Kao Corporation

Annual Report 1999

Year Ended March 31, 1999

Profile

Kao Corporation has served the needs of consumers for more than a century. Kao is one of the leading companies in Japan for personal care products, cosmetics, laundry and cleaning products, hygiene products, and bath additives.

The Company has also earned a reputation as a quality manufacturer of chemical products. Committed to a global approach to business, Kao has operations in 25 countries in Asia, North America, Europe, and other parts of the world.

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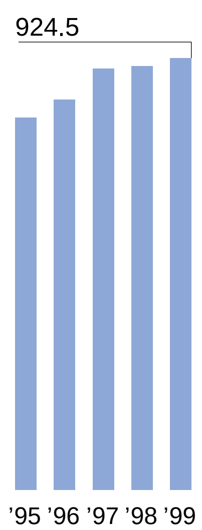
Financial Highlights

Kao Corporation and Consolidated Subsidiaries — Years ended March 31

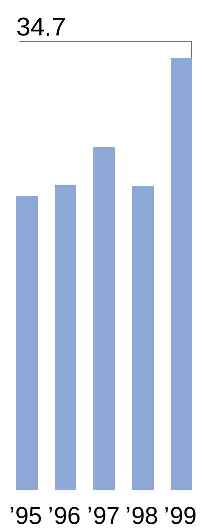
	Billions of yen			Millions of U.S. dollars
	1999	1998	1997	**1999**
For the year:				
Net sales	**¥924.5**	¥907.2	¥901.4	**$7,669.8**
Net income	**34.7**	24.4	27.5	**287.9**
At year-end:				
Total assets	**¥751.7**	¥778.7	¥807.1	**$6,235.7**
Total shareholders’ equity	**451.7**	424.4	379.5	**3,747.6**
	Yen			U.S. dollars
Per share:				
Net income	**¥55.98**	¥40.10	¥45.92	**$0.46**
Cash dividends	**16.00**	15.00	14.00	**0.13**

Notes: 1. The U.S. dollar amounts are translated, for convenience only, at the rate of ¥120.55=US$1, the approximate exchange rate at March 31, 1999.
2. Net income per share is computed based on the weighted average number of shares outstanding during the respective years.
3. Cash dividends per share are the amounts applicable to the respective years, including dividends to be paid after the end of the year.

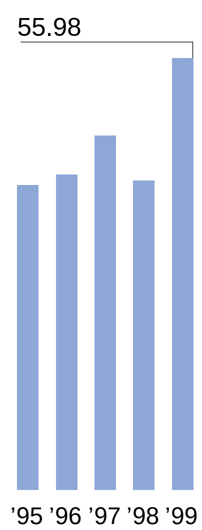
Net Sales
(Billions of yen)



Net Income
(Billions of yen)



Net Income per Share
(Yen)



President’s Message to the Shareholders

Takuya Goto
President

Kao had a very successful year in fiscal 1998/1999. We are pleased to report that the Company achieved excellent earnings growth and record net income despite continued sluggish market conditions, especially in Japan and elsewhere in Asia.

Consolidated net sales for the fiscal year ended March 31, 1999, totaled ¥924.5 billion (US$7,669.8 million), a 1.9% increase over the previous fiscal year. Consolidated net income increased 41.7%, to ¥34.7 billion (US$287.9 million). In view of these results, the Company has decided to increase its annual dividend to shareholders by ¥1.00, to ¥16.00 (US$0.13) per share, the sixth consecutive increase in annual cash dividends.

In Japan, sales of household products increased 1.0%. However, the withdrawal from the information technology business led to a 0.4% fall in net sales from the previous fiscal year.

A solid 2.9% sales increase from the previous fiscal year was achieved in Asia, despite the deepening of the recession there brought on by the region’s currency crisis. In North America and Europe, sales expanded 10.4% from the previous fiscal year, as substantial growth was registered in sales of household products, especially *bioré* in North America.

Consolidated operating income jumped 25.8% over the previous fiscal year. Cost reductions and spending efficiency drives conducted in Japan increased profitability, which was also enhanced by decreased depreciation expenses. Also contributing to the jump in consolidated operating income was a significant increase in profits in the household products business in the United States and a notable reduction in operating losses in the information technology business.

Kao accelerated restructuring efforts in the information technology business from 1997, ending all activities in the field in the fiscal year under review. As a result of these efforts, Kao wrote off extraordinary losses amounting to ¥23.8 billion for the fiscal year, yielding a total of ¥35.5 billion in such losses since 1997.

Consolidated capital expenditure during the year was ¥69.0 billion (US$572.5 million). In Japan, investment included equipment to develop new products in the household products business, to increase the production capacity of the chemical products business, to expand distribution facilities and for the general rationalization of operations. In overseas operations, investment included a new laundry detergent plant in China and development of operations in Asia. Another major investment activity was the acquisition of a skin care business in the United States, including the *Curél* brand, in May 1998.

As a result of the aforementioned, the fiscal year ended March 31, 1999 was a record year in terms of profit for Kao. Of course, many issues remain to be addressed, and we must be unrelenting in pursuing these. Nonetheless, this performance is significant as it confirms the underlying strengths that have driven the Company's growth. Policies for further growth will be developed on the basis of these strengths.

Kao's unique capabilities

I believe Kao's strength lies in the following four areas: ability to discover consumers' needs, superior R&D, a strong sales force, and effective profit management.

1. Ability to discover consumers' needs

In order to accurately identify consumers' real needs, Kao has long conducted marketing activities designed to gain an insight into their daily lives and thereby gain valuable feedback. With the remarkable diversification of people's lifestyles and values, it is becoming harder to recognize consumers' underlying needs. As consumers continue to change, the Company is developing and implementing methods to uncover genuine needs, by thinking of consumers not as a uniform mass, but as unique individuals with specific needs and desires that are constantly evolving.

2. Superior R&D

I should emphasize the Company's policy on research and development. In the Company, researchers in a wide range of fields, such as surface science, oleo and organic chemistry, polymer science, biological science, and material science, are engaged in cutting-edge research and development work. Kao is striving to nurture and grow the technological seeds it develops into products that provide new value and comfort to meet consumers' needs. In addition, the Company is actively studying ergonomics and art to produce better products by improving not only product quality and performance but also design and convenience of containers and packages.

3. A strong sales force

About 30 years ago in Japan, with the support of our wholesalers, Kao established its own sales company system, a unique and efficient sales system different from that of any other household products manufacturer. We developed close cooperative relationships with retailers, actively working hand in hand with them on everything from developing store shelves, where consumers could easily choose and purchase products, to improving the efficiency of delivery operations. Through these efforts, we have achieved a high level of integration of production and sales operations.

4. Effective profit management

Kao s guiding principle for all company activities is profitable growth. It goes without saying that ensuring profitability is essential to realizing continued growth and expansion. By offering value-added, cost-competitive products to many consumers, we can secure the profits required to develop even better products. In Japan, Kao s financial performance has enabled the Company to build a strong reputation for its effective profit management over many years. Nevertheless, looking at the industry from a global perspective, we see competitors with even stronger profitability and we realize the importance of further improving the Company s financial performance.

In light of the recession in Japan, the accelerating globalization of markets, and intensifying worldwide competition, the Company recognizes the urgency of focusing on core businesses while making use of the basic strengths described above. This means concentrating our use of limited resources in such a way as to build an even stronger Kao.

Management focus for the new fiscal year

With this in mind, in fiscal 1999/2000, we will vigorously carry out the following measures.

1. Developing new products and new businesses

The market for household products, Kao s main product area, is said to be mature, even saturated. However, I firmly believe that new products that offer new value or convenience will win the ardent support of consumers. We see the current period of market sluggishness not as a problem but as an opportunity to use our strengths in pinpointing needs and developing products to bring new and unique products to the market. Accordingly, we are redoubling our efforts in this area.

Furthermore, we are actively engaged in developing new businesses. In particular, we are devoting management resources to the health care and beauty care fields in anticipation of future growth in these areas.

In developing new businesses, it is vital that we target the fields where we can utilize our core competencies.

2. Enhancing brand power

In Japan and elsewhere in Asia, among Kao s more than 40 brands, the Company s key products, including *Attack* laundry detergent, *Humming* fabric softener, and *Biore* skin care products, enjoy a strong market position thanks to solid consumer support. Even so, we cannot deny that some of our brands have yet to establish strong foundations in the market. We need to look at how we can push our number two and number three brands to the top as we continue to strengthen and develop our number one brands. To achieve this, we are working to improve products, strengthen our product lineup, and implement effective marketing policies.

In addition, Kao s most important objective is to develop strong global brands that can succeed not only in the Japanese market but also in diverse foreign markets. Through these global brands, we will build on our strengths and use our innovative power to help improve the lives of our many overseas customers.

3. Ongoing reform of operations

Kao has been pursuing a company-wide initiative known as TCR (Total Cost Reduction) for many years. TCR started at the peak of the bubble economy in Japan in 1986. Operational reform at this time proved very effective in reducing costs and improving work methods and planning. TCR is now an integral part of our Company s corporate culture.

To strengthen the corporate structure further, we adopted a new management measurement known as EVA¤ (Economic Value Added)* in April of this year. EVA is a form of profit that deducts all costs of doing business including the cost of the capital invested in the business. Because of its attention to the use of capital, EVA will enable us to more accurately measure the value created by the Company. Our goal in introducing EVA is to actively pursue improvement in profitability and capital efficiency, rather than simply evaluating business operations on the basis of total sales or operating income, and in so doing to increase Kao s corporate value.

In order to make the Company more competitive in the global market, Kao will actively utilize EVA as a management system and apply it in determining standards for incentive systems throughout the Company.

We will also pursue structural reform in such areas as production, distribution and sales. By March 31, 2000, the transformation of the Kyushu Plant one of our long-standing, key production facilities from a production base to a distribution base, will be completed. In addition, in April of this year, eight Kao sales companies around the country were consolidated with the aim of becoming number one in customer service. We have high expectations for the new integrated Kao sales company.

In talking about building the strength of the Company, we are not just referring to our own activities. We are striving to establish partnerships with other companies, both in Japan and abroad, which possess strengths that complement ours.

One example is the development of *Biore* sales in Europe, which were strongly boosted by last year s strategic alliance with Beiersdorf AG. Similarly, a tie-up with Novartis Consumer Health S.A. in the health care business in Japan and an agreement with S.C. Johnson & Son, Inc., to sell Kao s household cleaning mop kit in the United States and other countries, provide examples of mutually productive partnerships.

While striving to make the Company strong and achieve increasing profitability, we at Kao also wish to continue playing a positive role in society through attention to environmental issues and strict adherence to our code of business ethics.

I would like to express my sincere gratitude to the Company s shareholders and business partners for their understanding and support of Kao s activities. I look forward to your continued cooperation.

June 29, 1999

Takuya Goto
President

**EVA¤ is a registered trademark of Stern Stewart.*

Committed to Grasping Consumers’ Real Needs

A Consumer-Oriented Approach Nurtures Strong Brands

Strong brands are the most important assets for consumer product manufacturers. The question is, how can a company produce and nurture strong brands? The secret is attentiveness to consumers. This is the underlying concept guiding Kao s marketing policy. In addition to carefully listening to consumers voices, Kao seeks to understand their underlying needs and wants and provide products that exceed their expectations. All Kao employees in product-related fields, from sales people to marketers and researchers, take a consumer-oriented approach and always keep in mind the requirements of each field by sharing information as they go about their work. This is the driving force behind Kao s success in generating hit products and developing strong brands in the mature consumer product market.

Researchers, marketers and other employees responsible for the Company s products actively discuss a product from their own perspective.

Consumer feedback quickly circulates throughout the Company

Kao s Consumer Information Center receives about 400 calls a day, or 90,000 a year, from all over Japan. The center not only responds promptly to consumers questions, comments and complaints, but also utilizes the feedback as a valuable company asset and pools it to ensure maximum utilization. Since 1987 Kao has used its Echo System, a computerized data bank of product-related information, to provide support through the Consumer Information Center and gather feedback from consumers.

After the Consumer Information Center receives a comment, question or complaint, employees in the relevant division at Kao can access the information related to the products in the database on the following day. Anybody involved with the Company s products, whether marketers or researchers, can share information through the company network. They can exchange information focused on a particular brand, regardless of their individual positions. This flexibility is one of the distinguishing characteristics of Kao that provides the driving force for brand management.

Immediately after launching new products, Kao begins working on product improvements. Careful

Examples of improvements to *Blaune Hair Manicure*

September 1993:	Release of product
November 1993:	Revision of instruction pamphlet
September 1994:	Improvement of product formula and comb attachment A special new comb attachment for hair ends is added
July 1995:	Relaunch of product
August 1996:	Hair color remover, in case the coloring agent is accidentally applied to the skin, is added Revision of instruction pamphlet
August 1997:	Introduction of a new range of colors
February 1998:	Introduction of the “Color Information Box” (a recorded voice guide and information service) Revision of instruction pamphlet and instructions on the packaging
July 1998:	Improvement of product formula
March 1999:	Utilizing the information accumulated from consumers on hair color, a new coloring product that is gentler on the hair, *Blaune Super Color*, is introduced

consideration is given to consumer feedback. For example, the Company has continued to improve *Attack* laundry detergent, its top brand, for the more than 10 years since the product s launch in an effort to constantly maintain *Attack* s position as the strongest and most innovative product. Skin care and hair care products, especially for women, constitute a field in which information about product performance, together with information about how to use the product more effectively and what the product provides, is critical. Consumer feedback is used in product development, product packaging, advertising and store display. For example, this approach enabled Kao to improve the hair coloring agent *Blaune Hair Manicure* by simplifying its use and making directions easier to understand. The changes have been well received by consumers. A 24-hour automatic telephone answering service is available to provide information to the many consumers who inquire about the use of hair coloring.

Consumers comments are pooled and recorded in Kao s Echo System and are utilized for making improvements and developing new products.

Understanding trends at sales outlets in real-time

The situation at sales outlets can be obtained through the Company's network in real-time. Point-of-sale data from major retailers throughout the country is used not only for sales analysis, but also for tracking which items are selling in retail stores. The latest sales trends for each product category, including other companies' products, can be seen. In addition, employees of Kao sales company, which exclusively handles Kao products, share winning sales tactics, including photos of store displays and activities that successfully boosted sales. Retail outlets are important points for making contact with consumers and information from these locations generates tips for new product development.

Product developers and marketers visit test users and, by gathering feedback, consider what the test users' real needs are for their everyday lives.

Sales tactics, including display proposals for sales outlets, are shared via a computer network in real-time.

At Kao, a leader in setting up this kind of infrastructure, both management and staff in each division have become enthusiastically motivated to effectively apply the information gathered. The Company will continue expanding this kind of information exchange as a valuable operational tool.

Understanding people's real needs in their everyday lives

Exchanging information in real-time is important, but people involved in the product development process also need to think from the point of view of consumers' everyday lives. Product developers and marketers visit the homes of product test users, interview them about their actual use of the products, and sometimes ask them to demonstrate how they use a product. The product developers and marketers are required to grasp consumers' potential needs in the context of their daily lives. In some cases the test users are asked to keep journals in which they describe the circumstances surrounding their use of the products. Kao makes

Product developers and marketers ask test users, who actually test hair color products at Kao's Beauty Center, to give their opinions on the products.

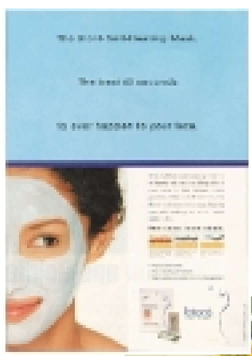
Attack Color, *which was introduced to meet the local demand for a laundry detergent that retains the brightness of vividly colored clothes, recorded strong sales in both Taiwan and Thailand.*

many discoveries by concentrating not only on the product itself but also on how it is used.

Product managers often visit consumers who have complained to the Consumer Information Center. They listen to the consumers and check the condition of the products and how the products are used. This enables the Company to improve its products and understand what products are in demand. Creating products that truly satisfy consumers' needs and wants is the foundation of establishing strong brands.

Implementing a consumer-oriented approach on a global scale

The idea of consumer-orientation is similarly widespread in areas outside Japan. Elsewhere in Asia, *Attack Color* is selling well in Taiwan. People in Taiwan tend to wear brightly colored clothes, and there is a need for a detergent that keeps colors as vivid as possible. Maintaining close contact with Taiwanese consumers, Kao gained a solid understanding of their needs and successfully developed products to satisfy those needs.



In the United States, a wide range of skin care products with distinctive characteristics are developed to meet local consumers' needs.

In the United States, The Andrew Jergens Company now sells a range of unique *bioré* skin care products, following up on its initial sales of *bioré pore perfect*. The main new products are based on Kao's *Biore Moisturizing Pack for Around the Eyes* and *Biore Cleansing Cotton*, which are marketed in Japan, and are being improved and adapted to meet the unique needs of consumers in the United States, taking into account their skin care habits and ways of using the products. Following this pattern, Kao aims to sell global brands simultaneously in markets around the world, through the use of key technologies and key product concepts, as well as by adapting products to meet the needs of consumers in each area.

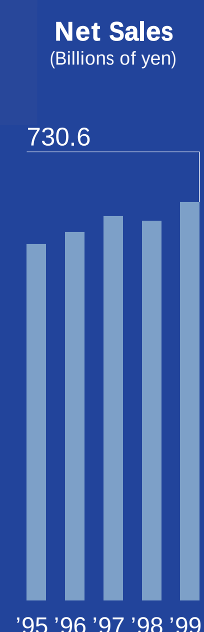
By taking a consumer-oriented approach to product development, Kao will continue to create and nurture strong brands and markets on a global basis.

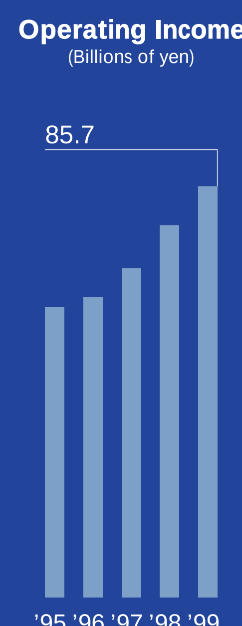
Household Products

In the fiscal year ended March 31, 1999, consolidated net sales in the household products business segment rose 4.9%, to ·730.6 billion (US$6,060.9 million), and operating income increased to ·85.7 billion (US$711.7 million), up 10.7% on a year-to-year basis.

In Japan, in spite of the continuing recession and a resulting drop in demand in the household products market, the Company increased profitability by marketing new product items with high added value, reducing costs and decreased depreciation expenses.

In North America and Europe, Kao s subsidiary in North America, The Andrew Jergens Company recorded strong sales of the *bior* brand, which contributed significantly to the growth of both sales and profit.





Chemical Products

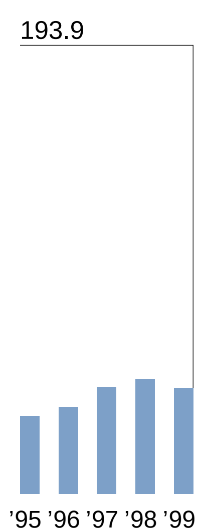
In the fiscal year ended March 31, 1999, consolidated net sales of the chemical products business were ·193.9 billion (US$1,608.8 million). The Company s withdrawal from the information technology business resulted in a 7.8% decrease in sales from the previous fiscal year. Consolidated net sales, with the exception of the information technology business, were ·145.5 billion (US$1,207.0 million), an 8.3% increase over the previous fiscal year.

Results by region, excluding the information technology business, were as follows. In North America and Europe, growth continued in sales of toners and toner binders for copiers and printers, tertiary amines and aroma chemicals. In Asia, sales on a yen basis dropped slightly from the previous fiscal year due to negative currency translation. In operations in Japan, excluding the addition of a newly consolidated subsidiary, sales dropped below the level of the previous fiscal year due to the effect of the recession on markets.

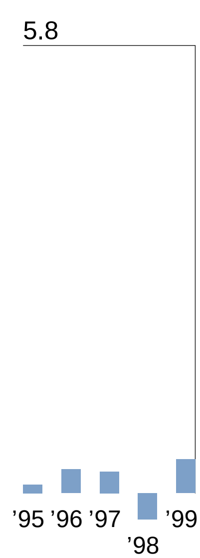
Operating income was ·5.8 billion (US$48.6 million), an overall improvement of ·10.5 billion, compared to the loss of ·4.6 billion in the previous fiscal year. This significant improvement was mainly due to reduced losses in the information technology business.

The withdrawal from the information technology business was completed in the fiscal year under review.

Net Sales
(Billions of yen)



Operating Income
(Billions of yen)



Personal Care Products and Cosmetics in Japan

Continuing to Create Proposals for New Lifestyles and Strengthen the Power of Brands

Despite the overall sluggishness of the Japanese market for personal care products, the Company's sales rose 1.2% over the previous fiscal year. The main reason behind this growth was the introduction of products designed to meet the changing needs and the diversifying individuality among consumers.

One example of this type of product is *Lavenus Designing Lotion*, a hair-styling lotion that gives shape to the tips of hair without hardening or affecting the natural flow. Another product winning increasing popularity is *Liese Mint Shower*, a mint-scented moisturizing hair mist.

The Company does not simply sell goods. Information and advice accompany the products as an added value. Marketing drives, such as the "Information Tips" initiative, which offers users styling proposals developed by popular hair stylists, provide interesting pointers for users. This approach has won increasing support for Kao products from consumers, particularly among young women.

In the field of men's hair care, *Medicated Shampoo* was added in the autumn of 1998, to the popular range of products sold under the *Success* brand. This product has become an instant hit. In the spring of 1999, Kao launched *Success Hair Foam Volume Up* and *Success Hair Liquid*.

Lavenus ***and*** **Liese** ***hair-styling products allow consumers to create fashionable hair styles, as they desire.***

To help relieve the stress encountered in modern society, an increasing number of Japanese consumers are choosing to care for their skin while relaxing in the bath at home. Kao has responded to this demand with new products, including skin care massage gels, such as *Biore Satiny Body Esthetic* and *Biore Satiny Face Esthetic*, which became instant successes after their launch in the spring and autumn of 1998, respectively. Both of these hit products are marketed under the concept of "home esthetics," which has proven to have great appeal. The development of these new products, which followed the marketing of *Biore Pore Pack* and *Biore Cleansing Cotton*, has strengthened the *Biore* lineup. Also, in the spring of 1999, *Biore Body Care Foam* was released under the concept of "healthy skin pH" in response to rising consumer concern about skin problems.

Sales of *Biore Pore Pack*, now past their earlier peak, fell somewhat, while sales of shampoos suffered from the effect of sluggish market conditions.

The women's cosmetics market, which had been described as resistant to the effects of economic slumps, finally sagged and market sales fell significantly compared to the previous year due to the ongoing recession in Japan. Despite this trend, sales growth was recorded for *Sofina* products, particularly those in the special care category.

The skin care massage gels, **Biore Satiny Body Esthetic** *and* **Biore Satiny Face Esthetic,** *allow esthetic massaging to be performed at home and make the skin so smooth you will want to show it to your friends.*

Sofina Very Very Water Pack Gel, *a moisturizing gel pack that is applied before going to bed, has won the support of women for its ability to allow them to feel the moisturizing effect when they wake up in the morning and throughout the day.*

Sofina Oil Clear Mist, launched in May 1998, has created a new market by offering consumers an alternative to conventional paper products used to remove oil from the face. *Sofina Very Very Water Pack Gel*, a moisturizing gel which went on sale in November 1998, has won acceptance not only from teenagers and women in their early 20s, the initial target group, but also from women in their 30s and 40s. The success of this product derives from a new method of applying it before going to bed as well as its high performance. Another success, the skin whitening product *Sofina Medicated Spots Clear*, has become popular because users have learned, largely by word of mouth, that the product is very effective in lessening the formation of spots and freckles.

In the oral care category, the toothpaste *Clear Clean* has established itself as a top brand because of its ability to remove tooth tartar effectively.

Attack laundry detergent was improved to further strengthen its dirt-removing power and its ability to leave clothes feeling fresh after washing.

Pursuing High Quality and High Added Value Together with Simplicity, Ease of Use and Convenience

Severe market conditions kept sales of Kao s laundry and cleaning products in Japan at approximately the same level as those in the previous fiscal year. Retail sales prices, which had been steadily declining, appear to have slowed to a gradual downward trend. Although the overall market situation remained as difficult as that of the previous year, sales of laundry detergents and other laundry finishing products remained comparatively strong, with contributions also from the products mentioned below.

In addition to looking for reasonable prices, consumers are looking for added value. In view of these trends, Kao strengthened its product lineup with high-quality, high-value-added products.

Kao has always believed that markets are stimulated by the ongoing improvement of top brands. This principle was applied to the well-established brand *Attack*, the sales of which increased on a year-to-year basis. In pursuit of higher quality, Kao launched an improved *Attack* detergent in March 1999, with stronger power to remove dirt from clothing.

Laundry detergents *Attack* in particular remained popular gift items. *Attack* was rated the number one brand in Japan in terms of brand power in the 1997 Nikkei Brand Power Ranking Survey. This rating reflected consumers opinions and feelings about 170 leading brands in 19 product categories including food products and daily household goods. This, plus the effort made to provide an effective lineup to meet the needs of department stores and

supermarkets for gift items, enabled the Company to increase sales in the gift market, despite an overall fall in demand for gifts.

A representative product in terms of high added value is *Floral Humming*, a fabric softener developed in response to rising demand for household goods with pleasant aromas. In addition to its excellent performance, its pleasant aroma which remains while washing, drying and wearing clothes, won the support of consumers.

The new premium dishwashing detergent *Family Pure*, with its pleasant herbal aroma and deodorizing ingredients that eliminate odors on cutting boards or grills even after cooking fish, is another successful example of a high-value-added product. *Family Pure* was launched as a follow-up to the popular dishwashing detergent *More Excellent*, released in autumn 1998. Sales of these products are steadily increasing. A team of women guided the product development of this value-added detergent, which seeks to make dishwashing more pleasant.

Kao continues to pursue product development based on the three basic concepts of simplicity, ease of use and convenience. This is exemplified in the series of paper-type cleaning products sold under the *Quickle* brand. This lineup was strengthened in the autumn of 1998 with the release of *Glass Quickle*, a product that won instant popularity for its ease of use and effectiveness in cleaning window glass. The *Vega* series of car care products was bolstered by the recent launch of *Car Mypet Vega Windshield Wipe Sheets*, a product that enables users to clean their car windshields easily. Despite these efforts, total sales in the paper-type cleaning and car care products categories declined below the level of the previous year.

Family Pure ***dishwashing detergent s excellent deodorizing effect and package design made the product popular among consumers.***

Responding to Market Needs with Functionality and Convenience

The market for most product categories of hygiene products and bath additives was flat compared to the level of the previous fiscal year. Notwithstanding this severe operating environment, the Company was able to increase sales of these categories by 4.8% over the previous fiscal year and, accordingly, profit improved. Particularly, the growth in sales of disposable diapers contributed to both sales and profit. Leading the way were increased sales of *Super Merries* disposable baby diapers, a product that has won the support of users due to carefully crafted improvements such as having a pattern appear on the diaper when the baby wets the diaper, and eliminating the noise caused when fastening and unfastening the adhesive tape.

To meet the need for a toilet-training diaper for two- to three-year olds, the Company added two new products to its lineup of *Merries* by launching *Merries Kids Bed-Wetting Pants* and *Merries Kids Training Pants*. With these products, Kao is striving to achieve greater understanding with respect to toilet training between parent and child. All *Merries* products are gentle on the skin because of the incorporation of a breathable material.

Kao s *Relief* incontinence products were originally designed with bedridden persons in mind. In 1997, however, consideration in product development began to be given to the needs of more-active senior citizens. In 1998, *Relief Absorbent Pad*, a removable pad for pants-type *Relief* incontinence products was brought to the market. This new and increasingly popular product, which is both simple and economical, allows users to change the pad without having to change the entire incontinence product. Kao will continue to actively pursue the development of new products that meet the diversifying needs of consumers in an aging society.

Although the market for sanitary napkins is shrinking due to the decline in the population of women between the ages of puberty and menopause, sales of Kao s *Laurier* brand in Japan remained unchanged from the previous year. An ongoing differentiation of sanitary napkin products according to consumer needs is taking place, with increasing use of sanitary napkins with maximum protection for heavy cycles for both daytime and nighttime. In response to this change in demand, *Laurier Double-Fit Dry-up Mesh* without wings and *Laurier Double-Fit Dry-up Mesh* with wings were placed on sale in January and September 1998, respectively. *Laurier Soft Mesh Super Guard* is being well received in the sanitary napkin category for heavy flow and overnight use. Kao s original nonwoven fabric used to make these products more absorbent and easier on the skin has raised consumer trust in these products even higher.

Increased sales, together with cost reductions and productivity gains, brought higher profitability in the hygiene products category.

Sales of bath additives dropped due to a depressed gift market for these products.

Relief ***incontinence products enable senior citizens to lead a more active, independent and healthier lifestyle.***

This advertisement for **Laurier** ***sanitary napkins proposes superior comfort under the slogan You can always be yourself.***

Super Merries ***disposable baby diapers were improved to provide extra comfort for babies.***

Enhancing Integration among Affiliated Companies and Strengthening Core Brands

Although currency markets in Asia, for the most part, had settled down as the business year began, the real economy in the region remained in a state of deepening recession. As a result, the toiletries market in Asia continued to slump. Despite this situation, sales increased on both a local currency and yen basis absorbing the impact from the decline in the value of the region s currencies. Operating income, however, decreased primarily due to a drop in sales of *Biore Pore Pack*, increased royalty payments to the parent company and the increased cost of launching new products.

Led by strong sales of facial cleansers and facial care products, healthy growth in the sales of *Biore* brand products was achieved, even though the initial surge in demand for *Biore Pore Pack* ended. *Biore Cleansing Cotton*, which had become an extremely popular product in

The introduction of new* Biore *facial cleanser and facial care products further strengthened sales of the brand.

Japan in 1997, was launched in Taiwan in the summer of 1998 and achieved rapid market penetration.

In the field of hair care products, the *Lavenus* hair care series was launched in 1998, first in Thailand in February, followed by China in June, and Malaysia and Singapore in October. The product concept adopted for *Lavenus* in these countries is Change Yourself, which is the same concept used in Japan. The products have already made *Lavenus* a leading brand in Thailand. In Taiwan, the Company launched *Lavenus* as a total hair care brand featuring shampoo, conditioner, coloring agents and styling lotions in March 1999.

In the household products field, *Attack Color*, a laundry detergent for washing colored or patterned clothes strikingly clean without fading, was launched in Taiwan and Thailand. Expanding sales of this product contributed to an increase in total sales of the whole *Attack* brand.

In the hygiene products field, sales of *Laurier* sanitary napkins have steadily increased in China. In the face of intensifying competition in this field, Kao is making every effort to improve profitability by strengthening brand power and raising productivity.

The* Lavenus *hair care series captured the hearts of young women in Asia with the concept of Change Yourself.

Transformation to a Total Skin Care Company in America and Continuing Efforts to Enhance Profitability in Europe

The fiscal year under review was a very successful year for operations in North America and Europe as operating income grew significantly over the previous year, which was the year that profitability was restored to operations in this area. This growth was driven particularly by expanded sales of *bioré* brand products at Kao's U.S. subsidiary, The Andrew Jergens Company. Sales of *bioré pore perfect*, a big hit in North America, however, gradually slowed from their initial peak and stabilized in the second half of 1998. The *bioré* brand name also won recognition from consumers in the United Kingdom as a result of Andrew Jergens' marketing activities there. At the same time in continental Europe, the strategic alliance between Beiersdorf AG and Kao for the marketing and sales of *Nivea Visage Kao bioré Clear-up Strip* expanded *Biore*'s presence in facial cleansing markets there.

Operations were further strengthened by Andrew Jergens' acquisition of the skin care business from Bausch & Lomb Inc., most notably products marketed under the premium *Curél* brand. With this move and the recent introduction and expansion of *bioré*, Andrew Jergens, a long-established

Andrew Jergens introduced various unique products to broaden the* bioré *series.

name in the field of soaps and skin lotions, has built itself into a total skin care company.

The *bioré self-heating mask*, a one-minute deep cleansing treatment product that heats up when placed on the face, has gained popularity since its launch in the United States in the autumn of 1998. In early 1999, Andrew Jergens launched *bioré fine line gel patches* and *bioré facial cleansing cloths*. The company intends to increase its brand power by continuing to launch unique products as a total skin care company.

At Goldwell GmbH, a subsidiary whose main market is for hair care products for beauty salons, sales remained at approximately the same levels as those of the previous fiscal year, operating income, however, decreased. Efforts were made to enhance profitability at Goldwell, including thorough reforms to streamline production, distribution, and sales systems, especially in Europe and North America.

At the same time, Goldwell is implementing measures to strengthen its line of products. In the spring of 1998, *LC2 (Le Coiffeur 2)*, a premium line of hair care products, was launched for top salons.

Goldwell launched the new product* LC2 *as a premium hair care brand.

Both sales and profits grew at Guhl Ikebana GmbH, which mainly handles premium hair care products in Europe. Making full use of the core products sold under its brand, in the autumn of 1998, the company marketed upgraded shampoo, conditioner and treatment products with added features and new packaging that accentuate the improvements made and the novelty of the products. New items added to the company's line of treatment products and newly developed products are posting good sales results. Guhl Ikebana has also benefited from moving its corporate headquarters from Berlin to Darmstadt, where Goldwell is already located. In addition to greater management efficiency, the company is reaping gains from improved product development made possible by closer integration of marketing activities and research and development.

Guhl Ikebana relaunched its* System-Haircare *range and added innovative hair treatment.


FLAMMABLE
T-995
DILUTE ALCOHOL

Meeting the Needs of the Global Market with Fatty Alcohols and Tertiary Amines

In the field of fatty chemicals and edible oils, the Company increased production and strengthened sales of its two core products, fatty alcohols and tertiary amines.

The market for fatty alcohols is borderless and global in scale. This means that producers must meet global standards for both quality and price. Kao, the third largest producer of fatty alcohols in the world, has earned a worldwide reputation for high product quality. Fatty Chemical (Malaysia) Sdn. Bhd., Kao's export base and primary production facility for alcohols has expanded its production capacity in recent years in response to increased demand in North America, Europe and Asia. In the fiscal year under review, the company improved production capability by adopting technology that makes more efficient use of catalysts, enabling full capacity utilization and an increase in sales and profits. Similarly, sales of fatty alcohols by Pilipinas Kao Inc. remained strong.

Tertiary amines, of which Kao is one of the largest producers in the world, was another element in improving profit in this field. In response to market demand, Kao Chemicals GmbH in Germany utilized full production capacity to increase production and sales of tertiary amines from the previous year.

In Japan, the lingering recession caused a sharp drop in demand, pushing Kao's sales of fatty chemicals below the previous year's level. However, sales of edible oils for industrial use increased slightly as consumption picked up.

Kao is aiming to further improve profitability in the fatty chemicals field, focusing on fatty alcohols and tertiary amines.

Fats and oils, initially extracted from palm and palm kernels, are used to produce fatty alcohols.

(Left) Fatty Chemical (Malaysia), one of the world's largest producers of fatty alcohols, has been meeting expanding market demand by increasing productivity through improvement of its catalyst technology.

Strengthening Ties among Group Companies while Continuing Technological Differentiation

In the specialty chemicals field, sales of technologically unique products have tended to expand in recent years. In the fiscal year ended March 31, 1999, strong sales of toner and related products, aroma chemicals, and polyurethane for shoe soles contributed to sales growth in this field.

One of the few growing industrial markets is that for copier and printer toner and related products. Kao boosted sales by expanding its toner binder facilities at High Point Chemical Corporation in the United States in response to growing demand. The Company has also established a cooperative production system whereby its technology from Japan is used to produce toner binder in the United States and to process toner in Spain. This system has helped the Company expand into European markets. In Japan, sales of copier toner and related products have also strengthened.

Kao Corporation S.A., in Spain, continued to expand sales of aroma chemicals used as raw materials for perfumes and flavors. Kao has transferred technology from Japan to its aroma chemical business in Spain, a strategy that has paid off handsomely in steady growth in Europe over the past few years.

Kao's copier and printer toner and related products are highly evaluated for their superior quality.

Shoe soles incorporate polyurethane which utilizes Kao's technology.

Sales of polyurethane for shoe soles also continued to enjoy healthy growth. In general, the production base for sports shoes has moved to Asia, where production costs are comparatively low. In response to this trend, Kao moved its production base for polyurethane to Asia, particularly Taiwan. Kao also plans to strengthen its polyurethane production capacity in China.

Sales of products related to construction materials and products for the resin processing industry fell from the previous year, particularly in Japan, under the influence of the slump in demand in these industries.

PT. Kao Indonesia Chemicals expanded its sulfonation facilities for the production of surfactants and worked to strengthen exports to users all over the world, particularly in Asia. Kao Chemical Corporation Shanghai, in its second year of operations, has almost completed establishment of its system, which will serve as a base for supplying raw materials for toiletry products in China.

Accordingly, as it develops global linkage for business expansion, Kao will focus on these kinds of specialized products as key sources of profit. The Company will also integrate management of its European businesses—in Germany, France and Spain—in keeping with integration in various fields within the EU, and strengthen cooperation among affiliates around the world.

Aroma chemicals produced by Kao Corporation S.A., in Spain, are not only used in many Kao products but are also supplied to a wide range of leading companies.

Manufacturing Environmentally-Friendly Products Based on the 3Rs

Refill products have become popular partly because of rising consumer awareness of environmental issues.

Kao actively strives to develop products that conserve resources and have less impact on the environment. This approach is expressed in the 3Rs approach. The 3Rs are: reduce, reuse and recycle.

1. Reduce

Compact laundry detergent *Attack* is a good example of Kao s efforts regarding the reduction of materials and waste. When *Attack* was launched in 1987, the size of the packaging was about one-fourth of conventional detergents. Reducing the size made large-scale reductions in all processes possible, from a 61% reduction in the weight of packaging to savings in energy consumed in production and transportation, and space needed for inventory and shelf displays at retail outlets.

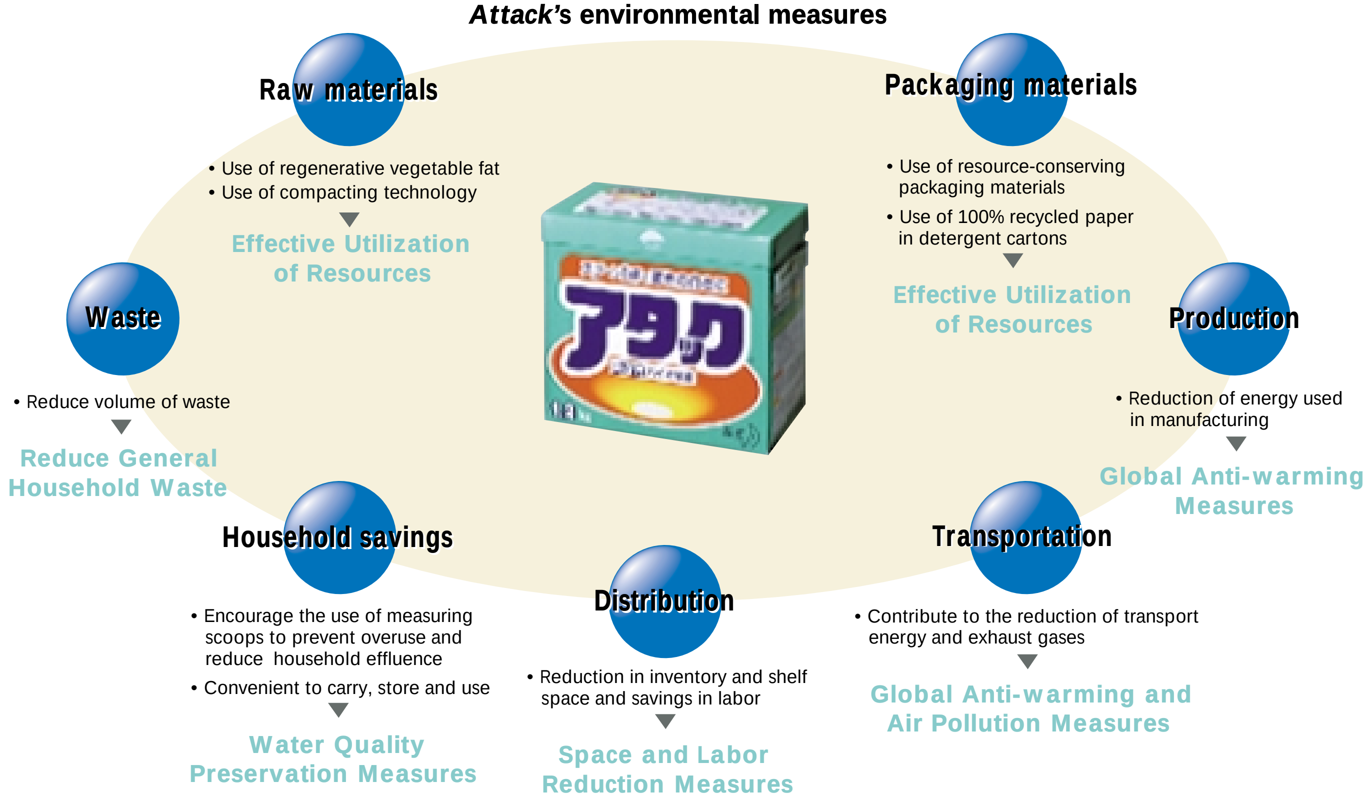
By making the package compact, Kao has succeeded in drastically reducing the product s environmental impact throughout its entire life cycle, from reducing the amount of packaging materials and volume of waste to saving energy. The development of the folding carton enabled a reduction in the weight and volume of waste generated by households after the products use. *Attack* is a product developed with the environment in mind. Reducing impact on the environment has been achieved with regard to energy, air, water, and waste in all stages of production, use and disposal.

Based on the same concept, Kao developed and launched a compact fabric softener and dishwashing detergent in 1988 and 1996, respectively.

2. Reuse

Kao has appealed to consumers to reuse packaging materials as well as the functional parts of containers by introducing refills of products. The Company markets a wide range of refills of dishwashing detergents, laundry detergents, and hair care products in standing pouches. The fabric softener *Humming 1/3*, the dishwashing detergent *Family*, and the shampoo and conditioner *Essential* are good examples of products for

***Attack*'s environmental measures**



which Kao has developed refills. In the case of fabric softener, as a result of the development of compact products and refill packs, a drastic reduction in the weight of packaging has been achieved, reducing packaging materials to almost half that of conventional products.

3. Recycle

Attack s carton and the measuring scoop included within are made of 100% recycled materials. Although Japan s Container and Packaging Recycling Law* will not take effect until 2000, Kao has already undertaken, and will continue to undertake initiatives to reduce impact on the environment through its Reduce and Reuse approach.

Environmental activities in the production process

Kao established the Pollution Control Committee under the supervision of the Board of Directors in 1970. In 1990, this committee was reorganized as the Environment and Safety Department.

Since 1995, the entire Company has been using a comprehensive Responsible Care management system which is designed to achieve continual improvements. The Environment and Safety Department, under the supervision of the Director of the Board responsible for the environment and safety, prepares policies and plans to enhance the Company s responsible care activities as well as conduct internal environmental and safety audits. In addition, the department publishes Kao s Responsible Care Environment, Safety and Health Report, every year.

Some detailed examples of these efforts are introduced below:

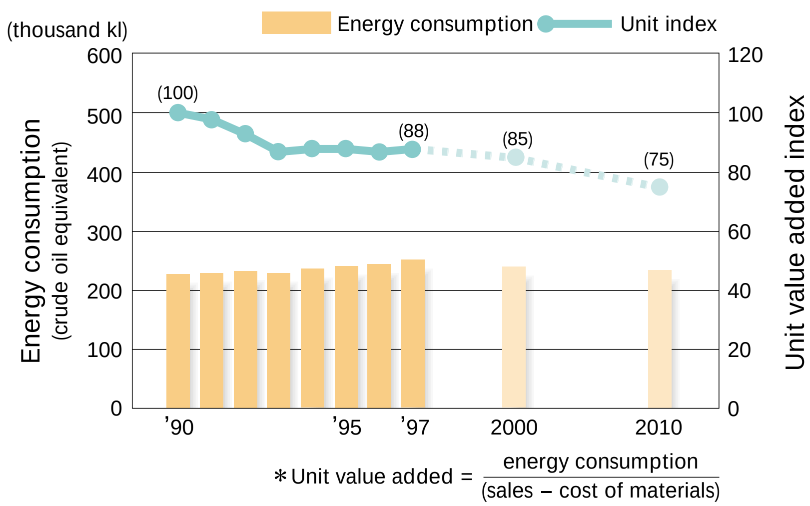
The Company s Kashima Plant obtained certification under the international standard ISO 14001 in December 1998. Kao is committed to ongoing initiatives to obtain certification for the Wakayama, Tochigi and Kawasaki Plants by 2000 and for all other plants in Japan by 2002.

Kao has been taking measures to save energy since the oil crisis of 1973, enabling the Company to achieve a reduction of approximately 40% in energy consumption by 1990. Taking 1990 as the base year with a unit value added index of 100, Kao was able to reduce this to 88 by 1997.

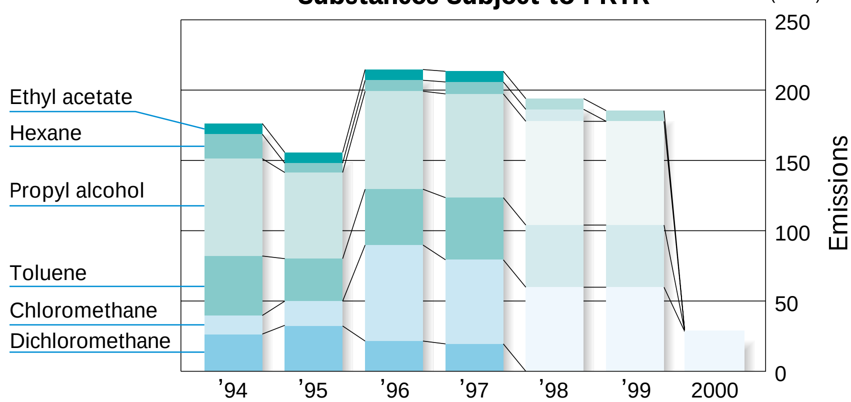
Even as it greatly expands production, Kao is working to keep CO_2 emissions in 2010 at 1990 levels.

The Pollutant Release and Transfer Register (PRTR), which requires emissions of chemical substances to be reported, will be enacted in Japan in 1999. Kao has formulated a program to reduce atmospheric emissions, based on the results of a comprehensive survey encompassing effluence, soil and the atmosphere. The Company intends to continue promoting emission reduction measures and aims to have largely completed them by 2000.

Trends in Energy Consumption and Unit Index



Emissions and Planned Reductions of Substances Subject to PRTR



** The Container and Packaging Recycling Law intends to realize recycling and reuse of containers and packaging materials, which make up 60% of the total volume of general waste in Japan, by requiring consumers to separate their garbage, municipalities to collect various types of garbage separately, and manufacturers to recycle and reuse containers and packaging materials.*

China

Kao Corporation Shanghai Commences Production and Sale of *Attack* Laundry Detergent in China

Kao Corporation Shanghai, an affiliate of Kao Corporation that manufactures and markets household products in China, entered the business field of laundry detergent with the commencement of production and sale of *Attack* in May 1999.

The manufacturing of *Attack* is being carried out at a plant, the construction of which has already been completed, located inside the company's plant in Shanghai.

Since its establishment to manufacture and sell shampoo in January 1994, Kao Corporation Shanghai has been increasing its range of products, including facial cleanser, basic cosmetics and sanitary napkins, to meet the needs of local consumers. These products have been steadily capturing the support of consumers in China.

Kao will strive to further expand its business operations in China through the launch of *Attack*, a product that enjoys immense popularity in Japan and other Asian countries.

Global

Kao's Household Cleaning Mop Kit and Sheets to be Sold in the United States by S.C. Johnson

In April 1999, Kao reached an agreement to license S.C. Johnson & Son, Inc. to market and sell in the United States and other countries a household cleaning mop kit and sheets developed and manufactured by Kao. The product was introduced in Japan in 1994 under Kao's brand name *Quickle Wiper*. After its release in Japan, *Quickle Wiper* became explosively popular due to its unique characteristics and ability to remove minute dust and hair, which were previously difficult to remove even with a vacuum, with the disposable sheets.

The product will be sold under the brand name *Pledge*, which is S.C. Johnson's global furniture-care brand.

Kao and S.C. Johnson are confident that by combining their strengths, Kao's unique product and S.C. Johnson's excellent marketing capabilities and distribution channels, the product will create a new global market.

Representatives of S.C. Johnson (right) and Kao (left) at the signing ceremony

Japan

Introduction of *Healthy Econa Cooking Oil* Strengthens Food Products Category

Healthy Econa Cooking Oil was launched in Japan in February 1999. This new cooking oil contains approximately 80% diacylglycerol which is made from soy and rapeseed. *Healthy Econa Cooking Oil* was the first cooking oil to be licensed as a Food for Specified Health Use by the Japanese Ministry of Health and Welfare.

The main features of the product are that it is used in the same fashion as conventional cooking oils and will prevent body fat from increasing, which in turn helps decrease excess neutral fat.

Due to the fact that *Healthy Econa Cooking Oil* was introduced into the market as a health care cooking oil that prevents fat deposits, the initial response by consumers has been greater than anticipated.

Europe

Nivea Visage Kao bioré Wins 1998 Marie Claire Prize

Nivea Visage Kao bioré Clear-up Strip received the exclusive "1998 Marie Claire Prix d'Excellence de la Beauté" for mass-market products at the thirteenth awards ceremony held in Paris on January 14, 1999. *Nivea Visage Kao bioré Clear-up Strip* was jointly launched with Beiersdorf AG in Europe in April 1998.

The prize is awarded to beauty products launched in Europe during the award year. A panel of 16 beauty journalists from leading European women's magazines evaluated the products nominated from within all beauty products launched in 1998 on the basis of overall excellence achieved in such categories as originality, effectiveness, ease of use, value-for-money and overall product quality.

The 1998 prize in the mass-market category was awarded to *Nivea Visage Kao bioré Clear-up Strip* because of the revolutionary nature of the product—it enables dirt in the pores of the nose to be removed simply by applying and removing the strip—and because of the wide-based support the product has won from consumers.

Financial Section

CONTENTS

Five-Year Summary

Kao Corporation and Consolidated Subsidiaries — Years ended March 31

	Millions of yen				
	1999	1998	1997	1996	1995
For the year:					
Net sales:					
Household	**¥730,647**	¥696,800	¥705,332	¥675,883	¥653,541
Chemicals	**193,949**	210,449	196,070	159,714	143,189
Total	**924,596**	907,249	901,402	835,597	796,730
Japan	**658,316**	662,220	684,337	661,909	641,681
Outside Japan	**266,280**	245,029	217,065	173,688	155,049
Operating income	**91,664**	72,868	72,101	66,509	61,926
Net income	**34,714**	24,495	27,594	24,531	23,686
Capital expenditures	**69,016**	59,012	65,283	79,254	72,241
Depreciation and amortization	**71,202**	81,405	73,592	70,623	73,648
Research and development expenditures	**36,062**	37,843	37,929	37,544	40,037
Advertising expenditures	**71,752**	65,404	61,012	58,592	55,574
At year-end:					
Total assets	**751,725**	778,762	807,124	756,849	709,264
Total shareholders' equity	**451,777**	424,430	379,552	359,812	342,003
	Yen				
Per share:					
Net income	**¥55.98**	¥40.10	¥45.92	¥40.85	¥39.49
Cash dividends	**16.00**	15.00	14.00	12.50	11.50

Notes: 1. Due to the change in the presentation requirements in Japan, certain reclassifications have been made to operating income for 1998 and prior years to conform to the presentation of the current year's results.
2. Net income per share is computed based on the weighted average number of shares outstanding during the respective years.
3. Cash dividends per share are the amounts applicable to the respective years, including dividends to be paid after the end of the year.

Results of Operations

For the fiscal year ended March 31, 1999, consolidated net sales rose 1.9%, to ¥924.5 billion (US$7,669.8 million).

In the household products business, sales in Japan rose 1.0%, in spite of the continued sluggishness in the market. Outside Japan, sales in Asia showed a steady increase on a year-on-year basis despite a further deterioration of the region's economies, while in North America and Europe substantial sales were achieved thanks mainly to the enormous success of *Biore Pore Pack**—in the *Biore* facial cleanser and facial care series—in the first half of the fiscal year in the United States. In Europe, the launch of *Biore Pore Pack* also provided a boost to overall sales in that region.

In the chemical products business, the Company accelerated the pace of the restructuring of its information technology business. Begun in the previous fiscal year, this restructuring effort culminated in the complete withdrawal from the information technology business in the fiscal year under review. Consequently, information technology products sales plummeted ¥27.7 billion, to ¥48.4 billion (US$401.8 million).

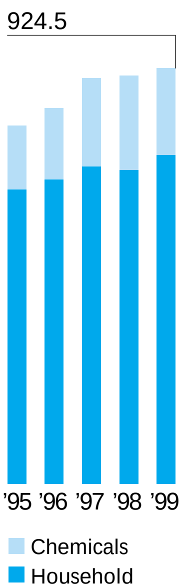
Sales in the chemical products business, excluding information technology products, expanded from the previous fiscal year. In Japan, operations were affected by slumping economic conditions. In Asia, the effects of adverse exchange rate moves were virtually offset by increased sales. In North America and Europe, new business operations continued to perform well.

The cost of sales ratio was 47.2%, down 2.8 points from the previous fiscal year. The primary factor behind this decrease was a major and favorable change in the Company's sales mix that stemmed from the withdrawal from the high-cost-of-sales information technology business and substantial increases in sales by the North American and European household products businesses, which enjoy comparatively low costs of sales. Furthermore, the household products business in Japan saw a decline in the cost of sales ratio thanks to decreased depreciation expenses as well as the significant results of activities aimed at cost reductions and spending efficiency.

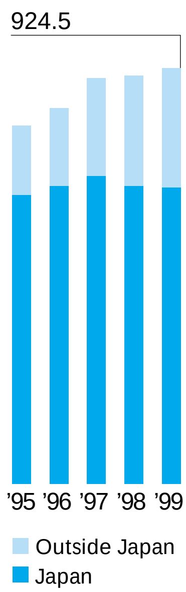
Selling, general and administrative (SG&A) expenses rose ¥16.0 billion, or 4.2% from the previous fiscal year, to ¥396.4 billion (US$3,289.0 million). The main factors behind this rise were an increase in the number of subsidiaries included in the Company's consolidated accounts and an increase in advertising expenses and sales promotion expenses in the household products business in the United States. Consequently, SG&A expenses as a percentage of net sales rose 0.9 point, to 42.9%, from 42.0% in the previous fiscal year.

* *Biore Pore Pack* is marketed under the product name "*bioré pore perfect*" in the United States and the United Kingdom and "*Nivea Visage Kao bioré Clear-up Strip*" in continental European countries.

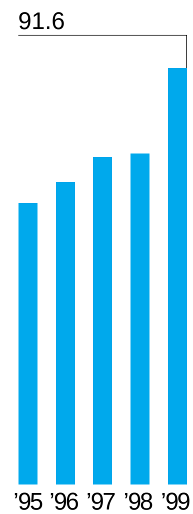
Net Sales by Business Segment
(Billions of yen)



Net Sales by Region
(Billions of yen)



Operating Income
(Billions of yen)



Operating income rose 25.8%, to ¥91.6 billion (US$760.3 million). Operating income as a percentage of net sales jumped to 9.9%, from 8.0% in the previous fiscal year.

The aforementioned accelerated restructuring of the information technology business resulted in extraordinary losses amounting to ¥23.8 billion (US$198.1 million), which was ¥12.2 billion more than in the previous fiscal year. On the other hand, as currency markets in Southeast Asia, for the most part, settled down, the foreign exchange loss for the fiscal year under review was negligible compared to the ¥4.4 billion (US$36.7 million) of the previous fiscal year, related to the losses mainly on outstanding loans denominated in foreign currencies due to the sharp drop in the values of the region's currencies.

Consequently, net income increased 41.7%, to ¥34.7 billion (US$287.9 million). Net income per share amounted to ¥55.98 (US$0.46), up 39.6% from the previous fiscal year. Cash dividends per share were raised ¥1.00, to ¥16.00 (US$0.13), for the full year.

Information by Business Segment

HOUSEHOLD PRODUCTS

Sales of household products rose 4.9%, to ¥730.6 billion (US$6,060.9 million). Operating income rose ¥8.2 billion from the previous fiscal year, to ¥85.7 billion (US$711.7 million).

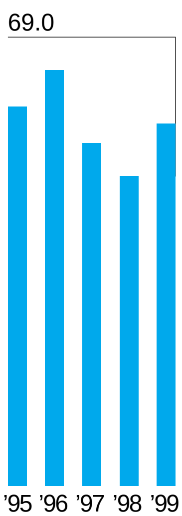
Japan

Domestic sales of household products rose 1.0% from the previous fiscal year. The primary reasons for this increase were successful product improvements and the addition of new products that further strengthened the power of the Company's brands in an operating environment marked by slumping demand and falling sales prices. Also contributing to the rise in sales were strengthened sales activities. The principal factors driving the increase in operating income were cost reductions, improved efficiency in expenses, including advertising, as well as a decrease in depreciation expenses.

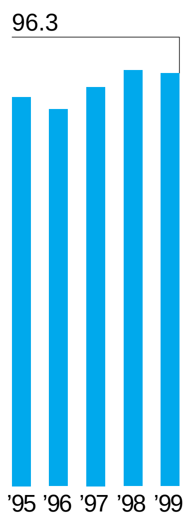
• Personal Care and Cosmetics

The women's cosmetics *Sofina* enjoyed increased sales amid a harsh market environment thanks to contributions by new products with unique features. Sales in the skin care and hair care fields rose as a result of the introduction of new products that aim to accent individuality and the changes taking place in lifestyles. Sales of *Biore Pore Pack,* now past their earlier peak, fell somewhat, while sales of shampoos suffered from the effect of the sluggish market conditions.

Capital Expenditures
(Billions of yen)

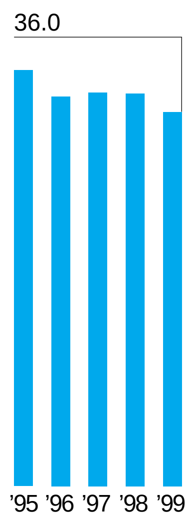


Cash Flows
(Billions of yen)

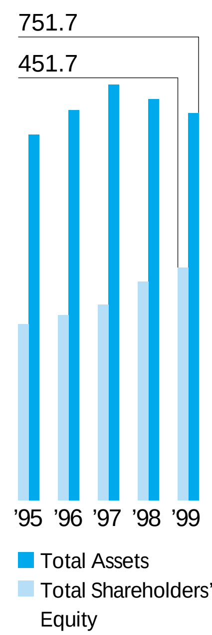


Note: Cash flows are defined as net income plus depreciation and amortization minus cash dividends.

R&D Expenditures
(Billions of yen)



Total Assets and Total Shareholders' Equity
(Billions of yen)



• Laundry and Cleaning Products

Despite continued stagnant market conditions, sales of laundry detergents and laundry finishers held firm due primarily to product improvements and strengthened product lineups. In addition, such new products as *Mold Remover Haiter* were well received by consumers, while sales of the paper-type cleaning product *Quickle Magic Hand Wiper* and the car care product *Car Mypet Vega* dropped below the level of the previous fiscal year.

• Hygiene Products, Bath Additives and Others

Sales of *Super Merries* disposable baby diapers were lifted higher due primarily to an overall improvement in product quality. *Relief* incontinence products also experienced higher sales. Sales of sanitary napkins were virtually unchanged from the previous fiscal year. In the field of food products, the Company introduced *Healthy Econa Cooking Oil*—a new cooking oil that prevents fat deposits.

Asia and Oceania

Although the decline in value of Asian currencies appears to have abated for the most part during the fiscal year under review, real economic activity in the region declined. Despite another year of deepening recession in the toiletries market, the Company's sales increased as a result of efforts to further strengthen core brands and an increase in the number of subsidiaries included in the Company's consolidated accounts. In Thailand and China, the Company launched the *Lavenus* hair care series, while in Taiwan and Thailand the Company introduced *Attack Color* laundry detergent. Sales of *Biore* brand facial cleanser and facial care products as well as sales of *Laurier* sanitary napkins enjoyed higher sales, while the initial surge in demand for *Biore Pore Pack* ended, which led to a drop in sales. On a local currency basis, sales in China, Taiwan and Thailand expanded, while sales in Hong Kong and Singapore fell as a result of the stagnant market conditions. Operating income decreased chiefly as a result of the drop in sales of *Biore Pore Pack,* increased royalty payments to the parent company, and the increased cost of launching new products.

North America and Europe

Sales were propelled substantially higher by a strong performance by *bioré* facial care products. In North America, the hit product *bioré pore perfect* achieved unprecedented levels of sales growth in the first half of the fiscal year, while other *bioré* brand products enjoyed steady sales increases. Moreover, the Company acquired the skin care business in the United States from Bausch & Lomb Inc. in May 1998, including *Curél*—premium skin care brand, which experienced expanded sales. In continental Europe, a tie-up was made with Beiersdorf AG in Germany to launch *Nivea Visage Kao bioré Clear-up Strip,* which is now marketed in more than 20 European countries. Sales of hair care products for beauty salons as well as sales of premium hair care products were on a par with those of the previous fiscal year. Efforts were made to strengthen profitability at Goldwell GmbH, which handles hair care products for beauty salons, and thorough reforms are still being conducted to improve production, distribution and sales systems in Europe and North America. Operating income jumped mainly due to contributions made by *Biore Pore Pack.*

CHEMICAL PRODUCTS

Sales of chemical products declined 7.8% from the previous fiscal year, to ¥193.9 billion (US$1,608.8 million). The major factor behind this decline in sales was the decrease of ¥27.7 billion due to the Company's withdrawal from the information technology business. Excluding the information technology business, sales of chemical products rose 8.3% from the previous fiscal year, to ¥145.5 billion (US$1,207.0 million). The primary factor driving this increase was expanded sales in Japan, North America and Europe. As a result of reduced losses from the information technology business, operating income improved ¥10.5 billion from the previous fiscal year, to ¥5.8 billion (US$48.6 million).

Japan

Mainly as a result of the decrease in sales of ¥13.6 billion due to the complete withdrawal from the information technology business, overall sales of chemical products fell 8.3% from the previous fiscal year. Excluding the information technology business, chemical products sales rose 6.8%, mainly as a result of the inclusion of Kao-Quaker Co., Ltd., in the Company's consolidated accounts. Sales of copier and printer toner and related products rose, while sales of products for construction materials and products for applications in the plastics industry contracted due to the adverse effects of the recession. Operating income rose substantially as reduced losses in the information technology business and the addition of Kao-Quaker more than offset the adverse effects of decreased sales and increased costs stemming from a fall in the value of the yen.

Asia

Despite increased export efforts amid slumping domestic demand as a result of worsening economic conditions, sales of chemical products on a yen basis fell slightly. On a local currency basis, exports of fatty alcohols from Malaysia and the Philippines increased as did exports of surfactants from Indonesia. Operating income remained virtually unchanged from the previous fiscal year, despite increased royalty payments to the parent company.

North America and Europe

Sales were below those of the previous fiscal year due to the accelerated effort to restructure the information technology business. However, excluding this business, sales rose 13.7% from the previous fiscal year thanks mainly to continued strong performances by copier and printer toner and related products in the United States, fatty amines in Germany, and aroma chemical products in Spain. Operating income increased substantially due to reduced losses in the information technology business.

As of March 31, 1999, the Company had completely withdrawn from the information technology business and had nearly completed such disposals as the sale of operations and assets.

Information by Geographic Segment

Japan

In Japan, the Company recorded total sales, including interarea transfers, amounting to ¥672.1 billion (US$5,575.4 million), a decline of 0.4% from the previous fiscal year. Operating income rose ¥9.2 billion, or 12.9%, to ¥80.9 billion (US$671.4 million). The primary factors driving this increase—despite a harsh market environment and the withdrawal from the information technology business—were cost reductions, spending efficiency drives, and decreased depreciation expenses in the household products business. Similarly, contributing factors in the chemical products business were reduced losses in the information technology business and the addition of Kao-Quaker as a consolidated subsidiary.

Asia and Oceania

The Company elsewhere in Asia and Oceania achieved total sales, including interarea transfers, of ¥104.6 billion (US$868.4 million), up 2.9% from the previous fiscal year, in spite of negative currency translation due to the depreciation of local currencies against the yen from the previous fiscal year. Operating income fell ¥2.1 billion, or 28.3%, to ¥5.3 billion (US$44.4 million) due primarily to the decrease in the household products business.

North America and Europe

Sales by Kao's North America- and Europe-based companies, including interarea transfers, totaled ¥178.9 billion (US$1,484.3 million), up 10.4% from the previous fiscal year. Sales in the information technology business decreased ¥13.8 billion as a result of restructuring, however, excluding this decline, overall sales expanded substantially and were aided considerably by increased sales of *Biore Pore Pack*. Operating income was boosted by reduced losses from the information technology business and contributions by *Biore Pore Pack*. Consequently, operating income totaled ¥5.3 billion (US$44.6 million), an overall improvement of ¥11.6 billion compared to the previous fiscal year.

Financial Position

Net cash provided by operating activities totaled ¥148.2 billion (US$1,229.6 million), a ¥52.9 billion increase from the previous term. Mainly as a result of the accelerated restructuring efforts of the information technology business, total depreciation and amortization fell ¥10.2 billion, to ¥71.2 billion (US$590.6 million). On the other hand, noncash expenses, other than depreciation and amortization, related to the restructuring of information technology business rose ¥16.5 billion, to ¥20.2 billion (US$168.2 million). In addition to increased net income, a decrease in working capital, mainly thanks to reduced notes and accounts receivable as well as decreased inventories, also contributed to the increase in net cash provided by operating activities.

Net cash used in investing activities rose ¥15.6 billion, to ¥74.1 billion (US$615.2 million). Capital expenditures on an accrued basis rose ¥10.0 billion, to ¥69.0 billion (US$572.5 million), including ¥17.8 billion (US$148.0 million) for the acquisition of Bausch & Lomb's skin care business in the United States in May 1998. In the household products business, funds were used mainly for new product production facilities, general rationalization of operations, and expansion of distribution facilities in Japan as well as for the construction of a new laundry detergent plant in China. In the chemical products business, funds were used mainly to increase production capacity in Japan and expand operations elsewhere in Asian countries.

Net cash used in financing activities involved the repayment of short- and long-term debt, mainly the redemption of ¥10.0 billion (US$82.9 million) in yen-denominated corporate bonds and ¥13.3 billion (US$110.3 million) in yen-denominated bonds issued under the Euro Medium-Term Note Program. In noncash financing activities, ¥2.3 billion (US$19.1 million) in unsecured convertible bonds were converted into common stock and the corresponding amount recorded under additional paid-in capital.

As a result, the Company's balance of short- and long-term debt, including the current portion, outstanding at the end of the fiscal year totaled ¥115.7 billion (US$960.1 million), down ¥43.4 billion from the previous fiscal year-end. End of year cash and cash equivalents rose ¥26.0 billion, to ¥98.6 billion (US$818.5 million).

Total shareholders' equity rose 6.4%, or ¥27.3 billion, to ¥451.7 billion (US$3,747.6 million), and rose 6.1%, to ¥727.01 (US$6.03) on a per share basis. The shareholders' equity ratio at the end of the fiscal year stood at 60.1%, up from 54.5% at the end of the previous fiscal year.

EVA

The Company implemented EVA (Economic Value Added) in its management systems from April 1999 for the parent company. The introduction of EVA is one of the Company's major initiatives toward profitable growth.

EVA measures how much economic value a company has created. It is calculated by deducting a charge (cost of capital) for the capital employed from net operating profit after tax (NOPAT). By implementing EVA into its management systems, the Company intends to encourage managers to use its precious capital more effectively and thereby strengthen its competitiveness.

The Company will use EVA as its main management measure to align the interests of managers and owners. The Company will also try to spread its use not only as a standard to evaluate business performance but also as a tool for decision-making in daily operations, including investment decisions. The Company will also train employees on how to use EVA to change their mindset for NOPAT and cost of capital. In addition, the Company introduced an incentive compensation system based on EVA for its executives and employees in Japan. The Company aims to achieve continuous improvement in EVA on a long-term basis which will lead to increasing corporate value. The Company has been profit-oriented but will reinforce it by adopting EVA built in to the entire organization.

After undertaking a three-month EVA familiarization study with the assistance of Stern Stewart, a U.S. consulting firm, beginning June 1998, the Company decided to move ahead with further steps towards the implementation of EVA from April 1999. The Company has already experienced EVA since 1997 at The Andrew Jergens Company in the United States. The result has been a change in mindset so that even at the employee level the awareness of cost of capital has been heightened.

Stern Stewart is the New York based consulting firm that developed EVA. Stern Stewart has assisted more than 300 companies around the world in the introduction of EVA applications. Kao is the first Japanese company to have used Stern Stewart's assistance to implement the EVA management system.

YEAR 2000

The Company has recognized that making computer systems compliant for the year 2000 (Y2K) is a significant management issue and has taken comprehensive measures in response. A summary of these measures is presented below.

Basic policy

Both in Japan and at overseas affiliates, a company-wide organization has been established—one that cuts across departmental and other organizational boundaries—to ensure that all personnel are aware of the problem and that proper measures, including follow-up measures, are being implemented.

Organizational structure

The Company began working on the Y2K problem when it commenced reorganization of its information systems in 1993. Furthermore, a company-wide project team headed by Executive Vice President Kazuya Inbe was formed in 1998 to establish policies, ensure that the specific measures were carried out and that information was exchanged between operations in Japan and overseas.

State of readiness

The Company has completed a study and assessment of its internal information systems, production systems, distribution equipment and all other microcomputer-controlled equipment that could be affected by the Y2K problem. Necessary modification and replacement of systems was completed in March 1999, and testing is scheduled to be completed by June 1999. Similar procedures will be completed at overseas affiliates by June 1999.

A survey of the impact of this problem on EDI and other systems which provide links with outside computer systems has been completed, and compliance with required standards for links with customers and vendors is presently being confirmed. Tests of critical systems, currently being carried out in collaboration with customers and vendors, are scheduled to be completed by September 1999.

Estimated costs

Although it is difficult to determine precisely what expenditures are being made in direct response to Y2K, it is estimated that the Company will spend about ¥8.6 billion (including expenses incurred for the reorganization of information systems) to make all systems in Japan and overseas Y2K compliant. Of this figure, ¥7.7 billion was spent by March 31, 1999.

Risk management program

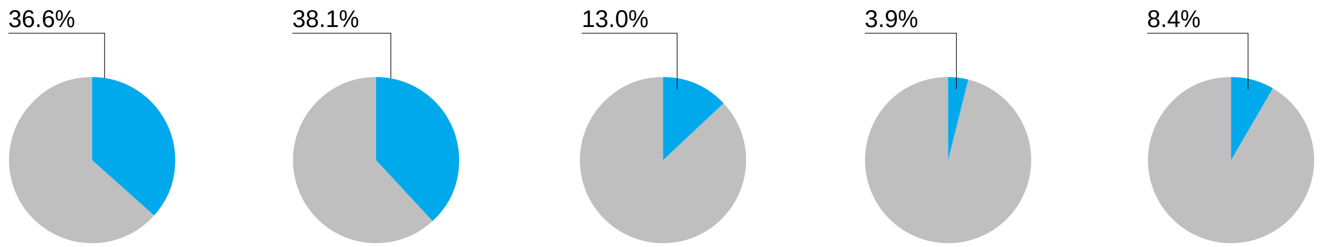
Everything reasonably possible will be done to assess, minimize, and avoid potential risks related to the Y2K problem. This includes careful testing and rehearsals. In addition, the Company will have a risk management plan in force by September 1999 to minimize the effect of any unexpected trouble that might occur in regard to information, production, or other important systems.

Overview of Operations (Nonconsolidated Basis)

Household Products

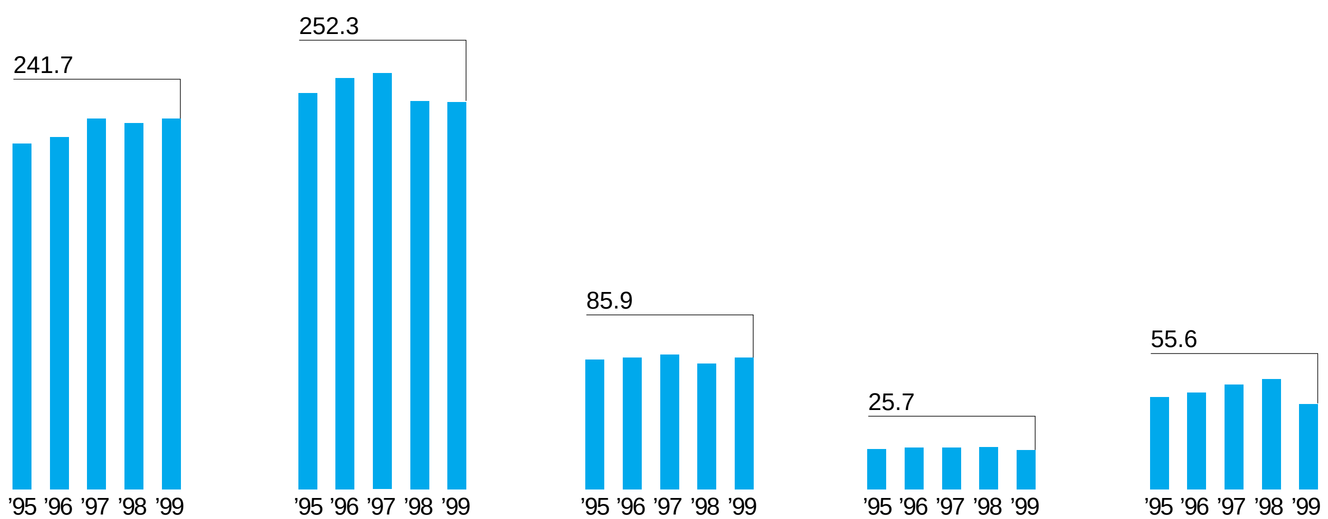
Chemical Products

Personal Care and Cosmetics | **Laundry and Cleaning Products** | **Hygiene Products, Bath Additives and Others** | **Fatty Chemicals and Edible Oils** | **Specialty Chemicals and Information Technology Products**



Net Sales

(Billions of yen)



Personal Care and Cosmetics

- Soap
- Body cleansers
- Shampoos
- Conditioners
- Hair care products
- Cosmetics and skin care products
- Toothpastes and toothbrushes

Laundry and Cleaning Products

- Laundry detergents
- Laundry finishers
- Kitchen and other household detergents
- Fabric softeners

Hygiene Products, Bath Additives and Others

- Sanitary napkins
- Disposable diapers
- Bath additives

Fatty Chemicals and Edible Oils

- Edible oils
- Fatty acids
- Fatty alcohols
- Fatty amines
- Glycerine

Specialty Chemicals and Information Technology Products

- Surface active agents
- Polyurethane systems and additives
- Plasticizers for synthetic resins
- Polyester resins
- Fragrances
- Toner and toner binders
- Floppy disks
- CD-ROMs

Consolidated Balance Sheets

Kao Corporation and Consolidated Subsidiaries

	Millions of yen		Thousands of U.S. dollars (Note 2)
Assets	**1999**	1998	**1999**
Current assets:			
Cash and time deposits	**¥ 37,704**	¥ 31,355	**$ 312,767**
Short-term investments (Note 3)	**60,977**	41,228	**505,823**
Notes and accounts receivable:			
Trade	**63,482**	70,632	**526,603**
Nonconsolidated subsidiaries and affiliates	**29,803**	35,151	**247,225**
Inventories (Note 4):			
Finished goods	**53,110**	62,665	**440,564**
Work in process and raw materials	**29,426**	34,251	**244,098**
Deferred income taxes	**4,912**	1,875	**40,747**
Other current assets	**11,749**	15,028	**97,462**
Allowance for doubtful receivables	**(2,108)**	(2,848)	**(17,487)**
Total current assets	**289,055**	289,337	**2,397,802**
Property, plant and equipment, at cost (Note 4):			
Land	**57,556**	59,249	**477,445**
Buildings and structures	**258,065**	258,759	**2,140,730**
Machinery, equipment and other	**672,961**	719,631	**5,582,422**
Construction in progress	**10,905**	16,660	**90,461**
	999,487	1,054,299	**8,291,058**
Accumulated depreciation	**(677,371)**	(685,075)	**(5,619,005)**
	322,116	369,224	**2,672,053**
Intangible assets:			
Goodwill	**28,585**	30,778	**237,121**
Trademarks	**14,776**	539	**122,572**
Excess of investment cost over net equity of consolidated subsidiaries acquired, net	**3,525**	4,391	**29,241**
Other intangible assets	**2,672**	3,166	**22,165**
	49,558	38,874	**411,099**
Investments and other assets:			
Investment securities	**9,227**	10,879	**76,541**
Investments in and advances to nonconsolidated subsidiaries and affiliates	**19,466**	17,751	**161,476**
Deferred income taxes	**12,541**	12,609	**104,031**
Other assets	**17,187**	17,056	**142,572**
	58,421	58,295	**484,620**
Foreign currency translation adjustments	**32,575**	23,032	**270,220**
	¥751,725	¥ 778,762	**$6,235,794**

See notes to consolidated financial statements.

March 31, 1999 and 1998

Liabilities and Shareholders' Equity	Millions of yen 1999	Millions of yen 1998	Thousands of U.S. dollars (Note 2) 1999
Current liabilities:			
Short-term debt (Note 4)	**¥ 14,856**	¥ 27,962	**$ 123,235**
Current portion of long-term debt (Note 4)	**13,942**	23,248	**115,653**
Notes and accounts payable:			
Trade	**71,343**	79,586	**591,813**
Nonconsolidated subsidiaries and affiliates	**1,569**	1,568	**13,015**
Other	**20,730**	23,007	**171,962**
Accrued income taxes	**12,949**	9,196	**107,416**
Accrued expenses	**56,292**	58,303	**466,960**
Other current liabilities	**11,453**	11,835	**95,006**
Total current liabilities	**203,134**	234,705	**1,685,060**
Long-term liabilities:			
Long-term debt (Note 4)	**86,946**	108,023	**721,244**
Liability for retirement benefits (Note 7)	**3,539**	2,508	**29,357**
Other	**926**	2,499	**7,681**
	91,411	113,030	**758,282**
Minority interests	**5,403**	6,597	**44,820**
Contingent liabilities (Note 8)			
Shareholders' equity (Notes 4, 9 and 14):			
Common stock:			
Authorized—1,000,000,000 shares;			
Issued—621,439,401 shares in 1999 and 619,710,243 shares in 1998, with par value of ¥50 per share	**79,148**	77,994	**656,557**
Additional paid-in capital	**102,622**	101,470	**851,282**
Retained earnings	**270,056**	244,986	**2,240,199**
	451,826	424,450	**3,748,038**
Treasury stock, at cost (19,557 shares in 1999 and 11,783 shares in 1998)	**(49)**	(20)	**(406)**
	451,777	424,430	**3,747,632**
	¥751,725	¥778,762	**$6,235,794**

Consolidated Statements of Income

Kao Corporation and Consolidated Subsidiaries — Years ended March 31, 1999 and 1998

	Millions of yen		Thousands of U.S. dollars (Note 2)
	1999	1998	**1999**
Net sales (Notes 10 and 11)	**¥924,596**	¥907,249	**$7,669,813**
Cost of sales	**436,437**	453,932	**3,620,382**
Gross profit	**488,159**	453,317	**4,049,431**
Selling, general and administrative expenses (Note 12)	**396,495**	380,449	**3,289,050**
Operating income (Note 11)	**91,664**	72,868	**760,381**
Other (income) expenses (Note 13):			
Interest and dividend income	**(1,998)**	(1,636)	**(16,574)**
Interest expense	**5,894**	6,941	**48,893**
Foreign currency exchange loss	**237**	4,096	**1,966**
Equity in earnings of nonconsolidated subsidiaries and affiliates	**(1,172)**	(944)	**(9,722)**
Restructuring charges related to:			
Information technology business	**23,883**	11,622	**198,117**
Household business in Europe and North America	**2,446**	—	**20,290**
Other, net	**1,942**	137	**16,109**
	31,232	20,216	**259,079**
Income before income taxes, equity items and other	**60,432**	52,652	**501,302**
Income taxes (Note 5):			
Current	**27,524**	28,251	**228,320**
Deferred	**(2,648)**	40	**(21,966)**
	24,876	28,291	**206,354**
Income before equity items and other	**35,556**	24,361	**294,948**
Equity items:			
Minority interests in losses (earnings) of consolidated subsidiaries	**(842)**	134	**(6,984)**
Net income	**¥ 34,714**	¥ 24,495	**$ 287,964**

Per share of common stock (Note 1. l):	Yen		U.S. dollars (Note 2)
Net income	**¥55.98**	¥40.10	**$0.46**
Fully diluted net income	**53.21**	37.63	**0.44**
Cash dividends applicable to the year	**16.00**	15.00	**0.13**

See notes to consolidated financial statements.

Consolidated Statements of Shareholders' Equity

Kao Corporation and Consolidated Subsidiaries

Years ended March 31, 1999 and 1998

	Thousands	Millions of yen			
	Number of shares of common stock issued	Common stock	Additional paid-in capital	Retained earnings	Treasury stock, at cost
Balance at April 1, 1997	601,004	¥63,302	¥ 86,784	¥229,476	¥(10)
Retained earnings of consolidated subsidiaries previously not consolidated at beginning of year				(10)	
Net income				24,495	
Cash dividends, ¥14.50 per share (Note 9)				(8,854)	
Directors' and corporate auditors' bonuses				(121)	
Conversion of convertible bonds	18,706	14,692	14,686		
Treasury stock acquired, net (3,939 shares)					(10)
Balance at March 31, 1998	619,710	77,994	101,470	244,986	(20)
Retained earnings of affiliate previously not accounted for by the equity method				**58**	
Net income				**34,714**	
Cash dividends, ¥15.50 per share (Note 9)				**(9,606)**	
Directors' and corporate auditors' bonuses				**(96)**	
Conversion of convertible bonds	**1,729**	**1,154**	**1,152**		
Treasury stock acquired, net (7,774 shares)					**(29)**
Balance at March 31, 1999	**621,439**	**¥79,148**	**¥102,622**	**¥270,056**	**¥(49)**

	Thousands	Thousands of U.S. dollars (Note 2)			
	Number of shares of common stock issued	Common stock	Additional paid-in capital	Retained earnings	Treasury stock, at cost
Balance at March 31, 1998	619,710	$646,985	$841,725	$2,032,236	$(166)
Retained earnings of affiliate previously not accounted for by the equity method				**481**	
Net income				**287,964**	
Cash dividends, US$0.129 per share (Note 9)				**(79,686)**	
Directors' and corporate auditors' bonuses				**(796)**	
Conversion of convertible bonds	**1,729**	**9,572**	**9,557**		
Treasury stock acquired, net (7,774 shares)					**(240)**
Balance at March 31, 1999	**621,439**	**$656,557**	**$851,282**	**$2,240,199**	**$(406)**

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

Kao Corporation and Consolidated Subsidiaries — Years ended March 31, 1999 and 1998

	Millions of yen		Thousands of U.S. dollars (Note 2)
	1999	1998	**1999**
Operating activities:			
Net income	**¥ 34,714**	¥24,495	**$ 287,964**
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	**69,407**	73,886	**575,753**
Depreciation included in restructuring charges	**1,795**	7,519	**14,890**
Restructuring charges related to information technology business except for depreciation	**20,282**	3,743	**168,246**
Loss (gain) on sales or disposals of property, plant and equipment	**627**	(1,284)	**5,201**
Unrealized foreign currency exchange loss	**602**	4,954	**4,994**
Deferred income taxes	**2,648**	40	**21,966**
Change in trade receivables	**15,294**	3,972	**126,868**
Change in inventories	**15,875**	(1,487)	**131,688**
Change in trade payables	**(11,309)**	(4,054)	**(93,812)**
Change in accrued income taxes	**3,523**	(13,974)	**29,224**
Change in accrued expenses	**(2,069)**	(126)	**(17,163)**
Other, net	**(3,160)**	(2,409)	**(26,213)**
Net cash provided by operating activities	**148,229**	95,275	**1,229,606**
Investing activities:			
Purchase of property, plant and equipment	**(50,879)**	(54,735)	**(422,057)**
Proceeds from sales of property, plant and equipment	**8,133**	6,375	**67,465**
Increase in intangible assets	**(18,391)**	(424)	**(152,559)**
Purchase of minority interest	**(1,799)**	(4,216)	**(14,923)**
Increase in other investments	**(11,238)**	(5,542)	**(93,223)**
Net cash used in investing activities	**(74,174)**	(58,542)	**(615,297)**
Financing activities:			
Proceeds from long-term debt	**3,420**	5,400	**28,370**
Repayments of long-term debt	**(29,227)**	(26,051)	**(242,447)**
Change in short-term debt	**(12,544)**	(11,535)	**(104,056)**
Payments of cash dividends	**(9,606)**	(8,854)	**(79,685)**
Net cash used in financing activities	**(47,957)**	(41,040)	**(397,818)**
Change in cash and cash equivalents	**26,098**	(4,307)	**216,491**
Cash and cash equivalents, beginning of year	**72,583**	76,890	**602,099**
Cash and cash equivalents, end of year	**¥ 98,681**	¥72,583	**$ 818,590**
Additional cash flow information:			
Cash paid during the year for:			
Interest	**¥ 6,397**	¥ 7,148	**$ 53,065**
Income taxes	**24,001**	42,225	**199,096**
Noncash financing activities:			
Convertible bonds converted into common stock and additional paid-in capital	**¥ 2,306**	¥29,378	**$ 19,129**

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies

a) Basis of presenting consolidated financial statements

The accompanying consolidated financial statements have been prepared in accordance with the provisions set forth in the Japanese Securities and Exchange Law and its related accounting regulations, and in conformity with accounting principles and practices generally accepted in Japan, which are different in certain respects as to application and disclosure requirements of International Accounting Standards. The consolidated financial statements are not intended to present the financial position, results of operations and cash flows in accordance with accounting principles and practices generally accepted in countries and jurisdictions other than Japan. The consolidated statements of cash flows are not required under such law and regulations, but are presented for the convenience of readers.

In preparing the consolidated financial statements, certain reclassifications have been made to the consolidated financial statements issued in Japan in order to present them in a form which is more familiar to readers outside Japan. Certain 1998 financial statement items were reclassified to conform to the presentation for 1999.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from estimates.

b) Consolidation and investments in nonconsolidated subsidiaries and affiliates

The accompanying consolidated financial statements include the accounts of Kao Corporation (the "Company") and its significant subsidiaries (collectively, the "Companies"). All significant intercompany balances and transactions have been eliminated in consolidation. All material unrealized profit included in assets resulting from transactions within the Companies is eliminated.

The excess of cost of investments in the subsidiaries and affiliates over their equity in the net assets at the dates of acquisition is being amortized over their estimated useful lives, or five years in case they are unknown.

Investments in certain nonconsolidated subsidiaries and significant 20% to 50% owned affiliates are accounted for by the equity method. Investments in the remaining subsidiaries and affiliates are stated at cost except that write-downs are recorded for the value of investments which have been permanently impaired. If the equity method of accounting had been applied to these investments, the effect of the accompanying consolidated financial statements would not be material.

c) Cash equivalents

For purposes of the statements of cash flows, the Company considers time deposits and short-term investments to be cash equivalents.

d) Inventories

Inventories are stated at the lower of cost or market. Cost is determined principally by the average method. The cost of inventories held by certain foreign consolidated subsidiaries is determined by the first-in, first-out method.

e) Short-term investments and investment securities

Short-term investments and investment securities are stated at cost determined by the average method.

The carrying values of investments are written down to fair value when management determines there has been a significant impairment.

f) Property, plant and equipment

Property, plant and equipment are stated at cost. Depreciation of property, plant and equipment is computed under the declining-balance method for the assets located in Japan and principally under the straight-line method for the assets located outside Japan, using rates based upon the estimated useful lives of the assets.

g) Intangible assets

Goodwill is amortized on a straight-line basis principally over 20 years except that write-downs are recorded for the value of goodwill which has been permanently impaired. Amortization of trademarks is computed on a straight-line basis principally over 10 years.

Effective April 1, 1998, the Company changed its principal amortization period for goodwill from 40 years to 20 years. The effect of this change was to decrease operating income by ¥1,517 million (US$12,584 thousand) for the year ended March 31, 1999.

h) Retirement benefits

The Company has a funded contributory pension plan covering substantially all of its employees. The pension plan also covers employees of the Hansha (see Note 10) and certain other subsidiaries and affiliates in Japan. Directors and corporate auditors are partially covered by the pension plan. It is the Company's policy to fund and charge to income normal pension costs as incurred.

Certain foreign subsidiaries have local pension plans covering their employees. The policies for the funded pension plans are to fund and charge to income the pension costs determined on an actuarial method.

Certain foreign subsidiaries also have local employees' retirement benefit plans and provide for the amount to state the liability for these employees' retirement benefits, primarily determined on an actuarial basis.

The provision for retirement benefits to directors and corporate auditors is recorded to state the liability at the amount which would be required, based on the Company's regulations, if all directors and corporate auditors terminated their offices at each balance sheet date. The accrued provisions are not funded and any amounts payable to directors and corporate auditors upon retirement are subject to the approval of the shareholders.

i) Income taxes

The Companies provide for income taxes applicable to all items included in the consolidated statements of income regardless of when such taxes are payable. Income taxes based on temporary differences between tax and financial reporting purposes are reflected as deferred income taxes in the consolidated financial statements using the asset and liability method.

j) Leases

All leases are accounted for as operating leases. Under Japanese accounting standards for leases, finance leases that deem to transfer ownership of the leased property to the lessee are to be capitalized, while other finance leases are permitted to be accounted for as operating lease transactions if certain "as if capitalized" information is disclosed in the notes to the lessee's financial statements.

k) Foreign currency items

Short-term receivables and payables denominated in foreign currencies are translated into Japanese yen at the current exchange rates as of each balance sheet date. Long-term receivables and payables denominated in foreign currencies are generally translated at historical rates. Assets and liabilities which are converted at the foreign exchange rate or swap rate are translated using the exchange rates set forth in the applicable exchange contract and relevant currency swap agreement. In the case where there is significant fluctuation of currencies with possible exchange losses, long-term receivables or payables denominated in foreign currencies are translated at the current exchange rates as of each balance sheet date.

Balance sheet accounts of the foreign consolidated subsidiaries are translated into yen at the current exchange rates as of the balance sheet date except in relation to shareholders' equity, which is translated at the historical rates. Revenue and expense accounts of the foreign consolidated subsidiaries are translated into yen at the annual average rates. Differences arising from such translations are shown as foreign currency translation adjustments in the accompanying consolidated balance sheets.

l) Per share of common stock

Net income per share is computed on the basis of the weighted average number of shares of common stock outstanding during the respective years. Fully diluted net income per share of common stock assumes full conversion of the outstanding convertible bonds at the beginning of the year or at the date of issuance with an applicable adjustment for related interest expense.

Cash dividends per share presented in the accompanying consolidated statements of income are dividends applicable to the respective years including dividends to be paid after the end of the year.

2. Translation into United States Dollars

The Companies' accounts are maintained in or translated into Japanese yen. The United States dollar ($) amounts included herein represent translations using the approximate exchange rate at March 31, 1999 of ¥120.55=US$1, solely for convenience. The translations should not be construed as representations that Japanese yen have been, could have been or could in the future be converted into United States dollars at that or any other rate.

3. Short-Term Investments and Investment Securities

The book value of current and noncurrent marketable debt and equity securities with market prices and the related aggregate market values at March 31, 1999 and 1998 were as follows:

	Millions of yen		Thousands of U.S. dollars
	1999	1998	**1999**
Current:			
Book value	**¥ 1,267**	¥ 1,246	**$ 10,510**
Aggregate market value	**1,317**	1,354	**10,925**
Net unrealized gains	**50**	108	**415**
Noncurrent:			
Book value	**¥ 8,716**	¥10,391	**$ 72,302**
Aggregate market value	**21,405**	21,511	**177,561**
Net unrealized gains	**12,689**	11,120	**105,259**

The difference between the above carrying amounts and the amounts shown in the accompanying balance sheets principally consists of money management funds and nonmarketable securities for which there is no readily-available market from which to obtain or calculate the market value thereof.

4. Short-Term and Long-Term Debt

Short-term debt at March 31, 1999 and 1998 comprised the following:

	Millions of yen		Thousands of U.S. dollars
	1999	1998	**1999**
Bank borrowings	**¥14,856**	¥27,962	**$123,235**

Long-term debt at March 31, 1999 and 1998 consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	1999	1998	**1999**
Unsecured convertible bonds due 2006, 0.95%	**¥ 47,346**	¥ 49,651	**$392,750**
Unsecured bonds due 1997–1998, 3.9% in 1998	**—**	10,000	**—**
Euro medium-term notes issued by the Company and certain consolidated subsidiaries, due 1997–2003, 2.5% in 1999 and 2.7% in 1998	**35,333**	52,599	**293,098**
Mortgage loans principally from banks	**1,548**	1,332	**12,841**
Unsecured loans principally from banks	**16,661**	17,689	**138,208**
	100,888	131,271	**836,897**
Less current portion	**13,942**	23,248	**115,653**
	¥ 86,946	¥108,023	**$721,244**

The interest rates of the unsecured bonds and the Euro medium-term notes shown above were the weighted average interest rates.

The aggregate annual maturities of long-term debt as of March 31, 1999 were as follows:

Years ending March 31	Millions of yen	Thousands of U.S. dollars
2000	¥13,942	$115,653
2001	11,692	96,989
2002	18,953	157,221
2003	2,745	22,771
2004	5,565	46,163
2005 and thereafter	47,991	398,100

The mortgage loans are collateralized by land and buildings having a book value of ¥715 million (US$5,931 thousand) and by inventories of ¥132 million (US$1,095 thousand) at March 31, 1999.

In addition, as is customary in Japan, substantially all of the bank borrowings are subject to general agreements with each bank which provide, among other things, that the banks may request additional security for these loans and may treat any security furnished to the banks as well as cash deposited with them as security for all present and future indebtedness.

The conversion price of the convertible bonds is ¥1,333.00 as of March 31, 1999, subject to adjustment to reflect stock splits and certain other events. Convertible bonds outstanding at March 31, 1999 were convertible into 35,518,379 shares of common stock of the Company on the basis of the above conversion price.

5. Income Taxes

The Company and its domestic subsidiaries are subject to Japanese national and local taxes based on income, which in the aggregate resulted in a normal statutory tax rate of approximately 47% for 1999 and 51% for 1998. Foreign subsidiaries are subject to income taxes of the countries in which they operate.

The effective rates of income taxes reflected in the consolidated statements of income differed from the statutory rate above principally due to (1) expenses not permanently deductible for tax purposes, (2) tax benefits not recognized on losses of certain foreign subsidiaries, (3) utilization of loss carry forwards and tax benefits recognized on losses of subsidiaries because of recovery in their profitability, (4) tax benefit of the loss carry forwards realized on liquidation of other subsidiaries, which were considered not to be tax deductible in the prior year and (5) lower income tax rates applicable to income of certain foreign subsidiaries.

6. Leases

a) Finance Leases:

The Companies lease certain machinery, computer equipment, and other assets. Total rental expenses under the above leases for the years ended March 31, 1999 and 1998 were ¥1,587 million (US$13,165 thousand) and ¥2,270 million, respectively.

Pro forma information of lease property of which ownership is deemed not to be transferred to the lessee on an "as if capitalized" basis for the years ended March 31, 1999 and 1998 was as follows:

	Building, machinery, equipment and other assets		
	Millions of yen		Thousands of U.S. dollars
	1999	1998	**1999**
Acquisition cost	**¥6,976**	¥8,865	**$57,868**
Accumulated depreciation	**4,351**	5,802	**36,093**
Net leased property	**¥2,625**	¥3,063	**$21,775**

Pro forma depreciation expense computed by the straight-line method is ¥1,587 million (US$13,165 thousand) and ¥2,270 million for the years ended March 31, 1999 and 1998, respectively.

Obligations under finance leases as of March 31, 1999 and 1998 were as follows:

	Millions of yen		Thousands of U.S. dollars
	1999	1998	**1999**
Due within one year	**¥ 856**	¥1,612	**$ 7,101**
Due after one year	**1,769**	1,451	**14,674**
	¥2,625	¥3,063	**$21,775**

Pro forma information above does not exclude the imputed interest portion because the remaining financial lease obligations are not material compared with the book values of property, plant and equipment.

b) Operating Leases:

The minimum rental commitments under noncancelable operating leases as of March 31, 1999 and 1998 were as follows:

	Millions of yen		Thousands of U.S. dollars
	1999	1998	**1999**
Due within one year	**¥1,891**	¥1,283	**$15,686**
Due after one year	**3,894**	4,983	**32,302**
	¥5,785	¥6,266	**$47,988**

7. Retirement Benefits

Liability for retirement benefits as of March 31, 1999 and 1998 comprised the following:

	Millions of yen		Thousands of U.S. dollars
	1999	1998	**1999**
Directors and corporate auditors	**¥ 900**	¥ 843	**$ 7,466**
Employees of certain foreign subsidiaries	**2,639**	1,665	**21,891**
	¥3,539	¥2,508	**$29,357**

Total charges to income for the pension and retirement plans for the years ended March 31, 1999 and 1998 were ¥8,450 million (US$70,095 thousand) and ¥5,785 million, respectively.

8. Contingent Liabilities

Contingent liabilities as of March 31, 1999 for guarantees of borrowings, principally by employees, were ¥3,235 million (US$26,835 thousand).

9. Shareholders' Equity

Under the Commercial Code of Japan (the "Code"), at least 50% of the issue price of new shares, with a minimum of the par value thereof, is required to be designated as stated capital. The portion which is to be designated as stated capital is determined by resolution of the Board of Directors. Proceeds in excess of the amounts designated as stated capital are credited to additional paid-in capital.

Dividends are paid semi-annually. Year-end dividends are approved by the shareholders at a meeting held subsequent to the fiscal year to which the dividends are applicable. In addition, semi-annual interim dividends may be paid upon resolution of the Board of Directors, subject to limitations imposed by the Code. Year-end dividends are reflected in the consolidated statements of shareholders' equity when authorized.

Under the Code, the amount available for dividends is based on retained earnings as recorded on the Company's books. At March 31, 1999, retained earnings recorded on the Company's books were ¥246,538 million (US$2,045,110 thousand).

10. Related Party Transactions

A significant portion of the Company's household products except for cosmetics is distributed through exclusive sales companies (the "Hansha") which primarily comprise the Company's affiliates. Sales of household products are recorded, with minor exceptions, at the time when such goods are shipped from the Hansha.

Sales to the Hansha for the years ended March 31, 1999 and 1998 were ¥479,057 million (US$3,973,928 thousand) and ¥481,199 million, respectively.

11. Segment Information

The Companies operate in two reportable segments: household and chemicals. Operations within the household segment include the manufacture and sale of personal care products such as shampoos and conditioners, cosmetics, laundry and cleaning products, and hygiene products. The chemicals segment manufactures and sells fatty chemicals, specialty chemicals such as surface active agents, and information technology products such as floppy disks and CD-ROMs.

Segment information by business of the Companies for the years ended March 31, 1999 and 1998 was as follows:

	Millions of yen			
	1999			
	Household	Chemicals	Corporate/ Eliminations	Consolidated
Sales	**¥730,647**	**¥193,949**	**¥ —**	**¥924,596**
Operating income	**85,798**	**5,866**	**—**	**91,664**
Assets	**¥574,660**	**¥145,042**	**¥32,023**	**¥751,725**
Depreciation and amortization	**54,755**	**16,447**	**—**	**71,202**
Capital expenditures	**57,900**	**11,116**	**—**	**69,016**

	Millions of yen			
	1998			
	Household	Chemicals	Corporate/ Eliminations	Consolidated
Sales	¥696,800	¥210,449	¥ —	¥907,249
Operating income	77,504	(4,636)	—	72,868
Assets	¥558,380	¥197,441	¥22,941	¥778,762
Depreciation and amortization	55,914	25,491	—	81,405
Capital expenditures	40,665	18,347	—	59,012

	Thousands of U.S. dollars			
	1999			
	Household	Chemicals	Corporate/ Eliminations	Consolidated
Sales	**$6,060,945**	**$1,608,868**	**$ —**	**$7,669,813**
Operating income	**711,720**	**48,661**	**—**	**760,381**
Assets	**$4,766,984**	**$1,203,169**	**$265,641**	**$6,235,794**
Depreciation and amortization	**454,210**	**136,433**	**—**	**590,643**
Capital expenditures	**480,298**	**92,211**	**—**	**572,509**

Geographic segment information of the Companies for the years ended March 31, 1999 and 1998 was as follows:

	Millions of yen				
	1999				
	Japan	Asia/ Oceania*	America/ Europe**	Corporate/ Eliminations	Consolidated
Sales to customers	**¥658,316**	**¥ 90,180**	**¥176,100**	**¥ —**	**¥924,596**
Interarea transfer	**13,807**	**14,514**	**2,833**	**(31,154)**	**—**
Total sales	**672,123**	**104,694**	**178,933**	**(31,154)**	**924,596**
Total expenses	**591,184**	**99,330**	**173,546**	**(31,128)**	**832,932**
Operating income	**¥ 80,939**	**¥ 5,364**	**¥ 5,387**	**¥ (26)**	**¥ 91,664**
Assets	**¥540,687**	**¥ 76,513**	**¥124,026**	**¥10,499**	**¥751,725**

	Millions of yen				
	1998				
	Japan	Asia/ Oceania*	America/ Europe**	Corporate/ Eliminations	Consolidated
Sales to customers	¥662,220	¥ 86,458	¥158,571	¥ —	¥907,249
Interarea transfer	12,420	15,268	3,521	(31,209)	—
Total sales	674,640	101,726	162,092	(31,209)	907,249
Total expenses	602,974	94,244	168,354	(31,191)	834,381
Operating income	¥ 71,666	¥ 7,482	¥ (6,262)	¥ (18)	¥ 72,868
Assets	¥548,453	¥ 84,065	¥160,318	¥(14,074)	¥778,762

	Thousands of U.S. dollars				
	1999				
	Japan	Asia/ Oceania*	America/ Europe**	Corporate/ Eliminations	Consolidated
Sales to customers	**$5,460,937**	**$748,071**	**$1,460,805**	**$ —**	**$7,669,813**
Interarea transfer	**114,533**	**120,398**	**23,501**	**(258,432)**	**—**
Total sales	**5,575,470**	**868,469**	**1,484,306**	**(258,432)**	**7,669,813**
Total expenses	**4,904,057**	**823,974**	**1,439,618**	**(258,217)**	**6,909,432**
Operating income	**$ 671,413**	**$ 44,495**	**$ 44,688**	**$ (215)**	**$ 760,381**
Assets	**$4,485,168**	**$634,699**	**$1,028,835**	**$ 87,092**	**$6,235,794**

*Asia/Oceania: Asia and Australia
**America/Europe: North America, Europe and South Africa

Sales to foreign customers were as follows:

	Millions of yen		Thousands of U.S. dollars
	1999	1998	**1999**
Asia/Oceania	**¥ 92,644**	¥ 91,504	**$ 768,511**
America/Europe	**177,522**	157,607	**1,472,601**
Sales to foreign customers	**¥270,166**	¥249,111	**$2,241,112**

12. Selected Operating Expenses

Expenditures relating to research and development activities, which are charged to income as incurred, were ¥36,062 million (US$299,146 thousand) and ¥37,843 million for the years ended March 31, 1999 and 1998, respectively. Expenditures relating to advertising activities, which are charged to income as incurred, were ¥71,752 million (US$595,205 thousand) and ¥65,404 million for the years ended March 31, 1999 and 1998, respectively.

13. Other (Income) Expenses

Foreign currency exchange loss for the year ended March 31, 1998 was related mainly to borrowing in foreign currencies in Southeast Asia.

Other, net consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	1999	1998	**1999**
Loss (gain) on sales or disposals of property, plant and equipment, net	**¥1,590**	¥(1,284)	**$13,189**
Other loss, net	**352**	1,421	**2,920**
	¥1,942	¥ 137	**$16,109**

14. Subsequent Event

At the ordinary general meeting of shareholders held on June 29, 1999, the Company's shareholders approved the appropriation of retained earnings, and the purchase of treasury stock for the redemption and related reduction of retained earnings:

a) Appropriation of retained earnings

	Millions of yen	Thousands of U.S. dollars
Ordinary year-end cash dividends, ¥8.00 (US$0.066) per share	¥4,971	$41,236
Directors' and corporate auditors' bonuses	106	879

b) Purchase of treasury stock for redemption and related reduction of retained earnings

The Company is authorized to repurchase, at management's discretion, up to 62 million shares of the Company's stock and canceling the shares by crediting such amounts against retained earnings.

Independent Auditors' Report

To the Board of Directors of
Kao Corporation

We have examined the consolidated balance sheets of Kao Corporation and consolidated subsidiaries as of March 31, 1999 and 1998, and the related consolidated statements of income, shareholders' equity, and cash flows for the years then ended, all expressed in Japanese yen. Our examinations were made in accordance with auditing standards, procedures and practices generally accepted and applied in Japan and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the consolidated financial statements referred to above present fairly the financial position of Kao Corporation and consolidated subsidiaries as of March 31, 1999 and 1998, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles and practices generally accepted in Japan applied on a consistent basis.

Our examinations also comprehended the translation of Japanese yen amounts into U.S. dollar amounts and, in our opinion, such translation has been made in conformity with the basis stated in Note 2. Such U.S. dollar amounts are presented solely for the convenience of readers outside Japan.

Deloitte Touche Tohmatsu

Tokyo, Japan
June 29, 1999

Board of Directors and Corporate Auditors

Chairman
Fumikatsu Tokiwa

President
Takuya Goto

Executive Vice President
Shotaro Watanabe

Executive Vice President
Kazuya Inbe

Senior Managing Director
Michinori Mochizuki

Senior Managing Director
Sumiaki Sasaki

Chairman
Fumikatsu Tokiwa

President
Takuya Goto

Executive Vice Presidents
Shotaro Watanabe
Kazuya Inbe

Senior Managing Directors
Michinori Mochizuki
Sumiaki Sasaki

Managing Directors
Masanori Sakata
Kunihiko Hachiya
Kinji Miwa
Toshio Hoshino
Shozo Tanaka
Masatoshi Kitahara
Takahiko Kagawa
Tadao Matsumoto
Kuniaki Watanabe

Directors
Kensei Nakanishi
Toshio Hirasaka
Moriyasu Murata
Junryo Mino
Yasuo Idemitsu
Akio Tsuruoka
Shigeo Yamada

Corporate Auditors
Seiki Nakajima
Kikuhiko Okamoto
Takashi Tajima

(As of June 29, 1999)

Principal Subsidiaries and Affiliates

HOUSEHOLD PRODUCTS AND CHEMICAL PRODUCTS BUSINESSES

Area	Country	Company		
Asia	Japan	Kao Cosmetics Sales Co., Ltd.	•	
	Japan	Nivea-Kao Co., Ltd.	•	
	Japan	Kao-Quaker Co., Ltd.		•
	China	Kao Corporation Shanghai	•	
	China	Kao Chemical Corporation Shanghai		•
	China	Zhongshan Kao Chemicals Limited		•
	Hong Kong	Kao (Hong Kong) Limited	•	
	Hong Kong	Kao Chemicals (Hong Kong) Limited		•
	Indonesia	PT. Kao Indonesia	•	
	Indonesia	PT. Kao Indonesia Chemicals		•
	Malaysia	Kao (Malaysia) Sdn. Bhd.	•	
	Malaysia	Kao Trading (M) Sdn. Bhd.	•	
	Malaysia	Fatty Chemical (Malaysia) Sdn. Bhd.		•
	Malaysia	Kao Soap (Malaysia) Sdn. Bhd.	•	
	Malaysia	Kao Oleochemical (Malaysia) Sdn. Bhd.		•
	Malaysia	Kao Plasticizer (Malaysia) Sdn. Bhd.		•
	Philippines	Pilipinas Kao Inc.		•
	Singapore	Kao (Southeast Asia) Pte. Ltd.		•
	Singapore	Kao (Singapore) Private Limited	•	
	Taiwan	Kao (Taiwan) Corporation	•	•
	Thailand	Kao Industrial (Thailand) Co., Ltd.	•	•
	Thailand	Kao Commercial (Thailand) Co., Ltd.	•	
	Vietnam	Kao Vietnam Co., Ltd.	•	•
Oceania	Australia	Kao (Australia) Marketing Pty. Ltd.	•	
America	Canada	Jergens Canada Inc.	•	
	Mexico	Quimi-Kao, S.A. de C.V.		•
	United States	The Andrew Jergens Company	•	
	United States	High Point Chemical Corporation		•
Europe	Austria	Guhl Ikebana Kosmetika GmbH	•	
	France	Kao Corporation (France) SARL		•
	Germany	Kao Corporation GmbH	•	
	Germany	Kao Chemicals GmbH		•
	Germany	Guhl Ikebana GmbH	•	
	Netherlands	Guhl Ikebana Cosmetics B.V.	•	
	Spain	Kao Corporation S.A.		•
	Switzerland	Guhl Ikebana AG	•	

• Household Products
• Chemical Products

GOLDWELL PRODUCTS FOR PROFESSIONAL HAIR SALONS

Country	Company
Austria	Goldwell Handelsgesellschaft mbH
Belgium	N.V. Goldwell Belgium S.A.
Denmark	Goldwell A/S
Finland	Goldwell Oy
France	Goldwell Paris S.a.r.L.
Germany	Goldwell GmbH
Germany	Goldwell Vertriebs GmbH
Italy	Goldwell Italia S.p.A.
Netherlands	Goldwell Nederland B.V.
Switzerland	Goldwell AG
United Kingdom	Goldwell (Hair Cosmetics) Ltd.
Canada	Goldwell Cosmetics (Canada) Ltd.
United States	Goldwell Cosmetics (USA), Inc.
South Africa	Goldwell South Africa (Pty.) Ltd.
Hong Kong	Goldwell Cosmetics (Hong Kong) Ltd.
Singapore	Goldwell Cosmetics (Singapore) Pte. Ltd.
Taiwan	Goldwell Cosmetics Taiwan Co., Ltd.
Australia	Goldwell Cosmetics (Australia) Pty. Ltd.

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