

## **CORPORATE GOVERNANCE**

The company's *corporate governance* system is based on the central role of the board of directors in providing strategic guidance, complete transparency of operational decisions, both internal and in relation to the market, efficient and effective internal controls, and rigorous rules governing conflicts of interest. As already described in the customary annual reports – in a specific section to which reference can be made – such system is based upon an aggregate of codes, principles and procedures which form the interconnecting weave of the system itself. The above codes, principles and procedures are periodically reviewed and updated, where necessary, to effectively respond, on the one hand, to changes in the law and international *best practices* and, on the other, to changes in the operating practices.

This section of the six-month report presents the updates and the additions to the *corporate governance* system of the company during the first half of the current year. In particular, during the board meeting held on March 22, 2005 all the directors tendered their resignations as from the date of the shareholders' meeting called for April 28, 2005, one year before the normal termination of their appointments. This was done in order to immediately render applicable the mechanism of the so-called slates for the appointment of the members of the board of directors, introduced in the bylaws last year, and encourage – in line with international *best practices* – an evermore increasing participation of all the shareholders in the life of the company and in the decisions capable of determining the success of the company.

The ordinary shareholders' meeting held on April 28, 2005 therefore:

- established the period of the term of office of the entire board of directors in three years (and thus up to the approval of the financial statements ending December 31, 2007), fixing the total annual compensation of the board of directors in a maximum amount of Euros 1,200,000 pursuant to art. 2389, paragraph 1, of the Italian Civil Code;

- determined the number of the members of the board in twenty and proceeded to appoint the directors Marco Tronchetti Provera, Alberto Pirelli, Carlo Alessandro Puri Negri, Carlo Buora, Carlo Acutis, Gilberto Benetton, Carlo De Benedetti, Gabriele Galateri di Genola, Dino Piero Giarda, Berardino Libonati, Giulia Maria Ligresti, Massimo Moratti, Giovanni Perissinotto, Giampiero Pesenti, Carlo Secchi, Paolo Vagnone, Carlo Angelici, Franco Bruni, Mario Garraffo and Aldo Roveri.

Leopoldo Pirelli was confirmed as Honorary Chairman of the company.

As a result of the adoption of the slate system, the minority shareholders elected four directors, equal to one fifth of the total (two lists, in fact, were presented: one by participants in the Pirelli & C. S.p.A. shareholders' agreement and another by certain Investment Management Companies (SGR).

Qualifying as independent directors are: Carlo Acutis, Carlo De Benedetti, Dino Piero Giarda, Berardino Libonati, Giampiero Pesenti, Carlo Secchi, Carlo Angelici, Franco Bruni, Mario Garraffo and Aldo Roveri, or half of the new board of directors. At the end of the aforementioned shareholders' meeting, the board of directors met and confirmed Marco Tronchetti Provera as Chairman, Alberto Pirelli and Carlo Alessandro Puri Negri as Deputy Chairmen and Carlo Buora as Managing Director.

In the light of and consistent with the new corporate regulations pursuant to Legislative Decree No. 6/2003, the Chairman and Managing Director have been identically recognized as legal representative of the company, with the powers necessary to execute any act concerning the various aspects of the business. Moreover, the limits of power conferred – in line with those conferred in the previous mandate (see the annual report on Corporate Governance 2004) – have been qualified as internal limits for the relations between the delegating body and the delegated parties.

The Chairman has also been conferred the following functions of an organizational nature:

- relations with shareholders and disclosure to the same;
- coordination of the activities of the Managing Directors;
- the determination, in agreement with the Managing Directors, of the strategies regarding the general direction and the development policy of the company and the group, as well as extraordinary transactions, to be submitted to the board of directors;
- the proposals, in agreement with the Managing Directors, for the appointment of the members of the general management departments and, after discussing the matter with the Remuneration Committee, their compensation, to be submitted to the board of directors;
- the chairmanship of the management committees with strategic functions;
- communication to the market using every means, with right to delegate this to the Managing Directors.

The board of directors also appointed the new members of the Remuneration Committee, composed of Berardino Libonati (Chairman), Giampiero Pesenti and Aldo Roveri, and the Internal Control and Corporate Governance Committee, composed of Carlo Secchi (Chairman), Carlo Angelici and Franco Bruni.

The members of these committees are all independent directors.

The board of directors also appointed, under the Organizational Model 231 adopted by the company, the new Supervisory Panel – which will remain in office until the end of the term of office of the current board of directors – the members of which are Carlo Secchi, independent director and member of the Internal Control and Corporate Governance Committee, Paolo Francesco Lazzati, Chairman of the Board of Statutory Auditors, and Sergio Romiti, head of the Internal Audit Department of Pirelli & C. S.p.A. These members ensure that all the various professional areas that control corporate operations are represented on the Panel and at the same time fully ensure compliance with the character of autonomy required by the regulations.

The Supervisory Panel was attributed all the powers necessary to make certain that precise and efficient control is exercised over the functioning and observance of the organizational and management model adopted by the company.

### **Composition of the share capital**

The share capital of Pirelli & C. S.p.A., as of September 12, 2005, amounts to Euros 2,764,021,430.56, for a total of 5,315,425,828 shares of par value Euros 0.52 each, consisting of 5,180,661,399 ordinary shares and 134,764,429 non-convertible savings shares.

Share capital may be increased up to a maximum par value of Euros 2,819,827,565.88 through the issue of a maximum number of 107,319,491 ordinary shares as a result of:

- the possible exercise of 212,374,566 Pirelli & C. 2003-2006 warrants for ordinary shares issued pursuant to the resolution approved by the shareholders' meeting held May 7, 2003. For every four warrants exercised, the warrant holder may subscribe – at the price of Euros 0.52 (equal to par value) – one Pirelli & C. ordinary share. The share capital indicated above already takes into account the exercise of 1,349,480,760 warrants;
- the issue of a maximum of 54,225,850 ordinary shares of par value Euros 0.52 each, at the price of Euros 1.15 each, with a share premium of Euros 0.63, for the possible exercise of options granted to the senior and junior executives of the company and its subsidiaries and their subsidiaries as part of the “Pirelli to People” and “Group Senior Executives” stock option plans set up by the merged company Pirelli S.p.A. in 2001.

To the best of the company's knowledge, no legal or natural person can exercise control pursuant to Article 93 of the Legislative Decree 58/1998.

It is nonetheless worth noting the existence of the "Pirelli & C. S.p.A. shareholders' agreement" aimed at ensuring the stability of Pirelli & C.'s shareholder structure and the unitary governance of the business. Extracts from this agreement are available on the company's website [www.pirelli.com](http://www.pirelli.com).

### **Relations with investors and other shareholders**

In March 1999, the company established an Investor Relations Department to foster continuous dialogue with the financial market. The *Investor Relations Department*, which reports directly to Managing Director Carlo Buora, is headed by Alberto Borgia and has its own section in the company's website [www.pirelli.com](http://www.pirelli.com).

In this section of the website investors can find every document of interest, in English as well as Italian, as regards to financial reporting (for example, the annual financial statements and the half-yearly and quarterly reports) and the company's corporate governance system (for example, the Rules of conduct for transactions with related parties, the Procedure for satisfying the requirements of Article 150.1 of Legislative Decree 58/1998, the Insider Dealing Code and the minutes of shareholders' meetings). The section also gives access to the documentation that the company makes available to the financial community in presentations and/or meetings and information on the company's share capital and shareholders (including the publication of shareholders' agreements).

Investor queries may be sent to:

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**PIRELLI & C. S.p.A. – SUMMARY DATA**

(in millions of euros)

<b>BALANCE SHEET</b>	<b>6/30/2005</b>	<b>12/31/2004</b>	<b>6/30/2004</b>
Intangible assets	22.5	9.6	11.3
Property, plant and equipment	54.7	55.9	56.0
Financial assets	6,346.6	4,834.4	4,683.9
Net working capital	64.6	243.8	60.2
	<b>6,488.4</b>	<b>5,143.7</b>	<b>4,811.4</b>
Shareholders' equity	4,490.2	3,571.0	3,192.4
Provisions	373.5	380.3	353.4
Net financial (liquidity)/debt position	1,624.7	1,192.4	1,265.6
	<b>6,488.4</b>	<b>5,143.7</b>	<b>4,811.4</b>

**Balance sheet and financial position**

The above statement presents the balance sheet and financial position of the company. The most significant changes refer to the following:

- **intangible assets** increased by Euros 12.9 million compared to December 31, 2004 as a result of the capitalization of the cost incurred for the share capital increase voted by the extraordinary shareholders' meeting held on January 21, 2005;
- **financial assets** went from Euros 4,834.4 million to Euros 6,346.6 million. The net increase of Euros 1,512.2 million mainly refers to the subscription of the Olimpia S.p.A. share capital increase (Euros 1,344 million), the purchase of 41,930,000 Capitalia S.p.A. ordinary shares from the subsidiary Pirelli Finance (Luxembourg) S.A. (Euros 140 million) and the payment of Euros 20 million against the future capital increase of the subsidiary Pirelli Broadband Solutions S.p.A.;

- **net working capital** decreased by Euros 179.2 million mainly on account of the dividends recorded on the accrual basis at December 31, 2004 of Euros 164 million;
- the increase in **shareholders' equity** compared to December 31, 2004 is summarized in the following table:

(in millions of euros)	
<b>Shareholders' equity at 12/31/2004</b>	<b>3,571.0</b>
Dividends paid	(113.6)
Exercise of 2003 - 2006 warrants	0.5
Share capital increase	1,064.6
Net loss	(32.3)
<b>Total change</b>	<b>919.2</b>
<b>Shareholders' equity at 6/30/2005</b>	<b>4,490.2</b>

- the decrease in **provisions** of Euros 6.8 million compared to December 31, 2004 is chiefly the result of the utilization of the provision for the recovery of abandoned areas for Euros 3.1 million, the utilization of the provision for investment writedowns for Euros 1.3 million, as a result of the writedowns of the investments in Eurofly Services S.p.A. and Altofim S.r.l., and the reduction in the provision for discounting interest flows to present value relating to the sale of the receivables from the tax authorities to Mediofactoring S.p.A. and Unicreditfactoring S.p.A. for Euros 0.9 million;

- **net financial debt position** went from Euros 1,192.4 million at December 31, 2004 to Euros 1,624.7 million at June 30, 2005. A summary of the changes is detailed in the following table;

	(in millions of euros)
Net loss	(32.3)
Investments in group companies	(1,344.0)
Other equity investments	(190.2)
Share capital increase	1,065.1
Dividends collected	174.8
Dividends paid	(113.6)
Others changes	7.9
<b>Total change</b>	<b>(432.3)</b>

**STATEMENT OF INCOME**

(in millions of euros)

STATEMENT OF INCOME	1 <sup>st</sup> half 2005	1 <sup>st</sup> half 2004	Year 2004
Financial income (expenses)	(30.9)	(25.6)	(49.7)
Investment income	11.6	1.2	176.8
Valuation adjustments to financial assets	(17.7)	(19.8)	(27.1)
Other operating income (expenses)	(4.5)	(11.6)	(24.3)
<b>Income (loss) before extraordinary items and income taxes</b>	<b>(41.5)</b>	<b>(55.8)</b>	<b>75.7</b>
Extraordinary items	-	1.1	46.0
Income taxes	9.2	-	27.9
<b>Net income (loss)</b>	<b>(32.3)</b>	<b>(54.7)</b>	<b>149.6</b>

The first half of 2005 ended with a net loss of Euros 32.3 million compared to a loss of Euros 54.7 million for the same period of the prior year.

**Income (loss) before extraordinary items and income taxes** went from a loss of Euros 55.8 million to a loss of Euros 41.5 million, with an improvement of Euros 14.3 million. This improvement is primarily attributable to higher dividends collected during the first half of 2005 compared to the same period of 2004 (Euros 9.5 million), lower writedowns to investments in portfolio (Euros 2.1 million) and a better operating result (Euros 7.1 million). Offsetting the above positive contributory factors are higher net financial expenses (Euros 5.3 million) due to higher average debt during the period compared to 2004.

**Income taxes** show a benefit of Euros 9.3 million after booking a net tax benefit under consolidated taxation for Euros 8.5 million. To this end, it should be recalled that during 2004, Pirelli & C. S.p.A. opted to file for consolidated taxation as head of the group.

The above data has been prepared by applying the principles used in the preparation of the annual statutory financial statements.

The interim statutory financial statements at June 30, 2005, prepared in accordance with IAS/IFRS, and used for the consolidation of the interim consolidated financial statements, show net income of Euros 130 million and shareholders' equity of Euros 4,687 million compared to a loss of Euros 32 million and shareholders' equity of Euros 4,490 million prepared in accordance with the principles already applied in the statutory financial statements for the year ended December 31, 2004.

The difference of Euros 162 million in the statement of income is due almost entirely to accounting for the dividends distributed by the subsidiaries on a cash basis, in the financial statements prepared in accordance with IAS/IFRS, and recorded on the accrual basis in the financial statements for the year ended December 31, 2004.

The increase in shareholders' equity is largely the result of fair value adjustments to investments in other companies.

The Board of Directors

Milan, September 12, 2005