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Annual Report 1998

PHILIPS

Annual Report 1998

PHILIPS

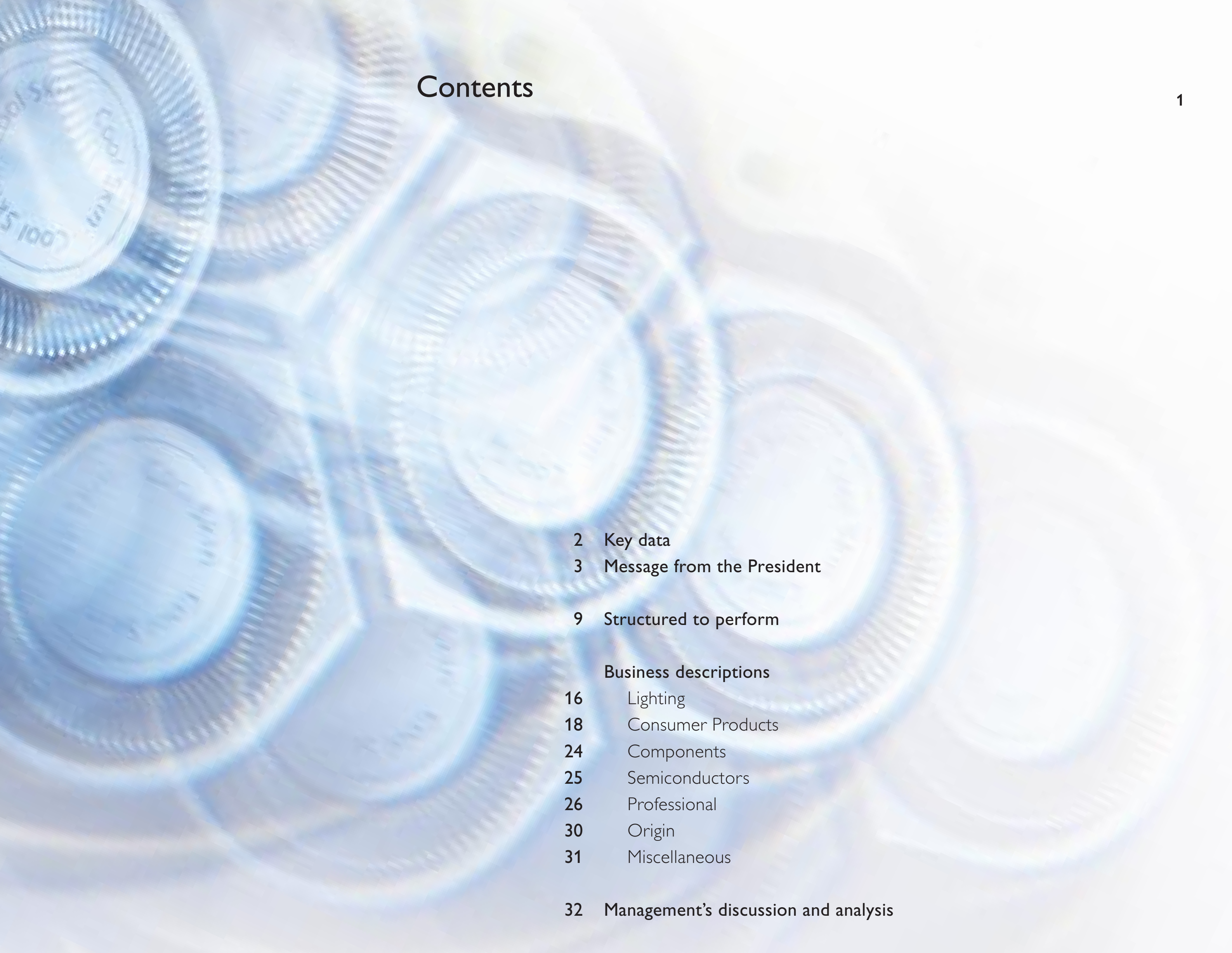
We are committed to building the Philips brand.
Providing dazzling products that radiate the dynamic aspirations of the digital age, it is our aim to bring new levels of quality to people's lives.

Besides presenting financial facts and figures, this report shows how we are working to create 'star' products – products that delight the customer through their performance and design.

PHILIPS

Let's make things better

Contents



'Safe Harbor' Statement under the Private Securities Litigation Reform Act of October 1995

This document contains certain forward-looking statements with respect to the financial condition, results of operations and business of Philips and certain of the plans and objectives of Philips with respect to these items.

By their nature, forward-looking statements involve risk and uncertainty because they relate to events and depend on circumstances that will occur in the future. There are a number of factors that could cause actual results and developments to differ materially from those expressed or implied by these forward-looking statements. These factors include, but are not limited to, levels of consumer and business spending in major economies, changes in consumer tastes and preferences, the levels of marketing and promotional expenditures by Philips and its competitors, raw materials and employee costs, changes in future exchange and interest rates, changes in tax rates and future business combinations, acquisitions or dispositions and the rate of technical changes.

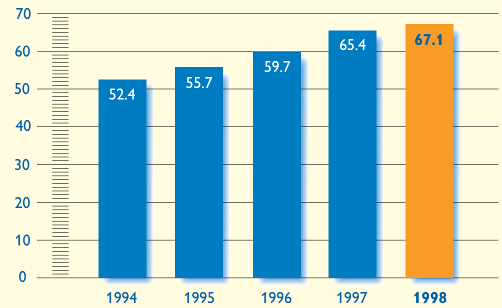
Market share estimates contained in this report are based on outside sources such as specialized research institutes, industry and dealer panels, etc. in combination with management estimates.

Key data

all amounts in millions of Dutch guilders unless otherwise stated

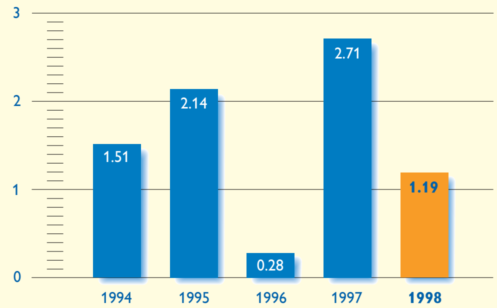
Sales

in billions of guilders



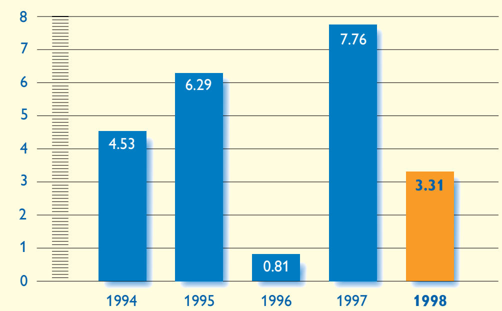
Income from continuing operations

in billions of guilders



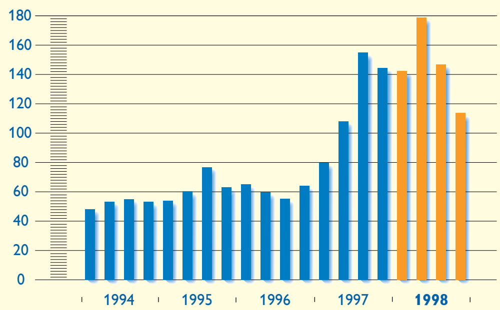
Income from continuing operations per common share

in guilders



Average share price per quarter

in guilders



	1996	1997	**1998**
Sales	59,707	65,358	**67,122**
Income from operations	929	3,777	**1,509**
As a % of sales	1.6	5.8	**2.2**
As a % of net operating capital (RONA)	4.2	16.4	**6.5**
Income from continuing operations	278	2,712	**1,192**
As a % of stockholders' equity (ROE)	1.9	16.1	**5.2**
Per common share	0.81	7.76	**3.31**
Net income (loss)	(590)	5,733	**13,339**
Per common share	(1.73)	16.41	**37.05**
Dividend per common share	1.60	2.00	**2.20**
Cash flows (before financing activities)	(2,038)	7,173	**1,540**
Stockholders' equity	13,956	19,457	**31,292**
Per common share	40.21	54.36	**86.76**
Net debt : group equity ratio	43:57	22:78	*

The consolidated financial statements have been restated to reflect the sale of PolyGram N.V. and to present the Philips Group accounts on a continuing basis for all years presented in this report.

* The current net cash situation renders the net debt to group equity ratio meaningless.

Despite the turmoil in the world economy, your Company emerged from 1998 in good shape

- We achieved significant advances in our move to refocus the Company and completed the divestment of PolyGram and Philips Car Systems and the acquisition of ATL Ultrasound.
- Divestments yielded non-recurring gains of NLG 12.0 billion.
- The balance sheet improved dramatically, ending the year with a net cash surplus.
- Given the state of the world economy, sales growth on a comparable basis was relatively good, at 6%.
- Income from continuing operations was down to NLG 1,192 million (NLG 3.31 per share) from last year's NLG 2,712 million (NLG 7.76 per share). Charges net of taxes in the fourth quarter negatively impacted income by NLG 1.6 billion.
- Cash flow before financing activities, including the proceeds from the sale of PolyGram, was significantly higher, at NLG 12.9 billion, compared to last year's NLG 7.2 billion.
- Inventories fell to a level of 14% of sales, an all-time low.
- We further strengthened our brand through an exciting new global campaign.
- Research and development spending, at NLG 4,513 million, or 6.7% of sales, was 11% up on 1997.

Dear Shareholder,

Considering the turmoil in the global economy, in particular the Asia Pacific region, Russia and Brazil, I am pleased to report that your Company came through 1998 in good shape. Sales on a comparable basis continued to grow, despite increasing price erosion. However, income from continuing operations failed to match last year's record level, the major disappointment being PCC. Besides Consumer Products, our Components sector also showed a downturn, which was only partly offset by performance improvements in our Lighting sector and at Origin.

We have made real progress in realigning our operations, and this has had a dramatic impact on our balance sheet, resulting in a net cash surplus. Although cash flow excluding the net proceeds of the sale and purchase of business interests and non-current financial assets was considerably down on last year's record figure, it still showed a level of NLG 1.6 billion. We propose to reduce our share capital by means of a total cash distribution of approximately NLG 3.3 billion to all shareholders, while reducing the number of outstanding common shares by 8%. We believe that this is the best investment for our surplus cash at this time.

Refocusing the Company

In 1998, further significant advances were made in the process of refocusing the Company. We divested or discontinued some 25 activities that were either peripheral to our core operations or consistently underperforming. We also strengthened other activities so that they can become among the top two or three players in their field, worldwide.

PolyGram

We decided to sell PolyGram because we believe that PolyGram will add more shareholder value together with Seagram's Universal music and film operations than as a separate subsidiary of Philips. Furthermore, the competences required to run this business are quite unlike those needed elsewhere in the Company, and the very different nature of the business means its contribution to strengthening the Philips brand was marginal at best.

PCC

In the field of mobile telephony we terminated our joint venture with Lucent Technologies. We had hoped that it would enable us to make a breakthrough, particularly in the US. But in September, after twelve months, there was still no sign of such breakthrough materializing, so we decided it was time to end the alliance. We are now continuing on our own, concentrating on GSM technology. We feel it is important to remain in mobile telephony, because as telecommunications, computer and multimedia technology converge, Philips needs to maintain world-class expertise in this field as an important part of the 'digital mix' in tomorrow's high-volume electronics products.

ATL Ultrasound

We are a world leader in diagnostic medical imaging – including x-ray, magnetic resonance, computed tomography and ultrasound. The market is still growing in all of these areas, particularly ultrasound. We have therefore strengthened our position by acquiring one of the top companies in this field, ATL Ultrasound. With this move, we have gained a leading market share in this technology, increased by 3% our global market share in medical imaging in general, and firmly established ourselves as No. 3 in the world – with the clear aim of moving up.

Other acquisitions?

During the coming year, we shall continue to look for appropriate acquisitions where we can strengthen an already strong position, gain proven management expertise, add significantly to a product line or business activity, and boost shareholder value. We intend to make every cent of your money count.

The year 2000 and the euro

We continue to make every effort to ensure that we are ready for the year 2000. We are implementing a far-reaching program to eliminate the business risks under our control that are involved in the Millennium roll-over, and we are also helping our suppliers and customers to reduce other, shared risks in the entire business chain. Our level of readiness for the European Monetary Union, which started on January 1, 1999, has been taken as a benchmark by other major companies. We are one of the few companies in Europe that changed over its administration (not just its reporting) in the respective countries to the euro on Day One.

Implementing the new strategy

We have made significant progress in implementing our high-volume electronics strategy. As announced last year, we have restructured our organization and now have a limited number of clear, accountable businesses, each with a well-defined scope with respect to customers, sales channels and products. The structure centers largely around our new Consumer Electronics division. Semiconductors and Components play a crucial role, both as internal suppliers and on the external market, while our Business Electronics division, as it pursues its own markets, also forms a breeding ground for technologies and concepts that can later be applied in new consumer products. Lighting, now increasingly incorporating sophisticated electronics, straddles both the consumer and professional markets, while Domestic Appliances and Personal Care and Medical Systems are active in the consumer and professional fields, respectively. Finally, Origin plays a key enabling role through its IT solutions. With our products we aim to make a contribution to improve the quality of people's lives – enabling them to enjoy the thrill of digital technology, organize their activities more effectively, keep in touch with others, and so on.

To reinforce the cultural change taking place within the Company, we have moved our corporate headquarters, including our Consumer Electronics marketing department, to

Amsterdam. The second phase of the move will be completed as soon as our new premises are ready.

Business-driven research

In the past, we often pioneered new technologies, only to discover that the market preferred a less sophisticated product. Now, while not surrendering any of our ingenuity and research expertise, we will make sure that, where necessary, we deploy it in alliances and partnerships with others, to share the substantial costs and risks involved. Our research strengths – including 1,300 new patent applications during the past year alone, on top of our 60,000 patents and design rights, registered trademarks and numerous license agreements – combined with a clear business focus, will provide an innovative foundation for the further implementation of our strategy.

Flexible manufacturing

We will continue to redefine our manufacturing systems to ensure maximum flexibility at lowest cost. As part of an ongoing process of fine-tuning the Company to the needs of the market, we have taken steps to streamline and upgrade our manufacturing base, bringing facilities in line with the size of today's market or merging them to gain the benefit of economies of scale.

New campaign to build global brand

An important tool in implementing our strategy is our new media campaign. It is based on an extensive study of consumer attitudes around the world that we carried out as part of our drive to enhance our marketing expertise. By focusing on a select group of dazzling, high-end products, we draw people's attention to just how special our products can be – both in design and technology – and how, in a very direct and personal sense, Philips can make people's lives better. We are also taking steps to expand the global awareness of the Philips name by introducing the brand in those countries where we have traditionally traded under other names.

Quality

A powerful driver for improving our business is quality. Quality is more than a system – it is about having the right mindset, being passionate about satisfying customers and being motivated to make things better. This applies throughout the organization. In this respect, Philips Semiconductors has given an outstanding lead with the QS-9000 certification of *all* relevant units following an implementation process carried out in close cooperation with its US automotive customers. We have made great strides in recent years, and we will be building upon this with our Business Excellence policy. It is our firm intention to be one of the best companies in the world: the best to trade with, work for and invest in. We also aim to be one of the most attractive employers for top-calibre people. To this end, we are making every effort to strengthen our human resource management and management development processes.

A sense of responsibility

As pioneers of energy-saving technologies, we have long been aware of the responsibility we have towards society and the environment. That is why, in May, I found it particularly gratifying to be able to accept on behalf of the Company the Gold Medal Award from the World Environmental Center. At that time, we also announced a new four-year environmental program called EcoVision to develop and market 'Green Flagship' products, responding to people's concerns about the environmental impact of the products they use.

We are also aware of the need to provide ethical guidelines to make clear to our employees, customers and suppliers how we do business. That is why we have issued a set of General Business Principles that will govern our business decisions and actions throughout the world. They apply equally to corporate actions and the behavior of individual employees in doing business on the Company's behalf.

The future in focus

I do not believe we should be disappointed about what we have achieved in 1998: we outperformed our most direct competitors. True, the financial results were not as good as we had hoped: we ran into unexpected difficulties. But – small comfort though it is – we were not the only ones.

What is more important is that we are still very much on course:

- We have continued the process of refocusing the Company
- We have continued to streamline our manufacturing operations
- We have improved our internal procedures and management control processes
- We have launched a massive brand-building campaign and taken other measures to ensure that we can maximize brand leverage across our entire portfolio
- We have used part of our surplus funds to boost shareholder value while we look for the most profitable use for them in the long term

- We have continued our drive to reduce costs
- And we have charted a clear course for the future.

These are the results that count in the long run, because they are what will create sustainable shareholder value in the years to come.

We realize that the change process currently under way within the Company can only be successfully completed with the full support of our employees. I would like to thank them – and of course our customers and shareholders – for the commitment they have shown over the past year.

Cor Boonstra, *President*

Structured to perform

Focusing on high-volume electronics, the Philips organization comprises some 80 businesses, each with a well-defined scope, but strongly interrelated through brand, technologies, manufacturing and sales channels. The structure centers around our Consumer Electronics division. Semiconductors and Components play a crucial role, both as internal suppliers and on the external market, while Business Electronics, as it pursues its own markets, also forms a seedbed for technologies and concepts that can later be applied in new consumer products. Lighting straddles both consumer and professional markets, while Domestic Appliances and Personal Care and Medical Systems are active in the consumer and professional fields, respectively. Finally, Origin plays a key enabling role through its IT solutions.

COMPONENTS & SERVICES

Components

- Display components
- Advanced ceramics and modules
- Optical storage
- Flat display systems
- General system components

Semiconductors

- MultiMarket products
- Consumer systems
- Telecom terminals
- Emerging businesses
- Discrete semiconductors

Origin

- Enterprise solutions
  integrated total-value-chain solutions, ERP implementation and related services (incl. SAP, Baan, QAD), technical automation
- Managed services
  outsourcing, infrastructure solutions, applications management, desktop services
- Professional services
  transformation consulting services, electronic commerce, euro and millennium services

CONSUMER PRODUCTS

'Home & Away'

Consumer Electronics

- Video
  TV, VCR, institutional TV, tuners, remote control
- Digital video
  DVD, Internet TV, digital TV, Flat TV, Creative Display Solutions
- Audio
  portable audio, audio systems, speakers, CD-Recordable, Marantz
- Communications
  mobile phones, corded/cordless phones, answering machines, faxes (Europe)
- PC peripherals
  monitors, PC add-ons, video camera modules
- Other
  mobile computing products (e.g. Velo, Nino), service, licenses

Domestic Appliances and Personal Care

- Personal care
  shavers, depilators, hair dryers, suncare, electric toothbrushes, skincare
- Domestic appliances
  vacuum cleaners, food processors, mixers, blenders, coffee makers, kettles, air cleaners
- Cooking and comfort
  steam irons, toasters, fans, grills, friers

PROFESSIONAL PRODUCTS

Business Electronics

- Digital video communication systems
- Broadband networks
- Business communication
- Speech processing
- Fax
- Video conference systems
- Integrated projects
- Communication and security systems
- Analytical X-ray systems
- Electronic manufacturing technology
- FEI (Electron Optics)

Medical Systems

- X-ray equipment
  radiography, universal R/F, cardio-vascular, surgery
- Computed tomography
- Magnetic resonance
- Ultrasound
- Healthcare services
  integrated clinical solutions, hospital management services, extended technical services

Lighting

Lamps, Luminaires, Lighting electronics & gear, Automotive, Batteries

THE THRILL OF TECHNOLOGY

Digital technology adds a whole new meaning to an evening out – bringing the pleasure of 'the cinema experience' to the home

FOCUSING ON CONSUMER NEEDS

The Philips brand stands for products that exceed expectations by combining outstanding technology with ease of use: products, for instance, to which we can talk by means of speech-recognition technology developed in early anticipation of consumer needs

GETTING BETTER ALL THE TIME

Philips is committed to pushing the limits – in research, design and the development of exciting new products such as this CD Sound Machine, which combines great sound with a stunning appearance

LIGHTING

Philips is No. 1 in the global lighting market, largely due to our leadership in innovation combined with our determined approach to seeking out new market opportunities. To make our organization more efficient, we have improved transparency and focus by introducing full accountability in our five lines of business: Lamps, Luminaires, Lighting Electronics & Gear, Automotive and Batteries.

We are placing strong emphasis on value creation through profitable growth in emerging markets such as Central and Eastern Europe and the Asia Pacific region while further improving our position in our mature markets. We are also shortening our time to market. In 1998 we began implementing a program called BEST (Business Excellence through Speed and Teamwork). This involves a push forward on three fronts: we will be focusing even more closely on business priorities, increasing the capability of our primary business processes, and stimulating better teamwork. We see continued growth potential, with special opportunities in areas such as energy-saving lighting and technologically advanced lighting applications.

Xenon headlamps – safer roads ahead

Philips is the market leader in Xenon headlamps. Providing superb illumination of the road, these lamps dramatically improve road safety and driver comfort. In fact, a recent German car industry survey showed that over 90% of drivers feel safer with our Xenon lamps.
With Mercedes Benz, we are also developing a new high-performance signaling system that will last the car's entire lifetime, cut fuel consumption and enhance styling.
Our position as a supplier of headlights to the car industry is very strong in Japan, where we are the market leader, and we are rapidly establishing a full global presence in this field.

Philips top scorer in soccer World Cup

Six of the ten stadiums staging the 1998 World Cup soccer finals in France were lit by Philips' highly versatile ArenaVision systems – demonstrating once more the company's global leadership in sports floodlighting. ArenaVision is specially designed for today's more dramatic, theatrical approach to sports events. While offering optimal low-glare conditions for players, it provides both spectators and TV audiences with more realistic action by creating accents and preserving natural colors.

Homing in on customer needs

In Europe, today's environmentally aware consumers are still very attached to the traditional bulb and the light it produces. Philips' award-winning Ecotone Ambiance combines the soft, attractive light of conventional bulbs with high energy savings, making it ideal for the home. Developed after extensive consumer research, Ecotone Ambiance lasts up to five years and uses 80% less electricity.

YOU WON'T BE LEFT IN THE DARK

In 1998, Philips launched the latest additions to its Halogená line in the US. With its unique form, this lamp offers consumers whiter light and an approximately three times longer life than standard incandescent lamps, and it comes with the added benefit of a two-year guarantee.

CONSUMER PRODUCTS

CONSUMER ELECTRONICS

Philips Consumer Electronics encompasses all Philips-branded products in the fields of audio, video, PC peripherals and communications. We are No. 3 in the world audio and video market and No. 2 in Europe. Our technological expertise puts us at the forefront of the convergence of entertainment and information – the cornerstones of the digital age. We are pioneers in, for instance, Digital TV, a medium that brings a new dimension to home entertainment, offering a wider choice of channels, true widescreen pictures, optimum sound quality and interactive services. We have launched Digital TV in the UK and introduced a widescreen rear-projection HDTV set in the US. Building on the success of the Philips Magnavox DVD-Video products in the US, where we are also running a DVD-Video rental program together with Blockbuster, we have introduced a number of DVD-Video players in Europe.

We market audio systems, portable audio products, speakers and accessories under the Philips name, as well as high-end audio products and systems under the Marantz brand. Philips was instrumental in the revolution unleashed by CD-Audio, which now has an installed base of some 700 million units worldwide, and continues to play a leading role in the development of related standards such as DVD, CD-Recordable and CD-ReWritable.

Design Line TV

Design Line widescreen TVs are a strikingly original blend of design furniture and high-end Matchline TV, giving outstanding performance when switched on and looking great when they are not. Masterpieces of design, they combine aluminum and glass in a style that complements the personality of the owner and the décor and mood of the room. The Design Line sets also feature Incredible Surround sound.

DVD-Video – the ultimate experience

In Europe, Philips and Warner Home Video have launched a joint marketing effort focusing on DVD-Video as the ultimate medium for a cinema-style viewing and listening experience in the home. A full-length feature movie fits onto a single DVD-Video disc. Philips' DVD-Video players can be connected to existing TV sets and audio systems and play regular Audio and Video CDs.

PERFECTING THE ART OF LISTENING

Philips' latest CD Recorders allow you to hear your choice of music as you really want to. With the dual-deck CDR 765, you can make your own personal CDs without the need for a second CD player.

CONSUMER PRODUCTS

CONSUMER ELECTRONICS

Philips develops, manufactures and markets a wide range of consumer communications products, including cellular, corded and cordless phones. In volume terms, Philips is one of Europe's leading providers of corded and cordless phones and answering machines. For the future, the main focus of cellular wireless products is on GSM technology, which represents 65% of the global cellular market. Meanwhile, development continues on third-generation digital mobile phone technology, involving the deployment of wideband wireless networks which will provide consumers with voice, data and multimedia services on their phones.

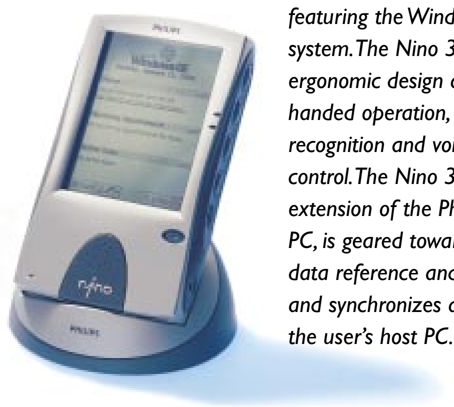
In the field of PC peripherals, Philips is – in volume terms – the world's No. 2 and Europe's No. 1 supplier of computer monitors. We make not only a full range of CRT monitors, but also LCD monitors and Net displays (monitors with a built-in processor and video card). The world leader in PC video cameras and observation systems, we also market USB peripherals, optical data storage products and multimedia sound systems, LCD projectors and input devices for the PC. Wireless interconnectivity for home networking will be a key focus for the coming years.

Talking magic

Philips' Genie Sport GSM phones are stylish personal accessories as well as state-of-the-art communication tools. Their fresh, vibrant colors underline Genie's personal appeal, making it the perfect choice for individuals with a mobile, dynamic lifestyle. Genie features Philips' Voice Dial: simply speak the name of the person you want to call and the phone does the rest. In China, it has consistently been one of the top-selling phones in its category.

BRILLIANCE – THAT SAYS IT ALL

A very tangible asset to any office, the Brilliance 151AX Flat Panel Monitor is kind to its users, eliminating heat, radiation and reflection … not to mention saving space.



Writing on the move

In 1998, Philips introduced the Nino 300, a small, pen-based companion featuring the Windows CE operating system. The Nino 300 has a sleek, ergonomic design and features one-handed operation, full handwriting recognition and voice command and control. The Nino 300, the natural extension of the Philips Velo handheld PC, is geared towards data retrieval, data reference and communications and synchronizes automatically with the user's host PC.

CONSUMER PRODUCTS

DOMESTIC APPLIANCES AND PERSONAL CARE

Philips Domestic Appliances and Personal Care (DAP) develops, manufactures and markets a wide range of home comfort and kitchen appliances, shavers and other personal care products. The division is the world market leader in dry shaving and No. 2 in ironing.

In 1998, significant progress was made in re-aligning our production facilities and reducing lead time. We also attracted many new customers from the wet shaving market by introducing Cool Skin, a revolutionary new method of shaving.

We have long been successful on the US market under the brand name Norelco and we will continue to use this brand name for our male shaving and grooming products. To further boost growth, we introduced the Philips brand name there in 1998, with the focus on body beauty and health. The first product to be launched under the Philips name was the Natura hairdryer with infrared heat-sensor. We have also started re-launching products formerly sold under the Norelco brand name as Philips products.

With product design being an increasingly important part of Philips' corporate identity, it is gratifying to note that no fewer than 17 of this division's products won major international awards in 1998.

Philips Alessi

The latest addition to the line of high-end kitchen appliances designed jointly by Philips and Italy's Alessi Design.

Taking the heat off

This new hair dryer senses when hair is exposed to too much heat and automatically switches to a lower setting. What's more, consumers themselves sense the difference. Thanks also to an excellent advertising campaign, the Natura hair dryer got off to a flying start.

Bob

Our cheeky new kitchen friend shares many characteristics with the Billy bar-blender, which was launched last year. Like Billy, Bob is boldly going where no domestic appliance has gone before.

A FRESH START TO SHAVING

To bring the freshness of wet shaving to the convenience of dry shaving, we've developed an entirely new concept – Philishave Cool Skin. Push a button to squeeze a small amount of Nivea For Men shaving gel onto the shaver heads – and a few moments later you're ready to face the day.

COMPONENTS

Philips Components is a leading supplier of display, storage and key components and power management systems. We are the world's No. 1 manufacturer of color picture tubes for televisions and monitors, market leader in modules for CD-ReWritable (RW) and Video CD, and a major supplier of flat displays. We are also an important producer of customized key component subsystems.

Based on world-class technology and customer knowledge, we provide a competitive advantage for Original Equipment Manufacturers (OEMs) in the consumer electronics, electronic data-processing, telecommunications and automotive industries. We have initiated a strategic refocus on innovative products for the above markets, exploiting the synergies available within Philips and, where necessary, entering into alliances to access the required competences. In 1998, this led to an agreement on the disposal of our non-ceramic passive components business.

Philips in space

Not even the sky is the limit for our LCD products – the cockpits of the Space Shuttle and the Boeing 777 are equipped with the latest Philips LCD screens.

New large-display technologies

PALC (Plasma Addressed Liquid Crystal) technology, developed in conjunction with Sharp and Sony, offers high brightness, excellent daylight contrast and a wide viewing angle. These characteristics make it ideally suited to wall-hanging digital and multimedia TV and other applications in bright ambient lighting conditions. Together with Pioneer, we are also working on the next generation of Plasma Display Panel (PDP) technology, one of the most promising technologies for large flat displays.

VERSATILITY AT HOME AND AT WORK

CD-ReWritable drives let you use discs again and again. The clear leader in this rapidly growing market, we are currently working with partners on the follow-up – DVD+RW.

SEMICONDUCTORS

Philips Semiconductors is a leading supplier of integrated circuits and discrete semiconductors for applications in consumer, telecommunication, multimedia and automotive electronics. Ranked No. 8 in the world and No. 4 in Europe, the division has a significant market position with chipsets for TV, audio, wired and wireless telephony, computer monitors, desk-top video and PC peripherals and is world leader in one-chip TV circuits.

Our Silicon Systems Platform approach takes the concept of integration – the 'system on a chip' – one step further. It involves creating platforms geared to specific applications and markets (e.g. digital video or digital communication). On the basis of a well- chosen architecture, high-quality blocks and modules can be used and re-used quickly and reliably in various combinations. In this way, we provide clients with total solutions based on cost-effective and easy-to-use 'toolkits'.

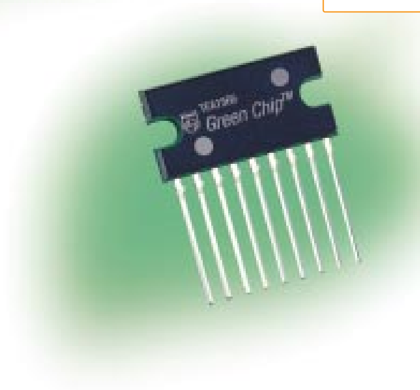
Building on our existing expertise in radio frequency, mixed signal, analog/digital conversion, video-processing and discrete semiconductors, we are expanding in other major fields. To that end, we need to invest in CMOS technology, libraries and software. Our CMOS chips are currently produced at 0.25 micron, and we will be shrinking this down to 0.18 micron and beyond. In addition, we will be investing in more software development facilities, as the software that runs on our chips has in some cases become as important as the chips themselves.

Our growth so far has been organic, and this pattern will largely continue, although we aim to complement this with participations and acquisitions, either to acquire new expertise or to access new markets. We are dedicated to supplying high-quality products with minimal impact on the environment: all our operational units have been certified in accordance with ISO-14001 and QS-9000.

CoolRunner

Complex Programmable Logic Devices (CPLDs) have the potential to reduce the environmental impact of portable products significantly.

Green Chip



Our Green Chip can cut the energy consumption of products in stand-by mode by up to 99%.

Gearing up for the future

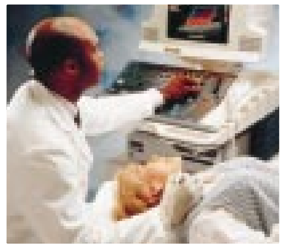
Together with Taiwan Semiconductor Manufacturing Company (TSMC) and EDB Investments, we are investing USD 1.2 billion in a new chip factory in Singapore. This will enable us to benefit from the growth in demand for logic chips for consumer electronics and communications applications toward the end of 2000. The factory will produce the latest type of chip, with circuits as thin as 0.25 micron (1/400th of the thickness of a human hair) ... and even thinner.

PROFESSIONAL

MEDICAL SYSTEMS

Philips Medical Systems ranks among the top three diagnostic imaging companies in the world. We offer healthcare providers a full range of innovative imaging modalities – including x-ray, computed tomography, magnetic resonance and ultrasound systems. Using our IT systems, imaging departments can become completely digital, with improved access to images and seamless integration with hospital-wide IT networks. Our services include management consultancy, training and technical services to help hospitals operate more efficiently and cost-effectively.

Philips Medical Systems, already the world leader in x-ray imaging systems, has significantly strengthened its position in the field of diagnostic imaging with the acquisition of ATL Ultrasound. This company is one of the leaders in ultrasound imaging systems – one of the fastest-growing sectors of the market – and the clear leader in all-digital ultrasound systems. The quality of its products and their performance is widely recognized, and its leading ultrasound product has been selected by NASA for use in the international space station scheduled to become operational in 2001. Demand for diagnostic imaging products and services will continue to grow as new markets emerge and advances are made in functionality, e.g. through the further integration of IT solutions.



ATL Ultrasound

In 1998, Philips acquired ATL Ultrasound, a worldwide leader in diagnostic ultrasound. For over 20 years ATL has been advancing ultrasound technology to provide better patient care while decreasing its cost. The company's dedicated focus on ultrasound allows it to meet the clinical demands for ultrasound in healthcare environments worldwide.

Healthy future for Gujarat

This year saw the start of a unique six-year project in which a consortium led by Philips Medical Systems will upgrade and maintain the entire healthcare system of the north-west Indian state of Gujarat. The focus will be on mother-and-child health, trauma care, kidney diseases and diseases of the eye. The project encompasses the whole range of activities from promoting health and disease prevention, to diagnostics, treatment, cure and rehabilitation. We will be responsible for modernizing 65 health centers and hospitals throughout the state and setting up six mobile ophthalmology units for cataract surgery.

The Integris H5000 digital cardiac x-ray system recently won an award in one of the world's most prestigious design competitions, the Industrial Design Excellence Awards. The Integris H5000 is smaller – and three times faster – than previous systems. Its all-digital imaging technology ensures consistently high image quality, and its comprehensive dose-management system keeps patients' exposure to x-rays to an absolute minimum.

PATIENT-FRIENDLY

All our products are designed for easy, efficient operation to improve patient care and boost cost efficiency. Their friendly appearance also makes for a less intimidating atmosphere for the patient.

PROFESSIONAL

BUSINESS ELECTRONICS

Our Business Electronics division focuses on the business-to-business sector, digital information distribution being the principal area of activity. The market for our products, software and services in the fields of digital video and natural speech recognition is expected to grow substantially in the near future, as voice, video and data communication technologies converge. We also expect their scope to extend gradually into the consumer market: that is why we see our business units in this field as not only creating value in their own right, but also serving as a breeding ground for new high-volume electronics products. We are currently the world's No. 2 supplier of digital video-communication systems, which includes digital set-top decoders.

Our businesses in analytical x-ray, optical metrology, electron microscopes and electronic manufacturing technology provide smart R&D and manufacturing solutions for the semiconductor industry based on our knowledge of materials science.

By providing sophisticated communication, security, lighting and control systems, we help customers to create intelligent infrastructures and turnkey solutions. Demand for such intelligent infrastructures is growing due to the needs of emerging markets and the increasing sophistication of software. We are also applying our know-how to create office/home networking solutions, including faxes and desktop video-conferencing systems.

Speech processing – talk of the town

Speech processing is one of Philips' fastest growing activities. We are active in all areas of this market, which is growing at almost 50% a year. In 1998, we launched FreeSpeech, a highly affordable software package that combines online natural speech recognition for dictation of documents with user control over many popular Windows-based applications.

Lighter traffic – Singapore's way ahead

Pay-per-mile is Singapore's answer to traffic congestion. Motorists pay using pre-paid smart cards inserted in units in their vehicles, and amounts are remotely debited from the card as they pass control points. The Singapore authorities chose Philips Projects as main contractor to mastermind the installation of the infrastructure.

G-O-O-O-A-A-A-L-L-L-L...

Making its debut at soccer's 1998 World Cup, our new LDK23HS high-speed slow-motion TV camera introduces a new dimension in sharp, fluid action replays. With a frame rate three times as fast as normal cameras, it produces film-quality pictures. And there's no waiting: the action can be replayed from disk instantaneously, making live events even 'live-er'.

Management's discussion and analysis

The following discussion is based on the consolidated financial statements included in this report and should be read in conjunction with those statements and the other financial information contained herein.
The consolidated financial statements were prepared in accordance with generally accepted accounting principles in the Netherlands (Dutch GAAP).
These accounting policies differ in some respects from generally accepted accounting principles in the United States (US GAAP), which are discussed in note 25 to the consolidated financial statements.

Sales in 1998 rose to NLG 67,122 million, an increase of 3% (1997: NLG 65,358 million). Income from continuing operations was down from last year's NLG 2,712 million (NLG 7.76 per share) to NLG 1,192 million (NLG 3.31 per share), mainly as a result of fourth-quarter charges amounting to NLG 1,568 million net after taxes and losses at Philips Consumer Communications (PCC). Divestments yielded non-recurring gains of NLG 12,014 million.

As a result, the cash flow before financing activities, including the proceeds from the sale of PolyGram, was significantly higher at NLG 12,887 million, compared to NLG 7,173 million in 1997.

Despite the turmoil in the world economy, a number of business sectors of the Philips Group ('Philips') achieved significant performance improvements in 1998. In many areas Philips outperformed its competitors. All sectors realized sales growth on a comparable basis (excluding the impact of consolidations and currency effects) and many achieved significant growth in market share: Consumer Electronics, Components, Semiconductors, Business Electronics and Origin. Practically all geographic areas, except Latin America, reported higher sales. However, only Lighting and Origin showed improvements in income from operations.

In 1998, various fundamental steps were taken towards making Philips a stronger company. The program to refocus Philips on its core businesses, which was started in 1996, was continued throughout the year. It included the sale or discontinuance of a number of businesses or parts of businesses that failed to meet our performance standards or were considered not to fit into our strategic portfolio of businesses. In addition, production facilities have been closed or integrated with other facilities, and in a number of cases relocated to countries where employment costs are lower. This process of consolidation of manufacturing units will be continued in 1999 and beyond, in order to increase efficiency and enhance profitability.

In line with our belief, and our undertaking to our shareholders, that the creation of value should always be the focal point of our decision-making, over a thousand senior business managers have committed themselves to the principles of value-based management. Economic Profit Realized (EPR) is now used to measure the financial performance of all our businesses. In the course of 1999, the value-based management approach will be incorporated in our incentive compensation program to reward managers for creating shareholder value.

In order to strengthen the businesses in which we seek to be among the top 3 worldwide players, for example in Medical Systems, we succeeded in acquiring ATL Ultrasound, one of the leaders in ultrasound imaging. While ATL added to operating income in 1998, Philips recorded a one-off charge of NLG 401 million relating to in-process research and development acquired in connection with the purchase, and various one-time charges totaling NLG 112 million, which reduced the income of the Medical Systems division.

At the beginning of 1998, Philips announced its plans to make a substantial investment in the backbone of the Philips Group, notably in the Philips brand and in IT infrastructure.
As part of the brand management program, a major global campaign was initiated under the name 'Star Products'. This campaign – based on a comprehensive survey of 14,000 consumers in 17 different countries – will be continued in 1999 and has already produced a very positive response in terms of enhanced brand awareness, brand image and increased market shares.

The additional investment in IT consists of streamlining various IT processes to obtain greater uniformity and standardization in infrastructure among the global Philips population, as well as addressing the challenges of the euro and the Millennium issue. This program will reduce IT spending in the year 2000 and beyond, and enhance efficiency within Philips.

While Philips continues to make significant investments in strategic areas that have increased the costs of the organization, there are several programs in place to optimize our spending. The Other Costs of Organization (OCOO) program that was started in late 1996 is aimed at reducing the cost of purchased services. This program has yielded significant savings and is being continued. During 1998 the Company also initiated a program in which disciplines such as purchasing, IT/Networks, real estate, finance and accounting and human resource management perform benchmark studies aimed at process improvement and cost reduction through the sharing of services and infrastructure. The performance of the joint ventures Philips Consumer Communications (PCC) and Hosiden and Philips Display Corporation (HAPD), as well as certain parts of Business Electronics, failed to meet our expectations for 1998. Hence we decided to invest an additional sum in the restructuring of these businesses in order to advance their respective break-even points. These realignments have led to considerable charges to the income of the respective divisions and product sectors.

PolyGram, which was 75%-owned by Philips, was sold in December 1998 because it failed to contribute to enhancing Philips' brand recognition and because both PolyGram's and Philips' interests would be best served by this divestment. A portion of the considerable proceeds from the sale will be used to reduce the number of common shares outstanding.

In 1998, Philips announced a share reduction program that is expected to begin in mid-1999 after the adoption of this proposal by the General Meeting of Shareholders. The plan involves a cash distribution to shareholders of approximately NLG 3.3 billion and a reduction by approximately 8% of the shares outstanding.

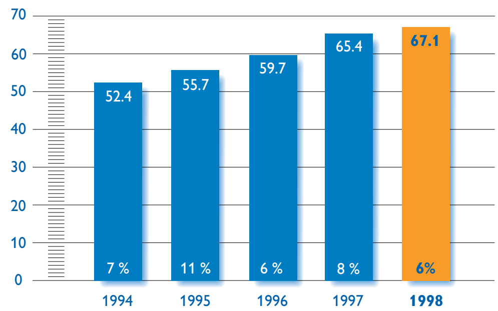
Following the sale of Philips' 75% interest in PolyGram to The Seagram Company Ltd. of Canada on December 10, 1998, it should be noted that PolyGram, formerly a separate product sector, is presented in this report as a discontinued operation for the three years ended December 31, 1998. Management's discussion and analysis focuses on the performance of the Group on a continuing basis (excluding PolyGram) for all periods presented, unless otherwise stated.

Sales and income from operations

Sales in 1998 totaled NLG 67,122 million, 3% higher than the 1997 figure of NLG 65,358 million, which in turn was 9% higher than the total of NLG 59,707 million in 1996. Sales growth in 1998 on a comparable basis was 6%, compared with 8% in 1997. This consisted of a volume increase of 16% that was offset to a considerable extent by an average decrease in selling prices of 9%, which particularly affected Consumer Electronics, Components and Semiconductors. Currency fluctuations had a negative effect on sales of 2%, primarily due to the depreciation of virtually all of the Asian currencies and a weakening of the US dollar against the Dutch guilder. Various changes in consolidations resulted in a negative effect of 2% on sales. The main deconsolidations related to the sale of Philips Car Systems, Pie Medical, Philips Financial Services in the UK, the Smart Card business and various other Industrial Electronics and Components activities. Positive effects on sales arose from the consolidation of the activities of the PCC joint venture with Lucent Technologies for 9 months in 1998 (until September 27, 1998, when the venture was dissolved) as compared to only 3 months in 1997, the consolidation of Hosiden and Philips Display Corporation (HAPD) from April 1, 1998, and the acquisitions of ATL Ultrasound, Philips Mietsysteme and Payer Lux.

Sales

in billions of guilders
% comparable growth



In 1997, the nominal sales growth of 9% included a positive effect of 8% arising from currency fluctuations, mainly due to the stronger US dollar, while consolidation changes had a net negative impact of 7%. This consisted of the deconsolidations of Grundig, the radiotherapy business of Medical Systems and Data Communications, and new consolidations of Hua Fei Colour Display Systems of China, FEI Company of the USA, Pabianice Lighting of Poland and PCC. Adjusted for the combined effects of currency and consolidation changes, the comparable sales growth in 1997 over 1996 totaled 8%, consisting of 16% sales volume growth offset by a 8% decrease in the average level of selling prices.

Income from operations in 1998 totaled NLG 1,509 million, or 2.2% of sales, compared to last year's record of NLG 3,777 million, or 5.8% of sales. The latter was four times the income of NLG 929 million, or 1.6% of sales, realized in 1996.

When comparing figures with previous years, it should be noted that the 1998 income from operations was influenced by some special charges:

- Effective September 27, 1998, the Philips Consumer Communications (PCC) joint venture with Lucent Technologies was dissolved. The 1998 income from operations incorporated losses related to the unwinding of the joint venture, including value adjustments for obsolete inventories (NLG 351 million) and the subsequent restructuring of the returned PCC activities (NLG 475 million);

- A major charge for the restructuring of the Hosiden and Philips Display Corporation (HAPD) joint venture affected income from operations by NLG 103 million;
- The write-off of in-process R&D obtained in the acquisition of ATL Ultrasound and an adjustment made to align ATL to Philips' accounting principles resulted in a non-recurring loss of NLG 513 million;
- The write-off of in-process R&D resulting from the acquisition of Active Impulse Systems (AIS) resulted in a charge of NLG 44 million.

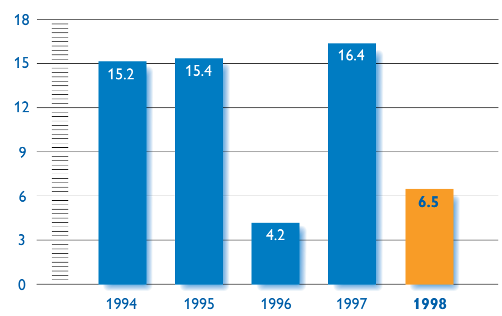
At the same time the Company incurred charges, making actuarial adjustments to the value of pension benefit plans due to declining interest rates in various countries (NLG 102 million), to cover the increased risk of non-collection of trade receivables following a major downturn in the Brazilian economy (NLG 88 million) and for other restructuring programs (NLG 148 million).

On January 26, 1999, Philips made a statement to the press, announcing pre-tax charges totaling approximately NLG 2.0 billion in the fourth quarter of 1998.
Taking into account some positive special gains, the net impact of all fourth-quarter charges on the 1998 income from operations came to NLG 1,824 million. Corrected for the gain on the sale of security investments and the lower effective tax rate in 1998 (11%), the net impact on income from continuing operations was NLG 1,568 million. In addition to these charges, income from operations in 1998 was adversely affected by the operational losses at PCC, together with declining profits at Components, which were only partly offset by performance improvements in the Lighting sector and at Origin.

In 1997, income from operations reached an all-time high of NLG 3,777 million (5.8% of sales) compared to NLG 929 million (1.6% of sales) in 1996. Income in 1996 had been affected by substantial restructuring charges of NLG 565 million compared to only NLG 105 million in 1997. Disregarding the impact of lower restructuring costs, the income improvement in 1997 over 1996 was primarily attributable to a strong volume increase, the favorable impact of exchange rates and the elimination of loss-making activities. The erosion of selling prices represented a negative factor that was only partly offset by lower purchase prices and other cost reductions.

At 6.5%, return on net assets (RONA) was significantly below last year's 16.4% (4.2% in 1996) and well short of the long-term RONA target of 24%. The principal reason for the decline was the decrease in income from operations as a percentage of sales, due in large part to the various charges this year. Excluding these charges the RONA would be 14.5%. The turnover rate

Income from operations
as a % of net operating capital (RONA)



of net operating capital (2.91) was slightly above that of 1997 (2.84).

Restructuring

The competitive environment in which Philips organizations operate requires rapid adjustments in organizational structure, product portfolio and customer orientation. In order to accelerate the process of reorganization, a major restructuring program was initiated in 1996 as a result of disappointing profitability and the need to make the organization more flexible to react adequately to changing market conditions. The program led to an ongoing process of restructuring and/or discontinuance of underperforming or non-core activities in 1996, which was continued in 1997 and 1998. Substantially all of the underperforming and non-strategic businesses identified during portfolio analysis have been either discontinued or sold. The main loss-making operations that have been restructured or eliminated over the past two years include Grundig, Philips Media (including Superclub's video rental business), the Data Communication activities and various activities of Industrial Electronics. Businesses that have also been sold include PolyGram, Philips Car Systems, Optoelectronics, a number of Components businesses (Magnetic Heads & Modules, Mechatronics, Photonique, Flat Shadow Masks, Rare Earth and Hard Ferrites), Consumer Electronics' retail and rental activities in Australia and sundry activities such as Philips' travel agency. Moreover, a preliminary agreement was signed on September 27, 1998, for the sale of the conventional Passive Components activities, which transaction was completed in January 1999. The resulting gain will also be recognized in 1999.

The Philips Group has also initiated various projects to improve the performance of its operations, including such measures as the closure of factories, the (partial) shift of production facilities to low-wage areas, the consolidation of production centers and the realignment of sales organizations.

Two areas of particularly serious concern in 1998 were the disappointing performance of the liquid crystal display joint venture Hosiden and Philips Display Corporation (HAPD) and the joint venture with Lucent Technologies – PCC. HAPD was established in April 1997 as a 50/50 joint venture with Hosiden, and in April 1998 Philips increased its shareholding to 80% due to the expected strategic importance of the AM-LCD technology. In view of the continuing losses incurred by this business, it has been decided to restructure large parts of this operation. This resulted in a substantial restructuring charge of NLG 103 million against income from operations in the fourth quarter of 1998.

The PCC joint venture with Lucent Technologies was established on October 1, 1997. Despite ambitious plans for break-even results in the second half of 1998, PCC continued to incur substantial losses due to delays in product introductions of cellular phones, quality problems and product returns. In October 1998, Philips and Lucent agreed to end the joint venture (effective September 27). In connection with the dissolution, Philips received the assets it originally contributed to the joint venture. Subsequently, Philips recognized a restructuring charge of NLG 475 million in the fourth quarter of 1998, including write-offs of inventory totaling NLG 264

million for activities terminated. Further costs relating to the unwinding of the joint venture amounted to NLG 351 million. Ambitions for the short term have been scaled back, the product offering has been streamlined and cost reduction is under way in order to achieve profitability.
The Company believes that the consumer communications business is of strategic importance to its Consumer Electronics business because of the synergy effects and natural spin-off to our 'home and away' product areas and the capabilities for our future digital products and home networks.
Furthermore, consumer communications is a rapidly growing market in which the Company believes it has the brand, the skill and the technologies to be a successful player.

As part of the ongoing process of realigning Philips to the anticipated economic environment and in order to enhance efficiency and profitability, the Company has developed plans for a further reduction of the number of manufacturing units over the next four years. This should create a more cost-efficient organization through the sharing of infrastructure and economies of scale. By integrating manufacturing facilities in larger units, closing a number of factories, and outsourcing a portion of its production, Philips envisions a reduction of about one-third of its manufacturing units by the year 2002. The ultimate number will depend on how markets develop over that period. The Company is in the early stage of evaluating the financial consequences of these plans. Any related costs will be expensed in future periods as Philips commits itself to detailed plans.
The total restructuring charges recorded against income from operations in 1998 totaled NLG 726 million, principally for the sectors Consumer Products and Components. In 1997, these charges totaled NLG 105 million, including the release of a provision no longer required.
In addition to the NLG 565 million restructuring charge to income from operations in 1996, an extraordinary charge of NLG 1,226 million was recognized, of which NLG 800 million related to the structural realignment of the former Sound & Vision division.

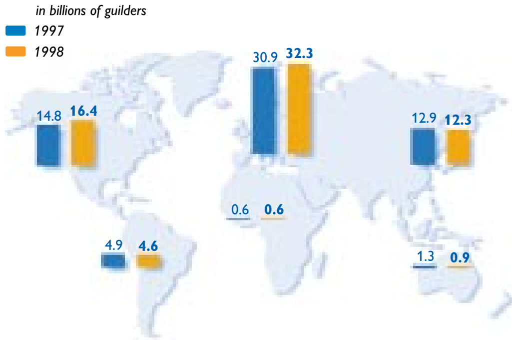
The costs of the organization in 1998 were 8% higher than in 1997. The relative increase is attributable, in part, to the substantial investments the Company has made in certain strategic areas. In 1998, the Company announced that it would invest an additional NLG 1 billion in brand management and information technology. Various brand management initiatives, including the establishment of Customer Care Centers throughout the world and a Marketing Competence Center, have taken off. Additionally, a major global brand image campaign that will continue into 1999 was launched in the fourth quarter. In the area of IT, the Company has begun upgrading its communications infrastructure to facilitate global communication. Additionally, significant investments have been made in systems in order to address the challenges presented by the euro and Millennium issues.

Employee costs showed a relative decrease of 1% compared to 1997, reflecting the relocation of production facilities to low-wage countries.

Geographically, sales growth in 1998 showed a divergent pattern. In Europe, sales growth increased, but decreased slightly in North America, while growth in Asia was positive but at a substantially lower level than in the previous year. The negative sales trend in Latin America that began in 1997 continued in 1998.

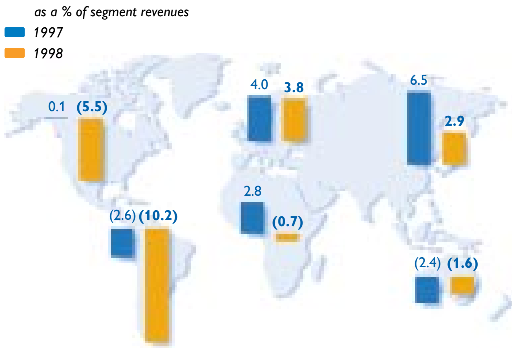
In Europe, all sectors contributed to the comparable sales growth of 10%. The largest increases came from Consumer Products (particularly Consumer Electronics), Origin, Components and Semiconductors. Within Europe, sales growth was principally attributable to the Netherlands, Italy, the United Kingdom and Eastern Europe. The 6% sales increase in the USA and Canada was largely attributable to Consumer Products, while the Professional sector also contributed, particularly Medical Systems.
The decline in sales in Latin America (6%) related solely to Brazil, where sales slumped by 14%. The remainder of the region, particularly Mexico, saw continued growth.
All sectors realized positive growth rates in Asia (overall growth 4% in 1998, following 12% in the previous year), with the largest increases at Consumer Electronics and Semiconductors. By contrast, sales were significantly lower at Domestic Appliances and Personal Care, principally due to the market collapse in the five countries most affected by the financial crisis in Asia: Malaysia, Thailand, Indonesia, South Korea and the Philippines. The countries that made the strongest contribution to the region's sales increase were China, Taiwan and India.
With the exception of Europe, all regions recorded lower operating income. In Europe, notably in Germany, Austria, Belgium, UK and France, income exceeded 1997 levels, with the main contributions from Semiconductors, Lighting and Components. North America was significantly affected by the PCC losses. In Asia, income was lower due to Consumer Products (PCC and other CE) as well as lower results from Components (Display Components and HAPD losses, including a substantial restructuring charge) and Semiconductors. The reduction in income in Latin America, relating entirely to Brazil, was attributable to Consumer Electronics and Components.

Sales per geographic area



The net cost of finance in 1998 amounted to NLG 686 million, which was down from last year's NLG 703 million and considerably less than the NLG 890 million in 1996. In 1998, the net cost included non-recurring gains totaling NLG 87 million from the sale of equity investments, principally in Flextronics, which were lower than

Income from operations per geographic area



the non-recurring gains in 1997 of NLG 158 million, mainly related to Viacom Inc. and Fluke Corporation. Net interest expense decreased by NLG 212 million in 1998, mainly reflecting the lower average debt position, which declined from NLG 12.7 billion in 1997 to NLG 9.0 billion in 1998. In 1998, exchange differences resulted in a loss of NLG 87 million, to a large extent related to increased hedging expenses in emerging markets. Furthermore, some losses were incurred in Eastern Europe, where hard-currency loans were used to finance the US dollar and euro-denominated export-oriented activities. The 1997 gain on exchange differences of NLG 27 million was principally due to the gain on US dollar deposits held in Taiwan, partially offsetting losses in South-East Asia.

Income tax charges totaled NLG 91 million in 1998, compared to NLG 607 million in 1997 and an income tax benefit of NLG 15 million in 1996. This corresponds to an effective tax rate in 1998 of 11%, down from 20% in 1997, and negative 40% in 1996. The decrease in the effective tax rate in 1998 resulted from the utilization of operating loss carryforwards in various countries, mainly in Europe, and releases of valuation allowances. These positive effects were only partly offset by unrecognized losses and by the incidental write-off related to ATL, which are not tax-deductible.

Results relating to unconsolidated companies in 1998 totaled NLG 86 million, compared with NLG 206 million in the year 1997.
The principal businesses, Taiwan Semiconductor Manufacturing Co. (TSMC) and ASM Lithography, generated significantly lower income than in 1997 due to the global slump in the semiconductor industry and the crisis in Asia. This was partially offset by lower losses at Navigation Technologies Corporation (NavTech). Income in 1997 of NLG 206 million was below the NLG 320 million in 1996 due to TSMC's lower income and substantial losses at NavTech. Additionally, the 1997 figure included the Company's share in the Grundig losses through June 30 and the HAPD losses from April 1. These were only partly offset by incidental gains from the sale of business interests such as the 25% shareholding in Bang & Olufsen.

The share of other group equity in group income totaled a positive NLG 374 million in 1998, compared with NLG 39 million in 1997 and NLG 96 million negative in 1996. The positive figure in 1998 is accounted for by third parties sharing in the substantial losses incurred by the PCC and HAPD joint ventures. As such, the minority interest in the losses partially offset the operating losses included in income from operations.

Compared to 1996, the reduction in third-party minority interests in 1997 group income was due to the settlement in relation to Grundig involving the discontinuance of dividend payments and other obligations.

Net income

Income from continuing operations was NLG 1,192 million in 1998, or NLG 3.31 per common share, compared to NLG 2,712 million, or NLG 7.76 per common share, in 1997 and NLG 278 million, or NLG 0.81 per common share, in 1996.

Income from discontinued operations represents Philips' 75% share in the operations of PolyGram N.V. through December 10, 1998, and amounted to NLG 462 million in 1998, NLG 579 million in 1997 and NLG 445 million in 1996.

Philips sold its shares in PolyGram to The Seagram Company Ltd. on December 10, 1998, and in connection with this sale recognized a gain of NLG 10,675 million, free of taxes.

Extraordinary items in 1998 totaled a net gain of NLG 1,010 million, compared to a NLG 2,442 million gain in 1997. Major items were Car Systems at a net gain of NLG 836 million and Optoelectronics at a net gain of NLG 171 million. Several smaller items were also included, such as provisions for the costs relating to early repayment of debt.

The 1997 gain was principally attributable to the sale of part of Philips' shareholding in TSMC (net gain NLG 1,979 million), the sale of the 50% shareholding in United & Philips Communications, the sale of a third tranche of the Company's shares in ASM Lithography and various other divestments. These gains were partially offset by the final settlement relating to Grundig, which resulted in a significant extraordinary loss.

Included in 1996 was an extraordinary loss of NLG 1,313 million, primarily attributable to the Grundig losses, the structural realignment of the former Sound & Vision division and the restructuring and discontinuance of various businesses. These were partly offset by gains from the sale of the second tranche of ASM Lithography shares.

Net income in 1998 – including PolyGram – reached an all-time high of NLG 13,339 million (NLG 37.05 per common share), compared to the previous record of NLG 5,733 million (NLG 16.41 per common share) in 1997. The Company incurred a net loss of NLG 590 million (NLG 1.73 per common share) in 1996.

US GAAP

The Group financial statements have been prepared in accordance with Dutch GAAP, which differs in certain respects from US GAAP. Net income determined in accordance with US GAAP would result in a profit of NLG 13,090 million in 1998, compared with NLG 5,881 million in 1997 and a loss of NLG 866 million in 1996. These aggregate amounts correspond to basic earnings per common share of NLG 36.36 in 1998, NLG 16.83 in 1997 and a loss of NLG 2.53 per common share in 1996.

The difference between income in accordance with Dutch GAAP versus US GAAP arises from, among other things, amortization of goodwill for acquisitions prior to 1992 and pension accounting.

Certain losses relating to higher accumulated benefit obligations compared to the market value of the plan assets or the existing level of pension provisions were reported as a charge to income under Dutch GAAP totaling NLG 74 million in 1998 (1997: NLG 139 million), whereas under US GAAP these amounts have been capitalized as an intangible asset or included in comprehensive income.

Part of the restructuring charge in 1998, NLG 51 million, failed to meet the US GAAP requirements, because the restructuring had not

been publicly announced in sufficient detail before the balance sheet date, and as a consequence has to be recorded in the 1999 income statement.
For US GAAP purposes a major restructuring provision for Grundig was recognized in 1996 whereas under Dutch GAAP it had been taken in 1995; 1996 financials also included the reversal of the put option liability to outside shareholders of Grundig which under US GAAP had been recognized in 1995.
Furthermore, in 1997 the US GAAP adjustments included the NLG 127 million gain on the sale of a 50% shareholding in UPC that under Dutch GAAP had already been recognized in 1995.

Reference is made to note 25 to the consolidated financial statements for a description of the primary differences between Dutch and US GAAP and the earnings per share information.

Dividend

A proposal will be submitted to the General Meeting of Shareholders to declare a dividend of NLG 2.20 per common share (compared with a dividend to shareholders of NLG 2.00 per common share for 1997). The consolidated financial statements presuppose the adoption of this proposal, which will result in a total dividend payment of NLG 794 million (compared with NLG 716 million for 1997).

Share reduction program

As part of the share reduction program and apart from the dividend proposal, a proposal will be submitted to the General Meeting of Shareholders to reduce the nominal share capital by distributing a cash amount of NLG 9.07 per common share to all Philips shareholders. This program will be combined with the redenomination of the share capital in the euro, whereby each common share will have a par value of 1 euro. The transaction is expected to be effected mid-1999.

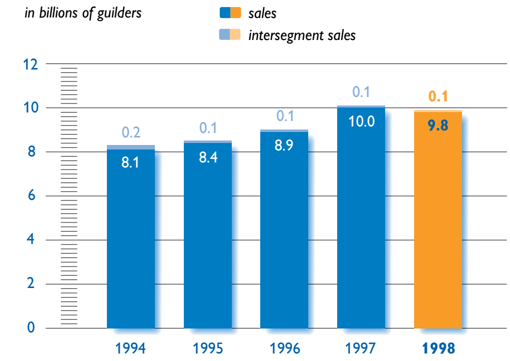
Segment sales and income from operations

In order to comply with the additional segment reporting requirements outlined in SFAS No. 131 ‘Disclosures about Segments of an Enterprise and Related Information’, issued by the Financial Accounting Standards Board of the USA in June 1997, the Board of Management has adjusted the Company’s external segmentation as of January 1, 1998. For the sake of comparability, the segment information for 1997 and 1996 has been restated.

The following segments are reported separately: Lighting, Consumer Products, Components, Semiconductors, Professional, Origin, Miscellaneous and Unallocated. For a comprehensive business description of the various Product Divisions, refer to the relevant section in the consolidated financial statements (note 26).

In order to facilitate a unified marketing approach for all consumer products and to pave the way for the implementation of an integrated strategy for high-volume electronics, the former divisions Sound & Vision, Business Electronics and Industrial Electronics have been regrouped as of January 1, 1998. The PC Peripherals activities of Business Electronics, Philips Consumer Communications and Sound & Vision now form a new division called Philips Consumer Electronics. The ‘new’ Business Electronics

Lighting



division comprises its former professional businesses, plus the activities of the former Industrial Electronics division.

At year-end 1997, Philips signed an agreement with Mannesmann VDO of Germany to sell the Philips Car Systems business. For the sake of comparability, the 1997 and 1996 contributions of this division have been included in the Miscellaneous sector. Similar reclassifications to Miscellaneous were made in prior years for the Grundig and Philips Media activities that were sold and/or discontinued towards the end of 1996 and 1997, respectively.

Lighting

Sales in the Lighting sector in 1998 decreased to NLG 9.8 billion from NLG 10.0 billion in 1997, reflecting a nominal decrease of 2%. Adjusted for currency movements (a decrease of 3%), sales on a comparable basis were 1% higher, with volume growth of 4% being largely offset by price erosion of 3%. For the division as a whole, growth continued in Europe and in Asia, partly offset by minor decreases in North America and Latin America.

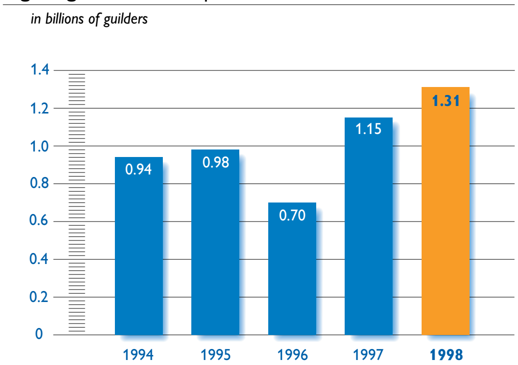
Income from operations in 1998 rose to NLG 1,311 million, or 13.2% of segment revenues, compared to NLG 1,151 million, or 11.3% of segment revenues, in 1997. Income benefited from cost savings associated with prior restructuring actions, purchasing efficiencies and an improved product mix. Income included a non-recurring gain of NLG 67 million from the sale of a factory building in Spain.

The nominal sales increase in 1997 over 1996 was 13%, with sales increasing to NLG 10.0 billion from NLG 8.9 billion. Changes in currency rates had a positive effect on sales of 8%, while changes in consolidations had a minor positive effect. Excluding these factors, sales growth on a comparable basis was 5%, comprising 8% volume growth that was partly offset by 3% price erosion.

Income from operations in 1997 improved to NLG 1,151 million, or 11.3% of segment revenues, up from 1996 income of NLG 702 million, or 7.8% of segment revenues.

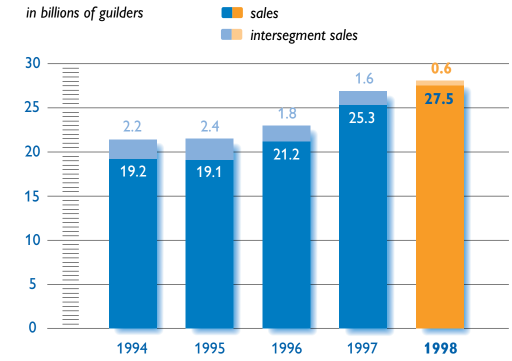
Income in 1997 benefited from cost savings associated with prior restructuring actions, ongoing development of Philips' manufacturing base in low-cost countries, better control of costs throughout the organization and an improved product mix. Currency movements also had a minor positive influence.

Lighting income from operations

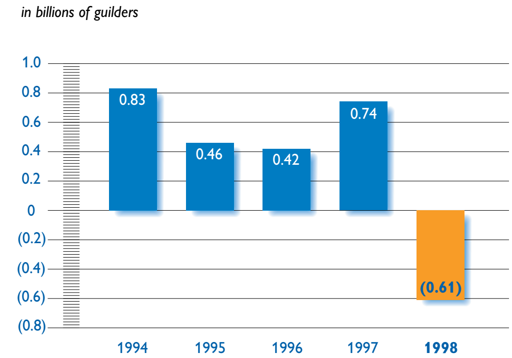


Consumer Products

Consumer Products



Consumer Products income from operations



Sales in this sector rose 9% to NLG 27.5 billion from NLG 25.3 billion in 1997. On a comparable basis the growth was 7%. Consolidation changes – notably the consolidation of Lucent Technologies' Consumer Products division as of October 1, 1997, through its subsequent dissolution effective September 27, 1998 – had a positive effect on sales of 3%, partly offset by the negative effect of lower currency exchange rates of almost 2%. Prices suffered a 13% decrease and volume increased by 20%.

Income from operations in the sector fell to a loss of NLG 613 million, or 2.2% of segment revenues, compared with a profit of NLG 738 million, or 2.7% of segment revenues, in 1997. The 1998 figure included the significant losses at the PCC joint venture of NLG 1,839 million, in part relating to various non-recurring charges of NLG 826 million in connection with the dissolution of the joint venture, part of which related to restructuring charges totaling NLG 475 million. In 1997, PCC incurred operating losses of NLG 602 million. Excluding the PCC losses, income in the sector was almost at the same level as in 1997, helped by a significant increase in license revenues and benefiting from restructuring programs carried out in prior years.

At NLG 25.3 billion, sales in 1997 were 19% higher than the 1996 sales of NLG 21.2 billion. However, adjusted for the favorable effects of higher currency exchange rates (8%) and consolidation changes (4%), comparable growth totaled 7%. Lower prices had a negative impact of 10%, whereas sales volume had a positive effect of 17%.

Income from operations in the sector rose to NLG 738 million, or 2.7% of segment revenues, in 1997, up from NLG 421 million, or 1.8% of segment revenues, in 1996. The improvement was primarily attributable to higher income for Domestic Appliances and Personal Care, higher license revenues and the fact that 1996 income had been affected by a restructuring charge of NLG 48 million (in addition to the NLG 800 million restructuring provisions charged to extraordinary income in 1996).

Consumer Electronics

Sales on a comparable basis increased by 9%. Steep volume growth of 24% was partly offset by price erosion of 16%, which was particularly strong in peripherals (monitors), video products and communications (telephony). Sales in Video increased strongly in spite of decreased markets, particularly in Western Europe and North

America. Most of the increase was attributable to TV and TV/VCR combinations. The sales growth in Audio was primarily from CD-Recordable and Portable Audio products and was substantially in excess of the declining markets. Booming sales in Digital Video (e.g. DVD and Internet TV) contributed strongly to the division's growth. Despite the pressure on worldwide PC markets and increasing price erosion, sales in PC Peripherals (Monitors, Add-on Cards etc.) maintained substantial growth. The strong sales increase in Communication products occurred primarily in GSM mobile phones in Europe, Asia and Latin America. Market shares increased in all business segments (Wireless and Wired).

Income from operations showed a loss, primarily due to the PCC losses, compared with a profit in 1997. In addition to the non-recurring and restructuring charges, the losses were caused by delays in the introduction of new products, among many other factors. The investment in a restructuring program is designed to streamline the product offering and to reduce costs in order to achieve profitability for the remaining business, which will focus on core strengths in GSM technology, corded and cordless phones. Most of the other consumer electronics businesses reported a profitable performance in 1998, but at a lower level than in 1997, partly due to the impact of the difficult economic situation in Brazil. Higher start-up costs for new activities, development costs, and continuing price erosion – especially in Monitors – further contributed to the decline in income.

Sales in 1997 grew by 21%. Disregarding the positive effects of consolidation changes (5%) – notably the start-up of the PCC joint venture from October 1, 1997 – and currency changes (8%), the growth was 8% on a comparable basis. This comprised 12% lower prices and 20% higher volume.

Income from operations in 1997 showed a higher loss, primarily attributable to the PCC joint venture, whose losses related to the development and introduction of new products, delayed product launches affecting operating margins and substantial costs for the integration and ramping-up of a global organization. Disregarding PCC, income from operations in this division rose sharply in 1997, benefiting strongly from prior-year restructuring actions designed to streamline business processes and reduce costs. The streamlining process and savings on purchases from other parties led to improved productivity, which – in combination with outsourcing – led to a significant reduction in the workforce.

Domestic Appliances and Personal Care

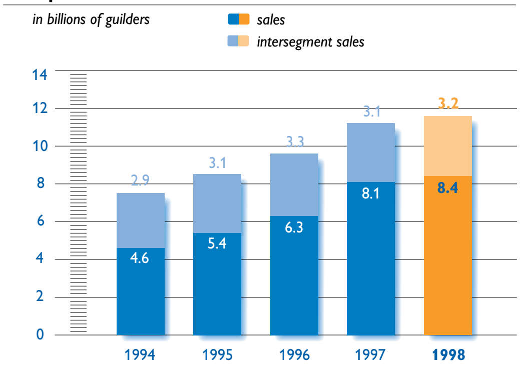
Sales in 1998 decreased slightly compared with 1997, mainly in connection with sharply decreasing markets in Asia, Latin America and Eastern Europe. Overall sales growth in Western Europe and North America was maintained at a high level. From a business perspective, sustained strong growth was achieved in Personal Care products, with Cool Skin shavers contributing strongly. In the Domestic Appliances and Cooking & Comfort businesses, sales ended lower than in 1997 due to higher exposure to the regions affected by the economic slowdown.

Income from operations in 1998 was lower – following last year's steep increase – and reflects the lagging sales development. In addition, costs increased partly because of restructuring charges and higher expenses for advertising and promotion relating to new product introductions. Restructuring involved the relocation of various industrial facilities. In spite of unfavorable market conditions, Personal Care maintained its strong income level, while Cooking & Comfort recorded good results, especially in Irons. Restructuring charges affected income in Domestic Appliances, which was further affected by its high exposure to the regions where markets have decreased.

Nominal sales growth in 1997 was 10%. However, excluding currency impacts, sales grew 3% on a comparable basis, primarily driven by 4% higher volume.

Income from operations in 1997 rose steeply, continuing a rise that started in the year before. The 1997 results reflected the strong performance of the Reflex Action shaver and successful introductions of new products, as well as the effect of the discontinuance of the loss-making Regina vacuum cleaner business in the USA.

Components



Components

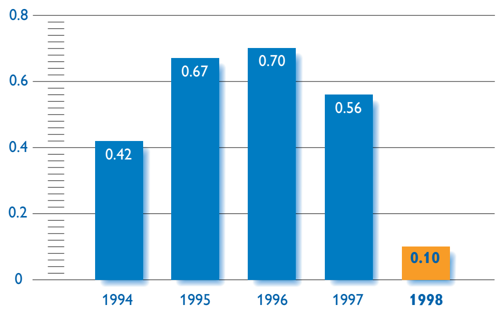
Sales in 1998 grew by 4% to NLG 8.4 billion from NLG 8.1 billion in 1997. Consolidation changes – principally HAPD, which was consolidated from April 1 upon acquisition of an additional 30% shareholding – had a net positive effect on sales of 1%, while currency changes had a negative effect of 2%. Comparable sales growth came to 5% and was in excess of the market, which fell by 9%. Substantial volume growth of 21% was partly offset by strong price erosion of 16%, principally relating to Color Monitor Tubes, due to excess capacity in the industry, and Optical Storage. Nearly all businesses contributed to the division's growth, predominantly Optical Storage, General System Components and Flat Display Systems (particularly LCD displays). The largest increase was in Europe; Asia also recorded positive growth in spite of the economic crisis, while North America was slightly down, and sales in Brazil were significantly lower, due to worsening economic conditions.

Income from operations in 1998 totaled NLG 98 million, or 0.8% of segment revenues, compared to NLG 562 million, or 5.0% of segment revenues, in 1997. The decline in income is partly due to the NLG 223 million losses of HAPD, of which NLG 103 million was charged to income for the planned restructuring in Japan, in order to bring forward the point in time when this strategic business in active matrix LCDs starts contributing to income. Significant price erosion in Display Components (monitors), Optical Storage and Passive Components accounted for a further decrease in results, in spite of being partly offset by higher results in General System Components and Magnetic Products.

In 1997, sales in this sector increased to NLG 8.1 billion from NLG 6.3 billion in 1996, a

Components income from operations

in billions of guilders



27% nominal increase. Adjusted for consolidation changes (12%, principally Hua Fei Colour Display Systems – China) and exchange rate fluctuations (10%), comparable sales growth was 5%, which was in line with the market. Significant price erosion (14%) was more than offset by the 19% volume increase.
Income from operations in 1997 fell to NLG 562 million, or 5.0% of segment revenues, from NLG 696 million, or 7.3% of segment revenues, in 1996. This was substantially due to a non-recurring charge to 1997 income in connection with the discontinuance of some business operations in Eastern Europe.

Semiconductors

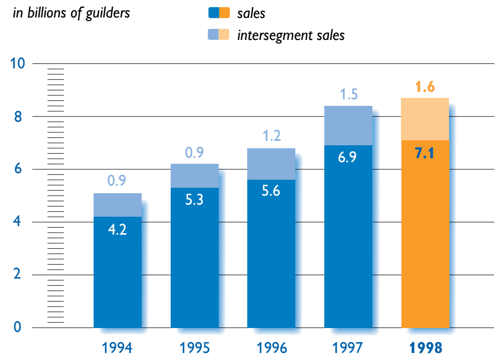
Sales in 1998 were NLG 7.1 billion, 2% up from NLG 6.9 billion in 1997. Adjusted for currency changes (decrease of 3%), the comparable sales growth was 5%. Volume growth was 15%, more than offsetting price erosion of 10%. The strongest contribution to the division's growth came from Consumer Systems and Telecom ICs. The regions that accounted for the increase were Europe and Asia. The division's sales growth was clearly in excess of that of the total semiconductor market, which decreased as a consequence of gloomy PC markets and deteriorating economic conditions in Asia. In the provisional Dataquest ranking, Philips Semiconductors climbed from ninth position to eighth.

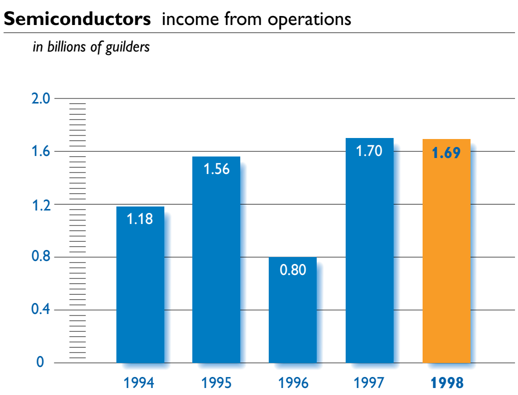
Income from operations of NLG 1,687 million, or 19.3% of segment revenues, was almost level with last year's NLG 1,700 million, or 20.3% of segment revenues. This achievement is mainly attributable to product, manufacturing and investing policies that have been pursued in an industry that as a whole has been sharply affected by the Asian crisis and by overcapacity. Weakening of the market led to lower capacity utilization in the second half of the year and increased price erosion.

In 1997 sales of NLG 6.9 billion were 24% higher than the previous year's NLG 5.6 billion. On a comparable basis, mainly adjusted for the 9% positive currency effect, growth was 14%. Price erosion in 1997 was relatively high at 10% – up from 8% in 1996 – but this was more than offset by 24% growth in terms of volume compared with 9% in 1996.
Nevertheless, income from operations more than doubled compared to 1996 due to higher levels of activity, which led to much-improved factory utilization and to positive currency effects,

Semiconductors

in billions of guilders





especially from the US dollar. Income was affected both in 1997 and 1996 by costs relating to the start-up of the MOS-4 submicron facility in Nijmegen, the Netherlands.

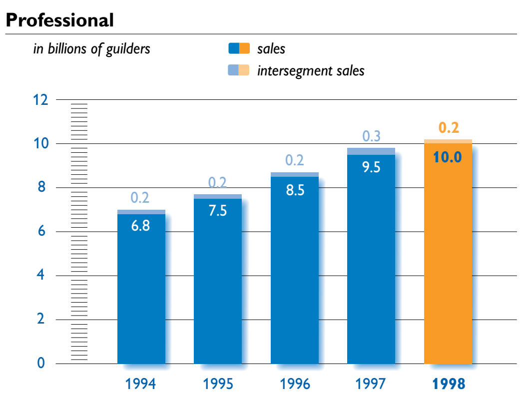
Professional

Sales in the Professional sector totaled NLG 10.0 billion in 1998, a 5% nominal increase over sales of NLG 9.5 billion in 1997. Adjusted for the impact of consolidation changes (down 1%, the net effect of the sale of the radiotherapy business in 1997 partially offset by the ATL Ultrasound acquisition in 1998) and the negative influence of exchange rate fluctuations (down 1%), comparable sales growth amounted to 7%. Sales volumes were up 12%, more than offsetting the impact of price erosion of 4%. Both Medical Systems and Business Electronics contributed to the sector's growth by 6% and 9%, respectively.

Income from operations in 1998 was a loss of NLG 122 million, or 1.2% of segment revenues, compared with income of NLG 456 million, or 4.6% of segment revenues, in 1997. Disregarding the NLG 557 million non-recurring charges for in-process R&D, goodwill amortization relating to the new consolidations of ATL Ultrasound and Active Impulse Systems, and other charges to align ATL to Philips' accounting policies, income for the sector totaled NLG 435 million. The remaining decrease from 1997 was attributable to the lower sales in some of the businesses of Business Electronics, which required additional restructuring charges of NLG 49 million and other non-recurring charges in 1998. However, despite higher one-time costs of the organization, Medical Systems' income was positively affected by the additional contribution from the ATL Ultrasound operations.

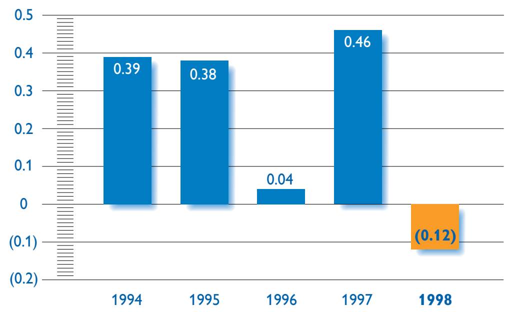
In 1997, this sector generated sales of NLG 9.5 billion, compared to NLG 8.5 billion in 1996, a nominal increase of 12%. Excluding consolidation changes (8% negative) and changes in currency exchange rates (9% positive), sales on a comparable basis increased by 11%, consisting of 5% growth in Medical Systems and 16% in Business Electronics. In terms of volume, sales rose 14%, while the average price level was 3% lower than in 1996.

Income from operations was NLG 456 million, or 4.6% of segment revenues, in 1997, up from NLG 40 million, or 0.5% of segment revenues, in 1996. Income benefited primarily from the turnaround in income of the Business Electronics activities.



Professional income from operations

in billions of guilders



Medical Systems

In 1998, Medical Systems recorded 6% comparable sales growth. Excluding ATL, the business grew virtually in line with the development of the market. The remaining growth was due to the acquisition of ATL. Volume increased by 10%, which was partly offset by price erosion of 4%. The regions North America and Eastern Europe, in particular, contributed to this increase, while Western Europe recorded limited growth. The businesses which contributed most were Ultrasound – through the acquisition of ATL –, Universal, Cardio/Vascular and Customer Support.

Income from operations showed a loss in 1998. Excluding ATL write-off, income increased by 10%. The acquisition of ATL resulted in a fourth-quarter charge of NLG 401 million for the write-off of in-process R&D obtained in this strategic acquisition. Disregarding this charge and certain other charges totaling NLG 112 million in connection with ATL, income benefited from the contribution of ATL's normal operations from the time of acquisition.

The 1997 sales increased by 5% on a comparable basis in line with the development of the market, consisting of 9% volume growth and 4% price erosion.

In-process R&D

As of the acquisition date there were three main products in development. Specific projects under development in different technology areas are those related to, among other things, scanheads, image acquisition, signal and image processing, 3-dimensional techniques and contrast agents. All of these projects have specific goals in areas such as breakthrough technologies, cost reduction and efficiency, and application-oriented developments. The outcome of these projects will strengthen Medical Systems' offerings in the cardiology area and in general imaging, while ultimately core functionality for the next-generation platform will become available. The products in which these new developments are to be used will be ready between 1999 and 2002.

The acquired in-process R&D consists of ATL's work to date on the projects described above. This work is very specific to the tasks and markets for which it is intended. There are no alternative uses for the in-process work in the event that the proposed products do not prove feasible and none of the future products involved have demonstrated their technological or commercial feasibility as of the valuation date. Significant risks exist because it is uncertain what obstacles will be encountered in the form of time and cost necessary to produce technologically feasible products. It is unlikely that the Company will be able to realize any value from the sale of this technology to another party. Furthermore, it is reasonable to assume that the projects would require significant amounts of time and research and development to complete the product.

An income approach was used in valuing the acquired in-process R&D, which reflects the present value of the operating cash flows generated by the in-process R&D taking into account the costs to complete the projects, the relative risks of the projects, the contribution of other assets and an appropriate discount rate to reflect the time value of invested capital.

Income from operations in 1997 was flat compared to 1996 because of the impact of non-recurring charges in 1997. Disregarding these items, income benefited mainly from efficiency improvements and stronger currencies, which outweighed the effects of price erosion and higher cost levels.

Business Electronics

Sales growth on a comparable basis was 9% in 1998. The growth was mainly attributable to Digital Videocommunication Systems (DVS), Projects and Electronic Manufacturing Technology. Latin America and Europe contributed the larger part of the increase. The decrease in the Asia Pacific region is related to the completion of the Telstra project in Australia, which more than offset the significant increase in Asia as a whole. Sales in North America were virtually flat.

Income from operations was a loss in 1998 compared with a profit in 1997. The loss primarily arose due to the write-off of in-process R&D of NLG 44 million related to the acquisition of AIS-USA and to charges for the restructuring of DVS/BTS-USA and FEI-USA. Positive income developments arose in Electronic Manufacturing Technology, Fax equipment and DVS-Digital Receivers.

In 1997, sales growth was 16% on a comparable basis as adjusted for consolidation changes (7% negative) and currency changes (10% positive), thus outpacing the market in a number of businesses.

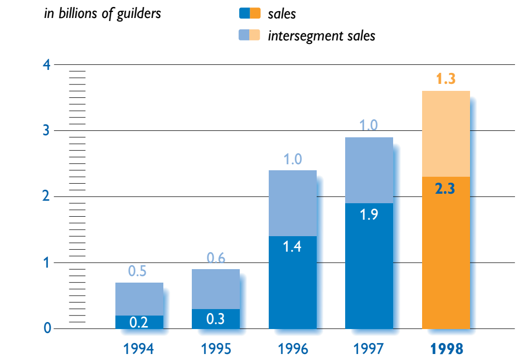
Income from operations saw a major turnaround to a profit in 1997, from a significant loss in 1996. This reflects the benefits of restructuring processes, volume increases and tight cost control in the businesses.

Origin

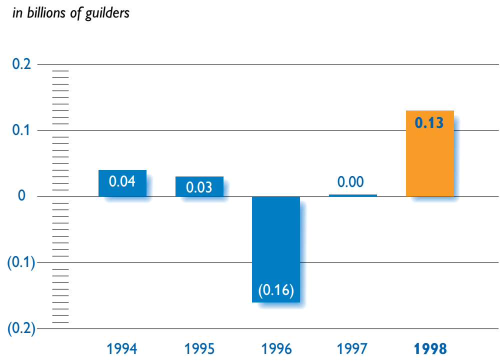
Origin's 1998 sales increased to NLG 2.3 billion from NLG 1.9 billion in 1997, a nominal increase of 25%. Exchange rate differences had a positive effect of 1%, resulting in comparable sales growth of 24%. This was primarily due to Enterprise Solutions and partly to Millennium-related services. Sales growth was mainly achieved in Europe, particularly in the Netherlands, the United Kingdom, Germany and France.

Income from operations rose to NLG 130 million, or 3.6% of segment revenues, which reflected a major turnaround from last year's break-even situation. This was primarily attributable to the strong sales growth and the focus on improving operational efficiency throughout the organization.

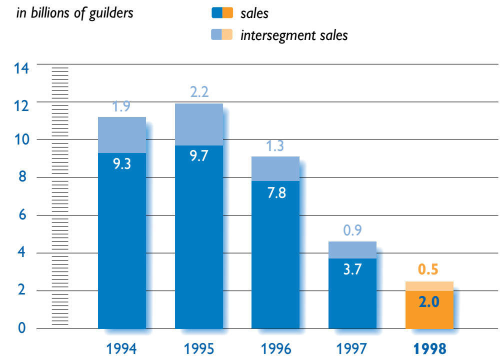
Origin



Origin income from operations



Miscellaneous



Sales in 1997 were NLG 1.9 billion, an increase of 30% in nominal terms. Excluding favorable currency effects (9%), the growth was 21% on a comparable basis following the start-up year of 1996.

Income from operations was zero in 1997 compared to a substantial loss of NLG 160 million in 1996, which included restructuring charges of NLG 96 million mainly relating to the merger of Philips C&P with BSO/Origin. Origin's loss-making screenphone business was discontinued in 1997 and the related costs were recorded as an extraordinary loss.

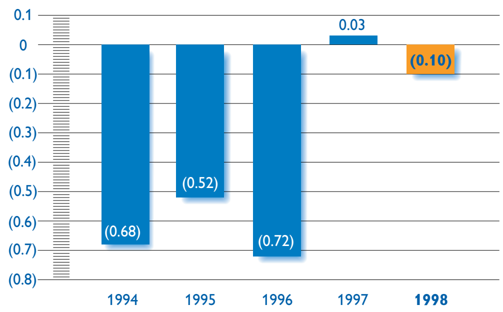
Miscellaneous

The businesses grouped in this sector recorded sales of NLG 2.0 billion in 1998, which was 45% below the NLG 3.7 billion sales in the preceding year. Changes in consolidation – principally Philips Car Systems – resulted in a decrease of 46%. On a comparable basis, sales growth was 6%, which was predominantly caused by growth in Philips Machinefabrieken and PMF, offsetting decreases in various other activities.

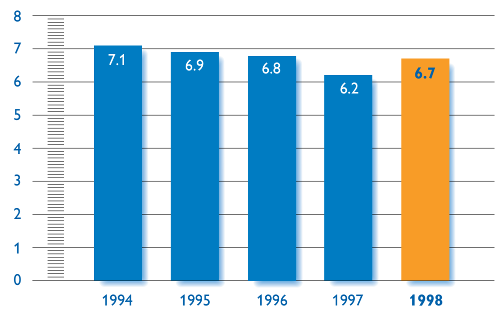
Income from operations fell to a loss of NLG 102 million, or 4.1% of segment revenues, from a profit of NLG 30 million, or 0.6% of segment revenues, in 1997. This was primarily due to the fact that activities divested in previous years, such as Philips Car Systems and some Communication Systems activities, no longer contributed to income in 1998. In addition, certain activities experienced lower profitability, principally Machinefabrieken (as a result of the downturn in the semiconductor industry) and Hearing Instruments. Philips' Plastics and Metalware Factories on the other hand maintained income performance at 1997's level. Research activities increased in 1998. A reduction in operating losses occurred as a result of a higher activity level of internal contract research and lower organization costs due to lower staffing levels.

Sales in 1997 amounted to NLG 3.7 billion, down 52% from the year-earlier sales of NLG 7.8 billion. This was substantially due to consolidation changes, including Grundig and Philips Media (both divested), ASM Lithography (deconsolidated March 31, 1996) and the former Communication Systems and Superclub activities (both phased out). Disregarding the consolidation changes (negative impact 67%) and currency influences (8%), sales growth on a comparable basis was 6%, attributable to a 10% volume increase that was partly offset by more than 4% lower prices.

Miscellaneous income from operations
in billions of guilders



Research and development expenditures
as a % of sales



Income from operations in 1997 totaled NLG 30 million, or 0.6% of segment revenues, compared to a loss of NLG 722 million, or 8.0% of segment revenues, in 1996. The turnaround was largely attributable to the divestiture and phasing-out of various unprofitable businesses such as Grundig, Philips Media and Superclub.

Research and Development

Management believes that continuous efforts to sustain the strong performance in the field of R&D are of the utmost importance to Philips in order to preserve and strengthen the competitive position the Company now holds in its various markets. Through substantial investments in R&D, Philips has created a huge knowledge base. Each year, new technological breakthroughs are added to Philips' long list of research successes. Recent advances applied in consumer products include Natural Motion, a system that eliminates judder from television and film pictures and is applied in high-end TV sets and video-conferencing systems, and Incredible Surround sound and UltraBass, two innovations in digital signal processing that have enhanced the perception of sound. Our speech recognition technology is to be found in a growing number of products in both the business and consumer sectors.

R&D spending in 1998 was NLG 4,513 million, compared to NLG 4,057 million in 1997 and NLG 4,050 million in 1996. R&D spending in 1998 equates to 6.7% of Group sales (or 7.0% of sales excluding Origin, which does not engage in R&D) compared with 6.2% in 1997 and 6.8% in 1996.

Expenditures on R&D are included in direct cost of sales and reported in the Miscellaneous product sector.

Intellectual property management

An indicator of Philips' innovative activity is its significant portfolio of intellectual property rights, a key asset that is managed to enhance the competitive position of the various Philips businesses. In a business environment that is becoming increasingly knowledge-driven, it is Philips' policy to protect and develop its intellectual property. Corporate Patents and Trademarks is responsible for the creation of a balanced portfolio that will give Philips maximum freedom in its commercial activities. It also provides support in respect of standard-setting and license revenues. The control of the size and composition of the Philips patent portfolio is proactive and intended to meet the needs of the various businesses.

In 1998, Philips filed 1,300 new patent applications and more than 1,000 worldwide patent families based on new patent filings made in 1997. In today's marketplace, branding has become a crucial issue. Corporate Patents and Trademarks ensures that Philips is able to conduct commercial activities in all relevant countries under the Philips brand name and certain trademarks selected for individual products.

Cooperative business activities and unconsolidated companies

Since its founding, Philips has engaged from time to time in cooperative activities with other organizations. Philips' principal cooperative business activities and participations, and the main changes therein, are set out below.

Taiwan Semiconductor Manufacturing Company Limited (TSMC) is a semiconductor foundry operation in which Philips has 27.6% ownership. During 1998, Philips' interest was reduced by 0.6% due to dilution arising from incentive plans for TSMC management. Nevertheless, Philips remains the largest shareholder in TSMC. The global slump in the semiconductor business as well as the Asian crisis significantly affected TSMC's income performance in 1998, which fell by approximately 15%.

Philips, TSMC and EDB Investments have announced a new joint venture which plans to build a new USD 1.2 billion wafer fab plant in Singapore. Construction will start in 1999, and production is planned to start in 2000. Philips expects to have a 48% interest in this joint venture once it is formed and will be entitled to use 60% of production capacity.

ASM Lithography Holding N.V. (ASML), based in the Netherlands and ranking second in the world lithography market, develops, manufactures and markets waferstepper equipment for the semiconductor industry. As part of a long-standing relationship, Philips Research and Philips' Center for Manufacturing Technology perform contract work for ASML. Philips has agreed not to sell its 23.9% shareholding until after March 2000. Philips' share in 1998 income of ASML was affected by adverse developments in the semiconductor industry resulting in a drastic cut in investment levels in new equipment.

In the People's Republic of China, Philips currently has some 20 operational business alliances that engage in manufacturing and marketing activities. Generally, these companies are not wholly owned; most of them are consolidated and some are reported as unconsolidated companies. The total investments in China have exceeded USD 1 billion, and with approximately 17,000 employees in China and more than 5,000 in Hong Kong, Philips is one of the larger private employers in the region. Philips is active in a wide range of activities, but has particularly strengthened its position in consumer electronics, cellular phones and components, maintaining strong positions in shavers, CD, energy-saving lamps and semiconductors. All product divisions in China are profitable, and posted considerable sales growth in 1998.

Navigation Technologies Corporation (NavTech) of the USA is engaged in the development of software databases for digital maps to be used for car navigation purposes. In 1999, Philips has found a new business partner and sold part of its shares in NavTech: this is of considerable importance to the future development of NavTech. As a consequence, Philips' interest in NavTech has been reduced to a minority shareholding.

Cash flows

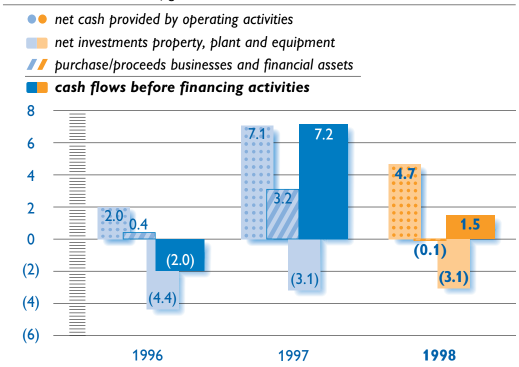
The dominant factor in this year's cash flow is the sale of Philips' 75% shareholding in PolyGram to The Seagram Company of Canada, which produced NLG 11.3 billion net cash proceeds. The total compensation from the sale of PolyGram was NLG 14.4 billion, of which NLG 3.1 billion in Seagram shares.

The 1998 cash flow before financing activities was NLG 1,540 million, compared with NLG 7,173 million in 1997 and a cash outflow of NLG 2,038 million in 1996.

Our objective of achieving a 'free' cash flow (cash flow minus the net proceeds from the sale and purchase of business interests and non-current financial assets) of more than NLG 1 billion was again achieved in 1998, when it totaled NLG 1,642 million. This compares to NLG 3,984 million in 1997 and a cash outflow of NLG 2,453 million in 1996.

The cash flow from operating activities totaled NLG 4,715 million, which is significantly less than last year's NLG 7,073 million (NLG 2,008 million in 1996). The primary causes of this reduction were the decline in income from operations and a decrease in cash generated by working capital to NLG 0.6 billion, compared to NLG 1.1 billion in 1997. The lower increase in accounts payable

Cash flow *in billions of guilders*



compared with last year was the main factor, with an additional effect of a higher increase in receivables. The reduced investment in inventories had an offsetting effect on total cash flow from working capital compared to 1997. Expressed as a percentage of sales, inventories fell to an all-time low of 14.0% in 1998, compared to 15.2% at year-end 1997 and 16.0% at the end of 1996. On a comparable basis, excluding currency effects and consolidation changes, the ratios are 14.8%, 15.3% and 16.7%, respectively.

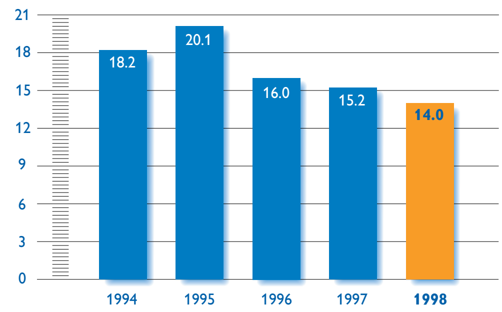
Outstanding trade receivables at the end of 1998 were the equivalent of 1.3 months' sales and remained unchanged from 1997 and 1996, respectively.

Investing activities required a net cash flow of NLG 3.2 billion, compared to a cash inflow of NLG 0.1 billion in 1997 and a cash requirement of NLG 4.0 billion in 1996. Capital expenditures of NLG 3.6 billion were level with the amount of NLG 3.6 billion in 1997, but substantially below the NLG 4.8 billion in 1996.

Cash required for the purchase of and investment in businesses amounted to NLG 1.9 billion. The acquisition of ATL Ultrasound and Active Impulse Systems required NLG 1.7 billion, and the additional debt funding of NavTech amounted to

Inventories

as a % of sales



NLG 0.2 billion. The sale of Philips Car Systems produced cash revenues of NLG 1.1 billion.

By comparison, the sale and acquisition of business interests in 1997 produced net cash totaling NLG 3.0 billion, which included the sale of a 5.4% shareholding in TSMC, an 11.5% shareholding in ASM Lithography, a 50% shareholding in United & Philips Communications, the Smart Card activities, a 25% shareholding in Bang & Olufsen and various Philips Media activities. Acquisitions included a 50% shareholding in HAPD Japan, an additional shareholding in Origin and debt funding of NavTech.
The net cash proceeds of NLG 0.3 billion in 1996 comprised the sale of ASML shares, parts of PKI Germany and TRT France, versus investments made in shares in La Radiotechnique and BSO/Origin.

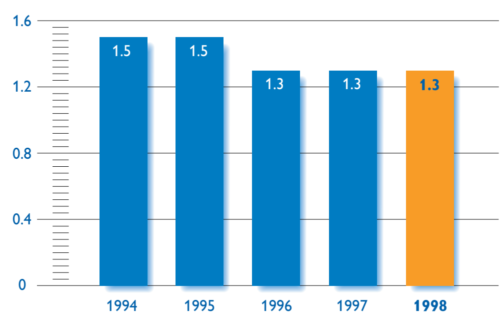
The cash flow before financing activities of NLG 1.5 billion was used to repay interest-bearing debt totaling NLG 1.0 billion and for the payment of dividends in 1998 amounting to NLG 719 million. Furthermore, NLG 345 million net cash was used for treasury stock transactions. In 1997, the larger part of the net cash inflow of NLG 7.2 billion was used to repay interest-bearing debt totaling NLG 5.0 billion, while the dividend payment in 1997 amounted to NLG 557 million. Additionally, NLG 251 million net cash was used for treasury stock transactions. In 1996, the net cash outflow of NLG 2.0 billion required NLG 2.2 billion additional borrowings.

Financing

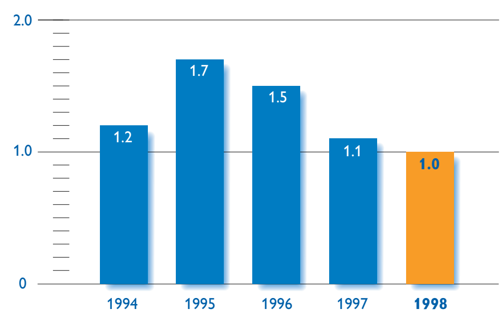
Total debt was NLG 7.9 billion at December 31, 1998, compared with NLG 8.9 billion at the end of 1997 and NLG 12.9 billion at the end of 1996. Following the sale of PolyGram, the Company had a net cash surplus at December 31, 1998, with cash exceeding total debt by NLG 6.5 billion. The net debt at the end of 1997 amounted to NLG 5.8 billion and NLG 11.2 billion the year before.

Outstanding trade receivables

in months' sales



Capital expenditures : depreciation



The current net cash situation renders the net debt to group equity ratio meaningless. That ratio was 22:78 at the end of 1997 and 43:57 at the end of 1996.

In 1998 long-term debt was reduced by NLG 1.0 billion, from NLG 7.1 billion to NLG 6.1 billion. The reduction was the result of net repayments totaling NLG 0.8 billion and currency and consolidation effects of NLG 0.2 billion. Philips has two 'putable' bonds outstanding for a total amount of NLG 548 million for which the investor may require prepayment at one specific month during the lifetime of the respective bonds. If we assume that investors require repayment at the relevant put dates, the average term of long-term debt was 6.4 years compared to 7.0 years in 1997. However, assuming that the 'putable' bonds will be repaid at final maturity dates, the average term at the end of 1998 was 8.3 years. Long-term debt in proportion to the total debt at the end of 1998 was 78% compared to 80% at the end of 1997.

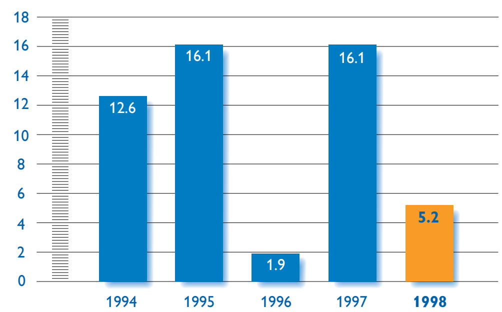
Short-term debt stood at NLG 1.8 billion at December 31, 1998, which was virtually unchanged from 1997 as a result of net repayments totaling NLG 0.2 billion offset by currency and consolidation effects of NLG 0.2 billion.

The cash position increased substantially in 1998 by NLG 11.3 billion from NLG 3.1 billion at the end of 1997 to NLG 14.4 billion at the end of 1998. This increase was the result of net cash receipts of NLG 11.3 billion and currency and consolidation effects of virtually nil.

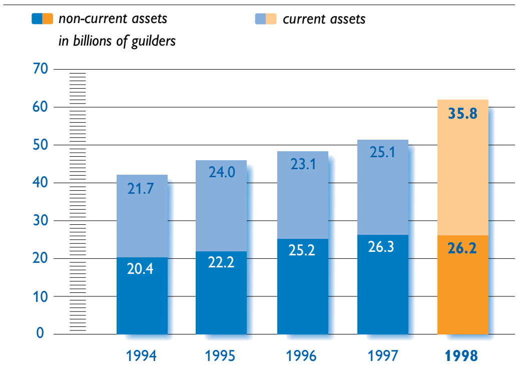
At the end of 1998, the Group had long-term committed and undrawn credit lines available to the value of USD 2.5 billion, unchanged from a year earlier.
The USD 2.5 billion committed credit line is a multi-currency revolving standby facility, which was signed in July 1996 and matures in July 2003.

Stockholders' equity rose to NLG 31.3 billion in 1998, up from NLG 19.5 billion at the end of 1997. The NLG 11.9 billion increase was largely due to 1998 net income of NLG 13.3 billion. Of the net income, an amount of NLG 794 million has been provisionally appropriated for a proposed distribution as a dividend to shareholders of NLG 2.20 per common share, subject to the approval of the Annual General Meeting of Shareholders.
The number of outstanding common shares of Koninklijke Philips Electronics N.V. ('Royal Philips Electronics') increased by 3.7 million to 368.5 million. This increase was the result of the exercise of the Superclub warrants and of convertible personnel debentures. As part of the financial restructuring of Superclub in 1992, warrants for common shares of Royal Philips Electronics were issued. These warrants expired in June 1998. During 1998, 3,636,861 warrants

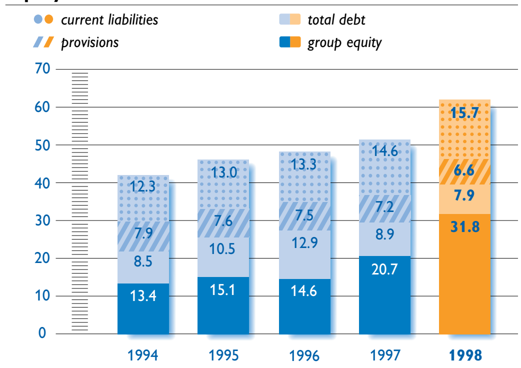
Income from continuing operations
as a % of stockholders' equity (ROE)



Assets



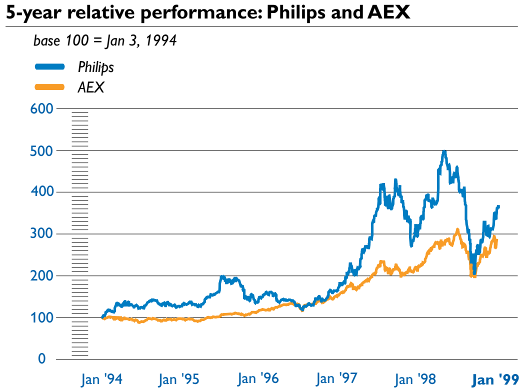
Equity and liabilities



were exercised at the exercise price of NLG 34 per common share, which resulted in an increase of stockholders' equity by NLG 123 million.
Currency effects had an unfavorable effect of NLG 421 million on stockholders' equity.
At year-end 1998 the Group held 7.8 million shares in treasury as a hedge against 7.2 million rights overhang at the end of 1998. At year-end 1997 the number of shares in treasury was equal to 6.8 million shares, while the overhang was equal to 12.2 million rights. The overhang at the end of 1997 included the above-mentioned warrants. Additionally, a number of shares were purchased as a partial hedge against the future issuance of such rights.

On December 17, 1998, Royal Philips Electronics revealed that its previously announced share reduction of 8% would be implemented by reducing the share capital, resulting in a total cash distribution of approximately NLG 3.3 billion to all shareholders and a subsequent reduction of the number of outstanding common shares by 8%. This share reduction program will be combined with the redenomination of the share capital into the euro.
Consequently, Philips will propose at its General Meeting of Shareholders the conversion of part of its surplus paid-in capital into nominal share capital, the reduction of the adjusted nominal share capital by distributing a cash amount of NLG 9.07 per common share to all Philips' shareholders, which amount equaled 8% of the December 17, 1998, closing price of NLG 113.40 in Amsterdam and the exchange of all presently existing 100 common shares into 92 shares, each of which will have a par value of 1 euro.
A detailed proposal will be sent to shareholders in connection with the General Meeting of Shareholders to be held on March 25, 1999, together with an explanation of the series of steps and resolutions required under Dutch civil and tax law. Upon adoption, consummation is expected in mid-1999 following completion of the required legal procedures and formalities.

5-year relative performance: Philips and AEX



Selected pro forma consolidated figures for 1998 after share reduction

in millions of Dutch guilders

Cash and cash equivalents	11,099	Current liabilities	19,626
Current assets (excl. cash)	21,411	Non-current liabilities	10,590
Non-current assets	26,189	Other group equity	533
		Stockholders' equity:	
		Share capital	
		(issued 339 million	
		shares, par value 1 euro)	747
		Share premium	3,615
		Other reserves	23,588
Total	**58,699**	**Total**	**58,699**

New accounting standard

On June 15, 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (FAS 133). In compliance with this guideline, Philips will apply FAS 133 in the year starting January 1, 2000. This Statement requires that all derivative instruments are recorded on the balance sheet at fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction. Philips is currently evaluating the full effects that the adoption of FAS 133 will have on results of operations and its financial position.

Quantitative and qualitative disclosures concerning market risks

Financial risk management

The Company is exposed to market risks, including the risk of changes in foreign exchange rates, interest rates and certain commodity prices. To manage these risks, the Company enters into various hedging transactions that have been authorized pursuant to its policies and procedures. The Company does not purchase or hold derivative financial instruments for trading purposes.

The analysis below presents the sensitivity of the fair value of the Company's financial instruments and of earnings to certain hypothetical changes in foreign exchange rates and interest rates. Financial instruments consist of derivative financial instruments, derivative commodity instruments and other financial instruments. The value of commodity hedges is not material. The following overview of the Group's risk management activities contains forward-looking statements that involve risks and uncertainties. Actual results could differ materially from those projected.

Foreign currencies

The Company's exposure to foreign exchange rates outside the euro block currencies relates principally to the US dollar.
The local currency is used by most subsidiaries

as the functional currency to prepare their financial information. Exceptions are made for highly inflationary countries where the functional currency differs from the local currency.
With regard to currency risks, it is the Company's policy to cover transaction exposures, including certain anticipated transaction exposures. For this purpose, the Company enters into forward foreign exchange and option contracts. Virtually all of these contracts will expire in 1999.

Financing of subsidiaries is mostly done in the functional currency of the borrowing entity. Exceptions are made in the case of those subsidiaries for which a significant part of the business is done in a currency other than the functional currency or when required by law. For these entities, financing takes place in the main business currency, providing a natural offset against potential exposures in the business.

If the financing currency is neither the functional currency nor the main currency of the business, the Company's exposure to foreign exchange rates is hedged against the functional currency where this is not restricted for regulatory reasons.
The value of the Group's financial instruments is affected by changes in foreign currencies. An instantaneous 10% strengthening or weakening of the non-euro block currencies versus the euro block currencies from their levels at December 31, 1998, with all other variables held constant, would result in an estimated net change in the value of the Company's financial instruments of NLG 105 million. A substantial proportion of the exposures relates to derivative instruments which are meant to offset foreign exchange exposures in the business. Therefore earnings effects of these hedges will be offset over time by changes in the value of hedged business assets or liabilities. Furthermore, part of the financial instruments are held in the functional currency.

Interest rates

At year-end 1998 the Company had a ratio of fixed-rate debt to outstanding debt of approximately 68%, compared to 66% one year earlier.

A sensitivity analysis shows the following results. If the long-term interest rates were instantaneously to decrease by 1% from their level of December 31, 1998, with all other variables (including foreign exchange rates) held constant, the fair market value of the long-term debt would increase by NLG 210 million. This increase is based on the assumption that the 'putable' bonds will be repaid at their final maturity date. This assumption was made since the current long-term interest rates are clearly below the coupon rates of these bonds, which makes it unlikely that investors will require prepayment of these bonds on their respective put dates. If the short-term interest rates were instantaneously to decrease by 1% from their level of December 31, 1998, with all other variables (including foreign exchange rates) held constant, the annualized interest income on the net cash position would decrease by NLG 115 million.

Commodities

The Company is a purchaser of certain base metals such as palladium, aluminum, copper, lead, nickel and zinc.
The Company covers a limited part of the commodity price risk exposures by entering into

hedge transactions such as forward purchasing agreements. Almost all agreements outstanding at December 31, 1998, will expire in 1999. The hedge transactions outstanding as of December 31, 1998, are not material.

Euro

Philips started its preparations for the new European single currency at the end of 1994. The Board of Management established the Philips Euro Project Steering Committee, comprising representatives of the product divisions, European country organizations and corporate functions. At the beginning of 1997 a full-time Euro Project Director was appointed, who reports directly to the Chief Financial Officer. He chairs the Steering Committee and coordinates some 35 different working groups dealing with the preparations for the introduction of the euro within the Company. Philips is convinced that the European single currency will improve Europe's competitive position. The disappearance of currency fluctuations within this massive market could have a positive impact in terms of attracting inward investment. In spite of the increased competition to be expected as a result of the greater transparency of the market, Philips stands to gain from the introduction of a single European currency in the long term.

The introduction of the euro will have an impact on the Company's business strategies: price transparency will increase and companies will compete in a much broader market, facilitated by new developments such as the Internet and e-commerce. Furthermore there will be a growing convergence in various labor-related fields. All of Philips' business managers have completed a business impact analysis to assess and quantify the business implications of the euro for each customer, product, country, currency, etc.

At the start of the Economic and Monetary Union on January 1, 1999, Philips introduced the euro as its reporting currency. When the participating member states became known and the internal conversion rates were provisionally fixed in May 1998, the Company decided to discontinue hedging contracts only involving EMU currencies. Intercompany transactions, previously expressed in EMU currencies, will be converted into euros. The consolidated quarterly figures and annual report for 1999 will be published in euros, and the share price was converted into the new currency when most European stock exchanges made the transition on January 4, 1999.

Under the proposals which will be submitted to the Annual General Meeting of Shareholders to amend the Company's Articles of Association, the new nominal value of a common share will be 1 euro.

Regarding the technical preparations for the euro, Philips has defined a set of minimum requirements to be met. In order to be able to cope with these technical requirements, Philips had to adapt thousands of computer systems and applications. Because this was often combined with other IT projects, it is difficult to identify the cost associated with this project. The euro project is not Philips' largest IT project, but it still accounts for a substantial part of the total IT cost.

During the summer of 1998, Philips informed its customers and suppliers of its plans. No prohibition/no compulsion during the transition period means that no one can be forced to use the euro instead of EMU currencies. Philips is offering its customers the possibility of being invoiced in euros as and when required. Philips' suppliers have been requested to start invoicing the Company in euros as of January 1, 1999.

Millennium

The Millennium issue refers to business continuity risks in Philips' integral national and international business chains, including the supply base and customer base, caused by systems, products and equipment with date-sensitive components that may fail to recognize the year 2000. The Millennium program is coordinated and supervised on behalf of the Board of Management by the Corporate Millennium Office, which reports directly to the Chief Financial Officer.

State of readiness

Philips' Millennium program has been designed and developed from the business perspective, integrating progressively the internal and external risk factors in the integral business chains, which operate in many different national and regional environments. The program identifies seven interrelated Millennium impact areas: customer base; supply base; IT applications; IT infrastructure; facilities and services; corporate core processes; and countries and regions. The program prescribes a standard procedure comprising the following phases:

1. business impact analysis;
2. strategy definition and action planning;
3. execution (including remediation, testing and, where applicable, contingencies).

All sectors and groups in the Company tailor the program as appropriate for the seven impact areas. Dedicated staff, supported by external solution and service providers, are active in all these sectors and groups worldwide.

Costs

The Millennium program fits into Philips' ongoing effort to improve its IT structure and its business processes. A substantial part of the Millennium costs relates to the replacement and upgrading of systems, which will be beneficial to the future operations of the Company. The cost of addressing the Millennium issue is expected to total approximately NLG 600 million, of which NLG 350 million has already been expensed. The remaining costs will be expensed as incurred. A major portion of the total cost is associated with the modification and testing of software, the hiring of external solution providers, the accelerated implementation of new systems, and the replacement of non-compliant systems.

Risks

Internal and external risk factors have been identified, relating to all Millennium impact areas and the relationships between them. The Company views the likelihood of disruption of business continuity as a result of internal risk factors as relatively small. However, due to the risks inherent in a number of external year 2000 issues, over which the Company has no control or for which no precedents exist, the Company is unable to determine at this time the likelihood of a material impact on the Company's performance.

Although Philips has taken what it believes to be reasonable, prudent measures to mitigate these risks through the implementation of the program, it can give no assurances that such measures will be sufficient to prevent a materially adverse impact on its operations, liquidity and financial condition. The Company expects that the program's progression will result in reduced uncertainty relating to the Company's year 2000 compliance and a reduced likelihood of interruptions to its operations.

Contingencies

The contingency policy considers internal and external risk factors, with the latter having clear priority. Based upon continuous information-gathering and qualitative analyses, contingency alternatives are being studied and developed, primarily for local risks in utility supply, banking, communication, transport and customs services. Philips' businesses are working to coordinate their respective contingency plans with key suppliers and customers and are specifically considering elements such as logistics, activity scheduling, maintenance and overhaul scheduling, and staff and holiday planning. The Company anticipates having contingency plans to minimize the external risks in place by the third quarter of 1999.

More detailed information is given on pages 135 to 139.

Corporate governance

The Company has consistently improved its corporate governance over the past decade by increasing transparency and accountability to its shareholders through simplification of the corporate structure, by improving the supervision of the Company's policies and activities, and by adopting recommendations on best practices.
The Supervisory Board has an Audit Committee, a Remuneration Committee and a Nomination and Selection Committee. It has adopted Rules of Procedure to consolidate its own governance rules. The profile for the Supervisory Board's composition and additional data on the individual members are given on page 68.
A proposal will be submitted to the General Meeting of Shareholders to be held on March 25, 1999, to simplify the Company's Articles of Association. The suggested simplification follows the Company's policy of continuously improving its corporate governance, this time by making the Articles of Association more transparent and easier to read.
The internal organization of the Philips Group has also been greatly improved by the further implementation of the Governance Model introduced in 1997. Last year, bottom-line accountability was increased, business controls at both Business Unit and Product Division levels were tightened, regional management was strengthened, and the role of country organizations was streamlined. In line with international business developments, the Company will continue to strengthen entrepreneurship and its commitment to corporate profit targets.
An incentive stock option scheme for senior managers, introduced in the late 1980s and since refined, focuses management and staff continuously on the performance of the Group and, through specific targets, on the performance of its constituent business units and divisions. This scheme has proven to be an indispensable

instrument in the highly competitive global market for management.

Business Controls

The Philips Policy on Business Controls is communicated to all levels of management. Key elements are: setting clear policies; setting clear directives; delegating tasks and responsibilities clearly; carrying out supervision; taking corrective action; and maintaining an adequate accounting system including an internal control system (internal accounting controls). The Company's internal control structure follows current thinking and practice in integrating management control over company operations, compliance with legal requirements and the reliability of financial reporting.

It makes management responsible for implementing and maintaining effective business controls, including internal financial controls. The effectiveness of these controls is monitored by self-assessment, and accountability is enforced through the formal issuance of a Statement on Business Controls by each Business Unit, resulting, via a cascade process, in a statement at Product Division level.

Audit Committees at Product Division level ensure adherence to the policy and take corrective action where necessary. They are also involved in determining the desired audit coverage. The entire process is reviewed on a regular basis by Corporate Internal Audit. Reports on the functioning of the process are sent to the Board of Management and the Audit Committee of the Supervisory Board.

Communication with shareholders

Philips is continuously striving to improve relations with its shareholders. In line with the Anglo-American model, the Company has joined together with several other major Dutch companies, banks and the Amsterdam Exchanges to enable proxy solicitation in the Netherlands. A Shareholders' Communication Channel will be operational before the Annual General Meeting of Shareholders in 1999. However, proxy solicitation will not yet be possible at that time as it first requires an amendment to Dutch law. It is expected that proxy solicitation will be introduced in time for the General Meeting of Shareholders in the year 2000. In a broader context, we are constantly intensifying our contact with the financial community at large.

Business Principles

In February 1998, we issued our General Business Principles. These govern our business decisions and actions throughout the world, applying equally to corporate actions and to the behavior of individual employees when on company business. They incorporate the values on which all Philips' activity is or should be based: business focus, integrity, speed, simplicity, quality, people and teamwork. The responsibility for compliance with the Principles rests first and foremost with the management of the business. A Corporate Review Committee supervises the practical implementation of the Principles, and Corporate Internal Audit is responsible for auditing the compliance procedure. In August 1998 the first set of additional directives was issued.

Environmental policy

Philips has restated its general objectives in the Global Environmental Policy 1998-2002 and defined additional targets in its EcoVision environmental program, focusing on green product development and manufacturing. Management believes that, handled imaginatively, the environment is a business opportunity. Philips is committed to taking environmental leadership and action and aims to become the leading eco-efficient company in electronics and lighting.
Eco-efficiency is achieved by the delivery of competitively priced goods and services that satisfy human needs and bring quality of life, while reducing ecological impact and intensity of resource usage throughout the life cycle. Philips has defined eco-efficiency as a major challenge: it encourages Philips businesses to become more competitive, more innovative and more environmentally responsible.

Some 35% of Philips' industrial sites already manage their environmental performance in accordance with ISO-14001, an internationally accepted environmental standard. The focus of environmental management based on ISO-14001 is not only on improving the environmental performance of manufacturing, but is also expanding towards products and services. Accordingly, ISO-14001 provides a basis for EcoDesign, environmentally conscious product design. Our EcoDesign program considers the environmental impact of a product during its entire life cycle and focuses on five areas to enhance environmental performance: weight, hazardous substances, energy consumption, packaging and recycling.

Praising the Company's 'clear and articulated set of values, history of proven accomplishment, global outlook and commitment to sustainable development', the World Environment Center based in New York presented Philips with its 1998 Gold Medal Award for International Corporate Environmental Achievement. Philips also received the 1998 Climate Protection Award from the United States Environmental Protection Agency (US EPA) in recognition of its energy-reduction program, which has resulted in a 20% energy saving in relation to 1994. This is equivalent to a cost reduction of approximately NLG 140 million per year and an avoided CO_2 emission of 704,000 tons per year – equivalent to the absorption effect of 350 km^2 of forest.

Employees

The number of employees at year-end 1998 was 233,686, which represents a decrease of 18,582 compared to December 1997. This decrease was mostly due to changes in consolidations. The most significant new consolidations were Hosiden and Philips Display Corporation with 962 employees in April 1998, ATL Ultrasound in October 1998, which added 2,649 employees to the Company's headcount, and 645 employees from all other new consolidations. The most important deconsolidation was PCC/Lucent resulting in a headcount reduction of 8,568 in October 1998 and the deconsolidation of the Passive Components business group as at December 31, 1998, with 4,134 employees. Various other divestments resulted in a decrease in the number of employees by 3,376. When compared with the comparable position as of January 1, 1998, the workforce decreased by 6,760 employees.

The most important decreases related to Consumer Electronics (3,918), Lighting (2,725) and Domestic Appliances and Personal Care (1,149). On a comparable basis, headcount increased at Origin (1,484) and Components (858). During 1998 the number of employees in Latin America and Asia fell by 3,327 and 3,692, respectively, in connection with the economic downturn in these areas. The headcount in Europe remained virtually stable, whereas in North America it increased by 714.

Outlook

Comparisons in the first two quarters will not be favorable; however we expect the second half of the year to show an improvement over the second half of 1998.

Capital expenditures will be somewhat higher but will track depreciation charges; employment will be down slightly, reflecting streamlining of operations and improvements in productivity.

We will continue to control cost; however, we will further spend to improve our brand and our IT infrastructure and to deal with the year 2000 issue.

Our objectives remain unchanged: annually double-digit earnings growth and positive cash flow and for the longer term RONA at 24%.

Eindhoven, February 9, 1999

Board of Management
Group Management Committee

Board of Management

Cor Boonstra 1938, Dutch
President and Chairman of the Board of Management and the Group Management Committee
Member of the Board of Management and the Group Management Committee since June 1994; Chairman and President of the Company since October 1996

Dudley Eustace 1936, British
Executive Vice-President and Vice-Chairman of the Board of Management and the Group Management Committee
Member of the Board of Management and the Group Management Committee since October 1992; Vice-Chairman since March 1997

Jan Hommen 1943, Dutch
Executive Vice-President and Chief Financial Officer
Member of the Board of Management and the Group Management Committee and Chief Financial Officer since March 1997

Adri Baan 1942, Dutch
Executive Vice-President
Member of the Board of Management since May 1998; member of the Group Management Committee since May 1996. Chairman of the Consumer Electronics division since 1998

Y.C. Lo 1939, Chinese
Executive Vice-President
*Member of the Board of Management since May 1998; member of the Group Management Committee since May 1996. Chairman of the Components division since 1996**

** As of January 1, 1999 Y.C. Lo has relinquished his position as Chairman of the Components division*

Arthur van der Poel 1948, Dutch
Executive Vice-President
Member of the Board of Management since May 1998; member of the Group Management Committee since May 1996. Chairman of the Semiconductors division since 1996

John Whybrow 1947, British
Executive Vice-President
Member of the Board of Management since May 1998; member of the Group Management Committee since April 1996. Chairman of the Lighting division since 1995

Roel Pieper 1956, Dutch
Executive Vice-President
Member of the Board of Management and the Group Management Committee since May 1998

Group Management Committee

The Group Management Committee is composed of the Board of Management and the following senior officers:*

Ad Veenhof 1945, Dutch

Member of the Group Management Committee since January 1996 and Chairman of the Domestic Appliances and Personal Care division since 1996

Kees Bulthuis 1937, Dutch

Member of the Group Management Committee since March 1997; responsible for establishing the Technology Management process

Hans Barella 1943, Dutch

Member of the Group Management Committee since March 1997 and Chairman of the Medical Systems division since 1997

Fred Bok 1940, Dutch

Member of the Group Management Committee since April 1998 and Chairman of the Business Electronics division since 1998

Jan Oosterveld 1944, Dutch

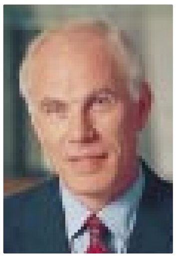
Member of the Group Management Committee since May 1998 and Senior Director of Corporate Strategy since 1997

Arie Westerlaken 1946, Dutch

Member of the Group Management Committee since May 1998, Secretary to the Board of Management since 1997 and Chief Legal Officer since 1996

Nico Bruijel 1945, Dutch

Member of the Group Management Committee since July 1998; responsible for Corporate Human Resource Management



*As of January 1, 1999, Gerard Kleisterlee has been appointed Chairman of the Components division and member of the Group Management Committee.

Supervisory Board

F.A. Maljers 1933, Dutch ** ***
Chairman
Member of the Supervisory Board since 1993; second term expires in 2001
Former Chairman and Chief Executive Officer of Unilever N.V. and currently Vice-Chairman of the Supervisory Board of KLM Royal Dutch Airlines and member of the Supervisory Board of SHV Holdings N.V.

A. Leysen 1927, Belgian ***
Vice-Chairman and Secretary
Member of the Supervisory Board since 1983; fourth term expires in 1999
Former Chairman and Chief Executive Officer of the Agfa-Gevaert Group and currently Chairman of the Supervisory Board of the Agfa-Gevaert Group

W. Hilger 1929, German * **
Member of the Supervisory Board since 1990; third term expires in 2001
Former Chairman of the Board of Management of Hoechst A.G. and currently member of the Supervisory Boards of Mannesman A.G., Victoria Versicherung A.G. and Victoria Lebensversicherung A.G.

L.C. van Wachem 1931, Dutch **
Member of the Supervisory Board since 1993; second term expires in 2001
Former Chairman of the Committee of Managing Directors of the Royal Dutch/Shell Group and currently Chairman of the Supervisory Board of Royal Dutch Petroleum Company

C.J. Oort 1928, Dutch *
Member of the Supervisory Board since 1995; first term expires in 1999
Former Treasurer General of the Dutch Ministry of Finance and currently Chairman of the Supervisory Boards of KLM Royal Dutch Airlines and the Robeco Group

L. Schweitzer 1942, French
Member of the Supervisory Board since 1997; first term expires in 2001
Chairman and Chief Executive Officer of Renault and member of the Boards of Pechiney, Banque Nationale de Paris and Credit National

Sir Richard Greenbury 1936, British
Member of the Supervisory Board since 1998; first term expires in 2002
Chairman and Chief Executive Officer of Marks & Spencer plc and former non-executive director of Lloyds TSB, ICI and Zeneca

W. de Kleuver 1936, Dutch *
Member of the Supervisory Board since 1998; first term expires in 2002
Former Executive Vice-President of Royal Philips Electronics

Profile of the Supervisory Board

The Supervisory Board will aim for an adequate spread of knowledge and experience among its members in relation to the global and multi-product character of the business of the Company. Consequently, the Board will aim for an adequate level of experience in financial, economic, social and legal aspects of international business and government and public administration. The Supervisory Board further aims to have available adequate experience within Philips by having one or two former Philips executives on the Supervisory Board. In the case of vacancies the Supervisory Board will ensure that when such persons are recommended for appointment, these various qualifications are reflected sufficiently.

Term of appointment

Members of the Supervisory Board are appointed for a fixed term of four years. In principle, they may be re-elected for two additional terms of four years (for further information, see page 140)

* Member of the Audit Committee
** Member of the Remuneration Committee
*** Member of the Nomination and Selection Committee

Report of the Supervisory Board

The Supervisory Board met six times in the course of 1998. Except in matters regarding the composition of the Supervisory Board, the Board of Management and the Group Management Committee, the members of the Board of Management and/or the Group Management Committee were present at our meetings to inform us on the course of business, important decisions and the strategy of the Philips Group. A number of important matters, such as the sale of PolyGram to Seagram, the tender offer for the shares in ATL, and the proposal to the shareholders regarding the share reduction program, were discussed at length. The Supervisory Board also held a separate meeting with regard to PolyGram. A two-day meeting was devoted to strategy.
The Audit Committee met four times in the presence of the external auditor. On behalf of the Supervisory Board and in preparation for our decisions, this committee monitors the effectiveness of internal financial control systems and reviews internal audit programs and their findings. It also advises the Supervisory Board on the annual and half-yearly figures and discusses the scale and scope of the annual audit by the external auditor. Important findings and identified risks are examined thoroughly so that appropriate measures can be taken.
The Remuneration Committee met twice. This committee is responsible for preparing resolutions regarding the remuneration of members of the Board of Management and the other members of the Group Management Committee. In addition, it advises the Supervisory Board with regard to the policy to be pursued.
The Nomination and Selection Committee met for the first time in August 1998, in particular to discuss the filling of vacancies in the Board of Management and/or the Group Management Committee.

Composition of the Supervisory Board

At the Annual General Meeting of Shareholders in 1999, Mr A. Leysen and Mr F. A. Maljers will retire from the Supervisory Board. Mr Leysen joined the Supervisory Board in 1983 and has been Vice-Chairman since 1984. He reaches the statutory age limit in this year. Mr Maljers has expressed the wish to retire from the Supervisory Board, which he joined in 1993. He has been Chairman since 1994. We want to put on record our gratitude to the departing members for their contribution to the Company, made in an often turbulent period with a difficult business environment, and we wish them well for the future.

In agreement with the Meeting of Priority Shareholders we will propose at the General Meeting of Shareholders to re-elect Mr C. Oort, whose present term ends at the 1999 Annual General Meeting of Shareholders, and to elect Mr J-M. Hessels to the Supervisory Board. Mr Hessels (57) is Chief Executive Officer of Vendex. He has

extensive international experience.
The Supervisory Board has appointed Mr L. van Wachem as its Chairman as from the Annual General Meeting of Shareholders.

Composition of the Board of Management-Group Management Committee

In the course of 1998, Messrs H. Bodt, W. de Kleuver and D.J. Dunn retired as members of the Board of Management and the Group Management Committee. We are most grateful to them for everything they did for the Company. Mr de Kleuver joined the Supervisory Board on August 1, 1998.
Messrs A. Baan, D.J. Dunn, Y.C. Lo, A.P.M. van der Poel, J.W. Whybrow and R. Pieper were appointed members of the Board of Management. Messrs F. Bok (April 1, 1998), J. Oosterveld (May 1, 1998), A. Westerlaken (May 1, 1998) and N.J. Bruijel (July 1, 1998) were appointed members of the Group Management Committee. Mr M. Moakley retired as a member of the Group Management Committee on January 31, 1999, and Mr K. Bulthuis will do so on April 1, 1999. We wish to thank both gentlemen for all their efforts on behalf of the Company.
As of April 1, 1999, Mr D.G. Eustace will relinquish his position as Vice-Chairman of the Board of Management and the Group Management Committee. Mr Eustace, who became Chief Financial Officer within the Board of Management in 1992, played an important role in regaining the confidence of our shareholders and financiers during the difficult period in the first half of the 1990s. We are greatly indebted to him for that.
Mr Y.C. Lo will retire as a member of the Board of Management and the Group Management Committee and Executive Vice-President of the Company in the middle of 1999. We wish to express our sincere thanks for the outstanding manner in which he served the Company.

Financial statements

The financial statements of Koninklijke Philips Electronics N.V. for 1998, as presented by the Board of Management, have been audited by KPMG Accountants N.V., independent public auditors. Their report appears on page 134. We approved these financial statements and recommend that you adopt them in accordance with the proposal of the Board of Management and likewise adopt the proposal to declare a dividend of NLG 2.20 per common share.

Eindhoven, February 9, 1999

The Supervisory Board

Important dates

Annual General Meeting of Shareholders	March 25, 1999
First quarterly report 1999	April 22, 1999
Second quarterly report 1999	July 22, 1999
Third quarterly report 1999	October 21, 1999
Publication of 1999 results	February 10, 2000*
Publication of the Annual Report 1999	February 10, 2000*
Annual General Meeting of Shareholders	March 30, 2000*
First quarterly report 2000	April 20, 2000*

* Under review

Payment of dividend

Shares of Koninklijke Philips Electronics N.V. ('Royal Philips Electronics') will be listed ex-dividend as of March 29, 1999. In compliance with the listing requirements of the New York Stock Exchange and the Amsterdam Exchanges, the record dates will be March 30, 1999, for holders of American shares of New York registry, and March 25, 1999, for other Philips shares.

The dividend as proposed to the General Meeting of Shareholders will be payable as of April 14, 1999, to holders of American shares, and as of April 9, 1999, to holders of other Philips shares. The dividend to holders of American shares will be made in USD at the USD/NLG rate at the close of business of the Amsterdam Exchanges on March 24, 1999.