ANNUAL REPORT 2005

Zapf Creation AG is Europe's leading brand manufacturer
of play and functional dolls including accessories.

The Company's most popular brands are BABY born®, Baby Annabell®
and CHOU CHOU. All branded play concepts share a high standard in terms of
design, quality, safety and play value.

Zapf Creation is represented internationally with eight subsidiaries
in America, Europe and Asia. The Company's branded play concepts are sold
in more than 65 countries throughout the world.

Consolidated Key Figures (IFRS)

	2005	2004	+/– %
Income statement before restructuring in € million			
EBITDA	–1.6	13.7	—
EBIT	–8.5	6.5	—
EBIT in % of sales	–6.0	4.0	—
EBT	–15.3	2.9	—
Net profit or loss for the period	–19.9	–0.1	—
Earnings per share in € 1)	–2.68	–0.02	—
Income statement after restructuring in € million			
Sales	140.7	163.3	–14
EBITDA	–9.3	13.7	—
EBIT	–16.3	6.5	—
EBIT in % of sales	–11.6	4.0	—
EBT	–23.1	2.9	—
Net profit or loss for the period	–27.7	–0.1	—
Earnings per share in € 1)	–3.73	–0.02	—
Restructuring costs	7.8	0	—
Depreciation and amortization	7.0	7.2	–3
Balance sheet in € million			
Total assets	133.1	143.4	–7
Non-current assets	28.9	37.5	–23
Investments	2.7	8.7	–69
Current assets	104.2	105.9	–2
Equity	10.2	37.9	–73
Equity ratio in %	7.7	26.4	–71
Return on equity before taxes in %	–226.5	7.7	—
Liabilities to banks	82.3	73.3	12
Cash flow in € million			
Cash flow from operating activities	–8.4	3.5	—
Cash flow from operating activities per share in €	–1.14	0.48	—
Net cash flow	–7.7	1.7	—
Employees			
Number as of the closing date (Dec. 31) 2)	408	493	–17

Figures are rounded.

1) undiluted = diluted
2) excluding the Management Board and trainees

Contents

Dr. Georg Kellinghusen,
Chairman of the Management Board (CEO, CFO)

Dear Shareholders,
Dear Friends of Zapf Creation AG:

The 2005 financial year was as eventful as it was difficult. It led to disappointing economic results, brought executives' transgressions to light, and exposed our organization's structural deficits. However, consistent steps aimed at bringing about a lasting operational and financial restructuring of the Zapf Creation Group were already undertaken in 2005 and have continued to date. We can now say that we are on the road to recovery even though we still face a lot of difficult work in the days ahead.

The Group closed 2005 with a net loss of € 27.7 million. Operating income (EBIT) before restructuring expense was € −8.5 million, remaining significantly below our target of positive operating income of € 5 million. At € 140.7 million, consolidated sales were just about 14 % below the previous year and below our target. All of these results undoubtedly are disappointing. We must acknowledge that the restructuring measures initiated in the first half of 2005 were insufficient to return Zapf Creation to its course of success.

What Were the Main Reasons for this Development?
In our view, five factors, both internal and external, shaped events:

1. Market Environment
In spite of a robust global economy, the competitive situation in the market for play and functional dolls – the Group's core segment – intensified yet again in the past year. We are facing a growing number of players from segments outside the industry, in some cases even in markets that are experiencing a downturn. In 2005, particularly the German market for play and functional dolls including accessories remained below our expectations due to ongoing weak consumer demand and a negative demographic development, generating a loss of 14 % on the heels of the clear decline in the 2004 financial year. Yet Zapf Creation succeeded nonetheless in maintaining its position as the number one in Europe with a market share of roughly 30 %.

Angelika Marr,
Member of the Management Board (CDO)

2. Personnel Changes

A number of changes were made on both the Management Board and the Supervisory Board in 2005 and in the first few months of 2006. Almost all Supervisory Board members were replaced during the financial year just ended. These personnel changes occasionally gave rise to backlogs in decision making within the Company's management, in turn triggering delays in the preparation and implementation of the restructuring measures.

3. Restructuring

The restructuring program that had been prepared and published in the spring of 2005 turned out to be insufficient, given the adverse market environment and the extent of the shortcomings in the Group's structures and processes. We did implement a large number of important structural measures, for example, adjusting our distribution strategy in the United States, centralizing core tasks such as controlling, accounting, and disposition, or accelerating the product development process by establishing Brand Teams that comprise key personnel from both marketing and design. Nonetheless, additional measures will be required to boost the Group's internal efficiency. To that end, the entire value chain – which ranges from product development to production and distribution – will once again be subjected to close analyses. Our aim is to continue to lower the Group's costs, simplify structures, and reduce the amount of tied-up capital.

We also did not succeed in 2005 in finding a viable solution to secure the Group's financing. Although a syndicated loan agreement was signed in July in order to secure the Group's financing in the medium term, business developments did not allow Zapf Creation to meet its targets and the Company thus failed to comply with the covenants that had been stipulated with the banks. This made new negotiations with the banks necessary, which were successfully concluded in April 2006, finally securing the medium-term financing of the Zapf Creation Group.

4. Special Audit

Concrete evidence that accounting irregularities had occurred in the consolidated financial statements, as well as in individual subsidiaries' single-entity statements – for instance, due to inaccurate interpretations of accounting standards or insufficient recognition of provisions – emerged in the fall of 2005. The Management Board and the Supervisory Board of Zapf Creation commis-

BABY born®
is unique in that it has nine life-like functions and does not require batteries. BABY born® "grows" with the girl and accompanies her wherever she goes – sometimes as a baby, sometimes as a friend.

sioned the auditing firm KPMG in October 2005 to conduct a special audit to fully clarify all events and circumstances. This special audit was not completed until April 2006 for a variety of reasons, among them, the highly complex nature of some of the facts and circumstances to be investigated, the need in some cases to examine individual vouchers, and the fact that the preparation of the 2005 financial statements resulted in yet more findings.

On February 27, 2006, we issued an ad-hoc press release to inform the public about the preliminary results of the special audit. According to the auditors' findings, we must assume that intentional violations of statutes have occurred. The effects from the special audit resulted in the need for corrections of the financial statements for both 2005 and 2004, as well as for previous years. These corrections have had a significant impact on the equity of the Zapf Creation Group. We have endeavored to describe all related facts and circumstances in detail in the 2005 Group management report.

The fact that statutory requirements were violated has shaken the faith of the capital market in Zapf Creation AG, which had already been undermined by the Company's repeated failure to meet targets. We can only counter this loss of faith by conducting a transparent and rigorous investigation and by taking the consequences that arise from these transgressions. You may rest assured that the Management Board will act accordingly.

Both the Management Board and the Supervisory Board filed criminal charges against certain individuals considered responsible for the violations immediately after receiving the preliminary results of the special audit. The Company's comprehensive review of and response to the audit results is ongoing.

5. Group Strategy

The large number of tasks that had to be mastered in 2005, as well as the special audit, which tied up resources in terms of both time and personnel, have obviously made it more difficult for the Group to continue developing its strategy as necessary. Hence the Management Board was unable to devote as much time to the Group's operating business – for example, product innovations and new distribution concepts – as would have been necessary in light of market developments. Defining future areas of growth thus is one of the central tasks to which we will have to turn in the short term.

Baby Annabell®, the soft and sweet functional doll, encourages girls to pay attention because it reacts like a real baby and even sheds real tears.

Strong Brands and Good Positioning Provide the Basis for a Future Upturn.

Dear Shareholders, this inventory of the challenges and shortcomings that were responsible, in the end, for the Group's loss in the past year should not cause Zapf Creation AG's strengths to be forgotten. These strengths will be at the heart of our Company's recovery, which we plan to conclude by the next financial year.

Zapf Creation continues to maintain an excellent position in its core segment – play and functional dolls including accessories – in the most important markets. In Germany, tried, tested, and successful concepts such as BABY born®, Baby Annabell®, and CHOU CHOU accounted for about 60 % of the total market volume of play and functional dolls including accessories. We even succeeded in expanding our market share in key markets such as Great Britain (where our market share exceeds 40 %) or France. Zapf Creation continues to be the leading brand manufacturer of play and functional dolls, and this leading position, which we have built up over many decades, will be pivotal to the Group's reorganization.

Our brands have not suffered from the current economic difficulties. The trade and end customers alike believe that Zapf Creation's products continue to satisfy highest claims to design, quality, and safety. It remains a special treat for girls to be given a BABY born® doll. Our brands' market value, which arises from this image, represents an asset that should not be underestimated in terms of both pricing policies and relationships to business partners.

Zapf Creation possesses highly qualified and motivated personnel. The past years have demanded much of our employees, and a strong commitment will be necessary in the future as well to bring about the turnaround. The Management Board wishes to express its heartfelt thanks to all of the Group's employees for their work in these difficult times. These thanks also include all those who were laid off in connection with the restructuring or will have to be laid off in the future. This refers to the loss of about 160 jobs in both 2005 and 2006 – roughly one third of the Group's total workforce as of the close of the 2004 financial year. As painful as these decisions have been for each and every one of the individuals concerned, they have been indispensable in view of securing the Company's existence and thus all remaining jobs.

CHOU CHOU
is a concept of soft, cheeky cuddly dolls with or without functions, which also comprises numerous accessories for mother-child role play.

What Precisely Do We Plan to Accomplish in the Current Financial Year?

Our restructuring and reorganization measures are based on the assumption that Zapf Creation cannot repeat the mistake of hoping that conditions in the markets themselves will improve. What must be done, therefore, is to reorganize the Group – strategically, operationally, and financially – such that it can remain profitable in the face of consistent or further deteriorating market parameters. Our aim must be to return to our previous profit level in the medium term. This means that we need to earn a double-digit operational margin in terms of the ratio of consolidated sales to EBIT.

Restructuring the financing of Zapf Creation in the short and medium term was the most urgent task in the first few months of the current year. We achieved this objective by signing a new syndicated loan agreement in mid-May 2006.

On the operational level, we have launched a total of eight projects aimed at undertaking systematic analyses of the Group's core processes and initiating improvements. This entails the following tasks:

- Stabilizing sales
- Returning to profitability in all markets
- Improving the gross profit margin
- Optimizing purchasing
- Optimizing the product portfolio
- Improving the sales performance
- Lower operating costs
- Lower working capital

These projects, all of which are subject to centralized control, entail concrete measures and timelines that are regularly monitored. The aim of all of these projects is to provide the Group with structures that have been fully adapted to lower sales flows.

But the above projects by themselves will not suffice. In a next step, we will have to open up new growth opportunities for Zapf Creation in the medium term as part of a strategic repositioning of the Group. This will require overhauling and streamlining the Group's entire product portfolio in 2006. We will increase the number of product innovations, especially with regard to accessories,

Missy Milly®
and her clique of four other 12-year old girls, a boy and a small dog experience all kinds of adventures together.

and plan to develop new themes for high-value girls' toys. It will also be necessary to clarify in the context of this repositioning whether our Company can or must enter related segments of the toy market above and beyond play and functional dolls, its core segment.

The current financial year will see another round of restructuring measures for Zapf Creation. But it will also be a time of new departures for the Group.

- We expect sales to decline yet again, but by less than ten percent, given the continued weakness of the German market and our modified distribution strategy in the United States.
- We will focus on improving the quality of sales and hence on enhancing our gross profit margin. The elimination of one-time expenses in the financial year just ended, for example, in connection with inventory writedowns, will contribute to our meeting this objective.
- Plans are to cut operating costs by a minimum of € 7 million and thus to lower them to an extent similar to the reductions achieved in 2005.
- We expect restructuring costs of approximately € 2 million in 2006 (2005: € 7.8 million).
- In sum, we expect operating income (EBIT) to improve by at least € 15 million and thus to achieve a balanced EBIT in 2006.

It must be our goal in 2007 to restore the Group's profitability at all levels with the aim of finally turning the corner. The course has been set. We will achieve this goal if we do our homework in both operational and structural terms – rapidly and consistently – and refocus on those potentials and strengths that have made Zapf Creation stand out for years. We would be very pleased indeed if you continued to accompany us on this journey.

Roedental, Germany, June 20, 2006

Sincerely,

Dr. Georg Kellinghusen
Chairman of the Management Board

Angelika Marr
Member of the Management Board

Product Portfolio

BABY born® (for girls aged 3 to 8 years)

BABY born® is unique in that it has nine life-like functions and does not require batteries. Mother-child role play is particularly realistic with BABY born®. The doll can eat porridge, drink water, shed real tears; it can also be bathed and use its potty or wet its diapers. Everything one needs for a real baby is also available for BABY born®. The BABY born® branded play concept "grows" with the girl and places no limits on her imagination. Sometimes BABY born® is an infant that needs care, while at other times she's a playmate and accompanies the girl wherever she goes.

Baby Annabell® (for girls aged 3 to 8 years)

Baby Annabell® is Zapf Creation's youngest baby. This play concept is focused on mother-child role play which is supported by suitable accessories. Baby Annabell® – the soft and sweet functional doll – encourages girls to pay attention. She reacts to sounds and movements and sucks on a bottle or pacifier while making realistic facial movements. The doll now also sheds real tears and thus seems even more life-like. Baby Annabell®, which always reacts randomly and differently to its environment, promotes girls' social skills, such as loving, caring, and taking responsibility.

CHOU CHOU (for girls aged 1 to 8 years)

CHOU CHOU, the soft, cuddly dolls that come in various sizes, with or without functions, are distinguished by their natural flexibility. This branded play concept includes accessories for mother-child role play and offers stylish clothes for CHOU CHOU dolls.

My Model (for girls aged 3 to 11 years)

My Model is the branded play concept for creative girls. By playing with these styling heads and a large selection of make-up products and hair accessories, girls can let their imagination run free. My Model PROFESSIONAL is conceived for girls 6 to 11 years of age who especially like to try out different kinds of hair styles.

Missy Milly® (for girls aged 4 to 9 years)

Missy Milly® is the new mini doll line from Zapf Creation. It is based on the "Missy Milly" cartoon series which is shown on the Super RTL television station in Germany. The main characters are a group of five 12-year old girls, a boy and dog, who experience all kinds of adventures together. With Missy Milly®, Zapf Creation closes a strategic gap in the mini doll market because the new line within a single concept offers all play themes relevant for this segment: fashion, mini-format animals and story-based concepts. The new Missy Milly® manages to address all three themes through "Laptop", the group's dog, trendy outfits and accessories, as well as the supporting story of the cartoon series. This gives the product line a true USP in the market.

Girls – best friends (for girls aged 4 to 9 years)

The new "girls" from Zapf Creation are "best friends" because girls aged 4 to 9 years prefer to play what they experience with their friends. The girls, Latisha, Malila, and Jenaya, are typical, trendy tweens who most prefer to do everything together. Zapf Creation's new play dolls are 42 cm tall, have long hair that is excellent to style, and wear trendy outfits. For the three girl-friends, everything revolves around topics from the target group's world: friendship, styling, music, and dancing. Each year, the "girls" will offer new highlights that reflect the interests of female tweens, as well as suitable accessories with interactive functions.

Investor Relations

2005 Corporate Governance Report

Investor Relations

News of the Company Determines the Volatility of Its Share Price

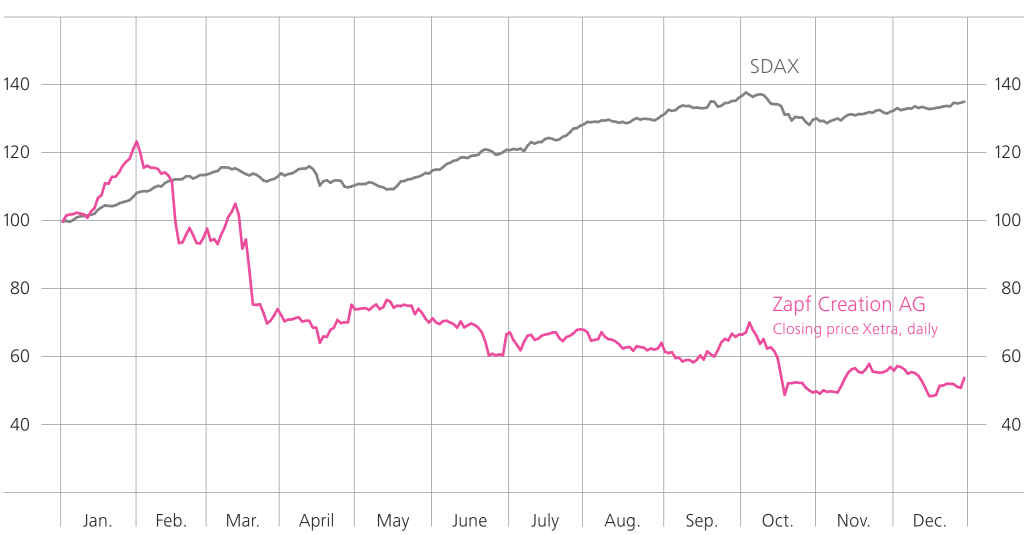
The stock of Zapf Creation AG opened the 2005 financial year at a price of € 14.75 per share, gaining close to 24 % by the time it reached € 18.24 per share on February 1, 2005, its peak for the year.

News in mid-February 2005 of the sales decline in 2004 and of additional impacts on earnings from operating results, as well as the announcement in mid-March 2005 that no dividend would be paid, triggered a rapid downslide of the share price in subsequent weeks. Overall, the development of the share price shows that it reacted with extreme sensitivity to news about the Company. The stock's movement down the price ladder came to a halt on December 15, 2005, reaching a low of € 7.05; the stock closed the year at € 7.83.

The considerable increase in share price volatility was also reflected in the considerably higher number of shares (49,918) traded daily on average in 2005 (previous year: 33,508 shares). In the financial year just ended, the stock of Zapf Creation AG declined by 46 %, in contrast to the increase of 36 % registered by the SDAX, the comparative index.

Share Performance 2005 (Index Data)

ISIN: DE 000 780 6002; Reuters code: ZPF.ETR; Bloomberg code: ZPF GR



Number of Treasury Shares Unchanged

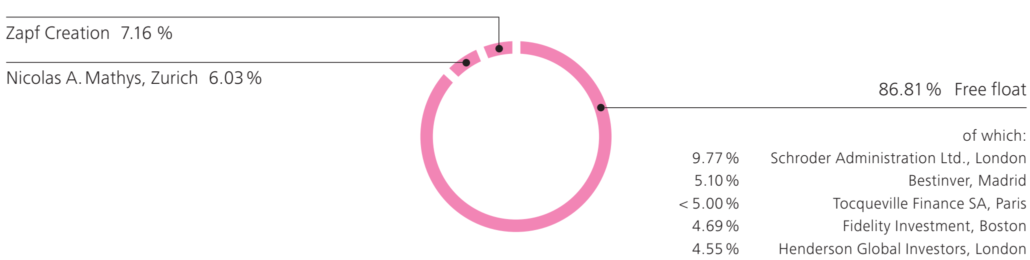
Zapf Creation AG continues to hold treasury shares for the Employee Stock Option Plan. The number of treasury shares held to back the Employee Stock Option Plan remained unchanged at 7.16 % of the share capital.

Key Share Figures

	2001	2002	2003	2004	2005
Market capitalization (based on the year-end price) in € million [1]	208	204	153	117	63
High (Xetra) in €	50.00 (Jan. 5)	29.50 (June 21)	37.65 (Sep. 5)	23.79 (Feb. 18)	18.24 (Feb. 1)
Low (Xetra) in €	17.61 (Oct. 9)	16.80 (Oct. 8)	17.18 (Nov. 26)	14.25 (Dec. 21)	7.05 (Dec. 15)
Year-end price (Xetra, Dec. 31) in €	26.00	25.54	19.13	14.60	7.83
Daily trading volume (average no. of shares)	11,364	16,478	47,180	33,508	49,918
P/E ratio (Xetra, Dec. 31) in €	12.5	9.0	12.5	—	—
EPS in €	2.09	2.70	1.53	−3.73	−0.02
CFPS in €	3.68	1.29	1.61	−1.14	0.48
Dividend per share in €	0.65	1.00	1.00	0.00	0.00
Dividend yield (Xetra, Dec. 31) in %	2.5	3.9	5.2	—	—

1) Number of shares: 8 million

Shareholder Structure as of March 17, 2006



Intensive and Continuous Investor Relations

Intensive and continuous efforts to explain important business developments and market changes in the toy segment, as well as the ongoing dialog with the public in the financial sector, ensured that the level of transparency regarding the Company's operating business remained high in 2005. The Management Board held numerous face-to-face meetings, particularly with analysts and investors, in connection with several pan-European road shows to financial centers such as Zurich, Paris, Frankfurt/Main, London, and Copenhagen. In addition, Zapf Creation also presented itself at the two analyst conferences it held in March and July 2005, as well as at various capital market and investor conferences in Germany.

2005 Corporate Governance Report

Zapf Creation attaches great importance to compliance with and implementation of the principles enshrined in the Corporate Governance Code with regard to good and responsible management. They determine corporate communications and efforts to maintain transparency in corporate affairs in the interest of shareholders, business partners, and employees. It is in this sense that this report provides information on the main activities of the Supervisory Board and the Management Board in the 2005 financial year, which essentially were focused on reconstituting the Company's governing bodies, developing its current business, and clarifying facts and circumstances that came to light during the special audit.

Changes in the Composition of the Supervisory Board and the Audit Committee

The Supervisory Board of Zapf Creation AG was newly elected at the Annual Stockholders' Meeting on May 11, 2005, i.e. at the expiration of its regular term. Two members, Dr. Petra Wibbe and Mr. Hans-Gerd Füchtenkort, left the Supervisory Board at that time. Dr. Horst F. Bröcker had already resigned from the Supervisory Board effective February 4, 2005. The membership of Dr. Peter Klein was inactive at the time the new election took place because he had assumed the duties of a deputy member of the Management Board effective February 22, 2005. The Company's shareholders reelected Dr. Dietmar Scheiter, Mr. Arnd Wolpers, and Dr. Peter Klein to the Supervisory Board. Messrs. Martin Gruschka, Gustavo Perez, and Francesc Robert were newly elected to the Supervisory Board. At the new Supervisory Board's constituent meeting, Dr. Dietmar Scheiter was elected its chairman and Gustavo Perez its deputy chairman.

On July 7, 2005, Dr. Scheiter resigned from the Supervisory Board effective August 5, 2005. Mr. Martin Gruschka was elected chairman of the Supervisory Board in his stead. Given the small number of active Supervisory Board members, Mr. Miguel Perez-Carballo Villar was appointed a regular member of the Supervisory Board by a court effective September 14, 2005, on urgent grounds. On October 17, 2005, Dr. Peter Klein resigned from his position as deputy member of the Management Board and concurrently resumed his duties as a member of the Supervisory Board. Effective November 18, 2005, Mr. Arnd Wolpers resigned from the Supervisory Board.

Changes on the Management Board and New Distribution of Responsibilities

The responsibilities of the members of the Management Board were reassigned at the Supervisory Board meeting on May 10, 2005, given the resignation of Mr. Rudolf Winning (chief financial officer) effective March 15, 2005, the fact that Dr. Peter Klein was serving as a member of the Management Board on an interim basis, and the Company's restructuring measures. The position of chief financial officer remained vacant temporarily following the resignation of Dr. Klein from his position as deputy member of the Management Board and the resumption of his duties as a member of the Supervisory Board.

Resolution to Implement the German Law on Corporate Integrity and the Modernization of the Right to Appeal (Gesetz für die Unternehmensintegrität und Modernisierung des Anfechtungsrechts – UMAG) in the Articles of Incorporation of Zapf Creation AG

In light of the UMAG, the Annual Stockholders' Meeting adopted a proposal to change the Company's articles of incorporation and thus facilitate the participation of shareholders in future Annual Stockholders' Meetings.

Commissioning a Special Audit

Following a review of individual facts and circumstances, the Management Board and the Supervisory Board jointly decided on October 16, 2005, to commission a special audit of the single-entity financial statements of individual subsidiaries and the consolidated financial statements of the Group for the 2004 financial year. The aim of the special audit was to review the validity of the annual financial statements, as well as to ensure the transparency of the Company's accounting. The special audit was not concluded in 2005.

Directors' Dealings and Shareholdings of Members of the Company's Governing Bodies

On February 16, 2005, Mr. Arnd Wolpers, member of the Supervisory Board, reported that Cornelia, Sarah, Eva, and Maria Wolpers had sold 24,500 shares.

As of December 31, 2005, the members of the Management Board and the Supervisory Board held a total of 4.62 % of the shares of Zapf Creation AG. Members of the Supervisory Board accounted for 4.05 % of this amount and members of the Management Board for the remaining 0.57 %.

Employee Stock Option Plan

The Management Board had already decided at the end of 2004 not to grant any stock options under the Company's 2003/2005 Employee Stock Option Plan (ESOP) that had not yet been granted. All participants in these ESOPs declared their agreement to waive options previously granted but not yet exercised as of December 15, 2004. This decision was made in light of the pending change in the treatment of the ESOPs under the International Financial Reporting Standards (IFRS), which would have a greater impact on earnings in the future. No stock options were granted in the 2005 financial year.

Declaration of Conformity 2005 of Zapf Creation AG Pursuant to Section 161 German Stock Corporation Act (AktG)

The "German Corporate Governance Code" as amended on May 21, 2003 was published in the official section of the electronic Federal Gazette on July 4, 2003.

Both the Management Board and the Supervisory Board of the Zapf Creation AG declare pursuant to Section 161 AktG that the Company is in compliance with the recommendations of the

Government Commission on the German Corporate Governance Code as amended on May 21, 2003, and as published by the German Ministry of Justice on July 4, 2003, in the official section of the electronic Federal Gazette, with the exception of the following items and / or topics:

3.8 "If the company takes out a D&O (directors' and officers' liability insurance) policy for the Management Board and Supervisory Board, a suitable deductible shall be agreed."

4.2.4 clause 2: "The figures shall be individualized."

5.2 para 2 clause 1: "The Chairman of the Supervisory Board shall also chair the committees that handle contracts with members of the Management Board and prepare the Supervisory Board meetings."

5.3.1"Depending on the specifics of the enterprise and the number of its members, the Supervisory Board shall form committees with sufficient expertise. They serve to increase the efficiency of the Supervisory Board's work and the handling of complex issues. The respective committee chairmen report regularly to the Supervisory Board on the work of the committees."

After issuing last year's declaration of conformity pursuant to Section 161 AktG in connection with Section 15 Introductory Law to the AktG, the Company has been in compliance with the recommendations made by the Government Commission on the German Corporate Governance Code as amended on May 21, 2003, and as published in the electronic Federal Gazette on July 4, 2003, with the exception of items 3.8, 4.2.4 clause 2, 5.2 para 2 clause 1, and 5.3.1 as stated above.

Reasons for the Deviations

Regarding Item 3.8: The D&O insurance purchased by Zapf Creation AG does not require the members of the Company's Management and Supervisory Boards to pay a deductible.

This insurance is a group insurance policy that was concluded for numerous executives at home and abroad and it did not seem appropriate to differentiate according to board members and other executives. Considering that an insurance policy can never cover more than negligent actions, deductibles are usually unsuitable for preventing losses and thus are generally taken into account by the insurance industry only in the calculation of the premium.

Regarding 4.2.4 clause 2: In order to protect the privacy of the members of the Management Board and their families, Zapf Creation has decided to refrain from individualized reporting of the compensation paid to them in the notes to the consolidated financial statements.

Regarding Item 5.2 para 2 clause 1 and Item 5.3.1: The Supervisory Board of Zapf Creation AG comprises six members. In view of its size, the Supervisory Board does not believe that it is appropriate to transfer duties to committees, some of which may have only three members. The Supervisory Board therefore decided to deviate from the recommendations of the German Corporate Governance Code. Given the Company's size, the composition and size of its Supervisory Board ensure the qualified treatment of particular issues by the full Supervisory Board as envisioned by the authors of the German Corporate Governance Codex.

Management Report of the Company and the Group

I. General

Business Concept

The Zapf Creation Group markets branded play concepts that consist of play and functional dolls and a world of matching accessories that are developed to a high standard of quality, design and play value. The Group's most popular brands are BABY born®, Baby Annabell® and CHOU CHOU. These globally successful play concepts have been conceived particularly for the Company's core target group – girls between three and eight years of age.

In addition to the parent company with headquarters in Roedental, Germany, the Zapf Creation Group operates wholly-owned subsidiaries both at home and abroad that are responsible for marketing and selling the Group's brand portfolio.

Four Group subsidiaries are headquartered in Germany: Zapf Creation (Central Europe) GmbH & Co. KG; Zapf Creation (Central Europe) Verwaltungs GmbH; Zapf Creation Logistics GmbH & Co. KG; and Zapf Creation Logistics Beteiligungs GmbH. Zapf Creation also operates sales and marketing companies in France, Great Britain, Spain, Poland and the USA.

An additional subsidiary in Hong Kong (China) is responsible for central purchasing, quality management, and worldwide distribution of Zapf Creation's products.

The Czech subsidiary is being liquidated. In the Czech Republic, the Group set up an information office in 2005, which is part of Zapf Creation (Central Europe) GmbH & Co. KG. In Italy, Zapf Creation handed over its operating business to a sales partner. The subsidiary's legal shell will continue to exist, however. In Australia, Zapf Creation also handed over its operating business to a sales partner at the end of 2004. The Australian subsidiary was liquidated in the 2005 financial year.

As of December 31, 2005, the Zapf Creation Group had 408 employees (excluding the members of the Management Board and trainees), 175 of which worked for the Group's foreign companies.

Economic Situation Overall

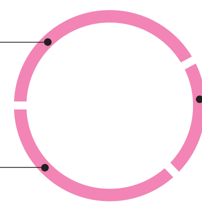
While the world economy as a whole again registered strong growth in 2005, the growth rate of 5 % remained slightly below that recorded in the previous year. Strong foreign trade coupled with rising domestic demand also propelled the economies of the EU member states along a strong growth trajectory. Overall, the euro zone posted a plus of roughly 1.5 %. The new EU member states were among the biggest growth drivers.

Increases in both exports and capital spending resulted in a slight upturn in the German economy at the close of the first half of 2005. But the forces underlying this upswing remained weak because domestic demand and especially private consumption continued to stagnate. As a result, the German gross domestic product (GDP) grew by less than 1 %.

Market Environment

In 2005, the top five markets of the European toy market registered overall sales growth of 2.7 % whereas the US market – the largest individual market – declined by 4 %. The market for girls' toys was characterized by intensified competition arising from the expanding presence of new providers from segments outside the industry or related categories.

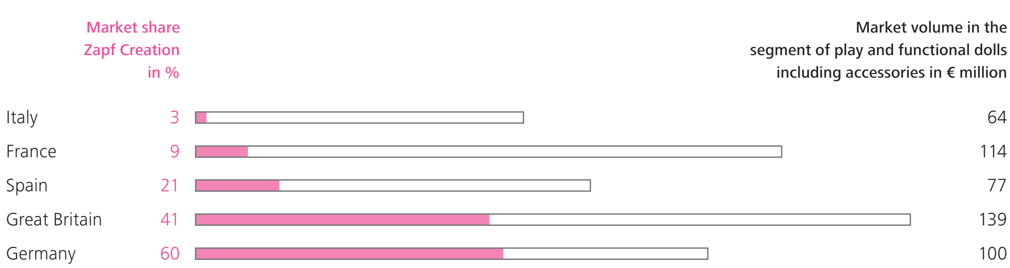
Doll Market Based on Sales Price Totals of About € 3.2 Billion



Zapf Creation's core market – i.e. the play and functional doll segment including accessories – developed at different rates throughout the world. Among the five largest markets in Europe, only Spain (+ 3 %), Italy (+ 10 %), and France (+ 13 %) posted growth. This is due, among other things, to beneficial demographic developments in France and rising expenditures for toys in Spain. Yet this market segment registered a downturn in both the UK (– 6 %) and Germany (– 14 %). After years of consistent growth, the forces of consolidation are making themselves felt in the UK, the largest European toy market. The German market, on the other hand, did not stabilize in the second half of the year contrary to expectations. Rather, the ongoing weakness of the country's economy, the decline in birth rates, and competition from other market segments further diminished sales in the toy market.

In contrast, the play and functional doll market segment in North America posted strong growth of about 15 %. At a market share of about 30 %, Zapf Creation succeeded in maintaining its leading position in Europe. The Group gained market share in two individual markets – the UK (market share of 41 %) and France (9 %). There was a slight decline in market share in Germany (60 %) and Spain (21 %), while market share in Italy (3 %) remained stable.

Market Share in the Segment of Play and Functional Dolls Including Accessories Top 5 Europe



(Source: NPD / Eurotoys 2005, Zapf Creation AG)

Developments in Eastern Europe are providing momentum for the toy market and, in particular, the market for play and functional dolls. This is due to the slow yet steady increase in purchasing power, for example, in Poland and the Czech Republic, as well as rising demand in Russia.

II. Noteworthy Occurrences after the End of the Financial Year: Special Audit

On the initiative of both the Management Board and Supervisory Board, a special audit of single-entity financial statements of Zapf Creation AG and individual subsidiaries of the Zapf Creation Group, as well as of the consolidated annual financial statements as of December 31, 2004, was conducted by the KPMG auditing firm between October 2005 and April 2006. The special audit was initiated in order to fully investigate individual findings made during the 2005 financial year.

The ongoing audit of the 2005 consolidated annual financial statements by the Rödl & Partner auditing firm yielded additional findings. Additional investigations indicated that legal regulations were knowingly violated. The Company has therefore filed charges. The KPMG auditing firm was then asked to examine certain accounting matters related to 2003/2004. The partial report on this audit was presented on April 10, 2006. The special audit came to the following conclusions:

Reclassification of Expense Items without Affecting Earnings

Among other things, the special audit resulted in reclassifications of individual expense items from sales expenses and/or cost of sales to sales deductions. The resulting increase in sales deductions triggered a corresponding reduction in the net sales posted by Zapf Creation (net sales = gross sales less sales deductions).

Effect on Sales of the Special Audit

	2005 (IFRS)	2004 (proforma US GAAP) corrected	2004 (US GAAP) as reported previously
Sales	€ 140.7 million	€ 163.3 million	€ 173.8 million

Allocation to the Proper Period and Provisions

The allocation of expenses to the relevant accounting period resulted in the need to make adjustments to earnings for the 2003, 2004 and 2005 financial years. These adjustments arose from provisions – e. g. for bonus payments, returns, and sales deductions – that had not been recognized at all or not in sufficient amounts, as well as from the failure to allocate marketing and sales expenses on trailing invoices to the proper period.

Restatement of Business Transactions

The audit of so-called barter transactions effected by Zapf Creation (Central Europe) GmbH & Co. KG and Zapf Creation (U.S.) Inc., as well as one consignment transaction (merchandise is delivered but remains the property of the seller until it is removed from the warehouse) in the United States, led to a restatement of these business transactions. In turn, this resulted in adjustments to profit or loss due to the inappropriate application of accounting standards in connection with the barter contracts and improper posting of the consignment transaction. The adjustments from recognition of accruals/deferrals and provisions to the proper period, as well as from the restatement of business transactions, had an impact on both operating income (EBIT) and equity in several periods.

The following table shows only the direct effects of these restatements on earnings, excluding subsequent effects, such as, for example, resulting tax adjustments.

EBIT Effects from the Special Audit

	2005 € million	2004 € million	2003 and earlier € million
Proper-period recognition of accruals/deferrals and additional provisions	+10.7	−0.2	−10.7
Restatement of business transactions	+0.2	−1.1	−1.9
Overall change in EBIT	**+10.9**	**−1.3**	**−12.6**

The corrections for the 2003 financial year and earlier were made by correcting the equity in the 2004 opening balance. A positive effect of € 3.0 million, which arose from the tax claim resulting from the adjustments in the 2003 financial year, was taken into account in that connection.

The preliminary results of the special audit were already published in February 2006.

Due to the need for significant corrections in the annual financial statements of both Zapf Creation AG and Zapf Creation (Central Europe) GmbH & Co. KG, the Management Board, with the approval of the Supervisory Board, decided to revise the annual financial statements for the 2003 and 2004 financial years – which had been prepared in accordance with the German Commercial Code (HGB) – and to commission a re-audit under Section 316 para 3 HGB. This served to ensure that all events that became known in retrospect were included in the revised financial statements. The comparative figures for the annual financial statements as of December 31, 2004, are already based on the revised figures in the single-entity financial statements.

III. Economic Report

The 2005 consolidated financial statements of Zapf Creation Group, as well as the comparative figures for the previous year, were prepared in accordance with International Financial Reporting Standards (IFRS) for the first time.

The figures for Zapf Creation AG were determined in accordance with the requirements of the German Commercial Code.

Development of Sales

Development of Sales within the Zapf Creation Group

In 2005, the Zapf Creation Group posted sales of € 140.7 million (previous year: € 163.3 million). The development of business in the United States, as well as sales declines in Central Europe, were the main cause for the decrease in sales.

Development of Consolidated Sales (in € Million)

1) US GAAP, as reported previously
2) IFRS

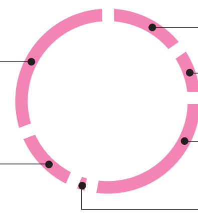
Sales by Operating Business Unit

Sales in Central Europe – which includes Germany, Austria, Switzerland, the Netherlands, and Luxembourg – declined by 19 % to € 43.0 million. This development was due primarily to the downturn in German sales as a result of both the streamlining of our portfolio, which entailed eliminating marginal brands, and the decline of two key concepts, BABY born® and CHOU CHOU.

In Northern Europe – which includes the Great Britain and Ireland, as well as Scandinavia – Zapf Creation posted sales of € 40.6 million, down 9 % from the previous year. Great Britain / Ireland (the largest European toy market) posted its very first decline ever but Zapf Creation succeeded nonetheless in slightly expanding its leading position to a market share of 41 %.

In Southern Europe – which includes Spain / Portugal, France / Belgium, as well as Italy – sales of € 21.6 million were only slightly below the previous year's level. Sales rose slightly in France, remained stable in Spain, and declined slightly in Italy.

Sales by Operating Business Unit



At € 12.9 million and a plus of 36 %, sales in Eastern Europe developed along a positive trajectory resulting mainly from sales growth in both Russia and Poland.

On the American market (which includes Canada), sales fell by 25 % to € 20.1 million. Yet the Group continued to maintain its market share of just above 6 % despite the overall decline of business.

At € 2.7 million, sales in Asia / Australia were 63 % below the previous year's level. This downturn occurred primarily in Australia. Zapf Creation's product portfolio has been distributed by its distribution partner, Funtastic Limited, the market leader on the Australian toy market, since November 1, 2004. Funtastic had taken over all inventories of Zapf Creation in Australia as of the contract's effective date at the end of 2004.

Development of Sales and EBITDA by Operating Business Unit

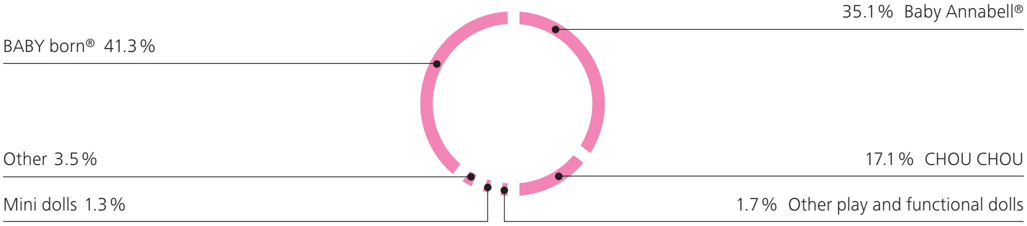
	Sales 2005 K€	EBITDA[1] 2005 K€	Sales 2004 K€	EBITDA 2004 K€
Europe	**117,961**	**– 14,200**	**129,186**	**19,093**
Central Europe	42,965	– 19,563	53,000	2,858
Northern Europe	40,571	3,901	44,694	11,361
Southern Europe	21,571	– 259	22,045	3,057
Eastern Europe	12,854	1,721	9,447	1,817
The Americas	**20,060**	**11,206**	**26,774**	**– 7,210**
Asia / Australia	**2,696**	**1,391**	**7,322**	**1,813**
Total	140,717	– 1,603	163,282	13,696

1) Reporting of EBITDA before restructuring costs

Development of Sales by Product Line

The decline in sales of the BABY born® concept results mainly from weak business in Central Europe coupled with the downturn in the German market – the Group's largest. Yet Zapf Creation succeeded nonetheless in lifting the BABY born® doll to seventh place in the ranking of the ten best-selling toys in 2005 (Source: NPD / Eurotoys 2005).

Sales by Product Line



The development of the Baby Annabell® concept remained positive in 2005 and the successful market launch of the new Baby Annabell® with tears boosted sales. In Great Britain – where the doll has been particularly popular ever since it was launched there in 1998 – the new Baby Annabell® was one of the "2005 Dream Toys". The past Christmas season was the third time it was designated as one of the ten most popular girls' toys by the British toy manufacturers association, in collaboration with the retail association. This doll also ranked third overall among the top ten best-selling toys in 2005. Baby Annabell® is popular in Germany, too, where it ranked fifth among the best-selling toys in 2005 (Source: NPD/Eurotoys 2005).

As far as the CHOU CHOU concept is concerned, in 2005 Zapf Creation was unable to repeat the success it had achieved the previous year in terms of sales following the market launch of the functional doll, Love me CHOU CHOU.

Sales from the Group's remaining product lines – other play and functional dolls, mini dolls, and other – also declined due to the streamlining of the portfolio.

Development of Sales by Product Line

	2005 K€	2004 K€
Play and functional dolls	**133,973**	**154,498**
BABY born®	58,089	64,500
Baby Annabell®	49,418	46,306
CHOU CHOU	24,101	38,920
Other play and functional dolls	2,365	4,772
Mini dolls	**1,788**	**3,671**
Other	**4,956**	**5,113**
Total	140,717	163,282

Sales Development of Zapf Creation AG

Zapf Creation AG posted revenue of € 0.5 million in 2005, compared to € 5.9 million the previous year. The year-on-year changes resulted from shifts in the way goods are bought and sold via our subsidiary, Zapf Creation (H.K.) Ltd. Zapf Creation AG now bills exclusively to affiliates, as it did in the 2004 financial year. The previous year's figures correspond to the annual financial statements of Zapf Creation AG as of December 31, 2004, which were amended based on a re-audit pursuant to Section 316 para 3 HGB.

The services provided by Zapf Creation AG focus on product development and global marketing, as well as management functions such as IT, finance and general administration. These services are billed to subsidiaries based on clearly defined, contractually agreed billing terms and are shown under other operating income. At the same time, the Company generates income from collecting profits in the same accounting period.

Earnings

Earnings of the Zapf Creation Group

Consolidated earnings before interest and taxes (EBIT) according to IFRS were € –16.3 million (previous year: € 6.5 million). This result was significantly impacted by restructuring expenses of € 7.8 million.

Development of Group Earnings (EBIT) (in € Million)

1) US GAAP, as reported previously
2) IFRS

The consolidated loss essentially stems from both the declines in sales and reorganization measures. For example, additional costs were generated by a restructuring program initiated in March 2005, which aims to adjust the Group's organizational structures to reduced sales levels, optimize core processes, and achieve savings of € 17 million by 2007. And lowering the costs of staff and material in 2006 made additional provisions necessary as well. All of this is due to larger-than-expected declines in sales and related earnings shortfalls. The Company thus decided in December 2005 to cut an additional 80 jobs. On the other hand, the strain on earnings was relieved as a result of measures previously implemented in 2005 in connection with the elimination of 80 jobs on the basis of a balancing of interests and a redundancy payments scheme that were negotiated with the Works Council and are applicable worldwide. Costs were reduced by € 6 million. The Group's gross earnings declined in 2005 to € 54.4 million (previous year: € 77.6 million). Its gross profit margin fell analogously by 8.8 % to 38.7 %. Besides the deterioration in margins, this is due primarily to the streamlining of the product portfolio and the attendant clearing out of inventories.

The Group's financial result fell by € 3.2 million year-on-year to € –6.8 million.

Consolidated tax expenses for 2005 are impacted by € 0.7 million resulting from the outcome of the tax audit of the 1999 to 2002 financial years. This is due mainly to a change in an administrative directive issued by the German Ministry of Finance on November 18, 2005. This guideline governs the recognition of expenses for tax-accounting purposes related to the introduction of a business software system (ERP software), in particular, the introduction of SAP software in the Zapf Creation Group.

Consolidated losses for the year were € 27.7 million (previous year: € 0.1 million). Earnings per share thus were € −3.73 (previous year: € −0.02).

Earnings of Zapf Creation AG

In 2005, Zapf Creation AG posted a loss after taxes of € 34.8 million (previous year: profit of € 4.8 million); the result from ordinary activities accounted for € −29.9 million (previous year: € 4.8 million) of this amount. Earnings were negatively impacted mainly by a loan to our US subsidiary that was written off in the amount of € 16.6 million, as well as by writedowns totaling € 9.9 million on the carrying value of Zapf Creation AG's interests in Zapf Creation (Central Europe) GmbH & Co. KG, Zapf Creation Logistics GmbH & Co. KG, and Zapf Creation (France) S.à.r.l. The writedown on the Group's treasury shares in the amount of € 3.9 million, as well as the expensing of both the syndication fees related to the syndicated loan agreement and the fees related to the waiver granted by the banks (€ 2.3 million), also had a negative impact on Zapf Creation AG's earnings performance.

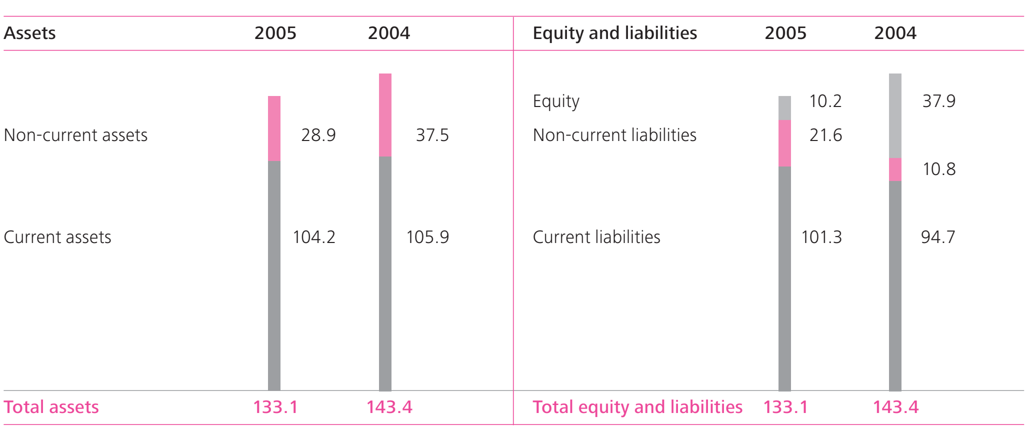
The extraordinary result of Zapf Creation AG in the amount of € −4.1 million stems from restructuring costs.

Net Assets and Financial Position

Net Assets and Financial Position of the Zapf Creation Group

Total consolidated assets of the Zapf Creation Group declined from € 143.4 million to € 133.1 million.

Balance Sheet Structure as of December 31 (in € Million)



In terms of assets, cash and cash equivalents fell by € 7.6 million to € 9.4 million while trade receivables rose from € 18.2 million to € 68.5 million. This is due primarily to the year-on-year reduction in the forfaiting volume to € 2.9 million (previous year: € 22.2 million).

Inventories fell by € 11.7 million to € 17.0 million due to the establishment of a centralized purchasing system for controlling the flow of goods worldwide and the attendant optimizing of processes, as well as for purging inventories.

Other assets rose to € 5.2 million in the financial year just ended (previous year: € 4.0 million).

Deferred tax assets declined by € 1.9 million to € 2.0 million.

In terms of liabilities and equity, equity fell by € 27.6 million to € 10.2 million, resulting in an equity ratio of 7.7 %.

Trade payables rose from € 22.8 million in the previous year to € 30.4 million in the financial year just ended. The increase in liabilities results primarily purchase commitments vis-à-vis our Asian suppliers in the amount of € 2.9 million, increased advertising subsidies in the amount of € 1.5 million, as well as liabilities of € 1.3 million from planned personnel reductions in 2006.

Liabilities to banks declined by € 9.0 million to € 82.3 million. Given the simultaneous reduction by € 7.6 million of cash, consolidated net debt (including factoring calculated on a comparable basis) declined from € 79 million as of the close of 2004 to € 76 million as of the close of 2005. The other liabilities rose by € 1.3 million to € 5.3 million, due mainly to liabilities toward employees in connection with obligations arising from the restructuring.

Provisions rose to € 3.6 million (previous year: € 2.7 million) as a result of consulting services related to the restructuring, as well as the realignment of the Company's North American business.

Net Assets and Financial Position of Zapf Creation AG

Total assets of Zapf Creation AG fell by € 19.9 million from € 125.0 million to € 105.1 million. The writedowns on the loan granted to Zapf Creation (U.S.) Inc. (€ 16.6 million), as well as on equity interests (€ 9.9 million), and the closing-date measurement of treasury shares (€ 3.9 million) had a negative effect on assets, whereas receivables from affiliates rose by € 10.9 million.

The other assets fell to € 4.2 million (previous year: € 8.6 million). The claim to reimbursement of trade taxes and corporation taxes from the tax authorities in the amount of € 4.0 million (which was accounted for in 2004) was paid in 2005.

A full valuation allowance was recognized for the loan granted to a former board member and for a loan granted to an employee (€ 0.7 million) in the 2005 financial year.

In terms of liabilities and equity, equity fell by € 34.7 million to € 15.4 million, resulting in an equity ratio of 14.7 %.

Provisions rose from € 2.7 million to € 5.7 million. This is due primarily to the tax provisions resulting from the tax audit (€ 0.7 million), license fees (€ 0.7 million), provisions for additional personnel measures, and ongoing consulting services provided by Roland Berger in 2006 (€ 0.8 million) in connection with the restructuring, as well as increased expenses related to both the annual financial statements and the re-audit (€ 0.2 million).

Liabilities to banks rose by € 18.4 million from € 44.6 million to € 63.0 million. Liabilities to affiliates fell to € 19.6 million (previous year: € 26.2 million).

Investments

Investments by the Zapf Creation Group

Total investments by the Group in the reporting period were € 2.7 million (previous year: € 8.7 million); intangible assets accounted for € 0.3 million (previous year: € 3.8 million) of this amount. Investments in plant, property, and equipment fell as planned to € 2.3 million (previous year: € 4.9 million).

Large investments in the previous year essentially were related to the purchase of the brand names and patent rights to the branded BABY born® toy concept (€ 3.8 million).

Investments by Zapf Creation AG

Total investments by Zapf Creation AG in the period just ended were € 0.3 million (previous year: € 5.1 million).

Financing

Financing of the Zapf Creation Group

The signing of the syndicated loan agreement in July 2005 secured the financing of the Zapf Creation Group through the end of 2007. However, the Zapf Creation Group violated the Covenant stipulated with the banks as of September 30, 2005, and December 31, 2005, respectively, in consequence of the development of the Group's business in 2005, which was marked by a larger than expected downturn in sales and the corresponding deterioration in earnings. Negotiations concerning new financing took place under a moratorium concluded with the banks until the end of April 2006. At a meeting on March 28, 2006, all eight banks agreed to grant the Zapf Creation Group secured financing under changed conditions for the next twelve months, including a seasonal line of credit. This agreement was confirmed, in writing, by Deutsche Bank, the lead manager, on April 18, 2006. The newly concluded syndicated loan agreement ensures the financing of the Zapf Creation Group through the end of April 2007, subject to compliance with the basic terms of the line of credit.

Cash Flow

Cash Flow of the Zapf Creation Group

The Group's cash flow from operating activities in the financial year just ended was € −8.4 million (previous year: € 3.5 million). The decline essentially resulted from the negative development of operating income before taxes (€ −26.1 million compared to the previous year), as well as from the increase in trade receivables (€ −14.1 million compared to the previous year). The large decline in the forfaiting volume (€ 2.9 million in 2005, compared to € 22.2 million in the previous year) and the corresponding increase in trade receivables had an impact on the operating cash flow in 2005.

On the other hand, inventory writedowns coupled with intensified monitoring of inventories had a positive effect on the development of liquidity (€ 12.0 million compared to the previous year). The increase in both liabilities and provisions (€ 10.6 million compared to the previous year) and the lower income tax burden (€ 4.4 million compared to the previous year) also had a positive effect. The change in cash and cash equivalents during the financial year just ended was € −7.7 million, after accounting for investing and financing activities.

Cash Flow of Zapf Creation AG

The cash flow from operating activities of Zapf Creation AG was € −27.7 million (previous year: € 9.1 million). The change in cash and cash equivalents during the financial year just ended was € −7.9 million, after accounting for investing and financing activities.

Employees

Zapf Creation Group

As of December 31, 2005, the Zapf Creation Group had 408 employees worldwide (excluding the members of the Management Board and trainees), 175 of which worked for the Group's foreign companies.

Annual Average Number of Employees of the Zapf Creation Group

	2005	2004
Salaried employees	387	418
Wage-earning employees	70	85
Employees	**457**	**503**

A significant number of jobs were eliminated during 2005 in connection with the Group's restructuring program.

As a result of this development, a decimated team had to master both existing tasks and new projects in a demanding environment. The personnel of Zapf Creation made an important contribution to the Group by their commitment.

The Group's executives also had to meet rising requirements against the backdrop of personnel reductions. They dealt intensely with the Group's reorganization and intensified their cooperation in connection with team-building measures at the management level. The Group is maintaining its executive development program that aims to ensure successful personnel management in the future as well.

Zapf Creation AG

Zapf Creation AG had 99 employees (excluding the members of the Management Board and trainees) as of December 31, 2005.

Annual Average Number of Employees of Zapf Creation AG

	2005	2004
Salaried employees	108	112
Wage-earning employees	0	11
Employees	108	123

Quality Management

The Group's quality management in Germany is focused on the relevance, as well as the practical and strategic ramifications, of national and international laws and regulations. Zapf Creation's own experts also participate in the development of relevant standards. The Group's quality management in Hong Kong/China is focused on the practical implementation of these standards, as well as on consistent monitoring of local manufacturers' compliance with these requirements. Close cooperation between the quality assurance departments in Germany and Hong Kong thus enables Zapf Creation to ensure ongoing, timely, and high-quality implementation of customer and market requirements in its manufacturing processes.

Compliance with Ethical Standards in Both Production and Procurement

Zapf Creation has outsourced about 97 % of the production of its play and functional dolls, including accessories, to select suppliers in China. Issues related to long-term and collaborative partnerships and ensuring appropriate workplace and social standards are at the heart of these relationships. High claims to quality, design, and play value are key to all of Zapf Creation's branded toy concepts. The Zapf Creation Group collaborates solely with suppliers that satisfy the Group's quality requirements and undertake to comply with uniform social standards.

Since October 2002, the Group's relationships with outside suppliers have been subject to the Code of Conduct issued by the International Council of Toy Industries (ICTI), which codifies binding principles and provides a system for independent monitoring. Suppliers that undertake to abide by the Code of Conduct are subject to an auditing process that leads to an ICTI certificate issued by the International Toy Association. Both independent institutes and Zapf Creation personnel regularly verify suppliers' sustained compliance with the ICTI Code of Conduct.

In the 2005 financial year, roughly 93 % of the Group's purchasing volume was obtained from suppliers already certified by the ICTI or undergoing the auditing process. In 2006, almost the entire Zapf Creation product portfolio will be manufactured by suppliers that abide by demonstrably safe and social workplace standards.

Compliance with International Standards and Regulations

The quality specifications contain binding definitions of relevant guidelines, norms, and standards – as well as customer-specific requirements – that apply to the Group's entire product portfolio, including, for example:

- The series of European EN 71 standards related to the safety of toys;
- The German Lebensmittel-, Bedarfsgegenstände- and Futtermittelgesetzbuch (LFGB) [Food and Consumer Products Act];
- The US ASTM F963 standard for toys;
- The EU directive on electromagnetic compatibility (EMC);
- The German standard on the safety of electrical toys (EN 50088 / EN 62115);
- The German cosmetics ordinance; and
- The German regulation on electronic scrap (implementation of the WEEE and RoHs directives)

Shifting Production to Phthalate-free Plasticizers

The Zapf Creation Group has shifted production of its entire product portfolio to plasticizers that are free of phthalates. The Group already uses a phthalate-free substitute for all new products manufactured in 2006 using soft PVC – irrespective of the recommended age group. During the first quarter of 2006, the Group's pass-through products were also shifted to alternative plasticizers so that all of Zapf Creation's branded toy concepts will be generally free of phthalates as of 2006.

IV. Supplementary Report

On February 2, 2006, the Company announced that Dr. Georg Kellinghusen would take over as chief financial officer of Zapf Creation AG effective February 15, 2006. After the departure of Mr. Rudolf Winning on March 15, 2005, and the resignation of Dr. Peter Klein, deputy member of the Management Board, who had taken over the position on an interim basis, the position had been vacant since October 17, 2005.

At a meeting on March 28, 2006, all eight banks agreed to grant the Zapf Creation Group secured financing under changed conditions for the next twelve months, including a seasonal line of credit. This agreement was confirmed, in writing, by Deutsche Bank, the lead manager, on April 18, 2006. This letter confirms that all of the participating banks have declared their agreement to continue cooperation with Zapf Creation AG. The reservation expressed by a few syndicate banks was hereby removed.

The ongoing audit of the 2005 consolidated annual financial statements by the Rödl & Partner auditing firm yielded additional findings. Additional investigations indicated that legal regulations were knowingly violated. The Company has therefore filed charges. The KPMG auditing firm was then asked to examine certain accounting matters related to 2003/2004. The partial report on this audit was presented on April 10, 2006.

Based on a Supervisory Board resolution of May 17, 2006, Mr. Thomas Eichhorn on May 18, 2006 was dismissed as member and chairman of the Management Board effective immediately. The Supervisory Board endeavors to make a decision regarding his successor very soon.

V. Risk Report

Monitoring, controlling, and analyzing risks is an key aspect of the management tools employed in the Zapf Creation Group. The Group's risk management is based on the principles of corporate governance codified in the German Act on the Further Development of Corporate and Accounting Law, Transparency, and Disclosure (TransPuG).

The Group utilizes a risk management system that was established in accordance with Section 91 para 2 German Stock Corporation Act (AktG).

Risk Management System

The Zapf Creation Group has developed parameters for doing business that include the identification, measurement, controlling, and documentation of risks in a risk management system. This system serves to ensure that the Company's decision makers are notified of existing and newly occurring risks, directly and immediately. Software implemented in the 2000 financial year provides the technical framework for systematically recording and analyzing individual risks, the probabilities of their occurring, as well as the probable extent of any resulting damage.

Risk identification is ongoing, while risk measurement is effected monthly. Both are supervised by a risk management officer appointed by the Company. The risk management officer informs the Management Board as soon as increasing risks that might even threaten the Company's existence are detected.

All risks are categorized according to the following risk types:

External Risks
- Economic risks
- Industry-specific risks
- Legal risks
- Ethical and environmental risks

Operational Risks
- Procurement risks
- Risks from operational processes

Financial Risks
- Equity risks
- Liquidity and financing risks
- Currency and interest rate risks

Strategic Risks
- Brand image risks
- Sales risks
- Development and quality risks
- Personnel risks

For purposes of Group controlling, in addition to existing risks, the Group's risk management system also analyzes and represents opportunities as they arise.

In 2005, the Company acted on the experience it gained in connection with risk management since it introduced a risk management system in the 2000 financial year, in particular, by making the following improvements:

1. Intensified focus on identified risks
2. Better dovetailing of the risk management system with current forecasts
3. Adjustment to the new organizational structure
4. Strengthening management's sense of responsibility
5. Stronger focus on measures

Given the interdependence of individual risks, the risk management system does not entail producing isolated analyses of individual risk types but rather an integrated risk portfolio for the Zapf Creation Group. The risk portfolio is differentiated according to risks "before countermeasures" and "after countermeasures" and is measured, documented, and communicated to the responsible corporate bodies.

External Risks

Economic Risks

In 2005, the global economy posted strong growth driven by two emerging markets in Asia (China and India), as well as by Latin American and US markets. The increasing growth momentum made itself felt in Europe too, especially in Eastern Europe. But Germany – which continued to experience long-term consumption problems rooted in the public's insecurity about both pending changes in social policies and high unemployment that continues unabated – did not keep pace with these developments.

Restrained consumption in Germany (the Zapf Creation Group's largest individual market) directly affected demand for the Company's products, leading to sales declines. Yet sales declined in other Central European markets as well due to economic and market conditions, causing the Company to sustain considerable losses in 2005.

The Zapf Creation Group does not believe that it currently faces any renewed risks from the economy as a whole, given the expected improvement of the economic situation in Germany and the attendant stabilization of consumption.

Industry-specific Risks

The toy market is particularly dependent on consumer behavior. The uncertain development of the German economy in 2005 – as perceived by consumers – triggered a measurable change in their spending patterns. Spontaneous purchases have declined, and more than ever business is focused on the critical Christmas season.

Demographic developments are particularly important to the development of the toy market. In Germany, the Group's core market, according to estimates of the Federal Statistical Office in Wiesbaden, Germany, the number of births fell from about 706,000 in 2004 to about 680,000 in 2005. In contrast, birth rates in the UK, Spain, France, and Italy – important toy markets all – are higher than the German average. Measured against population figures, demographic developments in both Spain (previous year: about 450,000 births) and France (previous year: about 770,000 births) are particularly positive.

The Zapf Creation Group is focused on its core business, gaining leading market share in several European markets in the process. The numbers published by NPD/Eurotoys, a market research institute, for the 2005 financial year prove the strength of the Zapf Creation brand. In spite of the sales declines, the Company has nonetheless succeeded in essentially maintaining its market share.

By developing and expanding its leading market position in its core business – play and functional dolls including accessories – Zapf Creation has created the conditions needed to better control and offset industry-specific influences in individual markets.

Legal Risks

The business of Zapf Creation requires the Group to take a multitude of international standards and regulations into consideration and abide by them.

The Group's quality specifications contain binding definitions of relevant guidelines, norms, and standards – as well as customer-specific requirements – that apply to its entire product portfolio. No legal risks are discernible in that regard.

As far as corporate taxes are concerned, currently the Zapf Creation Group is reviewing the intercompany pricing model as such and whether it can be adjusted to the Group's changed sales situation. Both the current model and a possible new, future intercompany pricing model entail tax risks for all participating companies of the Zapf Creation Group.

To avoid tax risks, the Company has decided to carry out the project in collaboration with a renowned auditing firm.

Ethical and Environmental Risks

Zapf Creation has outsourced the production of almost its entire portfolio of play and functional dolls including accessories to selected suppliers in China. Issues related to long-term and collaborative partnerships and ensuring appropriate workplace and social standards are at the heart of these relationships. High claims to quality, design, and play value are key to all of Zapf Creation's branded toy concepts. The Zapf Creation Group works solely with suppliers that satisfy its quality requirements and undertake to comply with the applicable standards.

Since October 2002, the Group's relationships with outside suppliers have been subject to the Code of Conduct issued by the International Council of Toy Industries (ICTI). Both independent institutes and Zapf Creation personnel regularly verify suppliers' sustained compliance with the ICTI Code of Conduct.

Against this backdrop, at the present time we do not discern any risks from noncompliance with these standards.

The Zapf Creation Group has shifted production of its entire product portfolio to plasticizers that are free of phthalates. Due to the strategic realignment of the Company's product portfolio as part of its restructuring program and after taking into account the current developments with regard to phthalates and the German ordinance on electronic scrap, merchandise that was deemed unsalable was removed from inventories as of December 31, 2005. The remaining inventories will be sold in 2006 via distribution channels which at that time are not subject to regulations regarding either phthalates or electronic scrap. All of these measures serve to minimize obvious risks from the utilization of substances containing phthalates.

Operational Risks

Procurement Risks

Almost all products of the Zapf Creation Group are procured and produced in China by several business partners, mostly of long standing. In addition, most of them maintain several physically separated manufacturing sites. This limits the risk of losing several suppliers simultaneously.

The labor shortage in Southern China's Pearl River Delta, where 70% of all toys sold worldwide are manufactured, continues unabated. Hence delivery bottlenecks cannot be precluded.

Price increases in procurement resulting from rising staff and material costs already made themselves felt in the reporting period and might lead to higher product procurement prices in the 2006 financial year. In addition to higher raw materials prices due to crude oil prices, this is also due to tightened environmental legislation in the EU, for example, the prohibition of phthalates in toys. Under the relevant EU directive, toys containing phthalates may no longer be sold as of January 14, 2007. The dollar's current weakness is favorable to gross profits earned in the euro region, weakening the impact of current price increases.

Zapf Creation has begun to take advantage of short-term order cycles among its suppliers in order to minimize inventory risks. Significantly lower minimum order amounts tend to generate procurement risks whenever sudden spikes in market demand must be satisfied. The Group counters this risk through its just-in-time order volume management system.

At present, no particular procurement risks are discernible. However, focusing all production on a single supplier country does pose a latent risk.

Risks from Operational Processes

The audit findings of the special auditor KPMG showed that systematic and intentional manipulations of the figures had occurred in the 2004 financial year and earlier. The Company has initiated various measures to avoid such risks in the future. Transferring the responsibility for internal audits to an external company specialized in such tasks is one of the major changes we have made.

In addition to these tasks, improving the efficiency and security of processes, increasing the level of detail in planning, preparing target/actual comparisons, as well as strengthening the Group's internal control system (including risk management), are equally pivotal. Zapf Creation is working on a master plan for launching relevant measures.

Several insurance policies – such as, for instance, business interruption insurance, fire insurance, and liability insurance – were purchased to protect the Company from operational disruptions of any kind.

Currently, operational risks are not generating risks that might threaten the Company's existence.

Financial Risks

Equity Risks

Under an intercompany license, the Group's subsidiaries pay Zapf Creation AG a fee that is contingent on sales for manufacturing the Group's products and for maintaining both the brands and the corporate names. The global downturn in sales in recent years and the relatively high overhead of Zapf Creation AG led to relatively large losses in the financial year. There is a risk that continued sales declines might deplete the equity of Zapf Creation AG.

Furthermore, ongoing losses among the Group's subsidiaries entail the risk of additional writedowns of Zapf Creation AG's equity interests in its balance sheet. This risk also concerns the recoverability of intercompany loans granted by and between the subsidiaries and Zapf Creation AG.

Writedowns of € 9.9 million on Zapf Creation AG's equity interests in individual subsidiaries and of € 16.6 million on the loans were already taken in the 2005 financial year.

No additional writedowns are necessary from our current vantage point.

Liquidity and Financing Risks

A decline in sales of roughly € 23 million in the financial year just ended significantly undermined the profitability of the Zapf Creation Group in its current structure. This was due mainly to the Group's declining business in Central Europe. Large inventories, which had been established as a result of optimistic sales plans, reduced gross profit margins in the financial year just ended. Even though cost reduction measures undertaken in 2005 did counter these developments, they were unable to offset them. The Management Board is currently preparing a range of measures aimed at securing the Company's profitability.

Declining demand also caused rising difficulties for some of Zapf Creation's trading partners. The number of defaults on payments to the Zapf Creation Group rose in the 2005 financial year as a result. Allowances on trade receivables climbed from € 0.6 million to € 1.0 million. Additional defaults in the current financial year resulting from insolvencies among trading firms cannot be precluded. Zapf Creation has purchased a comprehensive global insurance policy from a renowned insurance company that covers potential defaults among most of its major customers with the aim of minimizing the Group's bad debt risk.

At present, the equity ratio of the Zapf Creation Group is weak. The Group signed a syndicated loan agreement for € 112.053 million in July 2005. Due to the Company's results in 2005, Zapf Creation failed to achieve the agreed financial targets. Nevertheless, in March 2006 the Company was able to reach an agreement with the banks regarding the continuation of the syndicated loan agreement. This enabled the Company to achieve a twelve-month extension of the credit line, which was reduced from € 112 million to € 90 million, through the end of April 2007.

In light of the measures undertaken to date, from our current viewpoint we may preclude risks related to both liquidity and financing for the current financial year.

Currency and Interest Rate Risks

In connection with its operating and financing activities, the Zapf Creation Group is exposed to risks, in particular from fluctuations in exchange and interest rates. Corporate policy is to exclude or limit these risks by concluding hedging transactions. All hedging measures are coordinated and conducted centrally at the Group's parent company. Primarily derivative financial instruments are employed as hedging measures.

There are corporate guidelines for the foreign exchange and interest rate hedging policies that minimize the risks resulting from the use of financial instruments. These include the separation of the trading, processing, and posting functions, as well as the voluntary restriction to a small defined group of banks with high creditworthiness and the authorization of only a few qualified employees. All derivatives are used solely for hedging purposes. (See also the detailed discussion in the notes to the consolidated financial statements.)

Strategic Risks

Brand Image Risks

The Zapf Creation Group focuses on its core business – play and functional dolls including accessories – and claims market leadership in several European markets. The numbers published by NPD/Eurotoys, a market research institute, for the 2005 financial year prove the strength of the Zapf Creation brand. In spite of the sales declines, the Company has nonetheless succeeded in essentially maintaining its market share.

Protecting the Group's brands is essential, given that it considers them to be Zapf Creation's value drivers. Zapf Creation repeatedly engages in litigation in order to protect itself from breaches of patents and brands. However, no significant litigation is pending at the present time.

Sales Risks

Large inventories in the Group's own warehouses and increasingly among the trade as well have resulted from sales declines in the financial year 2005, as well as in the two prior financial years. In 2005, the Group was compelled to grant retroactive trade discounts in consequence of faulty assessments in previous years.

These discounts resulted from the pressure Zapf Creation's business partners were exerting on the Group to reduce existing inventories in order to make room for new products. In addition, the Group cleared out product inventories deemed no longer marketable as of December 31, 2005. The affected goods will be physically scrapped in 2006.

The trade has also changed its ordering patterns in light of long-term changes in consumer's spending patterns – a growing sensitivity to prices, restrained consumption, and a decline in spontaneous purchasing decisions. This has translated into relatively late and short-term orders for smaller unit numbers in order to limit inventories, in turn increasing the requirements that Zapf Creation must meet in terms of its flexibility within tightly circumscribed time windows. Finally, all of this has been compounded by a significant change in market structures. Large-scale chains and aggressive discounters have been expanding both their product range and their presence in the toy segment, displacing traditional retail toy stores and cutting into their market share.

Zapf Creation has adapted to these changes by clearing out its warehouses and increasing its flexibility in both distribution and deliveries. No additional risks related to distribution and sales above and beyond those described above are discernible at present.

Development and Quality Risks

The toy market as a whole and hence the market for play and functional dolls is subject to extremely high pressure from customers to innovate. The development department of Zapf Creation responds to this pressure by regularly launching new collections and product innovations. As a provider of sensitive consumer goods, Zapf Creation is always subject to the risk of product defects. The Group has purchased sufficient insurance to protect itself from the financial risks of such defects; however, the Company's quality management system must be improved to protect it from potentially negative repercussions of such defects for its brand image.

The Group's quality management in Germany is focused on the relevance, as well as the practical and strategic ramifications, of national and international laws and regulations. Zapf Creation's own experts also participate in the development of relevant standards. The Group's quality management in Hong Kong / China is focused on the practical implementation of these standards, as well as on consistent monitoring of local manufacturers' compliance with these requirements. Close cooperation between the quality assurance departments in Germany and Hong Kong thus enables Zapf Creation to ensure ongoing and timely implementation of customer and market requirements in its manufacturing processes.

The success of the Zapf Creation Group on the market largely depends on timely deliveries of the goods it has ordered from Zapf Creation (H.K.) Ltd. and the latter's Chinese suppliers. Ensuring that these companies satisfy Zapf Creation's quality requirements is playing an increasingly pivotal role in that connection.

Zapf Creation (H.K.) Ltd. works closely with suppliers in China in order to minimize the risk of quality defects. In addition, Zapf Creation AG has installed a centralized purchasing system to control the flow of goods worldwide with the aim of ensuring a high-quality and valuable procurement process.

Personnel Risks

Though the Zapf Creation Group was compelled to impose significant changes on its personnel into the current financial year, it was able to count on the loyalty and high commitment of its employees throughout. Recruiting and retaining qualified specialists and executives for the Company remains an ongoing challenge. The Group aims to use significant reductions in personnel in both 2005 and 2006 to streamline its processes and accelerate its decision making. Subjective views of the Company's prospects might cause qualified personnel in key positions to leave the Zapf Creation Group. Hence the risk of losing know-how can only be offset by cost-intensive measures aimed at recruiting new personnel.

The Company's Management Board deals with this risk by engaging in transparent and problem-oriented information and communications policies.

However, no threats to the Group's existence from these risks are discernible at the present time.

Overall Risks

Given the risks known to the Company and described in this risk report, at the present time no risks that might pose a direct threat, individually or jointly, to the existence of Zapf Creation AG and / or the Zapf Creation Group are discernible.

Opportunities

Zapf Creation had to undertake comprehensive and drastic measures in the financial year just ended in order to return to a positive growth trajectory and profitability. This path is not free of risks. However, the development potential that exists within the Company, the continued strength of its brands, and existing knowledge of specific markets also offer rewards and opportunities that will permit the Group to successfully tap into the changes that are occurring in the industry as a whole and once again achieve growth in the medium term.

Internationalization

Asian markets will continue to determine global economic growth in the years ahead. The need to satisfy pent-up consumer demand continues unabated in China, India, and several other markets. In Eastern Europe, the increasing growth of the gross domestic product and rising real incomes show that the economic climate is steadily improving after a difficult decade of transformation.

Hence Zapf Creation will focus its internationalization strategy on these markets in particular.

Stabilization of Market Share in Saturated Markets

In contrast, the Company aims to stabilize its market share in Europe's saturated markets, Germany above all. A market study conducted in Germany in March 2006 by NPD/Eurotoys shows that the Company's target group continues to enjoy playing with dolls and that mothers view such play as supporting their child's development in meaningful ways.

Zapf Creation's brands – BABY born®, Baby Annabell®, and CHOU CHOU – provide realistic options for the Group to maintain and even expand its position in the market for play and functional dolls.

Optimizing Operational Processes

The Company is using its "reloading" program, which is aimed at optimizing its complex operational processes and increasing the efficiency, transparency, and quality of its processes, to advance these objectives internally. It expects to make considerable progress in the reorganization of its processes as early as in 2006. This program is supplemented by efficient cost structures in both procurement and the centralized administration.

Opening up New Distribution Channels

Zapf Creation will concentrate on opening up new distribution channels and expanding its key account structures. The aim is to achieve full coverage of the market through a comprehensive product range. This strategy will be supported in targeted ways by the Group's TV advertising campaigns.

Enhancing Employees' Motivation and Personal Initiative

The reductions in the number of the Company's personnel open up new opportunities for its remaining personnel, especially those who possess particular know-how. Key positions that require much motivation and personal initiative on the part of each individual concerned, given this period of turbulent changes, need to be filled as well. Both parties – the personnel and the Company – will benefit from these developments.

Product Innovation

Thanks to the successful management by its development department, in the past Zapf Creation always detected trends early on and rapidly translated them into product innovations, especially with regard to accessories. Innovations are critical to kindling the interest of both the trade and customers in the Company's products. Its innovation strategy still offers untapped potential, especially with regard to its broad range of accessories and its brand name.

VI. Anticipated Developments

Zapf Creation Group

By launching the "reloading" program in early 2006, the management of the Zapf Creation Group undertook to play an active role in improving the Company's situation.

This essentially involves three key issues:

1. Lower the Group's economic risk profile through significant reductions in its operating costs, as well as in its assets, given the lower level of sales.

2. Generate profitable growth by improving the competitiveness of Zapf Creation's products, as well as the profitability of its retail/wholesale customers.

3. Fundamentally improve the core processes of the Zapf Creation Group.

The Company instituted project management for eight key projects to ensure that these measures bear fruit. These projects aim to reinstate the Group's profitability in individual markets, improve its gross margins, optimize purchasing processes and the product portfolio, stabilize performance in terms of sales, lower operating costs, and adjust working capital to the new sales structure.

These measures serve to help Zapf Creation achieve an EBIT margin of at least 10 % of sales by 2009. This margin would continue the Company's historic profitability.

The Company's growth potential can only be expanded once this goal has been achieved. In order to pave the way for meeting this target, Zapf Creation has overhauled and streamlined its entire product portfolio as it relates to its core brands: BABY born®, Baby Annabell®, and CHOU CHOU. From 2006 forward, the Company will significantly increase the number of standout accessories it offers. It also aims to boost the scale of product innovations related to its dolls and plans to bring one new functional doll to market every year.

New play concepts will translate Zapf Creation's innovative ideas into reality in the girls' toy segment in 2006 and 2007. Based on the new "Missy Milly" cartoon series, which premiered on Super RTL on German TV in December 2005, Zapf Creation fills a strategic gap with its Missy Milly® mini doll concept. This new product line for girls from four to nine years of age covers all topics that are relevant to the mini doll segment. Zapf Creation has also developed a new generation of functional dolls for girls aged four to eight years called "Girls – best friends". This highly promising concept for a new functional doll will be launched in the near future.

Zapf Creation AG

The forecast for Zapf Creation AG does not differ from that provided above for the Zapf Creation Group as a whole.

Outlook 2006

Zapf Creation anticipates a downturn in consolidated sales in the single-digit range for 2006, due both to the difficult market climate in Germany, which remains unchanged, and the Group's recently adjusted sales strategy in the United States. The Management Board expects the gross profit margin to improve significantly nonetheless as a result of the measures aimed at optimizing the quality of sales and by reducing extraordinary expenses. Measures aimed at lowering costs by € 7 million, specifically, by cutting 80 jobs, are also underway.

Overall, the Management Board expects EBIT to improve by at least € 15 million in 2006. The Zapf Creation Group also plans to reduce its net debt further by about € 5 million.

Roedental, Germany, May 29, 2006

Dr. Georg Kellinghusen
Member of the Management Board

Angelika Marr
Member of the Management Board

Consolidated Financial Statements

Consolidated Income Statement

for the Financial Year from January 1 to December 31, 2005

	Note	2005 K€	2004 K€
Revenue	Section B no. 1.1.	140,717	163,282
Cost of sales	Section B no. 1.2.	−86,285	−85,646
Gross profit		**54,432**	**77,636**
Selling and distribution expenses	Section B no. 1.3.	−18,592	−21,778
Marketing expenses	Section B no. 1.4.	−20,850	−26,348
Administrative expenses	Section B no. 1.5.	−23,985	−24,572
Other income	Section B no. 1.6.	2,581	1,827
Other expenses	Section B no. 1.7.	−2,150	−240
Restructuring costs	Section B no. 1.8.	−7,753	0
Earnings before interest and taxes		**−16,317**	**6,525**
Finance income	Section B no. 1.9.	230	258
Finance costs	Section B no. 1.9.	−7,031	−3,836
Earnings before income taxes		**−23,118**	**2,947**
Taxes on income	Section B no. 1.10.	−4,602	−3,065
Net profit or loss for the period		**−27,720**	**−118**
Earnings per share (in €)	Section B no. 1.11.	**−3.73**	**−0.02**

The included notes are an integral part of the consolidated financial statements

Consolidated Balance Sheet

as of December 31, 2005

	Note	Dec. 31, 2005 K€	Dec. 31, 2004 K€
Assets			
Current assets		**104,202**	**105,935**
Cash	Section B no. 2.1.1.	9,353	17,041
Trade receivables	Section B no. 2.1.2.	68,496	50,298
Inventories	Section B no. 2.1.3.	16,956	28,676
Income tax receivables	Section B no. 2.1.4.	4,411	7,270
Other assets	Section B no. 2.1.5.	4,986	2,650
Non-current assets		**28,934**	**37,489**
Property, plant and equipment	Section B no. 2.2.1.	20,194	23,091
Intangible assets	Section B no. 2.2.2.	6,523	9,076
Other assets	Section B no. 2.2.3.	217	1,389
Deferred tax assets	Section B no. 2.2.4.	2,000	3,933
Total assets		133,136	143,424

The included notes are an integral part of the consolidated financial statements

	Note	Dec. 31, 2005 K€	Dec. 31, 2004 K€
Equity and liabilities			
Current liabilities		**101,337**	**94,715**
Liabilities to banks	Section B no. 2.3.1.	61,266	62,689
Trade payables	Section B no. 2.3.2.	30,388	22,776
Income tax liabilities	Section B no. 2.3.3.	732	2,598
Other liabilities	Section B no. 2.3.4.	5,341	3,953
Provisions	Section B no. 2.3.5.	3,610	2,699
Non-current liabilities		**21,560**	**10,822**
Liabilities to banks	Section B no. 2.4.1.	21,060	10,604
Deferred tax liabilities	Section B no. 2.4.2.	500	218
Equity		**10,239**	**37,887**
Issued capital	Section B no. 2.5.1.	8,000	8,000
Capital reserves	Section B no. 2.5.2.	8,052	8,052
Net profit or loss for the period and profit brought forward	Section B no. 2.5.3.	5,564	33,284
Other recognized income and expense	Section B no. 2.5.4.	−19	−91
Treasury shares	Section B no. 2.5.5.	−11,358	−11,358
Total equity and liabilities		133,136	143,424

Consolidated Statement of Changes in Equity

for the Financial Year from January 1 to December 31, 2005

	Shares outstanding thsds.	Issued capital K€	Capital reserves K€
Balance at December 31, 2003:	7,427	8,000	8,052
Net profit or loss for the period	—	—	—
Change in other recognized income and expense	—	—	—
Total net income or loss for the period	—	—	—
Dividend payments	—	—	—
Balance at December 31, 2004:	7,427	8,000	8,052
Net profit or loss for the period	—	—	—
Change in other recognized income and expense	—	—	—
Total net income or loss for the period	—	—	—
Balance at December 31, 2005:	7,427	8,000	8,052

Net profit or loss for the period and profit brought forward	Other recognized income and expense: Adjustments from currency translation	Derivative financial instruments	Treasury shares	Total equity
K€	K€	K€	K€	K€
40,829	0	−134	−11,358	45,389
−118	—	—	—	−118
—	77	−34	—	43
−118	77	−34	—	−75
−7,427	—	—	—	−7,427
33,284	77	−168	−11,358	37,887
−27,720	—	—	—	−27,720
—	−143	215	—	72
−27,720	−143	215	—	−27,648
5,564	−66	47	−11,358	10,239

Consolidated Cash Flow Statement

for the Financial Year from January 1 to December 31, 2005

	2005 K€	2004 K€
Cash flow from operating activities:		
Earnings before income taxes	−23,118	2,947
Depreciation of non-current assets	6,961	7,171
Losses/gains from the disposal of non-current assets	692	−4
Finance costs/income	6,801	3,578
Other non-cash income/expenses	962	−12
Increase/decrease in assets and liabilities:		
Trade receivables	−17,898	−3,765
Inventories	12,267	254
Other assets	−2,362	1,134
Liabilities and provisions	8,562	−2,030
Income tax payments	−1,298	−5,725
Cash flow from operating activities	**−8,431**	**3,548**
Cash flow from investing activities:		
Cash receipts from sales of property, plant and equipment and intangible assets	762	282
Cash payments for investments in property, plant and equipment and intangible assets	−2,669	−8,735
Cash flow from investing activities	**−1,907**	**−8,453**
Cash flow from financing activities:		
Cash receipts from non-current bank borrowings	25,863	105
Cash payments for the repayment of non-current bank borrowings	−13,804	−6,032
Change in liabilities due to current borrowings	−3,026	23,934
Interest paid	−7,199	−3,987
Interest received	236	252
Dividend payments	0	−7,427
Cash flow from financing activities	**2,070**	**6,845**
Effects of exchange rate changes	580	−241
Net change in cash and cash equivalents	**−7,688**	**1,699**
Cash and cash equivalents at the beginning of the period	17,041	15,342
Cash and cash equivalents at the end of the period	9,353	17,041

A. General Disclosures Regarding the Annual Financial Statements

1. Nature of the Business

Zapf Creation AG – hereinafter also referred to as "the Company" or "Zapf Creation" is Europe's leading brand manufacturer of play and functional dolls including accessories.

The Company markets branded play concepts that consist of a doll and a world of matching accessories that are developed to a high standard of quality, design, and play value. The company's most popular brands include BABY born®, Baby Annabell® and CHOU CHOU. These globally successful play concepts have been conceived particularly for the Company's core target group – girls between three and eight years of age.

All branded play concepts share a high standard in terms of design, quality, safety and play value. In designing doll accessories and clothes, Zapf Creation takes its lead from trends in children's fashions and general lifestyle products and incorporates them into the roughly 70 % of new products that are launched each year. The doll's bodies conceal cutting-edge and creatively applied technology. The branded play concepts of Zapf Creation place no limits on a girl's imagination. Playing with dolls also addresses and supports social skill such as loving, caring, empathy and accepting responsibility.

Zapf Creation AG, as the Company is currently known, was originally established in 1932 by Max Zapf and his wife Rosa as "Max Zapf Puppen- und Spielwarenfabrik". The Company went public on April 26, 1999. Today, the shares of Zapf Creation AG are listed on the Frankfurt Stock Exchange. The Company is a member of the SDAX Small-Cap-Index.

Zapf Creation AG is headquartered in Moenchroedener Strasse 13, 96472 Roedental, Germany.

2. Accounting Principles

2.1. General Information

The consolidated financial statements of Zapf Creation AG for the financial year from January 1, 2005 to December 31, 2005, as well as for the corresponding comparison period from January 1, 2004 to December 31, 2004 were prepared in accordance with the International Financial Reporting Standards (IFRS) for the first time.

The accounting transition from the previous United States Generally Accepted Accounting Principles (US GAAP) to IFRS was made pursuant to the provisions of IFRS 1 (First-time Adoption of International Financial Reporting Standards) retrospectively as of January 1, 2004. In some cases, the accounting methods applied pursuant to IFRS differ from those under US GAAP. The effects arising from the adjustments were recognized directly in equity as increases or decreases to retained earnings. The disclosures required with regard to the transition from US GAAP to IFRS, as well as the effects on the Group's net assets, financial position, results of operations and cash flows due to the transition from the previous accounting under US GAAP to accounting under IFRS are presented in the reconciliation statement contained in these notes.

The euro (€) is the reporting currency. Figures are presented primarily in thousands of euros (K€).

2.2. Differences between German Commercial Accounting and IFRS

Based on the provisions of the German Commercial Code (HGB), Zapf Creation AG is required to prepare consolidated financial statements. Pursuant to Article 4 of Directive (EC) No. 1606/2002 of the European Parliament and the European Council dated July 19, 2002, as an exchange-listed company, the company is required to prepare these consolidated financial statements in accordance with IFRS.

According to Section 315 a HGB, the Company does not have to prepare consolidated financial statements under German law (HGB), if the consolidated financial statements are prepared according to IFRS. Based on this exemption rule, the Company does not prepare consolidated financial statements according to German commercial law. Regarding the disclosures in the notes required under Section 315 a HGB, we refer to Section C no. 6.

The significant differences between German commercial accounting and accounting under IFRS with respect to the consolidated financial statements of Zapf Creation AG are as follows:

Objective

The accounting principles under the German Commercial Code (HGB) and IFRS follow different objectives.

While financial statements prepared according to IFRS are primarily aimed at providing corporate information relevant to decision making on the part of investors and other interest groups and thus wants to provide fundamental information for assessing a Company's ability to generate cash and cash equivalents, financial statements prepared under the German Commercial Code (HGB) are primarily aimed at protecting creditors and thus are characterized by a cautionary approach.

Foreign Currency Translation

Under German commercial law, the imparity principle requires impending losses from foreign currency translation to be taken into account, while at the same time a recognition of unrealized gains from foreign currency translation is prohibited. On the other hand, under IFRS both gains and losses from foreign currency translation must be recognized in income.

Intangible Assets

Under IFRS, if predefined criteria are met, costs incurred in connection with the development of software are not recognized as a period expense, but are capitalized as an intangible asset instead. Following this rule, the company capitalizes portions of the internal costs incurred in connection with customizing its SAP ERP software.

Provisions

- *Restriction to External Obligations*

  Under IFRS, provisions may only be recognized if their existence is probable and their amount can be reliably measured. Recognition of internal obligations is not permitted under IFRS.

- *Reporting Differences*

  In contrast to the German Commercial Code, under IFRS a number of obligations (in particular outstanding invoices and short-term personnel liabilities) are not recognized under provisions, but rather under liabilities.

- *Accounting of the Bonus Plans*

  The Company recognizes the stock appreciation rights granted to employees in connection with the two bonus plans (2001/2003 Bonus Plan and 2003/2005 Bonus Plan) pursuant to IFRS 2 ("Share-based Payment").

  The Group's obligation to deliver cash resulting from these plans is recognized under provisions as a financial obligation and measured using the fair value as of the balance sheet date; if necessary, any resulting remeasurement gains/losses are recognized in income. IFRS 2 was applied to the bonus plans in accordance with the entry into force and transition guidelines of IFRS 2 and IFRS 1 for the period under review and for the comparison period.

Equity

- *Initial Public Offering Costs*

  Under IFRS, the direct one-off costs of the 1999 IPO that are incurred by the Company are offset against equity. The Company deducts these external costs directly from capital reserves at the time they are incurred, taking into account income tax consequences.

- *Treasury Shares*

  Under IFRS, gains and losses related to the acquisition or the subsequent reissuance of treasury shares are recognized directly in equity. The Company shows treasury shares as an item deducted from total equity. Under IFRS, treasury shares must be recognized at cost. Cost is not adjusted to fair value.

  Gains or losses from the sale of treasury shares are recognized directly in equity.

Deferred Taxes

Under IFRS, deferred tax assets and liabilities for differences expected in the future between the taxable carrying amount and the carrying amount in the IFRS financial statements must be recognized (recognition requirement), while German commercial law requires recognition only for deferred tax liabilities, but not for deferred tax assets.

In addition, IFRS requires the recognition of deferred tax assets on existing loss carryforwards; under German commercial law their capitalization has hitherto been in dispute. Finally, there are conceptual differences between IFRS and the German Commercial Code regarding the determination of deferred taxes.

2.3. Recognition of Income and Expense

The Company recognizes revenue and other income if the services have been provided and / or the merchandise has been delivered and risk has been transferred to the customer.

Operating expenses are recognized as an expense when the goods or services have been used or when incurred.

Borrowing costs are recognized over the appropriate period. Zapf Creation uses the option to capitalize borrowing costs under certain circumstances only in cases of qualifying assets. No borrowing costs were capitalized in 2005 and 2004 because the requirements for such capitalization were not fulfilled.

Expenses in connection with the sale or discontinuance of a business line, the closure of locations or relocation of business activities, changes to the management structure, as well as a fundamental reorganization with significant effects on the Company's character and emphasis of business activities are recognized under restructuring costs and reported separately in the income statement.

Gains and losses on changes in exchange rates arising from transactions in foreign currency are reported in Zapf Creation's income statement under the expense and income items under which the transaction triggering the exchange rate effect is subsumed.

2.4. Accounting Methods

2.4.1. Financial Instruments

General

Financial instruments are agreements that result in a financial asset at one company and a financial liability or an equity instrument at another company. Pursuant to IAS 32, this includes original financial instruments such as trade receivables and trade payables, as well as financial receivables and financial liabilities. Furthermore, derivative financial instruments must also be subsumed under financial instruments. The Zapf Creation Group uses these instruments as hedging transactions to hedge against risks from changes in foreign currency and interest rates.

Financial assets and financial liabilities are accounted for in the consolidated balance sheet as of the date on which the Group becomes a contractual party to the financial instrument. The initial recognition is made at fair value taking transaction costs into account. Pursuant to IAS 39, subsequent measurement is based on the classification of the financial instrument. In the Zapf Creation Group, original financial instruments currently only fall under "Loans and receivables" or "Other liabilities" categories, so that their measurement is made using amortized cost. Impairment losses and impairment reversals on financial assets are recognized immediately in income. For financial liabilities, gains and losses are recognized only upon retirement or impairment loss of the liability; transaction costs as well as any agreed discount or premium are distributed over the term of the liability using the effective interest method. For short-term receivables and liabilities, the amortized cost generally corresponds to the nominal or repayment amount, respectively.

The fair value generally corresponds to the market or exchange value. If no active market exists, the fair value is determined by means of mathematical methods and checked against confirmations from the banks that handle the transactions.

Original Financial Instruments

- *Cash*

  Cash includes cash and term deposits. Cash also includes highly liquid financial investments with an original maturity of up to 90 days. Cash is measured at fair value.

- *Trade Receivables*

  Due to their short-term nature, trade receivables are non-interest bearing and are recognized at nominal value less adjustments due to expected bad debts.

- *Other Assets*

  Other assets are recognized at depreciated cost. All recognizable default risks are taken into account by appropriate decreases in carrying values.

- *Financial Liabilities / Liabilities to Banks*

  Upon initial recognition, financial liabilities are recognized in the amount of the gross loan amount less any transaction costs incurred. In subsequent periods, non-current financial liabilities are measured at amortized cost using the effective interest method. Any difference between the net loan amount and the repayment value is distributed over the term of the financial liabilities and recognized in the income statement.

  Currently there are no financial liabilities recognized in income at fair value.

- *Other Liabilities*

  Other liabilities are generally recognized using the repayment amount.

- *Equity Instruments*

  An equity instrument is any contractual agreement that represents a residual interest in the Company's assets after deducting all liabilities. Equity is the residual amount after liabilities are deduced from assets.

Derivative Financial Instruments

As a rule, the Group only employs derivative financial instruments (forward exchange transactions and options as well as interest rate swaps) for hedging purposes (currency and interest rate risks). Please also see Section B no. 2.6.

• *Cash Flow Hedges*
The process of hedging future variable cash flows against fluctuations is called cash flow hedging. The Zapf Creation Group hedges interest rate and currency risks as part of its cash flow hedging. Changes in the fair value of derivative financial instruments intended for hedging a cash flow risk are documented. If the hedging relationships are classified as effective, the changes in the fair value are recognized directly in equity. Fluctuations in value from financial instruments classified as ineffective are recognized directly in the income statement.

• *Fair Value Hedges*
A fair value hedge is intended to compensate for changes in the market value of accounting assets and liabilities through opposite changes in the market value of the hedging transaction. Gain or losses arising from the change in market value of the hedging transaction are recognized immediately in the income statement. The underlying transaction must also be recognized in income with regard to the hedged risk when the hedge goes into effect. The Company does not currently have any fair value hedges.

2.4.2. Inventories

Merchandise is recognized using its historical cost or its correspondingly lower net realizable value as of the closing date using the sliding average price. The cost of inventories includes all acquisition costs, as well as all costs incurred for keeping the inventories at their current storage location and in their current state. For purchased merchandise, this comprises in particular the purchase price, freight and customs duties. Discounts, rebates and similar amounts are deducted when determining the acquisition costs.

To minimize risks, inventories are subject to regular impairment tests. These tests are made based on the expected sales quantity. Appropriate valuation allowances are used to account for developments in the market which cause the value of the inventories to fall below cost, taking into account anticipated selling expenses.

2.4.3. Leases

For lease agreements in which substantially all risks and rewards related to the asset transfer to the Zapf Creation Group as lessee, the respective asset and a corresponding liability are initially recognized in the amount of the fair value of the asset or the lower present value of the minimum lease payments, respectively. Upon subsequent measurement, the asset's carrying value is adjusted under appropriate application of the depreciation rules for assets legally owned by the Company. The leasing liability is measured taking the lease payments paid into account and applying the effective interest method.

The Company does not currently have any finance leases. With respect to operating leases, please see Section B no. 1.12. and Section C no. 1.2.

2.4.4. Property, Plant and Equipment

Property, plant and equipment is measured at cost and is depreciated over its estimated useful life using the straight-line method:

Buildings and building equipment	7 to 50 years
Machinery	20 years
Motor vehicles, furniture and fixtures, and office equipment	2 to 18 years

The depreciation period for property, plant and equipment, which the Company uses under capital leases or in connection with rental agreements (leasehold improvements), always begins with the date the asset is placed in operation. The depreciation period corresponds to the duration of the rental or lease agreements if this is shorter than the asset's economic life. Any gain or loss arising upon scrapping or disposal is recognized under other income and expenses.

The Company shows the cost of maintenance and repairs that only insignificantly extend the life of items of property, plant and equipment as an expense. Significant renovations and improvements are capitalized.

The Zapf Creation does not currently own property held for sale.

2.4.5. Intangible Assets

All intangible assets of the Zapf Creation Group have a determinable expected useful life and are measured at cost less straight-line amortization, whereby the following estimated useful lives are applied:

Patents, brand names and licenses	5 to 10 years
Computer software	3 to 4 years

2.4.6. Impairments

The Company reviews non-current assets for impairment whenever events or changes in circumstances indicate a decrease in value; intangible assets under construction are subject to an annual impairment test. Any impairment loss is determined by comparing the carrying amount of an asset with its recoverable amount. The recoverable amount is the higher of the asset's fair value less costs of disposal and its value in use. The fair value less costs of disposal is the amount realizable by selling an asset in an arm's length transaction between knowledgeable, willing parties after deducting the costs of disposal. The value in use results from the present value of future cash flows, which are expected to be derived from the asset. The assets is written down in an amount equivalent to the amount by which the carrying amount of the asset exceeds its recoverable amount.

2.4.7. Provisions

A provision is recognized if a current obligation – legal or actual – arises vis-à-vis third parties that will probably result in an outflow of resources that can be reliably estimated. The disclosure as a provision in the balance sheet is oriented on the extent of the uncertainty with regard to the timing or the amount of the future outlays required to fulfill the obligation.

Provisions for restructuring are recognized as liabilities if there is a detailed formal plan for the restructuring and the public announcement or beginning of implementation awakens a justified expectation among the affected parties that the restructuring will actually be carried out. Restructuring provisions are recognized using the value that corresponds to the best possible estimate of all costs directly related to the restructuring.

2.4.8. Pensions and Similar Obligations

Pensions and similar obligations comprise both defined-benefit as well as defined-contribution employee benefit plans.

- *Defined-benefit Plans*
  For defined-benefit employee benefit plans, the pension liabilities are determined pursuant to IAS 19 ("Employee Benefits") using the projected unit credit method.

- *Defined-contribution Plans*
  For defined-contribution plans, the mandatory payment contributions are charged directly as an expense. The creation of a provision for pension liabilities is not necessary because the Company has no additional obligation other than the obligation to pay the premium.

  The reinsured relief fund existing in the Zapf Creation Group must be classified as a defined-contribution plan within the meaning of IAS 19.

2.4.9. Share-based Compensation Systems

The Company has stock option plans and bonus plans that contain cash compensation to the members of the Management Board, members of the executive boards, as well as additional executives and employees of the Group that is based on the development of the stock price.

On December 15, 2004, the beneficiaries irrevocably renounced their claims from the stock option plans.

IFRS 2 did not enter into force until January 1, 2005. In addition, the transition guidelines in IFRS 2 and IFRS 1 do not prescribe a mandatory application of the provisions regarding the recognition and measurement of stock option plans to the aforementioned plans. A voluntary early application of IFRS 2 to the stock option plan was foregone. Therefore, the Company refrained from accounting for the stock option plans under IFRS 2 for the 2004 comparison period.

2.5. Use of Estimates

The preparation of financial statements in accordance with IFRS requires management to make assumptions and to perform estimates, both of which affect the amounts shown and any related information. Although these estimates are made to the best of management's knowledge based on current events and measures, actual events may deviate from these estimates.

3. Scope and Methods of Consolidation

3.1. General

The consolidated financial statements of Zapf Creation are prepared based on IFRS accounting methods in accordance with the following consolidation principles.

The financial year of Zapf Creation AG and its subsidiaries included in the consolidated financial statements corresponds to the calendar year.

3.2. Scope of Consolidation

In addition to Zapf Creation AG, the Group's parent company, all subsidiaries of the Group are included in the consolidated financial statements. All subsidiaries are wholly owned by the parent company.

An overview of the subsidiaries affiliated with Zapf Creation AG is presented in the table attached to these notes as Appendix 1.

The following table shows changes in the scope of consolidated subsidiaries in the reporting period:

	Domestic	Abroad	Total
December 31, 2004	4	9	13
Disposals in the 2005 financial year	0	1	1
December 31, 2005	4	8	12

In the 2005 financial year, the subsidiary Zapf Creation (Australia) Pty. Ltd. was sold and deconsolidated effective July 1, 2005.

Furthermore, the liquidation of the Group subsidiary Zapf Creation (CZ) s.r.o. was initiated in the 2005 financial year. The liquidation procedure was not concluded by December 31, 2005; the company continues to be fully consolidated.

In economic terms, the disposal or liquidation of the two companies merely means a change in the sales channel. In the case of the Australian subsidiary, the market has been serviced via a co-operation with Funtastic Limited, South Oakleigh, Australia since November 1, 2004. In the case of the Czech subsidiary, sales activities have been conducted via the German sales company Zapf Creation (Central Europe) GmbH & Co. KG, Roedental, Germany since August 1, 2005. A separate disclosure in the consolidated financial statements as of December 31, 2005 that would arise from IFRS 5 ("Non-current Assets Held for Sale and Discontinued Operations") is therefore not required.

There were no other major changes to scope of consolidation in the 2005 financial year.

3.3. Methods of Consolidation

All companies are fully consolidated. The financial statements of the companies included in the consolidated financial statements are prepared using uniform accounting principles.

The financial statements of each subsidiary are included in the consolidated financial statements of Zapf Creation under the purchase method by offsetting acquisition costs against equity as of the respective purchase date.

Loans, receivables and liabilities between the consolidated companies are offset in the course debt consolidation.

Revenue generated with affiliated companies and other intra-Group income is offset against the respective expenses during expense and income consolidation.

Intercompany profits and losses are eliminated.

The euro (€) is the reporting currency. Except for equity, carrying amounts in the balance sheets of foreign subsidiaries are consolidated by translating them into euros at exchange rates prevailing at the end of the financial year. Issued capital is included in consolidation at the exchange rate prevailing on the date of formation. Capital reserves are treated accordingly. Retained earnings and earnings brought forward are translated into euros at weighted average exchange rates since the respective subsidiary's date of formation. Items in the income statement and the cash flow statement are translated at average annual exchange rates. The resulting currency translation differences are recognized separately in equity.

Consolidation is based on the following (material, rounded) exchange rates as of December 31, 2005 (1 unit of foreign currency = x units of euros):

	USD	HKD	GBP	PLN
Closing rate as of Dec. 31, 2005	0.8453	0.1091	1.4543	0.2591
Average exchange rate from Jan. 1 to Dec. 31, 2005	0.8045	0.1035	1.4627	0.2491
Historical average exchange rate	0.9591	0.1145	1.5431	0.2425

4. Declaration of Compliance

The consolidated financial statements of Zapf Creation AG as of December 31, 2005 are in compliance with the standards (IFRS and IAS) and interpretations (IFRIC and SIC) as adopted by the European Union and applicable as of the balance sheet date.

The consolidated financial statements prepared according to the above standards give a true and fair view of the net worth, financial position and results of operations of the Zapf Creation Group.

Previous year’s comparative figures were determined based on the same principles.

B. Explanation of Items in the Annual Financial Statements

1. Explanation of Income Statement Items

The Company's income statement is prepared in accordance with the cost of sales method.

1.1. Revenue

In addition to the pure selling prices for merchandise, the gross revenue contains the shipping and handling fees billed to the customer. Net revenue is the gross amount less cash discounts, bonuses, rebates, advertising cost subsidies, sales promotion fees and freight reimbursements.

Revenue by geographical markets are comprised as follows:

	2005 K€	2004 K€	+/– %
Europe	**117,961**	**129,186**	**–9**
Central Europe	42,965	53,000	–19
Northern Europe	40,571	44,694	–9
Southern Europe	21,571	22,045	–2
Eastern Europe	12,854	9,447	36
The Americas	**20,060**	**26,774**	**–25**
Asia/Australia	**2,696**	**7,322**	**–63**
Revenue	140,717	163,282	–14

Europe
The Central Europe sales region is primarily supplied through the German subsidiary Zapf Creation (Central Europe) GmbH & Co. KG. The Northern European market is serviced by the sales company Zapf Creation (U.K.) Ltd. The Southern European markets are supplied through our own subsidiaries Zapf Creation (España) S.L., Zapf Creation (France) S.à.r.l. and Zapf Creation (Italia) S.R.L. In 2005, goods for the Eastern European market were supplied through Zapf Creation (Polska) Sp. z o.o. and Zapf Creation (Central Europe) GmbH & Co. KG. The subsidiary Zapf Creation (CZ) s.r.o., which previously was responsible for this segment, is in the process of being liquidated; in this context, we refer to the notes on the scope of consolidation in Section A no. 3.2.

The Americas
The subsidiary Zapf Creation (U.S.) Inc. is responsible for the entire American market.

Asia/Australia
The Asia/Australia region is serviced by Zapf Creation (H.K.) Ltd. The subsidiary Zapf Creation (Australia) Pty. Ltd., which was responsible for the Australian market in the previous year, discontinued its sales operations during the 2004 financial year. Sales in this region have since been handled by an external sales partner. For more details, please see the notes on the scope of consolidation in Section A no. 3.2.

Revenue by business segments is comprised as follows:

	2005 K€	2004 K€	+ / − %
Play and functional dolls	**133,973**	**154,498**	**−13**
BABY born®	58,089	64,500	−10
Baby Annabell®	49,418	46,306	7
CHOU CHOU	24,101	38,920	−38
Other play and functional dolls	2,365	4,772	−50
Mini dolls	**1,788**	**3,671**	**−51**
Other	**4,956**	**5,113**	**−3**
Revenue	140,717	163,282	−14

Gains and losses on changes in exchange rates realized on sales transactions and those arising from measurement of trade receivables on the closing date are recognized under revenue. In addition, please see the table of exchange rates in Section A no. 3.3.

Please see Segment Reporting attached to these notes as Appendix 3.

1.2. Cost of Sales

Expenses directly allocable to revenue are recognized as expenses for cost of sales.

This item essentially contains the expenses for purchased merchandise. In addition to the pure cost, all incidental acquisition costs of the merchandise sold in the reporting period are reported here. These costs primarily comprise freight and customs duties.

Gains and losses on changes in exchange rates realized on purchase transactions and those arising from measurement of trade payables on the closing date are recognized under cost of sales. In addition, please see the table in Section A no. 3.3.

1.3. Selling and Distribution Expenses

The Company's selling expenses contain the direct expenses for supporting and maintaining its distribution network as well as total freight costs for bringing the merchandise from the respective delivery warehouse of the Zapf Creation Group to the customer.

The distribution expenses comprise the expenses for the logistics center owned by the Company as well as all other Group logistical expenses.

The following are also recognized in selling and distribution expenses: staff costs totaling K€ 8,460 (previous year: K€ 10,065) and depreciation / amortization of the sales and distribution units totaling K€ 2,680 (previous year: K€ 2,316), as well as license fees, activities at the point-of-sale for the end consumer, and expenses resulting from the Company's receivables management.

1.4. Marketing Expenses

Marketing expenses include the Company's expenses for conducting advertisement measures of all kinds (advertising, promotional and marketing campaigns, TV spots), as well as expenses underlying the Company's comprehensive communications strategy, the production and design of sales catalog and brochure content, and the target-group related placement of advertisements in trade journals and magazines.

Expenses for advertising, promotional, and marketing campaigns as well as expenses for producing and broadcasting TV ads are recognized as an expense in the financial year in which the respective goods and services are used. The remaining advertising expenses are posted as an expense when they arise. Advance payments made are deferred and recognized under current assets.

The following are also recognized under marketing expenses: staff costs totaling K€ 2,477 (previous year: K€ 3,173) and depreciation/amortization of the marketing unit totaling K€ 848 (previous year: K€ 1,012), as well as those expenses resulting from communication with end customers. Among others, this concerns expenses for the design of mini catalogs, for conducting sweepstakes and competitions, as well as the BABY born® CLUB, a tool for creating customer loyalty and maintaining customer contact.

1.5. Administrative Expenses

The Company's other administrative expenses include expenses incurred by the finance, controlling and IT units as well as general administrative expenses. This includes staff costs totaling K€ 9,343 (previous year: K€ 10,733) and depreciation/amortization of these units totaling K€ 3,433 (previous year: K€ 3,843).

In addition, other administrative expenses also include development and design expenses if such expenses do not fulfill the requirements for being recognized as assets. Both the development department of the Company and external developers and designers are responsible for product development. The importance the Company attaches to product design is evidenced by its in-house design and technical development department. In Roedental and in Hong Kong, a total of about 40 employees work continuously on new product concepts and on improving and redesigning existing products.

1.6. Other Income

Exchange rate gains realized on transactions that are not directly allocable to the purchasing and sales process, and exchange rate gains arising from the measurement of assets and liabilities on the closing date that are not directly allocable to the purchasing and sales process totaling K€ 5,887 (previous year: K€ 4,929) are offset against corresponding exchange rate losses totaling K€ 3,941 (previous year: K€ 3,670) and reported under other income, to the extent that the resulting balance shows income. In the 2005 reporting period, reportable income from changes in foreign exchange rates was K€ 1,946 (previous year: K€ 1,259). In addition, please see the table of exchange rates in Section A no. 3.3.

The Company’s other income totaling K€ 635 (previous year: K€ 568) essentially comprises license income generated by the BABY born® brand totaling K€ 203 (previous year: K€ 167), income from the deconsolidation of the subsidiary Zapf Creation (Australia) Pty. Ltd. totaling K€ 113 (previous year: K€ 0) and income from the disposal of fixed assets totaling K€ 92 (previous year: K€ 144).

1.7. Other Expenses

Exchange rate losses realized on transactions that are not directly allocable to the purchasing and sales process, and exchange rate losses arising from the measurement of assets and liabilities on the closing date that are not directly allocable to the purchasing and sales process, are offset against corresponding exchange rate gains and reported under other expenses, to the extent that the resulting balance shows an expense. In the 2005 financial year, as well as in the previous year, there was no reportable expense from changes in foreign exchange rates. In addition, please see the table of exchange rates in Section A no. 3.3.

The Company’s miscellaneous other expenses totaling K€ 2,150 (previous year: K€ 240) contain, in particular, allowances on receivables from barter transactions totaling K€ 862 (previous year: K€ 0), allowances on loans granted to members of corporate bodies and employees totaling K€ 685 (previous year: K€ 0), interest and currency hedging fees totaling K€ 213 (previous year: K€ 81), and expenses from the disposal of non-current fixed assets totaling K€ 188 (previous year: K€ 138).

In connection with barter transactions, the Company sells its merchandise at fair value within the normal dealer price range to trade partners, who pay for the merchandise partly in cash and partly in “barter points”. The barter points received as compensation can be exchanged by the Company, for example in exchange for broadcast minutes at television companies.

1.8. Restructuring Costs

The restructuring costs of the Zapf Creation Group are disclosed separately in the income statement and totaled K€ 7,753 in the year under review (previous year: K€ 0).

The largest portion of restructuring costs is comprised of severance payments totaling K€ 3,222 for personnel measures in connection with the Company’s realignment, which were either conducted in the 2005 financial year or are pending for the 2006 calendar year. Restructuring costs also include consultancy services totaling K€ 2,789 that are also directly connected to the realignment program, as well as expenses totaling K€ 1,517 from the realignment of the company’s US business.

1.9. Finance Income and Costs

The finance income totaling K€ 230 (previous year: K€ 258) arises from short-term liquid assets in connection with cash management.

The finance expenses totaling K€ 7,031 (previous year: K€ 3,836) comprise interest on bank overdrafts and loans, fees for factoring conducted during the financial year as well as syndication fees.

1.10. Taxes on Income

Current income taxes are determined based on the respective national tax regulations.

Deferred income taxes are recognized for all temporary differences between the carrying amounts under IFRS and the carrying amounts for tax purposes of assets and liabilities, as well as for tax loss carryforwards.

Deferred tax assets from deductible temporary differences and from tax loss carryforwards, the total of which exceeds the deferred tax liabilities from taxable temporary differences, are recognized only to the extent that it can be assumed with sufficient probability that the respective company of the Zapf Creation Group will generate sufficient taxable income in the future to realize the corresponding benefit.

Deferred tax assets and deferred tax liabilities are offset before recognition if they pertain to the same taxation authority. Deferred tax items are not discounted.

Based on this, the tax expenses recognized in the consolidated financial statements of Zapf Creation AG are comprised as follows:

	2005 K€	2004 K€
Current taxes		
Domestic	715	411
Abroad	1,802	4,735
	2,517	**5,146**
Deferred taxes		
Domestic	814	−1,527
Abroad	1,271	−554
	2,085	**−2,081**
Taxes on income	4,602	3,065

Depending on their respective legal form, Zapf Creation AG and its subsidiaries in Roedental are subject to German corporation tax and trade tax.

The corporation tax rate applicable during the reporting period was 25 % plus the solidarity surcharge of 5.5 %. The trade tax is 15.25 % of taxable income. The expected nominal tax rate is therefore 37.61 % (previous year: 37.61 %).

The effective tax expense reported in the Zapf Creation Group differs from the expected tax expense based on the nominal tax rate. The following reconciliation shows the main deviation factors in the reporting period:

	2005		2004	
	K€	%	K€	%
Earnings before income taxes	**−23,118**	**100.00**	**2,947**	**100.00**
Expected income tax refund/ expected income tax expense	8,695	−37.61	−1,108	−37.61
Different tax assessment basis	2,201	−9.52	−300	−10.18
Different tax rate	613	−2.65	1,445	49.04
Uncapitalized deferred taxes on loss carryforwards	−13,554	58.63	−3,247	−110.18
Deferred taxes loss carryforwards, subsequently capitalized/use of existing loss carryforwards	192	−0.83	0	0.00
Valuation allowance on deferred taxes capitalized in previous years	−2,272	9.83	0	0.00
Tax expense, previous years	−677	2.93	−80	−2.71
Other	200	−0.87	225	7.64
Recognized income tax expense	**−4,602**	**19.91**	**−3,065**	**−104.00**

The Zapf Creation Group recognizes the following loss carryforwards as of the balance sheet date of the respective reporting period:

	Dec. 31, 2005	Dec. 31, 2004
	K€	K€
Corporation tax		
Domestic	45,071	7,716
Abroad	5,950	11,530
	51,021	**19,246**
Trade tax (domestic only)		
	46,069	**9,221**

Of the corporation tax loss carryforwards, K€ 45,071 relate to Zapf Creation AG (previous year: K€ 7,716), K€ 1,916 relate to Zapf Creation (U.S.) Inc. (previous year: K€ 9,954), K€ 1,541 relate to Zapf Creation (Italia) S.R.L. (previous year: K€ 1,018), and K€ 2,493 relate to Zapf Creation (France) S.à.r.l. (previous year: K€ 558).

Of the corporation tax loss carryforwards, K€ 48,177 (previous year: K€ 8,887) may be carried forward indefinitely; a further K€ 1,916 (previous year: K€ 9,954) may be carried forward until 2024, and the remaining K€ 928 (previous year: K€ 405) may be carried forward until 2009 and 2010.

Of the trade tax loss carryforwards, K€ 37,319 relate to Zapf Creation AG (previous year: K€ 6,575), K€ 6,609 relate to Zapf Creation (Central Europe) GmbH & Co. KG (previous year: K€ 0), and K€ 2,141 relate to Zapf Creation Logistics GmbH & Co. KG (previous year: K€ 2,646).

The trade tax loss carryforwards may be carried forward indefinitely.

Due to the insufficient probability of an earnings turnaround in future accounting periods, no deferred taxes were recognized on corporation tax loss carryforwards totaling K€ 40,481 (previous year: K€ 8,366) and on trade tax loss carryforwards totaling K€ 40,043 (previous year: K€ 3,761).

The determination of deferred taxes on loss carryforwards to be capitalized was based on a five-year planning period.

1.11. Earnings per Share

Basic earnings per share are determined as follows:

	2005	2004
Net profit or loss for the period (in K€)	−27,720	−118
Average number of shares outstanding (in thsds.)	7,427	7,427
Earnings per share (in €)	−3.73	−0.02

As of December 31, 2005 and as of the balance sheet date of the previous year, no options and subscription rights to purchase common shares were outstanding.

1.12. Other Disclosures Regarding the Income Statement

Staff costs included in the operating expenses of the Zapf Creation Group totaled K€ 20,280 (previous year: K€ 23,971) in the 2005 financial year.

Staff costs by functional areas are comprised as follows:

	2005 K€	2004 K€
Sales and distribution	8,460	10,065
Marketing	2,477	3,173
Other administration	9,343	10,733
Staff costs	20,280	23,971

The following table shows the average number of employees of the Group:

	2005	2004
Salaried employees	387	418
Hourly workers	70	85
Employees	457	503

Expenses for defined-contribution pension plans in the 2005 financial year totaled K€ 306 (previous year: K€ 280).

In the 2005 financial year, expenses under operating leases totaling K€ 2,268 (previous year: K€ 2,496) were recognized. These essentially relate to lease agreements for IT hardware, software and motor vehicles. Please also see Section C no. 1.2.

2. Explanation of Balance Sheet Items

2.1. Current Assets

2.1.1. Cash

Cash comprises the following items:

	Dec. 31, 2005	Dec. 31, 2004
	K€	K€
Cash on hand	14	23
Bank balances	9,339	17,018
Cash	9,353	17,041

Cash includes an offsetting of current liabilities from bank overdrafts totaling K€ 2,087 (previous year: K€ 4,004) as these represent an integral part of the Company's cash planning.

2.1.2. Trade Receivables

Trade receivables as of the balance sheet date are comprised as follows:

	Dec. 31, 2005	Dec. 31, 2004
	K€	K€
Receivables before valuation allowance	69,525	50,855
Valuation allowance	−1,029	−557
Trade receivables	68,496	50,298

In contrast to the previous year, as of December 31, 2005, the Company has assigned only comparatively small amounts of trade receivables to factoring companies.

The total amount of assigned or transferred Company receivables is comprised as follows:

	Dec. 31, 2005 K€	Dec. 31, 2004 K€
Domestic	2,909	6,416
Abroad	0	15,832
Factoring	2,909	22,248

2.1.3. Inventories

The Company's inventories are divided into the following main categories:

	Dec. 31, 2005 K€	Dec. 31, 2004 K€
Goods	15,881	28,333
Raw materials and supplies	1,075	343
Inventories	16,956	28,676

The following valuation allowances were made with regard to goods:

	Dec. 31, 2005 K€	Dec. 31, 2004 K€
Inventories before valuation allowance	21,375	30,690
Valuation allowance	−4,419	−2,014
Inventories	16,956	28,676

The valuation allowance on goods in the 2005 financial year totaling K€ 4,419 refers to a carrying value before valuation allowance totaling K€ 10,072. Due to the strategic realignment of the Company's product portfolio as part of its restructuring program and after taking into account the current developments with regard to phthalates and the German ordinance on electronic scrap, merchandise that was deemed unsalable was removed from inventories as of December 31, 2005. The affected goods will be physically scrapped in 2006.

2.1.4. Income Tax Receivables

Income tax receivables are comprised as follows:

	Dec. 31, 2005 K€	Dec. 31, 2004 K€
Domestic	3,368	7,022
Abroad	1,043	248
Income tax receivables	4,411	7,270

2.1.5. Other Assets

The other current assets as of the balance sheet date are comprised as follows:

	Dec. 31, 2005 K€	Dec. 31, 2004 K€
Other tax assets	2,391	455
Advances	744	260
Loans to members of corporate boards or employees	685	885
Barter transactions	300	100
Other	1,551	950
Other assets before valuation allowance	**5,671**	**2,650**
Valuation allowance on loans granted	−685	0
Other assets	4,986	2,650

A full valuation allowance was recogzined in the 2005 financial year for the loan of K€ 625 that was granted to a former member of the Management Board and a loan of K€ 60 that was granted to an employee.

2.2. Non-current Assets

2.2.1. Property, Plant and Equipment

Property, plant and equipment as of the balance sheet date is comprised as follows:

	Dec. 31, 2005 K€	Dec. 31, 2004 K€
Land and buildings	6,682	7,162
Machinery	1,009	671
Motor vehicles, furniture and fixtures, and office equipment	12,137	15,015
Assets under construction	366	243
Property, plant and equipment	20,194	23,091

Depreciation in the 2005 financial year totaled K€ 4,170 (previous year: K€ 5,135). Depreciation in the 2005 financial year includes writedowns totaling K€ 742 (previous year: K€ 0). They result primarily from the realignment of the Company’s American business and were recognized under restructuring costs.

Expenses for maintenance and repair (which were recognized in income) that only insignificantly extend the life of items of property, plant and equipment totaled K€ 417 in 2005 and K€ 599 in 2004.

For information on individual items of property, plant and equipment, please see the statement of changes in non-current assets, which has been attached to these notes as Appendix 2.

2.2.2. Intangible Assets

The intangible assets of the Company as of the balance sheet are comprised of the following items:

	Dec. 31, 2005	Dec. 31, 2004
	K€	K€
Patents, brand names and licenses	4,610	5,314
Computer software	1,807	3,430
Assets under construction	106	332
Intangible assets	6,523	9,076

Amortization in the 2005 financial year totaled K€ 2,791 (previous year: K€ 2,036). Amortization in the 2005 financial year includes writedowns totaling K€ 135 (previous year: K€ 0), which were recognized under restructuring costs.

The average remaining useful life of patents, licenses and brand names is six years.

For information on individual intangible assets, please see the statement of changes in non-current assets, which has been attached to these notes as Appendix 2.

2.2.3. Other Assets

The other non-current assets exclusively relate to receivables from barter transactions and non-current financial assets.

Receivables from barter transactions totaling K€ 187 (previous year: K€ 1,349) include a valuation allowance of K€ 907 made in the 2005 financial year.

The other non-current financial assets include a loan granted by the Company in the amount of K€ 30 (previous year: K€ 40).

2.2.4. Deferred Tax Assets

The deferred tax assets as of the balance sheet date result from the following items:

	Dec. 31, 2005 K€	Dec. 31, 2004 K€
Loss carryforwards	3,715	3,897
Trade receivables	564	379
Property, plant and equipment and intangible assets	102	0
Provisions	94	417
Inventories	24	281
Other assets	22	329
Other liabilities	0	263
Other	34	250
Deferred tax assets before offsetting	**4,555**	**5,816**
Offsetting with deferred tax liabilities	−2,555	−1,883
Deferred tax assets	2,000	3,933

For more information on deferred tax assets, please see Section B no. 1.10.

2.3. Current Liabilities

2.3.1. Liabilities to Banks

The current liabilities to banks are comprised as follows:

	Dec. 31, 2005 K€	Dec. 31, 2004 K€
Overdrafts	54,866	57,892
Current portion of non-current bank loans	6,400	4,797
Liabilities to banks	61,266	62,689

In July 2005, the Company concluded a syndicated loan agreement until March 31, 2008 with a total financing volume of K€ 112,053 to finance operations over the short- and mid-term (lines of credit in the previous year: K€ 146,000). The average interest rate for the drawdown in 2005 was 5.2 % (previous year: 3.5 %).

A collateral pool, in which the significant companies of the Zapf Creation Group are included, exists to secure the loan agreement.

The following collateral in particular was furnished by the Group companies included in the collateral pool in connection with the syndicated loan agreement (previous year: securitization by mortgages totaling K€ 4,601):

- Pledge of the bank deposits of the Group subsidiaries Zapf Creation (Central Europe) GmbH & Co. KG and Zapf Creation Logistics GmbH & Co. KG
- Assignment of the receivables from deliveries of goods and other services

- Assignment of the claims from the existing trade credit insurance and from other operating insurance
- Pledge of the shares of the Group parent company Zapf Creation AG in the Group companies included in the collateral pool
- Pledge of the rights to current and future trademarks owned by Zapf Creation AG
- Chattel mortgage of current and non-current assets stored in specific places
- Encumbrance of real estate with mortgages totaling K€ 9,601

2.3.2. Trade Payables

Trade payables in the reporting period totaled K€ 30,388 (previous year: K€ 22,776). They are essentially comprised of vendor invoices already submitted and still outstanding as of the balance sheet date as well as obligations of the Company from sales deductions granted.

2.3.3. Income Tax Liabilities

Income tax liabilities are comprised as follows:

	Dec. 31, 2005 K€	Dec. 31, 2004 K€
Domestic	714	352
Abroad	18	2,246
Income tax liabilities	732	2,598

2.3.4. Other Liabilities

Other current liabilities are comprised as follows:

	Dec. 31, 2005 K€	Dec. 31, 2004 K€
Other liabilities to employees	3,031	803
Other taxes	1,617	1,570
Other	693	1,580
Other liabilities	5,341	3,953

The other liabilities to employees in the 2005 financial year include K€ 1,300 (previous year: K€ 0) for severance payments in connection with the planned personnel measures as part of the restructuring of the Zapf Creation Group.

2.3.5. Provisions

Provisions in the reporting period developed as follows:

	Jan. 1, 2005	Use	Reversal	Addition	Dec. 31, 2005
	K€	K€	K€	K€	K€
Returned goods	2,375	2,375	0	1,789	1,789
Restructuring	0	0	0	1,460	1,460
Other	324	0	78	115	361
Provisions	2,699	2,375	78	3,364	3,610

Returned Goods
The provisions for returned goods result from the obligation to take back unsold merchandise.

Restructuring
The restructuring provision essentially relates to consultancy services in connection with the restructuring of the Zapf Creation Group and the realignment of its American business. Please also see the remarks in Section B no. 1.8.

Other
Other provisions concern personnel liabilities and risk provisions for ongoing processes.

2.4. Non-current Liabilities

2.4.1. Liabilities to Banks

The non-current liabilities to banks are comprised as follows:

	Dec. 31, 2005	Dec. 31, 2004
	K€	K€
Non-current bank loans	27,460	15,401
Current portion of non-current bank loans	−6,400	−4,797
Liabilities to banks	21,060	10,604

With respect to collateral for existing liabilities to banks, please see Section B no. 2.3.1.

2.4.2. Deferred Tax Liabilities

The deferred tax liabilities as of the balance sheet date result from the following items:

	Dec. 31, 2005 K€	Dec. 31, 2004 K€
Treasury shares	1,106	1,106
Provisions	588	30
Property, plant and equipment and intangible assets	489	475
Trade payables	335	197
Trade receivables	447	132
Other	90	161
Deferred tax liabilities before offsetting	**3,055**	**2,101**
Offsetting with deferred tax assets	−2,555	−1,883
Deferred tax liabilities	500	218

For more information on deferred tax liabilities, please see Section B no. 1.10.

2.5. Equity

2.5.1. Issued Capital

The Company’s share capital is € 8,000,000.00 (eight million euros). It is divided into 8,000,000 bearer shares of no par value.

Section 5 of the articles of incorporation of Zapf Creation AG authorizes the following capital increases:

The Management Board is authorized, subject to the approval of the Supervisory Board, to increase the Company’s share capital, on one or more occasions, until (and including) May 6, 2008, by issuing new shares without par value in exchange for contributions in cash or in kind, in a total amount not to exceed € 4,000,000.00 (Authorized Capital I). Subject to the following provisions, the stockholders shall be granted a subscription right in connection with cash capital increases. The Management Board is authorized, subject to the approval of the Supervisory Board, to exclude the legal subscription rights of stockholders:

a) To grant shares against contributions in kind, especially in connection with business combinations or the acquisition of companies or participating interests, provided that companies or participating interests may only be acquired if the purpose of the company to be acquired essentially falls within the scope of the Company’s purpose as defined by Section 2, no. 1 and 2 of the articles of incorporation or provided that the acquisition of the company or participating interest is in the reasonable interest of the Company or provided that the acquisition is made as part of contributing a loan granted to the Company (to the extent that applicable legal prerequisites are fulfilled);

b) If the capital increase is made against cash contributions and the total volume of the new shares for which the subscription right is excluded and of treasury shares which at the same time is disposed of pursuant to Section 186 para 3 sentence 4 German Stock Corporation Act

(AktG) by excluding subscription rights does not exceed 10 % of the share capital available at the time the increase is resolved, i.e. € 800,000.00, and the issue price is not significantly below the market price of shares of the same class already quoted at the time the issue price is finally fixed by the Management Board, as defined by Sections 203 paras 1 and 2, 186 para 3 sentence 4 German Stock Corporation Act (AktG);

c) Up until a total amount of € 250,000.00 (two hundred and fifty-thousand euros) for the purpose of issuing shares to employees of the Company and employees of affiliated companies (employee shares).

If the Management Board has not availed itself of the authorization to exclude subscription rights, the subscription rights of stockholders may only be excluded for fractional shares.

The Management Board is authorized, subject to the approval of the Supervisory Board, to determine the rights embodied in the respective shares of stock, the other conditions for issuing the shares, and further details of carrying out capital increases under Authorized Capital I.

The Supervisory Board is authorized to amend the articles of incorporation to reflect the extent of the capital increase under Authorized Capital I.

The share capital may be increased by up to € 80,000.00 by issuing up to 80,000 bearer shares without par value in the context of a contingent capital increase (Contingent Capital I). Said contingent capital increase shall be carried out only to the extent that holders of options which have been issued pursuant to the authorization resolution of the Company's Annual Stockholders' Meeting of April 26, 2000, under the Company's stock option plan exercise their subscription rights and if the Company does not grant treasury shares to fulfill such stock options. The new shares arising from the aforementioned exercise of stock options shall participate in the Company's profits as of the beginning of the financial year in which the shares are issued.

The share capital may be increased by up to € 300,000.00 by issuing up to 300,000 bearer shares without par value in the context of a contingent capital increase (Contingent Capital II). Said contingent capital increase shall be carried out only to the extent that holders of options which have been issued pursuant to the authorization resolution of the Company's Annual Stockholders' Meeting of July 31, 2001, under the Company's stock option plan exercise their subscription rights and if the Company does not grant treasury shares to fulfill the stock options. The new shares arising from the aforementioned exercise of stock options shall participate in the Company's profits as of the beginning of the financial year in which the shares are issued.

The share capital may be increased by up to a further € 400,000.00 by issuing up to 400,000 bearer shares without par value in the context of a contingent capital increase (Contingent Capital III). The contingent capital increase serves to back the options which are issued pursuant to the authorization resolution of the Company's Annual Stockholders' Meeting on May 7, 2003. Said contingent capital increase shall be carried out only to the extent that holders of options exercise their subscription rights and if the Company does not grant treasury shares to fulfill such stock options. The new shares shall participate in the Company's profits as of the beginning of the financial year in which the shares are issued.

The Supervisory Board is authorized to amend the articles of incorporation to reflect the capital increases under Contingent Capital I (Section 5 no. 3), Contingent Capital II (Section 5 no. 4), and Contingent Capital III (Section 5 no. 5).

Participation of new shares in the Company’s profit may be determined in derogation of Section 60 para 2 German Stock Corporation Act (AktG).

2.5.2. Capital Reserves

The capital reserves resulted from the premium received from the initial public offering in 1999 upon issuance of the shares less the expenses incurred by the initial public offering, taking the income tax consequences into account.

2.5.3. Net Profit or Loss for the Period and Profit Brought Forward

In addition to the net profit or loss for the period and the profit brought forward, this item includes additional adjustments due to the correction of errors pursuant to IFRS 1.41 and the effects from the accounting transition from US GAAP to IFRS as of January 1, 2004. For a detailed explanation of error corrections, please see Section D. The effects from the transition from US GAAP to IFRS are presented in Section E.

As in the previous year, there were no dividend distributions in the 2005 reporting period.

2.5.4. Other Recognized Income and Expense

The accumulated other recognized income and expense arises from differences from foreign currency translation and the closing date measurement of derivative financial instruments, both items being recognized directly to equity.

Adjustments from Foreign Currency Translation
The adjustments from foreign currency translation result from the translation of foreign financial statements from the respective functional currency into euros, the reporting currency. The currency translation differences arising from this process are allocated directly to equity in adjustments from foreign currency translation. Upon disposal of a foreign operation, existing currency translation differences are recognized in income.

In the course of the accounting transition from US GAAP to IFRS, use was made of the option under IFRS 1.22. Currency translations differences existing prior to the transition date of January 1, 2004 were assumed to be zero in the IFRS opening balance sheet.

Adjustments from Derivative Financial Instruments
The adjustments from derivative financial instruments include the remeasurement gains/losses from hedging transactions for hedging against interest rate risks in the form of interest rate swaps, as well as remeasurement gains/losses from forward exchange transactions and options used as hedging instruments that are classified as cash flow hedges, as well as the deferred tax effects attributable to the above, which result in deferred tax liabilities of K€ 28 (previous year: K€ 100).

2.5.5. Treasury Shares

By resolution of the Annual Stockholders' Meeting dated May 11, 2005, the Company is authorized to purchase treasury shares in order to:

a) be able to offer such shares as consideration or part of the consideration in connection with business combinations or the acquisition of companies, business units or participating interests in companies; or

b) be able to offer such shares as employee shares to employees of the Company and companies affiliated with the Company; or

c) to sell such shares to the stockholders in a manner other than over the exchange or through an underlying offer subject to specified conditions; or

d) to retire such shares.

The authorization dated May 11, 2005 is limited to a maximum of 10 % of the Company's share capital totaling € 8,000,000.00 and expires on November 11, 2006; the authorization to acquire treasury shares resolved in the Company's 2004 Annual Stockholders' Meeting ends when the new version comes into force.

As of December 31, 2005, the new authorization granted by the Annual Stockholders' Meeting on May 11, 2005 to acquire treasury shares had not been exercised.

As of the balance sheet date, the Company had two separate securities deposit accounts for treasury stock, the intended use of which differs as follows:

a) Account no. 1 serves to back the Company's stock option plan. The carrying amount as of December 31, 2005 was K€ 11,262 (previous year: K€ 11,262). As of the balance sheet date, the account included 569,593 treasury shares (previous year: 569,593); this corresponds to 7.12 % of the share capital.

b) Account no. 2 serves to grant shares to employees based on special performance or based on a positive development of the Company's business. The carrying amount as of December 31, 2005 was K€ 96 (previous year: K€ 96). As of the balance sheet date, the account included 3,085 treasury shares (previous year: 3,085); this corresponds to 0.04 % of the share capital.

There were no changes to either deposit account in the year under review.

The treasury shares acquired by the Company is measured at cost and deducted separately from equity.

2.5.6. Share-based Compensation Systems

As of December 31, 2005, there were three stock option plans and two share-price based bonus plans in place in the Zapf Creation Group.

Stock Option Plans
By appropriate resolutions of the Annual Stockholders' Meeting in April 1999, on July 31, 2001, and on May 7, 2003, stock option plans were created for incentive-based compensation of the Management Board, senior executives and employees of Zapf Creation AG and its affiliated Group companies (1999/2000 Stock Option Plan, 2001/2003 Stock Option Plan, and 2003/2005 Stock Option Plan). After expiration of a two-year lockup period, the stock option plans provide for the ability to exercise one third of the options each year during a three-year period. The exercise price is composed of a reference price plus a 20% premium on this reference price as a performance goal. The plans enable Zapf Creation AG to fulfill the claims of option holders at the time of exercise either by issuing shares under contingent capital, which was created especially for this purpose, or by issuing treasury shares which were acquired pursuant to Section 71 para 1 no. 8 German Stock Corporation Act (AktG).

On December 15, 2004, all eligible employees of the Zapf Creation Group and the entire Management Board of Zapf Creation AG signed an irrevocable waiver of their right to exercise the options they were granted under the stock option plans. As a result of this decision, no options were outstanding under these stock option plans as of December 31, 2004. Any compensation for the waiver was contractually excluded.

As of December 31, 2005, the total volume of all stock options plans launched so far is 826,000 options. Of these, 578,225 options were granted and 42,604 options were exercised.

The following overview contains detailed information on the development of granted and exercised options and on the weighted, average exercise prices in the reporting period and in the 2004 financial year:

	2005		2004	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
	Number	**€**	**Number**	**€**
Options outstanding as of January 1	0	—	421,121	38.09
Options granted	0	—	114,500	24.00
Options exercised	0	—	0	—
Options expired	0	—	−68,626	34.11
Options canceled	0	—	−466,995	35.22
Options outstanding as of December 31	0	—	0	—
Options exercisable as of December 31	0	—	0	—
Available for grant as of December 31	0	—	247,774	—
No longer available for grant as of December 31	247,774	—	0	—

There were no changes in the previous year's values during the 2005 reporting period. The 247,774 subscription rights unissued as of December 31, 2005 were no longer available for grant as of that date as a result of the expiration of the granting periods.

Bonus Plans

- *2001/2003 Bonus Plan*

  In financial year 2001, a separate bonus plan for the members of the Management Board, senior executives and managers of Zapf Creation AG and for managers of affiliated Group companies was implemented. This bonus plan provides for direct compensation of the eligible individuals by way of a cash payment that is oriented on the performance of the share.

  The bonus units under the plan may only be granted once a year within four weeks of formally approving the financial statements. They shall only be paid if the average of the opening and closing price of Zapf Creation shares in Xetra trading on the last trading day before a payment date is at least 20% higher than the reference price. The reference price equals the average closing price of the Zapf Creation share in Xetra trading during the last ten days before the day on which the bonus units are granted. The bonus units shall be payable on the second day after the Company's Annual Stockholders' Meeting, on the publication date of the half-year report, or the publication date of the quarterly report as of September 30 of each year, respectively.

  The period required to elapse until payment shall apply separately for each tranche. After two years, 33% shall become eligible for payment and after three years a further 33% shall become eligible for payment so that on the fourth anniversary all bonus units, in principle, are available for payment. If the requirements regarding the waiting period and the performance goals are fulfilled for the first time on a payment date, the beneficiary shall receive a one-time cash payment amounting to 20% of the reference price for every bonus unit.

  Based on this bonus plan, the Company issued a total of 87,539 bonus units with performance goals of € 28.01 in the 2003 financial year. With the exception of one bonus unit, the total volume of 300,000 bonus units available under the 2001/2003 Plan was utilized as of December 31, 2003.

  No bonus units were available for grant under the 2001/2003 Bonus Plan as of December 31, 2005.

- *2003/2005 Bonus Plan*

  In financial year 2003, the Company launched an additional bonus plan the terms and conditions of which were adopted from the 2001/2003 Bonus Plan. Only the amount of the cash payment due upon attaining the 20% performance target was increased to 30% of the reference price.

  The Company did not grant any bonus units in the 2005 financial year in connection with this program; 114,500 units with a performance target of € 24.00 were granted in the same period of the previous year.

  As in the previous year, no bonus units were exercised in the period under review. As of December 31, 2005, the exercise price for the bonus units outstanding ranged from € 24.00 to € 36.75.

  The total volume of the 2003/2005 Plan is 400,000 bonus units. The 247,774 units not granted as of December 31, 2005 were no longer available for grant as of that date as a result of the expiration the granting periods.

• *Other Disclosures*

The expense from both bonus plans is recognized in income over the period until payment (service period). At each balance sheet date, the fair value of the bonus plans is reviewed and an adjustment is made to reflect the current value. The provision to be allocated and staff costs to be recognized based on the development of the share price was K€ 11 as of December 31, 2005 and K€ 89 as of December 31, 2004. In the 2004 and 2005 financial years, K€ 78 of the provision was reversed (previous year: K€ 88).

The average of the fair values of the outstanding bonus units was K€ 21 as of the balance sheet date (previous year: K€ 177). The fair values are determined using a binomial pricing model. The calculation is based on the following assumptions:

	2005	2004
Risk-free interest rate	2.70 %	2.50 %
Expected volatility	38 %	25 %
Share price as of December 31	7.83 €	14.60 €
Weighted average exercise price as of December 31	27.35 €	27.46 €
Weighted expected remaining life (rounded)	2 years	2 years

The expected volatility of the share was ascertained based on its historical volatility in the previous 100 days.

The intrinsic value of the bonus plans granted as of December 31, 2005 remained unchanged at € 0.00.

The following table provides information on the bonus units issued and the average exercise price in the period under review and the previous year:

	2005		2004	
	Number of bonus units	Weighted average exercise price	Number of bonus units	Weighted average exercise price
	Number	**€**	**Number**	**€**
Bonus units outstanding as of January 1	389,205	27.46	306,005	28.87
Bonus units granted	0	—	114,500	24.00
Bonus units exercised	0	—	0	—
Bonus units expired	−126,323	27.68	−31,300	28.59
Bonus units canceled	0	—	0	—
Bonus units outstanding as of December 31	262,882	27.35	389,205	27.46
Bonus units exercisable as of December 31	0	—	0	—
Available for grant as of December 31	0	—	247,774	—
No longer available for grant as of December 31	247,774	—	0	—

2.6. Disclosures Regarding Financial Instruments

2.6.1. Risk Management Policy and Hedging Strategies

Original financial instruments exist within the Zapf Creation Group that result from operating business activities, essentially in the form of trade receivables and trade payables. There are also original financial instruments in the form of equity instruments and liabilities to banks.

In connection with its operating and financing activities, the Zapf Creation Group is exposed to risks, in particular from fluctuations in exchange and interest rates. Corporate policy is to exclude or limit these risks by concluding hedging transactions. All hedging measures are coordinated and conducted centrally at the Group’s parent company. Primarily derivative financial instruments are employed as hedging measures.

There are corporate guidelines for the foreign exchange and interest rate hedging policies that minimize the risks resulting from the use of financial instruments. These include the separation of the trading, processing, and posting functions, as well as the voluntary restriction to a small defined group of banks with high creditworthiness and the authorization of only a few qualified employees. All derivatives are used solely for hedging purposes.

2.6.2. Explanation of the Risks

Currency Risk

Currency risks existence in that, over time, exchange rate fluctuations change the values of items posted in foreign currency. To hedge the currency risk, the Group uses possibilities for balancing out currency risks naturally as well as forward exchange transactions and options. These transactions and options relate to the exchange rate hedging of significant items in foreign currency from operating activities. In the 2005 financial year, hedging related to the US dollar and the British pound.

Interest Rate Risk

Interest rate risks arise from possible fluctuations in value of a financial instrument due to changes in the market interest rates. An interest rate risk primarily threatens medium-term and long-term receivables and liabilities. Depending on the market situation, interest rate swaps and combined interest rate / currency swaps are concluded to hedge this risk.

Risks from Cash Flow Fluctuations

Risks from cash flow fluctuations arise in that the future cash flows expected from a financial instrument are subject to fluctuations and the amount can therefore not be determined. This is particularly the case with variable interest financial instruments if the effective interest rate changes over time. The Zapf Creation Group hedges this risk by using interest rate swaps.

Liquidity Risk

Liquidity risks exist in that the Company may not be able to acquire the funds necessary to pay the obligations entered into in connection with financial instruments. This risk is covered by a liquidity forecast based on a fixed planning horizon taking the existing syndicated loan agreement into account (continuous planning).

Default Risk

The default risk from financial assets exists in that the contractual partner in a transaction involving a financial instrument may not meet its obligations or may not meet them on schedule. The maximum amount of this risk is the positive fair value of the claim from the financial instrument vis-à-vis the respective counterparty. The risk from original financial instruments is taken into account by establishing an allowance for bad debts; in addition, the Company has an appropriate amount of loan insurance. With regard to derivative financial instruments, the actual default risk is low as these instruments are only concluded with selected banks and limits are set for each counterparty as part of the Company's risk management.

2.6.3. Derivative Financial Instruments

The following derivative financial instruments exist as of the balance sheet date:

	Dec. 31, 2005		Dec. 31, 2004	
	Nominal volume	Market values	Nominal volume	Market values
	K€	K€	K€	K€
Interest rate swaps (term > one year)	68,397	75	15,495	–146
Interest rate swaps (term < one year)	0	0	5,000	–1
Option transactions (term < one year)	22,692	184	0	0

To hedge against interest rate risks, the Company maintained interest rate swaps with a nominal volume of K€ 68,397 (previous year: K€ 20,495) as of December 31, 2005, including US-dollar swaps with a volume of K$ 7,500 (previous year: K$ 7,500).

To hedge against currency risks (US dollar and British pound), the Company entered into option transactions with a nominal volume of K€ 22,692 (previous year: K€ 0), including US-dollar option transactions with a volume of K$ 20,000 (previous year: K$ 0).

3. Explanation of the Items in the Statement of Changes in Equity

The statement of changes in equity shows the development of each item of equity for the 2005 and 2004 financial years and reports the change in outstanding shares in the reporting period and in the same period of the previous year. For an explanation of the individual items of equity, please see the statements regarding the balance sheet in Section B no. 2.5.

The opening balance of equity as of January 1, 2004 contains the cumulative effects from the correction of errors pursuant to IFRS 1.41 and the effects from the accounting transition from US GAAP to IFRS. For a detailed explanation of error corrections, please see Section D. The effects from the transition from US GAAP to IFRS are presented in Section E.

4. Explanation of the Items in the Cash Flow Statement

The cash flow statement is broken down by cash flows from operating, investing and financing activities.

The cash flow from operating activities is determined using the indirect method.

Interest paid and received is allocated to cash flows from financing activities.

The cash funds in the cash flow statement comprise the cash disclosed in the balance sheet.

The changes in the balance sheet items that are used to prepare the cash flow statement cannot be derived directly from the balance sheet because non-cash exchange rate effects must be eliminated.

5. Explanation of the Items in Segment Reporting

The segment report is attached to these notes as Appendix 3.

5.1. Overview

The structure of segment reporting in the Zapf Creation Group arises from the internal organizational and reporting structure, which is oriented on the origin and type of the Company's risks and income.

The primary reporting format is therefore determined by geographical segments. The secondary reporting format is defined by the business segments (product lines), which are oriented on the structure of the product portfolio.

Intercompany income and expenses are taken at terms that apply to arm's-length transactions and are eliminated during consolidation.

Information regarding the individual segments is presented below.

5.2. Primary Reporting Format

For the delineation of geographical segments in the Zapf Creation Group, please see their presentation in Section B no. 1.1.

Segment Revenue
The revenue of the respective geographical segments presented in the primary reporting format contain the net revenue from external customers, the total of which corresponds to the revenue shown in the consolidated income statement.

Segment Result
The total of the individual operating segment results before interest, income taxes and depreciation/amortization, presented before restructuring expenses, corresponds to the consolidated earnings before interest, taxes, depreciation/amortization and restructuring costs (EBITDA before restructuring).

Segment Assets
Segment assets contain all assets that are used in the respective segment and which neither bear interest nor represent tax assets. Segment assets comprise, in particular, trade receivables, both from outside parties and Group companies, inventories and other assets, as well as property, plant and equipment and intangible assets. In addition to intercompany receivables, the shares held by Zapf Creation AG are the primary item eliminated during consolidation.

Segment Investments and Depreciation / Amortization

Investments and depreciation / amortization refer to the property, plant and equipment and intangible assets recognized in the segment assets.

Segment Liabilities

Segment liabilities comprise the liabilities attributable to the respective segment, which neither bear interest nor represent tax liabilities. This includes, in particular, trade payables, liabilities to affiliated companies, other liabilities and provisions. Intercompany liabilities are eliminated during consolidation.

5.3. Secondary Reporting Format

For the delineation of business segments in the Zapf Creation Group, please see their presentation in Section B no. 1.1.

Segment Revenue

The total of the revenue of the Group's individual business segments corresponds to the revenue shown in the consolidated income statement. The type of business segmenting does not permit any internal sales.

C. Other Disclosures Regarding the Annual Financial Statements

1. Other Financial Obligations

1.1. Overview

The following table shows the Company's future minimum liabilities from financial obligations:

	Dec. 31, 2005	Dec. 31, 2004
	K€	K€
2005	—	6,445
2006	7,444	991
2007	716	386
2008 and beyond	280	408
Financial obligations	8,440	8,230

1.2. Leases and Rents

As of the balance sheet date, the Company had various lease and rental agreements. The agreements cover the use of office and warehousing areas as well as the use of furniture, fixtures and office equipment in connection with the Company's operations.

The obligations stemming from non-current lease and rental agreements total K€ 2,505 (previous year: K€ 3,919) and expire no later than in 2015.

1.3. Minimum License Payments

As of the balance sheet date, the Company was a contractual partner in several license agreements with external developers in order to be able to utilize technical solutions created by these developers for its own products. Some of these agreements contain provisions for payment of a guaranteed annual minimum license payment if the license fees payable based on the sale of the licensed item remains below a certain guaranteed amount. Although these obligations exist for an unlimited period or time, they become inapplicable until final expiration of the agreement, if the license agreement is terminated prior to a specified cutoff date.

The annual minimum license payments totaled K€ 60 (previous year: K€ 100).

1.4. Purchase Order Commitments

The obligations from purchase order commitments totaled K€ 5,875 (previous year: K€ 4,211). They result from purchase commitments for merchandise, legal consulting services, maintenance contract services and media services.

Goods

As of December 31, 2005, the Company had a minimum purchase obligation for goods, which is allocable to the ongoing purchasing process with suppliers in China. In this connection, the Group subsidiary Zapf Creation (H.K.) Ltd., beginning with the month of September of each reporting period, orders goods that are scheduled for delivery to customers in the first quarter of the respective following year. The total amount of the purchase order commitment as of December 31, 2005 was K€ 5,153 (previous year: K€ 4,211).

Legal Consulting Services

As of December 31, 2005, the Company had a minimum purchase obligation for legal consulting services totaling K€ 369, which runs until March 31, 2008. The obligation results from a consulting agreement signed by the Company on February 12, 2005, which became effective April 1, 2005 and has a term of three years.

Of the total amount, K€ 234 is attributable to the 2006 calendar year. The purchase obligation for legal consulting services in 2007 totals K€ 113. In 2008, the Company will have to pay K€ 22 for legal consulting services.

Maintenance Contract Services

As of December 31, 2005, the Company had a minimum purchase obligation for maintenance services totaling K€ 253 resulting from several maintenance contracts signed by the Company; the purchase obligation concerns the 2006 calendar year.

Media Services

As of December 31, 2005, the Company had a minimum purchase obligation for media services totaling K€ 100 resulting from an order production agreement concluded by the Company; the purchase obligation concerns the 2006 calendar year.

2. Contingent Liabilities

The Company is involved in various lawsuits in connection with its business. However, the outcome of these lawsuits will probably not have any significant adverse effect on the Company's business, financial position or results of operations. The Company creates appropriate provisions for legal disputes pending beyond year's end.

There were no other contingent liabilities or commitments requiring disclosure as of the balance sheet date.

3. Related Party Relationships

3.1. Management Board

The total remuneration of the Management Board of K€ 983 (previous year: K€ 842) is the sum of all cash compensation and non-cash benefits. It is composed of fixed and variable, performance-based compensation components. The variable component in the 2005 financial year, which consists primarily of bonus payments, was approximately 3 % (previous year: 16 %). One-time compensation to former board members in the 2005 financial year was approximately K€ 163 (previous year: K€ 120).

One member of the Management Board was granted a variable credit line in the maximum amount of K€ 625 (previous year: K€ 500), of which K€ 625 was used as of December 31, 2005 (previous year: K€ 500). The agreed interest rate is 4.25 % and is fixed until December 31, 2007. The loan can be terminated with a notice period of one year. No repayments were made in the 2005 financial year (previous year: K€ 125) and a total of K€ 125 was newly extended (previous year: K€ 355). The loan, for which a full valuation allowance was recognized, is secured by a mortgage in the amount of K€ 200 (previous year: K€ 200). There were no salary advances granted to members of the Management Board during the year (interest on salary advances in the previous year: 4.25 %).

By agreement dated December 15, 2004, all members of the Management Board irrevocably waived the options granted to them in connection with the existing stock option plans. There were no new stock options issued in the 2005 financial year under the 2003 / 2005 Stock Option Plan (previous year: 50,000 options).

The Company also did not grant any bonus units to the members of the Management Board under the 2003 / 2005 Bonus Plan in the 2005 financial year (previous year: 50,000).

With respect to further disclosures regarding existing plans, please see Section B no. 2.5.6.

3.2. Supervisory Board

The remuneration of the Supervisory Board is determined by the Annual Stockholders’ Meeting, on recommendation of the Management Board and the Supervisory Board. It is regulated by Section 20 of the articles of incorporation of Zapf Creation AG. The cash compensation includes a fixed and a dividend-based component.

On May 7, 2003, it was resolved to pay the chairman of the Supervisory Board a fixed compensation of K€ 28 (net), the vice chairman of the Supervisory Board a fixed compensation of K€ 21 (net), and all other members of the Supervisory Board a fixed compensation of K€ 14 (net). The compensation paid to Supervisory Board members who were not in office for a full financial year is pro rated in accordance with the duration of their membership on the Supervisory Board.

The variable bonus is calculated as follows: € 100.00 for each € 0.01 of dividend in excess of € 0.50 per no-par value share which is distributed to the stockholders for the expired financial year. No provision was created for the financial year ended (previous year: K€ 30).

The total obligation for the remuneration of the Supervisory Board in the 2005 financial year as of the balance sheet date of December 31, 2005 was K€ 88 (previous year: K€ 135).

There were no loans to members of the Supervisory Board in the past two financial years.

4. Events after the Balance Sheet Date

On February 2, 2006, the Company announced that Dr. Georg Kellinghusen would take over the job of chief financial officer of Zapf Creation AG effective February 15, 2006. After the departure of Mr. Rudolf Winning on March 15, 2005, and the resignation of Dr. Peter Klein, deputy member of the Management Board, who had taken over the position on an interim basis, the position had been vacant since October 17, 2005.

In a meeting on March 28, 2006, all eight banks agreed to grant the Zapf Creation Group secured financing under changed conditions for the next twelve months, including a seasonal line of credit. The agreement was confirmed by Deutsche Bank, the lead manager, on April 18, 2006. This letter confirms that all of the participating banks have declared their agreement to continue cooperation with Zapf Creation AG, thus eliminating the reservation expressed by some of the banks.

Further findings were made in the course of the ongoing audit of the 2005 consolidated financial statements by the Rödl & Partner auditing firm. Additional investigations indicated that legal regulations were knowingly violated. The Company has therefore filed charges. The KPMG auditing firm was then asked to examine certain accounting matters in 2003/2004. The partial report on this audit was presented on April 10, 2006.

Based on a Supervisory Board resolution of May 17, 2006, Mr. Thomas Eichhorn on May 18, 2006 was dismissed as member and chairman of the Management Board effective immediately. The Supervisory Board endeavors to make a decision regarding his successor very soon.

5. Disclosures Pursuant to Section 160 No. 8 German Stock Corporation Act (AktG)

Schroder Administration Limited, London/Great Britain, informed the Company pursuant to Section 21 para 1 German Securities Trading Act (WpHG) that its voting share in Zapf Creation AG on June 1, 2004 exceeded the threshold of 10% and as of that date equaled 10.06%. The voting rights are attributable to Schroder Administration Limited pursuant to Section 22 para 1 sentence 1 no. 6 and sentences 2 and 3 German Securities Trading Act.

FMR Corp., Boston, Massachusetts/USA, informed the Company pursuant to Section 21 para 1 German Securities Trading Act that its voting share in Zapf Creation AG on February 4, 2005 fell below the threshold of 5% and as of that date equaled 4.69%. The voting rights are attributable to Fidelity Management & Research Company, Boston, Massachusetts/USA pursuant to Section 22 para 1 sentence 1 no. 6 in connection with sentences 2 and 3 German Securities Trading Act.

Schroders plc and Schroder Holdings plc, both London/Great Britain, informed the Company pursuant to Section 21 para 1 German Securities Trading Act that its voting share in Zapf Creation AG on February 21, 2005 fell below the threshold of 10% and as of that date equaled 9.77%. The voting rights are attributable to Schroders plc and Schroder Holdings plc pursuant to Section 22 para 1 sentence 1 no. 6 and sentences 2 and 3 German Securities Trading Act. Schroder Investment Management Ltd., London/Great Britain, informed the Company pursuant to Section 21 para 1 German Securities Trading Act that its voting share in Zapf Creation AG on February 21, 2005 fell below the threshold of 10% and as of that date equaled 9.77%. The voting rights are attributable to Schroder Investment Management Ltd. pursuant to Section 22 para 1 sentence 1 no. 6 German Securities Trading Act.

Schroder Administration Limited, London / Great Britain, informed the Company pursuant to Section 21 para 1 German Securities Trading Act that its voting share in Zapf Creation AG on February 24, 2005 fell below the threshold of 10 % and as of that date equaled 9.77 %. The voting rights are attributable to Schroder Administration Limited pursuant to Section 22 para 1 sentence 1 no. 6 and sentences 2 and 3 German Securities Trading Act.

Tocqueville Finance SA, Paris / France, informed the Company pursuant to Section 21 para 1 German Securities Trading Act that its voting share in Zapf Creation AG on April 1, 2005 fell below the threshold of 5 % and as of that date equaled 4.17 %. The voting rights are attributable to Tocqueville Finance SA, Paris / France, pursuant to Section 22 para 1 sentence 1 no. 6 German Securities Trading Act.

Nicolas Mathys, Zurich / Switzerland, informed the Company pursuant to Section 21 para 1 German Securities Trading Act that his voting share in Zapf Creation AG on October 18, 2005 exceeded the threshold of 5 % and as of that date equaled 6.03 %.

Schroder Holdings plc, London / Great Britain, informed the Company pursuant to Section 21 para 1 German Securities Trading Act that its voting share in Zapf Creation AG on October 26, 2005 fell below the threshold of 5 % and as of that date equaled 0 %. The voting rights are attributable to Schroder Holdings plc pursuant to Section 22 para 1 sentence 1 no. 6 and sentences 2 and 3 German Securities Trading Act.

Bestinver Gestión, Madrid / Spain, informed the Company pursuant to Section 21 para 1 German Securities Trading Act that its voting share in Zapf Creation AG on November 18, 2005 exceeded the threshold of 5 % and as of that date equaled 5.104 %. The voting rights are attributable to Bestinver Gestión, Madrid / Spain, pursuant to Section 22 para 1 sentence 1 no. 6 German Securities Trading Act.

6. Disclosures Pursuant to Section 315 a German Commercial Code (HGB)

6.1. Shareholdings

With regard to the investment structure in the Zapf Creation Group, please see the presentation of Group subsidiaries, which is attached to these notes as Appendix 1.

6.2. Management Board

Composition
The Company's Management Board is comprised as follows:

Dr. Georg Kellinghusen, Management Board Member, appointed until February 15, 2009
- Finance, Controlling, Accounting, Risk Management, Human Resources, Organization, Investor Relations, Public Relations, IT, Strategy & Corporate Development, Internal Audit, Central Planning & Disposition, Purchasing, Quality Assurance, Logistics, Sales (on an interim basis), Marketing (on an interim basis)

Angelika Marr, Management Board Member, appointed until December 31, 2007
- Design, Product Development

Changes

The following changes occurred with regard to the composition of the Management Board during the period under review:

On February 22, 2005, the Supervisory Board appointed Dr. Peter Klein, a regular member of the Supervisory Board since April 15, 1999, to the Company's Management Board as a deputy member (Finance, Legal Affairs, Risk Management, Organization, Investor Relations, Logistics, IT, Human Resources and Production). On October 17, 2005, Dr. Klein resigned from his office and reassumed his duties as a Supervisory Board member effective that date. His membership in the Supervisory Board had been inactive until then.

On March 15, 2005, Mr. Rudolf Winning, Management Board member, resigned from his office and left the Company effective that date. During his time with the Company, Mr. Winning had been responsible for Finance, Legal Affairs, Risk Management, Organization, Investor Relations, Logistics and IT.

Dr. Georg Kellinghusen was appointed the Company's new chief financial officer by the Supervisory Board of Zapf Creation AG effective February 15, 2006.

Based on a Supervisory Board resolution of May 17, 2006, Mr. Thomas Eichhorn on May 18, 2006 was dismissed as member and chairman of the Management Board effective immediately.

Disclosures Regarding Compensation

Please see the related party disclosures in Section C no. 3.1. for information on the compensation of the Management Board.

Discloses Pursuant to Section 15 a German Securities Trading Act (WpHG)

The Company was not notified of any transactions made by members of the Management Board, their spouses or immediate relatives requiring disclosure pursuant to Section 15 a German Securities Trading Act. All members of the Management Board have been informed in detail regarding the disclosure requirement.

6.3. Supervisory Board

Composition

The Company's Supervisory Board is comprised as follows:

Martin Gruschka, chairman of the Supervisory Board, member since May 11, 2005
- Main occupation: Managing Member, Springwater Capital LLC.
- Further offices: Fontaine Holdings Ltd., director; Medicforma AG, Supervisory Board member; SSCP Plastics Holding S.A., director; SSCP Coatings S.à r.l., Advisory Board member; Springwater Holdings S.à r.l., Advisory Board member; Springwater Property Holdings S.à r.l., Advisory Board member; The Carbo Group GmbH, Advisory Board member; SWC Property S.à r.l., Advisory Board member; SWC I, Inc., Advisory Board member; SWC Research Ltd., director; MW Zander Luxembourg Holdings S.A., director; MWZ Beteiligungs GmbH, managing director

Gustavo Perez, vice chairman, member since May 11, 2005
- Main occupation: Chief executive officer, Betham Capital Investment
- No further offices

Francesc Robert, regular member since May 11, 2005
- Main occupation: Chief executive officer and chairman of the Supervisory Board, Octapris Investments S.L.
- Further offices: Daren Motorsport S.L., chairman; Irbe Xarxa 2001 S.L., chairman; La Seda de Barcelona S.A., vice chairman; Nominalia Internet S.L., vice chairman; Centric Software S.L., regular member; Kroopier S.L., regular member; USAP S.A., regular member; Angels Business & Financial Corporation, chairman

Miguel Perez-Carballo Villar, regular member since September 14, 2005
- Main occupation: Chief executive officer and managing director, Norte Motor S.A., and managing director, Uria Motor S.A.
- No further offices

Dr. Peter Klein, regular member since April 15, 1999 *
- Main occupation: Managing partner, Klein & Company GmbH
- Further offices: GetAhead AG, chairman

Changes

The following changes occurred with regard to the composition of the Supervisory Board during the period under review:

On February 4, 2005, Dr. Horst F. Bröcker, vice chairman of the Supervisory Board since March 18, 1999, resigned as a member of the Supervisory Board. At the time of his departure from the Supervisory Board, Dr. Bröcker's primary employment was as managing director and partner of Egon Zehnder International, Munich. Dr. Bröcker did not hold any additional supervisory board offices at the time of his departure.

On May 11, 2005, Dr. Petra Wibbe and Mr. Hans-Gerd Füchtenkort, both regular members of the Supervisory Board since March 18, 1999, left the Supervisory Board. At the time of her departure from the Supervisory Board, Dr. Wibbe worked as an attorney and did not hold any additional supervisory board offices. At the time of his departure, Mr. Füchtenkort's primary employment was as a managing partner and partner of Dr. Rochus Mummert and Partners. In addition to his office at Zapf Creation, at the time of his departure he held an additional supervisory board office at TUJA Holding GmbH.

On May 11, 2005, the following gentlemen were appointed to the Supervisory Board:
Mr. Gustavo Perez, who has since been the vice chairman of the Supervisory Board, Mr. Martin Gruschka, who initially was a regular member, and Mr. Francesc Robert, who is a regular member.

On July 7, 2005, Dr. Dietmar Scheiter resigned from his office as chairman of the Company's Supervisory Board. Mr. Martin Gruschka took over the position of chairman. At the time of his departure from the Supervisory Board on August 5, 2005, Dr. Scheiter was the chairman of the Management Board of TA Triumph-Adler AG. At that time, he did not hold any further offices in addition to his office as a member of the Supervisory Board of Zapf Creation.

On September 14, 2005, Mr. Miguel Perez-Carballo Villar was appointed to the Supervisory Board as a regular member.

* The membership of Dr. Peter Klein was inactive from February 22, 2005 to October 17, 2005. During that time, Dr. Klein served as a deputy member of the Company's Management Board.

On November 18, 2005, Mr. Arnd Wolpers, regular member of the Supervisory Board since March 18, 1999, left the Supervisory Board. At the time of his departure from the Supervisory Board, Mr. Wolpers primary employment was as managing director of Capital Management Wolpers GmbH. In addition to his Supervisory Board office at Zapf Creation, he held further Supervisory Board offices at Articon-Integralis AG (chairman) and Bavaria Industriekapital AG (regular member) at the time of his departure.

Disclosures Regarding Compensation
Please see the related party disclosures in Section C no. 3.2. for information on the compensation of the Supervisory Board.

Disclosures Pursuant to Section 15 a German Securities Trading Act (WpHG)
On February 16, 2005, transactions requiring disclosure pursuant to Section 15 a German Securities Trading Act were made by family members of Mr. Wolpers. Overall, 24,500 shares were sold within a price range of € 14.63 to € 14.80. The Company was not notified of any other transactions requiring disclosure made by members of the Supervisory Board, their spouses or immediate relatives. All members of the Supervisory Board have been informed in detail regarding the disclosure requirement.

6.4. Disclosure of the Auditor’s Fee

Rödl & Partner GmbH, Wirtschaftsprüfungsgesellschaft, Nuremberg, Germany, is the auditor of the consolidated financial statements of Zapf Creation AG.

The following auditor’s fees were recognized as an expense in the reporting period:

	2005 K€
Audit of the annual and consolidated financial statements	467
Tax consultancy services	34
Other services	273
Auditor’s fee	774

6.5. Declaration of Conformity Regarding the German Corporate Governance Code

The Company points out that it has issued the Declaration of Conformity with the Corporate Governance Code as required by Section 161 of the German Stock Corporation Act (AktG) and made this declaration available to the stockholders.

7. Disclosures Pursuant to Section 264 b German Commercial Code (HGB)

Zapf Creation (Central Europe) GmbH & Co. KG and Zapf Creation Logistics GmbH & Co. KG, both domiciled in Roedental, Germany, avail themselves of the exemption provisions of Section 264 b German Commercial Code (HGB).

Nevertheless, both companies subject themselves to a voluntary audit of their annual financial statements.

D. Disclosures Regarding Error Corrections in Connection with the Reconciliation to IFRS

On the initiative of both the Management Board and Supervisory Board, a special audit of single-entity financial statements of Zapf Creation AG and individual subsidiaries of the Zapf Creation Group as well as of the consolidated annual financial statements as of December 31, 2004, was conducted by the KPMG auditing firm between October 2005 and April 2006. The special audit was initiated in order to fully investigate individual findings made during the current 2005 financial year.

1. Effects on the Consolidated Balance Sheet as of January 1, 2004 before Reconciliation to IFRS

Taking into account the error correction pursuant to IFRS 1.41, the Company voluntarily prepared a proforma consolidated balance sheet according to US GAAP as of December 31, 2003. In this connection, we refer to the presentation of the balance sheet as of December 31, 2003 (proforma US GAAP), which is attached to these notes as Appendix 4 a.

The following corrections were made:

Trade receivables declined by K€ 11,306. This reduction resulted in particular from the recognition of provisions for merchandise returns and the increase of existing provisions for sales deductions, as well as the reclassification of provisions for advertising cost subsidies to customers previously recognized as liabilities. These subsidies must be classified as sales deductions and deducted from receivables as a contra-asset. In addition, an adjustment for deliveries made under DDP terms (Delivered Duty Paid), the sales from which are not recognized until transfer of economic control to the customer, resulted in a reduction in receivables. The reported receivables balance was also reduced due to the classification of warehouse stock at a customer as consignment stock, resulting in later and reduced revenue.

The value of inventories increased by K€ 57. This increase is substantially the result of the changed recognition of merchandise returns, deliveries of goods under DDP delivery terms, and the classification of warehouse stock at a customer as consignment stock.

Other assets increased by K€ 3,121. The increase is essentially the result of the recognition of the current income tax asset as a result of the decline in earnings in the German companies of the Zapf Creation Group.

Prepaid expenses decreased by a total of K€ 1,613, primarily due to the revaluation of the barter transactions in the USA. A total of K€ 1,337 is shown as prepaid expenses under non-current assets.

Deferred tax assets increased by K€ 369 as a result of the explained adjustments of the carrying amounts of assets and liabilities under the German Commercial Code because the correction results in differences compared to the carrying amounts to be used for tax purposes.

Trade payables increased by K€ 39 due to trailing invoices.

Provisions and other liabilities increased on the one hand due to the previously insufficient recognition of provisions, while on the other hand advertising cost subsidies to customers were reclassified as sales deductions and recognized under trade receivables. The two effects subsequently resulted in a reduction of this item by K€ 564.

Equity declined by K€ 8,847 to K€ 46,244 as a result of the correction of the financial statements. "Net profit or loss for the period and profit brought forward" declined by K€ 9,993, while other recognized income and expense increased by K€ 1,146 as result of exchange rate effects.

In detail, equity developed as follows:

	K€
Equity as of January 1, 2004 (US GAAP)	55,091
Decrease in trade receivables	–11,306
Increase in inventories	57
Increase in other assets	3,121
Decrease in prepaid expenses	–1,613
Increase in deferred tax assets	369
Increase in trade payables	–39
Decrease in provisions and other liabilities	564
Equity after error correction as of January 1, 2004	**46,244**

2. Effects on the Consolidated Income Statement 2004 before IFRS Reconciliation

Taking into account the error correction pursuant to IFRS 1.41, the Company voluntarily prepared a proforma consolidated income statement according to US GAAP for the 2004 financial year. In this connection, we refer to the presentation of the income statement for the 2004 financial year (proforma US GAAP), which is attached to these notes as Appendix 4 b.

The following corrections were made:

Revenue declined by K€ 10,486. This decline was essentially a result of the reclassification within the income statement of individual expense items from selling expenses and cost of sales to sales deductions. This reclassification did not affect earnings. This essentially concerned advertising cost subsidies granted to customers, freight reimbursements paid, and sales promotion expenses requiring classification as sales reductions. This resulted in a corresponding reduction of both selling expenses and cost of sales.

The allocation of expenses to the proper period also resulted in a need to correct sales recognized in the income statement. This was caused by provisions for returns not previously recognized and provisions for sales reductions not recognized in a sufficient amount. In addition, an adjustment for deliveries made under DDP terms (Delivered Duty Paid), the sales from which are not recognized until transfer of economic control to the customer, resulted in a reduction in sales. The reported sales were also reduced due to the classification of warehouse stock at a customer as consignment stock, resulting in later and reduced revenue, and based on the revaluation of the barter transactions in the USA and Germany.

The corrected cost of sales totals K€ 85,646. This corresponds to an increase of K€ 2,341 with a simultaneous reduction of revenue.

This effect can be explained essentially by the increase of the expenses for incoming freight and picking and packing reported in the cost of sales due to the recognition of the expense in the proper period and by the reclassification of the external warehouse rent previously disclosed in selling and distribution expenses to cost of sales. Furthermore, the cost of sales for 2004 was also impacted by additional inventory writedowns as of the 2004 balance sheet date.

The cost of sales was reduced by the reclassification of freight reimbursements that are recognized as sales deductions to revenue. As a result of the correction of deliveries under DDP delivery terms and the classification of warehouse stock at a customer as consignment stock, the cost of sales was adjusted analogously.

Selling and distribution expenses were reduced by K€ 12,017. The reduction resulted primarily from the reclassification within the income statement of the expense items mentioned above from selling and distribution expenses to revenue and cost of sales. The increase in recognized expenses for outgoing freight, an increase in provisions and setting up a provision for performance-based employee compensation had a compensatory effect.

Marketing expenses increased by K€ 52. This increase was caused by the recognition of trailing invoices for marketing in the proper period as well as the establishment of a provision for performance-based employee compensation. The increased use of trading credits from barter transactions owned by the Company had a compensatory effect.

In the US GAAP consolidated income statement, administrative expenses less other income are shown in a single line item. After correction, this net item increased by K€ 456. The increase resulted essentially from the establishment of insufficient provisions for trailing incoming invoices and from the recognition of a missing provision for performance-based employee compensation.

Income taxes declined by K€ 83. This decline resulted from the reversal of a deferred tax liability totaling K€ 249 and from an offsetting expense totaling K€ 166 from the increase in the income tax assessment basis.

The result for the period is reconciled as follows:

	K€
Net income for the 2004 financial year (US GAAP)	955
Decrease in revenue	−10,486
Increase in cost of sales	−2,341
Decrease in selling and distribution expenses	12,017
Increase in marketing expenses	−52
Increase in administrative expenses and other income	−456
Decrease in income taxes	83
Net loss after corrections for the 2004 financial year	**−280**

3. Effects on the Consolidated Balance Sheet as of December 31, 2004 before Reconciliation to IFRS

Taking into account the error correction pursuant to IFRS 1.41, the Company voluntarily prepared a proforma consolidated balance sheet according to US GAAP as of December 31, 2004. In this connection, we refer to the presentation of the balance sheet as of December 31, 2004 (proforma US GAAP), which is attached to these notes as Appendix 4 c.

The following corrections were made:

Trade receivables declined by K€ 9,825. This decline resulted in particular from the establishment of previously unrecognized provisions for merchandise returns and from the increase of existing provisions for sales deductions, as well as from the reclassification of provisions for advertising cost subsidies to customers. These subsidies must be classified as sales deductions and deducted from receivables as a contra-asset. In addition, an adjustment for deliveries made under DDP terms (Delivered Duty Paid), the sales from which are not recognized until transfer of economic control to the customer, resulted in a reduction in receivables. The reported receivables balance was also reduced due to the classification of warehouse stock at a customer as consignment stock, resulting in later and reduced revenue.

The value of inventories increased by K€ 393. This increase is substantially the result of the changed recognition of merchandise returns, deliveries of goods under DDP delivery terms, and the classification of warehouse stock at a customer as consignment stock. The change in the balance sheet disclosure also takes into account additional expenses from higher valuation allowances on inventory as of December 31, 2004.

Other assets increased by K€ 2,434. The increase is essentially the result of the recognition of the current income tax asset in the previous year as a result of the decline in earnings in the German companies of the Zapf Creation Group.

Prepaid expenses declined by a total of K€ 1,815. This is essentially due to the revaluation of the barter transactions in the USA and Germany; in addition, as of December 31, 2004, an allowance was made on the capitalized assets from barter transactions in the Zapf Creation (U.S.) Inc. Group subsidiary. A total of K€ 1,349 is shown as prepaid expenses under non-current assets.

Deferred tax assets increased by K€ 460 as a result of the explained adjustments of the carrying amounts of assets and liabilities under the German Commercial Code because the correction results in differences compared to the carrying amounts to be used for tax purposes.

Trade payables increased by K€ 115 due to trailing invoices.

Income tax liabilities increased by K€ 24. This increase was due to the resulting higher taxable assessment basis.

Provisions and other liabilities increased on the one hand due to the previously insufficient recognition of provisions, while on the other hand advertising cost subsidies to customers were reclassified as sales deductions and recognized under trade receivables. The two effects subsequently resulted in an increase of this item by K€ 1,192.

Equity declined by K€ 9,460 to K€ 38,580 as a result of the correction of the financial statements. Capital reserves were adjusted by K€ 54. “Net profit or loss for the period and profit brought forward” declined by K€ 11,228, while other recognized income and expense increased by K€ 1,714 as result of exchange rate effects.

In detail, equity developed as follows:

	K€
Equity as of December 31, 2004 (US GAAP)	48,040
Decrease in trade receivables	−9,825
Increase in inventories	393
Increase in other assets	2,434
Decrease in prepaid expenses	−1,815
Increase in deferred tax assets	460
Increase in trade payables	−115
Increase in income tax liabilities	−24
Increase in provisions and other liabilities	−1,192
Decrease in deferred liabilities	224
Equity after error correction as of December 31, 2004	**38,580**

E. Explanation of the Reconciliation from US GAAP to IFRS after Error Corrections

The consolidated financial statements of Zapf Creation AG for the 2005 financial year, as well as for the corresponding period of the previous year, were prepared in accordance with IFRS for the first time. The accounting transition from the previous US GAAP to IFRS was made pursuant to the provisions of IFRS 1 (First-time Adoption of International Financial Reporting Standards) retrospectively as of January 1, 2004.

1. Reconciliation of the Consolidated Balance Sheet under IFRS as of January 1, 2004

With regard to the reconciliation of the corrected (proforma US GAAP) consolidated balance sheet to the consolidated balance sheet under IFRS as of January 1, 2004, please see the voluntary presentation of the balance sheet as of January 1, 2004 (IFRS), which is attached to these notes as Appendix 5 a.

The following corrections were made:

Trade receivables increased by K€ 8,264, as the sales deductions in the Zapf Creation Group were previously recognized as a contra-asset and deducted from receivables. Under IFRS, sales deductions are recognized under trade payables.

Income tax receivables are disclosed separately under IFRS. The income tax receivables totaling K€ 5,374 were therefore reclassified from other assets.

Other assets declined by a total of K€ 3,807. In addition to the reclassification of the income tax receivables totaling K€ 5,374, advertising totaling K€ 715, TV and printing costs totaling K€ 297, and catalogs totaling K€ 171, which were previously capitalized under US GAAP, are no longer recognized as assets under IFRS given the definition of an asset and because advertising costs may not be capitalized under IFRS. In contrast, other assets increased by K€ 2,750 as the prepaid expenses reported as a separate item under US GAAP were recorded under other assets in IFRS.

The prepaid expenses are disclosed under other assets in the IFRS consolidated balance sheet.

Deferred tax assets are treated as non-current under IFRS. The (current) deferred tax receivables have therefore been reclassified.

In the US GAAP consolidated balance sheet, software had previously been recognized under "Property, plant and equipment and software". Under IFRS, software is an intangible asset. Software totaling K€ 3,485 has therefore been reclassified to intangible assets.

Trade payables increased by K€ 11,969 as sales deductions are no longer recognized as a contra-asset and deducted from trade receivables under IFRS, but rather are recognized as a liability. In addition, obligations previously reported under "Accrued liabilities", in particular for outstanding invoices, were reclassified to trade payables.

Under IFRS, provisions are disclosed as a separate line item. Personnel obligations in particular are disclosed under other liabilities.

The provisions remaining after the reclassifications include obligations arising from expected merchandise returns totaling K€ 2,543 and from bonus programs totaling K€ 177.

Deferred tax liabilities are treated as non-current under IFRS. The (current) deferred tax liabilities have therefore been reclassified. Deferred tax liabilities declined by a total of K€ 505. This relates to deferred taxes on the temporary differences from the non-capitalization of advertising, TV and printing costs, and catalogs, as well as from the recognition of the obligations from the bonus plans, which have been offset against corresponding deferred tax liabilities pursuant to IAS 12.

In detail, equity developed as follows:

	K€
Equity after error correction as of January 1, 2004	46,244
Non-capitalization of advertising	−715
Non-capitalization of TV and printing costs	−297
Recognition of obligations arising from bonus plans	−177
Non-capitalization of catalogs	−171
Deferred taxes on non-capitalization/recognition	505
Equity as of January 1, 2004 (IFRS)	**45,389**

The cumulative currency exchange losses totaling K€ 3,024 were set off against profit brought forward in exercise of the option under IFRS 1.

2. Reconciliation of the 2004 Consolidated Income Statement under IFRS

With regard to the reconciliation of the corrected (proforma US GAAP) consolidated income statement to the consolidated income statement under IFRS for the 2004 financial year, please see the voluntary presentation of the income statement for the 2004 financial year (IFRS), which is attached to these notes as Appendix 5 b.

The following corrections were made:

Marketing expenses declined by K€ 171. This was caused by the non-capitalization of advertising, TV and printing costs, and catalogs, which subsequently resulted in lower expenses in the 2004 financial year for advertising (K€ 90), TV and printing costs (K€ 49), and catalogs (K€ 32).

While administrative costs less other income are recognized as a single line item in the US GAAP consolidated income statement, the IFRS consolidated income statement differentiates between administrative expenses, other income and other expenses. As a result of the reclassification to other income, administrative expenses increased by K€ 1,827, while the reclassification to other expenses resulted in a reduction of K€ 240. In addition, the provision for obligations arising from the bonus plans in the 2004 financial year totaling K€ 88 was reversed.

Income taxes increased by K€ 97. This concerns the deferred taxes on the marketing expenses, which were reduced due to the non-capitalization of advertising, TV and printing costs, and catalogs, as well the deferred taxes on the reversal of the provision for obligations from the bonus plans.

The result for the period is reconciled as follows:

	K€
Net loss after corrections for the 2004 financial year	−280
Decrease in advertising expenses	90
Decrease in TV and printing costs	49
Decrease in expenses for catalogs	32
Partial reversal of obligations arising from bonus plans	88
Deferred taxes on the reduced marketing and administrative expenses	−97
Net loss for the 2004 financial year (IFRS)	**−118**

3. Reconciliation of the Consolidated Balance Sheet under IFRS as of December 31, 2004

With regard to the reconciliation of the corrected (proforma US GAAP) consolidated balance sheet to the consolidated balance sheet under IFRS as of December 31, 2004, please see the voluntary presentation of the balance sheet as of December 31, 2004 (IFRS), which is attached to these notes as Appendix 5 c.

The following corrections were made:

Trade receivables increased by K€ 6,262, as the sales deductions in the Zapf Creation Group were previously recognized as a contra-asset and deducted from receivables. Under IFRS, sales deductions are recognized under trade payables.

Income tax receivables are disclosed separately under IFRS. The income tax receivables totaling K€ 7,270 were therefore reclassified from other assets.

Other assets declined by a total of K€ 6,476. In addition to the reclassification of the income tax receivables totaling K€ 7,270, advertising totaling K€ 625, TV and printing costs totaling K€ 248, and catalogs totaling K€ 139, which were previously capitalized under US GAAP, are no longer recognized under IFRS given the definition of an asset and because advertising costs may not be capitalized under IFRS. In contrast, other assets increased by K€ 1,806 as the prepaid expenses reported as a separate item under US GAAP were recorded under other assets in IFRS.

The prepaid expenses are disclosed under other assets in the IFRS consolidated balance sheet.

Deferred tax assets are treated as non-current under IFRS. The (current) deferred tax receivables have therefore been reclassified.

In the US GAAP consolidated balance sheet, software had previously been recognized under "Property, plant and equipment and software". Under IFRS, software represents an intangible asset. Software totaling K€ 3,762 has therefore been reclassified to intangible assets.

Deferred tax assets declined by a total of K€ 1,222. The deferred tax assets recognized on the temporary differences (advertising, TV and printing costs, catalogs, and provisions for obligations arising from the bonus plans) totaled K€ 407 as of the balance sheet date. In addition, they were offset against deferred tax liabilities in the amount of K€ 1,629, as required under IAS 12.

Trade payables increased by K€ 9,513 as sales deductions are no longer recognized as a contra-asset and deducted from trade receivables under IFRS, but rather are recognized as a liability. In addition, obligations previously reported under "Accrued liabilities", in particular for outstanding invoices, were reclassified to trade payables.

Under IFRS, provisions are disclosed as a separate line item. Personnel obligations in particular are disclosed under other liabilities.

The provisions remaining after the reclassifications include obligations arising from expected merchandise returns totaling K€ 2,374 and from bonus programs totaling K€ 89.

Deferred tax liabilities are treated as non-current under IFRS. The (current) deferred tax liabilities have therefore been reclassified. As a result of the offsetting against deferred tax assets, deferred tax liabilities declined by a total of K€ 1,629.

In detail, equity developed as follows:

	K€
Equity after error correction as of December 31, 2004	38,580
Non-capitalization of advertising	−625
Non-capitalization of TV and printing costs	−248
Recognition of obligations arising from bonus plans	−89
Non-capitalization of catalogs	−139
Deferred taxes on non-capitalization / recognition	408
Equity as of December 31, 2004 (IFRS)	**37,887**

4. Effects of the Reconciliation to IFRS on the Cash Flow Statement for the 2004 Financial Year

The transition from US GAAP to IFRS essentially shows the following effects on the 2004 cash flow statement:

In contrast to the US GAAP cash flow statement, the cash flow from operating activities under IFRS is determined on the basis of earnings before income taxes (and not based on the annual result). Income tax payments are disclosed as a separate item.

In the future, interest paid and received will be recognized as part of the cash flow from financing activities, which means that it will have to be stripped out from the cash flow from operating activities.

The cash flow from financing activities under IFRS will show cash receipts from non-current bank borrowings and cash payments for the repayment of such borrowings as separate items from changes in liabilities due to current borrowings.

Roedental, Germany, May 29, 2006

Dr. Georg Kellinghusen
Member of the Management Board

Angelika Marr
Member of the Management Board

Appendix 1

Group Subsidiaries – 2005 Financial Year

Company	Headquarters	Date of formation
Zapf Creation (H.K.) Ltd.	Causeway Bay, Hong Kong	Apr. 30, 1991
Zapf Creation (U.S.) Inc.	Orlando, Florida, USA	Apr. 15, 1999
Zapf Creation (France) S.à.r.l.	Limonest, France	Jan. 1, 2000
Zapf Creation (U.K.) Ltd.	Corby, Northants, GB	Jan. 1, 2000
Zapf Creation (CZ) s.r.o.	Prague, Czech Republic	July 26, 2001
Zapf Creation (Italia) S.R.L.	Gallarate, Italy	July 31, 2001
Zapf Creation (Polska) Sp. z o.o.	Warsaw, Poland	Aug. 9, 2001
Zapf Creation (España) S.L.	Alicante, Spain	Jan. 1, 2002
Zapf Creation (Central Europe) GmbH & Co. KG	Roedental, Germany	Mar. 24, 2003
Zapf Creation (Central Europe) Verwaltungs GmbH	Roedental, Germany	Mar. 24, 2003
Zapf Creation Logistics GmbH & Co. KG	Roedental, Germany	Mar. 24, 2003
Zapf Creation Logistics Beteiligungs GmbH	Roedental, Germany	Mar. 24, 2003

The results for the 2005 accounting period and the resulting equity as of December 31, 2005 are based on IFRS.

Percentage held in issued capital	Carrying amounts of Zapf Creation AG as of Dec. 31, 2005 after allowance	Net profit or loss for the period, 2005	Equity as of Dec. 31, 2005
	€	Local currency	Local currency
100 %	795,979.77 €	11,634,593.08 HKD	89,811,065.67 HKD
100 %	93.40 €	7,563,714.03 USD	−9,968,886.97 USD
100 %	0.00 €	−1,257,303.25 €	−1,189,644.17 €
100 %	153,964.00 €	1,675,082.15 GBP	1,175,363.82 GBP
100 %	0.00 €	−12,618,319.64 CZK	4,917,935.75 CZK
100 %	50,000.00 €	−299,099.54 €	−439,458.17 €
100 %	13,794.62 €	4,051,673.10 PLN	2,657,402.45 PLN
100 %	129,075.13 €	799,866.31 €	5,572,636.29 €
100 %	27,004,410.01 €	−6,136,781.11 €	22,691,803.94 €
100 %	25,000.00 €	12.43 €	22,222.41 €
100 %	2,965,852.09 €	36,364.35 €	2,283,192.02 €
100 %	25,000.00 €	−124.83 €	22,083.58 €
	31,163,169.02 €		

Appendix 2

Statement of Changes in Property, Plant and Equipment and Intangible Assets from January 1 to December 31, 2005

	Cost					
	Jan. 1, 2005	Additions	Disposals	Transfers	Currency translation	Dec. 31, 2005
	K€	K€	K€	K€	K€	K€
Property, plant and equipment						
Land and buildings	13,434	46	29	14	38	13,503
Machinery	2,675	1,012	233	153	307	3,914
Motor vehicles, furniture and fixtures, and office equipment	27,510	712	2,748	2	260	25,736
Assets under construction	243	550	296	–169	38	366
	43,862	2,320	3,306	0	643	43,519
Intangible assets						
Patents, brand names and licenses	7,109	67	0	0	1	7,177
Goodwill	286	0	301	0	15	0
Computer software	10,406	188	414	320	23	10,523
Assets under construction	332	94	0	–320	0	106
	18,133	349	715	0	39	17,806

Depreciation/amortization						Residual values	
Jan. 1, 2005	Additions	Disposals	Transfers	Currency translation	Dec. 31, 2005	Dec. 31, 2005	Dec. 31, 2004
K€	K€	K€	K€	K€	K€	K€	K€
6,272	535	12	0	26	6,821	6,682	7,162
2,004	931	233	0	203	2,905	1,009	671
12,495	2,704	1,727	0	127	13,599	12,137	15,015
0	0	0	0	0	0	366	243
20,771	4,170	1,972	0	356	23,325	20,194	23,091
1,795	772	0	0	0	2,567	4,610	5,314
286	0	301	0	15	0	0	0
6,976	2,019	294	0	15	8,716	1,807	3,430
0	0	0	0	0	0	106	332
9,057	2,791	595	0	30	11,283	6,523	9,076

Appendix 3

Consolidated Segment Reporting as of December 31, 2005

Segment Reporting by Region

	Central Europe *		Northern Europe *		Southern Europe *		Eastern Europe *	
	2005	2004	2005	2004	2005	2004	2005	2004
	K€	K€	K€	K€	K€	K€	K€	K€
Segment revenue	42,965	53,000	40,571	44,694	21,571	22,045	12,854	9,447
Earnings before interest, taxes, depreciation and amortization (EBITDA) ***	–19,563	2,858	3,901	11,361	–259	3,057	1,721	1,817
Assets	147,048	129,128	19,619	20,317	24,449	17,549	3,165	5,537
Capital expenditure	624	7,253	80	204	22	82	8	24
Depreciation/amortization	5,207	5,500	190	206	134	154	67	90
Liabilities	54,998	50,150	21,922	16,132	16,292	10,290	3,291	6,225

* The European segments comprise the following countries:
Central Europe: Germany, Austria, Switzerland, the Netherlands and Luxembourg (main countries)
Northern Europe: Great Britain, Ireland and Scandinavia (main countries)
Southern Europe: Spain, France, Belgium and Italy (main countries)
Eastern Europe: Russia, Poland, Czech Republic and Slovakia (main countries)

** The "Other" item comprises balance sheet items that are not included in segment assets or segment liabilities

*** Reporting of EBITDA before restructuring costs

Segment Reporting by Product Line

	Play and functional dolls							
	BABY born®		Baby Annabell®		CHOU CHOU		Other play and functional dolls	
	2005	2004	2005	2004	2005	2004	2005	2004
	K€	K€	K€	K€	K€	K€	K€	K€
Segment revenue	58,089	64,500	49,418	46,306	24,101	38,920	2,365	4,772

The Americas		Asia/Australia		Consolidation		Other **		Group total	
2005	2004	2005	2004	2005	2004	2005	2004	2005	2004
K€	K€	K€	K€	K€	K€	K€	K€	K€	K€
20,060	26,774	2,696	7,322	0	0	0	0	140,717	163,282
11,206	−7,210	1,391	1,813	0	0	0	0	−1,603	13,696
14,840	16,347	15,999	10,944	−107,748	−84,642	15,764	28,244	133,136	143,424
91	300	1,844	872	0	0	0	0	2,669	8,735
189	173	1,174	1,048	0	0	0	0	6,961	7,171
11,002	12,819	8,418	8,133	−76,584	−74,321	93,797	113,996	133,136	143,424

Mini dolls		Other products		Group total	
2005	2004	2005	2004	2005	2004
K€	K€	K€	K€	K€	K€
1,788	3,671	4,956	5,113	140,717	163,282

Appendix 4 a

Consolidated Balance Sheet as of December 31, 2003 (Proforma US GAAP)

	Dec. 31, 2003 after correction	Reconciliation	Dec. 31, 2003 before correction
	K€	K€	K€
Assets			
Current assets	**92,076**	**−11,078**	**103,154**
Cash	15,342	0	15,342
Trade receivables	36,593	−11,306	47,899
Inventories	29,175	57	29,118
Other assets	6,591	3,121	3,470
Prepaid expenses	2,750	−2,950	5,700
Deferred tax assets	1,625	0	1,625
Non-current assets	**32,975**	**1,706**	**31,269**
Property, plant and equipment	28,428	0	28,428
Intangible assets	2,494	0	2,494
Prepaid expenses	1,337	1,337	0
Deferred tax assets	716	369	347
Total assets	**125,051**	**−9,372**	**134,423**
Equity and liabilities			
Current liabilities	**63,375**	**−525**	**63,900**
Liabilities to banks	40,506	0	40,506
Trade payables	10,127	39	10,088
Income tax liabilities	1,463	0	1,463
Other liabilities	237	237	0
Provisions	10,545	−801	11,346
Deferred tax liabilities	497	0	497
Non-current liabilities	**15,432**	**0**	**15,432**
Liabilities to banks	14,780	0	14,780
Other liabilities	67	0	67
Deferred tax liabilities	585	0	585
Equity	**46,244**	**−8,847**	**55,091**
Issued capital	8,000	0	8,000
Capital reserves	8,052	0	8,052
Net profit or loss for the period and profit brought forward	44,708	−9,993	54,701
Other recognized income and expense	−3,158	1,146	−4,304
Treasury shares	−11,358	0	−11,358
Total equity and liabilities	**125,051**	**−9,372**	**134,423**

Appendix 4 b

Consolidated Income Statement
for the Financial Year from January 1 to December 31, 2004 (Proforma US GAAP)

	2004 after correction	Reconciliation	2004 before correction
	K€	K€	K€
Revenue	163,282	−10,486	173,768
Cost of sales	−85,646	−2,341	−83,305
Gross profit	**77,636**	**−12,827**	**90,463**
Selling and distribution expenses	−21,778	12,017	−33,795
Marketing expenses	−26,519	−52	−26,467
Administrative expenses and other income	−23,073	−456	−22,617
Earnings before interest and taxes	**6,266**	**−1,318**	**7,584**
Finance income	258	0	258
Finance costs	−3,836	0	−3,836
Earnings before income taxes	**2,688**	**−1,318**	**4,006**
Taxes on income	−2,968	83	−3,051
Net profit or loss for the period	**−280**	**−1,235**	**955**
Earnings per share (in €)	**−0.04**	**−0.17**	**0.13**

Appendix 4 c

Consolidated Balance Sheet as of December 31, 2004 (Proforma US GAAP)

	Dec. 31, 2004 after correction	Reconciliation	Dec. 31, 2004 before correction
	K€	K€	K€
Assets			
Current assets	**101,483**	**−10,162**	**111,645**
Cash	17,041	0	17,041
Trade receivables	44,036	−9,825	53,861
Inventories	28,676	393	28,283
Other assets	9,126	2,434	6,692
Prepaid expenses	1,806	−3,164	4,970
Deferred tax assets	798	0	798
Non-current assets	**37,913**	**1,809**	**36,104**
Property, plant and equipment	26,853	0	26,853
Intangible assets	5,314	0	5,314
Prepaid expenses	1,389	1,349	40
Deferred tax assets	4,357	460	3,897
Total assets	**139,396**	**−8,353**	**147,749**
Equity and liabilities			
Current liabilities	**89,752**	**1,331**	**88,421**
Liabilities to banks	62,689	0	62,689
Trade payables	13,263	115	13,148
Income tax liabilities	2,598	24	2,574
Other liabilities	121	121	0
Provisions	9,694	1,071	8,623
Deferred tax liabilities	1,387	0	1,387
Non-current liabilities	**11,064**	**−224**	**11,288**
Liabilities to banks	10,604	0	10,604
Deferred tax liabilities	460	−224	684
Equity	**38,580**	**−9,460**	**48,040**
Issued capital	8,000	0	8,000
Capital reserves	8,052	54	7,998
Net profit or loss for the period and profit brought forward	37,001	−11,228	48,229
Other recognized income and expense	−3,115	1,714	−4,829
Treasury shares	−11,358	0	−11,358
Total equity and liabilities	**139,396**	**−8,353**	**147,749**

Appendix 5 a

Consolidated Balance Sheet as of December 31, 2003 (Proforma US GAAP) and January 1, 2004 (IFRS)

	Jan. 1, 2004 IFRS Opening balance sheet	Reconciliation	Dec. 31, 2003 after correction
	K€	K€	K€
Assets			
Current assets	**97,532**	**5,456**	**92,076**
Cash	15,342	0	15,342
Trade receivables	44,857	8,264	36,593
Inventories	29,175	0	29,175
Income tax receivables	5,374	5,374	0
Other assets	2,784	−3,807	6,591
Prepaid expenses	0	−2,750	2,750
Deferred tax assets	0	−1,625	1,625
Non-current assets	**34,600**	**1,625**	**32,975**
Property, plant and equipment	24,943	−3,485	28,428
Intangible assets	5,979	3,485	2,494
Other assets (prepaid expenses)	1,337	0	1,337
Deferred tax assets	2,341	1,625	716
Total assets	**132,132**	**7,081**	**125,051**

	Jan. 1, 2004 IFRS Opening balance sheet	Reconciliation	Dec. 31, 2003 after correction
Equity and liabilities			
Current liabilities	**71,319**	**7,944**	**63,375**
Liabilities to banks	40,506	0	40,506
Trade payables	22,096	11,969	10,127
Income tax liabilities	1,463	0	1,463
Other liabilities	4,369	4,132	237
Provisions	2,885	−7,660	10,545
Deferred tax liabilities	0	−497	497
Non-current liabilities	**15,424**	**−8**	**15,432**
Liabilities to banks	14,780	0	14,780
Other liabilities	67	0	67
Deferred tax liabilities	577	−8	585
Equity	**45,389**	**−855**	**46,244**
Issued capital	8,000	0	8,000
Capital reserves	8,052	0	8,052
Net profit or loss for the period and profit brought forward	40,829	−3,879	44,708
Other recognized income and expense	−134	3,024	−3,158
Treasury shares	−11,358	0	−11,358
Total equity and liabilities	**132,132**	**7,081**	**125,051**

Appendix 5 b

Consolidated Income Statement
for the Financial Year from January 1 to December 31, 2004 (Proforma US GAAP and IFRS)

	2004 according to IFRS	Reconciliation	2004 after correction
	K€	K€	K€
Revenue	163,282	0	163,282
Cost of sales	−85,646	0	−85,646
Gross profit	**77,636**	**0**	**77,636**
Selling and distribution expenses	−21,778	0	−21,778
Marketing expenses	−26,348	171	−26,519
Administrative expenses and other income	−24,572	−1,499	−23,073
Other income	1,827	1,827	0
Other expenses	−240	−240	0
Earnings before interest and taxes	**6,525**	**259**	**6,266**
Finance income	258	0	258
Finance costs	−3,836	0	−3,836
Earnings before income taxes	**2,947**	**259**	**2,688**
Taxes on income	−3,065	−97	−2,968
Net profit or loss for the period	−118	162	−280
Earnings per share (in €)	−0.02	0.02	−0.04

Appendix 5 c

Consolidated Balance Sheet as of December 31, 2004 (Proforma US GAAP and IFRS)

	Dec. 31, 2004 according to IFRS	Reconciliation	Dec. 31, 2004 after correction
	K€	K€	K€
Assets			
Current assets	**105,935**	**4,452**	**101,483**
Cash	17,041	0	17,041
Trade receivables	50,298	6,262	44,036
Inventories	28,676	0	28,676
Income tax receivables	7,270	7,270	0
Other assets	2,650	−6,476	9,126
Prepaid expenses	0	−1,806	1,806
Deferred tax assets	0	−798	798
Non-current assets	**37,489**	**−424**	**37,913**
Property, plant and equipment	23,091	−3,762	26,853
Intangible assets	9,076	3,762	5,314
Other assets (prepaid expenses)	1,389	0	1,389
Deferred tax assets	3,933	−424	4,357
Total assets	**143,424**	**4,028**	**139,396**
Equity and liabilities			
Current liabilities	**94,715**	**4,963**	**89,752**
Liabilities to banks	62,689	0	62,689
Trade payables	22,776	9,513	13,263
Income tax liabilities	2,598	0	2,598
Other liabilities	3,953	3,832	121
Provisions	2,699	−6,995	9,694
Deferred tax liabilities	0	−1,387	1,387
Non-current liabilities	**10,822**	**−242**	**11,064**
Liabilities to banks	10,604	0	10,604
Deferred tax liabilities	218	−242	460
Equity	**37,887**	**−693**	**38,580**
Issued capital	8,000	0	8,000
Capital reserves	8,052	0	8,052
Net profit or loss for the period and profit brought forward	33,284	−3,717	37,001
Other recognized income and expense	−91	3,024	−3,115
Treasury shares	−11,358	0	−11,358
Total equity and liabilities	**143,424**	**4,028**	**139,396**

Auditor's Opinion

We have audited the consolidated financial statements of Zapf Creation AG, Roedental, comprising the consolidated balance sheet, the consolidated income statement, the consolidated statement of changes in equity, the consolidated cash flow statement and the notes to the consolidated financial statements, together with the management report of the Company and the Group for the financial year from January 1 to December 31, 2005. The preparation of the consolidated financial statements and the management report of the Company and the Group in accordance with IFRS as adopted by the EU, and the additional requirements of German commercial law pursuant to Section 315 a para 1 HGB (German Commercial Code) and supplementary provisions of the articles of incorporation is the responsibility of the Company's legal representatives. Our responsibility is to express an opinion on the consolidated financial statements and the management report of the Company and the Group based on our audit.

We conducted our audit of the consolidated financial statements in accordance with Section 317 HGB and the German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer e. V. (IDW). Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the consolidated financial statements in accordance with the applicable financial reporting framework and in the management report of the Company and the Group are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Group and expectations as to possible misstatements are taken into account in the determination of audit procedures. The effectiveness of the accounting-related internal control system and the evidence supporting the disclosures in the consolidated financial statements and the management report of the Company and the Group are examined primarily on a test basis within the framework of the audit. The audit includes assessing the annual financial statements of those entities included in consolidation, the determination of entities to be included in consolidation, the accounting and consolidation principles used and significant estimates made by the legal representatives, as well as evaluating the overall presentation of the consolidated financial statements and the management report of the Company and the Group. We believe that our audit provides a reasonable basis for our opinion.

Our audit has not led to any objections.

In our opinion, based on the findings of the audit, the consolidated financial statements comply with IFRS as adopted by the EU, the additional requirements of German commercial law pursuant to Section 315 a para 1 HGB and supplementary provisions of the articles of incorporation, and give a true and fair view of the net assets, financial position and results of operations of the Group. The management report of the Company and the Group is consistent with the consolidated financial statements and as a whole provides a suitable view of the Group's position and suitably presents the opportunities and risks of future development.

Without qualifying this opinion, we refer to the explanations of the legal representatives provided in the management report of the Company and the Group under item "III. Economic Report – Financing of the Zapf Creation Group" and item "V. Risk Report – Liquidity and Financing Risks". There, the legal representatives state that the banks agreed to grant the Zapf Creation Group secured financing under changed conditions for the next twelve months, including a seasonal line of credit. The legal representatives believe that the newly concluded syndicated loan agreement ensures the financing of the Zapf Creation Group through the end of April 2007, subject to compliance with the basic terms of the line of credit.

Nuremberg, Germany, May 29, 2006

Rödl & Partner GmbH

Wirtschaftsprüfungsgesellschaft
Steuerberatungsgesellschaft

Schreyer
Wirtschaftsprüfer
(Independent auditor)

Dr. Bömelburg
Wirtschaftsprüfer
(Independent auditor)

Annual Financial Statements of Zapf Creation AG According to the German Commercial Code (HGB)

The full single-entity financial statements of Zapf Creation AG according to the German Commercial Code (HGB) are available on request.

Income Statement

for the Financial Year from January 1 to December 31, 2005

	2005 €	2004 €
1. Sales	458,585.60	5,933,171.39
2. Cost of sales	−396,636.58	−5,986,878.61
3. Gross profit (loss)	**61,949.02**	**−53,707.22**
4. Distribution costs	−8,563,646.67	−7,688,685.66
5. General administration expenses	−11,174,780.55	−11,476,491.85
6. Other operating income	20,285,262.47	22,263,398.38
7. Other operating expenses	−22,345,182.80	−5,584,244.00
8. Income from investments	10,207,303.01	11,328,353.53
– of which from affiliated companies:		
€ 10,207,303.01 (previous year: € 11,328,353.53)		
9. Income from investments in cooperative societies	33.15	9,078.54
10. Other interest and similar income	1,519,401.02	861,615.11
– of which from affiliated companies:		
€ 1,405,451.85 (previous year: € 750,687.33)		
11. Writedowns on financial assets and marketable securities	−13,827,578.11	−2,542,690.32
12. Interest and similar expenses	−6,055,873.27	−2,306,998.84
– of which payable to affiliated companies:		
€ 339,653.25 (previous year: € 174,686.43)		
13. Profit on ordinary activities before taxes	**−29,893,112.73**	**4,809,627.67**
14. Extraordinary profit (loss)	−4,145,700.17	0.00
15. Taxes on income	−718,820.29	−45,005.26
16. Other taxes	−16,718.04	−14,154.42
17. Net loss/income	**−34,774,351.23**	**4,750,467.99**
18. Retained earnings brought forward	24,450,334.70	17,157,176.39
19. Withdrawal from/transfer to reserve for treasury stock	3,882,756.84	2,542,690.32
20. Accumulated deficit/unappropriated surplus	**−6,441,259.69**	**24,450,334.70**

Balance Sheet

as of December 31, 2005

	Dec. 31, 2005		Dec. 31, 2004	
	€	€	€	€
Assets				
A. Fixed assets		**38,279,584.66**		**52,141,548.03**
I. Intangible assets				
1. Concessions, patents, licenses, trademarks and similar rights and assets	5,271,372.24		6,783,744.62	
2. Prepayments	106,583.19	**5,377,955.43**	324,216.30	**7,107,960.92**
II. Property, plant and equipment				
1. Land and buildings	415,186.20		567,916.20	
2. Plant and machinery	4.00		8.00	
3. Fixtures, fittings, tools and equipment	1,100,288.50		1,495,526.50	
4. Prepayments and assets under construction	8,378.85	**1,523,857.55**	18,473.22	**2,081,923.92**
III. Financial assets				
1. Investments in affiliated companies	31,163,169.02		41,371,563.83	
2. Loans to affiliated companies	184,342.66		1,539,059.36	
3. Investments in cooperative societies	260.00		1,040.00	
4. Other loans	30,000.00	**31,377,771.68**	40,000.00	**42,951,663.19**
B. Current assets		**66,717,377.64**		**72,346,515.30**
I. Inventories				
1. Raw materials and supplies	0.00		188,997.61	
2. Work in process	0.00		0.00	
3. Finished goods and merchandise	5,833.89	**5,833.89**	78,543.37	**267,540.98**
II. Receivables and other assets				
1. Accounts receivable	2,215.95		0.00	
2. Amounts owed by affiliated companies	57,703,045.25		46,840,260.62	
3. Other assets	4,187,603.27	**61,892,864.47**	8,632,542.66	**55,472,803.28**
III. Securities		**4,484,068.74**		**8,366,825.58**
Treasury stock				
IV. Cash at bank and on hand		**334,610.54**		**8,239,345.46**
C. Prepaid expenses		**110,196.28**		**441,862.41**
Total assets		**105,107,158.58**		**124,929,925.74**

	Dec. 31, 2005 €	Dec. 31, 2005 €	Dec. 31, 2004 €	Dec. 31, 2004 €
Liabilities				
A. Shareholders' equity		**15,367,809.05**		**50,142,160.28**
I. Subscribed capital		**8,000,000.00**		**8,000,000.00**
Nominal value of contingent capital € 780,000.00				
II. Additional paid-in capital		**9,325,000.00**		**9,325,000.00**
III. Revenue reserves				
Reserve for treasury stock		**4,484,068.74**		**8,366,825.58**
IV. Unappropriated surplus		**−6,441,259.69**		**24,450,334.70**
B. Accruals		**5,687,602.71**		**2,668,230.26**
1. Tax accruals	690,000.00		0.00	
2. Other accruals	4,997,602.71	**5,687,602.71**	2,668,230.26	**2,668,230.26**
C. Payables		**84,051,746.82**		**72,119,535.20**
1. Due to banks	63,012,861.21		44,643,815.66	
2. Accounts payable	1,410,835.42		1,057,333.71	
3. Payables to affiliated companies	19,628,050.19		26,219,880.15	
4. Other payables including	0.00	**84,051,746.82**	198,505.68	**72,119,535.20**
– taxes: € 0.00 (previous year: € 80,040.63)				
– social security: € 0.00 (previous year: € 118,545.05)				
Total liabilities		**105,107,158.58**		**124,929,925.74**

Report of the Supervisory Board for the 2005 Financial Year

In the 2005 financial year, the Supervisory Board thoroughly supervised the activities of the Management Board, providing advice and support as needed, on the basis of the reports, both written and verbal, that the Management Board regularly submitted to the Supervisory Board. Given the Company's economic difficulties, the Supervisory Board also ensured that it was kept abreast of current developments and important events by the Management Board, again both in writing and verbally, outside its meetings. The Supervisory Board thoroughly reviewed all reports that were submitted to it and discussed them with the Management Board in detail, to the extent necessary. And it initiated inspections of the Company's books and records in connection with individual issues.

Besides covering issues related to the development and planning of the Company's business, the Supervisory Board's reviews and discussions with the Management Board pertained, in particular, to the Company's restructuring and efforts to stabilize its financial footing. The reviews of the Company's activities triggered an urgent need to audit individual facts and circumstances in connection with the 2004 single-entity financial statements of individual subsidiaries and the consolidated financial statements. These individual facts and circumstances were subjected to a comprehensive internal audit and a subsequent special external audit. While dealing with numerous issues pertaining to the Management Board, the Supervisory Board also extensively discussed issues related to corporate governance, preparations for the Annual Stockholders' Meeting, dividends, risks and risk management, the reorganization of Management Board members' duties, as well as the quarterly figures for 2005 and the budget for 2006.

Given the particular situation of Zapf Creation AG in the 2005 financial year, the Supervisory Board held a total of twelve meetings in 2005, either in person or by way of telephone conferences. These meetings took place throughout 2005, specifically, on January 19, February 22, March 16, May 10 and 11, June 21, July 7 and 22, September 13, October 5 and 17, and December 13. In addition, the Supervisory Board also adopted four resolutions by circular letter.

The discussions of the Supervisory Board focused on the following issues, in particular:

Restructuring

The first half of the financial year just ended was governed by efforts to restructure the Company. The Supervisory Board allowed the Company to commission external consultants in connection with the realignment of Zapf Creation AG. The findings of these restructuring consultants and the implementation of their recommendations were discussed at Supervisory Board meetings, regularly and in detail. Both the Management Board and the Supervisory Board also discussed possible additional measures aimed at cutting costs and raising capital for the Company. This included, among other things, the conclusion of a syndicated loan agreement with a number of banks willing to provide such financing. The newly concluded syndicated loan agreement ensures the financing of the Zapf Creation Group through the end of April 2007, subject to compliance with the basic terms of the line of credit.

The Supervisory Board also agreed to the recommendation by both the Management Board and the Company's management to suspend the Company's Employee Stock Option Plan (ESOP). Finally, given the Group's low profits in 2004, the Supervisory Board decided not to propose a dividend distribution to the Annual Stockholders' Meeting.

Special Audit

In October 2005, the Management Board and the Supervisory Board jointly commissioned the auditing firm KPMG to perform a special audit of single-entity financial statements of both Zapf Creation AG and individual subsidiaries of the Zapf Creation Group, as well as of the consolidated financial statements as of December 31, 2004. The special audit was carried out from October 2005 to April 2006 and was aimed at fully investigating individual findings made during the 2005 financial year.

The audit of the 2005 consolidated annual financial statements by the Rödl & Partner auditing firm yielded additional findings. Additional investigations indicated that legal regulations were knowingly violated. The Company has therefore filed charges. A final legal assessment is still outstanding. The KPMG auditing firm was then asked to examine certain accounting matters related to 2003/2004. The special audit came to the following conclusions:

There was need for significant corrections with regard to Zapf Creation AG and Zapf Creation (Central Europe) GmbH & Co. KG. The Supervisory Board agreed to the Management Board's proposal to revise the annual financial statements prepared under the German Commercial Code (HGB) for the 2004 and 2003 financial years and to conduct a re-audit pursuant to Section 316 para 3 HGB.

Changes on the Management Board

Following the early withdrawal of Mr. Rudolf Winning from the Management Board, human resources consultants were commissioned to find a new CFO, and Dr. Peter Klein was appointed as deputy member of the Management Board on February 22, 2005. Dr. Peter Klein served as CFO on an interim basis until his resignation on October 18, 2005, and subsequently resumed his position on the Supervisory Board, which had remained inactive during that time. Effective February 15, 2006, Dr. Georg Kellinghusen, a CFO with much experience in the field of corporate restructurings, was appointed CFO. He supported the Company successfully, especially during the special audit, which was a difficult phase. On May 18, 2006, Mr. Thomas Eichhorn was dismissed with immediate effect from his posts as both member and chairman of the Management Board. Dr. Georg Kellinghusen took over the responsibilities of Mr. Eichhorn, i.e. marketing & sales, though only on an interim basis.

Changes on the Supervisory Board

The following changes occurred with regard to the composition of the Supervisory Board during the period under review:

On February 4, 2005, Dr. Horst F. Bröcker, vice chairman of the Supervisory Board since March 18, 1999, resigned as a member of the Supervisory Board.

The Annual Stockholders' Meeting on May 11, 2005 was called upon to vote in a new Supervisory Board. Dr. Petra Wibbe and Mr. Hans-Gerd Füchtenkort, both of whom had served as regular members of the Supervisory Board since March 18, 1999, left the Supervisory Board. Dr. Dietmar Scheiter was elected chairman of the Supervisory Board and Mr. Gustavo Perez its vice chairman at the constituent meeting of the Supervisory Board that took place immediately after the Annual Stockholders' Meeting.

At the Supervisory Board meeting on July 7, 2005, Mr. Martin Gruschka was elected chairman of the Supervisory Board following the resignation of Dr. Dietmar Scheiter from his post as Supervisory Board chairman on July 7, 2005. In light of Dr. Dietmar Scheiter's resignation from the

Supervisory Board effective August 5, 2005, the Registration Court in Coburg, Germany, appointed Mr. Miguel Perez-Carballo Villar to the Supervisory Board effective September 14, 2005. This appointment was made in response to the urgency the Supervisory Board and the Management Board had jointly attached to their application to the court.

Effective October 18, 2005, Dr. Peter Klein resumed his responsibilities on the Supervisory Board, which had been suspended while he acted as a vice member of the Management Board.

Mr. Arnd Wolpers resigned from the Supervisory Board as of November 18, 2005.

Constitution of Committees

The Supervisory Board of Zapf Creation AG constituted an Audit Committee under the chairmanship of Dr. Peter Klein; Dr. Petra Wibbe and Mr. Arnd Wolpers were appointed to this Committee as regular members. Following the new elections to the Supervisory Board on May 11, 2005, the Audit Committee comprised Mr. Gustavo Perez as chairman, as well as Mr. Martin Gruschka and Mr. Francesc Robert as regular members. The newly reconstituted Audit Committee met on January 31, 2006, and February 7, 2006. Its final meeting took place on June 19, 2006 (just prior to the Supervisory Board meeting), at which it thoroughly reviewed all annual financial statements submitted by the Company and / or the Group.

At its meeting on March 16, 2006, the Supervisory Board also established a Personnel Committee with decision-making power and commissioned it to review personnel decisions related primarily to the Management Board, especially in connection with the special audit that had been conducted. The Personnel Committee is composed of Mr. Martin Gruschka (chairman), Mr. Gustavo Perez (vice chairman), and Mr. Miguel Perez-Carballo Villar. To date, it has held three meetings by telephone, specifically, on March 24, 2006, as well as on May 17 and 23, 2006.

Corporate Governance

The Management Board and the Supervisory Board jointly issued a declaration of conformity in accordance with Section 161 German Stock Corporation Act (AktG). This declaration was published in the Federal Gazette No. 180 on September 22, 2005 and is permanently accessible on the Company's Web site. An interval of two years was established for the requisite review of the efficiency of the Supervisory Board's activities. This means that the next review will be conducted in 2006.

Annual Financial Statements and Consolidated Financial Statements

The auditing firm, Rödl & Partner GmbH Wirtschaftsprüfungsgesellschaft, Nuremberg, Germany, submitted its supplementary audit reports to the Supervisory Board, which reviewed them. These supplementary reports pertain to the revised annual financial statements of Zapf Creation AG as of December 31, 2003, and the revised Management Report for the financial year from January 1 to December 31, 2003; the revised annual financial statements of Zapf Creation AG as of December 31, 2004, and the revised Management Report for the financial year from January 1 to December 31, 2004. There was no reason to raise any objections based on the final result of this examination. The Supervisory Board approved the revised annual financial statements for 2003 and 2004 at its meeting on June 19, 2006, thus adopting the revised annual financial statements of Zapf Creation AG for both 2003 and 2004.

The aforementioned auditing firm, Rödl & Partner GmbH Wirtschaftsprüfungsgesellschaft, also audited the annual financial statements that were prepared for the financial year from January 1 through December 31, 2005, in accordance with German Commercial Code (HGB) and the consolidated financial statements for the same financial year that were prepared in accordance with the International Financial Reporting Standards (IFRS). Rödl & Partner GmbH Wirtschaftsprüfungsgesellschaft provided unqualified auditor's opinions for each.

The Company's annual financial statements and management report, the Group's consolidated financial statements and the Group management report, as well as the auditor's audit reports were made available to all members of the Supervisory Board. The Audit Committee was included in the preparation of the financial statements documents related to individual facts and circumstances from the outset. Finally, the financial statements documents were discussed in detail on June 19, 2006, by the Audit Committee, as well as by the Supervisory Board in its financials meeting in the presence of the auditor and following the latter's report, taking the findings of the special audit into consideration. The Supervisory Board approved the results of the audit and the opinion issued by the auditing firm; it also accepted the audit reports for both the annual financial statements and the consolidated financial statements.

The Supervisory Board reviewed both the annual financial statements and the management report that were prepared in accordance with German Commercial Code (HGB) for the 2005 financial year. There was no reason to raise any objections based on the final result of this examination. The Supervisory Board approved the annual financial statements for 2005 at its meeting on June 19, 2006, thus adopting the annual financial statements of Zapf Creation AG for 2005.

Finally, the Supervisory Board reviewed both the consolidated financial statements and the Group management report that were prepared in accordance with IFRS/IAS for the 2005 financial year. This review did not give rise to any objections either. Since the 2005 consolidated financial statements and the consolidated management report were approved by the Supervisory Board at its meeting on June 19, 2006, they have also been adopted.

Takeover Bid from Bandai

On June 12, 2006, Bandai GmbH, a company belonging to the Japanese toy manufacturer, Namco Bandai Holdings Inc., notified the Company of its intention to submit an offer to the shareholders of Zapf Creation AG to acquire all outstanding shares at a price of € 10.50 per share. This offer includes a premium of 18 % on the weighted average share price during the past three months.

The Supervisory Board of Zapf Creation AG supports this offer, subject to a review of the formal offer documents, and has thoroughly reviewed the initial proposal of Bandai Holdings Inc., taking all parties' interests into consideration. In the view of the Supervisory Board, a connection with Bandai will provide optimal development opportunities for Zapf Creation AG because it would profit from Bandai's worldwide presence and the power of its distribution network, especially in the Asian and North American markets, which are of strategic importance to the Company. The Management Board and the Supervisory Board will issue a full statement on the offer once it has been published.

The Supervisory Board thanks both the Management Board and the personnel of the Group for their commitment in the 2005 financial year.

Frankfurt/Main, Germany, June 19, 2006

Martin Gruschka
Chairman of the Supervisory Board

Financial Calendar

Date	Event	Place
June 21, 2006	Financial statements press conference	Munich
	Analyst conference	Frankfurt/Main
August 29, 2006	Annual Stockholders' Meeting	Roedental
August 29, 2006	Results Q2/half-year 2006	Roedental
November 2006	Results Q3/9 months 2006	Roedental

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Note:
Dieser Geschäftsbericht liegt auch in deutscher Sprache vor.
This Annual Report is also available in German.

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