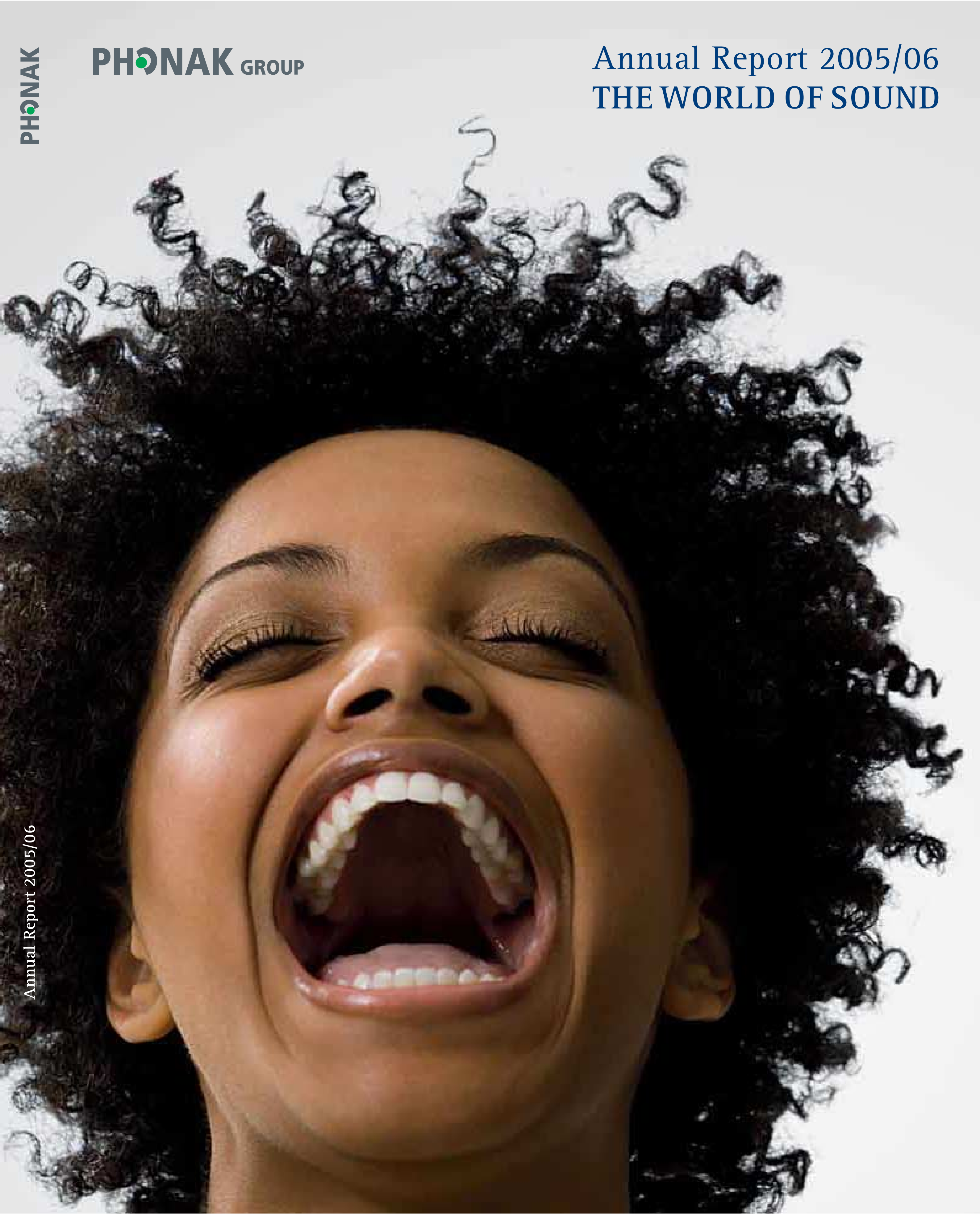
PHONAK GROUP

Annual Report 2005/06
THE WORLD OF SOUND



PHONAK
Annual Report 2005/06

HIGHLIGHTS

Sales increase by 31% to CHF 867 million

EBIT margin rises to 24% (prior year 19%)

Income after taxes grows by 80% to CHF 172 million

Phonak sales growth significantly exceeds hearing instrument market growth

Savia establishes itself as the benchmark product in the hearing instrument industry

Market share gains in all major markets

In 2006/07 several new, highly competitive hearing systems have been launched: microPower, Verve, and Indigo

The Phonak Group expects to outgrow the hearing instrument market once again in 2006/07

FIVE-YEAR KEY FIGURES
(Consolidated)

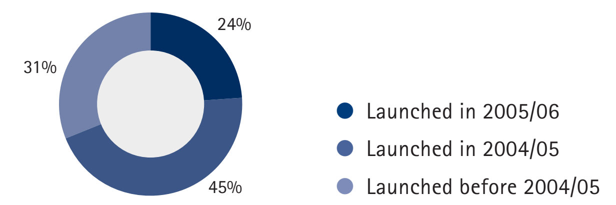
in CHF 1,000 unless otherwise specified	2005/06	2004/05	2003/04	2002/03	2001/02
Sales	**866,682**	**660,375**	**620,538**	**526,362**	**563,634**
change compared to previous year (%)	31.2	6.4	17.9	(6.6)	24.6
Gross profit	**577,204**	**417,814**	**372,642**	**286,159**	**299,456**
change compared to previous year (%)	38.1	12.1	30.2	(4.4)	15.9
in % of sales	66.6	63.3	60.1	54.4	53.1
Research and development costs	**63,039**	**48,932**	**58,203**	**48,879**	**31,453**
in % of sales	7.3	7.4	9.4	9.3	5.6
Sales and marketing costs	**206,846**	**159,117**	**129,457**	**120,945**	**126,828**
in % of sales	23.9	24.1	20.9	23.0	22.5
Operating profit before acquisition-related amortization (EBITA) [1]	**212,828**	**125,830**	**103,515**	**48,139**	**73,013**
change compared to previous year (%)	69.1	21.6	115.0	(34.1)	(26.8)
in % of sales	24.6	19.1	16.7	9.1	13.0
Operating profit/(loss) (EBIT)	**211,662**	**125,797**	**94,961**	**(37,359)**	**59,770**
change compared to previous year (%)	68.3	32.5	354.2	(162.5)	(37.3)
in % of sales	24.4	19.0	15.3	(7.1)	10.6
Income/(loss) after taxes	**172,465**	**95,856**	**69,359**	**(46,792)**	**42,746**
change compared to previous year (%)	79.9	38.2	248.2	(209.5)	(35.3)
in % of sales	19.9	14.5	11.2	(8.9)	7.6
Number of employees (average)	**3,166**	**2,719**	**2,523**	**2,397**	**2,378**
change compared to previous year (%)	16.4	7.8	5.3	0.8	50.2
Number of employees (end of period)	**3,428**	**2,926**	**2,689**	**2,385**	**2,416**
change compared to previous year (%)	17.2	8.8	12.7	(1.3)	13.9
Net cash/(net debt) [2]	**177,934**	**93,785**	**9,501**	**(87,262)**	**(121,790)**
Net working capital [3]	**125,866**	**79,496**	**58,358**	**86,634**	**78,704**
in % of sales	14.5	12.0	9.4	16.5	14.0
Capital expenditure (tangible and intangible assets) [4]	**26,995**	**23,083**	**21,351**	**21,515**	**29,794**
Capital employed [5]	**449,099**	**355,919**	**340,837**	**377,721**	**483,649**
in % of sales	51.8	53.9	54.9	71.8	85.8
Total assets	**931,260**	**743,360**	**683,684**	**606,861**	**742,246**
Equity	**627,033**	**449,704**	**349,090**	**289,551**	**360,821**
Equity financing ratio (%) [6]	**67.3**	**60.5**	**51.1**	**47.7**	**48.6**
Free cash flow [7]	**101,834**	**83,781**	**118,349**	**28,662**	**18,410**
in % of sales	11.7	12.7	19.1	5.4	3.3
Return on capital employed (%) [8]	**52.6**	**36.1**	**26.4**	**(8.7)**	**12.6**
Return on equity (%) [9]	**32.0**	**24.0**	**21.6**	**(14.4)**	**12.5**
Information per share					
Diluted earnings per share (CHF)	2.568	1.434	1.050	(0.721)	0.656
Dividend per share (CHF)	0.50 [10]	0.30	0.20	0.12	0.12

The five-year key figures include adjustments in accordance with new IFRS accounting standards and improvements of the presentation of financial statements (see Notes)

[1] Until 2003/04 amortization of Goodwill has been included in EBITA
[2] Cash and cash equivalents + financial assets at fair value through profit or loss – short-term debts – financial liabilities at fair value through profit or loss – mortgages – other long-term debts
[3] Receivables + inventories – trade payables – other short-term liabilities – short-term provisions
[4] Without goodwill and intangibles relating to acquisitions
[5] Total assets – cash – financial assets at fair value through profit or loss – trade payables – other liabilities – provisions – deferred tax liabilities
[6] Equity in % of total assets
[7] Cash flow from operating activities + cash flow from investing activities
[8] EBIT in % of capital employed (average)
[9] Income after taxes in % of equity (average)
[10] Proposal to the Annual General Shareholders' Meeting of July 6, 2006

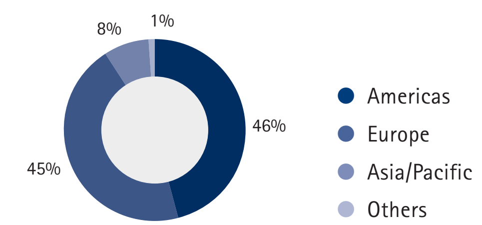
Share of sales 2005/06 – new products

Products launched in the last 24 months comprise 69% of total sales.



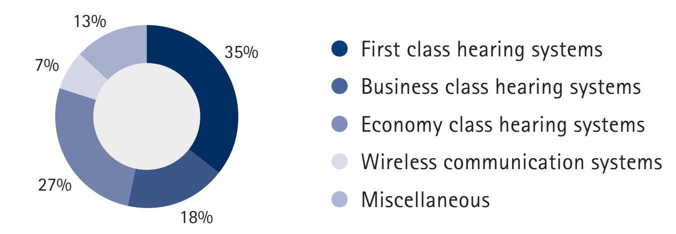
Share of sales by main markets 2005/06

Americas and Europe generated 91% of total sales.



Share of sales by product groups 2005/06

The first class hearing systems increased their share of total sales due to excellent Savia sales.



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CHAIRMAN'S FOREWORD

In 2005/06, the Phonak Group achieved excellent results that clearly exceeded our expectations. Both sales and profit rose to record highs. Our internal sales growth in local currencies of 23.8% was several times higher than the hearing instrument market growth. We achieved a disproportionately strong rise in both our operating profit and net profit. Operating profit (EBIT) as a percentage of sales rose by more than five percentage points to 24.4%. In addition to the very favorable share price performance, Phonak shareholders benefit from a new record dividend of CHF 0.50. This equals a growth rate of 67% after last year's increase of 50% to CHF 0.30.

I am especially pleased that we managed to achieve this record result while still making massive investments in our future. We increased our spending on research & development by 28.8%, and we expanded our global sales and marketing organization. Our plan to use our own distribution companies to directly serve the highly promising growth regions of Latin America and Eastern Europe delivered initial success.

Today, the Phonak Group has one of the most competitive product portfolios in the hearing instrument industry. For the first time our customers are able to purchase a superior hearing system from Phonak in every price segment, as well as in every conceivable shape and size. We have now completed our transformation from a niche supplier of high-end hearing devices to a provider of comprehensive, innovative hearing solutions in all price segments. With the recently launched product lines Verve and microPower, Phonak has even carved out for itself two completely new, unique market segments.

I have been particularly impressed by the speed and precision with which many new products have been developed and brought to market. This demonstrates how important it is to have optimized and expanded our organizational and management structures and also shows how the "people value" culture we have adopted leads to the creation of intellectual capital. This in turn results in continuous progress and increasingly sophisticated and more user-friendly hearing instruments.

As we have evolved over the years from making analog hearing devices to more and more sophisticated hearing systems, we have consistently applied our long-term vision in our plans and strategies, whether in the area of new platforms like PALIO or in the increasingly important field of wireless communication.

Our superior hearing systems and our clear commitment to driving innovation forward in the hearing instrument industry have enabled us to significantly expand our client base. More and more customers realize that by choosing Phonak they have made the best choice of business partner. I would like to thank all who contributed to this success, in particular our highly motivated employees all over the world.

Our success to date shows that we are on the right track and that our strategy is starting to produce results. Our task now is to consistently hold this course. As part of our ongoing improvement in the area of Corporate Governance, the annual report 2005/06 provides more detailed information of the Board of Directors' activities and compensation.

I am convinced that the hearing instrument market has enormous potential. The key factors for exploiting this potential more effectively are further improvements in hearing performance, increased customer satisfaction for end users, and a better public image for hearing instruments.

Phonak is extremely well positioned to further expand its market position in 2006/07. It has the entrepreneurial flexibility and financial means to play an active role in shaping the market and to set new trends and standards in the hearing instrument industry. Therefore, I look to the future of the Phonak Group with great confidence.

Andy Rihs
Chairman of the Board of Directors

CEO'S COMMENTS

In 2005/06, we made major progress towards our goal of transforming the Phonak Group into the most successful company in the hearing instrument industry. Once again, we managed to significantly expand our market share and set new standards with our innovative hearing systems. Our excellent business performance is to a large extent due to the consistent execution of our strategy to promote product innovation and to expand our global distribution network. In addition, we have delivered much stronger financial results, so that we are already close to achieving the mid-term targets we set out in 2005.

Starting from the record level of last year, we again increased sales by another 31.2% to CHF 866.7 million. Internal growth – measured in local currencies and without taking into account acquisitions – came to 23.8%. As a result of improved product mix and operational efficiencies, our gross profit margin climbed by 3.3 percentage points to reach 66.6%. In addition, the operating profit (EBIT) increased by 68.3%. The EBIT margin was increased to 24.4% compared to 19.0% in the previous financial year, underlining the overproportional profit growth. Assisted by a positive financial result and a lower tax rate, earnings per share (on a diluted basis) climbed 79.1% to a record level of CHF 2.57.

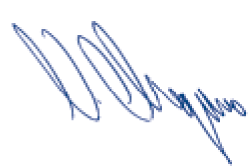
The importance of product innovation for our commercial success was once again demonstrated by the overwhelming market acceptance of our new Savia product line, which was complemented by the launch of microSavia in January 2006. This success had a positive impact on two other product launches: eXtra, the new digital economy product line, and Eleva in the mid price segment. These two lines will generate further growth in the coming financial year. In 2006/07, three very promising hearing instruments have been introduced into the market: Verve, microPower, and Indigo.

During 2005/06, we continued to expand our existing sales organizations and develop new markets. Our purchase of a controlling interest in CAS Produtos Médicos Ltda., the Brazilian market leader in hearing instrument distribution, significantly boosted our market presence in Latin America. In Eastern Europe we acquired our previously independent distribution partner in Poland. In 2006/07, the Phonak Group has further strengthened its market position by acquiring Canada's leading distributor of hearing devices, Island Hearing Services.

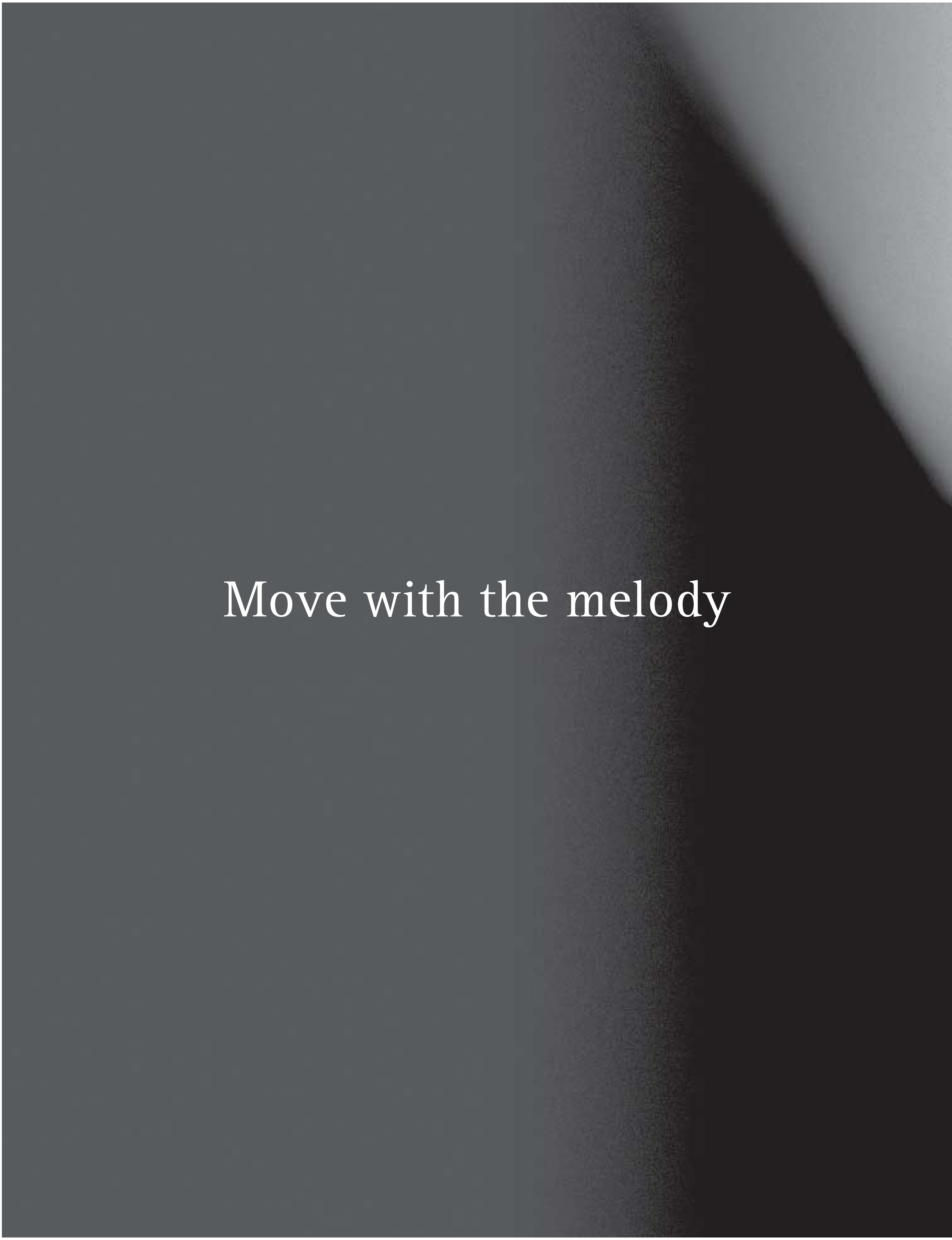
In the future, we expect further sales growth, increased market share, improved financial strength, and attractive returns on investments. The Phonak Group is in excellent shape: we have the strongest product portfolio of the hearing instrument industry and can rely on a full product pipeline. In addition, we will continue to work hard to further develop the Group in the areas of human resources, organization and processes, thereby building a strong base for sustained growth. To accomplish these objectives, we will focus on the continuous improvement of product functionality and increased customer benefits. Other priorities include further strengthening of our distribution channels.

The great success of the Phonak Group is mainly the result of the dedication, commitment, and great team spirit of our employees. We have a unique corporate culture that has enabled us to smoothly complete the fast transformation process of recent years. Our clear, sustainable strategy is supported by highly skilled and motivated staff and creates the foundation for a very promising future. I would like to thank each one of our employees for their hard work, commitment, and loyalty to the company. Without them, such excellent results would have been impossible.

I also want to express my thanks to all our customers, suppliers, partners, and shareholders for their important contribution to the success of the Phonak Group.



Dr. Valentin Chapero Rueda
CEO


Move with the melody

FINANCIAL RESULTS

The estimated global hearing instrument market growth in 2005/06 was 5%–7%.

Phonak sales increased by 31.2% to CHF 866.7 million. Sales growth in local currencies and excluding acquisitions was 23.8%.

The operating profit (EBIT) increased by 68.3% to CHF 211.7 million, and the EBIT margin of 24.4% clearly surpassed the comparable previous year's figure of 19.0%. Profitability improved due to the favorable product mix, enhanced efficiency, cost savings in materials procurement, and the operating leverage in general and administration expenses.

Earnings per share on a diluted basis reached CHF 2.57 (previous year CHF 1.43), which represents an improvement of 79.1%. This strong increase was supported by an improved net financial income and a lower tax rate.

Net cash increased by CHF 84.1 million to CHF 177.9 million (previous year CHF 93.8 million), in spite of the acquisition of sales companies.

Equity reached CHF 627.0 million and the equity financing ratio has increased to 67.3% (previous year 60.5%), reflecting a further substantial strengthening of the Group's financial position.

Free cash flow rose 21.5% to CHF 101.8 million (previous year CHF 83.8 million).

Outlook: The Phonak Group expects to outgrow the market once again in 2006/07.

Adjustments to prior year 2004/05 financial figures
The adoption of the new IFRS 2 standard "Share-based payment", resulted in a change in the accounting policy for share and option plans to employees. Prior-year figures have been adjusted accordingly in order to facilitate comparison. In addition, we improved the presentation of the Consolidated Income Statement which led to a reclassification of sales-related costs. For further details, we refer to Note 2 and Note 32 to the Consolidated Financial Statements (page 50 and 80 of this report).

Consolidated Income Statement

Sales

Measured in local currencies and excluding acquisitions, sales grew by 23.8%. The weakening of the Swiss Franc, especially against the US Dollar, led to a positive currency effect of 3.4%. In reported currency (CHF), sales increased by 31.2% to CHF 866.7 million, which includes a contribution of 4.0% from acquisitions.

Sales growth was driven mainly by the dynamic performance of our new premium product line Savia, which was complemented in January 2006 by microSavia, a micro hearing system for open fitting. Other significant sales drivers included miniValeo in the mid price segment, eXtra in the digital economy segment, the Unitron Hearing brand, and our wireless communication systems.

The first class hearing systems segment accounted for 35% of total sales (previous year 31%). With Savia, we have succeeded in establishing an industry benchmark. We expect Savia to continue to perform strongly in 2006/07. Other growth drivers in this segment will be the recently launched Verve product line, which is targeted at our most discerning customers, and Indigo, the latest flagship product from Unitron Hearing.

Business class hearing systems accounted for 18% of total sales (previous year 21%). Eleva, our newest product line in this segment, had a very successful launch at the start of March 2006, which meant it only made a positive contribution to sales during the final month of the financial year 2005/06. The key business class product lines of the Phonak brand – Valeo, miniValeo, and Supero – as well as Unitron's Conversa.NT, performed according to expectations. In 2006/07, the most important sales drivers will be Eleva and the recently launched microPower, the first micro hearing system for people with severe hearing loss.

The economy class hearing systems segment accounted for 27% of total sales, unchanged from last year's figure. However, the various strategic measures undertaken to strengthen our market position resulted in a sharp increase in sales in this segment. The main contributor to this success was eXtra, the new

digital entry-level product line, which began generating sales as of October 2005. Sales of eXtra's predecessor MAXX and of Unison remained buoyant, and also made a significant contribution to the strong sales performance.

Wireless communication systems (FM systems) are important additions to the hearing instrument product lines of the Phonak Group. Sales of these products rose significantly and accounted for 7% of total sales, nearly unchanged from last year's figure (8%).

Gross profit

The measures taken to further increase margins were very successful. Gross profit increased 38.1% to CHF 577.2 million or 66.6% of sales, compared to CHF 417.8 million or 63.3% of sales in the previous year. This improvement was mainly due to a favorable product mix, enhanced efficiency through higher production volumes, and cost savings in materials procurement.

Higher global prices for raw materials and energy had no significant impact on overall production costs, because of our very low material and energy requirements.

Since our production facility in China was still in the early development stages during the first half of 2004/05, the result in the first half of 2005/06 benefited from a baseline effect of higher production volumes in China. This baseline effect no longer applied in the second half of 2005/06.

Operating profit (EBIT)

The Phonak Group significantly increased its EBIT by 68.3% to CHF 211.7 million or 24.4% of sales, compared with CHF 125.8 million or 19.0% of sales in the previous year.

As planned, research and development (R&D) spending rose substantially during the financial year. However, R&D spending as a percentage of sales came to 7.3%, roughly the same as last year (7.4%), due to strong sales growth. In 2005/06, our R&D activities concentrated mainly on the development of new products and the further development of our modular hardware and software platform PALIO. R&D spending for 2006/07 will range between 7.0% and 7.5% of sales.

Spending for sales and marketing increased by 30.0% to CHF 206.8 million or 23.9% of sales. The additional spending is related to current sales organizations as well as the development of new markets. In 2006/07, we will continue to pursue our strategy for expanding our distribution network. Sales and marketing costs should rise in line with sales growth in the coming financial year, and will therefore be roughly on the same level as 2005/06 in terms of percentage of sales.

General and administration expenses increased to CHF 93.4 million or 10.8% of sales (previous year CHF 85.8 million or 13.0% of sales). The increase of 8.9% is attributable to the Group's growth and the further strengthening of the IT infrastructure and systems.

Income after taxes

For the first time, interest earned on investments exceeded the interest payable on financial liabilities in 2005/06. This was due to the settlement in full of the outstanding acquisition financing and a further reduction in mortgages, combined with the effects of an increase in cash and cash equivalents and "financial assets at fair value through profit or loss".

Income taxes decreased to 20.1% (prior year 23.4%) as a result of a change in the country mix of the taxable profit.

Consolidated income after taxes therefore reached CHF 172.5 million compared to CHF 95.9 million in the previous year, which represents an increase of 79.9%. On a diluted basis, earnings per share increased 79.1% over the previous year, to CHF 2.57.

Consolidated Balance Sheet

Capital employed

Capital employed has increased by 26.2% to CHF 449.1 million. This increase was mainly in working capital due to the growth of our business activities. Capital employed also increased due to the expansion of our global distribution network and the weakening of the Swiss Franc – especially against the US Dollar.

The number of "days sales outstanding" remained stable over the previous year. But trade receivables were much higher than in the previous year as a result of accelerating sales in the fourth quarter.

Inventories did not increase as strongly as sales, even though we built up reserve stocks at the end of the reporting period in order to avoid supply bottlenecks in the three new product lines Verve, microPower, and Indigo and to ensure a smooth market launch.

Capital expenditures in tangible and intangible assets amounted to CHF 27.0 million and were predominantly related to production facilities and technical equipment.

Taxes payable increased in line with the higher income before taxes compared with the previous year.

Trade payables, other short-term liabilities and provisions vary over the year due to timing differences, but, taken as a whole, increased roughly in line with the higher business volume.

Net Cash

Net cash increased by CHF 84.1 million to CHF 177.9 million (previous year CHF 93.8 million), in spite of acquisition of sales companies. Cash and cash equivalents plus "financial assets at fair value through profit or loss" minus "financial liabilities at fair value through profit or loss" amounted to CHF 190.7 million at the end of 2005/06. To reduce financial debt (CHF 12.7 million versus CHF 90.4 million in the prior year), we used part of the free cash flow for accelerated payments on the mortgages and the full repayment of the acquisition financing raised in 2000/01.

Equity

The equity financing ratio (total equity in % of total assets) has increased to 67.3% (prior year 60.5%), reflecting a further substantial strengthening of the Group's financial position.

Cash Flow

Cash flow before changes in working capital increased to CHF 260.7 million (previous year CHF 159.3 million) given the higher income before taxes, adding back the non-cash items such as depreciation and amortization.

Free cash flow, additionally taking into account the changes in working capital and the investing activities, rose 21.5% to CHF 101.8 million (previous year CHF 83.8 million), mainly as a result of the increase in working capital due to the business expansion on the one hand and increased investing activities on the other, largely consisting of capital expenditures in tangible and intangible assets (CHF 27.0 million versus CHF 23.1 million in the previous year) and cash considerations for acquisitions of sales companies (CHF 40.8 million versus CHF 3.0 million in the previous year).

Free cash flow was applied mainly to repayments of borrowings and mortgages (CHF 82.4 million), and dividends to shareholders (CHF 19.8 million).

Taking all elements of the consolidated cash flow statement into consideration, cash and cash equivalents increased to CHF 179.5 million (previous year CHF 173.2 million).

MARKETS

General market development

The estimated global hearing instrument market growth in 2005/06 was 5%–7%, of which 1%–2% stemmed from increases in average selling prices. Sales prices were increasing due to a strong high-end segment, which is driven by innovation, and a dynamic low-end segment, driven by the replacement of analog products by digital products. All key markets grew more or less in line with the above mentioned average market growth rate.

Group sales by product type

Both brands of hearing instruments, Phonak and Unitron Hearing, contributed to the expansion of sales. Behind-the-Ear (BTE) products remained very strong, supported by the new micro hearing systems for open fitting. In addition, wireless communication systems again delivered consistently high growth, demonstrating their solid market position.

Group sales by geographic region

The Phonak Group continued to increase its global market share as sales developed favorably in all key markets. The United States and the biggest Western European markets made the largest contribution to our growth. We also made progress in building up our market positions in Japan and China, even though our operations in these countries have not been established for very long and business volumes are still comparatively modest.

Latest developments

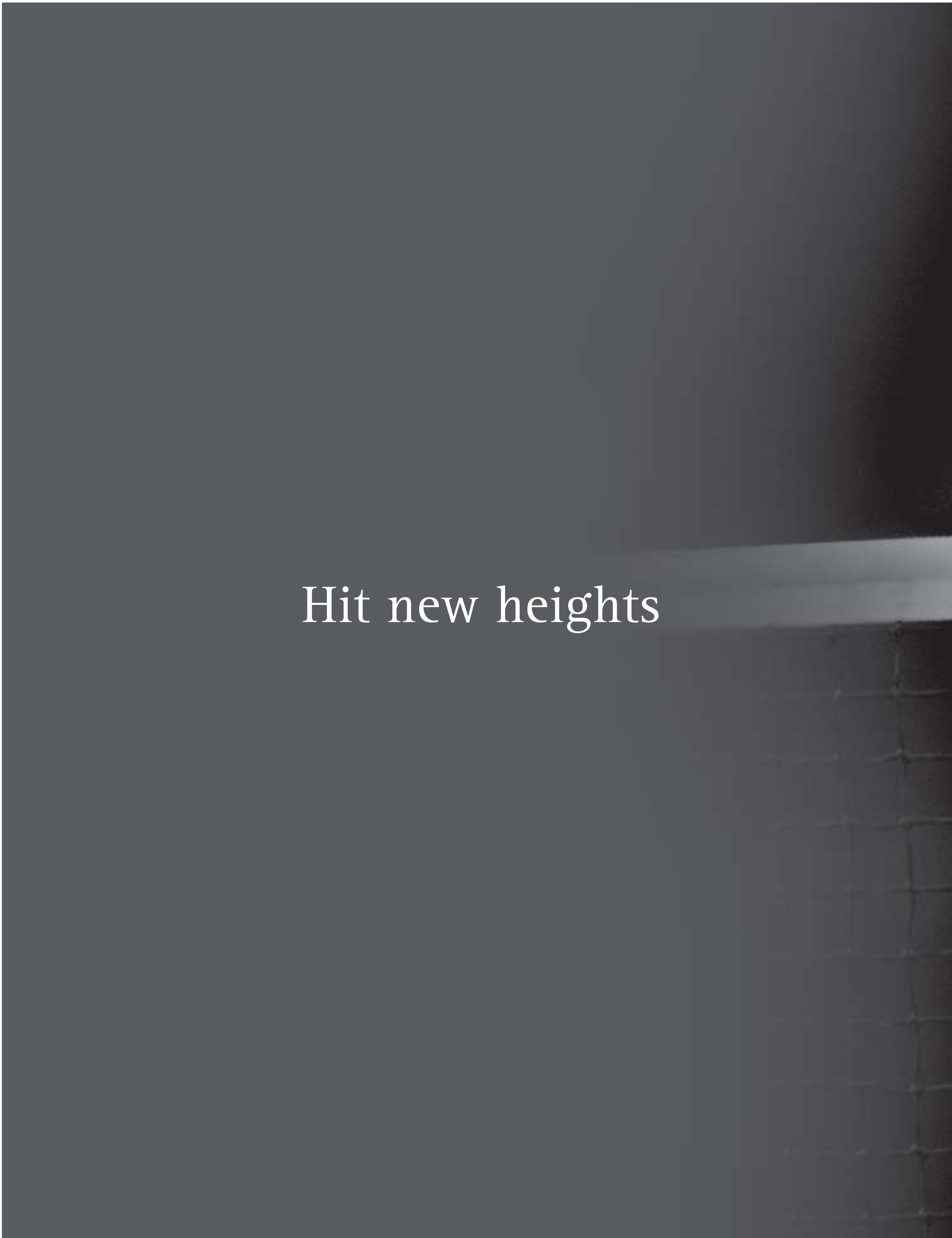
Thanks to our stronger sales organizations, intensified marketing efforts and excellent product offerings, the Phonak Group once again managed to attract many new clients and significantly expand its customer base. In 2005/06, sales to key accounts increased further as a result of closer cooperation with these industry players. We continued to ramp up our retail presence in China, a potentially huge market. Our purchase of a controlling interest in CAS Produtos Médicos Ltda., the Brazilian market leader in hearing instrument distribution, as well as a number of smaller acquisitions, significantly extended the geographic reach of our global sales network, as planned.

Outlook

The Phonak Group expects to outgrow the hearing instrument market once again, due to:

- having a comprehensive product range, which is continuously rejuvenated
- providing superior, innovative and easy-to-use products
- extending its support and service offering
- expanding its distribution channels

In 2006/07, we intend to further strengthen our sales organizations and expand our distribution network in Eastern Europe, Latin America, India, and Asia especially.


Hit new heights

NEW TECHNOLOGIES AND PRODUCTS

Platforms – a modular approach to developing new products

One of the key success factors of the Phonak Group is the strength of its product portfolio, which combines advanced technology with functional design. Phonak continuously sets new standards for technology in our industry.

The success of our Savia product line is evidence of the versatile functionality of our modular hardware and software platform PALIO, which has already been integrated into other product lines. PALIO offers a number of benefits, ranging from economies of scale to more flexibility in design and production, greater product development capacity, and shorter times to market for new products.

The launch of our Verve product line, which offers completely new functionalities such as "SmartVoice" (natural language output), has again shown the superior versatility and performance of PALIO. Thanks to the modular design and the standardized interfaces, we can continuously refine our hardware and software platform, giving us a future-proof modular system for developing new products.

At Phonak, innovation means developing solutions for everyday problems experienced by people with hearing impairment, identifying and satisfying customer's needs, and – in doing so – creating added value for the user. Along with the best possible hearing performance, reliability, comfort, and cosmetic aspects are the key drivers for customer satisfaction. Other aspects related to the product, such as fitting, after-sales support, and service, are also becoming increasingly important. Our two newest product lines, Verve and microPower, clearly confirm our strong focus on the customer's needs.

Verve – the world's most exclusive hearing system

Verve is an exclusive product line designed for the most demanding customers who expect personalized and comprehensive support over the entire product life cycle. Verve's superior audiological performance and its unique functionalities, coupled with its elegant brand styling and the innovative service offering, set a new standard in the hearing instrument industry. Verve is in a class of its own and has also carved out for itself a new market segment that is positioned above the current digital premium segment.

The first edition of the Verve product line boasts many technological innovations. "Self Learning" allows the hearing instrument to automatically adapt itself to the wearer's changing personal requirements. With its natural language output, "SmartVoice", Verve "speaks" to the users, informs them of the system's operating mode, and also tells them when it is advisable to have a service consultation with the audiologist, or when the battery needs to be changed. The wearer can therefore be confident of using the full functionality of the hearing instrument at all times. An exclusive network of specially trained and qualified audiologists ensures excellent customer support and high-quality servicing. The "Verve Priority Package" is the key component of the service offering. With a personalized Verve Card, the customer has access to the international 24/7 support line and to the Verve web portal.

microPower – the miniature hearing system for people with severe hearing impairment

Phonak's innovative Canal Receiver Technology (CRT) enables even those with severe hearing impairment to enjoy the advantages of a micro hearing system. With microPower, the loudspeaker is positioned in the ear canal and provides a clear sound that is as good as with a small and cosmetically attractive in-the-ear (ITE) hearing device. Although its performance is comparable to that of a powerful behind-the-ear (BTE) hearing instrument, its miniature size makes it nearly invisible. The majority of people using a hearing system today suffer from a moderate to severe hearing impairment and could benefit from the unique advantages of microPower.

New products launched in 2005/06

In 2005/06, the Phonak Group successfully introduced several new products, on a worldwide basis:

eXtra, the successor to Phonak's established entry-level MAXX product line, provides noticeably better clarity, comfort, and design and offers unrivalled performance features in this class.
Unison, the entry-level product line of Unitron Hearing, has further been refined. Unison 6 and 3 are now available in a miniaturized, easily adaptable Moda version as well.
Eleva, the newest product line in the business class, delivers a significantly improved hearing experience and maximum ease of use and comfort.
microSavia, a tiny and attractive hearing systems for open fitting has all the advantages and winning features of Savia.

More new products already launched in 2006/07

The Phonak Group recently launched a number of new products that will boost sales in 2006/07. The most relevant of which are:

microPower, the miniature hearing system for people with severe hearing impairment.
Indigo, the new flagship product in the premium segment from Unitron Hearing.
Verve, the world's most exclusive hearing system.
MicroMLxS, **MicroBoom** and **Campus SX**, the completely updated offering for schools in the wireless communication systems segment.

Additional product launches are planned during the course of the 2006/07 financial year.

Future product opportunities

In the future, we will continue to focus on the success factors of our business, such as fundamental research in audiology, wireless communication, ultra-low power electronics, and state-of-the-art software technologies. We are confident that the results of our more long-term research activities will be visible over the coming years in products which will set the industry standard for performance, "device intelligence", and ease of use. Phonak is well prepared to remain one of the most innovative companies in the hearing instrument industry.

OPERATIONS AND STAFF

Operations

Within operations – which includes purchasing, logistics, manufacturing, quality, and IT – one of the priorities in 2005/06 was to optimize product costs. Furthermore, the focus was on building up production to meet demand for many recently launched products and the associated transfer of production to the PALIO platform.

Production sites and processes

During 2005/06, the Phonak Group significantly expanded its production capacities and pushed ahead with the division of tasks between the two main manufacturing sites – Stäfa in Switzerland and Suzhou in China.

The establishment of the Chinese production facility was an important step to reduce product costs on a sustainable basis. During the financial year we also adapted our logistics concept to the new manufacturing structures and switched to direct distribution. At present, we are continuing to optimize goods flows and production processes as well as to improve cost efficiency in the design stage.

Staff

The Phonak Group employed 3,428 people as of March 31, 2006 (prior year 2,926). This total was allocated among research and development 214 (prior year 188), operations 1,624 (prior year 1,439), and sales, marketing, and general and administration 1,590 (prior year 1,299). Major staff increases were made in sales, marketing, and general and administration to increase market coverage through direct sales representatives and to support the many strategically important product launches, and in operations, to create new posts to keep up with the expansion of the Group's sales volume.

OUTLOOK

Sales – outgrow the market once again

We are confident that Phonak's sales will continue to develop positively thanks to our ongoing investment of human and financial resources in product innovation and the expansion of the distribution network. We expect the current growth trend in the hearing instrument industry to continue during 2006/07. We anticipate being able to once again outgrow the market, based on our recent and planned product launches.

Further enhance gross profit margin

In 2006/07, we expect a further increase in the gross profit margin. After years of exceptionally strong growth, however, the rise will be more moderate, i.e. less than in previous financial years. The most important drivers will be the growing quota of products based on the PALIO platform and economies of scale achieved through higher production volumes. Continuous measures to improve productivity and optimize production processes will also help to increase the gross profit margin. These forecasts assume no significant change will occur in the product mix – the percentage of total sales contributed by first class, business class, and economy class hearing systems.

Increase spending on research and development

Spending on research and development is expected to increase again significantly in 2006/07. Major projects include new product developments, hardware and software platform development, and new technology research.

Further improve EBIT margin

Management expects a further improvement in the EBIT margin as a result of the expected gross margin increase as well as a reduction in operating expenses as a percentage of sales.

Slightly increase capital expenditures

To provide the additional infrastructure needed to boost our sales, we plan to slightly increase our capital expenditures in 2006/07. Major investment projects will include tooling for new products, production equipment, and IT infrastructure and systems.

Use of financial resources

The financial resources of the Group are used primarily to finance capital expenditures and for the repayment of debt according to existing terms. In addition, the Phonak Group will invest a portion of its financial resources to further expand its distribution channels. We believe these investments will lead to further sales growth, increased market share, and an attractive return in profits.

Listen to life

CORPORATE GOVERNANCE

The Board of Directors has committed itself to maintaining the highest standards of integrity and transparency in its governance of the company. In this, it is guided by the Swiss Code of Best Practice and the most recent principles of Corporate Governance. Corporate Governance describes how our management is organized and how this is put into practice. It ultimately aims to lead us to success by protecting the interests of our shareholders while at the same time creating value for all stakeholders.

Good Corporate Governance seeks to balance entrepreneurship, control and transparency, while supporting the company with efficient decision-making processes. The Board of Directors constantly works on improving the quality of Corporate Governance.

In the course of the previous financial year 2004/05, the Board of Directors focused on optimizing organizational structures and improving shareholders' rights. The committee structure was simplified and the rules governing the right of shareholders to put items on the AGM agenda were changed from a minimum requirement of holding around 30% of the share capital to just 5%.

During the financial year 2005/06, the Board of Directors introduced a number of measures to improve transparency.

More transparent disclosure of compensation and shareholdings

The most important measure to improve transparency was in the area of "Compensation and shareholdings". In the future, the names of the members of the Board of Directors and of the Management Board who receive the highest level of compensation will be provided. In addition to the total remuneration paid to members of the Board of Directors as a group, this year's report provides details of the remuneration paid to individual members. Similarly, information is provided on the shareholdings in the Phonak Group owned by individual members of the Board of Directors.

Attendance at Board of Directors and committee meetings

Another improvement in this year's Corporate Governance report is the disclosure of the individual Board members' attendance at Board of Directors and committee meetings.

This report describes the principles of Corporate Governance for the Phonak Group and provides background information on the Group's executive officers and bodies, effective March 31, 2006. The report complies with the general principles on Corporate Governance set down in the Group's Articles of Association and Organizational Regulations, which in turn comply with the Directive on Information relating to Corporate Governance published by the SWX Swiss Exchange.

Group Structure and Shareholders

Group Structure

The Phonak Group is headquartered in Stäfa, Switzerland, and is active in over 70 countries through a combination of 32 subsidiaries in 22 countries and a network of independent distributors. The organization chart on page 20 shows the structure of the Phonak Group. The Phonak Holding AG is the parent company and is listed on the SWX Swiss Exchange.

Legal Structure

For details of the legal structure of the Phonak Group as of March 31, 2006, we refer to Note 38 to the Consolidated Financial Statements (page 86 of this report). Apart from Phonak Holding AG, there are no other companies belonging to the consolidated Phonak Group whose equity securities are listed on a stock exchange.

Shareholders

As of March 31, the shareholders of Phonak Holding AG were the following:

Outstanding shares	2006 Number	2006 in %	2005 in %
Founding shareholders			
Beda Diethelm	**7,462,000**	**11.24**	12.72
Andy Rihs	**7,239,100**	**10.91**	12.18
Hans-Ueli Rihs	**6,057,953**	**9.13**	9.50
Public shareholders	**45,601,872**	**68.72**	65.60
Total share capital	**66,360,925**	**100.00**	100.00

The founding shareholders are those who were already shareholders before the Initial Public Offering in November 1994. There are no shareholders' agreements between these persons.

The Phonak Group does not know of any minority shareholder who owns more than 5% of the share capital and voting rights. Investors who had previously exceeded the 5% threshold, FMR Corp., Fidelity International Limited, and Chase Nominees Ltd., have since reported the reduction of their holdings to below the obligatory disclosure limit of 5% in accordance with Art. 20 of the Swiss Stock Exchange Law "Disclosure of holdings".

As of March 31, 2006, a total of 16,235 (previous year 16,381) shareholders were entered in the share register of Phonak Holding AG. Of these 1,275 (previous year 1,027) were non-Swiss nationals who held a total of 17.4% (previous year 18.1%) of the outstanding shares.

Key data for shares

Key data for the shares of Phonak Holding AG as of March 31:

	2006	2005	2004
Market capitalization in CHF m	**4,924**	2,720	1,997
in % of equity	**785%**	605%	572%
Share price in CHF	**74.20**	41.20	30.50
P/E ratio	**28.9x**	28.7x	29.0x

Listing	SWX Swiss Exchange
Security No.	1,254,978
ISIN	CH0012549785

Phonak Holding AG
Board of Directors

Phonak Group
CEO, Management Board

Phonak Hearing Systems

Phonak AG
Stäfa, Switzerland

Phonak GmbH
Fellbach-Oeffingen, Germany

Hansaton Akustische Geräte-Gesellschaft m.b.H.
Wals-Himmelreich, Austria

Phonak France SA
Bron-Lyon, France

Phonak Italia Srl
Milan, Italy

Phonak Ibérica, S.A.
Alicante, Spain

Ets. Lapperre BHAC NV
Groot-Bijgaarden, Belgium

Phonak Belgium NV
Dilbeek, Belgium

Phonak B.V.
Nieuwegein, The Netherlands

Phonak Danmark A/S
Frederiksberg, Denmark

Phonak AB
Stockholm, Sweden

Phonak AS
Oslo, Norway

Phonak Group Ltd.
Warrington, United Kingdom

Phonak Polska Sp. Z o.o.
Warsaw, Poland

Phonak LLC
Warrenville, USA

Phonak Canada Ltd.
Mississauga, Canada

CAS Produtos Médicos Ltda.
Sao Paulo, Brazil

Phonak Pty. Ltd.
Baulkham Hills, Australia

Phonak New Zealand Ltd.
Auckland, New Zealand

Jordan Hearing Aids Manufacturing Co. Ltd.
Amman, Jordan

Phonak Japan Co., Ltd.
Tokyo, Japan

Phonak (Sichuan) Co., Ltd.
Sichuan, China

THC Finance Ltd.
Bermuda

RAV Finance Inc.
USA

Metro Hearing Inc.
Wilmington, USA

HIMSA, A/S
Copenhagen, Denmark

Cochlear Acoustics Ltd.
London, United Kingdom

Unitron Hearing

Unitron Hearing GmbH
Fellbach-Oeffingen, Germany

Unitron Hearing B.V.
Nieuwegein, The Netherlands

Unitron Hearing, Inc.
Plymouth (Minnesota), USA

Unitron Hearing Ltd.
Kitchener, Canada

Unitron Hearing (Suzhou) Co., Ltd.
Suzhou, China

Unitron Hearing Korea Co., Ltd.
Seoul, South Korea

Wireless Communication Systems

Phonak Communications AG
Murten, Switzerland

Capital Structure

Changes in capital structure since 2004

As of March 31, the capital of Phonak Holding AG comprised the following:

	2006	2005	2004
Share capital (in CHF)	**3,318,046**	3,301,120	3,273,110
Total shares	**66,360,925**	66,022,400	65,462,200
Conditional capital (in CHF)	**412,400**	264,270	292,280
Conditional shares	**8,247,995**	5,285,400	5,845,600
Authorized capital (in CHF)	**165,056**	0	0
Authorized shares	**3,301,120**	0	0

Phonak Holding AG registered shares have been quoted on the Swiss stock exchange (SWX Swiss Exchange) since November 1994. The par value of one standard registered share amounts to CHF 0.05. The share capital is fully paid up. With the exception of the shares held by the company itself, each ordinary share bears one voting right at the Annual General Shareholders' Meeting and is entitled to dividend payments. As of March 31, 2006, the company held 34,633 (previous year 7,700) own shares.

Ordinary share capital

The Annual General Shareholders' Meeting of July 5, 2001, approved a capital reduction and repayment of CHF 15 on the par value per share. At the same time, shareholders approved a 1:100 share split. This reduced the par value of Phonak registered shares from CHF 20 to CHF 0.05.

In the financial year 2005/06, a total of 338,525 employee options were exercised. Each option provides the right to purchase one registered share out of the conditional share capital. In the financial years 2004/05 and 2003/04, a total of 560,200 and 90,000 employee options were exercised. As a result, as of March 31 in each year, the total number of issued shares as well as the share capital increased correspondingly. At the same time, the exercising of these options led to a corresponding decrease in the conditional share capital reserved for key employees share option plans (see also table on page 30).

Conditional share capital

As of March 31, 2006, the company had a total conditional share capital of 8,247,995 registered shares with a par value of CHF 0.05 per share.

The Annual General Shareholders' Meeting held on July 7, 2005, approved the creation of conditional share capital of 3,301,120 registered shares with a par value of CHF 0.05 per share. The purpose of the extra conditional share capital created is to improve the company's financial flexibility. This capital may be used for exercising option and conversion rights granted in connection with bonds or similar debt instruments issued by the company for the purpose of financing the acquisition of or investment in companies. The conditional share capital of 3,301,120 registered shares created on July 7, 2005, has not yet been used.

At the Annual General Shareholders' Meetings in 1994 and 2000, conditional share capital was created with the purpose of offering Phonak shares, through an option program, to key employees of the Phonak Group. From a maximum of 8,000,000 approved shares with a par value of CHF 0.05, 3,053,125 shares have been issued up to March 31, 2006, reducing the maximum conditional share capital reserved for key employees share option plans to 4,946,875 (previous year 5,285,400) shares.

In the financial year 2005/06, a total of 420,818 options were granted as part of the Phonak Executive Equity Award Plan (EEAP). In the financial year 2004/05, a total of 712,000 options (as part of the EEAP), and in the financial year 2003/04, a total of 780,450 options (as part of the Key People Program) were granted.

At March 31, 2006, a total of 1,842,693 (prior year 1,852,250) options were outstanding. Each of these options entitles the holder to purchase one registered share in Phonak Holding AG with a par value of CHF 0.05.

Authorized share capital

As of March 31, 2006, the company had authorized share capital of 3,301,120 registered shares with a par value of CHF 0.05 per share.

The Annual General Shareholders' Meeting held on July 7, 2005, approved the creation of authorized share capital of 3,301,120 registered shares with a par value of CHF 0.05 per share. The Board of Directors is authorized to exclude subscription rights of shareholders and to allocate them to third parties if the new shares are to be used for the acquisition of companies, parts of companies, equity stakes or the financing of such transactions. The authorized share capital of 3,301,120 registered shares created on July 7, 2005, has not yet been used. The authorization granted to the Board of Directors to augment the company's share capital with the authorized share capital created expires on July 6, 2007.

Changes in shareholders' equity

Regarding changes in shareholders' equity see Note 3.6 to the Financial Statements of Phonak Holding AG (for the third financial year prior to the reporting period, refer to the same Note in the Annual Report 2004/05).

Restrictions on transferability

For restrictions on transferability, see the chapter entitled "Voting rights restriction and representation" on page 31 of this report.

Board of Directors

The primary duty of the Board of Directors of Phonak Holding AG is the overall direction of the company and the supervision and control of the management. To this end, the Board of Directors works in close collaboration with the Management Board. The Articles of Association of Phonak Holding AG state that the Board of Directors must consist of a minimum of three and a maximum of nine members.

During the reporting period, the Board of Directors held six meetings, one of which was a two-day strategy workshop. Telephone conferences were organized to discuss time-sensitive business issues. The Board of Directors receives consolidated financial statements (balance sheet, income statement as well as statement of cash flows) on a monthly, semi-annual, and annual basis. In addition, the Board of Directors receives monthly consolidated sales reports, providing data on turnover, average selling prices, and units for each major product, subsidiary, and market.

The Board of Directors approves resolutions and holds elections with the majority of its members present at the meeting. In the event of an equal number of votes, the Chairman has the casting vote.

Elections and term of office

At the Annual General Shareholders' Meeting, the shareholders elect the Board of Directors of Phonak Holding AG. In general, each member is elected for a period of three business years. The term ends on the day of the ordinary Annual General Shareholders' Meeting for the last business year of the term. If, during a term, a substitute is elected to the Board of Directors, the newly elected member finishes the term of his predecessor. Re-elections for successive terms are possible. A member of the Board of Directors who reaches the age of 70 during his or her term must resign at the next ordinary Annual General Shareholders' Meeting.

Left to right: Robert F. Spoerry, Dr. h.c. Daniel Borel, Andy Rihs, Dr. Michael Jacobi, Heliane Canepa, William D. Dearstyne

Audit Committee

Current members of the Audit Committee are Dr. Michael Jacobi (Chairman), Heliane Canepa, and William D. Dearstyne.

Within the context of its overall remit, the Audit Committee reviews on behalf of the Board of Directors the work and effectiveness of the external and internal audit, evaluates the financial control, the financial structure and risk management mechanisms of the company, and reviews the interim and annual financial accounts of the Group. The Audit Committee also supervises audits to be completed by the internal audit department and reviews the results of these audits.

The Audit Committee meets at least twice a year, but as often as required. In the reporting period, the Committee met four times.

Nomination and Compensation Committee

During the reporting period, the Nomination Committee and the Compensation Committee were merged into a single committee. This merger simplifies and optimizes the organizational structure and ensures more efficient deployment of human resources.

Current members of the new Nomination and Compensation Committee are Andy Rihs (Chairman), Dr. h.c. Daniel Borel, and Robert F. Spoerry, all former members of the Compensation Committee.

The primary task of this Committee is to review and propose to the Board of Directors the compensation structure and amount for the Board of Directors and the members of the Management Board, and to select and propose to the Board of Directors suitable candidates for election to the Board of Directors and for appointment to the Management Board. The Committee submits the relevant proposals and nominations to the Board of Directors.

The Committee meets as often as required. In the reporting period, the Committee met three times.

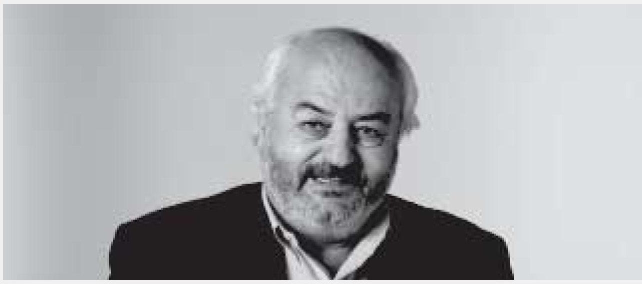
Attendance at Board of Directors and committee meetings

The following overview shows the individual Board members' attendance at Board of Directors and committee meetings.

	A	B	C
Number of meetings 2005/06	6	4	3
Andy Rihs	6	–	3
William D. Dearstyne	6	4	–
Dr. h.c. Daniel Borel	5	–	3
Heliane Canepa	6	4	–
Dr. Michael Jacobi	4	4	–
Robert F. Spoerry	6	–	3

A Board of Directors
B Audit Committee
C Nomination and Compensation Committee

Members of the Board of Directors



Andy Rihs 1942; Swiss
Position: Chairman, non-executive
First election to the Board: 1985; Chairman since 1992
Current Board term ends: AGM 2006
Other activities: Chairman of the Board of ARfinanz Holding AG
Member of the Board of Polyusus V AG
Member of the Board of Sport und Event Holding AG, Lucerne

William D. Dearstyne 1940; American
Position: Vice-Chairman, non-executive
First election to the Board: 2003; Vice-Chairman since 2004
Current Board term ends: AGM 2006
Other activities: Member of the Advisory Council of Earlybird Venture Capital GmbH & Co.
Member of the Board of Trustees of Bucknell University, Lewisburg, PA
Member of the Board of Bioness, Inc., California

Dr. h.c. Daniel Borel 1950; Swiss
Position: Non-executive
First election to the Board: 1999
Current Board term ends: AGM 2008
Other activities: Chairman of the Board of Logitech International Ltd.
Member of the Board of Julius Bär Holding AG
Member of the Board of Nestlé SA

Heliane Canepa 1948; Swiss
Position: Non-executive
First election to the Board: 1999
Current Board term ends: AGM 2008
Other activities: CEO Nobel Biocare Holding AG

Dr. Michael Jacobi 1953; German
Position: Non-executive
First election to the Board: 2003
Current Board term ends: AGM 2006
Other activities: CFO Ciba Specialty Chemicals AG

Robert F. Spoerry 1955; Swiss
Position: Non-executive
First election to the Board: 2003
Current Board term ends: AGM 2006
Other activities: Chairman, President and CEO of Mettler-Toledo International Inc.
Member of the Board of Conzetta Holding AG
Member of the Board of Schaffner Holding AG

Andy Rihs (born in 1942) has been Chairman of the Board of Directors of Phonak Holding AG since 1992. He is one of the founders of the Phonak Group, together with his partner, Beda Diethelm, and his brother Hans-Ueli Rihs.

In 1966, Andy Rihs joined Beda Diethelm who came to Phonak a year earlier as technical manager. Andy Rihs began to build up the marketing and commercial aspect of the company. He first established a sales organization for Switzerland, then gradually built up a global distribution network. Andy Rihs led the Phonak Group as CEO until April 2000, and as interim CEO, from April to September 2002. Under his leadership, the company grew continuously and succeeded in establishing an outstanding brand image for Phonak – known for products of the highest technological standard and reliability.

Andy Rihs completed his education and business training primarily in Switzerland and France.

Dr. h.c. Daniel Borel (born in 1950) has been Chairman of the Board of Logitech International Ltd. since 1988.

He co-founded Logitech in 1981 and served as CEO from 1992 to 1998. During this time, Daniel Borel was instrumental in growing Logitech around the world and establishing the company's high-volume manufacturing capability in Asia. In 1988, he took the Logitech Group public on the SWX Swiss Exchange and in 1997 on Nasdaq.

Daniel Borel holds an engineering degree from the Swiss Federal Institute of Technology Lausanne, Switzerland, and a master's degree in Computer Science from Stanford University, California. He was awarded an honorary doctorate from Lausanne's Federal Institute of Technology in 1992.

Dr. Michael Jacobi (born in 1953) is CFO and member of the Executive Committee of Ciba Specialty Chemicals AG – a position he has held since 1997 and in which he is responsible for Treasury, M&A, Investor Relations, and Controlling.

Michael Jacobi joined Ciba-Geigy's Control & Management Services in 1978 when he held positions in finance, accounting, and planning in Brazil and the US. In 1987, he returned as Head of Management Accounting at the Finance Department in Basel, Switzerland, where he later became responsible for Ciba-Geigy's overall corporate financial accounting and reporting.

Michael Jacobi studied at the University of St. Gallen, Switzerland, at the Washington University in Seattle, and at the Harvard Business School in Boston. In St. Gallen, he earned a doctorate degree with a thesis on the International Accounting Standards.

William D. Dearstyne (born in 1940) retired in April 2003 from his position as Company Group Chairman and member of the Medical Devices and Diagnostics Group Operating Committee of Johnson & Johnson.

During the 34 years of his career managing diversified healthcare companies, he gained valuable business experience in Asia, Central and Eastern Europe as well as Latin America. He served in many different functions during his 26 years at Johnson & Johnson. Within this period, he also led two major acquisitions for the company – Cordis and DePuy – both of which today occupy leadership positions in interventional cardiology and orthopedics respectively.

William D. Dearstyne studied at Bucknell University in Lewisburg, Pennsylvania, and at Syracuse University in New York where he earned an MBA in International Business.

Heliane Canepa (born in 1948) has been President and CEO of Nobel Biocare AB, Sweden, a company primarily engaged in dental implants, since 2001. Since 2002, she has also been CEO of the newly established group parent company, Nobel Biocare Holding AG.

Before joining Nobel Biocare, Heliane Canepa acted as CEO of the medical technology company Schneider Worldwide. In 1984, Schneider was sold to Pfizer Inc., which resold the entity to Boston Scientific in 1998. Because Boston Scientific already had a European production site in Ireland, the location in Bülach, Switzerland, was closed. Heliane Canepa earned special merit for her work in assisting employees to find new employment opportunities. She was voted Entrepreneur of the year in Switzerland in 1995 and 1999.

Heliane Canepa completed business school in Dornbirn, Austria, West London College in London, Sorbonne University in Paris, and the Foreign Executive Development Program at Princeton University, New Jersey.

Robert F. Spoerry (born in 1955) is Chairman, President and CEO of Mettler-Toledo International Inc., a leading global manufacturer of precision instruments for use in laboratory, manufacturing and food retailing applications, quoted on the New York Stock Exchange (NYSE) since 1997.

Robert F. Spoerry joined Mettler-Toledo in 1983, served as Head of the Industrial and Retail Division in Europe from 1987 until 1993, and was in charge of the lead in the acquisition and integration of Toledo Scale Corporation (USA). In 1989, he was appointed to the company's Executive Board, was nominated CEO in 1993 and assigned Chairman in 1998.

Robert F. Spoerry graduated in mechanical engineering at the Federal Institute of Technology in Zurich, Switzerland, and received an MBA from the University of Chicago.

Members of the Management Board

Dr. Valentin Chapero Rueda 1956; Spanish
Position: CEO
Appointment: October 2002

Oliver Walker 1969; Swiss
Position: CFO
Appointment: October 2004

Dr. Herbert Bächler 1950; Swiss
Position: CTO
Appointment: June 2002

Paul Thompson 1967; Canadian
Position: EVP Corporate Development
Appointment: January 2002

Toni Schrofner 1963; Austrian
Position: EVP Operations & Supply Chain
Appointment: December 2003

Dr. Valentin Chapero Rueda (born in 1956) joined the Phonak Group as CEO in October 2002.

Before joining Phonak, Valentin Chapero Rueda was CEO of the Mobile Networks Division of Siemens. Prior to this, between mid-1996 and the end of 1999, he was CEO of the Siemens Audiology Group, the world's largest hearing instrument manufacturer. He took the company into the digital era, tripling sales and significantly improving profitability. Valentin Chapero Rueda began his career within the R&D department of Nixdorf Computer.

Valentin Chapero Rueda, whose parents are Spanish, grew up and completed his education in Germany. He graduated in Physics at the University of Heidelberg, Germany, and was awarded his doctorate with a thesis in the medicine/physics field.

Dr. Herbert Bächler (born in 1950) has been a key member of Phonak's management team since 1981. In June 2002, he was appointed to the position of Chief Technology Officer (CTO) and became a member of the Management Board.

Herbert Bächler is responsible, on a groupwide basis, for directing the various research projects. His duties include the pursuit of new technologies and their application to hearing instruments and related business opportunities.

Herbert Bächler received his diploma in Electronic Engineering in 1973 and his doctorate in 1978 from the Swiss Federal Institute of Technology Zurich, Switzerland.

Toni Schrofner (born in 1963) joined the Phonak Group as Executive Vice President Operations & Supply Chain and became a member of the Management Board in December 2003.

Before joining Phonak, Toni Schrofner was acting as President of Tecan Instruments and member of Tecan Group's Executive Management Team. The position included the function of General Manager Tecan Schweiz AG. Prior to the appointment at Tecan headquarters, he was Managing Director of Tecan Austria GmbH between 1996 and 2001.

Toni Schrofner earned a diploma in mechanical engineering (focus on mechanical engineering and operation technology) at the HTL in Salzburg, Austria, and completed his MCI Studies of Economics/International Management at the University of Innsbruck, Austria.

Oliver Walker (born in 1969) was appointed CFO of the Phonak Group in October 2004.

Before joining Phonak, he held the position of CFO of Stratec Medical Group Oberdorf, Switzerland, since 2000. Stratec is a leading international medical devices company, specializing in the development, manufacture, and marketing of instruments and implants for the surgical treatment of bones. Prior to Stratec, Oliver Walker worked for seven years with the Von Roll Group, a diversified industrial company. His most recent position there was as Head of Finance and Controlling for the division Von Roll Infratec.

Oliver Walker studied Economics at the University of Berne, Switzerland; he holds a Masters Degree in Business Economics.

Paul Thompson (born in 1967) was appointed to the position of Executive Vice President Corporate Development in October 2004. In this position, he is responsible for the development of the Group Strategy and the implementation of various business development activities.

Prior to this appointment, he was CFO of the Phonak Group since the beginning of 2002. Between 1998 and 2001, Paul Thompson acted as CFO and later also as COO of the Unitron Hearing Group. Before joining Unitron Hearing, between 1987 and 1998, he worked for Ernst & Young in Canada, first in the auditing division and then in the management consulting division.

Paul Thompson studied Finance and Economics at the University of Waterloo, Canada. In 1992, Paul Thompson was granted his Chartered Accountant designation and in 1998, he achieved the designation of Certified Management Consultant.

Management Board

The Management Board is responsible for the operational management of the company. Furthermore, it prepares for and later executes decisions made by the Board of Directors. With the revision of Phonak's Organizational Regulations on May 25, 2005, a new management body was created: the "Management Board". This replaces the previous "Group Executive Management". According to the Organizational Regulations of Phonak, the Management Board consists of at least four members, with other members added to suit strategic requirements. The Management Board is appointed by the Board of Directors, as recommended by the Chief Executive Officer (CEO).

Compensation, Shareholdings, and Loans

Members of the Board of Directors receive a fixed payment and participation in the company's option plan as compensation. Members of the Management Board receive a performance-related compensation package, including a fixed basic salary, a performance-based bonus payment, and options. The compensation of the Board of Directors and the Management Board does not provide for the distribution of shares.

The remuneration of the members of the Board of Directors as well as the Management Board is determined and periodically reviewed by the Board of Directors as proposed by the Nomination and Compensation Committee.

During the reporting period, there were no honorariums paid for additional services above the ordinary remuneration nor were any loans awarded or guarantees given to members of the Board of Directors, members of the Management Board or to any parties closely linked to these governing bodies.

Compensation to members of the Board of Directors and the Management Board

Total remuneration (incl. employer's contribution) of the Board of Directors of Phonak Holding AG in the financial year 2005/06 amounted to CHF 0.6 million (previous year CHF 0.6 million).

The following table shows the remuneration in the form of fixed payment and options granted to the individual members of the Board of Directors in the financial year 2005/06.

Member of the Board of Directors	Payment in CHF	Options granted
Andy Rihs	152,451	12,000
William D. Dearstyne	86,458	12,000
Dr. h.c. Daniel Borel	82,265	12,000
Heliane Canepa	84,894	12,000
Dr. Michael Jacobi	82,765	12,000
Robert F. Spoerry	82,830	12,000
Total	**571,663**	**72,000**

Total remuneration (incl. employer's contribution) of the members of the Management Board in the financial year 2005/06 amounted to CHF 3.9 million (previous year CHF 4.1 million).

Additional severance payments to former members of the Board of Directors and the Management Board

In the financial year 2005/06, an additional severance payment of CHF 989,000 was made to a former member of the Management Board who gave up his function during the period under review.

Share and option ownership of members of the Board of Directors and the Management Board

As of March 31, 2006, the members of the Board of Directors held directly and indirectly 7,264,296 shares (10.9% of total share capital) and 213,000 options.

The following table shows the share and option ownership of the individual members of the Board of Directors as of March 31, 2006.

Member of the Board of Directors	Number of shares	Number of options
Andy Rihs	7,239,100	36,000
William D. Dearstyne	10	36,000
Dr. h.c. Daniel Borel	1	36,000
Heliane Canepa	15,010	33,000
Dr. Michael Jacobi	175	36,000
Robert F. Spoerry	10,000	36,000
Total	**7,264,296**	**213,000**

As of March 31, 2006, the members of the Management Board held directly and indirectly 9,389 shares and 607,000 options.

Options

As of March 31, 2006, the members of the Board of Directors (all non-executive) and the Management Board held 820,000 options on Phonak stock. Each option has a share subscription ratio of 1:1 (see table on page 30).

The options granted to all employees of the Group (incl. Board of Directors) in 2005/06 (420,818 options) had a value of approximately CHF 4.1 million over the term of the options, as calculated using a binomial option pricing model. The value of options granted is booked to the income statement. For further details, we refer to Note 32 on page 80 of the Consolidated Financial Statements within this report.

Options granted to the Board of Directors

Year	Options granted/outstanding Total granted	of which outstanding	Strike price (CHF)	Blocking and exercise periods Blocking period	Exercise period	Number of options
2003/04	84,000	84,000	28.00	01.02.04 – 31.01.07	01.02.07 – 31.01.09	84,000
2004/05	72,000	69,000	39.00	01.02.05 – 31.01.06	01.02.06 – 31.01.10	15,000
				01.02.05 – 31.01.07	01.02.07 – 31.01.10	18,000
				01.02.05 – 31.01.08	01.02.08 – 31.01.10	18,000
				01.02.05 – 31.01.09	01.02.09 – 31.01.10	18,000
2005/06	72,000	72,000	63.25	01.02.06 – 31.01.07	01.02.07 – 31.01.11	18,000
				01.02.06 – 31.01.08	01.02.08 – 31.01.11	18,000
				01.02.06 – 31.01.09	01.02.09 – 31.01.11	18,000
				01.02.06 – 31.01.10	01.02.10 – 31.01.11	18,000
Total	**228,000**	**225,000**				**225,000**

Options granted to the Management Board

Year	Options granted/outstanding Total granted	of which outstanding	Strike price (CHF)	Blocking and exercise periods Blocking period	Exercise period	Number of options
2003/04	87,000	87,000	28.00	01.02.04 – 31.01.07	01.02.07 – 31.01.09	87,000
2004/05	500,000	480,000	39.00	01.02.05 – 31.01.06	01.02.06 – 31.01.10	5,000
				01.02.05 – 31.01.07	01.02.07 – 31.01.10	25,000
				01.02.05 – 31.01.08	01.02.08 – 31.01.10	25,000
				01.02.05 – 31.01.09	01.02.09 – 31.01.10	25,000
				01.02.05 – 30.09.06	01.10.06 – 30.09.10	100,000
				01.02.05 – 30.09.07	01.10.07 – 30.09.10	100,000
				01.02.05 – 30.09.08	01.10.08 – 30.09.10	100,000
				01.02.05 – 30.09.09	01.10.09 – 30.09.10	100,000
2005/06	80,000	80,000	63.25	01.02.06 – 31.01.07	01.02.07 – 31.01.11	20,000
				01.02.06 – 31.01.08	01.02.08 – 31.01.11	20,000
				01.02.06 – 31.01.09	01.02.09 – 31.01.11	20,000
				01.02.06 – 31.01.10	01.02.10 – 31.01.11	20,000
Total	**667,000**	**647,000**				**647,000**

Highest total compensation

The highest total compensation paid to a member of the Board of Directors in the financial year 2005/06 was to Andy Rihs, Chairman. This compensation consisted of a fixed payment of CHF 152,451 (previous year CHF 172,908) and 12,000 options (previous year 12,000 options). These options provide the right to purchase one Phonak share at a strike price of CHF 63.25 between February 1, 2007 and January 31, 2011.

The highest total compensation paid to a member of the Management Board in the financial year 2005/06 was to Valentin Chapero Rueda, CEO. This compensation consisted of a basic salary (incl. employer's contribution) of CHF 1,186,739 (previous year CHF 1,158,792) as well as a performance-related bonus (incl. employer's contribution) of CHF 736,755 (previous year CHF 684,040). In the financial year 2005/06 no options were granted to Valentin Chapero Rueda (previous year 400,000 options in the course of the renewal of the long-term employment contract).

Shareholders' Participation Rights

Voting rights restriction and representation

To be recognized as a shareholder with comprehensive rights, the acquirer of shares must place an application for entry in the share register. The registration in the share register as a shareholder with voting rights is limited to 5% of the share capital (Art. 6 par. 2 of the Articles of Association). Linked parties are considered as one person. To abolish this regulation, the absolute majority of the votes represented at the Annual General Shareholders' Meeting is sufficient.

In exercising their voting rights, no shareholder may unite, by a combination of own and represented shares together, more than 10% of the shares of the company (Art. 12 par. 2 of the Articles of Association).

The restrictions on the voting and representation rights do not apply to the founding shareholders. The Board of Directors may approve further exceptions with good reason and no special quorum is required for such decisions. During the reporting period, no exceptions to the above listed rules were granted.

Right to request items on the Annual General Shareholders' Meeting agenda

Shareholders entitled to vote who represent at least 5% of the share capital may request items to be added to the agenda by indicating the relevant proposals. Such requests must be addressed in writing to the Chairman of the Board of Directors no later than 60 days before the meeting.

Registering deadlines

The share register will be closed for about five days before the Annual General Shareholders' Meeting for administrative reasons. During this period, an admission card, with corresponding voting papers, will be sent to shareholders. In case of a partial sale within this time, the confirming documents must be exchanged on the day of the Annual General Shareholders' Meeting at the information desk. The shares can be traded at any time and are not blocked.

Changes of Control and Defense Measures

Public purchase offer

A purchaser of shares is obliged to make a public purchase offer when he has more than 49% of the voting rights at his disposal ("opting up", as per Art. 8 of the Articles of Association).

Clauses on changes of control

There are no agreements in place that, in the event of a change of control, provide members of the Board of Directors or the Management Board with abnormally high severance payments or other lucrative benefits.

In 2005, a member of the Management Board, CEO Valentin Chapero Rueda, signed a long-term employment contract running until 2010. Under a change of control provision, he is entitled to his full salary and part of the bonus payments in case the employment is terminated due to a change of control.

Auditors

Duration and term of mandate

During the ordinary Annual General Shareholders' Meeting of July 5, 2001 PricewaterhouseCoopers was elected as auditors of Phonak Holding AG and the Phonak Group. The head auditor responsible for the existing auditing mandate, Mr. Stephen W. Williams, took office as of July 5, 2001. At the Annual General Shareholders' Meeting on July 7, 2005, PricewaterhouseCoopers was re-elected for another term of one year.

Fees

PricewaterhouseCoopers charged CHF 624,000 for auditing services and CHF 265,000 for non-audit services during the year under review.

Supervisory and control instruments

The external auditors report their findings semiannually directly to the Audit Committee of the Board of Directors. In 2005/06, the external auditors attended two out of four Audit Committee meetings.

The Audit Committee of the Board of Directors reviews the performance, compensation, and independence of the external auditors on a regular basis. The Audit Committee reports quarterly its treated issues to the Board of Directors.

Information Policy

As a publicly listed company, the Phonak Group pursues an open and active information policy. A governing principle of this policy is to treat all stakeholders alike and to inform them at the same time. It is one of our top priorities to inform our shareholders, employees, and business partners in the most direct, open, and transparent way about our strategy, our global activities, and the current state of the company.

Important information available on Phonak's investors website
Capital structure and shareholder rights:
Articles of Association of Phonak Holding AG
Capital structure
Restrictions on shareholder rights
Shareholder structure
www.phonak.com/company/investors/governance.htm
Internal organization:
Organizational regulations
Phonak Group code of conduct
www.phonak.com/company/investors/governance.htm
Financial information:
Corporate & ad hoc news
Annual reports
Semi-annual reports
IR presentations
www.phonak.com/company/investors/financial.htm
Information on the AGM:
Request to put an item on the AGM agenda
Invitation/agenda
AGM presentations
AGM minutes
www.phonak.com/company/investors/governance/agm.htm
IR online news service:
IR News Service
www.phonak.com/company/investors/ir_news.htm
Contact and order form:
IR Contact Form
Order form for annual reports
www.phonak.com/company/investors/ir_contact.htm

Investor Relations Calendar

July 6, 2006	Annual General Shareholders' Meeting of Phonak Holding AG at the Kongresshaus Zurich
November 15, 2006	Publication of Semi-annual Report as of September 30, 2006
May 2007	Publication of Annual Report as of March 31, 2007
May 2007	Media and Analysts Conference
June 2007	Annual General Shareholders' Meeting of Phonak Holding AG

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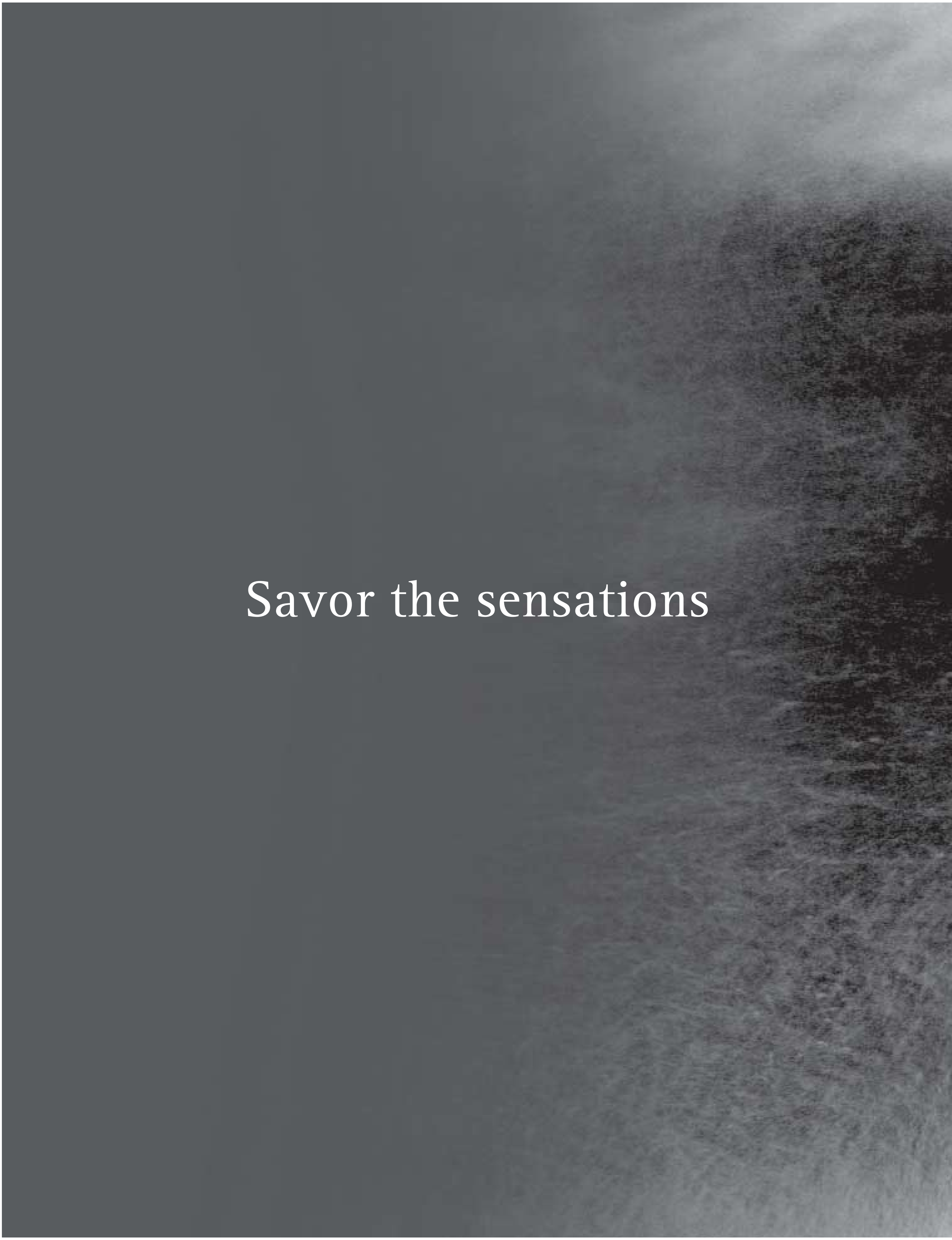

Savor the sensations

SUSTAINABILITY

Phonak's management strongly believes that striving for true economic success ultimately requires taking into account the needs and expectations of all relevant stakeholders.

The Board of Directors is totally independent and consists of well respected, very senior executives. Their professionalism, integrity, and reputation guarantee that the tasks and responsibilities of the Board of Directors are executed in the interest of the shareholders.

Phonak's unique corporate culture makes it an exceptionally attractive employer.

Knowledge management is a core element of Phonak's management philosophy: there are no barriers, no closed doors; employees can contact anybody at any time.

Over 750 employees already own shares in Phonak through various employee share option programs.

Our customers buy a better quality of life. We constantly strive for technological innovations, which can solve everyday problems of people suffering from hearing impairment.

Over several decades, Phonak has built up an excellent reputation for its high-quality and high-performance hearing instruments.

The quantity of raw materials going into Phonak's annual hearing instruments output equals approximately three passenger cars. The energy consumption of the production processes is also very modest.

The Phonak Group specializes in the development, manufacture, and worldwide distribution of technologically advanced hearing systems for adults and children with hearing impairment. Inherent in the Group's business activities is a fundamental commitment to improve individual hearing ability and speech understanding, thus contributing significantly to the quality of life of countless people worldwide.

Phonak's management strongly believes that striving for true economic success ultimately requires taking into account the needs and expectations of all relevant stakeholders. Phonak's enduring success story is based on particular respect for employees, a close relationship with customers, and a very constructive partnership with suppliers. Phonak's unique, innovative and powerful hearing instruments are the result of this teamwork. Finally, being economically successful allows Phonak to pass on attractive returns to its owners, i.e. the shareholders and to help those who are less fortunate.

This well-balanced approach, which considers all stakeholders, is observable throughout the company and is reflected in Phonak's core values. Working at Phonak is best characterized by flat hierarchical structures, equal treatment of employees, responsibility for one's own actions, transparent Corporate Governance, and open communication with all stakeholders. To sustain and further develop this strong corporate culture is one of management's top priorities and a driver for sustainable economic success.

Phonak's rapid growth and business expansion have made it important to set down in writing the core values we uphold and the ethical principles of our corporate culture, so that they are more readily accessible to our employees. The result is a groupwide Code of Conduct, which came into force on April 1, 2006. The purpose of the Code of Conduct is to encourage employees to act in an ethically correct way in their dealings with colleagues, business partners, and shareholders, as well as to help them live out our unique corporate culture in our worldwide operations. As a globally active company, the Phonak Group is fully aware of its responsibility for every individual member of staff. Not only does ethical conduct benefit all stakeholders – it also assures and strengthens our reputation and thereby contributes to our long-term commercial success.

Employees – our principal asset

The hearing instrument industry is not a capital-intensive business, but driven by constant product and service innovation. Thus, motivated, dedicated, and creative employees make a big difference and we must support them as best we can.

To safeguard our long-term success, we consistently invest in the professional training and development of our staff. In 2005/06, a total of 881 employees took part in training and professional development courses. This is roughly equivalent to

28% of the Phonak Group's headcount as of March 31, 2006. These data were collected for the first time during the financial year 2005/06. In 2006/07, we shall use the experiences to date to define standards for the whole Group.

During 2005/06, we launched a groupwide High Performance Program, designed to strengthen and develop our middle management, so that we are in a better position to fill key positions internally in the future. With this in mind, a steering committee comprising members of the Management Board identifies, assesses, and finally selects potential candidates from the entire Phonak Group. The training program is very practical, user-oriented, and tailored to the needs of the Phonak Group. The central goal is to promote specialist know-how, develop personal, social and management skills, and encourage entrepreneurial thinking beyond the individual's own area of responsibility. One important component of the High Performance Program is the mentor program sponsored by the members of the Management Board and top management. This aims to exploit the synergy potential arising from the combination of theory and practice. In February 2006, a total of 30 talented young managers from 16 Group companies took part in a one-week introductory event organized in conjunction with a distinguished management school. The feedback from those attending was extremely positive. Participants were particularly impressed by the quality and practical nature of the course content and the opportunity to exchange experiences beyond areas of responsibility and national borders. The program will carry on next year.

Interdisciplinary know-how in the "Science of Hearing" is paramount in order to develop and build superior hearing systems. Knowledge management is consequently a core element of Phonak's management philosophy: there are no barriers, no closed doors; employees can contact anybody at any time. This philosophy is also reflected in the open and light architecture of Phonak headquarters in Stäfa and of many other Group company offices worldwide. A groupwide, centralized project platform supports the integration of interdisciplinary and broadly based project teams. Dedicated and carefully planned professional development as well as systematic internalization of external know-how are also important knowledge management drivers.

The production setup for manufacturing a hearing instrument is similar to the watch industry. Very small components have to be manually positioned and soldered with the aid of microscopes, in very clean, climate-controlled, and light rooms. Employees at the different production sites share the same quality standards, identical production processes and standard work procedures.

In the current financial year, a groupwide survey of accident rates in the workplace was undertaken for the first time. This recorded 36 accidents that resulted in employees being unable to continue working. As expected, this rate is very low in relation to the total workforce of 3,428 (headcount as of March 31, 2006) and is a reflection of the low risk profile enjoyed by the hearing instrument industry. Those accidents reported were investigated; suggestions for improvements will be circulated to all Group companies. Viewed as a whole, the level of work accidents as a percentage of total reported accidents that led to work incapacity is almost negligible. Most of the accidents that happened to staff occurred during their free time or on their way to work, not actually at work. For the next financial year the Phonak Group plans to introduce accident prevention measures that exceed those for security at the workplace.

Phonak's unique corporate culture makes it an exceptionally attractive employer. We are able to attract skilled employees from very diverse backgrounds thanks to a dynamic work environment, challenging tasks, performance-based management style, flat hierarchical structures, and open communication, relaxed but courteous staff relations, and the fact that the hearing instrument business plays an important social role and has a secure future. To ensure that our staff participate in the company's long-term financial success, we have set up various employee share option programs. Over 750 employees already own shares in Phonak through these schemes.

Our customers buy a better quality of life

Our approach is not technology for its own sake. Instead, we constantly strive for technological innovations, which can solve everyday problems of people suffering from hearing impairment. For over 40 years now, Phonak has been committed to providing high-tech solutions for hearing-impaired people, thereby restoring some of their quality of life. In the case of children, Phonak's products give them access to the wealth of sounds, thereby helping them to develop the auditory skills they need to build their future. Furthermore, Phonak is a pioneer in the field of high-power amplification for people with severe hearing impairment.

Phonak drives innovation and has set the standards within the hearing instrument industry for many decades. Savia, Phonak's revolutionary hearing system in the digital premium segment, has established itself as the benchmark product in the hearing instrument industry. Savia incorporates many "world-firsts" like Real Ear Sound or EchoBlock, advanced functions which deliver unmatched hearing performance and provide an effortless and natural hearing experience. In the other price segments, Phonak now also offers eXtra and Eleva (both launched during 2005/06), two hearing systems that boast the excellent sound quality and basic functionality provided by the PALIO platform.

Another milestone in 2006/07 was the market launch of microPower and Verve. With microPower, the advantages of micro hearing systems – comfort and cosmetic appeal – are for the first time available to people with severe hearing impairment. Verve is in a class of its own – both in terms of technology and its comprehensive service package – and has carved out its own segment that is positioned above the digital premium segment.

Investment in training and continuing education

Last year, Phonak continued to invest heavily in the education of hearing care professionals and presented the latest scientific research and product innovations to a broad audience. As well as holding conferences, the company also created a unique web-based interactive learning platform. With innovation cycles becoming increasingly shorter and the number of hearing system functions steadily growing, our employees and distribution partners worldwide need to spend more time on training and continuing education. To ensure that users are able to fully benefit from the exceptional performance offered by our products, we need to ensure a high standard of education and training across the entire value chain. With the help of the new interactive learning platform, we can train our global workforce quickly and efficiently while at the same time addressing our clients directly. Leading scientists are already giving presentations on this platform and recorded product presentations can be downloaded from anywhere in the world. One positive consequence of this platform is that it reduces the amount of travel, thereby benefiting the environment.

During the last financial year, Phonak once again organized several highly regarded conferences on different topics in audiology. Over 350 experts from 34 different countries attended our Second European Conference for Pediatric Audiology in Amsterdam, the Netherlands, in October 2005. Here, internationally renowned specialists were able to share their knowledge with audiologists and pediatric experts. Topics included otitis media, causes of hearing impairment, environmental considerations, and current issues concerning the provision of hearing instruments for infants.

For November 2006 Phonak is planning an international conference in Chicago on the topic "Challenges associated with hearing care for the adult population". An international team of around 30 leading international experts will present the latest research findings. The scientific presentations are backed up by practical information that is useful for everyday work.

Recognizing that today's hearing instruments may still be improved to rival the hearing abilities of the human ear in all hearing situations, Phonak continuously pursues the development of new, innovative technologies that further improve the benefits for end users. Therefore, Phonak will invest significant R&D resources to further enhance the quality of life of many hearing-impaired children and adults. Phonak will continue its close collaboration with researchers and scientists worldwide in order to drive innovation in these respective fields even further.

The importance of product quality

Over several decades, Phonak has built up an excellent reputation for its high-quality and high-performance hearing instruments. In the process, it has transformed itself from a niche provider of high-end hearing systems to a complete solutions provider. The current product portfolio covers all price segments and caters for a wide variety of user requirements. Common to all products are the high quality standards typically associated with the name Phonak.

Hearing instruments are subject to standards imposed by the Medical Device Directive of the European Community, MDD 93/42/EEC, and by ISO standards 9001:2000 and 13485:2003, respectively. In order to comply with these rules, Phonak has to ensure biocompatibility of its products and must not use hazardous raw materials or operating supplies in its production process.

Unlike other medical devices, regulations allow a continuous product improvement process for previously introduced hearing instruments. Based on customer feedback and inputs from Phonak's quality assurance team, all hearing instruments are subject to continuous improvements during their product life cycle.

Ever shorter innovation cycles have fuelled a dramatic increase in the number of new products launched. In the financial year 2005/06 alone, the Phonak Group launched six new product families. In addition to the responsible product teams, a special quality assurance team has been set up to assure the quality of every individual product line across its entire life cycle.

The proprietary PALIO platform has been extended further during the financial year and provides the foundation for many other product lines, such as Indigo, the new Unitron Hearing instrument in the premium segment. The PALIO platform is a tool kit and is based on a modular approach that allows a high degree of reuse, resulting in further improvements in product quality. Every future product line will benefit from the learning curve and improvements of its predecessor. Consequently, the inherent risk of introducing a new product decreases significantly over time.

Close partnership with our suppliers

We have built close relationships with our suppliers over many years. Suppliers make a vital contribution to the development of new products: they provide the manufacturing equipment, raw materials, components, and operating supplies needed to make hearing systems. Innovation is based on effective collaboration between internal departments and several high-tech companies delivering specific building blocks incorporating their areas of expertise e.g. micro-electronics or electro-mechanics.

Hearing instruments are miniaturized high-performance medical devices and Phonak's suppliers share the same challenges and quality requirements and, like Phonak, are also subject to standards imposed by the Medical Device Directive of the European Community and by ISO norms.

In 2006/07, Phonak will continue to broaden and strengthen its cooperation with suppliers, which is key to keeping innovation at the current high level and to further improve competitiveness.

Corporate Governance

Phonak's Board of Directors is totally independent. The Board of Directors consists of well respected, very senior executives with a broad collective experience in many functions and in-depth knowledge of several industries. Their level of professionalism, integrity, and reputation guarantee that the tasks and responsibilities of the Board of Directors are executed in the interest of the shareholders.

As described in the "Corporate Governance" section of the Annual Report, the Board of Directors once again significantly improved the transparency of the compensation paid to the Board of Directors and the Management Board in 2005/06. It continuously monitors Corporate Governance principles and their observance, and will make further improvements if necessary.

Environmental impact is remarkably low

The quantity of raw materials going into Phonak's annual production of hearing instruments is equivalent to three mid-class passenger cars (see adjacent table). Due to the wide range of different product lines, this analysis is based on the new PALIO BTE platform which is currently used for Savia, Eleva, eXtra, microPower, Verve, and Indigo and in the future will be used as a basis for other product lines.

Hearing instruments are subject to standards imposed by the Medical Device Directive of the European Community, MDD 93/42/EEC, and by ISO standards 9001:2000 and 13485:2003. In order to comply with these rules, Phonak must not use hazardous raw materials or operating supplies in its production process. Unfortunately, these regulations also limit the use of recycled material or used components. Due to the premium quality of the input materials used, waste materials are still very valuable and are redirected into the recycling loop, which includes the recovery of plastic remnants from molding processes, cut-offs from printed circuit boards, and metals.

Waste water from cleaning processes is filtered, filters are disposed of and the processed water redirected into the normal water cycle. The energy consumption of the production processes is very modest. Climate control accounts for most of the energy consumed.

In 2005/06, the Phonak Group extended its recycling measures across the entire life cycle of the products and implemented the EU Directive WEEE (Waste Electrical and Electronic Equipment) worldwide. This directive requires that consumers no longer simply dispose of old electrical devices in their household rubbish, but in an environmentally responsible way through individual collection and recycling systems. This directive also affects owners of hearing instruments. Phonak has affiliated itself to country-specific disposal systems. If these do not exist, Phonak takes back used devices and disposes of them correctly at its headquarters in Stäfa, Switzerland.

In 2005/06, the ongoing miniaturization of hearing systems – especially the micro devices for open fitting such as microSavia and microEleva – led to lower consumption of raw materials and operating supplies per unit, while the acoustic performance of the hearing systems was substantially improved.

As more product lines are built on the PALIO platform, today's very low level of raw materials and operating supplies usage per unit will decrease further in 2006/07. Additional improvements in production processes will boost yields and support this trend.

Analysis based on the PALIO BTE platform

Plastics	2,142 kg
Rubber	111 kg
Metals	787 kg
Non-ferrous metal	25 kg
Printed Circuit Boards (PCB)	268 kg
Chipset	37 kg
Lacquer	36 kg
Total	**3,406 kg**

A high level of social commitment

Through its Phonak and Unitron Hearing Group companies, the Phonak Group is involved in numerous projects to raise general awareness about better hearing and the benefits of hearing instruments. It also supports a number of social projects to improve the quality of life for people with hearing impairment, especially children.

In 2005/06 Phonak increased the level of financing for the Eduplex project. The Eduplex School is a unique educational program, opened by Dr. Nelson Mandela in Pretoria, South Africa, in 2002, providing equipment to ensure that deaf children are fully included in the regular school program. The Eduplex program proves that today's technology, in combination with an inclusive, language-enabling environment, makes it possible for deaf and hearing-impaired children to acquire fluent spoken language and good academic results. The success of this program can be seen in the lives of talking deaf adults who have achieved their full academic potential.

Unitron Hearing supports children attending courses at the KidsAbility Centre for Child Development in Cambridge, Ontario (Canada). These courses include therapy sessions attended by the whole family in which students learn to improve their language and speech skills through listening.

Unitron Hearing is also involved in the Ontario Infant Hearing Program. This program conducts hearing tests on over 1,000 babies and infants every year, and the families receive assistance with the difficult task of bringing up small children who suffer from hearing loss.

Unitron Hearing also helps fund the China aid campaign run by the University of Iowa, whose purpose is to supply hearing instruments to orphans and disadvantaged Chinese children suffering from hearing loss and to train medical personnel to fit hearing systems.

Phonak New Zealand has a project that cares for hearing-impaired children in Lautoka School, Fiji. In a five-year program named "HearAid project", Phonak New Zealand is contributing funds, staff resources, and hearing instruments to the school. Last year, a teacher also received additional training in how to teach deaf pupils. Phonak staff regularly visit the Lautoka School to test children's hearing and adjust hearing systems.

Phonak New Zealand also supports the Federation for Deaf Children and each year awards academic prizes to deaf children who excel at their studies.

Phonak Denmark supports the Danish Auditory Processing Disorders (APD) Group, providing not only funding but also organizational and administrative assistance. The APD Group holds seminars and conferences on the topic "Auditory processing and perception disorders", thus contributing to research and the exchange of know-how.

Phonak Denmark also subsidizes research projects with autistic children. The focus here is on whether the use of sensory enhancers can effectively improve the exceptionally poor concentration of these children.

We will continue our projects and intensify our contribution to the community in 2006/07 onwards.

Push your performance

CONSOLIDATED FINANCIAL STATEMENTS

Consolidated Income Statement

1,000 CHF	Notes	2005/06	2004/05[1]
Sales	5	**866,682**	**660,375**
Cost of sales		(289,478)	(242,561)
Gross profit		**577,204**	**417,814**
Research and development		(63,039)	(48,932)
Sales and marketing		(206,846)	(159,117)
General and administration		(93,433)	(85,766)
Other (expenses)/income, net	8	(2,224)	1,798
Operating profit (EBIT)		**211,662**	**125,797**
Financial income	9	5,553	3,568
Financial expenses	9	(1,285)	(4,393)
Share of (loss)/gain in associates/joint ventures	19	(134)	152
Income before taxes		**215,796**	**125,124**
Income taxes	10	(43,331)	(29,268)
Income after taxes		**172,465**	**95,856**
Attributable to			
Equity holders of the parent		171,447	95,024
Minority interest		1,018	832
Basic earnings per share (CHF)	11	2.591	1.450
Diluted earnings per share (CHF)	11	2.568	1.434

[1] Including adjustments in accordance with new IFRS accounting standards (see Notes)
The Notes are an integral part of the consolidated financial statements

Consolidated Balance Sheet

Assets			
1,000 CHF	Notes	31.3.2006	31.3.2005[1]
Cash and cash equivalents	13	179,549	173,243
Financial assets at fair value through profit or loss	7, 14	12,762	12,401
Trade receivables	15	194,330	139,197
Other receivables and prepaid expenses	16	45,542	19,972
Inventories	17	94,244	86,550
Total current assets		**526,427**	**431,363**
Tangible assets	18	117,255	115,391
Intangible assets	21	208,379	139,141
Investments in associates/joint ventures	19	4,064	1,596
Other investments and long-term loans	20	12,854	7,811
Deferred tax assets	10	59,146	44,923
Retirement benefit assets	31	3,135	3,135
Total non-current assets		**404,833**	**311,997**
Total assets		**931,260**	**743,360**

Liabilities and equity			
1,000 CHF	Notes	31.3.2006	31.3.2005[1]
Short-term debts	23	12,253	30,789
Trade payables		37,562	30,988
Taxes payable		40,945	22,960
Financial liabilities at fair value through profit or loss	7	1,649	1,421
Other short-term liabilities	24	91,948	85,936
Short-term provisions	22	37,795	26,339
Total current liabilities		**222,152**	**198,433**
Mortgages	25	377	12,571
Other long-term debts	26	98	47,078
Long-term provisions	22	40,841	12,881
Other long-term liabilities	27	8,710	5,137
Deferred tax liabilities	10	32,049	17,556
Total non-current liabilities		**82,075**	**95,223**
Total liabilities		**304,227**	**293,656**
Share capital		3,318	3,301
Share premium		154,042	146,578
Treasury shares		(2,183)	(319)
Retained earnings		469,625	298,231
Equity attributable to equity holders of parent		624,802	447,791
Minority interest		2,231	1,913
Equity		**627,033**	**449,704**
Total liabilities and equity		**931,260**	**743,360**

[1] Including adjustments in accordance with new IFRS accounting standards (see Notes)
The Notes are an integral part of the consolidated financial statements

Consolidated Statement of Cash Flows

1,000 CHF	Notes		2005/06		2004/05[1]
Income before taxes			**215,796**		**125,124**
Depreciation of tangible assets	18	22,353		21,761	
Amortization of intangible assets	21	4,649		3,546	
Loss/(gain) on sale of tangible and intangible assets, net		843		(27)	
Share of loss/(gain) in associates/joint ventures	19	134		(152)	
Increase in other long-term provisions		16,864		3,123	
Financial (income)/expenses, net	9	(4,268)		825	
Unrealized exchange differences		(2,078)		881	
Reduction of payment to pension fund				980	
Other non-cash items		6,412	44,909	3,202	34,139
Cash flow before changes in working capital			**260,705**		**159,263**
Increase in trade receivables		(40,277)		(25,331)	
Increase in other receivables and prepaid expenses		(24,347)		(3,548)	
Decrease/(increase) in inventories		1,829		(9,888)	
Increase/(decrease) in trade payables		267		(3,277)	
Increase in other payables, accruals and short-term provisions		6,537		12,285	
Income taxes paid		(38,164)	(94,155)	(24,450)	(54,209)
Cash flow from operating activities			**166,550**		**105,054**
Purchase of tangible assets	18	(22,491)		(19,576)	
Proceeds from sale of tangible assets		2,899		934	
Cash consideration for acquisitions, net of cash acquired	29	(40,773)		(3,001)	
Purchase of intangible assets	21	(4,504)		(3,507)	
Purchase of financial assets at fair value through profit or loss		(133)		(1,715)	
Sale of financial assets at fair value through profit or loss				1,348	
(Increase)/decrease in other investments and long-term loans		(5,247)		1,030	
Interest received and realized gain from financial assets at fair value through profit or loss		5,533		3,214	
Cash flow from investing activities			**(64,716)**		**(21,273)**
Free cash flow			**101,834**		**83,781**
Repayments of borrowings and mortgages		(82,391)		(52,548)	
Proceeds from capital increases		6,447		7,560	
Sale of treasury shares		5,770		5,600	
Purchase of treasury shares		(8,176)		(319)	
Dividend paid by Phonak Holding AG		(19,840)		(13,074)	
Dividend paid to minorities		(133)		(136)	
Interest paid		(1,011)		(3,183)	
Proceeds from foreign exchange contracts				1,360	
Cash flow from financing activities			**(99,334)**		**(54,740)**
Currency translation differences			3,806		(926)
Increase in cash and cash equivalents			**6,306**		**28,115**
Cash and cash equivalents at April 1			173,243		145,128
Cash and cash equivalents at the end of the financial year			**179,549**		**173,243**

[1] Including adjustments in accordance with new IFRS accounting standards (see Notes)
The Notes are an integral part of the consolidated financial statements

Consolidated Changes in Equity

	Attributable to equity holders of Phonak Holding AG						
	Share capital	Share premium	Retained earnings	Cumulative translation adjustment	Treasury shares	Minority interest	Total equity
1,000 CHF							
Balance April 1, 2004 (as reported)	**3,273**	**135,164**	**238,190**	**(23,577)**	**(3,960)**	**1,248**	**350,338**
Effect of adopting IFRS 2[1)]		364	(364)				
Balance April 1, 2004 (restated)	**3,273**	**135,528**	**237,826**	**(23,577)**	**(3,960)**	**1,248**	**350,338**
Changes in accounting principles (IFRS 3)			107				107
Tax on items taken directly to the equity			42				42
Currency translation differences				1,883		(31)	1,852
Total income and expense recognized directly in equity			**149**	**1,883**		**(31)**	**2,001**
Consolidated income after taxes			95,024			832	95,856
Total recognized income and expense for the year			**95,173**	**1,883**		**801**	**97,857**
Capital increase of Phonak Holding AG from conditional capital	28	7,532					7,560
Share-based payments (IFRS 2)[1)]		1,878					1,878
Sale of treasury shares		1,640			3,960		5,600
Purchase of treasury shares					(319)		(319)
Dividend paid by Phonak Holding AG			(13,074)			(136)	(13,210)
Balance March 31, 2005	**3,301**	**146,578**	**319,925**	**(21,694)**	**(319)**	**1,913**	**449,704**
Changes in minorities						(567)	(567)
Currency translation differences				19,787			19,787
Total income and expense recognized directly in equity				**19,787**		**(567)**	**19,220**
Consolidated income after taxes			171,447			1,018	172,465
Total recognized income and expense for the year			**171,447**	**19,787**		**451**	**191,685**
Capital increase of Phonak Holding AG from conditional capital	17	6,430					6,447
Share-based payments (IFRS 2)		1,275					1,275
Sale of treasury shares		(241)			6,312		6,071
Purchase of treasury shares					(8,176)		(8,176)
Dividend paid by Phonak Holding AG			(19,840)			(133)	(19,973)
Balance March 31, 2006	**3,318**	**154,042**	**471,532**	**(1,907)**	**(2,183)**	**2,231**	**627,033**

1) Adjustments in accordance with new IFRS accounting standards (see Note 32)
The Notes are an integral part of the consolidated financial statements

Notes to the Consolidated Financial Statements

1. Corporate information

The Phonak Group (the "Group") specializes in the development, manufacture, and distribution of technologically advanced hearing systems for adults and children with hearing impairment. The Group operates worldwide and distributes its products in over 70 countries through its own distribution network and through independent distributors. The ultimate parent company is Phonak Holding AG, a limited liability company incorporated in Switzerland. Phonak Holding AG's registered office is located at Laubisrütistrasse 28, CH-8712 Stäfa, Switzerland.

2. Changes in accounting policies

The International Accounting Standards Board (IASB) issued a revised version of IAS 32 "Financial Instruments: Disclosure and Presentation", a revised version of IAS 39 "Financial Instruments: Recognition and Measurement" and a general revision of its International Accounting Standards (IAS) which included revisions of 14 existing standards published in 2003. In 2004, the IASB published the standards IFRS 2 "Share-based payment", IFRS 3 "Business Combinations", IFRS 4 "Insurance Contracts", IFRS 5 "Non-Current Assets Held for Sale and Discontinued Operations", IAS 36 "Impairment of Assets" and IAS 38 "Intangible Assets" as well as further additions to IAS 39.

The Phonak Group has applied these standards from April 1, 2005, with the exception of IFRS 3, IAS 36 (revised) and IAS 38 (revised) which had already been applied in financial year 2004/05.

IAS 1 (revised) Presentation of Financial Statements. As well as introducing other changes, this revised standard requires minority interests in consolidated entities to be presented as a component of consolidated equity, rather than as a separate category on the face of the balance sheet, and minority interests in the net income of consolidated entities to be presented as a component of consolidated net income.

In the course of the changes of IAS 1 (revised), sales-related costs are no longer shown as a separate line in the consolidated income statement. Sales-related costs in the total amount of CHF 28.1 million (previous year 26.7 million) have been netted with sales in the amount of CHF 19.4 million (previous year 18.4 million), and reclassified to cost of sales CHF 2.0 million (previous year 1.9 million), sales and marketing CHF 4.8 million (previous year 4.5 million) and to general and administration CHF 1.9 million (previous year 1.9 million).

IFRS 2 Share-based Payment. This new standard requires that the fair value of all equity compensation plan awards granted to employees be estimated at grant date and recorded as an expense over the vesting period. The expense is charged against the appropriate income statement heading. The standard requires retrospective application, to all awards granted after November 7, 2002 which had not vested prior to April 1, 2005, within certain transitional requirements. The impact of IFRS 2 is detailed in Note 32.

In addition, the Group decided to early adopt the amendment to **IAS 21 "The effects of Changes in Foreign Exchange Rates: Net investment in a Foreign Operation"** which is effective since January 1, 2006 and requires to record exchange differences that arise on all monetary items that form part of an entity's net investment in a foreign operation in a separate component of equity in the consolidated financial statement. In the last financial year, only monetary items that were denominated in the functional currency of the borrower or lender were recognized directly in equity.

Changes in accounting policies that arise from the application of new or revised standards and interpretations are applied retrospectively, unless otherwise specified in the transitional requirements of the particular standard or interpretation. Retrospective application requires that the results of the comparative period and the opening balances of that period are restated as if the new accounting policy had always been applied.

The Phonak Group has assessed the impact of the other revised and newly applicable standards, and has concluded that they have no significant effect on the consolidated financial statements, apart from additional disclosures.

The following new or revised IFRS standards will become effective for financial periods starting on or after January 1, 2006 or 2007:

IAS 19 (Amendment), Employee Benefits (effective from January 1, 2006).
IAS 39 (Amendment), Cash Flow Hedge Accounting of Forecast Intragroup Transactions (effective from January 1, 2006).
IAS 39 (Amendment), The Fair Value Option (effective from January 1, 2006).
IAS 39 and IFRS 4 (Amendment), Financial Guarantee Contracts (effective from January 1, 2006).
IFRS 1 (Amendment), First-time Adoption of International Financial Reporting Standards (effective from January 1, 2006).
IFRS 6, Exploration for and Evaluation of Mineral Resources (effective from January 1,2006).
IFRS 7, Financial Instruments: Disclosures, and a complementary Amendment to IAS 1, Presentation of Financial Statements – Capital Disclosures (effective from January 1, 2007).
IFRIC 4, Determining whether an Arrangement contains a Lease (effective from January 1, 2006).
IFRIC 5, Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds (effective from January 1, 2006).
IFRIC 6, Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment (effective from December 1, 2005).

The Group has assessed the effect of the changes of these standards and has concluded that there will be no significant effect on the Group's result and financial position, although the disclosure requirements will be expanded in certain areas, notably IFRS 7 "Financial Instruments: Disclosures" which will be effective from January 1, 2007.

3. Basis of the consolidated financial statements

The consolidated financial statements of the Group are based on the financial statements of the individual Group companies at March 31 prepared in accordance with uniform accounting policies. The consolidated financial statements have been prepared under the historical cost convention except for the revaluation of certain financial assets at market value, in accordance with International Financial Reporting Standards (IFRS), including International Accounting Standards and Interpretations issued by the International Accounting Standards Board (IASB). The consolidated financial statements were approved by the Board of Directors of Phonak Holding AG on May 12, 2006.

The consolidated financial statements include the financial statements of Phonak Holding AG as well as the domestic and foreign subsidiaries over which Phonak Holding AG exercises control. A list of the significant companies which are consolidated is given in Note 38.

The preparation of financial statements requires management to make estimates and assumptions that affect the amounts reported for assets and liabilities and contingent assets and liabilities at the date of the financial statements as well as revenue and expenses reported for the financial year. Actual results could differ from these estimates.

3.1 Principles of consolidation

Investments in subsidiaries

Investments in subsidiaries are fully consolidated. These are entities over which Phonak Holding AG directly or indirectly exercises control. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Under the full consolidation method, 100% of assets, liabilities, income and expenses are included. The interests of minority shareholders in equity and net income or loss are shown separately in the balance sheet and income statement. Changes in minority interests are accounted for using the "modified parent company model", with any excess of purchase consideration over the carrying values of the attributable net assets acquired being recorded as goodwill.

Group companies acquired during the year are included in the consolidation from the date on which control over the company is transferred to the Group, and are excluded from the consolidation as of the date the Group ceases to have control over the company. Intercompany balances and transactions (incl. unrealized profit on inter-company inventories), are eliminated in full.

Investments in associates

Investments in associates are accounted for using the equity method of accounting. These are entities in which Phonak has significant influence and which are neither subsidiaries nor joint ventures of Phonak. Significant influence is the power to participate in the financial and operating policy decisions of the acquired company but is not control or joint control over those policies (usually 20–50% of voting rights). Under the equity method, the investment in an associate is initially recognized at cost and the carrying amount is increased or decreased to recognize Phonak's share of profit or loss of the acquired company after the acquisition date.

The Group's share of equity in associated companies, consolidated using the equity method, is shown in the balance sheet as "Investments in associates/joint ventures", and its share of the results of operations for the year is shown in the income statement as "Share of (loss)/gain in associates/joint ventures".

Associates acquired during the year are accounted for as "Investments in associates/joint ventures" from the date on which significant influence over the acquired company is transferred to the Group, and derecognized from that position as of the date Phonak ceases to have significant influence over an associate.

Investments in joint ventures

Investments in joint ventures are accounted for using the equity method of accounting. These are contractual arrangements whereby two or more parties undertake an economic activity that is subject to joint control. Joint control is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control. Under the equity method, the investment in a joint venture is initially recognized at cost and the carrying amount is increased or decreased to recognize Phonak's share of profit or loss of the jointly controlled entity after the acquisition date.

The Group's share of equity in joint ventures consolidated using the equity method is shown in the balance sheet as "Investments in associates/joint ventures," and its share of the results of operations for the year is shown in the income statement as "Share of (loss)/gain in associates/joint ventures".

Joint ventures established during the year are accounted for as "Investments in associates/joint ventures" from the date on which joint control of the joint venture is transferred to the Group and derecognized from that position as of the date Phonak ceases to have joint control.

3.2 Currency translation

The consolidated financial statements are expressed in Swiss Francs ("CHF"), which is the company's functional and presentation currency. The functional currency of each Group company is based on the local economic environment to which an entity is exposed, which is normally the local currency.

Transactions in foreign currencies are accounted for at the rates prevailing at the dates of the transactions. The resulting exchange differences are recorded in the local income statements of the Group companies and included in net income.

Monetary assets and liabilities of Group companies which are denominated in foreign currencies are translated using year-end exchange rates. Exchange differences are recorded as an income or expense. Non-monetary assets and liabilities are translated at historical exchange rates. Exchange differences arising on inter-company loans that are considered part of the net investment in a foreign entity are recorded in equity.

When translating foreign currency financial statements into Swiss Francs, year-end exchange rates are applied to assets and liabilities, while average annual rates are applied to income statement accounts. Translation differences arising from this process are recorded as a separate component of equity. On disposal of a subsidiary, the related cumulative translation adjustment is transferred from equity and included in the profit or loss on disposal in the income statement.

3.3 Accounting and valuation principles

Cash and cash equivalents

This item includes cash in hand and at banks, time deposits and other short-term highly liquid investments with original maturities of 3 months or less, as well as bank overdrafts. The cash flow statement summarizes the movements on cash and cash equivalents. Free cash flow is the net amount of the cash flow from operating and from investing activities.

Trade receivables

Trade receivables are recorded at original invoice amount less provision made for impairment of these receivables. A provision for impairment of trade receivables is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of the invoice. The amount of the provision is the difference between the carrying amount and the recoverable amount, being the present value of expected cash flows.

Inventories

Purchased raw materials, components and finished goods are valued at the lower of cost or net realizable value. To evaluate cost, the standard cost method is applied, which approximates historical cost determined on a first-in first-out basis. Standard costs take into account normal levels of materials, supplies, labor, efficiency and capacity utilization. Standard costs are regularly reviewed and, if necessary, revised in the light of current conditions. At each period end, any production or purchase price variances are analyzed and credited or charged to inventory if not related to abnormal amounts of wasted materials, labor or other production costs. Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and selling expenses.

Manufactured finished goods and work-in-process are valued at the lower of production cost or net realizable value. Provisions are established for slow-moving, obsolete and phase-out inventory.

Tangible assets

Tangible assets (land, buildings, plant and equipment) are valued at purchase or manufacturing cost less accumulated depreciation and any impairment in value. Depreciation is calculated on a straight-line basis over the expected useful lives of the individual assets or asset categories. Where an asset comprises several parts with different useful lives, each part of the asset is depreciated separately over its applicable useful life. The applicable useful lives are 25–40 years for buildings, and 3–10 years for production facilities, machinery, equipment and vehicles. Land is not depreciated. Leasehold improvements are depreciated over the shorter of useful life or lease term.

Borrowing costs incurred for the construction of any qualifying asset are capitalized during the period of time that is required to complete and prepare the asset for its intended use. Subsequent expenditure on an item of tangible assets is capitalized at cost only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. Expenditures for repair and maintenance which do not increase the estimated useful lives of the related assets are recognized as an expense in the period in which they are incurred.

Research and development

The majority of research and development costs are expensed as incurred. In addition to the internal costs (direct personnel and other operating costs, depreciation on research and development equipment and allocated occupancy costs), total costs also include externally contracted research and development work. Development of tooling and equipment is recognized as an asset to the extent that it is expected that the corresponding project is determined to be technically and commercially feasible, thereby yielding probable future economic benefits.

Leasing

Assets that are held under leases which effectively transfer to the Group, the risk and rewards of ownership (finance leases) are capitalized at the inception of the lease at the fair value of the leased property or, if lower, at the present value of the minimum lease payments. Minimum lease payments are the payments over the lease term that Phonak is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with any amounts guaranteed by Phonak or by a party related to Phonak. Assets under financial leasing are depreciated over the shorter of their estimated useful life or the lease term. The corresponding financial obligations are classified as "short-term debts" or "other long-term debts", depending on whether they are payable within or after 12 months.

Leases of assets under which all the risks and rewards of ownership are effectively retained by the lessor are classified as operating leases, and payments are recognized as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the Group's benefit.

Intangible assets

Purchased intangible assets such as software, licences and patents, are measured at cost less accumulated amortization and any impairment in value. Software is amortized over a useful life of 3 years, whereas other intangible assets are amortized over a period of 3 to 5 years or over their expected useful lives applying the straight-line method. Except for the goodwill Phonak has no intangible asset with an indefinite useful life.

Business combinations and goodwill

Business combinations are accounted for using the purchase method of accounting. The cost of a business combination is equal to the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by Phonak, in exchange for control of the acquired company plus any costs directly attributable to the business combination. Any difference between the cost of the business combination and Phonak's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities so recognized is treated as goodwill. Goodwill is not amortized, but is assessed for impairment annually in the first half of each financial year, or more frequently if events or changes in circumstances indicate that its value might be impaired.

Short-term debts

Short-term debts consist of short-term bank debts and all other interest bearing debts with a maturity of 12 months or less.

Provisions

Provisions are recognized when the Group has a present obligation (legal or constructive) as a result of a past event, where it is probable that an outflow of resources will be required to settle the obligation, and where a reliable estimate can be made of the amount of the obligation. If the effect of the time value of money is material, provisions are determined by discounting the expected future cash flows. The Group recognizes provisions for warranty costs to cover any costs arising from the warranty given on the sale of its products. The provision is calculated using historical and projected data on warranty rates, service costs, remaining warranty period and number of hearing aids on which the warranty is still active. Short-term portions of warranty provisions are reclassified to short-term provisions at each reporting date.

Income taxes

Income taxes include current and deferred income taxes. Phonak is subject to income taxes in numerous jurisdictions and significant judgement is required in determining the worldwide provision for income taxes. The multitude of transactions and calculations imply estimates and assumptions. The Group recognizes liabilities based on estimates of whether additional taxes will be due.

Where the final tax outcome is different from the amounts that were initially recorded, such differences will impact the income tax and deferred tax provisions in the period in which such determination is made.

Deferred tax is recorded on the valuation differences (temporary differences) between the tax bases of assets and liabilities and their carrying values in the consolidated balance sheet. Deferred tax assets relating to tax loss carry-forwards are recognized only to the extent that it is probable that taxable income will be available against which the tax losses can be offset.

Provision is made for non-recoverable withholding taxes only on anticipated dividend distributions from subsidiaries. No provision is made in respect of possible future dividend distributions from undistributed earnings, as the parent is able to control the timing of the reversal of the temporary difference and such amounts are considered to be permanently reinvested.

Revenue recognition

Sales are recognized net of sales taxes and discounts upon delivery of products and reasonably assured collectibility of the related receivables. Probable returns of products are estimated and the related revenue is deferred. Intercompany sales are eliminated.

Sales of services are recognized in the accounting period in which the services are rendered.

Segment reporting

A business segment is a group of assets and operations engaged in providing products or services that are subject to risks and returns that are different from those of other business segments. A geographical segment is engaged in providing products or services within a particular economic environment that are subject to risks and returns that are different from those of segments operating in other economic environments.

Impairment

Phonak assesses at each reporting date whether there is any indication that an asset may be impaired. If any such indication exists, the recoverable amount of the asset is estimated. The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less selling costs and its value in use. Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit. If the recoverable amount is lower than the carrying amount, an impairment loss is recognized. Impairment of financial assets is described under the section on financial instruments.

For goodwill, an annual impairment test is performed in the first half of each financial year, even if there is no indication of impairment (see "business combinations and goodwill" on page 53).

Related parties

A party is related to an entity if the party directly or indirectly controls, is controlled by, or is under common control with the entity, has an interest in the entity that gives it significant influence over the entity, has joint control over the entity or is an associate or a joint venture of the entity. In addition, members of the key management personnel of the entity or close members of their family are also considered related parties as are post-employment benefit plans for the benefit of employees of the entity. No related party exercises control over the Group.

Employee benefits (IAS 19)

Pension obligations

Most employees are covered by post-employment plans sponsored by Group companies. Such plans in Phonak Group are mainly defined contribution plans (future benefits are determined by reference to the amount of contributions paid) and are generally administered by autonomous pension funds or independent insurance companies. These pension plans are financed through employer and employee contributions. The Group's contributions to defined contribution plans are charged to the income statement in the year to which they relate.

Phonak Group also has a number of defined benefit pension plans, both funded and unfunded. Accounting and reporting of these plans are based on annual actuarial valuations. Defined benefit obligations and service costs are assessed using the projected unit credit method: the cost of providing pensions is charged to the income statement so as to spread the regular cost over the service lives of employees participating in these plans. The pension obligation is measured as the present value of the estimated future outflows using interest rates of government securities which have terms to maturity approximating the terms of the related liability. Actuarial gains and losses are recognized over the average remaining service periods of employees participating in these plans as income or expense when the cumulative unrecognized actuarial gains or losses for each individual plan exceed 10% of the higher of the defined benefit obligation and the fair value of plan assets. Expenses from defined benefit plans are charged to the appropriate income statement heading within the operating results.

Other long-term benefits

Other long-term benefits comprise mainly length of service compensation benefits which certain subsidiary companies are required to provide in accordance with legal requirements in the respective countries. These benefits are accrued, and the corresponding liabilities are included under "Other provisions".

Equity compensation benefits

The Board of Directors of Phonak Holding AG, the Management Board, as well as management and senior employees of Group companies participate in equity compensation plans. In addition a share purchase plan offering three shares for every two purchased is offered to all Phonak employees. The fair value of all equity compensation awards granted to employees is estimated, using a binomial option pricing model, at the grant date and recorded as an expense over the vesting period. The expense is charged to the appropriate income statement heading within the operating results and an equivalent increase in equity is recorded.

3.4 Significant accounting judgements and estimates

Key management judgements made in applying accounting policies

In the process of applying the Group's accounting policies, management may be required to make judgements, apart from those involving estimates, which have an effect on the amounts recognized in the financial statements.

Key accounting estimates and assumptions

Preparation of financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expenses and related disclosures. The estimates and assumptions are continually evaluated and are based on experience and other factors, including expectations of future events that are believed to be reasonable. Actual results may differ from these estimates and assumptions.

The main estimates and assumptions, with the potential of causing an adjustment, are discussed below.

Cost of business combinations

A business combination agreement may provide for an adjustment to the cost of the combination contingent on future events. If the future events do not occur or the estimate needs to be revised, the cost of a business combination is revised accordingly, with a resultant change in the carrying value of goodwill. As at the end of the financial year 2005/06 such costs contingent on future events (earn-out and holdback of purchase prices) of CHF 16.5 million have been included in the cost of business combinations.

Property, plant and equipment and intangible assets, including goodwill

The Group has property, plant and equipment with a carrying value of CHF 117.3 million as disclosed in Note 18 and intangible assets, including goodwill with a carrying value of CHF 208.4 million as disclosed in Note 21.

The Group determines annually, in accordance with the accounting policy stated in Note 3.3, whether any of the assets are impaired. For the impairment tests, estimates are made of the expected future cash flows from the use of the asset. The actual cash flows could vary significantly from these estimates.

Deferred tax assets

The consolidated balance sheet includes deferred tax assets of CHF 59.1 million related to deductible differences and, in certain cases, tax loss carryforwards provided that their utilization appears probable. The recoverable value is based on forecasts of the corresponding taxable Group company over a period of several years. As actual results may differ from these forecasts, the deferred tax assets may be impaired accordingly.

Employee benefit plans

Phonak has various employee benefit plans. Most of its salaried employees are covered by these plans, many of which are defined benefit plans. The present value of the defined benefit obligations at the end of the financial period 2005/06 amounts to CHF 98.0 million as disclosed in Note 31. With such plans, actuarial assumptions are made for the purpose of estimating future developments, including estimates and assumptions relating to discount rates, the expected return on plan assets in individual countries and future wage trends. Actuaries also use statistical data such as mortality tables and staff turnover rates with a view to determining employee benefit obligations. If these factors change due to a change in economic or market conditions, the subsequent results could deviate considerably from the actuarial reports and calculations. Over the medium term such deviations could have a significant effect on income and expenses arising from employee benefit plans. The carrying amounts of the plan assets and liabilities in the balance sheet are set out in Note 31.

Provision for warranty and returns

The Group recorded provisions for warranty and returns of CHF 33.2 million as of March 31, 2006 as disclosed in Note 22.

The calculation of these provisions is based on turnover and past experience of warranty claims and returns. The actual costs for warranty and returns may differ from the estimates.

3.5 Financial risk management

The Group is exposed to the following financial risks:

Interest rate risk

Interest rate risk relates primarily to long-term interest bearing liabilities. The Group's mortgages as well as a portion of the other long-term debts represent long-term fixed-rate contracts, which minimize the risk of changing interest rates. The remainder of the long-term debts are currently subject to money market rates. The interest situation and hedging possibilities are continuously monitored. Derivative instruments are currently not being used to hedge against changes in interest rates.

Exchange rate risk

The Group buys and sells products in foreign currencies and is therefore exposed to exchange rate risks. To minimize foreign currency exchange risks, relating in particular to inter-company sales and the settlement of inter-company loans, forward currency contracts are entered into. Generally, these contracts do not qualify for hedge accounting treatment under IAS 39, and accordingly exchange losses and gains on forward currency contracts are recognized in the income statement. However, if a forward contract qualifies as a hedge, under IAS 39, such exchange gains and losses on the contract are recorded in equity and are reclassified to the income statement when the gains or losses on the underlying transaction are recorded.

Credit risk

Financial assets which could expose the Group to a potential concentration risk are principally cash and bank balances and trade receivables. Banking relations are maintained only with first-class financial institutions. The Group performs continuous credit checks on its customers and is not exposed to any significant concentration risks.

3.6 Investments

Phonak classifies its investments in the following categories: financial assets at fair value through profit or loss, loans and receivables, held-to-maturity investments, and available-for-sale financial assets. The classification depends on the purpose for which the investments were acquired. Management determines the classification of its investments at initial recognition and reclassifies them whenever their intention or ability changes. All purchases and sales are recognized on the settlement date.

Financial assets at fair value through profit or loss

Financial assets at fair value through profit or loss are assets held for trading, acquired for the purpose of generating a profit from short-term fluctuations in price or dealer's margin. Derivative financial assets and derivative financial liabilities are always deemed as held for trading unless they are designated and effective hedging instruments. Financial assets held for trading are measured at their fair value plus initial transaction costs. Fair value changes on a financial asset held for trading are included in net profit or loss for the period in which they arise. Assets in this category are classified as current assets if they are either held for trading or are expected to be realized within 12 months of the balance sheet date.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise when the Group provides money, goods or services directly to a debtor with no intention of trading the receivable. They are included in current assets, except for maturities more than 12 months after the balance-sheet date. These are classified as non-current assets. Loans and receivables are included in trade and other receivables in the balance sheet. Loans are measured at amortized cost. Amortized cost is the amount at which the financial asset is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between that initial amount and the maturity amount, minus any reduction for impairment or uncollectibility. The effective interest method is a method of calculating the amortized cost of a financial asset and of allocating the interest income over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset.

Held-to-maturity investments

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group's Management has the intention and ability to hold to maturity. Assets under this category that have a fixed maturity are valued at amortised cost using the effective interest rate method.

Available-for-sale financial assets

Available-for-sale financial assets are non-derivative financial assets that are designated in this category or not classified in any of the other categories. They are included in non-current assets unless Management intends to dispose of the investment within 12 months of the balance sheet date. Available-for-sale financial assets are initially measured at their fair value. After initial recognition available-for-sale financial assets are measured at fair value with gains and losses being recognized as a separate component of equity until the investment is derecognized or until the investment is determined to be impaired at which time the cumulative gain or loss previously reported in equity is included in the income statement.

The fair values of investments that are actively traded are based on current bid prices. If the market for a financial asset is not active fair value is determined using valuation techniques.

Impairment of financial assets

A financial asset is impaired if its carrying amount is greater than its estimated recoverable amount. The Group assesses, at each balance sheet date, whether there is any objective evidence that a financial asset may be impaired. If any such evidence exists, the Group estimates the recoverable amount of that asset and recognizes any impairment loss in the income statement. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be objectively related to an event occurring after the write-down, the write-down of the financial asset is reversed. The reversal generally will not result in a carrying amount of the financial asset that exceeds what amortized cost would have been, had the impairment not been recognized, at the date the write-down of the financial asset is reversed. The amount of the reversal is included in net profit or loss for the financial year.

3.7 Derivative financial instruments and hedging

The Group regularly hedges its net exposure from expected future cash in- and outflows in foreign currencies with forward contracts. Such contracts are not qualifying hedges and are therefore not accounted for using hedge accounting. Gains and losses on these transactions are taken directly to the income statement; the corresponding positive and negative replacement values are recognized on the balance sheet as financial assets/financial liabilities at fair value through profit or loss.

Until November 2004, the Group entered into derivative contracts in order to hedge investments in foreign entities. Such derivative contracts were designated as hedges, with changes in their fair value recognized in equity. However, no net investment hedge has been made since November 2004.

4. Changes in Group Structure

The following changes in the Group structure (fully consolidated companies) have occurred in the last 2 financial years:

Financial year 2005/06:
Acquisition of CAS Produtos Médicos Ltda., Brazil, as of October 4, 2005
Acquisition of Metro Hearing Inc., USA, as of November 1, 2005

In addition to the two main acquisitions mentioned above, 4 smaller entities have been acquired during the financial year 2005/06.

For more detailed information regarding the acquisitions please refer to Note 29.

Financial year 2004/05:
Unitron (Sichuan) Co., Ltd, China, founded in June 2004

5. Segment information

Profit or loss based on location of assets	Europe		Americas[2]		
1,000 CHF	**2005/06**	**2004/05**	**2005/06**	**2004/05**	
Sales					
Third parties	416,812	345,997	399,697	280,824	
Intersegment sales	275,930	264,339	33,321	22,460	
Total sales	**692,742**	**610,336**	**433,018**	**303,284**	
Operating profit (EBIT)	**207,628**	**142,076**	**24,334**	**25,196**	
Financial income/(expenses), net					
Share of (loss)/gain in associates/joint ventures	(134)	152			
Income before taxes					
Taxes					
Income after taxes					
Total assets [1]	**979,962**	**731,173**	**533,958**	**382,111**	
Total liabilities [1]	**391,045**	**336,167**	**331,361**	**206,468**	
Capital expenditure in tangible and intangible assets	17,999	17,421	10,066	3,668	
Depreciation and amortization on tangible and intangible assets	18,827	19,947	6,578	4,618	
Third party sales based on location of customers	**391,156**	**322,920**	**400,360**	**284,144**	
Growth in local currencies	20.4%		34.7%		

[1] "Others" include only unallocated corporate assets and liabilities
[2] The segment Americas includes North and South America (previous year North America only)
Prior-year figures have been adjusted accordingly

The Group is active in one business segment; the development, manufacture, production, distribution and service of hearing systems and related products.
The primary segment information is presented according to geographical regions based on location of assets. This corresponds to the organizational structure. Transactions between segments are generally conducted at market rates.

Asia/Pacific		Others		Eliminations		Total	
2005/06	**2004/05**	**2005/06**	**2004/05**	**2005/06**	**2004/05**	**2005/06**	**2004/05**
50,173	33,554					866,682	660,375
69,475	30,036			(378,726)	(316,835)		
119,648	**63,590**			**(378,726)**	**(316,835)**	**866,682**	**660,375**
5,326	**(4,185)**			**(25,626)**	**(37,290)**	**211,662**	**125,797**
						4,268	(825)
						(134)	152
						215,796	**125,124**
						(43,331)	(29,268)
						172,465	**95,856**
62,695	**50,535**	**102,229**	**152,915**	**(747,584)**	**(573,374)**	**931,260**	**743,360**
55,441	**50,532**	**30,049**	**78,478**	**(503,669)**	**(377,989)**	**304,227**	**293,656**
3,757	1,994					31,822	23,083
1,597	928				(186)	27,002	25,307
69,680	**48,061**	**5,486**	**5,250**			**866,682**	**660,375**
37.9%		2.6%				27.8%	

6. Consolidated Income Statement by type of expenditure

The income statement has been prepared using the operational format. In order to provide additional information, the income statement by nature of expenditure is presented below.

1,000 CHF	Notes	2005/06	2004/05[1]
Sales	5	**866,682**	**660,375**
Changes in finished goods and work in process		(1,009)	1,879
Other operating income		1,641	661
Operating income		**867,314**	**662,915**
Direct material costs		(195,202)	(141,451)
Own work capitalized		2,554	1,967
Personnel expenses		(263,421)	(226,576)
Other operating expenses		(169,674)	(147,738)
Depreciation and amortization	18,21	(27,002)	(25,307)
Exchange differences		(2,907)	1,987
Operating profit (EBIT)		**211,662**	**125,797**
Financial income/(expenses), net	9	4,268	(825)
Share of (loss)/gain in associates/joint ventures	19	(134)	152
Income before taxes		**215,796**	**125,124**
Income taxes	10	(43,331)	(29,268)
Income after taxes		**172,465**	**95,856**
Attributable to			
Equity holders of the parent		171,447	95,024
Minority interest		1,018	832

[1] Including adjustments in accordance with new IFRS accounting standards (see Notes)

7. Financial instruments

Options/Forward foreign exchange contracts		
1,000 CHF	**31.3.2006**	**31.3.2005**
Underlying principal amount	163,133	177,459
Positive replacement value	707	990
Negative replacement value	(1,649)	(1,421)
Total	**(942)**	**(431)**

Positive replacement values are recorded as financial assets at fair value through profit or loss (Note 14) whereas negative replacement values are recorded as financial liabilities at fair value through profit or loss.
The Group hedges its net foreign currency exposure based on future expected cash inflows and outflows. The hedges have a duration between 1 and 12 months. No hedge accounting has been applied to these hedges, since they do not qualify for such treatment under IAS 39.

8. Other (expenses)/income, net

1,000 CHF	**2005/06**	**2004/05**
Other operating expenses	(243)	(1,842)
Other operating income	927	1,653
Exchange differences	(2,908)	1,987
Total	**(2,224)**	**1,798**

9. Financial income/(expenses), net

1,000 CHF	2005/06	2004/05
Gain on financial assets at fair value through profit or loss	1,166	430
Interest income	4,368	1,190
Other financial income	19	1,948
Total financial income	**5,553**	**3,568**
Mortgage interest	(409)	(1,214)
Other interest expenses	(604)	(1,968)
Other financial expenses	(272)	(2)
Change in fair value of financial assets available for sale		(1,209)
Total financial expenses	**(1,285)**	**(4,393)**
Total financial income/(expenses), net	**4,268**	**(825)**

Mortgage interest is mainly related to the mortgages on Phonak's building in Stäfa, Switzerland. The interest rate on mortgages was between 2.8% and 5.3% in 2005/06 (see Note 25). Other interest expenses are mainly related to bank loans (see Notes 23 and 26).
The change in fair value of financial assets available for sale in the financial year 2004/05 is related to an adjustment of the fair value of three investments in third party companies (less than 20% of voting rights). These adjustments have been determined based on an analysis of the financial statements of the corresponding unquoted companies.
In the financial year 2005/06, these investments have been designated as financial assets at fair value through profit or loss (in accordance with revised IAS 39).

10. Taxes

1,000 CHF	2005/06	2004/05[1]
Income taxes	43,061	31,529
Change in deferred taxes	270	(2,261)
Total tax expense	**43,331**	**29,268**
Reconciliation of tax expense		
Income before taxes	215,796	125,124
Weighted average expected tax rate	20.0%	25.0%
Tax at weighted average rate	**43,249**	**31,331**
+/– effects of		
non tax deductible expenses (income)	1,310	(1,174)
utilization of previously unrecognized loss carryforwards	228	(1,345)
change in tax rates on deferred tax balances	(920)	(1,059)
prior-year expense and other items	(536)	1,515
Total tax expense	**43,331**	**29,268**
as a % of income before taxes	20.1%	23.4%

[1] Including adjustments in accordance with new IFRS accounting standards (see Notes)

The expected Group tax rate is the aggregate obtained by applying the currently effective rate for each individual jurisdiction to its respective result before taxes.
Due to a change in the country mix of the taxable profit the Group tax rate was reduced to 20.1%.

Composition of deferred tax assets and liabilities	Assets	Liabilities	Assets	Liabilities
1,000 CHF		31.3.2006		31.3.2005
Tax loss carry forward	18,244		13,865	
Trade receivables	996	1,924	1,137	1,185
Other receivables and prepaid expenses	1	2		101
Inventories incl. allowances	22,071	2,160	13,874	2,281
Tangible fixed assets	136	7,646	30	8,559
Intangible assets	1,601	7,011	815	2,843
Provisions	12,927	3,217	7,168	2,394
Other liabilities	3,170	10,089	8,034	193
Deferred taxes	**59,146**	**32,049**	**44,923**	**17,556**

Deferred tax assets have been capitalized based on the projected future performance of the Group companies, supplemented with tax planning opportunities.
In financial year 2004/05, CHF 42,000 have been credited to equity arising from the deferred tax impact on the currency translation difference related to the associate company Cochlear Ltd.
The gross values of unused tax loss carryforwards, which have not been capitalized as deferred tax assets, with their expiry dates are as follows:

1,000 CHF	2005/06	2004/05
Within 1 year		
Within 2 years		
Within 3 years		595
Within 4 years		
Within 5 years	84	
More than 5 years		80
Total	**84**	**675**

11. Earnings per share

Basic earnings per share

Basic earnings per share are calculated by dividing the income after taxes attributable to the ordinary equity holders of the parent company by the weighted average number of shares outstanding during the year.

	2005/06	2004/05[1]
Income after taxes (in 1,000 CHF)	171,447	95,024
Weighted average number of outstanding shares	66,162,237	65,548,317
Basic earnings per share (in CHF)	**2.591**	**1.450**

[1] Including adjustments in accordance with new IFRS accounting standards (see Note 32)

Diluted earnings per share

In the case of diluted earnings per share, the weighted average number of shares outstanding is adjusted assuming all outstanding dilutive options will be exercised. The weighted average number of shares is adjusted for all dilutive options issued under the stock option plans which have been granted in 2003, 2004, 2005, and 2006 and which have not yet been exercised. Anti-dilutive options have not been considered. The calculation of diluted earnings per share is based on the same income after taxes for the period as is used in calculating basic earnings per share.

	2005/06	2004/05[1]
Income after taxes (in 1,000 CHF)	171,447	95,024
Adjusted weighted average number of outstanding shares	66,755,959	66,263,423
Diluted earnings per share (in CHF)	**2.568**	**1.434**

[1] Including adjustments in accordance with new IFRS accounting standards (see Note 32)

12. Dividend per share

The Board of Directors of Phonak Holding AG proposes to the Annual General Shareholders' Meeting to be held on July 6, 2006, that a dividend of CHF 0.50 (previous year CHF 0.30) per share shall be distributed.

13. Cash and cash equivalents

1,000 CHF	31.3.2006	31.3.2005
Cash on hand	384	5,029
Postal checking and current bank accounts	132,818	83,727
Time deposits	46,347	84,487
Total	**179,549**	**173,243**

The time deposits and bank accounts are mainly denominated in CHF, EUR and USD.
For details of the movements in cash and cash equivalents refer to the consolidated statement of cash flows (page 48).

14. Financial assets at fair value through profit or loss

1,000 CHF	31.3.2006	31.3.2005
Marketable securities	12,055	11,411
Positive replacement value of forward foreign exchange contracts	707	990
Financial assets at fair value through profit or loss	**12,762**	**12,401**

For details of forward foreign exchange contracts refer to Note 7.

15. Trade receivables

1,000 CHF	31.3.2006	31.3.2005
Accounts receivable	202,959	147,495
Provision for doubtful accounts	(8,629)	(8,298)
Total	**194,330**	**139,197**

As usual in this industry, the Phonak Group has a large number of customers and there is no significant concentration of credit risk. During the financial year 2005/06 the Group has recognized a provision of CHF 1.1 million (previous year CHF 2.1 million) for the impairment of accounts receivable. During 2005/06 the Group has used provision for impaired receivables of CHF 0.8 million (previous year CHF 0.9 million). The recognition and usage of provision have been included in "other (expenses)/income, net" in the income statement.

16. Other receivables and prepaid expenses

1,000 CHF	31.3.2006	31.3.2005
Other receivables	26,226	11,832
Prepaid expenses	19,316	8,140
Total	**45,542**	**19,972**

The largest individual items included in other receivables are recoverable value added taxes and advances to suppliers.

17. Inventories

1,000 CHF	31.3.2006	31.3.2005
Raw materials and components	16,576	41,103
Work-in-process	38,607	30,151
Finished products (incl. purchased goods)	65,780	35,689
Allowances	(26,719)	(20,393)
Total	**94,244**	**86,550**

Allowances include write downs for slow moving, phase out and obsolete stock.
The amount of inventories recognized as an expense included in cost of sales amounted to CHF 228.2 million during the financial year 2005/06 (previous year CHF 196.9 million).

18. Tangible assets

1,000 CHF	Land	Buildings	Total Land & Buildings	Plant & Equipment	Total tangible assets 31.3.2006
Cost					
Balance April 1	10,166	80,461	90,627	153,370	243,997
Changes through business combinations		312	312	2,368	2,680
Additions		419	419	22,072	22,491
Disposals	(1,033)	(1,847)	(2,880)	(15,689)	(18,569)
Exchange differences	127	(590)	(463)	4,448	3,985
Balance March 31	**9,260**	**78,755**	**88,015**	**166,569**	**254,584**
Accumulated Depreciation					
Balance April 1	194	25,873	26,067	102,539	128,606
Changes through business combinations					
Additions		2,850	2,850	19,503	22,353
Disposals		(1,440)	(1,440)	(13,558)	(14,998)
Exchange differences	3	(492)	(489)	1,857	1,368
Balance March 31	**197**	**26,791**	**26,988**	**110,341**	**137,329**
Net book value					
Balance April 1	9,972	54,588	64,560	50,831	115,391
Balance March 31	**9,063**	**51,964**	**61,027**	**56,228**	**117,255**

1,000 CHF	Land	Buildings	Total Land & Buildings	Plant & Equipment	Total tangible assets
					31.3.2005
Cost					
Balance April 1	10,166	80,200	90,366	139,722	230,088
Changes through business combinations				355	355
Additions		349	349	19,227	19,576
Disposals		(10)	(10)	(4,680)	(4,690)
Exchange differences		(78)	(78)	(1,254)	(1,332)
Balance March 31	**10,166**	**80,461**	**90,627**	**153,370**	**243,997**
Accumulated Depreciation					
Balance April 1	195	23,696	23,891	87,339	111,230
Changes through business combinations				73	73
Additions		2,225	2,225	19,536	21,761
Disposals		(4)	(4)	(3,779)	(3,783)
Exchange differences	(1)	(44)	(45)	(630)	(675)
Balance March 31	**194**	**25,873**	**26,067**	**102,539**	**128,606**
Net book value					
Balance April 1	9,971	56,504	66,475	52,383	118,858
Balance March 31	**9,972**	**54,588**	**64,560**	**50,831**	**115,391**

The tangible assets (buildings, plant and equipment) are insured against fire for a value of CHF 232.9 million (previous year CHF 235.1 million).

Pledged assets amounted to CHF 42.3 million (previous year CHF 52.7 million) and were all related to mortgages.

Expenditures incurred in construction of plant and equipment, and included in the carrying amount thereof, amounted to CHF 5.5 million for financial year 2005/06 (CHF 3.5 million for financial year 2004/05).

19. Investments in associates and joint ventures

The Group's share of the results of its principal associates and joint ventures and its share of the assets (including goodwill and liabilities) are as follows:

Investments in associates and joint ventures		
1,000 CHF	**2005/06**	**2004/05**
Current assets	1,573	1,448
Non-current assets	1,548	1,172
Total assets	**3,121**	**2,620**
Current liabilities	(914)	(1,021)
Long-term liabilities	(74)	
Total liabilities	**(988)**	**(1,021)**
Net assets	**2,133**	**1,599**
Income for the year	3,332	2,665
Expenses for the year	(5,757)	(3,624)
Loss for the year	**(2,425)**	**(959)**
Net book value as at year end	4,064	1,596
Share of (loss)/gain recognized by Phonak	(134)	152

The significant investments consist of an associated company with a 25% equity share in Cochlear Accoustics Ltd. and of a 25% equity share in a joint venture with other leading hearing instrument manufacturers, HIMSA A/S, active in software development in Copenhagen.
In the financial year 2005/06 several acquisitions of investments in associates have been made for a total acquisition value of CHF 2.6 million. For two investments with a net book value of CHF 2.8 million, the financial statements with a business year ending on December 31 were included accordingly.

20. Other investments and long-term loans

1,000 CHF	31.3.2006	31.3.2005
Other investments	6,005	3,477
Long-term loans	6,849	4,334
Total	**12,854**	**7,811**

The other investments consist of minority interests in the Danish patent holding company HIMPP A/S, the Danish software development companies HIMSA II A/S (Hearing Instruments Manufacturers Software Association II A/S), HIMSA II K/S, in which Phonak has invested, together with other leading hearing instrument manufacturers, as well as three further minority interests in third party companies, of which two of them were purchased in the financial year 2005/06. Other investments have been classified in the last financial year as available-for-sale financial assets.

With the revision of IAS 39 (effective for annual periods beginning on or after January 1, 2005), the Group has in accordance with IAS 39 designated these other investments as "financial assets at fair value through profit or loss". These investments are measured at fair value, with changes in fair value recognized in profit or loss.

21. Intangible assets

1,000 CHF	Goodwill	Software	Intangibles relating to acquisitions	Other intangibles	Total intangible assets 31.3.2006
Cost					
Balance April 1	131,175	17,253	1,224	2,410	152,062
Changes through business combinations	38,190		17,471		55,661
Additions	4,827	4,114		390	9,331
Disposals		(1,747)		(1,776)	(3,523)
Exchange differences	9,089	(630)	253	(361)	8,351
Balance March 31	**183,281**	**18,990**	**18,948**	**663**	**221,882**
Accumulated amortization					
Balance April 1		10,630	33	2,258	12,921
Additions		3,513	1,166	(30)	4,649
Disposals		(1,664)		(1,688)	(3,352)
Exchange differences		(340)	(16)	(359)	(715)
Balance March 31		**12,139**	**1,183**	**181**	**13,503**
Net book value					
Balance April 1	131,175	6,623	1,191	152	139,141
Balance March 31	**183,281**	**6,851**	**17,765**	**482**	**208,379**

	Goodwill	Software	Intangibles relating to acquisitions	Other intangibles	Total intangible assets
1,000 CHF					**31.3.2005**
Cost					
Balance April 1	247,791	15,673		2,360	265,824
Change in accounting principles (IFRS 3)	(117,189)				(117,189)
Changes through business combinations			1,224		1,224
Additions		3,472		35	3,507
Disposals		(1,711)			(1,711)
Exchange differences	573	(181)		15	407
Balance March 31	**131,175**	**17,253**	**1,224**	**2,410**	**152,062**
Accumulated amortization					
Balance April 1	117,296	9,130		2,228	128,654
Change in accounting principles (IFRS 3)	(117,296)				(117,296)
Changes through business combinations			33		33
Additions		3,520		26	3,546
Disposals		(1,711)			(1,711)
Exchange differences		(309)		4	(305)
Balance March 31		**10,630**	**33**	**2,258**	**12,921**
Net book value					
Balance April 1	130,495	6,543		132	137,170
Balance March 31	**131,175**	**6,623**	**1,191**	**152**	**139,141**

No internally generated intangible assets have been capitalized during financial years 2005/06 and 2004/05. Goodwill has an indefinite life. Other intangibles and software have finite lives.

In accordance with the requirements of IFRS 3, the Group has eliminated the accumulated amortization of goodwill at March 31, 2004, with a corresponding decrease in cost of goodwill. Negative goodwill of CHF 107,000 has been derecognized with a corresponding adjustment of the opening balance of retained earnings.

The Group has performed an impairment test on goodwill in the first half of the financial year 2005/06. For the purpose of impairment testing, goodwill is allocated to a cash-generating unit or to a group of cash-generating units, which are expected to benefit from the synergies of the corresponding business combination. For the impairment test, the recoverable amount of a cash-generating unit (higher of the cash-generating unit's fair value less selling costs and its value in use) is compared to the carrying amount of the corresponding cash-generating unit. Future cash flows are discounted with the Weighted Average Cost of Capital (WACC) including the use of the Capital Asset Pricing Model (CAPM). Value in use is normally assumed to be higher than the fair value less selling costs, therefore, fair value less selling costs is only investigated when value in use is lower than the carrying amount of the cash generating unit.

The cash flow projections are based on a five-year period. Cash flows beyond the five-year period are extrapolated using estimated long-term growth rates. The growth rates do not exceed the long-term average growth rate for the hearing instruments industry in which the cash-generating units operate.

Key assumptions used for value-in-use calculations of material goodwill amounts:

Cash-generating unit	Carrying amount of goodwill	Currency	Basis for recoverable amount	Discount rate	Projection period	Long-term growth rate
1,000 CHF						
Unitron Group	68,545	Multiple	Value in use	9%	5 years	1.00%
Hansaton Akustische Geräte-Gesellschaft m.b.H.	33,271	EUR	Value in use	8%	5 years	1.00%
Lapperre BHAC NV	15,724	EUR	Value in use	8%	5 years	0.50%
Phonak Ibérica S.A.	8,038	EUR	Value in use	8%	5 years	1.00%
CAS Produtos Médicos Ltda.	14,995	BRL	Value in use	18%	5 years	1.00%
Metro Hearing Inc.	19,234	USD	Value in use	9%	5 years	1.00%

The discount rates applied are pre-tax.
Based on the impairment tests, there was no need for the recognition of any impairment in financial years 2005/06 and 2004/05.

22. Provisions

	Provision for warranty and returns	Other provisions	Total	Total
1,000 CHF			**31.3.2006**	**31.3.2005**
Balance April 1	**30,224**	**8,996**	**39,220**	**32,870**
Changes through business combinations	364	1,810	2,174	
Amounts used	(13,698)	(2,225)	(15,923)	(15,915)
Reversals	(1,220)	(3,665)	(4,885)	(1,320)
Increases	15,696	39,814	55,510	24,768
Exchange differences	1,863	677	2,540	(1,183)
Balance March 31	**33,229**	**45,407**	**78,636**	**39,220**
thereof short-term	25,434	12,361	37,795	26,339
thereof long-term	7,795	33,046	40,841	12,881

Up to financial year 2004/05 accrued liabilities for vacation pay and for bonus and incentive compensation have been classified under provisions. These liabilities in the amount of CHF 28.0 million have been reclassified to accrued expenses (refer to Note 24). Prior-year figures in the amount of CHF 24.3 million have been adjusted to reflect this reclassification.
On average, Phonak grants a 15-month warranty period for its products. During this period, products will be repaired or replaced free of charge. The provision is based on turnover and past experience of warranty claims. In some countries, extended warranty is sold against a corresponding fee. The timing of cash outflows of this provision is expected within the next one to three years.
Other provisions include liabilities for the present value of estimated earn-out payments resulting from the variable purchase price from companies bought in the amount of CHF 16.5 million. The timing of the cash outflows is expected within the next one to five years. In addition, other provisions include a provision for reimbursement to customers in the amount of CHF 14.3 million. The timing of cash outflows is expected within the next one to two years.

Among various other items, other provisions also include a provision for the expected costs for settling pending disputes and claims, which have arisen in the normal course of Phonak's business. The main claim relates to a patent dispute. The timing of cash outflows is uncertain since it will largely depend upon the outcome of administrative and legal proceedings.

23. Short-term debts

1,000 CHF	Notes	31.3.2006	31.3.2005
Current maturities of mortgages	25	12,253	7,186
Current maturities of long-term debts			23,603
Total		**12,253**	**30,789**
Unused borrowing facilities		**69,118**	**50,288**

The book value of short-term debts approximates to fair value.
At March 31, 2005, current maturities of long-term debts mainly related to bank loans with an average interest rate of 1.1%. During the financial year 2005/06 these bank loans have been repaid (refer to Note 26).

24. Other short-term liabilities

1,000 CHF	31.3.2006	31.3.2005
Other payables	17,976	12,113
Accrued expenses	67,824	67,575
Deferred income	6,148	6,248
Total	**91,948**	**85,936**

Other payables include amounts to be remitted in respect of sales taxes, value added taxes, social security payments, employees' income taxes deducted at source and customer prepayments. Accrued expenses include, among other items, salaries, social expenses, vacation pay, bonus and incentive compensation and accruals for outstanding invoices. Accrued expenses for vacation pay relate to both unconsumed holiday days as well as to payments for holidays required by law in certain countries.
Prior-year figures are adjusted to reflect the reclassification of vacation pay and bonus and incentive compensation from provisions to accrued expenses (refer to Note 22).

25. Mortgages

1,000 CHF	Short-term	Long-term	Total Mortgages 31.3.2006	Short-term	Long-term	Total Mortgages 31.3.2005
Analysis by currency						
Swiss Francs	12,100		12,100	6,900	12,100	19,000
Euro	131		131	247	104	351
Danish Crowns	22	377	399	39	367	406
Total	**12,253**	**377**	**12,630**	**7,186**	**12,571**	**19,757**
Of which maturing beyond 5 years			262			7,984

The above-mentioned mortgages are all secured by liens on the related real estate. Principal amounts bear interest at the following rates per annum: CHF 12.1 million at 2.8% and the remainder at 3.4% to 5.3%. Of the CHF mortgage, CHF 5.8 million were prematurely repaid in April 2005 and a further CHF 1.1 million were repaid in August 2005. The remaining amount of CHF 12.1 million will be repaid in August 2006.
The fair value of the mortgages approximates to book value.

26. Other long-term debts

1,000 CHF	31.3.2006	31.3.2005
Bank loans		47,000
Other long-term debts	98	78
Total	**98**	**47,078**
Analysis by currency		
Swiss Francs		47,000
Euro	2	54
Other currencies	96	24
Total	**98**	**47,078**
Of which maturing beyond 5 years		284

At March 31, 2005, the long-term debts denominated in Swiss Francs related to bank loans obtained to finance the purchase of the Unitron and Hansaton subsidiaries. These loans were repaid in June and December 2005.
The carrying amounts of bank loans and other long-term debts approximate to fair value.

27. Other long-term liabilities

1,000 CHF	31.3.2006	31.3.2005
Long-term deferred income	7,465	3,864
Retirement benefit obligations	1,245	1,273
Total	**8,710**	**5,137**

Long-term deferred income relates to long-term service contracts with customers. Deferred income is recognized as a sale over the period of the service contract.
The retirement benefit obligation relates to defined benefit plans. For details refer to Note 31.

28. Movements in share capital

Issued shares	Issued shares	Treasury shares[2]	Outstanding shares
(each share has a nominal value of CHF 0.05)			
Balance April 1, 2003	**65,372,200**	**(330,610)**	**65,041,590**
Issue of new shares from conditional capital[1]	90,000		90,000
Sale of treasury shares		188,898	188,898
Balance March 31, 2004	**65,462,200**	**(141,712)**	**65,320,488**
Issue of new shares from conditional capital[1]	560,200		560,200
Purchase of treasury shares		(7,700)	(7,700)
Sale of treasury shares		141,712	141,712
Balance March 31, 2005	**66,022,400**	**(7,700)**	**66,014,700**
Issue of new shares from conditional capital[1]	338,525		338,525
Purchase of treasury shares		(282,813)	(282,813)
Sale of treasury shares		255,880	255,880
Balance March 31, 2006	**66,360,925**	**(34,633)**	**66,326,292**

[1] Created for purpose of the employee share option plan
[2] Treasury shares are purchased on the open market and are not entitled to dividends. As per March 31, 2006, all treasury shares were at the company's disposal

Nominal value of share capital	Share capital	Treasury shares [2]	Outstanding share capital
1,000 CHF			
Balance April 1, 2003	**3,269**	**(17)**	**3,252**
Issue of new shares from conditional capital [1]	4		4
Sale of treasury shares		10	10
Balance March 31, 2004	**3,273**	**(7)**	**3,266**
Issue of new shares from conditional capital [1]	28		28
Purchase of treasury shares			
Sale of treasury shares		7	7
Balance March 31, 2005	**3,301**	**0**	**3,301**
Issue of new shares from conditional capital [1]	17		17
Purchase of treasury shares		(14)	(14)
Sale of treasury shares		12	12
Balance March 31, 2006	**3,318**	**(2)**	**3,316**

[1] Created for purpose of the employee share option plan
[2] Treasury shares are purchased on the open market and are not entitled to dividends. As per March 31, 2006, all treasury shares were at the company's disposal

At the Annual General Shareholders' Meetings on November 18, 1994, July 13, 2000, and July 7, 2005 a conditional share capital of a maximum of 11,301,120 shares was agreed. As of March 31, 2006, 8,247,995 (previous year 5,285,400) shares thereof have not yet been issued.

For additional information on the Shareholders and the Capital structure of the Group, refer to the Corporate Governance section (pages 19 to 22).

The Annual General Shareholders' Meeting held on July 7, 2005, approved the creation of authorized share capital of 3,301,120 registered shares with a par value of CHF 0.05 per share. The Board of Directors is authorized to exclude subscription rights of shareholders and to allocate them to third parties if the new shares are to be used for the acquisition of companies, parts of companies, equity stakes or the financing of such transactions. The authorized share capital of 3,301,120 registered shares created on July 7, 2005, has not yet been used. The authorization granted to the Board of Directors to augment the company's share capital with the authorized share capital created expires on July 6, 2007.

29. Acquisition of subsidiaries

During financial year 2005/06, the Group entered into the following business combinations:

Name	Place	Date	Structure	Purpose	Business acquired
CAS Produtos Médicos Ltda.	Brazil	4.10.2005	Share deal (100%)	Sale of hearing instruments	Hearing instruments business
Metro Hearing Inc.	USA	1.11.2005	Share deal (100%)	Sale of hearing instruments	Hearing instruments business

In addition to the above, further four smaller companies were acquired during the financial year 2005/06 in Europe and North America.
During financial year 2004/05, the Group entered into the following business combinations:

Name	Place	Date	Structure	Purpose	Business acquired
Kam Hearing Technology (Guangzhou) Co., Ltd.	China	8.6.2004	Net assets deal	Sale of hearing instruments	Hearing instruments business
Unitron (Sichuan) Hearing Technology Co., Ltd.[1]	China	8.6.2004	Share deal (100%)	Sale of hearing instruments	Hearing instruments business
Scancare OY	Finland	1.9.2004	Net assets deal	Sale of hearing instruments	Hearing instruments business

[1] Unitron (Sichuan) Hearing Technology Co., Ltd. has been renamed Phonak (Sichuan) Co. Ltd

All acquisitions have been accounted for using the purchase method of accounting.

The acquired companies contributed sales and income after taxes to the Group from date of acquisition to March 31, 2006 as follows:

Name	Sales since acquisition to	Net income since acquisition to
1,000 CHF	**31.3.2006**	**31.3.2006**
CAS Produtos Médicos Ltda.	14,828	712
Metro Hearing Inc.	5,769	254
Others	6,517	(231)

Sales and income after taxes of the acquired companies for the full financial year April 1, 2005 to March 31, 2006 were as follows:

Name	Sales for financial year	Net income for financial year
1,000 CHF	**2005/06**	**2005/06**
CAS Produtos Médicos Ltda.	30,094	1,445
Metro Hearing Inc.	12,093	603
Others	12,019	243

The assets and liabilities arising from the above mentioned acquisitions are as follows:

1,000 CHF	Notes	CAS	Metro	Others	Fair value of acquired companies Total 2005/06	Book value of acquired companies Total 2005/06	Fair value of acquired companies Total 2004/05
Assets							
Cash and cash equivalents		2,112	1,795	508	4,415	4,415	35
Trade accounts receivable		7,829	498	608	8,935	10,348	81
Other receivables and prepaid expenses		166	44	106	316	1,303	168
Inventories		2,907	86	1,096	4,089	5,012	1,000
Tangible assets	18	950	1,413	317	2,680	2,826	282
Financial assets		9			9	67	
Deferred tax assets		912	777		1,689		
Intangible assets	21	6,452	8,245	2,774	17,471	2,129	1,191
Total Assets		**21,337**	**12,858**	**5,409**	**39,604**	**26,100**	**2,757**
Liabilities							
Trade accounts payable		(2,551)	(2,340)	(438)	(5,329)	(5,800)	(182)
Income tax payable		(1,071)			(1,071)	(557)	
Other payables and accrued expenses		(1,964)	(1,511)	(612)	(4,087)	(1,934)	(447)
Short-term provisions		(961)	(263)	(67)	(1,291)	(1,108)	(34)
Long-term debts/provisions		(1,456)	(4,672)	(32)	(6,160)	(4,672)	
Deferred tax liabilities		(2,254)	(3,175)	(345)	(5,774)		
Total Liabilities		**(10,257)**	**(11,961)**	**(1,494)**	**(23,712)**	**(14,071)**	**(663)**
Net Assets		**11,080**	**897**	**3,915**	**15,892**	**12,029**	**2,094**
Minority interest				(380)	(380)		
Net Assets net of minority interest		**11,080**	**897**	**3,535**	**15,512**	**12,029**	**2,094**
Goodwill	21	14,736	18,865	4,589	38,190		
Purchase Price incl. acquisition-related costs		**25,816**	**19,762**	**8,124**	**53,702**		**2,094**
For which Phonak recorded a long-term provision for the earn-out or holdback		(12,999)	(1,826)	(1,602)	(16,427)		(336)
Cash consideration		**12,817**	**17,936**	**6,522**	**37,275**		**1,758**
Cash and cash equivalents acquired		(2,112)	(1,795)	(508)	(4,415)		(35)
Cash consideration, net of cash acquired		**10,705**	**16,141**	**6,014**	**32,860**		**1,723**
Earn-out payment in respect of prior-year acquisitions							1,278
Cash flow for acquisitions		**10,705**	**16,141**	**6,014**	**32,860**		**3,001**
Cash outflow for investments in associates and minority shareholdings					**7,913**		
Total Cash outflow from acquisitions					**40,773**		**3,001**

30. Related-party transactions

	Management Board		Board of Directors		Total	
1,000 CHF	**2005/06**	**2004/05**	**2005/06**	**2004/05**	**2005/06**	**2004/05**
Short-term employee benefits	3,933	4,067	572	639	4,505	4,706
Termination benefits	989				989	
Share-based payments	1,537	418	461	236	1,998	654
Total	**6,459**	**4,485**	**1,033**	**875**	**7,492**	**5,360**

The total compensation to the Management Board, as shown above, relates to six members, including one member who terminated the employment during the financial year 2005/06.
Phonak AG has a sponsorship agreement with ARcycling Ltd. effective until December 31, 2006. The corresponding expenses included in the consolidated income statement amount to CHF 3.8 million (previous year CHF 6.2 million).

31. Employee benefits

Phonak Group's retirement plans include defined-benefit pension plans in Switzerland, Austria, Canada, Germany and Norway. These plans are both funded and unfunded and are accounted for as defined benefit plans according to IAS 19, with recent actuarial valuations. The plans of Norway and Canada are not material. The results of the material plans are summarized below:

1,000 CHF	31.3.2006	31.3.2005
Amounts recognized in the balance sheet		
Present value of funded obligations	(96,947)	(82,031)
Fair value of plan assets	102,780	84,755
Net present value of funded plans	**5,833**	**2,724**
Present value of unfunded obligations	(1,067)	(1,087)
Unrecognized actuarial losses	3,135	3,135
Total assets, net	**7,901**	**4,772**
Amounts unrecognized in line with IAS 19.58b(ii)	(5,833)	(2,724)
Assets in the balance sheet, net	**2,068**	**2,048**
Amounts in the balance sheet		
Liabilities	(1,067)	(1,087)
Assets	3,135	3,135
Net assets in the balance sheet	**2,068**	**2,048**
Amounts recognized in the income statement		
Current service cost	5,451	4,100
Interest cost	3,132	2,714
Expected return on plan assets	(4,238)	(3,611)
Actuarial losses recognized in line with IAS 19.58A	1,034	
Waiver of the employer contribution reserve		3,365
Total employee benefit expenses	**5,379**	**6,568**
Movements in the assets, net		
At beginning of the year	2,048	2,912
Total employee benefit expenses	(5,379)	(6,568)
Contributions paid	5,399	5,704
At end of year	**2,068**	**2,048**
Principal actuarial assumptions		
Discount rate	3.25%	3.75%
Future salary increases	1.75%	2.50%
Future pension increases	0%	0%
Expected return on plan assets	4%	5%
Fluctuation rate	10%	10%

The amount recognized in the consolidated income statement has been charged to cost of sales (CHF 1.8 million), research and development (CHF 1.4 million), sales and marketing (CHF 0.8 million) and general and administration (CHF 1.4 million) in the income statement by type of function and to the position personnel expenses in the income statement by type of expenditure (CHF 5.4 million).
The actual return on plan assets was a gain of CHF 8.7 million (previous year gain of CHF 2.4 million).

Defined contribution plans
Several of the Group's entities have a defined contribution plan. The employer's contributions are recognized directly in the income statement, amounting to CHF 3.1 million in the year ended March 31, 2006 (previous year CHF 1.7 million).

Termination benefits
During financial year 2005/06, termination benefits of CHF 1.1 million have been expensed (previous year CHF 1.7 million).

32. Employee share option and share purchase plan

The adoption of IFRS 2 "Share-based payment" resulted in a change in the accounting policy for share and option plans to employees. Until March 31, 2005, no cost related to the fair value of the options of the employee option plans was charged to income. In addition to other requirements, the new standard requires that the fair value of the options granted be calculated on the date of issue and be charged over the vesting period to the respective income statement position. The effects of the introduction of IFRS 2 for the year ended March 31, 2006 are summarized below. Prior-year income after taxes, earnings per share and equity have been restated accordingly.

1,000 CHF	2005/06	2004/05
Cost of sales	181	159
Research and development	349	221
Sales and marketing	472	364
General and administration	2,832	1,134
Decrease in operating profit (EBIT)	**3,834**	**1,878**

Key People Program (granted between 2000 and 2004)
Up to financial year 2003/04, members of the Board of Directors of Phonak Holding AG, the Management Board, as well as management and senior employees of Group companies annually received a certain number of options on the shares of Phonak Holding AG in accordance with the "Key People Program" established in 1997. This was basically on the condition that the respective employees had been employed by the Phonak Group for a period of generally at least two years. The options were granted for no consideration and each option entitled the holder to one Phonak Holding AG share after a lock-up period of generally two or three years at a predefined exercise price. The exercise price corresponds to the average market price over the last one or three months immediately prior to the month of the grant. Also, in accordance with special agreements, key people within the Phonak Group were granted options, partially with and partially without consideration. The shares required for the share option plan were issued from the conditional share capital which was created by resolutions of the 2000 Annual General Shareholders' Meeting in accordance with Article 3a of Phonak Holding AG's articles of incorporation.
In February 2005, and again in February 2006, the Group launched an Executive Equity Award Program (EEAP) for the Board of Directors, for the Management Board, as well as for the management and senior employees of other Group companies and a Share Purchase Plan for all employees of the Group.

Executive Equity Award Plan (EEAP) (granted 2005 and 2006)

The Executive Equity Award Plan is offered annually to the Board of Directors, to the Management Board, as well as to management and senior employees of Group companies, which entitles them to receive options and/or shares free of charge.

The amount of options and/or shares granted varies depending on the degree of management responsibility held. Both options and shares granted as part of the EEAP are split into four equal tranches. For the options, one tranche vests each year over four years, starting one year after the grant date. The shares are blocked over four years, one tranche being released each year, starting one year after the grant date.

Options – Executive Equity Award Plan (granted 2005 and 2006)

The exercise price of the options is generally equal to the market price of the Phonak share at the SWX Swiss Stock Exchange (closing price) on the date the options are granted. The fair value of the options granted is estimated at the grant date and recorded as an expense over the vesting period. The options may be exercised after expiration of the vesting period during the term of the options, which is 5 years from the date the options are granted. When the options are exercised, shares are issued from the conditional share capital.

The following table shows the assumptions on which the valuation of share options granted during the period was based:

Executive Equity Award Plan	2006	2005
Valuation date	01.02.2006	01.02.2005
Expiration date	31.01.2011	31.01.2010/30.09.2010
Share price on grant date	CHF 63.25	CHF 39.00
Exercise price	CHF 63.25	CHF 39.00
Volatility	20.6%	22.2%
Expected dividend yield	0.75	0.80
Weighted risk free interest rate	1.9%	1.1%
Fluctuation rate	4.3%	1.9%
Weighted average fair value of options issued	**CHF 10.22**	**CHF 6.55**

Outstanding Options – Key People Program and Executive Equity Award Plan

Changes in outstanding options	2005/06 Number of options	2005/06 Weighted average exercise price	2004/05 Number of options	2004/05 Weighted average exercise price
		CHF		CHF
Outstanding options at April 1	1,852,250	29.94	2,060,950	26.15
Granted	420,818	63.25	712,000	39.00
Exercised [1]	(338,525)	19.04	(560,200)	13.50
Expired/forfeited	(91,850)	31.53	(360,500)	51.50
Outstanding options at March 31	**1,842,693**	**39.90**	**1,852,250**	**29.94**
Exercisable at March 31	**37,000**	**39.20**	**217,300**	**13.88**

[1] Total consideration from exercise of options amounted to CHF 6.4 million (previous year CHF 7.5 million)

Summary of outstanding and exercisable options at March 31, 2006

Exercise price range	Outstanding options Number	Average remaining life	Weighted average exercise price	Exercisable options Number	Weighted average exercise price
CHF		years	CHF		CHF
13.00	43,500	1.8	13.00		13.00
28.00	686,450	2.8	28.00		28.00
39.00	679,425	2.6	39.00	32,000	39.00
40.50	5,000	0.4	40.50	5,000	40.50
56.00	7,500	1.4	56.00		56.00
63.25	420,818	2.3	63.25		63.25
13.00 – 63.25	**1,842,693**	**2.6**	**39.90**	**37,000**	**39.20**

Shares – Executive Equity Award Plan (granted 2005 and 2006)
The shares are subject to a blocking period, which starts on the date the shares are granted. The shares delivered under this plan are shares repurchased by Phonak on the open stock market. The cost of the shares granted as part of the EEAP program is expensed pro rata temporis over the vesting period of 1 to 4 years.

Share Purchase Plan (granted 2005 and 2006)
The Share Purchase Plan is offered annually to all permanent employees of the Group, having completed their probationary period. A participant may purchase up to a maximum number of shares. For every two shares purchased, the participant receives one additional share free of charge. The purchase price of the shares will generally be equal to the market price on the SWX Swiss Stock Exchange on the date the shares are purchased and the free shares are accepted. The shares under this plan are subject to a blocking period commencing on the expiry date of the offer. The duration of the blocking period may be up to 24 months. All shares under this plan (the shares purchased by the participant and the share offered for free) are repurchased by Phonak on the open stock market. The cost of the shares offered as part of the SPP program is charged pro rata temporis over the blocking period to the income statement.

33. Contingent liabilities

At March 31, 2006 and 2005, there were no pledges given to third parties other than in relation to mortgages of CHF 12.6 million (previous year CHF 19.8 million) secured by properties (Note 25). The net book value of these properties amounts to CHF 42.3 million at March 31, 2006 (previous year CHF 52.7 million).
Guarantees given to third parties amounted to CHF 10.4 million (previous year CHF 0.3 million). There were no recourse liabilities in respect of discounted bills of exchange at March 31, 2006 and 2005. Open purchase orders as of March 31, 2006 and 2005 were related to recurring business activities.

34. Leasing liabilities

Minimum obligations under non-cancellable leases:

1,000 CHF	Operating leases	Finance leases
Business year		
2006/07	10,323	
2007/08	7,760	
2008/09	6,794	
2009/10	5,454	
2010/11	5,261	
thereafter	3,513	
Total	**39,105**	
Less interest component		
Total (excl. interest)	**39,105**	
Previous year	**41,027**	**315**
Less interest component		(9)
Previous year (excl. interest)	**41,027**	**306**

The operating lease commitments relate primarily to long-term rental agreements for office premises which are, in general, renewable. In financial year 2005/06, CHF 12.8 million have been recognized as expenses for leases in the consolidated income statement (previous year CHF 11.6 million).

35. Number of employees

At March 31, 2006, the Phonak Group employed 3,428 people (previous year 2,926). They were engaged in the following regions and activities:

	31.3.2006	31.3.2005
By region		
Switzerland	818	729
Europe (excl. Switzerland)	857	832
Americas	1,201	956
Asia/Pacific	552	409
Total	**3,428**	**2,926**
By activity		
Research and development	214	188
Operations	1,624	1,439
Sales and marketing, general and administration	1,590	1,299
Total	**3,428**	**2,926**

The average number of employees of the Phonak Group for the year was 3,166 (previous year 2,719).

36. Events after the balance sheet date

On April 1, 2006 the Group acquired 100% of National Hearing Services Inc., Canada. The company acquired is engaged in the business of providing hearing health solutions to retail customers.
The expected cash outflow for this transaction amounts to CHF 33.7 million and is made up of a fixed (CHF 26.4 million) and variable purchase price (CHF 7.3 million). In the financial year 2005/06, the company acquired reported sales of approximately CHF 19.7 million.
In addition, at the beginning of May 2006, the Group acquired two smaller companies engaged in the business of selling hearing instruments. The expected cash outflow for these two transactions amounts to CHF 26.2 million (CHF 14.1 million fixed purchase price and CHF 12.1 million variable purchase price). In the calendar year 2005, the companies acquired reported sales of approximately CHF 18.3 million.

37. Exchange rates

The following are the exchange rates used for currency translation:

	Year-end rates Balance sheet		Average rates for the year Income statement	
	31.3.2006	**31.3.2005**	**2005/06**	**2004/05**
AUD 1	0.93	0.93	0.96	0.91
BRL 1	0.59	n/a	0.59	n/a
CAD 1	1.12	0.99	1.07	0.96
CNY 1	0.16	0.14	0.16	0.15
DKK 100	21.12	20.85	20.79	20.70
EUR 1	1.58	1.55	1.55	1.54
GBP 1	2.27	2.25	2.27	2.26
JOD 1	1.85	1.63	1.80	1.72
JPY 100	1.11	1.12	1.13	1.14
NOK 100	19.69	18.95	19.48	18.60
NZD 1	0.80	0.85	0.88	0.82
PLN 1	0.40	n/a	0.40	n/a
SEK 100	16.72	17.00	16.58	16.91
USD 1	1.31	1.20	1.27	1.23

38. List of significant consolidated companies

Company name	Activity	Domicile	Share capital Local curr. 1,000		Shares held by Phonak Holding
Switzerland					
Phonak Holding AG	A	Stäfa (CH)	CHF	3,318	
Phonak AG	B,C,D	Stäfa (CH)	CHF	2,500	99.3%
Phonak Communications AG	B,C,D	Murten (CH)	CHF	500	100%
Europe (excluding Switzerland)					
Phonak GmbH	B	Stuttgart (D)	EUR	153	100%
Unitron Hearing GmbH	B	Stuttgart (D)	EUR	41	100%
Phonak France SA	B	Bron-Lyon (F)	EUR	305	100%
Phonak Italia Srl	B	Milan (I)	EUR	1,040	100%
Phonak Ibérica S.A.	B	Alicante (E)	EUR	7,000	100%
Ets. Lapperre BHAC NV	B	Groot-Bijgaarden (B)	EUR	124	100%
Phonak Belgium NV	A,B	Brussels (B)	EUR	15,311	100%
Phonak B.V.	B	Nieuwegein (NL)	EUR	227	100%
Unitron Hearing B.V.	B	Nieuwegein (NL)	EUR	18	100%
Phonak Danmark A/S	B	Frederiksberg (DK)	DKK	9,000	100%
Phonak AB	B	Stockholm (S)	SEK	200	100%
Phonak AS	B	Oslo (N)	NOK	900	100%
Phonak Group Ltd.	B	Warrington (GB)	GBP	150	100%
Hansaton Akustische Geräte-Gesellschaft m.b.H.	B	Wals-Himmelreich (AUT)	EUR	450	100%
Phonak Polska Sp. Z o.o.	B	Warsaw (POL)	PLN	100	100%
HIMSA A/S	D	Copenhagen (DK)	DKK	1,000	25%[1]
Cochlear Acoustics Ltd.	D	London (GB)	GBP	0[2]	25%[1]
Americas					
Phonak LLC	B	Warrenville (USA)	USD	1,250	100%
Phonak Canada Ltd.	A,B	Mississauga (CDN)	CAD	88,694	100%
Unitron Hearing Ltd.	B,C,D	Kitchener (CDN)	CAD	17,436	100%
Unitron Hearing, Inc.	B	Plymouth (USA)	USD	46,608	100%
THC Finance Ltd.	A	Bermuda	CHF	165,021	100%
RAV Finance Inc.	A	USA	USD	0[3]	100%
CAS Produtos Médicos Ltda.	B	Sao Paulo (BRA)	BRL	570	100%
Metro Hearing Inc.	B	Wilmington (USA)	USD	0[4]	100%
Asia/Pacific					
Phonak Pty. Ltd.	B	Baulkham Hills (AUS)	AUD	750	100%
Phonak New Zealand Ltd.	B	Auckland (NZ)	NZD	250	100%
Jordan Hearing Aids Manufacturing Co. Ltd.	B	Amman (JOR)	JOD	80	100%
Phonak Japan Co. Ltd.	B	Tokyo (JPN)	JPY	10,000	100%
Unitron Hearing (Suzhou) Co. Ltd.	C	Suzhou (CHN)	CNY	32,594	100%
Phonak (Sichuan) Co. Ltd.	B	Sichuan (CHN)	CNY	19,119	100%
Unitron Hearing Korea Co. Ltd.	B	Seoul (KOR)	KRW	200,000	37.5%[1]

Activities:
A Holding/Finance: The entity is a holding or finance company
B Sales: The entity performs sales and marketing activities for the Group
C Production: This entity performs manufacturing for the Group
D Research: This entity performs research and development activities for the Group

[1] Consolidated using the equity method
[2] GBP 100
[3] USD 1
[4] USD 10

Report of the Group Auditors

PRICEWATERHOUSECOOPERS

Report of the Group Auditors
to the Annual General Shareholders' Meeting of
Phonak Holding AG
Stäfa

As auditors of the Group, we have audited the consolidated financial statements (consolidated income statement, consolidated balance sheet, consolidated statement of cash flows, consolidated changes in equity and notes – pages 46 to 86) of Phonak Holding AG for the year ended March 31, 2006.

These consolidated financial statements are the responsibility of the board of directors. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We confirm that we meet the legal requirements concerning professional qualification and independence.

Our audit was conducted in accordance with Swiss Auditing Standards and with the International Standards on Auditing, which require that an audit be planned and performed to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement. We have examined on a test basis evidence supporting the amounts and disclosures in the consolidated financial statements. We have also assessed the accounting principles used, significant estimates made and the overall consolidated financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements give a true and fair view of the financial position, the results of operations and the cash flows in accordance with the International Financial Reporting Standards (IFRS) and comply with Swiss law.

We recommend that the consolidated financial statements submitted to you be approved.

PricewaterhouseCoopers AG

Stephen W. Williams Patrick Balkanyi

Zurich, May 12, 2006

Cherish the cheers

FINANCIAL STATEMENTS OF PHONAK HOLDING AG

Income Statement

1,000 CHF	Notes	2005/06	2004/05
Income			
Management and license fees		13,818	8,029
Investment income	4.1	30,261	28,698
Gains on marketable securities		994	2,036
Other income		492	
Interest income		11,462	11,642
Exchange gains, net		179	
Total income		**57,206**	**50,405**
Expenses			
Office and professional expenses		5,492	3,302
Advertising and PR expenses		447	392
Depreciation		43	45
Interest expenses		3,569	3,819
Other operating expenses		759	1,199
Other expenses		200	350
One-time write-down of investment			370
Exchange losses, net			954
Taxes	4.2	1,422	290
Total expenses		**11,932**	**10,721**
Net profit for the year		**45,274**	**39,684**

Balance Sheet

Assets			
1,000 CHF	Notes	31.3.2006	31.3.2005
Current assets			
Cash and cash equivalents		25,907	17,148
Marketable securities	3.1	14,238	11,164
Amounts due from Group companies		1,620	2,472
Other receivables	3.2	219	1,020
Prepayments		155	150
Total current assets		**42,139**	**31,954**
Non-current assets			
Investments and loans			
Loans to Group companies	3.3	388,100	335,410
Loan to third party			800
Investments	3.4	131,729	122,295
Tangible assets		43	86
Total non-current assets		**519,872**	**458,591**
Total assets		**562,011**	**490,545**

Liabilities and shareholders' equity			
1,000 CHF	Notes	31.3.2006	31.3.2005
Liabilities			
Trade payables			
To third parties		119	157
Other payables			
Third parties		1,825	231
Group companies		28,708	13,663
Loans from Group companies		204,146	183,117
Accruals		3,336	1,381
Total liabilities		**238,134**	**198,549**
Shareholders' equity			
Share capital		3,318	3,301
Legal reserves			
General legal reserve		149,248	142,818
Reserve for treasury shares	3.5	2,183	319
Free reserves		98,000	98,000
Retained earnings		71,128	47,558
Total shareholders' equity		**323,877**	**291,996**
Total liabilities and shareholders' equity		**562,011**	**490,545**

Notes to the Financial Statements

1. General

The financial statements of Phonak Holding AG are prepared in accordance with the principles of Swiss corporate law.

2. Disclosures required by Swiss corporate law

2.1 Sureties, guarantees and pledges given on behalf of third parties

1,000 CHF	31.3.2006	31.3.2005
Guarantees given to banks in respect of credit arrangements of foreign subsidiary companies	2,134	1,925
Guarantees given in respect of rental obligations and bank debts of Group companies	21,540	127,650

2.2 Conditional and authorized capital

1,000 CHF	31.3.2006	31.3.2005
Conditional capital at year-end	412	264
Authorized capital at year-end	165	

During the Annual General Shareholder's Meeting on July 7, 2005 the conditional share capital of CHF 264,270 (5,285,400 shares) has been increased by CHF 165,056 (3,301,120 shares) to CHF 429,326 (8,586,520 shares). As of March 31, 2006, 8,247,995 (previous year 5,285,400) shares thereof have not yet been issued. These shares are reserved for use in the key employees share option plans (Key People Program and Executive Equity Award Plan).
The Annual General Shareholders' Meeting held on July 7, 2005, approved the creation of authorized share capital of 3,301,120 registered shares with a par value of CHF 0.05 per share. The Board of Directors is authorized to exclude subscription rights of shareholders and to allocate them to third parties if the new shares are to be used for the acquisition of companies, parts of companies, equity stakes or the financing of such transactions. The authorized share capital of 3,301,120 registered shares created on July 7, 2005, has not yet been used. The authorization granted to the Board of Directors to augment the company's share capital with the authorized share capital created expires on July 6, 2007.

2.3 Significant shareholders

At year-end, the following significant shareholders were listed in the share register (with shareholdings in excess of 5% of the issued share capital):

	31.3.2006	31.3.2005
Beda Diethelm	11.2%	12.7%
Andy Rihs	10.9%	12.2%
Hans-Ueli Rihs	9.1%	9.5%

3. Notes to the balance sheet

3.1 Marketable securities

Marketable securities include, among other items, 34,633 treasury shares (previous year 7,700) purchased for a total consideration of CHF 2,182,937 (previous year CHF 319,368). At March 31, 2006, these shares had a market value of CHF 2,569,769 (previous year CHF 317,240).

During the financial year 2005/06, 161,657 treasury shares at an average price of CHF 50.57 have been purchased, while 134,742 treasury shares at an average price of CHF 46.85 have been disposed of.

3.2 Other receivables

Included are, in particular, amounts due from the Swiss Federal Tax Authority in respect of recoverable withholding taxes on dividend and interest income.

3.3 Loans to Group companies

Of total loans, 55% are denominated in Swiss Francs, 37% in Canadian Dollars, 3% in Euros, 4% in US Dollars and 1% in Japanese Yen.

3.4 List of significant investments

Company name	Activity	Domicile	Share capital Local curr. 1,000		Shares held by Phonak Holding
Switzerland					
Phonak AG	B,C,D	Stäfa (CH)	CHF	2,500	99.3%
Phonak Communications AG	B,C,D	Murten (CH)	CHF	500	100%
Indomed AG	A	Zug (CH)	CHF	1,000	100%
Europe (excluding Switzerland)					
Phonak GmbH	B	Stuttgart (D)	EUR	153	100%
Phonak France SA	B	Bron-Lyon (F)	EUR	305	100%
Phonak Italia Srl	B	Milan (I)	EUR	1,040	100%
Phonak Ibérica S.A.	B	Alicante (E)	EUR	7,000	100%
Phonak Belgium NV	A,B	Brussels (B)	EUR	15,311	100%
Phonak B.V.	B	Nieuwegein (NL)	EUR	227	100%
Phonak Danmark A/S	B	Frederiksberg (DK)	DKK	9,000	100%
Phonak AB	B	Stockholm (S)	SEK	200	100%
Phonak AS	B	Oslo (N)	NOK	900	100%
Phonak Group Ltd.	B	Warrington (GB)	GBP	150	100%
Hansaton Akustische Geräte-Gesellschaft m.b.H.	B	Wals-Himmelreich (AUT)	EUR	450	100%
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Phonak Canada Ltd.	A,B	Mississauga (CDN)	CAD	88,694	100%
RAV Finance Inc.	A	USA	USD	0[1)]	100%
Asia/Pacific					
Phonak Pty. Ltd.	B	Baulkham Hills (AUS)	AUD	750	100%
Phonak New Zealand Ltd.	B	Auckland (NZ)	NZD	250	100%
Jordan Hearing Aids Manufacturing Co. Ltd.	B	Amman (JOR)	JOD	80	100%
Phonak Japan Co. Ltd.	B	Tokyo (JPN)	JPY	10,000	100%
Unitron Hearing (Suzhou) Co. Ltd.	C	Suzhou (CHN)	CNY	32,594	100%
Phonak (Sichuan) Co. Ltd.	B	Sichuan (CHN)	CNY	19,119	100%

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A Holding/Finance: The entity is a holding or finance company
B Sales: The entity performs sales and marketing activities for the Group
C Production: This entity performs manufacturing for the Group
D Research: This entity performs research and development activities for the Group
[1)] USD 1

3.5 Reserve for treasury shares

A reserve for treasury shares in the amount of CHF 2,182,937 (previous year CHF 319,368) was established which is equal to the cost price (see Note 3.1). The increase in the amount of CHF 1,863,569 was debited to retained earnings.

3.6 Summary of changes in shareholders' equity

	Share capital	General legal reserve	Free reserve	Treasury share reserve	Retained earnings	Total shareholders' equity
1,000 CHF						
Balance April 1, 2005	**3,301**	**142,818**	**98,000**	**319**	**47,558**	**291,996**
Dividend paid					(19,840)	(19,840)
Capital increases (incl. share premium) from conditional capital	17	6,430				6,447
Increase in reserve for treasury shares				1,864	(1,864)	
Net profit for the year					45,274	45,274
Balance March 31, 2006	**3,318**	**149,248**	**98,000**	**2,183**	**71,128**	**323,877**

During the financial year 2005/06, an additional 338,525 registered shares with a par value of CHF 0.05 each, or a total par value of CHF 16,926 were issued from the conditional capital (which was created for the purpose of an equity participation for key employees of the Phonak Group) for a total net consideration of CHF 6,447,175. In the financial year 2005/06, the conditional share capital with a par value of CHF 429,326 (8,586,520 shares) decreased by CHF 16,926 or 338,525 shares (previous year CHF 28,010 or 560,200 shares), thereby leaving CHF 412,400 (8,247,995 shares) for distribution. Based on the remaining conditional capital, a total of 1,842,693 (previous year 1,852,250) employee stock options were outstanding as of March 31, 2006, which can be exercised until January 2011.

4. Notes to the income statement

4.1 Investment income

This comprises dividends received from Group companies and other investments.

4.2 Taxes

The tax expense consists of Swiss federal taxes on non-investment income (the company is exempt from income taxes in the canton of Zurich).

Appropriation of Available Earnings

As proposed by the Board of Directors to the Annual General Shareholders' Meeting of July 6, 2006		
1,000 CHF	31.3.2006	31.3.2005[2]
Carried forward from previous year	**27,718**	**4,233**
Release from/(allocation to) reserve for treasury shares	(1,864)	3,641
Net profit for the year	45,274	39,684
Available earnings	**71,128**	**47,558**
Dividend distribution	(33,163)[1]	(19,840)
Balance to be carried forward	**37,965**	**27,718**

[1] If the Annual General Shareholders' Meeting approves the proposed appropriation of available earnings, a gross dividend of CHF 0.50 per registered share of CHF 0.05 will be paid out
[2] Approved by the Annual General Shareholders' Meeting of July 7, 2005

Report of the Statutory Auditors

PRICEWATERHOUSECOOPERS

Report of the Statutory Auditors
to the Annual General Shareholders' Meeting of
Phonak Holding AG
Stäfa

As statutory auditors, we have audited the accounting records and the financial statements (balance sheet, income statement and notes – pages 92 to 97) of Phonak Holding AG for the year ended March 31, 2006.

These financial statements are the responsibility of the board of directors. Our responsibility is to express an opinion on these financial statements based on our audit. We confirm that we meet the legal requirements concerning professional qualification and independence.

Our audit was conducted in accordance with Swiss Auditing Standards, which require that an audit be planned and performed to obtain reasonable assurance about whether the financial statements are free from material misstatement. We have examined on a test basis evidence supporting the amounts and disclosures in the financial statements. We have also assessed the accounting principles used, significant estimates made and the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the accounting records, the financial statements and the proposed appropriation of available earnings comply with Swiss law and the company's articles of incorporation.

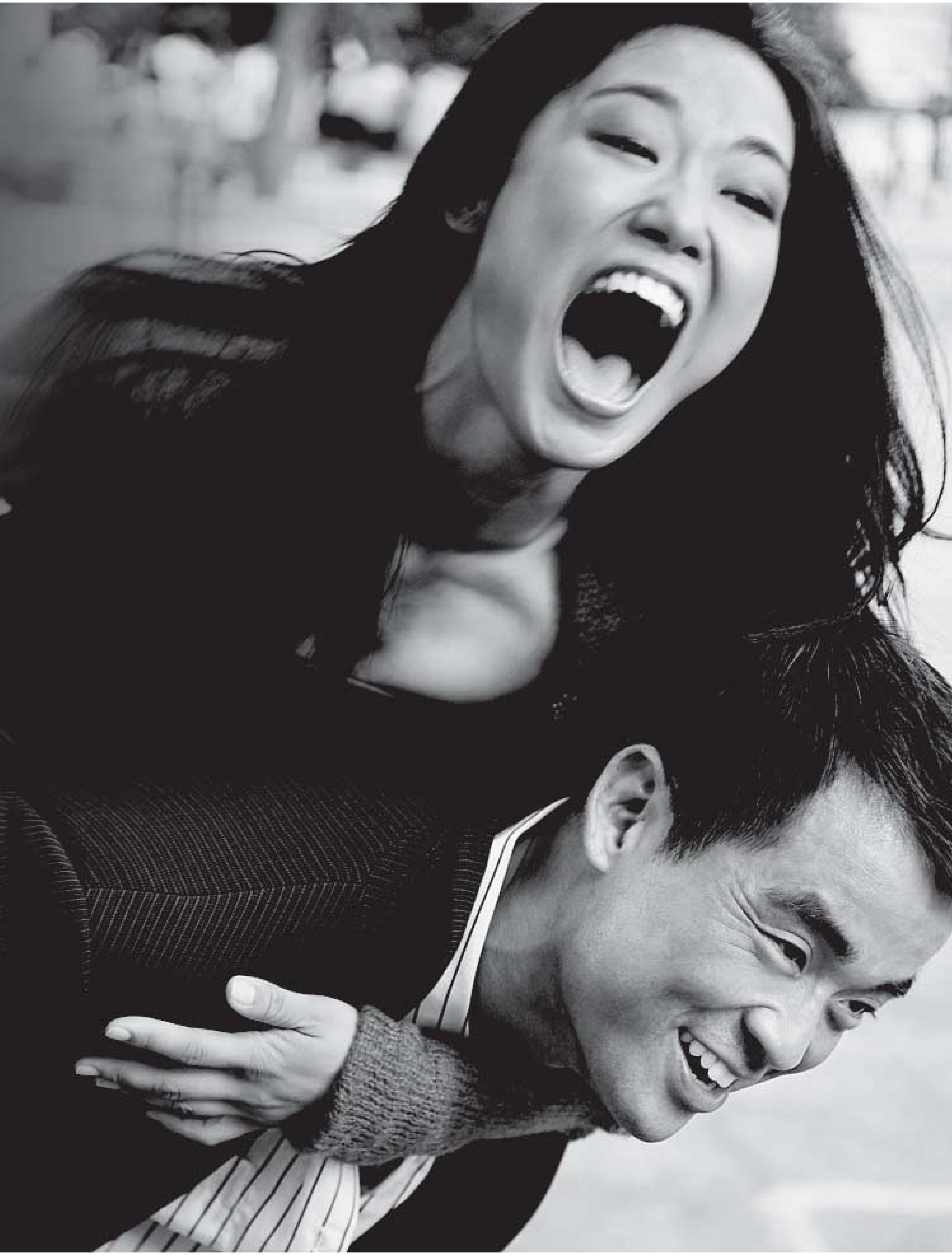
We recommend that the financial statements submitted to you be approved.

PricewaterhouseCoopers AG

Stephen W. Williams Patrick Balkanyi

Zurich, May 12, 2006

Launch a laugh



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The Annual Report is also available in German.
The English version is the governing text.

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