Industrie Natuzzi S.p.A. and Subsidiaries
Consolidated Financial Statements

At December 31, 1998 and 1997
and for each of the years in the
three-year period ended
December 31, 1998
(With Independent Auditors' Report)

Contents

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Consolidated Balance Sheets as of December 31, 1998 and 1997

(Expressed in millions of Italian lire, except as otherwise indicated)

Assets	1998	1997
Current assets:		
Cash and cash equivalents (note 4)	273,211	239,371
Marketable debt securities (note 5)	17,028	4,802
Trade receivables, net (note 6)	198,623	184,382
Other receivables (note 7)	73,782	64,858
Inventories (note 8)	106,546	114,724
Prepaid expenses and accrued income	1,572	1,151
Deferred income taxes (note 14)	4,071	3,483
Total current assets	**674,833**	**612,771**
Non current assets:		
Property, plant and equipment (note 9 and 16)	274,079	258,719
Less accumulated depreciation (note 9)	(79,611)	(70,464)
Net property, plant and equipment	**194,468**	**188,255**
Other assets (note 10)	4,757	10,912
Deferred income taxes (note 14)	205	372
Total assets	**874,263**	**812,310**

See accompanying notes to consolidated financial statements.

Liabilities and Shareholders' Equity	1998	1997
Current liabilities:		
Short-term borrowings (note 11)	3,890	1,796
Current portion of long-term debt (note 16)	1,684	3,191
Accounts payable-trade (note 12)	110,173	108,487
Accounts payable-other (note 13)	26,761	16,576
Allowance for unrealized foreign exchange losses (notes 23)	218	2,184
Income taxes (note 14)	17,872	19,362
Salaries, wages and related liabilities (note 15)	16,566	16,945
Total current liabilities	**177,164**	**168,541**
Long-term liabilities:		
Employees' termination indemnity (note 3 (k))	30,260	27,040
Long-term debt (note 16)	2,315	3,999
Deferred income taxes (note 14)	1,817	2,546
Other liabilities	4,181	3,417
Minority interest (note 17)	**1,398**	**1,349**
Shareholders' equity (note 18):		
Share capital	7,184	7,110
Reserves	62,241	62,241
Additional paid-in capital	15,441	9,238
Retained earnings	572,262	526,829
Total shareholders' equity	**657,128**	**605,418**
Commitments and contingent liabilities (notes 19 and 23)	-	-
Total liabilities and shareholders' equity	**874,263**	**812,310**

See accompanying notes to consolidated financial statements.

Consolidated Statements of Earnings for the years ended December 31, 1998, 1997 and 1996

(Expressed in millions of Italian lire, except per share data)

	1998	1997	1996
Net sales (note 20)	1,066,173	1,063,132	854,633
Cost of sales (note 21)	(691,824)	(716,235)	(576,792)
Gross profit	**374,349**	**346,897**	**277,841**
Selling expenses	(171,345)	(171,659)	(142,414)
General and administrative expenses	(38,032)	(39,053)	(35,022)
Operating income	**164,972**	**136,185**	**100,405**
Other income, net (note 22)	20,810	12,318	47,130
Earnings before taxes and minority interest	**185,782**	**148,503**	**147,535**
Income taxes (note 14)	(46,335)	(44,148)	(28,539)
Earnings before minority interest	**139,447**	**104,355**	**118,996**
Minority interest	(148)	(181)	(1,556)
Net earnings	**139,299**	**104,174**	**117,440**
Basic earnings per share (note 3 (q))	**2,434**	**1,832**	**2,073**
Diluted earnings per share (note 3 (q))	**2,433**	**1,817**	**2,056**

See accompanying notes to consolidated financial statements.

Consolidated Statements of Changes in Shareholders' Equity for the years ended December 31, 1998, 1997 and 1996

(Expressed in millions of Italian lire, except number of ordinary shares)

	Share capital					
	Number of ordinary shares	Amount	Reserves	Additional paid-in capital	Retained earnings	Total
Balances at December 31, 1995	**56,364,500**	**7,046**	**15,358**	**3,832**	**325,815**	**352,051**
Transfer of reserves to parent company	-	-	(553)	-	553	-
Other transfers	-	-	(297)	-	297	-
Exercise of stock options	514,300	64	-	5,406	-	5,470
Dividends distributed	-	-	-	-	(9,018)	(9,018)
Exchange difference on translation of financial statements	-	-	-	-	(195)	(195)
Net earnings	-	-	-	-	117,440	117,440
Balances at December 31, 1996	**56,878,800**	**7,110**	**14,508**	**9,238**	**434,892**	**465,748**
Dividends distributed	-	-	-	-	(14,788)	(14,788)
Exchange differences on translation of financial statements	-	-	-	-	2,551	2,551
Grants received	-	-	53,005	-	-	53,005
Taxes due on grants received	-	-	(5,272)	-	-	(5,272)
Net earnings	-	-	-	-	104,174	104,174
Balances at December 31, 1997	**56,878,800**	**7,110**	**62,241**	**9,238**	**526,829**	**605,418**
Dividends distributed	-	-	-	-	(91,006)	(91,006)
Exercise of stock options	590,088	74	-	6,203	-	6,277
Exchange differences on translation of financial statements	-	-	-	-	(2,860)	(2,860)
Net earnings	-	-	-	-	139,299	139,299
Balances at December 31, 1998	**57,468,888**	**7,184**	**62,241**	**15,441**	**572,262**	**657,128**

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows for the years ended December 31, 1998, 1997 and 1996

(Expressed in millions of Italian lire)

	1998	1997	1996
Cash flows from operating activities:			
Net earnings	139,299	104,174	117,440
Adjustments to reconcile net income to net cash provided by operating activities:			
• Depreciation and amortization	23,848	21,954	18,827
• Employees' termination indemnity	8,582	8,094	6,918
• Deferred income taxes	(1,150)	(4,121)	(505)
• Minority interest	148	181	1,556
• Provision for unrealized losses on marketable debt securities	-	66	(318)
• (Gain) loss on disposal of assets	202	(1,640)	(350)
• Change in provision for unrealized foreign exchange losses	(1,966)	2,184	-
Change in assets and liabilities:			
• Receivables, net	(23,165)	(14,845)	5,951
• Inventories	8,178	(24,274)	(8,644)
• Prepaid expenses and accrued income	(421)	3,507	302
• Other assets	(1,342)	(2,528)	(845)
• Accounts payable	11,871	523	(5,920)
• Income taxes	(1,490)	(1,051)	16,120
• Salaries, wages and related liabilities	(379)	1,355	4,011
• Other liabilities	764	501	1,468
• Employees' termination indemnity	(5,362)	(4,272)	(6,448)
Total adjustments	**18,318**	**(14,366)**	**32,123**
Net cash provided by operating activities	**157,617**	**89,808**	**149,563**

See accompanying notes to consolidated financial statements.

	1998	1997	1996

Cash flows from investing activities:

Property, plant and equipment:			
• Additions	(26,199)	(81,084)	(36,338)
• Disposals	447	1,245	970
Government grants received	-	46,876	-
Marketable debt securities:			
• Purchases	(17,018)	(102)	(71,793)
• Proceeds from maturities	3,284	4,579	64,720
• Proceeds from sales	1,757	70,585	8,866
Purchase of minority interest	-	(288)	(18,833)
Net cash provided by (used in) investing activities	**(37,729)**	**41,811**	**(52,408)**

Cash flows from financing activities:

Long-term debt:			
• Proceeds	-	-	2,000
• Repayments	(3,191)	(3,158)	(2,878)
Short-term borrowings	2,094	(2,071)	(6,331)
Exercise of stock options	6,277	-	5,470
Dividends paid	(91,006)	(14,788)	(9,018)
Dividends paid to minority shareholders	(99)	(1,018)	(1,124)
Net cash used in financing activities	**(85,925)**	**(21,035)**	**(11,881)**
Effect of translation adjustments on cash	(123)	786	(95)
Increase in cash and cash equivalents	33,840	111,370	85,179
Cash and cash equivalents, beginning of the year	239,371	128,001	42,822
Cash and cash equivalents, end of the year	273,211	239,371	128,001

Supplemental disclosure of cash flow information:

Cash paid during the year for interest	970	840	1,345
Cash paid during the year for income taxes	46,958	36,199	799

See accompanying notes to consolidated financial statements.

(Expressed in millions of Italian lire, except as otherwise indicated)

1 Description of business and Group composition

The consolidated financial statements include the accounts of Industrie Natuzzi S.p.A. ('Natuzzi' or the 'Company') and of its subsidiaries (together with the Company, the 'Group'). The Group's primary activity is the design, manufacture and marketing of contemporary and traditional leather and fabric-upholstered furniture.

The subsidiaries included in the consolidation at December 31, 1998, together with the related percentages of ownership, are as follows:

Name	Percent of ownership	Share Capital	Registered office	Activity
Divani e Poltrone Italia S.r.l.	99.98	Lit. 3,700	Bari, Italy	(1)
Soft Cover S.r.l.	100	Lit. 5,000	Bari, Italy	(1)
Spagnesi International S.r.l.	100	Lit. 800	Bari, Italy	(1)
Spagnesi S.p.A.	99.95	Lit. 1,000	Quarrata, Italy	(1)
Creazioni Ellelle S.p.A.	99	Lit. 2,500	Altamura, Italy	(1)
Natco S.p.A.	99.99	Lit. 8,500	Bari, Italy	(2)
I.M.P.E. S.p.A.	90.83	Lit. 1,500	Qualiano,Italy	(3)
Expan Italia S.r.l.	99	Lit. 90	Bari, Italy	(3)
Natex S.r.l.	98	Lit. 90	Bari, Italy	(4)
Natuzzi Trade Service S.r.l.	100	Lit. 3,500	Bari, Italy	(5)
Natuzzi Americas Inc.	100	US$ 50,000	High Point, NC, USA	(5)
Nagest S.r.l.	100	Lit. 90	Bari, Italy	(6)
Softaly S.r.l.	98.24	Lit. 190	Bari, Italy	(7)
Finat Ltd	100	Lit. 1,000	Dublin, Ireland	(8)
D.L.S. S.r.l.	100	Lit. 90	Bari, Italy	(9)
Italiana de Sofa Franquiciados S.L.	100	Pta 40,000,000	Madrid, Spain	(9)
Natuzzi Argentina	99	US$ 12,000	Buenos Aires , Argentina	(10)

(1) Manufacture and distribution
(2) Intragroup leather dyeing and finishing
(3) Production and distribution of polyurethane foam
(4) Intragroup production of fibrefill down cushion and polyurethane shaping
(5) Distribution
(6) Intragroup accounting services
(7) Intragroup building management
(8) Intragroup cash management and treasury operations
(9) In liquidation
(10) Non operative

During 1998, the Company liquidated Masternat S.r.l., Natuzzi Pacific Ltd. and Tecnolevante S.r.l.

In July 1997, the Company set up a subsidiary in Dublin (Ireland), known as Finat Ltd, which is engaged in the provision of intragroup cash management and treasury operations. The interest of the Group in this subsidiary is 100% for consideration of 140,000, of which 1,000 was recorded as share capital and remaining 139,000 as additional contributed capital. In addition, this subsidiary has received a certificate from the Minister for Finance of Ireland which confirms that all qualifying income derived from financial services activities is subject to corporation tax at a reduced rate of 10%.

During 1997, the Company acquired all of the minority interest of Italiana de Sofa Franquiciados S.L. and Tecnolevante S.r.l. for an aggregate consideration of 288 in cash. Goodwill arising from that acquisition amounted to 360.

In 1996, the Company acquired substantially all of the minority interest of Spagnesi S.p.A. and Creazioni Ellelle S.p.A. for an aggregate consideration of 18,951 in cash. The acquisition was accounted for using the purchase method. Accordingly, the purchase price has been allocated to the fair value of net assets acquired, including trademarks of 4,655 for Spagnesi S.p.A. and goodwill of 1,648 for Creazioni Ellelle S.p.A.

In July 1996, the Company established a joint venture in Madrid, Spain. The joint venture, known as Italiana de Sofa Franquiciados S.L., manages in Spain the Group's specialized retail furniture chain 'Divani & Divani', in addition to selling leather and fabric-upholstered furniture directly to customers. The initial interest of the Group in this joint venture was 51%, for consideration of 124. The financial statements of this joint venture have been consolidated creating a minority interest of 118.

During 1996, the Company liquidated Natuzzi United Kingdom Ltd.

2 Basis of preparation and principles of consolidation

The financial statements utilized for the consolidation are the statutory financial statements of each Group company at December 31, 1998, 1997 and 1996. The 1997 and 1996 financial statements have been approved by the respective shareholders of the relevant companies. The 1998 financial statements have been approved only by the directors of the relevant companies.

The financial statements of subsidiaries are adjusted, where necessary, to conform to Natuzzi's accounting principles, which are consistent with Italian legal requirements governing financial statements considered in conjunction with established accounting principles promulgated by the Italian Accounting Profession and, in their absence, by the International Accounting Standards Committee. The consolidated financial statements are classified in accordance with the presentations generally used in international practice.

The consolidated financial statements include all affiliates and companies that Natuzzi directly or indirectly controls, either through majority ownership or otherwise. Control is presumed to exist where more than one-half of a subsidiary's voting power is controlled by the Company or the Company is able to govern the financial and operating policies of a subsidiary or control the removal or appointment of a majority of a subsidiary's board of directors. Where an entity either began or ceased to be controlled during the year, the results of operations are included only from the date control commenced or up to the date control ceased.

The assets and liabilities of subsidiaries are consolidated on a line-by-line basis and the carrying value of intercompany investments held is eliminated against the related shareholder's equity accounts. The minority interests of consolidated subsidiaries are separately classified in the consolidated balance sheets and statements of earnings for all years presented. All intercompany balances and transactions have been eliminated in consolidation.

3 Summary of established accounting policies

The established accounting policies followed in the preparation of the consolidated financial statements are outlined below.

a *Foreign currency*

Foreign currency transactions are recorded at the exchange rates applicable at the transaction dates. Assets and liabilities denominated in foreign currency are remeasured at year-end exchange rates, except for certain accounts receivable and payables as discussed below. Foreign exchange gains and losses resulting from the remeasurement of these assets and liabilities are included in other income, net, in the statement of earnings.

Receivables being hedged by forward exchange contracts are remeasured using the related forward exchange rate. Foreign exchange gains and losses resulting from the remeasurement of hedged receivables are recognized in other income, net, in the statements of earnings. Foreign exchange gains and losses on receivables and payables not hedged are aggregated with the unrealized gains and losses on forward exchange contracts not used to hedge any on or off balance sheet items to determine recognition. If a net foreign exchange loss results from this aggregation, such loss is recognized in other income, net, in the statement of earnings. A net foreign exchange gain is not recognized until realized (refer to note 3 (i) for the accounting of foreign exchange contracts).

The financial statements of foreign subsidiaries for which the functional currency is not the Italian Lira are translated at (i) year-end exchange rate for assets and liabilities, (ii) historical exchange rates for share capital and reserves, and (iii) average exchange rates during the year for statements of earnings. The resulting exchange differences on translation are recorded as a direct adjustment to shareholders' equity.

b *Cash equivalents*

The Group considers time deposits to be cash equivalents.

c *Marketable debt securities*

Marketable debt securities are valued at the lower of cost or market value determined on an individual security basis. A valuation allowance is established and recorded as a charge to other income, net, for unrealized losses on securities. Unrealized gains are not recorded until realized. Recoveries in the value of securities are recorded as part of other income, net, but only to the extent of previously recognized unrealized losses.

Gains and losses realized on the sale of marketable debt securities were computed based on a weighted-average cost of the specific securities being sold.

Realized gains and losses are charged to other income, net.

d *Accounts receivable and payable*

Receivables are stated at nominal value net of an allowance for doubtful accounts. Payables are stated at face value.

e *Inventories*

Raw materials are stated at the lower of cost (determined under the specific cost method for leather hides and under the weighted-average method for other raw materials) or replacement cost. Goods in process and finish goods are valued at the lower of production cost or net realizable value.

f *Property, plant and equipment*

Property, plant and equipment is stated at historical cost, except for plant which were revalued in 1983 and 1991 according to Italian revaluation laws. Maintenance and repairs are expensed; significant improvements are capitalized and depreciated over the useful life of the related assets. The cost or valuation of fixed assets is depreciated on the straight-line method over the estimated useful lives of the assets (refer to note 9).

g *Other assets*

Other assets in the consolidated financial statements primarily include trademarks and patents, goodwill and certain deferred costs. These assets are stated at the lower of amortized cost or recoverable amount. The carrying amount of other assets are reviewed to determine if they are in excess of their recoverable amount, based on undiscounted cash flows, at the consolidated balance sheet date. If the carrying amount exceeds the recoverable amount, the asset is written down to the recoverable amount.

Trademarks, patents and goodwill are amortized on a straight-line basis over a period of five years.

h *Income taxes*

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss. Deferred tax assets are reduced by a valuation allowance to an amount that is more likely than not to be realized. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

i *Forward exchange contracts*

The Group enters into forward exchange contracts (known in Italian financial markets as domestic currency swaps) to manage its exposure to foreign currency risks. The accounting for forward exchange contracts depends on their use as follows:

- Forward exchange contracts used to hedge accounts receivable are considered when remeasuring the related balance sheet item at the contract rate. Foreign exchange gains and losses from the remeasurement of the accounts receivable at contract rate are recorded within other income, net, in the statements of earnings.

- Forward exchange contracts are used to hedge future sales if the sales are supported by sales orders and customer's indications of future purchases as of the balance sheet date which are confirmed by sales orders received within the earlier of four months after the year-end or the issuance of the consolidated financial statements. Unrealized gains and losses on these forward contracts are deferred.

- Unrealized gains and losses on forward exchange contracts not hedging any on or off balance sheet items are aggregated with the foreign currency gains and losses resulting from the remeasurement of unhedged accounts receivable and payable (refer to note 3 a).

j *Government grants*

Capital grants from government agencies are recorded when there is reasonable assurance that the grants will be received and that the Group will comply with the conditions applying to them. Capital grants are recorded, net of tax, within reserves in shareholders' equity.

The capital grants are part of the Italian government's investment incentive program, under which the Group receives amounts generally equal to a percentage of the aggregate investment made by the Group in the construction of new manufacturing facilities, or in the improvement of existing facilities, in designated areas of the country.

Cost reimbursement grants relating to training and other personnel costs are credited to income when received from government agencies.

k *Employees' termination indemnities*

Termination indemnities represent amounts accrued for each Italian employee that are due and payable upon termination of employment determined in accordance with applicable labor laws and agreements. The Group accrues the full amount of employees' vested benefit obligation as determined by such laws and agreements for termination indemnities.

The expense recorded for termination indemnities for the years ended December 31, 1998, 1997 and 1996 was 8,582, 8,094 and 6,918, respectively.

The number of workers employed by the Group totalled 3,363 and 3,465 at December 31, 1998 and 1997, respectively.

l *Sales of goods*

A sale is recorded when title passes to the customer, which is at the time of shipment.

m *Advertising costs*

Advertising costs are expensed in the periods incurred. Advertising expenses recorded for the years ended December 31, 1998, 1997 and 1996 were 22,918, 17,956 and 15,087, respectively.

n *Commission expense*

Commissions payable to sales representatives and the related expenses are recorded at the time shipments are made by the Group to customers. Commission expense is not paid until payment for the related sale is remitted to the Group by the customer.

o *Contingencies*

Liabilities for loss contingencies are recorded when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated.

p *Use of estimates*

The preparation of financial statements in conformity with established accounting policies 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 reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

q *Earnings per share*

Basic earnings per share is calculated by dividing net earnings attributable to ordinary shareholders by the weighted-average number of ordinary shares outstanding during the period. Diluted earnings per share include the effects of possible issuance of ordinary shares under share options in the determination of the weighted-average number of ordinary share outstanding during the period. The following table provides the amounts used in the calculation of earnings per share:

	1998	1997	1996
Net earnings attributable to ordinary shareholders	**139,299**	**104,174**	**117,440**
Weighted-average number of ordinary shares outstanding during the year	57,223,018	56,878,800	56,664,508
Increase resulting from assumed conversion of share options	29,834	458,711	443,920
Weighted-average number of ordinary shares and potential shares outstanding during the year	**57,252,852**	**57,337,511**	**57,108,428**

4 Cash and cash equivalents

Cash and cash equivalents are composed of the following items:

	1998	1997
Cash on hand	45	48
Time deposits in Italian lire	65,135	120,132
Bank accounts in Italian lire	149,971	91,320
Bank accounts in foreign currency	58,060	27,871
Total	**273,211**	**239,371**

Time deposits have various maturities extending through April 30, 1999.

5 Marketable debt securities

Details regarding marketable debt securities are as follows:

	1998	1997
Foreign corporate bonds	10,351	11
Foreign government bonds	6,639	-
Italian government bonds	38	4,867
Total	**17,028**	**4,878**
Valuation allowance for gross unrealized losses	-	(76)
Net book value	**17,028**	**4,802**

Further information regarding the Group's investments in marketable debt securities is as follows:

1998	Cost	Gross unrealized Gains	Gross unrealized Losses	Fair value
Foreign corporate bonds	10,351	662	-	11,013
Foreign government bonds	6,639	100	-	6,739
Italian government bonds	38	-	-	38
Total	**17,028**	**762**	**-**	**17,790**

1997	Cost	Gross unrealized Gains	Gross unrealized Losses	Fair value
Foreign corporate bonds	11	-	-	11
Italian government bonds	4,867	54	(76)	4,845
Total	**4,878**	**54**	**(76)**	**4,856**

	1998	1997	1996
Proceeds from sales	1,757	70,585	8,866
Realized gains	363	2,252	66
Realized losses	(114)	(408)	-

The contractual maturity of the Group's marketable debt securities at December 31, 1998 is as follows:

	Cost	Fair value
1 - 5 years	48	48
5 - 10 years	16,980	17,742
Total	**17,028**	**17,790**

At December 31, 1998 and 1997, securities held by banks as collateral for loans amounted to nil and 600, respectively.

6 Trade receivables, net

Trade receivables are analyzed as follows:

	1998	1997
North American customers	80,411	58,951
Other foreign customers	70,366	78,733
Domestic customers	54,100	50,024
Trade bills receivable	4,061	5,028
Total	208,938	192,736
Allowance for doubtful accounts	(10,315)	(8,354)
Total trade receivables, net	**198,623**	**184,382**

Trade receivables are due primarily from major retailers selling directly to customers.

No account receivable from any customer at December 31, 1998 and 1997 exceeded 10,000. The Company estimates an allowance for doubtful accounts based on the credit worthiness of its customers as well as general economic conditions. Consequently, an adverse change in those factors could effect the Company's estimate of its bad debts.

The following table provides the movements in the allowance for doubtful accounts:

	1998	1997	1996
Balance, beginning of year	8,354	8,516	6,254
Charges-bad debt expense	4,278	1,634	3,266
Reductions-write off of uncollectible accounts	(2,317)	(1,796)	(1,004)
Balance, end of year	**10,315**	**8,354**	**8,516**

Trade receivables denominated in foreign currencies at December 31, 1998 and 1997 and, where applicable, translated at the rate of the related domestic currency swaps, totalled 134,904 (131,745 translated at year-end exchange rates) and 116,259 (118,038 translated at year-end exchange rates), respectively. These receivables consist of the following:

	1998	1997
U.S. dollars	79,744	60,650
German marks	13,953	9,673
Australian dollars	8,252	11,177
British pounds	6,777	5,737
French francs	6,014	7,146
Canadian dollars	3,114	3,025
Belgian francs	2,899	3,838
Spanish pesetas	2,859	2,976
Dutch guilders	2,344	3,020
Other currencies	8,948	9,017
Total	**134,904**	**116,259**

7 Other receivables

Other receivables are analyzed as follows:

	1998	1997
VAT	44,551	40,721
Securities bought under agreements to resell	10,357	6,795
Government grants	6,459	6,623
Advances to suppliers	4,327	4,021
Receivable from tax authorities	4,426	3,107
Other	3,662	3,591
Total	**73,782**	**64,858**

The VAT receivable includes value added taxes and interest thereon reimbursable to various companies of the Group. While currently due at the balance sheet date, the collection of the VAT receivable may generally extend over a maximum period of up to two years.

The receivable from tax authorities represents taxes paid in excess of the amounts due in Italy and interest thereon.

8 Inventories

Inventories are analyzed as follows:

	1998	1997
Leather	42,631	54,303
Other raw materials	28,656	21,062
Goods in process	18,747	20,867
Finished products	16,512	18,492
Total	**106,546**	**114,724**

9 Property, plant and equipment and accumulated depreciation

Fixed assets are listed below together with accumulated depreciation.

1998	Cost or valuation	Accumulated depreciation	Annual rate of depreciation
Land	9,131	-	-
Industrial buildings	147,371	18,523	3 - 10%
Machinery and equipment	89,221	41,472	11.5 - 25%
Office furniture and equipment	20,496	14,000	12 - 20%
Transportation equipment	5,237	3,868	20 - 25%
Leasehold improvements	2,211	1,748	10 - 20%
Advances to suppliers	412	-	-
Total	**274,079**	**79,611**	

1997	Cost or valuation	Accumulated depreciation	Annual rate of depreciation
Land	7,682	-	-
Industrial buildings	104,743	14,505	3 - 10%
Machinery and equipment	89,898	36,835	11.5 - 25%
Office furniture and equipment	19,490	12,774	12 - 20%
Transportation equipment	5,437	3,747	20 - 25%
Leasehold improvements	3,746	2,603	10 - 20%
Construction in progress	26,627	-	-
Advances to suppliers	1,096	-	-
Total	**258,719**	**70,464**	

10 Other assets

Other assets consist of the following:

	1998	1997
Trademarks and patents	24,529	24,509
Goodwill	4,864	5,224
Others	7,740	6,624
Total, gross	37,133	36,357
Less accumulated amortization	(32,376)	(25,445)
Total, net	**4,757**	**10,912**

11 Short-term borrowings

Short-term borrowings consist of the following:

	1998	1997
Bank overdrafts	736	921
Export financing	3,154	875
Total	**3,890**	**1,796**

The weighted average interest rates on the above-listed short-term borrowings are as follows:

	1998	1997
Bank overdrafts	4.0%	9.5%
Export financing	10.8%	5.6%

Credit facilities available to the Group, including amounts guaranteed under surety bonds, amounted to approximately 157,000 and 133,100 at December 31, 1998 and 1997, respectively. The unused portion of these facilities amounted to approximately 137,000 and 112,300 at December 31, 1998 and 1997, respectively.

12 Accounts payable-trade

Accounts payable-trade totalling 110,173 and 108,487 at December 31, 1998 and 1997, respectively, represents principally amounts payable for purchases of goods and services in Italy and abroad, including invoices to be received at year end, and includes 24,296 and 27,388 at December 31, 1998 and 1997, respectively, denominated in foreign currencies.

13 Accounts payable-other

Accounts payable-other is analyzed as follows:

	1998	1997
Withholding taxes on dividends distributed	8,059	1,114
Withholding taxes on payroll	5,857	4,752
Withholding taxes other	105	156
Cooperative advertising and quantity premium	5,393	4,182
Provision for returns and discounts	4,549	3,261
Payable to customers for returns and financial discounts	2,224	2,304
Other	574	807
Total	**26,761**	**16,576**

14 Taxes on income

Italian companies are subject to two income taxes:

	1998	1997	1996
IRPEG (state tax)	37.00%	37.00%	37.00%
ILOR (regional tax)	-	16.20%	16.20%
IRAP (regional tax)	4.25%	-	-

During December 1997, the Italian Government approved two legislative decrees which introduced two new income tax schemes, one denominated the 'IRAP' and the other the 'Dual Income Tax'. The general guidelines regulating the new taxes are the following:

(a) for fiscal years beginning on or after January 1, 1998 IRAP replaced ILOR, net equity tax and other minor taxes. For 1998 and 1999 fiscal years the tax rate is 4.25%. Thereafter, each Italian Region will have the power to increase the rate by a maximum of 1%. In general, the taxable base is a form of gross profit determined as the difference between gross revenues (excluding interest and dividend income) and direct production costs (excluding labor costs, interest expenses and other financial costs); and, (b) for fiscal years beginning on or after January 1, 1997 the IRPEG was modified to introduce a dual income tax for the purpose of encouraging companies to use equity rather than debt finance. A first portion of the taxpayer's taxable income is calculated by applying an interest rate percentage (based on the return on government and private sector bonds) to the net increase in shareholders' equity of such taxpayer, subject to certain restrictions. This portion is subject to IRPEG at the reduced rate of 19%. The remaining profit will be subject to tax at the ordinary IRPEG tax rate (at present 37%). The combined application of IRPEG and the dual income tax cannot generate an overall tax charge lower than 27%. The application of the provisions of the modified IRPEG had no significant effect on the Group's income taxes for 1998 and 1997.

Furthermore, on December 18, 1997, the Italian Government approved a legislative decree that effectively eliminated income taxes imposed on the remittance of dividends to a parent company. The legislative decree is effective for fiscal years beginning after December 31, 1997.

Under Italian investment incentive schemes for under-industrialized regions, certain of the Group's operating entities are currently entitled to enjoy a full exemption from IRPEG and a significant part of IRAP (full exemption for ILOR for 1997 and 1996) for ten years. A very substantial portion of the Group's earnings in 1998, 1997 and 1996 is derived from companies entitled to some extent to the aforementioned exemptions, the most significant of which presently are not due to expire until 2002. See the table below for the effect of such exemptions on the Group's 1998, 1997 and 1996 income tax charge.

During 1997 and 1996, domestic subsidiaries of the Company distributed previously unremitted earnings to the parent company in the form of a dividend generating taxable income.

Approximately 95.2%, 97.2% and 99.6% respectively, of the Group's earnings before taxes were generated by its domestic Italian operations during 1998, 1997 and 1996.

The effective income tax rates for the years ended December 31, 1998, 1997 and 1996 were 24.9%, 29.7% and 19.3%, respectively. The actual income tax expense differs from the 'expected' income tax expense (computed by applying the state tax of 37% in 1998 and 53.2% in 1997 and 1996 to income before income taxes and minority interest) as follows:

	1998	1997	1996
Expected income tax charge at full tax rates	68,739	79,004	78,489
Effects of:			
• Tax exempt income	(32,613)	(38,658)	(54,594)
• Aggregate effect of different tax rates in foreign jurisdictions	(2,295)	(823)	(208)
• Tax effect of unremitted earnings of domestic subsidiaries	-	433	944
• Effect of net change in valuation allowance established against deferred tax assets	878	(2,774)	2,058
• Tax effect of change in tax rates on deferred taxes	-	3,427	-
• Non-deductible expenses and others	2,803	3,539	1,850
• Regional tax	8,823	-	-
Actual tax charge	**46,335**	**44,148**	**28,539**

Total taxes for the years ended December 31, 1998, 1997 and 1996 were allocated as follows:

	1998	1997	1996
Earnings from operations	46,335	44,148	28,539
Shareholders' equity, for deferred taxes on government grants (excluding minority interest)	-	5,283	-
	46,335	**49,431**	**28,539**

Income taxes on earnings, which primarily relate to Italian operations, are further analyzed as follows:

	1998	1997	1996
Current taxes	47,485	48,269	29,044
Deferred taxes	(1,150)	(4,121)	(505)
Total	**46,335**	**44,148**	**28,539**

Total current taxes for the years ended December 31, 1998, 1997 and 1996 were allocated as follows:

	1998	1997	1996
Italian State tax	37,697	32,841	20,778
Italian Regional tax	8,823	14,067	7,692
Tax of foreign subsidiaries	965	1,361	574
Total	**47,485**	**48,269**	**29,044**

Tax years for Italian companies are open from 1992 and subject to review pursuant to Italian tax laws.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 1998 and 1997 are presented below:

	1998	1997
Deferred tax assets:		
• Allowance for doubtful accounts	3,544	2,829
• Intercompany profit in assets	1,703	1,824
• Provision for returns and discounts	1,684	1,206
• Provision for termination indemnities of sales representatives	1,177	896
• Trademarks	1,031	151
• Tax loss carryforwards	1,056	920
• Provision for contingencies	370	370
• Unrealized foreign exchange losses	5	1,053
• Other temporary differences	444	624
Total gross deferred tax assets	11,014	9,873
• Less valuation allowance	(4,556)	(3,678)
Net deferred tax assets	6,458	6,195
Deferred tax liabilities:		
• Government grants related to capital expenditures	(3,860)	(4,886)
• Other temporary differences	(139)	-
Total deferred tax liabilities	(3,999)	(4,886)
Net deferred tax assets	**2,459**	**1,309**

A valuation allowance has been established principally for the allowance for doubtful accounts, provision for termination indemnities of sales representatives and for contingencies of certain subsidiaries.

The valuation allowance for deferred tax assets as of December 31, 1998 and 1997 was 4,556 and 3,678 respectively. The net change in the total valuation allowance for the years ended December 31, 1998 and 1997 was an increase of 878 and a decrease of 2,774, respectively. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and the tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods during which the deferred tax assets are deductible, management believes it is more likely than not that the Company will realize the benefits of these deductible differences, net of the existing valuation allowances at December 31, 1998. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.

Net deferred income tax assets is included in the consolidated balance sheets as follows:

1998	Current	Non current	Total
Gross deferred tax assets	8,174	2,840	11,014
Valuation allowance	(3,009)	(1,547)	(4,556)
Net deferred tax assets	5,165	1,293	6,458
Deferred tax liabilities	(1,094)	(2,905)	(3,999)
Net deferred tax assets (liabilities)	4,071	(1,612)	2,459

1997	Current	Non current	Total
Gross deferred tax assets	6,976	2,897	9,873
Valuation allowance	(2,412)	(1,266)	(3,678)
Net deferred tax assets	4,564	1,631	6,195
Deferred tax liabilities	(1,081)	(3,805)	(4,886)
Net deferred tax assets (liabilities)	3,483	(2,174)	1,309

The tax loss carryforwards of the Group total 2,853 and expire as follows:

2002	1,674
2003	1,179
Total	**2,853**

Losses may be carried forward for five years from the year of declaration for offset against IRPEG taxes only.

15 Salaries, wages and related liabilities

Salaries, wages and related liabilities are analyzed as follows:

	1998	1997
Salaries and wages	7,992	7,691
Social contribution	6,659	7,064
Vacation accrual	1,915	2,190
Total	**16,566**	**16,945**

16 Long-term debt

Long-term debt is repayable in semi-annual installments with 1,684, 1,197, 645, 312 and 161 maturing in the years ended December 31, 1999, 2000, 2001, 2002 and 2003, respectively. Interest rates on long-term debt ranged from 3.7% to 7.3% at December 31, 1998 (3.7% to 14.5% in 1997). All long-term debt is secured by mortgages on the Group's properties for a total of 22,000.

17 Minority interest

Minority interest shown in the accompanying consolidated balance sheet at December 31, 1998 of 1,398 (1,349 at December 31, 1997) includes 101 pertaining to the majority shareholders of the Group (103 at December 31, 1997).

18 Shareholders' equity

Share capital through October 28, 1996 was composed of 28,439,400 ordinary shares of par value Lit. 250 each, fully paid. On such date the Company's shareholders' at an Extraordinary General Meeting approved a two-for-one stock split of the Ordinary Shares. As a result of the stock split, the capital stock was increased to 56,878,800 ordinary shares of par value Lit. 125 each, fully paid. Accordingly, all share information in these consolidated financial statements has been adjusted to reflect this stock split.

In February 1994 the Board of Directors of the Company adopted an employee stock option plan (the "Plan") pursuant to which managers and certain key employees of the Group may be granted options to purchase an aggregate of up to 1,680,000 ordinary shares from the Company at an exercise price per share equal to 95% of the May 1993 initial public offering price, or 10,637.5 per share. Employees receiving options may exercise such options over four years during exercise periods from May 15 to May 31, as follows: (i) with respect to 25% of the options, in the year in which they were granted; (ii) with respect to 35% of the options, in the second year thereafter; and (iii) with respect to the remaining 40% of the options, in the fourth year thereafter. Following each exercise period, the Company must seek shareholder approval to increase its capital and comply with certain requirements of Italian law, after which the ordinary shares may be delivered.

A summary of the status of the Plan as of December 31, 1998, 1997 and 1996, and changes during the years ended on those dates is presented below:

	1998	
	Shares	**Exercise price**
Outstanding at the beginning of the year	620,000	10,637.5
Granted	19,240	10,637.5
Exercised	(590,088)	10,637.5
Forfeited	(8,752)	10,637.5
Outstanding at the end of the year	**40,400**	**10,637.5**
Options exercisable at year-end	-	
Weighted-average remaining contractual life	1.42 years	

1997

	Shares	Exercise price
Outstanding at the beginning of the year	620,000	10,637.5
Granted	-	-
Exercised	-	-
Forfeited	-	-
Outstanding at the end of the year	**620,000**	**10,637.5**
Options exercisable at year-end	-	
Weighted-average remaining contractual life	0.55 years	

1996

	Shares	Exercise price
Outstanding at the beginning of the year	1,093,500	10,637.5
Granted	168,800	10,637.5
Exercised	(514,300)	10,637.5
Forfeited	(128,000)	10,637.5
Outstanding at the end of the year	**620,000**	**10,637.5**
Options exercisable at year-end	-	
Weighted-average remaining contractual life	1.55 years	

The 590,088 Ordinary Shares with respect to which options were exercised in 1998 included 534,448 and 36,400 Ordinary Shares in respect of options granted to employees in 1994 and 1996, respectively, as well as 19,240 Ordinary Shares in respect of options received as a one-time bonus in 1998.

The share capital is owned as follows:

	1998	1997
Mr. Pasquale Natuzzi	45.4%	45.8%
Miss Anna Maria Natuzzi	2.4%	2.5%
Mrs. Annunziata Natuzzi	2.4%	2.5%
Public investors	49.8%	49.2%
	100.0%	**100.0%**

An analysis of the reserves follows:

	1998	1997
Legal reserve	2,151	2,151
Monetary revaluation reserve	2,065	2,065
Grants	58,025	58,025
Total	**62,241**	**62,241**

These reserves are all distributable except for the legal reserve which may be utilized to cover losses. Italian law requires that 5% of net income of the parent company and each of its consolidated subsidiaries be retained as a legal reserve until this reserve is equal to one-fifth of the issued capital stock of each relevant company. The combined legal reserves totalled 7,014 and 6,415 at December 31, 1998 and 1997, respectively.

As of December 31, 1998 taxes that would be due on distribution of the portion of shareholders' equity equal to capital grant reserves and unremitted earnings of foreign subsidiaries would approximate 7,000. The Group has not provided for such taxes as the likelihood of distribution is remote and such reserves and earnings are deemed to be permanently reinvested.

The cumulative translation adjustment included in shareholders' equity related to translation of the Group's foreign assets and liabilities at December 31, 1998 and 1997 was a credit of 172 and 3,032, respectively.

19 Commitments and contingent liabilities

Purchase commitments for raw materials at December 31, 1998 and 1997 amounted approximately to 14,000 and 34,000, respectively.

Several companies of the Group lease manufacturing facilities under non-cancellable lease agreements with expiration dates through 2006. Rental expense recorded for the years ended December 31, 1998, 1997 and 1996 was 1,984, 2,688 and 2,433, respectively. As of December 31, 1998, minimum annual rental commitments are as follows:

1999	1,492
2000	1,074
2001	827
2002	675
2003	350
Thereafter	192
Total	**4,610**

A bank has provided guarantees at December 31, 1998 to secure the payments to several suppliers of leather hides amounting to 13,871 (15,386 at December 31, 1997). These guarantees are unsecured and have various maturities extending through June, 30 1999.

VAT reimbursed by tax authorities during 1998 and in prior years is secured by surety bonds for 78,572 (135,662 at December 31, 1997) from certain financial institutions. These surety bonds are unsecured and will expire after a maximum period of up to two years or when the tax authorities perform the final review of VAT claim requests.

In December, 1996, the Company and the 'Contract Planning Service' of the Italian Ministry of the Budget signed a 'Program Agreement' with respect to the 'Natuzzi 2000 project'. In connection with this project, the Natuzzi Group has planned a multi-faceted program of industrial investments for the production of upholstered furniture. Investments are projected to total approximately 571,500. According to the agreement, the Italian government will contribute 281,600. Receipt of the Italian government funds is based upon, among other things, the Group constructing facilities in accordance with certain specifications and maintaining a minimum number of employees.

During 1997 the Group received under the aforementioned project capital grants for 52,549. Capital expenditures under the Natuzzi 2000 project amounted to approximately 121,000 at December 31, 1998 (113,000 at December 31, 1997). The capital grants are secured by surety bonds for 50,423 from a bank. These surety bonds are unsecured and will expire when the Italian Ministry of Budget releases the final approvals of all investments made.

During 1998, the Italian tax authorities conducted a routine audit of the corporate income tax returns and VAT declarations for the years ended December 31, 1992 - 1996 by a subsidiary enjoying full exemption from IRPEG and ILOR for the aforementioned years. As a result of the audit, the tax authorities have concluded that a portion of the taxable income generated by this subsidiary did not meet the fiscal law requirements to enjoy exemption from ILOR and assessed taxes in the amount of 23,000 (excluding penalties and interests estimated to be approximately 14,000).

The Italian tax authorities are currently auditing the corporate income tax returns and VAT declarations filed by the Company for the years ended December 31, 1996 and 1997.

The Group is also involved in a number of claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters, after considering amounts accrued, will not have a material adverse effect on the Group's consolidated financial position or results of operations.

20 Segmental and geographical information

The Group operates in a single industry segment, that is, the design, manufacture and marketing of contemporary and traditional leather and fabric upholstered furniture. It offers a wide range of upholstered furniture for sale, manufactured in production facilities located in Italy. The Group's products fall into five broad categories: stationary furniture, sectional furniture, motion furniture, sofa beds and lounge chairs. Sales information by products is not available.

The Group also sells to a minor extent polyurethane foam and leather by-products.

The following tables provide information about net sales of upholstered furniture and of long-lived assets by geographical location. Net sales are attributed to countries based on the location of customers. Long-lived assets consist of property, plant and equipment.

Sales of upholstered furniture	1998	1997	1996
United States	437,930	428,462	309,418
Italy	94,796	75,570	61,135
Germany	75,356	55,984	52,277
England	55,777	56,357	47,079
The Netherlands	41,632	42,106	35,862
Belgium	39,288	39,704	35,170
France	24,329	35,534	48,219
Other countries (none greater than 5%)	226,022	243,742	193,357
	995,130	**977,459**	**782,517**

Long lived assets

	1998	1997
Italy	152,625	160,293
United States	41,843	27,962
	194,468	**188,255**

No single customer accounted for more than 5% of net sales in 1998, 1997 or 1996.

21 Cost of sales

Cost of sales is analyzed as follows:

	1998	1997	1996
Opening inventories	114,724	90,450	81,806
Purchases	453,415	506,666	395,568
Labor	141,621	135,944	108,662
Third party manufacturers	53,184	62,695	53,891
Other manufacturing costs	35,426	35,204	27,315
Closing inventories	(106,546)	(114,724)	(90,450)
Total	**691,824**	**716,235**	**576,792**

22 Other income, net

Other income, net is analyzed as follows:

	1998	1997	1996
Interest income	14,041	13,358	15,279
Interest expense and bank commissions	(1,961)	(2,060)	(2,528)
Interest income, net	12,080	11,298	12,751
Gains (losses) on foreign exchange, net	4,445	(1,201)	30,895
Provision for unrealized exchange losses on domestic currency swaps	(218)	(2,184)	-
Gains (losses) on foreign exchange	4,227	(3,385)	30,895
Gains (losses), net on securities	249	1,844	(39)
Unrealized gains (losses) on securities	-	(37)	369
Gains on securities	249	1,807	330
Other net	4,254	2,598	3,154
Total	**20,810**	**12,318**	**47,130**

23 Financial instruments and risk management

A significant portion of the Group's net sales, but only approximately 30% of its costs, are denominated in currencies other than the lira, in particular the U.S. dollar. The remaining costs of the Group are denominated principally in lire. Consequently, a significant portion of the Group's net revenues are exposed to fluctuations in the exchange rates between the lira and such other currencies. The Group uses forward exchange contracts (known in Italy as domestic currency swaps) to reduce its exposure to the risks of short-term declines in the value of its foreign currency-denominated revenues. The Group uses such domestic currency swaps to protect the value of its foreign-currency denominated revenues, and not for speculative or trading purposes.

The Group is exposed to credit risk in the event that the counter-parties to the domestic currency swaps fail to perform according to the terms of the contracts. The contract amounts of the domestic currency swaps described below do not represent amounts exchanged by the parties and, thus, are not a measure of the exposure of the Group through its use of those financial instruments. The amounts exchanged are calculated on the basis of the contract amounts and the terms of the financial instruments, which relate primarily to exchange rates. The immediate credit risk of the Group's domestic currency swaps is represented by the unrealized gains on the contracts. Management of the Group enters into contracts with creditworthy counter-parties and believes that the risk of material loss from such credit risk to be remote. The table below summarizes in Italian lire equivalent the contractual amounts of forward exchange contracts used to hedge principally future cash flows from accounts receivable and sales orders at December 31, 1998 and 1997:

Sales	1998	1997
U.S. dollars	277,562	253,971
British pounds	35,516	33,919
German marks	22,253	32,351
French francs	7,442	27,333
Canadian dollars	14,325	22,442
Belgian francs	7,714	20,694
Dutch guilders	7,523	17,552
Australian dollars	26,217	15,209
Japanese yen	8,364	14,844
Swiss francs	5,534	7,566
Total	**412,450**	**445,881**

At December 31, 1998, these forward exchange contracts had a net unrealized gain of 15,406, of which 3,386, related to and was included as an increase in accounts receivable (3,159 in trade receivables and 227 in other receivables), 4,601 has not been recorded as it relates to existing sales commitments, 7,637 has been deferred as it did not relate to existing commitments at year-end and 218 has been accrued as a provision for unrealized foreign exchange losses in the balance sheet and charged to other income, net in the statement of earnings as it did not relate to existing commitments at year end.

At December 31, 1997, the forward exchange contracts had a net unrealized loss of 4,604, of which 1,779 related to and was included as a reduction in accounts receivable, 803 had not been recorded as it related to existing sales commitments and 2,184 had been accrued as a provision for unrealized foreign exchange losses in the balance sheet and charged to other income, net in the statement of earnings, as it did not relate to existing commitments at year-end.

The following table presents information regarding the contract amount in Italian lire equivalent amounts and the estimated fair value of all of the Group's forward exchange contracts. Contracts with unrealized gains are presented as ‘assets’ and contracts with unrealized losses are presented as ‘liabilities’.

	1998		1997	
	Contract amount	**Fair value**	**Contract amount**	**Fair value**
Assets	348,393	17,366	161,186	5,141
Liabilities	64,057	(1,960)	284,695	(9,745)
	412,450	**15,406**	**445,881**	**(4,604)**

The following table summarizes the carrying value and the estimated fair value of the Group's other financial instruments:

	1998		1997	
	Carrying value	**Fair value**	**Carrying value**	**Fair value**
Assets:				
• Marketable securities	17,028	17,790	4,802	4,856
Liabilities:				
• Long-term debt	3,999	3,885	7,190	6,779

Cash and cash equivalents, receivables, payables and short-term borrowings approximate fair value because of the short maturity of these instruments.

Market value for quoted marketable debt securities is represented by the securities exchange prices at year-end. Market value for unquoted securities is represented by the prices of comparable securities, taking into consideration interest rates, duration and credit standing of the issuer.

Fair value of the long-term debt is estimated based on cash flows discounted using current rates available to the Company for borrowings with similar maturities.

The carrying value of forward exchange contracts is determined based on the unrealized loss and gain of such contracts recorded in the consolidated financial statements. Fair value of forward exchange contracts is determined by using exchange rates at year-end.

24 Application of generally accepted accounting principles in the United States of America

The established accounting policies followed in the preparation of the consolidated financial statements (Italian GAAP) vary in certain significant respects from those generally accepted in the United States of America (US GAAP).

Those differences which have had a material effect on net earnings and/or shareholders' equity are as follows:

(a) Certain property, plant and equipment has been revalued in accordance with Italian laws. The revalued amounts are depreciated for Italian GAAP purposes. US GAAP does not allow for such revaluations, and depreciation is based on historical costs. The revaluation primarily relates to industrial buildings.

(b) In the application of US GAAP, the Group has classified its investment portfolio as securities available for sale, which are those securities that may be sold prior to maturity as part of asset and liability management or in response to other factors but are not trading securities. Such securities are carried at fair value, and any changes in fair value are recorded in a separate component of shareholders' equity, net of applicable deferred taxes. Under Italian GAAP, all current asset investments are stated at the lower of cost or market value on an individual security basis.

(c) The Group generally recognizes net unrealized foreign exchange losses but defers net unrealized foreign exchange gains until realized. In connection with its hedging activities employing forward exchange contracts, net unrealized foreign exchange gains and losses are deferred as they relate to future sales for which commitments are received at the balance sheet date. The Company defines such commitments for Italian GAAP purposes as sales orders on hand and customers' indications of future purchases as of the balance sheet date which are confirmed by sales orders within a designated time period. Unrealized gains and losses on forward exchange contracts not designated to cover accounts receivable or future sales commitments are generally deferred in the case of net unrealized gains and recognized in earnings when resulting in a net unrealized losses. See notes 3 (a) and (i) for the Group's accounting policy.

Under US GAAP, generally both unrealized foreign exchange gains and losses from foreign currency transactions are recognized in the statement of earnings unless prescriptive hedging criteria are met. The Company's accounting policy for US GAAP purposes is that unrealized gains and losses on forward exchange contracts are deferred only for such contracts designated to cover firmly committed transactions supported by sales orders on hand. Accordingly, under US GAAP, unrealized gains and losses on forward exchange contracts designated to cover anticipated future sales which are not supported by sales orders on hand as of the balance sheet date are credited or charged to the statement of earnings.

(d) Government grants related to capital expenditures are recorded, net of tax, within reserves in shareholders' equity. For US GAAP purposes, such grants would be classified as a reduction of the cost of the related fixed asset or as a deferred credit and amortized to income over the estimated useful lives of the assets. The adjustments to net income represent the annual amortization of the capital grants based on the estimated useful life of the related fixed assets. The adjustments to shareholders' equity are to reverse the amounts of capital grants credited directly to equity for Italian GAAP purposes, net of the amounts of amortization of such grants for US GAAP purposes. In 1995 and 1997, the Group received certain grants relating to fixed assets acquired between 1989 and 1997 with various useful lives. For US GAAP purposes, the Group is amortizing such grants over the remaining useful lives of the assets to which the grants relate.

(e) The Company does not record the compensation cost resulting from the granting of share options. For US GAAP purposes, this intrinsic value (resulting from the excess of the market price of the underlyng shares at the date of grant over the excercise price) is being recognized as compensation cost in the consolidated statement of earnings over the vesting period of the options. For US GAAP purposes, in 1998, 1997 and 1996 the Company recorded a charge of 1,322, 2,444 and 4,018, respectively, while the remaining unrecognized compensation of 434 will be charged in declining amounts annually through 2000.

(f) Included in cash equivalents in 1998 is a deposit of 25,000 with an original maturity of six months. Under US GAAP, this deposit would be classified as a short-term investment and the purchase of this investment would be included within investing activities for purposes of the consolidated statement of cash flows. Subsequent sale on maturity of this deposit would also be classified within investing activities under US GAAP.

The calculation of net earnings and shareholders' equity substantially in conformity with US GAAP is as follows:

Reconciliation of net earnings:

	1998	1997	1996
Net earnings under Italian GAAP	139,299	104,174	117,440
Adjustments to reported income:			
(a) Revaluation of property, plant and equipment	77	85	83
(b) Marketable debt securities	(76)	(477)	(574)
(c) Unrealized gains (losses) on foreign exchange	8,398	(7,213)	(2,032)
(d) Government grants	3,782	5,103	1,190
(e) Employee share option compensation	(1,322)	(2,444)	(4,018)
Effect of minority interests on US GAAP adjustments	(2)	(2)	128
Tax effect of US GAAP adjustments	(3,776)	2,872	900
Approximate net earnings in conformity with US GAAP	**146,380**	**102,098**	**113,117**
Basic earnings per share in conformity with US GAAP	**2,558**	**1,795**	**1,996**
Diluted earnings per share in conformity with US GAAP	**2,557**	**1,781**	**1,981**

Reconciliation of shareholders' equity:

	1998	1997
Shareholders' equity under Italian GAAP	657,128	605,418
(a) Revaluation of property, plant and equipment	(862)	(939)
(b) Marketable debt securities	762	54
(c) Unrealized gains (losses) on foreign exchange	8,282	(116)
(d) Government grants	(48,529)	(52,311)
Effect of minority interests on US GAAP adjustments	8	10
Tax effect of US GAAP adjustments	1,134	4,994
Approximate shareholders' equity in conformity with US GAAP	**617,923**	**557,110**

Accounting for Stock-Based Compensation

The Company has elected to continue to apply the provisions of Accounting Principles Board ('APB') Opinion No. 25, Accounting for Stock Issued to Employees, and provide the pro forma disclosure provisions of SFAS No. 123, Accounting for Stock-Based Compensation. The weighted-average fair value of each option granted by the Company during 1996 was estimated on the grant date at 62,500 using the Black-Scholes option pricing model with the following weighted-average assumptions: dividend yield of 0.6%; expected volatility of 25%; risk-free interest rate of 7.29%; and expected lives of 2.55 years. The weighted average fair value of options granted in 1998 was not material. Had compensation cost for the Company's Plan, for US GAAP purposes, been determined consistent with SFAS No. 123, the Company's US GAAP net earnings and earnings per share for the years ended December 31, 1998, 1997 and 1996 would approximate the actual amounts presented in the reconciliation.

Comprehensive Income

The Company has adopted SFAS No. 130, Reporting Comprehensive Income, which established standards for the reporting and presentation of comprehensive income and its components in a full set of financial statements. Comprehensive income/(loss) generally encompasses all changes in shareholders' equity (except those arising from transactions with owners). The Company's comprehensive income differs from net income only by the amount of the exchange differences on translation of financial statements charged to shareholders' equity for the period. Comprehensive income and accumulated other

Comprehensive income for the years ended December 31, 1998, 1997 and 1996 were as follows:

	Comprehensive income	Accumulated other comprehensive income
Balance at December 31, 1995		**676**
Comprehensive income		
Net income	117,440	
Exchange difference on translation of financial statements	(195)	(195)
Total comprehensive income	**117,245**	
Balance at December 31, 1996		**481**
Comprehensive income		
Net income	104,174	
Exchange difference on translation of financial statements	2,551	2,551
Total comprehensive income	**106,725**	
Balance at December 31, 1997		**3,032**
Comprehensive income		
Net income	139,299	
Exchange difference on translation of financial statements	(2,860)	(2,860)
Total comprehensive income	**136,439**	
Balance at December 31, 1998		**172**

SFAS No. 131, Disclosure about Segment of an Enterprise and Related Information was issued in June 1997 and is effective for fiscal years beginning after December 15, 1997. In the initial year of application comparative information for earlier years is to be restated. It requires that companies disclose segment data based on how management makes decisions about allocating resources to segments and measuring their performance. It also requires entity-wide disclosures about the products and services an entity provides and about the material countries in which it holds assets and reports revenues. The Group adopted the provision of SFAS 131 in 1997 and restated prior year disclosure.

Accounting Standards Issued not yet adopted

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133 ('SFAS 133'), 'Accounting for Derivative Instruments and Hedging Activities'. This statement establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. This statement is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. Management has not determined the effect of the adoption of SFAS 133.

During January 1998, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position 98-1 Accounting for the Costs of Computer Software Developed or Obtained for Internal Use ('SOP 98-1') which becomes effective for all fiscal years beginning after December 15, 1998. Under SOP 98-1, computer software costs that are incurred in the preliminary project stage are expensed as incurred. Once specific capitalization criteria have been met, external direct costs of materials and services consumed in developing or obtaining internal-use computer software, certain personnel costs, and interest costs incurred when developing computer software for internal use are capitalized. Training costs and data conversion costs are generally expensed as incurred. Such capitalized costs are amortized over the estimated useful life of the software. The Company is evaluating the effect of the pronouncement.

The AICPA issued Statement of Position 98-5, Reporting on the Costs of Start-up Activities ('SOP 98-5') in April 1998 and is effective for fiscal periods beginning after December 15, 1998. SOP 98-5 provide guidance on the financial reporting of start-up costs and organization costs. It requires costs of start-up activities and organization costs to be expensed as incurred. The Company is evaluating the effect of the pronouncement.

25 Event (unaudited) subsequent to the date of the independent auditorsí report

On May 24, 1999 the tax office in charge of issuing the final notice of tax assessments for the subsidiary enjoying full exemption from IRPEG and ILOR for the years 1992-1996 (see note 19) raised further tax claims on the basis of restrictive interpretations of fiscal rules related to such tax exemption. Such further claims were not expected at the date of approval of the Consolidated Financial Statements as of December 31, 1998 and 1997 and could have resulted in a higher tax liability than that previously assessed (see note 19). As a consequence, the Company, based on the advice of its tax consultants, agreed to settle the claims raised by the tax authorities for all open matters with respect to fiscal years 1992-1996. As a result of such settlement, a net expense of 11,400 will be charged to the consolidated statement of earnings for the period ended March 31, 1999.

Board of Directors

Pasquale Natuzzi	Chairman of the Board of Directors
Giuseppe Desantis	Vice Chairman of the Board of Directors
Jeff Baron	Director
Stelio Campanale	Director
Giambattista Massaro	Director
Claudio Dematté	Outside Director
Pietro Gennaro	Outside Director
Pietro Lascaro	Outside Director
Cataldo Sferra	Outside Director
Enrico Vitali	Outside Director

Management

Pasquale Natuzzi	Chief Executive Officer
Giuseppe Desantis	Vice Chairman
Giambattista Massaro	General Purchasing and Logistics Manager
Jeff Baron	Director and President of Natuzzi Americas
Michele Bonerba	Human Resources Manager
Stelio Campanale	General Counsel
Vito Dagostino	Purchasing Manager
Gaetano De Cataldo	Executive Vice President for Natuzzi Americas
Gaetano Del Re	Production Engineering Manager
Michele D'Ercole	Manager of Leather and dyeing operations
Giuseppe Firrao	Communication Manager
Pietro Lascaro	Outside Director
Nicola Lassandro	Manager of Management Information Systems
Cesare Laberinti	Manager of Polyurethane Foam Operations
Stefano Lorizio	Production Manager
Dino Lorusso	Sales Manager for the Far East and Africa
Nicola Masotina	Sales Manager for Franchising in Italy
Bruno Mele	Product Manager for Europe
Tommaso Melodia	Corporate Affairs Manager
Giovanni Mercadante	Accounting Manager
Gianluca Monteleone	Marketing Manager
Anna Maria Natuzzi	Product Development Manager
Annunziata Natuzzi	Internal Relations Manager
Giuseppe Pellegrino	Sales Manager for Europe
Giuseppe Stano	Sales Administration Manager
Giovanni Trentadue	Quality Manager
Giuseppe Trevissoi	Logistics Manager
Emanuele Valente	Transportation Manager

Board of Internal Auditors

Francesco Venturelli - President
Ferdinando Canaletti
Giuseppe Russo Corvace

Independent Auditors

KPMG S.p.A.

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