

Ciba Specialty Chemicals  
Financial Review 1998

Ciba



## Contents

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<b>Financial highlights</b>	1
<b>Management's discussion and analysis</b>	2
<b>Consolidated financial statements</b>	
Consolidated statements of income	12
Consolidated balance sheets	13
Consolidated statements of cash flows	14
Consolidated statements of shareholders' equity	15
Business segment data	16
Geographic data	18
Note 1: Summary of significant accounting policies	19
Note 2: Background to the spin-off	20
Note 3: Exchange rates of principal currencies	21
Note 4: Acquisitions and divestitures	21
Note 5: Inventories	21
Note 6: Property, plant and equipment	22
Note 7: Financial instruments	22
Note 8: Financial investments	23
Note 9: Accruals and other current liabilities	23
Note 10: Restructuring and special charges	23
Note 11: Short-term debt	24
Note 12: Long-term debt	24
Note 13: Income taxes	24
Note 14: Other liabilities	25
Note 15: Shareholders' equity	25
Note 16: Stock-based compensation plans	25
Note 17: Retirement benefits	26
Note 18: Earnings per share	27
Note 19: Related party transactions	27
Note 20: Commitments and contingencies	28
Independent auditors' report	29
<b>Five year summary of selected financial data</b>	30
<b>Shareholder information</b>	31
<b>Financial Calendar</b>	31
<b>Major consolidated subsidiaries and associated companies</b>	32
<b>Ciba Specialty Chemicals Holding Inc. financial statements</b>	34
<b>Principal management</b>	36
<b>Contact Addresses</b>	37
<b>Glossary of financial terms</b>	38

## Financial Highlights

(in millions of Swiss francs, except share and per share data)

Year ended December 31,	1998	1997
<b>Net sales</b>	<b>8 423</b>	<b>7 822</b>
<b>Financial data before restructuring and special charges<sup>(1)</sup></b>		
Operating income	877	854
Income before income taxes	505	728
Net income	369	571
Basic earnings per share	5.57	8.38
Diluted earnings per share	5.57	8.38
Cash flows from operating activities	843	1 143
Capital expenditures	459	523
Research and development expenditures	304	302
Number of employees at year end	24 456	21 442
Top line growth	7.7%	18.9%
Top line growth in local currencies	11.2%	8.8%
EBITDA	1 356	1 231
EBITDA margin	16.1%	15.7%
NOPAT	707	640
NOPAT margin	8.4%	8.2%
Velocity	0.83	0.95
NOPAT as a percentage of average invested capital	6.9%	7.8%
Economic profit	(6)	64

<sup>(1)</sup> The 1998 amounts exclude the impact of CHF 1 147 million related to restructuring and special charges of which CHF 1 012 million represents the write-off of in-process research and development costs. Including these charges, the Company reported an operating loss of CHF (270) million, a loss before income taxes of CHF (642) million, a net loss of CHF (739) million, and a basic and diluted loss per share of CHF (11.15). Cash flows from operating activities is presented before restructuring payments of CHF 323 million.

The 1997 amounts exclude the impact of CHF 373 million related to restructuring and special charges. Including these charges, the Company reported operating income of CHF 481 million, income before income taxes of CHF 355 million, net income of CHF 293 million, and basic and diluted earnings per share of CHF 4.29. Cash flows from operating activities is presented before restructuring payments of CHF 476 million.

See Glossary of Financial Terms

## Management's Discussion and Analysis

(in millions of Swiss francs, except share and per share data)

	1998	1997
Net sales	8 423	7 822
Operating income before restructuring and special charges	877	854
Net income before restructuring and special charges	369	571
Operating cash flows before restructuring payments	843	1 143
Shareholders' equity at year end	3 293	4 336
Dividend per share (CHF)	2.00 <sup>(a)</sup>	2.00

<sup>(a)</sup> Proposal to shareholders' meeting.

For a definition of the financial terms used, please refer to the Glossary of Financial Terms on page 38.

### Challenging Market Conditions

#### Stable performance in tough market conditions

The past year, 1998, was challenging with mixed global market conditions. Economic development in many countries deteriorated throughout the year. Worldwide GDP growth of an estimated 1–2 percent, primarily driven by the growth in the service sector, masked to some extent the declining output in manufacturing that occurred in many countries. The business environment for our customers' industries remained reasonably positive during the first half of 1998 despite the Asian crisis. During the second half, however, further negative economic developments occurred in Eastern Europe and Latin America. In addition, a weakening business environment emerged in the United States and certain Western European countries towards the end of the year. This led to declining demand in many of our customers' industries. The appreciation of the Swiss franc also adversely affected the Company's results.

The combination of these tough market conditions led to lower overall performance during the second half. The second half also included, for the first time, the full effect of the financing costs relating to the Allied Colloids acquisition.

For the full year, sales together with operating income and margins improved. Net income before restructuring and special charges, however, deteriorated compared to 1997, primarily due to increased financing costs relating to the Allied Colloids acquisition. Operating income before restructuring and special charges for the second half of 1998 was CHF 387 million compared to the CHF 490 million achieved for the first half. The result reflects the extremely challenging conditions in the textiles and the basic epoxy resins markets which worsened in the second half, especially

in the last two months of the year. These conditions adversely affected the results of the Colors and Performance Polymers divisions. Additives division and the Inks, Plastics and Paints business units, however, performed well. The Company as a whole achieved stable performance which underlines the strength of many of the Company's businesses and the dedicated commitment of its employees.

Management recognised, at an early date, the rapidly deteriorating market conditions and immediately initiated a number of proactive strategic steps to equip the Company for the future challenges. During the latter part of 1998, the adverse trends became more significant and widespread. Despite these circumstances, the Company remains committed to its long-term strategy to enhance and develop businesses with significant growth potential while simultaneously implementing a series of measures to improve innovation potential and efficiency. The objective in this process remains unwavering – to strengthen the Company's position as an industry leader and to ensure profitable growth over time.

#### A clear strategic direction

The strategy focuses on four key elements: building on already strong global market positions; focusing on high value-added and environmentally friendly products, services and technologies; achieving operational excellence through improving operational efficiency; and promoting and accelerating innovation.

#### Building on our strong market positions

Ciba Specialty Chemicals concentrates on developing and investing in businesses with the greatest potential. These are selected according to industry attractiveness and an assessment of the Company's ability to create and retain value. Particular opportunities for profitable and innovative growth are seen in the following businesses: in the Additives division – polymer additives, imaging and coating additives; in the Consumer

Care division – home and personal care products; in the Colors division – colour products, particularly for high value-added parts of the ink, paints and plastics industry; and in the Water Treatments division – water treatment additive products.

The most significant actions taken in 1998 to build on our strong market positions were the acquisition and integration of the former Allied Colloids, the creation of the Colors division, the establishment of the Fabric Processing and Finishing business unit, and the restructuring programme designed to improve the results of the Performance Polymers division.

#### Water Treatments – creating a future platform for growth

The March 1998 purchase of Allied Colloids enhances the Company's portfolio and creates a platform for growth. Clean water is an increasingly valuable and scarce global resource. To protect this vital resource, public demand for more stringent pollution control standards continue to provide additional growth opportunities. The acrylic chemistry and related technologies acquired enriches the Company's core chemistry know how and innovation in a high potential field.

The core business of the Water Treatments division is the production of water soluble acrylic polymers. Water Treatments' products and services are used to help provide pure water, clean industrial and municipal effluent and improve the efficiency of many industrial processes, including paper, mineral and oil processing.

In order to increase market penetration and capitalise on synergies, a number of businesses were combined with existing divisions. The former Allied Colloids' coatings business was transferred to the Additives division's imaging and coatings business. This enhances and expands the already strong product range of the imaging and coatings business existing in the Additives division. It also supports market expansion into industrial and trade coatings which will supplement the core automotive coatings business. Products for detergents and personal care as well as fabric pre-treatment and finishing were transferred to the Consumer Care division. This enables the home and personal care business of Consumer Care to offer customers a more complete and innovative range of products.

*Water Treatments – the next step*  
Effective March 1, 1999, the water

treatments business will be operated as a business unit of the Additives division. This will allow the water treatments business unit to share the Additives division infrastructure and will further support geographic expansion.

*Creating Colors division – A leader in colour*

The Colors division, a leading global colour supplier, was created through the combination of the former Pigments and Textile Dyes divisions. The new division was created with a clear strategic focus on the global colours market for industrial and consumer applications and serves the inks, paints, plastics, textiles and fibres industries. The division will focus on a growing market for new colour applications which the Company has previously only serviced to a limited extent. This comprehensive approach to new application areas in the colours market opens up a larger, redefined potential market of CHF 25 billion as compared to the CHF 16 billion potential market previously targeted by the former Textile Dyes and Pigments divisions. It also enables the division to pioneer the development and marketing of innovative colour systems that combine pigment technology with textile customer needs and vice versa.

*Fabric processing and finishing – a new market leader*

The Company created a market leader in the fabric processing and finishing business by combining the dyes and printing auxiliaries and textile finishing businesses of the former Allied Colloids and the former Textile Dyes division with those of the Consumer Care division. This makes the Company a global leader in this business; providing customers with an integrated and innovative range of products and services to meet their needs.

*External portfolio management*

Part of the strategy to build on strong global market positions includes external portfolio management. The acquisition of Allied Colloids and the exchange of the Additives division's PVC heat stabiliser business for Witco Corporation's (Witco) epoxy systems and adhesives business are current examples.

On November 9, 1998, the Company announced an agreement in principle to merge with Clariant. This agreement was contingent, among other things, on the outcome of due diligence. Even though the proposed deal appeared attractive from a strategic prospective, due diligence identified several significant commercial, financial, legal and regulatory risks that

outweighed the benefits of a merger. After a careful review by the Company's Board of Directors, it was decided and then announced on December 9, 1998 that the Company would not proceed with the merger.

**Focusing on high value-added and environmentally friendly products, services and technology**

The Company continues to focus on high value-added and environmentally friendly products, services and technologies. The most decisive move during 1998 was the Company's entry into the water treatments business through the acquisition of Allied Colloids. This business concentrates on products and services whose prime objective is to minimise environmental harm created by industry and consumers to the world's irreplaceable water supply. In the Colors division, the new Cibacron® cotton dyes and Lanazol® metal free wool dyes facilitate an environmentally friendly dyeing process. In Consumer Care, the division launched Dicylan® WSR, a promising finish for wool that prevents machine-washable wool garments from losing their shape, thereby, eliminating the need for dry cleaning, and products like Tinopal® CBS-X, which create low temperature detergent whiteners.

**Improving operational efficiency**

Improving operational efficiency is one of the Company's key strategic initiatives. The Company aims to provide still better customer service by bundling core competencies according to key industry segments. This leads to reduced costs by combining infrastructure and support services.

The Company continued to improve in operational efficiency in 1998 through a number of initiatives. These initiatives include the rapid integration of Allied Colloids, the creation of the new Colors division, and the decisive corrective actions to restructure the Performance Polymers division.

*Rapid integration of Allied Colloids*

A main focus of 1998 was the rapid integration of the former Allied Colloids business into Ciba Specialty Chemicals. Most of the year was devoted, as planned, to the integration, which was substantially completed by year end. Customer service and contact, however, remained a priority throughout this process.

Integration occurred in a number of key areas all of which established a platform for future operational improvement. Benefits have been achieved through

common sourcing of raw materials, especially with the Additives division, which enabled Water Treatments to use the Company's purchasing power to obtain lower raw material prices. The information and data management systems and processes of Allied Colloids are being replaced by the Company's standard, shared worldwide finance and supply chain systems and processes, including the Company's universal common data. Benefits will be realised through lower administration and systems maintenance costs as well as through supply chain systems that have been designed to satisfy customer needs and to allow management to effectively manage operational assets. The integration also allows the water treatments business to capitalise on the Company's global presence and critical mass.

For the business transferred to other divisions, the benefits are achieved through the combination of marketing and sales efforts and through sharing of the global administrative, supply chain and logistic infrastructure of those divisions.

*Creating Colors – an opportunity for saving costs*

In addition to the expanded market opportunities, the creation of the Colors division through the combination of the former Pigments and Textile Dyes divisions affords attractive opportunities for saving costs. These cost savings will be realised through a reduction in headcount and internal support structures. Operational benefits will be achieved by combining the infrastructure of the two predecessor divisions. Procurement, administration, supply chain, production and production technology will be shared by all business units. Individual and separate business units will, however, be maintained and be responsible for customer service from product development to marketing, sales, distribution and technical support. The creation of the Colors division was well advanced by year end 1998, and will be completed by mid-1999.

*Performance Polymers – decisive corrective actions*

The combined impact of lower selling prices in the weakening global basic epoxy resins market and simultaneous increases in raw material prices had a large negative effect on Performance Polymers gross profit margin. Margins in the business declined significantly towards the end of 1997 and, contrary to expectations, performance did not recover during 1998. In fact, margins declined

further during the first half and stabilised, at lower levels, during the second half of 1998. In addition to the generally lower margins, business conditions continued to weaken throughout 1998, especially during the last months of the year due to declining demand and worldwide industry over capacity. Aggressive pricing, often originating in Asia due to low demand in that region, and an industry trend toward business consolidation at the customer level created significant pressure in the market.

These challenging market conditions necessitated corrective actions to improve the division's low profitability. These decisive actions included: the implementation of a more value-based strategy in the resins systems business unit and increased focus on higher value-added formulated products; the introduction of a new top management team; the implementation of a comprehensive global cost-reduction programme; and the establishment of simplified streamlined business processes. In addition to these actions, further strategic options for the Performance Polymers division are being considered.

#### *Improving operational efficiencies leads to cost reduction*

As a consequence of the deteriorating economic environment in the second half of 1998, the Company's initiatives to improve operational efficiency were executed aggressively and rapidly. These initiatives lead to the reduction of 1 100 positions worldwide, and will support efforts to improve profitability in the Performance Polymers, Colors and Water Treatments divisions. As a result, the Company expects to achieve annual cost savings of CHF 150 million beginning in 1999.

#### **Promoting innovation in all key business areas**

Continuing innovation is one of the most important elements of future growth. The Company is therefore strongly committed to foster innovation. More than 1 600 employees and approximately CHF 300 million annually are dedicated to ongoing research and development. During 1998, the Company reviewed its research activities and increased resource allocation for cross-divisional research projects and new business development opportunities.

There are many examples of innovative product development. In Additives, Irgacure® is a revolutionary photoinitiator which allows coatings, even if pigmented, to harden instantly under UV light. In Colors, new optical storage chromophores

were developed for the rapidly growing CD recording industry. In Consumer Care, the introduction of Knittex® allows consumers to enjoy the benefits of no longer needing to iron cotton shirts. In Water Treatments, products are being developed which store body heat in clothing when the wearer is hot and returns it when the wearer is cold.

#### **Results of Continuing Operations**

##### **Adverse currency trends**

While the average value of the Swiss franc remained relatively stable compared to some major currencies such as the U.S. dollar and significant European currencies during 1998, its value appreciated against a number of other currencies. This trend was particularly noticeable when one compares to the Japanese yen, other Asian currencies and the currencies of a number of developing countries, especially those located in Latin America. This development is unfavourable for Ciba Specialty Chemicals as the Company has more sales into these markets than it has costs in those markets. The appreciation of the Swiss franc causes distortions in comparing the actual business performance of the Company. In 1998, the appreciation of the Swiss franc negatively affected the Company's operating profit by approximately CHF 140 million as compared to 1997.

##### **Top line growth in challenging markets**

Sales grew in 1998 by 8% in Swiss francs and by 11% in local currencies over 1997. Sales growth was achieved through a 4% volume/mix increase, plus net positive effects of acquisitions and divestments of 10%. These gains were offset by competitive price reductions of 3% and negative currency developments of 3% caused by the strengthening Swiss franc.

Geographically, sales advanced in the Western Hemisphere, which includes North, Central and South America, and in Europe. Sales into the Eastern Hemisphere, which includes Asia, Africa, Australia, New Zealand and the Middle East decreased, primarily due to the economic slowdown in the Asia region. In local currencies, sales in all regions increased. The Western Hemisphere accounts for 35% of total sales, Europe for 43% and the Eastern Hemisphere for 22%, of which 17% is attributable to Asia.

Excluding the effects of Allied Colloids, sales into the Asian region decreased by CHF 167 million compared to 1997; in line with expectations. While sales into many countries within the region were lower, sales into mainland China increased

reaching 109% of prior year in both Swiss francs and in local currencies.

In 1997, the Company set a performance target of increasing sales in excess of the average growth rate in each of its markets. While sales levels remained relatively buoyant during the first three quarters, a significant slowdown was noted during the last two months of the fourth quarter. The industry-wide trend of lower growth is also affecting the performance of other companies within the specialty chemicals market. This slowdown, evident to some extent in all divisions, is most pronounced in the textile and fibres business of the Colors division and the epoxy resins business of the Performance Polymers division. Geographically, the slowdown is most obvious in the United States, Germany and the United Kingdom. In comparable structures, excluding the effects of the Allied Colloids acquisition and the Witco swap, sales reached 98% in Swiss francs and 101% in local currencies of 1997.

##### *Additives*

On a comparable basis, excluding the effects of the Vinyl Additives and the Allied Colloids portfolio changes, sales increased to 101% of prior year in Swiss francs and 104% in local currencies. Sales growth was achieved through an 8% volume/mix increase. This gain was offset by competitive price reductions of 4% and negative currency effects of 3%. A number of factors contributed to the strong growth which was achieved despite difficult economic conditions. These include the introduction of enhanced and innovative products and an expanded product range, as well as a competitive pricing strategy. In addition, the growth was supported by the strategy of working in partnership with customers to establish integrated solutions. Sales development in the Western Hemisphere and certain key European countries was particularly strong. Sales in the Asia region, although growing in local currency, were below prior year in Swiss franc terms. Without adjusting for portfolio changes, the sales of the Additives division reached 94% of previous year in Swiss francs and 97% in local currencies.

##### *Colors*

Sales are at slightly lower levels than the prior year at 94% in Swiss francs and 98% in local currencies. The change consisted of a 1% increase in volume/mix, offset by competitive price reductions of 3% and negative currency effects of 4%. The Colors division enjoyed sales growth in the Inks, Paints and Plastics business. Sales

in industry paints, supported by successful new product launches, recorded particularly strong growth. The Textile and Fibres business faced challenging market conditions. Reduced demand for wool products in Asia, lower priced import substitution by consumers, especially in the United States, and a fashion trend away from darker shades adversely affected performance in this market. These conditions made it difficult to maintain selling prices and volumes at previous year's levels. In Europe, sales were generally stable with good performance in Germany. With the exception of Central America, Western Hemisphere sales levels are below prior year. Performance in the Eastern Hemisphere is mixed with sales growth in China and Africa/Middle East offset by declines in Asia, especially Japan.

#### *Consumer Care*

Sales of the Consumer Care division remained level, compared to 1997, at 100% in Swiss francs and 104% in local currencies. On a comparable basis, excluding the effects of the Allied Colloids portfolio changes, sales are 96% of prior year in Swiss francs and 100% in local currencies. The sales development is attributable to a 2% increase in volume/mix, offset by competitive price reductions of 2% and negative currency effects of 4%. Performance in both detergent whiteners and antimicrobials was positive with sales, in local currency, exceeding 1997 levels. This growth was achieved through close worldwide customer partnerships and was also supported by the introduction of innovative new products. Deteriorating market conditions in these markets were, however, noted during the fourth quarter. Excluding the increase in sales attributable to products transferred from the former Allied Colloids, the sales of fabric processing and finishing were lower than in 1997. Continued and dedicated customer focus was unable to fully compensate for the extremely difficult conditions in the textile industry. Including transferred products, fabric processing and finishing exceeded prior year performance. Geographically, performance in Swiss francs was stable or slightly above prior year. In local currencies, sales in all regions were ahead of 1997. The Western Hemisphere exceeded prior year with strong performance in the United States and Central America. In Europe, Germany, United Kingdom and Italy also performed well. Results in the Eastern Hemisphere were mixed with solid growth in China and Africa/Middle East offset by declines

in Japan and, to a lesser extent, the remainder of the region.

#### *Performance Polymers*

On a comparable basis, excluding the effects of the Witco swap, sales were flat at 100% of prior year in Swiss francs and 103% in local currencies. Price reductions of 4% and negative currency effects of 3% adversely affected sales growth, while positive changes in volume/mix of 7% offset these reductions. Sales remained at previous levels despite economic downturns in both Asia and Brazil and a weaker epoxy resins market. Market conditions, especially in basic resins, were weak due to worldwide industry over capacities coupled with increased global purchasing leverage from customers. Despite strong demand, sales for photopolymer products and coating systems, excluding the positive effects from the Witco swap, were unable to reach prior year levels. Adhesives and tooling achieved strong sales growth through customised product support and innovative application technology. The remaining business units were unable to fully compensate for the adverse market conditions and achieved lower sales levels than in 1997.

Including the positive effects on sales resulting from the addition of the epoxy and adhesives products acquired in the Witco business swap, the sales of the Performance Polymers division increased sharply by 10% in Swiss francs and 13% in local currencies. Geographically, including the positive effects of the Witco business swap, sales in Europe were strong, particularly in Germany and Italy. North and Central America also exceeded prior year. In Asia, sales performance was mixed.

#### *Water Treatments*

Sales totalled CHF 722 million for the nine months commencing April 1, 1998. This level of sales represents 96% of prior year in Swiss francs and 98% in local currency. The sales reduction is attributable to a positive 2% change in volume/mix offset by 4% competitive price reductions and negative currency effects of 2%. Strong growth was recorded in the Pollution Control business due to good performance in the Americas and increasing regulatory requirements for clean water worldwide. Polymers Resale, Paper Technology, and the Industrial Water businesses capitalised on market opportunities, however, sales were slightly down due to difficult market conditions. Mineral Processing, Soil Additives and the Oil Services businesses declined amid falling mineral and oil prices, which are curtailing extraction and

drilling activities. Geographically, sales rose in the Western Hemisphere, especially in the United States and South America, and declined in Europe, especially in the slowing United Kingdom, German and Russian markets. In the Asia region, sales declined in line with the overall regional slowdown. This decline occurred despite growing opportunities in the Asian mining and paper industries.

#### **Margins remain strong despite challenging market conditions**

##### *Gross profit margins*

The gross profit margin remained strong at around 30% of sales, only slightly down as compared to the 31% achieved in the more favourable market and currency conditions of 1997. Adverse exchange rate movements negatively affected the gross margin by one percent. The inclusion of the former Allied Colloids business did not have a significant effect on gross margin. Maintaining high margins despite challenging market conditions, negative currency effects, and strong competitive price reductions underlines the inherent quality of the Company's earnings. This was achieved through proactive product and raw material sourcing at lower prices, successful implementation of restructuring programmes leading to efficiency improvements in the production and supply chain processes, and continued robust sales volume growth.

##### *Selling, general and administrative expenses increase as a result of the Allied Colloids acquisition*

Selling, general and administrative expenses increased by 11% as compared to 1997. The majority of this increase relates to the expenses of the former Allied Colloids. In order to maximise synergy benefits, the supply chain and administrative organisations of the former Allied Colloids are being quickly replaced with the Company's integrated standard systems and processes. The benefits of sharing systems, processes and administration will be evident in 1999. In comparative structures, excluding the effects of the additional Allied Colloids expenses, selling, general and administrative expenses would have increased by only 1%. This increase is the net effect of a number of initiatives. The Company had a series of smaller start-up ventures and acquisitions especially in the Additives division. Goodwill amortisation of CHF 48 million relating to the Allied Colloids acquisition also increased expenses. Costs were reduced by process

improvements, a number of operating gains in the normal course of business, and favourable currency effects. In Swiss francs, selling, general and administrative expenses amounted to CHF 1 413 million as compared to CHF 1 274 million in 1997, or 17% of sales as compared to 16% in 1997. While an increase was experienced in selling costs due to an expanded sales force and market presence, general and administrative costs were further reduced through the Company's continuing streamlining and restructuring efforts.

#### *Continuing commitment to research and development*

The Company continues to support its strategic initiatives of innovation and development of environmental friendly products through significant investment in research and development. Research and development expenses increased by 1% to CHF 304 million in 1998 from CHF 302 million in 1997.

#### *Increased income from earnings of equity affiliates*

The income from earnings of equity affiliates (investments in unconsolidated companies with greater than 20% and less than or equal to 50% ownership) amounted to CHF 94 million, before income taxes, in 1998 compared to CHF 36 million in 1997. The related income taxes are recorded separately in the Company's provision for income taxes. The investment in Hexcel Corporation (49.7% ownership), represents the most significant equity affiliate. This investment resulted in the Company recording CHF 72 million in income from equity affiliates.

#### *Improved operating income and EBITDA margin*

Operating income, before restructuring and special charges, increased by 3% to reach CHF 877 million as compared to CHF 854 million in 1997. This acceptable performance was primarily a result of sales growth, both in existing businesses and acquired businesses, continuing strong gross margins, as well as successful process improvements. Negative currency changes had a significant effect on operating income.

On a comparable basis, excluding the effects of the Allied Colloids acquisition, EBITDA margin reached 15.9% of sales. Despite early and aggressive cost reduction programmes, the deteriorating market environment, especially in the second half of 1998, precluded the Company from reaching its original objective of significantly improving financial

performance. These challenging market conditions led to a noticeable decline in second half performance. Second half EBITDA amounted to CHF 644 million compared to the first half EBITDA of CHF 712 million. Performance would, however, have been CHF 43 million lower in the second half were it not for a one-time gain relating to an environmental insurance settlement in the United States. Second half performance was particularly weak in the Textile and Fibres business. In addition, the results of the Performance Polymers business remained at the lower profitability levels achieved during the first half.

Including the net restructuring and special charges of CHF 1 147 million (CHF 373 million in 1997), the Company reported an operating loss of CHF 270 million in 1998 and an operating income of CHF 481 million in 1997. Included in the 1998 net restructuring and special charges is the CHF 1 012 million write off of the acquired in-process research and development recognised in connection with the Allied Colloids acquisition.

#### *Additives*

The Additives division achieved an EBITDA margin of 24.5%; significantly ahead of the already strong 1997 level of 21.5%. This performance level is considered as being at the upper end of realistically achievable performance. EBITDA improved to CHF 539 million as compared to CHF 506 million in 1997. This excellent result was achieved in a strongly competitive environment. Improved efficiency in the raw material procurement process and production and supply chain processes, robust sales volume growth leading to higher capacity utilisation, and the beneficial effects of divesting the lower margin Vinyl Additives business all contributed to the success. The focused investments in new ventures and increased capacity supported the good performance.

#### *Colors*

EBITDA in the Colors division is CHF 335 million or 82% of prior year in Swiss francs. The EBITDA margin declined to 14.3% in 1998 from 16.5% in 1997. Negative currency changes significantly affected results. Product and product sourcing innovation, supply chain process improvements and lower raw material prices coupled with strong performance in inks, paints and plastics, positively affected the division's result. Reduced demand for wool products in Asia, lower priced import substitution by consumers, especially in the United States, and a fashion trend away from darker shades

adversely affected the performance of the division. Overall, the benefits of process improvements were insufficient to fully compensate for competitive pressures on selling prices, less profitable sales mix, and the incremental costs related to increased manufacturing capacity.

In order to address rapidly deteriorating market conditions, decisive actions were taken during the second half of 1998. The combination of the former Pigments and Textile Dyes divisions created a leading global colour supplier. Combining the two divisions will provide ongoing benefits due to the ability to share infrastructure. Integration and restructuring activities to ensure that the benefits are realised are well advanced. Strategically, the division remains focused on core products with significant growth potential that clearly distinguish it from competitors.

In 1998, as part of the formation of the Colors division, the fabric finishing business of the former Textile Dyes division was transferred to the Consumer Care division. Including, for comparative purposes, the operations of the transferred fabric finishing business would result in an EBITDA of CHF 370 million in 1998. This compares to the CHF 445 million in 1997 achieved by the sum of the former Pigments division of CHF 251 million, and the former Textile Dyes division of CHF 194 million. The 1998 performance of the former Textile Dyes division was significantly lower than in 1997. The main reason for this decline was the adverse market conditions in the global textile industry. Deteriorating market conditions were especially evident during the last two months of 1998.

The following table is designed to show the link between the previously reported Pigments and Textile Dyes divisions to the Colors division.

1998	Pigments	Textile Dyes	Fabric Finishing	Colors
Sales	1 227	1 299	(182)	2 344
Operating income	200	48	(34)	214
EBITDA	261	109	(35)	335

1997	Pigments	Textile Dyes	Fabric Finishing	Colors
Sales	1 252	1 424	(191)	2 485
Operating income	189	130	(33)	286
EBITDA	251	194	(36)	409

#### *Consumer Care*

The Consumer Care division improved its EBITDA margin to 15.4% in 1998 from 14.4% in 1997 and increased EBITDA in absolute terms to CHF 210 million in 1998 from CHF 196 million in 1997. This good performance was achieved through sales growth in detergent whiteners and

antimicrobials. These positive effects were counterbalanced by more challenging market conditions for fabric finishing products sold into the textile industry. The gross profit margin improved strongly compared to the already high levels achieved in 1997 due, in part, to the cost of certain key products being reduced through internal manufacture and re-negotiated lower prices from suppliers. In addition, the benefits of previous restructuring and process improvement initiatives supported the improvement. Increased investment in sales and marketing resources, to capitalise on market opportunities, offset to some extent, the improved gross profit.

Excluding, for comparative purposes, the fabric finishing businesses transferred to Consumer Care from the former Allied Colloids and the former Textile Dyes division, the division would have achieved an EBITDA of CHF 170 million in 1998 as compared to an EBITDA of CHF 160 million reported by the Consumer Care division in 1997.

#### *Performance Polymers*

The EBITDA margin of the Performance Polymers division declined to 6.6% in 1998 as compared to 12.1% in 1997. Division EBITDA was CHF 118 million in 1998 as compared to CHF 197 million in 1997. This decline is due, principally, to reduced gross profit margins. The simultaneous effects of a weakening basic epoxy resins market, industry-wide price reductions and higher costs for raw materials, in the early part of the year, adversely affected gross profit margins. Despite gross profit margins stabilising during the second half of 1998, sales development, especially in the fourth quarter, slowed. As a result, gross profit in absolute terms was lower in the second half. The effects of a deteriorating gross profit could not be compensated for through short-term expense reductions. To counteract these worsening market conditions, the Performance Polymers division, during the second half of 1998, commenced a reorganisation and strategic realignment. The division's restructuring and strategic focus measures include placing strategic emphasis on high value-added products, streamlining worldwide logistics activities, and reorganising divisional structures.

#### *Water Treatments*

Water Treatments division achieved an EBITDA of CHF 142 million or an EBITDA margin of 19.6% for the nine months commencing April 1, 1998. Compared to 1997, gross margins were negatively affected by competitive price reductions,

which could not be fully compensated for through increased volume and lower raw material costs. The results reflect the tough economic environment and competitors attempting to capitalise on uncertainties created as a consequence of the acquisition and integration. Division operating expenses remained at similar levels to 1997. Most of the year was devoted, as planned, to integration with many systems implementations completed by December 31, 1998. Integration was focused on activities which will yield future benefits. These include utilising the Company's purchasing power to obtain reduced raw material prices, setting up new global financial and product distribution systems that are integrated into the Company's worldwide shared services network, and the consolidation of several offices and other facilities. The combination of these integration activities provide a platform which will not only reduce costs but will also facilitate the use of the Company's global reach.

Including, for comparative purposes, the fabric finishing and personal care businesses transferred to Consumer Care and the coating systems business transferred to the Additives division results in an EBITDA of CHF 149 million for the nine months ended December 31, 1998.

#### *Responsive treasury management*

The international financial markets were volatile in 1998, which was caused in part by the financial instability experienced in many regions of the world. The markets were also affected by the easing of monetary policies by leading central banks.

Despite the fact that during 1998 the average value of the Swiss franc remained relatively stable compared to many major currencies, exchange rates exhibited high degrees of volatility within the period. The volatility in the currency markets experienced in the first half of 1998 increased further during the second half of the year, reaching its peak movements in October 1998. During this period, the Swiss franc fluctuated from a low of approximately CHF 1.50 to a high of approximately CHF 1.30 to the U.S. dollar. At December 31, 1998, the Swiss franc was at a level of CHF 1.38 to the U.S. dollar versus CHF 1.46 at the end of 1997. In addition, over the year, the Swiss franc strengthened against the British pound and other major currencies and remained relatively stable versus the German mark.

The strengthening of the Swiss franc against many currencies caused unfavourable currency effects in 1998.

The resulting negative financial effects were mitigated by the timely execution of effective hedging transactions by the Company. This hedging policy offset many of the currency losses experienced through gains on the related financial instruments. The Company continues to monitor its currency exposures and, where appropriate, enters into transactions to mitigate its overall exposures from currency volatility in the financial markets.

The 'Other financial income (expense)' of CHF (66) million consists of hedging expenses and foreign exchange transaction losses. These losses arose primarily in countries where hedging was not possible or where the costs outweighed the potential benefits from hedging. In addition, included in the net expense are currency swap costs relating to the refinancing of certain of the borrowings of the Company. Also included are commitment fees and commissions paid in relation to the financing of the Allied Colloids acquisition.

The average cost of all the Company's borrowings was less than 6% for the year. Total indebtedness and total interest expense increased in 1998 over 1997 levels as a result of increased borrowings to finance the Allied Colloids acquisition.

The Company's cash and short-term investments were decreased from 1997 levels as a direct result of management's efforts to optimise the Company's overall capital structure.

#### *Effective tax rate*

The Company has established and maintains a tax efficient organisational structure. This enabled the Company to achieve an effective tax rate of 29%. The effective tax rate is calculated by excluding the effects of the write-off of acquired in-process research and development costs, Allied Colloids goodwill amortisation, and a non-cash accounting gain on the exchange of a business, all of which are not recognised for tax purposes. The increase of 4% from the 25% effective tax rate reported in 1997 is primarily the result of a change in the profitability mix of the Company's subsidiaries to countries with higher fiscal tax rates.

*Restructuring and special charges, net*  
During 1998, the Company incurred net restructuring and special charges of CHF 1 147 million (1997: CHF 373 million). This amount includes a charge of CHF 1 012 million for acquired in-process research and development which was recognised during the year associated with the acquisition of Allied Colloids.

Under U.S. GAAP, in-process research and development costs are expensed immediately.

The remaining net restructuring and special charges of CHF 135 million relate primarily to the strategic realignment of the Company's business. The major components of the strategic realignment are the integration of the Water Treatments division, the formation of the Colors division and the profit recovery programme of the Performance Polymers division. The majority of the net restructuring and special charges, CHF 121 million, are for separation payments to be made to approximately 1 100 employees or full-time equivalents ("FTE's") whose positions will be eliminated. The remaining portion of the charge relates to other costs incurred for the reorganisation of administrative functions, streamlining of the supply chain, and systems integration, offset by a non-cash accounting gain of CHF 75 million recognised on the exchange of a business.

Management believes that the remaining restructuring provisions of CHF 346 million at December 31, 1998 are adequate to complete these projects.

As a result of the actions covered by the restructuring charges to reduce personnel and to streamline the Company's organisational structures, management estimates annual future cost savings of CHF 150 million. These cost savings will support the Company's performance in difficult market conditions.

#### *Net income affected by increased financing costs*

The Company's net income, before restructuring and special charges of CHF 1 147 million (1997: CHF 373 million) and related taxation of CHF 39 million (1997: CHF 95 million), was reduced to CHF 369 million from prior year CHF 571 million. Net (loss) income, after restructuring and special charges, decreased to CHF (739) million from CHF 293 million. The main change, comparing the net income of 1998 to 1997, relates to increased financing expenses and the write-off of in-process research and development incurred as a consequence of the Allied Colloids acquisition.

#### *Earnings per share*

Earnings per share before restructuring and special charges and related taxation are CHF 5.57 in 1998 compared to CHF 8.38 in 1997. Loss per share, after restructuring and special charges, was CHF (11.15) in 1998 compared to earnings per share of CHF 4.29 in 1997.

Earnings (loss) per share amounts were computed by dividing net income, before and after restructuring and special charges, by the weighted average number of common shares outstanding.

### **Temporary Reduction in Liquidity**

#### **Balance sheet**

*Excellent asset management leads to sharp reductions in operational assets*

Velocity (net sales divided by average invested capital) is a key element of the Company's Value Based Management measures. This measurement is designed to ensure that the Company continually improves the effectiveness of its asset utilisation.

Operationally, reducing invested capital was a strong focus of management attention. In comparable structures, through strict asset management, both fixed and current assets were significantly reduced during 1998. Excluding the effects of acquisitions and currency, accounts receivable and inventory were reduced by CHF 320 million and net property, plant and equipment was reduced by CHF 76 million. This excellent result was achieved through supply chain operational improvements coupled with strict control over capital expenditures. Currency effects further reduced inventories and receivables by CHF 123 million and net property, plant and equipment by CHF 159 million.

All divisions have current asset reduction programmes in place. Additives has introduced demand flow management, and Colors has reduced operating assets by outsourcing intermediate production steps. In addition, a demand activated manufacturing and distribution pilot programme is in progress. This approach to forecasting is similar to that used by retail stores. Consumer Care is working to improve supply chain management through warehouse outsourcing. Performance Polymers, as part of its restructuring initiatives, has critically evaluated current asset management. First successful results are evident. With the full integration of Water Treatments, improved supply chain management will support asset reduction programmes.

Despite the significant operational reduction in assets, the acquisition of Allied Colloids led to a large increase in average invested capital. For the year ended December 31, 1998, average invested capital amounted to CHF 10 190 million as compared to the prior year CHF 8 237 million. The increase is primarily attributable to goodwill paid and assets acquired in the Allied Colloids

acquisition. The sales increase of 8% and reduced operational asset levels were not sufficient to fully compensate for this increase. Velocity was reduced to 0.83 compared to 0.95 in 1997. In comparable structures, excluding the effects of the Allied Colloids acquisition, velocity improved to 0.97, primarily due to good asset management.

#### *Liquidity temporarily affected by acquisition financing*

The financial structure of the Company's balance sheet has been temporarily negatively affected due to the funding requirements for the acquisition of Allied Colloids. The business, however, continues to generate strong positive operating cash flow. Net cash provided by operating activities, before restructuring costs, is a healthy CHF 843 million.

The Company's management believes that its current cash and cash equivalents, short-term investments, debt facilities and the cash generated from ongoing initiatives and operations will be adequate to satisfy the Company's future cash requirements for normal capital expenditure programmes and its operations through fiscal 1999.

#### *Total assets and liabilities*

The major change in assets and liabilities, as compared to 1997, relates to the acquisition of Allied Colloids. This is principally reflected by an increase in intangible assets, offset by an increase in long-term borrowings and a reduction in retained earnings arising as a consequence of the one-time write-off of in-process research and development costs.

### **Continuing strong operating cash flows**

For the year ended December 31, 1998, the Company generated operating cash flows, before restructuring payments, of CHF 843 million as compared to CHF 1 143 million in 1997. The reduction is primarily due to increased interest payments of CHF 180 million compared to 1997.

Cash used for investing activities, CHF 4 024 million, relates primarily to the Allied Colloids acquisition, CHF 3 539 million (CHF 3 615 million cash paid less the CHF 76 million cash acquired), and capital expenditures of CHF 459 million mostly for production assets. Recognising the rapidly deteriorating external market conditions, management took proactive action to strictly control capital expenditures during 1998. Capital expenditures were restricted to the completion of already commenced projects. During 1998, the Company's

major investments occurred in the inks, papers and plastics part of the Colors division and in the core Water Treatments business. In Colors, investments were made to modernise and expand Quinacridone production capacity in the United States, and to facilities for granular pigment production in the United Kingdom. In Water Treatments, production efficiency was improved and capacity was increased for the production of Cationic Monomers in the United States. These investments create more cost-effective production processes and increase capacity. All other capital expenditures were restricted to absolute necessity. This resulted in reduced capital expenditure in 1998 of CHF 459 million as compared to CHF 523 million in 1997, despite significant capital investments in Water Treatments. Capital expenditures in 1998 were lower than the depreciation and amortisation charge of CHF 479 million.

Free cash flows (operating cash flows before restructuring payments less net cash used for investing activities, other than acquisitions) amounted to a total of CHF 358 million. The Company therefore continues to generate significant cash flows for reinvestment in the business and dividend payments.

During the year, net cash from financing activities was CHF 3 097 million. The Company raised unsecured long-term borrowings at very advantageous interest rates. The average cost of the Company's total borrowings was below 6% for 1998. Interest rates for long term borrowings are fixed for 5 to 15 years.

#### Environmental matters

The chemical industry is subject to stringent environmental, health and safety laws and regulations. It is the Company's policy to continuously develop and improve the environmental performance of key manufacturing processes through an active programme to address environmental matters. In addition to process improvements, advanced waste treatment and disposal facilities have been commissioned at all major manufacturing sites that allow the sites to comply with recent laws and regulations applicable to waste streams. Management believes that the Company is in compliance with all such laws.

Prior to the Company's spin-off from Novartis, a company-wide environmental audit was performed. Based on the results of the audit, management believed that the CHF 738 million in reserves recorded at that time were sufficient to meet all currently known and anticipated environmental claims and liabilities

relating to the Company's past operations. These provisions were adjusted as further information developed or circumstances changed and amounted to CHF 745 million at December 31, 1998 (CHF 777 in 1997). The Company's environmental protection and improvement cash expenditures were approximately CHF 55 million in 1998 (CHF 43 million in 1997), including investments in construction, operations and development. Based upon current regulation and the information available, management believes that adequate provisions have been made in the Company's consolidated financial statements and future costs will not have a material adverse impact on the Company's consolidated financial condition.

The predecessor of Novartis has been party to litigation with various insurance companies relating to environmental liability. Under the agreement with Novartis, the Company is entitled to 50 percent from any net proceeds from this litigation. In 1998, certain of the litigation related to sites located in the United States have been settled with the insurance companies. The Company's share of these settlements was approximately CHF 43 million.

#### Economic Profit Temporarily Affected by the Acquisition of Allied Colloids

Economic profit growth is dependent on improvements in EBIT coupled with continued asset control. During 1998, despite tough market conditions and adverse exchange rate effects, the Company's EBIT improved to CHF 877 million as compared to CHF 854 million in 1997, a 3% increase. This increase was, however, insufficient to fully compensate for the increase in invested capital. Despite good operational asset management, invested capital increased significantly due to the acquisition of Allied Colloids. The Company was therefore unable to earn more than its cost of capital. Economic profit for 1998 amounted to CHF (6) million as compared to CHF 64 million in 1997. Excluding the effects of the Allied Colloids acquisition, economic profit would have increased to CHF 88 million, reflecting the solid financial performance and excellent asset reduction.

#### Outlook 1999 and Beyond

Very weak global growth of between zero and one percent is expected in 1999. Management, therefore, does not expect any significant overall market or industry growth. The integration of Water

Treatments and the strength of much of the Company's portfolio, should, however, still allow for a minimal sales growth in 1999. It is expected that both sales growth and margins will be negatively affected by a strengthening Swiss franc. This is a continuation of the trend experienced during the last few months of 1998.

Management believes that the coming year, 1999, will be a demanding year. The Company is, therefore, cautious regarding the outlook for 1999, and does not share the optimistic view that the industry will reach its low point by mid year. Some support can be expected from the aggressive cost reduction programmes and further measures regarding asset and purchase management, and the strict control of capital expenditure and expenses. It is, however, difficult to forecast the full impact of the weakening economy on sales and margins and the resulting net effects including cost savings for 1999. Should the trends of the second half of 1998 continue, it will not be possible to maintain the current EBITDA margin levels; a weakening of at least one percentage point and possibly even somewhat more cannot be excluded.

#### Supplemental Information

##### Euro conversion

On January 1, 1999, eleven of fifteen member countries of the European Union established fixed conversion rates between their existing sovereign currencies and adopted the Euro as their new common currency. The Euro trades on currency exchanges while the legacy currencies will remain legal tender in the participating countries for a transition period between January 1, 1999 and January 1, 2002.

During the transition period, cash-less payments can be made in the Euro and parties can elect to pay for goods and services and transact business using either the Euro or a legacy currency. Between January 1, 2002 and July 1, 2002, the participating countries will introduce Euro notes and coins and withdraw all legacy currencies so that they will no longer be available.

The Company has in place a joint team representing affected functions within the Company. This team has established and implemented actions and performed the necessary systems changes to address the potential impact to the Company from the Euro conversion. These issues include, but are not limited to: 1) the technical challenges to adapt information systems to accommodate Euro transactions; 2) the competitive impact of cross-border price

transparency; 3) the impact on currency exchange rate risks; 4) the impact on existing contracts and 5) tax, legal and accounting implications. Based on our work to date, we believe the introduction of the Euro and the phasing out of the other currencies will not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

#### Year 2000

The Year 2000 Issue arises as a result of computer programmes being written using two digits rather than four to define the applicable year. Any computer programmes or any hardware that have date sensitive software or embedded chips may recognise a date using "00" as the year 1900 rather than the year 2000. This is a significant issue for most, if not all, companies, with far reaching implications, some of which cannot be anticipated or predicted with any degree of certainty. The Year 2000 Issue could result in a temporary inability to process transactions or engage in normal manufacturing or other business activities. Failure by the Company or any of its significant suppliers or customers to complete Year 2000 readiness activities could have a material adverse effect on the Company's business and results of operations.

The Company has, since the date of the spin-off, been addressing the Year 2000 Issue. This effort has been conducted in combination with its project to implement worldwide standard information systems and processes. This project has been designed to ensure that the Company achieves Year 2000 readiness for both information technology and non-information technology systems and to determine the readiness of the Company's significant suppliers and customers.

The Company implemented a two-phased, multi-step approach to address its Year 2000 compliance. The first phase focused on systems and production and manufacturing processes, which are critical to the Company's business. The second phase focused on remaining systems that are not critical to the Company's business. This approach consists of the following steps:

- (1) perform a professional and detailed review of business systems and processes to identify and prepare an inventory of Year 2000 readiness;
- (2) perform a professional and detailed review of embedded chip devices with specific emphasis on the production and manufacturing process and prepare an inventory of year 2000 readiness;

- (3) prioritise the inventoried items based on criticality to the business;
- (4) define and implement corrective actions;
- (5) evaluate customer and supplier Year 2000 readiness;
- (6) develop contingency plans; and
- (7) verify implementation and finalise contingency plans.

The Company has largely completed the evaluation, inventory and prioritisation steps across all divisions and functional areas of the Company.

The Company's information technology systems are comprised of a number of computer systems and end user applications. The implementation of corrective actions on non-compliant Year 2000 applications and systems have, by December 31, 1998, been substantially completed for the business systems and processes of all divisions and functional areas in the Company, except for the European operations of the Performance Polymers division which will be completed in the second half of 1999.

A formal testing plan has been approved that will evaluate all processes and systems for date sensitive issues and will test a representative number of sample items through the key business systems and applications. The testing phase will begin and be completed in the first half of 1999, except for the European operations of the Performance Polymers division which will be completed in the second half of 1999. The Company has contracted with an independent consultant to, jointly with the Company, review and issue a certification on the results of the testing phase.

The Company's non-information technology systems (embedded chip devices) are mostly found in the manufacturing infrastructure and facility support systems. The Company has made an inventory and assessment of these systems. All critical non-information technology systems are expected to be Year 2000 compliant by the end of the first half 1999. Manual alternatives are being established for non-critical functions. In addition, the Company has begun to develop contingency plans for critical non-information technology systems and expects them to be completed by the end of the first half of 1999.

The Company has identified and is communicating with customers, suppliers and other critical service providers to determine if companies with whom the Company transacts business have an effective plan to address the Year 2000 issue and to determine the extent of the Company's vulnerability to the failure of

third parties to solve their own Year 2000 issues. These actions are expected to be completed by the end of the first half of 1999. The Company is relying on statements received from its customers, suppliers and other service providers and is not auditing their preparation plans. Risks associated with this approach are being identified and contingency plans will be developed.

The second phase, which focuses on the non-critical systems, is scheduled for completion during the second half of 1999.

As a result of assessments, modifications, upgrades or replacements planned, ongoing or already completed, the Company believes the Year 2000 Issue as it relates to the Company's own date-dependent systems, will not pose significant problems for the Company's business, processes and operations. The Company believes that the costs of consultant fees, modifications, upgrades or replacements of software, hardware or capital equipment which would not otherwise be incurred, except for Year 2000 compatibility requirements, have not and will not have a material impact on the Company's financial position or results of operations. The Company currently estimates the total costs of resolving the Year 2000 Issue at approximately CHF 20 million to CHF 25 million. Of this amount, approximately CHF 13 million has been incurred through December 31, 1998. The estimated costs are based on currently available information and may be subject to change. These costs are being funded through operating cash flows.

Based on the previously accomplished implementation of worldwide standard information systems and processes together with the current Year 2000 Issue plans and efforts completed to date, the Company does not anticipate that the Year 2000 Issue will have a material effect on results of operations or financial condition. However, these expectations are subject to uncertainties. For example, if the Company is unsuccessful in identifying or solving all Year 2000 issues in its critical operations, or if it is adversely affected by the inability of suppliers or major customers to continue operations due to their Year 2000 issues, then the Company's results of operations or financial condition could be materially impacted.

**Forward-Looking Statements**

*Forward-looking statements contained herein are qualified in their entirety as there are certain important factors that could cause results to differ materially from those anticipated. Investors are cautioned that all forward-looking statements involve risks and uncertainty. In addition to the factors discussed above, among the factors that could cause actual results to differ materially are the following: the timing and strength of new product offerings, pricing strategies of competitors, the Company's ability to continue to receive adequate products from its vendors on acceptable terms and to continue to obtain sufficient financing to meet its liquidity needs, effects of overall economic conditions, including currency fluctuations, inflation and consumer confidence.*

## Consolidated Statements of Income

(in millions of Swiss francs, except share and per share data)

Year ended December 31,	Notes	1998	1997
Net sales		8 423	7 822
Cost of goods sold		5 923	5 428
<b>Gross profit</b>		<b>2 500</b>	<b>2 394</b>
Selling, general and administrative		1 413	1 274
Research and development		304	302
Income from earnings of equity affiliates	8	(94)	(36)
Restructuring and special charges	10	1 147	373
<b>Operating (loss) income</b>		<b>(270)</b>	<b>481</b>
Interest expense		(353)	(149)
Interest income		47	43
Other financial income (expense)		(66)	(20)
<b>(Loss) income before income taxes</b>		<b>(642)</b>	<b>355</b>
Provision for income taxes	13	97	62
<b>Net (loss) income</b>		<b>(739)</b>	<b>293</b>
<b>Per share data</b>	18		
Basic (loss) earnings per share		(11.15)	4.29
Diluted (loss) earnings per share		(11.15)	4.29
<b>Weighted average shares outstanding:</b>			
Basic		66 293 130	68 158 845
Diluted		66 293 130	68 158 845

See Notes to Consolidated Financial Statements

## Consolidated Balance Sheets

(in millions of Swiss francs, except share and per share data)

December 31,	Notes	1998	1997
<b>Assets</b>			
<b>Current assets</b>			
Cash and cash equivalents		206	644
Short-term investments		47	54
Accounts receivable, net of allowance of CHF 119 and CHF 99		1 416	1 395
Inventories	5	2 053	2 044
Prepaid and other current assets		819	781
<b>Total current assets</b>		<b>4 541</b>	<b>4 918</b>
Property, plant and equipment, net	6	4 396	3 991
Goodwill and other intangible assets, net of accumulated amortisation of CHF 116 and CHF 44		2 258	58
Financial investments	8	602	523
Other assets		547	444
<b>Total assets</b>		<b>12 344</b>	<b>9 934</b>
<b>Liabilities and Shareholders' Equity</b>			
<b>Current liabilities</b>			
Accounts payable		587	429
Short-term debt	11	1 905	1 814
Income taxes payable		22	30
Accruals and other current liabilities	9	1 085	1 229
<b>Total current liabilities</b>		<b>3 599</b>	<b>3 502</b>
Long-term debt	12	3 648	294
Deferred income taxes	13	227	164
Other liabilities	14	1 577	1 638
<b>Total liabilities</b>		<b>9 051</b>	<b>5 598</b>
<b>Shareholders' equity</b>			
Common stock, par value CHF 10 per share – 82 130 117 shares authorised and 72 130 117 issued in 1998 and 72 130 117 shares authorised and issued in 1997	15	721	721
Additional paid-in capital		3 718	3 719
Retained earnings		(579)	293
Accumulated other comprehensive income		(125)	(25)
Treasury stock, at cost (1998 – 5 676 798 shares; 1997 – 5 741 045 shares)		(442)	(372)
<b>Total shareholders' equity</b>		<b>3 293</b>	<b>4 336</b>
<b>Total liabilities and shareholders' equity</b>		<b>12 344</b>	<b>9 934</b>

See Notes to Consolidated Financial Statements

## Consolidated Statements of Cash Flows

(in millions of Swiss francs, except share and per share data)

Year ended December 31,	1998	1997
<b>Cash flows from operating activities</b>		
Net (loss) income	(739)	293
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortisation	479	377
Deferred income taxes	22	(17)
Unremitted earnings of equity affiliates	(81)	(32)
Restructuring and special charges	1 147	373
Restructuring payments	(323)	(476)
(Gain) on sale / disposal of assets	(116)	(15)
Other	(5)	(18)
Changes in operating assets and liabilities:		
Short-term investments	4	113
Accounts receivable	173	(81)
Inventories	160	77
Accounts payable	(10)	64
Other operating assets and liabilities	(191)	9
<b>Net cash provided by operating activities</b>	<b>520</b>	<b>667</b>
<b>Cash flows from investing activities</b>		
Capital expenditures	(459)	(523)
Proceeds from sale of assets	18	70
Acquisition of businesses, net of cash acquired	(3 539)	(34)
Loans and other long-term assets	(44)	(36)
<b>Net cash used in investing activities</b>	<b>(4 024)</b>	<b>(523)</b>
<b>Cash flows from financing activities</b>		
Increase (decrease) in short-term debt, net	9	(185)
Proceeds from long-term debt	3 829	(24)
Repayments of long-term debt	(544)	(84)
Dividends paid	(133)	0
Treasury stock transactions	(70)	(339)
Other	6	17
<b>Net cash provided by (used in) financing activities</b>	<b>3 097</b>	<b>(615)</b>
<b>Effect of exchange rate changes on cash and cash equivalents</b>	<b>(31)</b>	<b>(10)</b>
<b>Net decrease in cash and cash equivalents</b>	<b>(438)</b>	<b>(481)</b>
Cash and cash equivalents, beginning of year	644	1 125
Cash and cash equivalents, end of year	206	644
<b>Supplemental cash flow information</b>		
Cash paid for interest	(306)	(126)
Cash paid for income taxes	(66)	(55)

See Notes to Consolidated Financial Statements

## Consolidated Statements of Shareholders' Equity

(in millions of Swiss francs, except share and per share data)

	Notes	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Treasury stock: unreserved shares	Treasury stock: reserved shares	Total
<b>Balance at January 1, 1997</b>		721	3 701	0	0	(33)	0	4 389
Net income				293				293
Currency translation adjustments					(18)			(18)
Unrealised (loss) on available-for-sale securities, net of tax					(7)			(7)
Comprehensive income				293	(25)			268
Treasury stock transactions	15					(68)	(271)	(339)
Other	15		18					18
<b>Balance at December 31, 1997</b>		721	3 719	293	(25)	(101)	(271)	4 336
Net (loss)				(739)				(739)
Currency translation adjustments					(105)			(105)
Unrealised gain on available-for-sale securities, net of tax					5			5
Comprehensive (loss)				(739)	(100)			(839)
Cash dividends declared and paid				(133)				(133)
Treasury stock transactions	15					(63)	(7)	(70)
Other			(1)					(1)
<b>Balance at December 31, 1998</b>		721	3 718	(579)	(125)	(164)	(278)	3 293

See Notes to Consolidated Financial Statements

## Business Segment Data

(in millions of Swiss francs, except share and per share data)

	1998	1997		1998	1997
<b>Net sales</b>			<b>Depreciation and amortisation</b>		
Additives	2 199	2 349	Additives	121	121
Colors	2 344	2 485	Colors	120	124
Consumer Care	1 367	1 362	Consumer Care	57	55
Performance Polymers	1 791	1 626	Performance Polymers	67	62
Water Treatments (nine months)	722	–	Water Treatments (nine months)	55	–
<b>Total net sales</b>	<b>8 423</b>	<b>7 822</b>	Non-divisional depreciation and amortisation	59	15
			<b>Total depreciation and amortisation</b>	<b>479</b>	<b>377</b>
<b>Operating income</b>			<b>Research and development expenditures</b>		
Additives	418	385	Additives	111	120
Colors	214	286	Colors	89	89
Consumer Care	153	141	Consumer Care	38	41
Performance Polymers	52	135	Performance Polymers	55	52
Water Treatments (nine months)	87	–	Water Treatments (nine months)	11	–
Corporate and other expenses	(47)	(93)	<b>Total research and development expenditures</b>	<b>304</b>	<b>302</b>
Restructuring and special charges	(1 147)	(373)			
<b>Total operating (loss) income</b>	<b>(270)</b>	<b>481</b>	<b>Capital expenditures</b>		
			Additives	79	140
<b>EBITDA</b>			Colors	162	213
Additives	539	506	Consumer Care	31	45
Colors	335	409	Performance Polymers	65	93
Consumer Care	210	196	Water Treatments (nine months)	102	–
Performance Polymers	118	197	Non-divisional capital expenditures	20	32
Water Treatments (nine months)	142	–	<b>Total capital expenditures</b>	<b>459</b>	<b>523</b>
Corporate	12	(77)			
<b>Total EBITDA</b>	<b>1 356</b>	<b>1 231</b>	<b>Net assets</b>		
			Net operating assets:		
<b>EBITDA margin</b>			Additives	1 827	2 133
Additives	24.5%	21.5%	Colors	2 715	2 728
Colors	14.3%	16.5%	Consumer Care	993	1 022
Consumer Care	15.4%	14.4%	Performance Polymers	1 484	1 379
Performance Polymers	6.6%	12.1%	Water Treatments	979	–
Water Treatments	19.6%	–	Shared assets not allocated to divisions	2 646	763
Corporate	–	–	Net non-operating (liabilities) assets	(143)	93
<b>Total EBITDA margin</b>	<b>16.1%</b>	<b>15.7%</b>	<b>Total net assets</b>	<b>10 501</b>	<b>8 118</b>
<b>Economic profit</b>			Shared assets not allocated to divisions include the goodwill recognised in connection with the Allied Colloids acquisition.		
Additives	181	138	See Glossary of Financial Terms for definitions of net assets, EBITDA, EBITDA margin and economic profit.		
Colors	(29)	22			
Consumer Care	44	33			
Performance Polymers	(59)	9			
Water Treatments (nine months)	16	–			
Corporate	(159)	(138)			
<b>Total economic profit</b>	<b>(6)</b>	<b>64</b>			

See Notes to Consolidated Financial Statements

(in millions of Swiss francs, except share and per share data)

The Company's reportable segments are divisions that develop, manufacture and market different products and services. They are managed separately because each division requires different technology and marketing strategies.

In the second half of 1998, the Company began a programme to realign its businesses to better build on each business' unique competencies, address market opportunities and capture further synergies. These strategic realignments include:

(i) the creation of the "Colors" division in order to strengthen the focus on the Company's core competencies in colours for industrial and consumer applications. This new division was established through the combination of the Company's Pigments and Textile Dyes divisions.

(ii) the combination of the dyeing and printing auxiliaries and textile finishing business of the Consumer Care, Textile Dyes and Water Treatments divisions into the Consumer Care business. With the combination of these businesses within the Consumer Care division, customers are provided with a more integrated range of products and services.

(iii) the transfer of the Water Treatments division's coating business to the Additives division and its personal care business to the Consumer Care division enables the Water Treatments division to focus on its core competencies of water treatment additives for pollution control, paper manufacturing and the oil and mineral processing industries. The businesses transferred from Water Treatments to Additives and Consumer Care will complement existing product ranges in those divisions, enabling the Company to establish greater critical mass and market focus.

The following table provides a link between the previously reported Pigments and Textile Dyes divisions to the Colors division:

Year ended December 31, 1998	Pigments	Textile Dyes	Fabric Finishing	Colors
Sales	1 227	1 299	(182)	2 344
Operating income	200	48	(34)	214
EBITDA	261	109	(35)	335

Year ended December 31, 1997	Pigments	Textile Dyes	Fabric Finishing	Colors
Sales	1 252	1 424	(191)	2 485
Operating income	189	130	(33)	286
EBITDA	251	194	(36)	409

As of December 1998, the Company had five reportable segments: Additives, Colors, Consumer Care, Performance Polymers and Water Treatments.

Additives are ingredients added in small quantities to polymers, coatings, lubricants, printing inks and photographic films and papers. The division's products prevent ageing and corrosion and help improve the appearance, durability and performance of numerous finished goods, including automobiles, high-tech products and household appliances.

The division Colors provides colours to the inks, paints, plastics, textiles and fibres industries. Among its products are dyes and pigments for printing inks, automotive, industrial and decorative paints, plastics, digital printing, and for cotton,

polyester, wool and polyamide. The division provides rich hues and long-lasting colours for clothing, curtains, carpets, automobiles, children's toys, magazines and other items.

Consumer Care's products include whiteners, antimicrobials, specialty colours and fabric finishes tailored for producers of consumer goods. The division enhances the performance of products ranging from detergents and cosmetics to paper and textiles, and brings comfort, care and protection to the consumer.

The division Performance Polymers produces epoxy resins and other high performance thermosets that provide durability, extraordinary strength and resistance to heat and corrosion. Performance Polymers supplies its products to the coatings, aircraft, electrical and electronic industries, among others.

Water Treatments' products and services are used to provide clean water and to treat industrial and municipal effluent. The business also is focused on improving the efficiency of many industrial processes, including paper, mineral and oil processing. The division was created April 1, 1998 following the acquisition of Allied Colloids.

The accounting policies of the segments are the same as those described in Note 1 of Notes to Consolidated Financial Statements. The Company evaluates the performance of its reportable segments based on operating income before restructuring and special charges, corporate related items, and certain other net expenses not allocated to reportable segments. All intersegment sales between subsidiaries are based on market prices.

The segment data for 1997, as previously reported, has been restated to conform with the effects of the above mentioned divisional realignments. The totals for all captions are equal to the historical figures as previously reported, since the restated data do not retroactively reflect potential impact on sales or costs.

In continuation of its programme to realign its businesses, the Company announced, in January 1999, the formation of an enlarged Additives division by combining the Company's water treatments operations with the Company's additives business. This strategic realignment is intended to better utilise resources in order to grow the business and to achieve further synergies. A new Global Business Unit, Water Treatments, will be formed within the Additives division and the change will formally take effect March 1, 1999.

The following restated segment data for the enlarged Additives division reflects for 1998 the combined historical figures of the separate Additives and Water Treatments divisions and reflects for 1997 the historical figures of the Additives division only. Both years are presented without giving effect to any potential impact on sales or costs.

Year ended December 31,	1998	1997
Net sales	2 921	2 349
Operating income	505	385
Net operating assets	2 806	2 133
Depreciation and amortisation	176	121
Capital expenditures	181	140
Research and development expenditures	122	120
EBITDA	681	506
EBITDA margin	23.3%	21.5%
Economic profit	197	138

See Notes to Consolidated Financial Statements

See Glossary of Financial Terms

## Geographic Data

(in millions of Swiss francs, except share and per share data)

<b>Net Sales to Customers</b>	1998	1997
<b>Europe</b>		
Germany	903	724
United Kingdom	483	435
Italy	429	428
France	413	404
Rest of European Union	1 017	918
Switzerland	122	111
Rest of Europe	242	239
<b>Total Europe</b>	<b>3 609</b>	<b>3 259</b>
<b>Western Hemisphere</b>		
United States of America	2 199	1 925
Canada	194	155
Central America	197	181
South America	391	414
<b>Total Western Hemisphere</b>	<b>2 981</b>	<b>2 675</b>
<b>Eastern Hemisphere</b>		
Japan	477	487
Region China	363	378
Rest of Asia	564	634
Australia and New Zealand	148	134
Africa and Middle East	281	255
<b>Total Eastern Hemisphere</b>	<b>1 833</b>	<b>1 888</b>
<b>Total net sales to customers</b>	<b>8 423</b>	<b>7 822</b>

Net sales to customers are based on the final destination of the sale.

See Notes to Consolidated Financial Statements

<b>Long-lived Assets</b>	1998	1997
<b>Europe</b>		
Germany	513	557
United Kingdom	793	461
Italy	136	146
France	159	156
Rest of European Union	117	114
Switzerland	903	916
Rest of Europe	3	1
<b>Total Europe</b>	<b>2 624</b>	<b>2 351</b>
<b>Western Hemisphere</b>		
United States of America	1 239	1 104
Canada	16	10
Central America	86	110
South America	73	76
<b>Total Western Hemisphere</b>	<b>1 414</b>	<b>1 300</b>
<b>Eastern Hemisphere</b>		
Japan	28	26
Region China	222	231
Rest of Asia	67	52
Australia and New Zealand	28	18
Africa and Middle East	13	13
<b>Total Eastern Hemisphere</b>	<b>358</b>	<b>340</b>
<b>Total long-lived assets</b>	<b>4 396</b>	<b>3 991</b>

Long-lived assets represent property, plant and equipment, net and are shown by the location of the assets.

## Notes to Consolidated Financial Statements

(in millions of Swiss francs, except share and per share data)

### 1. Summary of significant accounting policies

#### Company operations

Ciba Specialty Chemicals Holding Inc. and its wholly owned and majority-owned subsidiaries (the "Company") is a global leader in the discovery and manufacture of innovative materials that provide colour, performance and care for plastics, coatings, fibres, fabrics and other products. The Company's products and services are also used to provide clean water and to treat industrial and municipal effluent. On March 13, 1997, Novartis AG ("Novartis") completed the spin-off of the Company through a distribution of all the shares of the Company to Novartis shareholders. For further discussion of the spin-off, see Note 2.

#### Basis of consolidation and presentation

The accompanying consolidated financial statements of the Company have been prepared in accordance with United States Generally Accepted Accounting Principles ("U.S. GAAP"). The assets, liabilities and results of operations of entities in which the Company has a controlling interest have been consolidated and any applicable minority interests are included in other liabilities in the balance sheet and other financial income (expense) in the statement of income. Investments in which the Company exercises significant influence, but which it does not control (generally 20–50 percent ownership interest) are accounted for under the equity method of accounting. Investments in which the Company has less than a 20 percent ownership interest are accounted for under the cost method of accounting. All significant intercompany accounts and transactions have been eliminated in consolidation.

#### Use of estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on management's best knowledge of current events and actions the Company may undertake in the future, actual results ultimately may differ from those estimates.

#### Foreign currency translation

The Company's financial statements are prepared in Swiss francs (CHF million). For most operations outside Switzerland, where the functional currency is the local currency, income, expense and cash flows are translated at average exchange rates during the period, and assets and liabilities are translated at period-end exchange rates. The translation adjustments are included as a component of accumulated other comprehensive income in shareholders' equity. The financial statements of subsidiaries that operate in economic environments that are highly inflationary maintain financial information for reporting purposes in U.S. dollars or Swiss francs and include gains and losses from translation in income.

#### Cash equivalents

All highly liquid investments with original maturities of three months or less are considered to be cash equivalents.

#### Short-term investments

Short-term investments consist of securities that are traded in highly liquid markets. Since they are held for the purpose of investing liquid funds and are readily convertible to cash, they are classified as trading securities and are carried at fair value. Gains and losses are recorded in other financial income (expense) in the Consolidated Statement of Income.

#### Financial instruments

The Company enters into derivative financial instruments in the ordinary course of business to mitigate its exposure to adverse changes in foreign exchange rates and manage its interest rate exposures. Various risk exposures arising from existing assets and liabilities, from future transactions in which the Company is firmly committed and from future anticipated transactions are assessed and managed centrally by the Company's treasury function based on the Company's aggregate exposure. Under the Company's written hedging policy, treasury management continuously monitors and reports the results of its risk management programmes to senior management, and may choose to partially or fully hedge exposures. The Company's hedging policy does not provide for the hedging of all positions on a permanent basis in cases when it is perceived that the costs outweigh the risks. The Company's risk management policies do not permit the utilisation of financial instruments for trading purposes.

A substantial portion of the Company's cash flows is denominated in foreign currencies. To hedge the balance sheet and revenue exposures associated with diminution in value of foreign currency cash flows, the Company primarily utilises forward exchange contracts and options. The cost (premium) associated with purchased option contracts is recorded as an asset (for front-ended premium payments) or a liability (for back-ended premium payments) and amortised to expense over the lives of the options. In order to lower the overall hedging costs, the Company may issue financial instruments on existing or future positions. For written options, the premium is deferred and recognised over the life of the option as an offset to the amortisation of the associated purchased option premium. Gains and losses related to qualifying hedges of existing assets or liabilities, firm commitments or anticipated transactions are deferred and are recognised in income or adjustments of carrying amounts when the hedged transaction occurs. Gains and losses on instruments that do not qualify as accounting hedges are recognised as other financial income (expense).

For interest rate swaps, the differential to be paid or received is accrued as interest rates change and is recognised over the life of the agreements.

#### Accounts receivable

Accounts receivable are recorded at their net realisable value after deducting an allowance for doubtful accounts. Such deductions reflect either specific cases or estimates based on historical evidence of collectibility. This also includes an allowance for country specific transfer risks.

#### Inventories

The Company values its inventories at the lower of cost (determined principally on a FIFO: first-in, first-out method) or market. Costs include all costs of production, including applicable portions of plant overhead. Allowances are made for obsolete and slow-moving inventory.

#### Property, plant and equipment

Property, plant and equipment are recorded at cost less accumulated depreciation. Depreciation is provided on a straight-line basis over the estimated useful lives of the assets ranging from approximately 20 to 50 years for buildings, 10 to 20 years for machinery and equipment, and 3 to 10 years for office furniture and other equipment. The Company assesses its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amounts may not be recoverable. If the sum of the expected future undiscounted cash flows is less than the carrying amount of the asset, a loss

(in millions of Swiss francs, except share and per share data)

is recognised for the difference between the fair value and carrying value of the asset.

Property, plant and equipment acquired through finance lease arrangements are recorded as assets at their fair value at the date of acquisition and depreciated over the shorter of the useful life of the asset or the lease term. The corresponding obligation is shown as a liability in the balance sheet.

#### **Goodwill and intangible assets**

Goodwill and purchased intangible assets are capitalised and amortised on a straight-line basis over the estimated periods to be benefited. This amortisation period is determined individually for each asset and can range from 5 to 40 years. The Company assesses its goodwill and intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amounts may not be recoverable. If the sum of the expected future undiscounted cash flows is less than the carrying amount of the goodwill or the intangible asset, a loss is recognised for the difference between the fair value and carrying value of the goodwill or the intangible asset.

#### **Financial investments and other assets**

Financial investments and other assets comprise primarily investments in and loans to equity affiliates, investments in unconsolidated companies (less than 20 percent ownership) and prepaid pension costs.

The investments in unconsolidated companies are accounted for as available-for-sale securities and are recorded at fair value with unrealised gains or losses, net of tax included in accumulated other comprehensive income of shareholders' equity.

#### **Income taxes**

Provision for income taxes has been determined using the comprehensive liability method and consists of income taxes paid or payable plus the change in deferred taxes for the current year. Deferred taxes represent the estimated future tax consequences of temporary differences between the amounts of assets and liabilities recognised for financial reporting purposes and such amounts recognised for tax purposes. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realised.

Provision has been made for income taxes on the earnings of foreign operations that are expected to be remitted to the parent company. No accruals are made for unremitted earnings of operations that are intended to be reinvested indefinitely or that can be remitted substantially free of tax. The provision for income taxes includes income taxes from earnings of equity affiliates.

#### **Environmental compliance and expenditures**

The measurement of environmental liabilities is based on evaluation of currently available facts with respect to each individual site and considers factors such as existing technology, presently enacted laws and regulations and prior experience in remediation of contaminated sites. Environmental operations and maintenance as well as remediation costs are accrued when environmental assessments and the need for remediation are probable and the costs can be reasonably estimated. Any potential insurance recoveries are not offset against the liability. Actual costs to be incurred at identified sites in future periods may vary from the estimates given inherent uncertainties in evaluating environmental exposures.

#### **Earnings per share**

Basic earnings per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per share is similar to basic

earnings per share except that it reflects the potential dilution that could occur if dilutive securities, such as stock options and convertible debt, were exercised or converted into common shares or resulted in the issuance of common shares that then shared in the earnings of the Company. In 1997, the earnings per share calculation was made giving effect to the issuance of the Company's common shares as of January 1, 1997, the effective date of the spin-off (see Note 2).

#### **New accounting standards**

As of January 1, 1998, the Company adopted the Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standard (SFAS) No. 130 "Reporting Comprehensive Income." This statement establishes new rules for the reporting and display of comprehensive income and its components. The adoption of the statement, however, has no impact on the Company's net income or total shareholders' equity. In accordance with SFAS No. 130, the December 31, 1997 currency translation adjustment has been reported as a component of accumulated other comprehensive income. In addition, the 1997 additional paid-in capital has been adjusted to reflect the reclassification of the net unrealised loss on available-for-sale securities, net of tax to accumulated other comprehensive income. These reclassifications had no effect on the previously reported total shareholders' equity.

In February 1998, the FASB issued SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits." SFAS No. 132 does not change the measurement or recognition of these plans, but revises disclosures about pensions and postretirement benefit plans. The Company adopted SFAS No. 132 in 1998. For comparative purposes, the related 1997 disclosures have been restated to conform with the 1998 presentation.

In 1998, the FASB issued SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" which replaces existing pronouncements and practices with a single, integrated accounting framework for derivatives and hedging activities. This statement expands the previous accounting definition of derivatives to include embedded derivatives and many commodity contracts. Under the statement, all derivatives are recorded in the balance sheet as either an asset or liability and are measured at their fair market values. Changes in the derivative's fair value have to be recognised in income unless specific hedge accounting criteria are met, in which case the effect is recorded in accumulated other comprehensive income in shareholders' equity. The Company will adopt this statement as of January 1, 2000 and has not yet determined what, if any, impact the adoption of this statement will have on the Company's net income or total shareholders' equity.

## **2. Background to the spin-off**

Based on the terms of the Master Spin-Off Agreement (MSA) with Novartis, the Company was spun-off from Novartis effective January 1, 1997. In accordance with the MSA, owners of Novartis capital stock as of February 25, 1997, received one right to purchase one share of the Company's common stock for every share of Novartis common stock or 72 105 117 rights, at a subscription price of CHF 10 (the Rights Offering). The rights were traded on the Swiss Exchange from February 26, 1997, through March 11, 1997, when all rights were exercisable. The shares of the Company began trading on the Swiss Exchange on March 13, 1997.

On January 8, 1997, the Company received an interest-free advance of CHF 707 million from Novartis representing the

(in millions of Swiss francs, except share and per share data)

expected net proceeds of the Rights Offering less 2 percent stamp tax. On March 24, 1997, the Company received gross proceeds of CHF 721 million from the Rights Offering which was used for the repayment of the advance received from Novartis and for the Company's portion of the fees related to the Rights Offering, which were approximately CHF 59 million, including the stamp taxes. In the MSA, Novartis and the Company agreed that the initial net debt position of the Company as of January 1, 1997 would be CHF 835 million.

Capital stock consisted of the CHF 721 million received from the initial offering plus CHF 250 thousand that was paid in on April 17, 1996, when the Company was incorporated. Additional paid-in capital of CHF 3 701 million was recorded for the residual net investment contributed by Novartis. Treasury stock of CHF 33 million represents approximately 3.3 million shares of common stock purchased from Novartis at the par value of CHF 10 per share.

The effect of these transactions was included in the opening balance sheet as of January 1, 1997, which is the effective date of the spin-off. The opening balance sheet was prepared using the principles of International Accounting Standards (IAS) and was in compliance with the Master Spin-Off Agreement.

### 3. Exchange rates of principal currencies

		Statement of income average rate		Balance sheet year end rates	
		1998	1997	1998	1997
1	U.S. dollar (USD)	1.45	1.45	1.38	1.46
1	British pound (GBP)	2.40	2.37	2.30	2.41
100	German marks (DEM)	82.37	83.69	81.84	81.25
100	French francs (FRF)	24.57	24.86	24.42	24.27
1000	Italian lira (ITL)	0.84	0.85	0.83	0.83
100	Japanese yen (JPY)	1.11	1.20	1.18	1.12

On January 1, 1999, eleven of fifteen member countries of the European Union established fixed conversion rates between their existing sovereign currencies and adopted the Euro as their new common currency. The Euro trades on currency exchanges and the legacy currencies will remain legal tender in the participating countries for a transition period between January 1, 1999 and January 1, 2002.

At January 1, 1999, the Swiss franc exchange rate to the Euro was 1.607.

### 4. Acquisitions and divestitures

On April 1, 1998, the Company completed the acquisition of all outstanding common shares of Allied Colloids (herein after referred to as Water Treatments), a leading company in the water treatment additives field for CHF 3 615 million, including acquisition costs of CHF 110 million. The consideration was financed through the issuance of debt. The acquisition was recorded under the purchase method of accounting and accordingly, Water Treatments' operations are included in the accompanying Consolidated Statements of Income from April 1, 1998. The fair value assigned to the business acquired was CHF 4 509 million and liabilities assumed were CHF 894 million, including CHF 485 million of assumed debt. Goodwill of CHF 2 215 million was recorded, which is being amortised over 33 years. In addition, based on an independent appraisal, the Company allocated CHF 1 012 million of the acquisition cost to acquired in-process research and development projects, which

represented the estimated fair market values related to these projects. Standard valuation procedures and techniques were utilised in determining the fair market value of each intangible asset. The developmental technologies had no alternative future uses. As these projects have not reached technological feasibility and alternative future uses do not exist, the costs were expensed at the acquisition date and are included in restructuring and special charges in the accompanying Consolidated Statements of Income.

The following unaudited pro forma results were prepared under the assumption that the transaction occurred at January 1, 1998 and 1997. The pro forma information is presented after giving effect to certain adjustments such as additional depreciation expense as a result of the step-up in the basis of fixed assets, additional amortisation expense as a result of goodwill, increased interest expense on acquisition debt, and related tax effects. These pro forma financial results are not indicative of the results of operations that would have been obtained had the Company acquired Water Treatments effective at the beginning of each respective year.

Year ended December 31 (unaudited),	1998	1997
Sales	8 728	9 007
Net income <sup>(1)</sup>	253	198
Basic earnings per share <sup>(1)</sup>	3.82	2.91
Diluted earnings per share <sup>(1)</sup>	3.82	2.91

<sup>(1)</sup> The pro forma net income in 1998 and 1997 excludes the CHF 1 012 million write-off of in-process research and development projects. It includes net restructuring and special charges of CHF 135 million in 1998 (CHF 96 million after taxes) and CHF 375 million in 1997 (CHF 281 million after taxes). Excluding these charges, pro forma net income would have been CHF 349 million in 1998 and CHF 479 million in 1997 and earnings per share would have been CHF 5.26 in 1998 and CHF 7.03 in 1997.

Effective January 1, 1998, the Company and Witco Corporation (Witco) exchanged, in a one-for-one transaction, the Additives division's PVC heat stabiliser business for Witco's epoxy systems and adhesives business. The business acquired was integrated into the Performance Polymers division. The transaction was accounted for as a sale and a purchase. The resulting goodwill of approximately CHF 204 million is being amortised over 20 years. The Company's non-cash gain on the assets sold is included in restructuring and special charges in the accompanying Consolidated Statements of Income (see Note 10).

In 1997, the Company effected a number of small acquisitions and divestments to complement all of its business segments. The largest acquisition was the October 1997 purchase by the Additives division of the additives pre-blend business from Mallinckrodt Inc. U.S.A. for USD 29 million. This resulted in goodwill of approximately USD 20 million, which is being amortised over 10 years.

### 5. Inventories

	1998	1997
Raw materials	316	318
Work in process and finished goods	1 814	1 797
Allowance for obsolete and slow-moving inventory	(77)	(71)
<b>Total</b>	<b>2 053</b>	<b>2 044</b>

(in millions of Swiss francs, except share and per share data)

**6. Property, plant and equipment**

	Land 1998	Buildings 1998	Machinery and equipment 1998	Construction in progress 1998	Total 1998	Total 1997
Cost at January 1	124	1 936	5 578	337	7 975	8 092
Additions	1	16	86	356	459	523
Retirements/disposals	(1)	(2)	(104)	(13)	(120)	(626)
Changes in consolidation scope	9	109	359	44	521	(26)
Currency adjustments	(3)	(55)	(178)	(24)	(260)	12
Other	3	73	246	(321)	1	
<b>Cost at December 31</b>	<b>133</b>	<b>2 077</b>	<b>5 987</b>	<b>379</b>	<b>8 576</b>	<b>7 975</b>
Accumulated depreciation at January 1		(899)	(3 085)		(3 984)	(4 002)
Depreciation		(57)	(353)		(410)	(361)
Accumulated depreciation on retirements/disposals		21	54		75	316
Changes in consolidation scope		10	52		62	34
Currency adjustments		14	64		78	29
Other		6	(7)		(1)	
<b>Accumulated depreciation at December 31</b>		<b>(905)</b>	<b>(3 275)</b>		<b>(4 180)</b>	<b>(3 984)</b>
<b>Net book value at December 31</b>	<b>133</b>	<b>1 172</b>	<b>2 712</b>	<b>379</b>	<b>4 396</b>	<b>3 991</b>

The insurance value of the property, plant and equipment was approximately CHF 11 362 and CHF 10 400 at December 31, 1998 and 1997, respectively.

**7. Financial instruments****Fair value of financial instruments**

Financial assets and liabilities with carrying values approximating fair market value include cash and cash equivalents, short-term investments, accounts receivable, accounts payable and short-term debt, due to their short-term nature. The fair value of financial investments for which quoted market prices are available are based on such market prices. The caption "Financial investments – other" includes CHF 323 million and CHF 286 million of equity investments at December 31, 1998 and 1997, respectively. These investments are reflected at their carrying value because it is not practical to estimate fair value as quoted market prices do not exist. Fair value of long-term debt is based on the current rates at which similar loans would be made to borrowers with similar credit ratings. Foreign currency forward contracts, options and swaps as well as interest rate swaps are valued based upon quoted market prices or market prices for instruments with similar terms and maturities.

The following table presents the carrying amounts and the estimated fair values of financial instruments at December 31, 1998 and December 31, 1997:

	1998		1997	
	Carrying value	Fair value	Carrying value	Fair value
<b>Assets</b>				
Financial investment in Hexcel <sup>(1)</sup>	249	208	216	654
Financial investments – other	353	353	307	307
<b>Liabilities</b>				
Long-term debt	3 654	3 655	315	316
<b>Derivative instruments</b>				
Foreign currency forward contracts – assets/(liabilities)	(7)	(7)	14	14
Foreign currency options contracts – assets/(liabilities)	2	2	3	3
Foreign currency swaps – assets/(liabilities)	0	(21)	–	–

<sup>(1)</sup> Due to the recent weakness in the equity market of the aerospace and defense industry in the U.S., the Company's investment in Hexcel exceeded the quoted market value as of December 31, 1998 by CHF 41 million. Management believes this situation to be temporary.

The foreign currency forward contracts notional value is CHF 711 million in 1998 and CHF 105 million in 1997. The foreign currency options contracts notional value is CHF 1 086 million in 1998 and CHF 906 million in 1997. At December 31, 1998, the Company had an interest rate swap outstanding (none at December 31, 1997) with a notional value of GBP 184 million. The carrying value and fair value of this instrument was CHF 0 million at year end.

**Derivative financial instruments**

The notional values of derivative financial instruments at year end provide an indication of the extent of the Company's involvement in such instruments, but do not represent exposure to market risks. There are no open risk positions, i.e. the maximum possible risk is known in all cases. The amounts indicated are gross values and include closed transactions that had not matured at the balance sheet date.

Foreign exchange currency forwards, swaps and options are mainly used to hedge existing assets and liabilities, firm commitments and anticipated transactions denominated in foreign currencies (principally U.S. dollars, German marks, British pounds, French francs, Italian lira, Australian dollar and Japanese yen). The Company has entered into currency contracts to cover foreign exchange risks on certain anticipated foreign currency transactions relating to sales and purchase transactions expected to occur within a period of one year. The premiums associated with purchased and written option contracts at December 31, 1998 and 1997, which are included in prepaid and other current assets as well as accruals and other current liabilities, are amortised over the lives of the options and are not material to the Company's results.

The Company has procedures to monitor the credit exposure amounts and manages exposure to counter-party credit risk through specific minimum credit standards and diversification of counter-parties. Counter-parties to financial instruments are financial institutions with a minimum 'A' credit rating and with significant experience with such instruments.

See also Note 16 for a discussion of the accounting for the hedging and related administrative costs of approximately CHF 51 million that were paid in 1997 to a major bank to supply all necessary equivalent shares of the Company's common stock in connection with the stock based compensation Leveraged Executive Asset Plan ('LEAP').

(in millions of Swiss francs, except share and per share data)

<b>8. Financial investments</b>	1998	1997
Investments in equity affiliates	572	502
Investments in unconsolidated companies	30	21
<b>Total</b>	<b>602</b>	<b>523</b>

Investments in unconsolidated companies (less than 20 percent ownership) are classified as available-for-sale securities and are recorded at fair value.

The following table presents summarised financial information on a 100% basis for the companies accounted for as investments in equity affiliates. The most significant of these are: Hexcel Corporation (49.7% and 48.9% equity ownership at December 31, 1998 and 1997, respectively) – which is shown separately due to its size, and Compagnie Industrielle de Monthey SA (50%), Daihan Swiss Chemical Corp. (50%), TFL Ledertechnik GmbH (50%), Cerdec AG (30%) and Musashino Ltd. (50%), all of which have maintained the same level of investment in 1998 and 1997.

1998	Hexcel	Other	Total
Sales	1 508	1 360	2 868
Income before taxes	148	45	193
Net income	98	22	120
Total assets	1 919	1 938	3 857
Shareholders' equity	413	666	1 079
1997	Hexcel	Other	Total
Sales	1 282	1 184	2 466
Income before taxes	59	69	128
Net income	100	57	157
Total assets	1 175	1 764	2 939
Shareholders' equity	341	613	954

The income from earnings of equity affiliates of CHF 94 million in 1998 and CHF 36 million in 1997 are shown before taxes as a separate line item in the operating income section of the Consolidated Statement of Income. The related income tax provision of CHF 35 million in 1998 and a credit in 1997 of CHF 18 million are included in the Company's provision for income taxes.

#### Investment in Hexcel

The investment in Hexcel is being recorded using a one quarter time lag. The Company's investment includes both a 49.7% share of Hexcel's shareholders' equity in 1998, 48.9% in 1997, as well as USD 43 million in 1998 and USD 45 million in 1997, relating to the remaining goodwill which originated at the time of the acquisition in 1996. The Company recognised CHF 72 million in 1998 and CHF 7 million in 1997 as its share of the Hexcel income in the line "Income from earnings of equity affiliates" and a provision of CHF 24 million in 1998 and a credit of CHF 25 million in 1997 as its share of the related Hexcel income taxes in the line "Provision for income taxes" in the accompanying Consolidated Statements of Income.

<b>9. Accruals and other current liabilities</b>	1998	1997
Payroll and employee benefits	134	166
Environmental remediation and compliance	62	57
Restructuring	346	305
Pension and postretirement benefits	19	20
Other	524	681
<b>Total</b>	<b>1 085</b>	<b>1 229</b>

#### 10. Restructuring and special charges

During 1998, the Company incurred net restructuring and special charges of CHF 1 147 million. This charge includes CHF 1 012 million for the write-off of acquired in-process research and development associated with the acquisition of Allied Colloids (see Note 4). The remaining net restructuring and special charges of CHF 135 million relate to the strategic realignment of the Company's business which included the formation of the Colors division, the profit recovery programme of the Performance Polymers division, the integration of Water Treatments, and the completion of the supply chain replacement project commenced in 1996. Thereof, approximately CHF 121 million are for separation payments to be made to approximately 1 100 employees or full-time equivalents ("FTE's"), whose positions will be eliminated, principally in the administration, sales and marketing functions. The remaining charges relate to other costs incurred for the reorganisation of administration functions, streamlining of the supply chain and systems integration, offset by a non-cash accounting gain from the exchange of a business of CHF (75) million and other minor amounts. During 1998, approximately 645 employees or FTE's were separated and approximately CHF 80 million was paid in separation costs.

In 1997, the Company incurred restructuring and special charges of CHF 373 million (1996: CHF 1 077). About half of these charges related to the continuation of the 1996 programme to implement entirely new solutions to manage the supply chains of all divisions on a worldwide basis and to improve structures in the finance organisation. About a third of these charges related to the establishment of the new Company after the spin-off from Novartis in all areas, such as human resources and environmental management, and the streamlining of the Company's operations, primarily facility alignments. The remaining charge related to asset impairments in the Asian region as a consequence of the economic uncertainties in the region. These activities were substantially completed at the end of 1997.

Included in the 1996 provision were separation costs of CHF 372 million for approximately 1 400 employees or FTE's, principally in the administration, sales and marketing and manufacturing functions. Approximately 650 employees or FTE's were separated in 1997 at a cost of CHF 173 million. The remaining separations were substantially completed in 1998.

The total provision for restructuring recorded at January 1, 1997 was CHF 528 million. In 1997, CHF 303 million was added to the provision and CHF 476 million of the provision was utilised, resulting in an ending provision of CHF 355 million. In 1998, the provision was increased by CHF 210 million for the restructuring described above and by approximately CHF 104 million in connection with the acquisition of Allied Colloids, and approximately CHF 323 million was utilised, resulting in an ending provision of CHF 346 million. Management believes that the remaining restructuring provision is adequate to complete all of its plans.

(in millions of Swiss francs, except share and per share data)

<b>11. Short-term debt</b>	1998	1997
Revolving loan agreements (multicurrency)	413	727
Bank overdrafts	251	346
Loans	522	281
Commercial paper	550	4
Other	163	435
Current portion of long-term debt	6	21
<b>Total</b>	<b>1 905</b>	<b>1 814</b>

On January 21, 1998 the Company entered into a CHF 4 000 million multicurrency revolving loan agreement to finance the acquisition of Allied Colloids. During the year, the Company issued long-term debt and, in view of these debt issuances, reduced the revolving loan agreement to CHF 800 million. At December 31, 1998, CHF 413 million (USD 300 million) was outstanding under this facility. The facility expires July 21, 1999 and bears interest at LIBOR plus 22.5 basis points.

In July 1998, the Company implemented a USD 1 000 million Commercial Paper programme which is secured by a USD 500 million standby credit facility. At December 31, 1998 CHF 550 million (USD 400 million) was outstanding under this programme.

In 1998, the Company entered into a CHF 300 million multicurrency standby facility with a major Swiss bank which bears interest at LIBOR plus 14 basis points. Commitment fees of 0.07% per annum are paid on the average unused facility. At December 31, 1998, no borrowings were outstanding under this facility.

The weighted average interest rate for short-term debt (excluding current portion of long-term debt) calculated at December 31, 1998 and 1997, was 7.3% and 6.6%, respectively. At December 31, 1998 and 1997, unused short-term credit lines totalled approximately CHF 1 195 million and CHF 1 213 million, respectively.

<b>12. Long-term debt</b>	1998	1997
Bonds and Euro Medium-Term Notes	2 609	292
Convertible bonds	885	0
Amounts owed to credit institutions	5	13
Other long-term debt	155	10
	<b>3 654</b>	<b>315</b>
Less: current portion of long-term debt	6	21
<b>Total long-term debt</b>	<b>3 648</b>	<b>294</b>
<b>Bonds and Euro Medium-Term Notes</b>		
CHF 1 000 3.25% Straight Bonds, principal due 2008	1 014	0
GBP 300 6.50% Euro Medium-Term Note, principal due 2013	691	0
USD 300 6.125% Euro Medium-Term Note, principal due 2003	409	0
DEM 300 4.875% Euro Medium-Term Note, principal due 2005	250	0
USD 178 U.S. pollution control and industrial development bonds, principal due between 2008 and 2028 (weighted average interest rate of 4.21%)	245	292
<b>Total bonds and Euro Medium-Term Notes</b>	<b>2 609</b>	<b>292</b>

In 1997, the Company entered into a USD 2 000 million Euro Medium-Term Note programme which allows the Company to issue multi-currency, unsecured, unsubordinated notes with a minimum maturity of one month at fixed, floating or indexed interest rates. As of December 31, 1998, the Company had borrowed CHF 1 350 million (CHF 0 million in 1997) under this programme.

In June 1998, the Company issued a USD 300 million Euro Medium-Term Note, with a 6.125% U.S. dollar fixed interest rate. In connection with the issuance of this note, the Company entered into an interest and principal currency swap that effectively established a fixed principal amount of GBP 184 million with a 6.76% fixed interest rate over the term of the note. In December 1998, the Company entered into an interest rate swap on the GBP 184 million debt whereby the Company swapped its 6.76% fixed interest rate for a floating rate based on the Swiss franc London Interbank Offered Rate (LIBOR) plus 4.38%. The interest rate swap agreement matures at the same time as the related debt.

In July 1998, the Company issued USD 687 million unsecured, unsubordinated convertible bonds, due 2003, with a 1.25% fixed interest rate. The bonds are convertible into the Company's common stock from September 2, 1998 to July 10, 2003 at a conversion price of CHF 254.14 per share. At December 31, 1998, the Company had 3 783 582 shares of treasury stock reserved for the potential conversion.

The annual maturities of long-term debt outstanding at December 31, 1998 are as follows: 1999 CHF 6 million; 2000 CHF 7 million; 2001 CHF 1 million; 2002 CHF 886 million; 2003 CHF 1 322 million; 2004 and thereafter CHF 1 491 million.

### 13. Income taxes

The provision for income taxes in 1998 and 1997 consists of the following:

	1998	1997
Current provision	74	60
Deferred provision	23	2
<b>Total provision for income taxes</b>	<b>97</b>	<b>62</b>

The Company is incorporated in Switzerland but operates in numerous countries with differing tax laws and rates. The income before income taxes and provision for income taxes are generated primarily outside of Switzerland. Therefore, the weighted average expected tax rate (computed by multiplying the statutory rate applicable to each local subsidiary's income or loss) may vary between periods reflecting the income or losses generated in each country. The main factors causing the effective tax rate to differ from the expected tax rate are:

	1998 %	1997 %
<b>Expected tax rate</b>	<b>(30)</b>	<b>30</b>
Non-deductible items	56	3
Tax free income	(16)	(3)
Income taxed at reduced rates	(1)	(3)
Changes in valuation allowance	2	(3)
Other	4	(7)
<b>Effective tax rate</b>	<b>15</b>	<b>17</b>

In 1998, "Non-deductible items" includes the tax effect of acquired in-process research and development costs and the amortisation of goodwill. "Tax free income" consists primarily of the tax effect of the non-cash accounting gain on the exchange of a business. Excluding these items, the Company's effective tax rate would have been 29%.

(in millions of Swiss francs, except share and per share data)

In 1997, "Other" includes a CHF 27 million (8%) reversal of a valuation allowance on tax loss carryforwards from the equity consolidated company Hexcel. Excluding this reversal, the Company's effective tax rate would have been 25%.

The significant components of activities that gave rise to deferred tax assets and liabilities on the balance sheet at December 31, 1998 and 1997, were as follows:

	1998	1997
<b>Deferred tax assets</b>		
Pensions and other employee compensation	89	75
Inventory	29	19
Restructuring and special charges	82	84
Environmental reserves	259	291
Tax loss carryforwards	123	53
Other	66	58
	648	580
Valuation allowance	(149)	(135)
<b>Total deferred tax assets</b>	<b>499</b>	<b>445</b>
<b>Deferred tax liabilities</b>		
Property, plant and equipment	(453)	(388)
Other	(124)	(93)
<b>Total deferred tax liabilities</b>	<b>(577)</b>	<b>(481)</b>
<b>Deferred tax liabilities, net</b>	<b>(78)</b>	<b>(36)</b>

"Deferred tax liabilities, net" consists of deferred income taxes of CHF 227 million in 1998 (CHF 164 million in 1997) included in long-term liabilities and deferred tax assets of CHF 149 million in 1998 (CHF 128 million in 1997) included in prepaid and other current assets.

For tax return purposes, the Company has available net tax loss carryforwards of approximately CHF 442 million, of which CHF 20 million will expire in the next five years and CHF 255 million will expire between five and fifteen years. The remaining carryforwards do not expire.

<b>14. Other liabilities</b>	1998	1997
Environmental remediation and compliance	683	720
Pension and postretirement benefits	610	596
Other (includes minority interest of CHF 56 in 1998 and CHF 59 in 1997)	284	322
<b>Total</b>	<b>1 577</b>	<b>1 638</b>

## 15. Shareholders' equity

On April 20, 1998, the Company's shareholders approved authorised and conditional increases in the share capital of the Company. The approval allows for the issuance of a maximum of 10 million registered shares. While 2 million shares are reserved for employee stock option plans, 4 million are primarily reserved for an issuance under future convertible bonds and similar debt instruments. Another 4 million shares may be issued until April 20, 2000 without a restriction.

During 1998, the Company purchased 806 915 shares (1997: 2 484 100). In 1998, the Company sold 505 000 shares of treasury stock, purchased at the spin-off date at the par value of CHF 10 (see Note 2), to the "Stiftung für Mitarbeiterbeteiligung der Ciba Spezialitätenchemie" (the Employee Investment Foundation of Ciba Specialty Chemicals) for CHF 15 per share. In addition, The Company sold 366 162 shares of treasury stock at market prices.

In 1997, additional paid-in capital includes a CHF 18 million "Other" adjustment that represents an adjustment to the residual net investment contributed by Novartis and minor U.S. GAAP adjustments (see Note 2).

## 16. Stock-based compensation plans

The Company has adopted the disclosure-only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," and applies Accounting Principles Board (APB) Opinion No. 25 and related interpretations in accounting for its plans. A description of the terms of the Company's plans are as follows:

LEAP – In March 1997, the Company established a one-time Leveraged Executive Asset Plan (LEAP) for key executives and non-executive Board members (participants), to promote share ownership. Under the LEAP, approximately 320 participants were given the right to purchase 288 400 shares of common stock of the Company at the market value at grant date for CHF 110 per share (equal to the Global Offering Price). For each share purchased, four share options (total 1 153 600) were then granted to the participants. The participants will receive the market price increase from the grant date to the exercise date in equivalent shares of the Company's common stock. The rights generally vest over a three year period and participants may exercise their rights monthly beginning on March 1, 2002 through March 11, 2005. As a result of terminations from the programme, 21 533 options have been returned to the Company.

The Company paid a fee to a major bank to supply all necessary equivalent shares of the Company's stock to the participants when they are due. Therefore, independent of the prevailing future share price, the total cost of the LEAP programme to the Company will not exceed the CHF 51 million hedging and related administration fee that was paid. Compensation expense is being recognised as this fee is being amortised over the three year vesting period.

CAPS – In 1997, the Company established a Capital Appreciation Performance Share Plan (CAPS) for key executives and non-executive Board members (participants). In accordance with the CAPS, participants are granted rights to receive shares of common stock of the Company in the event that the closing share price on any seven days up to August 2001 equals or exceeds CHF 264 per share (which is double the price at the initial grant date in August 1997). Under the programme, five participants were granted 8 192 rights in 1998 and 333 participants were granted 342 572 rights in 1997. As a result of terminations from the programme, 4 119 rights have been returned to the Company during 1998; resulting in 346 645 rights outstanding at December 31, 1998. No compensation expense was recorded

(in millions of Swiss francs, except share and per share data)

in 1998 or 1997, since the target price was not reached.

LTIP – In 1998, the Company established a “Long-Term Incentive Plan” (LTIP) which grants options to senior management and other employees. In January 1998, approximately 550 participants were given the right to purchase 351 055 shares of common stock at the market value at grant date for CHF 165. These options are restricted for three years following the date of grant. For grants made to participants in the United States, vesting is over three years; elsewhere at the date of grant. Of these options, 264 355 expire after 5 years from date of grant and 86 700 expire after 10 years from date of grant. In January 1998, the Company issued 68 500 stock appreciation rights (SAR’s) to certain of its senior managers with an exercise price of CHF 165 which equals the market value of the common stock at grant date. These SAR’s entitle the optionee to receive the appreciation in the common stock’s market value between grant date and exercise date in cash or under certain circumstances in common stock. These SAR’s vest rateably over a 3 year period and expire after 10 years from date of grant. In April 1998, 5 participants were given the right to purchase 6 007 shares of common stock at the market value at grant date for CHF 183. For each share purchased, four stock options (total 24 028) were granted to the participants at market value. These options vest after 4 years and expire after 7 years from date of grant. In 1998, no compensation expense was recorded under this plan.

ESPP – In 1998, the Company established a “Employee Share Purchase Plan” (ESPP) which enables substantially all employees to purchase annually up to 20 shares of common stock at a price equal to 85 percent of the average market price, as defined in the plan. During 1998, 7 404 employees purchased 126 324 shares for which approximately CHF 19 million was paid to the Company. In 1998, no compensation expense was recorded under this plan.

EIP – In 1998, the Company established a “Mitarbeiterbeteiligung” Plan (“Employee Investment Plan” or EIP) which grants annually to most Swiss employees (as an enhancement to their pension plan arrangements) the right to purchase 20 shares of common stock at CHF 15 per share (up to a maximum share price of CHF 200). The rights vest at the grant date and become exercisable at the date of the employees’ retirement or termination. As of December 31, 1998, 121 000 rights were granted and 7 700 were exercised.

#### Change in control and reserve of shares

Upon a change in control of the Company (defined in some plans as 30 percent of the total voting power and in others as 50 percent), the vesting and restriction periods for the plans stated above (if still current) will cease to apply and a cash or share payment for the value of the outstanding plans will be due to the participants.

To cover demands for future option plans that may be established in the next five years, the Company plans to purchase up to 5 percent of its common stock (exclusive of the shares purchased from Novartis in the spin-off). At December 31, 1998, the Company had 0.7 million shares of treasury stock reserved for issuance under the various stock based compensation plans.

#### Pro forma disclosure

The pro forma net income and earnings per share for 1998 and 1997 have been determined as if the Company had used the fair value method of accounting for its stock option grants and employee stock purchase plan in accordance with the provisions of SFAS 123. The pro forma amounts presented below reflect the portion of the estimated fair value of awards granted in 1998 and 1997 based on the vesting or service period over which the awards are earned.

Year ended December 31,	1998	1997
Pro forma net (loss) income	(752)	291
Pro forma (loss) earnings per share – basic	(11.35)	4.26
Pro forma (loss) earnings per share – diluted	(11.35)	4.26

The Company used the Black-Scholes model to value the stock options granted. The weighted average assumptions used to estimate the value of the options included in the pro forma amounts and the weighted average estimated fair value of an option granted are as follows:

Year ended December 31,	1998	1997
Expected option lives in years	6.28	5.00
Expected volatility in %	33.61	28.00
Risk-free interest rate in %	2.41	1.71
Expected dividend yield in %	1.29	1.74
Weighted average fair value in CHF	52.68	40.20

## 17. Retirement benefits

### Pension plans

Employees receive and the Company funds pensions and retirement benefits in accordance with the applicable laws and customs in the countries where the Company operates. The Company has both contributory and non-contributory defined benefit and defined contribution plans.

### Defined contribution plans:

In countries where employees are covered by defined contribution plans, contributions charged to income were CHF 15 million in 1998 and CHF 13 million in 1997.

### Defined benefit plans

Benefits are generally based on years of service, levels of compensation or stated amounts for each year of service.

The components of net pension expense for the Company-sponsored defined benefit plans were:

	Pension Benefits		Postretirement Benefits	
	1998	1997	1998	1997
<b>Major plans</b>				
Service cost	102	84	4	5
Interest cost	157	135	4	5
Expected return on plan assets	(205)	(160)	0	0
Amortisation of prior service cost	9	1	(1)	0
Other (gains), losses and amortisation	(43)	(37)	(13)	(2)
<b>Pension expense major plans</b>	<b>20</b>	<b>23</b>	<b>(6)</b>	<b>8</b>
Other plans	4	1	0	0
<b>Total pension expense</b>	<b>24</b>	<b>24</b>	<b>(6)</b>	<b>8</b>

The interest cost of approximately CHF 26 million in 1998 and CHF 27 million in 1997 relating to unfunded plans in Germany has been included as interest expense in the accompanying statement of income.

For the Company’s major plans, the following table provides a reconciliation of the changes in the projected benefit obligation, the changes in the fair value of assets, and the funded status as of December 31, 1998 and 1997.

(in millions of Swiss francs, except share and per share data)

	Pension Benefits		Postretirement Benefits	
	1998	1997	1998	1997
Benefit obligation, beginning of year	2 652	2 397	80	83
Service cost	102	84	4	5
Interest cost	157	135	4	5
Participant contributions	26	22	0	0
Actuarial (gain) loss	27	39	2	(2)
Plan amendments	10	5	2	(11)
Change in consolidation scope	242	1	(4)	0
Benefits paid	(67)	(37)	(5)	(4)
Foreign currency translation	(56)	6	(4)	4
Other	1	0	0	0
<b>Benefit obligation, end of year</b>	<b>3 094</b>	<b>2 652</b>	<b>79</b>	<b>80</b>
Plan assets, beginning of year	2 813	2 456	0	0
Actual return on plan assets	329	259	0	0
Employer contributions	72	66	5	4
Participant contributions	26	22	0	0
Change in consolidation scope	181	0	0	0
Benefits paid	(67)	(37)	(5)	(4)
Foreign currency translation	(67)	49	0	0
Other	(3)	(2)	0	0
<b>Plan assets, end of year</b>	<b>3 284</b>	<b>2 813</b>	<b>0</b>	<b>0</b>
Funded status	190	161	(79)	(80)
Unrecognised net (gain) loss	(321)	(403)	(19)	(35)
Unrecognised prior service cost	(10)	15	(11)	(13)
Prepaid (accrued) pension cost	(141)	(227)	(109)	(128)

Certain of the Company's pension plans have accumulated benefit obligations that exceed plan assets by CHF 426 million and CHF 396 million in 1998 and 1997, respectively. Those plans have aggregate accumulated benefit obligations of CHF 460 million and CHF 414 million and plan assets of CHF 34 million and CHF 18 million in 1998 and 1997, respectively.

These unfunded plans are mainly in Germany, where due to local practices, the Company has not funded the pension plans of its German subsidiaries. This results in accrued pension costs of approximately CHF 456 million in 1998 and CHF 423 million in 1997.

The weighted average key actuarial assumptions used to compute the benefit obligation were as follows:

	Pension Benefits		Postretirement Benefits	
	1998	1997	1998	1997
Discount (interest rate)	5.6%	5.4%	6.7%	7.3%
Rate of increase in compensation levels	3.3%	3.1%	n.a.	n.a.
Expected long-term rate of return on plan assets	6.6%	6.5%	n.a.	n.a.

The healthcare cost trend rate is assumed to decrease to an ultimate trend rate of 4.3 percent in 2003. A one percent annual increase in the assumed healthcare cost trend rate would increase the 1998 accumulated postretirement benefit obligation by approximately CHF 7 million and the annual postretirement benefit cost by approximately CHF 1 million in 1998. A one percent annual decrease in the assumed healthcare cost trend rate would decrease the 1998 accumulated postretirement benefit obligation by approximately CHF 6 million and the annual postretirement benefit cost by approximately CHF 1 million.

The market value of the Company's shares held by its various pension plans as of December 31, 1998 and 1997 were approximately CHF 46 million and CHF 5 million, respectively.

### Number of personnel and personnel expenses

The Company employed 24 456 personnel at December 31, 1998 and 21 442 at December 31, 1997. The Company's salaries and wages, including social charges were CHF 2 180 million in 1998 and CHF 1 941 million in 1997.

### 18. Earnings per share

The following table presents the calculation of basic and diluted earnings per share:

Year ended December 31,	1998	1997
Net (loss) income	(739)	293
<b>Weighted average shares outstanding:</b>		
Basic	66 293 130	68 158 845
Diluted	66 293 130	68 158 845
<b>(Loss) earnings per share:</b>		
Basic	(11.15)	4.29
Diluted	(11.15)	4.29

Diluted earnings per share assumes that the dilutive convertible bonds issued in 1998 were converted at the date of issuance, with related interest and common shares adjusted accordingly. It also assumes that the weighted average shares outstanding were increased by shares issuable upon exercise of those stock options for which the average stock market price exceeded the exercise price, less shares which could have been purchased by the Company with the related proceeds receivable from the exercise of the stock options. The convertible bonds, however, were not included in the computation of diluted earnings per share for 1998 since it would have resulted in an antidilutive effect. The effect of stock options outstanding are not included in diluted earnings per share since in each case the exercise price is greater than the average market price of the common shares during the year.

There were no dilutive securities in 1997.

### 19. Related party transactions

#### Transactions with equity affiliates

The Company had receivables of CHF 18 million and CHF 22 million in 1998 and 1997, respectively.

Investments of CHF 572 million and CHF 502 million are included in financial investments in 1998 and 1997, respectively, and are described in Note 8.

Loans receivable of CHF 99 million and CHF 91 million are included in other assets in 1998 and 1997, respectively. They consist primarily of CHF 52 million (USD 37 million) and CHF 51 million (USD 35 million) in 1998 and 1997, respectively, due from Hexcel Corporation relating to the 1996 acquisition, bearing interest at variable rates and is due in 2003, and CHF 40 million and CHF 40 million, for 1998 and 1997, respectively, due from CIMO AG, bearing interest at 2 percent in 1998 and 3 percent in 1997.

The Company had payables and accrued expenses of CHF 78 million and CHF 65 million in 1998 and 1997, respectively.

#### Other

The fair value of the compensation paid to members of the Board of Directors was CHF 1.5 million in 1998 and CHF 0.7 million in 1997. There were no loans between the Company and members of the Board.

(in millions of Swiss francs, except share and per share data)

## 20. Commitments and contingencies

### Lease commitments

The Company leases certain facilities under operating leases. The future minimum lease commitments required under fixed term leases are: 1999 CHF 48 million; 2000 CHF 34 million; 2001 CHF 26 million; 2002 CHF 19 million; 2003 CHF 17 million; 2004 and thereafter CHF 124 million. Rental expense amounted to CHF 75 million and CHF 63 million in 1998 and 1997, respectively.

### Purchase commitments

The Company has various purchase commitments for materials, supplies and items of permanent investment incident to the ordinary course of business. In the aggregate, these commitments are not in excess of current market prices and reflect normal business operations.

The Company and Prochimica S.R.L. announced in December 1997 an agreement whereby the Company will purchase Prochimica's photoinitiator production operations. The transaction is subject to clearance by Italian regulatory authorities and will be finalised in 1999, following completion of reorganisation projects that Prochimica has undertaken. Since the Company is Prochimica's primary customer in the area of photoinitiators, this transaction will only have a minor impact on sales.

### Guarantees

In the normal course of business, the Company has provided guarantees of approximately CHF 46 million. Although it is not practical to estimate their fair value, the Company does not expect to incur losses as a result of these guarantees.

### Contingencies

The Company operates in countries where political, economic, social, and legal developments could have an impact on the operational activities. The effects of such risks on the Company's results, which arise during the normal course of business, are not foreseeable and are therefore not included in the accompanying consolidated financial statements.

In the ordinary course of business, the Company is involved in lawsuits, claims, investigations and proceedings, including product liability, commercial, environmental, and health and safety matters. There are no such matters pending that the Company expects to be material in relation to the Company's business, financial position or results of operations.

Pursuant to the spin-off, the Company and Novartis reached certain agreements with the Swiss authorities concerning income and transaction related taxes, and stamp duties. Changes in control of the Company, larger concentrations of third-party voting rights or sale of material parts of the business within the next few years could trigger retroactive tax charges to the Company.

### Taxes

The separation of the business and the spin-off from Novartis could lead to tax liabilities in Germany and certain other countries, which are currently not quantifiable. In management's opinion, such potential tax liabilities will not ultimately result in a material adverse effect on its consolidated financial position. In arriving at this conclusion, management has considered, among other things, the Master Spin-Off Agreement with Novartis which provides that Novartis is responsible for taxes contemplated under the Master Spin-Off Agreement (subject to certain exceptions). Management believes that no such exception is applicable to the potential tax liabilities discussed above.

### Environmental

The specialty chemicals business is highly regulated in many countries. A number of increasingly stringent regulations govern the manufacturing processes used and the waste and emissions created by the Company in all of its jurisdictions in which it does business and will create significant ongoing costs for the Company. In addition, many of the Company's manufacturing sites have an extended history of industrial chemical and other processes.

The Company continues to participate in environmental assessments and clean-ups at a number of locations, including operating facilities, previously owned facilities and Superfund sites. The Company accrues for all known environmental liabilities for remediation costs when a clean-up programme becomes probable and costs can be reasonably estimated.

The predecessor of Novartis has been party to litigation with various insurance companies relating to environmental liability. Under the agreement with Novartis, the Company is entitled to 50% from any net proceeds of this litigation. In 1998, certain litigation related to sites located in the United States have been settled with the insurance companies. The Company's share of these settlements was approximately CHF 43 million, net of related legal cost incurred. The Company has not reflected any potential insurance recoveries that may be available in the future.

Management believes that the environmental reserves accrued are sufficient to meet all currently known environmental claims and contingencies, and that any additional costs, which are subject to cost sharing arrangements with Novartis, will not be material to the Company's financial position or results of operations. This cost sharing agreement with Novartis could terminate for certain liabilities in the United States, upon a change in control of the Company, a sale of substantially all of the Company's assets, or for individual facilities upon the sale of the facility. Because of the nature of the Company's operations, however, there can be no assurance that significant costs and liabilities from ongoing or past operations will not be incurred in the future. In addition, environmental clean-up periods are protracted in length and environmental costs in future periods are subject to changes in environmental remediation regulations.

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## Independent Auditors' Report

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### Report of the Group Auditors to the General Meeting of the Shareholders of Ciba Specialty Chemicals Holding Inc., Basel

As auditors of the Group, we have audited the consolidated financial statements (statement of income, balance sheet, statement of cash flows, statement of shareholders' equity and notes presented on pages 12 to 28) of Ciba Specialty Chemicals Holding Inc. and its subsidiaries for the year ended December 31, 1998.

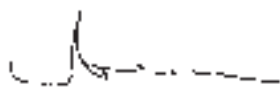
These consolidated financial statements are the responsibility of the Board of Directors. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We confirm that we meet the legal requirements concerning professional qualification and independence.

Our audit was conducted in accordance with auditing standards generally accepted in the United States and in accordance with auditing standards promulgated by the profession in Switzerland, which require that an audit be planned and performed to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement. We have examined on a test basis evidence supporting the amounts and disclosures in the consolidated financial statements. We have also assessed the accounting principles used, significant estimates made and the overall consolidated financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements give a true and fair view of the financial position, the results of operations and the cash flows in accordance with United States Generally Accepted Accounting Principles and comply with the Swiss law.

We recommend that the consolidated financial statements submitted to you be approved.

ARTHUR ANDERSEN AG



Paul Hoeve



Eric G. Ohlund

Basel, February 5, 1999

## Five Year Summary of Selected Financial Data

(in millions of Swiss francs, except share and per share data)

		U.S. GAAP		Previous Accounting System International Accounting Standards (IAS)		
		1998	1997	1996 <sup>(1)</sup>	1995 <sup>(1)</sup>	1994 <sup>(1)</sup>
<b>Results of operations</b>						
Total Company	Net sales	8 423	7 822	6 741	6 496	7 083
	Top line growth	8%	16%	4%	(8%)	(1%)
	Net income <sup>(2)</sup>	369	571	311	305	352
	EBITDA	1 356	1 231	885	n.m.	n.m.
	Economic profit	(6)	64	(199)	n.m.	n.m.
	Basic earnings per share <sup>(3)</sup>	5.57	8.38	n.a.	n.a.	n.a.
	Diluted earnings per share <sup>(3)</sup>	5.57	8.38	n.a.	n.a.	n.a.
	Equity per share	49.56	65.31	n.a.	n.a.	n.a.
	Dividend per share <sup>(4)</sup>	2.00	2.00	n.a.	n.a.	n.a.
Additives	Net sales	2 199	2 349	2 065	2 067	2 222
	Top line growth	(6%)	14%	(0%)	(7%)	6%
	EBITDA	539	506	464	n.m.	n.m.
	Economic profit	181	138	115	n.m.	n.m.
Colors <sup>(5)</sup>	Net sales	2 344	2 485	n.a.	n.a.	n.a.
	Top line growth	(6%)	n.a.	n.a.	n.a.	n.a.
	EBITDA	335	409	n.a.	n.a.	n.a.
	Economic profit	(29)	22	n.a.	n.a.	n.a.
Consumer Care <sup>(6)</sup>	Net sales	1 367	1 362	1 108	1 081	1 216
	Top line growth	0%	23%	2%	(11%)	(6%)
	EBITDA	210	196	121	n.m.	n.m.
	Economic profit	44	33	(38)	n.m.	n.m.
Performance Polymers	Net sales	1 791	1 626	1 322	1 239	1 238
	Top line growth	10%	23%	7%	0%	(1%)
	EBITDA	118	197	128	n.m.	n.m.
	Economic profit	(59)	9	(26)	n.m.	n.m.
Pigments <sup>(5)</sup>	Net sales	n.a.	n.a.	1 073	1 026	1 091
	Top line growth	n.a.	n.a.	5%	(6%)	2%
	EBITDA	n.a.	n.a.	182	n.m.	n.m.
	Economic profit	n.a.	n.a.	2	n.m.	n.m.
Textile Dyes <sup>(5)</sup>	Net sales	n.a.	n.a.	1 173	1 083	1 316
	Top line growth	n.a.	n.a.	8%	(18%)	(7%)
	EBITDA	n.a.	n.a.	110	n.m.	n.m.
	Economic profit	n.a.	n.a.	(75)	n.m.	n.m.
Water Treatments <sup>(7)</sup>	Net sales (nine months)	722	n.a.	n.a.	n.a.	n.a.
	Top line growth	n.a.	n.a.	n.a.	n.a.	n.a.
	EBITDA (nine months)	142	n.a.	n.a.	n.a.	n.a.
	Economic profit (nine months)	16	n.a.	n.a.	n.a.	n.a.
<b>Financial position</b>						
Total Company	Current assets	4 541	4 918	5 007	4 219	4 159
	Property, plant and equipment, net	4 396	3 991	4 090	4 352	4 640
	Short and long-term debt	5 553	2 108	2 126	1 700	1 700
	Shareholders' equity	3 293	4 336	4 389	4 886	5 041
Other data	Capital expenditures	459	523	559	462	468
	Depreciation and amortisation	479	377	384	398	413
	Research and development expenditures	304	302	325	313	315
	Personnel costs	2 180	1 941	n.m.	n.m.	n.m.
	Number of employees at year end	24 456	21 442	n.m.	n.m.	n.m.

See Glossary of Financial Terms

### Footnotes

(1) The 1996, 1995 and 1994 historical financial information used for comparative purposes was prepared in accordance with International Accounting Standards (unaudited) and is in compliance with the Master Spin-Off Agreement. This information is not necessarily indicative of the results of operations or related effects on the financial position that would have been obtained had the Company been a stand-alone entity during the periods presented. For comparative purposes with 1997, the 1996 operating profit has been adjusted to reflect the Company's new organisational structure. Balance sheet comparisons are based on the consolidated Balance Sheet at January 1, 1997 (see Note 2).

(2) Net income is presented before restructuring and special charges.

(3) Basic and diluted earnings per share are calculated using net income before restructuring and special charges divided by the weighted average number of common shares outstanding.

(4) 1998 is presented based on the proposal to the shareholders' meeting.

(5) For comparative purposes, the 1997 Colors division's financial data has been restated to reflect the effects of the combination of the former Pigments and Textile Dyes divisions as well as the effect of the transfer of products of the former Textile Dyes division to the Consumer Care division. Financial data for years prior to 1997 has not been restated as the information related to the products transferred to the Consumer Care division for the periods prior to 1997 is not readily available. As a result, top line growth for 1997 is not presented. Top line growth in 1997 for the former Pigments and Textile Dyes divisions, as previously reported, was 22% and 21%, respectively.

(6) For comparative purposes, the 1997 Consumer Care financial data has been restated to reflect the effects of products transferred from the former Textile Dyes division. Financial data for years prior to 1997 has not been restated as the information related to the products transferred for periods prior to 1997 is not readily available. Top line growth for 1997 has been calculated including the product transfers from the former Textile Dyes division. Excluding these product transfers, net sales for 1997 would have been CHF 1 171 million and top line growth would have been 18%.

(7) Financial data for the Water Treatments division is presented for the nine month period since April 1, 1998, the date of the Allied Colloids acquisition. Top line growth is not presented as the division was acquired in 1998.

n.a.: not applicable

n.m.: Data is not meaningful as the basis, which relied on estimated allocations of Ciba-Geigy corporate expenses and net assets, is not comparable.

## Shareholder Information

(in millions of Swiss francs, except share and per share data)

### The shares

Ciba Specialty Chemicals Holding Inc. has one category of listed shares – registered shares with a nominal value of CHF 10 – which are listed on the Swiss Exchange (“SWX”) under the ticker symbol “CIBN” and are included in the Swiss Market Index (SMI). Shares are also traded on SEAQ International in the United Kingdom under the symbol “CBA”. Investors have the option of investing in the Company through sponsored but unlisted American Depository Receipts (ADRs). They are traded over the counter in the United States under the symbol “CSYCY”.

### Transfer of shares

No shareholder or group of shareholders will be registered with more than 2 percent of the Company’s share capital as a shareholder with voting rights, and no shareholder or group of shareholders may represent more than 5 percent of the Company’s share capital at a shareholders’ meeting.

### Dividend policy

The amount of dividends to be paid by the Company to its shareholders will depend on general business conditions, the Company’s financial performance, and other relevant factors. The Board of Directors of the Company has adopted a policy on the proposal of dividends which will provide shareholders with dividend growth in line with the underlying growth in the earnings of the Company.

Per share information	1998	1997
Basic earnings per share <sup>(1)</sup>	5.57	8.38
Diluted earnings per share <sup>(1)</sup>	5.57	8.38
Operating cash flow per share	12.71	16.77
Equity per share	49.56	65.31
Dividend per share <sup>(2)</sup>	2.00	2.00

### Key ratios

EBITDA margin	16.1%	15.7%
NOPAT margin	8.4%	8.2%
Velocity	0.83	0.95
NOPAT as a percentage of average invested capital	6.9%	7.8%
Economic profit	(6)	64
Return on average equity <sup>(1)</sup>	9.7%	13.1%
Price-earnings ratio (year end) <sup>(1)</sup>	20.7	20.8

<sup>(1)</sup> Before restructuring and special charges.

<sup>(2)</sup> 1998 is presented based on the proposal to shareholders’ meeting.  
See Glossary of Financial Terms

Share price and market capitalisation		1998	1997
Registered shares (SWX closing prices)	high	214.00	174.50
	low	102.75	110.00
	year end	115.00	174.00
Market capitalisation	year end	8 295	12 551

## Financial Calendar

### Ciba Specialty Chemicals sales and earnings release dates

First-Quarter Sales	April 15, 1999
First-Half Results	August 17, 1999
Nine-Month Sales	October 14, 1999

The Annual General Meeting for the 1998 financial year will take place March 30, 1999 in Basel, Switzerland.

Dividend payment date	April 6, 1999
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## Major Consolidated Subsidiaries and Associated Companies

	Group holding 100%	Group holding over 50%	Group holding 20% – 50%	Selling	Manufacturing	Research	Services, Finance
<b>Europe</b>							
<b>Austria</b>							
Ciba Spezialitätenchemie GmbH, Wien	•				•		
<b>Belgium</b>							
Ciba Specialty Chemicals N.V., Groot-Bijgaarden	•				•		
<b>Denmark</b>							
Ciba Specialty Chemicals A/S Denmark, Copenhagen	•				•		
<b>Finland</b>							
Ciba Specialty Chemicals Finland OY, Helsinki	•				•		
<b>France</b>							
Ciba Spécialités Chimiques SA, Rueil–Malmaison	•				•	•	•
Société Nouvelle de Chimie Industrielle (S.N.C.I.), Saint Jeoire en Faucigny	•				•	•	•
Société Pyrénéenne de coloration "Sopyco" Sàrl, Abidos Moureux	•				•	•	
<b>Germany</b>							
Cerdec AG, Frankfurt am Main				•	•	•	
Ciba Solvay Duromer GmbH, Bergkamen				•	•	•	
Ciba Spezialitätenchemie Bergkamen GmbH, Bergkamen	•				•	•	•
Ciba Spezialitätenchemie Grenzach GmbH, Grenzach-Wyhlen	•				•	•	
Ciba Spezialitätenchemie Holding Deutschland GmbH, Lampertheim	•						•
Ciba Spezialitätenchemie Lampertheim GmbH, Lampertheim	•				•	•	•
Ciba Spezialitätenchemie Pfersee GmbH, Langweid/Lech	•				•	•	•
TFL Ledertechnik GmbH & Co. KG, Darmstadt			•		•	•	•
<b>Greece</b>							
Ciba Specialty Chemicals Hellas ABEE, Athens	•				•	•	
<b>Hungary</b>							
Ciba Specialty Chemicals Magyarorszag, Kft. Budapest	•				•		
<b>Italy</b>							
Ciba Specialty Chemicals S.p.A., Sasso Marconi (Bologna)	•				•	•	•
Magenta Master Fibres, S.r.L., Milano		•			•	•	•
<b>Netherlands</b>							
Ciba Specialty Chemicals International Nederland B.V., Maastricht	•						•
Ciba Specialty Chemicals (Maastricht) B.V., Maastricht	•				•	•	•
<b>Norway</b>							
Ciba Specialty Chemicals A/S Norway, Oslo	•				•		
<b>Portugal</b>							
Ciba Especialidades Químicas Lda., Porto	•				•		
<b>Spain</b>							
Ciba Especialidades Químicas S.L., Barcelona	•				•	•	
Industrias Químicas de Navarra S.A., Pamplona	•				•	•	
<b>Europe</b>							
<b>Sweden</b>							
Ciba Specialty Chemicals Sweden AB, Göteborg	•				•		
<b>Switzerland</b>							
<b>Ciba Spezialitätenchemie Holding AG, Basel</b> (listed on Swiss Exchange)							
Ciba SC Recherche Marly SA, Marly	•						•
Ciba Spécialités Chimiques Monthey SA, Monthey	•				•		
Ciba Spezialitätenchemie AG, Basel	•				•	•	•
Ciba Spezialitätenchemie Finanz AG, Basel	•				•		•
Ciba Spezialitätenchemie International AG, Basel	•				•		•
Ciba Spezialitätenchemie Kaisten AG, Kaisten	•				•		
Ciba Spezialitätenchemie Schweizerhalle AG, Muttenz	•				•		
Ciba Spezialitätenchemie Services AG, Basel	•						•
CIMO Compagnie Industrielle de Monthey SA, Monthey			•				•
<b>Turkey</b>							
Ciba Özel Kimyevi Ürünler Sanayi ve Ticaret Ltd., Istanbul	•				•	•	
<b>United Kingdom</b>							
Ciba Specialty Chemicals (Financial Services) Ltd., Macclesfield	•						•
Ciba Specialty Chemicals PLC, Macclesfield	•				•	•	•
Ciba Specialty Chemicals Investment PLC, Macclesfield	•						•
Ciba Specialty Chemicals Water Treatments Ltd., Bradford	•				•	•	•
<b>North America</b>							
<b>Bermuda</b>							
Chemical Insurance Company Ltd., Hamilton	•						•
Ciba Specialty Chemicals International Finance Ltd., Hamilton	•						•
Ciba Specialty Chemicals Investment Ltd., Hamilton	•						•
<b>Canada</b>							
Ciba Specialty Chemicals Canada Inc., Mississauga	•				•	•	
Ciba Specialty Chemicals Water Treatments Corp., Brampton	•				•		
<b>United States of America</b>							
Ciba Specialty Chemicals Corporation, Tarrytown, NY	•				•	•	•
Ciba Specialty Chemicals Water Treatments Inc., Suffolk, VA	•				•	•	•
Hexcel Corporation, Pleasanton, CA			•		•	•	•

	Group holding 100%	Group holding over 50%	Group holding 20% – 50%	Selling	Manufacturing	Research	Services, Finance
<b>Latin America</b>							
<b>Argentina</b>							
Ciba Especialidades Químicas S.A., Buenos Aires	•				•		
<b>Brazil</b>							
Ciba Especialidades Químicas Ltda., São Paulo	•				•	•	
<b>Chile</b>							
Ciba Especialidades Químicas Ltd., Santiago de Chile	•				•		
Ciba Especialidades Químicas Conosur S.A., Santiago de Chile		•			•		
<b>Colombia</b>							
Ciba Especialidades Químicas S.A., Bogota	•				•	•	
<b>Guatemala</b>							
Ciba Especialidades Químicas, S.A. (ACC), Guatemala	•				•	•	
<b>Mexico</b>							
Ciba Especialidades Químicas Mexico S.A. de C.V., Mexico	•				•	•	
<b>Panama</b>							
Ciba Especialidades Químicas Colon S.A., Colon	•				•		
<b>Asia</b>							
<b>China</b>							
Ciba Specialty Chemicals (China) Ltd., Beijing	•						•
Ciba Specialty Chemicals (Hong Kong) Ltd., Hong Kong	•				•		
Guangdong Ciba Polymers Co. Ltd., Panyu, Guangdong		•			•	•	
Guangzhou Ciba Specialty Chemicals Co. Ltd., Guangzhou		•			•	•	
Qingdao Ciba Dyes Co. Ltd., Qingdao		•			•	•	
Qingdao Ciba Pigments Co. Ltd., Qingdao		•			•	•	
Shanghai Ciba Gao-Qiao Chemical Co. Ltd., Shanghai		•			•	•	
Shenzhen Ciba Specialty Chemicals Co. Ltd., Shenzhen		•			•	•	
Xiangtan Chemicals & Pigments Co. Ltd., Xiangtan			•		•	•	
<b>India</b>							
Ciba India Private Ltd., Mumbai	•						•
Ciba Specialty Chemicals (India) Ltd., Mumbai	•				•	•	•
INDO Swiss Textile Chemicals Ltd., Mumbai	•				•	•	
Petro Araldite Pvt. Ltd., Chennai	•				•	•	
Pigments Specialties India Pvt. Ltd., Mumbai	•				•	•	
Plastichemix Industries Ltd., Baroda	•				•	•	
Swathi Organics & Specialities Pvt. Ltd., Pondicherry			•		•	•	
<b>Indonesia</b>							
P.T. Candra Sari, Jakarta	•				•	•	
P.T. Ciba-Geigy Indonesia, Jakarta	•				•	•	

	Group holding 100%	Group holding over 50%	Group holding 20% – 50%	Selling	Manufacturing	Research	Services, Finance
<b>Asia</b>							
<b>Japan</b>							
Asahi-Ciba Ltd., Tokyo		•			•	•	•
Chemipro Fine Chemical Kaisha Ltd., Kobe		•			•	•	
Ciba Specialty Chemicals K.K., Takarazuka/Tokyo	•				•		•
Musashino-Geigy Co. Ltd., Tokyo					•	•	•
Nagase-Ciba Ltd., Osaka					•	•	
Nippon Alkyl Phenol Co. Ltd., Tokyo					•	•	
<b>Republic of Korea (South Korea)</b>							
Cheil Ciba-Geigy Co. Ltd., Kumi					•	•	•
Ciba Specialty Chemicals Korea Ltd., Seoul	•				•		
Daihan Swiss Chemical Corp., Seoul					•	•	•
<b>Malaysia</b>							
Ciba Specialty Chemicals (Malaysia) SDN. BHD., Klangg	•				•	•	
<b>Singapore</b>							
Ciba Specialty Chemicals (Singapore) Pte Ltd., Singapore	•				•	•	
<b>Taiwan</b>							
Asia Pacific Resin Corporation, Kaohsiung Hsien		•			•	•	
Ciba Specialty Chemicals (Taiwan) Ltd., Taipei	•				•	•	
<b>Thailand</b>							
Ciba Specialty Chemicals (Thailand) Ltd., Bangkok	•				•	•	
Ciba Specialty Chemicals Industries Ltd., Mahachai/Samutaskorn			•		•	•	
<b>United Arab Emirates</b>							
Ciba Specialty Chemicals (Middle East) FZE, Dubai	•				•		
<b>Africa</b>							
<b>Egypt</b>							
Ciba Specialty Chemicals Co. (S.A.E.), Cairo		•			•	•	
<b>South Africa</b>							
Ciba Specialty Chemicals (Pty) Ltd., Spartan	•				•		
<b>Australia &amp; New Zealand</b>							
<b>Australia</b>							
Ciba Specialty Chemicals Pty. Ltd., Thomastown	•				•	•	
<b>New Zealand</b>							
Ciba Specialty Chemicals N.Z. Ltd., Auckland	•				•	•	

## Ciba Specialty Chemicals Holding Inc. Financial Statements

(in thousand Swiss francs, except share and per share data)

<b>Statements of income</b>	1998	1997
Financial income	196 977	235 399
Extraordinary income	1 311	0
<b>Total income</b>	<b>198 288</b>	<b>235 399</b>
Administrative expenses	7 503	5 996
Financial expenses	43 670	33 419
Taxes	6 875	6 657
Extraordinary expenses	0	53 839
<b>Total expenses</b>	<b>58 048</b>	<b>99 911</b>
<b>Profit for the year</b>	<b>140 240</b>	<b>135 488</b>

<b>Balance sheets</b>	December 31 1998	December 31 1997
<b>Assets</b>		
Cash and cash equivalents	2 967	3 382
Marketable securities	95 293	100 343
Accounts receivable:		
Group companies	289 395	119 184
Third parties	35 833	32 576
<b>Total current assets</b>	<b>423 488</b>	<b>255 485</b>
Financial investments	2 550 953	2 973 577
<b>Total long-term assets</b>	<b>2 550 953</b>	<b>2 973 577</b>
<b>Total assets</b>	<b>2 974 441</b>	<b>3 229 062</b>
<b>Liabilities and shareholders' equity</b>		
Liabilities:		
Group companies	412 920	0
Third parties	12 685	12 813
Banks	0	677 400
Provisions	126 000	126 000
<b>Total liabilities</b>	<b>551 605</b>	<b>816 213</b>
Share capital	721 301	721 301
Legal reserves:		
General reserve	1 160 551	1 145 771
Treasury stock reserve	359 517	371 772
Retained earnings	181 467	174 005
<b>Total shareholders' equity</b>	<b>2 422 836</b>	<b>2 412 849</b>
<b>Total liabilities and shareholders' equity</b>	<b>2 974 441</b>	<b>3 229 062</b>

## Notes to the financial statements of Ciba Specialty Chemicals Holding Inc.

### 1. Summary of significant accounting policies

The accompanying financial statements have been prepared in accordance with the legal stipulations of the Swiss Code of Obligations.

The positions on the balance sheet denominated in foreign currencies are translated into Swiss francs at year end exchange rates. The resulting exchange rate differences and the differences from current business operations are charged to the income statement. Exchange rate differences from identical active and passive loans are offset against each other.

### 2. Marketable securities

Marketable securities include treasury stock at a book value of CHF 95 million in 1998 and CHF 100 million in 1997 (see also Note 5).

### 3. Financial investments

Financial investments include loans to group companies of CHF 1 055 million in 1998 and CHF 1 488 million in 1997. The major direct and indirect investment in group companies and joint ventures of Ciba Specialty Chemicals Holding Inc. are listed in this report in the section "Major consolidated subsidiaries and associated companies".

### 4. Share capital

The General Meeting of the Shareholders on April 20, 1998 passed the following resolutions:

#### Authorised increase of share capital

Until April 20, 2000 the board of directors is allowed to issue at maximum 4 million fully paid-in registered shares at a nominal value of CHF 10 per share. This results in an increase of the share capital of CHF 40 million at maximum.

#### Conditional increase of share capital

The Company's share capital is increased by issuance of at maximum 4 million fully paid in registered shares at a nominal value of CHF 10 per share. This increase of the share capital by up to CHF 40 million is restricted to the execution of option and conversion rights. The subscription right for existing shares is excluded.

The Company's share capital is increased by issuance of at maximum 2 million fully paid in registered shares at a nominal value of CHF 10 per share. This increase of the share capital by up to CHF 20 million is restricted to the execution of option and conversion rights granted to the Group's employees.

(in thousand Swiss francs, except share and per share data)

<b>5. Treasury stock (number)</b>	1998	1997
Treasury stock on January 1	5 741 045	0
Purchased from Novartis AG at a nominal value of CHF 10 per share	0	3 256 945
Purchased at market prices	806 915	2 727 500
Sale to "Stiftung für Mitarbeiter-beteiligung der Ciba Spezialitätenchemie" at a price of CHF 15 per share	(505 000)	0
Sale at market prices	(366 162)	(243 400)
<b>Treasury stock on December 31</b>	<b>5 676 798</b>	<b>5 741 045</b>

<b>6. Contingencies</b>	1998	1997
Guarantees for capital and interests for "Industrial Revenue Bonds"	380 960	402 715
Guarantees for the benefit of group companies	956 876	157 131
Guarantees for bonds and notes for the benefit of group companies	5 782 960	0
<b>Total as per December 31</b>	<b>7 120 796</b>	<b>559 846</b>

## 7. Major shareholders

According to our knowledge no shareholder holds more than 2 percent of the share capital.

## Proposed appropriation of retained earnings

	1998	1997
Profit carryforward	41 227	38 517
Profit for the year	140 240	135 488
<b>Total free surplus</b>	<b>181 467</b>	<b>174 005</b>
Distribution of a gross dividend of CHF 2.00 (1997: CHF 2.00) on 66 453 319 registered shares (1997: 66 389 072 registered shares) at a nominal value of CHF 10 per share (excluding treasury stock)	132 907	132 778
<b>Balance carried forward</b>	<b>48 560</b>	<b>41 227</b>

## Report of the statutory auditors to the General Meeting of the Shareholders of Ciba Specialty Chemicals Holding Inc., Basel

As statutory auditors, we have audited the accounting records and the financial statements (balance sheet, income statement and notes) of Ciba Specialty Chemicals Holding Inc., Basel, for the year ended December 31, 1998.

These financial statements are the responsibility of the Board of Directors. Our responsibility is to express an opinion on these financial statements based on our audit. We confirm that we meet the legal requirements concerning professional qualification and independence.

Our audit was conducted in accordance with auditing standards promulgated by the profession, which require that an audit be planned and performed to obtain reasonable assurance about whether the financial statements are free from material misstatement. We have examined on a test basis evidence supporting the amounts and disclosures in the financial statements. We have also assessed the accounting principles used, significant estimates made and the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the accounting records and financial statements and the proposed allocation of retained earnings comply with the law and the company's articles of incorporation.

We recommend that the financial statements submitted to you be approved.

ARTHUR ANDERSEN AG



Eric G. Ohlund



Markus Schweizer

Basel, February 5, 1999

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## Principal Management

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### Board of Directors

**Rolf A. Meyer**  
**Chairman of the Board, Ciba Specialty Chemicals**  
Chief Executive Officer, Ciba Specialty Chemicals  
(as of January 1, 1999)

**Theodor M. Tschopp\***  
**Vice Chairman of the Board, Ciba Specialty Chemicals**  
Chairman, Alusuisse Ionza group ag  
(until March 30, 1999)

**Erwin W. Heri**  
**Member of the Board**  
Member of the Executive Board, Winterthur Insurance

**Gertrud Höhler**  
**Member of the Board**  
Management consultant, humanities professor and author

**Jean-Marie Pierre Lehn**  
**Member of the Board**  
Noted professor and researcher in chemistry and  
co-recipient of the Nobel Prize in Chemistry in 1987

**Peter Littmann**  
**Member of the Board**  
Chairman and CEO, Wünsche AG, a German clothing  
and textile company

**Armin Meyer**  
**Member of the Board**  
Executive Vice President, Head of Segment Products  
and Contracting and Member of the ABB Group  
Executive Committee

**Hermann Vodika**  
**Member of the Board**  
Chief Executive Officer, Ciba Specialty Chemicals  
(until December 31, 1998)

\*Theodor Tschopp will tender his resignation as Vice Chairman of the Board at the shareholder meeting on March 30, 1999. In his new role as designated Chairman of the Supervisory Board of VIAG-Algroup, a conflict of interest is emerging as Ciba Specialty Chemicals is taking the first small steps to enter a promising technology field in the fine chemicals sector. The Board of Directors has established a nomination committee to put together an election proposal for the shareholder meeting in March 1999.

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### Executive Committee

**Rolf A. Meyer**  
Chairman of the Board and Chief Executive Officer

**John Cheesmond**  
Executive Vice President, Corporate Strategy  
& Business Development

**Franz Gerny**  
Executive Vice President, International Coordination  
& Human Resources

**Michael Jacobi**  
Chief Financial Officer

**Reinhard Neubeck**  
Global President, Additives

**Martin Riediker**  
Global President, Consumer Care (and representing the  
Performance Polymers division in the Executive Committee)

**Jean-Luc Schwitzguébel**  
Global President, Colors

**Hermann Vodicka**  
Chief Executive Officer and Member of the Board of Directors  
(until December 1998)

**David Farrar**  
Global President, Water Treatments  
(until April 1999)

**Werner Dittes**  
Global President, Performance Polymers  
(until August 1998)

**Peter Schütz**  
Global President, Pigments  
(until August 1998)

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## Contact Addresses

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### Investor Relations

For investor or analyst enquiries, please contact:

#### Headquarters

##### Switzerland

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Chisato Akamatsu  
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Fax: +81 3 5403 8223

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### Corporate Communications

For media enquiries, please contact:

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##### Singapore

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Fax: +65 334 7131

##### United Kingdom

Mike Bold  
Tel: +44 1625 888 217  
Fax: +44 1625 619 002

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### Shareholder Register

To report shareholder address or other changes, please contact:

#### Shareholder Register

Ciba Specialty Chemicals Holding Inc.  
P.O. Box  
CH-4002 Basel, Switzerland  
Tel: +41 61 636 2922 or  
+41 61 636 5791  
Fax: +41 61 636 5243

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### Internet Address

<http://www.cibasc.com>

#### Ciba Specialty Chemicals Inc.

Klybeckstrasse 141  
CH-4002 Basel  
Switzerland  
Tel: +41 61 636 1111

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## Glossary of Financial Terms

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**Acquired In-Process Research and Development Costs** is the portion of the consideration paid in an acquisition that is allocated to incomplete research and development (R&D) projects. The amount allocated is based on an independent appraisal using standard valuation procedures and techniques. In accordance with U.S. GAAP, in-process R&D costs are expensed immediately.

**Average Invested Capital** is the sum of invested capital at year end plus the invested capital as of the beginning of the year divided by two; the result is adjusted for an annualising adjustment for acquisitions and divestitures that occurred during the reporting period, plus the current year goodwill amortisation. The annualising adjustment amends average invested capital in a way which ensures that invested capital relating to an acquisition/divestment is proportional to the period during which the investment was consolidated. To illustrate, for an acquisition where the operations are consolidated for nine months, invested capital is proportionately adjusted to reflect nine-twelfths of the amount that would normally be expected for a full year. Average invested capital was CHF 10 190 million in 1998 and CHF 8 237 million in 1997.

**Basic Earnings per Share** is defined as net income divided by the weighted average number of common shares outstanding during the reporting period.

**Cash Flows from Operating Activities** is the net cash provided from the principal revenue-producing activities of the business. It excludes financing and investing activities as well as restructuring payments.

**Commercial Paper** are short-term borrowings that are typically due within 30 to 270 days from the date of issuance and are issued by companies with good credit ratings.

**Convertible Bonds** are debt instruments that may be converted into shares based on predefined conditions as stipulated in the debt agreement.

**Cost of Capital** is calculated by multiplying the average invested capital by the weighted average cost of capital.

**Defined Benefit Pension Plan** is a pension plan that provides employees at their date of retirement, a predefined payment. The payment is, depending on the benefit plan, a function of one or more factors such as age, years of service or compensation level of the employee.

**Defined Contribution Pension Plan** is a pension plan for employees that provides the employees, at the date of their retirement, benefits based on the amount of capital paid-in by the participant or the Company, plus returns earned on the investment of those contributions.

**Diluted Earnings per Share** is similar to basic earnings per share (net income divided by the weighted average number of common shares outstanding) except that it reflects the potential dilution that could occur if dilutive securities, such as stock options and convertible debt, were exercised or converted into common shares or resulted in the issuance of common shares that then shared in the earnings of the Company.

**Derivatives, Derivative Financial Instruments** are financial contracts or agreements, the value of which is linked to current or future interest rates, exchange rates, prices of securities, or financial or commodity indices. Financial instruments currently used by the Company are forward exchange contracts, options and interest and currency swaps. The Company uses these instruments to reduce its exposure to adverse fluctuations in interest and exchange rates and other market risks.

**EBIT (Earnings Before Interest and Taxes)** is calculated as operating income before restructuring and special charges.

**EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortisation)** is calculated as operating income before restructuring and special charges plus depreciation and amortisation.

**EBITDA Margin** is EBITDA expressed as a percentage of net sales (EBITDA divided by net sales).

**Economic Profit** is determined by subtracting a capital charge from NOPAT. A capital charge is calculated by multiplying the average invested capital by the weighted average cost of capital ("WACC").

**Equity per Share** is calculated by dividing total shareholders' equity by the number of outstanding common shares (total common shares issued less treasury shares outstanding) at the balance sheet date.

**Free Cash Flow** is Cash Flows from Operating Activities less net cash used for investing activities, other than acquisitions. The Company uses free cash flows for reinvestment in the business and dividend payments.

**Goodwill** is recognized in an acquisition of a business if the amount of the consideration paid by the Company is in excess of the fair value of the acquired entity's tangible and identifiable intangible net assets.

**Gross Profit** is defined as net sales less costs of goods sold.

**Gross Profit Margin** is Gross Profit expressed as a percentage of net sales (Gross Profit divided by net sales).

**Invested Capital** is the sum of total assets less non-interest bearing current liabilities (i.e. accounts payable, income taxes payable as well as accruals and other current liabilities) less the current portion of deferred tax assets.

**Net Assets** are defined as Invested Capital. Please refer to the definition of Invested Capital.

**Net Cash Provided by Operating Activities** is the net cash provided from the principal revenue-producing activities of the business. It excludes financing and investing activities.

**NOPAT (Net Operating Profit After Tax)** is calculated as EBIT before amortisation of goodwill, less a notional tax charge of 25 percent.

**NOPAT Margin** is NOPAT expressed as a percentage of net sales (NOPAT divided by net sales).

**Notional Value (of a derivative financial instrument)** is the stated contract amount or the notional principal amount if there is no stated contract amount for the financial instrument.

**Operating Cash Flows per Share** is calculated by dividing Cash Flows from Operating Activities by the weighted average number of common shares outstanding during the period.

**Top Line Growth** is the increase of the current period's net sales in Swiss francs over the previous period's sales in Swiss francs expressed as a percentage.

**Top Line Growth in Local Currencies** is the increase of the current period's net sales in local currencies over the previous period's net sales expressed as a percentage.

**Velocity** is calculated by dividing net sales by average invested capital for the period.

**Weighted Average Cost of Capital ("WACC")** is the weighted average cost associated with the Company's debt and equity. Currently this is approximately 7 percent.

Ciba Specialty Chemicals' 1998 Annual Report consists of the Business Review and Financial Review.

The documents were written in English and translated into German and are available in both languages.

This report was produced using Ciba Specialty Chemicals' products contained in papers, inks and other materials.

Ciba Specialty Chemicals Inc.

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**Ciba**



Value beyond chemistry