

Annual Report 2005

*Grendene step by step*

**Grendene**<sup>®</sup>

## Contents

<b>I.</b>	<b>Message from management</b>	<b>3</b>
<b>II.</b>	<b>Main indicators</b>	<b>6</b>
<b>III.</b>	<b>Grendene: step by step</b>	<b>8</b>
1.	Our profile	9
2.	Our products	10
3.	Our history	15
4.	Our strategy	17
5.	Our intangibles – Grendene’s “DNA”	18
6.	Our risk management	19
<b>IV.</b>	<b>Management discussion and analysis (MD&amp;A)</b>	<b>20</b>
1.	Gross revenue	21
2.	Net sales	25
3.	Cost of goods sold	26
4.	Gross profit	28
5.	Sales, general & administrative expenses (SG&A)	29
6.	Adjusted Ebitda	31
7.	Net financial income (expenses)	32
8.	Other operating income (expenses)	33
9.	Provision for income tax and Social Contribution	34
10.	Adjusted net income	35
11.	Debt	36
12.	Capital expenditure	37
13.	Adjusted cash flow (pro forma)	38
<b>V.</b>	<b>Corporate governance</b>	<b>39</b>
1.	The Novo Mercado	40
2.	Corporate action and subsequent events	43
<b>VI.</b>	<b>The capital markets</b>	<b>45</b>
<b>VII.</b>	<b>Social and environmental statement</b>	<b>47</b>
1.	Our programs	50
2.	Our benefits	52
3.	Our campaigns	54
4.	Our partnerships	55
5.	Our dates	56
6.	Our achievements	57
7.	Our employees’ profile	58
8.	Our environment	61
9.	Our added value	65
<b>VIII.</b>	<b>Audited financial statements</b>	<b>66</b>
1.	Balance sheets assets	67
2.	Balance sheets liabilities	68
3.	Statements of income	69
4.	Statements of shareholders’ equity	70
5.	Statements of changes in financial position	71
6.	Adjusted consolidated statements of income 2005 (pro forma)	72
7.	Adjusted consolidated statements of income 2004 (pro forma)	73
8.	Notes to the financial statements	74
9.	Report of independent auditors	91
<b>IX.</b>	<b>General information</b>	<b>92</b>
1.	Corporate information	93
2.	Information for shareholders	96
3.	Credits	98



Ipanema ★ Gisele Bündchen

**Message from Management**

## I. Message from management

### To our Shareholders:

In accordance with the legislation and the Bylaws, the management of Grendene S.A. submits this Report of Management to you, accompanied by the financial statements of the company and the consolidated financial statements including the operations of its subsidiaries, together with the Opinion of independent auditors for the business year ended December 31, 2005. The economic, financial and operational information of the company presented in the comments on performance is consolidated and was prepared based on the adjusted financial information (pro forma) in *Reais*, as indicated in the item *Reconciliation of the Financial Statements for 2005 and 2004*, with the respective explanatory notes.

**2005 was a difficult year for the sector, as a result of the 17% weakening of the US dollar against the Real** in the year (the average exchange rate in the year was R\$2.43/US\$, compared to R\$2.92/US\$ in 2004). As well as the lower income from exports, there is an adverse effect on the domestic market caused by the increase of imports of competing similar products (footwear) and also *non-similar* products (other durable and non-durable consumer goods), which dispute the consumer's limited disposable income. Brazilian GDP grew by 2.4% in 2005, but this was less than its 4.9% growth of in 2004. Continuing high interest rates prevented higher growth in some sectors, through lower economic activity (the Selic basic rate was 18% p.a. at the end of the year).

**Grendene's gross revenue was 11% lower in 2005 than in 2004 (in Reais)**, at R\$1.35 billion, on sales volume of 130 mn pairs/year, 10% less than in 2004. The domestic market, which provides 86% of gross revenue, was the main factor, with gross revenue 9.3% lower in the year, and volume 12% lower.

As well as the macro and market factors, another factor that affected our sales in the domestic market was the fact that some models of promotional products in our spring-summer collection, which were well accepted by consumers in 2004, did not have the same success in 2005 – this is part of the risk of the business, which is to find the optimum combination between model and price. Growth continued in the mass-consumption and children's segment, and some lines of the feminine segment.

Exports, which provided 14% of gross revenue, were also down 22% in gross revenue in *Reais* (6.3% in US dollars), resulting from a fall of 19% in average price in *Reais* (the fall was only 2.9% in dollars), and sales volume 3.6% lower.

**Fall in domestic market share, increase in export market share:** Based on apparent consumption reported by *Abicalçados* (the Brazilian Footwear Manufacturers' Association), Grendene had 19% of the Brazilian domestic footwear market in 2005, compared to 21% in 2004. In the export market we gained market share, increasing from 13% of Brazilian footwear exports in 2004 to 15% in 2005. According to Decex (the Brazilian Central Bank Export Department), the volume of Brazilian footwear exports was 11% down, while our volume was only 3.6% down. "Traditional" footwear manufacturers (producing shoes built from leather, which are more labor-intensive) suffered much more heavily from the marked loss in competitiveness in relation to Asian producers.

**2005 profit of R\$195 mn, in line with market expectations:** In spite of the weaker sales revenue and volume, profit in *Reais* was at the level of 2004, and profitability (net margin) increased, due to reduction of costs and expenses and the significant improvement in *Net financial income (expenses)* resulting from our elimination of net FX exposure.

**Operational cash flow (Ebitda)** was R\$267 mn (16.8% lower than the R\$320 mn Ebitda of 2004); net income was R\$195 mn (3% lower than the R\$202 mn of 2004), and the proposed dividend was of the order of R\$81 mn (27% more than the R\$64 mn of 2004). An interim dividend of R\$38 mn was distributed on account of this total dividend in November 2005. We maintain our dividend policy of distributing 100% of the available accounting income (= net income, less the legally obligatory reserves).

Our positive cash flow and our high capacity for generating cash from operations resulted in a net cash position of R\$333 mn on December 31, 2005.

**2005 was a year that fell far short of what we could and should have achieved.** But it was also a year of much learning and new experiences. It was also our first complete business year as a listed company. With the listing we began to look at the company in a different way, with continuing evolution from the culture of a privately-held company to a listed one. This involves not only the tighter focus on short-term results, with the quarterly publication of economic and financial figures, but also the internal strategic discussion for the medium and long term, and monthly reviews of planning and budget. The discipline of reporting to our minority shareholders and to the market has highlighted for us that in 2005 we achieved less than we should have, even considering the difficult macro environment.

The attentive eye of approximately 4,000 shareholders – institutional and non-institutional investors – and of the investment analysts continues to give us vital feedback, as they make their perceptions and concerns clear to us, and demand information about the performance of the company and about the future scenario. For us, this factor transformed a period of crisis in the footwear sector also into a year of learning, and *significant improvements in our management discipline*.

After five consecutive quarters of declines in our result on a year-on-year basis, we were able to present the inflection point starting in the third quarter of 2005. This was not, however, enough to reverse the weak performance of the first and second quarters, and 2005 was the first year in which we showed a decline in sales revenue (11%) and volume (10%), after growing at an annual average of 30% p.a. in sales revenue and 16% p.a. in volume in the four previous years (2001-2004).

We are in the process of deciding which mechanisms to adopt to try to reverse the present situation and to return to the growth that was interrupted by the deterioration in the macro environment. There has been an important reaction by management, showing flexibility, and the company has shown its agility in “reinventing itself”: rationalizing processes, reducing operational costs, and seeking gains in technology. All these processes have resulted in the *improvement in our margins*.

However, we are clearly aware that there is still scope for improvement of our sales strategy in both the domestic and external markets. We are seeking alternatives for new products which can reduce our intrinsic seasonality, and opportunities to conquer new markets niches. In all this is a clear targeted – recovery of our growth path with solid margins.

**Disseminating and reinforcing consciousness of our basic values:** 2005 was the year in which we involved and mobilized the whole company in the search for common objectives, also aiming to make the implicit **Grendene Values** into an explicit statement by their dissemination. This dissemination started in the fourth quarter. The values are:

**I) PROFIT:** Profit is essential – irreplaceable for Grendene’s survival, and maintenance of jobs.

**II) COMPETITIVENESS:** Growing productivity – constant re-examination, reduction of costs and expenses.

**III) INNOVATION, AGILITY:** Anticipate difficulties – innovate, improve.

**IV) ETHICS:** Integrity, respect and transparency – think, speak and act.

Our **Values** could be described as our “DNA” – an identity that has always existed in the organization, underlying the processes and development of a company which in only 12 years (from 1994) grew from gross sales of R\$120 mn and net income of R\$20 mn, to gross revenue of R\$1,353 mn and profit of R\$195 mn – multiplying gross revenue by 11, and profit by 10. This was achieved only with a great deal of bold actions – such as when we decided to migrate practically all our production from the South of the country (the State of Rio Grande do Sul) to the Northeast (State of Ceará). We located initially in Ceará’s state capital, *Fortaleza*, and subsequently in two areas that had little infrastructure at the time – *Sobral* and *Crato*, in the interior of the state, looking for more competitive conditions in terms of cost of staff and the advantages of tax benefits. And all this was achieved without taking on debt, and while maintaining a solid financial situation.

This “DNA” enabled us to make evolutionary leaps, and achieve the growth rates that we achieved: we generated innovative product; we used aggressive and differentiated marketing; we developed our own technology, and continued to develop it constantly, our people have the ability, knowledge and the talent to face any challenge; and more recently we incorporated the concepts of best practices in corporate governance and adding value for shareholders with our decision to offer only voting shares, committing to the *Novo Mercado* (the highest-standards category of the São Paulo stock exchange), at our IPO. As a result the shareholder who invests in Grendene has the following advantages: a vote; 100% tag-along rights; a Board of Directors independent members; the facility of an arbitration chamber in the event of stockholder disputes; an aggressive dividend policy (100% of the available accounting profit); professional management; and a proactive investor relations group practicing a policy of high level of disclosure and transparency – reflecting the company’s values.

In one more action to remain ahead of the crowd as a benchmark for excellence in all its areas of operation, Grendene now offers its 2005 Annual Report solely in an online version, aiming not only to save on the expense of elaborate printing, but, primarily, to get the information to the investor faster: in contrast to the majority of printed reports which reach the market in general only at the end of the first half, we are making this report available on our site on the same day as publication of our 2005 results, March 6, 2006.

We remain firm in our belief that we know how to overcome whatever challenges the macro scenario presents us with, and we thank all our stakeholders, who have helped to make Grendene one of the most admired companies in Brazil: the stockholders, for their continued confidence in our capacity to create value in the long term; our 20,500 employees, for their dedication and commitment to results; our suppliers, for their partnership; and our clients and consumers, who prefer our brands and constantly challenge us in the search for excellence in quality, innovation and creativity.

**The management**



Main Indicators

## II .Main indicators (adjusted pro forma financial statements)

R\$ million	2005	2004	2003	2002	2001	Change, % 2005/04	CAGR 2005/01
<b>Gross revenue</b>	<b>1,353</b>	<b>1,525</b>	<b>1,276</b>	<b>907</b>	<b>697</b>	<b>(11%)</b>	<b>18.0%</b>
<b>Domestic market</b>	<b>1,170</b>	<b>1,290</b>	<b>974</b>	<b>740</b>	<b>590</b>	<b>(9%)</b>	<b>18.7%</b>
<b>Exports</b>	<b>183</b>	<b>235</b>	<b>303</b>	<b>167</b>	<b>107</b>	<b>(22%)</b>	<b>14.4%</b>
<b>Net sales</b>	<b>1,068</b>	<b>1,212</b>	<b>1,061</b>	<b>755</b>	<b>577</b>	<b>(12%)</b>	<b>16.6%</b>
<b>Gross profit</b>	<b>444</b>	<b>526</b>	<b>504</b>	<b>333</b>	<b>239</b>	<b>(16%)</b>	<b>16.7%</b>
<b>Adjusted Ebitda</b>	<b>267</b>	<b>320</b>	<b>354</b>	<b>212</b>	<b>157</b>	<b>(17%)</b>	<b>14.3%</b>
<b>Adjusted net income</b>	<b>195</b>	<b>202</b>	<b>238</b>	<b>117</b>	<b>96</b>	<b>(3%)</b>	<b>19.5%</b>
<b>Earnings per share (R\$)</b>	<b>1.95</b>	<b>2.02</b>	<b>2.38</b>	<b>1.17</b>	<b>0.96</b>	<b>(3%)</b>	<b>19.5%</b>
<b>Sales volume (millions of pairs)</b>	<b>130</b>	<b>145</b>	<b>121</b>	<b>116</b>	<b>94</b>	<b>(10%)</b>	<b>8.4%</b>
<b>Domestic market</b>	<b>103</b>	<b>117</b>	<b>94</b>	<b>100</b>	<b>79</b>	<b>(12%)</b>	<b>6.9%</b>
<b>Exports</b>	<b>28</b>	<b>29</b>	<b>27</b>	<b>16</b>	<b>15</b>	<b>(4%)</b>	<b>16.9%</b>
<b>Average price/pair (R\$)</b>	<b>10.39</b>	<b>10.50</b>	<b>10.52</b>	<b>7.80</b>	<b>7.39</b>	<b>(1%)</b>	<b>8.9%</b>

Share of volume, margins	2005	2004	2003	2002	2001	Change, basis points, 2005/04	Average 2005/01
<b>Domestic consumption volume market share*</b>	<b>18.6%</b>	<b>21.2%</b>	<b>19.5%</b>	<b>20.7%</b>	<b>16.4%</b>	<b>(260)</b>	<b>19.3%</b>
<b>Brazilian footwear exports market share**</b>	<b>14.8%</b>	<b>13.7%</b>	<b>14.3%</b>	<b>9.8%</b>	<b>8.8%</b>	<b>110</b>	<b>12.3%</b>
<b>Gross margin</b>	<b>41.5%</b>	<b>43.4%</b>	<b>47.5%</b>	<b>44.1%</b>	<b>41.4%</b>	<b>(190)</b>	<b>43.6%</b>
<b>Ebitda margin</b>	<b>25.0%</b>	<b>26.4%</b>	<b>33.4%</b>	<b>28.0%</b>	<b>27.1%</b>	<b>(140)</b>	<b>28.0%</b>
<b>Net margin</b>	<b>18.3%</b>	<b>16.7%</b>	<b>22.4%</b>	<b>15.5%</b>	<b>16.6%</b>	<b>160</b>	<b>17.9%</b>

\* Abicalçados apparent consumption figures.

\*\* Decex (Brazilian Trade Ministry).



### III. Grendene: step by step

#### 1. Our profile

Operating since 1971, Grendene is **one of the world's largest producers of synthetic footwear** – and the leader in various segments of this market in Brazil. It has its own exclusive technology for production of shoes based on PVC (polyvinyl chloride) and EVA (ethylene vinyl acetate), which are referred to as injectable thermoplastics, and produces its own moulds, launching about 450 products each year.

**It owns successful brand names**, including: *Melissa, Rider, Grendha, Ipanema, Ipanema Gisele Bündchen, Grendene Kids*, and *Grendene Baby*. In 2005 it launched one more: *Ilhabela*. It also produces footwear for a range of more than 20 licenses from celebrities and characters from children's media and cartoons.

**Grendene is totally integrated**, with installed capacity, in its 4 industrial plants and 11 footwear factories, for 176 million pairs/year, as well as one molding plant and one PVC plant producing about 51,000 tons/year of thermoplastics for the injection machinery in the factories.

It has **5 industrial units**. 3 are in the state of Ceará, in three cities: in *Sobral*, where the headquarters and the largest plant – 6 footwear factories producing 86% of the company's total output, the first of them established in 1993 – are located; in *Fortaleza*, the state capital, where it has two footwear factories and one factory producing PVC components, established in 1990; and in *Crato*, where it has 1 factory producing footwear and EVA components, which started operating in 1997. In the state of Rio Grande do Sul – where the company was founded in 1971 – it has 2 units, 3 footwear factories and its administrative office, in the town of **Farroupilha**; and the mold producing facility, in the town of **Carlos Barbosa**.

With 20,500 employees, 86% of its sales to the domestic market and 14% exported, Grendene has a wide range of competitive advantages, resulting in its 19% Brazilian domestic footwear market share (at the end of 2005), and 15% of Brazilian footwear exports.

**These competitive differentials**, which have been built on the "Grendene Values", include its intangibles – the "Grendene DNA" – which translate into: innovative products; talented people researching trends, producing and carefully monitoring the results; aggressive marketing; proprietary technology; logistics; its client base and relationships; and financial solidity.

**2. Our products**

Values in Grendene's "DNA" transform into innovative products, positioning the company as a fashion product manufacturing organization launching about 450 products each year. This means in practice that about every three months, on average, the products in the market are entirely renewed.

Our Research and Development area creates new fashion concepts and trends, seeks and defines new tendencies, seeks to create entry barriers against competitors through planned obsolescence, using creativity and design that combines the best talent available worldwide and especially in Brazil, translating and transforming information into business design, looking always for the most up-to-date result possible in worldwide terms.

Grendene launches **two collections per year, as well as maintaining a specific range of some products.** The *Melissa* line is the most conceptual, with an Autumn-Winter collection launched in January and a Spring-Summer collection launched in July of each year, both at São Paulo Fashion Week. The other lines also launch two collections per year: the Autumn-Winter collection is launched at Couromoda, a fair held in January, and the Spring-Summer collection at the Francal Footwear Fair, held in July – these are two of the biggest and most important international footwear fairs held in Brazil.

Grendene's product portfolio has four segments: masculine, feminine, children's and mass-market.

**The masculine segment**

**The Rider line:** The *Rider* brand, now synonymous with a slip-on sandal for "after sports", targeted to the masculine public, was launched in August 1986 and has three "archetypes" – segmentation according to consumers' preference and use. The main models of the 2005/2006 collection are:

**Sports**

**Basic**



**Middle**



**Selective**



**Beach**

**Basic**



**Middle**



**Selective**



**Adventure**

**Basic**



**Middle**



**Selective**



**Third-party brands:** We also manufacture for other brands, such as *Bad Boy* and *Mormaii*.



**Feminine segment**

**The Melissa line:** Now synonymous with plastic sandals worldwide, this line is basically conceptual as a top-of-line design and fashion product, being sold in specific channels, such as boutiques, specialized fashion stores and even design stores, aiming to add value to the brand and to the full plastic construction type in general. Partnerships are made with important and well-known fashion brands, fashion designers, and even designers outside the area of fashion, who create models for the *Melissa* line. Examples are the recent partnerships with the *Campana Brothers*, *Alexandre Herchcovitch*, *Marcelo Sommer*, and the New-York-based Egyptian designer *Karim Rashid*. In 2005 we opened the *Galeria Melissa* in São Paulo, in the “fashion Mecca” street Oscar Freire, as a mixture of art gallery, design gallery and store selling the *Melissa* line of footwear.



**The Grendha line:** This line, which targets the feminine public, was launched in July 1994, envisaging segmentation and positioning in five archetypes. Grendene uses aggressive marketing, especially in the promotional products that use celebrities in TV media, with strong emotional appeal.

**Grendha Casual – classic models**



**Grendha Fashion – trend and innovation models**



**Grendha Verão – basic and beach sandals**



**Grendha Promocional – supported by celebrities and advertising**



**Ivete Sangalo**



**The Gisele Bündchen line:** This was launched in July 2002, with the support of the *Top Model Gisele Bündchen*, using dedicated advertising support:



**The Ilhabela line:** This new brand was launched at the Franca Fair in July 2005, segmented for the young public, and is also a promotional line, with commercials starring actress Alinne Moraes.



**Children's segment**

**Grendene Kids:** This line, marketed since 1984, targets the pre-adolescent and infant public. Products are linked to licensing contracts, using famous fashion brands, TV presenters, singers, actors, and characters from cartoons and other children's media, adding emotional appeal to the products.



**Boys**



**Girls**



**Grendene Baby:** Targeted to mothers for their babies, this line also uses licensing along the lines of *Grendene Kids*.

**Boys**



**Girls**



Both lines use a successful marketing strategy, using famous fashion brands and characters from cartoons and other children's media, adding emotional appeal to the products.

**Mass Market segment**

**The Ipanema line:** This was launched in July 2001 for “flip-flop” sandals, sandals and clogs, for the mass market, unisex, with competitive price and focus on distribution strategy.



**Basic – basic and classic models**



**Themes – women's**



**Themes – men's**



### 3. Our history

**Grendene** was founded in 1971, in Brazil's southernmost state, Rio Grande do Sul, by Pedro Grendene, grandfather of the current controlling shareholders, Alexandre and Pedro Grendene Bartelle. These twin brothers, born entrepreneurs and innovators, continued the tradition, transforming Grendene into one of the largest footwear companies in the world. In 1990 the company moved its headquarters to the state of Ceará, in Brazil's Northeast – a bold and courageous move, seeking more competitive conditions in terms of cost of labor and the advantages arising from tax concessions given by Ceará State. Production was moved from the coastal hills of Rio Grande do Sul, initially to the capital city of Ceará, Fortaleza, and other plants were later built in the more primitive interior of the state – in *Sobral*, in 1993, which became the company's headquarters, and *Crato* (1997). These locations were very challenging – in terms of culture, an adverse climate, with only minimal infrastructure available at that time, and local labor not specialized in the footwear industry – indeed even less specialized in thermoplastic injection molding, which use sophisticated techniques and automated equipment.

But we see the Grendene DNA coming through: the result is pioneering action, innovation, and major challenges have led, today, 16 years later, to 10 of Grendene's total of 13 production plants being located in the state of Ceará, and producing 97% of the company's total output, with 93% of its employees. Of the Ceará staff, 96% work in the operational area, have been trained and acquired specific skills, and have a high level of productivity – a great majority of them having been recruited locally in Ceará state. Only 7% of the employees now work in the state of Rio Grande do Sul: in Farroupilha, where the administrative office, Research and Development, and 3 factories are located, and in the mold making plant in Carlos Barbosa.

#### Timeline

##### 1971

Grendene was founded in *Farroupilha*, state of Rio Grande do Sul, February 25. Its first product line was plastic packaging for wine flasks, an innovation in the market which at that time produced only wicker flask holders, manually.

##### 1976

Start of production of plastic parts for farm machinery and equipment, and subsequently shoe components such as soles and heels. Grendene was the pioneer in the use of nylon (polyamide) as a raw material for these components.

##### 1979

Launch of the first plastic sandal, under the brand name *Nuar*, developed on the basis of technology used to make the footwear components. The company became a privately-held corporation.

A collection of plastic sandals under the brand name *Melissa* was launched in this year, in the "spider's-web" style, inspired by the sandals used by French fishermen – and became synonymous with the product category.

##### 1980

The mold-making operation was started at *Carlos Barbosa*, in Rio Grande do Sul, to produce moulds for the manufacture of plastic shoes.

##### 1986

Launch of the *Rider* sandals line, a new generation of footwear with differentiated design and comfort targeted for the masculine public. Within a few years after the launch the brand became a synonym of the product category, "after-sport" sandals.

##### 1990

The first factory was established in the state of Ceará, in Brazil's Northeast, under the name *Grendene do Nordeste S.A.*, now with production capacity for 5 million pairs/year.

##### 1993

Also in Ceará, the plant at *Sobral* was inaugurated, later taking the name *Grendene Sobral S.A.*, and later, in 2001, *Grendene Calçados S.A.*, producing the largest share of the company's output (around 85% of the total). Tax benefits, lower labor costs and strategic location for access to the international market were the reasons for transfer of the manufacturing operations which had until then been located in *Farroupilha*.

##### 1994

Launch of the *Grendha* product line, targeting the feminine public.

**1997**

Startup of the third plant in Ceará, in the municipality of *Crato*, as *Indústria de Calçados Grendene Ltda.*, currently with production capacity for 12 million pairs/year of ethylene vinyl acetate (“EVA”) products.

**1998**

The holding company *Grendene S.A.* absorbed *Grendene Nordeste S.A.*, of Fortaleza (Ceará).

**2001**

Stockholding restructuring: *Grendene Calçados S.A.* absorbed *Indústria de Calçados Grendene Ltda.* Launch of the ***Ipanema*** line of flip-flops and full sandals.

**2002**

Agreement signed with top model *Gisele Bündchen* for launch of the ***Ipanema by Gisele Bündchen*** line.

**2003**

In preparation for the IPO, the holding company *Grendene S.A.* absorbed *Grendene Calçados S.A.*, in August, becoming an operational company, with only one wholly-owned subsidiary, *Saddle Corporation*, based in Uruguay, which in turn controls two wholly-owned subsidiaries: *Grendha Shoes* in the United States, and *Saddle Calçados*, in Argentina.

**2004**

IPO: On October 29, Grendene was floated on the *Novo Mercado* of the São Paulo stock exchange, offering 100% voting shares.

The 25<sup>th</sup> birthday of the Melissa line was commemorated with the launch of the *Melissa Celebration* line. The *Rider* line was now 18 years old.

**2005**

Important new licenses: *Batman*, *Hot Wheels*, *Hello Kitty* and *Strawberry Collection*.

The new brand ***Ilhabela*** is launched, at the Francal footwear fair, in São Paulo, in July, with the actress and celebrity *Alinne Moraes* in its “starring role”.

Opening of *Galeria Melissa*, a conceptual design, fashion and arts store, in São Paulo.

With the first full year of Grendene's listing on Bovespa's *Novo Mercado*, significant improvement in management discipline and the level of quarterly information; publication of cash flow for the first time; continually improving corporate governance.

The *Bradesco* brokerage house is hired to operate as a market maker in Grendene shares, in September.

#### 4. Our strategy

Another strand in the “Grendene DNA” is a strategy centered on growth both in and outside Brazil. This is supported by: the constant quest for improvement of its proprietary technology; modernization of the synthetic footwear manufacturing process; expansion of installed capacity (completed in July 2005); integration, with proprietary manufacturing of its own PVC in more than 60 different formulas depending on the required hardness or malleability of the plastic; constant product innovation, with quality, fashion, differentiated design, versatility and price; a logistics system enabling national and international distribution through various sales channels; and aggressive marketing using strong brands, advertising, licensing, celebrities and accessories.

**Growth in the domestic market:** The Brazilian domestic market provides 86% of Grendene's gross sales revenue and 79% of its sales volume. Although the domestic market is more competitive, our strategy of segmentation by market and brand has earned us a position of leadership in most of the market segments we operate in (men's, women's, children's and mass-market). There is certainly scope for Grendene not only to recover the two percentage points of domestic market share that it lost in 2005, but to grow further in the domestic market. Its main competitive differences, as well as the segmentation of markets, are innovative products, distribution logistics – serving approximately 18,000 points of sale, speed of action to reach different distribution channels, production scale, and the financial strength for spending on advertising or on financing clients.

**Growth in the export market:** The export market provides 14% of Grendene's gross sales revenue and 21% of its sales volume. Although the exchange rate is now less favorable for exports, we have succeeded in maintaining our international competitiveness, and we gained two percentage points in market share of Brazilian footwear exports in 2005. We export to about 60 countries, with approximately 19,500 points of sale outside Brazil, and proprietary design for our brands and brands of third parties.

## 5. Our intangibles – Grendene's "DNA"

Grendene's "DNA" is expressed in its **intangible assets**, which take several forms:

**Brands:** Brands that are consolidated, strong and widely known in the Brazilian market, and in some cases in the international market. Many of these brands become synonymous with the product, as well as the differentiation by fashion product concept – as a result of originality, functionality, design, and emotional appeal to the consumer public. All this through the medium of aggressive marketing, associated with Brazilian and international celebrities, and, in the case of the Kids and Baby lines, through licensing of famous characters from the children's and infants' media in Brazil and worldwide.

**Research and development:** constant innovation through translation of references; creation of fashion concepts and trends, footwear designs and models; a range of colors, and of composition of materials. A team of about 120 specialists create approximately 450 models per year – they include architects, fashion designers, industrial designers, company management professionals, model-makers, chemists, sewing specialists, technicians, and specialists in marketing.

**Production technology:** Grendene has state-of-the-art proprietary technology vertically integrated with production of injected thermoplastic footwear; proprietary technology for development of moulds; production of PVC in our own plant; and automated manufacture of shoes, in which all the components of the shoes are fused together during the injection process – an important point of difference from the traditional footwear industry.

**Relationship with clients:** Grendene's aim is to seek and maintain long-term partnerships that produce consistent results throughout the whole of the production chain, going as far as the consumer, strictly within a concept of sustainability. Grendene's representatives and salespeople act as consultants for clients – a differential that helps to attract clients and create loyalty. To make this consultancy role a working, daily reality, there is a system of personalized sales, referred to as the SMAV, updated daily, which makes a wide range of data on each client available on-line: product catalogue, color range, purchasing history, advertising campaigns and media plan including dates and times of publication or broadcasting, and marketing and after-sales support.

**Talents:** Our people have knowledge and profound experience in their areas of activity – and with the Grendene "DNA" in their veins they are part of the company's assets, with accumulated knowledge in their respective areas, and the knowledge and experience for major challenges. The development of our employees in the various factories, with training and experience gained in the machinery and equipment and perfected over a large number of years, continues to result in significant gains in productivity, providing one more competitive differential for Grendene.

**Information technology:** Grendene is a benchmark in many aspects of its IT area, with more intensive data automation than is usual for the sector. Its Enterprise Resource Planning (ERP) was modeled with a web interface, another differential, which enables access by Intranet and Internet for all the functions of the business system. Security systems facilitate connections between the units in an integrated corporate system with a single database – which is stored and replicated in two different environments, simultaneously, with resources management 24/7 in real time.

**Corporate governance:** Initially a family company, Grendene now has a modern corporate management structure, and for its IPO just over a year ago opted for a listing that commits to highest level of corporate governance standards, the *Novo Mercado* of the Bovespa. Hence investors have access to all the advantages of this listing category.

**Sustainability:** Grendene's concern with sustainability is reflected in its participation in the international group working to establish the indicator parameters for the apparel and footwear sector for the Global Reporting Initiative (GRI). The concept of sustainable design also arises from the Grendene values, with all economic, social and environmental aspects being taken into account in the development of products. The priority is to use processes that enable full recycling, even when the finished product has components made in different raw materials. This results in financial benefits and eliminates the risk of negative impact on the environment. All product development is focused on the business and on the production process.

## 6. Our risk management

Grendene is subject to the same risks as any company, but additionally to the risk of the fashion business: each new product that is designed and developed is subject to acceptance, or not, by consumers, and may or may not be successful in creating the desire to consume.

The principal external and domestic risks are well-known – macroeconomic (exchange rate, interest rates, inflation, disposable income, commodity raw materials) and microeconomic (production and information technology, illegal reproduction of designs, liquidity, default, tax benefits), and also the environmental and social risks – which in Grendene's case are low, as a look at our *Social and environmental statement* will confirm. However, increasingly high-quality management discipline has been helping to create mechanisms that minimize many of these risks, as can be seen in the *Management Discussion and Analysis* in this report.

The following is an outline of the principal risks that we have to manage:

**Operational:** The manufacturing structure, with production in various plants in four different cities as well as proprietary production of moulds and PVC, reduces the risk of general shutdown. Electricity outages are avoided by our maintaining our own generators. We have insurance cover against the common risks, including replacement insurance against natural disasters for all the Grendene installations and equipment.

**Market:** We apply various strategies to mitigate the sales risk of the business: segmentation of sales, diversification of markets and a very high level of product diversification, even including the concept of planned obsolescence. However, as with every fashion product, we can have problems from time to time, as we did in 2005, when some models did not please the consumer, resulting in a fall in sales.

**Raw materials:** The main input materials are the PVC resin and plastifying oils that create the PVC, the main raw material used in the production of injected thermoplastic shoes and *coverline* (synthetic leather). The raw materials, being commodities, are volatile in the international market, subject to supply and demand, the price of oil, and the exchange rate. We have contracts with large-scale suppliers to buy these raw materials in significant volumes, aiming to achieve competitive prices.

**Tax Benefits:** All the industrial units located in the state of *Ceará* benefit from tax concessions, granted under long-term contracts signed with the state government under the applicable legislation. At the state level the company has two types of tax benefits: 1) *Provin*, a concession exempting the company from 75% of the ICMS tax on sales in the domestic market; 2) *Proapi*, a tax concession on the FOB value of exports, representing 11% of export revenue. The periods of the ICMS tax benefits for the principal factories have been extended for a further 10 years – with expiry extended from 2009 to 2019 in *Sobral*, from 2012 to 2022 in *Crato*, and from 2015 to 2025 in *Fortaleza* – all these are tax incentive periods of significant duration. The company complies with all the requirements linked to these benefits, and believes that there is no risk of the benefits being suspended, for several reasons: the company's scale, the quality of its projects, the fact that it is the largest private-sector employer in the state of *Ceará*, and the contractual guarantees protected by federal and state legislation.

At the federal level, the company has a 75% exemption from income tax granted by the federal government through the *Adene* system. For the *Sobral Unit* the exemption is for 10 years, until 2012; for the *Fortaleza Unit* it continues until 2010; and for the *Crato Unit* it continues until 2006. None of the tax benefits that the company enjoys are subject to any prohibition on renewal.



*Gary Hart*



## Management Discussion and Analysis



**IV. Management discussion and analysis (MD&A)**

**1. Gross revenue**

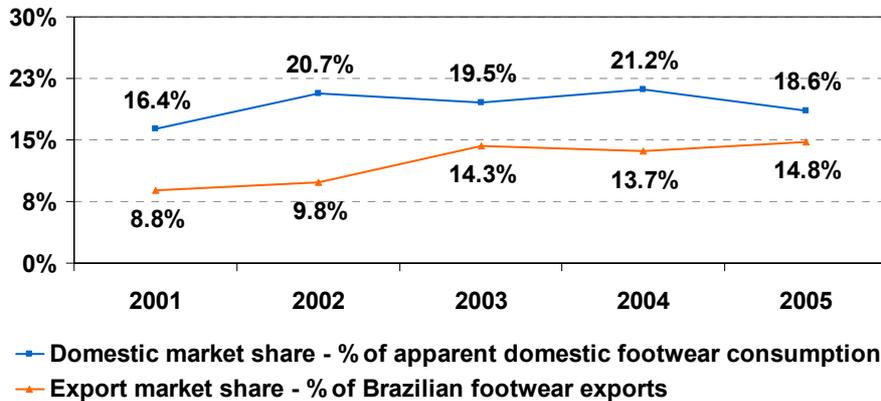
Gross revenue in 2005 was R\$1,353 mn, 11.3% lower than in 2004 (R\$1,525 mn). The domestic market provided 86.5% of this total, and exports 13.5%, versus 84.6% and 15.4% in 2004. The lower gross revenue arises from sales volume 10.3% lower, at 130.3 mn pairs, than in 2004 (145.3 mn pairs) and average price of R\$10.39 per pair, vs. R\$10.50 per pair in 2004. The reduction in gross revenue from 2004 to 2005 was 9.3% in the domestic market, and much larger (22.1%) in exports (in *Reais*) – though export revenue in US dollars was only 6.3% lower, in comparison to the appreciation of 16.8% in the average exchange rate for the *Real* against the *US dollar* from 2004 to 2005. The 3% growth in the average domestic market price was not enough to offset the 19.1% fall in the average export price in *Reais* (though this was only 2.9%, in *US dollars*). In *Reais*, the global average price was only 1% lower in 2005 than 2004.

The fall in volume from 2005 to 2004 was more severe in the domestic market (12%) than in exports (3.6%). Demand in the domestic market continued to retract, caused by a reduction in disposable income, an increase in credit sales of durables, and also weak performance by some of our product lines. In exports, a downward trend in volumes began to be reversed, with recovery in some European markets, good performance in the Andean Pact countries and Mexico, and new sales frontiers growing in Asia and Africa – in spite of the continued negative effect of the strengthening of the *Real* against other currencies.

Over the last five years Grendene’s gross revenue has grown at an average annual rate of 18% per year, and its sales volume at an average 8.4% per year. Both these rates are greater than the average growth in Brazilian GDP over the period (2.3% / year), and in volume of the footwear sector (3.6% / year). These figures are based on apparent footwear consumption according to the Brazilian Footwear Manufacturers Association (Abicalçados) – which also reported a 1.3% reduction in per capita consumption of footwear in Brazil in 2005, to 2.98 pairs / year.

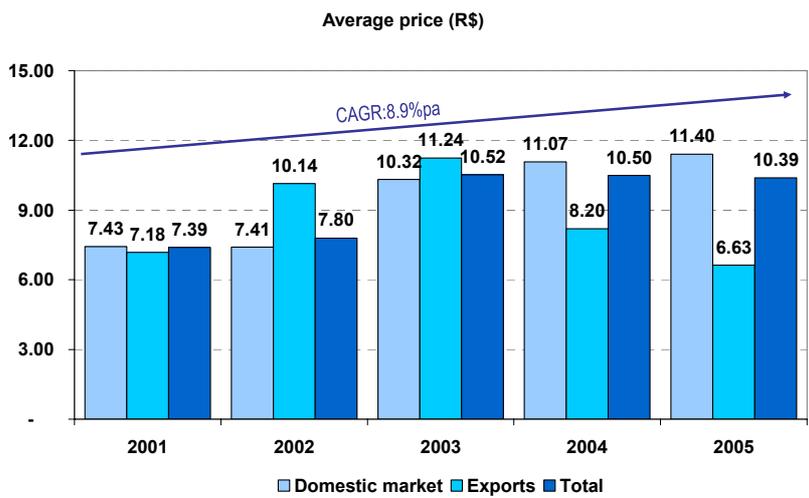
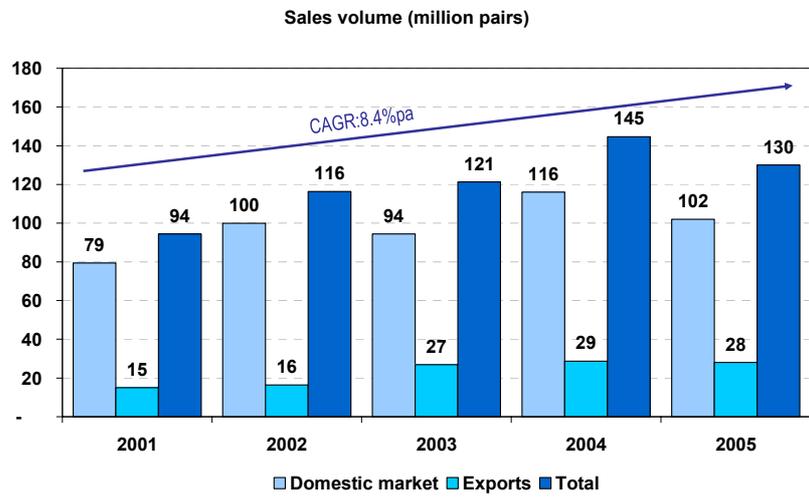
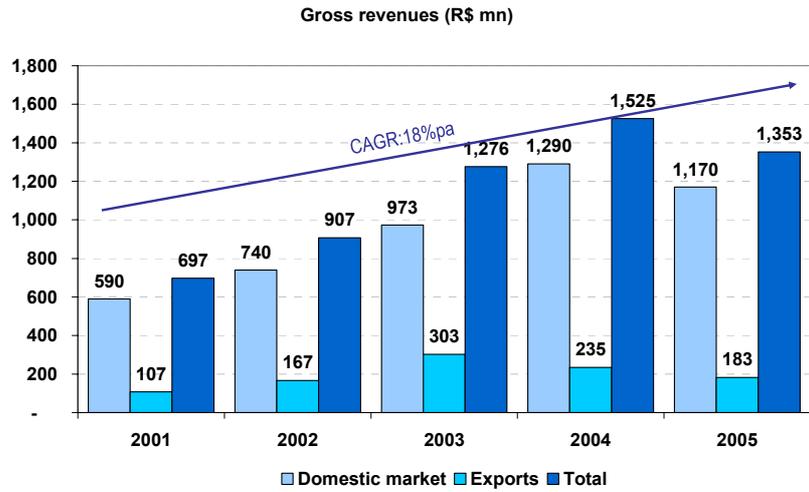
The chart below shows Grendene’s share of the domestic Brazilian footwear market (based on Abicalçados apparent consumption). The reduction in 2005 reflects our reduction in domestic market sales volume, while volume for the industry was flat. In the export market, however, even with the challenge of the exchange rate, we gained share of total Brazilian footwear exports (*source: Decex*) in 2005, since our footwear exports fell by less than the average for the industry.

**Market share by volume  
domestic market and exports**



Sources: Abicalçados, Decex.

These charts show Grendene's gross revenue, sales volume and average price in the domestic market and exports over the last five years:



**Domestic market sales:** Our sales revenue in the **domestic market** in 2005 totaled R\$1,169.6 mn, 9.3% less than in 2004, on sales volume 12% lower, and average price 3% higher. Domestic sales provided 86.5% of total sales revenue, vs. 84.6% in 2004.

**Negative highlight – accentuated fall in volume due to weak performance of some products:** Some promotional products in our spring-summer collection, representing a significant percentage of our products offered at the end of the year, were not as successful as in 2004. Success depends on an optimal combination of model and price, and this is part of our business risk.

Our **positive performance highlight** in 2005 was the **mass-market segment**, which showed good growth in sales revenue and average price. Some lines from the new *Ipanema* collection sold very well in the high summer season.

In the **children’s segment**, there was a small reduction in sales revenue, with volume and average price practically stable over the whole year, but with some products outstanding in sales in both the autumn-winter and the spring-summer collections. We were also successful with important new product licenses. Highlights of the year – including specific campaigns and the licenses acquired in 2005, included: *SpongeBob Squarepants*; *Strawberry Collection*; *Hello Kitty light*; *Senninha Tuning*; *Barbie*; *Rouge*; *Batman Action*; *Powerpuff Girls College*; *Guga Travel*; *Hot Wheels Xenon*; the *Grendene Baby* line; and campaigns involving celebrities, such as: *Xuxa Melody*; *Sandy Hit*; *Sandy Candy*; *Wanessa Camargo Ritmo*; *Kelly Key Young*; and *Eliana Jelly*.

**Positive highlight in the women’s market: market segmentation by brands.** In spite of the fall in sales revenue and volume, though with average price higher than in 2004, several brands launched recently were well accepted and performed well in the last quarter, leading us to believe they could do well in 2006. They include *Ilhabela*, starring *Alinne Moraes*, segmented for a younger public, with the *Ilhabela Destiny and Bijoux commercials*; and products under the **Malhação** license. The leading commercials we showed in 2005 were those for the feminine segment of the *Grendha* line, starring celebrities. These included *Carolina Dieckman*; the *Grendha Doll* commercial with *Daniela Cicarelli*; *Adriane Galisteu*; *Ivete Sangalo*; the *Gianechini Grendha* collection, in which we used a masculine celebrity, *Reinaldo Gianechini*, to help sell feminine sandals; *Grendha Zen* with *Débora Secco*; the new *Grendha Fashion* collection with the Portuguese actor *Ricardo Pereira*; and the *Ipanema* line with top model *Gisele Bündchen* (the “*Tattoo*” commercial) which has been a benchmark for quality and media impact.

In the **men’s segment**, both sales revenue and volume were lower, but not as markedly as in the feminine segment. Outstanding advertising in the year included the *Red Nose* commercial, and the new campaign and launch of *Rider BRX* at the Francal Footwear Fair in July. The *Rider* launch used an exclusive new recording by the band *Jota Quest*, of Roberto Carlos’s classic *Além do Horizonte* – which became a summer hit, taking the place of the “*Let’s Rider*” campaign by the band *Skank*, which was the hit of the previous year’s summer collection with the track “*Vamos Fugir*”.

**The stronger Real and its impact on the domestic market: unfortunately, we expect this factor to continue to exert pressure.** We continue to see several relatively counterintuitive adverse effects of the strengthening *Real*. As well as the familiar increase in imports (including smuggled items), there is also the reduced competitiveness of other footwear exporters – who are obliged to place their product in the domestic market, pressuring price downward due to increased supply. But the greatest impact, and maybe the most difficult to measure, is that *relative prices in the economy tend to fall as a result of the increase of other imported consumer goods*, outside the footwear segment, such as mobile phones, home electronics, toys, clothing, etc. And with the present consensus outlook for the exchange rate, we do not expect a significant improvement on a visible horizon – over the coming quarters.

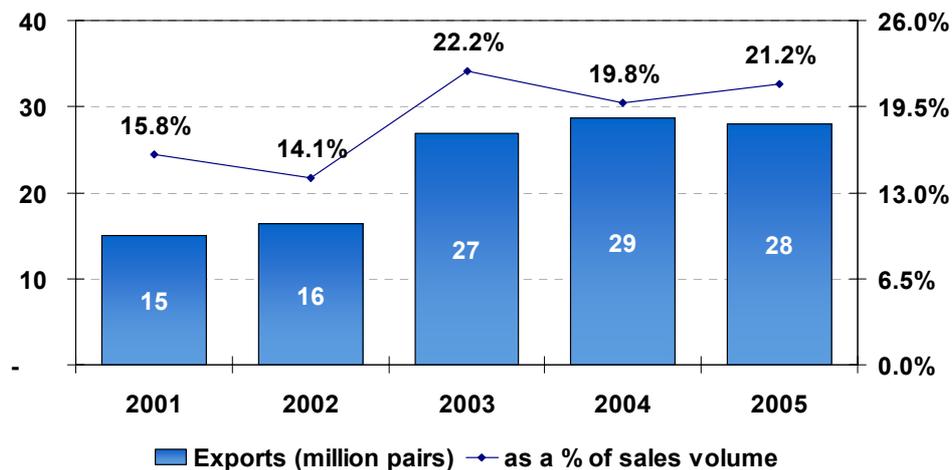
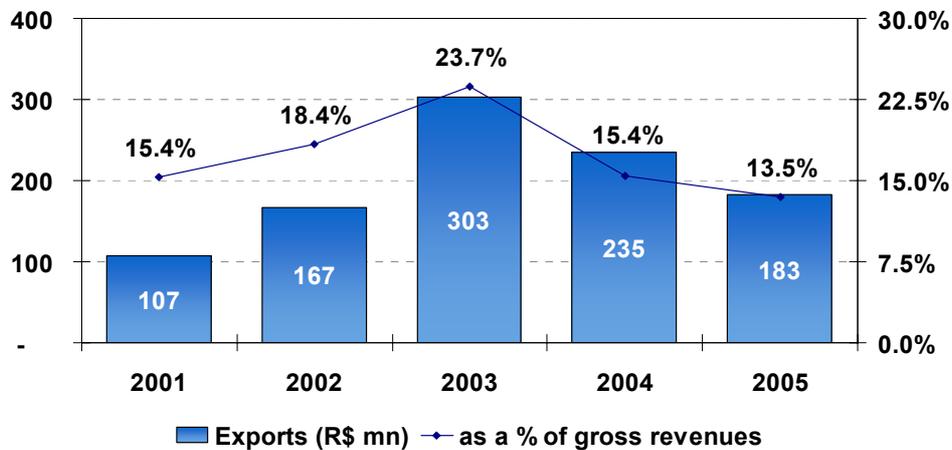
**What positive factors are there for an improvement in the scenario during 2006?** The main factors are the gradual recovery in economic activity (the scenario of reduction of the *Selic* basic interest rate), the gradual increase in real disposable income as a result of lower inflation, and the increase in the minimum wage. The increase in the minimum wage is especially positive for a company selling mass-market products such as our footwear, which mainly targets the C, D and E income groups.

**Export sales:** Our export sales revenue in 2005 totaled R\$ 183.3 mn, 22.1% less, in *Reais*, than in 2004 (R\$235.2 mn), with sales volume 3.6% lower, at 27.7 mn pairs (vs. 28.7 mn pairs in 2004), and average price 19.1% lower in *Reais*. Export revenue in dollars, however, was only 6.3% lower, with average price 2.9% lower than in 2004 – at US\$2.72/pair, vs. US\$2.80/pair in 2004. This was a much smaller reduction than the 16.8% comparison between the average exchange rates in 2005 and 2004.

Exports are more concentrated in the fourth and first quarters (due to the timing of the Northern Hemisphere summer). In the last three years the fourth quarter has provided, on average, 27.5% of our gross export revenue, and the first quarter 32.9%.

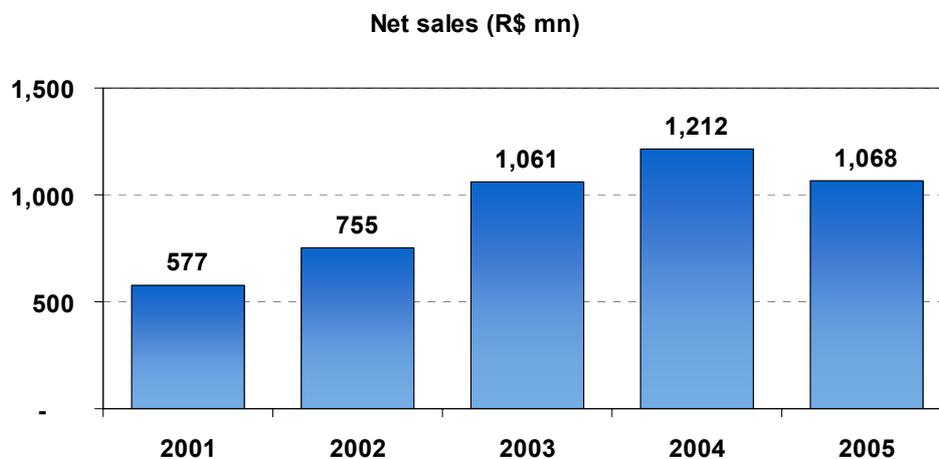
Our lower exports in 2005 were partly due to a strategic decision to upgrade the positioning of the *Melissa* brand, starting more selective distribution of its products in January 2005, and withdrawing the brand from traditional retail channels. This especially impacted the US market, where the brand began to be sold to boutiques and specialized fashion stores, targeting clients with greater purchasing power. This has resulted in a significant fall in sales in the short term, but could result in an increase in sales with higher added value in the medium and long term. Another important factor in the fall in exports was a retraction of purchasing in Europe in the first quarter of 2005, due to the very rainy summer of 2004, which increased distributors' and retailers' inventories, reducing new purchases for the summer of 2005.

Exports produced 13.5% of Grendene's total revenues in 2005, compared with 15.4% in 2004; and 21.2% of total sales volume in 2005, vs. 19.8% in 2004.



## 2. Net sales

Grendene's net sales revenue in 2005 was R\$1,068 mn, 11.8% less than the 2004 total sales revenue of R\$1,212 mn – the reduction is proportional to the reduction in gross sales revenue.



### 3. Cost of goods and services sold

Grendene's COGS in 2005 was R\$624.5 mn, a reduction of 9% (or R\$61 mn) from the 2004 COGS of R\$685.9 mn. The table below shows the components of COGS for the periods indicated and percentage changes for each component.

Cost per pair was 1.3% higher in *Reais* in 2005, at R\$4.79, compared with R\$4.73 in 2004. This reflected increases in the prices of utilities (administered prices including energy, water, and gas) imposed during the year; increased depreciation with the addition to fixed assets of the seventh factory at Sobral; and increased cost of employees. The price of raw materials per pair fell by 6.5% in 2005, showing our greater rationalization in the use of inputs, as well as the effect of the exchange rate after conversion from dollars to *Reais*.

We further improved the criterion for appropriation of the calculation of the components of cost, aiming for more detailing in cost of raw materials and in the separation of elements of products in process and finished products, also separating for the holding company and the subsidiaries – and also taking into account the reversal, and making, of provisions starting in the second quarter of 2005, and the totals for the year.

COGS increased from 56.6% of net sales revenue in 2004 to 58.5% in 2005.

COGS (R\$ mn)	12 months				
	2004	%	2005	%	▲%
Raw material, supplies, intermediate materials, freight and packaging	404.7	59.0%	339.7	54.4%	(16.1%)
Labor	224.7	32.8%	226.6	36.3%	0.8%
Depreciation	21.9	3.2%	22.4	3.6%	2.3%
Other costs (1)	34.6	5.0%	35.8	5.7%	3.5%
<b>Cost of goods sold</b>	<b>685.9</b>	<b>100.0%</b>	<b>624.5</b>	<b>100.0%</b>	<b>(9.0%)</b>
<b>Sales volume (million of pairs sold)</b>	<b>145.3</b>		<b>130.3</b>		<b>(10.3%)</b>

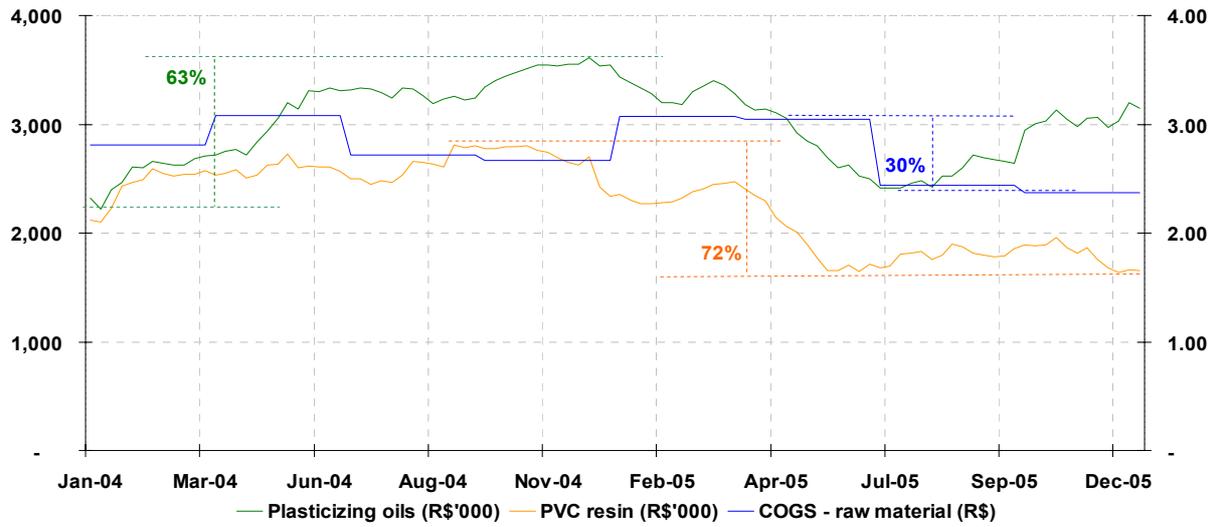
COGS per pair (R\$)	12 months				
	2004	%	2005	%	▲%
Raw material, supplies, intermediate materials, freight and packaging	2.79	59.0%	2.61	54.5%	(6.5%)
Labor	1.55	32.8%	1.74	36.3%	12.3%
Depreciation	0.15	3.2%	0.17	3.5%	13.3%
Other costs (1)	0.24	5.0%	0.27	5.7%	12.5%
<b>Cost of goods sold</b>	<b>4.73</b>	<b>100.0%</b>	<b>4.79</b>	<b>100.0%</b>	<b>1.3%</b>

(1) Other costs include electricity, water, gas, consultancy, IT services, maintenance and other costs.

**Low correlation between input costs per pair and petrochemicals prices:** The great variety of models, and diversity of design, result in the *average weight* per pair varying from quarter to quarter, not necessarily in the same direction as the average price of inputs, factors such as international supply and demand of PVC, volume, negotiation with suppliers, or our cycle of raw materials inventories.

The chart below gives a good illustration of this low correlation, showing the volatility – that is to say the variation between the lowest and highest prices in *Reais* for the period: **for PVC resin, this was 72%; for plastifying oils, 63% – and for our average cost per pair, only 30%.**

“Deconstructing myths” – I: low correlation between input cost per pair and petrochemicals prices

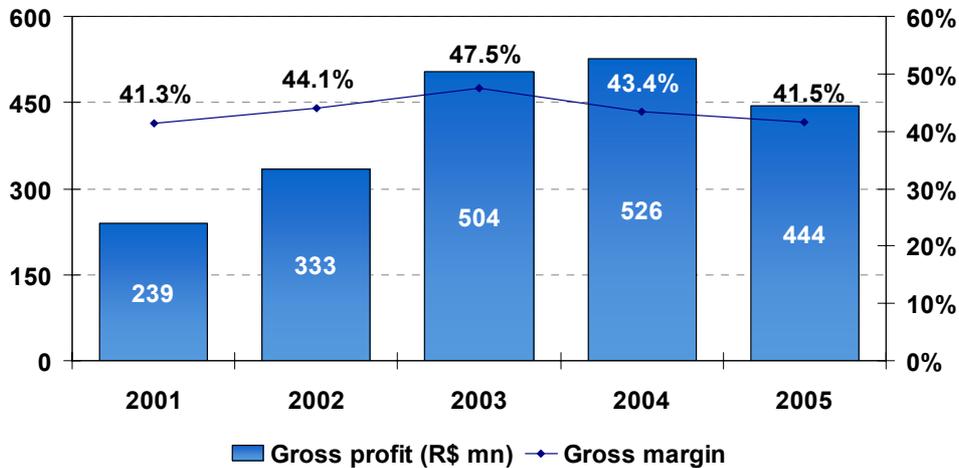


Sources: For petrochemicals prices, ICS-LOR; for Grendene data, previously published quarterly reports.

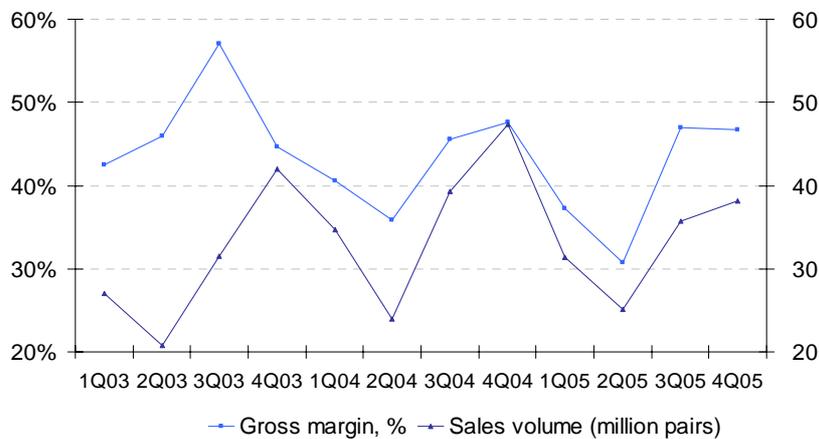
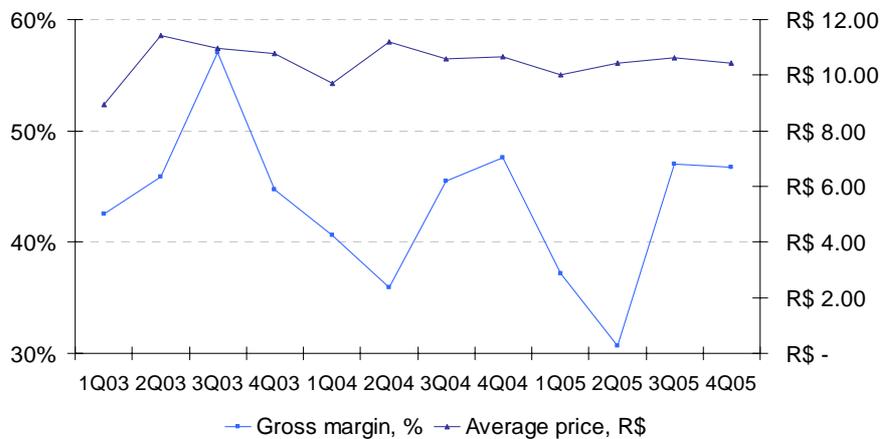
4. Gross profit

Gross profit in 2005 was 15.6% lower, at R\$443.6 mn, compared with R\$525.7 mn in 2004. Gross margin (on net sales) was 41.5%, vs. 43.4% in 2004.

The reduction in gross profit of ~R\$82 mn is the result of net sales R\$144 mn lower, and COGS R\$61 mn lower.



*‘Deconstructing myths’ II – Correlation between average price, sales volume and gross margin:* Gross margin (and hence final profitability) is not strongly affected by average price, as shown at in the chart below. **Volume** has been the more determining variable. Thus an expression such as “improvement or worsening in the mix” is not appropriate – the expression should be “mix with higher or lower average price”, without this necessarily implying higher or lower margin.

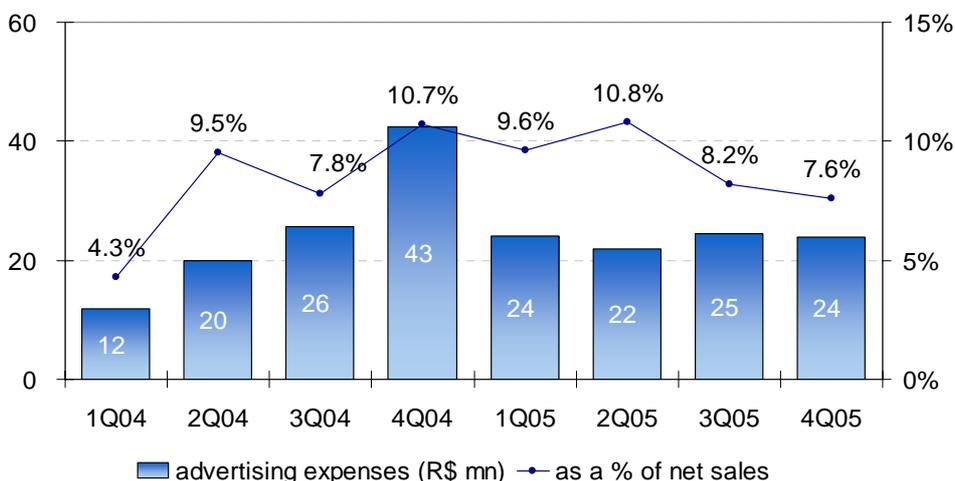
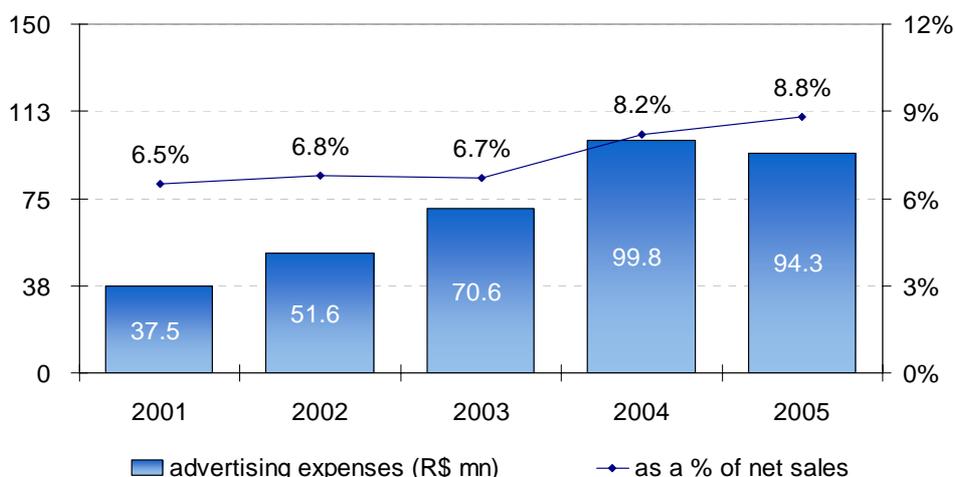


**5. Sales, general & administrative expenses (SG&A)**

**Selling expenses:** Selling expenses were 5.6% lower in 2005 than in 2004, though higher as a percentage of net sales – due to the fall in net sales – at 24.7% (R\$263.7 mn), vs. 23.1% (R\$279.3 mn) in 2004. Most of the reduction was due to direct selling expenses (commissions) 5.6% lower, due to lower sales; spending on marketing and advertising 5.4% lower, and freight expenses 3.1% lower, also reflecting lower domestic sales. Spending on marketing and advertising in 2005 was R\$94.4 mn, vs. R\$99.8 mn in 2004, or 8.8% of net sales (8.2% in 2004).

**Tighter criteria for accounting advertising expenditure:** Starting in 2Q05 we refined our detailing of advertising expenses, to include expenses on sponsorships and disclosures, in a separate item; and adopted the same breakdown criteria for our subsidiaries outside Brazil.

In 2005 we negotiated new licenses, which are now part of the Grendene portfolio: *Batman*; *Hot Wheels*; *Barney*; *Strawberry Collection* and new *Walt Disney* products including *Nemo*, *Pooh Bear* and *Princesses*. A new item in 2006 will be *Superman*, the film of which will reach the market in June.



The reduction in spending on advertising reflects our effort to find the optimum allocation of advertising spending to maximize results, without ceasing to be attentive to the reaction of competitors and the high level of competitiveness in the domestic market. We continue to be alert for market opportunities, but we are strategically more selective in the use of television media in our promotional products.

For 2006 we are projecting advertising spending, aiming to maintain the historic percentages of between 7% and 8% of net sales, without prejudice to our strategy of aggressive marketing using celebrities and emotional appeal.

**General and administrative expenses:** G&A (including compensation of management) in 2005 totaled R\$49.9 mn, 24.8% lower than in 2004, and 4.7% of net sales. This is a reduction of R\$16.5 mn, achieved by reduction of general expenses, from G&A of R\$66.4 mn, or 5.5% of net revenue, in 2004.

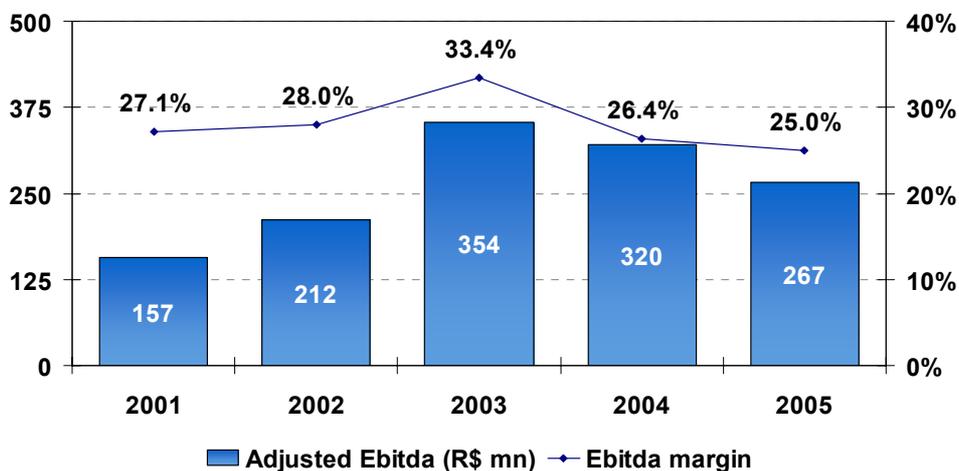
Much of this saving comes from the reduction in outsourced services, totaling around R\$3.3 mn – these include: the one-off expenses of the IPO (legal advice, external audit, printing of prospectuses, legally obligatory advertising, and other expenses inherent to listing), posted in the last quarter of 2004 (not repeated in 4Q05); reduction in spending on material, and cessation of the expense on the leasing contract for the Falcon 2000 company jet, terminated in July 2005.

## 6. Adjusted Ebitda

2005 adjusted Ebitda was R\$266.7 mn, 16.8% less than in 2004 (R\$320.4 mn). Adjusted Ebitda margin (on net sales) was 25%, vs. 26.4% in 2004.

Adjusted Ebitda				
(R\$ mn)	2004	%	2005	%
<b>Gross profit</b>	525,694	43.4%	443,590	41.5%
(-) Selling expenses	(279,333)	(23.1%)	(263,706)	(24.7%)
(-) General and administrative expenses	(65,996)	(5.4%)	(49,069)	(4.6%)
(-) Management fees	(374)	0.0%	(835)	(0.1%)
(+) Equity pick-up	-	0.0%	-	0.0%
(+) Adjustments for tax benefits	113,203	9.3%	109,664	10.3%
(+) Depreciation and amortization	27,221	2.2%	27,089	2.5%
<b>Adjusted Ebitda</b>	<b>320,415</b>	<b>26.4%</b>	<b>266,733</b>	<b>25.0%</b>

(\*) % of net sales



## 7. Net financial income (expenses)

Grendene has been improving this line by improved discipline in management, and a policy of FX exposure based on only operational needs: for acquisition of PVC resin and plastifying oils (whose prices are related to the US dollar), and to pay for imports. This success is clear in the 2005 result, with *Financial income (expenses)* close to zero, compared with net financial expenses of R\$53.3 mn in 2004.

The main aspects of this line were:

- i. Reduction of 19% in the discounts given to clients, proportional with the fall in sales in the domestic market – the net expense on discounts given to clients for punctual payment was R\$47.5 mn in the year, vs. R\$58.6 mn in 2004.
- ii. The effect of exchange rate variation (including BM&F hedge) was a net expense of R\$0.6 mn in 2005, vs. R\$3.6 mn in 2004.
- iii. Income from cash investments was almost 100% higher, due to the higher generation of cash in the period, which increased from R\$32.3 mn in 2004 to R\$66.9 mn in 2005. Net cash at December 31, 2005 was 80.6% higher, at R\$332.7 mn, than at December 31, 2004 (R\$184.2 mn).

Financial income and expenses in the two years were made up as follows:

(in thousand of R\$)	2004	2005	%
<b>Financial expenses</b>			
Client discounts	(58,643)	(47,522)	(19.0%)
Loan costs	(18,501)	(14,232)	(23.1%)
Exchange rate variation expenses	(22,780)	(32,928)	44.5%
BM&F hedge expenses	(1,486)	(7,493)	404.2%
Other financial expenses	(10,562)	(10,077)	(4.6%)
<b>Total financial expenses</b>	<b>(111,972)</b>	<b>(112,252)</b>	<b>0.2%</b>
<b>Financial income</b>			
Financial investments	32,300	66,936	107.2%
Interest received from clients	2,495	2,557	2.5%
Exchange rate variation revenue	13,811	13,283	(3.8%)
BM&F hedge income	6,869	26,527	286.2%
Other financial income	3,166	2,793	(11.8%)
<b>Total financial income</b>	<b>58,641</b>	<b>112,096</b>	<b>91.2%</b>
<b>Net financial result</b>	<b>(53,331)</b>	<b>(156)</b>	<b>n.s.</b>

## 8. Other operational income (expenses)

**Other operational income:** The *Other operational income* account line in 2005 was R\$1.4 mn, mainly from: sale of scrap and other consumption material totaling R\$0.9 mn, rentals totaling R\$0.2 mn, recovery of expenses; and agreements with the industrial training organization, *Sesi*, totaling R\$0.3 mn. *Other operational income* in 2004 were R\$6.7 mn, from R\$4.1 mn in recovered IPI and Cofins tax, under Law 10833/03; R\$1 mn in sale of scrap and consumption material; R\$0.2 mn in income from rentals; R\$1.2 mn in recovery of costs and credits; and R\$0.2 mn from other sources.

**Other operational expenses:** Grendene's *Other operational expenses* account in 2005 totaled R\$1.2 mn, made up primarily of: Cofins, PIS and ICMS taxes and contributions in the amount of R\$0.3 mn; and provision for credits receivable from suppliers in the amount of R\$0.9 mn. In 2004 the line totaled R\$2.3 mn, made up of: R\$0.9 mn in Cofins, PIS and ICMS tax on *Other operational income*; R\$0.8 mn in provisions for obsolete inventories; and other expenses totaling R\$0.6 mn.

### 9. Provision for income tax and Social Contribution

The provision for corporate income tax in 2005 was R\$31.7 mn, lower than the provision of R\$32 mn for 2004. The provision for Social Contribution (CSLL) tax in 2005 was R\$12.3 mn, vs. R\$11.8 mn in 2004.

#### Income tax and Social Contribution Consolidated, R\$'000

Item	2004	2005
Income tax provision	31,955	31,744
Social Contribution provision	11,794	12,330

#### Corporate income tax - net payable

Item	2004	2005
Income tax provision	31,955	31,744
(-) Income tax benefits	(20,048)	(25,701)
<b>(=) Net payable</b>	<b>11,907</b>	<b>6,043</b>

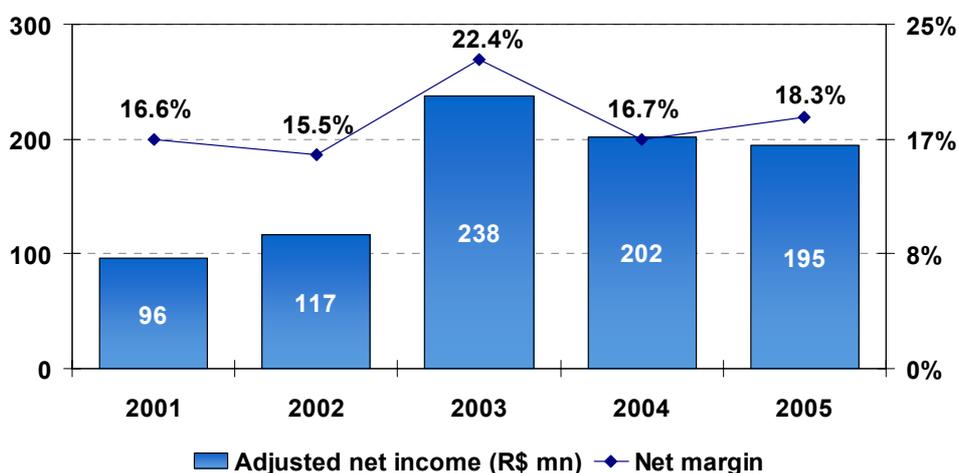
As the table shows the actual cash disbursement on corporate income tax in 2005 (tax payable less tax benefits) was R\$6 mn, vs. R\$11.9 mn in 2004.

## 10. Adjusted net income

In spite of the fall in gross sales revenue and volumes in 2005, respectively of the order of 11% and 10%, the company's major efforts to reduce costs and expenses resulted, with the adjustments in the financial statements, in a less than proportional reduction in adjusted net income, of the order of 3.3%, to R\$195.1 mn – compared with R\$201.8 mn in 2004. At the same time there was a recovery in net margin, of approximately 160 basis points, from 16.7% in 2004 to 18.3% in 2005.

Since the revenues arising from tax benefits under tax incentive programs are accounted directly to Stockholders' equity, in the *Tax incentive reserves* account, without appearing in the income statement, we include them in our adjustment of net income for the years 2005 and 2004, as follows:

<u>R\$ mn</u>	<u>2004</u>	<u>2005</u>
<b>Net income for the year</b>	67.6	85.4
( - ) Deferred Income tax and Social Contribution	(8.2)	0.0
( + ) Reversal of provisions made on 31/12/03	29.2	0.0
<b>Adjusted net profit before tax incentive benefits (pro forma consolidated)</b>	<b>88.6</b>	<b>85.4</b>
( + ) Tax incentive benefits (Provin, Proapi, corporate income tax)	113.2	109.7
<b>Adjusted net income for the year</b>	<b>201.8</b>	<b>195.1</b>

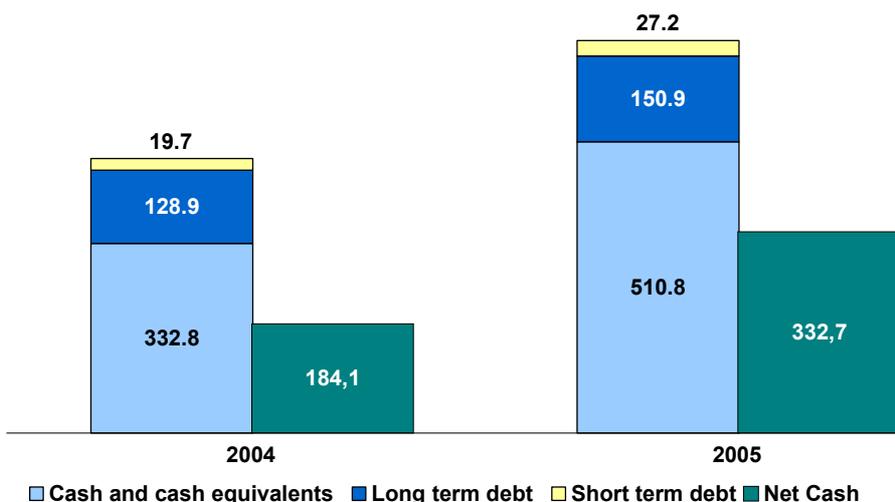


**11. Debt**

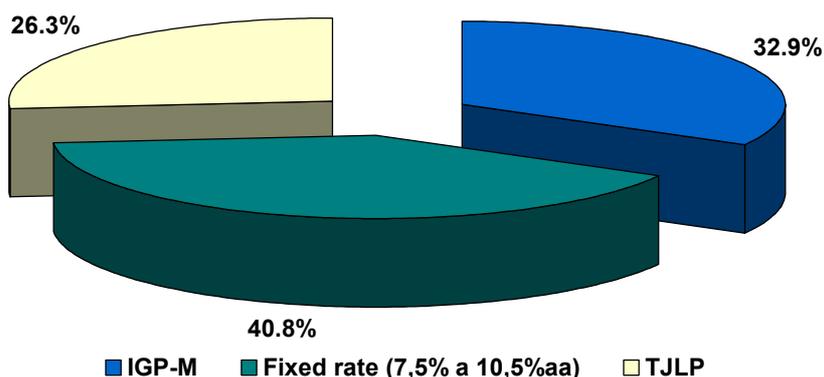
On December 31, 2005 cash and cash equivalents and consolidated cash investments totaled R\$510.8 mn, while short and long term loans and financings totaled R\$178,1 mn. On December 31, 2004, cash, cash equivalents and consolidated cash investments totaled R\$332.8 mn, and loans and financings totaled R\$148.6 mn.

On December 31, 2005, long term loans and financings totaled R\$150.9 mn, and short term loans and financings R\$27.2 mn. On December 31, 2004 these figures were R\$128.9 mn and R\$19.7 mn respectively. The increase in loans and financings consists of undertakings contracted with Banco do Nordeste do Brasil S.A. (final maturity in 2012, fixed rates from 7.5% to 10.5% p.a.), for acquisition of industrial equipment and financing of construction, and with Banco do Estado do Ceará, in loan contracts with periodic repayments linked to the tax benefits given to the company by the State of Ceará (final tenor 60 months, inflation adjustment by the IGP-M Index, TJLP long-term interest rate plus 0%).

**Net Cash of R\$332.7 million in 2005**



**Cost of Debt in 2005**



The table below shows total debt, cash, cash equivalents and cash investments, and net debt on the dates indicated:

Item (in million of R\$)	12M04	12M05
Total debt	148.6	178.1
Cash and equivalents and financial investments	332.8	510.8
<b>Net Debt (Cash)</b>	<b>(184.2)</b>	<b>(332.7)</b>

## 12. Capital expenditure

Grendene's capital expenditure on fixed assets in 2005 totaled R\$40.6 mn, vs. R\$27.5 mn in 2004, broken down as follows:

<b>Capital expenditure</b>		
<b>(R\$ mn)</b>	<b>2004</b>	<b>2005</b>
Industrial buildings and plant	11.3	16.6
Machinery and equipment	10.7	20.2
IT equipment & software	2.4	2.2
Other capital expenditure <sup>(1)</sup>	3.1	1.6
<b>Total capital expenditure</b>	<b>27.5</b>	<b>40.6</b>

*(1) includes investments in vehicles, aircraft, real state, utensils, brands and patents*

In 2005 the project to expand and modernize the seventh plant at the company's largest industrial unit (in Sobral, in the state of Ceará), now responsible for 86% of total production – was concluded, in June, for investment of R\$25 mn. It increases capacity by 16 million pairs.

As mentioned in quarterly releases, the Memorandum of Intent with the government of the state of Bahia for expansion of capacity by addition of one more plant at Teixeira de Freitas in that state gives us until September 2007 to decide whether or not to go ahead with the expansion. The decision will be naturally linked to improvement of market conditions, for it to be a project with an attractive rate of return.

The company now has capacity for production of 176 million pairs/year, sufficient not only to meet present demand but also to give a rapid response to any accelerated growth in consumption of semi-durables in the coming years.

Our estimate for maintenance capex in 2006 is R\$12 mn/year.

### 13. Adjusted cash flow (pro forma)

The adjusted (pro forma) statement of cash flow for the periods ended December 31, 2005 and 2004 (in the table below) shows the company's high capacity for generation of cash flow – and the increase of 57% from 2004 to 2005, with net cash provided by operational activities in the year totaling R\$291.3 mn. The figure for the end of 2005 was R\$178 mn.

#### CONSOLIDATED STATEMENT OF CASH FLOW (R\$'000)

	12/31/2005 Audited	12/31/2005 Pro forma	12/31/2004 Audited	12/31/2004 Pro forma
<b>CASH FLOW FROM OPERATING ACTIVITIES</b>				
Net income for the year	85,401	195,065	67,654	201,805
Minority interest	165	165	-	-
<b>Adjustments to reconcile net income to cash provided by operating activities</b>				
Equity in results of subsidiaries	-	-	-	-
Depreciation	27,089	27,089	27,221	27,221
Tax benefits income tax and exports incentives (Proapi and Provin)	109,664	-	113,203	-
Deferred income tax	665	665	(9,446)	(1,228)
Adjustments from previous periods	-	-	4	4
Decrease in assets	2,231	2,231	1,722	1,722
	<b>225,215</b>	<b>225,215</b>	<b>200,358</b>	<b>229,524</b>
<b>Decrease (increase) in assets and liabilities</b>				
Accounts receivable, net	40,445	40,445	(67,576)	(79,919)
Inventories, net	34,226	34,226	30,606	14,233
Other accounts receivable	4,491	4,491	19,615	19,615
Suppliers	(7,379)	(7,379)	(1,466)	(1,466)
Payroll and related charges	(1,189)	(1,189)	5,874	5,874
Fiscal duties	(1,180)	(1,180)	(1,704)	(1,704)
Other	(3,295)	(3,295)	(134)	(584)
<b>Net cash provided by operating activities</b>	<b>291,334</b>	<b>291,334</b>	<b>185,573</b>	<b>185,573</b>
<b>Cash flows from investing activities</b>				
Investments in affiliates	-	-	-	-
Additions to property, plant and equipment	(40,627)	(40,627)	(27,501)	(27,501)
<b>Net cash used in investing activities</b>	<b>(40,627)</b>	<b>(40,627)</b>	<b>(27,501)</b>	<b>(27,501)</b>
<b>Cash flow from financing activities</b>				
Capital increase	-	-	-	-
Short-term and long-term debt	29,430	29,430	16,428	16,428
Dividends paid	(102,151)	(102,151)	(69,331)	(69,331)
<b>Net cash provided by (used in) financing activities</b>	<b>(72,721)</b>	<b>(72,721)</b>	<b>(52,903)</b>	<b>(52,903)</b>
<b>Increase in cash and cash equivalents</b>	<b>177,986</b>	<b>177,986</b>	<b>105,169</b>	<b>105,169</b>
<b>Statement of increase in cash and cash equivalents</b>				
Start of year	332,774	332,774	227,605	227,605
End of year	510,760	510,760	332,774	332,774
<b>Increase in cash and cash equivalents</b>	<b>177,986</b>	<b>177,986</b>	<b>105,169</b>	<b>105,169</b>



## V. Corporate governance

### 1. The Novo Mercado

On October 29, 2004, Grendene offered stock to the market, within the *Novo Mercado* category of the São Paulo stock exchange (Bovespa) – the division of the Brazilian capital markets with the highest requirements in terms of corporate governance. A stockholder who invests in Grendene knows that this investment has the following features: a vote, since the company has only voting shares; a 100% tag-along right (in the event of a change of control the minority stockholders receive the same value and sale conditions as the controlling stockholders); independent board members; and an aggressive dividend policy (distribution of 100% of the available accounting profit). Further advantages are: the company submits to the Bovespa Arbitration Chamber; will start publishing its financial statements in accordance with international standards (either US GAAP or IFRS), for the 2006 business year; and plans to achieve the minimum required free float of 25% (currently 19.9%) by October 2007.

BOVESPA instituted the *Novo Mercado* at the end of 2000, and since then its regulations have remained unchanged. However, due to changes in the legislation for the capital markets, evolution by the listed companies themselves, and in the domestic and international markets over these five years, Bovespa has made changes to the *Novo Mercado* listing regulation coming into effect on January 6, 2006, reflecting the conclusions of closed consultation meetings with the participating companies held between October 25 and November 25, 2005, and approved by the Brazilian Securities Commission (*Comissão de Valores Mobiliários – CVM*).

These new regulations set the following new standards: 20% of the members of the Board must be independent; their mandate must be up two years; introduction of the concept of dispersed ownership of control, and of shares in circulation; changes in the Arbitration Chamber; and inclusion in the company's bylaws of an arbitration commitment clause (a clause committing to arbitration to solve disputes, including stockholder disputes).

Grendene's board of directors has six members. It met five times in 2005. In compliance with the new regulations of the *Novo Mercado*, proposals adapting Grendene's bylaws will be made to the next Annual General Meeting, to be held on April 10, 2006.

In accordance with the rules of the *Novo Mercado*, we state below the stockholding structure of the group on Dec. 31, 2005 and Dec. 31, 2004, down to the level of beneficial ownership by individuals:

#### 1. Structure of Grendene S.A.

Shareholders	Dec. 31, 2005		Dec. 31, 2004	
	# ON Shares	%	# ON Shares	%
Alexandre G. Bartelle Particip. S/A	30,000,000	30.0%	30,000,000	30.0%
Verona Neg. e Particip. S/A	24,000,000	24.0%	24,000,000	24.0%
Grendene Negócios S/A	20,100,000	20.1%	20,100,000	20.1%
Alexandre G. Bartelle	3,000,002	3.0%	3,000,002	3.0%
Pedro Grendene Bartelle	2,999,986	3.0%	2,999,986	3.0%
Free float (*)	19,900,012	19.9%	19,900,012	19.9%
<b>Total</b>	<b>100,000,000</b>	<b>100.0%</b>	<b>100,000,000</b>	<b>100.0%</b>

(\*) Shareholders holding less than 5% of company's voting shares.

1.1. Structure of **Alexandre G. Bartelle Participações S.A.**

Shareholders	Dec. 31, 2005		Dec. 31, 2004	
	# ON Shares	%	# ON Shares	%
Alexandre G. Bartelle	9,999,997	99.9%	9,999,997	99.9%
Pedro Grendene Bartelle	1	0.0%	1	0.0%
Elizabeth Bartelle Laybauer	1	0.0%	1	0.0%
Maria de Lourdes Bartelle	1	0.0%	1	0.0%
<b>Total</b>	<b>10,000,000</b>	<b>100.0%</b>	<b>10,000,000</b>	<b>100.0%</b>

1.2. Structure of **Verona Negócios e Participações S.A.**

Shareholders	Dec. 31, 2005		Dec. 31, 2004	
	# ON Shares	%	# ON Shares	%
Pedro Grendene Bartelle	5,008,000	50.0%	5,008,000	50.0%
Élida Lurdes Bartelle	2,496,000	25.0%	2,496,000	25.0%
Maria Cristina Nunes de Camargo	2,496,000	25.0%	2,496,000	25.0%
<b>Total</b>	<b>10,000,000</b>	<b>100.0%</b>	<b>10,000,000</b>	<b>100.0%</b>

1.3. Structure of **Grendene Negócios S.A.**

Shareholders	Dec. 31, 2005		Dec. 31, 2004	
	# ON Shares	%	# ON Shares	%
Alexandre G. Bartelle Particip. S.A.	5,522,390	55.2%	5,522,390	55.2%
Verona Neg. Particip. S/A	4,477,610	44.8%	4,477,610	44.8%
<b>Total</b>	<b>10,000,000</b>	<b>100.0%</b>	<b>10,000,000</b>	<b>100.0%</b>

## 2. Controlling shareholders, directors and free float

Shareholders	Dec. 31, 2005		Dec. 31, 2004	
	# ON Shares	%	# ON Shares	%
Controlling stockholders	80,099,988	80.1%	80,099,988	80.1%
Board of Directors	109	0.0%	12	0.0%
Audit Board (*)	-	-	-	-
Executive Officers	27,800	0.0%	9,617	0.0%
Free float	19,900,012	19.9%	19,900,012	19.9%

(\*) Audit Board not currently installed.

## 3. Free float: investors by type

Investors	Dec. 31, 2005			Dec. 31, 2004		
	#	# ON Shares	%	#	# ON Shares	%
<b>Non-institutional</b>						
Individual investors	3,288	1,876,073	9.4%	4,875	1,917,622	9.6%
Investment clubs	26	112,712	0.6%	43	165,734	0.8%
<b>Total</b>	<b>3,314</b>	<b>1,988,785</b>	<b>10.0%</b>	<b>4,918</b>	<b>2,083,356</b>	<b>10.4%</b>
<b>Institutional</b>						
Insurance companies	1	40,000	0.2%	1	53,800	0.3%
Pension funds	71	1,398,310	7.0%	94	1,668,838	8.4%
Mutual funds	102	4,124,385	20.7%	146	1,705,314	8.6%
<b>Total</b>	<b>174</b>	<b>5,562,695</b>	<b>27.9%</b>	<b>241</b>	<b>3,427,952</b>	<b>17.3%</b>
<b>Foreign investors</b>	<b>86</b>	<b>11,457,464</b>	<b>57.6%</b>	<b>139</b>	<b>14,137,175</b>	<b>71.0%</b>
<b>Public and private companies</b>	<b>65</b>	<b>101,059</b>	<b>0.5%</b>	<b>79</b>	<b>140,023</b>	<b>0.7%</b>
<b>Financial institutions</b>						
Commercial banks and Consumer financing	4	511,000	2.6%	3	36,000	0.2%
Investment banks and brokerage houses	7	279,009	1.4%	8	75,506	0.4%
<b>Total</b>	<b>11</b>	<b>790,009</b>	<b>4.0%</b>	<b>11</b>	<b>111,506</b>	<b>0.6%</b>
<b>Total</b>	<b>3,650</b>	<b>19,900,012</b>	<b>100%</b>	<b>5,388</b>	<b>19,900,012</b>	<b>100%</b>

## 2. Corporate action and subsequent events

### Highlights

**Meeting of the Board of Directors of January 28, 2005:** Approval of Grendene's stock trading policy. This put in place mechanisms for control and transparency of trading in the company's stock by all interested parties, without giving any individual group privilege over any other.

**March 23 to April 4, 2005: Apimec meetings:** In accordance with the regulations of the Novo Mercado, public meetings with capital market analysts were held in São Paulo, Rio de Janeiro, Porto Alegre and Belo Horizonte.

**Annual General Meeting of April 18, 2005:** Ratified the proposal by the directors for distribution of dividends of R\$0.64151 per common share, payable on May 11, 2005; approved the financial statements for 2004, decided on distribution of profit, and elected members of the Board.

**Extraordinary General Meeting of April 18, 2005:** This approved an increase of R\$113 mn in the company's capital, arising from tax incentive reserves accumulated to December 31, 2004, to 100 mn common shares on March 31, 2005.

**Prize award, April 19, 2005:** Grendene received the "Wal-Mart International Supplier of the Year, 2004" award at a ceremony in the Rangtze Renaissance Hotel in Shanghai (China). Wal-Mart's Global Procurement Department chose 50 global suppliers for the quality of their products, punctuality and partnership values, including Grendene S.A. Only three suppliers in the footwear sector were selected – Grendene S.A. was the first Latin American company to earn this award – the other two being suppliers from Asia.

**Meeting of the Board of April 29, 2005:** This approved the restructuring of the company's management, with creation of the Administrative and Controller's Department, headed by Gelson L. Rostirolla; and election of Marcus Peixoto, CFA, as Chief Financial Officer and Investor Relations Director.

**Termination of the aircraft leasing contract, July 22, 2005:** As stated on page 84 of the IPO prospectus dated October 28, 2004, in the chapter "*Contractual Obligations and Commercial Commitments*", we had an operational leasing contract (without option to purchase) for one aircraft, with a renewal date on July 22, 2005. Notice was given to terminate this operational leasing, the annual rental payment under which was US\$ 1.35 mn, paid in two equal half-yearly installments.

**Notice of convocation to the Extraordinary General Meeting of Shareholders of August 12, 2005:** Grendene, focusing on corporate governance best practices, proposed to its shareholders the replacement of one of the members of the controlling family on the board with an independent member, Ms. Ana Novaes. An Extraordinary General Meeting of Shareholders was called to elect the new member to replace Ms. Elizabeth Bartelle Laybauer, who resigned in accordance with the sub-paragraph of Clause 17 of the Bylaws, for termination of her period of office on the date of the next Annual General Meeting. Ana Novaes, as an independent member, will add substantial value to Grendene's board of directors. Our shareholders were invited to express their opinion in a free vote, with about two weeks' notice, in accordance with the legislation in force, and by voting supported one more action aligning the company with the interests of its minority shareholders.

**Extraordinary General Meeting of August 12, 2005:** There were no votes against the election of Ana Novaes, and she was elected unanimously, replacing a member of the board linked to the controlling family with an independent member. In an action unprecedented among Brazilian companies, shareholders were informed, on Tuesday August 1, of the proposal for election of an independent Board member approximately two weeks in advance, giving Ana Novaes's name, and attaching her summary CV, giving the minority shareholders time to consider the proposed election and inviting them to exercise their right to vote – in line with the best corporate governance practices.

**Market Announcement of September 23, 2005:** Bradesco Corretora was contracted to operate as market maker of Grendene's ON shares, and started operating on September 26, 2005. The São Paulo stock exchange specified a maximum permitted spread of 3% between bid and offer price.

**Meeting of the Board of directors of October 28, 2005:** This meeting approved the interim dividend for 2005 in the amount of R\$38,000,000.00 (**R\$0.38 per common share**), subject to ratification by the Annual General Meeting that considers the financial statements for 2005. The interim dividend was paid on account of net income for 2005, for the period January through September, to shareholders of record on October 31, 2005. The shares traded ex-dividend on November 1, 2005, and the dividend was paid on and after November 17, 2005.

**Dividends**

**Meeting of the Board of March 6, 2006:** This approved the directors' proposal for a total dividend for 2005 of R\$81.2 mn (R\$0.81181 per common share).

**The remaining balance of dividends for 2005**, will be payable to shareholders of record on the date of the Annual General Meeting that approves the financial statements for the business year ended December 31, 2005 – April 10, 2006. The shares will trade ex-dividend on April 11, 2006, with payment to begin on April 26, 2006.

**The calculation of dividends distributed**, and the remaining balance for the business year ended December 31, 2005, was as follows:

**2005 business year**

(+)	Net account income (company) 2005	R\$	84,395,180.91
(-)	Legal reserve: 5%	R\$	(4,219,759.05)
(+)	Reversal of realizable profits reserve	R\$	2,402,584.44
(+)	Realizable profits reserve	R\$	(1,397,000.00)
(=)	<b>Net dividend distributable</b>	<b>R\$</b>	<b>81,181,006.30</b>
	Basis for calculation of dividends (per common share)	R\$	0.81181006
	<b>Payout on distributable net income</b>		<b>100%</b>

**Interim dividend for January-September 2005**

(+)	Net account income (company) 2005	R\$	42,170,113.02
(-)	Legal reserve: 5%	R\$	(2,108,505.65)
(+)	Reversal of realizable profits reserve	R\$	2,402,584.44
(+)	Realizable profits reserve	R\$	(3,491,000.00)
(-)	Retained earnings reserve	R\$	(973,191.81)
(=)	<b>Net dividend distributable</b>	<b>R\$</b>	<b>38,000,000.00</b>
	Basis for calculation of dividends (per common share)	R\$	0.38000000
	<b>Payout on distributable net income</b>		<b>100%</b>

**Balance of 2005 dividends payable in April 2006**

(=)	<b>Net dividend distributable (after deducting interim payment)</b>	<b>R\$</b>	<b>43,181,006.30</b>
	Basis for calculation of dividends (per common share)	R\$	0.43181006
	<b>Payout on distributable net income</b>		<b>100%</b>

**Dividend policy**

Under the bylaws the minimum obligatory dividend is 25% of the remaining net profit for the business year after the reserves required by law have been constituted. Our dividend policy, however, is to pay as dividend 100% of the distributable accounting net profit after deduction of the legal reserves, paid always half-yearly, in April and November, the November payment being an interim dividend on account of the net profit for the year.



## VI. The capital markets

Grendene floated its stock by a secondary public offering of common shares on October 29, 2004, in the highest corporate governance category of the Brazilian capital markets, under the ticker **GRND3**. It has 100 million common shares, of which 19.9% are in the hands of the market. Since it was listed on the Bovespa *Novo Mercado*, it is included in the Differentiated Corporate Governance Share Index (the IGC Index), made up of a theoretical portfolio of shares with good levels of corporate governance. In the four-month period September through December 2005, Grendene shares represented 0.302% of the IGC Index.

On June 29, 2005 the Bovespa launched its Differentiated Tag-Along Share Index – the ITAG Index – which measures the performance of a theoretical portfolio of the shares that give the best tag-along conditions – superior to those in the applicable legislation – to minority stockholders in the event of a change of stockholding control.

**Grendene gives its shareholders a 100% tag-along right** – that is to say in the event of a change of control minority shareholders will receive the same price per share as the controlling stockholders, where the Corporate Law calls for 80% of that price. In the four-month period September through December 2005 Grendene’s shares represented 0.37% of the ITAG Index.

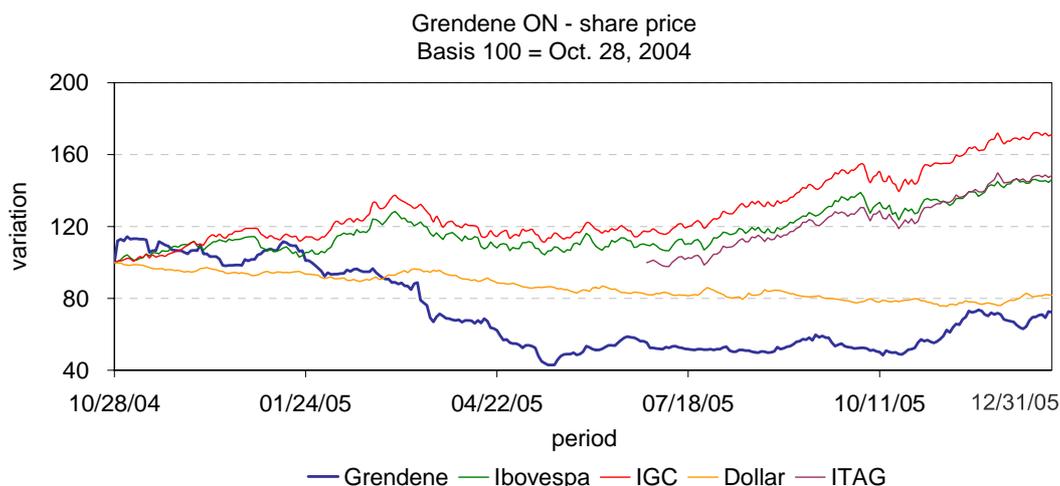
In the 12 months of 2005 the stock traded at a daily average of 152,000 common shares, with average daily financial value of R\$3.1 mn, and an average of 101 transactions per day.

Trading, Jan. 1 - Dec. 31, 2005	Average Price	Change	Trades	Shares	Financial volume R\$	Maximum price	Minimum price	Average Shares/trade	Average R\$ per trade
Daily averages	20.29		101	152,279	3,133,325	34.61	13.29	1,510	31,071.20
<b>Total, Jan. 1 - Dec. 31</b>		(27.55)	25,110	37,917,500	780,197,820				

**Larger number of trades, smaller average number of shares per trade:** The table below gives liquidity indicators for Grendene’s common stock – number of trades, number of shares, financial volume – after the market maker began operating on September 26, 2005. Financial volume per trade in the period from July 1 to September 30, 2005 was approximately R\$ 36,000, averaging 2,258 shares per trade. After the market maker began operating, these figures decreased to approximately R\$ 28,000 and 1,485 shares/trade, a reduction of approximately 34% in the average number of shares per trade.

Trading, Sept. 26 - Dec. 31, 2005	Average Price	Change	Trades	Shares	Financial volume R\$	Maximum price	Minimum price	Average Shares/trade	Average R\$ per trade
Daily averages	18.89		148	219,348	4,144,626	22.80	14.99	1,485	28,064.56
<b>Total, Sep. 26 - Dec. 31</b>		(27.55)	9,747	14,477,000	273,545,298				

The chart below shows the behavior of Grendene’s ON shares, on the basis of an index number of 100 for October 28, 2004 – the date of the initial published notice of the secondary public distribution of common shares at R\$ 31.00 per share – in comparison with movements in the Bovespa index, the IGC index, the ITAG index, and the US dollar exchange rate, up to December 31, 2005.





VII. Social and environmental statement

**Sustainability, with business ethics:** Grendene has taken a pioneer initiative in the sector, again indicating benchmark quality in corporate governance, with its participation in the *Global Apparel and Footwear Project of the Global Reporting Initiative (GRI)*. GRI is an international non-profit company based in Amsterdam which carries out global surveys on parameters for sustainability in business models based on business and work ethics, environmental practices, relationships with employees and the community – among the most important – involving the experience of large companies in each sector, NGOs and entities related to the subject.

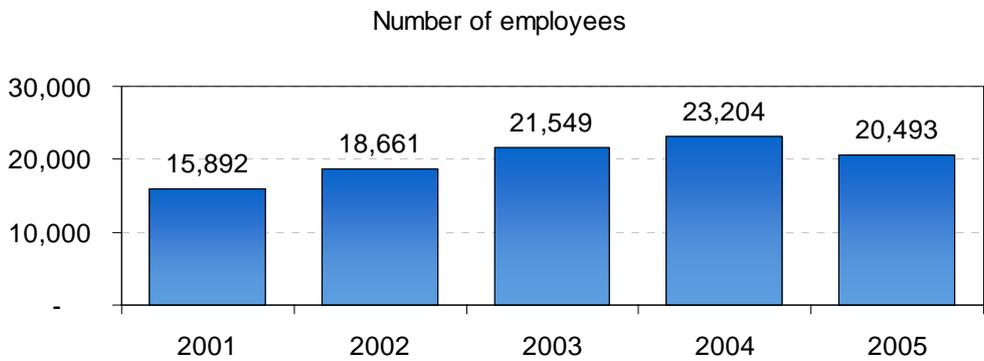
The *Global Reporting Initiative* brings together a task force of leading companies in each sector, to provide a parameter framework for the sector and create global comparability between different companies within it.

Grendene is the first Brazilian company to take part in the preparation of the framework of indicators for the GRI for a sector. The best practices for obtaining sustainability will be defined based on the “triple bottom line”: economic result, minimization of environmental impact and maximization of positive social impact. The first meeting was in Amsterdam on September 29 and 30, 2005, and the second in Colombo, Sri Lanka, on December 15 and 16, 2005, with the presence of important companies of the sector: *C&A, Feng Tay Group, Gap, Grendene, H&M, Levi-Strauss, Mas Holdings, and Nike* – and various representatives of environmental and social entities. The project will have duration of one year from September 2005.

Grendene has a clear vision of its corporate responsibility, especially in the communities where it operates in the states of Ceará, where it has been based for more than 15 years, and Rio Grande do Sul, where it has been for 35 years – and also its economic and social importance.

On December 31, 2005, Grendene employed 20,500 people, including those in administrative areas, in all the plants in the state of Ceará (Sobral, Crato and Fortaleza) and Rio Grande do Sul (Farroupilha, and the mold-making center in Carlos Barbosa). This compares with 23,200 people on December 31, 2004. The reduction reflects the adjustment made necessary by the fall in sales volume of 10.3%, and in sales revenue of 11%, from 2004 to 2005, in turn due to the more adverse market conditions and exchange rate.

Grendene’s headquarters is in the municipality of Sobral, where its largest industrial unit is located, with seven factories, producing 86% of the company’s total output, and 14,800 employees – around 40% of the economically active population of the region. The main administrative office is in Farroupilha (Rio Grande do Sul).



Ever working for improvement, we are aware of our role in the globalized economy, and in 2005 we widely disseminated the Grendene Values – which attach importance to profit, competitiveness, innovation, agility, and ethics – in tune with socially just and environmentally fair attitudes that show commitment to the communities where we work. We communicate these values to society, clients, employees, suppliers and shareholders.

As part of this attitude, over the last five years Grendene has been reviewing its social actions, and publishing the results of this review to its stakeholders. Along with the consolidated data, these reports highlighted the city of Sobral, because it hosts Grendene’s largest production unit and is an example of work with the community where the company operates. Similar projects were undertaken in the Crato and Fortaleza units, and in the units of Rio Grande do Sul with the appropriate regional differences and taking into account the needs of each community. Since 1993 the city of Sobral has undergone several changes, and Grendene has been part of this history. In 13 years it has generated 10 times more jobs than it initially proposed, in this town alone (without including Crato and Fortaleza), and transformed itself into one of the largest plastic shoe manufacturing companies in the world, as these figures show:

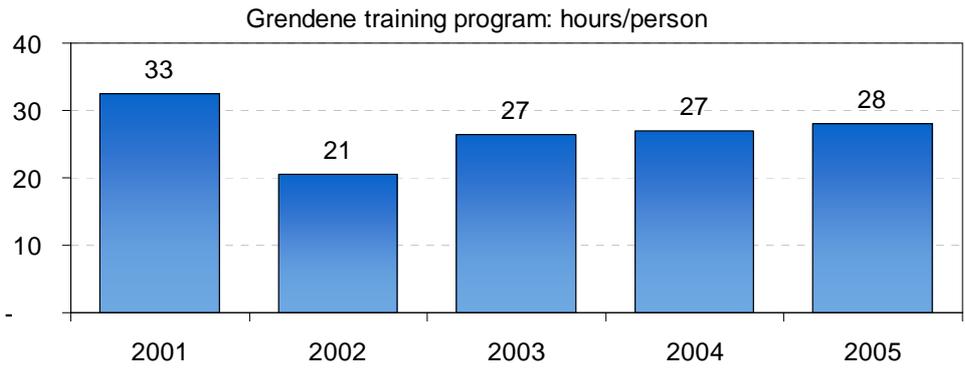
	<b>Grendene, consolidated figures</b>	<b>Figures for the Sobral unit</b>
Start of operation	1971	1993
Number of plants	13	7
Built area	266,000 m <sup>2</sup>	166,000 m <sup>2</sup>
Installed capacity	176 mn pairs	154 mn pairs
Employees	20,500	14,800

Grendene’s social and environmental statement is made up of nine groups of information:

**1. Our programs**

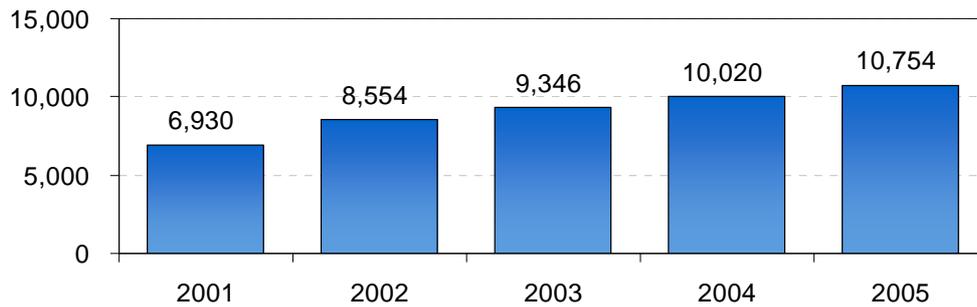
We have eight programs functioning in the company, of which six are of a social nature and two environmental. They aim to improve the quality of life of the employees and interact directly with local communities. There are also joint programs developed with partnerships. The main programs and their aims are:

I. **Training program:** Training of employees in their specific functions, and promoting their technical and professional development. Additionally, in 2005, with the dissemination of the Grendene Values, there was an emphasis in all activities on making all teams aware of acting with focus on the business, awakening the “feeling of ownership”, seeking improvements, reduction of costs and optimization of processes. Leadership development programs connected with the principal market trends helped to define a new profile for supervisors. 1,693 employee-hours of internal training were given, and external training partially or totally funded.



- II. **Work safety program:** This aims to preserve the health and safety of workers through a secure and healthy working environment. 204 campaigns, with a total of 8,158 employee-hours of training, were given in 2005 – led by training on chemical products, with 79 class groups, and educative campaigns on the use of Individual Protection Equipment (IPE), prevention of accidents and ergonomic risks.
- III. **Home and hospital visits program:** This gives support in the solution of personal problems of employees and their family members, principally those related to health. The visits seek to support the employee by becoming familiar with his or her situation, making it possible to provide orientation on medical, hospital and illness-assistance resources.
- IV. **Institutional visits program:** This aims to promote transparency and integration with the community by giving schools, and public and private institutions, access to the company’s factory premises. 16 visits to the Sobral factory units were organized in 2005, two of them with groups of Brazilian and foreign investors.
- V. **Family planning program (“Bemfam”):** This provides assistance in sexual and reproductive health, facilitating the offer of family planning services. The program’s main instrument is individual counseling, and educational activities for groups of women and men. Oriented access to family planning methods regulated by the Health Ministry is made available, and gynecological pathologies are diagnosed and treated, or the employee is introduced to outpatient facilities of the public health network. The program exists in the other units, but is most intensive at Sobral, as this chart shows:

Grendene's BEMFAM family planning program:  
Numbers of people assisted, 2001-2005



- VI. **Blood donor corporate citizenship program:** This program, with the acronym *Hemoce*, runs campaigns to make people aware of the value of giving blood, through educational lectures to employees. With the Hemoce program's topping-up policy, we ensure the necessary reserves to serve our employees, their family members and the community – aiming for self-sufficiency in the blood banks of the town of Sobral. There are similar activities in other Grendene units.
- VII. **Solid waste management program:** This minimizes the impact of Grendene's operations on the environment, through reduction and recycling of solid wastes and raw material. All waste resulting from the industrial processes is totally recycled. To preserve and improve the environment, there is a continuous quest for reduction, re-use and recycling of wastes and raw materials used in the production process. In the number 4 plant at Sobral there is an entire area dedicated to the recovery of waste.

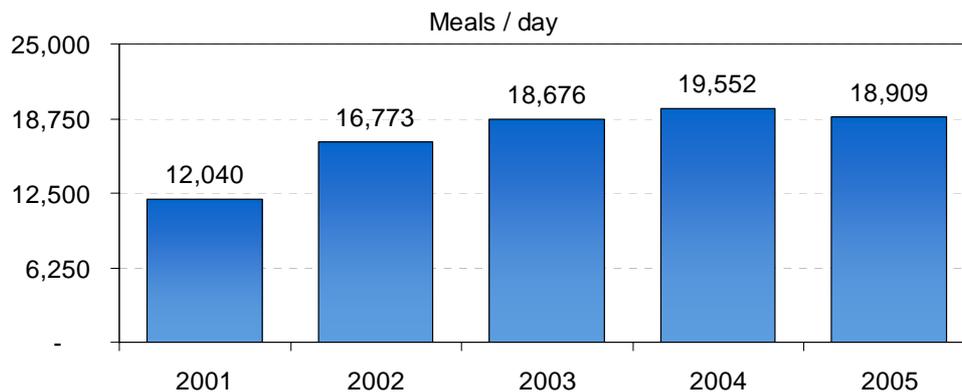
Waste material	Quantity generated	State	Units	Description
PVC	5,379.07	Solid	tons	100% recycled
Vincal	462.40	Solid	tons	100% recycled
Acetone	295,026.67	Liquid	liters	100% recycled
Paint residues/acetone	36.80	Plastic	tons	100% recycled

- VIII. **Tree planting service program:** This aims increasingly to humanize the factory environment through gardening and planting of trees on the external and internal patios. Grendene's sapling banks have a partnership with the Sobral town hall, and through co-operation the two organizations plant trees in the city, which has an extremely hot and arid climate. The sapling bank, created in 2003, now has 2,000 saplings of trees and small ornamental plants. Grendene already has 2,414 trees in the Sobral factories as a whole.

## 2. Our benefits

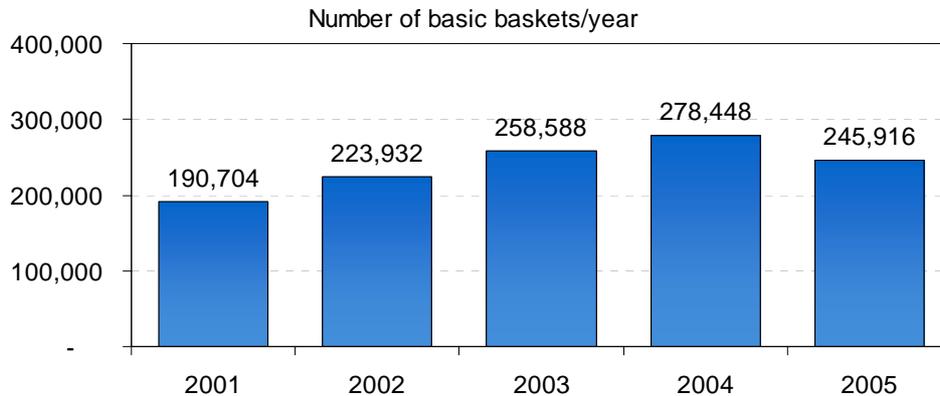
Grendene's social commitment is to foster citizenship. For this we make the following benefits available to our employees, with the aims indicated:

- I. **Health services.** Aim: To help maintain employees' health. Clinical and gynecological consultations, pre-natal monitoring and audiometric exams are made available. Quality service, focused on efforts for prevention through educative lectures centering on prophylactic medicine, are offered. There is a medical team in all the units to serve employees.
- II. **Hearing and speech specialists.** Aim: Contribute to employees' auditory health. Four speech and audition professionals are available to carry out audition metric tests as part of the Hearing Conservation program (PCA).
- III. **Specific preventive campaigns.** Aim: Permanent promotion of preventive and corrective actions, on themes centering on current needs. Highlights of 2005 were the lectures on: arterial hypertension, gynecological cancer prevention, drug use prevention, first aid, work quality of life, eating habits, physical and chemical risks, diabetes, dengue, conjunctivitis, health during pregnancy, family planning, prevention of AIDS, sexually transmitted diseases, hearing loss induced by noise in the workplace, prevention of biomechanical disorders of the spine and legs; and dental health.
- IV. **Meals.** Aims: To offer healthy and balanced food with a high standard of quality, satisfying users, in partnership with Nutrinor. A team of five nutrition experts, a domestic economist, five food technologists and two production supervisors daily monitor the supply of about 16,000 meals/day in Sobral alone, operating with a team of about 160 employees in two industrial kitchens. Grendene subsidizes 95% of the cost of these meals: each employee pays R\$0.17 per meal.



- V. **Dental assistance.** Aim: To promote employees' dental health. The company has a team of seven dentists and three assistants in four surgeries placed in two sectors serving the seven Sobral factories. The proportions are different in the other units in accordance with their size.
- VI. **Internal outpatient units.** Aim: To provide first aid and outpatient service 24 hours per day. The centers provide consultations by appointment, temperature and blood pressure tests, bandages, passing through to medical specialists and administration of medication according to medical prescriptions. There are six of these centers in the Sobral factory units, and one for each of the units at other locations, equipped with doctors' surgeries and first aid materials.
- VII. **Appointments for specialized exams.** Aim: To provide appointments for specialized tests and consultations inside the company, through its Social Service in partnership with the Medical Consultations Appointment Service of the municipality of Sobral, aiming to facilitate and speed up service to our employees. There is also a partnership with the regional laboratory of the municipality, to which test samples taken in the company's out-patient centers are sent for analysis. This facilitates the life of the employee, avoids congestion in the services of the municipality, and generates greater efficiency for all those involved.

VIII. **“Basic basket” food supplies.** Aim: To provide food supplementation for the employee’s family. This benefit envisages the wellbeing of the employee and his family. Each month each employee receives, free of charge, two bags with 24 kilos of foods. In 2005 5.1 tons of food was distributed in this form through 245,916 of these “basic basket” food hampers.



IX. **Personal loans.** Aim: To provide subsidized credit to employees in adverse situations relating to the homes they live in, health and education. This is part of a policy of social empowerment which aims to enable employees to own their own homes, also providing support to employees in adverse situations related to health and education. A case-by-case assessment is made by Grendene’s social workers for granting of the loans, which are made at below-market levels with repayment in up to six installments.

X. **Bank branch.** Aim: Convenience for employees in receipt of their salaries, and for payment of bills and other bank services. An agreement with Bradesco facilitates employees’ transactions with two Bradesco branches and eight Bradesco 24-hour ATMs at strategic locations throughout the company’s premises.

XI. **Day care and pre-school.** Aim: Access to day-care and pre-school facilities for children to the age of six whose mothers work for the company. The employees’ children receive the free service of three teaching and infant-school institutions, on authorization by our social workers, and this is seen as a form of social empowerment.

XII. **Agreements with specialized services.** Aim: To provide ease of access to certain specialized services.

**Eye clinics:** For consultations Grendene provides access to three private clinics in Sobral, and at its other plants, for a special price, debited in installments from payroll.

**Eyewear:** Discounts of up to 40% on the standard prices of the local Association (Ceará Jewelers’ Association) at three opticians in Sobral, and in other cities where the company has units, deducted in installments from payroll.

**Pharmacies:** Facilitating acquisition of medical drugs under agreements with two pharmacies, one of which has a unit working inside the Sobral factory premises – with 17.5% discounts on the nationwide price list.

### **3. Our campaigns**

Corporate and social responsibility manifested through concrete action and campaigns.

- I. **“No Hunger at Christmas” donation campaign:** This collects food, clothes, footwear and toys to be given to needy communities in the areas around our factories.
- II. **Warm Clothing campaign:** This collects winter clothes to be given to needy communities, especially around our units in the South, where the winter can be very cold.

#### 4. Our partnerships:

The highlight is our relationships with the communities of Sobral, Crato and the northwest of the state of Ceará, with public and private agencies, and NGOs:

- I. **The positive solidarity network.** Aim: Supplementary food supplies for HIV positive patients at the Madre Ana Rosa Gattorno home. This center offers the following services free to HIV positive patients in Sobral region: Temporary food, dormitory accommodation and support; clinical backup (patients who come to the city for tests, medication or other procedures and need to stay there for any practical reason); social/educational workshops on various themes, including family planning and sexually transmitted diseases; and professional training courses. We have received a diploma of recognition from the Institute for Voluntary Help to those who live with HIV. A total of 860kg of foods was donated in 2005.
- II. **Good Samaritan Home, and Municipal Hostel:** Grendene transports food – including 1,200 liters of soup in the whole of 2005 – not used in the company’s restaurant kitchens, and provided by Nutrinor – the outsourced company which administers the company’s restaurants.
- III. **Congregation of the Josefinas Sisters of the Dom José District.** Aim: To provide additional food for 90 needy families in the district – in partnership with Nutrinor, 21,600 liters of soup were donated in 2005.
- IV. **“Mothers’ House” Project of the Santa Casa Hospital.** Aim: To provide “basic food hampers” monthly to support this institution, which provides accommodation to need mothers of Sobral and other locations whose babies are in prolonged treatment at the Santa Casa Hospital and need breastfeeding. 2,007kg of foods were donated in 2005.
- V. **Donation of footwear to Ceará State government:** 3,000,000 pairs of shoes will be donated to children in the public schools of the state of Ceará, through the state’s Social Action and Education Departments, in a four-year program (2003-2006). So far 2,394,057 pairs of shoes have been delivered.
- VI. **Sobral town hall:** Maintenance to the São João Square in the town paid for by Grendene, under the *Adopt a Square* program: A small urban favor to the town center, maintaining all the gardens of the square, which is one of the most important and pleasant in Sobral. Every Thursday a fair selling handmade art objects is held in the square, which is an important historical and architectural feature of the town.
- VII. **Recruitment program for people with special needs.** Aim: Inclusion in the labor market of people with special needs, through an agreement with the organization *Sine-IDT*, which provided candidates to be selected by Grendene. The program has been recognized by the government of Ceará State through its **open doors trophy**, since its creation.
- VIII. **Guarany Sporting Club.** Aim: Stimulate the town’s football team, by stimulating sport. Grendene believes the support for the club has contributed to its winning the State Second Division Championship. A project to establish a school for young footballers, to spot and develop local talent, is in preparation, in which candidates would also receive full schooling. This project is planned to start in the first half of 2006. Grendene donates R\$36,000 to the Guarany Sporting Club annually.
- IX. **Sobral Diocese:** Help in the *No Hunger at Christmas* donations campaign, and other campaigns.

## 5. Our dates

Aim: Increasingly to integrate employees' families with the company, improve quality of life, and transmit values, through celebration of important dates linked to Christianity.

- I. **Easter:** Distribution of Easter gift baskets, containing chocolate candy, eggs and rabbits, to every employee during Holy Week.
- II. **Children's' Christmas:** We believe this is a special date, because it is an important moment for people to come together, and Grendene seeks to awaken and promote the spirit of solidarity between the company, employees and their families. Messages of faith and thankfulness are placed on outdoor billboards, and a Mass is celebrated in the company's internal patio, with representatives of the Diocese and the employees, and giving of presents. An effort is made to identify the symbolism of the material presence with the Christian faith and the Christmas spirit through decorations and panels, most of them created by employees.

In the afternoon the celebrations are dedicated to the children. The SAIC exhibition park becomes a stage with a show by clowns, workshops for walking on stilts, distribution of sandwiches and a Christmas present according to the age group of each child of the employee. Children anxiously await the arrival of Father Christmas and all are involved in an atmosphere of happiness and fraternal love. The event is closed with a message of Christian faith and solidarity.

## 6. Our achievements

Application of the Grendene Values in day-to-day life is an essential element in meeting the major challenges. Grendene seeks **profitability** by anticipating difficulties and **innovating** in processes, as the best way of continually improving products and services. To achieve this, Grendene is **competitive**, always giving priority to **ethics**. This has resulted in the following acts of recognition from the various communities in which we are active:

- I. **The Open Doors Trophy from the government of Ceará State, December 2005:** This recognizes the company's commitment to the inclusion of people with special needs, young people from 16 to 24, workers over the age of 40, and ex-convicts and those who have otherwise been involved with the penal system. The company received the Seal of Corporate Social Responsibility since the creation of this trophy, and was Highlight Company in 2005. At present 817 people with special needs work in the company.
- II. **“Brazil's most admired companies” Survey by Carta Capital and TNS InterScience – eighth annual award, November 2005:** It was a great satisfaction for Grendene to achieve first place in the leadership of the footwear sector in this survey which elects the best company in 43 sectors based on 11 aspects – respect for the consumer, quality of products and services, fame, ethics, innovation, social responsibility, HR commitment, management quality, financial solidity, commitment to Brazil and global competitiveness.
- III. **Certification by the Regional Department of the Labor Ministry, November 2005:** The Regional Labor Ministry Office certified Grendene for its contribution in hiring, and thus including in the labor market, rehabilitated and disabled workers, under Article 93 of Law 8213/91. The percentage of these employees in Grendene's total workforce is now 5%.
- IV. **Sobral radio broadcasting organizations Class A trophy, 9th year – 2005:** Grendene has been winning the accolade of the best company in Sobral in this annual survey of the local community on a regular basis.
- V. **“Biggest and best companies of Ceará” – Delmiro Gouvêa Prize, 2005:** This prize is given by the *Povo* newspaper and the regional stock exchange (BVRg), for corporate excellence, to the 10 largest companies in Ceará by economic performance – financial and social. We have been among the State's four largest companies since the prize was created in 2001.

Grendene's social actions seek to satisfy the needs of its workers and also promote social empowerment of the needy population in the communities where it operates.

The evolution of Grendene's corporate responsibility actions in the last five years (2001-2005), shown in the charts below, clearly shows that investments in training were maintained even in a year in which market conditions were adverse. As well as the various benefits granted to employees, of which some are extended to their families, the company maintained a direct and healthy relationship, with the number of employees tending toward stability.

Since it produces footwear primarily for the hot seasons, Grendene typically works with seasonal fluctuations: Sales tend to be weaker in the first and second quarters, and concentrated in the third and fourth quarters. This tends to result in some seasonal fluctuation in hirings over the year.

The social actions focus on the communities where we operate, reaching not only employees and their families, but also the populations of areas neighboring our factories, and do in fact bring significant benefits to Society. The most important have been the programs in which Grendene assumes the role of Corporate Citizen, showing its corporate and social responsibility – without losing focus on its profitability, minimization of environmental impact and maximization of positive social effect.

With this focus on the employee and the community, Grendene has achieved significant recognition, which is a stimulus in the quest for self-sustaining development and contribution to the economic and social development of the communities where it operates.

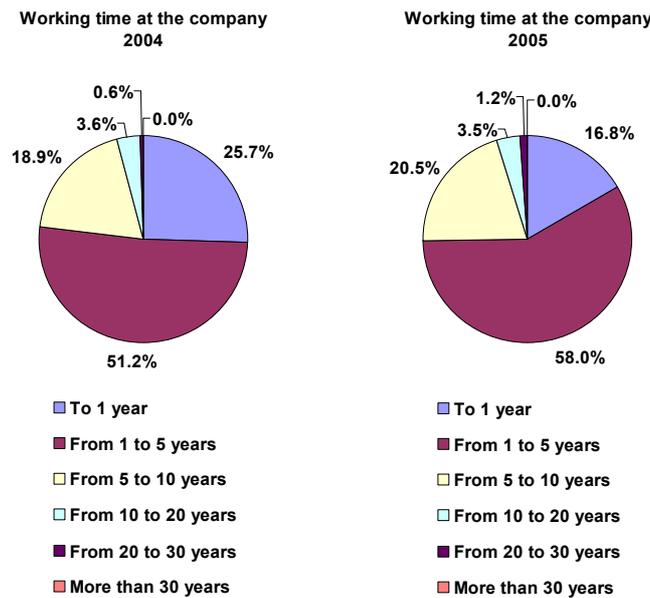
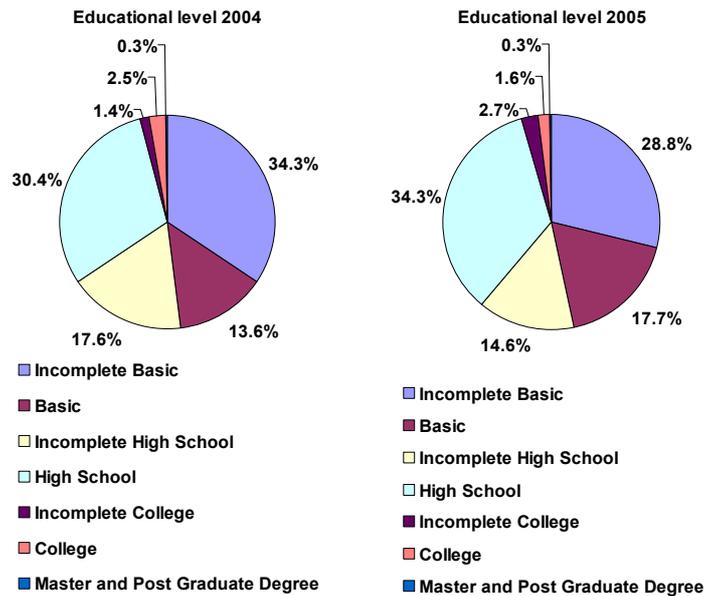
An important point is that all this work in the social area has been reflected in the profile of our employees, outlined in the charts below for the years 2004 and 2005.

**7. Our employees' profile**

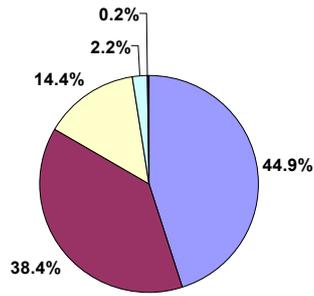
Grendene has a policy of diversity and respect for the different ethnic origins of the Brazilian population. In 2005, as in 2004, 60% of our employees were of African-Brazilian descent or of mixed race. Five per cent of our employees were people with special needs.

In terms of schooling the profile of our workforce has been improving significantly: the percentage of our employees who had not completed primary education was reduced from 34% in 2004 to 29% in 2005, while those who had completed only primary education increased from 14% to 18%; those with full secondary education increased from 30% to 34%; and those with partial higher education, graduation or post-graduation increased from 4% to nearly 5%. In both years, 96% of our employees were in operational areas and only 4% in administrative work. In terms of age groups: 43% were age 25 or younger; 39% from 25 to 35; 15% from 35 to 45; and 3% over 45.

Another highlight is our low employee turnover: 17% of our employees have been with us less than a year; 58% between 1 and 5 years; 21% from 5 to 10 years; and 4% more than 10 years. Male and female employees are balanced: in both years, 54% were male, and 46% female.

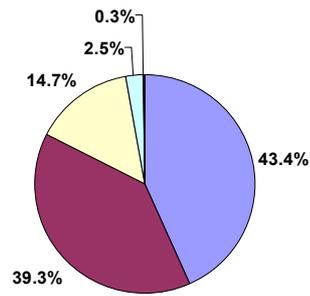


Age Distribution 2004



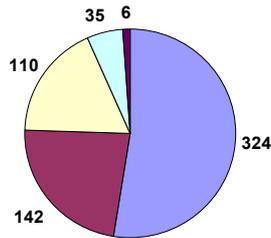
- Up to 25 years
- From 25 to 35 years
- From 35 to 45 years
- From 45 to 55 years
- More than 55 years

Age Distribution 2005



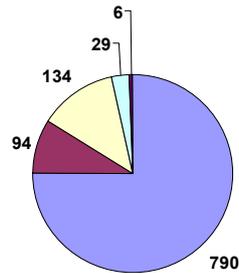
- Up to 25 years
- From 25 to 35 years
- From 35 to 45 years
- From 45 to 55 years
- More than 55 years

Employees with special needs 2004



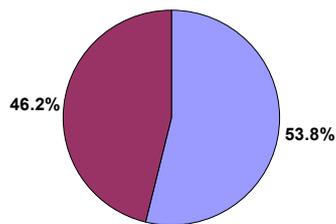
- Sobral
- Fortaleza
- Crato
- Farroupilha
- Carlos Barbosa

Employees with special needs 2005



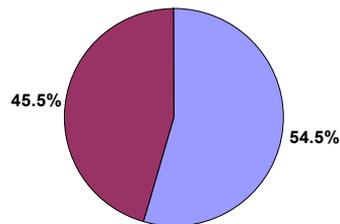
- Sobral
- Fortaleza
- Crato
- Farroupilha
- Carlos Barbosa

Male/Female 2004



- Male
- Female

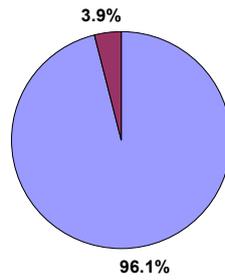
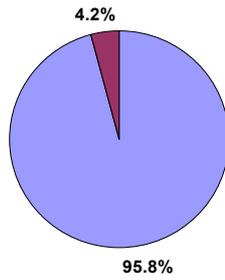
Male/Female 2005



- Male
- Female

Job Position Breakdown 2004

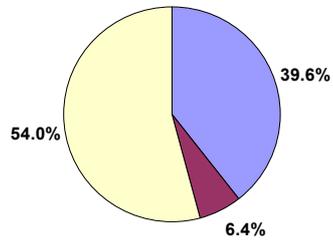
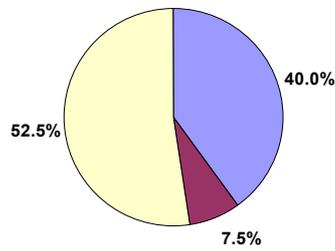
Job Position Breakdown 2005



■ Operational Area ■ Administrative Area    ■ Operational Area ■ Administrative Area

Employees by race 2004

Employees by race 2005



■ white ■ black ■ mixed race    ■ white ■ black ■ mixed race

## 8. Our environment

Grendene does not have any industrial activity which *per se* represents a threat to the environment.

### I. Environmental responsibility

In the interests of preservation and improvement of the environment, Grendene aims continuously to reduce, re-use or recycle wastes and raw materials used in the productive process. Leftover offcuts of PVC and cover line (synthetic leather) are re-used 100%, and residues of EVA (Ethylene Vinyl Acetate), are reprocessed. Product packagings are reused by the company and recycled by third parties. In the painting chambers, which have air extraction and air washing systems, all the residues are re-used by manufacturers of glues and paints, and the acetone is recycled and reused in washing of molds. Although the production process uses water only for cooling of certain equipment, even so the company has a closed circuit water system, which reduces the need to source water, and limits discarding of water.

Residues from the restaurants are stored in refrigerated chambers, removed daily and used for animal feed. The only items allocated to landfill are the organic wastes arising from sweeping of the factory and office floors and employees' personal hygiene. Materials such as empty cans, metal drums and paper and cardboard packaging are stored and sold to scrap merchants. All these measures, as a group, make up our policy of environmental preservation, as a result of which we have succeeded in continually reducing production costs, especially in acquisition of raw materials. The company also has its own sewerage treatment systems at the Crato and Sobral factories, which use anaerobic filters, digestion decanting, stabilization lakes, water oxygenation systems and chlorination tanks. The policy includes constant laboratory testing of product, for control of formulations, and uses coverline (synthetic leather), the wastes from which are totally recycled – complying with a European standard planned to be met only in 2008. The industrial processes of the PVC production chain are safe and widely regulated all over the world, which eliminates any possibility of environmental risk related to fabrication of this plastic material.

The environmental preservation policy has also reduced production costs, notably in acquisition of raw materials, due to the re-use of raw materials and inputs. In 2005 we widened our concept of recycling, to include not only the scraps left over from the process of production of sandals, but also the PVC milled off in several of the factories, and reprocessing of PVC fabrics, achieving a total of 6,900 tons – or recycling of 14% of the total of PVC used in the production process. In 2004, on the basis of the same concept of recycling, this amount was 7,300 tons or 13% of the total. The reduction in the total amount reflects lower volume produced in 2005. Thus the PVC is 100% recycled and re-used in the production of shoes, as can be seen in our solid wastes recycling program.

Sources and uses of energy	% of total, 2005
Electricity acquired from distributors	99.5%
Wind and solar energy	0.0%
Fuel oil (generator)	0.1%
Wood/coal (boiler)	0.4%
Natural gas	0.0%
<b>Total</b>	<b>100.0%</b>

Environmental performance indicators	2004	2005
Energy consumption (kWh/year)	101,561,473	93,043,686
Energy consumption per pair of shoes produced (kWh/year)	0.69952	0.71452
Water consumption (m <sup>3</sup> /year)	305,274	278,213
Water consumption per pair of shoes produced (m <sup>3</sup> /pair)	0.00210	0.00214
Solid wastes generated – garbage, unused material, rubble, etc. (tons/year)	2,154,774	2,223,898
Solid wastes generated – restaurant (tons/year)	484,937	366,311
Production (pairs/year)	145,187,223	130,218,183

**II. Licenses**

Grendene has environmental licenses that are valid for all its industrial units, and complies rigorously with the conditions of the bodies that grant them. The Sobral, Fortaleza and Crato factories are licensed by the Ceará State Environmental Authority (*Semace*), and the Farroupilha and Carlos Barbosa units by the Henrique Luis Roessler State Environmental Protection Foundation (*Fepam*), of Rio Grande do Sul. The company operates on the basis of a solid waste management plan, and sends control reports on each unit to Semace and Fepam quarterly. It also rigorously obeys the law and regulation related to the environment at the National, State and Municipal levels.

## Annual Social Report 2005

1 – Calculation Base	2005 Value (R\$'000)	2004 Value (R\$'000)
Net Revenues (NR)	1,068,046	1,211,618
Operating Result (OR)	130,036	101,886
Gross Payroll (GP)	258,544	256,912

2 - Internal Social Indicators	Amount ('000)	% of GP	% of NR	Amount ('000)	% of GP	% of NR
Food	24,089	9.32%	2.26%	25,361	9.87%	2.09%
Mandatory payroll taxes	59,016	22.83%	5.53%	58,181	22.65%	4.80%
Private pension plans	0	0.00%	0.00%	0	0.00%	0.00%
Health	2,452	0.95%	0.23%	2,648	1.03%	0.22%
Safety and medicine in the workplace	1,495	0.58%	0.14%	1,499	0.58%	0.12%
Education	0	0.00%	0.00%	0	0.00%	0.00%
Culture	0	0.00%	0.00%	0	0.00%	0.00%
Training and professional development	618	0.24%	0.06%	2,308	0.90%	0.19%
Child care facilities	254	0.10%	0.02%	252	0.10%	0.02%
Profit/results sharing	0	0.00%	0.00%	0	0.00%	0.00%
Others (Life insurance, transport, toys, Easter presents, Christmas party)	3,704	1.43%	0.35%	4,340	1.69%	0.36%
<b>Total – Internal social indicators</b>	<b>91,628</b>	<b>35.44%</b>	<b>8.58%</b>	<b>94,589</b>	<b>36.82%</b>	<b>7.81%</b>

3 - External Social Indicators	Amount (R\$'000)	% of OR	% of NR	Amount (R\$'000)	% of OR	% of NR
Education	0	0.00%	0.00%	0	0.00%	0.00%
Culture	0	0.00%	0.00%	0	0.00%	0.00%
Health and sanitation	0	0.00%	0.00%	0	0.00%	0.00%
Sport	36	0.03%	0.00%	36	0.04%	0.00%
Combating hunger and food safety	27	0.02%	0.00%	27	0.03%	0.00%
Others (Donations of shoes)	802	0.62%	0.08%	1,620	1.59%	0.13%
<b>Total contributions to society</b>	<b>865</b>	<b>0.67%</b>	<b>0.08%</b>	<b>1,683</b>	<b>1.65%</b>	<b>0.14%</b>
Taxes (excluding payroll taxes)	171,760	132.09%	16.08%	192,539	188.97%	15.89%
<b>Total - External Social Indicators</b>	<b>172,625</b>	<b>132.75%</b>	<b>16.16%</b>	<b>194,222</b>	<b>190.63%</b>	<b>16.03%</b>

4 - Environmental Indicators	Amount (R\$'000)	% of OR	% of NR	Amount (R\$'000)	% of OR	% of NR
Investments related to production/company operations	3,738	2.87%	0.35%	1,349	1.32%	0.11%
Investments in programs and/or external projects	7	0.01%	0.00%	6	0.01%	0.00%
<b>Total investments in the environment</b>	<b>3,745</b>	<b>2.88%</b>	<b>0.35%</b>	<b>1,355</b>	<b>1.33%</b>	<b>0.11%</b>
In relation to the setting of “annual targets” to minimize waste, consumption in general in production/operations and increase the efficient use of natural resources, the company:	The company complies from 76% to 100%		The company complies from 76% to 100%			

<b>5 – Employee Indicators</b>	<b>2005</b>	<b>2004</b>
No. of employees at the end of the period	20,493	23,204
No. of employees hired during the period	4,132	6,950
No. of outsourced employees	370	399
No. of interns	39	48
No. of employees above 45 years of age	557	558
No. of female employees	9,323	10,722
% of management positions occupied by women	8.87%	9.07%
No. of Afro-Brazilian employees	1,307	1,740
% of management positions occupied by Afro-Brazilians	2.05%	2.65%
Nº disabled employees or with special needs	1,053	617

<b>6 – Information on corporate citizenship</b>	<b>2005</b>			<b>Targets 2006</b>		
Relation between the highest and lowest remuneration in the company	45			45		
Total number of accidents at work	372			330		
Company-sponsored social and environmental projects were decided by:	Executive and middle management			Executive and middle management		
Safety and health standards in the workplace were set by:	All employees + health and safety committee			All employees + health and safety committee		
With respect to labor union freedom, collective bargaining rights and in-house employee representation, the company:	Encourages and follows ILO model			Will encourages and follow ILO model		
The company pension plan covers:	Has no plan			Has no plan		
The profit/results sharing program covers:	Has no program			Has no program		
In the selection of suppliers, the same standards of ethics and social and environmental responsibility adopted by the company:	Not considered			Will be considered		
With relation to volunteer work by employees, the company:	Organizes and encourages			Will organize and encourage		
Total number of complaints and criticism from consumers:	In company 27.248	At Procon consumer protection body 18	In Litigation 8	In company 20.000	At Procon consumer protection body 10	In Litigation 5
% of complaints and criticism attended or resolved:	In company 99%	At Procon consumer protection body 94%	In Litigation 94%	In company 100%	At Procon consumer protection body 100%	In Litigation 100%
Total value to be distributed (R\$'000):	In 2005: 636,601			In 2004: 599,808		
Distribution of Added Value (DAV):	28.0% government 40.6% employees 12.9% shareholders 17.9% third parties 0.6% retained			26.3% government 42.8% employees 10.7% shareholders 19.6% third parties 0.6% retained		

*Mode l suggested by the Brazilian Institute of Social and Economic Analysis (IBASE)*

## 9. Our Added Value

The Statements of Added Value help to measure the wealth that the Company delivers to society as a whole through its business activities. It totaled R\$636 million in 2005 (R\$600 million in 2004). This value is arrived at by calculating the difference between revenues obtained (R\$1,309 million) and costs related to the acquisition of products and services from third parties (R\$709 million).

Description	R\$ '000, Corporate Law accounting method		
	2003	2004	2005
<b>1 – Revenues</b>	<b>1,225,326</b>	<b>1,452,652</b>	<b>1,308,891</b>
1.1) Sales of goods, products and services	1,225,529	1,475,462	1,308,966
1.2) Provision for bad debts - Reversal/constitution	0	(23,184)	(232)
1.3) Non-operational	(203)	374	157
<b>2 – Input acquired from suppliers (includes value of ICMS and IPI taxes)</b>	<b>550,965</b>	<b>884,264</b>	<b>757,711</b>
2.1) Raw materials consumed	299,721	539,315	315,945
2.2) Cost of goods sold	35,105	4,945	9,171
2.3) Materials, energy, services from third parties and others	211,463	330,216	431,981
2.4) Loss / recovery of assets	4,676	9,788	614
<b>3) Gross added value ( 1 - 2 )</b>	<b>674,361</b>	<b>568,388</b>	<b>551,180</b>
<b>4 – Retentions</b>	<b>21,960</b>	<b>27,221</b>	<b>26,675</b>
4.1) Depreciation, amortization and obsolescence	21,960	27,221	26,675
<b>5 – Net added value produced by the entity ( 3 - 4 )</b>	<b>652,401</b>	<b>541,167</b>	<b>524,505</b>
<b>6 – Added value received by transfer</b>	<b>129,422</b>	<b>58,641</b>	<b>112,096</b>
6.1) Equity pickup	45,071	0	0
6.2) Financial income	84,351	58,641	112,096
<b>7 – Total added value to be distributed ( 5 + 6 )</b>	<b>781,823</b>	<b>599,808</b>	<b>636,601</b>
<b>8 – Distribution of added value</b>	<b>781,823</b>	<b>599,808</b>	<b>636,601</b>
8.1) Export market and charges	208,131	256,912	258,544
8.2) Taxes and contributions	235,690	157,486	178,618
8.3) Interest and rent	134,781	117,756	114,038
8.4) Interest on own capital and dividends	0	0	0
8.5) Retained profit/loss for the period	<b>203,221</b>	<b>67,654</b>	<b>85,401</b>

ilhabela 



**Audited Financial Statements**

## VIII. Audit financial statements

A free translation from Portuguese into English of financial statements prepared in accordance with the accounting practices adopted in Brazil

### Grendene S.A. and subsidiaries

#### 1. Balance sheets assets

December 31, 2005 and 2004

(In thousands of reais)

	Company		Consolidated	
	2005	2004	2005	2004
<b>Assets</b>				
<b>Current assets</b>				
Cash and cash equivalents	19,367	22,692	23,039	23,534
Short term investments	464,739	281,993	487,721	309,240
Accounts receivable	321,885	367,550	329,319	369,764
Inventories	96,297	126,938	100,320	134,546
Recoverable taxes	6,365	5,534	8,962	7,023
Notes receivables	5,896	9,992	6,066	12,303
Other receivables	3,297	5,237	4,175	5,336
Deferred income and social contribution taxes	8,654	9,481	8,954	9,713
Deferred expenses	1,382	4,484	1,549	4,735
Total current assets	927,882	833,901	970,105	876,194
<b>Noncurrent assets</b>				
Judicial deposits	376	642	376	642
Recoverable taxes	608	987	608	987
Notes receivables	4,781	-	4,781	-
Other receivables	203	185	203	185
	5,968	1,814	5,968	1,814
<b>Permanent assets</b>				
Investments	42,067	46,680	1,764	1,764
Property, plant and equipment	181,020	169,397	181,603	170,296
	223,087	216,077	183,367	172,060
<b>Total assets</b>	<b>1,156,937</b>	<b>1,051,792</b>	<b>1,159,440</b>	<b>1,050,068</b>

A free translation from Portuguese into English of financial statements prepared in accordance with the accounting practices adopted in Brazil

Grendene S.A. and subsidiaries

1. Balance sheets liabilities

December 31, 2005 and 2004

(In thousands of reais)

	Company		Consolidated	
	2005	2004	2005	2004
<b>Liabilities and shareholders' equity</b>				
Current liabilities				
Financial institutions	9,340	4,703	11,283	4,703
ICMS tax related loans	15,940	15,029	15,940	15,029
Trade accounts payable	15,981	24,059	16,680	24,059
Provision for commissions	17,220	20,500	17,047	20,311
Taxes, fees and contributions	8,417	9,801	8,759	9,939
Salaries and charges payable	33,017	34,193	33,069	34,258
Accounts payable	3,888	4,773	3,888	4,773
Provision for contingencies	600	450	600	450
Proposed dividend	43,181	64,151	43,181	64,151
Deferred income tax	-	-	159	253
Other debts	5,936	5,533	6,649	5,857
Total current liabilities	153,520	183,192	157,255	183,783
Noncurrent liabilities				
Financial institutions	61,338	50,897	61,338	50,897
ICMS tax related loans	89,512	78,014	89,512	78,014
Other debts	-	-	-	88
	150,850	128,911	150,850	128,999
Minority interest	-	-	165	-
	-	-	165	-
Shareholders' equity				
Paid-in capital	733,783	620,580	733,783	620,580
Capital reserve	109,664	113,203	109,664	113,203
Profit reserve	9,120	5,906	7,723	3,503
	852,567	739,689	851,170	737,286
<b>Total liabilities and shareholders' equity</b>	<b>1,156,937</b>	<b>1,051,792</b>	<b>1,159,440</b>	<b>1,050,068</b>

See accompanying notes.

## Grendene S.A. and subsidiaries

## 2. Statements of income

Years ended December 31, 2005 and 2004

(In thousands of reais, except per share information)

	Company		Consolidated	
	2005	2004	2005	2004
<b>Gross sales revenue</b>	<b>1,339,889</b>	1,499,180	<b>1,352,900</b>	1,524,981
Sales deductions	<b>(283,496)</b>	(309,723)	<b>(284,854)</b>	(313,363)
Net sales revenue	<b>1,056,393</b>	1,189,457	<b>1,068,046</b>	1,211,618
Cost of products sold	<b>(619,570)</b>	(692,931)	<b>(624,456)</b>	(700,034)
<b>Gross profit</b>	<b>436,823</b>	496,526	<b>443,590</b>	511,584
<b>Operating income (expenses)</b>				
Selling expenses	<b>(255,899)</b>	(270,996)	<b>(263,706)</b>	(280,796)
General and administrative expenses	<b>(47,198)</b>	(58,837)	<b>(49,069)</b>	(65,996)
Financial expenses	<b>(105,546)</b>	(117,787)	<b>(112,252)</b>	(122,852)
Financial income	<b>110,102</b>	57,837	<b>112,096</b>	58,641
Equity pickup	<b>(6,864)</b>	(3,748)	-	-
Management fees	<b>(835)</b>	(374)	<b>(835)</b>	(374)
Other operating income	<b>1,418</b>	6,652	<b>1,418</b>	6,675
Other operating expenses	<b>(1,203)</b>	(4,996)	<b>(1,206)</b>	(4,996)
	<b>(306,025)</b>	(392,249)	<b>(313,554)</b>	(409,698)
<b>Operating result</b>	<b>130,798</b>	104,277	<b>130,036</b>	101,886
Nonoperating result	<b>157</b>	48	<b>157</b>	71
<b>Income before income taxes and minority interest</b>	<b>130,955</b>	104,325	<b>130,193</b>	101,957
Income and social contribution taxes:				
	<b>(45,733)</b>	(43,749)	<b>(44,074)</b>	(43,749)
Deferred	<b>(827)</b>	9,481	<b>(665)</b>	9,446
Minority interest	-	-	<b>(53)</b>	-
<b>Net income</b>	<b>84,395</b>	70,057	<b>85,401</b>	67,654
Earnings per share (in reais)	<b>0,84</b>	0.70		

See accompanying notes.

## Grendene S.A. and subsidiaries

**3. Statements of shareholders' equity**  
 Years ended December 31, 2005 and 2004  
 (In thousands of reais)

	Revaluation	Capital	Revenue reserves		Retained earnings	Total	
	reserve	reserve	Legal	Realizable			
	Own	Tax	reserve	profits			
	assets	incentive					
	Paid-in						
	capital						
<b>Balances at December 31, 2003</b>	137,477	2,815	63,707	27,495	-	461,232	692,726
Capital increase	483,103	-	(63,707)	(27,495)	-	(391,901)	-
Prior year adjustments	-	4	-	-	-	-	4
Realization of revaluation reserve	-	(59)	-	-	-	-	(59)
Reversal of revaluation reserve	-	(2,760)	-	-	-	-	(2,760)
Dividends distributed	-	-	-	-	-	(69,331)	(69,331)
Tax incentive investments:							
ICMS (Provin and Proapi)	-	-	93,155	-	-	-	93,155
Income tax	-	-	20,048	-	-	-	20,048
Net income	-	-	-	-	-	70,057	70,057
Appropriation of net income:							
Legal reserve	-	-	-	3,503	-	(3,503)	-
Realizable profits reserve	-	-	-	-	2,403	(2,403)	-
Proposed dividend	-	-	-	-	-	(64,151)	(64,151)
<b>Balances at December 31, 2004</b>	<b>620,580</b>	<b>-</b>	<b>113,203</b>	<b>3,503</b>	<b>2,403</b>	<b>-</b>	<b>739,689</b>
Capital increase	113,203	-	(113,203)	-	-	-	-
Reversal of realizable profit reserve	-	-	-	-	(2,403)	2,403	-
Tax incentive investments:							
ICMS (Provin and Proapi)	-	-	83,963	-	-	-	83,963
Income tax	-	-	25,701	-	-	-	25,701
Net income	-	-	-	-	-	84,395	84,395
Appropriation of net income:							
Legal reserve	-	-	-	4,220	-	(4,220)	-
Realizable profits reserve	-	-	-	-	1,397	(1,397)	-
Dividends paid in advance (R\$0.38 per share)	-	-	-	-	-	(38,000)	(38,000)
Proposed dividends (R\$0.43 per share)	-	-	-	-	-	(43,181)	(43,181)
<b>Balances at December 31, 2005</b>	<b>733,783</b>	<b>-</b>	<b>109,664</b>	<b>7,723</b>	<b>1,397</b>	<b>-</b>	<b>852,567</b>

See accompanying notes.

## Grendene S.A. and subsidiaries

## 4. Statements of changes in financial position

Years ended December 31, 2005 and 2004

(In thousands of reais)

	Company		Consolidated	
	2005	2004	2005	2004
<b>Sources of working capital:</b>				
<b>From operations:</b>				
Net income	84,395	70,057	85,401	67,654
Minority interest	-	-	165	-
Items not affecting working capital:				
Investment disposals	-	95	-	1,265
Property, plant and equipment disposals	2,225	358	2,231	457
Result of equity pickup	6,864	3,748	-	-
Depreciations	26,842	26,894	27,089	27,221
	<u>120,326</u>	<u>101,152</u>	<u>114,886</u>	<u>96,597</u>
<b>From shareholders and third parties:</b>				
Income tax and ICMS (VAT) tax incentives	109,664	113,203	109,664	113,203
Prior year adjustments	-	4	-	4
Decrease in noncurrent assets	-	824	-	824
Increase in noncurrent liabilities	21,939	11,464	21,851	11,552
	<u>131,603</u>	<u>125,495</u>	<u>131,515</u>	<u>125,583</u>
<b>Total sources of working capital</b>	<b>251,929</b>	<b>226,647</b>	<b>246,401</b>	<b>222,180</b>
<b>Application of working capital:</b>				
In investments	2,251	-	-	-
Increase in noncurrent assets	4,154	-	4,154	-
In property, plant and equipment	40,690	27,327	40,627	27,501
Dividends distributed	38,000	69,331	38,000	69,331
Proposed dividends	43,181	64,151	43,181	64,151
<b>Total application of working capital</b>	<b>128,276</b>	<b>160,809</b>	<b>125,962</b>	<b>160,983</b>
<b>Increase in working capital</b>	<b>123,653</b>	<b>65,838</b>	<b>120,439</b>	<b>61,197</b>
<b>Application in working capital:</b>				
<b>Current assets</b>				
At end of the year	927,882	833,901	970,105	876,194
At beginning of the year	833,901	688,107	876,194	743,439
	<u>93,981</u>	<u>145,794</u>	<u>93,911</u>	<u>132,755</u>
<b>Current liabilities</b>				
At end of the year	153,520	183,192	157,255	183,783
At beginning of the year	183,192	103,236	183,783	112,225
	<u>(29,672)</u>	<u>79,956</u>	<u>(26,528)</u>	<u>71,558</u>
<b>Increase in working capital</b>	<b>123,653</b>	<b>65,838</b>	<b>120,439</b>	<b>61,197</b>

See accompanying notes.

## Grendene S.A. and subsidiaries

## 5. Adjusted consolidated statements of income (pro forma)

Years ended December 31, 2005

(In thousands of reais)

Adjusted statement of income (in thousand of R\$)	2005 according financial statement	Deferred income tax and Social Contribution	Reverted provisions 12/31/04	Effects of tax benefits	2005 pro forma
<b>Gross sales revenues</b>	1,352,900	-	-	-	1,352,900
Sales deduction	(284,854)	-	-	-	(284,854)
<b>Net sales revenues</b>	<b>1,068,046</b>	-	-	-	<b>1,068,046</b>
Cost of sales	(624,456)	-	-	-	(624,456)
<b>Gross profit</b>	<b>443,590</b>	-	-	-	<b>443,590</b>
Operating income (expenses)	(313,554)	-	-	-	(313,554)
Selling expenses	(263,706)	-	-	-	(263,706)
General and administrative expenses	(49,069)	-	-	-	(49,069)
Financial expenses	(112,252)	-	-	-	(112,252)
Financial income	112,096	-	-	-	112,096
Equity pickup	-	-	-	-	-
Management fees	(835)	-	-	-	(835)
Other operating expenses	1,418	-	-	-	1,418
Other operating income	(1,206)	-	-	-	(1,206)
<b>Operating result</b>	<b>130,036</b>	-	-	-	<b>130,036</b>
Non-operating result, net	157	-	-	-	157
<b>Income before income taxes and minority interests</b>	<b>130,193</b>	-	-	-	<b>130,193</b>
Current income tax	(31,744)	-	-	-	(31,744)
Current social contribution	(12,330)	-	-	-	(12,330)
Deferred income tax	(446)	-	-	-	(446)
Deferred social contribution	(219)	-	-	-	(219)
Minority interests	(53)	-	-	-	(53)
<b>Earnings before tax benefit effects</b>	<b>85,401</b>	-	-	-	<b>85,401</b>
Tax benefits effect - Provin/Proapi	-	-	-	83,963	83,963
Tax benefit effect - IRPJ	-	-	-	25,701	25,701
<b>Adjusted Net Income</b>	<b>85,401</b>	-	-	<b>109,664</b>	<b>195,065</b>

## Grendene S.A. and subsidiaries

## 5. Adjusted consolidated statements of income (pro forma)

Years ended December 31, 2004

(In thousands of reais)

Adjusted Statement of Income (in thousand of R\$)	2004 according Financial Statement	Deferred income tax and social contribution	Reverted provisions 12/31/03	Effects of tax benefits	2004 pro forma
<b>Gross sales revenues</b>	1,524,981	-	-	-	1,524,981
Sales deduction	(313,363)	-	-	-	(313,363)
<b>Net sales revenues</b>	<b>1,211,618</b>	-	-	-	<b>1,211,618</b>
Cost of sales	(700,034)	-	14,110	-	(685,924)
<b>Gross profit</b>	<b>511,584</b>	-	<b>14,110</b>	-	<b>525,694</b>
Operating income (expenses)	(409,698)	-	15,056	-	(394,642)
Selling expenses	(280,796)	-	1,463	-	(279,333)
General and administrative expenses	(65,996)	-	-	-	(65,996)
Financial expenses	(122,852)	-	10,880	-	(111,972)
Financial income	58,641	-	-	-	58,641
Equity pickup	-	-	-	-	-
Management fees	(374)	-	-	-	(374)
Other operating expenses	6,675	-	-	-	6,675
Other operating income	(4,996)	-	2,713	-	(2,283)
<b>Operating result</b>	<b>101,886</b>	-	<b>29,166</b>	-	<b>131,052</b>
Non-operating result, net	71	-	-	-	71
<b>Income before income taxes and minority interests</b>	<b>101,957</b>	-	<b>29,166</b>	-	<b>131,123</b>
Current income tax	(31,955)	-	-	-	(31,955)
Current social contribution	(11,794)	-	-	-	(11,794)
Deferred income tax	6,930	(6,043)	-	-	887
Deferred social contribution	2,516	(2,175)	-	-	341
Minority interests	-	-	-	-	-
<b>Earnings before tax benefit effects</b>	<b>67,654</b>	<b>(8,218)</b>	<b>29,166</b>	-	<b>88,602</b>
Tax benefits effect - Provin/Proapi	-	-	-	93,155	93,155
Tax benefit effect - IRPJ	-	-	-	20,048	20,048
<b>Adjusted Net Income</b>	<b>67,654</b>	<b>(8,218)</b>	<b>29,166</b>	<b>113,203</b>	<b>201,805</b>

## Grendene S.A. and subsidiaries

## 6. Notes to financial statements

December 31, 2005 and 2004

(In thousands of reais)

## 1. Operating activities

Grendene S.A. was founded in 1971 with the following operating objective: a) management of own assets and investing in other companies (civil or commercial, national or foreign, as shareholder or partner); b) the planning, organization and handling of business in general; c) rendering administrative advisory and consulting services to companies in which it participates as partner, quotaholder or shareholder, directly or indirectly; and d) manufacturing and selling shoes and materials for use in the shoe industry, both locally and abroad.

## 2. Basis of Preparation and Presentation of Financial Statements

a) Comparability of the Financial Statements

Certain amounts of operational income and expense in the 2004 income statement, presented for comparison purposes, have been reclassified due to the accounting allocation of the respective transactions at December 31, 2005.

Furthermore, when preparing the financial statements as of and for the year ended December 31, 2003, some provisions amounting to R\$29,166 (R\$20,948 net of tax effects) were not recorded. These amounts, relate mainly to the provision for discounts on payments made on due date (R\$10,880), provision for adjustment of inventories (R\$14,110) and supplementary allowance for doubtful accounts (R\$1,463), among others (R\$2,713). These amounts were recorded by the Company during the year ended December 31, 2004, which affected each relevant account of the income statement, in accordance with the accounting practices adopted in Brazil and the guidelines of the Brazilian Securities Commission.

The following table summarizes income for the year ended December 31, 2004 and sets out the allocation of the above mentioned adjustments to each income statement account:

	Balances at 12/31/2004 as reported	Effect of 2003 adjustments recorded in 2004	Balances at	
			12/31/2004 (pro forma)	12/31/2005 as reported
Net sales	1,211,618	-	1,211,618	1,068,046
Cost of products and services sold	(700,034)	14,110	(685,924)	(624,456)
Gross profit	511,584	14,110	525,694	443,590
Operating income (expense):				
Selling	(280,796)	1,463	(279,333)	(263,706)
General and administrative	(65,996)	-	(65,996)	(49,069)
Interest expense	(122,852)	10,880	(111,972)	(112,252)
Interest income	58,641	-	58,641	112,096
Directors' fees	(374)	-	(374)	(835)
Other operating income	6,675	-	6,675	1,418
Other operating expense	(4,996)	2,713	(2,283)	(1,206)
Operating income (expense)	101,886	29,166	131,052	130,036
Non-operating income	71	-	71	157
Pretax income	101,957	29,166	131,123	130,193
Income and social contribution taxes				
Current	(43,749)	-	(43,749)	(44,074)
Deferred	9,446	(8,218)	1,228	(665)
Minority interest	-	-	-	(53)
Adjusted net income	67,654	20,948	88,602	85,401

## Grendene S.A. and subsidiaries

## 6. Notes to financial statements -- continued

December 31, 2005 and 2004

(in thousands of reais)

## 2. Basis of Preparation and Presentation of Financial Statements --continued

b) Financial Statements (Company and consolidated)

The financial statements were prepared in accordance with the accounting practices adopted in Brazil and in conformity with the provisions in Brazil's Corporation Law.

The consolidated financial statements were prepared in conformity with the consolidation principles provided for Brazil's Corporation Law and norms established by the CVM – Brazilian Securities Commission, including the financial statements of Company Grendene S.A. and the subsidiaries mentioned in Note 8.

During the process of consolidation of the financial statements, all balances linked to operations involving assets and liabilities, income and expenses, deriving from business transactions between the consolidated companies, were eliminated as well as the subsidiary investment against the shareholders' equity of the subsidiaries.

The reconciliation of the subsidiary's operating result and shareholders' equity, and the consolidated balances, comprise the following:

	<u>Net income</u>		<u>Shareholders' equity</u>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Company	<b>84,395</b>	70,057	<b>852,567</b>	739,689
Unrealized profit from inventories	<b>1,006</b>	(2,403)	<b>(1,397)</b>	(2,403)
Consolidated	<b>85,401</b>	67,654	<b>851,170</b>	737,286

## 3. Summary of Significant Accounting Practices

a) Operating result

Revenues and expenses are recorded on the accrual basis.

b) Short-term investments

Short-term investments are stated at investment value plus earnings to the balance sheet date, not exceeding market value.

c) Allowance for doubtful accounts

Constituted up to the limit considered sufficient to cover possible losses resulting from the realization of accounts receivable and other credits.

d) Provision for discounts granted for payments made on the due date

Constituted at discount amounts that are estimated to be granted in relation to trade accounts receivable, for the payments made within the respective due dates.

## Grendene S.A. and subsidiaries

## 6. Notes to financial statements -- continued

December 31, 2005 and 2004

(in thousands of reais)

## 3. Summary of Significant Accounting Practices -- continued

e) Inventories

Inventories of finished products and work in process are valued at the tax criterion which determines that finished products should be stated at 70% of the cash sales price at the balance sheet date, whereas work in process should be stated at 80% of the finished products value, as previously computed. In order to adjust these inventories to their probable average production cost, a provision for devaluation is recorded as mentioned in Note 6.

Inventories of raw materials, packaging materials, goods for resale and other inventories are stated at average acquisition cost.

In both cases the cost should not exceed market value.

f) Investments

Investments in subsidiaries are stated by the equity pickup method, based on the shareholders' equity of subsidiaries computed as of the same base date as that of the Company. The remaining investments are stated at acquisition cost and adjusted to market value, whenever applicable.

The financial statements of direct and indirect subsidiaries abroad were prepared in their respective local currencies, converted into U.S. dollars and pesos and subsequently converted into reais at the official exchange rate on the balance sheet date, as follows: R\$2.3399 / US\$1.00 and R\$0.7707 / P\$1.00, respectively at December 31, 2005 (R\$ 2.6536 / US\$ 1.00 and R\$0.8916 / P\$1.00, respectively at December 31, 2004).

g) Property, plant and equipment

Stated at acquisition or construction and revaluation cost, adjusted by accumulated depreciation and calculated by the straight-line method at rates that take into consideration the estimated useful life of assets, as mentioned in Note 9.

h) Financial institutions

Loans and financing are monetarily corrected by the incurred monetary and exchange variations, according to the rates contracted with financial institutions plus interest calculated on a daily pro rata basis to the balance sheet date. Monetary and exchange variations and interest are charged to financial expenses in the operating result.

i) ICMS tax related loans (Proapi and Provin)

Represented by loan installments granted to the Company for purposes of settling ICMS tax debts, not entitled to incentives and which should be paid on different due dates. The loan installments subject to incentives (see Note 11) are directly recorded as credit in the shareholders' equity account, under tax incentives sub-account, at the time the referred loans (which are considered investment grants) are obtained.

## Grendene S.A. and subsidiaries

## 6. Notes to financial statements -- continued

December 31, 2005 and 2004

(in thousands of reais)

## 3. Summary of Significant Accounting Practices --continued

## j) Income and social contribution taxes

Income and social contribution taxes are calculated according to the current legislation for each base period.

Grendene S.A. receives income tax incentives due to its establishment in the northeastern region of the country. These incentives are granted via exemption or reduction of the tax amount due, calculated based on the result of the activities subject to these incentives. The referred tax amounts are recorded as if normally due and subsequently deducted from liabilities against the account 'tax incentives reserve' in shareholders' equity. The tax exemption Rule will expire during calendar year 2012.

Deferred income and social contribution taxes are calculated on temporary differences.

k) Other current and noncurrent assets

Stated at realizable value, including accrued earnings and monetary variation, when applicable.

l) Other current and noncurrent liabilities

Stated at known or estimated amounts, increased by the corresponding charges, when applicable.

m) Supplemental information

To improve its information disclosed to the market, the Company is presenting as supplemental information (see Note 19) the cash flow statement (individual and consolidated), prepared in accordance with Accounting Standards and Procedure No. 20 of the IBRACON - Institute of Independent Auditors of Brazil, taking into consideration the impact of key transactions that affected the cash and cash equivalents. These statements are comprised of operating activities, investments and financing.

n) Use of estimates

Preparing the financial statements in conformity with the accounting practices requires that Management uses estimates that affect the amounts reported in the financial statements and in the notes thereto. Final results may differ from these estimates.

## 4. Short-term Investments

These mainly represent variable interest investments remunerated, on average, by 100% of the CDI variation. Investments are maintained with first-rate banks, have several maturities and may be redeemed at any one time.

## Grendene S.A. and subsidiaries

## 6. Notes to financial statements -- continued

December 31, 2005 and 2004

(in thousands of reais)

## 5. Accounts Receivable

	Company		Consolidated	
	2005	2004	2005	2004
Falling due	337,654	377,381	344,483	378,953
Overdue up to 30 days	6,102	5,226	6,773	6,217
Overdue from 31 to 60 days	913	747	914	757
Overdue from 61 to 90 days	719	271	734	277
Overdue from 91 to 180 days	1,919	1,731	2,026	1,731
	<b>347,307</b>	385,356	<b>354,930</b>	387,935
Exchange advances	(12,614)	(1,985)	(12,614)	(1,985)
Allowance for doubtful accounts	(1,967)	(1,735)	(2,156)	(2,100)
Provision for discounts on payments made on due date	(10,841)	(14,086)	(10,841)	(14,086)
	<b>321,885</b>	<b>367,550</b>	<b>329,319</b>	<b>369,764</b>

## 6. Inventories

	Company		Consolidated	
	2005	2004	2005	2004
Finished products	11,288	14,967	14,370	22,575
Work in process	21,385	27,842	21,385	27,842
(-) Provision for adjustment to probable production cost	(4,089)	(3,462)	(4,200)	(3,462)
	<b>28,584</b>	39,347	<b>31,555</b>	46,955
Raw material	42,254	57,385	42,254	57,385
Packaging material	9,619	14,357	9,619	14,357
Intermediate materials and others	15,155	12,281	15,155	12,281
Advances to suppliers	2,985	4,604	2,985	4,604
Imports in transit	978	2,415	2,030	2,415
(-) Provision for adjustment to obsolete inventories	(3,278)	(3,451)	(3,278)	(3,451)
	<b>96,297</b>	126,938	<b>100,320</b>	134,546

## 7. Recoverable Taxes

	Company		Consolidated	
	2005	2004	2005	2004
Income and social contribution tax prepayment	1,036	2,256	3,380	3,745
Income and social contribution withholding	2,601	-	2,601	-
Federal VAT (IPI) recoverable	512	549	512	549
State VAT (ICMS) recoverable	2,824	3,504	3,077	3,504
Social Contribution on Corporate Revenue (COFINS)	-	212	-	212
	<b>6,973</b>	6,521	<b>9,570</b>	8,010
(-) Total current assets	(6,365)	(5,534)	(8,962)	(7,023)
Total noncurrent assets	<b>608</b>	987	<b>608</b>	987

Income and social contribution tax prepayment

This corresponds to income and social contribution tax prepayments to be offset at the end of the year against the respective federal taxes and contributions calculated through the annual tax income return.

Income and social contribution tax prepayment

This corresponds to withholding income tax on financial investments, offset against federal taxes and contributions.

ICMS and IPI recoverable

Balances came from commercial operations and may be offset against the same type of taxes.

## Grendene S.A. and subsidiaries

## 6. Notes to financial statements -- continued

December 31, 2005 and 2004

(in thousands of reais)

## 8. Investments

At December 31, 2005 and 2004, Company investments were as follows:

	Company		Consolidated	
	2005	2004	2005	2004
Subsidiaries	40,303	44,916	-	-
Eletróbrás credit rights	894	894	894	894
Properties on sale	870	870	870	870
	<u>42,067</u>	<u>46,680</u>	<u>1,764</u>	<u>1,764</u>

Investments in subsidiaries comprise the following:

a) Direct subsidiaries (consolidated)

	2005						2004	
	Capital	Shareholders' equity	Income	Ownership interest-%	Equity pickup	Investment	Equity pickup	Investment
Saddle Corporation S.A.	23,633	37,160	(2,580)	100,00%	(7,757)	37,160	(3,748)	44,916
Saddle Calzados S/A	2,312	3,309	1,062	95,00%	893	3,143	-	-
Total					<u>(6,864)</u>	<u>40,303</u>	<u>(3,748)</u>	<u>44,916</u>

On June 3, 2005 the Company acquired 95% of Saddle Calzados S/A's capital, becoming the direct parent company of that subsidiary.

Equity pickup at December 31, 2005 in the subsidiaries Saddle Calzados S/A. and Saddle Corporation S.A. includes a negative amount of R\$5,293 (negative amount of R\$ 3,956 in 2004) concerning effects from exchange variation caused by converting into reais the subsidiary's financial statements originally prepared in U.S. dollars and pesos, respectively. The effect of the foreign exchange variation on investments shown in the consolidated P&L statement is recorded under financial income (expenses).

b) Indirect subsidiary

Through subsidiary Saddle Corporation S.A., Company also holds the following indirect investment:

	2005						2004	
	Paid-in capital monetarily adjusted	Shareholders' equity	Net income	Ownership interest %	Equity pickup	Investment	Equity pickup	Investment
Grendha Shoes Corporation	1,170	9,864	(3,971)	100,00%	(3,971)	9,864	(1,365)	15,690
Total					<u>(3,971)</u>	<u>9,864</u>	<u>(1,365)</u>	<u>15,690</u>

The investments account movement comprises the following:

	Company		Consolidated	
	2005	2004	2005	2004
Balances at beginning of year	46,680	50,523	1,764	3,029
Investment additions	2,251	-	-	-
Investment disposals	-	(95)	-	(1,265)
Equity pickup	(6,864)	(3,748)	-	-
Balances at end of the year	<u>42,067</u>	<u>46,680</u>	<u>1,764</u>	<u>1,764</u>

## Grendene S.A. and subsidiaries

## 6. Notes to financial statements -- continued

December 31, 2005 and 2004

(in thousands of reais)

## 9. Property, Plant and Equipment

		Company					
		2005			2004		
Annual depreciation rates		Cost	Accumulated depreciation	Net	Cost	Accumulated depreciation	Net
		<b>2,741</b>	-	<b>2,741</b>			
Land	-				2,295	-	2,295
Buildings	4%	<b>134,917</b>	<b>(42,506)</b>	<b>92,411</b>	122,666	(37,750)	84,916
Machines and equipment	20%	<b>130,373</b>	<b>(91,788)</b>	<b>38,585</b>	111,455	(77,624)	33,831
Installations	10%	<b>30,342</b>	<b>(9,289)</b>	<b>21,053</b>	23,366	(7,034)	16,332
Furniture and fixtures	10%	<b>5,085</b>	<b>(2,203)</b>	<b>2,882</b>	4,239	(1,807)	2,432
Tools	20%	<b>1,064</b>	<b>(784)</b>	<b>280</b>	966	(650)	316
Vehicles	20%	<b>410</b>	<b>(254)</b>	<b>156</b>	477	(249)	228
Data processing equipment	20%	<b>21,627</b>	<b>(13,822)</b>	<b>7,805</b>	19,743	(10,947)	8,796
Other fixed assets	10%	<b>16,234</b>	<b>(4,300)</b>	<b>11,934</b>	14,015	(2,850)	11,165
Fixed assets in progress	-	<b>1,900</b>	-	<b>1,900</b>	4,678	-	4,678
Imports in process	-	-	-	-	1,987	-	1,987
Advances to suppliers	-	<b>1,273</b>	-	<b>1,273</b>	2,421	-	2,421
		<b>345,966</b>	<b>(164,946)</b>	<b>181,020</b>	308,308	(138,911)	169,397

		Consolidated					
		2005			2004		
Annual depreciation rates		Cost	Accumulated depreciation	Net	Cost	Accumulated depreciation	Net
		<b>2,741</b>	-	<b>2,741</b>	2,295	-	2,295
Land	-				2,295	-	2,295
Buildings	4%	<b>134,917</b>	<b>(42,506)</b>	<b>92,411</b>	122,666	(37,750)	84,916
Machines and equipment	20%	<b>130,373</b>	<b>(91,788)</b>	<b>38,585</b>	111,455	(77,624)	33,831
Installations	10%	<b>30,362</b>	<b>(9,290)</b>	<b>21,072</b>	23,366	(7,034)	16,332
Furniture and fixtures	10%	<b>5,602</b>	<b>(2,459)</b>	<b>3,143</b>	4,826	(1,902)	2,924
Tools	20%	<b>1,064</b>	<b>(784)</b>	<b>280</b>	966	(650)	316
Vehicles	20%	<b>410</b>	<b>(254)</b>	<b>156</b>	477	(249)	228
Data processing equipment	20%	<b>22,676</b>	<b>(14,568)</b>	<b>8,108</b>	20,890	(11,357)	9,533
Other fixed assets	10%	<b>16,234</b>	<b>(4,300)</b>	<b>11,934</b>	14,037	(3,202)	10,835
Fixed assets in progress	-	<b>1,900</b>	-	<b>1,900</b>	4,678	-	4,678
Imports in process	-	-	-	-	1,987	-	1,987
Advances to suppliers	-	<b>1,273</b>	-	<b>1,273</b>	2,421	-	2,421
		<b>347,552</b>	<b>(165,949)</b>	<b>181,603</b>	310,064	(139,768)	170,296

## Grendene S.A. and subsidiaries

## 6. Notes to financial statements -- continued

December 31, 2005 and 2004

(in thousands of reais)

## 9. Property, Plant and Equipment --continued

In prior years, the Company's property, plant and equipment assets were revalued based on appraisal reports issued by qualified appraisers. The balances related to these revaluations are summarized as follows:

	Company and Consolidated	
	2005	2004
Land	664	664
Buildings and improvements	9,769	9,769
	10,433	10,433
(-)Accumulated depreciation	(5,540)	(4,905)
	4,893	5,528

In June 2004 the Company reversed to revaluation reserve in shareholders' equity the residual amount of the revaluation reserve amounting to R\$2,760, based on a specialized study that detected that the provision then recorded needed to be adjusted.

## 10. Financial Institutions

	Index	Interest rates (p.a.)	Company		Consolidated	
			2005	2004	2005	2004
Short term:						
Fixed assets						
Banco do Nordeste S.A.	Pre-fixed	10.50%	9,340	4,703	9,340	4,703
Banco Rio De La Plata	Pre-fixed	9.50%	-	-	1,943	-
Total short term			9,340	4,703	11,283	4,703
Long-term:						
Fixed assets						
Banco do Nordeste S.A.	Pre-fixed	10.50%	61,338	50,897	61,338	50,897
Total long term			61,338	50,897	61,338	50,897
			70,678	55,600	72,621	55,600

The guarantees linked to loans and financing are as follows: a) statutory lien over purchased machinery and equipment; b) land; and c) personal sureties provided by Company directors.

## 10. Financial Institutions -- continued

Long-term installments are classified as per the maturity year:

Maturity	R\$
2007	11,305
2008	14,178
2009	14,178
2010	14,178
2011	7,499
	61,338

In 2004 the Company recorded R\$4,032 as administrative expenses corresponding to the installments of an aircraft leasing contract entered into on January 9, 1997. The leasing agreement was terminated in the beginning of 2005 without expenses for the Company.

## Grendene S.A. and subsidiaries

## 6. Notes to financial statements -- continued

December 31, 2005 and 2004

(in thousands of reais)

## 11. ICMS Tax Related Loans

Company is entitled to tax incentives granted by the State Government of Ceará up to 2019 due to the activities carried out in that Brazilian state through loans obtained from Banco do Estado do Ceará S.A. These loans are based on the ICMS (State VAT) tax due and partly on the tax on exports, as computed monthly. Loans must be settled within a period ranging from 36 to 60 months after granting and, according to the respective granting clauses, amounts due will be reduced by 75% to 99% in relation to the total borrowed, depending on the contract terms.

Management believes that recording the benefit at the time the loans are obtained reflects the accrual method of accounting for the year more adequately, as the cost derived from ICMS tax on the operations subject to incentives is also being concomitantly recorded with the benefits.

At the year end December 31, 2005, the Company recorded an equity increase due to the incentive portion of these financing amounting to R\$83,963 (R\$93,155 in 2004).

At December 31, 2005 the non-incentive amounts of these financings amounting to R\$15,940 (R\$15,029 in 2004) and R\$89,512 (R\$78,014 in 2004), respectively, are recorded in current and noncurrent liabilities.

## 12. Provision for Contingencies

Company has been involved as Defendant in several labor claims. Based on counsel's opinion, who consider the chances of unfavorable outcome as probable, Company recorded a provision to cover possible losses deriving from these cases.

## 13. Shareholders' Equity

a) Capital

The Extraordinary General Meeting held on April 18, 2005 approved the increase in capital, with reserves, in the amount of R\$113,203.

At December 31, 2005, capital fully owned by shareholders domiciled in Brazil comprised 100,000,000 common shares at par value of R\$7.3378 each (100,000,000 at par value of R\$6.2058 in 2004). Capital shares are of a sole class regarding the nature of the respective owners' rights and are all voting, observing the legal conditions.

b) Legal reserve

The legal reserve is computed based on 5% of the remaining net income for the year ended December 31, 2005, limited to 20% of Capital, in the amount of R\$7,723 (R\$3,503 in 2004).

## Grendene S.A. and subsidiaries

## 6. Notes to financial statements -- continued

December 31, 2005 and 2004

(in thousands of reais)

## 13. Shareholders' Equity -- continued

c) Realizable profits reserve

It corresponds to the unrealized profit from transactions with subsidiaries in the amount of R\$1,397 (R\$2,403 in 2004), which are reversed to retained earnings upon effective collection.

d) Dividends

As per Company's by-laws, minimum compulsory dividends are computed based on 25% of the remaining net income for the year, once reserves required by law have been set up.

The dividends related to the year ended December 31, 2004 totaled R\$64,151, and were paid in 2005.

From income for the year ended December 31, 2005 and based on the Company's ability of generating cash in its operations, Management has proposed to Ordinary General Meeting the distribution of dividends, calculated as follows:

	<u>2005</u>
Net income for the year	<b>84,395</b>
Legal reserve	<b>(4,220)</b>
Reversal of realizable profits reserve	<b>2,403</b>
Realizable profits reserve	<b>(1,397)</b>
Proposed dividend	<b><u>81,181</u></b>

The Board of Directors approved, on October 28, 2005 the payment of interim dividends in the amount of R\$38,000 (R\$0.38 per common share). In addition, the Management has proposed, at December 31, 2005, a complementary payment of R\$43,181 (R\$0.43 per common share), thus reaching a total dividend of R\$81,181, i.e. 100% of the profit at December 31, 2005, after the legal and statutory deductions.

## 14. Income and Social Contribution Taxes

Current income and social contribution taxes

Income and social contribution taxes payable are recorded in current liabilities under the heading taxes, charges and contributions, net of offsets made in the period and tax incentives, as set out below:

	<u>2005</u>					
	<u>Company</u>			<u>Consolidated</u>		
	<u>Income tax</u>	<u>Social contribution</u>	<u>Total</u>	<u>Income tax</u>	<u>Social contribution</u>	<u>Total</u>
Amount due	33,403	12,330	45,733	31,744	12,330	44,074
Tax incentives	(25,701)	-	(25,701)	(25,701)	-	(25,701)
Offsets	(7,702)	(11,145)	(18,847)	(4,384)	(11,145)	(15,529)
	<u>-</u>	<u>1,185</u>	<u>1,185</u>	<u>1,659</u>	<u>1,185</u>	<u>2,844</u>
	<u>2004</u>					
	<u>Company</u>			<u>Consolidated</u>		
	<u>Income tax</u>	<u>Social contribution</u>	<u>Total</u>	<u>Income tax</u>	<u>Social contribution</u>	<u>Total</u>
Amount due	31,955	11,794	43,749	31,955	11,794	43,749
Tax incentives	(20,048)	-	(20,048)	(20,048)	-	(20,048)
Offsets	(13,255)	(11,944)	(25,199)	(13,255)	(11,944)	(25,199)
	<u>(1,348)</u>	<u>(150)</u>	<u>(1,498)</u>	<u>(1,348)</u>	<u>(150)</u>	<u>(1,498)</u>

## Grendene S.A. and subsidiaries

## 6. Notes to financial statements -- continued

December 31, 2005 and 2004

(in thousands of reais)

## 14. Income and Social Contribution Taxes -- continued

Deferred income and social contribution taxes

Deferred income and social contribution taxes are as follows:

	Company		Consolidated	
	2005	2004	2005	2004
Deferred charges:				
Income tax				
Allowance for doubtful accounts	488	434	536	434
Provision for discounts on payments made on due date	2,707	3,521	2,707	3,521
Provision for adjustment to probable production cost	1,019	865	1,047	865
Provision for adjustment of obsolete inventory	816	863	816	863
Other	1,327	1,282	1,551	1,514
	<u>6,357</u>	<u>6,965</u>	<u>6,657</u>	<u>7,197</u>
Social contribution tax				
Allowance for doubtful accounts	177	156	177	156
Provision for discounts on payments made on the due date	976	1,267	976	1,267
Provision for adjustment to probable production cost	368	311	368	311
Provision for adjustment of obsolete inventory	295	310	295	310
Other	481	472	481	472
	<u>2,297</u>	<u>2,516</u>	<u>2,297</u>	<u>2,516</u>
	<u>8,654</u>	<u>9,481</u>	<u>8,954</u>	<u>9,713</u>
Deferred liabilities				
Income tax	-	-	159	253
	<u>-</u>	<u>-</u>	<u>159</u>	<u>253</u>

Deferred income and social contribution taxes are expected to be substantially offset within 12 months.

## Grendene S.A. and subsidiaries

## 6. Notes to financial statements -- continued

December 31, 2005 and 2004

(in thousands of reais)

## 14. Income and Social Contribution Taxes--Continued

Reconciliation of Tax Expenses with Official Rates

Income and social contribution taxes calculated according to official rates have been reconciled with the amounts recorded as income and social contribution tax expenses, as follows:

	2005			
	Company		Consolidated	
	Incometax	Social contribution tax	Incometax	Social contribution tax
Net income before taxes	130,955	130,955	130,193	130,193
Income and social contribution taxes at nominal rate of 25% and 9%, respectively	(32,739)	(11,786)	(32,548)	(11,717)
Adjustments to demonstrate effective rate				
Positive equity pickup	(1,716)	(618)	(1,716)	(618)
Permanent additions	(403)	(145)	(403)	(145)
IRPJ tax incentives	822	-	822	-
Others	25	-	1,655	(69)
Amount recorded in the operating result	<u>(34,011)</u>	<u>(12,549)</u>	<u>(32,190)</u>	<u>(12,549)</u>
Effective rate	26.0%	9.5%	24.7%	9.6%
	2004			
	Company		Consolidated	
	Incometax	Social contribution tax	Incometax	Social contribution tax
Net income before taxes	104,325	104,325	101,957	101,957
Income and social contribution taxes at nominal rate of 25% and 9%, respectively	(26,081)	(9,389)	(25,489)	(9,176)
Adjustments to demonstrate effective rate				
Positive equity pickup	(937)	(337)	(937)	(337)
Permanent additions	(326)	(116)	(326)	(116)
IRPJ tax incentives	196	-	196	-
Others	2,158	564	1,531	351
Amount recorded in the operating result	<u>(24,990)</u>	<u>(9,278)</u>	<u>(25,025)</u>	<u>(9,278)</u>
Effective rate	23.9%	8.9%	24.5%	9.1%

## Grendene S.A. and subsidiaries

## 6. Notes to financial statements -- continued

December 31, 2005 and 2004

(in thousands of reais)

## 15. Financial Result

	Company		Consolidated	
	2005	2004	2005	2004
Financial expenses				
Discounts granted to costumers	(50,279)	(55,437)	(50,767)	(55,437)
Financing expenses	(14,232)	(18,501)	(14,232)	(18,501)
Exchange variation expenses	(27,460)	(18,824)	(32,928)	(22,780)
Setup of provision for discount for payment on due date	3,245	(14,086)	3,245	(14,086)
Expenses from hedge activities	(7,493)	(1,486)	(7,493)	(1,486)
Other financial expenses	(9,327)	(9,453)	(10,077)	(10,562)
	<b>(105,546)</b>	<b>(117,787)</b>	<b>(112,252)</b>	<b>(122,852)</b>
Financial income				
Income from investments	65,328	32,300	66,936	32,300
Interest received from costumers	2,472	2,495	2,557	2,495
Exchange variation income	13,255	13,811	13,283	13,811
Interest from hedge activities	26,527	6,869	26,527	6,869
Other financial income	2,520	2,362	2,793	3,166
	<b>110,102</b>	<b>57,837</b>	<b>112,096</b>	<b>58,641</b>
Net financial result	<b>4,556</b>	<b>(59,950)</b>	<b>(156)</b>	<b>(64,211)</b>

## 16. Financial Instruments

Company has certain operations that may be directly construed as "Financial Instruments," as recorded in assets and liabilities.

The Company's policy does not address engaging swap operations or others that may be featured as derivatives. Up to December 31, 2005 the Company recorded R\$19,034 gains on such operations, net of costs.

Company's financial instruments and criteria for assessing their fair market value are as follows:

- Cash and cash equivalents – amounts stated in the balance sheet are formed by amounts available in the current account at the date of the balance sheet and they are thus posted at their fair market value.
- Accounts receivable and payable – amounts stated in the balance sheet are close to their fair market value, when considering the allowances set up, and the lack of monetary adjustment for the portion of accounts receivable that has already become due.
- Short-term investments – short-term operations that do not consider the possibility of losses for the Company. Interest rates used are similar to those in similar operations.
- Loans and Financing – as shown in Note 10, charges are recognized on a pro rata die basis up to the balance sheet date. These operations do not pose additional risk to the Company.
- Other accounts – Management is unaware of any other account that might translate into material differences between the amounts recorded and fair market value at December 31, 2005. To date management is also unaware of any material fact or subsequent event that might significantly impact amounts recorded.



## Grendene S.A. and subsidiaries

## 6. Notes to financial statements -- continued

December 31, 2005 and 2004

(in thousands of reais)

## 19. Cash flow statements (supplemental information)

	Company		Consolidated	
	2005	2004	2005	2004
Cash provided by operations:				
Net income	84,395	70,057	85,401	67,654
Minority interest	-	-	165	-
Reconciliation to net cash provided by operating activities:				
Result of equity pickup	6,864	3,748	-	-
Depreciation	26,842	26,894	27,089	27,221
Income tax and ICMS (VAT) tax incentives	109,664	113,203	109,664	113,203
Deferred income and social contribution tax	827	(9,481)	665	(9,446)
Prior year adjustments	-	4	-	4
Investments disposals	-	95	-	1,265
Property, plant and equipment disposals	2,225	358	2,231	457
	230,817	204,878	225,215	200,358
Changes in assets and liabilities:				
Trade receivables	45,665	(54,990)	40,445	(67,576)
Inventories	30,641	19,296	34,226	30,606
Other assets	4,153	3,710	4,491	19,615
Suppliers	(8,078)	(1,466)	(7,379)	(1,466)
Payroll and related charges	(1,176)	5,868	(1,189)	5,874
Tax payable	(1,384)	5,028	(1,180)	(1,704)
Other payable	(3,612)	1,411	(3,295)	(134)
Net cash provided by operations	297,026	183,735	291,334	185,573
Cash used in investing activities				
In investments	(2,251)	-	-	-
Acquisition of property, plant and equipment	(40,690)	(27,327)	(40,627)	(27,501)
Net cash provided by investment activities	(42,941)	(27,327)	(40,627)	(27,501)
Cash provided by (used in) financing activities				
Debts	27,487	16,428	29,430	16,428
Proposed and paid dividend	(102,151)	(69,331)	(102,151)	(69,331)
Net cash used in financing activities	(74,664)	(52,903)	(72,721)	(52,903)
Increase in cash	179,421	103,505	177,986	105,169
Cash and cash equivalents at beginning of year	304,685	201,180	332,774	227,605
Cash and cash equivalents at end of year	484,106	304,685	510,760	332,774
Increase in cash	179,421	103,505	177,986	105,169

**Grendene S.A. and subsidiaries**

**Board of directors**

**Alexandre Grendene Bartelle**  
Chairman

**Pedro Grendene Bartelle**  
Deputy chairman

**Directors**  
Ana Novaes  
Maílson Ferreira da Nóbrega  
Oswaldo de Assis Filho  
Renato Ochman

**Executive board of directors**

**Alexandre Grendene Bartelle**  
Chief Executive Officer

**Pedro Grendene Bartelle**  
Vice President

**Marcus Peixoto, CFA**  
Chief Financial Officer and Investor Relations Director

**Gelson Luis Rostirolla**  
Administrative and Controller Director

**Rudimar Dall'Onder**  
Industrial and Commercial Director

**Sergio Victor Machado**  
Accountant – CRC/CE – SEC – 19.823

**A free translation from Portuguese into English of Report of Independent Auditors on financial statements prepared in accordance with the accounting practices adopted in Brazil**

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**Grendene S.A. and subsidiaries**

**7. Report of independent auditors**

The Board of Directors and Shareholders  
**Grendene S.A.**

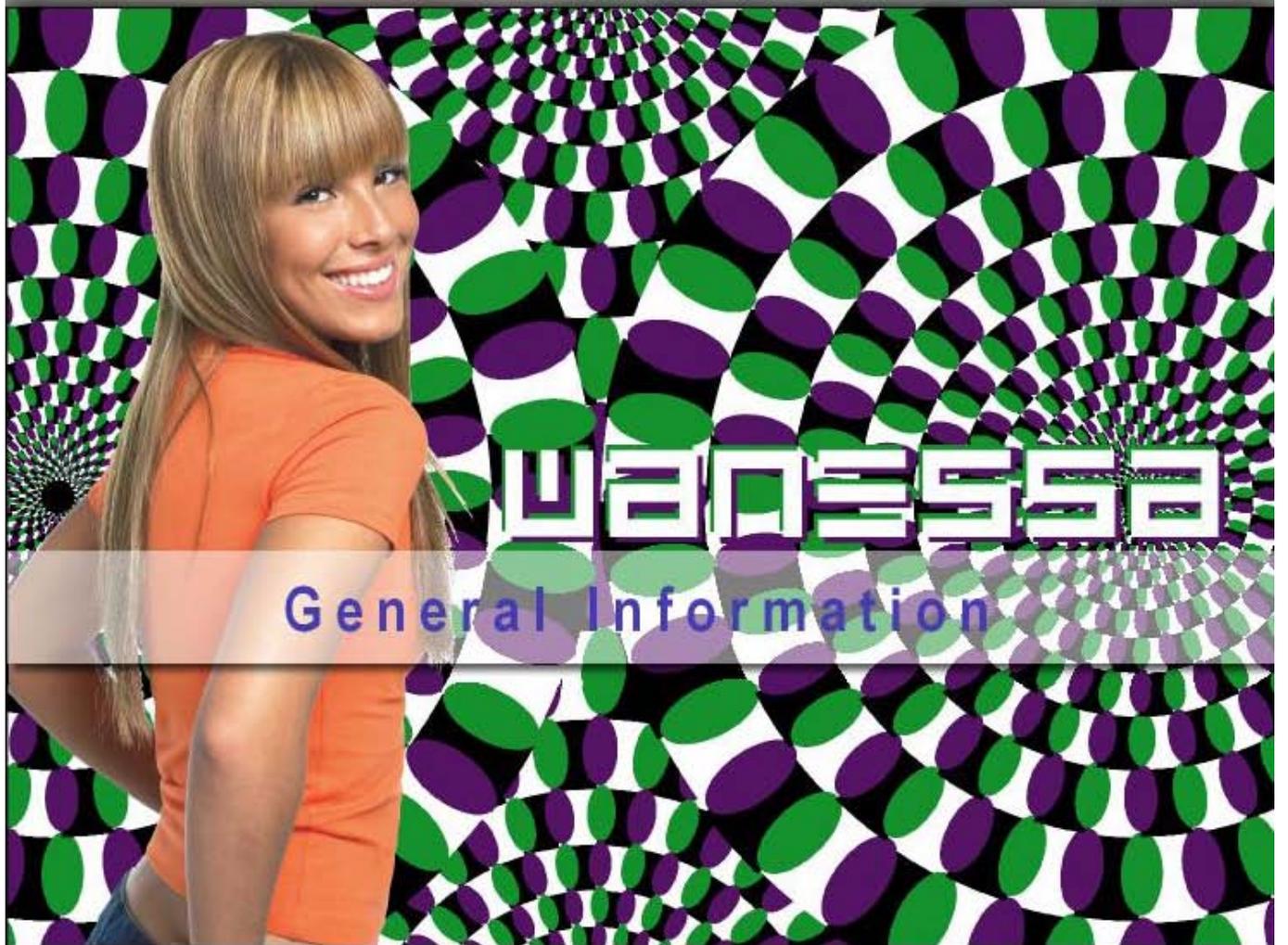
1. We have audited the balance sheets of Grendene S.A. and the consolidated balance sheets of Grendene S.A. and subsidiaries as of December 31, 2005 and 2004, and the related statements of income, shareholders' equity and changes in financial position for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements. The audit of the financial statements of the indirect subsidiary Grendha Shoes Corp. for the years ended December 31, 2005 and 2004 were conducted by other independent auditors. Our opinion insofar as it relates to the amount of this investment amounting to R\$9,864 thousand (R\$15,690 thousand at December 31, 2004) and the negative equity pickup arising therefrom during the year, amounting to R\$3,971 thousand (R\$1,365 thousand negative in the year ended December 31, 2004), is based solely on the reports issued by these independent auditors.
2. We conducted our audit in accordance with generally accepted auditing standards in Brazil, which comprised: (a) the planning of our work, taking into consideration the materiality of balances, the volume of transactions and the accounting and internal control systems of the Company; (b) the examination, on a test basis, of documentary evidence and accounting records supporting the amounts and disclosures in the financial statements; and (c) an assessment of the accounting practices used and significant estimates made by management, as well as an evaluation of the overall financial statement presentation.
3. In our opinion, based on our examinations and on the opinion issued by other independent auditors, as mentioned in paragraph one above, the financial statements referred to above present fairly, in all material respects, the financial position of Grendene S.A. and the consolidated financial position of Grendene S.A. and subsidiaries at December 31, 2005 and 2004, the results of their operations, changes in their shareholders' equity and changes in their financial position for the years then ended, in accordance with the accounting practices adopted in Brazil.
4. We conducted our audit with the objective of issuing an opinion on the financial statements, mentioned in paragraph one above. The supplemental information mentioned in Note 19, corresponding to the cash flow statement (individual and consolidated), prepared in accordance with accounting practices adopted in Brazil, is being presented to provide additional information about the Company, despite not being a mandatory component of the financial statements. This information was submitted to the audit procedures described in the second paragraph above, and, in our opinion, is presented fairly, in all material respects, in relation to the financial statements taken as a whole.

Fortaleza (Brazil), February 10, 2006.

ERNST & YOUNG  
Auditores Independentes S.S.  
CRC-2 SP 15.199/O-6/F/RS

Marcos Antônio Quintanilha  
Accountant CRC1SP132776/O-3/T-SC/S-CE

Américo F. Ferreira Neto  
Accountant CRC1SP192685/O-9/S-CE



**IX. General information****1. Corporate Information****BOARD OF DIRECTORS****Chairman**

Alexandre Grendene Bartelle

**Deputy chairman**

Pedro Grendene Bartelle

**Directors**

Ana Novaes

Maílson Ferreira da Nóbrega

Oswaldo de Assis Filho

Renato Ochman

**EXECUTIVE OFFICERS**

Alexandre Grendene Bartelle – Chief Executive Officer

Pedro Grendene Bartelle – Vice-president

Marcus Peixoto, CFA – Chief Financial Officer and Investor Relations Director

Gelson Luis Rostirolla – Administrative and Controller Director

Rudimar Dall'Onder - Industrial and Commercial Director

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**Members of the Board of Directors and Executive Officers**

**Alexandre Grendene Bartelle** – Chairman of the Board of Directors and Chief Executive Officer (56). Mr. Bartelle has a degree in law from the University of Caxias do Sul. He founded Grendene in 1971, along with his grandfather, Pedro Grendene. Over the years he has been among those responsible for redirecting the Company's business lines by developing new concepts, products and innovative design, as well as the decision to transfer the main industrial unit to the state of Ceará. He is involved in other businesses in Brazil and abroad, including Telasul S.A., a producer of tubular furniture; Dell'Anno Móveis Ltda., a modular wood kitchen and closet manufacturing Company; Agropecuária Jacarezinho Ltda., a sugar mill and cattle-raising enterprise; and Reebok Chile, a footwear company.

**Pedro Grendene Bartelle** – Deputy chairman of the Board of Directors and Executive Vice-president (56). He was among those responsible for redirecting the company's business lines by developing new concepts, products and innovative design, as well as the decision to transfer the main industrial unit to the state of Ceará. He is involved in other businesses in Brazil and abroad, including Vulcabrás and Vulcabrás do Nordeste, a footwear company where he is chief executive officer and chairman of the Board of Directors; Agropecuária Grendene Ltda., a sugar mill and cattle-raising enterprise; and Reebok Chile, a footwear company.

**Ana Dolores Moura Carneiro de Novaes** – Director (44), PhD. in Economy from the University of California at Berkeley (1990); Master's Degree in Economics from PUC University of Rio de Janeiro (1986); and holder of the CFA charter from AIMR of USA (since 1998). She has been an independent member of the Board of Directors of CCR, a highway concessions company, since 2002; she has been a lecturer in macroeconomics at PUC University of Rio de Janeiro (2003); she was Director of Investments at Modal Pictet Asset Management from 1998 to 2003; investment analyst at Banco Garantia from 1995 to 1997; and an economist at the World Bank in Washington from 1991 to 1995.

**Mailson Ferreira da Nóbrega** – Director (63). After graduating in economics at Centro Universitário de Brasília (CEUB), Mr. Nóbrega began his career with Banco do Brasil S.A., as head of the rural and industrial credit area in the Pernambuco branch. After nine years with Banco do Brasil, he became head of the Economic Advisory area of the Industry and Trade Ministry and then headed the same area in the Finance Ministry. He has been general secretary of the Finance Ministry on two occasions and between 1988 and 1990 was Finance Minister and chairman of the National Monetary Council, the National Foreign Trade Council (Concex), the National Private Insurance Council (CNSP), the Federal Privatization Council and the Financial Policy Council (Confaz). He is currently a partner in the Tendências Consultoria Integrada consulting firm and is involved in various social and business organizations. He is a member of the boards of directors of a number of companies in Brazil and abroad, including the official Brazilian statistics body, the IBGE and the Brazilian-Dutch Chamber of Commerce. He is also on the editorial committee of the *Estado de São Paulo* newspaper and the Board of Directors of the São Paulo State Industry Federation (Fiesp). Mr. Nóbrega has also acted as a representative of the Brazilian government at international events and committees and is the author of a number of books and articles on the Brazilian economy published in Brazil and abroad.

**Oswaldo de Assis Filho** – Director (56). He graduated in 1973 in electronic engineering from ITA (the Aeronautical Technology Institute) and has a master's degree in economics from the Economics and Business Management Faculty of São Paulo university. Between 1978 and 1983, he was a director of Banco Mercantil de São Paulo. He was a partner in the brokerage houses Planibanc Corretora de Valores – from 1984 to 1991, and Convenção Corretora de Valores – from 1992 to 1994. In 1994, he became Vice-president of Banco Itamarati, a position he occupied until 1996. In 1996 and 1997 he was Vice-president of Banco de Crédito Nacional (BCN), and in 1998 became a partner in Banco Pactual S.A., a position he still holds. He is currently a member of its Corporate Finance group.

**Renato Ochman** – Director (46). Mr. Ochman graduated in law from the Catholic University of Rio Grande do Sul and has a master's degree and postgraduate degree in business law from the Catholic University of São Paulo (PUC/SP). He began his career as an assistant professor of civil law at PUC/SP and lectured at the Fundação Getúlio Vargas university between 1989 and 1993, and between 2001 and 2003. Since 1989, he has been a partner in the law firm Ochman Real Amadeo Advogados Associados, which specializes in corporate law and capital markets. He is involved in a number of social and business organizations and is currently a member of the Board of Directors of Ultrapar Participações S.A. and a member of the Audit Board of the Association to Assist Handicapped Children (AACD). He is also the author of various legal articles published in specialist newspaper and magazines.

**Marcus Peixoto, CFA** – Chief Financial Officer and Investor Relations Director (35). He graduated in 1993 in electronic engineering from ITA (the Aeronautical Technology Institute). He initially worked as an equities and investment analyst for nearly a decade at Garantia / CSFB (1994-2003), joining Banco Pactual in December 2003. He joined Grendene on April 29, 2005. He was awarded the CFA charter in 1998.

**Gelson Luis Rostirolla** – Administrative and Controller Director (53). Mr. Rostirolla graduated in Business Management and Accounting at the Oeste Catarinense university. He joined the company in 1980 as financial manager and in 1985 became financial director, a position he held until April of 2005. He began his career in 1972 as administrative and financial manager of Leticia Avícola S.A., a company operating in poultry and supplying Sadia S.A., Perdigão S.A., Frangosul S.A. and Seara Avícola S.A. He is vice-president of Saddle Corp. and a member of the Board of Directors of Vulcabrás do Nordeste.

**Rudimar Dall'Onder** – Industrial and Commercial Director (49). He graduated in mechanical engineering at the University of Caxias do Sul and entered the Company in 1979 as manager of the Information Technology department. In 1987, he became Industrial and Commercial director, a position he still holds.

## **2. Information for shareholders**

### **Investor relations**

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Doris Wilhelm – Manager

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Alexandre Vizzotto and Lenir Baretta – Analysts

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### **Stock market**

São Paulo Stock Exchange (Bovespa)

Corporate governance level: *Novo Mercado*

Ticker: GRND3

### **Shareholder department**

**Banco Itaú S.A. - Custody department / Share registration service**

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**Salvador**

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Comércio – Salvador/BA  
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Telephone: 55 71 3319 8010

**Independent auditors****Ernst & Young Auditores Independentes S.S.**

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Porto Alegre – RS – 90510-040  
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**Newspapers in which obligatory corporate information is published**

*Diário Oficial do Estado do Ceará, O Povo, and Valor Econômico.*

### 3. Credits

Coordination: Marcus Peixoto and Investor Relations team.

General coordination: Doris Wilhelm – IRO

Text: Doris Wilhelm

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Design: ID – Design Inteligente – Tel: +55 51 3029-9891

Web technology: Size OF - Where Solution Sized – Tel: +55 51 2106-1000

Photographs: Grendene archives

## Thanks

We thank all the Grendene people who have participated in the production of this report: the Marketing, Sales, and Financial and Controllers' Departments; and the Human Resources, Industrial, R&D, Procurement, Information Technology, and Investor Relations team – not only for the information rapidly researched and supplied but also for useful ideas contributed.

We also thank our suppliers, who provided excellent creative ideas, technological solutions, and rigorous compliance with tight deadlines, making possible one more pioneering Grendene innovation: **publication of our 2005 Annual Report on-line simultaneously with publication of our 2005 results (on March 6, 2006).**

## Special Thanks

Gelson L. Rostirolla and João B. F. de Moraes