# SÀFILO S.p.A.

# Annual Report Year 2005

April 28th, 2006

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## FORWARD-LOOKING STATEMENTS

This Annual Report includes forward-looking statements. All statements other than statements of historical fact included in this Annual Report regarding our business, financial condition, results of operations and certain of our plans, objectives, assumptions, projections, expectations or beliefs with respect to these items and statements regarding other future events or prospects, are forward-looking statements. These statements include, without limitation, those concerning: our strategy and our ability to achieve it; expectations regarding sales, profitability and growth; plans for the launch of new products; our possible or assumed future results of operations; research and development, capital expenditure and investment plans; adequacy of capital; and financing plans. The words "aim", "may", "will", "expect", "anticipate", "believe", "future", "continue", "help", "estimate", "plan", "intend", "should", "shall" or the negative or other variations thereof as well as other statements regarding matters that are not historical fact, are or may constitute forward-looking statements. In addition, this Annual Report includes forward-looking statements relating to our potential exposure to various types of market risks, such as foreign exchange rate risk, interest rate risks and other risks related to financial assets and liabilities. We have based these forward-looking statements on our management's current view with respect to future events and financial performance. These views reflect the best judgment of our management but involve a number of risks and uncertainties which could cause actual results to differ materially from those predicted in our forward-looking statements and from past results, performance or achievements. Although we believe that the estimates reflected in the forward-looking statements are reasonable, such estimates may prove to be incorrect. By their nature, forward-looking statements involve risk and uncertainty because they relate to events and depend on circumstances that will occur in the future. There are a number of factors that could cause actual results and developments to differ materially from these expressed or implied by these forward-looking statements.

These factors include, among other things:

- factors affecting our ability to negotiate, maintain and renew license arrangements on satisfactory terms with leading designers;
- uncertainties associated with changing consumer preferences;
- the impact of currency exchange rate and interest rate fluctuations;
- risks relating to our manufacturing and distribution operations and our arrangements with third party manufacturers;
- risks relating to international sales and exposure to changing local conditions;
- factors affecting our ability to compete effectively in the eyewear market, including new products and distribution strategies of our competitors;
- risks associated with our significant debt and our ability to meet our financial obligations;
- human resource factors, including our ability to retain our senior management and other key personnel and employee costs;
- factors affecting our ability to design, develop and introduce successful new products;
- factors affecting our ability to obtain or maintain intellectual property protection for our products;
- uncertainties associated with general economic conditions;
- governmental factors, including the costs of compliance with regulations and the impact of regulatory changes; and
- other risks, uncertainties and factors inherent in our business.

These risks are not exhaustive. For further discussion of these factors and other risks, see "Risk Factors", "Business Overview" and "Operating and Financial Review and Prospects".

We do not intend to update or revise any forward-looking statements whether as a result of new information, future events or otherwise. All subsequent written or oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements contained throughout this Annual Report. As a result of these risks, uncertainties and assumptions, you should not place undue reliance on these forward-looking statements as a prediction of actual results or otherwise.

## PRESENTATION OF FINANCIAL AND OTHER INFORMATION

This Annual Report contains the historical financial information derived from the audited consolidated financial statements as of and for the years ended December 31, 2004 and 2005 that were prepared in accordance with International Financial Reporting Standards as adopted by the European Commission for use in the European Union ("IFRS") and from our consolidated financial statements as of and for the years ended December 31, 2001, 2002, 2003 and 2004 prepared in accordance with Italian law, as interpreted by and integrated with, the accounting principles issued by the *Consiglio Nazionale dei Dottori Commercialisti e dei Ragionieri* and by Document No.1 of the *Organismo Italiano di Contabilità* (OIC) –the Italian Accounting Board-(collectively, "Italian GAAP").

Pursuant to European Community Regulation EC 1606/2002 and to the subsequent Legislative Decree n. 38 approved by the Italian government on February 25, 2005, companies listed on Italian stock exchange have been required to prepare their consolidated financial statements using IFRS instead of the current Italian GAAP for the financial year ending December 31, 2005.

Safilo S.p.A. is owned by Safilo Group S.p.A., which is listed on the Italian stock exchange. According to the above mentioned Legislative Decree n. 38, subsidiaries of companies listed on the Italian stock exchange can prepare their consolidated and their own stand alone financial statements according to IFRS for the financial year ending December 31, 2005.

Safilo S.p.A. has decided to apply IFRS for its consolidated and its own stand alone financial statements for the financial year ending December 31, 2005. The transition date was as of January 1, 2004. A reconciliation between Italian GAAP and IFRS is disclosed in "ITEM 18 - Financial Information".

The financial information included in this Annual Report is not intended to comply with SEC reporting requirements. Compliance with such requirements would require the presentation of U.S. GAAP financial information and the modification or exclusion of certain financial measures and the presentation of certain other information not included herein or the exclusion of certain information presented herein.

### Certain defined terms

Unless otherwise indicated, references in this Annual Report to "Euro" or "€" are to the single currency introduced at the start of the third stage of the European Economic and Monetary Union pursuant to the Treaty establishing the European Community, as amended; references to "dollar", "dollars", "U.S. dollars", "US$", "USD" or "$" are to the lawful currency of the United States of America; references to "GBP" are to the lawful currency of the United Kingdom; references to "billions" are to thousands of millions.

In this Annual Report, and unless the context indicates otherwise, the terms "we", "us", "our", "the Group" and "our Group" mean Safilo S.p.A. and our consolidated subsidiaries.

Except where indicated, references to "IFRS" in this Annual Report are to IFRS as adopted by the European Commission for use by companies on markets in the European Union.

### Rounding Adjustments

Certain figures in this Annual Report, including percentage amounts, have been subject to rounding adjustments. Accordingly, figures shown for the same category presented in different tables may vary slightly and figures shown as totals in certain tables may not be an arithmetic aggregation of the figures which precede them.

## EXCHANGE RATE INFORMATION

The following chart sets for the periods indicated, certain information regarding the Noon Buying Rate for Euros expressed in Dollars per Euro.

| Year ended December 31, USD per Euro | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|
| Exchange rate at end of period | 0.8813 | 1.0487 | 1.263 | 1.3621 | 1.1797 |
| Average exchange rate during period(1) | 0.8956 | 0.9454 | 1.1313 | 1.2439 | 1.2441 |
| Highest exchange rate during period | 0.9538 | 1.0487 | 1.2630 | 1.3633 | 1.3507 |
| Lowest exchange rate during period | 0.8359 | 0.8578 | 1.0377 | 1.1802 | 1.1667 |

| Month, USD per Euro | At end of Period | Average rate(2) ($/Euro) | Highest exchange rate during the month | Lowest exchange rate during the month |
|---|---|---|---|---|
| October 2005 | 1.2023 | 1.2015 | 1.2144 | 1.1933 |
| November 2005 | 1.1769 | 1.1786 | 1.2041 | 1.1667 |
| December 2005 | 1.1797 | 1.1856 | 1.2020 | 1.1697 |
| January 2006 | 1.2118 | 1.2103 | 1.2294 | 1.1826 |
| February 2006 | 1.1875 | 1.2025 | 1.2092 | 1.1852 |
| March 2006 | 1.2104 | 1.2023 | 1.2185 | 1.1913 |

(1) The annual average of the daily closing priced based upon European Central Bank data.
(2) The monthly average of the daily closing priced compiled upon European Central Bank data.

The noon buying rate on April 25, 2006, was US$ 1.2425 per Euro.

The above rates may differ from the actual rates used in the preparation of our consolidated financial statements and other financial information appearing in this Annual Report. Our inclusion of the exchange rates is not meant to suggest that the euro amounts actually represent such dollar amounts or that such amounts could have been converted into dollars at any particular rate, if at all.

## PART I

### ITEM 1. IDENTIFY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

### ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

# ITEM 3. KEY INFORMATION

## SELECTED HISTORICAL CONSOLIDATED FINANCIAL DATA

The following tables set forth selected historical consolidated financial data for the periods indicated. The selected historical consolidated financial data presented below as of and for the years ended December 31, 2001, 2002, 2003 and 2004 have been derived from our audited consolidated financial statements prepared in accordance with the Italian GAAP.

The selected consolidated financial data as of and for the years ended December 31, 2004 and 2005 have been derived from our audited consolidated financial statements prepared in accordance with IFRS.

The selected historical consolidated financial data in the tables below should be read in conjunction with the audited consolidated financial statements and relative notes in Item 18 and with "Operating and Financial Review and Prospects" in Item 5 of this Annual Report.

**As of and for the years ended December 31, 2001, 2002, 2003 and 2004**

| (Italian GAAP) | Year ended December 31, 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|
| | | *(Euro in millions)* | | |
| **Statement of Income Data** | | | | |
| Net sales | 845.0 | 894.1 | 900.1 | 939.8 |
| Cost of sales | (352.2) | (347.9) | (375.3) | (379.3) |
| Gross profit | 492.8 | 546.2 | 524.8 | 560.5 |
| *Gross margin* | *58.3%* | *61.1%* | *58.3%* | *59.6%* |
| Selling and marketing expenses | (272.5) | (283.9) | (300.7) | (310.4) |
| General and administrative personnel costs | (96.7) | (119.1) | (124.4) | (130.7) |
| Goodwill amortization[1] | (43.0) | (23.9) | (23.3) | (23.5) |
| Other expenses | (0.2) | 0.0 | 0.0 | (1.6) |
| Operating income | 80.4 | 119.3 | 76.4 | 94.3 |
| *Operating margin* | *9.5%* | *13.3%* | *8.5%* | *10.0%* |
| Interest expense and other financial charges, net | (34.3) | (70.9) | (68.1) | (66.0) |
| Extraordinary income (expenses), net | 1.4 | 0.9 | (7.1) | 26.0 |
| Income/(loss) before taxation | 47.5 | 49.3 | 1.2 | 54.3 |
| Income taxes | (36.4) | (35.6) | (8.5) | (31.3) |
| Net income/(loss) | 11.1 | 13.7 | (7.3) | 23.0 |
| Net income attributable to minority interests | 3.8 | 3.4 | 3.6 | 3.2 |
| Net income/(loss) attributable to the Group | 7.3 | 10.3 | (10.9) | 19.8 |

[1] *During the year ended December 31, 2002, we changed the estimated useful life of goodwill from 10 years to 20 years. Under IFRS, goodwill is not amortized but is reviewed annually for impairment*

| (Italian GAAP) | Year ended December 31, 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|
| | | *(Euro in millions)* | | |
| **Statement of Cash Flows Data** | | | | |
| Net cash provided by operating activities | 49.3 | 112.6 | 23.9 | 44.3 |
| Net cash used in investment activities | (575.1) | (216.7) | (80.4) | (31.2) |
| Net cash provided by financing activities | 523.8 | 197.0 | 22.2 | 2.8 |

| (Italian GAAP) | As of December 31, 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|
| | | *(Euro in millions)* | | |
| **Balance Sheet Data** | | | | |
| Cash in hand and at bank | 30.9 | 51.4 | 38.7 | 33.8 |
| Property, plants and equipment, net | 151.5 | 176.9 | 184.1 | 184.1 |
| Net working capital[2] | 261.1 | 189.1 | 224.2 | 239.1 |
| Total assets | 1,053.9 | 1,224.5 | 1,236.5 | 1,232.3 |
| Total debt[3] | 704.2 | 851.3 | 835.8 | 791.5 |
| Net debt[4] | 673.3 | 799.8 | 797.1 | 757.7 |
| Total shareholders' equity | 129.2 | 90.7 | 98.6 | 138.6 |

| (Italian GAAP) | Year ended December 31, 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|
| | | *(Euro in millions)* | | |
| **Other Data** | | | | |
| Purchase of property, plants and equipment, net | 45.0 | 58.4 | 45.5 | 27.9 |
| Depreciation and amortization of other intangibles[5] | 30.7 | 32.7 | 31.8 | 32.4 |
| EBITDA[6] | 154.0 | 175.8 | 131.6 | 150.3 |

*[2] We define net working capital as total current assets (excluding cash in hand and at banks) less total current liabilities (excluding bank loans, short term debt, current portion of long-term borrowings and other borrowing).*

*[3] We define total debt as short-term borrowings plus long-term borrowings.*

*[4] We define net debt as total debt, net of cash in hand and at banks.*

*[5] Depreciation and amortization excludes goodwill amortization and is included under cost of sales and general and administrative expenses in the consolidated financial statements of the Company.*

*6 With respect to the years ended December 31, 2001, 2002, 2003 and 2004 (for which our financial statements were prepared in accordance with Italian GAAP) we have calculated EBITDA as net income/(loss) before income tax expenses, net interest expenses and other financial charges, net extraordinary expenses, amortization of goodwill and other intangibles and depreciation of property, plants and equipment. With respect to the periods ended December 31, 2004 and 2005, (which were prepared in accordance with IFRS), we have calculated EBITDA as net income before income tax expenses, net interest expenses and other financial charges, share of income from associates, amortization of intangibles and depreciation of property, plants and equipment. EBITDA is not a measurement of performance under Italian Accounting Principles or IFRS, and you should not consider EBITDA as an alternative to (a) operating income or net income (as determined in accordance with generally accepted accounting principles), or as a measure of our operating performance, (b) cash flows from operating, investing or financing activities (as determined in accordance with generally accepted accounting principles), or as a measure of our ability to meet cash needs, or (c) any other measures of performance under generally accepted accounting principles. EBITDA may not be indicative of our historical operating results, nor is it meant to be predictive of our future results. We believe that EBITDA is a measure commonly reported and widely used by investors in comparing performance on a consistent basis without regard to depreciation and amortization, which can vary significantly depending upon accounting methods (particularly when acquisitions have occurred) or non-operating factors. Accordingly, EBITDA has been disclosed in this Annual Report to permit a more complete and comprehensive analysis of our operating performance relative to other companies and of our ability to service our debt. Because companies do not calculate EBITDA identically, our presentation of EBITDA may not be comparable to similarly titled measured used by other companies.*

The following table presents the calculation of EBITDA:

| (Italian GAAP) | Year ended December 31, 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|
| | | *(Euro in millions)* | | |
| **Net income/(loss)** | 11.1 | 13.7 | (7.3) | 23.0 |
| Income taxes | 36.4 | 35.6 | 8.5 | 31.3 |
| Interest expenses and other financial charges, net | 34.3 | 70.9 | 68.1 | 66.0 |
| Extraordinary expenses, net | (1.4) | (0.9) | 7.1 | (26.0) |
| Goodwill amortization | 43.0 | 23.9 | 23.3 | 23.5 |
| Other intangibles amortization | 3.0 | 2.9 | 5.5 | 6.2 |
| Plant, property and equipment depreciation | 27.6 | 29.7 | 26.4 | 26.3 |
| **EBITDA**[6] | 154.0 | 175.8 | 131.6 | 150.3 |

**As of and for the years ended December 31, 2004 and 2005**

| (IFRS) | Year ended December 31, 2004 | 2005 |
|---|---|---|
| | *(Euro in millions)* | |
| **Statement of Income Data** | | |
| Net sales | 944.7 | 1,025.3 |
| Cost of sales | (381.5) | (416.5) |
| Gross profit | 563.2 | 608.8 |
| Selling and marketing expenses | (344.1) | (379.4) |
| General and administrative expenses | (106.9) | (102.1) |
| Other expenses, net | (0.9) | 1.0 |
| Operating income | 111.3 | 128.3 |
| Share of income from associates | - | 1.5 |
| Interest expense and other financial charges, net | (66.1) | (85.3) |
| Non recurring financial charges | - | (19.5) |
| Income taxes | (20.5) | (11.4) |
| Net income/(loss) | 24.7 | 13.6 |
| Net income attributable to minority interests | 3.1 | 3.2 |
| Net income attributable to the Group | 21.6 | 10.4 |

| (IFRS) | Year ended December 31, 2004 | 2005 |
|---|---|---|
| | *(Euro in millions)* | |
| **Statement of Cash Flows Data** | | |
| Net cash provided by operating activities | 55.8 | 30.1 |
| Net cash used in investment activities | (28.6) | (37.3) |
| Net cash used in financing activities | (22.0) | 21.3 |

| (IFRS) | As of December 31, 2004 | 2005 |
|---|---|---|
| | *(Euro in millions)* | |
| **Balance Sheet Data** | | |
| Cash in hand and at bank | 33.8 | 151.0 |
| Property, plants and equipment, net | 195.8 | 193.6 |
| Net working capital[2] | 231.5 | 290.4 |
| Total assets | 1,171.6 | 1,390.8 |
| Total debt[3] | 787.9 | 652.2 |
| Net debt[4] | 754.1 | 501.2 |
| Total shareholders' equity | 68.6 | 385.8 |

| (IFRS) | Year ended December 31, 2004 | 2005 |
|---|---|---|
| | *(Euro in millions)* | |
| **Other Data** | | |
| Capital expenditure | 31.2 | 38.6 |
| Depreciation and amortization [5] | 35.6 | 35.2 |
| EBITDA[6] | 146.9 | 163.5 |

| (IFRS) | Year ended December 31, 2004 | 2005 |
|---|---|---|
| | *(Euro in millions)* | |
| **Net income/(loss)** | 24.7 | 13.6 |
| Income tax expenses | 20.5 | 11.4 |
| Interest expense and other financial charges, net | 66.1 | 85.3 |
| Non recurring financial charges | 0.0 | 19.5 |
| Share of income from associates | - | (1.5) |
| Amortization of intangibles | 5.5 | 5.6 |
| Property, plants and equipment depreciation | 30.1 | 29.6 |
| **EBITDA[6]** | 146.9 | 163.5 |

## RISK FACTORS

### Risks Relating to Our Business

***Our business depends on our ability to negotiate, maintain, comply with and renew license agreements on satisfactory terms with leading fashion brand owners.***

We have entered into license agreements that enable us to manufacture and distribute prescription frames and sunglasses under brands owned by third parties. During 2005, 80.0% of our total net sales were attributable to sales of licensed brands, and sales generated under agreements with our top four licensed brands accounted for 50.5% of our total net sales. We believe that our ability to negotiate, maintain, comply with and renew license agreements on satisfactory terms with leading designers in the fashion and luxury goods industries is essential to managing a successful brand portfolio and, therefore, material to the success of our business. Accordingly, if we are unable to maintain and renew license arrangements on terms that are commercially acceptable to us with our current licensors or comparable replacements or if we are unable to negotiate new license agreements with other leading designers, our growth prospects and financial results could be materially and adversely affected.

The majority of our licenses, including certain of our key licenses, contain provisions that permit a licensor to terminate the license upon the occurrence of certain events including, by way of example, the following:

- change of control of our Group;
- outsourcing production without the consent of the licensor;
- selling models that are not approved by licensor;
- failure to reach certain revenue targets;
- selling products through distribution outlets that have not been approved by the licensor; and
- in the event that a competitor of the licensor acquires a controlling shareholding in our company.

Certain of the license agreements expressly define a change of control in our Group as Vittorio Tabacchi and his family directly or indirectly losing control of the Group or ceasing to be our majority shareholder.

Outside our top four licensed brands agreements, two license agreements grant the licensor the right to terminate the agreement in the event a competitor of the licensor acquires more than 10% of our share capital and is able to influence our company policies and strategies.

A few of our license agreements, including two of our top four licensed brands agreements allow the licensor to terminate the agreement if we replace our current key management. One of our top four licensed brand agreements provides for termination in the event that a competitor of that licensor becomes a member of our board of directors.

***Our fashion eyewear business is sensitive to economic conditions and changing consumer preferences that are often guided by innovative products and trends.***

The fashion eyewear industry is cyclical. Downturns in general economic conditions or uncertainties regarding future economic prospects, which affect consumer disposable income, have historically adversely affected consumer spending habits in our principal markets. Therefore, economic downturns or uncertainties could have an adverse effect on our business, results of operations and financial condition.

The fashion eyewear industry is also subject to rapidly changing consumer preferences. While eyewear has achieved a significant degree of acceptance as a fashion accessory, and the fashion eyewear industry has grown significantly in recent years, this growth may not continue and consumer preferences could change in a

manner which will adversely affect the fashion eyewear industry as a whole and our business in particular. Changes in fashion preferences could also affect the popularity and, therefore, the commercial success of the licensed brand products. The prescription frames and sunglasses markets in which we compete could be affected by these changes in fashion trends and consumer preferences. Our future success will also depend on our continued ability to develop and introduce eyewear in accordance with consumers' shifting preferences. Any event or circumstance resulting in reduced market acceptance of one or more of these designers could reduce our sales and the value of our inventory of models based on that design. In addition, our success depends, in part, on our ability to anticipate and react to changing fashion trends in a timely manner. Any sustained failure to identify and respond to such trends would adversely affect our business, results of operations and financial condition.

The mid- and high-end prescription frames and sunglasses markets in which we compete are particularly vulnerable to changes in fashion trends and consumer preferences that are often guided by innovative products and trends. Our historical success is attributable, in part, to our introduction of innovative eyewear products which are perceived to represent an improvement over products otherwise available in the market. Our future success will depend on our continued ability to develop and introduce such innovative products.

***Because our assets, liabilities, sales and costs are denominated in multiple currencies, we are vulnerable to exchange rate fluctuations.***

Our reporting currency is the euro and we conduct and will continue to conduct transactions in currencies other than the euro. As a result, we have been and will continue to be vulnerable to foreign exchange rate fluctuations because:

- we incur a significant portion of our manufacturing costs in euro and generate a substantial portion of our revenues in other currencies, particularly U.S. Dollars, which represent 40% of our consolidated revenues; therefore, a strengthening of the Euro relative to such other currencies in which we receive revenues could negatively impact our operating margins, which could adversely affect our business and results of operations; and

- a portion of our assets, liabilities, revenues and costs are denominated in various currencies other than euro; as a result, our operating results, which are reported in Euro, are affected by currency exchange rate fluctuations.

Future movements of the exchange rate of the euro against the U.S. dollar and other currencies may have a material adverse affect on our results of operations. Fluctuations could also significantly affect the comparability of performance between financial periods. See Item 5 "Operating and Financial Review and Prospects—Foreign Exchange Effects."

***Our results of operations could be adversely affected by a disruption of operations at our manufacturing facilities or our distribution centers or by problems with our third-party manufacturers.***

We own and operate manufacturing facilities in Italy and Slovenia. Our primary distribution facility is located in Padua, Italy and our other key distribution facilities are in Parsippany, New Jersey (United States) and in Hong Kong (China). All of these facilities are subject to operational risks, including:

- equipment failure;

- failure to comply with applicable regulations and standards and to maintain necessary permits and approvals;

- material supply disruptions;

- labor force shortages or work stoppages;

- events impeding or increasing the cost of transporting our products;

- natural disasters; and

- terrorist attacks.

Any significant disruption in operations at our manufacturing facilities or our distribution facilities resulting from these or other events may, to the extent not covered by our business interruption insurance, adversely affect our results of operations.

In addition to our owned manufacturing facilities, we use third-party manufacturers and suppliers, mainly located in Asia but also in Italy and the United States, to produce certain of our products. The use of third-party manufacturers entails a number of additional risks, including the risk of termination and less control over the quality of manufactured products. Any delays or disruptions in the products furnished by third-party manufacturers, or disruption or termination of our present arrangements with third-party manufacturers without suitable alternative arrangements in place, could have an adverse effect on our business, results of operations and financial condition.

***Our business is subject to risks relating to international sales and exposure to changing local conditions.***

We currently have operations in 30 countries and our products are sold in approximately 130 countries. We are therefore subject to various risks inherent in conducting business internationally, including, by way of example, the following:

- exposure to local economic, political and civil conditions;
- export and import restrictions;
- currency exchange rate fluctuations and currency controls;
- changes in government regulations, including those relating to payments for prescription eyewear;
- withholding and other taxes on remittances and other payments by subsidiaries;
- investment restrictions or requirements; and
- local content laws requiring that certain products contain specified minimum percentage of components produced locally.

Our exposure to these and other risks and their potential impact on us varies from country to country and is unpredictable, but may have a significant effect on our business, results of operations, financial conditions and prospects.

***We are subject to significant restrictive debt covenants, which limit our operating flexibility.***

We have undertaken that, during the term of the Senior Credit Agreement (as defined in Item 5), we will comply with certain covenants relating to our results of operations and financial condition such as interest cover, cash flow cover and leverage, which must be calculated quarterly at a consolidated level.

The Senior Credit Agreement and the indenture governing the Senior Notes (as defined in Item 5) contain covenants in line with market practice that impose significant restrictions on the way our Group companies can operate, including restrictions on our ability to:

- incur additional indebtedness or guarantee indebtedness of others;
- make certain loans or investments;
- distribute dividends; or
- acquire or sell our own shares.

These covenants could limit our ability to finance our future operations and capital needs and our ability to pursue acquisitions and other business activities that may be in our interest.

Our Senior Credit Agreement also requires us to maintain specified ratios and satisfy specified financial tests. Our ability to meet these financial ratios and tests may be affected by events beyond our control and, as a result, we cannot assure you that we will be able to meet these ratios and tests. In the event that we default under the Senior Credit Agreement, the lenders could terminate their commitments and accelerate the payment of the entire outstanding principal and interest due. Borrowings under other debt instruments that contain cross-acceleration or cross-default provisions may as a result also be accelerated and become due and payable. Any such failure or default could severely restrict our ability to fund our liquidity and capital expenditure needs and otherwise have a material adverse effect on our financial condition and results of operations.

Moreover, under the Senior Credit Agreement and the Senior Notes, in addition to the senior and subordinated guarantees, most of our assets are subject to first and second ranking security interests. As a consequence, even where we are permitted to incur additional debt under the Senior Credit Agreement or the Senior Notes, to the extent any such financing would require security, we may have difficulty obtaining or may not be able to obtain financing because we have insufficient available assets, or unencumbered interest in such assets, to secure such debt.

***The markets in which we compete are highly competitive, and a failure to maintain an extensive distribution network could harm our business.***

The prescription frames and sunglasses markets in which we operate are highly competitive. We believe that, in addition to successfully introducing new products, responding to changes in the market and maintaining superior production capabilities, our ability to remain competitive is dependent on our maintaining an extensive distribution network. One of the key objectives of our business strategy is to strengthen our existing distribution network. This effort will require additional expenditures and may not be successful. If we are unable to strengthen and to maintain our distribution network, our business, results of operations and financial condition could be adversely affected.

***Our high leverage and debt service obligations could adversely affect our business.***

We are highly leveraged and have significant debt service obligations. As of December 31, 2005 we had €501.2 million of consolidated net debt. Although we have repaid a substantial portion of our consolidated debt with the proceeds received from the shareholders' contribution of our holding Company Safilo Group S.p.A., we will continue to have significant debt service obligations and interest expenses for the foreseeable future.

The majority of our indebtedness consists of financing that we incurred in 2002 in connection with the public tender offer in 2001 for Safilo S.p.A by Vittorio Tabacchi, the subsequent de-listing of Safilo S.p.A. and the reorganization of our Group, including the Senior Credit Agreement entered into in December 2002 and the €300,000,000 9 5/8% senior notes due 2013 issued on May 15, 2003 (the "Senior Notes"). For a description of our indebtedness, see Item 5 "Operating and Financial Review and Prospects". Should we be unable to generate income from ordinary operations sufficient to make payments due under the Senior Credit Agreement or the Senior Notes, this could result in a default on those financing obligations which could have a material adverse effect on our business, results of operations and financial condition.

***We depend on the services of our senior management and other key personnel, and if we are not able to retain our senior personnel or retain suitable replacements, our business could be negatively impacted.***

We are currently managed by a relatively small number of senior executive officers and employees, many of whom have numerous years of experience with us and in the eyewear industry, who would be difficult to replace. Our senior managers, including our Chairman, Vice Chairman, Chief Executive Officer and Regional Managing Directors, and our senior product design, sales, marketing and production staff have extensive knowledge of our business, industry, licensors and customers. Any loss or interruption of the services of our key senior personnel, or our inability to recruit sufficient qualified replacement personnel, could adversely affect our ability to maintain the loyalty of key customers and licensors, to continue to develop important product

improvements, to design, manufacture, distribute and market our products and to implement our strategy. This could adversely affect our business, results of operations and financial condition.

We believe that our continued growth and success largely depends on our ability to retain skilled, qualified and experienced managerial, design, research and development, sales, marketing and production personnel and to train our staff to produce and to sell successfully the broad range of products that we offer. Even if we are successful in attracting and retaining such personnel, competition for such employees may significantly increase our compensation costs and adversely affect our operating results.

***We rely on the continued availability of high quality raw materials and semi-finished products.***

We manage the purchase of high quality raw materials and semi-finished goods used in our own production. Until now, we have been able to identify and purchase quality raw materials, semi-finished goods and finished goods to support our production volumes and sales requirements while preserving our high quality standards. If the availability of, our access to, or the cost of high quality raw materials, semi-finished or finished goods is adversely affected (for example, due to a decrease in the number of suppliers or manufacturers of such materials or goods, or a reduction in the overall availability of such materials or goods, whether due to a lack of supply, the loss of a supply contract, or increased demand from our competitors), we may have to bear greater expenses for or be unable to acquire such materials or goods. Any such adverse changes may require us to increase prices or stop producing certain products and could adversely affect our sales and results of operations.

We believe we are not dependent on any one supplier; however in the event of any material disruption in, or termination for any reason of, our relationship with our current suppliers, there could be negative effects on our operations and the process of selecting and evaluating qualified alternative suppliers may be onerous and time-consuming in light of the high quality standards that we require. We also can provide no assurance that in the event of such a disruption or termination that we would be able to find an alternative supplier able to supply the materials currently used in our products or that materials would be available at prices similar to those offered by our current suppliers.

***Our business could be adversely affected by the availability of vision correction alternatives to prescription eyeglasses.***

Our business could be adversely affected by the availability and acceptance of vision correction alternatives to prescription eyeglasses, such as refractive optical surgery. According to industry estimates, the use of refractive optical surgery has grown substantially since it was approved by the U.S. Food and Drug Administration in 1995.

Increased availability and use of vision correction alternatives could result in decreased use of our prescription eyewear products, which, in 2005, represented 41.2% of our consolidated revenues, and could have a material adverse effect on our business, results of operations, financial condition and prospects.

***We may be unable to protect our proprietary rights, which would adversely affect our business and financial results.***

We rely on trade secret, unfair competition, trade name, service mark, trademark, copyright and patent laws to protect our rights to certain aspects of our products, including product designs, proprietary manufacturing processes and technologies, product research and concepts and recognized trademarks, all of which we believe are important to the success of our products and our competitive position. However, pending patent and trademark applications may not generate registered patents and trademarks, and any patent or trademark registration that is granted may be ineffective in preventing competition and could be held invalid and/or revoked if subsequently challenged. In addition, the actions we take to protect our proprietary rights may be inadequate to prevent imitation of our products. Our proprietary information could become known to competitors, and we may not be able to protect meaningfully our rights to proprietary information. Furthermore, other companies may independently develop substantially equivalent or better products that do not infringe on our intellectual property rights or could assert rights in, and ownership of, our proprietary rights. Moreover, the laws of certain countries do not protect proprietary rights to the same extent as the laws of the European Union and the United States.

If the level of potentially infringing activities by others were to increase substantially, we might have to increase significantly the resources we devote to protecting our rights. Additionally, an adverse determination in

any dispute involving our proprietary rights could require us to grant licenses to, or obtain licenses from, third parties, or prevent us from manufacturing or selling our products or could subject us to substantial liability. Any of these possibilities could have a material adverse effect on our business, results of operations, financial condition and prospects.

***Maintaining and achieving compliance with governmental regulations requires us to incur costs and may limit our operations or otherwise negatively affect our business.***

Our operations are subject to various laws and regulations by governmental authorities in Europe, the United States and other jurisdictions in which we conduct business. Governmental regulations, whether in the European Union, the United States or other jurisdictions, have historically been subject to change. Violations of these laws and regulations, including those relating to the environment and other matters, could result in significant fines, or civil or criminal sanctions. We also could incur cleanup costs in the event that significant contamination is discovered at any of our facilities, or at any off-site location for which we may be responsible. In addition, new laws and regulations, or changes in how existing requirements are enforced, could require us to incur additional costs, subject us to unexpected liabilities, limit our operations or negatively affect our business.

***Our operating results are subject to fluctuations in seasonality.***

The market in which we operate is typically characterized by seasonal fluctuations, particularly with respect to sales of our sunglasses and the related invoicing, the majority of which is concentrated in the first two quarters of the year. As a result of these quarterly fluctuations, we believe that comparisons of our net sales and operating results between different quarters within a single fiscal year are not meaningful and such comparisons cannot be relied upon as an indication of our future net sales or operating results for the full year.

***We are controlled by our shareholders and their interests may conflict with your interests.***

As of December 31, 2005, companies controlled by Vittorio Tabacchi, funds advised by CSFB Private Equity and the market collectively own 100% of the capital shares of our parent company, Safilo Group S.p.A.. As a consequence, they have and will continue to have, directly or indirectly, the power, among other things, to affect our legal and capital structure and our day-to-day operations, as well as the ability to elect and change our management and to approve any other changes to our operations or strategic direction. The interests of these shareholders, in certain circumstances, may conflict with your interests as holders of the notes. For example, our shareholders could vote to declare dividends or to cause us to incur indebtedness, in each case as permitted under the indenture, causing capital outflows or increasing our debt service obligations, all of which could hinder our ability to meet our obligations under the notes.

***Our payment obligations are subject to fluctuations in interest rates.***

We are subject to interest rate fluctuations as a result of our debt position, a portion of which is repayable at a floating interest rate, normally based on Euribor or Libor. As a result, we enter into interest rate swap contracts with the aim of hedging a portion of our interest rate risk. See Item 5 "Operating and Financial Review and Prospects". If significant fluctuations of floating interest rates occur, our interest obligations on the portion of interest that we have not hedged would become greater, which would adversely affect our results of operations.

# ITEM 4. INFORMATION ON THE COMPANY

## HISTORY AND DEVELOPMENT OF THE COMPANY

### Overview

We believe that we are the world's second largest wholesale eyewear producer in terms of net sales and that we are the worldwide leader in the high-end eyewear market segments, which comprise eyewear with retail prices above €100 in Europe and above USD100 in the United States. In 2004, our market share in the high-end eyewear market segments was approximately 40% (source: Bain & Company estimates). In 2003 we had a market share of 61% in the luxury segment of the high-end market (source: Bain & Company). Sales of our prescription frames and sunglasses positioned in the high-end market segments represented approximately 77% of our total net sales in 2005.

We design, manufacture and distribute high-quality eyewear products, including prescription frames, sunglasses frames and lenses, sport goggles and other sport accessories such as helmets and ski masks. We sell these products across a variety of geographic regions.

We believe that our prescription frames, sunglasses and brands are recognized worldwide for their high quality design and distinctiveness. We produce and distribute eyewear products under our owned brands as well as under license agreements for leading luxury and designer brands. Our license agreements typically are exclusive and have terms of five to eight years, and our relationships with some of our key licensors date back to the late 1980s. Our licensed brands include *Alexander McQueen*, *Bottega Veneta, Boucheron, Diesel* and *55DSL, Dior, Emporio Armani, Fossil, Giorgio Armani, Gucci, Imatra, Jennifer Lopez, Juicy Couture, Kate Spade, Liz Claiborne, Marc Jacobs, Max Mara, Nine West, Oliver, Pierre Cardin, Polo Ralph Lauren, Saks Fifth Avenue, Stella McCartney, Valentino,* and *Yves Saint Laurent*. Our owned brands include *Safilo, Oxydo, Carrera, Smith* and *Blue Bay* and exclusive American brands, such as *Adensco*, *Chesterfield*, *La Strada* and *Maurice Saint Michel*.

We oversee the entire chain of production and distribution, which includes the following phases: technological research and innovation, product development and design, planning, purchase planning, production and quality control, marketing and sales, purchase management, distribution and logistics.

We currently operate five principal manufacturing plants, with four located in Italy and one in Slovenia. We directly manage our internal production and closely monitor and supervise any third-party production. Third-party manufacturers are selected among primary manufacturers in Italy, the United States and the Asia Pacific region, in order to streamline costs, maintain flexibility during the production process and to manufacture products that are consistent with the design needs of our customers.

We operate three main distribution centers, one in Padua, which is highly automated, one center in Parsippany (New Jersey) and one center in Hong Kong, as well as other smaller distribution centers. We distribute our products in approximately 130 countries, through a distribution network comprising 28 distribution subsidiaries operating in 30 countries, and through approximately 170 independent distributors elsewhere. Each distribution subsidiary coordinates a network of local sales agents, most of whom sell our products on an exclusive basis, reaching over 130,000 retail points of sale. Our points of sale include optometrists, ophthalmologists, opticians, retail distribution chains, department store chains and specialty stores.

Our revenues are partially influenced by seasonality, as we experience our highest level of demand during the first semester due to sales of sunglasses leading up to the summer months, and we experience our lowest level of sales demand in the third quarter because, traditionally, the majority of shops are closed for some portion of the summer season.

### Background

Safilo was founded in 1934 when Guglielmo Tabacchi (father of our current Chairman, Vittorio Tabacchi) assumed control of a lens and frame factory, Safilo ("*Società Italiana Azionaria Fabbrica Italiana Lavorazione*

*Occhiali"*), which was established in 1878 in northeast Italy, a region where many leading companies in the eyewear industry are located. In 1964, we opened a second factory in Santa Maria di Sala (Venice), to which we transferred all production of frames in acetate and cellulose. During the 1970s, we expanded our production facilities in Calalzo di Cadore, and we purchased and opened our offices in Padua in northeast Italy, the current location of our headquarters and our primary distribution facility (1975 - 1977).

Beginning in the 1980s, we began to create our first distribution subsidiaries in Belgium, Spain, Germany and France. In 1983 through 1986, we gained control of American Starline Optical Corp. (now known as Safilo USA Inc.), a large U.S. eyewear trading company that had been exclusively distributing our products in the United States since 1962.

**The luxury eyewear market**

In the 1980s our management team perceived potential for significant growth of the eyewear market and began promoting eyewear, especially sunglasses, as a luxury accessory as opposed to a device for correcting vision. We have since followed our strategy of cooperating with the leading luxury fashion houses, through our license agreements for their trademarks, making priorities of innovation and superior product quality as well as being selective of our sales channels.

In line with our strategy, in 1984 we acquired Optifashion S.r.l., which had license agreements with *Ferrari* and *Ferré*. In 1988 we acquired American Optique du Monde Corp., a company that had a license agreement for the *Ralph Lauren* brand.

In the 1990s, we targeted the high-end eyewear market segments by entering into brand licensing agreements with well known fashion houses, including the following brands: *Gucci* (1990), *Pierre Cardin* (1991), *Diesel* (1994), *Dior* (related to the 1996 acquisition of certain assets of Carrera Optyl), *Max Mara* (1997), *Valentino* and *Oliver by Valentino* (1998), *Nine West* (1998), *Fossil* (2000), *Kate Spade* (2000), *Yves Saint Laurent* (2001), *Saks Fifth Avenue* (2001), *Bottega Veneta* (2002), *Stella McCartney* (2002), *Liz Claiborne* (2002), *Boucheron* (2002), *Alexander McQueen* (2002) *Giorgio Armani* (2003), *Emporio Armani* (2003), *J.Lo by Jennifer Lopez* (2003), *55DSL* (2003), *Marc Jacobs* (2004), *Imatra* (2005), *Juicy Couture* (2005), *Boss* and *Hugo* (2005).

**The sports goggles market**

In 1996 we acquired certain assets of Carrera GmbH, a producer of specialized sports eyewear, including the Optyl know-how for plastic frames, and also acquired two manufacturing facilities in Traun, Austria, and Ormoz, Slovenia. With these acquisitions, we became one of the principal European producers and marketers of sports goggles and ski masks. In 1996, we also acquired the U.S. company Smith Sport Optics Inc. and added sports goggles targeted at the U.S. market to our product lines.

**Industrial and commercial development and expansion**

We began our industrial expansion plan in 1989, when we constructed a large new manufacturing facility in Longarone. The plant became operational in 1990 and was and continues to be among the most technologically advanced manufacturing eyewear plants in Europe. In 2001, we opened a centralized, highly automated warehouse at our headquarters in Padua.

During the past 15 years, we have followed a strategy aimed at strengthening and expanding our distribution network and opening distribution branches in the most promising markets in order to directly control distribution in the most important geographic areas. Implementation of our strategy has allowed us to create a closer relationship with our clients.

In 1994, we opened our Safilo Far East distribution branch in Hong Kong, to penetrate the Asian and Australian markets. In the late 1990s, we strengthened our presence in Europe by opening distribution branches in the UK, Greece, the Netherlands, Austria, Portugal and Switzerland, and in the rest of the world by opening distribution branches in Australia, South Africa, Japan, Brazil, India, Singapore, Hong Kong and Malaysia. In 2004, we opened our branch in Shenzen, China, one of the markets we believe has significant growth potential.

**Recent Developments**

With respect to our production, in 2000, we began to outsource production to third-party manufacturers in the Asia Pacific region, in order to increase our flexibility during peak production periods and to limit costs. In addition, since 2004, we have been following a policy of streamlining our production facilities in order to reduce production times and costs. In line with this policy, we closed the plant in Traun, Austria, in 2004, and in 2005 we began a reorganization process to merge our Italian production facilities.

During the period from 2003 to 2005, we have implemented several projects aimed to strengthening our operations and customer relations, such as upgrading our distribution structure, implementing our customer relations management program and concentrating our call center operations in our Padua call center.

During 2005, we have undertaken a project to rationalize production, which will gradually lead to the closure of our production plant in Calalzo di Cadore (Belluno) and of our two minor production centers in Coseano and Ronchis (both in the province of Udine). The production carried out at the three facilities that will be closed will be moved to our other production plants, as described in "Business Strategy".

During the third quarter of 2005, we renewed each of our license agreements with *Dior* and *Gucci* for two additional years, up to 2010, and our licenses with *Armani* and *Emporio Armani* for an additional two years, up to 2012. Our license with *Burberry* terminated on December 31, 2005, and hasn't been renewed. In the year ending on December 31, 2005, net sales for products licensed under the *Burberry* license agreement represented 2.9% of our net sales.

On November 9, 2005, we entered into a new seven-year license agreement with Hugo Boss Group for the worldwide design, production, distribution and sale of sunglasses and prescription frames with the BOSS Hugo Boss and HUGO Hugo Boss trademarks. We will begin distributing the first collections of Hugo Boss brand products on October 1, 2006.

On January 11, 2006 the license agreement with Yves Saint Laurent has been extended until the end of 2010.

On January 13, 2006, the subsidiary Safilo Capital International S.A. with headquarters in Luxembourg, repaid 35% of the bonds listed on the Luxembourg market (Senior notes 9 5/8%) for a total amount of Euro 105 million, also making a payment to the holders of the bonds of approximately Euro 10 million for the higher interest related to the advance repayment of the bond.

On February 27, 2006, the Group announced the non-renewal of the license agreement for the manufacture and marketing of Ralph Lauren sunglasses, which expires on December 31, 2006. The turnover in 2005 of the brands belonging to the Polo Ralph Lauren Group was approximately 10% of the total Group turnover.

**Significant Corporate Events**

In 1987, Safilo S.p.A. was listed on the Italian Stock Exchange. In July 2001, Safilo S.p.A.'s Chairman Vittorio Tabacchi acquired the majority of the share capital of that company and began a tender offer, through a special vehicle company called Programma 2002 S.p.A. The original tender offer was launched at a price of €12.5 per share for an aggregate value of €161.3 million of shares; the residual tender offer for the entirety of the share capital was launched at a price of €14.48 for an aggregate value of €9.4 million. After completion of the tender offer, Safilo S.p.A. was de-listed in December 2001.

In 2002, Safilo S.p.A. was merged into Programma 2002 S.p.A., which in turn was later merged into Programma 2001, another special vehicle company owned by Vittorio Tabacchi's family, which took the name of "Safilo S.p.A." and is the current Safilo S.p.A.

In December 2002 our holding company Safilo Group S.p.A. acquired, through a contribution in kind, 100% of Safilo S.p.A.'s outstanding share capital. In December 2002, two special vehicle companies, SunlightLuxco S.à.r.l. and SunlightLuxco II S.à.r.l., indirectly owned by CSFB Private Equity, became our holding's

shareholders. Their shareholdings were later transferred to, respectively, SunlightLuxco A S.à.r.l. and SunlightLuxco III S.à.r.l., our holding's current shareholders.

On September 14, 2005, pursuant to a resolution of our extraordinary shareholders' meeting, our parent company changed its name from Safilo Holding S.p.A. to Safilo Group S.p.A.

On December 9, 2005 the shares of Safilo Group S.p.A., were admitted on the listing of the Italian Stock Exchange (Mercato Telematico Azionario) at an initial price of Euro 4.9 per share.

The Global Offer initially consisted in 140,000,000 shares, of which 64,300,000 shares offered for subscription, 3,947,252 shares offered to the beneficiaries of the 2003-2007 and 2004-2008 Stock Option Plans and 71,752,748 shares offered for sale by the shareholders SunlightLuxco A S.à.r.l. and SunlightLuxco III S.à.r.l..

Against the requests received and in virtue of the exercise, by the Co-ordinators of the Offer, of the loan option (so-called "Over allotment") totalling 16,800,000 shares, a total of 156,800,000 shares were allocated as follows:

- 37,873,800 shares to Italian retail investors in relation to the public offer;
- 118,926,200 shares, to Professional Investors in Italy and International Institutional Investors in relation to the Institutional Placement.

Following the exercise, in January 2006, of the so-called *Greenshoe* by the Co-ordinators of the Offer for a total amount of 7,667,515 shares, the selling shareholders SunlightLuxco A and SunlightLuxco III were returned the shares subject to the loan, equal to 9,132,485 shares.

The offer generated a total demand of over Euro 1.5 billion and the company commenced trading on the Stock Exchange with a capitalisation of approximately Euro 1.4 billion, placing the Safilo Group amongst the largest Italian listed industrial companies.

The institutional placement related to the subscription of over 250 institutional investors which included the largest Italian and international investment funds. The shares reserved for the retail sector in Italy resulted in the subscription of over 43,000 private investors.

Safilo Group S.p.A. has used part of the proceeds received from the listing for a shareholders' contribution in Safilo S.p.A. for a total amount of Euro 294,713 thousand in order to give the subsidiary the opportunity to repay part of the Senior Credit Agreement and to redeem part of the Senior Notes (see "Liquidity and Capital resources" in Item 5 for further details).

## BUSINESS OVERVIEW

### Competitive Strengths

We believe that the following factors give us competitive advantages in the global eyewear industry:

- **a leadership position in the high-end eyewear market**. We have been in the market for over 70 years and we are one of the major operators in the sector of design manufacture and distribution of sunglasses and other eyewear products. We believe we are the global leader in the high-end market (comprising products with prices over €100 and USD100). We believe that we have obtained our global leadership in the high-end market segments through our focused strategy since the second half of the 1980s, and we intend to remain focused on these market segments.

- **a portfolio of prestigious licensed brands, focused primarily in the luxury and premium segments.** We manage a portfolio of selected brands by developing products that are consistent with our status as a market leader with international prestige. We follow a marketing diversification strategy, and no brand represents more than 20% of our total sales. We have steadily won acceptance from the designers of licensed brands, and agreed to work with them for long periods (between five and eight years) under tailored licensing contracts, some of which have been renewed repeatedly.

- **superior product quality, design and innovation**. Our products are renowned for their quality and innovative features by both optical retailers and end customers. We believe that product quality is a key competitive factor that enables us to successfully position our products in the market. In addition, we believe that our emphasis on quality has been an important factor in establishing and retaining our leading portfolio of brands. We have traditionally placed value on product craftsmanship. All of our products are developed and designed internally by our design group of approximately 106 highly qualified employees, which we believe to be the largest design team in the eyewear industry. We have focused on providing innovative technical solutions for our end customer's optical needs.

- **worldwide distribution and sales network**. Our three main distribution centers supporting the sales network are the core of our distribution platform and are located in Padua, in Parsippany (New Jersey) and in Hong Kong. Our worldwide distribution platform includes 28 commercial subsidiaries, enabling us to operate directly in 30 countries with a network of approximately 1,400 sales agents. Additionally, we are able to market our products in 130 countries through 130,000 points of sale, using a network of 170 independent distributors. Each member of our sales force is trained specifically to sell the product lines of a single licensed or owned brand. We maintain close contact with our distributors in order to monitor sales and to control the quality of the points of sale that display our products. We select our retail sales channels based on where our brands would be best placed. We believe that our careful selection of retailers is the key to our success, and has helped us to obtain and retain licenses.

- **superior client service**. We believe that we are a leader in providing service to our clients. We support our customers through our large and experienced sales force, modern call centers for telephone orders, strong advertising and promotional support at the point of sale and an extensive distribution network capable of rapid delivery. Our sales force of approximately 1,400 exclusive sales representatives is largely commissioned-based. This sales force is supported by approximately 700 persons who assist in meeting customer needs. We have created a structure inclusive of "key account managers", who assist our customer retail sales chains. For any customer assistance and re-orders, we have multi-language call centers in Europe and the United States, through which we seek to ensure that the reorder will be processed within 24 hours. The call centers use our proprietary customer relationship management software, which allows us to profile each customer and therefore process customers' requests more efficiently.

- **balanced sales mix**. We believe that we have been successful in balancing our net sales in terms of product mix, price per unit and geographic market, which allows us to hedge against market fluctuations and provides us with opportunities to expand into emerging markets. We generate a stable revenue stream (both in terms of seasonality fluctuations and as a component of our historical revenues over the past ten years) from sales of prescription frames, which have represented about half of our total net sales and sales volume in recent years. Our prescription frame customer base primarily consists of an established network of independent optical industry professionals that purchase frames for prescription eyewear. In 2005, sales of prescription frames accounted for 41.2% of our net revenues and approximately 30.9% of our sales in terms of number of units. We sell prescription frames to an independent client base of opticians and optometrists. On a geographic basis, our net sales in the American region were 37.4% of total net sales in 2005 and our revenues in Italy and Europe were 46.6% in 2005. Within Europe, besides our home market of Italy, we have significant sales in the key markets of France, Spain, Germany and the United Kingdom. This geographic balance partly insulates us from a downturn in any particular region. Similarly, we believe that our diversified portfolio of brands mitigates against risks related to changes in fashion trends in any given market or market segment. In addition, we

believe that the long-term nature of our license agreements provides stability to our sales. Finally, our brands are positioned at distinct price points in the mid-range and high-end eyewear segments, and targeted at discrete groups of consumers.

- **sales growth.** In recent years, events such as the terrorist attacks on the World Trade Center, the SARS epidemic, the war in Iraq and a weakening of the U.S. dollar have had negative repercussions on the global economy. In the past ten years, however, our Group has been able to achieve constant growth in sales and revenues.

- **experienced management team**. We believe that our management team has a long track record in the eyewear industry and is well regarded in terms of industry knowledge and strategic outlook. Our management team is lead by our Chairman Vittorio Tabacchi, our Vice Chairman Giannino Lorenzon and by Roberto Vedovotto, who is our Chief Executive Officer. A significant component of the compensation of our management team is based on the operating performance of our business. In addition, certain of our directors, senior management and other key employees have been granted options to subscribe for our shares under our stock option plans. See Item 6 "Directors, Senior Management and Employees".

- **flexibility in production**. In the past few years, we have been streamlining our operations in order to achieve more efficient and flexible production. In accordance with our "lean manufacturing" plan, we have divided our production so that all our production involving metals, acetate or Optyl is each carried out in only one or two plants, so that each plant only manufactures products of only one material. Furthermore, we have increased our outsourced production, which has enabled us to optimize our production capacity at our own plants and allows us to meet peak periods of productivity without disruption and at lower costs. This strategy has also enabled our own plants to focus on production of products in the high-end market, which require more craftsmanship.

**Competitive Position**

The worldwide market for high quality prescription frames and sunglasses is highly competitive and fragmented. Our principal competitors on a worldwide basis are the Luxottica Group S.p.A., Oakley, Inc., Marchon Eyewear Inc., Silhouette International Schmied AG, Charmant Inc., Marcolin S.p.A. and De Rigo S.p.A. We also face competition from numerous national, regional and local companies in the markets in which we distribute our products.

We and a few other market operators, in the aggregate, represent approximately 27% of the wholesale eyewear market. In the high-end wholesale market, we had a market share of approximately 40% in 2004 (source: Bain & Company estimates). In the luxury segment of the high-end market, we held a market share of approximately 61% in 2003 (source: Bain & Company).

During the last years we believe we have steadily increased our market share in the high-end market in the principal countries where we operate. In 2004 our market share in North America was approximately 50%, in Europe it was 36%, and in Japan it was 30% (source: Bain & Company).

We believe that important competitive factors in the prescription frames and sunglasses markets include product quality and innovation, scope of product portfolio, brand name recognition, relationships with licensors, customer service and a strong distribution network. Some of our global competitors have acquired or established their own significant retail distribution networks for their eyewear products. We instead have decided to continue to rely upon what we believe are our key competitive strengths. To showcase our luxury eyewear products, we have concentrated our retail efforts to open a small number of stores selling only luxury sunglasses in premium locations in few select metropolitan areas in the United States.

**Business strategy**

We seek to strengthen our current position in the global eyewear market and enhance our financial profitability. As part of our strategy, we intend to:

- ***Improving the management of our portfolio of brands***. We intend to continue to strengthen our portfolio of both owned and licensed brands. We believe that we are well-positioned to take advantage of the historically consistent revenues generated from sales of prescription frames to an established customer base while continuing to exploit the attractive sales growth opportunities available in the premium sunglasses market segments.
  *Owned brands.* We have identified the successful characteristics of each of our owned brands. We seek to ensure that each trademark reflects the consumers' wishes and to position each trademark with advertising campaigns aimed to the appropriate target audience. We aim to satisfy the needs of both our optician clients and those of the end customers.
  *Licensed Brands.* Jointly with the licensors of our global brands, we have prepared guidelines for expansion and promotion of our products to the appropriate target audience in order to achieve greater market penetration, both in terms of numbers of customers and of geographical areas. We carefully position our licensed brands in order to avoid duplicating brands that might appeal to the same type of consumer. Our policy is to diversify according to brand, geographical area and price, while maintaining our focus on market trends and market demand.

- ***Improving our operating efficiency and effectiveness.*** We intend to improve continually the efficiency and effectiveness of our production and management processes. To achieve this goal, we are implementing the following projects:

  - *Lean Manufacturing: This project aims to streamline our production structure and processes and concentrate, as first step, manufacturing activities in three areas as follows:*
    - Metal: at the plant in Longarone, which took over all the activities which were carried out at the Calalzo plant;
    - Plastics: at the plants in Santa Maria di Sala, Ormoz, Slovenia and Precenicco, which took over the activities carried out at the plant in Ronchis during the year 2005; and
    - Semi-finished products: at the plant in Martignacco, which took over the activities carried out at the plant in Coseano during the year 2005.

  We believe this project will allow us to significantly increase efficiency, both in terms of making better use of available production capacity and in terms of rationalizing available production space and improve our inventory management.

  - *Time to Market:* This project is designed to help us better control the timing of our production, to avoid any backlog which will allow us to reduce response times, limit our obsolete inventory, and to avoid unnecessary work.
  - *Cost Efficiency*: This project aims to increase efficiency. We intend to improve our collections from customers and to limit our warehouse stock to improve cash flow. We have established a compensation of our managers that is tied to performance and to progress increasing cost efficiency.

- ***Strengthen distribution and expand in new markets.*** We wish to continue our policy to strengthen our direct and indirect distribution network in the markets in which we operate, and to enter other markets with high-growth potential. We intend to select a specific market strategy for each market we approach, focused on wholesale distribution. In more mature markets, we plan to improve our wholesale commercial structure, to become leaders in the wholesale channel. In growing markets where we are already present, we plan to increase our marketing activity, especially in high-growth markets such as China, India and Brazil. In other high-growth potential markets, such as Russia and South

Korea, we intend to continue to select local partners who have a tight control on distribution and a highly qualified sales network, aligned with our licensed portfolio. Our "Selective Luxury Retail" project, intends to strengthen our distribution network. We plan to increase the number of our U.S. Solstice stores, to increase the visibility of luxury eyewear specialty stores and enhance the prestige of our high-end licensed brands.

- ***Continue to focus on superior design, development and innovation***. In our 70 years of operations we have always emphasized technological research, design and innovation. These recent projects are examples of our commitment to technological innovation, which is linked to research and development machinery and products. As a result of research and innovation, we are able to plan how to invest in new equipment and machinery to develop and research new products. We are finalizing project "Klap", to create lenses that do not fog and protect from UVA and UVB rays. We have recently completed an important project related to nosepieces to add to frames. We intend to continue to invest in this area in order to maintain our superior level of design. We have recently entered into an agreement with a leading research firm focused on nanotechnologies, which is the science of working with materials smaller than 100 nanometers (a nanometer is equivalent to one-billionth of a meter). We believe nanotechnology may have a significant impact on our business, the materials we use and our production processes.

**Products and brands**

We design, manufacture and distribute high-quality eyewear in three product categories: prescription frames, sunglasses and sports goggles. Our product portfolio comprises our owned brands and licensed brands in each of the three high-quality eyewear product categories.

Our prescription eyewear and sunglasses products are positioned mainly in the high-end eyewear market segments.

The following table illustrates the number of units of products sold for the years ended on December 31, 2004 and 2005.

| | December 31, | | | |
|---|---|---|---|---|
| *(in thousands of units)* | 2004 | % | 2005 | % |
| Prescription frames | 11,224 | 35.8 | 10,318 | 31.0 |
| Sunglasses | 16,399 | 52.3 | 19,212 | 57.7 |
| Sports products | 3,731 | 11.9 | 3,757 | 11.3 |
| **Total** | **31,354** | **100.0** | **33,287** | **100.0** |

The following table illustrates our revenues, broken down by product type, for the financial years ended on December 31, 2004 and 2005.

| | December 31, | | | |
|---|---|---|---|---|
| *(Euro in millions)* | 2004 | % | 2005 | % |
| Prescription frames | 425.0 | 45.0 | 422.1 | 41.2 |
| Sunglasses | 445.5 | 47.2 | 527.7 | 51.5 |
| Sports products | 57.5 | 6.1 | 61.2 | 6.0 |
| Other | 16.7 | 1.7 | 14.3 | 1.3 |
| **Total** | **944.7** | **100.0** | **1,025.3** | **100.0** |

Our products are complementary, insofar as sunglasses are viewed by the market more as a fashion accessory and as related to fashion trends, while prescription frames are more linked to demographic trends.

We continually design and launch new models and update existing models to match consumers' preferences, fashion trends and technological innovations. Our products are generally launched concurrently with spring/summer and fall/winter fashion collections. Every quarter, generally in January, April, August and October, existing models are updated with new designs, colors and color combinations to meet uses and preferences in different geographic regions.

Every year we launch over 2,500 new prescription frames, sunglasses and sports goggles, making over 4,500 models of eyewear for sale each year.

**Brand Portfolio**

Our brand portfolio includes:

- our owned brands, for prescription frames, sunglasses, sports products; and
- licensed brands, for prescription frames and sunglasses.

In 2005, licensed brands constituted 80.0% of our consolidated net sales (59.1% of units sold) and our owned brands represented 18.6% (40.9% of units sold).

The following table illustrates net sales for owned brands and licensed brands, for the years ended December 31, 2004 and 2005.

| | December 31, | | | |
|---|---|---|---|---|
| *(Euro in millions)* | **2004** | **%** | **2005** | **%** |
| Owned brands | 197.4 | 20.9 | 190.7 | 18.6 |
| Licensed brands | 731.2 | 77.4 | 820.2 | 80.0 |
| Other | 16.1 | 1.7 | 14.4 | 1.4 |
| **Total** | **944.7** | **100.0** | **1,025.3** | **100.0** |

To minimize the impact of volatility in consumer preferences, we aim to diversify our brand portfolio in terms of geographic area, gender, age, income and preference of the end user. Generally, we enter into worldwide agreements for our licensed brands, except where the trademark is one of principally local importance.

Our diversified portfolio includes brands of world-famous fashion designers, such as *Armani, Dior*, *Gucci* and *YSL*, fashion designers with a strong reputation in North America, such as *Liz Claiborne, Juicy Couture* and *Nine West,* specialized trademarks such as *Carrera, Imatra* and *Smith* and luxury sport trademarks, such as *Emporio Armani*. Our portfolio is diversified also in terms of age of the targeted consumer. For example, *Diesel* and *Kate Spade* appeal to younger customers, while *Valentino* and *Max Mara* appeal to consumers in a higher age range.

The license agreement for the *Burberry* trademark expired on December 31, 2005. The license agreement for the *Polo Ralph Lauren* brand will expire on December 31, 2006 and on January 27, 2006 the Group announced the non-renewal of the license agreement for the production and distribution of Ralph Lauren sunglasses.

On November 2005, we executed with the Hugo Boss Group a license agreement for worldwide design, production, distribution and sale of sunglasses and prescription frames bearing the trademarks BOSS Hugo Boss and HUGO Hugo Boss. The license agreement will start from July 2006 and will expire in 2013.

On January 2006 the license agreement with *Yves Saint Laurent* has been extended until the end of 2010.

***Owned Brands***

Our owned brands are of strategic importance for our objectives in the mid-range and mid-to-high markets in the fashion, casual fashion, and sport of our prescription frames, sunglasses, sports goggles and ski masks. Our portfolio of our owned brands includes *Safilo*, *Oxydo*, *Blue Bay*, *Carrera*, and *Smith*. Each of these brands is positioned to address a specific eyewear market segment.

Additionally, we have minor trademarks, such as *Adensco, Chesterfield, La Strada, Maurice Saint Michel* and *SunCloud*, which are used mainly in the U.S. market.

*Safilo* is our historic trademark, and since the 1930s has been the cornerstone of our international development of prescription frames. Today the *Safilo* brand is considered our "family master brand" and is positioned in the mid-range to high-end prescription eyewear segments. The *Safilo* brand has several sub-brands, each with specific collections and each targeted to consumers in a specific age range:

- *Safilo Junior*, for children from four to 14 years of age;
- *Safilo Design*, to meet the style, design and technological preferences of adult males;
- *Safilo Prestige*, the newly launched fashion line to meet the fashion and style preferences of a refined adult female clientele;
- *Safilo Diamond*, for women, and intended to connote great attention to detail;
- *Safilo Library* and *Elasta*, designed mostly for a more senior clientele and to privilege functionality; and
- *Seventh Street*, for adolescents and young adults up to the age of 30, characterized by the use of vivid colors and innovative design.

We distribute the *Safilo* brand in most of the 130 countries we service. In certain markets such as the United States, Japan and Germany, we develop specific collections to match the preferences or to fit the physical characteristics of local consumers.

The *Safilo* brand is our flagship brand, and during the next three years we plan to increase public awareness of this brand with advertising campaigns targeted at consumers and optical retail channels and to add innovations to the brand products to reinforce its image as the specialist leader brand in prescription frames.

*Oxydo* was launched in the mid-1990s and is positioned in the casual sport segment. We plan to focus on the sunglasses sector, which is experiencing significant growth. The brand appeals to fashionable young adults (18-35 years of age) of both sexes through its colorful and innovative design. Although the *Oxydo* brand is distributed primarily in European markets, we intend to widen its distribution internationally, with specific advertising investments targeted to consumers and using testimonials linked to the music industry.

*Blue Bay* was launched in the early 1990s and is targeted to younger consumers (adolescents) who prefer not to wear designer eyewear but are still interested in good designs and colors seen as in innovative. *Blue Bay* products are mainly sold in the European market, predominantly in Italy, Spain, France and Germany. We intend to test whether the Blue Bay brand has potential for a successful international distribution and to promote the brand's youth-oriented image with specific trade marketing activities.

*Carrera* is a specialized sports goggle and eyewear brand. We purchased the *Carrera* trademark in 1996 and it has been crucial in our development in the sports goggles and eyewear sector, mainly in the European market and in emerging economies. The *Carrera* brand is targeted mostly to men who pursue outdoor and highly physical recreational activities. We support this *Carrera* brand image with advertising involving sports figures active in the fields of skiing, rugby, motorcycling and cycling. We wish to further strengthen the *Carrera*

trademark in the main European countries and to test whether it could successfully be distributed in all our markets.

*Smith* is one of the most popular U.S. sports goggle and ski mask brands, and it is also sold in over 50 other countries. We acquired the *Smith* brand in 1996. Designed for active and competitive sports, such as free-style skiing, surfing and mountain biking, *Smith* sunglasses are targeted to young adults interested in technological innovation.

***Licensed Brands***

Our portfolio of licensed sunglasses and prescription frames, comprising brands from many of the leading luxury designers in the world, is one of the broadest and most diverse portfolios in the eyewear industry. Each of our licensed brands is designed, positioned and marketed to address a specific eyewear market segment. Our portfolio consists of both global brands, such as *Armani, Dior, Gucci,* and *YSL*, and brands positioned to address specific segments of the U.S. market, such as *Fossil, Kate Spade*, *Liz Claiborne*, *Nine West,* and *Saks Fifth Avenue*.

Our licensed brand eyewear products are positioned mainly in the high-end of the market, predominantly in the luxury segment.

We pay a royalty for use of the licensed brand name based on a percentage of net sales of that brand. Under most of our licenses, we have to pay annual guaranteed minimum royalties to the licensors. Generally, minimum guaranteed royalty payments are payable quarterly and are calculated either as a predefined percentage (generally from 70% to 80%) of the previous year's royalty payments or, less often, are a predefined minimum amount.

Our licenses typically have a duration of five to eight years. In certain circumstances, for example if we have a change of control, outsource production without consent of the licensor, sell models that are not approved by the licensor, fail to reach minimum sales targets or sell products through distribution outlets that have not been approved by the licensor, a licensor may terminate a license agreement.

Pursuant to our license agreements, we incurred in royalty expenses of €91.0 million in 2005 and of €80.0 million in 2004.

The license agreements require us to invest a certain percentage of the previous year's sales for advertising and promotional campaigns for the licensed brand. Some licenses require us to contribute further amounts to the budget for the promotional activities carried out directly by the licensor.

Our portfolio of brands licensed from fashion designers is described below.

*Alexander McQueen.* The *Alexander McQueen* collection was launched in April 2004. A brand of the Gucci group, *Alexander McQueen* is a design brand, intended to convey creativeness and innovation. Collections for this brand use innovative materials, such as wood, lace and exclusive colors. The *Alexander McQueen* brand is intended to appeal predominantly to women from 25 to 45 years of age and is positioned in the luxury segment. The products are sold worldwide, mainly in Europe and the Asia Pacific region.

*Bottega Veneta*. We launched the first *Bottega Veneta* collection in March 2003. The *Bottega Veneta* brand is intended to convey exclusivity, elegance and craftsmanship, and therefore this brand's products are highly distinctive, with a trademark braided pattern, and bear no logo. *Bottega Veneta* appeals mainly to a female clientele, aged from 30 to 45 years of age, and is positioned in the luxury segment. The products are sold worldwide, mainly in Europe and the United States.

*Boucheron.* The *Boucheron* brand is a brand of the Gucci group, and is the symbol of the French jewellery designer. The brand is positioned in the luxury segment. The products are created using materials inspired from the jewellery designed by the famous jewellery house since 1858. *Boucheron* are designed to appeal to customers who are sophisticated and elegant; the prescription frames are targeted to both men and women over 30 years of age, while sunglasses are targeted mostly to women over 40 years of age. The products are sold worldwide, mainly in Europe and the Asia Pacific region.

*Diesel*. The *Diesel* brand began as a jeans fashion brand, and *Diesel* eyewear is intended to convey aggressiveness, irony and to be in the forefront of fashion trends. *Diesel* products are targeted to young adults, aged from 15 to 35, of both sexes, and are positioned in the fashion segment of the market. The products are sold worldwide.

*55DSL.* A new innovative trademark of the *Diesel* group designed to appeal to young urban customers who enjoy vintage, 1970s-inspired products. *55DSL*'s products, with their angel-shaped logo, are targeted to young adults, aged from 15 to 24, of both sexes and are positioned in the fashion segment of the market.

*Dior*. *Dior* is a leading French luxury brand. *Dior* products are distinctive and exclusive both in shape and color. The collections are targeted primarily to women, but we have launched a collection, called *Dior Homme*, targeted to men, which collection is intended to convey technological innovation, modernity and elegance. *Dior*'s customers are generally aged from 16 to 40 and the brand is positioned in the premium and luxury segments of the market. The products are sold worldwide.

*Emporio Armani*. The *Emporio Armani* brand is intended to convey informality and extroversion, and uses various materials within the same product. The brand is targeted to young customers of both sexes and is positioned in the fashion segment of the market. The products are sold worldwide.

*Fossil*. The *Fossil* brand products are designed to complement the styling of *Fossil* brand watches. Fossil has a specific line for children's eyewear. The products are targeted to customers of both sexes, aged 18 to 55 and is positioned in the mid range of the market, in the casual-sport segment.

*Giorgio Armani*. *Giorgio Armani* brand products are intended to be elegant and simple, and to convey Italian style. The materials used are of the highest quality and exclusive to this brand, and each model has its own characteristics. We use advanced technologies to obtain a comfortable and functional product. The *Giorgio Armani* brand is intended to appeal to women and men, and is in the premium and luxury segments of the market. The products are sold worldwide.

*Gucci*. The *Gucci* brand is one of the most famous trademarks in the world and the eyewear products are well-recognized. The collections offer a wide range of models, mostly intended to convey sophistication and trendiness, and include the famous Gucci detail and style. The products are targeted to both men and women, aged 20 to 50, and are positioned in the premium and luxury segments of the market. The products are sold worldwide.

*Imatra.* Under the *Imatra* brand, we intend to convey the unity of the fashion world with the sports world. Motor GP winner Valentino Rossi promotes *Imatra*, which was developed to convey his image and was launched in April 2005. The *Imatra* brand is intended to appeal to men and women aged from 20 to 50 and is positioned in the casual-sport segment of the market. The products are sold predominantly in Europe.

*Jennifer Lopez.* The *Jennifer Lopez* brand was launched in 2001. The collections are intended to convey modernity, loudness, aggressiveness and self-assertiveness, and target young adults of both sexes from 15 to 30 years of age. The products are in the mass segment and are sold predominantly in the United States, and to a lesser extent in Canada.

*Juicy Couture.* The *Juicy Couture* is a new brand, part of the Liz Claiborne group. The brand is targeted to women aged eight to 80 and is positioned in the fashion segment of the market. These products are sold exclusively in the United States.

*Kate Spade*. The *Kate Spade* brand is designed to embody clean classic lines, and the colors used are intended to convey sophistication. The collections are targeted to women 25 to 55 and are positioned in the fashion segment of the market. These products are sold exclusively in the United States.

*Liz Claiborne*. The *Liz Claiborne* brand, well known in the United States, is intended to convey femininity and classic style, with attention to color. The portfolio of this brand includes also the trademarks: *Villager, Lizwear*, *Crazy Horse, Axcess* and *First Issue*, which are lower priced lines targeted to a different market segment. The *Liz Claiborne* collections target women from 30 to 55 and to men from 25 to 54 years of ages and

are positioned to cover different market sectors. The *Liz Claiborne* trademark is in the casual segment. These products are sold predominantly in the United States.

*Marc Jacobs.* The brand is intended to embody two characteristics: fashion and quality. The collections are targeted to women from 25 to 45 years of age. The products are positioned in the luxury segment of the market. The products are sold worldwide.

*Max Mara*. The *Max Mara* collection was launched in 1998, and is intended to convey distinctive elegance and refined identity reflecting the characteristics of the image projected in other *Max Mara* products and accessories. We will continue to work closely with the licensor to harmonize the *Max Mara* eyewear collections with its other products and accessories, particularly the colors that characterize the *Max Mara* clothes line. The *Max Mara* collections are targeted to women aged 25 to 50 and are positioned in the fashion and premium segments of the market. The products are sold worldwide, predominantly in Europe and the Asia Pacific region.

*Nine West*. The *Nine West* brand is a well known shoe and accessory trademark in the United States. The products are intended to be fashionable and trendy. The *Nine West* collections are targeted to women and men aged 18 to 30, and are positioned in the fashion segment of the high-end market. The products are sold in the United States.

*Oliver*. The *Oliver* brand was launched in 1998 along with *Valentino*. The *Oliver* collections are unisex in style and targeted to young customers aged 18 to 30. The products are positioned in the fashion segment of the market and are sold worldwide, predominantly in Europe.

*Pierre Cardin*. Under the *Pierre Cardin* brand, we produce "classic" prescription frames and sunglasses targeted for the mid-range market segment. The collection was launched in 1991, and has a very broad range, targeted to customers of both sexes aged 18 to 60. The products are positioned in the fashion segment and are sold in almost every country, but predominantly in Europe.

*Ralph Lauren*. The *Ralph Lauren* brand products are intended to embody classic styling, luxury and sportsmanship. Our *Ralph Lauren* collections include several lines, each inspired by different Ralph Lauren styles: classic, fashion and casual. The brand is targeted for men and women aged 20 to 50 and is positioned mostly in the luxury and premium segments, with a few collections in the casual-sport segment. The products are sold worldwide.

*Saks Fifth Avenue*. *Saks Fifth Avenue* collections are designed to embody simple elegance and understated designs and are targeted to women aged 25 to 55. The products are positioned in the fashion segment and are sold in the United States and Canada.

*Stella McCartney*. *Stella McCartney* is a new brand, inspired by vintage collections. We do not use any animal or vegetal products for these collections, respecting the desires of the designer. The collections are mainly targeted to women customers, aged 25 to 50, and are positioned in the fashion segment. The products are sold worldwide, predominantly in Europe.

*Valentino*. The *Valentino* brand is intended to convey Italian style, creativeness and elegance. Each model in these collections bears the distinctive "V" mark, in various colors. *Valentino* eyewear products are set apart by special details and innovative shapes. The collections are targeted to men and women aged 25 to 50, and are positioned in the luxury and premium segments of the market. The products are sold worldwide.

*Yves Saint Laurent*. The *Yves Saint Laurent* brand is intended to reflect French luxury and classic design, with sophisticated collections, and uses exclusive materials and a variety of shapes, bearing the "YSL" logo. The collections are targeted to men and women aged 25 to 50, and are positioned in the luxury and premium segments. The products are sold worldwide.

**Our Business Model**

Our business model covers our entire production and distribution process, from the research and development phase up through the distribution and logistics phase, seeking to assure a high quality product with a flexible and efficient production and distribution process. We strive to satisfy client demand and preferences based on the most recent trends and to achieve an efficient time-to-market of our products.

Our production and distribution process starts with the development and design of the collections followed by production of the volumes determined jointly with the marketing department. Thereafter, our production is distributed to tens of thousands of opticians.

The graph below sets forth the time cycle of our production and distribution process for prescription frames and sunglasses, which lasts approximately nine months from design to finished product.

Our product development takes into account recommendations and other input provided by our internal designers and brand managers and by our licensors, as well as by our continued research and development efforts and technological innovations. Our planning process also considers data related to the sales of our products, client suggestions and market trends.

The manufacturing of our products is carried out internally in our six facilities and externally through selected third-party manufacturers. Quality control for both internal and external manufacturing is managed directly by our personnel.

The sales campaign is principally carried out by exclusive agents. Our distribution centers, the three principal of which are in Italy, the United States and Hong Kong, supply the products to retailers and wholesalers.

***Planning, Programming and Purchases***

The departments of Planning, Programming and Purchases are under the direction of the operating division.

The planning department uses information from internal sources (those with objectives focused on commercial activities, promotional events, forecasts for sales by semester and past data) and from external sources (such as orders from clients and feedback from significant clients to indicate market trends) in order to make weekly production demands to send to the Programming department.

The programming department analyses the production demands by the planning department to develop a weekly production plan and order supplies, taking into account the quantities available in our warehouses, the products under production and limits on production capacity. The programming department uses a system of analysis called Global Planning System (GPS). The GPS amends the weekly plan of production on a daily basis and further subdivides it for the two internal production divisions, one for plastics and one for metal, and for the outsourcing division. The outsourcing division purchases mid-range and lower-range finished products from third party manufacturers.

The purchase department is responsible primarily for the purchase of raw materials (such as resins and catalysts for optyl, steel, metals, lenses, cases and other packaging) and in exceptional circumstances also of other semi-finished goods such as temples and nosepieces. This department is managed primarily by the central Padua office and partially by the Slovenian production subsidiary in Ormoz.

To guarantee the quality of raw materials and semi-finished goods, we use suppliers that we select and continuously assess on the basis of their delivery times and their ability to maintain certain standards of quality of materials and availability of production capacity.

We purchase raw materials and semi-finished goods primarily in the European market (79%) and to a lesser extent in other markets (approximately 20% in the Asia Pacific region and 1% in the United States). The establishment of our subsidiary Lenti S.r.l. in 1996 has brought us the know-how for the production of lenses for sunglasses.

***Production***

We manufacture our products in our plants and through third-party manufacturers. In 2005, we produced nearly half of our prescription frames and sunglasses in our plants, with the remaining portion being manufactured by third-party manufacturers in Italy, the Asia Pacific region and the United States. In 2005, almost all *Carrera* ski masks were produced in our plants, and *Smith* ski masks were produced by third-party producers in the United States under the supervision of our design team.

Over the course of the past three years, we have progressively increased the volume of production outsourced to third-party manufacturers, who are mostly located in the Asia Pacific region. This has allowed us to significantly reduce costs and has given us greater flexibility in production. We produce internally all our products that entail a very high degree of craftsmanship.

*Direct Production*

Our internal production is carried out at our five plants in Italy and at the Ormoz plant in Slovenia. Our Italian subsidiary, Lenti S.r.l., produces a part of the lenses for sunglasses we use in our products.

The following table sets forth the location and the production specialization of our plants as of the date of this Annual Report.

| Product Division | Plant | Country | Production Specialization |
|---|---|---|---|
| Plastics | Santa Maria di Sala | Italy | Finished products |
| | Precenicco | Italy | Finishing, assembly and varnishing |
| | Ormoz | Slovenia | Semi-finished products, optyl, and injected plastics |
| Metals and semi-finished products | Longarone | Italy | Finished products |
| | Martignacco | Italy | Components and accessories |

Aiming to streamline production coherently with our business plan, we have a system whereby each plant is specialized in working with specific materials and production technology and we have transferred the production from the plant in Traun (Austria) to our Italian plants. In 2005, 51.0% of the frames we produced (excluding ski masks) were metal, and 49.0% were of plastic materials.

The main plastic materials we use are described below:

- *Cellulose acetate*: This plastic is the most widely used in the production of eyewear frames, and is obtained from particles of cotton and wood and can be colored in a variety of ways. Acetate is worked by cold-cutting sheets of various sizes using precision machines. The advantages of working with acetate derive from the fact that it is easy to process and mould into the required shape, it is easy to insert lenses in acetate frames, and the shape of acetate frames does not change over time;

- *Injected plastics*: This material is injected in especially designed moulds at the liquid state. Use of this material guarantees characteristics of transparency and a high degree of flexibility in the choice of shape and size. Additionally, the material allows for high quality of colors and is very

durable, it reflects light and it is highly resistant to sweat, cosmetic products and alcohol based detergents; and

- *Optyl*: This is a heat-hardening resin obtained through a specific and unique technique we developed internally. Moreover, it has a polished surface and more heat-resistance than other thermoplastic materials. Among its other advantages are that it is light and comfortable, adapts easily to the shape of the customer's face, does not deform at high temperatures, is resistant to sweat and cosmetic products, is non-allergenic and has unique color effects.

The main metal materials we use are described below:

- *Titanium*: This material is used for luxury frames and does not contain any nickel. The advantages of titanium frames are their very light weight (titanium weighs 48% less than other metal alloys), resistance against corrosion, resistance to high levels of acids, sweat and cosmetics, non-allergenic qualities and adaptability to the shape of a customer's face; and

- *Steel*: Because steel can be cut very finely, weighs little, is resistant, allows for versatile designs, and is extremely flexible, it is one of the most useful materials for frames. Other advantages of steel are that it is guaranteed to resist corrosion, sweat and rain, is lightweight and adapts to the shape of a customer's face.

*Phases of Production*

The phases of production leading to the finished product can be grouped into three broad activities.

- *Structural manufacturing*: in this stage the structure of the frame is made using moulds based on prototypes developed by the internal design team. For plastics, this stage of production uses milling, injection and sifting, while for metals it involves welding;

- *Treatment*: in this stage the frames are varnished or treated with various coating methods. For plastics, the process involves colouring and varnishing; for metals, it is completed by galvanic treatment and varnishing the surfaces; and

- *Finishing*: In this phase the products are assembled and completely accessorized. This is the most labor-intense process. Lenses for sunglasses are cut at this stage. Both for plastics and for metals this production stage involves a process of assembly and finish.

We continually research, develop, design, and internally fine-tune precision instruments and moulds in order to improve the efficacy, efficiency and quality of the production process. We believe that carrying out this activity internally will allow us to reduce time-to-market and consistently save on production costs.

*Production by third parties*

Our policy on outsourcing aims to optimize our productive capacity and to decrease costs. We avail ourselves of third-party manufacturers in Italy, the Asia Pacific region and the United States. Production of fewer units, or of models requiring complex handicraft work, is outsourced only to Italian manufacturers. Production of a greater number of units are outsourced to Asian manufacturers. This policy allows us to manage peak production periods and periods of low demand and to focus our own production on products in the luxury market segment.

***Quality control***

Our quality control procedures aim to offer our clients products that meet not only the applicable safety regulations but also the best quality standards. We have a dedicated team, coordinated by a manager, in each of our production facilities and distribution centers.

We test incoming raw materials and semi-finished product, production and distribution processes and finished goods (or final product).

*Quality control of incoming raw materials and semi-finished products*

Our quality control system is the same for all types of incoming materials/products. We carry out laboratory analysis to verify that the quality of incoming materials/products is in line with our standards. Quality control on raw materials is carried out on the basis of strict criteria. Our quality control involves:

- identification of the technical and chemical characteristics of the products; and
- sample survey of incoming raw materials and sample testing prior to purchase.

*Quality control of the production and distribution processes*

We monitor all phases of the production and distribution processes, and we sample test our products for defects and irregularities.

*Quality control of finished goods (or final product)*

We sample test our finished products by:

- mechanical resistance tests: the frames and their parts are tested for strength, movement and endurance; and
- physical chemical resistance tests: we simulate aging from sun exposure, using a powerful source of UV light. We test products by exposing them to aggressive chemical substances at higher than normal temperatures.

Finished goods manufactured by third parties are inspected, on a sample basis, prior to delivery to our distribution centers. We have two quality control teams, one located in Hong Kong and one located in the Italian production facilities and in the Padua distribution center. Most of our Asian manufacturers have obtained ISO certifications.

All our products bear the CE logo and are ISO 9001:2000 certified. After obtaining the ISO 9002:1994 quality certification in 1996, in 2003 we obtained by the ISO 9001:2000 quality certification Det Norske Veritas (DNV). We have also achieved the International Quality Rating System (IQRS). The ISO 9000 standards series is an international quality management standard sanctioned by the International Organization for Standardization based in Geneva, Switzerland.

The ISO 9002:1994 standards set out 20 provisions for developing, implementing and maintaining an effective quality management system.

***Marketing and Communication***

Our marketing strategy seeks:

- to ensure the correct image of the brands in our portfolio, positioning them in the high-end market—mostly in the luxury and premium segments; and
- to communicate to our customers the design and technology behind all products (prescription frames, sunglasses, sports goggles).

We develop our marketing strategy and advertising plan worldwide by a three-year marketing plan and by a one-year plan. We develop our plans considering market trends, customer needs, prices, type of products and advertising and promotional investments. We develop and implement a strategy for the marketing of each brand in our portfolio in order to achieve the optimal positioning of the individual brand and avoid products with overlapping images. We develop the strategy for each licensed brand working closely with the licensors. In 2005, our total investment in marketing and advertising activities was approximately €78.5 million, equal to 7.7% of our consolidated revenues.

Our marketing and communication activities comprise both activities dedicated to customers and trade marketing in our points of sale. Activities dedicated to customers constitute about two-thirds of our advertising and promotional investments. We mostly use the press (weekly and monthly magazines), posters, television (mainly for our owned brands), sponsorships (with particular reference to sports goggles of *Carrera* and *Smith*), public relations with fashion journalists and product placement with fashion, sports and show business personalities.

Trade marketing activities in our points of sale comprise approximately one-third of our advertising and promotional investments. These activities are important to foster customer confidence. We provide marketing materials to our points of sale, such as posters, banners, displays, specialized window displays as well as training courses and brochures of our brands and products.

We focus on the quality of advertising and promotional materials to ensure the appropriate positioning of our brands. Our marketing and promotion program with respect to each point of sale is divided into four promotional campaigns per year to support the launch of collections of new products, which generally occurs in January, April, August and October. We emphasize corporate communication both through our participation to the most important trade fairs worldwide, including the Mido in Milan, the Visionexpo in the United States and the Silmo in Paris, and through internet communication on our website.

We coordinate promotional materials and activities with the licensors. We benefit from the promotional and advertising activities directly carried out by the licensors. We take part in this activity by paying the licensors a predetermined percentage of our turnover related to the products with licensed brands. We allocate our investments on a geographical basis pursuant to medium- to long- term strategic purposes of growth identified in our three-year plans. Our promotional activity and our media strategy are coordinated with and adapted to specific market needs to ensure efficiency in our marketing efforts.

On December 31, 2005, our marketing and promotion department comprised 135 persons, who work in the central coordinating unit and marketing divisions, which are located in the various business units and in each commercial subsidiary.

***Sales and Distribution***

Our products are primarily sold to wholesale customers, and to a much lesser extent to retail customers, in approximately 130 countries and approximately 130,000 points of sale.

The table below shows our consolidated revenues for the financial years ended December 31, 2004 and 2005, broken down by geographic area.

| | December 31, | | | |
|---|---|---|---|---|
| ***(Euro in millions)*** | **2004** | **%** | **2005** | **%** |
| Italy | 123.5 | 13.1 | 138.6 | 13.5 |
| Europe (excluding Italy) | 329.6 | 34.9 | 339.4 | 33.1 |
| The Americas | 332.3 | 35.2 | 353.7 | 34.5 |
| Asia Pacific | 99.8 | 10.6 | 119.8 | 11.7 |
| Other | 40.5 | 4.2 | 44.2 | 4.3 |
| *Wholesale Total* | 925.7 | 98.0 | 995.7 | 97.1 |
| Solstice[1] | 19.0 | 2.0 | 29.6 | 2.9 |
| *Retail Total* | 19.0 | 2.0 | 29.6 | 2.9 |
| **Total** | **944.7** | **100.0** | **1,025.3** | **100.0** |

(1) Specialized distribution channel in the United States.

Our clients are independent opticians, optometrists, chains of optics stores, department stores, specialty stores, our licensors' stores, duty free and sports gear stores.

We distribute our products directly in 30 of our largest markets (representing 91% of our consolidated revenues in 2005) through our 28 commercial subsidiaries. In the remaining markets, where we do not have commercial subsidiaries, we distribute our products through over 170 independent distributors.

Each distribution subsidiary coordinates its own network of sales agents who are, in most cases, compensated on a commission basis. Our network of sales agents currently consists of about 1,400 sales agents and, depending on the country, approximately 30% are employees, while the rest are independent sales agents. Our agents sell our prescription frames and sunglasses exclusively, and undertake not to sell our competitors' products with regards to sports goggles and other sports products.

In our major markets, such as Europe and the United States, we have created dedicated sales teams led by Key Account Managers, which service the major chains selling eyewear in the territory.

We maintain close contact with our distributors in order to monitor sales and to control the quality of the points of sale that display our products. We typically enter into distribution agreements with such distributors that establish minimum annual purchases and impose territorial limitations. In addition, to the extent permitted by law, we allow for distribution only through specifically authorized retail channels and qualified sales agents. We select our retail sales channels based on where our brands would be best placed.

Additionally, we have a number of showrooms in prime locations to showcase our products in Milan, New York, London and Paris.

Our distribution network is divided geographically into three divisions called "business units" covering, respectively, the Americas (North and South America), Asia and Australia, and Europe and other parts of the world. Each business unit is managed by a top manager reporting directly to the chief executive officer who is responsible for the overall coordination of the three business units.

The following table lists our branches, divided by business unit:

| Business Unit 1 - Europe and the rest of the world | Business Unit 2 - Asia Pacific | Business Unit 3 - America |
|---|---|---|
| Safilo S.p.A. | Safilo Far East Ltd. (Hong Kong) | Safilo U.S.A. Inc. (New Jersey, U.S.A.) |
| Safilo UK Ltd. (England)[(a)] | Safilo Hong Kong Ltd. (Hong Kong) | Safilo Canada Inc. (Canada) |
| Safilo Switzerland A.G. (Switzerland) | Safilo Singapore Pte Ltd. (Singapore) | Canam Sport Optics Inc. (Canada) |
| Safilo Benelux S.A. (Belgium) | Safilo Optical Sdn Bhd (Malaysia) | Smith Sport Optics Inc. (Idaho, U.S.A.) |
| Safilo Nederland B.V. (the Netherlands) [(b)] | Safilo Trading (Shenzen) Co. Ltd. (China) | Solstice Marketing Concepts LLC(New Jersey, U.S.A.) |
| Safilo Nordic A.B. (Sweden) | Safilo Japan Co. Ltd. (Japan) | Safilo Do Brasil (Brazil) |
| Safilo France S.à r.l. (France) | Safilo Australia Partnership (Australia) | |
| Safilo G.m.b.H. (Germany) | | |
| Safilo Austria G.m.b.H. (Austria) | | |
| Carrera Optyl D.o.o. (Slovenia) | | |
| Safilo Espana S.A. (Spain) | | |
| Safilo Portugal Lda (Portugal) | | |
| Safilo Hellas Ottica S.A. (Greece) | | |
| Safilo India (Pty) Ltd. (India) | | |
| Safilo South Africa (Pty) Ltd. (South Africa) | | |

(a) Territory includes U.K. and Ireland.
(b) Territory includes Sweden, Denmark, Finland and Norway.

Set forth below is a description of each business unit:

*Europe*. Our European regional headquarters is located in Padua, Italy. Our European managing director and business unit head is also responsible for other parts of the world, including the Middle East, Africa and India.

Our European client base is highly fragmented: in Italy most of our clients are independent retailers, in Great Britain our principal clients are distribution chains and in Germany our major clients are purchasing groups and distribution chains.

We distribute our products directly in 19 European countries. Almost 80% of our approximately 700 European sales agents are independent contractors and work on a commission basis and approximately 20% are employees who receive a base salary and commission.

Most of our sales agents are connected to our centralized distribution system via laptop computers in order to process orders quickly. We can monitor sales and marketing information on a daily basis. We also have a special sales division for sports products (ski goggles, helmets and sports goggles).

We have recently created a key account team, based in Padua, to service the major European distribution chains from one central location. Where we have no distribution branch, we have established a long-term relationship with local distributors, most of which distribute our products exclusively.

*The Asia Pacific region*. Our Asia Pacific headquarters are located in Hong Kong, where the managing director and business unit head oversees the Asian region. The Asian region managing director is also responsible for Australia and our global duty free business through a dedicated key account manager.

We currently distribute our products in the Asia Pacific market through distribution subsidiaries in China, Australia, Hong Kong, Japan, Malaysia and Singapore and exclusive third-party distributors in other key markets. Our customer market is highly fragmented, and we sell mainly to independent stores and department stores.

We believe that the Japanese market represents a high potential for growth in our sales of our principal licensed brands and, therefore, we have developed design prescription frames to meet the specific fitting requirements of our Asia Pacific consumers.

*America.* The head of our American business unit is responsible for the markets in the United States; Canada, the larger countries in Central and South America and for sales through our Solstice retail chain. The center of the American business unit is in New Jersey, United States.

We organize marketing and distribution in the United States based on our three distribution channels: opticians, ophthalmologists and optometrists; the retail market consisting of department stores and specialty stores; and sports stores.

We sell to opticians, ophthalmologists and optometrists that are organized in large retail chains as well as individual stores and practices.

We have approximately 607 independent sales agents who cover the American business unit. Approximately 80 operate in Canada and Brazil. In the United States, out of the approximately 527 independent sales agents, we have over 330 independent sales agents that focus on opticians, ophthalmologists and optometrists, 50 agents that focus on retail outlets such as department stores and specialty stores and 97 sales agents that are exclusive for a product category, such as sports goggles. We have a showroom in New York City dedicated to showing our sunglasses collection to our customers.

The major distribution chains are served directly through a key account structure. All distributors in Central and South America are managed through our Miami, Florida office of Safilo USA.

*Solstice Specialty Store Program.* We acquired our chain of Solstice specialty stores in early 2002 from Moët Hennessy Louis Vuitton. As of December 31, 2005, we had 54 stores and we plan to continue to selectively increase the number of our stores. We believe that the Solstice program will raise the visibility of our licensed brands. The Solstice stores are located in metropolitan areas selected pursuant to the potential customer base. Our Solstice stores sell exclusively sunglasses in the high-end market.

***Account Management***

Collection and management of orders is carried out by the commercial network and by the Planning & Logistics Department, respectively.

We have offices for order management in Italy, in every European country where a commercial branch is located, in the United States where they serve both North America and South America, and in the Asia Pacific region where they serve the Asian and Australian market.

Orders are either:

- collected by sale agents; or
- made by a telephone call from the client to the relevant call center; or
- ordered by the client by website trough the e-commerce system, or through electronic request forms, or at our head offices.

The majority of our orders are collected through our sales agents, who use specifically designed software and laptop computers to transmit all orders in real time.

Our call centers process reorders of final products and spare parts and provide client services (status of orders and technical problems with products). Our call centers employ approximately 260 highly qualified persons and use modern software systems, which creates a profile of each client. Our Customer Relationship Management software, or CRM, allows us to monitor the market.

To optimize the management process and improve the level of service, we are in the process of consolidating all call centers located in the European territory into Padua.

Another important element of our order processing function relates to the e-commerce system, which allows clients to use the internet for order transmissions, to view the collection and to download technical information.

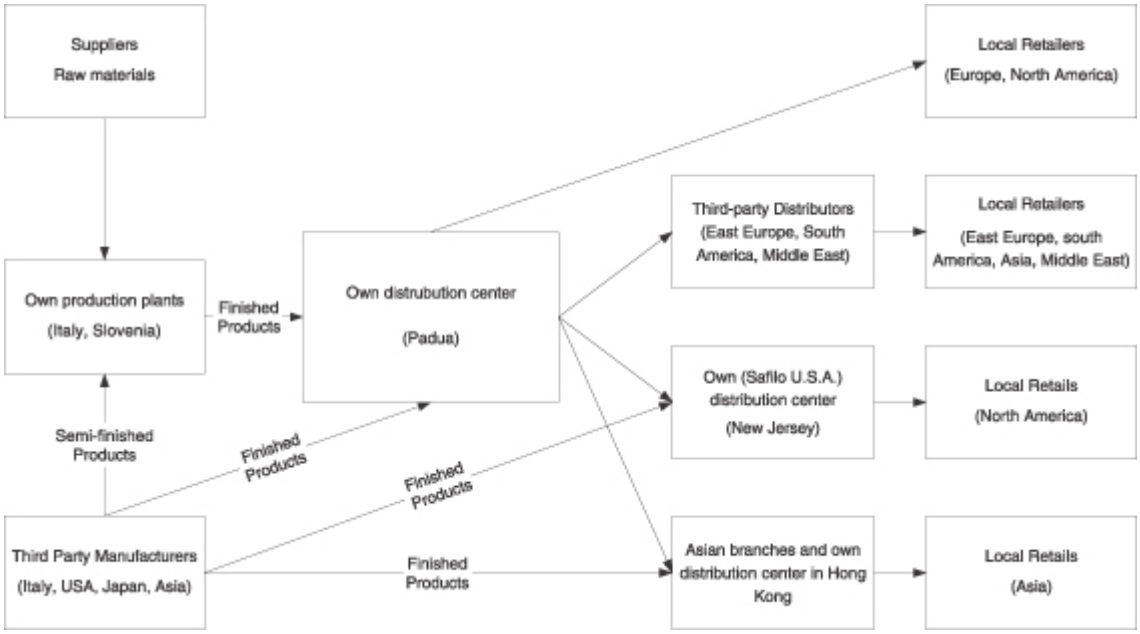
We process orders on the basis of the importance of credit risk of the client, the date of delivery and delivery logistics.

Subsequently, the order management system notifies the relevant warehouses and arranges for the delivery of the products. Our clients who order through our e-commerce website are notified by e-mail that their order has been shipped, and are billed monthly.

***Logistics***

We have one integrated logistics platform through which we are able to connect directly the distribution center in Padua with each single optician in Europe and with distributors in Asia and Australia. We are able to send products to opticians directly from our distribution center in Padua, without any intermediate steps, which helps us to provide superior customer service. Our platform also allows us to monitor effectively our stock of finished products.

The chart below illustrates the flow of our products in our distribution network.




As shown in the chart above, our distribution network is anchored by our highly automated distribution center in Padua. We also have distribution centers in Parsippany, New Jersey (United States), Hong Kong (China) and several minor distribution centers in Denver, Colorado (United States) and in Utah (United States), Japan, Australia, India, South Africa, Canada, Greece, Brazil, Singapore and China, each of which serves its assigned and specific geographic area. Using our worldwide distribution centers, we are able to optimize client service in all markets in which we operate.

We undertook a complete upgrading and reorganization of our distribution center in Padua, which we completed in 2004. This has enabled us to service our customers better due to a higher level of automation of certain activities. Currently, our Padua distribution center has a distribution capacity of over 100,000 units per day.

To ensure minimum shipping times and maximum cost reduction, we select our shippers and couriers on the basis of efficiency and reliability.

We receive supplies from European countries mostly by road transport and from Asia mostly by ship. We receive finished products from Asia both by ship and air.

Upon completion of our production process, the finished products are sent to Padua to our distribution center. Shipping orders, costs and instructions for couriers are processed during the night. The processing system takes into account the area of delivery to minimize transport costs and the number of trips to the same retailer. Transportation orders and schedules are generated, and the merchandise is picked up for distribution in the morning. Distribution to the retailers occurs generally within 24-48 hours throughout Italy and within 48-72 hours throughout Europe.

**Information Technology**

Our information technology department has two main data centers, one in Padua and one in Parsippany, New Jersey (United States). Certain distribution subsidiaries outside of Italy have smaller data centers. The information technology headquarters is in Padua and supports the information technology operations for the European subsidiaries and several Asian subsidiaries; the data center in Parsippany supports the information technology operations for the United States.

We develop and maintain a significant part of our management software, to promote continuous collection and timely update of the information necessary for the operative management of (i) production,

(ii) tracking sales, (iii) logistics and credit management. Other applications allow clients and agents to have direct quick access to the information.

The management software includes some standard software packets, bought from leading software producers and related mostly to administrative and accounting applications.

Our companies are interconnected by means of data transmission networks, which enable a continuous transmission and adjournment of information.

We use basic hardware and software for a safe and continuous functioning of the information systems. We have installed hardware and the relevant software supplied by leading producers, with whom we have maintenance contracts to ensure the integrity of our information system. We have created a disaster recovery program and have systems in place to prevent unauthorized access to our system, and minimize the risk of viruses attacking our system.

As of December 31, 2005, our information technology department employs approximately 42 people in Europe and 15 in the United States. We outsource some services, such as personnel management to third-party information technology companies.

**Regulatory matters**

Our facilities and operations are subject to environmental and occupational health and safety laws and regulations in each of the jurisdictions in which we operate. These laws govern, among other things, discharges of pollutants into the air, water and land, the use, storage and disposal of hazardous substances and wastes, and the clean-up of contaminated properties.

Violations of environmental laws and permits can result in significant fines or civil or criminal sanctions. In addition, the discovery of significant contamination at our facilities could require us to incur cleanup costs. Finally, environmental permits required for some of our operations may be reviewed, modified or revoked by the issuing authorities.

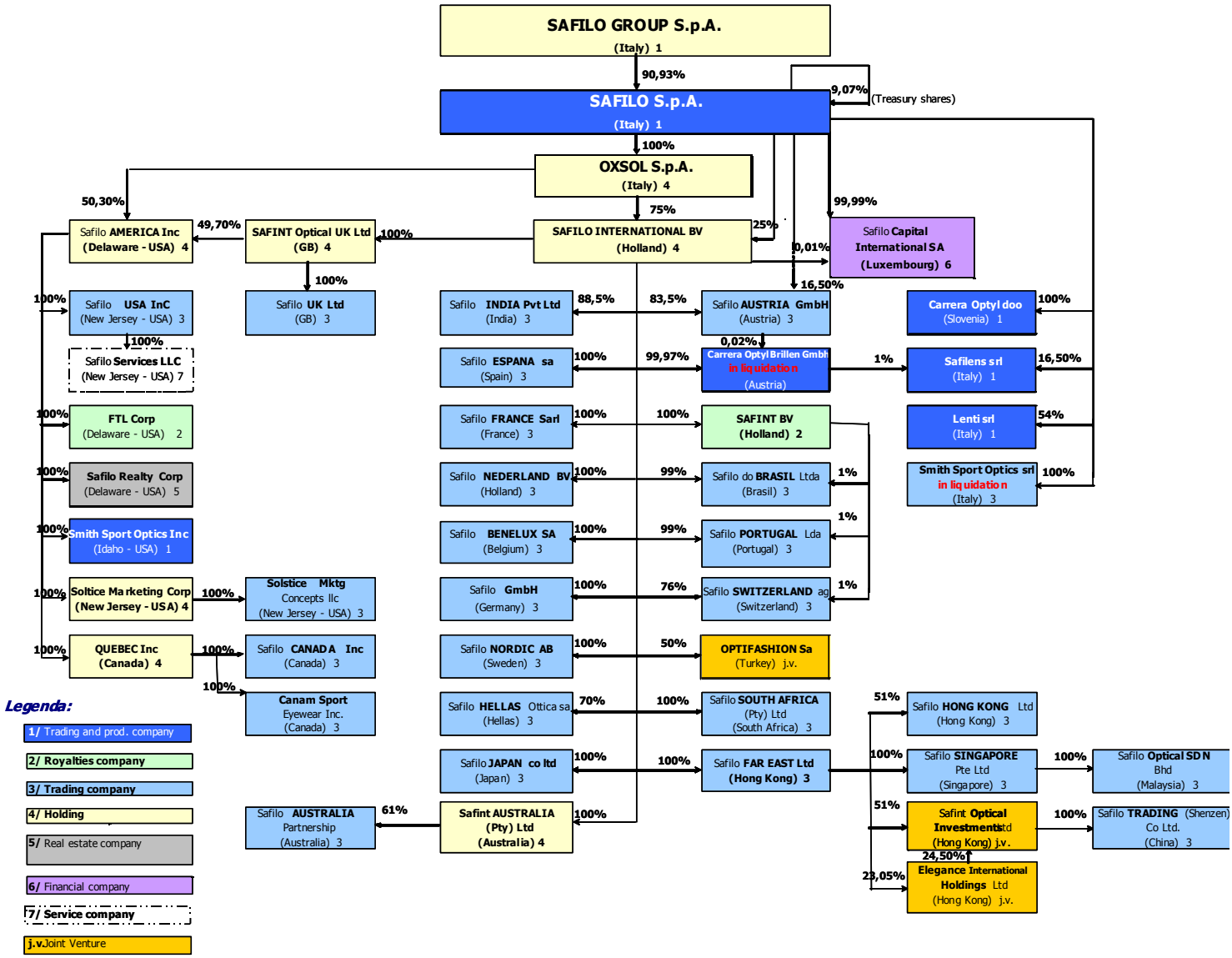
We believe that we are in material compliance with environmental laws and permits applicable to our business. However, from time to time we incur costs to maintain or achieve compliance with such requirements. Costs for these matters and our past environmental and safety costs have not significantly affected our operations, and future environmental costs are not expected to be material.

## ORGANIZATIONAL STRUCTURE

Our commercial activities are carried out by the commercial companies of our Group in the 30 countries where we are present.

Additionally, our Group holds minority shareholdings in a limited number of companies, such as Elegance, which owns manufacturing plants in Hong Kong. We generally have the right to appoint the majority of the members of the Boards of Directors and other managing bodies of the companies in which we own the majority of the corporate capital.

The graph below illustrates the organizational structure of our Group as of the date of this Annual Report.



## PROPERTY, PLANTS AND EQUIPMENT

Our major production facilities are in part owned and in part leased. In addition, we lease administrative and distribution office space in various locations in which we operate.

The table below lists the address of our real estate property owned by Group companies as of the date of this Annual Report.

| Owner | Location | Use | Surface Area(m²) |
|---|---|---|---|
| *Italian Companies* | | | |
| Safilo S.p.A. | Via Malignani, 6 Precenicco (UD) | Manufacturing plant and offices, land | 13,000 |
| | Via Spilimbergo, 154 Martignacco (UD) | Manufacturing plant and offices, land | 4,460 |
| | Via Molinà, 1 Calalzo di Cadore (BL) | Manufacturing plant and offices, land | 14,432 |
| | Zona Industriale Villanova di Faè Longarone (BL) | Manufacturing plant and offices, land | 58,775 |
| | Settima Strada, 15 Padova | Offices and distribution center, land | 20,937 |
| | Fagagna (UD) | Land | 69,065 |
| *Foreign Companies* | | | |
| Safilo España S.A. | Madrid (Spain) c/ Julian Camarillo, 7 4A | Offices | 600 |
| Safilo Realty Corp | Ketchum (USA) 280 Northwood Way | Offices and warehouse | 2,330 |
| Carrera Optyl Brillen Vertriebs GmbH in liquidation [(a)] | Traun (Austria) Johann Rothner Strasse 131 | Manufacturing plant and offices | 23,000 |
| Carrera Optyl D.o.o. | Ormoz (Slovenia) Ljutomerska 38/a | Manufacturing plant and offices | 20,314 |

(a) We are currently in the final stage of negotiations with a potential buyer of these properties.

All real estate properties we own are covered by a pledge in favor of the lending banks under the Senior Credit Agreement and the Senior Notes. All equipment and machinery we own is covered by a floating charge in favor of the lending banks under the Senior Credit Agreement and the Senior Notes.

The table below sets forth the real estate properties, which we lease or hold under a financial leasing agreement for which the annual lease is greater than €100,000 or equivalent amount in local currency.

| Parties to the Lease | Location | Use | Expiry of Lease | Annual Rent Amount [1] |
|---|---|---|---|---|
| *Italian Companies* | | | | |
| Futura Srl/Safilo | Z.I. S. Andrea Coseano (UD) | Production facility | December 31, 2005 | 142,542 |
| Sanpaolo Leasint S.p.a./Safilo | VII Strada 17/2 Padua | Prototyping facility | March 5, 2012 | 135,190 |
| Sanpaolo Leasint S.p.a./Safilo | VII Strada 15 Padua | Warehouse | August 1, 2015 | 1,192,458 |
| *Foreign Companies* | | | | |
| Safilo France S.a.r.l. | 142, Av. des Champs Elysées75008 Paris | Showroom | January 31, 2011 | 205,212 |
| Safilo GmbH | Otto Hahn Strasse 7D-50997 Koeln | Offices, showroom for "*House Collection*" | December 31, 2007 | 100,833 |
| Safilo UK Ltd | Suite E - 2nd Floor Holborn Hall 193-197 High Holborn London UK | Offices and showroom | March 24, 2012 | GBP 93,000 (Euro136.044) |
| Safilo Far East Ltd | 52/F The Center 99 Queen's Road Central Hong Kong | Offices | August 31, 2007 | HK$ 3,900,667 (Euro 403.026) |
| | 52/F The Center 99 Queen's Road Central Hong Kong | Sales offices | August 31, 2007 | HK$ 1,004,241 (Euro 103,778) |
| Safilo Japan Co. Ltd | Nihonbashi Kato Bldg, 5/F2-1-14 Nihonbashi Chuo-ku Tokyo 103-0027 | Offices | May 19, 2007 | JPY 34,251,840 (Euro 250.289) |
| Safilo USA Inc | 801, Jefferson Road Parsippany NJ 07054, USA | Offices and storage facility | December 31, 2006 | US$ 1,377,396 (Euro 1,107,142) |
| | SunSights 404 Fifth Avenue New York | Showroom | June 30, 2008 | US$ 433,259 (Euro 348,251) |
| | Outlook Eyewear 12360 East 46th Ave, Suite 300 Denver, CO | Storage facility | December 31, 2005 | US$ 510,844 (Euro 410,613) |

| Parties to the Lease | Location | Use | Expiry of Lease | Annual Rent Amount (1) |
|---|---|---|---|---|
| Solstice Marketing Concepts LLC#1001 | The Florida Mall Sp 1328001 S. Orange Blossom Trail Orlando, FL | Point of sale/retail store | January 31, 2010 | US$ 154,560 (Euro 124,234) |
| Solstice Marketing Concepts LLC#1003 | Garden State Plaza 1 Garden State Plaza T19C Paramus, NJ, 07652 | Point of sale/retail store | January 31, 2011 | US$ 130,900 (Euro 105,217) |
| Solstice Marketing Concepts LLC#1004 | Valley Fair Mall Ste. 2561 2855 Stevens Creek Blvd Santa Clara, CA | Point of sale/retail store | January 31, 2012 | US$ 136,350 (Euro 109.597) |
| Solstice Marketing Concepts LLC#1009 | 500 Fifth Avenue New York, NY 10110 | Point of sale/retail store | December 31, 2017 | US$ 169,400 (Euro 136,163) |
| Solstice Marketing Concepts LLC#1011 | The Mall at Short Hills Route 24 & JFK Parkway Short Hills, NJ 07078 | Point of sale/retail store | January 31, 2013 | US$ 150,000 (Euro 120,569) |
| Solstice Marketing Concepts LLC#1012 | 805 Lincoln Road Miami, FL 33139 | Point of sale/retail store | June 30, 2012 | US$ 140,000 (Euro 112,531) |
| Solstice Marketing Concepts LLC#1013 | 27 West 34th Street New York, NY 10001 | Point of sale/retail store | December 30, 2009 | US$ 254,616 (Euro 204,659) |
| Solstice Marketing Concepts LLC#1031 | 8522 Beverly Boulevard Suite 786 Los Angeles, CA 90048 | Point of sale/retail store | January 31, 2013 | US$ 140,000 (Euro 112.531) |
| Solstice Marketing Concepts LLC#1032 | 5135 West Alabama Suite 7220 Huston, TX 77056 | Point of sale/retail store | January 31, 2014 | US$ 124,320 (Euro 99.928) |
| Solstice Marketing Concepts LLC#1035 | Columbus Circle 10, Space 306 New York, NY 10023 | Point of sale/retail store | January 31, 2015 | US$ 139,305 (Euro 111.972) |
| Solstice Marketing Concepts LLC#3001 | 811 Madison Avenue New York, NY 10021 | Point of sale/retail store | November 30, 2015 | US$ 681,300 (Euro 547.625) |

(1) Local currency exchanged to Euro at the average rate for 2005.

# ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

*The following is a discussion of our results of operations and financial condition as of and for the years ended December 31, 2004 and 2005. You should read this discussion in conjunction with the sections entitled "Presentation of Financial and Other Information", "Selected Financial Data" and our consolidated financial statements and accompanying notes included elsewhere.*

*We have prepared our consolidated financial statements as of and for the years ended December 31, 2004 and 2005 in accordance with IFRS, which differ from Italian GAAP and U.S. GAAP in certain respects. There are certain differences between Italian GAAP and IFRS and as result, the Italian GAAP financial statements presented for the year ended December 2004 are not directly comparable to the IFRS financial information presented for the year ended December 31, 2004. For a description of certain differences between Italian GAAP and IFRS, see Note 10 of the IFRS Consolidated Financial Statements.*

*The following discussion and analysis contains statements reflecting our views about our future performance and are considered "forward-looking statements". These views may involve risks and uncertainties that are difficult to predict and may cause our actual results to differ materially from the results discussed in such forward-looking statements. You should consider that various factors including changes in general economic conditions, nature of competition, developments in distribution, industry trends, influence of currency fluctuations and inflation, and other factors discussed below, may affect our projected performance.*

## OPERATING RESULTS

### Overview

We are the parent company of the Group Safilo S.p.A., a leader in the production and sale of prescription frames, sunglasses and sports eyewear. Our products are sold in approximately 130 countries through a distribution network comprising 28 distribution subsidiaries operating in 30 countries and through approximately 170 independent distributors elsewhere. Our net sales of prescription frames, sunglasses and sports products accounted for 41.2%, 51.5% and 6.0%, respectively, of our net sales in 2005. We also sell a limited line of complementary accessories, which accounted for 1.3% of our net sales in 2005. We produce and distribute eyewear products under license agreements that are typically long-term, as well as under our owned brands. Sales of licensed brand products accounted for 80.0% of our net sales in 2005, and sales of our owned brand products accounted for 18.6%. Our principal geographic markets are the Americas (principally the United States), which accounted for 37.4% of our net sales in 2005; Italy, which accounted for 13.5% of our net sales in 2005; Europe (excluding Italy), which accounted for 33.1% of our net sales in 2005; and the Asia Pacific region, which accounted for 11.7% of our net sales in 2005.

### Principal Factors Affecting our Results of Operations

#### *Strengthening of Distribution Network*

One of our key strategic objectives is to continue strengthening our distribution network through selective expansion into attractive geographic markets and through increasing our control over product distribution. We operate three main distribution centers: our Padua distribution center, a center in Parsippany (New Jersey) and a center in Hong Kong. During 2002, we began our Solstice specialty store business in the United States by acquiring six stores; at the date of this Annual Report we have 55 Solstice stores. We expect to continue to establish distribution subsidiaries in geographic markets where we currently use third-party distributors at such time as we determine that the size of the market (based on number of units sold on a per annum basis) would allow us to increase our net sales and profitability through direct control.

The strengthening of our distribution network through geographic expansion and increased control has affected, and is expected to continue to affect in future periods, our results of operations. The establishment of a

distribution subsidiary usually permits an increase in margins and the units sold resulting from our enhanced control and understanding of brand placement.

***Luxury Brands***

Sales of licensed luxury brands have represented, and are expected to continue to represent, the most important component of our business. One of our strategic objectives is to renew existing agreements with top luxury fashion houses and designers and to enter into new agreements on favorable terms for new internationally known brands or established brands in attractive regional and national markets. Despite the payment of royalties from sales of licensed luxury brands (which account for the great majority of our overall luxury brand sales), luxury brands have been profitable due to their high margins.

***Working Capital Requirements***

Net working capital, which we define as total current assets (excluding cash in hand and at banks) less total current liabilities (excluding the current portion of medium-and long-term loans), depend largely upon customer requirements for prompt delivery of our products and the prevailing payment terms in the eyewear business. Therefore, our working capital requirements, including inventory and trade receivables, are significant. See, Item 4 "Liquidity and Capital Resources—Working Capital."

***Outsourcing of Production***

Another one of our strategic objectives is to maintain production flexibility by efficiently allocating our own production resources, utilizing subcontractors for certain phases of production and purchasing finished products from third-party manufacturers. We have reduced the use of sub-contractors and have optimized the use of our own production facilities. While we have increasingly purchased finished products from third-party manufacturers in order to maintain maximum flexibility and cost-effectiveness without threatening intellectual property protection or product quality. Our goal also is to reduce excess capacity and to realize economies of scale through the efficient allocation of processes and products at our own production facilities. We aim to outsource the production of models that have lower prices to manufacturers that can produce the units at a lower cost per unit than we would otherwise be able to achieve using our own facilities, and we retain production in our own facilities of models that require a more intensive or technical production process, whether from a design or engineering standpoint. We have a high degree of control over third-party production and we have set the same quality standards as for units we produce ourselves.

***Seasonality and Cash Flows***

Our revenues are somewhat seasonal as we experience our highest level of net sales during the first half of the year (55% in 2004 and in 2005), primarily due to higher sales of sunglasses leading up to the summer, and our lower level of net sales in the third quarter of the year. Also, due to this seasonality in net sales, our profitability fluctuates on a quarterly basis, with our EBITDA being better in the first half of the year both in terms of absolute amount and as a percentage of net sales. Our cash levels tend to be lower in the first half of each year because we have higher working capital requirements, as a result of increased receivables deriving from stronger sales.

**Critical Accounting Estimates**

The preparation of this consolidated financial information requires management to apply accounting methods and policies that are based on difficult or subjective judgments, estimates based on past experience and assumptions determined to be reasonable and realistic based on the related circumstances. The application of these estimates and assumptions affects the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the balance sheet date and the reported amounts of income and expenses during the reporting period. Actual results may differ from these estimates given the uncertainty surrounding the assumptions and conditions upon which the estimates are based. We have summarized below our accounting estimates that require the more subjective judgment of our management in making assumptions or estimates regarding the effects of matters that are inherently uncertain and for which changes in conditions may significantly affect the results reported in the combined and consolidated financial statements.

***Goodwill***

The Group tests annually whether goodwill is subject to impairment. The recoverable amounts of the cash-generating units are determined based on fair value calculations. Should the fair values result in a lower value than the book value of the asset, an impairment is recorded. The allocation of goodwill amongst the cash-generating units and the valuation under fair value requires management to make estimates that depend on many factors that can change through time. Changing the assumptions selected by management to determine the level, if any, of impairment, including the discount rates or the growth rate assumptions in the cash flow projections, could materially affect the net present value used in the impairment test and as a result affect the Group's financial condition and results of operations.

***Impairment of long-lived assets***

Assets that are subject to depreciation and amortization are reviewed to determine whether there is any indication that the carrying value of these assets may not be recoverable and have suffered an impairment loss. If any such indication exists, the recoverable amount is the higher of an asset's fair value less costs to sell and value in use. Such impairment loss is recognized in the consolidated income statement.

Management judgement is required in the area of asset impairment, particularly in assessing: (i) whether an event has occurred that may affect asset values; (ii) whether the carrying value of an asset can be supported by the net present value of future cash flows which are estimated based upon the continued use of the asset in the business; and (iii) the appropriate key assumptions to be applied in preparing cash flow projections including whether these cash flow projections are discounted using an appropriate rate. Changing the assumptions selected by management to determine the level, if any, of impairment, including the discount rates or the growth rate assumptions in the cash flow projections, could materially affect the net present value used in the impairment test and as a result affect the Group's financial condition and results of operations.

***Deferred tax assets***

Deferred income tax assets are recognized to the extent that is probable that future taxable income will be available against which the temporary differences can be utilized. The valuation of future taxable income depends on assumptions that can change through time with the possibility of causing significant differences on the final valuation of deferred income tax accounted for by management. Judgment is required to determine the key assumptions adopted in the assessment and changes to these key assumptions can significantly affect the outcome of the assessment.

**Results of Operations for the Years Ended December 31, 2004 and 2005**

***Year Ended December 31, 2005, Compared with Year Ended December 31, 2004***

| Consolidated Statement of Operations *(Euro in millions)* | 2005 | % of net sales | 2004 | % of net sales | Change % |
|---|---|---|---|---|---|
| Net sales | 1,025.3 | 100.0 | 944.7 | 100.0 | 8.5 |
| Cost of sales | (416.5) | (40.6) | (381.5) | (40.4) | 9.2 |
| **Gross profit** | **608.8** | **59.4** | **563.2** | **59.6** | **8.1** |
| Selling and marketing expenses | (379.4) | (37.0) | (344.1) | (36.4) | 10.3 |
| General and administrative expenses | (102.1) | (10.0) | (106.9) | (11.3) | (4.5) |
| Other operating income and expenses, net | 1.0 | 0.1 | (0.9) | (0.1) | (211.1) |
| **Operating income** | **128.3** | **12.5** | **111.3** | **11.8** | **15.3** |
| Share of income/ (loss) of associates | 1.5 | 0.1 | - | - | n.s. |
| Interest expense and other financial charges, net | (85.3) | (8.3) | (66.1) | (7.0) | 29.0 |
| Non recurring financial charges | (19.5) | (1.9) | - | - | n.s. |
| **Income before taxation** | **25.0** | **2.4** | **45.2** | **4.8** | **(44.7)** |
| Income tax expense | (11.4) | (1.1) | (20.5) | (2.2) | (44.4) |
| **Net income** | **13.6** | **1.3** | **24.7** | **2.6** | **(44.9)** |
| Net income attributable to minority interests | 3.2 | 0.3 | 3.1 | 0.3 | 3.2 |
| **Net income attributable to the Group** | **10.4** | **1.0** | **21.6** | **2.3** | **(51.9)** |
| **EBITDA** | **163.5** | **15.9** | **146.9** | **15.5** | **11.3** |

***Net sales***

Group sales, at current exchange rates, reached to Euro 1,025.3 million up to 8.5% compared to Euro 944.7 million recorded in 2004. The slight fluctuation in the average Euro/US dollar exchange rate did not result in any significant changes.

The improved results were achieved due to the increase in the sales of licensed products (+12.2%) and to the strong increase in sales in all of the markets in which the Group operates, with the Asian market having a noteworthy impact(+20.0%).

The year also confirmed the important growth in the sunglasses segment (+18.5%), together with substantially stable sales for optical frames.

The opening of new outlets continued at a sustained rate, in particular for the outlet chain Solstice. We also launched new brands such as *Marc Jacobs* and *Imatra*, the latter advertised by the Grand Prix motorbike world champion- Valentino Rossi.

The tables below set forth our net sales by geographic region, product category and brand category for the years ended December 31, 2004 and 2005.

| Net sales by geographical region *(Euro in millions)* | 2005 | % | 2004 | % | Change % |
|---|---|---|---|---|---|
| Italy | 138.6 | 13.5 | 123.5 | 13.1 | 12.2 |
| Europe (excluding Italy) | 339.4 | 33.1 | 329.6 | 34.9 | 3.0 |
| The Americas | 383.3 | 37.4 | 351.3 | 37.2 | 9.1 |
| Asia Pacific | 119.8 | 11.7 | 99.8 | 10.6 | 20.0 |
| Other | 44.2 | 4.3 | 40.5 | 4.2 | 9.1 |
| **Total** | **1,025.3** | **100.0** | **944.7** | **100.0** | **8.5** |

| Net sales by product *(Euro in millions)* | 2005 | % | 2004 | % | Change % |
|---|---|---|---|---|---|
| Prescription frames | 422.1 | 41.2 | 425.0 | 45.0 | (0.7) |
| Sunglasses | 527.7 | 51.5 | 445.5 | 47.2 | 18.5 |
| Sports products | 61.2 | 6.0 | 57.5 | 6.1 | 6.4 |
| Other | 14.3 | 1.3 | 16.7 | 1.7 | (14.4) |
| **Total** | **1,025.3** | **100.0** | **944.7** | **100.0** | **8.5** |

| Net sales by brand category *(Euro in millions)* | 2005 | % | 2004 | % | Change % |
|---|---|---|---|---|---|
| Owned brands | 190.7 | 18.60 | 197.4 | 20.90 | (3.4) |
| Licensed brands | 820.2 | 80.00 | 731.2 | 77.40 | 12.2 |
| Other | 14.4 | 1.40 | 16.1 | 1.70 | (10.6) |
| **Total** | **1,025.3** | **100.0** | **944.7** | **100.0** | **8.5** |

*Italy*

The sales in the domestic market increased by 12.2% compared to 2004. The Italian eyewear market due to the Group collections has permitted the Group to reach strong results, both in the sales of sunglasses (+13.9%) and optical frames (+9.1%). The growth recorded in this latter sector represents a significant achievement within the Group's strategy to increase the presence in the optical frame market. Sporting articles, helmets and goggles also recorded strong results with an increase of approximately 50%. The major brands which contributed to this strong performance were Armani, Dior, Gucci and Valentino, Oxydo and Sàfilo.

*Europe (excluding Italy)*

The European market recorded a growth of 3.0% with a positive performance in the sunglasses category (+9.4%) and substantially stable sales in the optical eyewear frames category (-1.3%). In relation to geographical information, Spain and Germany offered the greatest contribution to the good performance in sales. In terms of growth by brand Armani, Dior, Gucci and Valentino were the best performers.

*The Americas*

The sales in the American markets continued the growth as in the previous quarters of 2005 with an increase of 9.1% compared to the previous year (at constant exchange rates: +9.9%). Canada and Brazil continue to be markets in strong growth increasing by 19.1% and by 52.2%, respectively. The Group has successfully focused its marketing strategies on the independent opticians and department stores sectors, becoming absolute leader in both sales channels. In relation to the brands, strong results were obtained in all of the most important collections, in particular Armani, Dior and Gucci, together with the traditional American brands such as Kate Spade, Liz Claiborne and J.Lo. The strong performance in the sporting sector was also as a result of the important growth in the sale of goggles and sunglasses of the brand Smith.

Strong results were also recorded in the sales division Outlook (+19.1%) and in the retail chain Solstice (+56.2%), which now is represented by 54 outlets.

*Asia Pacific*

The Asian market throughout the year confirmed the strong growth rates reported in the previous quarters. Revenues increased in the year by 20.0%. All the merchandise categories continued to provide strong results, both in terms of volumes and turnover. The optical frames reached the same growth rates as the sunglasses with an increase of 20% compared to 2004. This success is due to the continued strategy of the Group regarding the Asian market. In 2004 compared to 2003, the revenues in the Asian market had already increased by approximately 30%. Furthermore in Asia, as in America, almost all the major brands contributed to the strong growth in the year with particularly good results in Australia (+8.4%), Japan (+10.9%), Korea (+72.6%), Philippines (+97.3%) and China (+110%).

***Cost of sales***

| *(Euro in millions)* | 2005 | 2004 | Change% |
|---|---|---|---|
| Purchase of raw materials and finished goods | 282.9 | 263.1 | 7.5 |
| Change in inventories | (7.8) | (36.7) | (78.7) |
| Payroll and social security contributions | 91.3 | 95.8 | (4.7) |
| Capitalization of costs for increase in property, plant and equipment | (9.9) | (7.5) | 32.0 |
| Subcontracting costs | 23.3 | 33.5 | (30.4) |
| Depreciation | 25.4 | 24.8 | 2.4 |
| Rental and operating leases | 0.8 | 1.0 | (20.0) |
| Other industrial costs | 10.5 | 7.5 | 40.0 |
| **Total** | **416.5** | **381.5** | **9.2** |

Cost of sales increased by 9.2% from €381.5 million in 2004 to €416.5 million in 2005, remaining substantially stable when considered as a percentage of net sales (40.6% in 2005 and 40.4% in 2004).

***Selling and marketing expenses***

Selling and marketing expenses increased by 10.3% from €344.1 million in 2004 to €379.4 million in 2005 mainly as a consequence of increased sales to which those costs are directly related. As a percentage of net sales, our selling and marketing expenses increased from 36.4% in 2004 to 37.0% in 2005. Part of this growth is due to our royalty expenses, which increased 13.8% from €80.0 million in 2004 to €91.0 million in 2005 due mainly to a shift in revenues generated from our owned brands to licensed brands.

***General and administrative expenses***

General and administrative expenses decreased from €106.9 million in 2004 to €102.1 million in 2005; also as a percentage of net sales our general and administrative expenses decreased from 11.3% in 2004 to 10.0% in 2005 as a result of cost containment activities taken by the Group during 2005 financial year.

***Interest expense and other financial charges, net***

Interest expense and other financial charges, increased by 29.0% from €66.1 million in 2004 to €85.3 million in 2005. This increase was mainly due to exchange losses related to the American Dollar revaluation impacting foreign currency loans and resulting in a charge to the income statement for a total amount of €15.0 million due to both the exchange losses recorded on the repayments made during the year and unrealized exchange losses deriving from the valuation of loans in U.S. Dollars at the exchange rate at the balance sheet date.

***Non recurring financial charges***

The advance repayment of a portion of the Senior loan and of one third of the High Yield bond through the use of proceeds received from Safilo Group S.p.A. had the following effect on the income statement:

- higher financial costs due to, in accordance with IFRS, the accelerated amortization of charges related to the above borrowings;
- a penalty to be paid to High Yield bond holders.

***Income tax expense***

Income tax expense decreased from €20.5 million in 2004 to €11.4 million in 2005; however, as a percentage of the income before taxation, our income taxes remained stable (45.4% in 2005 and 45.4% in 2004).

***Net income attributable to Group***

For the reasons stated above, our net income attributable to the Group decreased from €21.6 million in 2004 to €10.4 million in 2005.

## LIQUIDITY AND CAPITAL RESOURCES

### Cash Flow

The following table summarizes our cash flow activity during the years ended December 31, 2004 and 2005.

| *(Euro in millions)* | Year ended December 31, 2005 | 2004 |
|---|---|---|
| **Net cash flows:** | | |
| Provided by operating activities | 30.0 | 55.7 |
| Used in investment activities | (37.3) | (28.6) |
| Provided by/(used in) financing activities | 21.3 | (22.0) |
| Cash and cash equivalents at the end of period | 25.9 | 18.2 |

***Net Cash Flow provided by Operating Activities***

Net cash flows provided by operating activities consist of net income adjusted for changes in working capital and non-cash items such as depreciation and amortization.

Cash flow from operating activities decreased from €55.7 million in 2004 to €30.0 million in 2005. This decrease was mainly due to the combined effect of (i) a lower net income compared to the previous period due primarily to higher financial costs and non-recurring financial charges, (ii) an increase in trade receivables and other current receivables as a result of the growth in sales in the fourth quarter of 2005 compared to the previous year, and (iii) a lower increase in our inventory comparing 2005 to 2004 as a consequence of an improved inventory control policy.

***Cash Flow used in Investment Activities***

Net cash used in investment activities consists of additions to property, plant and equipment, net of disposals, increases in intangible assets and acquisitions of equity investments.

Cash used in investment activities increased in 2005 when compared to 2004 as a result of higher investments mainly related to Italian factories for the renewal of plants and equipments relating to production of new models. In Europe investments in property, plant and equipment mainly refers to the factory in Slovenia whilst in the United States capital expenditures mainly relate to the development of the Solstice outlet chain.

Investments in intangible assets mainly relate to software and the management of the brands in our portfolio.

***Cash Flow provided by Financing Activities***

Net cash flows provided by financing activities include repayment of loans, additional proceeds form loans, movements in share capital and dividend payments to shareholders. Cash flow from financing activities increased by €43.3 million from an outflow of €22.0 million in 2004 to a cash generation of €21.3 million in 2005. This effect was mainly due to new borrowings from the capex facility of the Senior Credit Agreement.

***Capital Resources***

*Intra-Group Funding*

We operate a central treasury function that controls all decisions and commitments regarding cash management, arrangement of borrowing facilities and banking relationships.

The Group's cash management account structure and management of accounts is decentralized. Local accounts are established with domestic banks for collection and disbursement purposes. All account receivables and account payables functions are handled locally as well. Generally, each entity works with functional currencies for collection and disbursement purposes.

The temporary liquidity needs of each Group company are principally met by managing intra-Group payment obligations arising from intra-Group trading.

We usually manage debt service requirements arising from the Senior Notes issued by Safilo Capital International S.A., through payments under the loan agreement with Safilo International BV, funded by dividends from its operating subsidiaries.

The Group's principal U.S. operating subsidiary, Safilo USA, is a borrower under the senior credit facilities. To date, Safilo USA has met, and we expect that it will continue to meet, its debt service obligations under the senior credit facilities through internally generated funds. We also expect that Safilo USA will continue to fund the capital requirements of the Solstice specialty store program.

*External Sources of Liquidity*

Our external sources of liquidity consist principally of our Senior Credit Facilities, the Senior Notes, factoring agreements, equity contributions and any subordinated loans from our shareholders. We also have undrawn lines of credit and overdraft facilities and have entered into finance leases. The following is a description of our primary external sources of liquidity:

***Senior Credit Facilities***

*Structure*

The table below summarizes the various facilities of the Senior Credit Agreement and their terms.

| | Repayment Date | Currency | Maximum Amount Available as of December 31, 2005 | Interest Rate |
|---|---|---|---|---|
| | | | *(millions of Euro)* | |
| Term A1 *Tranche* 2 | December 31, 2009 | USD | 48.0 | Libor U.S.$ 3M + 225bp |
| Term A2 | December 31, 2009 | USD | 54.1 | Libor U.S.$ 3M + 225bp |
| Term B | December 31, 2010 | Euro | 134.4 | Euribor 3M + 275bp |
| Term C | December 31, 2011 | Euro | 61.2 | Euribor 3M + 325bp |
| Capex facility | December 31, 2009 | Euro | 21.0 | Euribor 3M + 250bp |
| Revolving facility | December 31, 2009 | Euro | 50.0 | Euribor[(a)] + 225bp |

Commissions and fees paid on the Senior Credit Agreement are calculated as follows: (i) 0.125% lending commission, payable quarterly on available total; (ii) 0.75% commitment fee payable quarterly on undrawn portions; and (iii) agency commissions of €250,000 per year.

*Covenants*

The Senior Credit Agreement contains customary operating and financial covenants, subject to certain agreed exemptions, which impose significant restrictions on the way our Group companies can operate, including restrictions on our ability to:

- incur additional indebtedness or guarantee indebtedness of others;
- make certain loans or investments;
- distribute dividends;
- acquire or sell our own shares.

The Senior Credit Agreement also requires us to maintain specified customary ratios and satisfy specified customary financial tests to be calculated on a consolidated level. As of December 31, 2005, all such financial tests have been met.

*Mandatory Prepayments*

All obligations under the Senior Credit Agreements must be prepaid in full if there is a change of control or if all or substantially all of our assets are sold. Certain mandatory partial prepayments are required in some circumstances.

*Maturity and Amortization*

Term loan facilities A1 and A2 are repayable in semiannual instalments, beginning September 30, 2003, and continuing through December 31, 2009. Starting from 2004, each instalment has expired on June 30 and December 31 of each year. Term loan facility B is to be repaid in full on December 31, 2010. Term loan facility C is to be repaid in full on December 31, 2011. The revolving credit facility will cease to be available for drawing on November 30, 2009. Loans under the €21 million senior secured capex facility may be made through December 31, 2005 and any loans outstanding on that date then must be repaid, starting from June 30, 2006, in eight equal semiannual instalments, by December 31, 2009.

As of December 31, 2005, the total outstanding amount of the Senior Credit Facilities was approximately €294.3 million, €21.0 million of which were drawn under the capex facility.

***The Senior Notes***

In 2003, our affiliate Safilo Capital International S.A. issued the Senior Notes. The Senior Notes are guaranteed on a senior subordinated basis by Safilo S.p.A. and certain of its subsidiaries and are governed by an indenture dated May 15, 2003 between us, Safilo Capital International S.A and certain subsidiaries and The Bank of New York as Trustee. The indenture provides for standard covenants including, among others, restrictions on our ability to:

- borrow additional money;
- pay dividends on our or our subsidiaries' stock or repurchase our or our subsidiaries stock;
- make payments on or redeem or repurchase indebtedness junior to the Senior Notes;
- make investments;
- create liens;
- create restrictions on the payment of dividends or other amounts to us from our subsidiaries;
- enter into transactions with affiliates;
- sell assets or consolidate or merge with or into other companies;
- guarantee our other indebtedness and our subsidiaries' other indebtedness;
- incur any indebtedness subordinate or junior in right of payment to senior indebtedness and senior to the guarantees;
- issue or sell our capital stock or our subsidiaries' capital stock; and
- expand into unrelated businesses.

*Security*

Our obligations under the Senior Notes and the indenture governing the Senior Notes are secured by a second priority security interest in our shares and a second priority security interest in a loan agreement between us and the issuer of the Senior Notes.

*Optional Redemption*

Due to the consent of UBM and San Paolo IMI S.p.A., the lending banks under the Senior Credit Agreement, we used part of the proceeds received for the increase of the Shareholders' contribution from our parent company Safilo Group S.p.A. to redeem, before their maturity date, on January 13, 2006, the Senior Notes for the 35% of the principal amount (€105 million, plus accrued interest and the early redemption make-whole premium of €10,1 million).

*Change of Control*

If we or our holding company Safilo Group S.p.A. experiences specific kinds of changes in control, holders of the Senior Notes have the right to require us to repurchase all or part of their Senior Notes at 101% of their principal amount, plus accrued and unpaid interest and additional amounts, if any.

*Events of Default*

The indenture governing the Senior Notes makes the occurrence of any of a number of events an "Event of Default" which could accelerate the due date of the Senior Notes. These events include, but are not limited to: a default in the payment of interest on the Senior Notes when due, continued for 30 days, or a default in the payment of principal on the maturity date; the failure to comply with certain of the covenants of the indenture; the failure to pay other indebtedness, in certain circumstances; or certain events of bankruptcy, insolvency or reorganization of the issuer of the Senior Notes or ourselves or certain significant subsidiaries.

The Senior Notes have been rated Caa 2 by Moody's, CCC+ by Standard & Poor's Financial Services and CCC+ by Fitch. The Senior Notes were sold to institutional investors in private placements managed by Credit Suisse First Boston as sole bookrunner and lead manager.

***Factoring Agreement***

In 2004 we entered into a without-recourse factoring agreement with Centro Factoring S.p.A. We transfer some of our Italian trade receivables on a revolving basis and receive an up-front payment of 85% of the face value of the receivables we sell. The difference between cash received and trade receivables sold will be collected at its maturity date. We have a servicing obligation to act as a collection agent on behalf of Centro Factoring S.p.A.

As of December 31, 2005 the amount due to the factor was €28.3 million.

**Financial Indebtedness**

As at December 31, 2005, our total indebtedness (total debt excluding overdrafts and the redemption make-whole premium of €10,1 million) was €637.1 million. At that date, approximately 46% of our indebtedness was at floating rate, indexed primarily at a spread to benchmark rates such as EURIBOR or LIBOR (generally from 225 to 325 basis points above the benchmark), with the remainder at a fixed rate.

The tables below set forth our total indebtedness as at December 31, 2004, and as at December 31, 2005.

| *(Euro in millions)* | Year ended December 31, 2004 | 2005 |
|---|---|---|
| ***Floating Rate:*** | | |
| Senior Credit Facility | 444.9 | 294.3 |
| —Term A1 *Tranche* 1 | 42.7 | - |
| —Term A1 *Tranche* 2 | 95.1 | 39.6 |
| —Term A2 | 44.5 | 44.8 |
| —Term B | 129.7 | 129.9 |
| —Term C | 129.4 | 59 |
| —Capex Facility | - | 21 |
| —Revolving Facility | 3.5 | 0 |
| Factoring agreements | 26.5 | 28.3 |
| Operating Leases | 13.2 | 14.1 |
| Other | 2.2 | 7.2 |
| ***Fixed Rate:*** | | |
| Senior Notes | 287.1 | 291.9 |
| Other | 1.9 | 1.3 |
| **Total** | **€775.8** | **€637.1** |

**Inflation**

We do not believe that inflation has had a material impact on our operations in the past, although there can be no assurance that this will be the case in the future.

## RESEARCH AND DEVELOPMENT, PATENT AND LICENSES, ETC.

**Research and Development**

Our research and development activities are divided into two principal segments:

- development of new materials, new production processes and technologies and, instruments and machinery; and
- product design.

Our research and development of new materials, new production processes, instruments and machinery is carried out by an internal division known as the Research and Technical Innovation Division. Development of product designs is carried by our three Design Centers (in Italy, the United States and Hong Kong), each focusing on the design needs of a specific geographic area.

***New raw materials, new production processes and, instruments and machinery***

Through the Research and Technical Innovation Division, which is principally responsible for testing the use of new materials, we seek to improve our products' technical specifications as well as innovate our production process to obtain higher efficiency and a better product quality.

During the course of 2005, the Research and Technical Innovation Division focused on:

- increasing our products' resistance and durability;
- developing innovative features for sports goggles;
- improving lenses, both in terms of aesthetics and as protective gear for sports eyewear;
- improving our products in terms of weight and fit; and
- designing and building new machinery to improve efficiency and quality of product.

During the past several years, our research and development efforts resulted in the filing of numerous patents for, among other things, flexible hinges, nose hinges, lenses bases, nose pieces and ski mask internal and external protection. For further information on our patents see the following paragraph "—Intellectual Property and Licenses —Patents".

Our instruments and machinery research and development aims to provide us with designs and precision instruments and moulds that we may use to increase the capacity, efficiency and quality of our production process. We believe that carrying out this type of activity internally allows for a shorter time-to-market of our products as well as a continued reduction in our production costs.

The Research and Technical Innovation Division was composed of 27 members as of December 31, 2005, with the research part of the group based in the Santa Maria di Sala production site center, who works closely with our production process, while the technical innovation part based in Padua, working closesly iwith our design center.

***Product design***

Over a decade ago, we identified product design as a strategic objective of our Group, especially in connection with high-end products. Our design research and development activity consists of developing shapes and color and material schemes for the creation of new eyewear models. Our design group is divided into three centers, collectively referred to as our Design Center, and is made up of designers engaged in the development of our product prototypes. Our principal Design Center is located in Italy with the remaining two centers located in the United States, specializing in the development of designs for the American exclusive brands, and in Hong Kong. As of December 31, 2005, our worldwide design team consisted of approximately 100 people, including designers and staff in charge of the creation of prototypes.

Our design center in Padua is subdivided into six units, each dedicated to the development of a range of brands, and is coordinated by a senior designer. Each brand design team meets the licensor to discuss ideas and concepts for the brand during the development phase of our new collections. The marketing department, together with the brand manager, provides our designers with market demand and consumer preference data. With this information, we create style guidelines for our collections in order to achieve an appropriate positioning of our products.

Once new models are defined and the technical feasibility is confirmed by the department of Research and Technological Innovation, the stage of prototyping is commenced. The prototypes are formed using design and industrial computer programs called "computed aided design" (CAD) and "computer aided manufacturing" (CAM). The CAD and CAM technology allows the visualizing of the frames with two-dimensional and three-dimensional images and allows the modifying of the design directly on the computer. The integration of the CAD and CAM design technology with the production process strongly simplifies the consequent industrialization and production of the prototype.

For the licensed brands, the development unit makes use of the designs of the new collections on the basis of the indications of the licensors in relation to colors, shapes and materials and once the prototypes are ordered, the collections are approved by the licensors.

Of the 4,800 current models, 2,500 were new models designed by our design center in 2005. There is a complete regeneration of the collections every two years, with the exception of a few models (called "evergreen models"), which remain in the collection for a longer period.

## Intellectual Property and Licenses

### *Patents*

We hold patents for inventions, models and designs. Patents for inventions relate to parts of our products, such as flexible hinges, nose hinges, lenses bases, nose pieces and internal and external protection for ski masks. Patents for models and designs cover our most characteristic and cutting-edge models of sun glasses and sports goggles. As at December 31, 2005, we had approximately 70 patents registered or pending in the United States and many European countries. Each year, we apply for approximately eight new patents, generally for hinges and other structural parts of the product. In particular, our formerly patented (expired) and currently trademarked *Elasta* (self-adjusting hinges) is an important eyewear feature for many of our end customers. *Elasta* has 22 variations, many of which have been registered. We also have the know-how for Optyl, the result of a unique process of a special combination of resins we developed. Optyl hard-plastic products are lightweight, non-allergenic, have attractive, sophisticated chromatic effects and are resilient even in extreme temperatures, thus retaining the shape of the frame under harsh conditions such as inside a hot vehicle. The molecular structure of this material also ensures strength and permanent elasticity with improved fit.

In 2005, we developed the "Klap" model, which we currently use in our Oxydo products. The Klap model uses technical characteristics normally used only on ski goggles and masks to sunglasses. The Klap is an innovative lens, which does not fog and offers a high degree of protection from UVA and UVB rays. As at the date of this Annual Report, our patent for the Klap system is pending.

### *Licenses*

*Revenues*

We have license agreements with several companies pursuant to which we manufacture and distribute prescription frames and sunglasses. Our performance is dependent on these licenses. In terms of revenues, our top four license agreements are those with *Armani, Dior, Gucci* and *Ralph Lauren.*

The following table shows net sales resulting from our top-earning licenses, expressed as a percentage of our total net sales for the year ended December 31, 2005.

| | **% of our consolidated revenues for the year ended December 31, 2005** |
|---|---|
| Net sales from first four licensed trademarks | 50.5% |
| Net sales from first ten licensed trademarks | 71.7% |

*Royalties*

We pay a royalty for use of the licensed brand name based on a percentage of net sales of that brand, which may be offset by guaranteed minimum royalty payments. Our licenses typically have a duration of five to eight years. In certain circumstances, a license agreement may be terminated by the licensor such as if there is a change in our control, we outsource production without consent of the licensor, we sell models that are not

approved by the licensor, we fail to reach minimum sales targets or we sell products through distribution outlets that have not been approved by the licensor. Many of these conditions apply to our key licenses.

We incurred in royalty expenses of €91.0 million in 2005 and of €80.0 million in 2004.

In many of our agreements there are annual guaranteed minimum royalty payments to the licensor. Often the guarantee is 80% of the prior year's royalty payment or a certain amount is specified. We will be required to pay the minimum guaranteed royalties under these provisions of the license agreements even if sales decrease significantly or did not meet expectations.

The license agreements also provide for a mandatory payment for the advertising and promotion of the brand linked to the prior year's sales. In some cases, the licensor requires payments to assist the licensor in its own advertising and promotional activities. Certain of our licenses require minimum guaranteed payments for promotional and advertising expenses.

## TREND INFORMATION

During the third quarter of 2005, and the first quarter of 2006 we renewed each of our license agreements with *Dior* and *Gucci* for two additional years, and with *Yves Saint Laurent* for three additional years, up to 2010, as well as our licenses with *Armani* and *Emporio Armani* for two additional years, up to 2012. Two of our licensors, *Burberry* and *Polo Ralph Lauren*, have expressed an intention not to renew the license agreement with us. The license with *Burberry*, terminated on December 31, 2005, and the license with Polo Ralph Lauren will expire on December 31, 2006.

On November 9, 2005 we entered into a new seven-year license agreement with the Hugo Boss Group for the worldwide design, production, distribution and sale of sunglasses and prescription frames with the BOSS Hugo Boss and HUGO Hugo Boss trademarks. We will begin distributing the first collections of Hugo Boss branded products on October 1, 2006.

During 2005, we have undertaken a project to rationalize production, which gradually led to the closure of our production plant in Calalzo di Cadore (Belluno) and of our two minor production centers in Coseano and Ronchis (both in the province of Udine). The production carried out at these three facilities was moved to our other production plants during the last months of 2005 and January 2006, as described in the Item 4, paragraph "Our Business Model—Production."

During the period from 2003 to 2005, we implemented several projects aimed at strengthening our operations and customer relations, such as upgrading our distribution structure, implementing our customer relations management program and concentrating our call center operations in our Padua call center.

With respect to our production, in 2000, we began to outsource production to third-party manufacturers in the Asia Pacific region, in order to increase our flexibility during peak production periods and to limit costs. In addition, since 2004, we have been following a policy of streamlining our production facilities in order to reduce production times and costs. In line with this policy, we closed the plant in Traun, Austria, in 2004, and in 2005 we began a reorganization process to merge our Italian production facilities.

## OFF-BALANCE SHEET ARRANGEMENTS

The table below sets forth our off-balance sheet commitments as at December 31, 2004 and 2005.

| | As at December 31, | |
|---|---|---|
| ***(Euro/000)*** | **2005** | **2004** |
| ***Unsecured guarantees given to third parties*** | **2,697** | **2,845** |
| *Secured guarantees given to third parties:* | | |
| - Mortgage and lien on property, plant and equipment of Group companies | 163,432 | 125,751 |
| - Lien on trade receivables of Safilo S.p.A. | 185,827 | 169,333 |
| ***Total secured guarantees*** | **349,259** | **295,084** |
| **Total** | **351,956** | **297,929** |

Some of our trademarks and the shares of some subsidiaries are also pledged.
The majority of our guarantees, mortgages and pledges relate to the Senior Credit Facilities and the Senior Notes.

## CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

We have numerous contractual obligations providing for payments pursuant to, among other things, royalty agreements with licensors, leases for plant, warehouse and office facilities, as well as certain equipment leases. We also have, and will have, payment obligations pursuant to our outstanding borrowings, including the financial obligations arising from the Senior Credit Agreement and the Senior Notes.

The following table sets forth the scheduled maturities of our long-term debt, minimum lease commitments and non-cancellable royalty arrangements as of December 31, 2005:

| | Payments Due by Period *(Euro/000)* | | | | |
|---|---|---|---|---|---|
| **Contractual Obligations and Commercial Commitments as of December 31, 2005** | **Total** | **Less than 1 year** | **1-3 years** | **3-5 years** | **More than 5 years** |
| Long Term Debt Obligations (including current portion) | 633,150 | 175,525 | 61,898 | 149,403 | 246,324 |
| Finance Lease Obligations (including current portion) | 14,052 | 3,436 | 2,130 | 2,136 | 6,350 |
| Operating Lease Obligations | 57,839 | 11,877 | 18,764 | 13,245 | 13,953 |
| Minimum Royalty Arrangements | 236,952 | 82,734 | 61,468 | 60,731 | 32,019 |
| **Total** | **941,993** | **273,572** | **144,260** | **225,515** | **298,646** |

# ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

## DIRECTORS AND SENIOR MANAGEMENT

### Board of Directors

As of the date of this Annual Report, our board of directors (the "Board of Directors") is composed of 7 members.

The following table sets forth the names and dates of birth of the members of our Board of Directors.

| Name | Date of Birth | Domicile for the Office | Date of appointment |
|---|---|---|---|
| Vittorio Tabacchi | October 26, 1939 | Safilo S.p.A. | February, 25 2003 |
| Giannino Lorenzon | September 26, 1939 | Safilo S.p.A. | February, 25 2003 |
| Roberto Vedovotto | September 30, 1965 | Safilo S.p.A. | February, 25 2003 |
| Massimiliano Tabacchi | October 10, 1970 | Safilo S.p.A. | February, 25 2003 |
| Carlo Gilardi | November 17, 1942 | Via Massimi, 119, Roma | April, 29 2004 |
| Ennio Doris | September 3, 1940 | Mediolanum S.p.A., Via F. Sforza, Palazzo Meucci, Milano 3, Basiglio (MI) | March, 7 2006 |
| Riccardo Ruggiero | August 26, 1960 | Telecom Italia S.p.A., Piazza Einaudi 8, Milano | March, 7 2006 |

**Vittorio Tabacchi,** our Chairman, is the second son of our founder, Guglielmo Tabacchi, since 1993. Mr. Vittorio Tabacchi joined our Group in 1970 as Production Manager, and later served as our Vice Chairman and as our Managing Director. In June 2004, he received an honorary degree in engineering from the University of Padua.

**Giannino Lorenzon** has been our Vice Chairman since 2005. He joined our Group in 1973 as Director of the finance, administration and control department. From 1986 to 2004, Mr. Lorenzon was Chief Executive Officer of Safilo S.p.A., overseeing the finance, administration and control, human resources, information technology, legal, organization and quality departments. He has been a registered accountant since 1975 and an auditor since 1995.

**Roberto Vedovotto** has been our Chief Executive Officer, since 2002. Prior to joining our Group, he worked for 11 years at Morgan Stanley International Limited and served as Managing Director and head of sales and marketing in the investment management division for Southern Europe. Before joining Morgan Stanley, Mr. Vedovotto worked for Banca di Roma, in its New York and London branches. He is a member of the Advisory Boards of Università Bocconi in Milan and of the London Business School.

**Massimiliano Tabacchi**, our Chief Operating Officer since January 1, 2005, is the son of our Chairman. He began working with our Group in Safilo USA, then at our manufacturing facility in Santa Maria di Sala, Italy, and became our Director of Operations in 2002. Prior to joining our Group, Mr. Massimiliano Tabacchi was contract project manager at OTIS.

**Carlo Gilardi** has been our Director since 2004. From 2001 to 2003, he was the managing director of Cofiri S.p.A. and from 1995 until 2001 he was the managing director of Benetton Group S.p.A. Prior to 1995, Mr. Gilardi was a finance manager for Banca di Roma.

**Ennio Doris** is our Director starting from March 2006. He is also the Chairman of Banca Mediolanum S.p.A. and is director of Mediobanca S.p.A. and of Banca Esperia S.p.A. Prior to joining Banca Mediolanum S.p.A., Mr. Doris was a financial consultant for Fideuram and the Ras Group. He has founded Programma Italia, a securities brokerage company, of which he has been Managing Director.

**Riccardo Ruggiero** is our Director starting from March 2006. He is also the Managing Director of Telecom Italia S.p.A. Prior to joining Telecom Italia S.p.A. in July 2001, Mr. Ruggiero was sales director at Fininvest, as well as sales and marketing director of AT&T Italy. He has also worked in the Olivetti Group in various roles, and in 1996 was appointed managing director of Infostrada.

**Management**

The table below sets forth the names, dates of birth and seniority of the senior managers of our Safilo S.p.A.

| Position | Name | Year of Birth | Seniority |
|---|---|---|---|
| Director Legal Department | Katia Buja | January 20, 1966 | 1 year |
| Director of Finance | Christian De Felice | August 20, 1970 | 5 years |
| Managing Director Business Unit 3 (Manager of Safilo USA) | Claudio Gottardi | June 24, 1956 | 18 years |
| Director of Business Development | Massimo Lisot | November 2, 1969 | 7 years |
| Managing Director Business Unit 1 | Giovanni Materassi | June 23, 1959 | 12 years |
| Managing Director Business Unit 2 (Manager of Safilo Far East Ltd.) | Mario Pietribiasi | February 4, 1957 | 12 years |
| Director of Administration and Control | Francesco Tagliapietra | March 18, 1967 | 5 years |
| Director Human Resources | Alessandro Visconti | May 2, 1953 | 17 years |

**Katia Buja** has been head of our Legal Department since January 1, 2005. Prior to joining our legal department in 1995, Ms. Buja worked for several years as a trainee and then an attorney in several law firms, specializing in corporate, probate and bankruptcy law.

**Christian De Felice** has been our Director of Finance since 2002. From 1999 to 2002, he was Head of Structured Finance and Treasury at e. Biscom and Fastweb. Prior to 1999, Mr. De Felice was Treasurer of Omnitel (now Vodafone) and a trader with Banca di Roma, London Branch, in the Capital Markets Division. Mr. De Felice has been registered in Italy as an actuary since 1995.

**Claudio Gottardi** joined Safilo S.p.A. in 1985 as Area Manager for Central Europe and, after gaining experience at Safilo USA, became Director of Marketing in 1993. In 1996, he became Managing Director for our Business Unit 3 (Americas), and he is the CEO of Safilo USA, Smith Sport Optics, Solstice Marketing Corp., Solstice Marketing Concepts LLC, Safilo Canada Inc., and Canam Sport Optics. Prior to joining our Group, he headed the marketing department of the Italian subsidiary of W.L. Gore, in Munich, Germany.

**Massimo Lisot** has been our Director of Business Development since 2001, and is currently our manager of Licensing. Prior to joining our Group, Mr. Lisot worked for three years at Morgan Stanley International Limited, in the corporate finance sector of the Private Wealth Management Group.

**Giovanni Materassi** joined our Group in 1988 as Sales Manager for Italy, and in 1992 became Sales Manager for other European sales areas. He has been Manager of our Business Unit 1 (Europe, Middle East, India

and South Africa) since 1997. Prior to joining our Group, Mr. Materassi had been a Sales Area Manager for Stefanel and for Superga.

**Mario Pietribiasi** joined us in 1987 as Area Manager, and in 1993 became Sales Director of other European sales areas. In 1997, he became Managing Director and manager for our Business Unit 2 (Asia). Prior to joining our Group, he was Area Manager for Cartiera Rossi and for Simod.

**Francesco Tagliapietra** joined us in 1997 as Senior Controller and has been our Director of Administration and Control since 2001. He oversees the department responsible for budgeting, reporting and administration. Prior to joining us, Mr. Tagliapietra was a consultant with two consultancy firms and a controller for Alfa Laval Artec S.p.A.

**Alessandro Visconti** has been manager of our human resources department since 1997. Prior to joining our Group, Mr. Visconti had been manager of human resources at Ricordati S.p.A., Glaxo S.p.A. and Jolly Hotel S.p.A.

**Board of Statutory Auditors and Independent Auditors**

Pursuant to Italian law, we also maintain a Board of Statutory Auditors, composed of three individuals who are required to have no other affiliation with us and who must satisfy certain professional criteria and other standards. The Board of Statutory Auditors is required to verify that: (i) we comply with applicable law and bylaws; (ii) we comply with the principles of fair management; (iii) our organizational, administrative and accounting structure is adequate and in operation. Although members of the Board of Statutory Auditors are required to attend the meetings of the board of directors and shareholders, they do not vote at such meetings.

The Board of Statutory Auditors is required to meet at least once each quarter and is also obliged to report specific matters to the shareholders and to the courts. Any member of the Board of Statutory Auditors may request information directly from the Board of Directors; and the Board of Statutory Auditors or any two of its members may, subject to prior notification to the Chairman of the Board of Directors, call meetings of the shareholders, the Board of Directors and the executive committee, if any. The Statutory Auditors may also request information from the Directors regarding our management, carry out inspections at the Company and exchange information with our external auditors.

The following table sets forth the current members of the Board of Statutory Auditors and their dates of birth. The current Board of Statutory Auditors was appointed by the ordinary shareholders' meeting on April 29, 2005. The Board of Statutory Auditors was nominated for a three-year period and its mandate is due to expire upon approval of the financial statements as at and for the year ending December 31, 2007. Pursuant to our By-laws, the members to the Board of Statutory Auditors are elected for a maximum term of three-year terms and may be re-elected.

| Office | Name | Date of Birth |
|---|---|---|
| Chairman | Franco Corgnati | July 10, 1942 |
| Regular Auditor | Paolo Mazzi | October 10, 1946 |
| Regular Auditor | Lorenzo Lago | February 1, 1966 |
| Alternate Auditor | Giampietro Sala | February 17, 1938 |
| Alternate Auditor | Ornella Rossi | January 20, 1946 |

**Independent Auditors**

Our annual financial statements have to be audited by independent auditors appointed by the shareholders at a general meeting. Our Board of Statutory Auditors expresses an opinion on such an appointment. The external auditors verify that the financial statements of the company fairly present the financial position of the company and its results of operations in accordance with IFRS approved by the European

Commission. The independent auditors express their opinion on the financial statements in a report that may be consulted by shareholders prior to the relevant shareholders' meeting. The general shareholder's meeting held on March 7, 2006 appointed PricewaterhouseCoopers S.p.A. as statutory auditor for the six-year period ending with the approval of the statutory financial statements as of December 31, 2010.

## COMPENSATION

### Board of Directors' and Board of Statutory Auditors compensation

According to Company by-laws, the Board of Directors and the Board of Statutory Auditors receive reasonable compensation plus reimbursement for out of pocket expenses that they incur in connection with their service as members of the Board of Directors and Board of Statutory Auditors, respectively. The following table illustrate the compensation paid to the members of our Board of Directors (directors' fees, any salary, bonuses and benefits) and compensation paid to the Board of Statutory Auditors (auditors' fees) for the year ended December 31, 2005.

| Name | Office | Our Company *(Euro/000)* | Our Subsidiaries *(Euro/000)* |
|---|---|---|---|
| **Board of Directors** | | | |
| Vittorio Tabacchi | Chairman | 1,506 | 550 |
| Giannino Lorenzon | Vice-Chairman | 485 | 641 |
| Roberto Vedovotto | Chief Executive Officer | 1,285 | 540 |
| Carlo Maria Calabria[7] | Director | 7 | - |
| Thompson Dean[8] | Director | 20 | - |
| Ennio Doris[9] | Director | - | - |
| Carlo Gilardi | Director | 20 | - |
| Julian Masters[8] | Director | 13 | - |
| Charles Paul Pieper[8] | Director | 13 | - |
| Riccardo Ruggiero | Director | - | - |
| Massimiliano Tabacchi | Director | 395 | - |
| Colin Taylor[8] | Director | 20 | - |
| **Board of Statutory Auditors** | | | |
| Franco Corgnati | Chairman | 27 | 2 |
| Lorenzo Lago | Regular Auditor | 18 | 2 |
| Paolo Mazzi | Regular Auditor | 18 | 3 |

### Management Compensation

Members of our management team are compensated on the basis of a fixed salary plus a bonus based on economic and qualitative performance objectives. The aggregate compensation, including bonuses, paid by the Company during 2005 to the senior executives amounted to €2.7 million.

[7] *Resigned on April 22, 2005.*
[8] *Resigned on February 15, 2006.*
[9] *Appointed at the general meeting of the shareholders of March 7, 2006.*

### Stock Option Plans

On February 25, 2003, the shareholders' meetings of Safilo Group S.p.A. and of Safilo S.p.A. approved the 2003-2007 Plan - "Stock Option plans of the Safilo Group S.p.A. and Safilo S.p.A. 2003-2007".

In execution of the 2003-2007 Plan, some employees and consultants of the Group were vested with exercisable options on a maximum number of 992,128 ordinary shares of Safilo Group S.p.A. or, whenever specific events arise, on a maximum number of 672,510 ordinary shares of Safilo S.p.A.

On November 24, 2004 and December 16, 2004 respectively, the shareholders' meetings of Safilo Group S.p.A. and of Safilo S.p.A. approved the 2004-2008 Plan - "Stock Option plans of the Safilo Group S.p.A. and Safilo S.p.A. 2004-2008".

In execution of the 2004-2008 Plan, some employees and consultants of companies the Group were vested with exercisable options on a maximum number of 1,004,079 ordinary shares of Safilo Group S.p.A. or, whenever specific events arise, on a maximum number of 714,285 ordinary shares of Safilo S.p.A.

The option rights relating to the 2003-2007 Plan matured on March 1, 2005, while those relating to the 2004-2008 Plan matured on the quotation of the Safilo Group S.p.A.

All of the rights relating to the above-mentioned plans, in accordance with the provisions contained in the respective regulations, as modified on October 24, 2005, following the listing of Safilo Group S.p.A. were exercisable exclusively on the shares of Safilo Group S.p.A. in two tranches: (i) in relation to 50% of the rights, before the commencement in trading of the shares of Safilo Group S.p.A. on the MTA segment in order to permit the beneficiaries to subscribe for shares of Safilo Group S.p.A. and the sale of the shares on the Institutional Placement, (ii) in relation to the remaining 50% of the rights, from the first working day after the expiry of 180 days from the commencement of trading of the shares of Safilo Group S.p.A. on the MTA segment.

It should be noted that the beneficiaries of the 2003-2007 and 2004-2008 Plans have exercised the first tranche of the option rights relating to these plans for a total of 986,813 rights of which 755,785 relating to the first stock option plan at a price of Euro 2.5325 per share (including nominal price and share premium) and 231,028 rights relating to the second plan at a price of Euro 3.5438 per share (including nominal price and share premium) totalling 3,947,252 shares with total receipts of approximately €10.9 million.

## BOARD PRACTICES

Safilo S.p.A. Directors are appointed at the general meeting of the shareholders to serve a maximum 3 years term. The terms of all current directors will expire upon approval of the financial statements as at and for the year ending December 31, 2005.

The Board must consist of a minimum of 3 members and a maximum of 11 members, and the Directors may be re-elected. They may be removed at any time by the voting shareholders at a general meeting, and they may resign at any time by written notice to the Board of Directors and to the Chairman of the Company's Board of Statutory Auditors. If a vacancy occurs on the Board, the remaining directors may choose an interim Director to fill the vacancy, which director will serve until the next meeting of shareholders at which meeting the shareholders will be asked to vote to ratify the nomination of the interim director.

## EMPLOYEES

### Overview

As of December 31, 2005, we had 6,384 employees worldwide, comprising 4,222 factory employees, 2,087 clerical employees and 75 executive-level employees.

We believe that the majority of our European employees are represented by trade unions. We consider our relationship with the unions to be good and are committed to maintaining those relationships. We have not experienced any material labor strikes or disruptions.

The following tables set forth the number of our employees as of December 31, 2004 and 2005, broken down by job function and by job location.

| | December 31, 2004 | 2005 |
|---|---|---|
| Headquarter (Padova – Italy) | 707 | 765 |
| Factory personnel | 4,561 | 4,192 |
| Subsidiaries | 1,024 | 1,053 |
| Solstice – retail chain | 221 | 374 |
| **Total** | **6,513** | **6,384** |

| | December 31, 2004 | | | December 31, 2005 | | |
|---|---|---|---|---|---|---|
| | Italy | Other Countries | Total | Italy | Other Countries | Total |
| Managers | 30 | 49 | 79 | 30 | 45 | 75 |
| Clerical | 749 | 1,088 | 1,837 | 805 | 1,282 | 2,087 |
| Factory | 2,976 | 1,621 | 4,597 | 2,824 | 1,398 | 4,222 |
| **Total** | **3,755** | **2,758** | **6,513** | **3,659** | **2,725** | **6,384** |

***Public Fund for Employees' Salaries***

On July 21, 2005, we signed an agreement with trade unions before the Ministry of Labor in relation to our plan to close our industrial plant in Calalzo di Cadore and our two production facilities in Coseano and Ronchis. The agreement allows us to seek access to the special Italian public fund *Cassa Integrazione Guadagni Straordinaria* ("CIGS"), which is funded by contributions from both employers and employees. As of the date of this Annual Report, we obtained the authorization to access CIGS for 89 employees.

Use of CIGS entails suspension from work of each employee involved, for a maximum period of 24 months. During their CIGS suspension period, the affected employees will attend training and/or retraining courses to increase their preparation for re-entry in the labor force. At the expiry of the 24-month CIGS period, any employees who have not been relocated will be made redundant.

## SHARE OWNERSHIP

We have one shareholder, Safilo Group S.p.A., which owns 90,9% of our ordinary shares. The remaining share are owned by Safilo S.p.A. itself as treasury shares.

None of the members of the Board of Directors, the Board of Statutory Auditors or senior managers hold shares of Safilo S.p.A. or its subsidiaries.

The Chairman and some members of the Board of Directors hold shares in companies having an indirect controlling interest in Safilo S.p.A.

# ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

## MAJOR SHAREHOLDERS

Safilo's capital stock as of December 31, 2005 consisted of 35,000,000 ordinary shares with full voting rights, of which 31,824,000 are owned by Safilo Group S.p.A. and 3,176,000 are held by Safilo S.p.A. as treasury shares.

As of December 31, 2005 Safilo Group S.p.A., whose shares are publicly traded on the Italian Stock Exchange, was owned by a company controlled collectively by Vittorio Tabacchi's family, funds advised by CSFB Private Equity and the market.

## RELATED PARTY TRANSACTIONS

Safilo USA leases the premises it uses as headquarters and as a distribution center in New Jersey, United States, pursuant to a lease agreement with TBR Inc., a U.S. company that is owned (i) in part by Vittorio Tabacchi, who is our Chairman and Safilo Group S.p.A.'s shareholder and (ii) in part by one of our subsidiaries. We indirectly purchased our shareholding in TBR Inc. in 2002, for the price of €629,000. Under the lease agreement, we paid €1,107 thousands in rent for 2005. We believe that the terms and conditions of the lease, including the rent amount, are in line with market practice.

Our subsidiary Safilo Far East Limited owns 23.05% of Elegance, a company listed on the Hong Kong Stock Exchange, which produces eyewear products and produces for us as a third-party manufacturer. The prices, terms and conditions of our manufacturing contract with Elegance are in line with the prices, terms and conditions that Elegance offers to its other customers. One of our managers, Massimiliano Tabacchi, is a non-executive Director of Elegance. One of our managers, Mario Pietribiasi, owns 0.30% of the share capital of Elegance and is one of its non-executive Directors.

See note 6 to our consolidated financial statements for further information on related party relationships and transactions.

# ITEM 8. FINANCIAL INFORMATION

## CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION

See ITEM 18 "Financial Statements."

### Legal proceedings

We are currently party to various claims and legal actions that arise in the ordinary course of business. We believe such claims and legal actions, individually and in the aggregate, will not have a material adverse effect on our business, financial condition or results of operations.

In June 2005, a claim was filed with the Court of Milan against Safilo S.p.A. and other defendants for approximately €7 million in legal fees allegedly owed to an Italian law firm for legal services provided to the defendants from 1999 to 2001. We believe the claim is unsupported and that no money is to be owed to the plaintiff, and consequently we have not reserved any provision in connection with this matter. The next hearing regarding this legal proceeding has been set for November 8, 2006.

In June 2003, a claim alleging unfair business practices was filed with the Court of Rome against Safilo S.p.A. by one of our clients, who later filed bankruptcy. The claim has been taken over by the plaintiff's receiver, who seeks approximately €2 million in damages. We have denied all allegations concerning this claim. A hearing was held on November 23, 2005 to hear witness statements and the next hearing is scheduled for May 2006. Our legal counsel has advised us that the claim is unsupported, therefore we have not reserved any provision in connection with this matter.

In February 2005, two companies (having the same owner) that are clients of the Group filed two claims against Safilo S.p.A. with the Court of Vicenza, seeking €3.7 million in damages for breach of contract. We filed a response reaction challenging the jurisdiction of the Court of Vicenza. No hearing has been held (the first is scheduled for June 13, 2006) and no decision has been rendered on either the jurisdiction matter or the merits of the case. Our legal counsel has advised us that the claims are without merit. We have not reserved any provision in connection with this matter. In March 2005, we filed a claim with the Court of Padua against the same two companies, seeking payment of approximately €3.3 million, owed to us for products sold. In July 2005, the Court of Padua ruled that the full amount is due and payable to us and ordered that the two companies pay us approximately €3.3 million. The two companies are currently challenging this order. On January 19, 2006 the Court of Padua postponed its decision after the resolution of the Court of Vicenza. Next hearing on the matter is scheduled for July 14, 2006.

### Dividend Policy

Payment of an annual dividend is subject to the approval of our shareholders at an ordinary shareholders' meeting, which must be convened within 120 days, or, in certain exceptional circumstances, 180 days, after the end of the financial year to which it relates. It is the practice in Italy that the shareholders vote on a proposal made by a company's Board of Directors as to the amount of a dividend.

As provided by Italian law, before dividends may be paid with respect to any financial year, we must allocate at least 5% of our net income for such year as legal reserve, until such reserve, including amounts set aside during prior years, is equal to at least 20% of the aggregate nominal value of our issued share capital. Net income allocated to dividends is divided in accordance with the resolutions approved by a shareholders' meeting. Dividends are payable on the date specified by the shareholders' meeting. Dividends not claimed within five years from the date upon which they become payable will be forfeited to us.

Safilo S.p.A. did not pay any dividends to its shareholders for the year ended December 31, 2004 and December 31, 2005.

The declaration and payment of future dividends to our shareholder Safilo Group S.p.A will be at its discretion. Our ability to pay dividends in future periods will depend on a number of factors, including, but not limited to, our financial position, results of operations, distributable reserves, cash flows, prospects, capital requirements, as well as general economic conditions and statutory restrictions.

## SIGNIFICANT CHANGES

In the period subsequent to the closing of the financial year, there were no events that could be considered to significantly affect the data contained in the present report.

During the first quarter of 2006 a significant increase in orders has taken place; the Group is facing, with some difficulties, this growth by increasing its production capability.

On January 13, 2006, the subsidiary Safilo Capital International S.A., with headquarters in Luxembourg, made an advance repayment of 35% of the bonds listed on the Luxembourg market (Senior notes 9 5/8%), for a total amount of nominal Euro 105,000 thousand.

At the end of January 2006 the Group completed a significant step of the "lean manufacturing project", which resulted in the closure of the manufacturing activities in the plants of Calalzo, Coseano and Ronchis.

On January 27, 2006, the Group announced the non-renewal of the license agreement for the production and distribution of Ralph Lauren sunglasses, which expires on December 31, 2006. This license had an impact of 10% of the entire turnover. Appropriate actions have already been taken to minimize the impact of this missing renewal in 2006 and subsequent years.

## ITEM 9. THE OFFER AND LISTING

### Offer and listing details

The Company has 9.625% senior notes due May 2013, issued through its subsidiary Safilo Capital International S.A.(the "Notes"), listed on the Luxembourg Stock Exchange. The table below sets forth the annual high and low closing sales prices of the Notes, as reported by Bloomberg L.P., for the three most recent full financial years since the Notes began trading on the Luxembourg Stock Exchange in May 2003:

| | High | Low |
|---|---|---|
| **2003** | 105.09% | 86.04% |
| **2004** | 102.37% | 76.74% |
| **2005** | 113.15% | 100.60% |

The table below sets forth, by fiscal quarter, the high and low closing sales prices of the Notes, as reported by Bloomberg L.P., for the two most recent full financial years:

| | High | Low |
|---|---|---|
| | - | - |
| **2004** | | |
| First quarter | 87.58% | 76.74% |
| Second quarter | 94.32% | 86.00% |
| Third quarter | 96.83% | 93.78% |
| Fourth quarter | 102.38% | 96.60% |
| **2005** | | |
| First quarter | 107.78% | 101.54% |
| Second quarter | 108.41% | 100.60% |
| Third quarter | 112.87% | 107.88% |
| Fourth quarter | 113.15% | 111.94% |

The table below sets forth the high and low closing sale prices of the Notes, as reported by Bloomberg L.P., for the most recent six months:

| | High | Low |
|---|---|---|
| | - | - |
| **2005** | | |
| October | 113.15% | 112.49% |
| November | 112.77% | 112.03% |
| December | 112.39% | 111.94% |
| **2006** | | |
| January | 114.41% | 112.06% |
| February | 114.36% | 113.37% |
| March | 113.49% | 113.20% |

# ITEM 10. ADDITIONAL INFORMATION

## MEMORANDUM AND ARTICLES OF ASSOCIATION

### Registration

As set forth in Article 4 of the Articles of Association, the Company's corporate purposes are:

a) carrying out, directly or indirectly, through subsidiaries or affiliates, in Italy or abroad, activities in the field of the manufacturing and marketing of eyeglasses frames, sunglasses, sport glasses, lenses, machinery and equipment for the production of eyewear and other accessories for optics, sport and leisure-time gadgets;

b) the acquisition, negotiation and management of shareholdings in companies operating in the sectors of optics and precision mechanics; implementation of financial transactions; financing of subsidiaries or affiliates and execution of financial agreements for the technical and financial co-ordination of their activities, except that any activity deemed "financial" under the law will not be carried out in relation to the public at large but exclusively within the Group;

c) advising on the economic, administrative, structural and commercial planning of some sectors of the market or of single enterprises; their restructuring; feasibility studies on acquisitions of companies; management of development programs for relationships with foreign countries; management of industrial and commercial enterprises operating in the field of optics and precision mechanics. The company may carry out all commercial and industrial transactions, on movable or immovable property, which the Board deems necessary or instrumental to achieve the corporate purpose; it may receive loans from its shareholders, and grant or receive intra-group loans; it may give guarantees and endorsements, and any other security, provided not in relation with the public; it may represent national or foreign enterprises, and directly or indirectly, purchase shares in other companies, consortia, partnerships and enterprises which have an identical, similar related corporate purpose.

### Directors' Voting Powers

Under Italian law, attendance of a majority of the Board of Directors at a Board meeting is required in order to establish a quorum.

Any director also may participate in any meeting of the Board in person, by telephone conference call, video conference or by any other similar means allowing all directors participating in the meeting to hear one another.

There is no age limit for Directors and there are no requirements that a Director must own a minimum number of shares in order to qualify to act as a Director.

According to Italian law, in the case of a conflict of interest of a Director, the Director must inform the Board of Directors and the Board of Auditors of the conflict and should abstain from voting on any issue in which he is materially interested.

Shareholders vote on Director's compensation at the general meeting of shareholders which appoints the Board. The Board of Directors may determine specific compensation for those of the directors appointed in the Board of Directors with the specific offices of Chairman, Vice Chairman and Chief Executive Officer.

**Share Rights, Preferences and Restrictions**

The authorized and issued share capital is EUR 35,000,000.00, divided into 35,000,000 ordinary shares, each with a nominal value of EUR 1.00.

The shareholders' meeting may, in the circumstances provided for by law, reduce the share capital by assigning to the single shareholders certain assets of the company ("attività sociali") or shares/quotas of other companies which it owns.

***Pre-emption Rights***

New issue of ordinary shares or other classes of capital stock may be authorized by a shareholder's resolution passed at an extraordinary shareholders' meeting. The articles of association may also authorize the Board of directors to increase the share capital up to a pre-defined amount within a five-year period. Pursuant to Italian law, shareholders are entitled to subscribe for new issues of: (i) shares; (ii) debt instruments convertible into ordinary shares; and (iii) any other instruments such as warrants, rights or options entitling the holder to acquire shares, in each case in proportion to their respective shareholdings. Subject to certain conditions and special voting majorities principally designed to prevent dilution of the rights of shareholders these pre-emption rights may be waived or limited in whole or in part for all such shareholders for any particular issue of such securities, but only by way of a resolution adopted at an extraordinary meeting with the affirmative vote of shareholders representing more than 50% of the outstanding shares, even if such vote is taken at a shareholders' meeting held on a second or third call and provided that our interest so requires. In any event such pre-emption rights will not apply where the increase in share capital is to be subscribed by way of a contribution in kind.

Pre-emption rights can also be limited when the newly issued shares are offered for subscription to our employees or employees of our subsidiaries or of the controlling company. Pursuant to Italian law, resolutions that exclude pre-emption rights for less than one quarter of the newly issued shares must be adopted at an extraordinary meeting with the required majorities. When the exclusion of pre-emption rights relates to more than one quarter of the newly issued shares when these are offered for subscription to our employees or employees of our subsidiaries or of the controlling company then the relevant resolution must be adopted with the affirmative vote of shareholders representing more than 50% of the outstanding shares, even if such vote is taken at a shareholders' meeting held on the second call.

***Different Classes of Shares***

In accordance with Italian law, we are permitted to issue different classes of shares, defining the rights to which such shares will be entitled, within the limits of the applicable law. We could issue shares that may not have the right to vote in any shareholders' meeting or only in certain shareholders' meetings or regarding certain matters or under certain conditions, to be defined in the by-laws. We could issue shares that may have preferential rights with respect to the payment of dividends and to the repayment of capital in the event of liquidation.

**Shareholders' Meetings**

Under Italian law, shareholders' meetings may be either ordinary or extraordinary.

The ordinary shareholders' meeting must be convened at least once a year, within 120 days from the end of the financial year, or within 180 days in case certain conditions are met.

The Board of Directors may also call a meeting whenever it deems it appropriate and it is required by Italian law to promptly call a shareholders' meeting upon the request of shareholders representing at least 10% of the issued and outstanding share capital, or a lower percentage if the By-laws so provide. Additionally, the Board of Statutory Auditors, or the president of the Court that has jurisdiction over the company has the duty to call shareholders' meetings in certain circumstances under Italian law, by giving Notice.

According to the By-Laws, meetings are called by the Board of Directors by giving a written notice that states the date, time, place and agenda for the meeting (the "Notice"). According to the By-Laws, shareholders are informed of all shareholders' meetings to be held by publication of the Notice in the *Gazzetta Ufficiale*, or,

alternatively, by transmission of the Notice through means which guarantee its receipt by the addressee at least 8 days before the meeting in the first call. The notice may specify a date for a second call in the event that the quorum required by the law for the validity of the shareholders' meeting and its resolutions is not met in the first call.

The provisions of the Italian Civil Code will apply to determine the valid constitution of shareholders' meetings and the validity of their resolutions. Meetings may be held by video or telephone conference if some conditions aimed at ensuring full participation by all shareholders are met.

Shareholders who hold ordinary shares are entitled to attend and vote both at ordinary and extraordinary shareholders' meetings. Each holder will be entitled to cast one vote for each Share held. Votes may be cast personally or by proxy. However, the voting rights of shares held in breach of applicable law may in some cases not be exercised.

Resolutions adopted at a shareholders' meeting are binding on all shareholders, including dissenting or absent shareholders. However, pursuant to Italian law, any shareholders who do not vote in favour of a resolution passed at a shareholders' meeting or who do not attend such meeting or abstain from voting, representing a shareholding equal to or higher than 5% of the share capital of a company (as well as all directors and statutory auditors) are entitled to challenge the resolution on the basis that it was taken in violation of the applicable laws or By-laws. Such challenges must be made within 90 days from the date of the resolution or, if the resolution is subject to required registration in the companies' register, within 90 days of registration.

There are no restrictions arising under Italian law or the By-laws on the rights of non-resident or foreign persons to hold or vote the shares other than those limitations that apply generally to all shareholders.

***Change in Control***

The transfer of Company's shares is no longer subject to the pre-emption right in favour of the other Shareholders, due to the resolution of the shareholders' extraordinary meeting which amended the articles of association of the Company.

**Liquidation Rights**

Under Italian law, and subject to satisfaction of the claims of all other creditors, shareholders are entitled to a distribution of the remaining liquidated assets in proportion to the nominal value of the shares they hold in the capital stock. Thereafter, if there were surplus assets, shareholders of ordinary shares would rank equally in their claims to the distribution of such surplus assets, unless the share capital of the company includes classes of shares that have preferential rights with respect to distribution of the company assets in case of liquidation.

**Purchase by us of our own shares**

We may purchase our own shares, subject to certain conditions and limitations imposed by applicable law and provided that the shares are fully paid. These purchases must be authorized by the ordinary shareholders' meeting and only paid out of retained earnings or distributable reserves remaining from the last approved unconsolidated financial statements. Further, we may only repurchase fully paid shares. The nominal value of shares to be repurchased, together with any shares previously repurchased by us or any of our subsidiaries, may not (except in limited circumstances) exceed in the aggregate 10% of the company's share capital then issued and outstanding.

We are not entitled to vote or to receive dividends on the shares we own. Neither we nor any of our subsidiaries can subscribe for new shares in the case of capital increases, except the case where shareholders, within the limits described above, may authorize the exercise of our pre-emption right on our own shares. Ordinary shares owned by us and our subsidiaries count at shareholders' meetings for quorum purposes.

In 2002 Safilo S.p.A. repurchased 3,176,000 ordinary shares or 9.1% of Share Capital for an aggregate cost of €80,988 thousands.

**Company and shareholders' actions against our board of directors**

Under Italian law, actions against members of a board of directors may be brought by a company pursuant to a resolution adopted by the ordinary shareholders' meeting. In addition, under Italian law, a single shareholder may bring an action against the members of a board of directors in respect of any damage directly suffered for negligence or wilful misconduct within five years from the occurrence of the event that prejudiced shareholders.

**Shareholders' Agreements**

There are no shareholders' agreements concerning the company.

## MATERIAL CONTRACTS

**Senior Credit Facilities and Senior Notes**

Safilo S.p.A. and certain of its direct and indirect subsidiaries entered into a senior credit agreement with Credit Suisse First Boston, Milan Branch, Sanpaolo IMI S.p.A. and Unicredit Banca Mobiliare S.p.A. as arrangers, the banks and financial institutions named therein as lenders, and Unicredit Banca Mobiliare S.p.A. as facility agent, security agent and issuing bank.

In 2003, our affiliate Safilo Capital International S.A. issued €300,000,000 9 5/8% Senior Notes. The Senior Notes are guaranteed on a senior subordinated basis by Safilo S.p.A. and certain of its subsidiaries and are governed by an indenture dated May 15, 2003 between Safilo S.p.A., Safilo Capital International S.A., Safilo Group S.p.A. and certain subsidiaries and The Bank of New York as Trustee.

For details, see section entitled "Liquidity and Capital Resources" included in Item 5.

**Put Option Agreement**

Safilo Capital International S.A., the issuer of the notes, is owned by Safilo S.p.A. and Safilo International B.V., a subsidiary of Safilo S.p.A. Pursuant to the put option agreement, Safilo S.p.A. has the right to put the shares of Safilo Capital International S.A. to Safilo S.p.A.'s parent company, Safilo Group S.p.A. The put right has been assigned to Unicredit Banca Mobiliare S.p.A., as the security agent for the lenders under the senior credit agreement. The effect of the put option agreement and the assignment is to allow the lenders, if they enforce their security pursuant to a company share charge enforcement sale, to exclude Safilo Capital International S.A. from a sale of the Safilo Group S.p.A..

**Intercreditor Agreement**

As part of our refinancing in 2003, we entered into an intercreditor agreement to establish the relative rights of certain creditors dated as of May 15, 2003, between Safilo Capital, Safilo, its parent Safilo Group S.p.A., the subsidiary guarantors of the Notes, the lenders under the senior credit agreement and The Bank of New York as the trustee under the indenture for the Notes. The intercreditor agreement restricts, among other things, the ability of the obligors under the notes:

- if there is a payment default under the senior credit agreement or if there is an outstanding payment blockage notice, to make payments on;
- to grant security for;
- otherwise to provide financial support in relation to

the Notes and the related guarantees for so long as any indebtedness under the senior secured credit facilities remains outstanding. The postponement, subordination, blockage or prevention of payment on the issuer loan agreement is not a waiver by the issuer of its claims and other rights under the issuer loan agreement. Payments on the issuer loan agreement shall remain due and payable, and interest shall continue to accrue.

Any of the trustees under the indenture and the note holders may bring an action to enforce the obligations of Safilo Capital and the guarantors under the notes and guarantees. The intercreditor agreement does not restrict enforcement in respect of the Notes against the Safilo Capital, but does not permit other enforcement action against the guarantors and places certain limitations on enforcement action of Safilo Capital in respect of the issuer loan agreement.

In the event of insolvency, the intercreditor agreement provides that all obligations in respect of the Notes, the guarantees and the issuer loan agreement are subordinated to the prior payment in full of all obligations under the senior credit agreement. Any release by the lenders under the senior credit agreement of their security for the shares of Safilo S.p.A. must be a release of the security over all of the shares and not part of them. In the event the lenders enforce their security over these shares and the shares are sold, the intercreditor agreement provides for certain circumstances in which the guarantors of the Notes shall be released from all their obligations relating to the Notes.

**Factoring agreement**

In 2004 we entered into a without-recourse factoring agreement with Centro Factoring S.p.A. We transfer some of our Italian trade receivables on a revolving basis and receive an up-front payment of 85% of the face value of the receivables we sell. The difference between cash received and trade receivables sold will be collected at its maturity date. We have a servicing obligation to act as a collection agent on behalf of Centro Factoring S.p.A.

As of December 31, 2005 the amount due to the factor was €28.3 million.

## ITALIAN EXCHANGE CONTROLS

*The following is a summary of relevant Italian laws in force as of the date of this Annual Report but does not purport to be a comprehensive description of all exchange control considerations that may be relevant.*

There are no exchange controls as such in Italy restricting rights deriving from the ownership of Notes. Residents of Italy may hold foreign currency and foreign securities of any kind, within and outside Italy. Non-residents may invest in Italian securities without restriction and may transfer to and from Italy cash, instruments of credit and securities, in both foreign currency and Euro, representing interest, dividends, other asset distributions and the proceeds of dispositions.

Certain procedural requirements, however, are imposed by Italian legislation that implements an EC directive regarding the free movement of capital. Such legislation requires that transfers into or out of Italy of cash or securities in excess of €12,500 be reported in writing to the *Ufficio Italiano dei Cambi* (the Italian Exchange Office) by residents or non-residents that effect such transfers directly, or by credit institutions or other intermediaries that effect such transactions on their behalf. In addition, credit institutions and other intermediaries effecting such transactions on behalf of residents or non-residents of Italy are required to maintain records of such transactions for five years, which may be inspected at any time by Italian tax and judicial authorities. Non-compliance with these reporting and record-keeping requirements may result in administrative fines or, in the case of false reporting and in certain cases of incomplete reporting, criminal penalties. The *Ufficio Italiano dei Cambi* is required to maintain reports for a period of ten years and may use them, directly or through other government offices, to police money laundering, tax evasion and any other crime or violation.

Individuals and non-profit entities that are residents of Italy must disclose on their annual tax declarations all investments and financial assets held outside Italy, as well as the total amount of transfers to, from, within and between countries other than Italy relating to such foreign investments or financial assets, even

if at the end of the taxable period such persons no longer owned such foreign investments or financial assets. Such disclosure requirement does not apply if the total value of the investments and assets at the end of the taxable period or the total amount of the transfers carried out during the year is not greater than €10,300. Corporations and partnerships resident in Italy are exempt from such disclosure requirements with respect to their annual tax declarations because this information is required to be disclosed in their financial statements.

There can be no assurance that the present regulatory environment in or outside Italy will continue or that particular policies presently in effect will be maintained, although Italy is required to maintain certain regulations and policies by virtue of its membership of the EU and other international organizations and its adherence to various bilateral and multilateral international agreements.

## TAXATION

### Taxation related to Notes

#### U.S. Federal Income Tax Considerations

The following discussion is a summary of certain material U.S. federal income tax consequences of the purchase, ownership and disposition of the notes by U.S. Holders (as defined below). The summary is not a complete analysis or description of all potential tax consequences to U.S. Holders and does not address all tax considerations that may be relevant to all categories of holders (such as dealers or traders in securities, commodities, or currencies, tax-exempt investors, investors whose "functional currency" is not the U.S. dollar, investors who own 10 percent or more of our voting stock, financial institutions, thrifts, regulated investment companies, insurance companies, grantor trusts, individual retirement accounts or other tax-deferred accounts, partnerships and other pass-through entities and persons who hold the notes through such partnerships or other pass-through entities, investors that hold the notes as part of a "hedging", "integrated", "conversion" or constructive sale transaction, as part of a "synthetic security" or a "straddle", persons who have ceased to be U.S. citizens or to be taxed as resident aliens, or investors liable for the alternative minimum tax).

This summary is based on the Internal Revenue Code of 1986, as amended (the "Code"), judicial decisions, administrative pronouncements, and existing and proposed U.S. Treasury Regulations, changes to any of which after the date of this annual report could apply on a retroactive basis and affect the tax consequences described herein.

You are a U.S. Holder if you are, for U.S. Federal income tax purposes:

- a citizen or resident of the United States;
- a corporation, or other entity treated as a corporation, created or organized in or under the laws of the United States or any State;
- an estate, the income of which is subject to U.S. federal income taxation regardless of its source; or
- a trust:
  - (a) the administration of which is subject to the primary supervision of a court within the United States and for which one or more U.S. persons have the authority to control all substantial decisions; or
  - (b) that has a valid election in effect under applicable U.S. Treasury Regulations to be treated as a U.S. person.

If a partnership holds notes, the U.S. federal income tax treatment of a partner generally will depend upon the status of the partner and the activities of the partnership. Partners of partnerships holding the notes should consult their own tax advisors concerning the associated tax consequences.

Holders of the notes should consult their own tax advisors concerning the U.S. Federal, state and local tax consequences of the purchase, ownership and disposition of the notes.

*Payments of Interest*

Payments of interest on a note will be includible in the gross income of a U.S. Holder as ordinary income from foreign sources at the time it is received or accrued, in accordance with the U.S. Holder's method of accounting for U.S. federal income tax purposes, under the rules set forth below.

In the case of a U.S. Holder that is not required to accrue interest income prior to the receipt thereof (for example, an individual U.S. Holder who uses the cash method of accounting), the amount of interest income in respect of any interest payment will be determined by translating such payment into U.S. dollars at the spot exchange rate in effect on the date such interest payment is received. No exchange gain or loss will be realized with respect to the receipt of such interest payment, other than exchange gain or loss that is attributable to the actual disposition of the euros received.

In the case of a U.S. Holder that is required to accrue interest income prior to receipt thereof (for example, a U.S. Holder that uses the accrual method of accounting), the amount of any interest income accrued during any accrual period will generally be determined by translating the accruals into U.S. dollars at the average spot exchange rate applicable to the accrual period, or, with respect to an accrual period that spans two taxable years, the part of the period within the taxable year. A U.S. Holder will additionally realize exchange gain or loss with respect to any interest income accrued on the date such interest income is received (or on the date the note is disposed of) in an amount equal to the difference between (x) the amount determined by converting the amount of the payment received into U.S. dollars at the spot exchange rate in effect on the date such payment is received (or on the date the note is disposed of) and (y) the amount of interest income accrued in respect of such payment according to the rule set forth in the preceding sentence. Notwithstanding the preceding two sentences, a U.S. Holder that is required to accrue interest income prior to receipt thereof may alternatively make an election to apply a "spot accrual convention," as set forth in Section 1.988-2(b)(2)(iii)(B) of the U.S. Treasury Regulations. A U.S. Holder who makes this election translates accrued interest into U.S. dollars at a single spot exchange rate, which is generally the rate in effect on the last day of the accrual period or, in the case of an accrual period that spans two taxable years, the exchange rate in effect on the last day of the part of the accrual period within the taxable year. If the last day of the accrual period is within five business days of the date the interest payment is actually received, an electing accrual basis U.S. Holder may instead translate that interest payment at the exchange rate in effect on the day of actual receipt. This election must be applied consistently to all debt instruments from year to year and cannot be changed without consent from the Internal Revenue Service. Exchange gain or loss is treated as ordinary income or loss from sources within the United States for U.S. federal income purposes.

Interest payments on a note received by a U.S. Holder will be treated as foreign source income for purposes of computing the U.S. Holder's foreign tax credit allowable under U.S. federal income tax law. The rules relating to foreign tax credits and the timing thereof are complex and U.S. Holders should consult their own tax advisors regarding the availability of a foreign tax credit and the application of foreign tax credit limitations to their particular situation.

*Sale, Exchange, Retirement and Other Disposition of the Notes*

Upon the sale, exchange, retirement or other disposition of a note, a U.S. Holder will generally recognize taxable gain or loss equal to the difference between the amount realized (not including any amounts received that are attributable to accrued and unpaid interest, which will be taxable as interest income, and exchange gain or loss on such accrued, unpaid interest, as set out above) and the U.S. Holder's tax basis in the note. A U.S. Holder's tax basis in a note generally will be its U.S. dollar cost calculated at the exchange rate in effect on the date of purchase. The amount realized on the sale, exchange or retirement of a note for an amount of foreign currency will be the U.S. dollar value of that amount on (i) the date the payment is received in the case of a cash basis U.S. holder, (ii) the date of disposition in the case of an accrual basis U.S. holder, or (iii) in the case of a note traded on an established securities market (as defined in the applicable U.S. Treasury Regulations), that is sold by a cash basis U.S. holder (or an accrual basis U.S. holder that so elects), on the settlement date for the sale.

Gain or loss on the sale, exchange or retirement of a note that is attributable to changes in currency exchange rates will be ordinary income or loss and will be characterized as principal exchange gain or loss. Principal exchange gain or loss will generally equal the difference between the U.S. dollar value of the issue price of the note in foreign currency determined using the spot exchange rate on the date of the sale, exchange or retirement, and the U.S. dollar value of the issue price of the note in foreign currency determined using the spot exchange rate on the date the U.S. Holder acquired the note. Such gain or loss will be recognized only to the extent of the total gain or loss realized by the U.S. Holder on the sale, exchange or retirement of the note, and will generally be treated as ordinary income or loss from sources within the United States for U.S. federal income tax purposes.

Gain or loss in excess of principal exchange gain or loss will be capital gain or loss, and will be long-term capital gain or loss if the note was held for more than one year at the time of the disposition. Certain U.S. Holders (including individuals) are eligible for preferential rates of U.S. federal income tax in respect of long-term capital gain. The deduction of long-term capital losses is subject to significant limitations. Gain or loss recognized by a U.S. Holder generally will be treated as U.S. source income or loss.

*Non-US Holders*

As used herein, a non-US Holder is a person who is not a US Holder. Subject to the discussion concerning information reporting and backup withholding below, generally, a non-US Holder will not be subject to US federal income tax on payments of interest on, or gain on the sale of a note, unless such non-US Holder held the note in connection with a US trade or business carried on by such non-US Holder, or in the case of the sale of a note to a non-US Holder who is an individual, such individual was present in the US for 183 days or more during the tax year in which such gain is realized and certain other conditions are met.

*Backup Withholding and Information Reporting*

The paying agent or the financial intermediary through whom you hold the notes may be required to file information returns with the US Internal Revenue Service in connection with payments made in respect of a note to certain US persons. If you are a US Holder, you generally will not be subject to a US backup withholding tax on such payments if you provide your taxpayer identification number and certain other information in the required manner to such paying agent or financial intermediary. You may also be subject to information reporting and backup withholding tax requirements with respect to the proceeds from a sale or other disposition of the notes. If you are a non-US Holder, you may have to comply with certification procedures to establish that you are not a US person in order to avoid information reporting and backup withholding tax requirements. Backup withholding is not an additional tax. Amounts withheld as backup withholding may be credited against a holder's US federal income tax liability.

**Italian Tax Considerations**

*The statements herein regarding taxation are based on the laws in force in Italy as of the date of this Annual Report and are subject to any changes in law occurring after such date, which changes could be made on a retroactive basis. The following summary does not purport to be a comprehensive description of all the tax considerations which may be relevant to non-individual holders or to individual holders that hold notes in a business.*

***Interest on the Notes***

Interest, premium and other proceeds paid on Notes by the non-resident Issuer to a beneficial owner who is not resident in Italy for tax purposes, without a permanent establishment in Italy to which the Notes are effectively connected, should not be subject to any Italian taxation.

If you are a resident of Italy for Italian tax purposes, and you are a private individual holding Notes not in connection with entrepreneurial activity, payments of interest, premium and other proceeds in respect on the Notes

will be subject to final *imposta sostitutiva* (substitute tax) at a rate of 12.5%. The 12.5% final *imposta sostitutiva* will be applied by the Italian resident qualified financial intermediaries that will intervene, in any way, in the collection of Interest, premium and other proceeds on the Notes or in the transfer of the Notes. Where interest, premium and other proceeds, on the Notes are not collected through the intervention of an Italian resident qualified financial intermediary and as such no *imposta sostitutiva* is applied, the Italian resident beneficial owners will be required to declare interest, premium and other proceeds, in their yearly income tax return and subject them to final substitute tax at a rate of 12.5%, unless option for a different regime is allowed and made.

The same regime upon described is also applicable to Italian resident beneficial owners who are partnerships, other than public and private entities, not carrying out commercial activities.

Payments of interest, premium and other proceeds in respect on the Notes, to Italian resident corporations or permanent establishments in the Republic of Italy of non resident corporations, will not be subject to the *imposta sostitutiva* at the rate of 12.5%. In fact, interest, premium and other proceeds on Notes accrued to these subjects will be included in the taxable business income for corporate income tax purposes (and, in certain cases, depending on the *status* of the Notes holders, may also be included in their taxable net value of production for purposes of regional tax on productive activities – IRAP) of such beneficial owners, subject to tax in Italy in accordance with ordinary tax rules. A tax credit for withholding taxes applied outside Italy, if any, should be generally available.

***Capital gains***

If you are not a resident of Italy for income tax purposes, gains realized on the sale or other disposition of notes will not be subject to Italian tax, even if Notes, listed on a regulated market, are held in Italy.

If capital gain, realised upon the sale for consideration or redemption of the Notes, derives by Noteholders who are Italian resident corporations, permanent establishments in Italy of foreign corporations to which the Notes are effectively connected or Italian resident individuals carrying out a commercial activity, would be treated as part of the taxable business income (and, in certain cases, may also be included in taxable net value of production for IRAP purpose), subject to tax in Italy according to the relevant tax provisions.

Any capital gain realised by Italian resident individuals holding Notes not in connection with entrepreneurial activity, upon sale for consideration or redemption of the Notes would be subject to an *imposta sostitutiva* at the current rate of 12.5%.

***Inheritance and gift taxes***

According to Law No. 383 of 18 October 2001 ("Law No. 383"), Italian inheritance and gift tax, previously payable on transfer of securities on death or by gift, has been abolished as of 25 October 2001.

However, according to the current literal interpretation of Law No. 383, for donees other than spouses, direct descendants or ancestors and other relatives within the fourth degree, if and to the extent that the value of the gift to any such donee exceeds €180,759.91, the gift of Notes may be subject to the ordinary transfer taxes that would apply if the Notes had been transferred for consideration. Future official ministerial decrees or guidelines should clarify this point.

Moreover, an anti-avoidance rule is provided by Law No. 383 for any gift of assets (such as Notes) which, if sold for consideration, would give rise to capital gains subject to Italian *imposta sostitutiva* on capital gains. In particular, if the donee sells Notes for consideration within 5 years from the receipt thereof as gift, the donee will be required to pay the relevant Italian *imposta sostitutiva* on capital gains, where applicable, as if the gift has never taken place.

***Other taxes***

No Italian transfer, stamp turnover or other similar taxes will be payable upon the issue, purchase or sale of the notes.

***Changes in The European Union "Savings Directive"***

On June 3, 2003, the Council of the European Union adopted a directive regarding the taxation of savings income (the "Directive"). The Italian government adopted the above Directive through the approval of the Legislative Decree n. 84 del 2005 and, as a consequence, companies resident in Italy are required as from July 1, 2005 to provide to the tax authorities of another Member State details of payments of interest within the meaning of the Directive (including interest, premiums, discounts or other debt income) made by a paying agent within the jurisdiction to an individual resident in that other Member State (the "Disclosure of Information Method"). The term "paying agent" is defined in the Directive as any economic operator who pays, or secures the payment of interest for the immediate benefit of individuals, who are the beneficial owners of the interest. However, throughout the transitional period, paying agents established in certain Member States (the Grand Duchy of Luxembourg, Belgium and Austria) will withhold an amount on interest payments instead of using the Disclosure of Information Method used by other Member States. The rate of such withholding tax would equal 15% for the first three years after the date of implementation of the Directive, this rate being increased to 20% (three years after the date of implementation of the Directive) and 35% (six years after the date of implementation of the Directive). Such transitional period will end if and when the European Union enters into agreements on exchange of information upon request with several jurisdictions (Switzerland, Liechtenstein, San Marino, Monaco and Andorra) and when the Council of the European Union agrees that the United States is committed to use the Disclosure of Information Method.

## DOCUMENTS ON DISPLAY

You may inspected the documents concerning us referred to this annual report at Safilo S.p.A. headquarters at Settima Strada, 15 – Padua – Italy.

## ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

In the ordinary course of our business, we are exposed to a variety of market risks arising from fluctuations in interest rates, commodity prices and exchange rates. We monitor and manage these risks as an integral part of our overall risk management program, which recognizes the unpredictability of financial markets and seeks to reduce their potentially adverse effects on our results. As a result, we do not anticipate any material losses in these areas.

We operate a central treasury function that controls all decisions and commitments regarding cash management, arrangement of borrowing facilities, banking relationships and foreign currency commitments. Our treasury operations are conducted within the framework that has been authorized by our board of directors to regulate and approve levels and the scope of decision-making of the central treasury function. Weekly reports from subsidiaries have been established to ensure that treasury related activities are appropriately managed.

To reduce our currency translation and interest rate risks, we selectively use a number of financial instruments. We do not use financial instruments for trading or speculative purposes.

**Interest Rate Risk Management**

Our income and operating cash flows are substantially independent of changes in market interest rates. Our cash flow interest rate risk arises from long-term borrowings. Borrowings issued at variable rates expose the Group to cash flow interest rate risk. We manage our cash flow interest rate risk by using floating-to-fixed interest rate swaps. Such swaps have the economic effect of converting borrowings from floating rates to fixed rates. We raise long-term borrowings at floating rates and then swap them with fixed rates instruments. Under the interest rate swaps, we agree with other parties to exchange, at specified intervals (mainly quarterly), the difference between fixed contract rates and floating market rates interest amounts calculated with reference to the agreed notional principal amounts.

As of December 31, 2005, we were hedged by 2.47 years' average swap maturity on approximately 89% of our exposure in euro and by 1.25 years' average swap maturity on approximately 60% of our exposure in U.S. dollars.

**Foreign Exchange Risk Management**

The Group operates internationally and is exposed to foreign exchange risk arising from various currency exposures, primarily with respect to the U.S. dollar. Some Group companies use derivative instruments, under the control of the Group's finance department, to manage their foreign exchange risk arising from future commercial transactions. However, unfavorable fluctuations in currency exchange rates could adversely affect our results of operations.

With respect to the U.S. dollar, Safilo S.p.A. manages cash inflows related to the portion of our net sales derived from operations outside of Europe, primarily in North America and Asia, and cash outflows related to the purchases of finished goods we obtain from third-party producers, and to the payment of interest and principal installments of the U.S. dollar denominated tranches of the Senior Credit Agreement. The net exposure resulting after offsetting such streams of cash flows is regularly assessed and hedged to safeguard our activities on a continuous basis, by using appropriate hedging instruments for periods consistent with our foreign exchange exposure. We do not enter hedging arrangements for trading or speculative purposes.

The value of the derivative products that we enter into was not recorded in our financial statements prepared according to Italian GAAP. In our financial statements prepared according to IFRS, these derivative instruments are valuated at their fair value as of the date of the financial statements.

**Commodity Price Risk Management**

Due to the limited quantities purchased, we believe that we do not face significant risks in procuring raw materials or risks associated with price variations of such raw materials. The management of commodity risk is carried out by monitoring both market supply and prices and by our procurement policies. In case of increased price volatility, and consequently, an increase in our financial exposure to such procurement risks, we are

confident that we will be able to implement appropriate policies, including the use of derivative instruments to manage such risks.

## ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

## PART II

### ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELIQUENCIES

None.

### ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

None.

### ITEM 15. CONTROLS AND PROCEDURES

Not applicable.

### ITEM 16. [Reserved]

## PART III

## ITEM 17. FINANCIAL STATEMENTS

Not applicable.

## ITEM 18. FINANCIAL STATEMENTS

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## ITEM 19. EXHIBITS

Not applicable.

# AUDITOR REPORT IN ACCORDANCE WITH ARTICLE 156 AND WITH ARTICLE 165 OF LAW DECREE N° 58 DATED 24 FEBRUARY 1998

To the Shareholder of
Safilo - Società Azionaria Fabbrica Italiana Lavorazione Occhiali S.p.A.

1 We have audited the consolidated financial statements, which comprise the balance sheet, income statement, cash flow statement, statement of recognized income and expense and the related notes of Safilo - Società Azionaria Fabbrica Italiana Lavorazione Occhiali S.p.A. and its subsidiaries as of 31 December 2005. These consolidated financial statements are the responsibility of Safilo - Società Azionaria Fabbrica Italiana Lavorazione Occhiali S.p.A.'s directors. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The aforementioned consolidated financial statements have been prepared for the first time in accordance with the International Financial Reporting Standards as adopted by the European Union.

2 We conducted our audit in accordance with the auditing standards and criteria recommended by CONSOB. In accordance with those standards and criteria, the audit has been planned and performed to obtain the necessary assurance about whether the consolidated financial statements are free of material misstatement and, taken as a whole, are reliable. An audit includes examining, on a sample basis, evidence supporting the amounts and disclosures in the financial statements, as well as assessing the appropriateness of the accounting principles used and the reasonableness of the estimates made by the Directors. We believe that our audit provides a reasonable basis for our opinion.

The responsibility for the audit of the financial statements of certain subsidiaries and associated companies, representing 1.8 per cent of the consolidated assets and 4.5 per cent of consolidated net sales, lies with other auditors.

3 The consolidated financial statements present the prior year corresponding figures prepared in accordance with the same accounting principles. Furthermore, Note 10 explains the effects of the transition to the International Financial Reporting Standards as adopted by the European Union. The information presented in Note 10 has been examined by us to

provide a basis for our opinion on the consolidated financial statement at 31 December 2005.

4 In our opinion, the consolidated financial statements of Safilo - Società Azionaria Fabbrica Italiana Lavorazione Occhiali S.p.A. Group as of 31 December 2005 comply with the International Financial Reporting Standards as adopted by the European Union; accordingly, they give a true and fair view of the financial position, the results of operations, statement of recognized income and expense and cash flows of Safilo - Società Azionaria Fabbrica Italiana Lavorazione Occhiali S.p.A. Group for the year then ended.

Padova, 12 April 2006

(This report has been translated from the original which was issued in accordance with Italian legislation. References in this report to the Financial Statement refer to the Financial Statement in original Italian and not to their translation)

PricewaterhouseCoopers SpA

signed by

Antonio Taverna
(Partner)

## Consolidated financial statements as of and for the years ended December 31, 2005 and 2004

### Consolidated Balance Sheets as of December 31, 2005 and 2004

| *(Euro/000)* | *Note* | 31/12/2005 | 31/12/2004 |
|---|---|---|---|
| **ASSETS** | | | |
| **Current assets** | | | |
| Cash in hand and at banks | *4.1* | 151,018 | 33,795 |
| Trade receivables, net | *4.2* | 307,558 | 274,067 |
| Inventory, net | *4.3* | 208,802 | 192,196 |
| Assets held for sale | *4.4* | 2,984 | - |
| Other current receivables | *4.5* | 64,733 | 31,848 |
| **Total current assets** | | **735,095** | **531,906** |
| **Non-current assets** | | | |
| Property, plant and equipment, net | *4.6* | 193,603 | 195,768 |
| Intangible assets | *4.7* | 25,580 | 21,226 |
| Goodwill | *4.8* | 365,121 | 363,161 |
| Investments in associates | *4.9* | 13,492 | 10,167 |
| Financial assets available-for-sale | *4.10* | 6,009 | 6,897 |
| Deferred tax assets | *4.11* | 49,279 | 40,658 |
| Other non-current assets | *4.12* | 2,571 | 1,826 |
| **Total non-current assets** | | **655,655** | **639,703** |
| **Total assets** | | **1,390,750** | **1,171,609** |

| (Euro/000) | Note | 31/12/2005 | 31/12/2004 |
|---|---|---|---|
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | | |
| **Current liabilities** | | | |
| Short-term borrowings | 4.13 | 184,006 | 69,918 |
| Trade payables | 4.14 | 182,633 | 173,527 |
| Tax payables | 4.15 | 20,870 | 19,179 |
| Other current liabilities | 4.16 | 80,301 | 65,463 |
| Provision for risks and charges | 4.17 | 128 | 136 |
| **Total current liabilities** | | **467,938** | **328,223** |
| **Non-current liabilities** | | | |
| Long-term borrowings | 4.18 | 468,242 | 718,006 |
| Employee benefits liability | 4.19 | 39,365 | 34,607 |
| Provisions for risks and charges | 4.17 | 8,644 | 6,356 |
| Deferred tax liabilities | 4.11 | 10,969 | 7,379 |
| Other non-current liabilities | 4.20 | 9,836 | 8,479 |
| **Total non-current liabilities** | | **537,056** | **774,827** |
| **Total liabilities** | | **1,004,994** | **1,103,050** |
| **Shareholders' equity** | | | |
| Share capital | 4.21 | 35,000 | 35,000 |
| Share premium reserve | 4.22 | 53,350 | 53,350 |
| Retained earnings/(deficit) and other reserves | 4.23 | 285,326 | (40,132) |
| Fair value and cash flow reserves | 4.24 | (3,899) | (6,342) |
| Income attributable to the Group | | 10,442 | 21,610 |
| **Total shareholders' equity attributable to the Group** | | **380,219** | **63,486** |
| **Shareholders' equity attributable to minority shareholders** | | **5,537** | **5,073** |
| **Total shareholders' equity** | | **385,756** | **68,559** |
| **Total liabilities and shareholders' equity** | | **1,390,750** | **1,171,609** |

## Consolidated Statements of Operations for the years ended December 31, 2005 and 2004

| *(Euro/000)* | *Note* | 2005 | 2004 |
|---|---|---|---|
| Net sales | *5.1* | 1,025,274 | 944,740 |
| Cost of sales | *5.2* | (416,505) | (381,529) |
| **Gross profit** | | **608,769** | **563,211** |
| Selling and marketing expenses | *5.3* | (379,419) | (344,067) |
| General and administrative expenses | *5.4* | (102,122) | (106,879) |
| Other income/(expenses), net | *5.5* | 1,054 | (866) |
| **Operating income** | | **128,282** | **111,399** |
| Share of income/(loss) of associates | *5.6* | 1,532 | (42) |
| Interest expense and other financial charges, net | *5.7* | (85,272) | (66,150) |
| Non recurring financial charges | *5.8* | (19,507) | - |
| **Income before taxation** | | **25,035** | **45,207** |
| Income tax expenses | *5.9* | (11,373) | (20,474) |
| **Net income** | | **13,662** | **24,733** |
| Net income attributable to minority interests | | 3,220 | 3,123 |
| **Net income attributable to the Group** | | **10,442** | **21,610** |

## Consolidated Statement of recognized income and expense for the years ended December 31, 2005 and 2004

| *(Euro/000)* | *Note* | 31/12/2005 | 31/12/2004 |
|---|---|---|---|
| Cash flow hedges | *4.24* | (2,780) | (3,637) |
| Financial assets available-for-sale | *4.24* | (452) | (398) |
| Actuarial gain/losses | *4.23* | (3,207) | - |
| Translation differences | *4.23* | 10,153 | 4,843 |
| Other movements | *4.23* | 701 | - |
| **Total** | | **4,415** | **808** |
| Net income in the period | | 13,662 | 24,733 |
| **Total recognized income for the year** | | **18,077** | **25,541** |
| Net income attributable to the Group | | 10,442 | 21,610 |
| Income and expenses attributable to the Group | | 4.208 | 703 |
| **Total** | | **14,650** | **22,313** |
| Net income attributable to minority interests | | 3,220 | 3,123 |
| Income and expenses attributable to minorities | | 207 | 105 |
| **Total** | | **3,427** | **3,228** |
| **Total income** | | **18,077** | **25,541** |

## Consolidated Statements of Cash Flows for the years ended December 31, 2005 and 2004

| *(Euro/000)* | 31/12/2005 | 31/12/2004 |
|---|---|---|
| **A – Cash and cash equivalents at the beginning of the period** | **18,151** | **23,234** |
| **B - Cash flows from operating activities** | | |
| Net income (including minority interests) | 13,662 | 24,733 |
| Depreciation and Amortization | 35,197 | 35,505 |
| Share income on equity investments | 2,644 | 770 |
| Net movements in the employee benefits liability | 4,753 | 6,079 |
| Net movements in other provisions | 2,232 | (4,476) |
| Interest expenses | 84,597 | 64,309 |
| Income tax expense | 11,373 | 20,474 |
| **Income from operating activities prior to movements in working capital** | **154,458** | **147,394** |
| (Increase) Decrease in trade receivables and other current receivables | (39,672) | 8,654 |
| (Increase) Decrease in inventory, net | (2,314) | (37,153) |
| Increase (Decrease) in trade payables and other current payables | 22,374 | 24,663 |
| Interest expenses paid[1] | (71,085) | (59,947) |
| Income taxes paid | (33,675) | (27,837) |
| **Total (B)** | **30,086** | **55,774** |
| **C - Cash flows (for) investing activities** | | |
| Purchase of property, plant and equipment (net of disposals) | (27,737) | (26,643) |
| Acquisition of investments in associates and financial assets | - | 287 |
| Disposal of investments in associates and financial assets | - | 227 |
| Purchase of intangible assets | (9,602) | (2,491) |
| **Total (C)** | **(37,339)** | **(28,620)** |
| **D - Cash flows from (for) financing activities** | | |
| Proceeds from borrowings | 24,967 | 4,863 |
| Repayment of borrowings | (190,382) | (48,770) |
| Bank deposit for High Yield repayment | (105,000) | - |
| Net increase in share capital | 294,713 | 25,000 |
| Dividends paid | (3,025) | (3,149) |
| **Total (D)** | **21,273** | **(22,056)** |
| **E - Cash flows for the year (B+C+D)** | **14,020** | **5,098** |
| Effect of exchange rates | (4,630) | (4,735) |
| Other movements in shareholders' equity | (1,675) | (5,446) |
| **Total (F)** | **(6,305)** | **(10,181)** |
| **G - Cash and cash equivalents at the end of the period (A+E+F)** | **25,866** | **18,151** |

[1] *As of December 31, 2005 this item includes Euro 10,106 thousand due to the penalty paid in January 2006 for the early reimbursement of part of the High Yield bond.*

# Notes to the Consolidated Financial Statements as of and for the years ended December 31, 2005 and 2004

## 1. General information

### 1.1 General information

Safilo S.p.A., holding company, is a limited liability company registered in Italy. The registered office is located in Pieve di Cadore (BL) – Piazza Tiziano 8, whilst the administrative headquarters are located in Padua – Industrial Zone, VII strada 15.

These consolidated financial statements are presented in thousands of Euro, covering the financial period from January 1, 2005 to December 31, 2005 with comparative figures for the period from January 1, 2004 to December 31, 2004.

These financial statements have been approved by the Board of Directors on March 28, 2006.

Companies included in the consolidation area are reported in the paragraph 2.2 "Consolidation method and consolidation area".

### 1.2 Activities of the Group

Safilo is the second largest eyewear producer worldwide and is the worldwide leader in the eyewear luxury segment and is also one of the top three sports eyewear producers and distributors worldwide.

Safilo designs, produces and distributes high quality optical eyewear, sunglasses, sports glasses and accessories. The distribution is done through specialized outlets and retail distribution chains.

The products of the Group are sold in 130 countries and there are approximately 130,000 retail outlets worldwide. The Group directly distributes its products in 27 of its principal markets worldwide through its subsidiaries and its strong sales team of over 1,300 people.

The Group brands include *Sàfilo, Oxydo, Carrera, Smith* and *Blue Bay*, while the licensed brands include *Alexander McQueen, Bottega Veneta, Boucheron, Diesel, Dior, Emporio Armani, Fossil, Giorgio Armani, Gucci, Kate Spade, Liz Claiborne, Marc Jacobs, Marc by Marc Jacobs, Max Mara, Nine West, Oliver, Pierre Cardin, Polo Ralph Lauren, Saks Fifth Avenue, Stella McCartney, Valentino* and *Yves Saint Laurent*.

## 2. Summary of significant accounting policies

### 2.1 General information

Accounting policies adopted for the preparation of these consolidated financial statements are those presented below and have been applied in a comparative manner for both financial years presented.

Consolidated financial information reported for financial years ended December 31, 2005 and 2004 was prepared in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board and approved by the European Commission as of December 31, 2005 ("IFRS").

Some new IFRS principles, some amendments and IFRIC interpretations have already been issued by IASB and will be effective after the approval of these financial statements. The Group has decided, as permitted, to adopt two amendments issued by IFRS. These amendments relate to:

- IAS 19 – Accounting treatment for actuarial gain and losses;
- IAS 39 – Accounting treatment for cash flow hedges related to intercompany transactions.

Other accounting principles, amendments or interpretations should not have significant impact on future consolidated financial statements.

The consolidated financial statements of the Group are presented in Euro. The Euro is the functional currency as it is the currency in which the Group mainly operates.

The consolidated financial statements for the years ended December 31, 2005 and 2004 were prepared in accordance with the cost criteria except for available-for-sale financial assets and some financial assets or liabilities including derivative instruments.

The preparation of the consolidated financial statements require the Directors to make estimates and assumptions that impact upon the amounts reported in the financial statements, such as the balance sheet, the income statement and the cash flow statement, and on the disclosures in the notes to the accounts. Actual results could differ from those estimates. The financial statements area most impacted by the above estimates and assumptions are reported in the paragraph 2.19 "Use of estimates".

This is the first financial statements prepared in accordance with International Accounting Standards. The adoption of IFRS involved significant adjustments to equity and the net income determined in accordance with Italian GAAP. See section 10 "Transition to IFRS" for further details.

## 2.2 Consolidation method and consolidation area

The direct and indirect holdings, included in the consolidation scope under the line-by-line method, are the following:

| | | Share Capital | Quota held % |
|---|---|---|---|
| **ITALIAN COMPANIES** | | | |
| Oxsol S.p.A. - Pieve di Cadore (BL) | EUR | 121,000 | 100 |
| Lenti Srl – Bergamo | EUR | 500,000 | 54 |
| Smith Sport Optics S.r.l.(in liquidation)–Florence | EUR | 102,775 | 100 |
| **FOREIGN COMPANIES** | | | |
| Safilo International B.V. - Rotterdam (NL) | EUR | 24,165,700 | 100 |
| Safint B.V. - Rotterdam (NL) | EUR | 18,200 | 100 |
| Safilo Capital Int. S.A. (Luxembourg) | EUR | 31,000 | 100 |
| Safilo Benelux S.A. - Zaventem (B) | EUR | 560,000 | 100 |
| Safilo Espana S.A. - Madrid (E) | EUR | 390,650 | 100 |
| Safilo France S.a.r.l. - Paris (F) | EUR | 960,000 | 100 |
| Safilo Gmbh - Kòln (D) | EUR | 511,300 | 100 |
| Safilo Nordic AB - Taby (S) | SEK | 500,000 | 100 |
| Safilo Far East Ltd. - Hong Kong | HKD | 49,700,000 | 100 |
| Safint Optical Investment Ltd -Hong Kong | HKD | 10,000 | 51 |
| Safilo Hong-Kong Ltd – Hong-Kong | HKD | 100,000 | 51 |
| Safilo Singapore Pte – Ltd - Singapore | SGD | 400,000 | 100 |
| Safilo Optical Sdn Bhd – Kuala Lumpur – Malaysia | MYR | 100,000 | 100 |
| Safilo Trading (Shenzhen) Co. Inc. China | CNY | 2,481,000 | 51 |
| Safilo Hellas Ottica S.a. – Atene (GR) | EUR | 489,990 | 70 |
| Safilo Nederland B.V. - Bilthoven (NL) | EUR | 18,200 | 100 |
| Safilo South Africa – Bryanston (South Africa) | ZAR | 3,383 | 100 |
| Safilo Austria Gmbh -Traun (A) | EUR | 217,582 | 100 |
| Carrera Optyl Gmbh (in liquidation) –Traun (A) | EUR | 7,630,648 | 100 |
| Carrera Optyl D.o.o. - Ormoz (SLO) | SIT | 135,101,000 | 100 |
| Carrera Optyl Marketing Gmbh – Traun (A) | EUR | 181,683 | 100 |
| Safilo Japan Co Ltd (Tokyo) | JPY | 100,000,000 | 100 |
| Safilo Do Brasil Ltda – San Paulo (Brasil) | BRL | 8,077,500 | 100 |
| Safilo Portugal Lda – Lisbona (P) | EUR | 500,000 | 100 |
| Safilo Switzerland – Liestal (Svizzera) | CHF | 1,000,000 | 77 |
| Safilo India Ltd | INR | 42,000,000 | 88.5 |
| Safint Australia Pty Ltd.- Sidney (Australia) | AUD | 3,000,000 | 100 |
| Safilo Australia Partnership – Sidney (Australia) | AUD | 204,081 | 61 |
| Safint Optical UK Ltd. (UK) | GBP | 21,139,001 | 100 |
| Safilo UK Ltd. - North Workshire (UK) | GBP | 250 | 100 |
| Safilo America Inc. - Delaware (USA) | USD | 8,430 | 100 |
| Safilo USA Inc.- New Jersey (USA) | USD | 23,289 | 100 |
| FTL Corp. - Delaware (USA) | USD | 10 | 100 |
| Safilo Realty Corp. Delaware (USA) | USD | 10,000 | 100 |
| Safilo Services LLC - New Jersey (USA) | USD | - | 100 |
| Smith Sport Optics Inc. - Idaho (USA) | USD | 12,162 | 100 |
| Solstice Marketing Corp. – (USA) | USD | 1,000 | 100 |
| 2844-2580 Quebec Inc. – Montreal (CAN) | CAD | 100,000 | 100 |
| Safilo Canada Inc. - Montreal (CAN) | CAD | 2,470,425 | 100 |
| Canam Sport Eyewear Inc. Montreal (CAN) | CAD | 300,011 | 100 |

Investments in subsidiaries

The companies in which the Group exercises control ("subsidiary companies"), either due to direct shareholdings or indirect holding of the majority of the voting rights, having the power to determine the financial and operating choices of the company and thus obtaining the relative benefits, are consolidated using the line-by-line method. The existence of potential exercisable voting rights at the balance sheet date is considered in order to determine control. The subsidiary companies are consolidated from the date on which control is assumed and are deconsolidated from the date when control ceases.

The business combinations, in which the control of a company/entity is acquired, are recorded applying the purchase method, where the assets and liabilities acquired are initially measured at their current value at the acquisition date. The difference between the purchase cost and the current value of the assets and liabilities acquired, if positive, are allocated to goodwill, and if negative are recorded in the income statement. The acquisition cost is based on the fair value, at the purchase date, of assets sold, of liabilities incurred and of capital instruments issued, and any other accessory charges.

On consolidation, the amounts resulting from intra-group operations between consolidated companies are eliminated, such as receivables and payables at the balance sheet date, costs and revenues as well as financial income and charges. Also excluded are the gains and losses realized between companies fully consolidated.

Investments in associates

The holdings in companies in which a significant influence is exercised ("associated companies") is presumed to exist when the percentage held is between 20% and 50% and are valued under the equity method. Due to the application of the equity method, the value of the investment is aligned to the net equity adjusted, where necessary, to reflect the application of the IFRS and includes the recording of any goodwill identified at the moment of the acquisition. The quota of gains/losses realized by the associated companies after the acquisition is recorded in the income statement, while the quota of movements of the reserves after the acquisition is recorded in the equity reserves. When the share of losses of the Group in an associated company is equal to or exceeds its holding in the associated company, taking into account all receivables not guaranteed, the value of the investment is fully written down and the Group does not record further losses above its share, except where the Group has the obligation to cover these losses. The gains and losses not realized generated on operations with associated companies are eliminated for the part pertaining to the Group.

## 2.3 Segment information

The following information is provided with reference to the geographic areas in which the Group operates. The geographic areas were identified as the primary segments of activity. The criteria applied for the identification of the primary segments of activity were inspired, among other issues, by the manner in which management directs the Group and attributes managerial responsibility. In particular, this criteria is based on the regrouping by geographical area of the headquarters of the companies belonging to the Group; therefore, the sales identified in accordance with this segmentation are determined by origin of invoicing and not by target market.

Finally, it is noted that at the date of the present report no secondary segments were identified. The secondary segments could be related, also in consideration of market practices, to the "distribution" system. In the circumstances, however, the distribution of the products is almost exclusively wholesale; in fact the distribution activity through sales points directly controlled by the Group (retail sales) is marginal.

## 2.4 Translation of financial statements in currencies other than the Euro

Translation of financial statements of companies in currencies other than the functional currency of the Euro is as follows:

- the assets and the liabilities were translated using the exchange rate at the balance sheet date;
- the costs and revenues, and income and charges, were translated using the average exchange rate for the year;

- the "translation reserve" includes both the foreign exchange differences generated from the translation of foreign currency transactions at a rate different than at the balance sheet date and those generated from the translation of the opening shareholders' equity at a rate different than at the balance sheet date;
- the goodwill and the fair value adjustments related to the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the exchange rate at the balance sheet date;
- in the preparation of the consolidated cash flow statement the average exchange rates for the year are used to convert the cash flows of foreign subsidiaries.

The exchange rates applied in the conversion of financial statements of companies prepared in a currency other than the Euro as of December 31, 2005 were as follows:

| | Year end December 31, 2005 | Year end December 31, 2004 | Average 2005 | Average 2004 |
|---|---|---|---|---|
| USD | 1.1797 | 1.3621 | 1.2441 | 1.2439 |
| HKD | 9.1474 | 10.5881 | 9.6768 | 9.6881 |
| CHF | 1.5551 | 1.5429 | 1.5483 | 1.5438 |
| CAD | 1.3725 | 1.6416 | 1.5079 | 1.6167 |
| JPY | 138.9 | 139.65 | 136.8492 | 134.4446 |
| GBP | 0.6853 | 0.70505 | 0.6836 | 0.6787 |
| SEK | 9.3885 | 9.0206 | 9.2822 | 9.1244 |
| AUD | 1.6109 | 1.7459 | 1.6327 | 1.6905 |
| ZAR | 7.4642 | 7.6897 | 7.9191 | 8.0092 |
| SIT | 239.5 | 239.76 | 239.5681 | 239.0874 |
| BRL | 2.7432 | 3.67282 | 3.0346 | 3.6329 |
| IND | 53.1679 | 59.7404 | 54.8365 | 56.3422 |
| SGD | 1.9628 | 2.2262 | 2.0702 | 2.1016 |
| MYR | 4.4584 | 5.17529 | 4.7567 | 4.7262 |
| CNY | 9.5204 | 11.2781 | 10.1983 | 10.2975 |

Foreign currency transactions are converted into the currency using the exchange rate at the transaction date. The foreign exchange gains and losses resulting from the settlement of transactions and from the translation at the balance sheet date of monetary assets and liabilities denominated in foreign currencies are recognized in the income statement.

## 2.5 Property, plant and equipment

Property, plant and equipment are measured at purchase or production cost, net of accumulated depreciation and any loss in value. The cost includes all charges directly incurred in bringing the assets to their current location and condition. Interest charges relating to the construction of property, plant and equipment are charged directly to the income statement.

The charges incurred for the maintenance and repairs of an ordinary and/or cyclical nature are directly charged to the income statement in the year in which they are incurred. The capitalization of the costs relating to the expansion, modernization or improvement of owned property, plant and equipment or of those held in leasing, is made only when they satisfy the requirements to be separately classified as an asset or part of an asset. The inscription value is adjusted for depreciation on a systematic basis, over its useful life.

When circumstances indicate that there may be a permanent impairment in value, an estimate is made of the recoverable amount of the asset, recording any loss in the income statement. When the reasons for the

write-down no longer exist, the book value of the asset is restated through the income statement, up to the value at which the asset would be recorded if no write-down had taken place and depreciation had been recorded.

The assets held through finance lease contracts, where the majority of the risks and rewards related to the ownership of an asset have been transferred to the Group, are recognized as assets of the Group at their fair value or, if lower, at the current value of the minimum lease payments. The corresponding liability due to the lessor is recorded in the financial statements under financial payables. The assets are depreciated applying the criteria and rates indicated below.

The leased assets where the lessor bears the majority of the risks and rewards related to an asset are recorded as operating leases. The costs relating to operating leases are recorded on a straight-line basis in the income statement over the duration of the lease contract.

Depreciation is calculated on a straight-line basis over the estimated useful life of the asset, in accordance with the following depreciation rates:

| | |
|---|---|
| Buildings | 20- 33 years |
| Plant, machinery & equipment | 5- 15 years |
| Furniture, EDP and motor vehicles | 4- 8 years |

Land is not depreciated.

When the asset to be depreciated is composed of separately identifiable elements whose useful life differ significantly from the other parts of the asset, the depreciation is made separately for each part of the asset, with the application of the "*component approach*" principle.

## 2.6 Intangible assets

An intangible asset is an identifiable non-monetary asset without physical substance, and capable of generating future economic benefits. These assets are recorded at purchase and/or production cost, including the costs of bringing the asset to its current use, net of accumulated amortization, and any loss in value. The amortization begins when the asset is available for use and is recorded on a systematic basis over the useful life of the asset.

When circumstances indicate that there may be a permanent impairment in value, an estimate is made of the recoverable amount of the asset, recording any loss in the income statement. When the reasons for the write-down no longer exist, the book value of the asset is restated through the income statement, up to the value at which the asset would be recorded if no write-down had taken place and amortization had been recorded.

Goodwill

Goodwill represents the excess of the purchase cost compared to the fair value of the share of equity in the subsidiary or associated company at the purchase date, or of the business unit acquired. The goodwill deriving from the purchase of subsidiaries is recorded under intangible assets, while that deriving from the purchase of associated companies is included in the investments in associated companies. Goodwill is not amortized, but is subject to an impairment test on an annual basis. For the purposes of the impairment test the goodwill is allocated to the smallest cash-generating unit, which can be identified and compared with the discounted operating cash flows generated. Gains and losses deriving from the sale of an entity are determined considering the value of the goodwill relating to the entity sold.

Trademarks and licenses

Trademarks and licenses are recorded at cost. They have a finite useful life and are recorded at cost net of accumulated amortization. The amortization is calculated on a straight-line basis allocating the cost of trademarks and licenses over the duration of the relative contracts.

Software

The licenses purchased and relating to software are capitalized on the basis of the costs incurred for their acquisition and in bringing them to their current condition. The amortization is calculated on a straight-line basis over their estimated useful life (from 3 to 5 years).

The costs associated with the development and maintenance of software programs are recorded as costs when incurred. The costs which are directly associated with the production of unique and identifiable

software products controlled by the Group and which generate future economic benefits beyond one year are recorded as intangible assets. The direct costs include the costs relating to employees developing the products as well as any appropriate share of general costs.

## 2.7 Assets held for sale

These include non-current assets (or groups of assets held for sale) whose book value is recoverable mainly through sale rather than continued use. The assets available-for-sale are measured at the lower between their purchase cost, net of accumulated depreciation, and the current value less costs to sell.

## 2.8 Impairment of non financial assets

At each balance sheet date the Group performs a review of the book value of its the property, plant and equipment and intangible assets in order to assert if there are indicators of the existence of a potential loss in value. When it is determined that a potential loss exists, the Directors make valuations on the recoverable amount of those assets in order to identify the potential amount of the loss. Where it is not possible to make an estimate of the recoverable amount of an asset individually considered, the Group makes an estimate of the recoverable amount of the cash generating unit the asset belong to.

Intangible assets with an indefinite useful life such as goodwill are tested on a yearly basis and whenever there are circumstances that indicate that an impairment may exist, calculating the related loss.

When the recoverable amount of an asset is lower than its book value, the related loss is accounted for in the income statement.

## 2.9 Financial instruments

The classification of the financial instrument is dependent upon the purpose for which the financial instrument was acquired. Management determines the classification of its financial instruments on the initial recognition in the financial statements. The purchases and sales of financial instruments are recognized at the transaction date or at the date when the Group commits to purchase or sell the asset. All financial instruments are initially recognized at fair value.

Financial assets

The financial assets are classified into the following categories:

- financial assets measured at fair value with changes recognized in the income statement: this category includes the financial assets acquired mainly for sale in the short-term or those designated as such by management, in addition to derivative instruments unless they are not designated as hedges. The fair value of these instruments is determined with reference to the market value (offer price) at the balance sheet date; in the case of non-quoted instruments they are determined through technical financial valuation models commonly used. The fair value changes of the instruments belonging to this category are recognized in the income statement. The financial instruments in this category are classified as short-term if they are "held for trading" or if it is expected that they will be sold within 12 months from the balance sheet date. The Group has not held this kind of activities in the periods covered by these financial statements.
- loans and receivables: they are non-derivative financial instruments, with fixed or determinable payments, not quoted in an active market and are for a medium/long-term period and are normally included under trade receivables. They are stated as current assets except for amounts due beyond 12 months from the balance sheet date which are classified under non-current assets. These assets are measured at amortized cost, on the basis of the effective interest rate. Any loss in value determined through an impairment test is recognized in the income statement. Trade receivables: they are initially recognized in the financial statements at their current value and subsequently recorded under the amortized cost method less any write-downs for loss in value. An allowance for doubtful accounts is made when there is evidence that the Group will not be capable of receiving the original amount due. The accruals made are recorded in the income statement.

- investments held-to-maturity: they are non-derivative financial instruments with fixed or determinable payments, with a fixed maturity date, that the Group has the full intention and capacity to maintain until maturity. The receivables and the investments held-to-maturity are measured under the amortized cost method using the effective interest rate. The Group does not hold this type of investment in the period reported upon.
- financial assets available-for-sale: they are non-derivative financial instruments that are explicitly designated in this category or are not classified in any of the previous categories. They are measured at fair value, determined with reference to market prices at the balance sheet date or through financial measurement techniques or models, recording the changes in value in an equity reserve. This reserve is recognized in the income statement only when the financial asset is sold, or, in the case of negative cumulative changes, when it is considered that the reduction in value already recorded under equity can not be recovered. The classification as a current or non-current asset depends on the intentions of management and of the real liquidity of the security; they are recorded under current assets when they are expected to be realized within 12 months.

The financial assets are derecognized from the balance sheet when the right to receive the cash flows from the instrument ceases and the Group has transferred all the risks and rewards relating to the instrument.

Loans

Loans are initially recognized at fair value less transaction costs. After initial recognition, they are measured at amortized cost; all differences between the amount financed (net of the transaction costs) and the nominal value are recognized in the income statement over the duration of the loan using the effective interest method. When there is a change in the expected cash flows and management is capable of estimating it reliably, the value of the loans is recalculated to reflect the expected change in the cash flows. The value of the loans is recalculated on the basis of the current value of the new expected cash flows and of the internal rate of the original yield.

The loans are classified under current liabilities unless the company has an unconditional right to defer the payment for at least 12 months after the balance sheet date.

The loans are derecognized from the balance sheet when they expire and the Group has transferred all the risks and rewards relating to the instrument.

Derivative instruments

The derivative financial instruments are only used with the intention of hedging, in order to reduce the foreign currency or interest rate risk. In compliance with IAS 39 as approved by the European Commission, the derivative financial instruments can be recorded in accordance with the "hedge accounting" method only when, at the beginning of the hedge, the following conditions are met: a formal designation and documentation relating to the hedge exists; it is presumed that the hedge is highly effective; the effectiveness can be reliably measured and the hedge is highly effective over the accounting periods for which it was designated.

All the derivative financial instruments are measured at fair value, as established in accordance with IAS 39. When the financial instruments have the characteristics to be recorded under hedge accounting, the following accounting treatment is applied:

- Fair value hedge – if a derivative financial instrument is designated as a hedge to the exposure of the changes in the current value of an asset or liability in the financial statements attributable to a specific risk which can have effects on the income statement, the gain or loss after the initial valuation of the fair value of the hedge instrument is recognized in the income statement. The gain or loss on the item hedged, related to the risk hedged, changes the book value of that item and is recognized in the income statement.
- Cash flow hedge – if a derivative financial instrument is designated as a hedge to the exposure of the changes in the cash flows of an asset or liability recorded in the financial statements or of an operation considered highly probable and which may have effects on the income statement, the effective portion of the gains or of the losses of the financial instrument is recognized in an equity reserve. The cumulative gains or losses are reversed from equity and recorded in the income statement in the same period as the operation that is hedged. The gains or losses associated to a hedge or to that part of the hedge which has become ineffective, are immediately recorded in the income statement. If a hedge instrument or a relation of a hedge is closed, but the operation hedged has not yet been realized, the cumulative gains and losses, up to that

moment recorded in equity, are recognized in the income statement when the relative operation is realized. If the operation hedged is no longer considered probable, the unrealized gains or losses recorded in equity are recognized immediately in the income statement.

If the hedge accounting cannot be applied, the gains or losses deriving from the fair value of the derivative financial instruments are immediately recognized in the income statement.

## 2.10 Inventory

Inventory is measured at the lower of purchase or production cost and the net realizable value. The cost of raw materials and purchased finished products is calculated using the weighed average cost method. The cost of semi-finished products and internally produced finished goods includes design, raw material, direct labor costs and the indirect costs allocated based on normal production capacity.

The net realizable value is determined based on the estimated selling price in normal market conditions, net of direct sales costs.

Against the value of inventories as determined above, provisions are made in order to take account of obsolete or slow-moving inventories.

## 2.11 Cash in hand and at banks

Cash and cash equivalents include cash in hand, bank deposits on demand, other highly liquid short-term investments and bank overdrafts. Bank overdrafts are stated under current liabilities. The items included in the net cash and cash equivalents are measured at fair value and the relative changes are recorded in the income statement.

## 2.12 Shareholders' equity

Share capital

The share capital is the amount of the subscribed and paid-in capital of the parent company.

## 2.13 Employee benefits

Pension plans

The Group recognizes different forms of defined benefit plans and defined contribution plans, in line with the local conditions and practices in the countries in which it carries out its activities.

The premiums paid for defined contribution plans are recorded in the income statement for the part matured in the year. The defined benefit plans are based on the working life of the employees and on the remuneration received by the employee during a predetermined period of employment.

The obligation of the company to finance the defined benefit plans and the annual cost recognized in the income statement are determined by independent actuaries using the projected unit credit method. The obligation deriving from defined benefit plans represents the current value of the estimated future cash flows and is determined using the projected unit credit method. The related costs are recorded in the income statement on the basis of the estimated employment period of employees. Actuarial gain or losses are recorded in an equity reserve in the period in which they arise.

Remuneration plans under the form of share capital participation

The Group recognizes additional benefits to some employees and consultants through "equity-settled" type stock options. In accordance with IFRS 2 – Share-based payments, the current value of the stock options determined at the vesting date applying the "Black & Scholes" method is recognized in the income statement

under personnel costs in constant quotas over the period between the vesting date of the stock options and the maturity date, and directly to an equity reserve.

The effects of the vesting conditions not related to the market are not taken into consideration in the fair value of the vested options but are important in the valuation of the number of options which are expected to be exercised.

At the balance sheet date the Group reviews its estimates on the number of options which are expected to be exercised. The impact of the revision of the original estimates is recognized in the income statement over the maturity period and directly in equity reserves.

On the exercise of the stock option the amounts received from the employee, net of the costs directly attributable to the transaction, are credited to share capital for an amount equal to the nominal value of the shares issued and to the share premium reserve for the remaining part.

### 2.14 Provisions for risks and charges

The Group records provisions for risks and charges when it has an obligation, legal or implicit, to third parties, and it is probable that it will be necessary to use resources of the Group to settle the obligation, and a reliable estimate of the amount can be made. The changes in estimates are recorded in the income statement of the period in which the changes occur.

### 2.15 Revenue recognition

The revenues include the fair value of the sale of goods and services, less VAT, returns and discounts. Specifically, the Group recognizes the revenues from the sale of goods sold at the shipment date, when all the risks and rewards relating to the ownership of the goods have been transferred to the client, or on delivery to the client, in accordance with the sales terms agreed. If the sale includes the right for the client to return unsold goods (generally these clauses are only applied in the United States), the revenue is recognized on the shipment to the client, net of a provision which represents the best estimate of the products to be returned by the client and which the Group is unable to place on the market. This provision is based on specific historical data and on the specific knowledge of the clients; historically there have not been significant differences between the estimates made and the products actually returned.

### 2.16 Royalty income and expense

The Group recognizes Royalty income and expenses in accordance with the accruals principle and in compliance with the substance of the contracts agreed.

### 2.17 Dividends

Dividends are recorded when the right of the shareholders to receive the payment arises, which normally occurs at the shareholders' meeting for the distribution of dividends. The distribution of dividends is therefore recorded as a liability in the financial statements in the period in which the distribution is approved by the shareholders' meeting.

### 2.18 Income taxes

Income taxes include all the taxes calculated on the taxable income of the Group companies. The income taxes are recorded in the income statement, except those relating to accounts directly credited or debited to equity, in which case the fiscal effect is recognized directly to equity.

The deferred taxes are calculated on fiscal losses and all the timing differences between the taxable income of an asset or liability and the relative book value, with the exception of the goodwill and of those differences deriving from investments in subsidiaries for which a write-down is not expected in the foreseeable future. The deferred tax assets are recognized only for those amounts for which it is probable there will be future taxable income to recover the amounts. The deferred tax assets and liabilities are compensated when the income tax is applied by the same fiscal authority and when there is a legal right of compensation. The deferred tax assets and liabilities are determined with the fiscal rates that are expected to be applied, in accordance with the regulations of the countries in which the Group operates, in the years in which the temporary differences will be realized or extinguished.

Deferred tax assets and liabilities are offset when income taxes are applied by the same tax authorities and there is a legal right to compensate. Deferred income tax is determined using tax rates that are expected to apply in the different jurisdictions where the Group operates for the financial years in which the temporary differences will be realized or extinguished.

## 2.19 Critical accounting estimates

The preparation of the consolidated financial statements require the Directors to apply accounting principles and methods that, in some circumstances, are based on difficulties and subjective valuations and estimates based on the historical experience and assumptions which are from time to time considered reasonable and realistic based on the relative circumstances. The application of these estimates and assumptions impact upon the amounts reported in the financial statements, such as the balance sheet, the income statement and the cash flow statement, and on the disclosures in the notes to the accounts. The final outcome of the accounts in the financial statements, which uses the above-mentioned estimates and assumptions, may differ from those reported in the financial statements due to the uncertainty, which characterizes the assumptions and the conditions upon which the estimates are based. Below are briefly described the accounting standards which require greater subjectivity by the directors in the preparation of the estimates and for which a change in the underlying conditions or the assumptions may have a significant impact on the consolidated financial statements of the Group.

- Goodwill: in accordance with the accounting standards adopted for the preparation of the financial statements, the company annually verifies the goodwill in order to assert the existence of any loss in value to be recorded in the income statement. The verification results in the determination of the fair value related to the goodwill allocated to the financial cash-generating units. When the fair value is lower than the book value of the cash-generating unit, a write-down of the goodwill is recorded. The allocation of the goodwill to the cash-generating units and the determination of their fair value require estimates which depend on factors that may change over time with consequent effects, which may be significant, compared to the valuations made by the Directors.
- Write-down of property, plant and equipment: in accordance with the accounting standards applied by the Group, the property, plant and equipment are verified to assert if there has been a loss in value which is recorded by means of a write-down, when it is considered there will be difficulties in the recovery of the relative net book value through use. The verification of the existence of the above- mentioned difficulties requires the Directors to make valuations based on the information available within the Group and from the market, as well as historical experience. In addition, when it is determined that there may be a potential loss in value, the Group determines this using the most appropriate technical valuation methods available. The correct identification of the indicators of the existence of a potential loss in value as well as the estimates for their determination depends on factors which may vary over time impacting upon the valuations and estimates made by the Directors.
- Deferred taxes: the accounting of the deferred tax assets is made on the basis of the expectations of future assessable income. The valuation of the expected assessable income in order to record the deferred tax asset depends upon factors which may change over time and result in significant effects on the valuation of the deferred tax assets.

### 2.21 Estimates of the fair value

The fair value of the financial instruments traded in an active market are based on the listed price at the balance sheet date.

The fair value of the financial instruments not traded in an active market are calculated in accordance with valuation techniques. The techniques used are varied and the assumptions used are based on the market conditions at the balance sheet date. More specifically:

- the fair value of the interest rate swaps is calculated on the basis of the current value of the future cash flows;
- the fair value of the forward currency hedging contracts is determined on the basis of the current value of the differences between the contracted forward exchange rate and the market rate at the balance sheet date;
- the fair-value of the advanced repayment option included in the bond issued by the subsidiary Safilo Capital International S.A. was valued using models applied by primary financial institutions;
- the fair value of the stock options is calculated using the Black & Scholes model.

## 3. Financial risks and derivative instruments

The Group is exposed to financial nature risks, market risks and cash flow risks.
The financial nature risks are managed at a central level based on the group hedging policies through the use of derivative instruments which minimize the effects deriving from foreign exchange rate fluctuations (especially in relation to the U.S. Dollar), and the effect of interest rate movements.

The market risks can be divided into the following categories:

Foreign currency risks
The Group operates at an international level and is therefore exposed to foreign currency risks, specifically in relation to the US dollar as a large part of sales are made in the United States. The Group has constantly attempted to reduce the impact from the movements in the U.S. Dollar by procuring suppliers in areas where it is possible to purchase in U.S. Dollars. In relation to the portion of U.S. dollars movements that are not hedged by purchases in U.S. Dollars, the Group uses hedging instruments such as forward currency contracts.

Changes in fair value risk
The group holds some assets which may change in value over time dependent on market movements.

Credit risk
The Group strives to reduce as much as possible the risk relating to the insolvency of its customers through policies which ensure that sales are made to customers who are reliable and solvent. These policies, designed to reduce the exposure of individual clients minimize the credit risk.

Cash flow risks

Debt exposes the Group to the risks associated with changes in interest rates. The variable interest rate loans result in a cash flow risk while the fixed interest rates result in a potential change in the fair value of the loans.

## 4. Notes to the Consolidated Balance Sheets as of December 31, 2005 and 2004

### 4.1 Cash in hand and at banks

This balance sheet item represents the temporary liquidity held invested at market rates.

The significant increase compared to the previous year is due to the liquidity, equal to Euro 294,713 thousand, deriving from the shareholders' contribution of our holding company Safilo Group S.p.A. which was used as follows:

- on November 9, 2005 part of the medium/long-term loans of the subsidiary Safilo S.p.A. was repaid which consisted of financing from UniCredit Banca d'Impresa S.p.A. and San Paolo IMI S.p.A., for a total amount of Euro 170,609 thousand;
- on January 13, 2006, 35% of the bond (High Yield) recorded in the financial statements of the Luxembourg subsidiary Safilo Capital International S.A. for nominal Euro 105,000 thousand and for the payment of the higher charges on the advanced repayment for an amount of Euro 10,106 thousand was repaid.

The following table shows the reconciliation with of cash and cash equivalents at the end of the period reported in the cash flow statement:

| *(Euro/000)* | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|
| Cash in hand and cash held at banks | 151,018 | 33,795 |
| Bank overdrafts | (10,046) | (15,644) |
| current account for High Yield reimbursement | (115,106) | - |
| **Total** | **25,866** | **18,151** |

### 4.2 Trade receivables, net

| *(Euro/000)* | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|
| Gross value | 328,928 | 294,442 |
| Allowance for doubtful accounts | (21,370) | (20,375) |
| **Net value** | **307,558** | **274,067** |

Exchange rates being equal, the net trade receivables increased by Euro 22,898 thousand due to the increase in sales in the fourth quarter of 2005 compared to the previous year.

The Group does not have a significant concentration of its credit risk as its receivables are related to a large number of customers.

Allowance for doubtful accounts includes the accrual for products given to clients which, in accordance with specific contractual clauses, are expected to be returned as not placed to the final customers. This accrual is accounted for as a reduction of sales in the income statement.

The allowance for doubtful accounts also includes the accrual for insolvency accounted for on the income statement on the line "general and administrative expenses" (note 5.4).

The movements in the allowance for doubtful accounts are as follows:

| *(Euro/000)* | Balance at January 1, 2005 | Increase | Decrease | Transl. Diff. | Balance as of December 31, 2005 |
|---|---|---|---|---|---|
| Allowance for doubtful accounts | 13,894 | 1,904 | (3,750) | 438 | 12,486 |
| Sales return provision | 6,481 | 7,660 | (6,311) | 1,054 | 8,884 |
| **Total** | **20,375** | **9,564** | **(10,061)** | **1,492** | **21,370** |

### 4.3 Inventory, net

This account is comprised as follows:

| *(Euro/000)* | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|
| Raw materials | 43,784 | 34,966 |
| Work-in-progress | 8,123 | 9,001 |
| Finished goods | 176,272 | 162,801 |
| **Gross** | **228,179** | **206,768** |
| Obsolescence provision | (19,377) | (14,572) |
| **Total** | **208,802** | **192,196** |

The growth in raw materials is due to the forecasted increase of the internal production in 2006.

The increase in finished products is mainly due to Euro 13,380 thousand in relating to the strengthening of the US Dollar compared to the Euro.

For obsolete and slow moving items, a specific accrual, based on their possible future sale or use, has been recorded. The accrual impacts the income statement line item "cost of sales" (note 5.2).

The movements in the obsolescence provision are as follows:

| *(Euro/000)* | Balance at January 1, 2005 | Increase | Transl. Diff. | Balance as of December 31, 2005 |
|---|---|---|---|---|
| Obsolescence provision | 14,572 | 3,256 | 1,549 | 19,377 |
| **Total** | **14,572** | **3,256** | **1,549** | **19,377** |

### 4.4 Assets held for sale

Assets held for sale amount to Euro 2,984 thousand and refers to the net book value of the building of the Austrian subsidiary Carrera Brillen (Traun) which is classified under current assets, due to the planned sale of the assets in a short time period time frame.

### 4.5 Other current receivables

| *(Euro/000)* | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|
| Receivables from the holding company Safilo Group S.p.A. | 33,818 | - |
| VAT receivable | 4,453 | 3,953 |
| Tax credits and advance payments | 11,445 | 11,831 |
| Prepayments and accrued income | 5,281 | 5,450 |
| Receivables from sale agents | 4,943 | 4,273 |
| Financial derivative instruments | - | 1,911 |
| Other current receivables | 4,793 | 4,430 |
| **Total** | **64,733** | **31,848** |

The receivables from our holding company Safilo Group S.p.A. refer to the following:

- for Euro 20.300 thousand to deferred tax assets recorded by Safilo S.p.A. during 2005 and attributed to its holding Company Safilo Group S.p.A. as a result of the fiscal regime ("consolidato fiscale nazionale"). The above fiscal regime, where Safilo Group S.p.A. is the holding company and Safilo S.p.A., Oxsol S.p.A. and Lenti S.r.l. are the subsidiaries, resulted in that the tax losses recorded by Safilo S.p.A. during financial year 2005 were transferred to the holding company. Receivables from the holding company represent the counterpart for fiscal benefits transferred to the holding company;
- for Euro 700 thousand to an interest-bearing loan granted by Safilo S.p.A. based at a floating rate (2.592% as of December 31, 2005);
- for the remaining part to the costs incurred by Safilo S.p.A for the IPO process and recharged to its parent company Safilo Group S.p.A.

The tax credits and payments on account mainly relate to the income advance tax payments and will be compensated against the relative taxes payable.

Prepayments and accrued income as of December 31, 2005 include:

- Prepaid advertising costs of Euro 2,247 thousand;
- Prepaid insurance premiums of Euro 329 thousand;
- Prepaid rent and operating leases of Euro 1,225 thousand;
- Accrued income and other prepayments of Euro 1,480 thousand.

The receivables from sales agents mainly refer to receivables deriving from the sale of product samples.

As of December 31, 2005, financial derivative instruments, reported on the assets side as of December 31, 2004 for Euro 1,911 thousand, are included in "other non-current liabilities" for a total amount of Euro 878 thousand (note 4.16).

Other short-term receivables relate to the receivable from the Italian Ministry of Industry ("Ministry") for Euro 1,257 thousand in relation to grants approved but not yet paid by the Ministry in relation to loans that extinguished in 2002. Other short-term receivables also include receivables for insurance reimbursements related to various Group companies.

### 4.6 Property, plant and equipment

| *(Euro/000)* | Balance at January 1, 2004 | Increase | Decrease | Reclass. | Transl. Diff. | Balance as of December 31, 2004 |
|---|---|---|---|---|---|---|
| **Gross value** | | | | | | |
| Land and buildings | 100,883 | 9,543 | (724) | 199 | (374) | 109,527 |
| Plant and machinery | 144,424 | 11,818 | (4,703) | - | (344) | 151,195 |
| Equipment and other assets | 106,327 | 12,834 | (11,123) | - | (2,254) | 105,784 |
| Assets under construction | 9,922 | 13,571 | - | (19,915) | (36) | 3,542 |
| **Total** | **361,556** | **47,766** | **(16,550)** | **(19,716)** | **(3,008)** | **370,048** |
| **Accumulated depreciation** | | | | | | |
| Land and buildings | 18,250 | 2,868 | (591) | - | (55) | 20,472 |
| Plant and machinery | 73,672 | 11,555 | (4,677) | - | (144) | 80,406 |
| Equipment and other assets | 68,988 | 15,613 | (9,874) | - | (1,325) | 73,402 |
| **Total** | **160,910** | **30,036** | **(15,142)** | **-** | **(1,524)** | **174,280** |
| **Net book value** | **200,646** | **17,730** | **(1,408)** | **(19,716)** | **(1,484)** | **195,768** |

| *(Euro/000)* | Balance at January 1, 2005 | Increase | Decrease | Reclass. | Transl. Diff. | Balance as of December 31, 2005 |
|---|---|---|---|---|---|---|
| **Gross value** | | | | | | |
| Land and buildings | 109,527 | 4,510 | (1,025) | (5,444) | 535 | 108,103 |
| Plant and machinery | 151,195 | 6,989 | (2,061) | - | 413 | 156,536 |
| Equipment and other assets | 105,784 | 18,339 | (2,038) | - | 4,540 | 126,625 |
| Assets under construction | 3,542 | 1,493 | - | (2,268) | 64 | 2,831 |
| **Total** | **370,048** | **31,331** | **(5,124)** | **(7,712)** | **5,552** | **394,095** |
| **Accumulated depreciation** | | | | | | |
| Land and buildings | 20,472 | 3,440 | (249) | (2,460) | 99 | 21,302 |
| Plant and machinery | 80,406 | 11,265 | (1,651) | - | 172 | 90,192 |
| Equipment and other assets | 73,402 | 14,913 | (1,897) | - | 2,580 | 88,998 |
| **Total** | **174,280** | **29,618** | **(3,797)** | **(2,460)** | **2,851** | **200,492** |
| **Net book value** | **195,768** | **1,713** | **(1,327)** | **(5,252)** | **2,701** | **193,603** |

As described in the note 4.4 "assets held for sale", the reclassification of land and buildings for a net value of Euro 2,984 thousand refers to the net book value of land and buildings of the Austrian subsidiary Carrera Brillen (Traun).

A part of the property, plant and equipment held by the Group companies, for a total amount of Euro 160 million, is pledged by mortgages and/or liens given in favor of credit institutes to guarantee the loans obtained.

Some of the Group companies have property, plant and equipment in financial leasing. The following table shows the gross value and the related accumulated depreciation fund for property, plant and equipment in

leasing while the information related to the leasing contracts are disclosed in the paragraph 4.18 "Long-term borrowings".

| *(Euro/000)* | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|
| Land and buildings | 14,261 | 13,325 |
| Accumulated depreciation (-) | (230) | (116) |
| **Net book value** | **14,031** | **13,209** |
| Plant and machinery | 1,837 | 1,837 |
| Accumulated depreciation (-) | (1,437) | (1,234) |
| **Net book value** | **400** | **603** |
| Equipment and other assets | 377 | 484 |
| Accumulated depreciation (-) | (107) | (127) |
| **Net book value** | **270** | **357** |
| **Net book value** | **14,701** | **14,169** |

### 4.7 Intangible assets

| *(Euro/000)* | Balance at January 1, 2004 | Increase | Decrease | Reclass. | Transl. Diff. | Balance as of December 31, 2004 |
|---|---|---|---|---|---|---|
| **Gross value** | | | | | | |
| Software costs | 1,130 | 1,892 | - | 4,057 | (107) | 6,972 |
| Trademarks and licenses | 33,317 | 1,325 | - | (785) | (31) | 33,826 |
| Other intangible assets | 22,942 | - | - | (5,092) | (109) | 17,741 |
| Intangible assets in progress | 947 | 153,00 | - | (944) | 6 | 162 |
| **Total** | **58,336** | **3,370** | **-** | **(2,764)** | **(241)** | **58,701** |
| **Accumulated amortization** | | | | | | |
| Software costs | 961 | 1,121 | - | 3,247 | (72) | 5,257 |
| Trademarks and licenses | 11,092 | 3,903 | - | (170) | (7) | 14,818 |
| Other intangible assets | 21,919 | 444 | - | (4,963) | | 17,400 |
| **Total** | **33,972** | **5,468** | **-** | **(1,886)** | **(79)** | **37,475** |
| **Net book value** | **24,364** | **(2,098)** | **-** | **(878)** | **(162)** | **21,226** |

| *(Euro/000)* | Balance at January 1, 2005 | Increase | Decrease | Reclass. | Transl. Diff. | Balance as of December 31, 2005 |
|---|---|---|---|---|---|---|
| **Gross value** | | | | | | |
| Software costs | 6,972 | 1,709 | (739) | - | 197 | 8,139 |
| Trademarks and licenses | 33,826 | 7,618 | - | - | 65 | 41,509 |
| Other intangible assets | 17,741 | 416 | - | - | 342 | 18,499 |
| Intangible assets in progress | 162 | - | - | (141) | 12 | 33 |
| **Total** | **58,701** | **9,743** | **(739)** | **(141)** | **616** | **68,180** |
| **Accumulated amortization** | | | | | | |
| Software costs | 5,257 | 1,304 | (739) | - | 120 | 5,942 |
| Trademarks and licenses | 14,818 | 3,986 | - | - | 14 | 18,818 |
| Other intangible assets | 17,400 | 288 | - | - | 152 | 17,840 |
| **Total** | **37,475** | **5,578** | **(739)** | **-** | **286** | **42,600** |
| **Net book value** | **21,226** | **4,165** | **-** | **(141)** | **330** | **25,580** |

Amortization and depreciation expense related to intangible and property, plant and equipment for the 2005 and 2004 financial years are divided into these income statement line items:

| *(Euro/000)* | *note* | 2005 | 2004 |
|---|---|---|---|
| Cost of sales | *5.2* | 25,382 | 24,800 |
| Sales and marketing | *5.3* | 2,545 | 2,360 |
| General and administrative | *5.4* | 7,270 | 8,345 |
| **Total** | | **35,197** | **35,505** |

### 4.8 Goodwill

| *(Euro/000)* | Balance at January 1, 2004 | Transl. Diff. | Balance as of December 31, 2004 |
|---|---|---|---|
| Goodwill | 364,619 | (1,458) | 363,161 |
| **Net book value** | **364,619** | **(1,458)** | **363,161** |

| *(Euro/000)* | Balance at January 1, 2005 | Transl. Diff. | Balance as of December 31, 2005 |
|---|---|---|---|
| Goodwill | 363,161 | 1,960 | 365,121 |
| **Net book value** | **363,161** | **1,960** | **365,121** |

For impairment tests purposes, the Group has identified its cash-generating units (*CGUs*) that match with the Safilo Group entities operating in each country. Goodwill divided by CGUs is as follows:

| *Goodwill (Euro/000)* | Italy and Europe | America | Asia | Total |
|---|---|---|---|---|
| **31-dic-05** | 121,377 | 107,383 | 136,361 | **365,121** |
| **31-dic-04** | 120,725 | 106,806 | 135,630 | **363,161** |

The recoverable amount of the cash-generating units has been determined based on estimated cash flow projections. This computation derives from five-year financial budgets approved by management considering its expectations for market and Group development. Such cash flows have been discounted using a rate that reflects specific features and risks for the country in which the CGU operates.

Cash flows beyond the five-year period are extrapolated using the perpetual estimated growth rate that do not exceed the long-term average growth rate forecasted by analysts for the business in which the CGU operates.

| *Key assumptions* | Discount rate "WACC" | | Growth rate "g" | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| **Euro Area** | 6.5% | 6.2% | 1.0% | 1.0% |
| **USA Area** | 7.5% | 6.6% | 1.0% | 1.0% |
| **Far East Area** | 8.8% | 8.0% | 2.0% | 1.7% |
| **Australia** | 8.3% | 7.8% | 1.0% | 1.0% |
| **Japan** | 4.7% | 4.1% | 1.0% | 1.0% |
| **South Africa** | 10.4% | 10.4% | 4.7% | 4.5% |
| **India** | 11.7% | 10.8% | 3.6% | 4.3% |
| **Brazil** | 13.2% | 12.2% | 4.9% | 5.0% |

### 4.9 Investments in associates

Investments in associated companies refer to the following:

| Company | Registered office or headquarters | % of share capital | Type of investment | Main activity |
|---|---|---|---|---|
| Elegance Int. Holdings Ltd | Hong Kong | 23.05% | Associated company | Commercial |
| Optifashion As | Turkey | 50.00% | Non consolidated. subsidiary. | Commercial |
| TBR Inc. | USA | 33.33% | Associated company | Real Estate |

The movements in investments in associated companies during the year were as follows:

| | 31.12.2004 | | | Movements for the year | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| *(Euro/000)* | Gross value | Reval. (Deval.) | Net book value | Share of income (note 5.6) | dividends | Effect on equity | Reclass. | Transl. diff. | Balance as of December 31, 2005 |
| TBR Inc. | - | - | - | 122 | - | 225 | 437 | 109 | 893 |
| Elegance Ltd | 5,406 | 4,465 | 9,871 | 1,399 | (580) | - | - | 1,602 | 12,292 |
| Optifashion | 353 | (57) | 296 | 11 | - | - | - | - | 307 |
| **Total** | **5,759** | **4,408** | **10,167** | **1,532** | **(580)** | **225** | **437** | **1,711** | **13,492** |

There were no new acquisitions in financial year 2005. The changes compared to December 31, 2004 are mainly due to the gains realized in the year, net of the dividends distributed. The table below reports the main data relating to the last approved financial statements of the above-mentioned companies:

| 31 Dec 2004 *(Euro/000)* | Assets | Liabilities | Net equity | Net sales | Income (Loss) | % Group | Group net equity |
|---|---|---|---|---|---|---|---|
| Elegance Ltd | 55,738 | 11,759 | 43,979 | 21,797 | 2,232 | 23.05% | 9,871 |
| Optifashion As | 371 | 75 | 296 | 1,055 | 70 | 50.00% | 296 |
| **Total** | **56,109** | **11,834** | **44,275** | **22,852** | **2,302** | | **10,167** |

| 31 Dec 2005 *(Euro/000)* | Assets | Liabilities | Net equity | Net sales | Income (Loss) | % Group | Group net equity |
|---|---|---|---|---|---|---|---|
| Elegance Ltd | 67,990 | 16,748 | 51,242 | 20,571 | 1,350 | 23.05% | 12,293 |
| Optifashion As | 613 | 170 | 443 | 1,107 | 85 | 50.00% | 306 |
| TBR Inc. | 5,396 | 2,717 | 2,679 | 1,161 | 368 | 33.33% | 893 |
| **Total** | **73,999** | **19,635** | **54,364** | **22,839** | **1,803** | | **13,492** |

The company Optifashion A.s., with registered office in Istanbul (Turkey), a 50% held subsidiary of the Group, is not included in the consolidation scope as the amounts are considered insignificant.

### 4.10 Financial assets available-for-sale

The account represents the financial assets, which may be sold. They are measured at current value with a corresponding entry in the fair value equity reserve. This value is calculated with reference to official listed market prices at the balance sheet date.

| *(Euro/000)* | % of share capital | Relationship | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|---|---|
| Banca Pop. Italiana S.p.A. | == | Other equity inv. | 5,589 | 6,087 |
| TBR Inc. (USA) | 33.33% | Other equity inv. | - | 437 |
| Safilens Srl | 17.50% | Other equity inv. | 209 | 209 |
| Unicredit S.p.A. | == | Other equity inv. | 168 | 122 |
| Other | == | Other equity inv. | 43 | 42 |
| **Total** | | | **6,009** | **6,897** |

The movements in the above-mentioned assets available-for-sale were as follows:

| | 31.12.2004 | | | Movements for the year | | | |
|---|---|---|---|---|---|---|---|
| *(Euro/000)* | Gross value | Reval. (Deval.) | Net book value | Incr. | Decr. | Reclass. | Balance as of December 31, 2005 |
| Banca Pop. Italiana | 10,198 | (4,111) | 6,087 | - | (498) | - | 5,589 |
| UNICREDIT | 48 | 74 | 122 | 46 | - | - | 168 |
| TBR -USA | 437 | - | 437 | - | - | (437) | - |
| Safilens Srl | 209 | - | 209 | - | - | - | 209 |
| Other | 42 | - | 42 | 1 | - | - | 43 |
| **Total** | **10,934** | **(4,037)** | **6,897** | **47** | **(498)** | **(437)** | **6,009** |

With reference to the investment held in Banca Popolare Italiana S.p.A., an amount totaling Euro 3,370 thousand was recorded in the income statement in 2005 relating to the part of the cumulative negative changes in the previous years considered as a permanent impairment in value no longer recoverable in future years.

### 4.11 Deferred tax assets and deferred tax liabilities

| *(Euro/000)* | 2005 | 2004 |
|---|---|---|
| Deferred tax assets | | |
| - recoverable within 1 year | 22,775 | 16,824 |
| - recoverable after 1 year | 26,504 | 23,834 |
| **Total** | **49,279** | **40,658** |
| Deferred tax liabilities | | |
| - recoverable within 1 year | 533 | - |
| - recoverable after 1 year | 10,436 | 7,379 |
| **Total** | **10,969** | **7,379** |
| **Total, net** | **38,310** | **33,279** |

Deferred tax assets

Deferred tax assets refer to income taxes calculated on fiscal losses recoverable in future years and temporary differences between the tax basis of assets and liabilities and their book carrying amount.

| | | impact on | | | |
|---|---|---|---|---|---|
| *(Euro/000)* | Balance at January 1, 2005 | Income statement | Equity | Reclass. | Balance as of December 31, 2005 |
| Fiscal losses | 15,862 | 15,108 | - | (20,306) | 10,664 |
| ICO profit and obsolescence | 7,990 | 1,323 | 2,120 | - | 11,433 |
| Receivables | 5,237 | (46) | 15 | - | 5,206 |
| Contingent liabilities | 1,499 | 752 | (1) | - | 2,250 |
| Employee benefits | 1,058 | 616 | (1) | - | 1,673 |
| Intangible assets | 839 | 5,961 | - | - | 6,800 |
| Property, plant and equipment | 2,197 | 426 | 77 | (341) | 2,359 |
| Unrealized exchange differences | 871 | 1,279 | - | - | 2,150 |
| Derivative instruments fair value | 1,791 | - | (422) | - | 1,369 |
| Equity investments | 624 | 1,295 | (1,255) | - | 664 |
| Goodwill | 505 | 1,017 | 13 | - | 1,535 |
| Other payables | 935 | (573) | 3 | - | 365 |
| Translation difference | - | - | 1,418 | - | 1,418 |
| Other | 1,250 | 143 | - | - | 1,393 |
| **Total** | **40,658** | **27,301** | **1,967** | **(20,647)** | **49,279** |

The following table shows the Group fiscal losses on which deferred tax assets have been calculated as there is a reasonable expectation of the recovery of these amounts through future assessable income.

| *(Euro/000)* | Tax losses | Financial year | Expiring date | calculated deferred tax assets | transfer to holding company | Total deferred tax ass. for tax losses |
|---|---|---|---|---|---|---|
| | 1,711 | 2003 | 2008 | 565 | - | 565 |
| | 30,602 | 2004 | 2009 | 10,099 | - | 10,099 |
| | 61,535 | 2005 | 2010 | 20,306 | (20,306) | - |
| **Total** | **93,848** | | | **30,970** | **(20,306)** | **10,664** |

Deferred tax liabilities

Deferred tax liabilities refer to taxes calculated on the temporary differences between the book value of the assets and liabilities and the related tax value.

The most important account included in deferred tax liabilities mainly derives from the effects of the different criteria used in the calculation of the depreciation of property, plant and equipment of Safilo S.p.A. In 2003 the estimates of the useful life of some assets were revised with particular reference to the category plant and machinery. The effects of this revision, both for fiscal purposes and for Italian Accounting Standards purposes were adjusted in 2003, while in compliance with IFRS 1, Paragraph 7, they were calculated as if the assets were always depreciated in accordance with the re-determined useful life.

| | | impact on | | |
|---|---|---|---|---|
| *(Euro/000)* | Balance at January 1, 2005 | Income statement | Equity | Balance as of December 31, 2005 |
| Property, plant and equipment | 7,604 | 99 | 24 | 7,727 |
| Goodwill | 90 | 295 | 16 | 401 |
| Equity investments | - | 1,565 | 85 | 1,650 |
| *Fair value* derivative instruments | - | 418 | - | 418 |
| Dividends | - | 99 | - | 99 |
| Other | (315) | 833 | 140 | 658 |
| Translation difference | - | - | 16 | 16 |
| **Total** | **7,379** | **3,309** | **281** | **10,969** |

## 4.12 Other non-current assets

At December 31, 2005, the other non-current assets amount to Euro 2,571 thousand and relate:

- to the fair value of the advanced repayment option included in the bond issued by the subsidiary Safilo Capital International S.A.. The valuation was made using models applied by primary financial institutions and resulted in the recognition of a fair value of the option of Euro 1,268 thousand;
- to deposits and other long-term receivables.

### 4.13 Short-term borrowings

This account is comprised as follows:

| *(Euro/000)* | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|
| Bank overdrafts | 5,046 | 12,144 |
| Short-term bank loans | 5,000 | 3,500 |
| Short-term portion of long-term loans | 26,614 | 23,448 |
| Short-term portion of High Yield bond | 105,000 | - |
| Short-term portion of financial leasing | 3,436 | 2,516 |
| Payable for High Yield advance repayment | 10,106 | - |
| Other short-term loans | 28,804 | 28,310 |
| **Total** | **184,006** | **69,918** |

Short-term bank loans are as follows:

- a short-term loan of Euro 3,000 thousand granted by Banca Popolare di Vicenza on December 30, 2005 with an interest rate of 3.227% and reimbursed on January 31, 2006;
- a short-term loan of Euro 2,000 thousand granted by Cassa di Risparmio di Padova e Rovigo on December 30, 2005 with an interest rate of 3.227% and reimbursed on February 28, 2006.

The short-term portion of the High Yield bond refers to the quota of debt which was repaid in advance on January 13, 2006 by the Luxembourg subsidiary Safilo Capital International S.A. for a total amount equal to 35% of the Euro 300 million nominal value; the payable for the High Yield advanced repayment refers to the penalty paid as compensation to the bond holders following the advanced repayment.

Other short-term loans include, for an amount of Euro 28,296 thousand, a payable to a primary factoring company deriving from the contract signed by Safilo S.p.A.

Short-term loans by currency are as follows:

| *(Euro/000)* | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|
| Euro | 162,642 | 49.958 |
| U.S. Dollar | 19,205 | 17,812 |
| YEN | 2,160 | 2,148 |
| **Total** | **184,006** | **69,918** |

Interest rate applied on Group bank overdrafts on an average basis amounts to about 3%. Interest rates on long term loan are reported in the note 4.18 "long-term borrowings".

### 4.14 Trade payables

| *(Euro/000)* | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|
| Purchase of raw materials | 42,098 | 33,794 |
| Purchase of finished products and subcontractors | 71,299 | 71,336 |
| Commissions and royalties | 26,725 | 23,091 |
| Advertising and marketing costs | 17,456 | 14,519 |
| Services received from third parties | 21,756 | 18,046 |
| Payables for purchase of property, plant and equipment and intangible assets | 3,299 | 12,741 |
| **Total** | **182,633** | **173,527** |

Purchases of raw materials reflect the higher purchases of the last quarter of 2005 to support production.

The growth of payables for advertising and marketing costs is mainly related to the increase in net sales, whereas the growth of payables for royalties mainly refers to a mix of sales more focused on licensed products.

### 4.15 Tax payables

Tax payables as of December 31, 2005 amount to Euro 20,870 thousand and relate for Euro 8,471 thousand to income taxes for the year, for Euro 5,117 thousand to VAT payables and for the remainder to various tax liabilities and local taxes.

The accrual for current income tax expenses is disclosed in the note related to income taxes (5.9).

### 4.16 Other current payables and accrued expenses

| *(Euro/000)* | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|
| Due to personnel and social security institutions | 44,913 | 30,199 |
| Premiums to clients | 17,195 | 15,851 |
| Agent fee payable | 2,962 | 2,379 |
| Advertising & sponsorship costs | 2,746 | 1,931 |
| Interest expense payables on long term payables | 3,628 | 3,618 |
| Other accrued expenses | 2,898 | 5,475 |
| Due to minority shareholders for dividends | 2,170 | 2,264 |
| Financial derivative instruments | 878 | - |
| Payables to the holding c. Safilo Group S.p.A. | 959 | - |
| Other current liabilities | 1,952 | 3,746 |
| **Total** | **80,301** | **65,463** |

Due to personnel and social security institutions mainly refer to wages and salaries for December and for vacation days acumulated and not taken. The increase compared to previous year refers to the normal salary increase and to personnel compensation linked to the IPO process.

Due to minority shareholders for dividends relate to the dividends approved at the shareholders' meetings and not yet paid at the balance sheet date.

Financial derivative instruments refers to the liability deriving from the fair value of the forward currency contracts that in the previous financial year represented an asset for a total amount of Euro 1,911 thousand (note 4.5). The fair value of the derivative contracts as of December 31, 2005 and 2004 is shown below:

| | December 31, 2005 | | December 31, 2004 | |
|---|---|---|---|---|
| | Nominal value | *Fair value* | Nominal value | *Fair value* |
| | *(USD/000)* | *(Euro/000)* | *(USD/000)* | *(Euro/000)* |
| **Foreign currency contracts** | | | | |
| Expiry year 2005 | | | 27,000 | 1,911 |
| Expiry year 2006 | 34,000 | (878) | | |
| **Total** | **34,000** | **(878)** | **27,000** | **1,911** |

Gains and losses recorded in the cash flow reserve in equity at the balance sheet date will be reversed in the income statement over the duration of the hedged loans.

### 4.17 Provisions for risks and charges

This account is comprised as follows:

| *(Euro/000)* | Balance at January 1, 2005 | Increase | Decrease | Transl. Diff. | Balance as of December 31, 2005 |
|---|---|---|---|---|---|
| Product warranty provision | 3,119 | 312 | (312) | - | 3,119 |
| Agent's severance indemnity | 2,861 | 416 | (116) | 3 | 3,164 |
| Litigations | - | 2,000 | - | - | 2,000 |
| Other provisions for risks and charges | 376 | 191 | (251) | 45 | 361 |
| **Provisions for risks - long term** | **6,356** | **2,919** | **(679)** | **48** | **8,644** |
| **Provisions for risks - short term** | **136** | | **(8)** | | **128** |
| **Total** | **6,492** | **2,919** | **(687)** | **48** | **8,772** |

The product warranty provision was made against the costs to be incurred for the replacement of products sold before the balance sheet date.

The agent's severance provision was created against the risk deriving from the payment in the case of termination of the agency agreement. This provision has been calculated based on existing laws at the balance sheet date considering all the future expected financial cash flows.

The accrual for the financial year has been recorded in the income statement in the line item "selling and marketing expenses (note 5.3).

### 4.18 Long-term borrowings

| *(Euro/000)* | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|
| Long-term borrowings | 456,763 | 705,489 |
| Payables for finance leases | 10,616 | 11,055 |
| Other medium/long term loans | 863 | 1,462 |
| **Total** | **468,242** | **718,006** |

Long-term borrowings refer to the following:

- to a convertible bond with a nominal value of Euro 300 million, issued on May 15, 2003 by the Luxembourg subsidiary Safilo Capital International S.A., at a fixed rate of 9.625% and repayment due on May 15, 2013. As reported in the note 4.13 "short-term borrowings", the above-mentioned loan was partially repaid by the Luxembourg subsidiary Safilo Capital International S.A. for an amount of Euro 105,000 thousand.
- to the Senior loan agreement originally granted by a pool of banks composed of UniCredit Banca d'Impresa S.p.A. and San Paolo IMI S.p.A.. On December 9, 2005, this loan was paid in advance for a total amount of Euro 188,502 thousand.
- to a long-term credit line ("Capex") provided, in relation with the above Senior loan agreement, by UniCredit Banca d'Impresa S.p.A. for an amount of Euro 21,000 thousand.

The bond and the Senior Loan agreement, in accordance with International Accounting Standards, were measured under the amortized cost method.

Some Group companies acquired some property, plant and equipment in leasing (see note 4.6). The average duration of leasing contracts is 10 years. All leasing contracts at the balance sheet date are reimbursable through constant installments and the contracts do not include any option for reviewing the original contract.

| *(Euro/000)* | *Note* | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|---|
| Property, plant and equipment | *4.6* | 16,475 | 15,646 |
| Installments paid | | (2,726) | (2,253) |
| Interests | | 303 | 178 |
| **Total debt** | | **14,052** | **13,571** |
| Short term leasing financial debts | *4.13* | 3,436 | 2,516 |
| Long term leasing financial debts | *4.18* | 10,616 | 11,055 |
| **Total debt** | | **14,052** | **13,571** |

Some Group companies entered into operating leasing contracts. Costs related to operating leasing contracts are recorded in the income statement in the line "cost of sales" (note 5.2), "selling and marketing expenses" (note 5.3) and "general and administrative expenses" (note 5.4).

Other medium and long term loans refer:

- to a loan given to Safilo S.p.A by SIMEST S.p.A. for a project to develop a commercial program on the Japanese market, at a fixed rate of 1.44%,
- to a loan given to Safilo S.p.A. in accordance with Law 46/82 at a rate of 0.705%.

The repayment dates of the loans are as follows:

| *(Euro/000)* | 31 Dec. 2005 |
|---|---|
| Within 2007 | 30,464 |
| Within 2008 | 33,564 |
| Within 2009 | 20,471 |
| Within 2010 | 131,068 |
| Beyond 2010 | 252,675 |
| **Total** | **468,242** |

The principal characteristics of the loans in force as of December 31, 2005 and 2004 are as follows:

| **31 Dec. 2005** ***(Euro/000)*** | | **Nominal interest value** | **Internal Interest rate** | **Fair value** | **Expiry date** |
|---|---|---|---|---|---|
| Senior Loan - Term B | EURO | Euribor + 2.75% | 6.2402% | 134,400 | 31/12/2010 |
| Senior Loan - Term C | EURO | Euribor + 3.25% | 6.7288% | 61,226 | 31/12/2011 |
| Senior Loan - Term A1 - T2 | USD | Libor + 2.25% | 8.4636% | 40,670 | 31/12/2009 |
| Senior Loan - Term A2 | USD | Libor + 2.25% | 8.2889% | 45,890 | 31/12/2009 |
| Capex line | EURO | Euribor + 2.50% | 4.6460% | 7,000 | 31/12/2009 |
| Capex Line | EURO | Euribor + 2.50% | 4.6426% | 14,000 | 31/12/2009 |
| High Yield | EURO | 9.625% | 10.6887% | 337,013 | 15/05/2013 |
| Loans in YEN | YEN | Tibor + 0.54% | Tibor + 0.54% | 2,160 | 27/03/2006 |

| **31 Dec. 2004** ***(Euro/000)*** | | **Nominal interest value** | **Internal Interest rate** | **Fair value** | **Expiry date** |
|---|---|---|---|---|---|
| Senior Loan - Term A1 - T1 | EURO | Euribor + 2.25% | 5.9422% | 44,250 | 31/12/2009 |
| Senior Loan - Term B | EURO | Euribor + 2.75% | 5.9032% | 135,000 | 31/12/2010 |
| Senior Loan - Term C | EURO | Euribor + 3.25% | 6.3899% | 135,000 | 31/12/2011 |
| Senior Loan - Term A1 - T2 | USD | Libor + 2.25% | 6.3176% | 98,373 | 31/12/2009 |
| Senior Loan - Term A2 | USD | Libor + 2.25% | 6.1508% | 45,891 | 31/12/2009 |
| High Yield | EURO | 9.625% | 10.6887% | 306,990 | 15/05/2013 |
| Loans in YEN | YEN | Tibor + 0.54% | Tibor + 0.54% | 2,148 | 27/03/2006 |

The fair value of the loans refer to the residual nominal value at the balance sheet date except for the High Yield bond whose fair value derives from its market value as of December 31, 2005.

The medium/long-term loans and short-term loans sub-divided by currency are as follows:

| *(Euro/000)* | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|
| Euro | 402,980 | 596,153 |
| U.S. Dollars | 65,262 | 121,853 |
| **Total** | **468,242** | **718,006** |

The above loans are guaranteed by mortgages on buildings owned by some companies of the Group, by pledges on the share capital of Safilo S.p.A and by pledges on the shares of some subsidiaries, on the trademarks and on part of the trade receivables of the Group.

The contractual agreements relating to the loans granted by the pool of banks composed of Credit Suisse First Boston, San Paolo IMI Spa and UniCredit Banca d'Impresa Spa include a series of obligations which concern the operating and financial aspects of such loans. In particular, it is requested that pre-determined levels related to certain parametric indices (covenants), which are calculated based on the data of the final statements at the end of every three month period, are respected. The possibility cannot be excluded that such parameters may not be complied with. Should such parameters not be complied with, the conditions with which the loan relationship is to be continued must be negotiated with the financers, that is appropriate waivers or modifications to adapt the above-mentioned parameters. If this does not happen, an "Event of Default" could take place, that may involve obligatory early repayment of the loans granted.

The following table shows credit lines granted to the Group, their utilization and the credit lines available at the balance sheet date:

| *(Euro/000)* | Granted Credit lines | Utilization | Available credit lines |
|---|---|---|---|
| Credit lines on short-term loans | 69,307 | 11,814 | 57,494 |
| Credit lines on long-term loans | 303,186 | 303,186 | - |
| **Total** | **372,493** | **315,000** | **57,494** |

### 4.19 Employee benefit liability

This account shows the following movements:

| *(Euro/000)* | Balance as of January 1, 2005 | Increase | Decrease | Balance as of December 31, 2005 |
|---|---|---|---|---|
| Employee benefit liability | 34,607 | 7,175 | (2,417) | 39,365 |
| **Total** | **34,607** | **7,175** | **(2,417)** | **39,365** |

This payable refers to different forms of defined benefit and defined contributions pension plans, in line with the local conditions and practices in the countries in which the Group carries out its activities.

The amounts charged to the income statement (operating and financial components) and the net equity (actuarial differences) can be sub-divided as follows:

| *(Euro/000)* | 31 Dec. 2005 |
|---|---|
| Service cost | 3,312 |
| Interest cost | 656 |
| Actuarial gain | 3,207 |
| **Total** | **7,175** |

Actuarial estimates used for the employees' benefit are based on:

a) demographic parameters;

b) economic parameters;

c) financial parameters.

Demographic parameters are normally summarized in tables based on samples deriving from different Italian institutions (Istat, Inail, Inps, National accounts, etc).

Economic parameters mainly refer to long-term inflation rates and financial yield rate, critical for the revaluation of amounts accrued in the employees' benefit fund.

Economic parameters also include compensation factors of the work-force in question. Personnel compensation average increase has been taken into account considering the employees' service life and the professional qualification (blue collars, white collars, executives).

The most important financial parameter is the discount rate. For the present value of the future cash flows related to the services and charges, the zero coupon rate term structure has been derived using the interest rates swap term structure on December 31, 2005 has been used.

## 4.20 Other non-current liabilities

The other non-current liabilities as of December 31, 2005 amount to Euro 9,836 thousand and include:

- liabilities deriving from existing contracts with licensors for the production and distribution of licensed products;
- liabilities deriving from the market valuation of interest rate swap contracts. This value was calculated by specialized financial institutions on the basis of normal market conditions.

A summary of the characteristics and the fair value of interest rate swap contracts in force as of December 31, 2005 and 2004 is shown below:

| *(Euro/000)* | December 31, 2005 | | December 31, 2004 | |
|---|---|---|---|---|
| | Nominal value | *Fair value* | Nominal value | *Fair value* |
| **Interest rate swap** | | | | |
| Expiry 2007 | 164,080 | 537 | 319,708 | (3,432) |
| Expiry 2010 | 25,000 | (1,681) | 25,000 | (1,804) |
| Expiry 2011 | 25,000 | (2,127) | 25,000 | (2,104) |
| **Total** | **214,080** | **(3,271)** | **369,708** | **(7,340)** |

Gains and losses recorded in the Cash flow reserve in equity at the balance sheet date will be reversed in the income statement over the duration of the hedged loans.

## 4.21 Share capital

Safilo's capital stock as of December 31, 2005 amounted to Euro 35,000 thousand and consisted of 35,000,000 ordinary shares having a nominal value of Euro 1 per share.

## 4.22 Share premium reserve

The share premium reserve amounts to Euro 53,350 thousand and refers to:

- ·Euro 29,000 thousand for the higher price paid by the parent company's shareholders above the nominal price, in relation to the decision to underwrite the share capital increase, approved in the extraordinary shareholders' meeting on April 30, 2003;
- ·Euro 24,350 thousand for the higher price paid by the parent company's shareholders above the nominal value, in relation to underwriting the share capital increase, decided with the extraordinary shareholders' meeting on May 19, 2004;

### 4.23 Retained earnings and other reserves

The retained earnings and other reserves include both the reserves of the subsidiary companies generated after their inclusion in the consolidation scope and the currency differences deriving from the translation into Euro of the financial statements of consolidated companies.

| *(Euro/000)* | January 1, 2004 | Previous year's income allocation | Impact on equity | Impact on Income Statement | Dividends distribution | Consolidation area | December 31, 2004 |
|---|---|---|---|---|---|---|---|
| Group translation difference | - | - | (4,738) | - | - | - | (4,738) |
| Translation difference – Minority interests | - | - | (105) | - | - | - | (105) |
| **Total** | **-** | **-** | **(4,843)** | **-** | **-** | **-** | **(4,843)** |
| Other reserves - Group | (35,633) | - | - | (540) | - | 779 | (35,394) |
| Other reserves – Minority interests | 5,876 | - | - | 107 | (3,149) | (779) | 2,055 |
| **Total** | **(29,757)** | **-** | **-** | **(433)** | **(3,149)** | **-** | **(33,339)** |
| **Total** | **(29,757)** | **-** | **(4,843)** | **(433)** | **(3,149)** | **-** | **(38,182)** |

| *(Euro/000)* | January 1, 2005 | Previous year's income allocation | Impact on equity | Impact on Income Statement | Dividends distribution | Consolidation area | December 31, 2005 |
|---|---|---|---|---|---|---|---|
| Group translation difference | (4,738) | - | 9,946 | - | - | - | 5,208 |
| Translation difference – Minority interests | (105) | - | 207 | - | - | - | 102 |
| **Total** | **(4,843)** | **-** | **10,153** | **-** | **-** | **-** | **5,310** |
| Other reserves - Group | (35,394) | 21,610 | 292,207[2] | 1,695 | - | - | 280,118 |
| Other reserves – Minority interests | 2,055 | 3,123 | - | 62 | (3,025) | - | 2,215 |
| **Total** | **(33,339)** | **24,733** | **292,207** | **1,757** | **(3,025)** | **-** | **282,333** |
| **Total** | **(38,182)** | **24,733** | **302,360** | **1,757** | **(3,025)** | **-** | **287,643** |

[2] *This amount refers for Euro 294,713 thousand to the shareholders' contribution received from Safilo Group S.p.A. and for the remaining part to actuarial losses related to employee benefits.*

### 4.24 Fair value and cash flow reserves

| *(Euro/000)* | Balance at January 1, 2004 | Impact on equity | Impact on Income Statement | Balance as of December 31, 2004 |
|---|---|---|---|---|
| Cash flow reserve | 1,481 | (3,637) | (1,481) | (3,637) |
| Fair value reserve | (2,307) | (398) | - | (2,705) |
| **Total** | **(826)** | **(4,035)** | **(1,481)** | **(6,342)** |

| *(Euro/000)* | Balance at January 1, 2005 | Impact on equity | Impact on P&L | Balance as of December 31, 2005 |
|---|---|---|---|---|
| Cash flow reserve | (3,637) | (2,780) | 3,637 | (2,780) |
| Fair value reserve | (2,705) | (452) | 2,038 | (1,119) |
| **Total** | **(6,342)** | **(3,232)** | **5,675** | **(3,899)** |

The cash flow reserve refers to the current value of the interest rate swap contracts and to the current value of the forward currency contracts, while the fair value reserve refers to the current value of the investments classified under financial assets available-for-sale.

## 4.25 Consolidated changes in shareholders' equity

In accordance with IFRS 1, the table below sets forth the movements of equity for the years ended December 31, 2005 and 2004.

| *(Euro/000)* | Share capital | Share premium | Shareh.' contrib. | Treasury shares | Transl. Diff. | Fair value and cash flow reserve | Retained earnings | Net profit | Total equity |
|---|---|---|---|---|---|---|---|---|---|
| **Group net equity at January 1, 2004** | **34,350** | **29,000** | **4,810** | **(80,988)** | **-** | **(826)** | **40,547** | **-** | **26,893** |
| Retained earnings | 650 | 24,350 | - | - | (4,738) | (5,516) | 237 | - | 14,983 |
| 2004 net profit | - | - | - | - | - | - | - | 21,610 | 21,610 |
| **Group net equity at Dec. 31, 2004** | **35,000** | **53,350** | **4,810** | **(80,988)** | **(4,738)** | **(6,342)** | **40,784** | **21,610** | **63,486** |
| **Minority interests at January 1, 2004** | **-** | **-** | **-** | **-** | **-** | **-** | **5,876** | **-** | **5,876** |
| Retained earnings | - | - | - | - | (105) | - | (672) | - | (777) |
| Dividends distribution | - | - | - | - | - | - | (3,149) | - | (3,149) |
| 2004 net profit | - | - | - | - | - | - | - | 3,123 | 3,123 |
| **Minority interests at December 31, 2004** | **-** | **-** | **-** | **-** | **(105)** | **0** | **2,055** | **3,123** | **5,073** |
| **Consolidated net equity at Dec. 31, 2004** | **35,000** | **53,350** | **4,810** | **(80,988)** | **(4,843)** | **(6,342)** | **42,839** | **24,733** | **68,559** |

| *(Euro/000)* | Share capital | Share premium | Shareh.' contrib. | Treasury shares | Transl. Diff. | Fair value and cash flow reserve | Retained earnings | Net profit | Total equity |
|---|---|---|---|---|---|---|---|---|---|
| **Group net equity at January 1, 2005** | **35,000** | **53,350** | **4,810** | **(80,988)** | **(4,738)** | **(6,342)** | **40,784** | **21,610** | **63,486** |
| Prevoius year's profit allocation | - | - | - | - | - | - | 21,610 | (21,610) | 0 |
| Capital increase | - | - | 294,713 | - | - | - | - | - | 294,713 |
| Retained earnings | - | - | - | - | 9,946 | 2,443 | (811) | - | 11,578 |
| 2005 net profit | - | - | - | - | - | - | - | 10,442 | 10,442 |
| **Group net equity at Dec. 31, 2005** | **35,000** | **53,350** | **299,523** | **(80,988)** | **5,208** | **(3,899)** | **61,583** | **10,442** | **380,219** |
| **Minority interests at January 1, 2005** | **-** | **-** | **-** | **-** | **(105)** | **-** | **2,055** | **3,123** | **5,073** |
| Prevoius year's profit allocation | - | - | - | - | - | - | 3,123 | (3,123) | 0 |
| Retained earnings | - | - | - | - | 207 | - | 62 | - | 269 |
| Dividends distribution | - | - | - | - | - | - | (3,025) | - | (3,025) |
| 2005 net profit | - | - | - | - | - | - | - | 3,220 | 3,220 |
| **Minority interests at December 31, 2005** | **-** | **-** | **-** | **-** | **102** | **-** | **2,215** | **3,220** | **5,537** |
| **Consolidated net equity at Dec. 31, 2005** | **35,000** | **53,350** | **299,523** | **(80,988)** | **5,310** | **(3,899)** | **63,798** | **13,662** | **385,756** |

The shareholders' contribution of Euro 294,713 thousand has been made by our shareholder Safilo Group S.p.A. on December 2005.

## 4.26 Stock options plans

On March 25, 2003, the respective shareholders' meetings of Safilo Holding S.p.A.(now Safilo Group S.p.A.) and Safilo S.p.A. approved the "SOP I", which provides for the free vesting of rights for the subscription of new shares issued to some of the Group companies' employees and consultants.

On November 24, 2004 and December 16, 2004 respectively, the shareholders' meetings of Safilo Group S.p.A. and Safilo S.p.A. approved a new plan, the "SOP II", which provides for the free vesting of rights for the subscription of new shares issued to some some of the Group companies' employees and consultants.

The fair value of the options, in accordance with the requirements of IFRS, is recorded under personnel costs with a corresponding increase in a specific equity reserve over the duration of the maturity period, as the stock option plans are of an "equity-settled" type. In compliance with the requirements of IFRS 2, irrespective of which company is obliged to issue the new shares, the stock option cost is recorded in the company in which the employees carry out their employment. The amount received, net of the costs directly attributable to the transaction, will be credited to the share capital (nominal value) and the share premium reserve, when the options are exercised.

With reference to the first stock option plan mentioned above, the Group has decided to apply the exemption for share-based payments. In substance IFRS 2 is applied from January 1, 2004 for all the options issued after November 7, 2004 but not matured ("vested") before January 1, 2005. The application of this exemption results in the recording of only the third tranche of the 2003-2007 stock option plans as a cost in the Group's income statement.

The total costs recorded for the years 2005 and 2004 are summarized as follows:

| *(Euro/000)* | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|
| SOP I | 79 | 658 |
| SOP II | 1,635 | - |
| **Total** | **1,714** | **658** |

During December 2005 the holders of these options, in consideration of the public offering of our parent company Safilo Group S.p.A. on the Italian Stock Market, exercised 50% of the rights in their possession.

| SOP I | 2005 | | | 2004 | | |
|---|---|---|---|---|---|---|
| | Strike price | N. of Shares | N. of rights | Strike price | N. of Shares | N. of rights |
| **At January 1, 2005** | **2.5325** | **3,932,540** | **983,135** | **2.5325** | **3,968,512** | **992,128** |
| Issued | - | - | - | - | - | - |
| Granted | - | - | - | - | - | - |
| Not assigned | - | - | - | - | - | - |
| Forfeited | - | - | - | 2.5325 | (35,972) | (8,993) |
| Exercised | 2.5325 | (3,023,140) | (755,785) | - | - | - |
| **At Dec. 31, 2005** | **2.5325** | **909,400** | **227,350** | **2.5325** | **3,932,540** | **983,135** |
| *- of which exercisable* | *2.5325* | *909,400* | *227,350* | | *2,634,802* | *658,700* |

| SOP II | 2005 | | | 2004 | | |
|---|---|---|---|---|---|---|
| | Strike price | N. of Shares | N. of rights | Strike price | N. of Shares | N. of rights |
| **At January 1, 2005** | **3.5438** | **4,016,316** | **1,004,079** | **-** | **-** | **-** |
| Issued | - | - | - | 3.5438 | 4,016,316 | 1,004,079 |
| Granted | 3.5438 | 4,016,316 | 1,004,079 | - | - | - |
| Not assigned | - | - | - | - | - | - |
| Forfeited | 3.5438 | (54,352) | (13,588) | - | - | - |
| Exercised | 3.5438 | (924,112) | (231,028) | - | - | - |
| **At Dec. 31, 2005** | **3.5438** | **3,037,852** | **759,463** | **-** | **-** | **-** |
| *- of which exercisable* | *3.5438* | *3,037,852* | *759,463* | - | - | - |

| TOTAL SOP I + SOP II | 2005 | | | 2004 | | |
|---|---|---|---|---|---|---|
| | Avg. Strike price | N. of Shares | N. of rights | Avg. Strike price | N. of Shares | N. of rights |
| **At January 1, 2005** | **2.5325** | **3.932.540** | **983.135** | **2.5325** | **3,968,512** | **992,128** |
| Issued | - | - | - | 3.5438 | 4,016,316 | 1,004,079 |
| Granted | 3.5438 | 4,016,316 | 1,004,079 | - | - | - |
| Not assigned | - | - | - | - | - | - |
| Forfeited | 3.5438 | (54,352) | (13,588) | 2.5325 | (35,972) | (8,993) |
| Exercised | 2.7693 | (3,947,252) | (986,813) | - | - | - |
| **At Dec. 31, 2005** | **3.3108** | **3,947,252** | **986,813** | **2.5325** | **3,932,540** | **983,135** |
| *- of which exercisable* | | *3,947,252* | *986,813* | | *2,634,802* | *658,700* |

## 5. Notes to the Consolidated Statements of Operations

### 5.1 Net sales

Group sales in financial year 2005 amounted to Euro 1,025,274 thousand and report an increase of 8.5% compared to Euro 944,740 thousand recorded in the previous year. The slight change in the average Euro/US dollar exchange rate in 2005 compared to 2004 did not have a significant impact on net sales.

We refer the reader to the directors' report and the note 5.12 "Segment information" for further details regarding the sales trend compared to previous year.

### 5.2 Cost of sales

| *(Euro/000)* | 2005 | 2004 |
|---|---|---|
| Purchase of raw materials and finished goods | 282,892 | 263,126 |
| Change in inventories | (7,770) | (36,722) |
| Payroll and social security contributions | 91,278 | 95,846 |
| Capitalization of costs for increase in property, plant and equipment | (9,851) | (7,475) |
| Subcontracting costs | 23,275 | 33,473 |
| Depreciation | 25,382 | 24,800 |
| Rental and operating leases | 766 | 956 |
| Other industrial costs | 10,533 | 7,525 |
| **Total** | **416,505** | **381,529** |

The increase in purchases of raw materials and finished goods relates mainly to the higher quantities of finished products acquired as a consequence of both increased sales and the "outsourcing" strategy of the company.

These changes in inventories are comprised as follows:

| *(Euro/000)* | 2005 | 2004 |
|---|---|---|
| Finished goods | (913) | (36,674) |
| Work-in-progress | 1,321 | 252 |
| Raw materials | (8,178) | (300) |
| **Total** | **(7,770)** | **(36,722)** |

Payroll and social security contributions decreased by approximately 4.8%, mainly as a result of the decrease in the average number of employees in the production facilities of the Group.

The total workforce of the Group as of December 31, 2005 and 2004 is broken down as follows:

| | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|
| Headquarters at Padua | 765 | 707 |
| Production facilities | 4,192 | 4,561 |
| Commercial companies | 1,053 | 1,024 |
| Solstice – retail chain | 374 | 221 |
| **Total** | **6,384** | **6,513** |

The average number of employees broken down by category is summarized as follows:

| | 31 Dec. 2005 | 31 Dec. 2004 |
|---|---|---|
| Managers | 76 | 76 |
| Clerical | 1,967 | 1,810 |
| Factory workers | 4,280 | 4,636 |
| **Total** | **6,323** | **6,522** |

Compared to 2004 the costs for subcontracting costs decreased by Euro 10,198 thousand, due to the Group carrying out some of the processes directly, as previously some of these processes had been outsourced. The other costs include energy, industrial services, maintenance and consultancy services relating to the production area.

### 5.3 Selling and marketing expenses

| *(Euro/000)* | 2005 | 2004 |
|---|---|---|
| Payroll and social security contributions | 81,817 | 73,852 |
| Commissions to sales agents | 74,725 | 65,585 |
| Royalty expenses | 91,040 | 79,980 |
| Advertising and promotional costs | 78,493 | 76,482 |
| Amortization & depreciation | 2,545 | 2,360 |
| Logistic costs | 14,259 | 12,968 |
| Rental and operating leases | 5,873 | 4,606 |
| Utilities | 713 | 347 |
| Provision for risks | 2,919 | 1,109 |
| Other sales and marketing expenses | 27,035 | 26,778 |
| **Total** | **379,419** | **344,067** |

The increase of selling and marketing expenses is a result of the increase in the after-sales structure, the development of the American retail chain Solstice and the normal salary increases.

The growth in commissions to sales agents and royalty expenses is directly related to the increase in sales. The amount of royalties has been impacted by a mix of sales more focused on licensed products.

## 5.4 General and administrative expenses

| *(Euro/000)* | 2005 | 2004 |
|---|---|---|
| Payroll and social security contributions | 48,416 | 52,165 |
| Allowance for doubtful accounts | 1,904 | 4,566 |
| Amortization & depreciation | 7,270 | 8,345 |
| Consultants fees | 9,706 | 9,927 |
| Rental and operating leases | 6,226 | 5,464 |
| EDP costs | 3,543 | 3,469 |
| Insurance costs | 2,091 | 1,893 |
| Utilities | 3,486 | 3,486 |
| Taxes (other than on income) | 2,227 | 2,298 |
| Other general and administrative expenses | 17,253 | 15,266 |
| **Total** | **102,122** | **106,879** |

General and administrative expenses for the different Group companies decreased by about 4% as a result of cost containment activities taken by the Group during 2005 financial year.

### *5.4.1 Remuneration (including all possible and deferred remuneration) and benefits-in-kind received by Directors and Statutory Auditors)*

All forms of remuneration paid by the parent company and by its direct or indirect subsidiaries to Directors and Statutory Auditors, as of the balance sheet date, for the year ended December 31, 2005 are reported below:

| Name | Office | Our Company *(Euro/000)* | Our Subsidiaries *(Euro/000)* |
|---|---|---|---|
| **Board of Directors** | | | |
| Vittorio Tabacchi | Chairman | 1,506 | 550 |
| Giannino Lorenzon | Vice-Chairman | 485 | 641 |
| Roberto Vedovotto | Chief Executive Officer | 1,285 | 540 |
| Carlo Maria Calabria[3] | Director | 7 | - |
| Thompson Dean[4] | Director | 20 | - |
| Ennio Doris[5] | Director | - | - |
| Carlo Gilardi | Director | 20 | - |
| Julian Masters[4] | Director | 13 | - |
| Charles Paul Pieper[4] | Director | 13 | - |
| Riccardo Ruggiero[5] | Director | - | - |
| Massimiliano Tabacchi | Director | 395 | - |
| Colin Taylor[4] | Director | 20 | - |
| **Board of Statutory Auditors** | | | |
| Franco Corgnati | Chairman | 27 | 2 |
| Lorenzo Lago | Regular Auditor | 18 | 2 |
| Paolo Mazzi | Regular Auditor | 18 | 3 |

[3] *Resigned on April 22, 2005.*
[4] *Resigned on February 15, 2006.*
[5] *Appointed by the Shareholders' Meeting of March 7, 2006.*

### 5.5 Other income/(expenses), net

This account is comprised as follows:

| *(Euro/000)* | 2005 | 2004 |
|---|---|---|
| Losses on asset disposals | (621) | (585) |
| Other operating expenses | (974) | (2,894) |
| Gains on asset disposals | 159 | 100 |
| Other operating revenues | 2,490 | 2,513 |
| **Total** | **1,054** | **(866)** |

### 5.6 Share of income/ (losses) of associates

This account amounts to Euro 1,532 thousand and consists of the income and losses deriving from the equity valuation of the holdings in associated companies (note 4.9).

### 5.7 Interest expense and other financial charges, net

This account is comprised as follows:

| *(Euro/000)* | 2005 | 2004 |
|---|---|---|
| Interest expense on loans | 34,954 | 34,734 |
| Interest expense and charges on High Yield | 29,773 | 29,575 |
| Bank commissions | 4,820 | 4,700 |
| Foreign exchange rate differences | 21,125 | 8,015 |
| Financial discounts | 5,262 | 4,715 |
| Write-down on financial assets | 3,370 | - |
| Other financial charges | 237 | 2,879 |
| **Total financial charges** | **99,541** | **84,618** |
| Interest income | 820 | 437 |
| Foreign exchange rate differences | 11,740 | 17,792 |
| Other financial income | 1,709 | 239 |
| **Total financial income** | **14,269** | **18,468** |
| **Total financial charges, net** | **88,272** | **66,150** |

As already described in the note 4.10 "available-for-sale financial assets" the impairment of the value of the investment held in Banca Popolare Italiana, being considered a permanent reduction, was recorded in the 2005 income statement for a total amount of Euro 3,370 thousand.

Foreign exchange losses have been significantly impacted by costs related to the American Dollar revaluation of foreign currency loans resulting in a charge of Euro 15,031 thousand due to both the repayments made and the residual debt at the balance sheet date.

### 5.8 Non recurring financial charges

| *(Euro/000)* | 2005 | 2004 |
|---|---|---|
| Accelerated fees for advance repayment | 9,401 | - |
| Penalty on High Yield advance repayment | 10,106 | - |
| **Total** | **19,507** | **-** |

The advance repayment of a portion of the Senior loan and of one third of the High Yield bond through the use of proceeds from the stock exchange listing has had the following effect on income statement:

- higher financial charges due to, in accordance with IFRS, the accelerated amortization of charges related to the above borrowings;
- a penalty to be paid to High Yield bond holders.

### 5.9 Income tax expenses

| *(Euro/000)* | 2005 | 2004 |
|---|---|---|
| Current taxes | (35,366) | (31,192) |
| Deferred taxes | 23,993 | 10,718 |
| **Total** | **(11,373)** | **(20,474)** |

Theoretical income taxes are calculated using a 33% rate on estimated taxable income for the year. The above percentage represents the tax rate (IRES) that the Italian holding company is subject to. Effective income taxes can be reconciled with the theoretical income taxes as follows:

| *(Euro/000)* | % | 2005 | % | 2004 |
|---|---|---|---|---|
| **Income before taxation** | ***100.0*** | **25,035** | ***100.0*** | **45,207** |
| Tax calculated at domestic tax rate | *33.0* | 8,262 | *33.0* | 14,918 |
| IRAP and other taxes | *24.4* | 6,117 | *14.3* | 6,470 |
| Income not subject to tax | *(22.2)* | (5,557) | *(12.1)* | (5,449) |
| Non deductible expenses | *8.0* | 1,998 | *1.8* | 792 |
| Other permanent differences | *2.2* | 553 | *8.3* | 3,743 |
| **Effective tax charge** | ***45.4*** | **11,373** | ***45.3*** | **20,474** |

The year ended December 31, 2005 was impacted by a fiscal charge substantially in line with the previous year.

### 5.10 Dividends

During the current and the previous financial year, the holding company Safilo S.p.A. has not paid any dividends to its shareholders.

## 5.11 Segment information

The following information is provided with reference to the geographical areas where the Group operates. The geographical area has been identified as the primary segment. The criteria used in identifying the primary segment have been based on the modality of which management operates the Group and the way it attributes managerial responsibilities. Such criteria are based on the grouping of geographical areas which are defined by the location of the registered office of each Group Company. Therefore segment information is determined by the invoices issued at country of origin and not by the country of destination.

As of December 31, 2005, the secondary segment has not been identified. The secondary segment could be defined, in line with the standard procedure, as the "wholesale". In our case the distribution of products is almost entirely "wholesale", whilst the distribution activity through the direct sales points controlled by the Group ("retail") is only marginal.

| **December 31, 2005** *(Euro/000)* | **Italy (1)** | **Europe (2)** | **America (3)** | **Asia (4)** | ***Corporate* (5)** | **Eliminat.** | **Total** |
|---|---|---|---|---|---|---|---|
| **Net sales** | | | | | | | |
| -to other segments | 280,865 | 37,540 | 1,833 | 977 | - | (321,215) | - |
| -to third parties | 240,196 | 288,389 | 376,899 | 119,786 | 4 | | 1,025,274 |
| **Total Net Sales** | **521,061** | **325,929** | **378,732** | **120,763** | **4** | **(321,215)** | **1,025,274** |
| **Gross Profit** | **207,167** | **143,100** | **199,029** | **60,930** | **4** | **(1,461)** | **608,769** |
| **Operating income** | **32,128** | **51,341** | **40,996** | **20,960** | **727** | **(17,870)** | **128,282** |
| Interest expense | | | | | | | (116,164) |
| Interest income | | | | | | | 14,755 |
| Share losses of inv. - equity method | (3,370) | | | | | | (3,370) |
| Share income/(loss) of associates | | | 123 | 1,398 | 11 | | 1,532 |
| Income taxes | | | | | | | (11,373) |
| **Net income** | | | | | | | **13,662** |
| *Gross profit margin* | *40%* | *44%* | *53%* | *50%* | | | *59%* |
| *Operating profit margin* | *6%* | *16%* | *11%* | *17%* | | | *13%* |
| **Other information** | | | | | | | |
| Segment assets | 560,156 | 255,475 | 284,324 | 183,560 | 4,265 | | 1,287,780 |
| Investment in equity method assoc. | | | 893 | 12,293 | 306 | | 13,492 |
| Unallocated corporate assets | | | | | | | 89,478 |
| **Consolidated total assets** | | | | | | | **1,390,750** |
| Segment liabilities | 214,585 | 34,783 | 39,947 | 16,699 | 1,798 | | 307,812 |
| Unallocated corporate liabilities | | | | | | | 697,182 |
| **Consolidated total liabilities** | | | | | | | **1,004,994** |
| Capital expenditure | 26,406 | 5,688 | 5,544 | 1,027 | - | | 38,665 |
| Depreciation & Amortization | 24,999 | 5,615 | 3,601 | 961 | 21 | | 35,197 |
| Non-cash expenses other than depreciation | 5,666 | 2,793 | 457 | 887 | - | | 9,803 |

| **December 31, 2004** *(Euro/000)* | **Italy (1)** | **Europe (2)** | **America (3)** | **Asia (4)** | ***Corporate* (5)** | **Eliminat.** | **Total** |
|---|---|---|---|---|---|---|---|
| **Net sales** | | | | | | | |
| -to other segments | 275,951 | 44,587 | 1,088 | 348 | 30 | (322,004) | - |
| -to third parties | 221,801 | 280,398 | 342,699 | 99,815 | 27 | | 944,740 |
| **Total Net Sales** | **497,752** | **324,985** | **343,787** | **100,163** | **57** | **(322,004)** | **944,740** |
| **Gross Profit** | **192,258** | **137,793** | **181,174** | **54,454** | **58** | **(2,526)** | **563,211** |
| **Operating income** | **33,577** | **32,426** | **32,708** | **22,539** | **659** | **(10,510)** | **111,399** |
| Interest expense | | | | | | | (84,619) |
| Interest income | | | | | | | 18,469 |
| Share income/(loss) of associates | 2 | | | (111) | 67 | | (42) |
| Income taxes | | | | | | | (20,474) |
| **Net income** | | | | | | | **24,733** |
| *Gross profit margin* | *39%* | *42%* | *53%* | *54%* | | | *60%* |
| *Operating profit margin* | *7%* | *10%* | *10%* | *23%* | | | *12%* |
| **Other information** | | | | | | | |
| Segment assets | 405,944 | 254,780 | 265,193 | 175,743 | 1,343 | | 1,103,003 |
| Investment in equity method associates | | | | 9,871 | 296 | | 10,167 |
| Unallocated corporate assets | | | | | | | 58,439 |
| **Consolidated total assets** | | | | | | | **1,171,609** |
| Segment liabilities | 178,045 | 37,769 | 42,433 | 16,747 | 5,466 | | 280,460 |
| Unallocated corporate liabilities | | | | | | | 822,590 |
| **Consolidated total liabilities** | | | | | | | **1,103,050** |
| Capital expenditure | 21,949 | 5,921 | 2,210 | 972 | 169 | | 31,221 |
| Depreciation & Amortization | 23,989 | 6,893 | 3,848 | 762 | 13 | | 35,505 |
| Non-cash expenses other than depreciation | 4,522 | 3,852 | 4,261 | 1,202 | - | | 13,837 |

(1) Operating companies with based in Italy.
(2) Operating companies with based in European countries different from Italy, India and South Africa.
(3) Operating companies with based in USA, Canada and Brazil.
(4) Operating companies with based in the Far East, Australia, Singapore, Malaysia and China.
(5) Non operating companies.

## 6. Related party transactions

The nature of the related party transactions is disclosed in the table below:

| Related parties *(Euro/000)* | Relationship | 2005 | 2004 |
|---|---|---|---|
| *Receivables* | | | |
| Safilens s.r.l. | (a) | 207 | - |
| Elegance International Holdings Ltd | (a) | 750 | 525 |
| **Total** | | **957** | **525** |
| *Payables* | | | |
| Safilens s.r.l. | (a) | 22 | - |
| Elegance International Holdings Ltd | (a) | 8,533 | 10,715 |
| **Total** | | **8,555** | **10,715** |
| *Revenues* | | | |
| Optifashion As | (b) | 179 | 268 |
| Safilens s.r.l. | (a) | 2 | - |
| Elegance International Holdings Ltd | (a) | 578 | 4 |
| **Total** | | **759** | **272** |
| *Costs* | | | |
| Safilens s.r.l. | (a) | 81 | 387 |
| Elegance International Holdings Ltd | (a) | 20,673 | 21,654 |
| TBR Inc. | (a) | 1,107 | 1,054 |
| **Total** | | **21,861** | **23,095** |

(a) associated company
(b) unconsolidated subsidiary

The nature of the transactions with related parties is illustrated in the table below. These transactions relate to commercial relationships on the basis of prices defined at normal market conditions similar to transactions with third parties.

Safilo USA rents its headquarters and distribution center in the USA (New Jersey), based on a rental contract with TBR Inc., a company one-third owned by Vittorio Tabacchi, Chairman of our Board of Directors and shareholder of Safilo Group S.p.A., one third by a subsidiary company of the Safilo Group S.p.A. and one third by a third party. Safilo Group S.p.A. indirectly acquired the holding in TBR Inc. in 2002 for Euro 629,000. In 2005, the Group paid rent of Euro 1,107 thousand to TBR Inc. The terms and conditions of the rental contract are in line with market conditions for similar contracts.

Safilo Far East Limited, a subsidiary of Safilo S.p.A, holds 23.05% of Elegance International Holdings Limited ("Elegance"), a company listed on the Hong Kong Stock Exchange. Elegance is a producer of eyewear products in Asia, and to which the Group assigns part of its production. The price and the other conditions of the production contract between Safilo Far East Limited and Elegance are in line with those applied by Elegance to its other clients. Massimiliano Tabacchi, Director of Safilo S.p.A., and Mario Pietribiasi, executive of the Group, are non-executive directors of Elegance. In addition, Mario Pietribiasi is also a shareholder of the company with a holding of 0.30%.

## 7. Contingent liabilities

The Group does not have any significant contingent liabilities that have not been disclosed in the previous notes or not covered by adequate provisions.

Nevertheless, as of December 31, 2005, we are currently party to various claims and legal actions that arise in the ordinary course of business. We believe such claims and legal actions, individually and in the

aggregate, are groundless, nevertheless a negative outcome of them beyond estimates, could have a material adverse effect on our business, financial condition or results of operations.

Among the most important claims in monetary terms, we highlight: (i) in June 2005, a claim against Safilo S.p.A. in legal fees allegedly owed to an Italian law firm for legal services provided to the defendants from 1999 to 2001 related to the IPO; (ii) a claim alleging unfair business practices against Safilo S.p.A. by one of our clients, who later filed bankruptcy. The claim has been taken over by the plaintiff's receiver, who seeks damages; (iii) two companies (having the same owner) that are clients of the Group filed two claims against Safilo S.p.A. seeking damages for breach of contract. We filed a claim against the same two companies, seeking payment owed to us for products sold.

## 8. Commitments

At the balance date the Group does not significant purchase commitments.

## 9. Subsequent events

In the period subsequent to the closing of the financial year, there are no events that could be considered to significantly affect the data contained in the present report.

During the first quarter of 2006, a significant increase in orders has taken place; the Group is facing, with some difficulties, this growth by increasing its production capability.

On January 13, 2006, the subsidiary Safilo Capital International S.A., with headquarters in Luxembourg, made an advance repayment of 35% of the bonds listed on the Luxembourg market (Senior notes 9 5/8%), for a total amount of nominal Euro 105,000 thousand.

At the end of January 2006 the Group completed a significant step of the "lean manufacturing project", which resulted in the closure of the manufacturing activities in the plants of Calalzo, Coseano and Ronchis.

On January 27, 2006, the Group announced the non-renewal of the license agreement for the production and distribution of Ralph Lauren sunglasses, which expires on December 31, 2006. This license had an impact of 10% of the entire turnover. Appropriate actions have already been taken to minimize the impact of this missing renewal in 2006 and subsequent years.

# 10. Transition to International Financial Reporting Standards (IFRS)

## 10.1 Transition to International Financial Reporting Standards (IFRS)

The European Union Regulation No. 1606/2002 of July 19, 2002, enacted in Italy under Law No. 306/2003, established that, effective from 2005, all companies in the European Union whose shares are listed on a regulated market are obliged to present Consolidated financial statements in accordance with International Financial Reporting Standards (IFRS), as the comparability of financial information is considered fundamental for the full integration of the markets and financial services.

The consolidated financial statements of the Group for the year ended December 31, 2005 therefore represent the first annual accounts prepared in accordance with international accounting standards approved by the European Commission.

The transition date, that is the beginning of the year prior to the first adoption of the IFRS, was January 1, 2004. The Group has retrospectively applied the IFRS approved by the European Commission to all of the periods ended prior to the transition date, except for some exemptions permitted and the obligatory exceptions adopted in accordance with IFRS 1, as described in the following paragraph.

The balance sheet at January 1, 2004 reflects the following differences in treatment compared to the consolidated financial statements as of December 31, 2003, prepared in accordance with Italian Accounting Standards:

- all assets and liabilities were measured and recognized in IFRS approved by the European Commission, including those not in accordance with Italian Accounting Standards;

- all the assets and liabilities which are required to be recognized by Italian Accounting Standards, but not permitted by IFRS, as approved by the European Commission, were eliminated;

- some accounts in the financial statements were reclassified in accordance with the IFRS approved by the European Commission.

The effects of these adjustments were directly recognized in the opening shareholders' equity at the transition date (January 1, 2004).

## 10.2 Format for the presentation of the financial statements

For the Balance Sheet the "current/non-current" criteria was adopted while for the Income Statement the classification of costs according to their destination was adopted as this criterion is considered by the Company to be more appropriate to give relevant, reliable and more significant information if compared with the classification of costs according to their nature. For the cash flow statement the indirect method was adopted.

## 10.3 Exemptions permitted and obligatory exceptions from the application of the IFRS approved by the European Commission

*Exemptions permitted by IFRS 1 adopted on the first application of the IFRS approved by the European Commission:*

- business combinations: it was decided not to retrospectively apply IFRS 3 – Business combinations for the operations carried out before the transition date to IFRS approved by the European Commission;
- fair value or re-determination of the value as replacement of cost: for the buildings at the production site of Ormoz, instead of the original cost of the asset at the acquisition date, the re-valued amount was adopted in accordance with Italian re-valuation laws which at the date of the revaluations approximated to the market value of the assets;
- employee benefits: all of the cumulative actuarial gains and losses existing at January 1, 2004 were recorded;
- translation reserve deriving from the conversion of financial statements in currencies other than the Euro: the cumulative net exchange differences deriving from the previous conversion of financial statements in currencies other than the Euro were not recorded at the transition date;
- classification and measurement of the financial instruments: IAS 32 – Financial Instruments: disclosure

and presentation and IAS 39 – Financial instruments: recognition and measurement, were adopted, as permitted, from January 1, 2004;

- share-based payments: the provisions of IFRS 2 – Share-based payments are applied from January 1, 2004, in accordance with the prospective method to all capital instrument assignments after November 7, 2002 and not matured at the transition date.

*Obligatory exemptions of IFRS 1 on the first application of the IFRS approved by the European Commission:*

- cancellation of financial assets and liabilities: the financial assets and/or liabilities other than derivatives relating to transactions made before January 1, 2004 which were eliminated in the financial statements prepared in accordance with Italian Accounting Standards, shall not be recognized and therefore not re-stated in the financial statements;
- accounting of hedging operations: a derivative shall not be treated as a hedge operation if the relative hedge did not exist at the transition date;
- estimates: the estimates made at the transition date to the IFRS approved by the European Commission shall be in conformity with the estimates made at the same date in accordance with Italian GAAP (after the necessary adjustments to reflect any differences in the accounting standards).

*Treatments chosen in relation to the accounting options permitted by IFRS approved by the European Commission*

- Inventories: in accordance with IAS 2 - Inventories, the cost of inventories shall be determined adopting either the FIFO or the weighed average cost method. It was decided to use the weighted average cost method.
- Measurement of property, plant and equipment and intangible assets: after initial recognition at cost, IAS 16 – Property, plant and equipment and IAS 38 - Intangible assets, allows these assets to be valued at cost, or periodically determining the market value and adjusting the book value to this value at the measurement date. It was decided to adopt the cost method.
- Financial charges: IAS 23 - Financial charges, provides that the financial charges shall be charged directly to the income statement, or, if certain conditions are met, the possibility to capitalize these charges together with the cost of acquisition, construction or production of the asset to which they refer. It was decided to charge such financial charges to the income statement.

*Significant effects of the transition either with regard to the classification of the various accounts in the financial statements or in relation to their measurement and, therefore, to the consequent effects on the balance sheet and income statement*

The effects, in relation to both reclassifications and adjustments, of the transition to the IFRS approved by the European Commission on the balance sheet at January 1, 2004 (transition date) and as of December 31, 2004 (in Euro millions) and the relative explanatory notes are reported in the section following the notes to the financial statements.

The preparation of the financial statements in accordance with IFRS accounting standards requires management to make estimates and assumptions which have an impact on the amounts reported in the financial statements and the relative notes.

## 10.4 Description of the significant effects of the transition either with regard to the classification of the various accounts in the financial statements or in relation to their measurement and, therefore, to the consequent effects on the balance sheet and income statement

In the following table, the effects, in relation to both reclassifications and adjustments, of the transition to the IFRS approved by the European Commission on the balance sheet at January 1, 2004 (transition date) and as of December 31, 2004, are shown:

## IFRS consolidated balance sheet at January 1, 2004

| January 1, 2004 *(in Euro million)* | ITA GAAP | Adjustments and reclass. | IFRS approved by the European Commission | Note |
|---|---|---|---|---|
| **ASSETS** | | | | |
| **Current assets** | | | | |
| Cash in hand and at banks | 38,741 | 12,992 | 51,733 | a |
| Trade receivables, net | 209,077 | 71,049 | 280,126 | a |
| Inventory, net | 166,580 | (4,425) | 162,155 | b |
| Other current receivables | 71,087 | (38,965) | 32,122 | a,c |
| **Total current assets** | **485,485** | **40,651** | **526,136** | |
| **Non-current assets** | | | | |
| Property, plant and equipment | 184,096 | 1,655 | 200,646 | d |
| Intangible assets | 63,045 | (38,888) | 24,157 | d,e |
| Goodwill | 364,826 | - | 364,826 | |
| Investments in associates | 11,530 | - | 11,530 | |
| Financial assets available-for-sale | 15,274 | (7,599) | 7,675 | f |
| Treasury shares | 80,988 | (80,988) | - | g |
| Deferred tax assets | 35,637 | 4,551 | 40,188 | h |
| Other non-current assets | 3,957 | (1,917) | 2,040 | |
| **Total non-current assets** | **759,353** | **(108,291)** | **651,062** | |
| **Total assets** | **1,244,838** | **(6,764)** | **1,177,198** | |

| January 1, 2004 *(in Euro million)* | ITA GAAP | Adjustments and reclass. | IFRS approved by the European Commission | Note |
|---|---|---|---|---|
| **LIAB. AND SHAREHOLDERS' EQUITY** | | | | |
| **Current liabilities** | | | | |
| Short term borrowings | 54,150 | 50,482 | 104,632 | a,i |
| Trade payables | 141,594 | - | 141,594 | |
| Tax payables | 13,195 | (632) | 12,563 | |
| Other current payables and accrued expenses | 74,036 | 2,012 | 76,048 | j |
| **Total current liabilities** | **282,975** | **51,862** | **334,837** | |
| **Non-current liabilities** | | | | |
| Long term borrowings | 767,957 | (33,129) | 734,828 | e |
| Employee benefits | 28,784 | (237) | 28,547 | k |
| Provisions for risks and charges | 38,588 | (27,598) | 10,990 | l |
| Deferred tax liabilities | 6,455 | 11,418 | 17,873 | h |
| Other non-current liabilities | 21,510 | (4,156) | 17,354 | c |
| **Total non-current liabilities** | **863,294** | **(53,702)** | **809,592** | |
| **Shareholders' equity** | | | | |
| Share capital | 34,350 | - | 34,350 | |
| Share premium reserve | 29,000 | - | 29,000 | |
| Treasury shares reserve | 80,988 | - | 80,988 | g |
| Translation reserve | (10,575) | 10,575 | - | m |
| Retained earnings and other reserves | (40,619) | (76,000) | (116,619) | g, n |
| Fair value and cash flow reserve | - | (826) | (826) | |
| **Total shareholders' equity attributable to the Group** | **93,144** | **(66,251)** | **26,893** | |
| **Shareholders' equity attrib. to minority shareholders** | **5,425** | **451** | **5,876** | |
| **Total shareholders' equity** | **98,569** | **(65,800)** | **32,769** | |
| **Total liabilities and shareholders' equity** | **1,244,838** | **(67,640)** | **1,177,198** | |

**Notes to the reconciliation of the consolidated balance sheet as of January 1, 2004**

a) The amount mainly relates to a reclassification deriving from the accounting in accordance with IFRS of the securitization of receivables made through the incorporation of a vehicle company (Law 130), "Sunlight". As per the Italian GAAP, the companies incorporated in accordance with Law 130/99 must state the receivables acquired and the payables contracted as an off-balance sheet line item, while in application of IFRS, these receivables and payables must be stated in the financial statements. Below are reported the effects as of January 1, 2004 related to the above reclassification:

- recording of the trade receivables for Euro 75.0 million, relating to the amount of the receivables ceded to the special purpose entity (SPE);

- increase in financial payables, with a consequent decline in the net debt of Euro 50.0 million, relating to the payables of the SPE to third party lenders;

- increase in liquidity of Euro 13.0 million, relating to the liquidity of the SPE;

- decrease of other receivables of Euro 37.5 million, relating to the receivable of Safilo S.p.A. from the SPE.

The residual amount relates to the adjustment of the receivables in foreign currencies hedged by forward currency contracts at the end of the year. The Italian GAAP requires the accounting of these receivables at the hedged exchange rate while the IFRS requires they are adjusted at the year-end exchange rate.

With reference to the preparation of the financial statements in accordance with IFRS approved by the European Commission, in application of SIC 12, which governs the consolidation of special purpose vehicle companies, it was determined that the vehicle was controlled by the Group and therefore it must be included in the consolidation scope. For this reason, the receivables and payables acquired by the vehicle were recorded in the balance sheet at January 1, 2004.

b) The adjustment relates to promotional and advertising materials, which in the financial statements prepared in accordance with Italian GAAP were recorded under inventories, while for IFRS purposes they may not be recorded in this line item.

c) The adjustment relates to the effects connected to the fair value as, in accordance with IAS 39, (Interest Rate Swaps and forward contracts on the US Dollar).

d) The amount represents the effects of the adjustment deriving from a different depreciation criteria on property, plant and equipment. Italian GAAP depreciates land together with the buildings, while for IFRS 16 the portion relating to land cannot be depreciated. In addition, the estimated useful life of some assets were reviewed whose effects in relation to the financial statements prepared in accordance with Italian GAAP were adjusted in 2003, while for the purposes of the transition to IFRS 1, the effects were calculated retrospectively, that is as if the assets were always depreciated in accordance with the re-determined useful life.

The account includes a reclassification relating to leasehold assets, which in accordance with IFRS are stated under property, plant and equipment and no longer under intangible assets.

e) The reclassification, in addition to the reclassification of leasehold assets at point d), relates to the different accounting treatment of the costs incurred on loans received. In accordance with Italian GAAP, these costs were capitalized under intangible assets and amortized over the duration of the loan, while in accordance with IFRS 39, these costs shall be recorded as a direct reduction of the amount of the loans received and amortized applying the effective interest rate criteria. The adjustment refers to expansion and set-up costs for which IFRS, differing from the Italian GAAP, requires recognition in the income statement in the year in which they are incurred.

f) The adjustment relates to the valuation of the investments classified as financial assets available-for-sale. In accordance with Italian GAAP, these investments are classified under financial assets and measured at cost, adjusted for any permanent impairment in value. IFRS requires that these investments are measured at fair value and that the gains and losses deriving from this measurement are recorded in a separate equity reserve. On the sale of the investment the realized gain or loss is recognized in the income statement.

g) The treasury shares are classified in accordance with IFRS as a reduction of net equity instead of being stated as an asset.

h) The adjustment relates to the effect of the deferred taxes calculated on the IFRS adjustments approved by the European Commission. The recording of the deferred taxes was performed in accordance with the provisions contained in IAS 12, Paragraphs 15, 24 and 61.

i) The amount refers for Euro 50 million to the accounting of the securitization described above (point a) and for the difference to the accounting effects of the application of the "amortized cost".

j) The adjustment primarily derives from employee payables accounted for by some subsidiaries in accordance with the requirement of IAS 19.

k) The adjustment relates to the valuation of the existing liabilities against the employee benefits to be paid on termination of employment, including the employee leaving indemnity due by the Italian companies. In accordance with Italian GAAP, the benefits are represented by liabilities determined in accordance with local legislation, while the rules contained in IAS 19, Paragraph 50, provide for their calculation through the use of technical actuaries.

l) The adjustment relates to the recognition in the income statement of the exchange gains, suspended in a provision for Italian Accounting Standards, resulting from the long-term portion of foreign currency payables.

m) The translation reserve at January 1, 2004 was fully reversed, in accordance with the exemptions permitted by IFRS 1 adopted on the first application of the IFRS approved by the European Commission.

n) In addition to the reversal of the treasury share reserve, the account includes the cumulative equity effect of the IFRS adjustments described above.

## IFRS consolidated balance sheet as of December 31, 2004

| December 31, 2004<br>*(in Euro million)* | ITA GAAP | Adjustments and reclass. | IFRS approved by the European Commission | Note |
|---|---|---|---|---|
| **ASSETS** | | | | |
| **Current assets** | | | | |
| Cash in hand and at banks | 33,795 | - | 33,795 | |
| Trade receivables, net and other receivables | 278,418 | 27,497 | 305,915 | a |
| Inventory, net | 196,254 | (4,058) | 192,196 | b |
| **Total current assets** | **508,467** | **23,439** | **531,906** | |
| **Non-current assets** | | | | |
| Property, plant and equipment | 184,108 | 11,660 | 195,768 | c |
| Intangible assets | 55,417 | (34,191) | 21,226 | d |
| Goodwill | 339,932 | 23,229 | 363,161 | e |
| Investments in associates | 10,160 | 7 | 10,167 | |
| Financial assets available-for-sale | 10,969 | (4,072) | 6,897 | f |
| Treasury shares | 80,988 | (80,988) | - | g |
| Deferred tax assets | 41,181 | (523) | 40,658 | h |
| Other non-current assets | 1,784 | 42 | 1,826 | |
| **Total non-current assets** | **724,539** | **(84,836)** | **639,703** | |
| **Total assets** | **1,233,006** | **(61,397)** | **1,171,609** | |

| December 31, 2004 *(in Euro million)* | ITA GAAP | Adjustments and reclass. | IFRS approved by the European Commission | Note |
|---|---|---|---|---|
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | | | |
| **Current liabilities** | | | | |
| Short term borrowings | 43,398 | 26,520 | 69,918 | i |
| Trade payables | 173,747 | (220) | 173,527 | |
| Tax payables | 82,136 | 2,506 | 84,642 | j |
| Other current payables and accrued expenses | 136 | - | 136 | |
| **Total current liabilities** | **299,417** | **28,806** | **328,223** | |
| **Non-current liabilities** | | | | |
| Long term borrowings | 747,943 | (29,937) | 718,006 | d |
| Employee benefits | 31,869 | 2,738 | 34,607 | k |
| Provisions for risks and charges | 6,406 | (50) | 6,356 | l |
| Deferred tax liabilities | 7,675 | (296) | 7,379 | h |
| Other non-current liabilities | 1,139 | 7,340 | 8,479 | m |
| **Total non-current liabilities** | **795,032** | **(20,205)** | **774,827** | |
| **Shareholders' equity** | | | | |
| Share capital | 35,000 | - | 35,000 | |
| Share premium reserve | 53,350 | - | 53,350 | |
| Treasury shares reserve | 80,988 | - | 80,988 | g |
| Retained earnings and other reserves | (35,532) | (63,978) | (99,510) | g, n |
| Fair value and cash flow reserve | - | (6,342) | (6,342) | |
| **Total shareholders' equity attributable to the Group** | **133,806** | **(70,320)** | **63,486** | |
| **Shareholders' equity attributable to minority shareholders** | **4,751** | **322** | **5,073** | |
| **Total shareholders' equity** | **138,557** | **(69,998)** | **68,559** | |
| **Total liabilities and shareholders' equity** | **1,233,006** | **(61,397)** | **1,171,609** | |

**Notes to the reconciliation of the consolidated balance sheet as of December 31, 2004**

a) The reclassification is mainly due to the method adopted for the accounting of the factoring operations. In relation to these operations, it was determined that not all of the conditions were satisfied in accordance with IAS 39, Paragraph 17 and thereafter, for the removal from the balance sheet of the receivables ceded and therefore these amounts were restated in the balance sheet, with a corresponding liability recorded to the factoring company. With regard to the effects of this reclassification they can be summarized as follows:

- increase in trade receivables of Euro 58.1 million, relating to the amount of receivables ceded to the factoring company;
- increase in the financial payables, with consequent deterioration of the net debt of Euro 26.5 million, relating to the advance given to Safilo by the factoring company;
- decrease in the other current assets of Euro 31.6 million, which represent the receivables from the factoring company for the transfers not yet paid.

b) Advertising material being written-off in accordance with the requirements of IFRS given that the above-mentioned account may not be recorded as inventory in accordance with IAS 2, paragraph 6.

c) The adjustment results from the adoption of a different depreciation criteria on property, plant and equipment. Italian GAAP depreciates land together with buildings while IAS 16, Paragraph 58, provides that the portion relating to land cannot be depreciated. In addition, the estimated useful life of some assets were reviewed whose effects in relation to the financial statements prepared in accordance with Italian GAAP were adjusted in 2003, while in compliance with IFRS 1, Paragraph 7, they were calculated as if the assets were always depreciated in accordance with the re-determined useful life.

d) The IFRS adjustment relates to the different accounting treatment of the costs incurred on loans received. In particular, in accordance with the Italian GAAP, these costs were capitalized under intangible assets and amortized over the duration of the loan, while IAS 39, Paragraph 43, provides that these costs shall be recorded as a direct reduction of the amount of the loans received and amortized applying effective interest rate criteria. Minor effects related to the reclassification of the leasehold improvements and to the write-off of some intangible assets which may not be recorded as assets in accordance with IFRS (see IAS 38 paragraphs 9 and 10);

e) the adjustment refers to the reversal of the amortization on goodwill, no longer allowed by IFRS (see IFRS 3, paragraph 55) which instead requires only an impairment test at least annually;

f) The adjustment relates to the valuation of the investments classified as financial assets available-for-sale. These investments were classified in the financial statements prepared in accordance with Italian GAAP as financial assets and measured at cost, and adjusted for permanent impairment in value. In accordance with IAS 39, Paragraphs 46 and 55 point (b), these investments are measured at fair value and the gains and losses are recorded in a separate equity reserve which must be charged to the income statement when the gain or loss is realized on sale.

g) For IFRS the treasury shares are classified as a reduction of net equity instead of being stated as an asset.

h) The adjustment relates to the effect of the deferred taxes calculated on the IFRS adjustments approved by the European Commission described above. The recording of the deferred taxes was performed in accordance with the provisions contained in IAS 12, Paragraphs 15, 24 and 61.

i) The adjustment is mainly due to the factoring operations whose effects are described in note a).

j) The adjustment mainly derives from employee payables accounted for by some subsidiaries in accordance with the requirement of IAS 19.

k) The adjustment relates to the valuation of the existing liabilities against the employee benefits to be paid on termination of employment, including the employee leaving indemnity due by the Italian companies. In accordance with Italian GAAP, the benefits are represented by liabilities determined in accordance with local legislation, while the rules contained in IAS 19, Paragraph 50, provide for their calculation through the use of technical actuaries.

l) the adjustment represents the reversal of a provision for risks which in accordance with IFRS may not be recognized in the financial statements.

m) The adjustment relates to the effects connected to the fair value that, in accordance with IAS 39, Paragraph 46 for financial assets and Paragraph 47, Point (a) for financial liabilities, shall be made for all derivative instruments. In the Italian GAAP the hedging operations must not be valued, but contribute to the formation of the result for the period adjusting the item hedged to include the effects of the hedge.

n) The adjustment refers to the reclassification of the treasury shares (see point g) and to the equity impact of the adjustments made based on the IFRS.

The following table reports the reconciliation of the net equity, determined in accordance with Italian GAAP and the net equity determined in accordance with IFRS approved by the European Commission:

| *(in Euro millions)* | January 1, 2004 | December 31, 2004 | Note Dec 31, 2004 | Note Jan 1, 2004 |
|---|---|---|---|---|
| **Shareholders' Equity as reported under Italian GAAP** | **98,6** | **138,6** | | |
| Trade receivables | (4,0) | (4,0) | *a* | *a* |
| Promotional and advertising material | (4,4) | (4,1) | *b* | *b* |
| Derivative instruments measured at fair value | 0,3 | (6,4) | *m* | *c* |
| Revaluation of property, plant ad equipment | 15,5 | 10,6 | *c* | *d* |
| Start-up, research and development costs | (1,4) | (2,0) | *d* | *d, e* |
| Financial assets available for sale measured at fair value | (3,4) | (4,0) | *f* | *f* |
| Employee Benefits | (1,1) | (4,2) | *k* | *k* |
| Provision for deferred currency transition | 26,8 | - | | *l* |
| Debt issuance costs | (1,4) | (1,7) | *d* | *e* |
| Goodwill amortization | - | 23,4 | *e* | |
| Tax effect on reconciling items | (11,6) | 3,8 | *h* | *h* |
| Reclassification Treasury shares | (80,9) | (80,9) | *g* | *g* |
| Other | (0,2) | (0,5) | | |
| **Shareholders' Equity as reported under IFRS** | **32,8** | **68,6** | | |

**Consolidated statement of operations for the year ended December 31, 2004 restated in accordance with IFRS**

| December 31, 2004 *(in Euro million)* | ITA GAAP | Adjustments and reclass. | IFRS approved by the European Commission | Note |
|---|---|---|---|---|
| Net sales | 939,764 | 4,976 | 944,740 | a |
| Cost of sales | (379,275) | (2,254) | (381,529) | b |
| **Gross profit** | **560,489** | **2,722** | **563,211** | |
| Selling and marketing expenses | (310,433) | (33,634) | (344,067) | c |
| General and administrative expenses | (130,741) | 23,862 | (106,879) | c |
| Goodwill amortization | (23,509) | 23,509 | - | d |
| Other income and expenses, net | 24,509 | (25,375) | (866) | e |
| **Operating income** | **120,315** | **(8,916)** | **111,399** | |
| Share of income (loss) of associates | (42) | - | (42) | |
| Interest expense and other financial charges, net | (65,930) | (220) | (66,150) | f |
| Income tax expense | (31,310) | 10,836 | (20,474) | g |
| **Net income** | **23,033** | **1,700** | **24,733** | |

## Notes to the reconciliation of the consolidated statement of operations for the year end 2004

a) The adjustment refers to the adjustment on the sales in dollars hedged by forward currency contracts. For Italian GAAP the gains and losses realized on the receivables in US Dollars hedged by forward currency contracts are classified in the cost of sales while for IFRS the gains and losses are recognized as an increase or decrease of the net sales;

b) The effects deriving from the adoption of the international accounting standards are mainly due to: (i) reclassifications which have the objective of providing a better sub-division of the different types of costs (cost of sales, selling and marketing expenses, general and administrative expense), (ii) the difference on the depreciation relating to property, plant and equipment and the write-off of the advertising materials recorded in inventory, (iii) the reclassification of the sales in dollars hedged by foreign currency contracts (see note a);

c) The largest part of the effect deriving from the adoption of international accounting standards is related to the reclassification between selling and marketing expenses and administrative and general expenses following a more precise criteria used for the sub-division of these costs. Minor effects were due to the accounting of the stock option costs and to the write-off of some intangible assets which may not be recorded as assets in accordance with IFRS (see IAS 38 paragraphs 9 and 10);

d) The adjustment refers to the reversal of the amortization on goodwill, no longer allowed by IFRS (see IFRS 3, paragraph 55) which instead requires an impairment test at least annually;

e) The largest part of the effects derives from the costs relating to the securitization program (Sunlight) and from the reversal of the deferred foreign exchange gains provision calculated on the long-term portion of the debt in US Dollars, which, in line with the requirements of IAS 21, paragraph 23, eliminated the extraordinary revenues accounted for in accordance with Italian GAAP;

f) the difference is mainly due to the interest payable calculated in accordance with the effective interest rate as required by the amortized cost method.

g) The adjustment relates to the effect of the deferred taxes calculated on the IFRS adjustments approved by the European Commission described above. The recording of the deferred taxes was performed in accordance with the provisions contained in IAS 12, Paragraphs 15, 24 and 61.

The following table reports the reconciliation of the net income for the year ended December 31, 2004, calculated according to the Italian GAAP and the net income calculated according to the IFRS approved by the European Commission:

| ***(in Euro millions)*** | | **Note** |
|---|---|---|
| **Net income attributable to the Group under Italian GAAP** | **23,0** | |
| Depreciation of property, plant and equipment | (4,9) | *b* |
| Start-up, development and research costs | (0,6) | *c* |
| Employee benefits | (3,1) | *f* |
| Provision for deferred currency translation | (26,8) | *e* |
| Amortization of Goodwill | 23,4 | *d* |
| Tax effect on reconciling items | 13,8 | *g* |
| Other | (0,1) | |
| **Net income attributable to the Group under IFRS** | **24,7** | |

## IFRS consolidated statement of cash flows for the year ended December 31, 2004

| December 31, 2004<br>*(in Euro million)* | ITA GAAP | Adjustments and reclass. | IFRS approved by the European Commission | Note |
|---|---|---|---|---|
| **A. Cash and cash equivalents at the beginning of the period** | **10,623** | **12,611** | **23,234** | a |
| **B - Cash flows from (for) operating activities** | | | | |
| Net income/(loss) for the year (including minority interests) | 23,033 | 1,700 | 24,733 | b |
| Amortization and depreciation | 60,750 | (25,246) | 35,505 | c |
| Decrease in fees (amortized cost) | - | 4,735 | 4,735 | |
| Share income (loss) on equity investments | 882 | (112) | 770 | |
| Net changes in the employee' benefit provision | 3,099 | 2,980 | 6,079 | d |
| Net movements in other provisions | (29,319) | 24,844 | (4,476) | e |
| **Income from operating activities prior to movements in working capital** | **58,445** | **8,901** | **67,346** | |
| (Increase)/Decrease in trade receivables and other current receivables | (10,487) | 11,778 | 1,291 | f |
| (Increase) Decrease in inventory, net | (36,791) | (362) | (37,153) | g |
| Increase (Decrease) in trade payables and other current payables | 30,202 | (5,912) | 24,290 | h |
| **Total (B)** | **41,369** | **14,405** | **55,774** | |
| **C - Cash flows from (for) investing activities** | | | | |
| Purchase of property, plant and equipment (net of disposals) | (27,753) | 1,110 | (26,643) | |
| Acquisition of investments in associates and financial assets | (80) | 367 | 287 | |
| Disposal of investments in associates and financial assets | - | 227 | 227 | |
| Purchase of intangible assets | (3,241) | 750 | (2,491) | |
| **Total (C)** | **(31,074)** | **2,454** | **(28,620)** | |
| **D - Cash flows from (for) financing activities** | | | | |
| Proceeds from borrowings | 4,863 | - | 4,863 | |
| Repayment of borrowings | (21,116) | (27,654) | (48,770) | f |
| Net increase in share capital | 25,000 | - | 25,000 | |
| Dividends paid | (3,149) | - | (3,149) | |
| **Total (D)** | **5,598** | **(27,654)** | **(22,056)** | |
| **E – Cash flows for the year (B+C+D)** | **15,893** | **(10,795)** | **5,098** | |
| Other movements in shareholders' equity | - | (5,446) | (5,446) | |
| Effect of exchange rates | (8,365) | 3,630 | (4,735) | |
| **F – Cash and cash equivalents at the end of the period** | **18,151** | **-** | **18,151** | |

## Notes to the reconciliation of the consolidated cash flow statement for the year ended 2004

a) The change follows the effect of the different criteria for recording the securitization operations between IFRS approved by the European Commission and the Italian GAAP.

b) The changes represent the effects on net income as a consequence of the application of the IFRS approved by the European Commission.

c) The change represents the different criteria for the calculation of amortization and depreciation between the IFRS approved by the European Commission and the Italian GAAP on goodwill and on property, plant and equipment as described in detail in the preceding notes to the balance sheet.

d) The nature of the change is described in detail in note k in the preceding table regarding the balance sheet.

e) The change mainly refers to the different accounting treatment between IFRS approved by the European Commission and the Italian GAAP in relation to recording the effects of the translation of foreign currency payables and receivables to the Euro, as reported in note e) of the comments to the income statement for the year end 2004.

f) The change is mainly due to the combined effect of the reclassifications relating to the securitization and factoring described with reference to the reconciliation of the net equity determined in accordance with Italian GAAP and the net equity determined in accordance with IFRS approved by the European Commission.

g) The change represents the different criteria for the recording of the inventories described in note b in the previous table on the balance sheet.

h) The change is mainly represented by the recording of the deferred taxes on the accounting adjustments consequence of the transition to the IFRS approved by the European Commission.