the Plan is a prototype plan for which the Plan's trustee has obtained a favorable ruling from the IRS regarding its tax exempt status.

5. Related Party Transactions

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Certain Plan investments are shares of mutual funds and collective trust funds managed by Merrill Lynch. Merrill Lynch is the trustee as defined by the Plan and, therefore, these transactions qualify as party-in-interest transactions. Certain Plan investments are shares in Sterling Financial Corporation common stock. Sterling Financial Corporation is the parent company of Sterling Savings Bank and therefore these transactions also qualify as party-in-interest transactions.

F-8

6. Reconciliation of Financial Statements to Form 5500

The following schedules reconcile the financial statements with the Form 5500.

As of December 31,	2003	2002
Net assets available for benefits per the financial statements	\$ 30,047,642	\$ 16,287,135
Benefit obligations currently payable	0	(15,389)
Net assets available for benefits per the Form 5500	\$ 30,047,642	\$ 16,271,746
For the Year Ended December 31,	2003	
Benefits paid to participants per the financial statements	\$ 845,170	
Add: Amounts currently payable at December 31, 2003	0	
Less: Amounts previously payable at December 31, 2002	(15,389)	
Benefits paid to participants per the Form 5500	\$ 829,781	

Amounts currently payable to participants are recorded on the Form 5500 for benefit requests that have been processed and approved for payment prior to December 31, 2003, but had not yet been paid as of that date.

7. Merged Plan

On February 28, 2003, Empire Bank was merged with and into Sterling, with Sterling being the surviving institution in the merger. As a result of the merger, Sterling transferred \$194,324 from the Empire Bank Financial Institutions Thrift Plan into Sterling's plan during the year ended December 31, 2003.

8. Subsequent Event - Merged Plan

On January 2, 2004, Klamath First Federal Savings and Loan Association was merged with and into Sterling, with Sterling being the surviving institution in the merger. As a result of the merger, Sterling subsequently transferred approximately \$2.0 million from the Klamath First 401(k) Plan into Sterling's plan.

Supplemental Schedules

F-10

Sterling Savings Bank
Employee Savings and Investment Plan and Trust

Schedule of Assets Held for Investment Purposes at End of Year
December 31, 2003
EIN: 91-1166044 Plan Number: 001

(a)	(b) Identity of Issuer, Borrower Lessor or Similar Party	(c) Description of Investment Including Maturity Date, Rate of Interest, Collateral, Par or Maturity Value	(d) Cost **	(e) Current Value
Common Stock				
	* Sterling Financial Corporation	Common stock, 470,359 shares at \$1 par value	\$ 8,455,424	\$ 16,095,687
Collective Trust Funds				
	* Merrill Lynch Retirement Preservation Trust	3,613,154 shares		3,613,154
Mutual Funds				
	MFS Value Fund	Mutual fund, 102,031 shares		2,075,319
	MFS Capital Opportunity Fund	Mutual fund, 148,031 shares		1,761,570
	Delaware Group Trend Fund	Mutual fund, 92,585 shares		1,746,155
	* Merrilan">	(1,689)		
		(8,487)	1,874	
Net cash (used in) provided by operating activities		(7,393)	2,780	
Cash flows from investing activities:				
Capital expenditures		(389)	(420)	
Proceeds from sale of assets		-	2	
Net cash used in investing activities		(389)	(418)	
Cash flows from financing activities:				
Net borrowings on revolving loans		8,059	47	
Decrease in book overdraft		(515)	(1,450)	
Proceeds from term loans		8,182	-	
Repayments of term loans		(6,999)	(750)	

Direct costs associated with debt facilities	(557)	-
Net cash provided by (used in) financing activities	8,170	(2,153)
Effect of exchange rate changes on cash	85	(22)
Net increase in cash	473	187
Cash, beginning of period	747	683
Cash, end of period	\$ 1,220	\$ 870

See Notes to Condensed Consolidated Financial Statements.

[index](#)

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

Note 1. SIGNIFICANT ACCOUNTING POLICIES

Consolidation Policy and Basis of Presentation – The condensed consolidated financial statements include the accounts of Katy Industries, Inc. and subsidiaries in which it has a greater than 50% voting interest or significant influence, collectively “Katy” or the “Company”. All significant intercompany accounts, profits and transactions have been eliminated in consolidation. The Condensed Consolidated Balance Sheet at July 2, 2010 and the related Condensed Consolidated Statements of Operations for the three and six months ended July 2, 2010 and July 3, 2009 and Cash Flows for the six months ended July 2, 2010 and July 3, 2009 have been prepared without audit, pursuant to the rules and regulations of the Securities and Exchange Commission, and reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial condition, results of operations and cash flows of the Company for the interim periods. Interim results may not be indicative of results to be realized for the entire year. The condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto, together with management’s discussion and analysis of financial condition and results of operations, contained in the Company’s Annual Report on Form 10-K for the year ended December 31, 2009. The Condensed Consolidated Balance Sheet as of December 31, 2009 was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States (“GAAP”).

Fiscal Year – The Company operates and reports using a 4-4-5 fiscal year which always ends on December 31. As a result, December and January do not typically consist of five and four weeks, respectively. The three and six months ended July 2, 2010 consisted of 64 shipping days and 128 shipping days, respectively, and the three and six months ended July 3, 2009 consisted of 62 shipping days and 128 shipping days, respectively.

Use of Estimates – The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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

	July 2, 2010	December 31, 2009
Raw materials	\$ 9,488	\$ 10,240
Finished goods	11,761	10,744
Inventory reserves	(1,197)	(1,315)
LIFO reserve	(3,976)	(3,474)
	\$ 16,076	\$ 16,195

At July 2, 2010 and December 31, 2009, approximately 59% and 56%, respectively, of Katy’s inventories were accounted for using the last-in, first-out (“LIFO”) method of costing, while the remaining inventories were accounted for using the first-in, first-out (“FIFO”) method. Current cost, as determined using the FIFO method, exceeded LIFO cost by \$4.0 million and \$3.5 million at July 2, 2010 and December 31, 2009, respectively.

Share-Based Payment – Compensation cost recognized during the three and six months ended July 2, 2010 and July 3, 2009 includes: a) compensation cost for all stock options granted subsequent to January 1, 2006, based on the grant date fair value amortized over the options' vesting period and b) compensation cost for outstanding stock appreciation rights ("SARs") as of July 2, 2010 and July 3, 2009 based on the July 2, 2010 and July 3, 2009 fair value, respectively.

index

Compensation expense (income) is included in selling, general and administrative expense in the Condensed Consolidated Statements of Operations. The components of compensation expense (income) are as follows (amounts in thousands):

	Three Months Ended		Six Months Ended	
	July 2, 2010	July 3, 2009	July 2, 2010	July 3, 2009
Stock option expense	\$ 53	\$ 113	\$ 131	\$ 274
Stock appreciation right (income) expense	(87)	146	(106)	(8)
	\$ (34)	\$ 259	\$ 25	\$ 266

The fair value of stock options is estimated at the date of grant using a Black-Scholes option pricing model. As the Company does not have sufficient historical exercise data to provide a basis for estimating the expected term, the Company uses the simplified method for estimating the expected term by averaging the minimum and maximum lives expected for each award. In addition, the Company estimated volatility by considering its historical stock volatility over a term comparable to the remaining expected life of each award. The risk-free interest rate is the current yield available on U.S. treasury issues with a remaining term equal to each award. The Company estimates forfeitures using historical results. Its estimates of forfeitures will be adjusted over the requisite service period based on the extent to which actual forfeitures differ, or are expected to differ, from their estimate. There were no stock options granted during the three and six months ended July 2, 2010. The assumptions for expected term, volatility and risk-free rate for stock options granted during the three and six months ended July 3, 2009 are presented in the table below:

	July 3, 2009
Expected term (years)	5.5 - 6.5
Volatility	109.9%
	-
Risk-free interest rate	117.4%
	2.0% - 2.3%

The fair value of SARs, a liability award, was estimated at July 2, 2010 and July 3, 2009 using a Black-Scholes option pricing model. The Company estimated the expected term by averaging the minimum and maximum lives expected for each award. In addition, the Company estimated volatility by considering its historical stock volatility over a term comparable to the remaining expected life of each award. The risk-free interest rate is the current yield available on U.S. treasury issues with a remaining term equal to each award. The Company estimates forfeitures using historical results. Its estimates of forfeitures will be adjusted over the requisite service period based on the extent to which actual forfeitures differ, or are expected to differ, from their estimate. The assumptions for expected term, volatility and risk-free rate are presented in the table below:

July 2, 2010	July 3, 2009
-----------------	-----------------

Expected term (years)	0.3 - 6.2	0.1 - 5.0
Volatility	134.0%	126.4%
	-	-
	186.0%	183.7%
Risk-free interest rate	0.2% - 2.2%	0.2% - 2.4%

Comprehensive Income (Loss) – The components of comprehensive income (loss) are as follows (amounts in thousands):

	Three Months Ended		Six Months Ended	
	July 2, 2010	July 3, 2009	July 2, 2010	July 3, 2009
Net income (loss)	\$ 1,533	\$ (547)	\$ (653)	\$ (2,962)
Foreign currency translation gains	63	82	60	48
Comprehensive income (loss)	\$ 1,596	\$ (465)	\$ (593)	\$ (2,914)

index

The components of accumulated other comprehensive loss are foreign currency translation adjustments and pension and other postretirement benefits adjustments. The balance of foreign currency translation adjustments was \$0.7 million and \$0.8 million at July 2, 2010 and December 31, 2009, respectively. The balance of pension and other postretirement benefits adjustments was \$1.3 million at each of July 2, 2010 and December 31, 2009.

Earnings Per Share – The Condensed Consolidated Financial Statements include basic and diluted earnings per share. Diluted per share information is calculated by also considering the impact of potential common stock on the weighted average shares outstanding. Potential common stock consists of (a) incremental shares that would be available for issuance upon the assumed exercise of stock options “in the money” based on the average stock price for the respective period and (b) convertible preferred shares accounted for using the “if converted” basis, which assumes their conversion to common stock at a ratio of 16.6:1. The following table sets forth the computation of diluted earnings per share for the three months ended July 2, 2010 (amounts in thousands):

	Three Months Ended July 2, 2010		
	Net Income	Shares	Per Share Amount
Basic EPS			
Net income	\$ 1,533	7,951	\$ 0.19
Effect of Dilutive Securities [a]			
Stock options		242	
Convertible preferred stock		18,859	
Diluted EPS	\$ 1,533	27,052	\$ 0.06

[a] For the six months ended July 2, 2010, and the three and six months ended July 3, 2009, the stock options and convertible preferred stock were not reflected as their effect on loss per share for the periods were anti-dilutive.

Segment Reporting – Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief decision maker or group in deciding how to allocate resources and in assessing performance. The Company’s chief decision maker reviews the results of operations and requests for capital expenditures based on one industry segment: manufacturing, importing and distributing commercial cleaning and storage products. The Company’s entire revenue is generated through this segment.

Note 2. NEW ACCOUNTING PRONOUNCEMENTS

Accounting Standards Not Yet Adopted – In October 2009, the Financial Accounting Standards Board (“FASB”) issued guidance concerning multiple-deliverable arrangements which would enable vendors to account for products or services separately rather than as a combined unit. This guidance is effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company is currently evaluating the impact of this guidance on its consolidated financial statements.

In January 2010, the FASB issued guidance which revises two disclosure requirements concerning fair value measurements and clarifies two others. It requires separate presentation of significant transfers into and out of Levels 1 and 2 of the fair value hierarchy and disclosure of the reasons for such transfers. It will also require the presentation of purchases, sales, issuances, and settlements within Level 3 on a gross basis rather than a net basis. The amendments also clarify that disclosures should be disaggregated by class of asset or liability and that disclosures

about inputs and valuation techniques should be provided for both recurring and non-recurring fair value measurements. The guidance about Level 1 and 2 transfers was effective immediately, and the guidance about gross presentation of Level 3 activity is effective for fiscal years beginning after December 15, 2010. The adoption of this guidance had no effect on the Company's financial position or results of operations.

index

Note 3. INTANGIBLE ASSETS

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

	July 2, 2010			December 31, 2009		
	Gross Amount	Accumulated Amortization	Net Carrying Amount	Gross Amount	Accumulated Amortization	Net Carrying Amount
Patents	\$1,217	\$ (1,003)	\$214	\$1,202	\$ (952)	\$250
Customer lists	10,231	(8,678)	1,553	10,231	(8,582)	1,649
Tradenames	5,054	(3,067)	1,987	5,054	(2,943)	2,111
Total	\$16,502	\$ (12,748)	\$3,754	\$16,487	\$ (12,477)	\$4,010

All of Katy's intangible assets are definite long-lived intangibles. Estimated aggregate future amortization expense related to intangible assets is as follows (amounts in thousands):

2010 (remainder)	\$270
2011	514
2012	489
2013	468
2014	451
Thereafter	1,562
	\$3,754

Note 4. INDEBTEDNESS

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

	July 2, 2010	December 31, 2009
Term loan payable under the PNC Credit Agreement and the Bank of America Credit Agreement, respectively, interest based on Eurodollar and Base Rates (6.69% - 8.50%)	\$8,082	\$6,899
Revolving loans payable under the PNC Credit Agreement and the Bank of America Credit Agreement, respectively, interest based on Eurodollar and Base Rates (3.60% - 5.50%)	16,907	8,856
Total debt	24,989	15,755
Less revolving loans, classified as current	(16,907)	(8,856)
Less current maturities	(1,212)	(6,899)
Long-term debt	\$6,870	\$-

Aggregate remaining scheduled maturities of the Term Loan (as defined below) as of July 2, 2010 are as follows (amounts in thousands):

2010 (remainder)	\$500
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2011	1,275
2012	1,425
2013	4,882
	\$8,082

On May 26, 2010, Continental Commercial Products, LLC (“CCP”) and Glit/Gemtex, Ltd. (collectively, the “Borrowers”), wholly owned subsidiaries of the Company, entered into a Revolving Credit, Term Loan and Security Agreement with PNC Bank, National Association (the “PNC Credit Agreement”).

index

The PNC Credit Agreement is a \$33.2 million credit facility with an \$8.2 million term loan (the “Term Loan”) and a \$25.0 million revolving loan (the “Revolving Credit Facility”), including a \$3.5 million sub-limit for letters of credit. The proceeds of the Term Loan and Revolving Credit Facility were used to repay the Second Amended and Restated Credit Agreement with Bank of America (“Bank of America Credit Agreement”) and pay fees and expenses associated with the negotiation and consummation of the PNC Credit Agreement. All extensions of credit under the PNC Credit Agreement are collateralized by a first priority security interest in and lien upon substantially all present and future assets and properties of the Company. The Company guarantees the obligations of the Borrowers under the PNC Credit Agreement.

The principal balance of the Term Loan is payable in monthly installments followed by a final installment on May 26, 2013 equal to the then outstanding and unpaid principal balance of the Term Loan. Mandatory prepayments of the Term Loan will be required upon the occurrence of certain events, including sales of certain assets, and the Company must make annual prepayments of the Term Loan in an amount equal to 50% of excess cash flow (as defined in the PNC Credit Agreement), provided, that for the fiscal year ending December 31, 2010, the calculation will be based on the period commencing on June 1, 2010 and ending on December 31, 2010.

The Revolving Credit Facility has an expiration date of May 26, 2013 and its borrowing base is determined by eligible inventory and accounts receivable, amounting to \$22.3 million at July 2, 2010. The Company’s borrowing base under the PNC Credit Agreement is reduced by the outstanding amount of standby and commercial letters of credit. Currently, the Company’s largest letters of credit relate to its casualty insurance programs. At July 2, 2010, total outstanding letters of credit were \$2.9 million, and are being held by Bank of America under the Bank of America Credit Agreement until they are transferred to PNC Bank, National Association under the PNC Credit Agreement. The Company was required to advance to Bank of America cash as collateral for the outstanding letters of credit in the amount of \$3.1 million, which was still outstanding at July 2, 2010. The cash advance is recorded within other current assets and the revolving credit agreement in the Condensed Consolidated Balance Sheets. The Company expects all outstanding letters of credit to be transferred to PNC Bank, National Association by December 31, 2010. The PNC Credit Agreement requires the Company to have a minimum level of availability such that its eligible collateral must exceed the sum of its outstanding borrowings and letters of credit by at least \$1.5 million. This amount is reduced to zero upon the later to occur of (i) the satisfaction of certain financial covenants as set forth in the PNC Credit Agreement, supported by audited year-end financial statements of the Company on a consolidated basis for the fiscal year ending on December 31, 2010 and (ii) the reduction of the Term Loan by an aggregate sum of \$1.5 million.

The Term Loan bears interest at the Company’s option at either (i) the Eurodollar Rate (as defined in the PNC Credit Agreement), plus 6.25% or (ii) the Base Rate (as defined in the PNC Credit Agreement), plus 5.25%. Borrowings under the Revolving Credit Facility bear interest at the Company’s option at either (x) the Eurodollar Rate plus 3.25% or (y) the Base Rate plus 2.25%. For U.S. dollar borrowings, the Base Rate is the highest of (i) the Federal Funds Open Rate (as defined in the PNC Credit Agreement) plus one half of 1.0%, (ii) the interest rate announced by PNC Bank, National Association as its base commercial lending rate and (iii) the sum of the Daily LIBOR Rate (as defined in the PNC Credit Agreement) plus 1.0%. For Canadian dollar borrowings, the Base Rate is the higher of (x) the interest rate announced by the PNC Bank Canada Branch as its reference rate of interest for loans in Canadian dollars to Canadian borrowers and (y) the sum of the one month CDOR Rate (as defined in the PNC Credit Agreement) plus 1.75%. An unused commitment fee of 50 basis points per annum will be payable quarterly on the average unused amount of the Revolving Credit Facility.

The PNC Credit Agreement includes financial covenants regarding minimum earnings before interest, taxes, depreciation and amortization (“EBITDA,” as defined in the PNC Credit Agreement) and fixed charge coverage ratio.

All of the debt under the PNC Credit Agreement is re-priced to current rates at frequent intervals. Therefore, its fair value approximates its carrying value at July 2, 2010. For the three and six months ended July 2, 2010 and July 3, 2009, the Company had amortization of debt issuance costs, included within interest expense, of \$0.3 million and \$0.4 million, and \$0.1 million and \$0.2 million, respectively. Included in amortization of debt issuance costs for the three and six months ended July 2, 2010 is approximately \$0.2 million of debt issuance costs written off due to the extinguishment of the Bank of America Credit Agreement. The Company incurred \$0.6 million of debt issuance costs during the three and six months ended July 2, 2010 associated with entering into the PNC Credit Agreement.

The Revolving Credit Facility under the PNC Credit Agreement requires lockbox agreements which provide for all Company receipts to be swept daily to reduce borrowings outstanding. These agreements, combined with the existence of a material adverse effect (“MAE”) clause in the PNC Credit Agreement, cause the Revolving Credit Facility to be classified as a current liability, per guidance in the Accounting Standards Codification established by the Financial Accounting Standards Board. The Company does not expect to repay, or be required to repay, within one year, the balance of the Revolving Credit Facility, which is classified as a current liability. The Revolving Credit Facility does not expire or have a maturity date within one year, but rather has a final expiration date of May 26, 2013. The MAE clause, which is a fairly typical requirement in commercial credit agreements, allows the lender to require the loan to become due if it determines there has been a material adverse effect on the Company’s operations, business, properties, assets, liabilities, condition, or prospects.

index

In addition, the Borrowers and the Company entered into an Export-Import Revolving Credit and Security Agreement with PNC Bank, National Association, which provides for up to a \$1.5 million revolving advance amount on certain foreign accounts receivable as part of the Revolving Credit Facility.

Note 5. RETIREMENT BENEFIT PLANS

Certain subsidiaries have pension plans covering substantially all of their employees. These plans are noncontributory, defined benefit pension plans. The benefits to be paid under these plans are generally based on employees' retirement age and years of service. The Company's funding policies, subject to the minimum funding requirements of employee benefit and tax laws, are to contribute such amounts as determined on an actuarial basis to provide the plans with assets sufficient to meet the benefit obligations. Plan assets consist primarily of fixed income investments, corporate equities and government securities. The Company also provides certain health care and life insurance benefits for some of its retired employees. The postretirement health plans are unfunded.

Information regarding the Company's net periodic benefit cost for pension and other postretirement benefit plans for the three and six months ended July 2, 2010 and July 3, 2009 is as follows (amounts in thousands):

	Pension Benefits			
	Three Months Ended		Six Months Ended	
	July 2, 2010	July 3, 2009	July 2, 2010	July 3, 2009
Components of net periodic benefit cost:				
Interest cost	\$ 19	\$ 19	\$ 37	\$ 38
Expected return on plan assets	(16)	(13)	(31)	(26)
Amortization of net loss	11	11	22	22
Net periodic benefit cost	\$ 14	\$ 17	\$ 28	\$ 34

	Other Benefits			
	Three Months Ended		Six Months Ended	
	July 2, 2010	July 3, 2009	July 2, 2010	July 3, 2009
Components of net periodic benefit cost:				
Interest cost	\$ 32	\$ 35	\$ 65	\$ 71
Amortization of net loss	8	-	16	-
Net periodic benefit cost	\$ 40	\$ 35	\$ 81	\$ 71

During the three and six months ended July 2, 2010, the Company made contributions to the pension plans of \$11,000 and \$21,000, respectively. The Company expects to contribute an additional \$20,000 to the pension plans throughout the remainder of 2010. The Company uses a December 31 measurement date for its pension and other postretirement benefit plans. The fair value of plan assets was determined by using quoted prices in active markets for identical assets (Level 1 inputs per the fair value hierarchy).

Note 6. STOCK INCENTIVE PLANS

The Company has various stock incentive plans that provide for the granting of stock options, nonqualified stock options, SARs, restricted stock, performance units or shares and other incentive awards to certain employees and directors. Options have been granted at or above the market price of the Company's stock at the date of grant, typically vest over a three-year period, and are exercisable not less than twelve months or more than ten years after the date of grant. SARs have been granted at or above the market price of the Company's stock at the date of grant, typically vest over periods up to three years, and expire ten years from the date of issue. No more than 50% of the cumulative number of vested SARs held by an employee can be exercised in any one calendar year.

index

The following table summarizes stock option activity under the Company's applicable plans:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2009	1,501,000	\$ 1.97		
Granted	-	\$ -		
Exercised	-	\$ -		
Expired	(14,000)	\$ 9.93		
Cancelled	-	\$ -		
Outstanding at July 2, 2010	1,487,000	\$ 1.90	6.37 years	\$ 316
Vested and Exercisable at July 2, 2010	987,001	\$ 2.27	5.48 years	\$ 168

A summary of the status of the Company's non-vested stock options as of July 2, 2010 is presented in the table below:

	Options	Weighted Average Grant Date Fair Value
Non-Vested at December 31, 2009	791,666	\$ 0.89
Granted	-	\$ -
Vested	(291,667)	\$ 0.86
Cancelled	-	\$ -
Non-Vested at July 2, 2010	499,999	\$ 0.90

As of July 2, 2010, total unvested compensation expense associated with stock options amounted to \$0.1 million and is being amortized on a straight-line basis over the respective options' vesting period. The weighted average period in which the above compensation cost will be recognized is 0.9 years as of July 2, 2010. The Company expects all stock options outstanding at July 2, 2010 to vest. The fair value of options that vested during the three and six months ended July 2, 2010 and July 3, 2009 was \$0.3 million and \$0.2 million, respectively. The weighted average grant date fair value of options granted during the three months ended July 3, 2009 was \$0.80.

index

The following table summarizes SARs activity under the Company's applicable plans:

	SARs	Weighted Average Fair Value
Non-Vested at December 31, 2009	32,000	\$ 1.54
Granted	66,000	\$ 1.31
Vested	(6,000)	\$ 1.30
Cancelled	-	\$ -
Non-Vested at July 2, 2010	92,000	\$ 1.31
Total Outstanding at July 2, 2010	561,267	\$ 0.93

Note 7. INCOME TAXES

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, various states and foreign jurisdictions. The Company and its subsidiaries are generally no longer subject to U.S. federal, state and local examinations by tax authorities for years before 2005.

As of July 2, 2010 and December 31, 2009, the Company had deferred tax assets, net of deferred tax liabilities, of \$75.7 million. Domestic net operating loss ("NOL") carry forwards comprised \$48.6 million of the deferred tax assets for both periods. Katy's history of operating losses in many of its taxing jurisdictions provides significant negative evidence with respect to the Company's ability to generate future taxable income. As a result, valuation allowances have been recorded as of such dates for the full amount of deferred tax assets, net of the amount of deferred tax liabilities.

Accounting for Uncertainty in Income Taxes

Included in the balances at July 2, 2010 and December 31, 2009 are \$0.4 million and \$0.9 million, respectively, of liabilities for unrecognized tax benefits. Because of the impact of deferred tax accounting, other than interest and penalties, the recognition of these liabilities would not affect the annual effective tax rate. The income tax benefit for the three and six months ended July 2, 2010 primarily reflects current tax benefit for the recognition of uncertain tax positions of \$0.5 million due to the expiration of certain statutes of limitations. The Company anticipates reductions to the total amount of unrecognized tax benefits of an additional \$0.2 million within the next twelve months due to expiring statutes of limitations.

The Company recognizes interest and penalties accrued related to the unrecognized tax benefits in the income tax provision. The Company had approximately \$0.1 million and \$0.3 million of interest and penalties accrued at July 2, 2010 and December 31, 2009, respectively.

Note 8. RELATED PARTY TRANSACTIONS

Kohlberg & Co., L.L.C. (“Kohlberg”), whose affiliate holds all 1,131,551 shares of the Company’s Convertible Preferred Stock, provides ongoing management oversight and advisory services to the Company. At July 2, 2010, the Company owed Kohlberg \$0.3 million for these services. This amount is recorded in accounts payable in the Condensed Consolidated Balance Sheets and selling, general and administrative expenses in the Condensed Consolidated Statements of Operations.

index

Note 9. COMMITMENTS AND CONTINGENCIES

General Environmental Claims

The Company and certain of its current and former direct and indirect corporate predecessors, subsidiaries and divisions are involved in remedial activities at certain present and former locations and have been identified by the United States Environmental Protection Agency (“EPA”), state environmental agencies and private parties as potentially responsible parties (“PRPs”) at a number of hazardous waste disposal sites under the Comprehensive Environmental Response, Compensation and Liability Act (“Superfund”) or equivalent state laws and, as such, may be liable for the cost of cleanup and other remedial activities at these sites. Responsibility for cleanup and other remedial activities at a Superfund site is typically shared among PRPs based on an allocation formula. Under the federal Superfund statute, parties could be held jointly and severally liable, thus subjecting them to potential individual liability for the entire cost of cleanup at the site. Based on its estimate of allocation of liability among PRPs, the probability that other PRPs, many of whom are large, solvent, public companies, will fully pay the costs apportioned to them, currently available information concerning the scope of contamination, estimated remediation costs, estimated legal fees and other factors, the Company has recorded and accrued for environmental liabilities in amounts that it deems reasonable and believes that any liability with respect to these matters in excess of the accruals will not be material. The ultimate costs will depend on a number of factors and the amount currently accrued represents management’s best current estimate on an undiscounted basis of the total costs to be incurred. The Company expects this amount to be substantially paid over the next five to ten years.

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

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

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

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

Asbestos Claims

A. The Company has been named as a defendant in eleven lawsuits filed in state court in Alabama by a total of approximately 325 individual plaintiffs. There are over 100 defendants named in each case. In all eleven cases, the Plaintiffs claim that they were exposed to asbestos in the course of their employment at a former U.S. Steel plant in Alabama and, as a result, contracted mesothelioma, asbestosis, lung cancer or other illness. They claim that while in the plant they were exposed to asbestos in products which were manufactured by each defendant. In nine of the cases,

Plaintiffs also assert wrongful death claims. The Company will vigorously defend the claims against it in these matters. The liability of the Company cannot be determined at this time.

B. Sterling Fluid Systems (USA) (“Sterling”) has tendered approximately 2,800 cases pending in Michigan, New Jersey, New York, Illinois, Nevada, Mississippi, Wyoming, Louisiana, Georgia, Massachusetts, Missouri, Kentucky, California and Canada to the Company for defense and indemnification. With respect to one case, Sterling has demanded that the Company indemnify it for a \$200,000 settlement. Sterling bases its tender of the complaints on the provisions contained in a 1993 Purchase Agreement between the parties whereby Sterling purchased the LaBour Pump business and other assets from the Company. Sterling has not filed a lawsuit against the Company in connection with these matters.

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

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

index

C. LaBour Pump Company, a former division of an inactive subsidiary of the Company, has been named as a defendant in approximately 400 of the New Jersey cases tendered by Sterling. The Company has elected to defend these cases, the majority of which have been dismissed or settled for nominal sums. There are approximately 85 cases which remain active as of July 2, 2010.

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

Other Claims

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

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

Note 10. SEVERANCE, RESTRUCTURING AND RELATED CHARGES

In the second quarter of 2010, the Company informed employees of its intent to close the Wilen facility in Atlanta, Georgia and relocate the manufacturing and distribution functions to the CCP location in Bridgeton, Missouri. The relocation is expected to be complete by the end of 2010. Charges were incurred during the three months ended July 2, 2010 associated with severance (\$0.2 million) and other miscellaneous costs associated with the restructuring (\$0.1 million). Additionally, charges of \$0.6 million will be incurred in the third quarter of 2010 related to the exit of the current lease at the Wilen facility. Total costs expected to be incurred for the relocation are \$1.0 million. Following is a rollforward of restructuring liabilities by type for the Wilen facility relocation:

	Total	One-time Termination Benefits	Other
Restructuring liabilities at December 31, 2009	\$ -	\$ -	\$ -
Additions	255	207	48
Payments	(48)	-	(48)
Restructuring liabilities at July 2, 2010	\$ 207	\$ 207	\$ -

In 2002, the Company committed to a plan to consolidate the manufacturing and distribution of the four CCP facilities in the St. Louis, Missouri area. Management believed that in order to implement a more competitive cost structure, the excess capacity at the four plastic molding facilities in this area would need to be eliminated. This plan was

completed by the end of 2003. Management believes that no further charges will be incurred for this activity, except for potential adjustments to non-cancelable lease liabilities as actual activity compares to assumptions made. Following is a rollforward of restructuring liabilities for the consolidation of St. Louis manufacturing/distribution facilities (amounts in thousands):

index

	Contract Termination Costs
Restructuring liabilities at December 31, 2009	\$ 415
Additions	-
Payments	(56)
Other	96
Restructuring liabilities at July 2, 2010	\$ 455

These amounts relate to non-cancelable lease liabilities for abandoned facilities, net of potential sub-lease revenue. The amount in Other represents changes to sub-lease revenue assumptions. Total maximum potential amount of lease loss, excluding any sub-lease rentals, is \$1.0 million as of July 2, 2010. The Company has included \$0.5 million as an offset for sub-lease rentals. As of July 2, 2010, the Company does not anticipate any further significant severance, restructuring and other related charges in the upcoming year related to the plan discussed above.

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

2010 (remainder)	\$408
2011	254
	\$662

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

Forward-Looking Statements

This report and the information incorporated by reference in this report contain various "forward-looking statements" as defined in Section 27A of the Securities Act of 1933 and Section 21E of the Exchange Act of 1934, as amended. The forward-looking statements are based on the beliefs of our management, as well as assumptions made by, and information currently available to, our management. We have based these forward-looking statements on current expectations and projections about future events and trends affecting the financial condition of our business. Additional information concerning these and other risks and uncertainties is included in Item 1A under the caption "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2009. Words and phrases such as "anticipates," "believes," "estimates," "expects," "intends," "plans," "projects," "may," "should," "will," "continue," "is subject to" are intended to identify forward-looking statements. The results referred to in forward-looking statements may differ materially from actual results because they involve estimates, assumptions and uncertainties. Forward-looking statements included herein are as of the date hereof and we undertake no obligation to revise or update such statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. All forward-looking statements should be viewed with caution. These forward-looking statements are subject to risks and uncertainties that may lead to results that differ materially from those expressed in any forward-looking statement made by us or on our behalf, including, among other things:

- Increases in the cost of, or in some cases continuation of, the current price levels of thermoplastic resins, paper board packaging, and other raw materials.
- Our inability to reduce product costs, including manufacturing, sourcing, freight, and other product costs.

- Our inability to protect our intellectual property rights adequately.
 - Our inability to control our raw materials costs.
- Our inability to expand our customer base and increase corresponding revenues.
- Our inability to achieve product price increases, especially as they relate to potentially higher raw material costs.

index

- Unfavorable economic or business conditions, as well as our exposure to the credit risks of our customers and distributors, which may reduce our sales or make it difficult to collect accounts receivable.
 - Competition from foreign and domestic competitors.
 - The potential impact of rising interest rates on our debt outstanding under the PNC Credit Agreement.
 - Our inability to meet covenants associated with the PNC Credit Agreement.
- Our inability to access funds under our current loan agreements or refinance our loan agreements given the current instability in the credit markets.
- Our failure to identify, and promptly and effectively remediate, any material weaknesses or significant deficiencies in our internal control over financial reporting.
 - The potential impact of rising costs for insurance for properties and various forms of liabilities.
 - The potential impact of changes in foreign currency exchange rates related to our Canadian operations.
- Labor issues, including union activities that require an increase in production costs or lead to a strike, thus impairing production and decreasing sales, and labor relations issues at entities involved in our supply chain, including both suppliers and those involved in transportation and shipping.
- Changes in significant laws and government regulations affecting environmental compliance and income taxes.

OVERVIEW

We are a manufacturer, importer and distributor of commercial cleaning and storage products. Our commercial cleaning products are sold primarily to janitorial/sanitary and foodservice distributors that supply end users such as restaurants, hotels, healthcare facilities and schools. Our storage products are primarily sold through major home improvement and mass market retail outlets.

RESULTS OF OPERATIONS

Three Months Ended July 2, 2010 versus Three Months Ended July 3, 2009

Net sales increased 2.5% from \$37.7 million during the three months ended July 3, 2009 to \$38.6 million during the three months ended July 2, 2010. This increase was a result of two more shipping days in the quarter (64 days in the three months ended July 2, 2010 versus 62 days in the three months ended July 3, 2009). Gross margin was 14.4% for the three months ended July 2, 2010, a decrease of 2.0 percentage points from the same period a year ago. Gross margin was impacted by an unfavorable variance in our LIFO adjustment of \$0.2 million resulting from an increase in resin prices. Excluding the LIFO adjustment, gross margin decreased 1.4 percentage points from the three months ended July 3, 2009. The decrease was primarily a result of higher resin prices.

Selling, general and administrative expenses were \$5.9 million for the three months ended July 2, 2010, a \$1.0 million reduction from the same period a year ago. The decrease was primarily due to prior year expenses associated with the transition and hiring of executive level personnel and a decrease in self-insurance accruals.

Interest expense increased by \$0.3 million during the three months ended July 2, 2010 as compared to the three months ended July 3, 2009 primarily as a result of \$0.2 million of debt issuance costs being written off with the extinguishment of the Bank of America Credit Agreement, as well as higher interest rates and average borrowings under the PNC Credit Agreement.

Other income during the three months ended July 2, 2010 consists of a \$2.1 million gain recognized from a settlement of an existing obligation due to Pentland USA, Inc. ("Pentland") and \$0.3 million in proceeds from the sale of process technology, partially offset by a \$0.1 million loss on foreign exchange.

The income tax benefit for the three months ended July 2, 2010 includes a benefit for the recognition of uncertain tax positions of \$0.5 million as the statutes of limitations on certain tax years expired.

index

Overall, we reported net income of \$1.5 million, or \$0.06 per diluted share, for the three months ended July 2, 2010, as compared to a net loss of \$0.5 million, or \$0.07 per diluted share, for the three months ended July 3, 2009.

Six Months Ended July 2, 2010 versus Six Months Ended July 3, 2009

Net sales decreased slightly from \$72.8 million during the six months ended July 3, 2009 to \$72.5 million during the six months ended July 2, 2010. Gross margin was 13.2% for the six months ended July 2, 2010, a decrease of 2.4 percentage points from the same period a year ago. Gross margin was impacted by an unfavorable variance in our LIFO adjustment of \$1.8 million resulting from an increase in resin prices. Excluding the LIFO adjustment, gross margin for the six months ended July 2, 2010 increased 0.1 percentage points from the six months ended July 3, 2009. The increase was despite the rise in resin prices and was a result of improvements in productivity, including the related impact on material costs and scrap reduction, as well as better sourcing results from lower cost countries.

Selling, general and administrative expenses were \$12.0 million for the six months ended July 2, 2010, a \$2.1 million reduction from the same period a year ago. The decrease was primarily due to prior year expenses associated with the transition and hiring of executive level personnel and a decrease in self-insurance accruals.

Interest expense increased by \$0.3 million during the six months ended July 2, 2010 as compared to the six months ended July 3, 2009 primarily as a result of \$0.2 million of debt issuance costs being written off with the extinguishment of the Bank of America Credit Agreement, as well as higher interest rates and average borrowings under the PNC Credit Agreement.

Other income during the six months ended July 2, 2010 consists of a \$2.1 million gain recognized from a settlement of an existing obligation due to Pentland and \$0.3 million in proceeds from the sale of process technology.

The income tax benefit for the six months ended July 2, 2010 includes a benefit for the recognition of uncertain tax positions of \$0.5 million as the statutes of limitations on certain tax years expired.

Overall, we reported a net loss of \$0.7 million, or \$0.08 per diluted share, for the six months ended July 2, 2010, as compared to a net loss of \$3.0 million, or \$0.37 per diluted share, for the three months ended July 3, 2009.

LIQUIDITY AND CAPITAL RESOURCES

We require funding for working capital needs and capital expenditures. We believe that our cash flow from operations and the use of available borrowings under the PNC Credit Agreement (as defined below) provide sufficient liquidity for our operations going forward. As of July 2, 2010, we had cash of \$1.2 million as compared to cash of \$0.7 million at December 31, 2009. As of July 2, 2010, we had outstanding borrowings of \$25.0 million (66% of total capitalization) under the PNC Credit Agreement (as defined below). Our unused borrowing availability at July 2, 2010 on the Revolving Credit Facility (as defined below) was \$3.9 million after the \$1.5 million minimum availability requirement discussed below. As of December 31, 2009, we had outstanding borrowings of \$15.8 million (54% of total capitalization) with unused borrowing availability of \$1.3 million after the \$5.0 million minimum availability requirement under the Bank of America Credit Agreement (as defined below).

PNC Credit Agreement

On May 26, 2010, Continental Commercial Products, LLC and Glit/Gemtex, Ltd. (collectively, the "Borrowers"), wholly owned subsidiaries of the Company, entered into a Revolving Credit, Term Loan and Security Agreement with PNC Bank, National Association (the "PNC Credit Agreement").

The PNC Credit Agreement is a \$33.2 million credit facility with an \$8.2 million term loan (the “Term Loan”) and a \$25.0 million revolving loan (the “Revolving Credit Facility”), including a \$3.5 million sub-limit for letters of credit. The proceeds of the Term Loan and Revolving Credit Facility were used to repay the Second Amended and Restated Credit Agreement with Bank of America (“Bank of America Credit Agreement”) and pay fees and expenses associated with the negotiation and consummation of the PNC Credit Agreement. The PNC Credit Agreement results in two important benefits related to our long-term strategy: (1) the reduction of the availability block under the Revolving Credit Facility from \$5.0 million to \$1.5 million allows for additional borrowing capacity and increased working capital flexibility and (2) the additional \$1.7 million availability under the Term Loan allowed us to negotiate a settlement of an existing obligation due to Pentland, whereby we accelerated all amounts due to Pentland in 2010 of \$1.9 million and paid an additional \$0.1 million in satisfaction of a liability of \$4.1 million. This settlement eliminates cash requirements of \$1.8 million in 2011 and \$0.4 million in 2012.

index

All extensions of credit under the PNC Credit Agreement are collateralized by a first priority security interest in and lien upon substantially all present and future assets and properties of the Company. The Company guarantees the obligations of the Borrowers under the PNC Credit Agreement.

The principal balance of the Term Loan is payable in monthly installments followed by a final installment on May 26, 2013 equal to the then outstanding and unpaid principal balance of the Term Loan. Mandatory prepayments of the Term Loan will be required upon the occurrence of certain events, including sales of certain assets, and the Company must make annual prepayments of the Term Loan in an amount equal to 50% of excess cash flow (as defined in the PNC Credit Agreement), provided, that for the fiscal year ending December 31, 2010, the calculation will be based on the period commencing on June 1, 2010 and ending on December 31, 2010.

The Revolving Credit Facility has an expiration date of May 26, 2013 and its borrowing base is determined by eligible inventory and accounts receivable, amounting to \$22.3 million at July 2, 2010. The Company's borrowing base under the PNC Credit Agreement is reduced by the outstanding amount of standby and commercial letters of credit. Currently, the Company's largest letters of credit relate to its casualty insurance programs. At July 2, 2010, total outstanding letters of credit were \$2.9 million, and are being held by Bank of America under the Bank of America Credit Agreement until they are transferred to PNC Bank, National Association under the PNC Credit Agreement. The Company was required to advance to Bank of America cash as collateral for the outstanding letters of credit in the amount of \$3.1 million, which was still outstanding at July 2, 2010. The cash advance is recorded within other current assets and the revolving credit agreement in the Condensed Consolidated Balance Sheets. The Company expects all outstanding letters of credit to be transferred to PNC Bank, National Association by December 31, 2010. The PNC Credit Agreement requires the Company to have a minimum level of availability such that its eligible collateral must exceed the sum of its outstanding borrowings and letters of credit by at least \$1.5 million. This amount is reduced to zero upon the later to occur of (i) the satisfaction of certain financial covenants as set forth in the PNC Credit Agreement, supported by audited year-end financial statements of the Company on a consolidated basis for the fiscal year ending on December 31, 2010 and (ii) the reduction of the Term Loan by an aggregate sum of \$1.5 million.

The Term Loan bears interest at the Company's option at either (i) the Eurodollar Rate (as defined in the PNC Credit Agreement), plus 6.25% or (ii) the Base Rate (as defined in the PNC Credit Agreement), plus 5.25%. Borrowings under the Revolving Credit Facility bear interest at the Company's option at either (x) the Eurodollar Rate plus 3.25% or (y) the Base Rate plus 2.25%. For U.S. dollar borrowings, the Base Rate is the highest of (i) the Federal Funds Open Rate (as defined in the PNC Credit Agreement) plus one half of 1.0%, (ii) the interest rate announced by PNC Bank, National Association as its base commercial lending rate and (iii) the sum of the Daily LIBOR Rate (as defined in the PNC Credit Agreement) plus 1.0%. For Canadian dollar borrowings, the Base Rate is the higher of (x) the interest rate announced by the PNC Bank Canada Branch as its reference rate of interest for loans in Canadian dollars to Canadian borrowers and (y) the sum of the one month CDOR Rate (as defined in the PNC Credit Agreement) plus 1.75%. An unused commitment fee of 50 basis points per annum will be payable quarterly on the average unused amount of the Revolving Credit Facility.

The PNC Credit Agreement includes financial covenants regarding minimum earnings before interest, taxes, depreciation and amortization ("EBITDA," as defined in the PNC Credit Agreement) and fixed charge coverage ratio.

All of the debt under the PNC Credit Agreement is re-priced to current rates at frequent intervals. Therefore, its fair value approximates its carrying value at July 2, 2010. For the three and six months ended July 2, 2010 and July 3, 2009, the Company had amortization of debt issuance costs, included within interest expense, of \$0.3 million and \$0.4 million, and \$0.1 million and \$0.2 million, respectively. Included in amortization of debt issuance costs for the three and six months ended July 2, 2010 is approximately \$0.2 million of debt issuance costs written off due to the extinguishment of the Bank of America Credit Agreement. The Company incurred \$0.6 million during the three and

six months ended July 2, 2010 associated with entering into the PNC Credit Agreement.

The Revolving Credit Facility under the PNC Credit Agreement requires lockbox agreements which provide for all Company receipts to be swept daily to reduce borrowings outstanding. These agreements, combined with the existence of a material adverse effect (“MAE”) clause in the PNC Credit Agreement, cause the Revolving Credit Facility to be classified as a current liability, per guidance in the Accounting Standards Codification established by the Financial Accounting Standards Board. The Company does not expect to repay, or be required to repay, within one year, the balance of the Revolving Credit Facility, which is classified as a current liability. The Revolving Credit Facility does not expire or have a maturity date within one year, but rather has a final expiration date of May 26, 2013. The MAE clause, which is a fairly typical requirement in commercial credit agreements, allows the lender to require the loan to become due if it determines there has been a material adverse effect on the Company’s operations, business, properties, assets, liabilities, condition, or prospects.

index

In addition, the Borrowers and the Company entered into an Export-Import Revolving Credit and Security Agreement with PNC Bank, National Association, which provides for up to a \$1.5 million revolving advance amount on certain foreign accounts receivable as part of the Revolving Credit Facility.

Cash Flows

Cash provided by operating activities before changes in operating assets and liabilities was \$1.1 million in the first half of 2010 as compared to \$0.9 million in the same period of 2009. This variance was a result of a \$2.3 million reduction in net loss from operations year over year, offset by a \$2.1 million gain recognized from a settlement of an existing obligation due to Pentland. Changes in operating assets and liabilities used \$8.5 million in the first half of 2010 as compared to providing \$1.9 million in the same period of 2009. The current year usage was a result of an increase in accounts receivable and other assets and a decrease in other liabilities, partially offset by an increase in accounts payable. The change in accounts receivable was due to increased sales from the fourth quarter of 2009 to the second quarter of 2010. The increase in other assets was a result of the letters of credit collateral advance paid to Bank of America. The decrease in other liabilities was a result of the settlement of an existing obligation due to Pentland. The increase in accounts payable was primarily a result of improved payment terms with certain vendors and the timing of resin purchases. As of July 2, 2010 we were turning our inventory at 5.1 times per year as compared to 3.9 times per year as of December 31, 2009 and 4.6 times per year as of July 3, 2009.

Cash flows provided by financing activities in the first half of 2010 reflect a \$9.2 million increase in our debt levels since December 31, 2009, partially offset by \$0.6 million in direct costs associated with refinancing. As previously discussed, debt levels increased during the second quarter of 2010 as a result of the refinancing with PNC Bank, National Association, the required cash collateralization with Bank of America for the outstanding letters of credit in the amount of \$3.1 million, the payments to Pentland in the amount of \$2.0 million, and a \$2.2 million increase in accounts receivable.

OFF-BALANCE SHEET ARRANGEMENTS

As of July 2, 2010, the Company had no off-balance sheet arrangements.

SEVERANCE, RESTRUCTURING AND RELATED CHARGES

See Note 10 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for further discussion of severance, restructuring and related charges.

ENVIRONMENTAL AND OTHER CONTINGENCIES

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

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

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

CRITICAL ACCOUNTING POLICIES

We disclosed details regarding certain of our critical accounting policies in the Management's Discussion and Analysis section of our Annual Report on Form 10-K for the year ended December 31, 2009 (Part II, Item

7). There have been no changes to these policies as of July 2, 2010.

Item 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our filings with the Securities and Exchange Commission (“SEC”) is reported within the time periods specified in the SEC's rules, regulations and related forms, and that such information is accumulated and communicated to our management, including the principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

index

Katy carried out an evaluation, under the supervision and with the participation of our management, including the principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (pursuant to Rule 13a-15(e) under the Exchange Act) as of the end of the period of our report. Based upon that evaluation, the principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective as of the end of the period covered by this report.

Changes in Internal Control over Financial Reporting

There have been no changes in Katy's internal control over financial reporting during the quarter ended July 2, 2010 that have materially affected, or are reasonably likely to materially affect, Katy's internal control over financial reporting.

[index](#)

PART II - OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

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

Item 1A. RISK FACTORS

We are affected by risks specific to us as well as factors that affect all businesses operating in a global market. The significant factors known to us that could materially adversely affect our business, financial condition, or operating results are described in Part I, Item 1A of our Annual Report on Form 10-K, filed on March 25, 2010. There has been no material change in those risk factors.

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

None.

Item 3. DEFAULTS UPON SENIOR SECURITIES

None.

Item 4. (REMOVED AND RESERVED)

Item 5. OTHER INFORMATION

None.

Item 6. EXHIBITS

Exhibit
Number

Exhibit Title

- | | |
|-------------|---|
| 10.1 | Revolving Credit, Term Loan and Security Agreement dated May 26, 2010 among Continental Commercial Products, LLC, Glit/Gemtex, Ltd., the Company and PNC Bank, National Association (incorporated by reference to the Company's Current Report on Form 8-K filed June 2, 2010). |
| <u>31.1</u> | <u>CEO Certification pursuant to Securities Exchange Act Rule 13a-14, as adopted* pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| <u>31.2</u> | <u>CFO Certification pursuant to Securities Exchange Act Rule 13a-14, as adopted* pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| <u>32.1</u> | <u>CEO Certification required by 18 U.S.C. Section 1350, as adopted pursuant to*# Section 906 of the Sarbanes-Oxley Act of 2002.</u> |
| <u>32.2</u> | <u>CFO Certification required by 18 U.S.C. Section 1350, as adopted pursuant to*# Section 906 of the Sarbanes-Oxley Act of 2002.</u> |

* Indicates filed herewith.

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

index

Signatures

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

KATY INDUSTRIES, INC.
Registrant

DATE: August 12, 2010
David J. Feldman
President and Chief Executive Officer

By /s/ David J. Feldman

By /s/ James W. Shaffer
James W. Shaffer
Vice President, Treasurer and Chief Financial Officer