ANNUAL REPORT 2004

Zapf Creation®

MANAGING A STRONG PORTFOLIO OF BRANDS

Consolidated Key Figures	2000	2001	2002	2003	2004	+/– % [8]
Income statement without extraordinary item[1] in € million						
EBITDA[2]	—	—	—	29.8	—	n/a
EBIT	—	—	—	23.4	—	n/a
EBIT in % of sales	—	—	—	11.6	—	n/a
EBT	—	—	—	19.6	—	n/a
Net income[3]	—	—	—	14.8	—	n/a
Basic earnings per share in €[3]	—	—	—	1.87	—	n/a
Income statement in € million						
Net sales	164.9	193.1	222.7	201.4	173.8	– 14
EBITDA[2]	25.4	30.0	38.3	26.2	14.8	– 44
EBIT	23.4	26.4	32.9	19.8	7.6	– 62
EBIT in % of sales	14.2	13.7	14.8	9.8	4.4	– 55
EBT	21.4	23.2	30.6	16.0	4.0	– 75
Net income	15.3	16.4	21.2	12.1	1.0	– 92
Basic earnings per share in €[4]	1.93	2.09	2.70	1.53	0.13	– 92
Amortization and depreciation[5]	2.4	4.0	5.7	6.8	7.2	6
Balance sheet in € million						
Total assets	100.7	112.0	139.9	134.4	147.7	10
Fixed assets (incl. deferred taxes)	15.3	26.7	30.1	31.3	36.1	15
Investments	7.5	16.1	9.9	8.2	8.7	6
Current assets (incl. prepaid expenses)	85.4	85.4	109.8	103.2	111.6	8
Stockholders' equity	37.7	47.7	60.8	55.1	48.0	– 13
Equity ratio in %[6]	39.7	47.3	48.6	46.3	36.8	– 5
Return on equity before taxes in %	56.8	48.7	50.4	29.0	8.3	– 71
Liabilities due to banks	31.9	34.5	43.2	55.3	73.3	33
Cash flow in € million						
Net cash flow from operating activities	– 10.1	29.0	10.1	12.7	0.0	– 100
– per share in €[4]	– 1.28	3.68	1.29	1.61	0.00	– 100
Net cash flow	0.0	5.4	3.6	0.5	1.7	240
Number of employees at the closing date (Dec. 31)[7]	415	498	514	538	493	– 8

1) Extraordinary item = costs from closing of production.
2) The figure includes depreciation related to operating expenses (excl. production depreciation).
3) Costs of closing of production and the resulting income tax effect were excluded.
4) Based on 7.427 million shares in 2004 and 7.907 million shares in 2003. See also Note 2 "Earnings Per Share".
5) According to fixed asset schedule (incl. production depreciation).
6) Calculation: $\frac{\text{Total stockholders' equity}}{\text{(Total assets ./. cash and cash equivalents)}}$
7) Not including Management Board and trainees.
8) Change 2004 versus 2003, rounded.

Dear Stockholders,
Dear Friends of Zapf Creation AG,

The 2004 fiscal year was a disappointing one for us. We had to contend with yet another downturn in sales revenues and a dramatic decline in profitability. The core question is thus: what made 2004 so difficult for Zapf Creation?

Put briefly, there are three clear answers to that question:
• our mini doll segment;
• the downturn in the German doll market, our largest and most important market; and
• rising inventories, both in our own warehouses and partially within the trade.

But a closer look reveals that these three facts are much more complex than the above would suggest.

Compared to the previous year, in the 2004 fiscal year sales fell by 14 percent or by 13 percent adjusted for currency translation. In absolute numbers, this corresponds to a decline in sales of € 27.6 million.

Of that amount, a decline of € 10.1 million resulted solely from the weak performance of the mini doll segment consisting of the BABY born® miniworld brand. The adjustments we had made in our sales and marketing strategy to address sell-through weaknesses that had already made themselves felt in 2003 have thus failed. Nevertheless, at 15 percent our German market share remains relatively high. We had already focused sales much more on Germany than on our foreign business in the year just ended. This means that we will limit our endeavors in this segment solely to Germany in 2005, with the aim of selling off most or all of the residual inventories of BABY born® miniworld in the first half of 2005 while still maintaining our double-digit market share in Germany.

Germany, our largest market, fell significantly short of our expectations. I do not want to take the easy way out here by citing the difficult market environment, uncertainty among consumers, and an unmistakable trend toward the view that "it's cool to be cheap" as the main causes. Besides the downturn in the mini doll segment previously mentioned, which occurred primarily in Germany, an oversupply of Zapf Creation products in certain sales channels gave rise to the decline in sales of about € 21 million in Germany. This was due mainly to the weakness in the accessories segment of our branded play concept, BABY born®, the strongest brand we manage within our brand portfolio. We have therefore made the range of accessories much more attractive this year in terms of pricing and in the design of themes such as “sports,” “pop star” or “fairies,” all of which will be launched over the course of the current fiscal year.

In contrast, the product launch of New BABY born® with a bathing function has led to positive growth in the doll segment and to the fourth-place finish of BABY born® in the German toy market’s top-10 list for all of 2004. Consequently, this positive development will spawn additional sales of BABY born® accessories.

The downturn in sales in the past two fiscal years led to high inventories, especially in Germany and the United States. Inventory reductions in 2004, mainly in the US market, reduced our gross margin by 5.3 percent to 52.1 percent and represent a drag on operating profit. Consolidated net income was reduced by this fact, among others, to approximately € 1 million and thus is significantly below our expectations and plans.

But, as always, every coin has two sides, and I would like to address two positive developments which boost our confidence at Zapf Creation:

We succeeded in expanding our market share in each one of Europe’s most important toy markets – Germany, Great Britain, France, Spain, and Italy – further strengthening our European market leadership position in the play and functional doll segment.

As a result, our European core business, the play and functional doll segment including accessories – with our three strong branded play concepts, BABY born®, Baby Annabell, and CHOU CHOU – grew slightly by 2.1 percent, even though this growth was below expectations due to the decline in sales mentioned previously.

The second question concerns the immediate future:
how will things proceed at Zapf Creation?

Since going public in 1999, we clearly oriented our organization toward growth and we did not anticipate such dramatic reductions in both sales and earnings as happened in the past two years. In the next few weeks, we will concentrate on developing a series of strategic and structural measures with a focus on Central Europe and the United States and on improving the efficiency of our organization.

The past two years have challenged our employees to work to their maximum capacity. I would like to take this opportunity to thank all of our employees for their great commitment during these trying times for our company. But I would also like to thank you, dear stockholders, for the trust that you have placed in us.

Sincerely,

Thomas Eichhorn
Chairman of the Management Board

Zapf Creation's three core brands:
BABY born®, Baby Annabell and CHOU CHOU.

Europe's Leading Doll Manufacturer

Zapf Creation AG is Europe's leading brand manufacturer of play and functional dolls including accessories. Zapf Creation markets branded play concepts that consist of both dolls and a world of matching accessories that are developed in keeping with the company's customary attention to quality, design, and play value.

The company's most popular brands are BABY born®, Baby Annabell and CHOU CHOU. The branded play concepts, My Model and my lovely BABY, have also extended the company's product portfolio to new target groups. These play concepts, which are successful all over the world, have been conceived particularly for the company's core target group – girls between three and eight years of age.

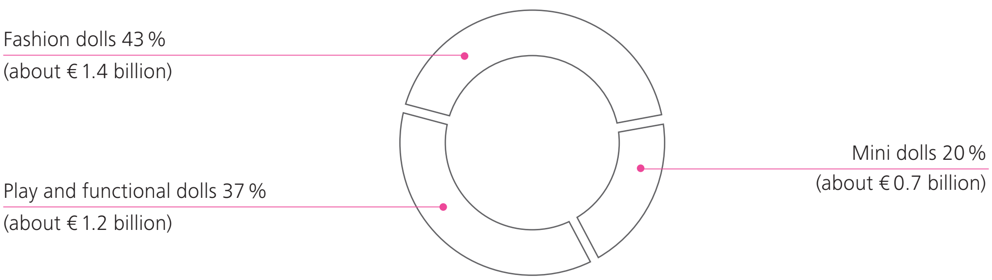
In designing doll accessories and clothes, Zapf Creation takes its lead from trends in children's fashions and general lifestyle products and incorporates them into the roughly 70 percent of new products that are launched each year. The dolls' soft bodies also conceal cutting-edge technology used in creative ways to enable diverse functions.

The branded play concepts of Zapf Creation don't limit a girl's imagination, following, as it were, the company's philosophy, "setting free a child's imagination." Playing with dolls also addresses and supports social skill such as loving, caring, empathy and accepting responsibility.

Doll Market Segments Top 5 in Europe plus USA

The worldwide doll market is Zapf Creation's market environment. The US, as the world's largest individual market, and the top five toy markets in Europe (UK, Germany, Spain, France, and Italy) represent just under 60 percent of the total market. These are the company's key sales regions.

Doll Market Based on Sales Price Totals: about € 3.3 Billion



Source: 2004 estimates of Zapf Creation

Play and functional dolls including accessories represent the company's core business. With a market share of approximately 32 percent, Zapf Creation is the market leader in the European play and functional doll segment including accessories (top five toy markets).

Core Functions Centralized in Germany and in Hong Kong

All central functions such as strategic planning, marketing & product development, communications, finance & controlling, IT, and human resources are carried out from the company's headquarters in Roedental, Germany. This also includes the logistics center which is responsible for warehousing and just-in-time delivery of Zapf Creation's products to Central and Eastern European markets.

As Zapf Creation's high-quality branded play concepts are manufactured by select suppliers in China, central procurement, quality management, and worldwide product distribution are based in the company's Hong Kong offices.

Distribution in Europe and the US via Subsidiaries

Zapf Creation's branded play concepts, most notably BABY born®, are marketed in about 65 countries. Zapf Creation operates wholly-owned subsidiaries at nine locations responsible for marketing and distribution in key international markets. In addition, Zapf Creation works with independent sales agents active solely in countries where Zapf Creation does not maintain any offices.

Product Portfolio

BABY born® (for girls aged 3 to 8 years)
BABY born® is unique. It has eight life-like functions and does not require a battery. This makes role playing with BABY born® particularly realistic. The doll can eat a special baby food, 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® too. 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. Love me CHOU CHOU is Zapf Creation's most active doll as it possesses many life-like functions. The doll can kick its feet, say "mama," make quiet babbling sounds, and cry; it also suckles on its bottle or a pacifier making realistic facial movements. Cute Rock-a-bye CHOU CHOU can laugh, cry, make babbling sounds, and drink from her bottle. If the doll is placed down, she yawns and the doll's mother can put her to sleep by softly rocking her.

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.

my lovely BABY (for infants & toddlers aged 0 to 3 years)
The colorful and cuddly fabric characters of my lovely BABY, which are modeled on the well-known and successful elements of Zapf Creation's brands, inspire even the youngest children to play and cuddle with a doll. The lovingly designed my lovely BABY products stimulate the development of all the senses by playfully helping infants to recognize colors, sounds, and different materials. Parents consider this branded play concept to be ideally suited as a companion during their child's first exciting years.

Maggie Raggies (for girls aged 1 to 8 years)
The Maggie Raggies are cheeky fabric dolls with brightly colored hair, funny faces, and colorful, stylish outfits (for girls aged 1 to 4 years). Stylish Maggie Raggies accessories that give the perky Maggie Raggies their unique and special appearance are designed for "little ladies" (ages 3 to 8). The characters of the Maggie Raggies are as unique as their styling: impish, fun, witty, or cute. They are a perfect toy or a imaginative gift for many occasions.

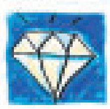
Our Corporate Values

Zapf Creation has changed a great deal in recent years. The company has developed from a family-owned enterprise with a strong focus on the German market to a publicly traded group whose high-quality toys make children's hearts beat faster worldwide.

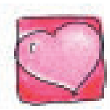
Employees of long standing in Germany and many new colleagues in Zapf Creation's foreign subsidiaries have cooperated with each other and continue to write the company's history. It was time for us to become conscious of our company's foundation – of the values that are important to all of us.

We asked our personnel worldwide what Zapf Creation stands for. Our corporate values were developed on the basis of their answers: creativity, quality, dedication, and partnership characterize our thinking and our actions. All of us at Zapf Creation agree on these concepts. The corporate values of Zapf Creation aim to help all employees to make decisions in ways that further the company's interests and serve as a guideline for personal conduct toward all individuals who deal with Zapf Creation.

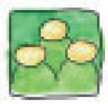
Creativity Is the Key to Our Growth.
We strive for new and creative product ideas in order to stimulate children's enthusiasm for our products again and again through imaginative play concepts. We search for innovative and forward-looking solutions in order to retain our competitive edge in the market.



Quality Guides Our Principles.
Our integrity and our claim to quality represent a commitment toward our customers, employees, and business partners alike. We demand high quality standards of both ourselves and our suppliers in the development and production of imaginative and safe products. We place the highest quality demands on the services we provide.



Dedication Is Our Badge.
We dedicate ourselves to the development and marketing of dolls and accessories with long-term play value which enable children worldwide to develop their imagination and their physical, intellectual, and emotional skills through playing.



For Us, Partnership Means Respect.
We stand for honest business relationships characterized by integrity. We promote our employees and stand for fair and safe working conditions. We support the work of organizations that help children worldwide.

Our Social Commitment

Zapf Creation is deeply committed to the welfare of children and their social and emotional development. We focus our support on projects and organizations that work to benefit primarily children.

SOS-Kinderdörfer weltweit

We Are Committed to Children's Welfare – More Than 1,000 Children Have Found New Homes in the SOS Children's Villages Sponsored by Zapf Creation

Zapf Creation has been sponsoring different projects that benefit the SOS Children's Villages for several years. In order to intensify our commitment, which has evolved over time, in July 2003 we decided to sponsor nine SOS Children's Villages with the aim of providing long-term and continuous support for their important work. As a German company with international subsidiaries that markets its branded play concepts worldwide we also focus our social commitment on international demands. This is why we consider the unique, international model of the SOS Children's Village family – which creates a stable and loving environment for its young members – to be particularly worthy of support. In the SOS Children's Villages, boys and girls of different ages live with an SOS Children's Village mother in a house and are integrated into the social life of the village. These children have come to the Village because in the long run they could no longer live with their birth parents. Joint daily routines, special support programs, therapy, and joint leisure activities help the children to deal better with the harrowing experiences they have had. Sometimes children can return to their parents after a while, but in most cases they leave the SOS Children's Village only when they are capable of leading independent lives.

Spontaneous Aid for the Victims of the Tsunami in Asia – World Vision and Zapf Creation Help Traumatized Children

The effects of the tsunami in Asia on December 26, 2004, confronted us with unimaginable suffering among the people in the affected areas. Given the extent of the destruction, we decided to provide rapid and targeted assistance. Zapf Creation made a spontaneous donation of approximately € 10,000 to World Vision, Hong Kong, to provide urgently needed local help. Besides distributing goods, under its broad three-phase program World Vision also erected 20 "children's tents" where traumatized children receive psychological counseling, medical attention, food, as well as classroom instruction.

Social Production Standards in China

Zapf Creation stands for safe and high-quality toys. We believe that we owe that much to our customers and consumers worldwide. It goes without saying that we also apply this sense of responsibility to the manner in which our products are manufactured. Our social responsibility as a "corporate citizen" thus is a lived reality – also, or especially, in light of our globalized world.

Partnership and Long-term Commitment: Our Motto for Securing Appropriate Working Conditions in Toy Production

All of Zapf Creation's play concepts are linked by a common claim to quality, design, and play value. In order to achieve these goals, we work with select, mainly Asian producers; we have maintained long-term and trusting business relationships with many of them. As early as 1995, Zapf Creation AG introduced its own "Code of Conduct" (COC) which sets forth the social standards and workplace safety measures that the suppliers must comply with.

Principles of Zapf Creation's Work and Social Standards

In October 2002, the International Council of Toy Industries (ICTI) presented uniform social standards in its "Code of Business Practices" (COBP) and a system for the independent monitoring of compliance with the COBP in toy factories worldwide. The ICTI was founded in 1974 as a nonprofit trade association that represents the interests of currently 20 national toy associations. The products manufactured by the members of the national associations cover the entire range of toys and related goods.

As early as October 2002, Zapf Creation was one of the first German companies to commit to the application of this code of conduct at its suppliers' facilities.

The suppliers undergo audits in which compliance with the following principles is monitored and certified:

Main issues	Principles
Child labor	No employment of under-age children
Forced or prison labor	No forced or prison labor
Working hours	Binding working hours/schedules, statutory overtime
Wages	Appropriate compensation, overtime pay, and other corporate benefits
Discrimination	No denial of work on the basis of gender, ethnicity, religion, or membership in a social class or interest group
Working conditions/ workplace safety	Measures aimed at providing an appropriate working environment as well as compliance with workplace safety and heath standards
Fire safety	Emergency lighting and emergency exits; evacuation plans including reflecting lines on the floor; quarterly fire safety drills
First aid	First-aid equipment in every production room; trained first-aid personnel; public hospital in the vicinity
Production safety	Safety equipment for all machines; safety training in using the machines; eye-washing stations in all rooms containing chemicals; regular maintenance of all electrical machinery; vacuum units at the workplaces
Safety equipment for workers	Availability of protective goggles, breathing masks, and gloves
Social standards	Appropriate housing for the workers; orderly and clean living spaces; hygienic kitchens and canteens; clean toilets and wash rooms that meet appropriate standards
Environmental protection	Compliance with environmental protection laws

Zapf Creation Pushes the Auditing Process among Its Suppliers

Zapf Creation works with four key suppliers in China which employ about 6,350 workers in the production of the company's products. Additional suppliers are an integral part of the process of manufacturing Zapf Creation's product portfolio.

As of February 2005, Zapf Creation's suppliers had implemented ICTI's Code of Business Practices as follows:

Key suppliers	Application	Auditor selection	First audit	Action plan	Repeat audit	ICTI review	ICTI certificate
6 suppliers	✓	✓	✓	✓	✓	✓	✓
3 suppliers	✓	✓	✓	✓	✓		
1 supplier	✓	✓	✓	✓			
3 suppliers	✓						

Moreover, ICTI's Code of Business Practices also requires an independent and regular monitoring procedure:

- The audits are performed by independent, authorized auditing companies;
- The auditors carry out both scheduled and unannounced plant inspections;
- The auditors inspect internal production and employee compensation records;
- The auditors conduct surveys and anonymous interviews with workers;
- Zapf Creation staff continually monitor local production facilities; and
- The staff of Zapf Creation's partners carry out additional controls.

In order to emphasize the significance of social standards, as of June 2006 Zapf Creation will work solely with suppliers that have a proven record of implementing ICTI's Code of Business Practices and can prove their compliance through a certificate issued by an external accredited auditing firm.

Both Independent and Our Own Inspections Ensure Safety

Through both scheduled and surprise visits in factories, Zapf Creation's management in the company's Hong Kong office, as well as a specially trained "Code of Conduct Manager," verify the suppliers' ongoing compliance with the required standards. Such inspections are usually conducted up to twice a week during our regular contact with suppliers or regular quality controls.

Taking Matters One Step Further: Zapf Creation Initiates Projects Aimed at Increasing Factory Workers' Responsibility and Input

The foremost goal of Zapf Creation is to ensure that its suppliers provide workplace safety and protection from health risks. In April 2002, Zapf Creation AG was the first company in the toy industry to launch a pilot project – together with a relevant local nongovernmental organization (NGO) and a supplier – aimed at informing and training factory workers about workplace safety and health issues. These training programs, which until that time had been used solely by suppliers in the textile industry, can rightly be considered a towering achievement of the toy industry. This pilot project was the first to bring the members of an NGO, manufacturers, factory managers, and factory workers to a table, making it possible to pursue the training program in a joint partnership.

The program aims to call workers' attention to possible health hazards and sources of danger during production processes and to provide specific information about protective measures. It also aims to enable factory workers to find solutions to risk situations independently. The pilot program was completed successfully by the end of 2002. Since then, training programs have been conducted in cooperation with the NGO at two of Zapf Creation's suppliers. Additional suppliers are conducting internal training.

Zapf Creation in a Dialogue with "Fair spielt"

In February 2005, the "Fair Toys" alliance based in Nuremberg, Germany, as well as the initiators of the "Fair spielt" (fair play) campaign and the German Federal Minister of Consumer Protection, Food, and Agriculture, Renate Künast, renewed their demands that the German toy industry only import toys from China and other countries that have been certified by the International Council of Toy Industries according to its standards. To this end, all participants are supposed to commit themselves to a binding date as of which they will only offer toys produced in compliance with the social standards set forth in ICTI's codex. Zapf Creation committed itself to a binding deadline as early as 2004. Therefore, as of June 2006, Zapf Creation will work solely with toy producers who are in compliance with ICTI standards.

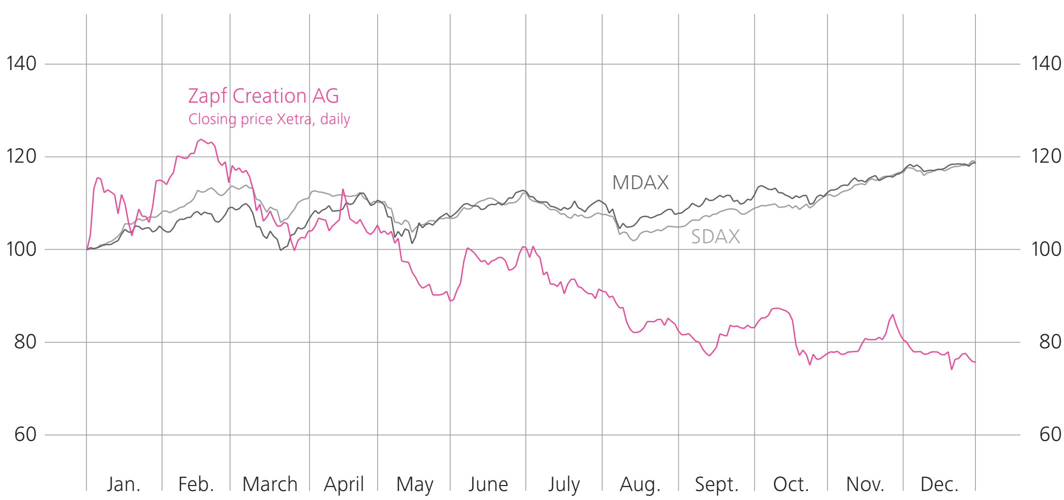
Stock's Price Reflects Operative Development of Business

Zapf Creation's stock started into the new year at a price of € 19.21 and reached its high of € 23.79 for the year on February 18, 2004. The announcement of a decline in sales and a loss in the first quarter of 2004 triggered a decline in the stock price that continued through the next three quarters of the year.

The downgrading of the stock into the SDAX, as well as additional corrections of the sales and earnings forecasts in both October and December, accelerated the stock's downward trend, causing it to fall to a low of € 14.25 for the year on December 21, 2004, and close at € 14.60 at year's end.

The two benchmark indices, MDAX and SDAX, rose by approximately 19 percent in 2004, compared to a decline of 24 percent for the stock of Zapf Creation AG.

Stock Performance 2004 (Index)



Zapf Creation Again Listed on the SDAX Since September 20, 2004

Effective September 20, 2004, the stock was downgraded from the MDAX to the Small Cap Index, SDAX. This decision of the stock exchange is due to the lower market capitalization of Zapf Creation. The average stock price on the preceding 20 trading days was used to calculate the Company's market capitalization as of August 31, 2004, which was just over € 100 million. The trading volume of the stock fell to about 33,500 shares per day on average for the whole of 2004, compared to about 47,200 shares the previous year.

Low Participation at the Annual Stockholders' Meeting

The fifth Annual Stockholders' Meeting of Zapf Creation AG was held on May 11, 2004, at the Group's logistics center in Roedental, Germany. Overall, only slightly more than 19 percent of the votes representing the Company's share capital attended the Annual Stockholders' Meeting. It is our view that functional and dynamic corporate governance also requires stockholders to actively exercise and discharge their rights and duties.

Key Figures Regarding Zapf Creation Stock

ISIN	DE 000 780 6002
Reuters code	ZPF.ETR
Bloomberg code	ZPF GR
Number of shares	8 million

	2000	2001	2002	2003	2004
Market capitalization (based on the year-end price) in € million	392	208	204	153	117
High (Xetra) in €	79.40 (May 9)	50.00 (Jan. 5)	29.50 (June 21)	37.65 (Sep. 5)	23.79 (Feb. 18)
Low (Xetra) in €	28.00 (Nov. 30)	17.61 (Oct. 9)	16.80 (Oct. 8)	17.18 (Nov. 26)	14.25 (Dec. 21)
Year-end price (Xetra, Dec. 31) in €	49.00	26.00	25.54	19.13	14.60
Daily trading volume (average no. of shares)	5,921	11,364	16,478	47,180	33,508
P/E ratio (Xetra, Dec. 31) in €	25.4	12.5	9.0	12.5	112.3
Basic EPS in €	1.93	2.09	2.70	1.53	0.13
CFPS in €	– 1.28	3.68	1.29	1.61	0.00
Dividend per share in €	0.60	0.65	1.00	1.00	0.00
Dividend yield (Xetra, Dec. 31) in %	1.2	2.5	3.9	5.2	—

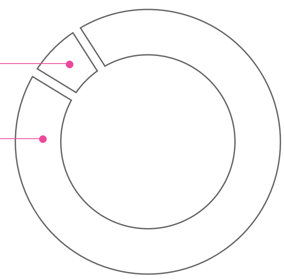
Zapf Creation AG Continues to Hold Treasury Stock for the Employee Stock Option Plan

The Company's holdings of treasury stock to back its employee stock option plan remain at 7.16 percent, and the remaining 93 percent constitute the free float, as before. The free float is divided primarily among institutional investors in France, Great Britain, the Netherlands, the United States, and the rest of the world.

Stockholder Structure

Zapf Creation (treasury stock)	7.16 %
Free float	92.84 %

including:
9.77 % Schroders Asset Management, London
5.19 % Tocqueville Finance SA, Paris
4.69 % Fidelity Investment, Boston
4.55 % Henderson Global Investors, London



As of February 28, 2005

Research Coverage/Analyst Recommendations

Analyst	Date	Recommendations
ABN Amro	March 2005	Sell
Bankhaus Lampe	March 2005	Sell
Bayerische Landesbank	March 2005	Sell
CAI Cheuvreux	March 2005	Underperform
Deutsche Bank	March 2005	Sell
DZ Bank	March 2005	Sell
Hamburger Sparkasse	March 2005	Sell
HypoVereinsbank	March 2005	Sel
Berenberg Bank	February 2005	Hold
Commerzbank	February 2005	Sell
Cazenove	July 2004	Hold

Deviation from the Company's Dividend Policies

The profitability of the Zapf Creation Group clearly fell in the fiscal year just ended and the Group posted consolidated net income of just € 1.0 million (previous year: € 12.1 million). Basic earnings per share thus were € 0.13. Against the backdrop of the imminent restructuring of the Group and the expense required for it, the Management Board and the Supervisory Board will propose to the Annual Stockholders' Meeting not to pay any dividend for the 2004 fiscal year.

This is the first time since 1999 that the Company is deviating from its dividend policy of distributing 50 percent of the consolidated net income, thus taking the Company's current financial status into account.

Financial Calendar

Date	Event	Place
February 16, 2005	Publication of preliminary unaudited financial figures for 2004	Roedental
February 16, 2005	Global Conference Call	Roedental
March 23, 2005	Financial statements press conference	Munich
March 23, 2005	DVFA Analyst Conference	Munich
March 23, 2005	Global Conference Call	Roedental
March 24, 2005	Roadshow	Paris
March 29 to 30, 2005	Roadshow	Germany, Switzerland
April 27, 2005	Results Q1/3 months 2005	Roedental
May 11, 2005	6th Annual Shareholders´ Meeting (AGM)	Roedental
May 31, 2005	8th German Corporate Conference (GCC)	Frankfurt/Main
July 27, 2005	Results Q2/half-year 2005	Roedental
July 27, 2005	Global Conference Call	Roedental
November 16, 2005	Results Q3/9 months 2005	Roedental
November 16, 2005	Global Conference Call	Roedental
November 21 to 23, 2005	German Equity Capital Forum	Frankfurt/Main

Corporate Governance

Both the Management Board and the Supervisory Board of the Zapf Creation Group declare pursuant to Section 161 German Stock Corporation Act, in connection with Section 15 Introductory Law to the German Stock Corporation Act, that the Company is in compliance with the recommendations of the Regierungskommission Deutscher Corporate Governance Kodex (Government Commission on the German Corporate Governance Code) as amended on May 12, 2004, 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:

- *Reasonable deductibles in connection with the purchase of a D&O insurance for members of the Management and Supervisory Boards (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.

- *Agreement on the possibility of imposing limitations (caps) on the exercise of stock options in connection with extraordinary, unforeseen events (4.2.3 para 2 clause 4)*
  The stock exchange segment in which the stock of Zapf Creation is listed does not require a cap, given customary procedures within that segment and in light of the forecasts regarding the development of the stock price in the coming years.

- *Individualized reporting of the compensation paid to Management Board members (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.

A change relative to the previous year concerns the following item:

- *Creation and composition of committees within the Supervisory Board (5.2 para 2 clause 1, 5.3.1, and 5.3.2)*
  In the 2004 fiscal year, a review and auditing committee consisting of three members of the Supervisory Board and chaired by Dr. Peter Klein was constituted for the first time; it reviewed the consolidated financial statements for 2004.

As in the previous year, the following applies to all other tasks of the Supervisory Board: The Supervisory Board of Zapf Creation AG comprises six members. 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 Code.

Zapf Creation AG created a separate section on its Web site at www.zapf-creation.com/company on the issue of corporate governance, which contains detailed explanations for the public on the aforementioned differences, in addition to the formal Declaration of Compliance. Furthermore, this section also contains information on the Management and Supervisory Boards, the report of the Supervisory Board, as well as information on director's dealings. The articles of incorporation and the risk management report are also published in that section.

Corporate Boards

Supervisory Board	Profession/Position
Dr. Dietmar Scheiter, Chairman	Chairman of the Management Board of TA Triumph-Adler AG
Dr. Horst F. Bröcker, Deputy Chairman (until February 4, 2005)	Managing Director of Egon Zehnder International München and Partner of Egon Zehnder International
Dr. Petra Wibbe	Lawyer
Arnd Wolpers	Managing Director of Capital Management Wolpers GmbH
Dr. Peter Klein (membership suspended since February 22, 2005)	Managing Partner of Klein & Company GmbH
Hans-Gerd Füchtenkort	Managing Partner and Partner of Dr. Rochus Mummert & Partner

Management Board	Responsibilities
Thomas Eichhorn, Chairman	Marketing, Sales, Human Resources, Strategy & Corporate Development, Investor and Public Relations, Internal Audit, Production, Quality Management, Purchasing
Angelika Marr	Design, Product Development
Dr. Peter Klein (Deputy Member of the Management Board since February 22, 2005)	Finance, Risk Management, Organization, Logistics, IT, and Legal Affairs
Rudolf Winning (until March 15, 2005)	—
Christian Ewert (until April 30, 2004)	—

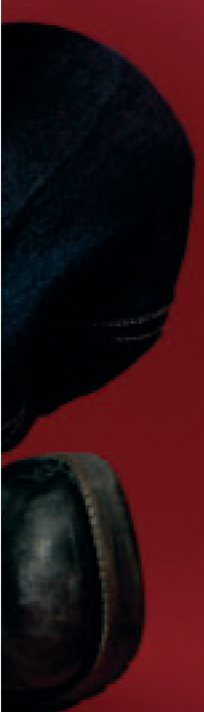
As of March 23, 2005

SETTING FREE A CHILD'S IMAGINATION

Girls aged two to ten years are our young customers. They live with their families and are shaped by their environment. Yet each of them is an independent personality who likes to express her individuality through her clothing, her body language, and her hair style. They have their favorite spots, favorite friends, hobbies, and favorite toys, but they also have their own views and ideas about their life.

Luisa

I got my first BABY born® when I was just two years old. I always called her “Bayborn.” Actually her name is Lucie. We have four BABY born® dolls at home. I’m in second grade already. For bringing home a good report card, my parents got me riding outfits for Lucie even though she doesn’t have a horse. I love to go horseback riding and perform tricks on horseback. My sister Paulina is four years old but she prefers to play with Barbie and she has 32 Barbie dolls!



Lea

My friends call me Pohli. I have seven best girlfriends: Sana, Linditta, Malou, Tamara, India, Rosi, and Janina. I've already been to Egypt on vacation with Janina. But we usually spend our vacations in our vacation home in Bad Reichenhall, Germany (the place where the salt is from). I go horseback riding almost every weekend when we're there. At home, I love to read murder mysteries, but only those for kids, or put make-up on my doll and style her hair.

SHELLY

I love to wear really colorful clothes. I also have a colorful dress. I dress my BABY born® Anna in colorful clothes and her yellow bathrobe too. But I dress up as Mickey Mouse for carnival. When grandma is visiting us, she takes me and my sister Jamie to the carnival party. We sometimes drive to a farm. There's a really big horse on that farm. Its name is Victoria. I also have a pink horse at home.

STEPHANIE

I like to sing and dance – especially hip-hop and aerobics. And I like to put on cool clothes and sneakers for that. Red is my favorite color. At home, I like to play with my doll Isabella or with my two brothers. But then I always fight with them about butter pretzels because those are the ones I like best.

Hannah

Greece is our favorite vacation spot. I've been to the island of Mykonos at least 11 times already. We really like it there. That's why my nickname is Pipe Phakidomyte Pipilota, that's Greek for Pippi Longstocking. Probably because I have hair like Pippi and because I'm as cheeky as she is. Once I forgot Annabell at the port. When I came back to get her, she was still sitting there, looking out over the ocean.

Group Management Report of Zapf Creation AG

I. The Group

The Zapf Creation Group markets branded play concepts consisting of play and functional dolls and a broad world of matching accessories that are developed in keeping with the Company's customary attention to quality, design, and play value. The Company's most popular brands are BABY born®, Baby Annabell and CHOU CHOU. My Model, the creative make-up and hairstyling concept, rounds off the Company's product portfolio. These play concepts, which are successful all over the world, have been conceived particularly for the Company's core target group – girls between three and eight years of age.

In addition to the 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. The Group's foreign sales and marketing companies are located in France, Great Britain, Italy, Spain, Poland, the Czech Republic, and the United States. The Australian subsidiary ceased its operations as of December 31, 2004. In November 2004, Funtastic Limited, South Oakleigh, Australia, took over the sales and marketing of Zapf Creation's entire product portfolio in Australia and New Zealand as a cooperation partner. An additional subsidiary in Hong Kong (China) is responsible for central procurement, quality management, and worldwide distribution of Zapf Creation's products. In Germany, the Group has four subsidiaries: 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.

As of the end of the fiscal year (12/31/04), Zapf Creation AG had 493 employees worldwide (not including the Management Board and trainees), of which 200 were employed by the foreign subsidiaries.

II. The Market

The worldwide toy market declined slightly in 2004. Competition via aggressive pricing was further intensified through cheap imports from the Far East, shaping the market.

The regional toy markets developed differently. While the European toy market grew by 0.2 percent, the U.S. market – the largest individual toy market – declined by 3 percent (market share figures: NPD Eurotoys Retail Panel 2004).

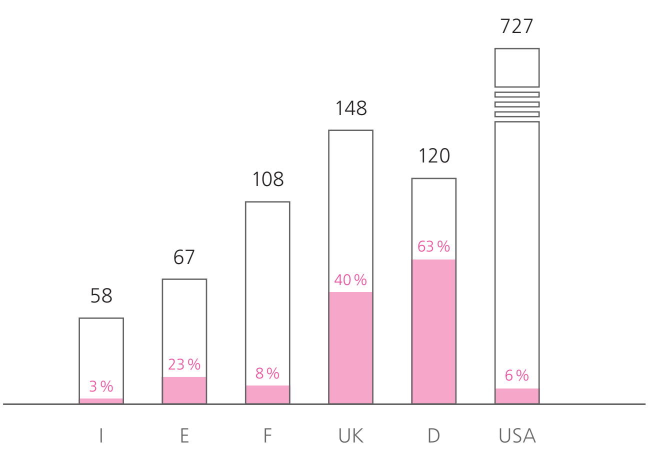
The toy market category relevant to Zapf Creation – the play doll and functional doll segment including accessories – also developed differently in individual countries. In Europe, this segment grew by 0.4 percent. The U.S. play and functional doll segment, however, shrank by 4 percent.

An analysis of the five relevant individual markets in Europe reveals the following picture: The German and France markets declined by just under 10 percent and about 4.5 percent, respectively, while Great Britain rose by just over 12 percent, Spain by 1.8 percent, and Italy by just under 5 percent.

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

Market volume in the segment of play and functional dolls including accessories in € million
Zapf Creation market share in %

Source: NPD Eurotoys 2004



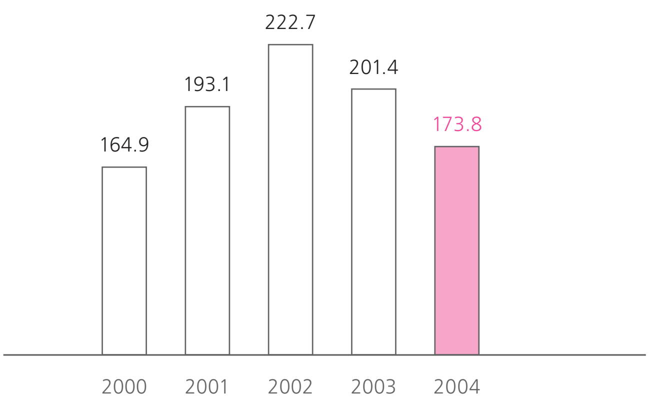
Notwithstanding this market environment, Zapf Creation expanded its market leadership in Europe from a share of 31 percent to 32 percent. The Group increased its market share in the following individual toy markets: Great Britain (market share of 40 percent), France (8 percent), Spain (23 percent), and Italy (3 percent). Zapf Creation maintained its unchallenged market leadership position in Germany with a market share of 63 percent in spite of a declining market for play and functional dolls.

The toy industry is hoping that Eastern Europe will provide impetus for growth in the future because the eastward expansion of the European Union will open up new markets. Yet the industry will also have to face the challenge of responding to short-lived trends even more rapidly.

III. Sales

At € 173.8 million, consolidated sales were 14 percent below the previous year's level. Adjusted for currency translation, consolidated sales were 13 percent below the previous year.

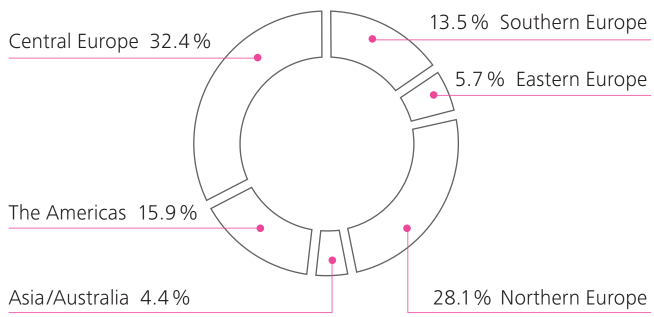
Sales for the Group (in € Million)



Sales by Business Unit

In Central Europe – which includes Germany, Austria, Switzerland, the Netherlands, and Luxembourg – sales fell by 32 percent to € 56.4 million. This was due mainly to lower sales in Germany in the mini doll and BABY born® accessories segments.

Breakdown of Sales by Business Unit 2004

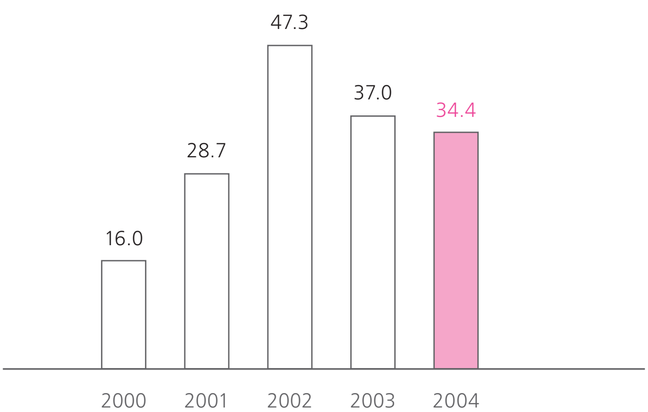


In Northern Europe – which includes Great Britain/Ireland, the growth engines, as well as Scandinavia – sales increased by 7 percent to € 48.8 million. Sales growth in Great Britain/Ireland alone, the largest toy market in Europe, was 12 percent expressed in local currency and 14 percent expressed in euros. As before, the success of the branded play concept, Baby Annabell, continued the longstanding growth momentum in this market. But the BABY born® concept developed into the second growth driver following the launch of the new BABY born® doll, which now has eight functions. Growth in the play and functional doll segment overall helped Zapf Creation to boost its market share in Great Britain to 40 percent.

In Southern Europe – which includes Spain/Portugal, France/Belgium, as well as Italy – sales were € 23.5 million and thus at the previous year's level. The Group's market share in the Spanish, French, and Italian markets increased.

Eastern Europe as a region achieved sales of € 9.8 million, an increase of 24 percent. As before, Poland, Russia, and the Czech Republic provided the strongest growth momentum.

Sales in the Americas in USD Terms (in USD Million)



In the American market, including Canada, sales came in at € 27.6 million, which was 16 percent below the previous year, but 7 percent lower when measured in local currency (USD 34.4 million). Aggressive inventory reductions, which cut our inventory in the United States by one half, and currency translation effects are the root causes for this decline. However, Zapf Creation succeeded in maintaining its market share of more than 6 percent despite the downturn overall.

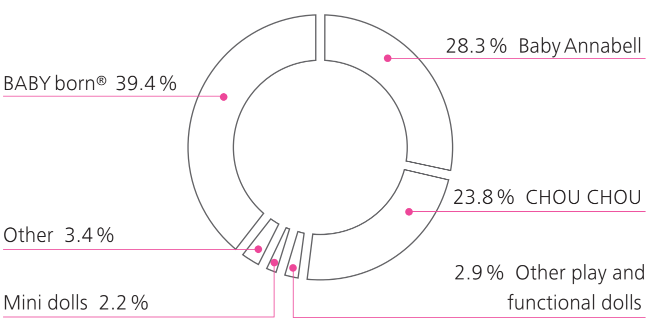
Markets in Asia/Australia declined by 8 percent to sales of € 7.6 million. Most of these sales were achieved in the Australian market, which rose compared to the previous year's level. As of November 1, 2004, Zapf Creation's product portfolio is distributed in Australia and New Zealand by Funtastic Limited, the leading distributor in the Australian toy market.

	2003 K€	2004 K€
Europe	**160,418**	**138,537**
Central Europe	83,187	56,359
Northern Europe	45,736	48,812
Southern Europe	23,600	23,544
Eastern Europe	7,895	9,822
The Americas	**32,775**	**27,645**
Asia/Australia	**8,230**	**7,586**
Net sales	201,423	173,768

Sales by Product Group

Sales of the BABY born® concept, which was launched in 1991, dropped by approximately € 13.2 million. This decline was due solely to the downturn in the BABY born® accessories business. The launch of the New BABY born® doll – in the summer of 2004 in Germany and worldwide in the second half of the 2004 fiscal year – boosted sales of the BABY born® doll. In the fiscal year just ended, BABY born® took fourth place overall in terms of value in the German toy market (NPD Eurotoys 2004 retail panel).

Breakdown of Sales by Product Group 2004



The Baby Annabell concept continued its unabated growth trajectory in 2004 due to the accessories business. The strength of this branded play concept likely results in a certain cannibalization at the expense of the BABY born® and CHOU CHOU concepts. In Great Britain, where Baby Annabell has been particularly popular with young girls since she was launched in 1998, the doll was recognized as the best functional doll in 2004 by the British Toy Retailers Association.

The CHOU CHOU concept grew in 2004 due to the worldwide market launch of the functional doll, Love me CHOU CHOU, even though the doll did not perform as well as both Zapf Creation and its partners had expected.

The decline in the “Other play and functional dolls” category was planned and due to product lines that were discontinued.

At € 10 million, the mini doll segment (BABY born® miniworld) declined as expected. This branded play concept will be eliminated from the Group’s product portfolio in the second half of 2005.

The My Model concept also contributed to the decline in the “Other” category. Weak accessories business and increased competition in Germany resulted in this downturn.

	2003 K€	2004 K€
Play and functional dolls	**178,388**	**164,083**
BABY born®	81,694	68,502
Baby Annabell	47,690	49,179
CHOU CHOU	39,930	41,334
Other play and functional dolls	9,074	5,068
Mini dolls	**14,065**	**3,899**
Other	**8,970**	**5,786**
Net sales	201,423	173,768

IV. Earnings

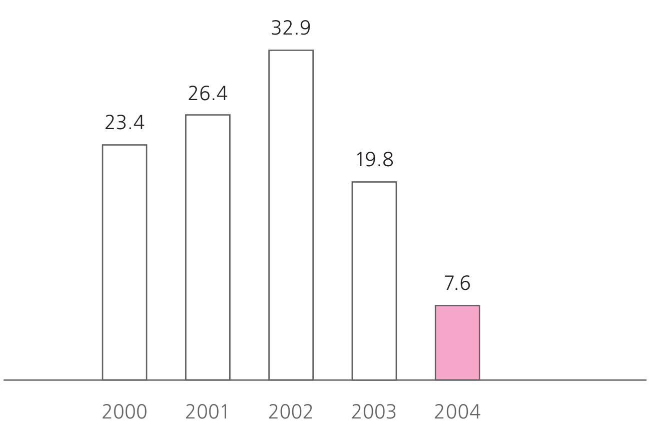
In the fiscal year just ended, the Zapf Creation Group had to face the second significant decline in sales in succession, which at a level of € 27.6 million was greater than in the previous year. This decline was concentrated primarily in the Central European business unit and, in contrast to the previous year, was thus influenced only marginally by negative currency developments. The German market, which accounts for about 80 percent of sales in this business unit, collapsed in the fourth quarter after posting a slight increase in the first nine months of the year, ending the crucial Christmas season with a double-digit minus in the play and functional doll segment including accessories.

The sales decline of close to € 50 million in two years – the scope of which was not foreseeable either in the United States in 2003 or in Central Europe in 2004 until the Christmas season – made extensive inventory reductions necessary in 2004, above and beyond the plans and forecasts in effect at the time. Even though inventories were reduced by more than € 11 million to approximately € 6 million in the United States, the gross margin of this business unit still fell from 54.4 percent in 2003 to only 33.1 percent in 2004. During preparation of the annual financial statements, write-downs on increased inventories were taken in light of their measurement at net realizable value in Central Europe.

Overall, the consolidated gross margin fell from 57.4 percent in 2003 to 52.1 percent in 2004. De facto, this means that a decline in sales of € 27.6 million accounts for more than 90 percent – or expressed in absolute terms, € 25.1 million – of the decline in the gross margin and thus in the operating profit as well.

Operating expenses in fiscal year 2004 decreased by € 12.9 million to € 82.9 million (previous year: € 95.8 million). This decline results from the extraordinary item “Costs from closing of production” in the amount of € 3.6 million in 2003 and from cost savings. In 2004, earnings before interest and taxes (EBIT) fell by € 12.2 million to € 7.6 million (previous year: € 19.8 million).

Group Earnings (EBIT) (in € Million)



At € 3.6 million, net interest expense, net of interest income, was below the previous year (2003: € 3.8 million) despite the increased need for working capital. This is due mainly to the financing climate which remains advantageous overall and in which Zapf Creation participated in 2004 as well using its centralized cash management system.

Earnings before taxes were € 4.0 million (previous year: € 16.0 million). The Group's total tax rate rose to about 76 percent in 2004 (previous year: about 25 percent) as a result of adjustments to deferred tax assets, primarily in the United States.

The Zapf Creation Group posted consolidated net income of approximately € 1.0 million (previous year: € 12.1 million) in the 2004 fiscal year. Basic earnings per share were € 0.13 (previous year: € 1.53).

Against this backdrop, the Management Board and the Supervisory Board will propose to the Annual Stockholders' Meeting not to pay any dividend for the 2004 fiscal year.

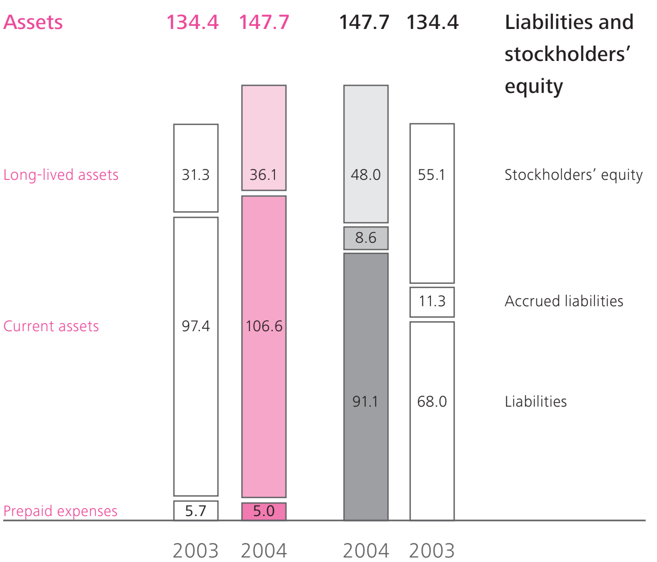
V. Cash Flow

Cash flow from operating activities in the fiscal year just ended was K€ 29 and thus almost at breakeven, whereas a positive cash flow from operating activities of € 12.7 million had been achieved in 2003. This decline corresponds almost entirely to the development of consolidated net income. Bear in mind, however, that cash flow from operating activities in 2004 was influenced by the decline in the forfaiting of trade receivables, which fell from € 31.8 million in 2003 to € 21.4 million in 2004. If the forfaiting volume had remained unchanged, the operating cash flow would have been almost the same as in the previous year. The Zapf Creation Group will receive these payments on receivables in the first quarter of the 2005 fiscal year. Cash rose by approximately € 1.7 million (previous year: € 0.5 million), after investing and financing activities, as well as dividend payments.

VI. Balance Sheet

Total assets of the Zapf Creation Group as of the 2004 balance sheet date were € 147.7 million, an increase by € 13.3 million over the previous year's level. Given the reduced level of forfaiting mentioned above, current assets less prepaid expenses rose by € 9.2 million while prepaid expenses fell by € 0.7 million. "Long-lived assets," which include "Intangible assets" and "Deferred tax assets," rose by a total of € 6.4 million, while "Property, plant, equipment, and software" fell by € 1.6 million. The Group's balance sheet structure thus is as follows:

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



Accrued liabilities and accounts payable totaled € 21.8 million (previous year: € 21.4 million). The net debt was € 56.3 million as of the balance sheet date, an increase of € 16.3 million compared to the previous year's level. It would have increased by € 5.9 million, if the forfaiting volume had remained unchanged.

The equity of the Zapf Creation Group as of the balance sheet date was € 48.0 million (previous year: € 55.1 million). The equity ratio, based on total assets less cash and cash equivalents, was 37 percent (previous year: 46 percent).

VII. Investments

The Group invested a total of € 8.7 million in the reporting year, of which intangible assets accounted for € 3.8 million. Zapf Creation AG made a lump-sum payment of € 3.8 million to acquire the brand and patent rights to BABY born® – the Company's best-selling branded play concept – retroactively as of January 01, 2004, eliminating the need for further licensing payments. Investments in property, plant, equipment, and software decreased to € 4.9 million as planned (previous year: € 6.8 million).

VIII. Risk Report

Monitoring, controlling, and analyzing risks is an important aspect of the management tools used by Zapf Creation AG. 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 thus utilizes a risk management system that was established in accordance with Section 91 para 2 German Stock Corporation Act.

Risk Management System

The risk management system employed by Zapf Creation AG ensures that existing risks are recorded, analyzed, and assessed and that the relevant information is submitted to the Group's decision makers. To this end, the Company implemented a software system at the start of the 2000 fiscal year, which serves to systematically record and evaluate individual risks, their probability of occurring, as well as anticipated losses.

The recording, analysis, and assessment of risks occurs monthly; it is updated and supplemented, if necessary. Any new risks to the Company's existence or any substantial increase in risks are immediately reported to the Risk Monitor and directly to the Management Board.

All risks are categorized, depending on the Group's goals as they relate to different departments. This leads to an initial rough categorization into the following risk groups:

- Procurement risks;
- Marketing and distribution risks;
- Income and liquidity risks;
- Process risks;
- Legal risks;
- Industry risks; and
- Economic risks overall

The analysis, categorization, assessment, and prioritization of individual risks yields the risk portfolio.

Frequently, different types of risk can be classified among the individual risk groups only to a limited extent. Furthermore, the individual risks also affect each other or give rise to subsequent risks in a neighboring risk category. Given the interrelationship of processes, for example, a distribution risk may, for one, evolve into a serious problem on the procurement side or, for another, into an inventory risk and thus spawn earnings risks.

Therefore, an overview of the current risk situation of the Zapf Creation Group is presented below, classified according to individual risk groups, as well as of the essential countermeasures that have either been initiated already or that are conceivable. Subsequent risks, if any, are also discussed.

Procurement Risks

Over 95 percent of the Zapf Creation Group's product portfolio are procured and manufactured in China by several, mainly long-term business partners which, in turn, operate several production facilities situated mainly in different localities. This significantly limits the risk of losing several suppliers concurrently due to fires or similar events or largely precludes such risks. In the fiscal year just ended, one supplier was lost due to economic problems, or rather bankruptcy, but this did not result in any noteworthy disruptions in the procurement process.

In the fiscal year just ended, price increases due to increases in the cost of both personnel and materials, which might lead to higher product procurement prices in the current fiscal year, began to make themselves felt on the procurement side. However, at present price increases can still be offset almost entirely because the current extreme weakness of the US dollar has an extremely favorable impact on gross margins in the euro regions. Zapf Creation is thus currently exploring currency hedging measures. The fiscal year just ended already saw a shortage of labor in the South Chinese Pearl River delta, where 70 percent of the world's toys are manufactured. Further intensification of the labor shortage during the main season of toy production, which begins in May, is already looming on the horizon. Delivery bottlenecks thus cannot be precluded.

As Zapf Creation missed its sales targets in the past two years, in the future the Company will have to be able to react much more quickly on the procurement side in order to minimize inventory risks and work with significantly lower minimum order volumes in order to limit inventory risks. On the supplier side, however, higher prices are being quoted for smaller lot sizes. In turn, this will make it possible to avoid write-downs of excess inventory, reducing the amount of capital tied up and increasing order flexibility.

Marketing and Distribution Risks

The past two fiscal years resulted in high inventories in the Group's own warehouses and increasingly within the trade as well, despite increased marketing expenses. In such cases, the trade increases the pressure on the sales organization of Zapf Creation to participate financially in the reduction of the inventories, in order to make way for new products. This gives rise to retroactive price reductions which allow the trade to reduce inventories by way of price campaigns.

Zapf Creation expects the reduction of its own inventories, especially in Central Europe, to have a negative effect on the consolidated gross margin in 2005 as well. The measurement of the inventories at market prices was largely taken into account in the 2004 financial statements through write-downs on inventories.

Income and Liquidity Risks

The decline in sales by about € 27.6 million in the fiscal year just ended greatly weakened the earnings power of the Zapf Creation Group in its current structure. This was due primarily to the downturn in the Group's business in Central Europe. High inventories due to optimistic sales targets reduced the consolidated gross margin in the fiscal year just ended by 530 basis points. Cost reduction measures succeeded in countering this development in 2004, but they were unable to fully offset it. The Company's Management Board is currently developing a slate of measures aimed at securing its earnings power.

The Zapf Creation Group continues to posses a solid equity ratio and credit lines that are more than sufficient to finance the Company's operations that are strongly characterized by seasonal fluctuations. Nevertheless, Zapf Creation is currently reviewing whether to undertake a fundamental change in its financing structure, which would include short-, medium- and long-term financing instruments, such as for example, a non-recourse sale of trade receivables.

Process Risks

Zapf Creation pays particular attention to maintaining its ongoing operating business. A number of insurance policies were purchased for losses of any kind, such as, for instance, business interruption insurance, fire insurance, and liability insurance. The Company's core processes comprise product development, procurement, and marketing. The introduction of a new logistics software program in the first quarter of 2004 led to delays and losses in deliveries. In the meantime, however, all systems have been stabilized and no noteworthy system changes or modifications that might undermine core processes are planned at present.

Legal Risks

It is essential to protect the brand products of Zapf Creation because they create value. The Group must litigate again and again in order to defend itself against breaches of its patents and brands. At present, however, no significant litigation is pending.

Industry Risks

The Zapf Creation Group focuses strongly on its core business – the play and functional doll segment including accessories – and has already achieved a leadership position in a number of European markets. Fluctuations among the individual product segments, which occur again and again within an otherwise relatively stable toy market, thus can have positive or negative effects on a company with a focused product range. In general, however, such fluctuations do not last, provided the Company succeeds in maintaining the attractiveness of its own brands by innovating, as well as by recognizing and translating trends into quality products.

Demographic declines in key European markets will have a negative impact on the toy industry in years to come.

Economic Risks Overall

In times of weak economic growth and high unemployment, general economic risks are becoming ever more real in the toy market too. Consumers' spending patterns have changed dramatically. Impulse buying is declining and business is concentrated even more on the important year-end holiday season.

The current financial situation of numerous nationally and internationally renowned firms in the trade provides little room for optimism. The Zapf Creation Group did not incur any significant bad debts in the 2004 fiscal year. Doubtful debt allowances on receivables were reduced from about € 1.0 million to K€ 557. Nevertheless, additional bankruptcies in the current fiscal year cannot be precluded. A global comprehensive insurance policy that covers most of Zapf Creation's major customers reduces the risk of loss from bad debts.

Overall, the assessment of the risk situation of the Zapf Creation Group shows that risk has risen compared to the previous years. However, the Company is still not threatened by risks that might undermine its existence.

IX. Noteworthy Occurrences after the End of the Fiscal Year

Rudolf Winning, chief financial officer of Zapf Creation AG, resigned early and will leave the Company effective March 15, 2005. Dr. Peter Klein has been serving as deputy member of the Management Board effective February 22, 2005, until a permanent replacement is appointed. Dr. Klein, who has served on the Supervisory Board of Zapf Creation AG since 1999, will not exercise his duties as a Supervisory Board member during this transition phase.

The current sales and earnings situation of the Zapf Creation Group requires both a repositioning of the Company and a clear adjustment of its costs to its financial position. The Management Board is in the process of developing a comprehensive slate of measures aimed at securing earnings of the Zapf Creation Group in the long term. This will comprise structural changes in the organization, as well as a reorientation in the product portfolio. The requisite measures and strategic turning points shall be presented at the balance sheet press conference at the end of March 2005.

X. Outlook

2005 will be a difficult year for Zapf Creation. It will be necessary to adapt the Company's organizational structure, which was clearly oriented toward growth in connection with its expansion between 1999 and 2002, to current conditions and to make it more efficient. Changes and resulting improvements in the product portfolio, however, will not gain any traction until 2006. The Management Board of Zapf Creation AG thus expects this year to be characterized by restructuring and consolidation.

Roedental, Germany, February 28, 2005

Thomas Eichhorn
Chairman of the Management Board

Angelika Marr
Member of the Management Board

Dr. Peter Klein
Deputy Member of the Management Board

Consolidated Financial Statements and Notes of Zapf Creation AG

Consolidated Income Statement	2004 K€	2003 K€
Net sales	173,768	201,423
Cost of goods sold	−83,305	−85,796
Gross profit	**90,463**	**115,627**
Selling and distribution expenses	−33,795	−31,470
Marketing expenses	−26,467	−29,706
Administrative expenses, net	−22,617	−31,033
Costs from closing of production	0	−3,620
Operating profit before interest and taxes	**7,584**	**19,798**
Interest income	258	158
Interest expense	−3,836	−3,933
Profit before income tax expense	**4,006**	**16,023**
Income tax expense	−3,051	−3,947
Net income	955	12,076
Earnings per share		
Basic €	0.13	1.53
Diluted €	0.13	1.52

The accompanying footnotes are an integral part of the Consolidated Financial Statements.

Consolidated Balance Sheet		Dec. 31, 2004 K€	Dec. 31, 2003 K€
Assets			
Cash and cash equivalents		17,041	15,342
Accounts receivable (net of allowance for doubtful accounts of € 556,952 and € 997,157 at December 31, 2004 and 2003 respectively)		53,861	47,899
Inventories	Note 2	28,283	29,118
Prepaid expenses	Note 3	4,970	5,700
Other currents assets	Note 4	6,692	3,470
Deferred tax assets (short-term)	Note 5	798	1,625
Total current assets		**111,645**	**103,154**
Property, plant, equipment and software, net	Note 2	26,853	28,428
Intangible assets, net	Note 2	5,314	2,494
Deferred tax assets (long-term)	Note 5	3,897	347
Other long-term receivables		40	0
Total long-lived assets		**36,104**	**31,269**
		147,749	134,423
Liabilities and stockholders' equity			
Current portion of long-term debt and short-term borrowings		62,689	40,506
Accounts payable		13,148	10,088
Accrued liabilities	Note 11	8,623	11,346
Income taxes payable		2,574	1,463
Deferred tax liabilities (short-term)	Note 5	1,387	497
Total current liabilities		**88,421**	**63,900**
Long-term debt	Note 6	10,604	14,780
Other long-term liabilities		0	67
Deferred tax liabilities (long-term)	Note 5	684	585
Total long-term liabilities		**11,288**	**15,432**
Commitments and contingencies	Note 9		
Common stock 12,000,000 shares authorized 8,000,000 shares issued 7,427,322 shares outstanding at December 31, 2004 7,427,322 shares outstanding at December 31, 2003	Note 8	8,000	8,000
Additional paid-in capital		7,998	8,052
Treasury stock		– 11,358	– 11,358
Accumulated other comprehensive income (loss)		– 4,829	– 4,304
Retained earnings		48,229	54,701
Total stockholders' equity		**48,040**	**55,091**
		147,749	134,423

The accompanying Notes are an integral part of the Consolidated Financial Statements.

Consolidated Statement of Cash Flows	2004 K€	2003 K€
Cash flow from operating activities:		
Net income	955	12,076
Adjustments to reconcile net income to net cash flow from operating activities:		
Depreciation and amortization	7,171	6,764
Loss (gain) on sale of property, plant, equipment and software	−4	−11
Stock-based compensation expense	0	−277
Increase (decrease) from changes in assets and liabilities:		
Accounts receivable	−6,017	9,411
Inventories	820	295
Prepaid expenses and other assets	−2,548	−4,121
Accounts payable, accrued liabilities and other liabilities	283	−7,548
Income taxes payable	1,101	−3,389
Deferred taxes	−1,732	−515
Net cash flow from operating activities	29	12,685
Cash flow from investing activities:		
Proceeds from sale of property, plant, equipment and software	282	286
Capital expenditures	−8,735	−8,154
Net cash flow from investing activities	−8,453	−7,868
Cash flow from financing activities:		
Net borrowings under short- and long-term debt agreements	17,939	12,055
Purchases of treasury stock / proceeds from issuance of treasury stock	−54	−7,531
Payment of dividends	−7,427	−7,924
Net cash flow from financing activities	10,458	−3,400
Effects of foreign exchange rate changes	−335	−925
Net increase in cash	1,699	492
Cash at beginning of period	15,342	14,850
Cash at end of period	17,041	15,342

Consolidated Statement of Stockholders' Equity

	Shares outstanding number (thsds.)	Common stock K€	Additional paid-in capital K€
Balance at December 31, 2002:	**7,874**	**8,000**	**8,406**
Net income			
Other comprehensive income (loss)			
Total comprehensive income (loss)			
Dividend payments			
Purchase of treasury stock	– 542		
Issuance of treasury stock	95		– 354
Balance at December 31, 2003:	**7,427**	**8,000**	**8,052**
Net income			
Other comprehensive income (loss)			
Total comprehensive income (loss)			
Dividend payments			
Purchase of treasury stock			
Issuance of treasury stock			
Deferred taxes not affecting income			– 54
Balance at December 31, 2004:	**7,427**	**8,000**	**7,998**

The accompanying Notes are an integral part of the Consolidated Financial Statements.

Consolidated Statement of Fixed Assets

	Movements of costs				
	Jan. 1, 2004 K€	Translation effect previous year K€	Additions K€	Disposals K€	Dec. 31, 2004 K€
Intangible assets	**3,609**	**– 12**	**3,800**	**0**	**7,397**
Property, plant and equipment					
1. Land and buildings	12,653	0	291	0	12,944
2. Technical installations and machinery	861	0	0	291	570
3. Other installations, plant, furniture and fixtures	38,092	– 206	4,644	2,402	40,128
	51,606	**– 206**	**4,935**	**2,693**	**53,642**
	55,215	**– 218**	**8,735**	**2,693**	**61,039**

		Accumulated other comprehensive income (loss)		
Treasury stock	Retained earnings	Adjustments to currency translation	Derivative financial instruments	Total equity
K€	K€	K€	K€	K€
– 4,181	**50,549**	**– 1,987**	**0**	**60,787**
	12,076			12,076
		– 2,331	14	– 2,317
	12,076	**– 2,331**	**14**	**9,759**
	– 7,924			– 7,924
– 10,415				– 10,415
3,238				2,884
– 11,358	**54,701**	**– 4,318**	**14**	**55,091**
	955			955
		– 364	– 161	– 525
	955	**– 364**	**– 161**	**430**
	– 7,427			– 7,427
				0
				0
				– 54
– 11,358	48,229	– 4,682	– 147	48,040

Movements of depreciation						Net book value	
Jan. 1, 2004	Translation effect previous year	Translation effect average exchange rate	Additions	Disposals	Dec. 31, 2004	Dec. 31, 2004	Dec. 31, 2003
K€	K€	K€	K€	K€	K€	K€	K€
1,115	**0**	**– 10**	**978**	**0**	**2,083**	**5,314**	**2,494**
5,811	0	0	309	0	6,120	6,824	6,842
861	0	0	0	291	570	0	0
16,506	27	– 194	5,884	2,124	20,099	20,029	21,586
23,178	**27**	**– 194**	**6,193**	**2,415**	**26,789**	**26,853**	**28,428**
24,293	27	– 204	7,171	2,415	28,872	32,167	30,922

Note 1:
Nature of the Business

Zapf Creation AG (hereinafter also called "the Company") is Europe's largest manufacturer of play dolls and functional dolls including doll accessories and stands for branded products that fulfill the highest quality and safety requirements. Due to its consistently implemented brand strategy, the Company has established itself as a provider of quality brands.

Like in the world of fashion, the most popular brands of Zapf Creation AG, such as BABY born®, CHOU CHOU, Baby Annabell and the My Model make-up head are subject to constant change. Permanent updating of these products ensures trendy products that correspond to the demands of the fashion-conscious young target audience.

The Company must address intensive competition on a global scale and is subject to the seasonal fluctuations that are typical of the toy industry. Its activities therefore focus on the Easter and Christmas seasons, which are the highlights of the year.

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". Following a number of changes in the Company's legal status, it finally went public on April 26, 1999.

Pursuant to a spin-off agreement dated April 20, 2004, a resolution of the Annual Stockholders' Meeting of May 7, 2003, and resolutions of shareholders' meetings of the receiving companies of April 20, 2004, the Company transferred some of its assets ("Sales" operations) to Zapf Creation (Central Europe) GmbH & Co. KG and ("Logistics" operations) to Zapf Creation Logistics GmbH & Co. KG, both headquartered in Roedental, Germany, by way of a spin-off. The spin-off became effective retroactively to January 1, 2004 upon entry in the register of Zapf Creation AG.

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

Note 2:
Accounting Principles

General Information

The Consolidated Financial Statements of the Company and its subsidiaries were prepared in accordance with the "United States Generally Accepted Accounting Principles" (US GAAP). All amounts are stated in euros ("€").

Principles of Consolidation

The Consolidated Financial Statements include the financial statements of Zapf Creation AG ("the Parent Company") and of each of its 13 wholly-owned subsidiaries. All companies are thus fully consolidated.

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

In the course of expense and earnings consolidation, all internal sales, intercompany profits and other intra-group earnings are offset against the respective costs.

The financial statements of each subsidiary are included in the Parent Company's Consolidated Financial Statements under the purchase method, whereby the acquisition costs are offset against stockholders' equity as of the respective purchase date.

Main Differences between German and US Accounting Principles

Introduction
In the Consolidated Financial Statements presented here, Zapf Creation AG is availing itself of the possibilities of exemption under Section 292a HGB (Handelsgesetzbuch – German Commercial Code).

According to this provision, the Company does not have to prepare consolidated financial statements under German law (HGB), if the consolidated financial statements are prepared according to internationally recognized accounting principles (in this case: US GAAP).

In order to be able to take advantage of this exemption, the Company must describe the significant differences between the accounting principles that were actually applied (US GAAP) and the corresponding German rules (HGB). These differences are presented below:

Main Differences
The accounting principles under US GAAP and HGB (the German Commercial Code) follow different objectives. While financial statements prepared according to US GAAP are primarily aimed at providing corporate information relevant to decision making on the part of investors and other interest groups, financial statements prepared under HGB are primarily aimed at protecting creditors and thus are characterized by a cautionary approach. In the final analysis, however, US GAAP accords much greater significance to comparability in time and the determination of a company's actual performance than HGB.

Foreign Currency Translation
It is mandatory under US GAAP to show unrealized gains and losses on foreign currency transactions. Such a procedure is prohibited under HGB.

Deferred Taxes
Under US GAAP, deferred income tax assets and liabilities related to the future differences between the value stated for tax purposes and the value stated in the financial statements according to US GAAP must be taken into account.

Accruals
US GAAP requires the creation of a provision for a liability only when it is highly probable that such a liability exists and when its amount can be reasonably estimated. It must be noted that US GAAP does not permit the accrual of internal commitments.

Initial Public Offering Costs
Under US GAAP, the direct one-off costs of the 1999 IPO that are incurred by the Company are offset against stockholders' equity. These external costs are thus directly deducted from additional paid-in capital.

Stock Options
The Company accounts for granted employee stock options pursuant to US GAAP according to APB Opinion no. 25. If the market value of the stock at the time the stock option is granted does not exceed its exercise price, it is not recognized as an expense.

Treasury Stock
Under US GAAP, profits and losses related to the acquisition or the subsequent re-issuance of treasury stock are shown as stockholders' equity under the item "additional paid-in capital". Pursuant to US GAAP, treasury stock must always be recorded at its acquisition cost and offset against stockholders' equity as a capitalized asset.

In contrast, the valuation of treasury stock under HGB rules is subject to the strict lower-of-cost-or-market principle so that a comparison of the current valuation (average price) with the closing price of the stock on the stock exchange as of the balance sheet date may result in a write-down, if the stock price as of the respective balance sheet date is lower than the book value. Profits or losses from the sale of treasury stock are treated under HGB as other operating income or expenses.

Software Development Costs

Different rules exist in US GAAP and HGB with regard to the capitalization of costs incurred for the development of software, including the permission under US GAAP to capitalize certain personnel expenses.

Interest Costs as Acquisition or Production Costs for Construction in Progress

Under certain circumstances, interest costs must be capitalized under US GAAP as a part of the acquisition or production costs related to unfinished construction or to the acquisition or production of an asset. Such capitalization ends when the asset begins to serve its purpose.

Financial Statement Classifications

There are also differences between US GAAP and HGB regarding the classification of items in the balance sheet and the income statement.

Notes on the Income Statement

Selling and distribution expenses comprise the direct costs of supporting and maintaining the Company's sales network. This includes personnel costs and depreciation costs incurred by the sales department, as well as commissions paid to sales representatives and compensation paid to independent sales agents. Included are also license fees, advertising allowances and costs in connection with the management of accounts receivable as well as POS activities[1]. This category also comprises costs for logistics centers such as salaries and wages, depreciations on the Company's own warehouses, warehouse rents and maintenance costs.[2]

In addition to TV advertising, *marketing expenses* include a variety of measures directed at the trade, such as, for instance, participation in trade fairs and expenses for the development of a comprehensive communication strategy, such as packaging, catalogues and flyers, printed advertising in trade journals and magazines. This item also covers costs related to communication with end users, such as, for instance, mini catalogues, sweepstakes and competitions and the BABY born® CLUB. Personnel expenses and depreciation related to the Company's marketing department are also included in the marketing expenses.

The item *administrative expenses, net*, can be divided into finance, IT and other administrative expenses. Administrative expenses, net include personnel expenses, depreciation in relation to the sub-categories and expenses for in-house product development.

As of January 1, 2004, the company no longer discloses costs incurred in connection with SAP and Microsoft software under "other administrative expenses" but assigns them to the users from the areas which cause these costs to be incurred. The fees mentioned include license fees payable to third parties and personnel costs and amortization of the IT department.[3]

1) POS = Point of Sale. This comprises all advertising activities at the point of sale, including shelf and store decoration and ceiling hangers.
2) Freight (without internal freight), premium payments for transport insurance, penalties, order picking, agency logistics personnel and transport insurance payments are included in cost of goods sold.
3) In 2004, Zapf Creation AG charged a total of K€ 1,881 of SAP-related and K€ 1,284 of Microsoft-related costs to affiliated companies.

Interest expenses of K€ 3,836 (previous year: K€ 3,933) comprise the following:
– checking account interest and interest on loans
– fees related to notes
– forfaiting costs.

Information pursuant to FAS 34:

	2004 K€	2003 K€
Interest expenses, gross	3,836	3,933
Capitalization of interest costs for assets under construction	0	0
Interest expenses, net	**3,836**	**3,933**

Estimates and Assumptions

The preparation of financial statements requires estimates and assumptions that may affect the reported amounts of assets, liabilities and contingent liabilities as of the balance sheet date, as well as the reported amounts of revenues and expenses during the reporting period. Actual amounts may differ from estimates and assumptions.

Fiscal Year

The fiscal year of the Company and all of its subsidiaries corresponds to the calendar year and thus comprises the period from January 1 to December 31 of any given year.

Scope of Consolidation

The scope of consolidation covers both Zapf Creation AG, which is domiciled in Roedental, Germany, and all of its subsidiaries.

Changes in the scope of consolidation are shown in the following table:

Fully consolidated subsidiaries	Domestic	Foreign	Total
Dec. 31, 2003	4	9	13
Additions	0	0	0
Disposals	0	0	0
Dec. 31, 2004	**4**	**9**	**13**

Changes in the Book Value of Investments

In fiscal year 2004, cash capital increases of K€ 11 and K€ 650, respectively, were carried out at Zapf Creation (H.K.), Ltd. and Zapf Creation (France), S.a.r.l.

The book value of Zapf Creation AG's investment in Zapf Creation (Central Europe) GmbH & Co. KG increased by € 34,628,755.01 due to the spin-off with retroactive effect as of January 1, 2004 and the transfer of assets ("Sales" operations) to the receiving company in connection with this spin-off.

The book value of Zapf Creation AG's investment in Zapf Creation Logistics GmbH & Co. KG increased by € 5,425,276.09 due to the spin-off with retroactive effect as of January 1, 2004 and the transfer of assets ("Logistics" operations) to the receiving company in connection with this spin-off.

On October 15, 2004, Zapf Creation AG announced its co-operation with Funtastic Limited, South Oakleigh, Australia. As of November 1, 2004 Funtastic will market and sell the entire product portfolio of Zapf Creation in Australia and New Zealand. Zapf Creation (Australia), Pty. Ltd. thus discontinues its operations effective at year's end. Plans are to liquidate the company as of January 31, 2005.

Relevant key data of subsidiaries are shown in the following table:

Affiliated companies as of December 31, 2004 Name	Headquarters	Date of formation	Percentage owned by parent company	Book value Dec. 31, 2004	Net income*) 2004	Equity*) 2004
Zapf Creation (H.K.), Ltd.	Causeway Bay, Hong Kong	Apr. 30, 1991	100 %	€ 795,979.77	HKD 26,513,697.96	HKD 105,186,078.85
Zapf Creation (U.S.), Inc.	Orlando, Florida, USA	Apr. 15, 1999	100 %	€ 93.40	USD – 8,164,948.09	USD – 10,673,015.18
Zapf Creation (France), S.a.r.l.	Limonest, France	Jan. 1, 2000	100 %	€ 700,000.00	€ – 174,769.08	€ 139,959.08
Zapf Creation (U.K.), Ltd.	Corby, Northants, GB	Jan. 1, 2000	100 %	€ 153,964.00	GBP 4,934,726.83	GBP 5,034,726.83
Zapf Creation (Australia), Pty. Ltd.	Melbourne, Australia	Mar. 5, 2001	100 %	€ 263,573.54	AUD – 740,219.49	AUD 542,248.70
Zapf Creation (CZ), s.r.o.	Prague, Czech Republic	July 26, 2001	100 %	€ 11,904.76	CZK 5,758,571.63	CZK 17,536,255.39
Zapf Creation (Italia), S.R.L.	Gallarate, Italy	July 31, 2001	100 %	€ 50,000.00	€ 54,940.59	€ – 140,358.63
Zapf Creation (Polska), Sp. z o.o.	Warsaw, Poland	Aug. 9, 2001	100 %	€ 13,794.62	PLN 58,247.34	PLN – 1,394,270.65
Zapf Creation (España), S.L.	Alicante, Spain	Jan. 1, 2002	100 %	€ 129,075.13	€ 1,923,852.38	€ 4,820,265.08
Zapf Creation (Central Europe) GmbH & Co. KG	Roedental, Germany	Mar. 24, 2003	100 %	€ 34,678,755.01	€ 1,955,244.09	€ 36,631,722.91
Zapf Creation (Central Europe) Verwaltungs GmbH	Roedental, Germany	Mar. 24, 2003	100 %	€ 25,000.00	€ – 1,304.00	€ 22,209.98
Zapf Creation Logistics GmbH & Co. KG	Roedental, Germany	Mar. 24, 2003	100 %	€ 5,475,276.09	€ – 3,178,197.01	€ 2,294,790.32
Zapf Creation Logistics Beteiligungs GmbH	Roedental, Germany	Mar. 24, 2003	100 %	€ 25,000.00	€ – 1,291.30	€ 22,208.41
				€ 42,322,416.32		

*) According to US GAAP

Foreign Currency Translation

During consolidation, the assets and liabilities of the Company's foreign subsidiaries are translated into euros, the Group's currency, at exchange rates as of the end of the fiscal year. In contrast, both the income statement and the cash flow statement are translated into euros at average annual exchange rates. The resulting currency translation differences between the balance sheet and the income statement are posted separately as part of stockholders' equity under "accumulated other comprehensive income (loss)."

In contrast, the stockholders' equity of subsidiaries is converted into euros as follows: The subscribed capital of the Company's foreign subsidiaries is translated into euros prior to consolidation at the exchange rates as of the respective company's founding date. Profits brought forward, however, are translated into euros at the average exchange rate since the company's founding date. The resulting currency translation differences again are posted under stockholders' equity as a separate item of "accumulated other comprehensive income (loss)".

Transactions in foreign currencies, as reported in the Consolidated Income Statement of Zapf Creation AG, include foreign exchange gains (+) and foreign exchange losses (–) in the amount of K€ +1,965 in 2004 and K€ −1,663 in 2003, respectively. Such currency gains and losses are included in the Consolidated Income Statement of Zapf Creation AG in accordance with the related expense and revenue items. For example, foreign exchange gains and losses from the valuation of accounts payable as of the balance sheet date are shown under costs of goods sold, while foreign exchange gains and losses from the valuation of accounts receivable as of the balance sheet date are recorded under revenues.

Translation table (1 FC[4] = x euros)

	AUD	GBP	HKD	USD
Closing rate[5]	0.5721	1.4154	0.0943	0.7327
Average exchange rate[6]	0.5929	1.4748	0.1034	0.8046

4) FC = foreign currency, rounded
5) As of December 31, 2004
6) For the period from January 1 to December 31, 2004

Derivative Financial Instruments

As a rule, Zapf Creation AG uses derivative financial instruments for hedging purposes only.

Recognition of financial instruments is based on the provisions of SFAS 133 "Accounting for Derivative Instruments and Hedging Activities" as amended by SFAS 137 and SFAS 138. SFAS 133 requires all derivative financial instruments to be accounted for at market value as assets or liabilities, respectively, regardless of their purpose or intended use. Depending on the type of hedges (fair value hedges or cash flow hedges), changes in the fair value of the derivatives are recognized in earnings or in equity as part of accumulated other comprehensive income (loss).

Derivative instruments which do not fulfill the requirements for hedge accounting must be recognized as revenues or expenses at fair value.

Further information on the derivative financial instruments is included in Note 7.

Cash and Cash Equivalents

Liquid assets consist of both cash and cash equivalents (term deposits), i.e. cash and highly liquid financial investments with an original maturity of up to 90 days.

Inventories

Inventories are stated at the historical acquisition or manufacturing cost, or at the lower fair value as of the balance sheet date.

Assets acquired from third parties for the inventories are valued at moving-average prices. Products manufactured wholly or partially by the Company are stated at a calculated standard price which reflects the costs of manufacturing the products.

To minimize risk, the Company evaluates inventory levels on a periodic basis in terms of the need for depreciation allowances. Such a need is based on the analysis of the anticipated sales, among other things.

Appropriate valuation allowances are used to account for developments in the market, which cause the value of the inventories to fall below the acquisition or manufacturing cost, taking into account anticipated selling expenses.

In the reporting period, Zapf Creation (Central Europe) GmbH & Co. KG took write-downs of K€ 1,500.

	2004 K€	2003 K€
Finished products and goods	27,940	27,849
Unfinished products	0	83
Raw materials and supplies	343	1,186
Inventories	28,283	29,118

Fair Value of Financial Instruments

Based on discounted borrowing rates currently available to the Company for loans with similar terms, the book value of notes payable and of capital lease transactions are stated at their fair value. All other financial instruments are stated at their approximate fair value due to their short maturities.

Property, Plant and Equipment

Property, plant and equipment are stated at acquisition cost and are depreciated over their estimated useful lives using the straight-line method.

	Useful life of property, plant and equipment
Buildings	40 years
Technical installations and machinery	5 to 10 years
Furniture and fixtures	5 to 15 years
Computer hardware	3 years
Software	3 to 4 years

The depreciation period on property, plant and equipment held by the Company under capital leases or under leasehold improvements always begins at the time the property, plant or equipment is taken into service. The depreciation period corresponds to the duration of the rental or lease agreements. Depreciation of property, plant, equipment and software in 2004 amounted to K€ 6,193 (previous year: K€ 6,416). Upon retirement or sale, the cost of the disposed assets is offset against the related accumulated depreciation. The resulting profit or loss, respectively, is posted to other administrative income or expenses, taking into account any gains on disposal.

Fiscal year 2003 included a write-down of K€ 164 due to the closing of production. This write-down primarily concerned furniture and fixtures as well as machinery. In contrast, no write-downs were taken in the reporting period.

	2004 K€	2003 K€
Land and buildings	12,944	12,653
Technical installations and machinery	570	861
Other installations, software, plant, furniture and fixtures	40,128	38,092
	53,642	**51,606**
Less accumulated depreciation	– 26,789	– 23,178
Property, plant, equipment and software, net	26,853	28,428

Zapf Creation AG shows the cost of maintenance and repairs that only insignificantly extend the life of items of property, plant and equipment as operating expenses. These were K€ 599 in 2004 and K€ 635 in 2003.

“Other installations, software, plant, furniture and fixtures” include construction in progress worth K€ 25 (previous year: K€ 2,462) and down payments for as yet incomplete projects in connection with the SAP-R /3 implementation in the amount of K€ 332 for 2004 and K€ 266 for 2003.

Intangible Assets

Intangible assets consist primarily of capitalized licenses aimed at protecting brand names. Most of them are amortized over ten years. Accumulated amortization on intangible assets was K€ 2,083 as of December 31, 2004, and K€ 1,115 as of December 31, 2003. Of these, K€ 1,797 (previous year: K€ 1,054) related to the protection of rights to names.

In the reporting period, Zapf Creation AG acquired the BABY born® license. The Company recorded this addition (K€ 3,800) as of January 1, 2004 under intangible assets.

The goodwill capitalized by Zapf Creation (Australia) Pty. Ltd. was also included in the intangible assets. Originally, the goodwill was to be amortized over a period of ten years. Due to the transfer of operations to Funtastic Limited and the related closing of the subsidiary, the goodwill was fully written down in the reporting period. Accumulated amortization thus was K€ 286 as of December 31, 2004, and K€ 60 as of December 31, 2003.

Research and Development

The Company always expenses research and development costs at the time they are incurred. The external R&D costs were K€ 326 in 2004 and K€ 347 in 2003; they are recorded as part of “administrative expenses, net”.

Both the development department of Zapf Creation AG and external inventors 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, which has continuously grown over the years. At both locations – at the Company’s headquarters and in Hong Kong – a total of about 50 employees work continuously on new product concepts and on improving and redesigning existing products. The internal costs for this department (e.g. wages and salaries, depreciation) are also included in “administrative expenses, net”.

Customer Concentration

The Company transacts most of its business with major customers. Even though this results in a potential default risk from the sale of products, the actual risk determined by the Company is low, because the Company maintains worldwide insurance coverage for most of its major customers and because, in the past, the default rate of uninsured, smaller customers has been insignificant.

Allowance for Doubtful Accounts

The Company determines any allowances for doubtful accounts based on systematic, regular reviews of individual cases.

The total volume of overdue accounts is reviewed in detail with regard to necessary allowances, taking into consideration any related collateral. The Company writes off the unsecured portion of receivables to the extent that these are found to be uncollectible.

Adjustments to Currency Translation

The translation of the individual financial statements of the Company’s foreign subsidiaries into euros results in gains and losses that are shown separately as part of stockholders’ equity under “accumulated other comprehensive income (loss)”.

Revenue Recognition

Revenue from product sales is recognized upon shipment or delivery to customer. Provisions for sales deductions and returns of defective products are recognized in the necessary amounts at the time the corresponding revenue is recognized but no later than at the time of closing the respective monthly accounts. The values determined in such a way are based on historical values or contractual agreements. The amount of these provisions may vary, depending on the existing circumstances. The shipping and processing fees billed to customers are also recognized as revenue by the Company.

Advertising

Zapf Creation AG treats the cost of producing and broadcasting TV commercials as an operating expense in the fiscal year in which a TV spot is first aired. The costs of other advertising, promotional and marketing campaigns are expensed in the fiscal year in which they are incurred. The cost of developing product catalogues and the like are treated as operating expenses as soon as these catalogues are issued, i.e. the Company always treats these costs as prepaid expenses until such date. Nonpersonal expenses in this sector (i.e. excluding personnel expenses and depreciation in the marketing department) were K€ 22,305 in 2004 and K€ 26,114 in 2003.

Earnings per Share

Basic earnings per share are calculated by using the following formula:

$$\frac{\text{Net income}}{\text{average number of shares and equivalent shares outstanding during the fiscal year}}$$

Diluted earnings per share are based on the following formulas:

1. If the market price of exercised stock options is higher than the exercise price:

$$\frac{\text{Net income}}{\text{average number of shares and equivalent shares outstanding during the fiscal year} + \text{shares from the option plan}}$$

2. If the Company was able to purchase the stock by using the related proceeds:

$$\frac{\text{Net income}}{\text{average number of shares and equivalent shares outstanding during the fiscal year ./. number of shares purchased during the fiscal year}}$$

Calculation of Earnings per Share in Detail		2004		2003	
		Basic	Diluted	Basic	Diluted
Net income	K€	955	955	12,076	12,076
Adjusted net income	K€	955	955	12,076	12,076
Average number of shares outstanding	thsds.	7,427	7,427	7,907	7,907
Options and warrants	thsds.	0	0	0	66
Shares and equivalent shares	**thsds.**	**7,427**	**7,427**	**7,907**	**7,973**
Earnings per share	**€**	**0.13**	**0.13**	**1.53**	**1.52**

As of December 31, 2004, no stock options to purchase shares of common stock were outstanding (previous year: 421,121 shares).

Impairment

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate a permanent decrease in value. The recoverability of assets is measured by comparing the book value of an asset to future undiscounted revenue streams which the asset in question is expected to generate. If such assets were considered to be impaired, the Company would write down the asset in an amount equivalent to the amount by which the book value of the asset exceeds its repurchase value.

The fair value is determined, depending on the nature of the asset involved, pursuant to either the discounted cash flow method or by way of appraisals. Assets to be disposed of are valued at the lower of the book or market value, less disposal costs.

New Accounting Rules

SFAS 151

In November 2004, the Financial Accounting Standard Board ("FASB") published Statement of Financial Accounting Standard ("SFAS") 151 "Inventory Costs, an amendment of ARB No. 43, Chapter 4". SFAS 151 clarifies that abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage) must be recognized as current-period charges and requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS 151 shall be applied prospectively to inventory costs incurred during fiscal years beginning after June 15, 2005.

SFAS 153

In December 2004, the FASB published SFAS 153 "Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29". This standard is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. This Statement amends Accounting Principals Board Opinion (APB) 29 and shall be applied to transactions taking place after June 15, 2005.

SFAS 123R

In December 2004, the FASB published SFAS 123 (revised 2004) "Share-Based Payment" ("SFAS 123R"). This Statement is a revision of SFAS 123, "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25 "Accounting for Stock Issued to Employees" and its related implementation guidance. SFAS 123R requires all stock-based compensation to be recognized as an expense in the consolidated financial statements. It establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. SFAS 123R also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. Compensation plans that are to be accounted for as equity are measured at fair value at the grant date. Compensation plans that are to be accounted for as liabilities are measure at fair value at reporting date through the settlement date. The provisions of SFAS 123R apply to reporting periods beginning after June 15, 2005.

Note 3:
Prepaid Expenses

Prepaid expenses are comprised as follows:

	2004 K€	2003 K€
Barter deals[7]	3,341	3,088
Marketing expenses	950	2,022
Administrative expenses, net	499	342
Selling and distribution expenses	165	163
Interest	12	21
Personnel expenses	3	64
	4,970	5,700

7) Barter deals are transactions in which the Company sells its products at the regular price to a partner who pays for them partly in cash and partly in the form of barter points. These barter points can be exchanged, for instance, for broadcast time with TV stations.

Note 4:
Other Assets

Other assets comprise the following:

	2004 K€	2003 K€
Tax receivables due from the tax office	4,622	2,219
Other receivables	1,041	590
Employee loans	885	595
Payments on account	144	66
	6,692	3,470

Note 5:
Income Taxes

The expenses for current and deferred income taxes consist of the following:

	2004 K€	2003 K€
Current taxes		
Germany	245	3,439
Foreign	4,735	1,413
	4,980	**4,852**
Deferred income taxes		
Germany	−1,400	−1,345
Foreign	−529	440
	−1,929	**−905**
	3,051	3,947

The following table shows the Company's deferred income tax assets and liabilities:

	2004 K€	2003 K€
Deferred tax assets		
Operating loss carryforwards	3,890	390
Valuation allowances, current assets	70	979
Interest	448	535
Other	287	68
Gross deferred tax assets	**4,695**	**1,972**
Deferred tax liabilities		
Net unrealized foreign exchange gains	−275	−175
Property, plant, equipment and software	−739	−718
Other	−1,057	−189
Gross deferred tax liabilities	**−2,071**	**−1,082**
	2,624	890

The anticipated tax expenses are computed by multiplying the total tax rate of 37.61 percent applicable for the fiscal year (previous year: 37.61 percent) by earnings before taxes. This results in anticipated tax expenses of K€ 1,507 for fiscal year 2004 (previous year: K€ 6,023).

The total tax rate as combined income tax rate is composed of a corporation tax rate of 25.00 percent (previous year: 25.00 percent) plus solidarity surcharge of 5.50 percent (previous year: 5.50 percent) plus an effective trade tax rate of 11.23 percent (previous year: 11.23 percent), which was computed on the basis of this effective corporation tax rate.

The following table shows the reconciliation of the anticipated tax rate to the reported tax rate for the respective fiscal years:

	2004 K€	2003 K€
Anticipated tax expense	1,507	6,023
Foreign earnings taxed at different rates	−297	−812
Federal trade and solidarity taxes	−1,162	−1,344
Non-deductible stock option expenses	0	−40
Write-downs of deferred tax assets	2,725	0
Other tax-free income and non-deductible expenses	300	0
Other	−22	120
Disclosed tax expense	3,051	3,947

As of December 31, 2004, the Group hat corporation tax loss carryforwards of K€ 17,335 (previous year: K€ 1,125) and trade tax loss carryforwards of K€ 9,344 (previous year: K€ 0). The corporation tax loss carryforwards primarily relate to Zapf Creation AG and Zapf Creation (U.S.), Inc. The trade tax loss carryforwards primarily relate to Zapf Creation AG and Zapf Creation Logistics GmbH & Co. KG.

Of the corporation tax loss carryforwards, K€ 7,820 may be carried forward until 2024, and K€ 9,515 may be carried forward indefinitely. The trade tax loss carryforwards may be carried forward indefinitely.

Whether or not deferred tax assets are recoverable is determined based on assessing the probability of the reversal of valuation differences and of the usability of the loss carryforwards that resulted in deferred tax assets. This depends on the occurrence of future taxable income during periods in which tax valuation differences are reversed and tax loss carryforwards can be utilized.

The deferred tax assets on tax loss carryforwards of K€ 3,890 include write-downs of K€ 2,725, which were taken based on the assessment of the future reliability of existing claims from tax loss carryforwards.

Note 6: Short-term and Long-term Bank Debts

Short-term Financing

The Company can draw on unsecured lines of credit in the amount of approximately € 146 million. Most of the short-term bank debts as of December 31, 2004, result from borrowings under the aforementioned lines of credit; the average interest rate in 2004 for the credit lines was 3.5 percent. The aforementioned credit lines fully ensure that the Company’s working capital needs are met.

Development of Long-term and Short-term Bank Debts as of December 31, 2004	Borrowing limit €	Lending rate %	Due date	Status as of Jan. 1, 2004 €	Additions 2004 €
Long-term debts					
Bank loan no. 1		5.00	2006	159,778.74	
Bank loan no. 2		5.00	2006	958,672.24	
Bank loan no. 3		4.45	2008	639,114.82	
Bank loan no. 4		4.35	2011	5,000,000.00	
Bank loan no. 5		4.35	2011	4,687,500.00	
Bank loan no. 6		5.16	2006	6,750,000.00	
Bank loan no. 7		4.99	2004	940,615.04	
Bank loan no. 8		3.98	2007	1,736,292.71	
Bank loan no. 9		6.35	2004	768,014.68	
Disagio			2011	−311,700.10	
				21,328,288.13	**0.00**
Less current portion of long-term debts (without disagio)				6,548,112.35	
Long-term debts				14,780,175.78	
Lines of credit					
Overdraft	28,427,102	6.50	unlimited	11,113,691.90	
Overdraft	10,000,000	4.35	in part limited	2,173,771.65	
Overdraft	19,663,540	6.10	in part limited	3,415,620.60	
Overdraft	22,327,081	5.75	in part limited	6,880,576.24	
Overdraft	5,000,000	5.75	until Apr. 30, 2005	4,087,703.75	
Overdraft	5,000,000	5.50	until Dec. 31, 2004	1,736,627.87	
Overdraft	10,000,000	6.50	in part limited	0.00	
Overdraft/other	45,333,979	6.25	in part limited	4,549,702.35	
				33,957,694.36	
Current portion of long-term debts				6,548,112.35	
Short-term borrowings				40,505,806.71	

Redemption 2004 €	Status as of Dec. 31, 2004 €	2005 €	2006 €	Redemption 2007 €	2008 €	2009 €	2010+ €
63,911.48	95,867.26	63,911.48	31,955.78	0.00	0.00	0.00	0.00
383,468.92	575,203.32	575,203.32	0.00	0.00	0.00	0.00	0.00
127,822.98	511,291.84	127,822.97	127,822.97	127,822.97	127,822.93	0.00	0.00
625,000.00	4,375,000.00	625,000.00	625,000.00	625,000.00	625,000.00	625,000.00	1,250,000.00
312,500.00	4,375,000.00	625,000.00	625,000.00	625,000.00	625,000.00	625,000.00	1,250,000.00
2,250,000.00	4,500,000.00	2,250,000.00	2,250,000.00	0.00	0.00	0.00	0.00
940,615.04	0.00	0.00	0.00	0.00	0.00	0.00	0.00
508,633.32	1,227,659.39	529,801.71	551,461.06	146,396.62	0.00	0.00	0.00
768,014.68	0.00	0.00	0.00	0.00	0.00	0.00	0.00
52,526.66	−259,173.44	−52,526.65	−43,323.40	−43,323.39	−40,000.00	−40,000.00	−40,000.00
6,032,493.08	**15,400,848.37**	**4,744,212.83**	**4,167,916.41**	**1,480,896.20**	**1,337,822.93**	**1,210,000.00**	**2,460,000.00**
	4,796,739.48						
	10,604,108.89						
	10,207,426.31						
	2,855,548.25						
	11,322,321.90						
	10,746,806.94						
	4,800,307.13						
	0.00						
	4,862,739.44						
	13,096,873.22						
	57,892,023.19						
	4,796,739.48						
	62,688,762.67						

Breakdown of the disagio amount related to each individual bank loan:

Loan no. 2	
Status as of December 31, 2004, gross	575,203.32
Disagio*)	−9,203.25
Status as of December 31, 2004, net	**566,000.07**

*) Life: 10 years/remaining life: 2 years

Loan no. 3	
Status as of December 31, 2004, gross	511,291.84
Disagio*)	−9,970.19
Status as of December 31, 2004, net	**501,321.65**

*) Life: 10 years/remaining life: 4 years

Loan no. 4	
Status as of December 31, 2004, gross	4,375,000.00
Disagio*)	−120,000.00
Status as of December 31, 2004, net	**4,255,000.00**

*) Life: 10 years/remaining life: 7 years

Loan no. 5	
Status as of December 31, 2004, gross	4,375,000.00
Disagio*)	−120,000.00
Status as of December 31, 2004, net	**4,255,000.00**

*) Life: 10 years/remaining life: 7 years

Disagio total	−259,173.44

Long-term liabilities toward banks as of the end of fiscal year 2004 were secured by mortgages in the amount of K€ 4,601 (drawn in 2004: K€ 1,182).

As of December 31, 2004, the Company forfaited receivables and wrote off the respective amount against the receivables shown in the balance sheet. Forfaiting is comprised as follows:

	2004 K€	**2003 K€**
Domestic customers	5,539	15,885
Foreign customers	15,832	15,964
	21,371	31,849

Note 7: Derivative Financial Instruments

Forward Exchange Contracts

In the course of any given year, Zapf Creation uses foreign currency futures with maturities of up to 12 months to hedge against adverse exchange rate fluctuations in connection with the Company's foreign business activities. These OTC contracts, which hedge future inventory purchases and other transactions, are primarily denominated in United States and Hong Kong dollars, as well as in British pounds.

As of the balance sheet date, however, there were no currency futures denominated in foreign currencies outstanding; the same applies to the previous year.

Use of Derivative Financial Instruments
The Company's financing requirements vary depending on its seasonal purchasing activities and the resulting need for working capital. To reduce risks caused by interest rate changes in connection with the short-term seasonal credit lines and to benefit from current, relatively low interest rates as long as possible, Zapf Creation AG entered into three euro-denominated interest swaps with a nominal total amount of K€ 15,000 and one US-dollar denominated interest rate swap with an initial nominal value of K$ 5,000. The nominal value of the US-dollar interest swap increases from K$ 5,000 to K$ 10,000 at the end of the interest rate hedging period in 2007 and hedges only the seasonal financing requirements during four months of the year. This interest rate swap amounted to K$ 6,250 in December 2004.

As of December 31, 2004, the Company's portfolio included derivative financial instruments to hedge against interest rate risks with a maximum maturity of four years. The interest rate swaps cause floating interest payments to be swapped for fixed interest payments during their entire maturity. This does not create currency risks.

Zapf Creation AG expects interest rates to increase further and the interest rate swaps entered into by the Company to continue to show a positive development. This should make medium-term interest rate hedging possible at the existing interest rate level.

Fair Value of Derivative Financial Instruments
The interest rates must be classified as cash flow hedges according to SFAS 133. Instruments hedging future cash flows are accounted for at fair value.

The fair value of a financial instrument is the price at which a party would assume the rights and/or obligations arising from this financial instrument from another party. The fair value of the financial instruments was calculated based on the market information that was available on the balance sheet date and by using the valuation methods described below.

To determine the fair value of an interest rate swap, the expected cash flows on both sides of the swap are discounted taking into account the market interest rates applicable for the remaining life of the financial instruments according to the current interest rate structure curve. The difference between the two calculated amounts is the net fair value of the interest rate swap.

Accounting for and Disclosure of Derivative Financial Instruments and Hedge Accounting
Changes in the fair value of interest rate swaps which are included in a cash flow hedge are disclosed under equity (accumulated other comprehensive income). Changes in the fair value of derivative interest rate instruments which were included in a cash flow hedge to hedge variable interest loans, are also disclosed under equity. These amounts are reposted from the hedged underlying transaction to the financial result as a correction of the interest.

As of December 31, 2004, the financial result does not include ineffective hedges or components of financial instruments which are excluded from the assessment of hedge effectiveness.

Note 8: Equity

Common Stock

The Company's share capital is € 8,000,000 (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, items 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 stock which at the same time is disposed of pursuant to Section 186 para 3 sentence 4 German Stock Corporation Act by excluding subscription rights does not exceed 10 percent of the common stock 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;

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 stock 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 fiscal 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 stock 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 fiscal 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 conditional 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 stock to fulfill such stock options. The new shares shall participate in the Company's profits as of the beginning of the fiscal 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 item 3), Contingent Capital II (Section 5 item 4), and Contingent Capital III (Section 5 item 5).

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

Treasury Stock

Zapf Creation AG owns two separate securities deposit accounts, which are used in different ways:

Account no. 1 exclusively serves to back the stock option plan; its book value as of December 31, 2004 was K€ 11,262. Account no. 1 as of December 31, 2004, comprised 569,593 shares of treasury stock, equaling 7.12 percent of the share capital. The account remained unchanged in the reporting period.

Account no. 2 includes shares which in the past were frequently offered to employees at preferred prices because of the positive development of the Company's business or in connection with successfully completed projects. The book value is K€ 96. The number of shares in the portfolio (3,085) equals 0.04 percent of the share capital as of December 31, 2004. There were no additions or withdrawals in the reporting period.

	Account no. 1			Account no. 2			Total		
	Stock	Book value	Capital share	Stock	Book value	Capital share	Stock	Book value	Capital share
	Number	K€	%	Number	K€	%	Number	K€	%
Addition 1999	40,000	794	0.50	20,000	593	0.25	60,000	1,387	0.75
Addition 2000	25,000	1,217	0.31				25,000	1,217	0.31
Disposal 2000				−11,990	−356	−0.15	−11,990	−356	−0.15
Addition 2001	32,500	1,003	0.41	55,000	1,705	0.69	87,500	2,708	1.10
Disposal 2001	−10,069	−198	−0.13	−2,050	−61	−0.03	−12,119	−259	−0.16
Disposal 2002	−14,452	−284	−0.18	−7,775	−232	−0.09	−22,227	−516	−0.27
Jan. 1, 2003	**72,979**	**2,532**	**0.91**	**53,185**	**1,649**	**0.67**	**126,164**	**4,181**	**1.58**
Additions 2003									
December	542,000	10,415	6.78				542,000	10,415	6.78
Disposals 2003									
January				−50	−2	0.00	−50	−2	0.00
February				−50	−2	0.00	−50	−2	0.00
April				−50,000	−1,549	−0.63	−50,000	−1,549	−0.63
May	−40,666	−1,536	−0.51				−40,666	−1,536	−0.51
November	−4,720	−149	−0.06				−4,720	−149	−0.06
Dec. 31, 2003	**569,593**	**11,262**	**7.12**	**3,085**	**96**	**0.04**	**572,678**	**11,358**	**7.16**
Additions 2004	0	0	0.00	0	0	0.00	0	0	0.00
Disposals 2004	0	0	0.00	0	0	0.00	0	0	0.00
Dec. 31, 2004	569,593	11,262	7.12	3,085	96	0.04	572,678	11,358	7.16

Disclosure Pursuant to Section 160 Number 8 German Stock Corporation Act

Schroder Investment Management Ltd, 31 Gresham Street, London EC2V 7QA, informed the Company pursuant to Section 21 (1) German Securities Trading Act that its voting share in Zapf Creation AG on April 20, 2004, exceeded the threshold of 10 percent and as of that date equaled 10.06 percent. The 804,800 voting shares are assigned to Schroders plc and Schroder Holding plc pursuant to Section 22 para 1 sentence 1 number 6, and sentence 2 and 3 German Securities Trading Act.

Fidelity Management & Research Company, 82 Devonshire Street, Boston, Massachusetts, 02109, USA, informed the Company pursuant to Section 21 (1) German Securities Trading Act that its voting share in Zapf Creation AG on February 19, 2004, exceeded the threshold of 5 percent and as of that date equaled 5.02 percent, representing 401,600 voting shares.

Henderson Global Investors Limited, London, informed the Company pursuant to Section 21 (1) German Securities Trading Act that its voting share in Zapf Creation AG on September 24, 2004, fell below the threshold of 5 percent and as of that date equaled 4,55 percent, representing 364,000 voting shares.

Tocqueville France SA, Paris, informed the Company pursuant to Section 21 (1) German Securities Trading Act that its voting share in Zapf Creation AG on October 26, 2004, exceeded the threshold of 5 percent and as of that date equaled 5.19 percent (415,200 voting rights). The voting shares are assigned to Tocqueville Finance SA pursuant to Section 22 para 1 sentence 1 number 6, and sentence 2 and 3 German Securities Trading Act.

Stock-based Compensation

As of December 31, 2004, three stock option plans and two stock-price based bonus plans are in place at the Zapf Creation Group. Taking into account SFAS 123, Accounting for Stock-Based Compensation, the Company decided to apply Accounting Principle Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, for the disclosure of its stock-based compensation plans.

Stock Option Plan Waiver

On December 15, 2004, all eligible employees 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.

This waiver concerns the following plans: Stock Option Plan 1999/2000, Stock Option Plan 2001/2003, Stock Option Plan 2003/2005. 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.

Stock Option Plan 1999/2000

In April, 1999, the Supervisory Board and the Management Board recommended a stock option plan, which was approved by the Company's shareholders at its Extraordinary Shareholders' Meeting of April 1999. The applicable option terms and conditions were amended by resolution of the stockholders in April 2000, effective retroactively for all 40,000 stock options from 1999 which had been issued at that time. The option terms and conditions for these 40,000 stock options were retroactively adapted to the option terms and conditions applicable for the 86,000 stock options which were granted in fiscal year 2000. The total volume of the Stock Option Plan 1999/2000 originally comprised 40,000 stock options from 1999 and an additional 380,000 stock options from 2000.

As part of the Stock Option Plan 1999/2000 and based on the underlying resolutions of the Annual Stockholders' Meeting, the stockholders authorized the Management Board and the Supervisory Board to grant non-transferable subscription rights to the members of the Management Board and to the employees of the Company and of companies affiliated with it as defined by Section 15 ff German Stock Corporation Act. The stock options were granted within four weeks of formally approving the financial statements. The exercise price of the subscription rights under the Stock Option Plan 1999/2000 is equivalent to the average opening and closing price of the stock in Xetra trading on the last trading day before the meeting of the Company's Supervisory Board at which the Supervisory Board decides whether or not to grant the options to the Management Board, plus a premium of 20 percent. To ensure the incentive function, reimbursement of the 20 percent premium was agreed if the options are exercised (successful attainment of the goal of increasing the stock price by 20 percent). One third of the subscription rights may be exercised for the first time after a lock-up period of two years, one third after three years, and the remaining third after four years. The options may be exercised until the end of the first exercise period ending at least five years after the date on which the options were granted. The options may only be exercised within two weeks of the second day of the Company's Annual Stockholders' Meeting, within two weeks of the publication of the half-year report, or within two weeks of the publication of the quarterly report as of September 30 of each year, respectively.

Due to these terms and conditions and the retroactive amendment of the original option terms and conditions from fiscal year 1999 to the option terms and conditions for fiscal year 2000, the stock option plan will be treated as a variable plan affecting personnel expenses according to APB Opinion no. 25.

At the time of exercise, the Company may offer the owners of subscription rights either new shares from Contingent Capital I, which was created for this purpose, or treasury stock. The Management Board and the Supervisory Board shall jointly decide which of the two alternatives is offered to the owners of subscription rights. Until December 31, 2004, only treasury stock was issued to option holders under the stock option plan.

Stock Option Plan 2001/2003

On July 31, 2001, the Annual Stockholders' Meeting passed the Stock Option Plan 2001/2003. A total of 299,999 options were issued under this second plan. In contrast to the Stock Option Plan 1999/2000, only the members of the Management Board, members of the executive management of affiliated companies and senior managers and other selected key employees of the Company and affiliated companies are entitled to receive options under the Stock Option Plan. Following a two-year lock-up period, one third of the options may be exercised within clearly defined exercise periods after one, two, and three years, respectively. The exercise price is composed of the reference price and a premium of 20 percent as a performance goal. The reference price equals the average closing price of Zapf Creation stock in Xetra trading during the last ten days before the day on which the options are granted, but it may not be lower than the closing price on the day on which the options are granted. Other terms and conditions including exercise periods, maturity, and non-transferability are similar to those applicable for the Stock Option Plan 1999/2000. The design of the plan enables Zapf Creation AG to fulfill the claims of option holders at the time of exercise either by issuing stock under Contingent Capital II, which was created especially for this purpose, or by issuing treasury stock which was acquired pursuant to Section 71 para 1 no. 8 German Stock Corporation Act. The Management Board and the Supervisory Board shall jointly decide which of the two alternatives is offered to the owners of subscription rights. Furthermore, the option holder may exercise his option by way of an "exersale". This means that the option holder asks the Company to sell the shares for which he owns subscription rights immediately. In this case, he receives the difference between the exercise price and the market price. As the design of the stock option plan fulfills the requirements of a fixed plan according to APB Opinion no. 25 and the subscription price at the time of granting the option is higher than the underlying market price, the Stock Option Plan 2003/2005 does not affect personnel expenses pursuant to APB Opinion no. 25. Until December 31, 2004, only treasury stock was issued to option holders under the stock option plan.

Stock Option Plan 2003/2005

On May 7, 2003, the stockholders passed the Stock Option Plan 2003/2005, the third of its kind at Zapf Creation. The plan provides for the granting of up to 400,000 bearer options to members of the Management Board and senior executives of Zapf Creation as well as senior executives of affiliated companies. Furthermore, this plan stipulates that the options are to be issued in up to three annual tranches, with the volume of each tranche not to exceed 40 percent of the total volume. The stock options may be granted once a year within four weeks of formally approving the financial statements. Notwithstanding this provision, the first tranche is granted within six weeks of registering Contingent Capital III, which was created to back this stock option plan, in the commercial register. This was done on July 28, 2003. The options granted under this plan can be exercised at a reference price determined at the time of granting, plus a premium of 20 percent. The basic definition of the reference price is the same as in the Stock Option Plan 2001/2003. After expiry of the two-year lock-up period, one third of the options become exercisable after two years, one third after three years, and one third after four years. Unexercised options expire five years after granting. Further details of the option terms and conditions directly follow those established for the Stock Option Plan 2001/2003.

The design of the Stock Option Plan 2003/2005 also enables Zapf Creation AG to fulfill the claims of option holders at the time of exercise either by issuing stock under Contingent Capital III, which was created especially for this purpose, or by issuing treasury stock which was acquired pursuant to Section 71 para 1 no. 8 German Stock Corporation Act. The Management Board and the Supervisory Board shall jointly decide which of the two alternatives is offered to the owners of subscription rights. Furthermore, the option holder may exercise his option by way of an "exersale". This means that the option holder asks the Company to sell the shares for which he owns subscription rights immediately. In this case, he receives the difference between the exercise price and the market price. As the design of the stock option plan fulfills the requirements of a fixed plan according to APB Opinion no. 25 and the subscription price at the time of granting the option is higher than the underlying market price, the Stock Option Plan 2003/2005 also does not affect earnings pursuant to APB Opinion no. 25.

The following section contains detailed information on the development of granted and exercised options and on the weighted, average exercise prices. As of December 31, 2004, the total volume of all stock options plans launched so far is 826,000 options. Of these, 578,225 options (previous year: 463,725) were granted and 42,604 options (previous year: 42,604) were exercised. One option under Stock Option Plan 2001/2003 can no longer be granted due to an expiration of the granting period.

In April 2004, 114,500 options were issued under the Stock Option Plan 2003/2005 at a subscription price of € 24.00.

	2004		2003	
	Options Number	Weighted average exercise price €	Options Number	Weighted average exercise price €
Options outstanding at January 1	421,121	38.09	314,139	39.70
Options granted	114,500	24.00	125,265	31.98
Options exercised	0	0.00	– 18,283	23.77
Options expired	– 68,626	34.11	—	—
Options terminated	– 466,995	35.22	—	—
Options outstanding at December 31	**0**	**0.00**	**421,121**	**38.09**
Exercisable at December 31	0	0.00	86,448	58.31
Available for grant at December 31	247,774	—	362,274	—
No longer available for grant at December 31	0	0.00	1	—

As of December 31, 2004, there were no options outstanding because all outstanding options were terminated as of December 15, 2004.

As permitted by Statement of Financial Accounting Standards No. 123 ("SFAS 123"), the Company continues to apply the Accounting Principles Board Opinion No. 25 ("APB 25") in accounting for its stock option plans. Accruals for the stock option plans were K€ 0 in 2004 and K€ 0 in 2003.

Had personnel expenses under the stock option plan been posted pursuant to SFAS 123, the effect thereof on the Company's earnings and earnings per share would have been as follows:

		2004	2003
Reported net income	K€	955	12,076
Pro forma compensation expense, net of tax	K€	0	– 13
Pro forma net income	**K€**	**955**	**12,063**
Earnings per share			
Basic	€	0.13	1.53
Basic – pro forma	€	0.13	1.53
Diluted	€	0.13	1.52
Diluted – pro forma	€	0.13	1.51

The fair value of the stock options issued by Zapf Creation AG since 1999 was computed at the time of granting using an individually modified Black-Scholes option price model. Fair value calculation was based on the following assumptions:

		2004	2003
Expected life	(in years)	—	4.0
Risk-free interest rate	%	—	4.9
Expected volatility	%	—	36.0
Expected dividend yield	%	—	1.5

Bonus Plan 2001/2003

In fiscal year 2001, a separate bonus plan for the members of the Management Board and senior executives of Zapf Creation AG and affiliated companies was implemented. The bonus plan is designed similar to the implemented Stock Option Plan 2001/2003. However, the beneficiaries of the bonus plan are compensated directly by way of a cash payment.

The bonus units under the plan may only be granted once a year within four weeks of formally approving the financial statements. The bonus units shall only be paid if the average of the opening and closing price of Zapf Creation stock in Xetra trading on the last trading day before a payment date is at least 20 percent higher than the reference price. The reference price equals the average closing price of Zapf Creation stock 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 percent shall become eligible for payment and after three years a further 33 percent 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 percent of the reference price for every bonus unit.

Based on this bonus plan, a total of 87,539 bonus units with performance goals of € 28.01 were issued in 2003 so that the total volume was exhausted as of December 31, 2004. The total volume under the Plan 2001/2003 with the exception of one bonus unit was issued as of December 31, 2004.

Due to the stock price development, a provision of K€ 0 and K€ 0 had to be set up in 2004 and 2003, respectively, which affected personnel expenses. Personnel expenses resulting from this bonus plan amounted to K€ 0 in fiscal year 2004 (previous year: K€ 128). The remaining maximum additional personnel expenses of the bonus units granted under the Bonus Plan 2001/2003 until December 31, 2004, can amount to K€ 1,233 for the full term of the bonus plan (previous year: K€ 1,241).

Bonus Plan 2003/2005

In fiscal year 2003, a bonus plan similar to the Stock Option Plan 2003/2005 was launched. The same had been done in 2001 with a bonus plan similar to the Stock Option Plan 2001/2003. The detailed terms and conditions were adopted from the Bonus Plan 2001/2003. Notwithstanding this, the cash compensation payable for attaining the 20 percent performance goal was set at 30 percent.

Based on the Bonus Plan 2003/2005, a total of 37,726 bonus units were issued to the beneficiaries for the first time in 2003, at an exercise price of € 36.75. In fiscal year 2004, the second tranche of 114,500 bonus units with a performance goal of € 24.00 was issued.

Due to the stock price development as of December 31, 2004, no provision effecting personnel expenses needs to be set up. The maximum additional personnel expenses of the bonus units issued under the Bonus Plan 2003/2005 until December 31, 2004, can amount to K€ 937 for the full term of the bonus plan (previous year: K€ 320).

The following schedule provides information on the bonus units issued and the average personnel expenses:

	2004			2003		
	Bonus units	Weighted average exercise price	Weighted personnel expenses	Bonus units	Weighted average exercise price	Weighted personnel expenses
	Number	€	€	Number	€	€
Bonus units outstanding at January 1	306,005	28.87	5.10	212,460	26.35	4.39
Bonus units granted	114,500	24.00	5.54	125,265	31.98	6.04
Bonus units exercised	0	0.00	0.00	−31,720	24.31	4.05
Bonus units expired	−31,300	28.59	4.92	—	—	—
Bonus units outstanding at December 31	**389,205**	**27.46**	**5.25**	**306,005**	**28.87**	**5.10**
Available for grant at December 31	247,774	—	—	362,274	—	—
No longer available for grant at December 31	0	0.00	0.00	1	—	—

Note 9:
Commitments and Contingencies

Dependence on Suppliers

The principal suppliers of the goods purchased by Zapf Creation AG are located exclusively in the People's Republic of China. The business relationships with Asian suppliers, which were initiated in the mid-1980s, were and continue to be strengthened by Zapf Creation (H.K.) Ltd. Although the Company relies on external Asian suppliers, it retains the ability and flexibility to use alternative sources of supply because no long-term, mutually binding purchase obligations towards the suppliers exist. However, any extended interruptions or disruptions of these business relationships might impact the Company's financial situation and its results of operations.

Leasing Contracts and Leases

In the normal course of business, the Company concludes a multitude of leasing contracts and leases for office facilities and warehouses, as well as for plant and equipment.

The expenses recognized under such contracts were K€ 2,495 in fiscal year 2004 (previous year: K€ 3,139).

The following table shows the future minimum obligations of Zapf Creation Group under leasing contracts and leases in K€:

Operating leases	K€
2005	2,134
2006	991
2007	386
2008	115
2009	97
Thereafter	196
	3,919

Obligations stemming from long-term leasing contracts expire no later than in 2015. The Company's management expects expiring leasing contracts and leases to be renewed or replaced as necessary in the normal course of business.

Other Financial Obligations

The Company had unused open letters of credit in the amount of K€ 144 as of December 31, 2004 (previous year: K€ 8).

Zapf Creation routinely concludes license agreements with external inventors with the aim of using their technical designs for the Company's products. A small number of agreements contain provisions for payment of a guaranteed minimum annual license fee, should the revenues from the sale of the product(s) remain under a guaranteed fixed amount. Although these agreements were concluded for an unlimited period of time, they may be terminated if certain conditions apply. The licensing agreements will continue to be valid regardless of any such termination.

The expected revenue from product sales under these agreements exceed the stipulated minimum amounts so that there will be no contingent liabilities.

The cost of product license agreements was K€ 2,606 in 2004 and K€ 3,266 in 2003. These sales-related costs will remain at this low level as the Company acquired the BABY born® license in the reporting year.

Litigation

The Company is involved in various lawsuits incidental to its business. The Management Board believes, however, that the resolution of these matters will not have any adverse effect on the Company's business, financial condition, or results of operations. Zapf Creation creates appropriate provisions for any legal disputes pending beyond year's end.

Relationships with Related Parties
A variable credit line in the maximum amount of K€ 500 was granted to the members of the Management Board, of which K€ 500 were outstanding as of December 31, 2004 (previous year: K€ 270). The agreed interest rate is 4.25 percent. The loan can be terminated with a notice period of one year. During fiscal year 2004, a total of K€ 125 was repaid (previous year: K€ 480) and a total of K€ 355 was newly extended under this credit line (previous year: K€ 250). Salary advances paid to the member of the Management Board were subject to an interest rate of 4.25 percent, in line with the remaining loan.

Senior executives of the Company were granted a fixed loan in the amount of K€ 325, of which K€ 325 were outstanding as of December 31, 2004 (previous year: K€ 325). No repayments were made in 2004 and 2003. The related interest agreement with a fixed interest rate of 4.5 percent remains unchanged until the loan becomes repayable on March 31, 2005. To secure the loan, a mortgage in the amount of K€ 200 was taken and the blocking of a securities account was agreed.

Note 10:
Segment Reporting

Given the structure of the Zapf Creation Group, all subsidiaries (also called “business units”) are responsible for their respective markets. The Company markets only branded play concepts and as of the end of the reporting period did not have product segments that are subject to reporting requirements. Therefore, this segment report focuses on the various subsidiaries and their respective markets. Segment performance is measured at the operating profit level, prior to consolidation.

Compared to its subsidiaries, Zapf Creation AG had a different role until December 31, 2003, because it assumed a number of centralized corporate functions and also invoiced customers (through the Central Europe and Eastern Europe business units). The Parent Company thus accounted for the majority of operating expenses and assets in its 2003 Financial Statements. The spin-off of operations from Zapf Creation AG to Zapf Creation (Central Europe) GmbH & Co. KG and Zapf Creation Logistics GmbH & Co. KG has improved the comparability between these entities and the other business units. Since 2004, Zapf Creation AG has only performed centralized and service functions for its subsidiaries.

Inter-company sales and expenses are carried out under terms and conditions which, in the view of the Company’s management, are appropriate for arm’s length transactions.

Zapf Creation AG and all its subsidiaries apply the accounting policies of the Group. See also Note 2.

Information by segment and the reconciliation to the amounts reported in the Consolidated Financial Statements are as follows:

	Net sales from external customers K€	Affiliated revenues*) K€	Depreciation and amortization expense**) K€	Interest result K€
2004				
Zapf Creation AG	0	18,852	3,227	8,659
Zapf Creation (España), S.L.	12,505	112	74	−78
Zapf Creation (France), S.a.r.l.	9,093	273	49	−147
Zapf Creation (U.K.), Ltd.	47,981	450	206	−69
Zapf Creation (H.K.), Ltd.	4,524	57,492	707	116
Zapf Creation (U.S.), Inc.	27,645	330	173	−915
Zapf Creation (Australia), Pty. Ltd.	6,264	33	341	−33
Zapf Creation (Italia), S.R.L.	1,707	404	31	−6
Zapf Creation (CZ), s.r.o.	2,950	6	51	−11
Zapf Creation (Polska), Sp. z o.o.	2,286	0	39	−81
Zapf Creation (Central Europe) GmbH & Co. KG	58,813	5,254	949	−294
Zapf Creation Logistics GmbH & Co. KG	0	5,303	1,324	−620
Zapf Creation (Central Europe) Verwaltungs GmbH	0	1	0	0
Zapf Creation Logistics Beteiligungs GmbH	0	1	0	0
Consolidation	**0**	**−88,511**	**0**	**−10,099**
Consolidation total	173,768	0	7,171	−3,578
2003				
Zapf Creation AG	84,656	23,637	5,623	11,365
Zapf Creation (España), S.L.	12,889	33	100	−81
Zapf Creation (France), S.a.r.l.	9,161	349	49	−82
Zapf Creation (U.K.), Ltd.	43,175	455	144	−210
Zapf Creation (H.K.), Ltd.	7,260	58,316	472	273
Zapf Creation (U.S.), Inc.	32,775	958	172	−838
Zapf Creation (Australia), Pty. Ltd.	6,283	0	114	−87
Zapf Creation (Italia), S.R.L.	1,073	403	16	−10
Zapf Creation (CZ), s.r.o.	2,740	4	50	−24
Zapf Creation (Polska), Sp. z o.o.	1,411	0	24	−40
Zapf Creation (Central Europe) GmbH & Co. KG	0	0	0	0
Zapf Creation Logistics GmbH & Co. KG	0	0	0	0
Zapf Creation (Central Europe) Verwaltungs GmbH	0	1	0	0
Zapf Creation Logistics Beteiligungs GmbH	0	1	0	0
Consolidation	**0**	**−84,157**	**0**	**−14,041**
Consolidation total	201,423	0	6,764	−3,775

*) Including mark-ups, royalties, redebited product licenses

**) According to the fixed asset schedule including production depreciation

Tax expense (income: –) K€	Operating profit***) K€	Capital expenditures K€	Long-lived assets (net of deferred taxes/long-term receivables) K€	Total assets K€
– 1,609	– 16,803	4,946	52,169	113,042
1,016	4,255	17	155	9,309
– 32	967	29	142	6,116
3,128	15,745	196	480	24,342
419	– 1,846	1,044	1,209	15,071
– 319	– 2,333	273	630	21,545
55	120	14	47	3,352
– 177	3	36	53	2,039
87	596	13	84	3,052
30	337	13	83	3,276
385	9,185	839	3,309	45,242
68	– 2,490	1,315	16,129	17,957
0	– 1	0	0	23
0	– 1	0	0	23
0	**– 150**	**0**	**– 42,323**	**– 116,640**
3,051	7,584	8,735	32,167	147,749
2,094	3,524	6,471	29,454	97,740
1,024	4,472	63	213	7,903
– 33	919	103	168	4,250
2,125	12,700	352	500	21,888
409	125	723	907	15,403
– 1,833	486	188	571	29,415
103	1,112	70	451	4,702
– 20	– 229	5	49	1,491
74	584	58	118	2,581
4	– 53	121	99	2,043
0	– 2	0	0	49
0	– 2	0	0	49
0	– 1	0	0	25
0	– 2	0	0	25
0	**– 215**	**0**	**– 1,608**	**– 53,141**
3,947	23,418	8,154	30,922	134,423

***) Excluding the extraordinary item from the closing of production (K€ 3,620) in 2003

Billings by Business Unit	Zapf Creation (Central Europe) GmbH & Co. KG[8]	Zapf Creation (España), S.L.	Zapf Creation (H.K.), Ltd.	Zapf Creation (U.S.), Inc.	Zapf Creation (U.K.), Ltd.
	K€	K€	K€	K€	K€
2004					
Europe	**58,797**	**12,505**	**3,218**	**0**	**47,981**
Central Europe	53,930	0	2,406	0	0
Northern Europe	19	0	812	0	47,981
Southern Europe	262	12,505	0	0	0
Eastern Europe	4,586	0	0	0	0
The Americas	**0**	**0**	**0**	**27,645**	**0**
Asia/Australia	**16**	**0**	**1,306**	**0**	**0**
Net sales	58,813	12,505	4,524	27,645	47,981
2003					
Europe	**84,548**	**12,889**	**5,420**	**0**	**43,175**
Central Europe	80,337	0	2,831	0	0
Northern Europe	– 28	0	2,589	0	43,175
Southern Europe	495	12,889	0	0	0
Eastern Europe	3,744	0	0	0	0
The Americas	**0**	**0**	**0**	**32,775**	**0**
Asia/Australia	**108**	**0**	**1,840**	**0**	**0**
Net sales	84,656	12,889	7,260	32,775	43,175

8) Due to the spin-off (see also Note 1), the sales were attributed to Zapf Creation AG in 2003, whereas in 2004, the sales subsidiary Zapf Creation (Central Europe) GmbH & Co. KG was responsible for the markets.

	Zapf Creation (France), S.a.r.l.	Zapf Creation (Australia), Pty. Ltd.	Zapf Creation (Italia), S.R.L.	Zapf Creation (CZ), s.r.o.	Zapf Creation (Polska), Sp. z o.o.	Net sales
	K€	K€	K€	K€	K€	K€
	9,093	**0**	**1,707**	**2,950**	**2,286**	**138,537**
	23	0	0	0	0	56,359
	0	0	0	0	0	48,812
	9,070	0	1,707	0	0	23,544
	0	0	0	2,950	2,286	9,822
	0	**0**	**0**	**0**	**0**	**27,645**
	0	**6,264**	**0**	**0**	**0**	**7,586**
	9,093	6,264	1,707	2,950	2,286	173,768
	9,161	**1**	**1,073**	**2,740**	**1,411**	**160,418**
	19	0	0	0	0	83,187
	0	0	0	0	0	45,736
	9,142	1	1,073	0	0	23,600
	0	0	0	2,740	1,411	7,895
	0	**0**	**0**	**0**	**0**	**32,775**
	0	**6,282**	**0**	**0**	**0**	**8,230**
	9,161	6,283	1,073	2,740	1,411	201,423

The following table shows the development of sales in the different product lines:[9)]

	2004 K€	2003 K€
Play and functional dolls	**164,083**	**178,388**
BABY born®	68,502	81,694
Baby Annabell	49,179	47,690
CHOU CHOU	41,334	39,930
Other play and functional dolls	5,068	9,074
Mini dolls	**3,899**	**14,065**
Other	**5,786**	**8,970**
Net sales	173,768	201,423

Breakdown of net sales by business unit is as follows:

	2004 K€	2003 K€
Europe	**138,537**	**160,418**
Central Europe	56,359	83,187
Northern Europe	48,812	45,736
Southern Europe	23,544	23,600
Eastern Europe	9,822	7,895
The Americas	**27,645**	**32,775**
Asia/Australia	**7,586**	**8,230**
Net sales	173,768	201,423

Dependence on Product Lines and Major Customers

The BABY born® branded play concept accounted for 39 percent of total sales (previous year: 41 percent)[10)].

9) In contrast to the previous year (2003), mini dolls are included as a separate item.
10) Excluding mini dolls.

The Company's sales to its two main customers accounted for 20 percent of total consolidated sales in 2004 (previous year: 21 percent). Sales to all top ten customers accounted for 42 percent of total consolidated sales in 2004 (previous year: 46 percent). The share of receivables attributable to these major customers in comparison to total receivables is 41 percent before forfaiting (previous year: 45 percent). This share is reduced to a net share of 22 percent as of the end of the fiscal year due to the forfaiting transactions affected (previous year: 11 percent).

Note 11: Supplemental Financial Information

Supplemental Disclosure of Cash Flow Information	2004 K€	2003 K€
Cash paid during the year for:		
Interest	3,679	3,919
Income taxes	5,740	7,101

Some of the changes in financial position shown in the Cash Flow Statement cannot be compared with the figures reported in the current or previous year's Consolidated Balance Sheet, given that the changes shown in the Cash Flow Statement also take into account the effect of varying foreign exchange rates on cash and cash equivalents.

Accrued Liabilities	2004 K€	2003 K€
Advertising and public relations	3,015	3,692
Other accrued liabilities	2,085	3,471
Management bonuses	0	157
Tax liabilities (VAT, other)	1,570	1,874
Other liabilities employees	507	549
Commissions	523	552
License fees	923	1,051
	8,623	11,346

Supplemental Information According to Section 292a HGB

As permitted under Section 292a HGB (German Commercial Code), the Financial Statements of the Zapf Creation Group are prepared in accordance with the Generally Accepted Accounting Principles of the United States ("US GAAP").

To make use of the exemption provisions under Section 292a HGB, the following additional information must be provided.

The Company further points out that it has issued the Declaration of Compliance with the Corporate Governance Code that is required by Section 161 of the German Stock Corporation Act and made this declaration available to the stockholders.

Information According to Section 264b HGB

Zapf Creation (Central Europe) GmbH & Co. KG and Zapf Creation Logistics GmbH & Co. KG, both of which are domiciled in Roedental, Germany, make use of the exemption provisions of Section 264b HGB and subject themselves to a voluntary audit of their Financial Statements.

1) Consolidated Statement of Fixed Assets for Zapf Creation AG, Roedental, Germany

The overview is given on pages 50 and 51.

2) Billings by Business Unit

The overview is given on pages 80 and 81.

3) Liabilities with Remaining Terms of More Than Five Years

In fiscal year 2004, the Company had liabilities with remaining terms of more than five years in the amount of K€ 2,500 (previous year: K€ 3,438). Taking into account the disagio, the liabilities with remaining terms of more than five years amounted to K€ 2,460 (previous year: K€ 3,388).

4) Disclosure of the Cost of Materials and Personnel According to HGB

The cost of materials in 2004 and 2003 according to HGB was K€ 71,155 and K€ 75,665, respectively. The cost of materials comprises the cost of raw materials and supplies in the amount of K€ 1,171 (previous year: K€ 3,582) and the cost of goods purchased in the amount of K€ 69,984 (previous year: K€ 72,083).

Consolidated personnel expenses in fiscal year 2004 were K€ 24,222 (previous year: K€ 25,743). Besides salaries and wages of K€ 20,858 (previous year: K€ 22,697), this amount also includes social security contributions and benefits of K€ 3,364 (previous year: K€ 3,047).

5) Annual Average Number of Employees[11)]

	2004	2003
Salaried employees	418	390
Industrial workforce	85	140
Home workers	0	2
	503	532

11) Excluding the Management Board and trainees

Since October 2004, the number of employees has also included the Chinese quality inspectors. They are attributable to Zapf Creation (H.K.), Ltd. Please note that this group of employees is not included in the comparison figures for the previous year. These quality inspectors carry out permanent quality controls at local manufacturers during production.

6) Supervisory Board

As of the balance sheet date, the Supervisory Board of Zapf Creation AG consisted of the following members:

Name	Member	Function since	Principal occupation	Further supervisory board membership
Dr. Dietmar Scheiter	March 18, 1999	Chairman	Chairman of the Management Board TA Triumph-Adler AG	No memberships outside the Group
Dr. Horst F. Bröcker	March 18, 1999	Deputy Chairman	Managing Director Egon Zehnder International München and Partner Egon Zehnder International	No further memberships
Dr. Petra Wibbe	March 18, 1999	Full member	Lawyer	No further memberships
Arnd Wolpers	March 18, 1999	Full member	Managing Director Capital Management Wolpers GmbH	Articon-Integralis AG, Ismaning Chairman
Dr. Peter Klein	April 4, 1999	Full member	Managing Director Anders + Kern Präsentationssysteme GmbH & Co. KG	GetAhead AG, Hamburg Chairman
Hans-Gerd Füchtenkort	July 31, 2001	Full member	Managing Partner and Partner Dr. Rochus Mummert & Partner	No further memberships

As of December 31, 2004

Dr. Peter Klein was appointed to the Management Board as a deputy member on February 22, 2005. Dr. Klein, who has served on the Supervisory Board of Zapf Creation AG since 1999, will not exercise his duties as a Supervisory Board member during the transition phase. Dr. Horst F. Bröcker resigned from the Supervisory Board effective February 4, 2005.

Remuneration

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 16 para 1 and Section 20 item 1 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 deputy 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).

In addition, for each ordinary member of the Supervisory Board a variable, dividend-based cash compensation of K€ 5 (previous year: K€ 5) for fiscal year 2004 was set aside pursuant to Section 20 item 2 of the articles of incorporation.

This 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 fiscal year.

The total provision set up for the remuneration of the Supervisory Board for fiscal year 2004 was K€ 135 as of December 31, 2004 (previous year: K€ 135).

In the past two fiscal years, no loans were extended to members of the Supervisory Board.

Directors' Dealings

The members of the Supervisory Board and their spouses and relatives in the first degree did not engage in any transactions involving stock, other derivatives or equivalent shares of Zapf Creation AG in the fiscal year, which would have to be disclosed under Section 15a German Securities Trading Act.

7) Management Board

The following table lists the members of the Management Board of Zapf Creation AG and their areas of responsibility. The members of the Management Board are jointly responsible for managing Zapf Creation AG and all independent and dependent subsidiaries.

Name	Function	Term of office	Area of responsibility
Thomas Eichhorn	Chairman	December 31, 2007	Strategy & Corporate Development, Sales, Marketing, Investor and Public Relations, Human Resources, Internal Audit, Quality Management, Purchasing
Christian Ewert	Full member	April 30, 2004	Production, Quality Management, Purchasing, Logistics, IT
Angelika Marr	Full member	December 31, 2007	Design, Product Development
Rudolf Winning	Full member	March 15, 2005	Finance, Legal Affairs, Risk Management, Organization, Investor Relations, Logistics, IT

Remuneration

The total remuneration of the Management Board is the sum of all cash compensation and non-cash benefits. At Zapf Creation AG, this remuneration is composed of fixed and variable or performance-based componentfls. Total compensation in 2004 was K€ 760 (previous year: K€ 953). The variable component in fiscal year 2004, which mainly consists of bonus units, was approximately 19 percent (previous year: 30 percent). The deviation in the share of variable compensation as compared to the previous year is due to the fact that no stock options and bonus units were exercised in fiscal year 2004.

In addition, the members of the Management Board received 50,000 stock options (previous year: 21,000) under the Stock Option Plan 2003/2005. However, these options were terminated by way of a waiver on December 15, 2004.

The Company also granted the members of the Management Board 50,000 bonus units (previous year: 21,000) under the Bonus Plan 2003/2005. Further details regarding the individual plans are explained in Note 8 “Stock-based Compensation”.

In fiscal year 2004, a former member of a corporate board was paid a variable compensation of K€ 120.

A variable credit line in the maximum amount of K€ 500 was granted to the members of the Management Board, of which K€ 500 were outstanding as of December 31, 2004 (previous year: K€ 270). The agreed interest rate is 4.25 percent. The loan can be terminated with a notice period of one year. During fiscal year 2004, a total of K€ 125 was repaid (previous year: K€ 480) and a total of K€ 355 was newly extended under this credit line (previous year: K€ 250). Salary advances paid to the member of the Management Board were subject to an interest rate of 4.25 percent, in line with the remaining loan.

Directors’ Dealings

No transactions were carried out by members of the Management Board and their spouses and relatives in the first degree which would require disclosure under Section 15a German Securities Trading Act since July 1, 2002.

Roedental, Germany, February 28, 2005

Thomas Eichhorn
Chairman of the
Management Board

Angelika Marr
Member of the
Management Board

Dr. Peter Klein
Deputy Member of the
Management Board

We have audited the Consolidated Financial Statements of Zapf Creation AG for the fiscal year from January 1, 2004 to December 31, 2004, comprising the Balance Sheet, the Income Statement, the Statement of Changes in Equity, the Cash Flow Statement, and the Notes to the Consolidated Financial Statements. The preparation of the Consolidated Financial Statements and their contents are the responsibility of the Company's management. Our responsibility is to express an opinion whether the Consolidated Financial Statements are in conformity with United States Generally Accepted Accounting Principles (US GAAP) based on our audit.

We conducted our audit of the Consolidated Financial Statements in accordance with the generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer in Deutschland (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 are detected with reasonable assurance. The effectiveness of the internal control system and the evidence supporting the disclosures in the Consolidated Financial Statements are examined primarily on a test basis within the framework of the audit. The audit includes assessing the accounting and consolidation principles used and significant estimates made by management, as well as evaluating the overall presentation of the Consolidated Financial Statements. We believe that our audit provides a sufficiently sound basis on which to issue our opinion.

In our opinion, the Consolidated Financial Statements give a true and fair view of the net assets, financial position, and results of operations of the Group in accordance with United States Generally Accepted Accounting Principles (US GAAP) of proper accounting.

Our audit, whose scope also extends to the Group Management Report by the management for the period from January 1, 2004 to December 31, 2004, has not led to any reservations. On the whole, the Group Management Report provides a suitable understanding of the Group's position and suitably presents the risk of future development. Furthermore, we confirm that the Consolidated Financial Statements and the Group Management Report for the fiscal year beginning January 1, 2004 and ending December 31, 2004 fulfill the requirements for exempting the Company from the necessity of preparing Consolidated Financial Statements and a consolidated Group Management Report according to German law.

Nuremberg, Germany, February 28, 2005

Rödl & Partner GmbH
Wirtschaftsprüfungsgesellschaft
Steuerberatungsgesellschaft

Kastl
Wirtschaftsprüfer
(Independent auditor)

Schäfer
Wirtschaftsprüfer
(Independent auditor)

Ladies and Gentlemen,
There were no changes regarding the composition of the Supervisory Board of Zapf Creation AG in fiscal year 2004. Dr. Horst Bröcker resigned from the Supervisory Board effective February 4, 2005. The Supervisory Board thanks Dr. Bröcker for his great personal commitment.

The number of members on the Management Board of Zapf Creation AG was reduced from four to three in the reporting period. Christian Ewert, who had been appointed as chief operating officer to the Management Board effective July 24, 2002, prematurely resigned from the Board at his own request effective April 30, 2004. Since then, the business of Zapf Creation AG has been managed by Thomas Eichhorn (chief executive officer), Rudolf Winning (chief financial officer) and Angelika Marr (chief design officer). On December 2, 2004, the Supervisory Board reappointed Thomas Eichhorn and Angelika Marr to the Management Board until December 31, 2007. Rudolf Winning resigned from the Management Board by mutual agreement effective March 15, 2005.

The Supervisory Board carried out its duties as provided by law and the Company's articles of incorporation in a total of six meetings. At these meetings, the Management Board of Zapf Creation AG informed the Supervisory Board of the current state of business and the development of the Company, both verbally and in writing. Key topics were the development of business in the USA and in Central Europe including Germany, the most important market for Zapf Creation AG. Other topics of interest included assessments and evaluations in connection with risk management and with the product portfolio for 2005/2006. In addition, the chairman of the Supervisory Board and the chairman of the Management Board met regularly for in-depth discussions of current issues.

An audit committee chaired by Dr. Peter Klein, member of the Supervisory Board of Zapf Creation AG, was implemented to audit the Financial Statements for the 2004 fiscal year. The audit committee met twice for in-depth discussions of the Financial Statements and the Management Report of the Zapf Creation Group together with the chief financial officer and the auditors and presented a report to the Supervisory Board.

The present Financial Statements for fiscal year 2004 and the Management Report including the accounts were audited by the auditors, Rödl & Partner GmbH, Wirtschaftsprüfungsgesellschaft, Nuremberg, which were elected by the Annual Stockholders' Meeting and appointed by the Supervisory Board. The auditors issued an unqualified audit certificate.

The auditors presented their audit report to the Supervisory Board. The Supervisory Board agrees with the auditors' findings. At its meeting on March 16, 2005, the Supervisory Board extensively discussed, examined, and approved the Financial Statements and the Management Report prepared by the Management Board. The auditors were present during this meeting. The Financial Statements are therefore final. The Supervisory Board also reviewed and approved the proposal of the Management Board regarding the appropriation of profits.

At its meeting on March 16, 2005, the Supervisory Board also thoroughly reviewed and approved the Consolidated Financial Statements as of December 31, 2004, which received an unqualified audit certificate from Rödl & Partner GmbH Wirtschaftsprüfungsgesellschaft, Nuremberg, and the Group Management Report.

The Supervisory Board wishes to thank the Management Board and the Company's employees for their dedication and their achievements in a difficult market environment.

Munich, Germany, March 16, 2005
For the Supervisory Board

Dr. Dietmar Scheiter
Chairman

Published by:

Zapf Creation AG
Moenchroedener Strasse 13
96472 Roedental, Germany
Phone: +49 (0) 9563/72 51-0
Fax: +49 (0) 9563/72 51-116
E-mail: info@zapf-creation.de

Contact Investor Relations:

Monika Collée
Phone: +49 (0) 9563/72 51-195
E-mail: monika.collee@zapf-creation.de

Text:
Zapf Creation AG, Roedental

Concept and realization:
CAT CONSULTANTS GmbH & Co., Hamburg

Photography:
Andreas Pohlmann, Munich
Peter Kaus, Hamburg

The photos published in the “Social Responsibility” section were taken at Zapf Creation AG’s Chinese suppliers during a routine control visit of Chief Design Officer Angelika Marr.

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

Publication date: March 23, 2005

The Financial Statements of Zapf Creation AG according to HGB are available by mail upon request.

Zapf Creation AG
Moenchroedener Strasse 13
96472 Roedental, Germany
Phone: +49 (0) 9563/72 51-0
Fax: +49 (0) 9563/72 51-116
E-mail: info@zapf-creation.de
Internet: www.zapf-creation.com