DOW CHEMICAL CO /DE/
Form 10-Q
October 31, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended SEPTEMBER 30, 2006

Commission File Number: 1-3433

THE DOW CHEMICAL COMPANY

(Exact name of registrant as specified in its charter)

Delaware	**38-1285128**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2030 DOW CENTER, MIDLAND, MICHIGAN 48674

(Address of principal executive offices) (Zip Code)

989-636-1000

(Registrant s telephone number, including area code)

Not applicable

(Former name, former address and former fiscal year, if changed since last report)

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

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 x Accelerated filer o Non-accelerated filer o

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

Class	**Outstanding at September 30, 2006**
Common Stock, par value $2.50 per share	955,192,111 shares

The Dow Chemical Company

QUARTERLY REPORT ON FORM 10-Q
For the quarterly period ended September 30, 2006

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

The Dow Chemical Company and Subsidiaries

Consolidated Statements of Income

In millions, except per share amounts (Unaudited)	**Three Months Ended**		**Nine Months Ended**	
	Sept. 30, 2006	**Sept. 30, 2005**	**Sept. 30, 2006**	**Sept. 30, 2005**
Net Sales	$ 12,359	$ 11,261	$ 36,888	$ 34,390
Cost of sales	10,600	9,610	31,027	28,247
Research and development expenses	291	264	856	790
Selling, general and administrative expenses	420	379	1,210	1,153
Amortization of intangibles	13	13	37	40
Restructuring charges	579		579	
Equity in earnings of nonconsolidated affiliates	317	240	717	739
Sundry income net	4	39	87	178
Interest income	48	42	128	98
Interest expense and amortization of debt discount	155	168	462	543
Income before Income Taxes and Minority Interests	670	1,148	3,649	4,632
Provision for income taxes	137	328	831	1,153
Minority interests share in income	21	19	69	60
Net Income Available for Common Stockholders	$ 512	$ 801	$ 2,749	$ 3,419
Share Data				
Earnings per common share basic	$ 0.53	$ 0.83	$ 2.85	$ 3.55
Earnings per common share diluted	$ 0.53	$ 0.82	$ 2.82	$ 3.51
Common stock dividends declared per share of common stock	$ 0.375	$ 0.335	$ 1.125	$ 1.005
Weighted-average common shares outstanding basic	959.1	965.2	963.5	962.1
Weighted-average common shares outstanding diluted	969.9	978.4	975.5	974.2
Depreciation	$ 492	$ 454	$ 1,418	$ 1,378
Capital Expenditures	$ 420	$ 400	$ 1,118	$ 1,050

See Notes to the Consolidated Financial Statements.

The Dow Chemical Company and Subsidiaries

Consolidated Balance Sheets

In millions (Unaudited)	**Sept. 30, 2006**	**Dec. 31, 2005**
Assets		
Current Assets		
Cash and cash equivalents	$ 3,134	$ 3,806
Marketable securities and interest-bearing deposits	35	32
Accounts and notes receivable:		
Trade (net of allowance for doubtful receivables 2006: $132; 2005: $169)	5,278	5,124
Other	3,046	2,802
Inventories	6,118	5,319
Deferred income tax assets current	269	321
Total current assets	17,880	17,404
Investments		
Investment in nonconsolidated affiliates	2,623	2,285
Other investments	2,096	2,156
Noncurrent receivables	272	274
Total investments	4,991	4,715
Property		
Property	43,374	41,934
Less accumulated depreciation	30,016	28,397
Net property	13,358	13,537
Other Assets		
Goodwill	3,230	3,140
Other intangible assets (net of accumulated amortization 2006: $612; 2005: $552)	441	443
Deferred income tax assets noncurrent	3,486	3,658
Asbestos-related insurance receivables noncurrent	750	818
Deferred charges and other assets	2,441	2,219
Total other assets	10,348	10,278
Total Assets	$ 46,577	$ 45,934
Liabilities and Stockholders Equity		
Current Liabilities		
Notes payable	$ 181	$ 241
Long-term debt due within one year	828	1,279
Accounts payable:		
Trade	3,580	3,931
Other	1,772	1,829
Income taxes payable	642	493
Deferred income tax liabilities current	217	201
Dividends payable	362	347
Accrued and other current liabilities	2,506	2,342
Total current liabilities	10,088	10,663
Long-Term Debt	9,199	9,186
Other Noncurrent Liabilities		
Deferred income tax liabilities noncurrent	1,084	1,395
Pension and other postretirement benefits noncurrent	3,400	3,308
Asbestos-related liabilities noncurrent	1,273	1,384
Other noncurrent obligations	3,387	3,338
Total other noncurrent liabilities	9,144	9,425
Minority Interest in Subsidiaries	354	336
Preferred Securities of Subsidiaries	1,000	1,000
Stockholders Equity		
Common stock	2,453	2,453

Additional paid-in capital	777	661
Unearned ESOP shares		(1)
Retained earnings	16,371	14,719
Accumulated other comprehensive loss	(1,738)	(1,949)
Treasury stock at cost	(1,071)	(559)
Net stockholders equity	16,792	15,324
Total Liabilities and Stockholders Equity	$ 46,577	$ 45,934

See Notes to the Consolidated Financial Statements.

The Dow Chemical Company and Subsidiaries

Consolidated Statements of Cash Flows

In millions (Unaudited)	**Nine Months Ended Sept. 30, 2006**	**Sept. 30, 2005**
Operating Activities		
Net Income Available for Common Stockholders	$ 2,749	$ 3,419
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,544	1,507
Provision for deferred income tax	246	440
Earnings of nonconsolidated affiliates in excess of dividends received	(239)	(294)
Minority interests share in income	69	60
Pension contributions	(395)	(634)
Net (gain) loss on sales of investments	2	(15)
Net gain on sales of property and businesses	(48)	(54)
Other net loss		37
Restructuring charges	579	
Net gain on sale of ownership interest in nonconsolidated affiliate		(98)
Tax benefit nonqualified stock option exercises		66
Changes in assets and liabilities that provided (used) cash:		
Accounts and notes receivable	(304)	(29)
Inventories	(811)	(371)
Accounts payable	(435)	(604)
Other assets and liabilities	(53)	104
Cash provided by operating activities	2,904	3,534
Investing Activities		
Capital expenditures	(1,118)	(1,050)
Proceeds from sales of property and businesses	69	82
Purchase of previously leased assets	(205)	
Investments in consolidated companies	(109)	(105)
Investments in nonconsolidated affiliates	(56)	(208)
Proceeds from sales of nonconsolidated affiliates		89
Distributions from nonconsolidated affiliates	4	41
Purchases of investments	(1,079)	(725)
Proceeds from sales of investments	1,172	687
Cash used in investing activities	(1,322)	(1,189)
Financing Activities		
Changes in short-term notes payable	9	81
Payments on long-term debt	(598)	(1,422)
Proceeds from issuance of long-term debt		4
Purchases of treasury stock	(650)	(48)
Proceeds from sales of common stock	97	323
Distributions to minority interests	(54)	(66)
Dividends paid to stockholders	(1,044)	(964)
Cash used in financing activities	(2,240)	(2,092)
Effect of Exchange Rate Changes on Cash	(14)	(182)
Summary		
Increase (Decrease) in cash and cash equivalents	(672)	71
Cash and cash equivalents at beginning of year	3,806	3,108
Cash and cash equivalents at end of period	$ 3,134	$ 3,179

See Notes to the Consolidated Financial Statements.

The Dow Chemical Company and Subsidiaries

Consolidated Statements of Comprehensive Income

In millions (Unaudited)	**Three Months Ended Sept. 30, 2006**	**Three Months Ended Sept. 30, 2005**	**Nine Months Ended Sept. 30, 2006**	**Nine Months Ended Sept. 30, 2005**
Net Income Available for Common Stockholders	$ 512	$ 801	$ 2,749	$ 3,419
Other Comprehensive Income (Loss), Net of Tax				
Net unrealized gains (losses) on investments	42	(1)	17	(15)
Translation adjustments	(39)	(51)	325	(860)
Minimum pension liability adjustments			(2)	11
Net gains (losses) on cash flow hedging derivative instruments	(89)	120	(129)	152
Total other comprehensive income (loss)	(86)	68	211	(712)
Comprehensive Income	$ 426	$ 869	$ 2,960	$ 2,707

See Notes to the Consolidated Financial Statements.

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(Unaudited) **Notes to the Consolidated Financial Statements**

NOTE A CONSOLIDATED FINANCIAL STATEMENTS

The unaudited interim consolidated financial statements of The Dow Chemical Company and its subsidiaries (Dow or the Company) were prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) and reflect all adjustments (including normal recurring accruals) which, in the opinion of management, are considered necessary for the fair presentation of the results for the periods presented. These statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005, and the Current Report on Form 8-K filed on July 11, 2006, reflecting a change in the composition of the Company s reported segments.

NOTE B ACCOUNTING CHANGES

Accounting for Stock-Based Compensation

On January 1, 2006, the Company adopted revised Statement of Financial Accounting Standards (SFAS) No. 123 (SFAS No. 123R), Share-Based Payment. Because the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, and SFAS No. 123R were materially consistent under the Company s equity plans, the adoption of this standard had an immaterial impact on the Company s consolidated financial statements.

In November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. 123R-3, Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards. The FSP, which became effective in November 2005, requires an entity to follow either the transition guidance for the additional-paid-in-capital pool as prescribed in SFAS No. 123R or the alternative transition method described in the FSP. An entity that adopts SFAS No. 123R using the modified prospective application may make a one-time election to adopt the transition method described in the FSP, and may take up to one year from the latter of its initial adoption of SFAS No. 123R or the effective date of the FSP to evaluate the available transition alternatives and make its one-time election. The Company has adopted the alternative transition method provided in the FSP for calculating the tax effects of stock-based compensation under SFAS No. 123R.

See Note H for disclosures related to stock-based compensation.

Accounting for Conditional Asset Retirement Obligations

In March 2005, the FASB issued FASB Interpretation (FIN) No. 47, Accounting for Conditional Asset Retirement Obligations, which clarifies the term *conditional asset retirement obligation* as used in SFAS No. 143, Accounting for Asset Retirement Obligations, as 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 Company. FIN No. 47 was effective no later than the end of fiscal years ending after December 15, 2005.

Dow has 156 manufacturing sites in 37 countries. Most of these sites contain numerous individual manufacturing operations, particularly at the Company s larger sites. Asset retirement obligations are recorded in the period in which they are incurred and reasonably estimable, including those obligations for 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 Company. Retirement of assets may involve such efforts as remediation and treatment of asbestos, contractually required demolition, and other related activities, depending on the nature and location of the assets, and are typically realized only upon demolition of those facilities. In identifying asset retirement obligations, the Company considers identification of legally enforceable obligations, changes in existing law, estimates of potential settlement dates and the calculation of an appropriate discount rate to be used in calculating the fair value of the obligations. Dow has a well-established global process to identify, approve and track the demolition of retired or to-be-retired facilities; no assets are retired from service until this process has been followed. Dow typically forecasts demolition projects based on the usefulness of the assets; environmental, health and safety concerns; and other similar considerations. Under this process, as demolition projects are identified and approved, reasonable estimates may then be determined for the time frames during which any related asset retirement obligations are expected to be settled. For those assets where a range of potential settlement dates may be reasonably estimated, obligations are recorded.

Assets that have not been submitted/reviewed for potential demolition activities are considered to have continued usefulness and are generally still operating normally. Therefore, without a plan to demolish the assets or the expectation of a plan, such as shortening the useful life of assets for depreciation purposes under the requirements of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, Dow is unable to reasonably forecast a time frame to use for present value calculations. As such, Dow has not recognized obligations for individual plants/buildings at its 156 manufacturing sites where estimates of potential settlement dates cannot be reasonably made. In addition, the Company

has not recognized conditional asset retirement obligations for the capping of its approximately 50 underground storage wells at Dow-owned sites when there are no plans or expectations of plans to exit the sites. Dow routinely reviews all changes to the list of items under consideration for demolition to determine if an adjustment to the value of the asset retirement obligation is required.

Adoption of FIN No. 47 on December 31, 2005 resulted in the recognition of an asset retirement obligation of $34 million and a charge of $20 million (net of tax of $12 million), which was included in Cumulative effect of changes in accounting principles in the fourth quarter of 2005. The discount rate used to calculate the Company s asset retirement obligations was 4.6 percent.

In accordance with FIN No. 47, the Company has recognized conditional asset retirement obligations related to asbestos encapsulation as a result of planned demolition and remediation activities at manufacturing and administrative sites in the United States, Canada and Europe. At December 31, 2005, the aggregate carrying amount of conditional asset retirement obligations recognized by the Company was $34 million. These obligations are included in the consolidated balance sheets as Other noncurrent obligations.

If the conditional asset retirement obligation measurement and recognition provisions of FIN No. 47 had been in effect on January 1, 2005, the aggregate carrying amount of those obligations on that date would have been $32 million. If the amortization of asset retirement cost and accretion of asset retirement obligation provisions of FIN No. 47 had been in effect during 2005, the impact on Income before Cumulative Effect on Changes in Accounting Principles and Net Income Available for Common Stockholders would have been immaterial. Further, the impact on earnings per common share (both basic and diluted) would have been less than $0.01.

See Note E for the Company s disclosures related to asset retirement obligations.

Other Accounting Changes

In November 2004, the FASB issued SFAS No. 151, Inventory Costs an amendment of ARB No. 43, Chapter 4, which clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) and also requires that the allocation of fixed production overhead be based on the normal capacity of the production facilities. SFAS No. 151 was effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Because the Company previously used nameplate capacity to calculate product costs, the adoption of SFAS No. 151 on January 1, 2006 had an immaterial favorable impact on the Company s consolidated financial statements in the first quarter of 2006.

In September 2005, the FASB ratified the consensus reached by the Emerging Issues Task Force (EITF) with respect to EITF Issue No. 04-13, Accounting for Purchases and Sales of Inventory with the Same Counterparty. EITF Issue No. 04-13 is effective for new arrangements entered into, and modifications or renewals of existing arrangements, in the first interim or annual period beginning after March 15, 2006. The Company has determined that its current accounting treatment for purchases and sales of inventory with the same counterparty is consistent with the guidance in EITF Issue No. 04-13; therefore, the issue had no impact on the Company s consolidated financial statements.

In November 2005, the FASB issued FSP Nos. FAS 115-1 and 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, which addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment. The FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in the FSP amends SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, SFAS No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations, and Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock. The Company has reviewed the guidance of FSP Nos. FAS 115-1 and 124-1 and has determined that its practices are consistent with the FSP; therefore, the adoption of the FSP on January 1, 2006 had no impact on the Company s consolidated financial statements.

In April 2006, the FASB issued FSP No. FIN 46(R)-6, Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R). The guidance in this FSP was applicable prospectively to all entities (including newly created entities) and when a reconsideration event has occurred pursuant to paragraph 7 of FIN No. 46(R), beginning the first day of the first reporting period beginning after June 15, 2006. Beginning July 1, 2006, the Company will apply the guidance of this FSP as it applies FIN No. 46(R).

In June 2006, the FASB issued FIN No. 48, Accounting for Uncertainty in Income Taxes, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of adopting this interpretation.

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In September 2006, the U.S. Securities and Exchange Commission (the SEC) issued Staff Accounting Bulletin (SAB) No. 108, which expresses the views of the SEC staff regarding the process of quantifying financial statement misstatements. SAB No. 108 provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The guidance of this SAB is effective for annual financial statements covering the first fiscal year ending after November 15, 2006, which is December 31, 2006 for the Company. SAB No. 108 is not expected to have an impact on the Company s consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements and is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of adopting this Statement.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R). This Statement, which is effective December 31, 2006 for the Company, requires employers to recognize the funded status of defined benefit postretirement plans as an asset or liability on the balance sheet and to recognize changes in that funded status through comprehensive income. SFAS No. 158 also establishes the measurement date of plan assets and obligations as the date of the employer s fiscal year end, and provides for additional annual disclosures. Dow currently uses a December 31 measurement date for all of its plans, consistent with its fiscal year end. The Company is currently evaluating the impact of adopting this Statement.

NOTE C INVENTORIES

The following table provides a breakdown of inventories:

Inventories In millions	**Sept. 30, 2006**	**Dec. 31, 2005**
Finished goods	$ 3,367	$ 2,941
Work in process	1,447	1,247
Raw materials	734	645
Supplies	570	486
Total inventories	$ 6,118	$ 5,319

The reserves reducing inventories from the first-in, first-out (FIFO) basis to the last-in, first-out (LIFO) basis amounted to $1,270 million at September 30, 2006 and $1,149 million at December 31, 2005.

NOTE D GOODWILL AND OTHER INTANGIBLE ASSETS

The following table shows the carrying amount of goodwill by operating segment:

Goodwill **In millions**	**Performance Plastics**	**Performance Chemicals**	**Agricultural Sciences**	**Basic Plastics**	**Hydrocarbons and Energy**	**Total**
Balance at December 31, 2005	$ 913	$ 750	$ 1,320	$ 94	$ 63	$ 3,140
Goodwill related to acquisition of Zhejiang Omex Environmental Engineering Co. LTD		90				90
Balance at September 30, 2006	$ 913	$ 840	$ 1,320	$ 94	$ 63	$ 3,230

On July 11, 2006, FilmTec Corporation, a wholly owned subsidiary of the Company, completed the acquisition of Zhejiang Omex Environmental Engineering Co. LTD. The initial recording of the acquisition resulted in goodwill of $90 million. Final determination of the fair values to be assigned may result in adjustments to the preliminary values assigned at the date of acquisition.

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The following table provides information regarding the Company s other intangible assets:

Other Intangible Assets	**At September 30, 2006**			**At December 31, 2005**	
	Gross			**Gross**	
	Carrying	**Accumulated**		**Carrying**	**Accumulated**
In millions	**Amount**	**Amortization**	**Net**	**Amount**	**Amortizatio**