Zapf Creation AG

Annual Report 2003

Zapf Creation AG
Annual Report 2003

Contents

At a Glance

Consolidated Key Figures

	2003	2002	2001	2000	Change in %[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	201.4	222.7	193.1	164.9	– 10
EBITDA[2]	26.2	38.3	30.0	25.4	– 32
EBIT	19.8	32.9	26.4	23.4	– 40
EBIT in % of sales	9.8	14.8	13.7	14.2	– 34
EBT	16.0	30.6	23.2	21.4	– 48
Net income	12.1	21.2	16.4	15.3	– 43
Basic earnings per share in €[4]	1.53	2.70	2.09	1.93	– 43
Amortization and depreciation[5]	6.8	5.7	4.0	2.4	19
Balance sheet in € million					
Total assets	134.4	139.9	112.0	100.7	– 4
Long-lived assets (incl. deferred taxes)	31.3	30.1	26.7	15.3	4
Investments	8.2	9.9	16.1	7.5	– 17
Current assets	103.2	109.8	85.4	85.4	– 6
Stockholders' equity	55.1	60.8	47.7	37.7	– 9
Equity ratio in %[6]	46.3	48.6	47.3	39.7	– 5
Return on equity before taxes in %	29.0	50.4	48.7	56.8	– 42
Liabilities due to banks	55.3	43.2	34.5	31.9	28
Cash flow in € million					
Net cash flow from operating activities	12.7	10.1	29.0	– 10.1	25
– per share in €[4]	1.61	1.29	3.68	– 1.28	25
Net cash flow	0.5	3.6	5.4	0.0	– 86
Number of employees at the closing date (Dec. 31)[7]	538	514	498	415	5

[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 7.907 million shares in 2003 (2002: 7.864 million shares). 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 2003 versus 2002, rounded.

Corporate Boards

Supervisory Board
Dr. Dietmar Scheiter, Chairman Chief Executive Officer of TA Triumph-Adler AG
Dr. Horst F. Bröcker, Deputy Chairman 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 Managing Director of Anders + Kern
Hans-Gerd Füchtenkort Managing Partner and Partner of Dr. Rochus Mummert & Partner

Management Board
Thomas Eichhorn, Chairman Strategy & Corporate Development, Sales, Marketing, Investor Relations, Public Relations, Human Resources, Internal Audit
Christian Ewert Production, Quality Management, Purchasing, Logistics, IT
Angelika Marr Design, Product Development
Rudolf Winning Finance, Legal Affairs, Risk Management, Organization, Investor Relations

Thomas Eichhorn, Chairman of the Management Board

Angelika Marr, Member of the Management Board

Rudolf Winning, Member of the Management Board

Christian Ewert, Member of the Management Board

Foreword of the Management Board

Dear Stockholders,
Dear Friends of Zapf Creation AG,

Last year, the economy showed little or no momentum at all. Events outside of the economy, such as the war in Iraq and the outbreak of SARS in the first half of the year, were some of the negative forces that put the brakes on economic development and continued to weaken demand among private households.

In Germany, retailers reacted to the "buyers' strike" with a discount war that triggered consumers' never-ending "quest for the biggest savings". This climate made itself felt in the toy industry, too. Prices for toys were slashed significantly as early as in November 2003 and thus long before the holiday season, which is critical to our industry.

Sales development was stable in the worldwide toy industry in the 2003 fiscal year. However, regional markets were subject to different trends. While regional toy markets in Europe experienced stable or positive growth, the U.S. toy market declined by three percent. In 2003, the worldwide toy market was once again awash in trendy toys such as battle tops and collectors' cards. Among little girls, fashion was the trendy topic, leading to increased competition in the fashion doll segment, to the detriment of the play and functional doll segment including accessories. But it has been equally clear for many decades that playing with dolls and the traditional mother-child role play that goes with it remain very important internationally for children and parents alike and that there are no signs that this will change any time soon.

In the past few years, Zapf Creation posted annual sales growth of 15 percent on average. In the 2003 fiscal year, sales declined by about four percent relative to the previous year, adjusted for currency translation. This was due mainly to developments in the United States. In contrast, the Company's core business – its strong brands BABY born®, Baby Annabell, and CHOU CHOU, including the respective accessories, in the play doll and functional doll segment – developed positively in all other regions, growing by just under six percent in Europe. Sales declined to $ 37.0 million in North America, where previously Zapf Creation had tripled sales to almost $ 47.3 million in fiscal years 2000 through 2002. This decline was rooted in the operative development of business. We made changes in the U.S. management in December 2003 once these developments had become visible in the late fall of 2003.

Foreword of the Management Board

In July 2003, we made the strategic decision to focus on our core business – which includes our branded play concepts in the play doll, functional doll, and mini doll segments – and to withdraw simultaneously from the niche segment of high-valued artists' dolls that was covered by our Designer Collection product line. This decision was made in the face of consumers' increasing restraint, especially with regard to high-end articles, and strong concentration among retailers. This step will also lead to the closing of production at the Company's headquarters in Roedental, Germany, where the artists' dolls in the Designer Collection were manufactured by hand. The elimination of 74 jobs that this decision entails will be completed by May 2004.

The share of production that had been outsourced was at 95 percent even before this decision was made. With the exception of a few high-volume articles, our products are now delivered exclusively from China. To this end, Zapf Creation has maintained an office in Hong Kong since 1991, which plays a central role in the Group's procurement process. Zapf Creation thus also had to deal with SARS, the infectious disease that circulated in Asia. As an immediate preventive measure aimed at maintaining smooth procurement processes and at protecting our employees in Hong Kong, we rented additional office space in April 2003 and, by dividing the employees, created two organizationally similar units that could perform all core functions independently of each other. Zapf Creation would thus have remained functional without major problems, even if one of the offices would have had to close.

Furthermore, local management compiled a list of preventive measures and rules of conduct in cooperation with our suppliers in mainland China. Detailed emergency plans were discussed with and made available to these suppliers. Fortunately, there was never any need to implement our emergency plans. After the announcement by the World Health Organization (WHO) on July 5, 2003, that the chain of infection had been broken, our employees were reunited once again and the second Hong Kong office was closed.

What are our plans in terms of strategy? We invested a lot of time and energy in the past few months to analyze both our business model and our processes. We are now prepared to stay the course, even if the business climate turns a bit rough, and to at least maintain or even strengthen our current position. In concrete terms, this means that we must optimize our core segment (play, functional, and mini dolls, along with the respective accessories), make our product portfolio even more efficient, and streamline our product development so that we can react even faster to market conditions. We are convinced that this will enable us to generate continued growth from our core business in the future as well.

In order to make the Company and our activities even more transparent for our partners in the sense of lived corporate governance, at the Annual Stockholders' Meeting on May 7, 2003, we obtained approval for spinning off the sales and logistics segments located at our Roedental headquarters, which to this day remain legally dependent entities that are independently managed. This measure not only turns these two units into legally independent entities, it also ensures the future transparency of these two areas in terms of both costs and efficiency. An internal project team has been working on the necessary preparations since May 2003. Following the registration of the new companies in the German Commercial Register, which is scheduled for the late spring of 2004, Zapf Creation (Central Europe) GmbH & Co. KG and Zapf Creation Logistics GmbH & Co. KG will operate independently and for their own account.

In the future, we will also intensify our efforts to bring about uniform positioning and perception of the Group worldwide. Our internationalization strategy, which we successfully implemented until 2002, drew many new employees, cultures, and languages into the Group. Plans are to create a consistent platform in the future for this new multicultural organization, which will govern our decisions, our conduct, and our presence worldwide and turn us into a powerful cohesive and effective unit. We have already started to work with our executives, in the context of an ongoing training program, on furthering the development of our corporate culture and structures. The significance of this crucial step is also documented in this annual report in the chapter entitled, “The Capital in Their Heads.”

More than ever, we are banking on the innovative power of our company and on our new products. That is how we plan to boost our core business, especially in America and France, where we expect to achieve the largest growth in the short and medium term. In 2001, we decided to gain ten market share points in the medium term in both markets in the play doll and functional doll segment including accessories, and we continue to pursue that objective.

The past fiscal year was certainly not an easy one, and the new fiscal year will most likely not be any easier. But Zapf Creation has talented and motivated employees who once again proved that they remain energetic, highly committed, and loyal. We thank them for that. But we also want to thank you, dear stockholders, for your loyalty and your trust. The trust you place in us means that we will continue to stay committed to our goals.

Thomas Eichhorn
Chairman of the
Management Board

Christian Ewert
Member of the
Management Board

Angelika Marr
Member of the
Management Board

Rudolf Winning
Member of the
Management Board

Zapf Creation Stock

A Promising Beginning ...

The positive development of business in 2002 and the resulting positive sentiment toward Zapf Creation AG also helped the Company's stock to buck the negative trend of the MDAX at the beginning of 2003. By the end of March 2003, Zapf Creation stock was already trading 18 percentage points above the MDAX. It expanded its lead to just under 31 percentage points by mid-May 2003, even though the MDAX had already gained 7 percent relative to the start of the year. By this time, Zapf Creation stock had reached its first interim high for the year of € 35.20. At a total of just under 44 percentage points, the MDAX continued its almost uninterrupted rise until the last trading day of 2003. Zapf Creation stock, however, fluctuated between the time it reached its first interim high in mid-May and the time it reached € 37.65 on September 5, 2003, its highest level for the year. The stock's positive trend overall was not even undermined by the announcement on July 24, 2003, of the sales figures for the first six months of 2003, which were "only" on the previous year's level. Until the end of October, the MDAX and Zapf Creation stock kept abreast of each other.

... and a Surprise Turn of Events

The parallel movement of the MDAX and Zapf Creation stock came to a sudden halt when Zapf Creation AG published its third quarter figures on October 29, 2003. The fact that for the first nine months of 2003 sales had "only" remained at the previous year's level and that, according to the revised outlook, sales for the year would also attain "only" the previous year's level, as well as the fact that the outlook for revenue growth (EBIT) for all of 2003 had been reduced to plus 7 percent, caused Zapf Creation stock to fall by about 25 percent in just a few days. A further reduction in the sales and earnings forecasts for 2003 triggered yet another decline in the stock price to € 17.18, on the very same day (November 26, 2003), the stock's lowest price for the year. At the end of 2003, the price rallied slightly, closing at € 19.13, which was about 25 percent below the opening price at the beginning of the year (€ 25.50) and just under 69 percentage points below the MDAX.

All of this was accompanied by a significant increase in the stock's trading volume to 47,200 per day on average in 2003, almost a tripling of the previous year's volume (about 16,500 shares per day).

Zapf Creation AG Takes Advantage of the Low Stock Price to Purchase Stock for its Employee Stock Option Plan

In the fourth quarter of 2003, especially in December, Zapf Creation AG purchased about 6.8 percent of its own stock for its employee stock option plans. Treasury stock holdings as of the close of the year were 7.16 percent, valued at an average price of € 19.83 per share. The remaining 93 percent of the Group's stock constitutes the free float, as before.

Current Developments after the Close of the Year 2003

The capital markets reacted in two ways to the publication on January 20, 2004, of preliminary and unaudited figures as per the close of 2003, which confirmed the sales outlook published at the end of November 2003 of about € 200 million but contained yet another reduction in earnings before interest and taxes (EBIT) to about € 23.5 million (previously about € 26 million). Analysts, particularly those in banks' research departments, were disappointed yet again and understandably uncertain about the stock. But institutional investors, who thought that the forecast problem had finally been solved and considered the problems in the United States to be a one-time "slip", reacted by beginning to include Zapf Creation stock in their portfolios. This boosted the stock price to a level of € 22 to € 23 in early February 2004.

Increased Communication with the Financial Community

Given the particular forecast problem at the end of 2003, the Management Board of Zapf Creation again intensified its activities aimed at continuously maintaining and strengthening communication with all relevant capital market participants. The aim was to take into account the particular need for explaining the unique events in the United States to date.

On October 29, 2003, the first Capital Market Day for analysts, financial reporters, and investors was organized under the banner "Fashion, Trends, and Design", with the aim of offering an in-depth look into the processes of developing and creating doll worlds and branded play concepts.

Maintaining the Dividend Payment for 2003 Despite Reduced Earnings

Despite the decline in sales and earnings by about 10 percent and 43 percent, respectively, compared to the previous year, the Management Board and the Supervisory Board will propose to the Annual Stockholders' Meeting to adopt a dividend at the previous year's level of € 1.00 per share. This is designed to underscore that last year's problems were one-time occurrences, which should not be borne by the stockholders, and to demonstrate our optimism that we are back on our growth track in the current year.

The retained earnings in the amount of € 28,504,144.02 as per the individual financial statements of Zapf Creation AG prepared according to the German Commercial Code [Handelsgesetzbuch – HGB] for the 2003 fiscal year shall be used to pay the dividend in the amount of € 7,427,322.00. The balance of € 21,076,822.02 shall be carried forward.

Stock Performance 2003 (Index)

*Closing price Xetra, daily

Corporate Governance

Both the Management Board and the Supervisory Board of the Zapf Creation AG 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 21, 2003, and as published by the German Ministry of Justice on July 4, 2003, in the official section of the electronic Federal Gazette [Bundesanzeiger], with the exception of the following items and/or topics:

3.8
– Reasonable deductible in connection with the purchase of a D&O insurance for members of the Management and Supervisory Boards

4.2.3
– Agreement on the possibility of imposing limitations (caps) in connection with the exercise of stock options
– Statement in the annual report and on the Company's Web site, as well as at the Annual Stockholders' Meeting, concerning key aspects of the compensation system

4.2.4
– Individualized reporting of the compensation paid to Management Board members

5.2, 5.3.1, and 5.3.2
– Creation and composition of committees within the Supervisory Board

7.2.1
– Statement concerning the independence of the auditors in terms of professional, financial, and other relationships to the Company

Zapf Creation AG created a separate section on its German Web site at www.zapf-creation.de/unternehmen on the issue of corporate governance, which contains detailed explanations on the aforementioned differences and the formal Declaration of Compliance. In addition, 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 can also be accessed on our Web site.

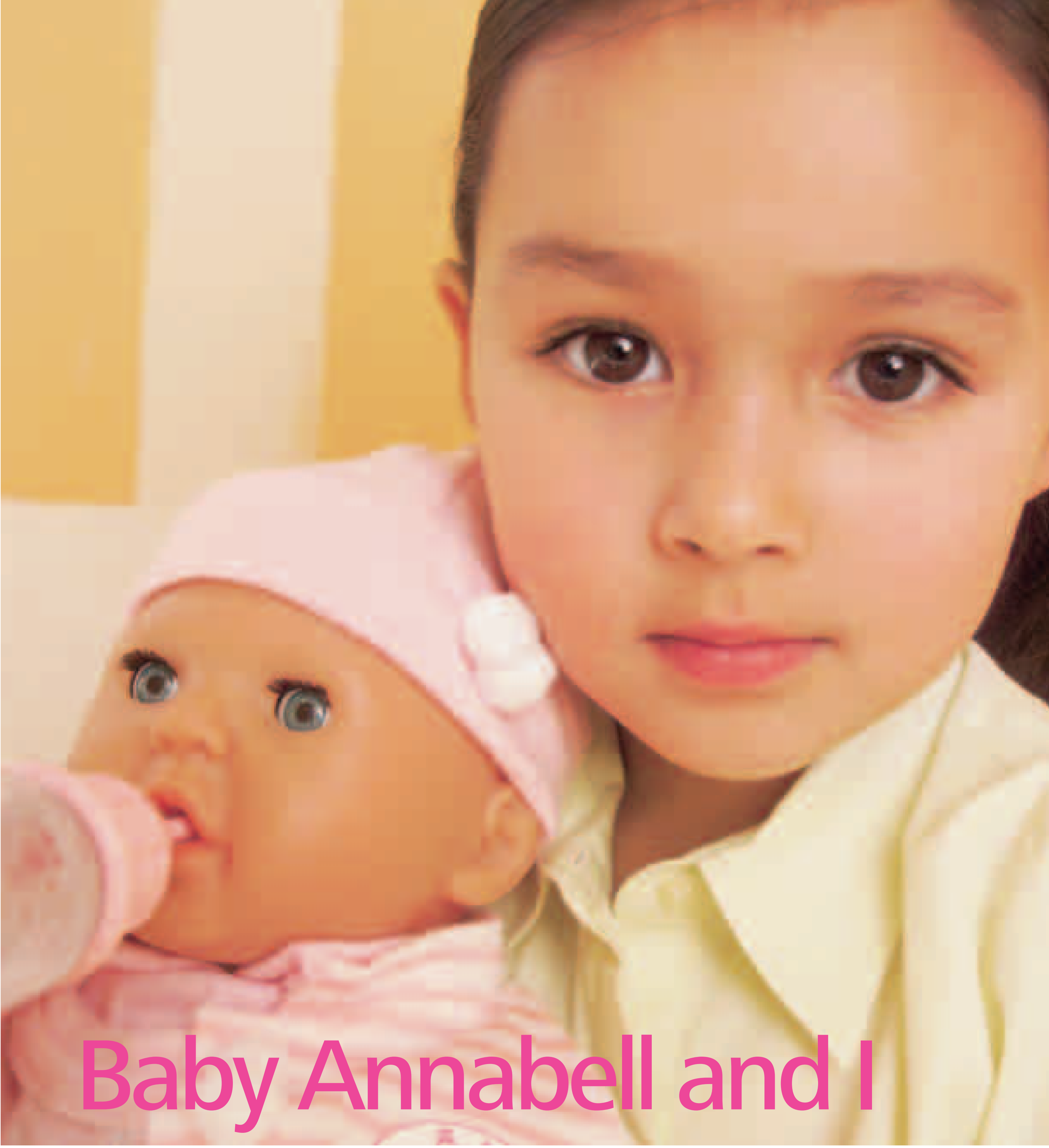
The fourth Annual Stockholders' Meeting of the Zapf Creation AG took place on May 7, 2003, at the logistics center in Roedental, Germany. Unfortunately, only about 19 percent of the votes representing the Company's share capital attended the Annual Stockholders' Meeting. This was all the more disappointing, because about 52 percent of the share capital had been deposited with depositary banks, but the respective instructions did not reach the Zapf Creation AG in due time for the voting. 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

	2003		2002		2001	
Market capitalization (based on the year-end price) in € million	153		204		208	
High (Xetra) in €	37.65	(Sep. 5)	29.50	(June 21)	50.00	(Jan. 5)
Low (Xetra) in €	17.18	(Nov. 26)	16.80	(Oct. 8)	17.61	(Oct. 9)
Year-end price (Xetra, Dec. 31) in €	19.13		25.54		26.00	
Daily trading volume (average no. of shares)	47,180		16,478		11,364	
Average price (Xetra) in €	29.40		23.77		31.20	
P/E ratio (Xetra, Dec. 31)	12.5		9.0		12.5	
Basic EPS in € [1]	1.53 [2]		2.70		2.09	
CFPS in €	1.61 [2]		1.29		3.68	
Dividend per share in €	1.00 [3]		1.00		0.65	
Dividend yield (Xetra, Dec. 31) in %	5.2		3.9		2.5	

[1] basic, average number of shares outstanding [2] with extraordinary item [3] subjekt to approval by the Annual Sockholders' Meeting

Research coverage/analyst recommendations		
Dresdner Kleinwort Wasserstein	March 2004	Hold
Bankhaus Lampe	March 2004	Sell
CAI Cheuvreux	March 2004	Underperform
Deutsche Bank	February 2004	Buy
ABN Amro	January 2004	Reduce
Berenberg Bank	January 2004	Buy
Cazenove	January 2004	Hold
Commerzbank	January 2004	Equal weight
DZ Bank	January 2004	Sell
Hamburger Sparkassse	January 2004	Hold
HypoVereinsbank	January 2004	Underperform
HSBC Trinkaus & Burkhardt	January 2004	Reduce
Nord LB	November 2003	Reduce



Baby Annabell and I

I just love my Baby Annabell, because it's like a real baby – my friend in Great Britain thinks so, too.

What a beautiful day! Annabell woke me up because she wants to have breakfast.
When she's being fed, Baby Annabell makes real sucking sounds and moves her mouth like a real baby. Whether bottle, pajamas, or changing bag – everything you need for a baby is also available for my Baby Annabell.

I'm going to show Baby Annabell the harbor today. Hope she's not going to be cold!
Baby Annabell still is very young and has to be protected. She needs warm clothes to wear outside. In her pink raincoat, she'll be bundled up for trips on the sightseeing boat. That'll make the tour around the harbor real fun.

Baking a cake with Baby Annabell and mom. We're a great team!
Annabell and I are celebrating her birthday today. But first we must finish baking her cake. It tastes really good. Mom gave Baby Annabell a new dress that has flowers and little sheep on it – I like it.

Here come the water nymphs…

Water attracts us as if by magic. We could spend all day swimming, splashing around, and diving. Let’s go have some fun at the pool – the New BABY born® can now come along, too.

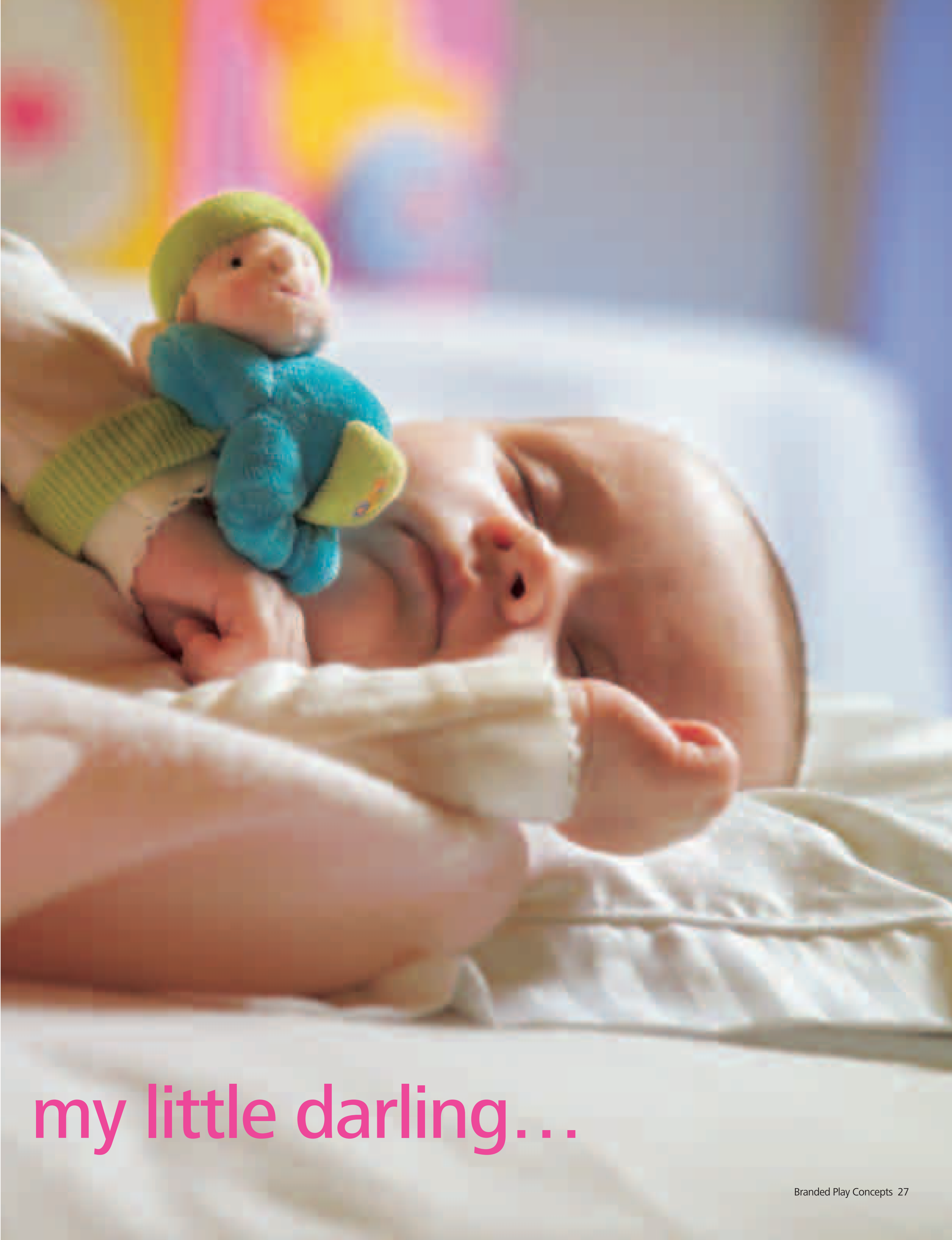
Our BABY born® is as much a water nymph as we are!

The New BABY born® likes water as much as many little girls do. Taking BABY born® along helps little girls to dare something special and to dive from the diving board. BABY born® cuts an athletic figure in its green flippers and froggie diving mask.

A trip to the pool is fun. We can horse around here as much as we like.

The new accessories for BABY born® include everything for being in and around water. Snorkeling equipment and a bikini, as well as a cozy hooded towel with duck slippers or a soft robe at home. And who hasn't met "Berta", the duck, yet? It comes with every New BABY born®.

The youngest are the greatest.
Especially when they're sound asleep. While a baby can hear and see from birth, in the beginning it's eyes can only perceive the world around it as light and dark. At about three months, babies start to recognize colors and react to them. Strong colors are a particular favorite at this time. The colorful and soft fabric characters of my lovely BABY, which are similar in design to Zapf Creation's well-known and successful branded elements, inspire even our youngest to play and cuddle. Playing with the lovingly designed my lovely BABY products helps infants to recognize colors, sounds, and different materials and promotes the development of all of their senses.



my little darling…

It’s so great that you’re here with me…

To rediscover the world all over again with you. What a pleasure...
Toddlers discover something new every day. They turn learning and playing into colorful adventures in which amusing playmates can offer them a lot of comfort.

Even a great discoverer

There's so much to marvel at and understand. Take your time. Tomorrow's a new day.
A baby's skin develops into an important sense organ even before it is born. After they've been born, babies need to be touched and caressed a lot to feel secure. Babies' sense of touch improves more every day in the first year of their life. Little friends like my lovely BABY help in playful ways to develop a baby's motor skills and sense of touch.

needs a break…

Little witches make it big…

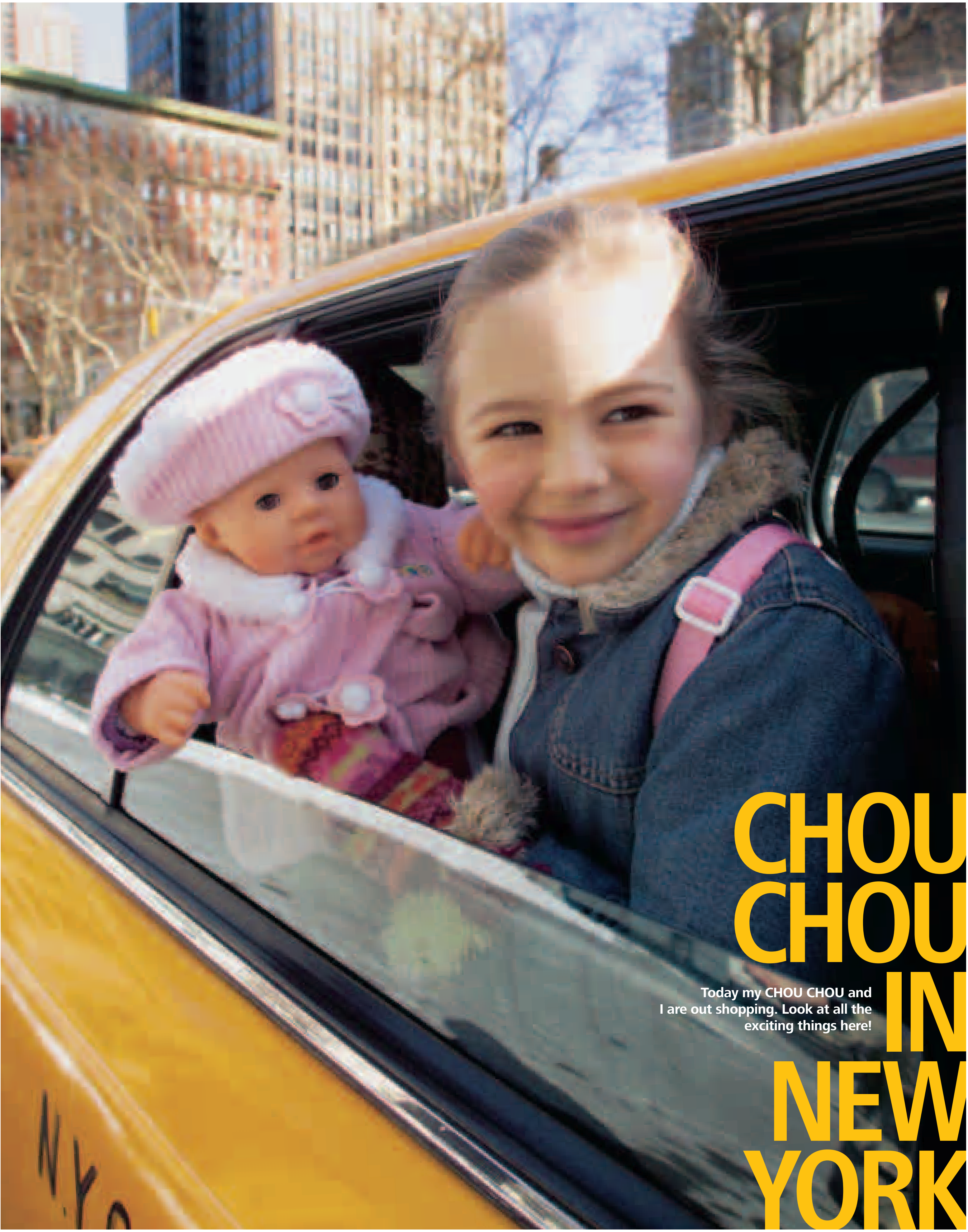
You can also get this fantastic world full of scary characters, ghosts, and pumpkins as part of the BABY born® miniworld.

Halloween, on the 31st of October, brings sweets and pranks. Mini BABY born® and I like to disguise ourselves – especially as little witches – so that we can ride on broomsticks and be charmed.

My little mermaid…

…is getting a new home in the ocean.
I draw a lot of fish and mussels for my little mermaid's new house, which is hidden away deep in the ocean under the waves. Today is a special day. Friends are coming over to visit my little mermaid. "Hello, elf and princess. You can make one wish today."


Atlantic



CHOU CHOU IN NEW YORK

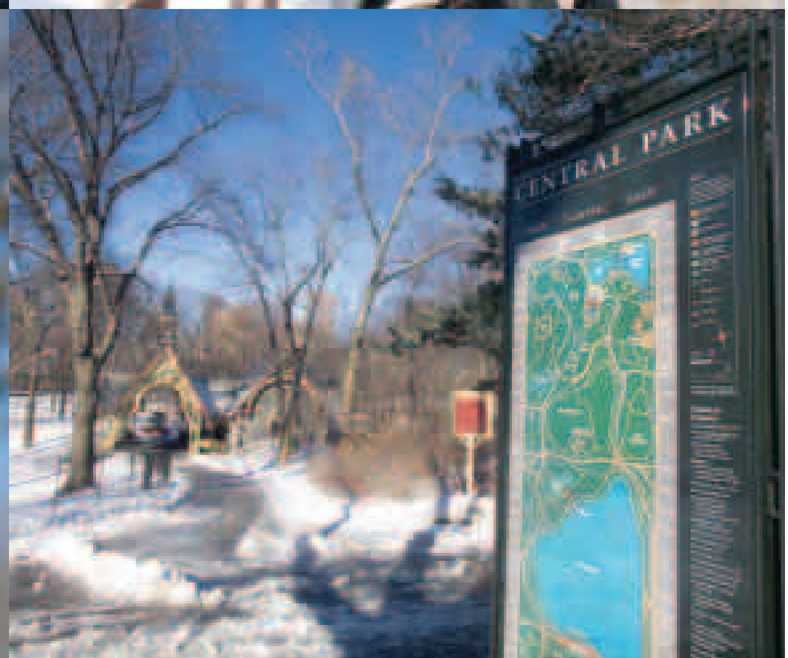
Today my CHOU CHOU and I are out shopping. Look at all the exciting things here!






CHOU CHOU, my sister, and I will conquer New York…

My CHOU CHOU looks really fashionable in her new pink winter coat. The snow and the great weather have lured the three of us to the Central Park skating rink. CHOU CHOU is very popular in the United States and has found a home among many girls.




CHOU CHOU

I take CHOU CHOU everywhere!

We just bought new shoes for her at a big department store. They're purple and match her soft corduroy coat well. But since it's pretty cold outside, we're going to go back to the hotel. "Come on, CHOU CHOU, we'll continue our discoveries tomorrow."

My Model

We can do whatever we like!
Styling without limits – just try everything. You can design the neatest hairdos and glittering party makeup for My Model or do something completely different. The craziest hairdo gets the prize.


SUTTON PLACE
HAIR-
DRESSER

Highlights, nails, makeup, styling…
…that's the My Model concept for creative girls who enjoy fashion and beauty. The makeup and hair styling accessories come in hip packaging and the girls can even use them themselves. My Model is in demand especially among girls who want to be hair and makeup artists one day because it allows them to give full rein to their imagination.


My Model

Who's the fairest of them all?
My Model comes with shoulder-length blond hair, finer facial features, and soft makeup – it's even more elegant and natural than before. The makeup products in the body-shaped flacon and the new accessories in a T-shirt and jeans design match our young hairstylists' outfits perfectly.


My Model

Group Management Report

I. The Group

The Zapf Creation Group develops, produces, and markets doll worlds – in particular, play dolls, functional dolls, as well as mini dolls, including a broad selection of doll accessories. The Group's branded play concepts – BABY born®, Baby Annabell, and CHOU CHOU – are successful all over the world and are conceived especially for girls between three and eight years of age, with the aim of encouraging them to engage in mother-child role play.

The Zapf Creation Group includes wholly-owned subsidiaries in Australia, France, Great Britain, Hong Kong (China), Italy, Spain, Poland, the Czech Republic, and the United States. In 2003, four new domestic subsidiaries were established: 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. All these companies are wholly owned by Zapf Creation AG.

II. The Market

In 2003, the global toy market was dominated by two strong trendy toys that were supported by TV series and were targeted at boys. The regional toy markets developed differently. While the markets in Europe remained stable or positive throughout, the U.S. toy market declined by 3 percent.

The play doll and functional doll segment developed differently in individual countries. In the 2003 fiscal year, sales in this segment in Great Britain rose by about 2.4 percent and in Spain by 16.5 percent. At the same time, the segment declined by 7.8 percent in Germany, by 3.5 percent in France, and by 15.0 percent in the United States.

Fashion as a trendy topic remained extremely popular among little girls. This trend has triggered increased competition in the fashion doll segment, giving growth in this segment a considerable boost. Furthermore, the highly competitive mini doll segment increased its share of the toy market overall. However, the growth of these two segments (fashion and mini dolls) negatively affected growth in the play and functional doll segment.

The Zapf Creation Group succeeded nevertheless in increasing sales in its core business, play and functional dolls, by 6 percent in Europe. Germany accounted for 1 percent of this increase. The Company also maintained its market leadership position in Germany in the play and functional doll segment including accessories. Market share in other European countries also increased throughout.

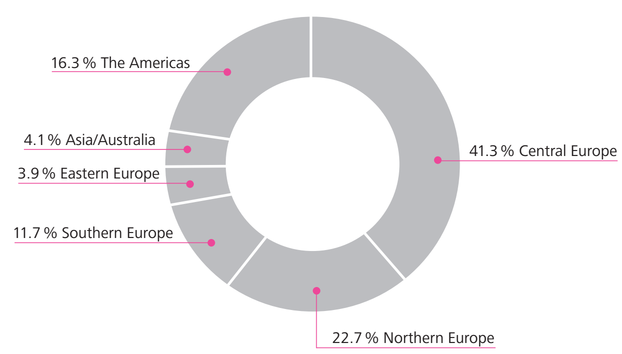
III. Sales

Sales by Operating Business Unit

The uncertain economic climate overall and consumers' resulting restraint also had an impact on the sales of the Zapf Creation AG, as did ongoing currency translation effects. At € 201.4 million, consolidated sales were 10 percent below the previous year (€ 222.7 million). Adjusted for currency translation, consolidated sales were 4 percent below the previous year.

In Central Europe – which includes Germany, Austria, Switzerland, the Netherlands, and Luxembourg – sales declined by 6 percent to € 83.2 million. This was due mainly to lower sales in the mini doll segment. In Germany, Zapf Creation had a 61 percent market share and thus maintained its leading position in its core business – play and functional dolls including accessories.

Breakdown of Sales by Business Unit 2003



In Northern Europe – which includes Great Britain/Ireland, the growth engines, as well as Scandinavia – sales increased by 2 percent to € 45.7 million. Sales growth in Great Britain/ Ireland alone was 4 percent and even about 15 percent if considered in local currency. The positive development in Great Britain was due to the success of the branded play concept, Baby Annabell. Baby Annabell, the functional doll, is particularly popular in this market and was once again the best-selling doll in Great Britain. Zapf Creation thus succeeded in significantly expanding its market share in Great Britain in the play doll and functional doll segment including accessories, by 8 percentage points to 39 percent.

In Southern Europe – which includes Spain/Portugal, France/ Belgium, as well as Italy – sales were up 2 percent to € 23.6 million. Zapf Creation is pleased about the development of the Spanish market, which grew by 8 percent. At a market share of 20 percent, the Group outpaced a local competitor and became the market leader in its core segment, play and functional dolls, for the first time. The Group expanded in France, too, attaining a market share of 6 percent in its core segment.

Eastern Europe as a region once again developed well and achieved sales of € 7.9 million, an increase of 36 percent. The growth markets, Russia, the Czech Republic, and Poland accounted for more than 80 percent of sales in this region.

In the American market, including Canada, sales came in at € 32.8 million ($ 37.0 million), which was 35 percent below the previous year's level. This decline by about € 17.4 million was due mainly to business in the United States. Of this decline, € 7 million resulted from currency translation effects and about € 10 million from operations.

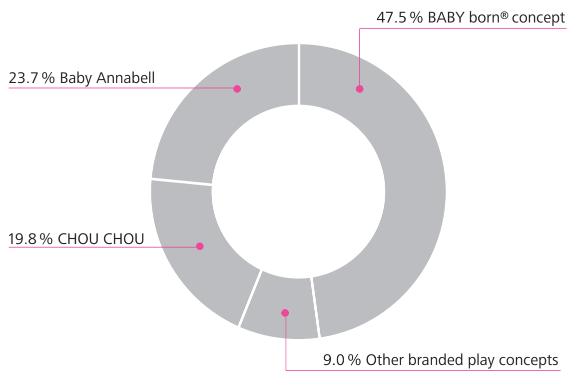
The situation analysis performed by the Zapf Creation Group will serve as the basis for a variety of measures aimed at boosting business in the United States. In this connection we have already made changes in the management of our U.S. subsidiary. Concentrating on major customers and focusing on the core business, which includes play and functional dolls and accessories, are key aspects of these measures. They are designed to return the United States market to positive growth.

Markets in Asia/Australia were characterized by aggressive pricing in the toy sector with a strong focus on fashion dolls. Posting sales of € 8.2 million, the Group had to accept a decline of 22 percent in this Business Unit.

Sales by Product Group

At € 95.8 million, sales of the BABY born® concept fell by 16 percent compared to the previous year. This decline was due mainly to developments in the mini doll segment. Following the successful introduction of BABY born® miniworld in 2002, the past fiscal year revealed weaknesses in retail sales to end consumers, which led us to make adjustments in the sales and marketing strategy for the mini doll concept. The central issues in this new strategy include revising the product range, changing the packaging, and adapting individual price points.

Breakdown of Sales by Product Group 2003



The successful introduction of new Baby Annabell in Europe helped to boost sales of the branded play concept by about 23 percent to € 47.7 million. Baby Annabell is particularly popular in Great Britain. In the past five years, it received awards such as "Girls Toy of the Year" and "Best Selling Girls Toy". In 2003, this successful play concept placed fourth on the list of best-selling toys (best-selling toys, total toys in the UK by value; source: NPD eurotoys retail panel), which made it the best-selling doll. In Germany, Baby Annabell was the number one doll in 2003 in terms of revenues, and in December of 2003 it placed first on the list of best-selling toys for the first time.

In contrast, the branded play concept CHOU CHOU suffered in 2003 due to lower sales overall in the United States and the success of Baby Annabell. Cumulatively, these influences resulted in a decline in sales of about 17 percent to € 39.9 million.

Of sales in connection with the branded play concepts BABY born®, Baby Annabell, and CHOU CHOU, 45 percent were attributable to the dolls and 55 percent to the accessories.

IV. Earnings

The Zapf Creation Group posted consolidated net income of € 12.1 million in the 2003 fiscal year, down from € 21.2 million in the previous year. Adjusted for the charge taken in connection with the closing of production in Roedental, Germany, consolidated net income was € 14.8 million[1].

The Management Board and the Supervisory Board will propose to the Annual Stockholders' Meeting to pay the same dividend as last year, i.e. € 1.00 per share entitled to a dividend payment. It is expected that approximately 7,427,322 shares will be entitled to dividend payments at the time of the 2004 Annual Stockholders' Meeting. The total payout will be € 7,427,322, which is about 60 percent of the Group's consolidated net income (as of January 31, 2004).

Basic earnings per share were € 1.53 (previous year: € 2.70), and diluted earnings per share were € 1.52 (previous year: € 2.69).

In structural terms, the Income Statement for the 2003 fiscal year is characterized mainly by developments in the exchange rate between the euro and the US dollar. The fact that, on an annual average, the US dollar lost about 20 percent of its value relative to the euro affected the following figures in the 2003 Income Statement in particular:

- Sales fell by about 6 percent compared to the previous year due to currency effects. This was mainly caused by the weakness of the US dollar, but also of the British pound, which was about 10 percent lower relative to the euro, the reporting currency, than in 2002.

- As the Zapf Creation Group purchases almost all its goods in USD or HKD, the consolidated gross margin improved by about 200 basis points to 57.4 percent (previous year: 55.4 percent). The gross margin thus improved by about € 4 million, primarily as a result of these currency translation effects.

[1] This excludes the resulting tax effect.

- Other administrative expenses rose by about € 3.3 million due to foreign exchange losses stemming from the valuation of foreign exchange reserves and inter-company loans. While the Group generated gains from currency translation in the amount of about € 1.4 million in 2002, it suffered losses of about € 1.9 million in 2003.

Adjusted for these foreign exchange effects and the charge taken for closing the production facility, operating expenses were € 90.3 million in the reporting period, compared to € 92.0 million in 2002. Selling and distribution expenses fell by € 3.4 million to € 31.5 million, mainly due to lower sales revenues, while marketing expenses basically remained at the previous year's level (2003: € 29.7 million; 2002: € 29.8 million). Other administrative expenses, excluding foreign exchange gains and losses, rose by € 1.8 million to about € 29.1 million. Higher amortization and depreciation, the launch of the Polish subsidiary's operations, as well as the rise in consultant fees accounted for this development.

Earnings before interest, taxes, depreciation and amortization (EBITDA) in the 2003 fiscal year were € 26.2 million; adjusted for the charge taken for the closing of the production facility, EBITDA was € 29.8 million (previous year: € 38.3 million). Depreciation and amortization already included in this figure rose by € 1.0 million to € 6.4 million; this includes the first full year's depreciation of the logistics center which was opened in July 2002.

Earnings before interest and taxes (EBIT) were € 19.8 million, or, adjusted for the charge taken in connection with the closing of production, € 23.4 million. This corresponds to an operating margin of 11.6 percent (previous year: 14.8 percent). Earnings before taxes (EBT) were € 16.0 million (adjusted: € 19.6 million), down from € 30.6 million in 2002.

V. Cash Flow

Cash flow from operating activities in the 2003 fiscal year was about € 12.7 million and thus about € 2.6 million above the previous year's level. Despite the significantly lower consolidated net income, as expected this figure benefited from the extremely high level of payments on receivables in the first quarter of 2003, a logical consequence of the high growth in sales in the fourth quarter of 2002, which, unfortunately, we did not even come close to in the reporting year. Cash increased by about K€ 500, after investing and financing activities.

VI. Balance Sheet

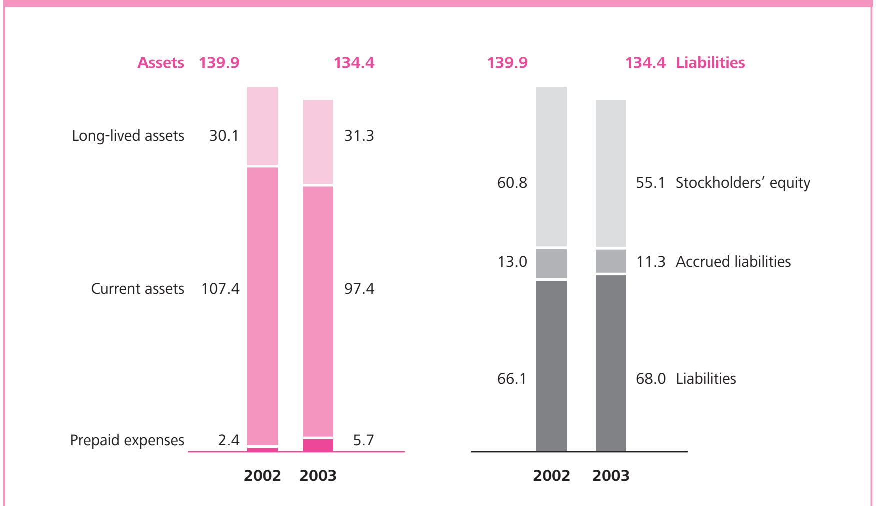
At € 134.4 million, total assets of the Zapf Creation Group declined by € 5.5 million compared to 2002, as the restrained development of business in the fourth quarter of 2003 led to a decline in accounts receivable by € 9.8 million.

At € 55.1 million, the equity of the Zapf Creation Group before dividend payments was lower than in the 2002 fiscal year (€ 60.8 million). This was due to the significant increase in deductions for treasury stock at purchase prices at € 11.4 million (previous year: € 4.2 million). As of December 31, 2003, Zapf Creation held 572,678 own shares, almost of all which were purchased for underwriting the Group's existing stock option plans. These shares are not entitled to a dividend payment until they are distributed.

The equity to asset ratio, less cash and cash equivalents, as of the balance sheet date was about 46 percent (previous year: 49 percent).

The Group's balance sheet structure thus is as follows:

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



VII. Investments

The Zapf Creation Group invested a total of about € 8.2 million in the reporting year. Intangible assets accounted for about € 1.4 million of this amount. The Group paid $ 1.5 million to acquire the rights to its successful brand, Baby Annabell, in early 2003. No additional licensing fees have been due in the high-growth accessories segment since that time. Relative to 2002, investments for property, plant and equipment thus fell by € 3.1 million from € 9.9 million to € 6.8 million.

VIII. Risk Report

Monitoring and controlling risks is an important aspect of the management tools used by the 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 the Zapf Creation AG ensures that existing risks are recorded, analyzed, and assessed; the relevant information is then 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, as well as anticipated losses.

The recording, analysis, and assessment of risks occurs monthly; it is updated and supplemented, if necessary. Any new substantial risks that arise are immediately included in the Risk Monitor.

All risks stem from the Group's goals as they relate to different departments. Risks are thus organized as follows:

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

A great many different types of risk are classified among each of these categories. The following information is recorded, analyzed, and assessed in connection with each and every risk:

- Definition and description of the risk;
- Corporate objective affected thereby;
- Probability and anticipated losses, before and after the implementation of countermeasures;
- Description of measures already taken or planned;
- Assignment of responsibilities for both the risks and the countermeasures;
- Recording of the priority, status, cost, and utility of the countermeasures; and
- Recording of signals and early warning signs, which indicate a change in a particular risk.

All risks are shown in a risk portfolio that is analyzed by the Company's executives and the Management Board in monthly discussions. Major latent risks remain on the agenda of the Management Board meetings that usually take place every two weeks.

Procurement Risks

Over 95 percent of our products are procured and manufactured in the Far East. To minimize this risk, production has been divided among a large number of suppliers at various locations in the Far East, primarily in China. This helps to minimize the risk of losing a main supplier due to bankruptcy, fire, natural disasters, or diseases such as SARS. Quality inspectors check and monitor the production and shipping of our products, supervising each process on a daily basis. Furthermore, close cooperation of our procurement office in Hong Kong with our suppliers in mainland China assures the consistency and efficiency of the supply chain.

In the 2003 fiscal year, the procurement office in Hong Kong was divided into two physically separate office units operating independently of each other. The aim was to be able to maintain all critical functions in case of an emergency.

Marketing and Distribution Risks

Zapf Creation delivers its products to customers in different geographical markets that have very different risk profiles. These risk profiles are directly related to the market position of Zapf Creation in the respective market. Risks decline in tandem with an increase in market share, as the necessary expenses for marketing and distribution decline significantly as a percentage of sales. Conversely, however, in markets where the Group's market share is low, such as, for instance, in the United States, in order to continue expanding our market share we must operate with marketing and distribution expenses that far exceed the Group's average. If the anticipated sales do not transpire at all, or only in part, profitability is affected to a greater extent in less developed markets than in developed ones. It thus must be our goal to attain rapid yet controlled growth in these markets.

Income and Liquidity Risks

As the European market leader in the play and functional doll segment including accessories, the Zapf Creation Group has for years been generating continuously high if not increasing levels of income and cash flow in most markets. In this connection, from a financial vantage point the Business Units Central and Northern Europe have developed into an engine for organic growth in our less developed markets – the United States, France, Italy, and Eastern Europe. To manage risk, Zapf Creation will enter additional potential growth markets only after it has attained satisfactory market share in the aforementioned markets.

Bad Debt Risks

The weakness of the economy in both Europe and the United States, along with intensified competition among wholesalers and retailers, increase the default risk from bankruptcies. Zapf Creation AG uses a comprehensive and timely system for tracking non-payment risks. The company always obtains credit histories of new customers before making initial deliveries. The subsidiaries monitor and control the age structure of receivables on a daily basis. The Management Board is notified of the status of receivables on a monthly basis. Credit insurance is purchased for domestic and foreign customers, provided such policies are available and economically feasible.

Process Risks

Zapf Creation pays particular attention to maintaining its ongoing operating business and devotes particular care to the monitoring of existing risks. A number of insurance policies were purchased for losses of various kinds, such as, for instance, business interruption insurance, fire insurance, and liability insurance. The core processes comprise product development, procurement, and marketing.

The Group uses SAP R/3, a powerful and integrated IT system that covers all business processes. With the exception of the Czech Republic and Italy, all local companies are linked to SAP. These two companies will be linked in 2005. The networking of the IT environment gives rise to the risk of data loss, data manipulation, system downtimes, and the resulting interruption of operations. Measures such as securing the data and mirroring the systems help to minimize this risk. Based on its current knowledge, the Group believes that its IT systems are secure against unauthorized data manipulation, data espionage, and data losses and that interruptions of the system can be limited in duration.

Legal Risks

It is essential to protect the brand products of Zapf Creation because they create value. The Group maintains an in-house legal department responsible for defending the Company against breaches of its copyrights. Developing long-term relationships with suppliers in China as partners also helps to minimize any breaches of our existing licenses.

Industry Risks

Zapf Creation is active in the play doll and functional doll segment including accessories, as well as in the mini doll segment. This business is subject to highly seasonal fluctuations and strong shifts in trends, such as, for example, in 2003 from play dolls to fashion dolls, which was due to the extremely successful positioning of another strong brand in the fashion doll segment. Such trend shifts in one or another direction have always occurred in the past without affecting the general behavior of the target group at play in any lasting and significant manner.

Economic Risks Overall

The general restraint on the part of consumers against a backdrop of a weak economy and high unemployment represents the biggest economic risk overall. Though expenses for classic toys per child and year account for only a few hundred euros, demand has declined here, too. This is due not so much to the end consumers, who do not necessarily shift the burden of their savings to their children, but rather to the insecurity of wholesalers and retailers alike, who are less and less likely to order generous quantities of products, given generally restrained consumption patterns. As a trend, this leads to increasingly late and small just-in-time deliveries which, in turn, make it increasingly difficult to maintain the visibility of Zapf Creation and thus the security of its plans, particularly in the less developed markets.

The Management Board of Zapf Creation AG currently does not see any risks that might threaten the existence of the Company.

IX. Noteworthy Occurrences

No special events occurred after the close of the fiscal year that would be significant to the evaluation of the net assets, financial situation, or operating results of the Zapf Creation Group.

X. Outlook

Zapf Creation's core business – play dolls, functional dolls, and mini dolls – offers unabated growth potential. Implementing the Group's long-term marketing and distribution strategy, which is aimed at optimizing its core business, will thus be at the center of its activities in the 2004 fiscal year. This strategy entails, among other things:

- An optimized shelving concept for retailers aimed at boosting retail sales to end consumers of individual products.
- Using interactive media, events, and special promotions to create adventure-oriented and emotional sales areas in retail stores.
- Optimizing the packaging concept, in order to better respond to international size and design requirements.

However, this strategy also includes numerous new products, innovations, and the ongoing development of the Group's branded play concepts.

The 2004 fiscal year will be the "Year of BABY born®" for Zapf Creation. This successful concept, which has been on the market for 13 years is conquering a new element: water. The introduction of the New BABY born® with an additional eighth function – it can now be bathed – will be at the center of the brand's relaunch in the second quarter of 2004, as well as a new range of accessories related to concept that "water is fun". The new function of BABY born® expands the possibilities of mother-child role play as the girls can now bathe their doll just like a real baby; it also allows them to take BABY born® along to the pool.

The introduction of Love me CHOU CHOU will provide increased sales opportunities for the CHOU CHOU branded play concept during the holiday season. The new Love me CHOU CHOU has unique, lifelike movements and functions and thus is Zapf Creation's most active doll. It kicks its legs when it's happy or when it doesn't like to be changed. It can also say "mama" and make quiet babbling sounds. When Love me CHOU CHOU drinks from its bottle, it makes lifelike movements with its mouth and sucks on the pacifier like a real baby by moving its lower lip and chin. These interactive functions, which are triggered at random, make mother-child role play particularly varied.

Zapf Creation believes that these new product launches will fortify its position in the 2004 fiscal year. However, it is to be expected that competition in the fashion doll segment will continue to intensify this year, especially in Europe. Whether and to what extent this will affect the other doll segments is difficult to gauge at this time.

The trend among wholesalers and retailers to ever decreasing just-in-time orders will probably continue in the current fiscal year.

The ongoing devaluation of the US dollar relative to the euro, the reporting currency, will, at least for the foreseeable future, continue to have a negative impact on the revenue figures of the Zapf Creation Group, while business in Europe will continue to benefit from lower product procurement costs. The reorientation of the Group's business in the United States in the sense of a concentration on major clients and optimized allocation of the sales and marketing budget is intended to improve the operating results in 2004 already.

Roedental, Germany, February 18, 2004

Thomas Eichhorn
Chairman of the
Management Board

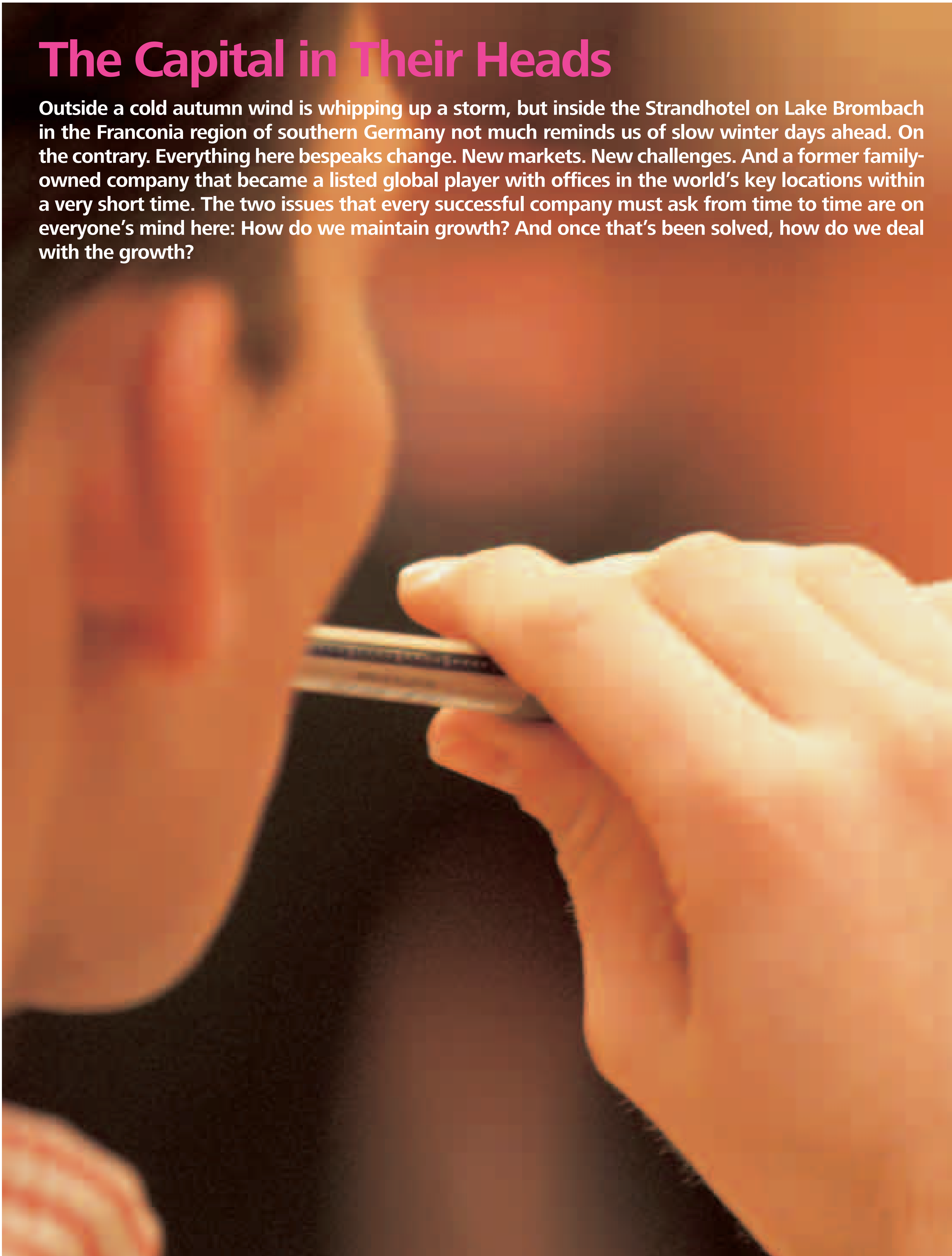
Christian Ewert
Member of the
Management Board

Angelika Marr
Member of the
Management Board

Rudolf Winning
Member of the
Management Board

The Capital in Their Heads

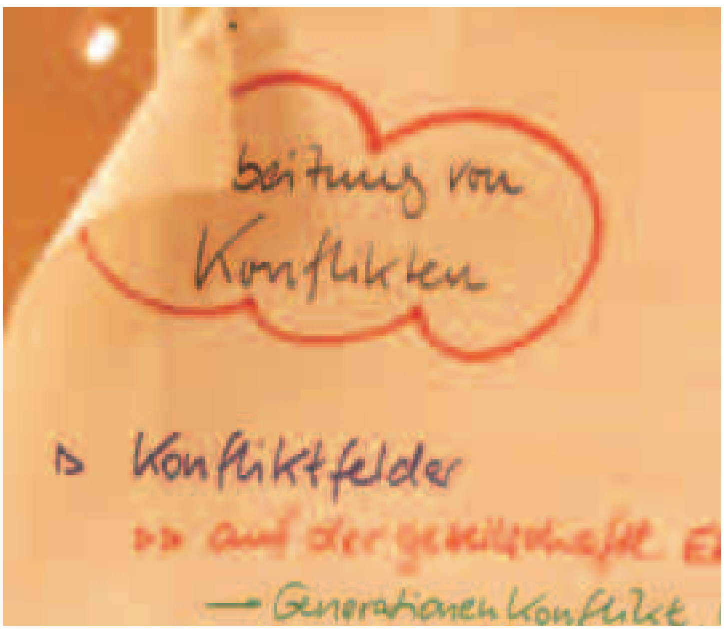
Outside a cold autumn wind is whipping up a storm, but inside the Strandhotel on Lake Brombach in the Franconia region of southern Germany not much reminds us of slow winter days ahead. On the contrary. Everything here bespeaks change. New markets. New challenges. And a former family-owned company that became a listed global player with offices in the world's key locations within a very short time. The two issues that every successful company must ask from time to time are on everyone's mind here: How do we maintain growth? And once that's been solved, how do we deal with the growth?



This morning, eight employees of Zapf Creation AG have assembled in the hotel's conference room for a workshop and discussions. Their conversations center on leadership qualities and the management of change, on ways to encourage employees, and on the question how executives can best deal with conflict. These are new topics for the eight people assembled in this room because most of them were just promoted to the executive level. Caroline Winning, for instance, started at Zapf Creation as an financial analyst in Controlling five years ago. She now is Director of Corporate Finance and responsible for everything related to corporate consolidation. "It's nice to be able to solve problems in a team," Winning, who has a German university degree in business administration, says pensively, "but the line I have to tread between trust and control is narrow indeed. You don't learn that at university."

Seated next to her is Markus Sebald, a quiet, level-headed sales manager, who rarely speaks up but listens all the more intently. As Vice President for Sales and Marketing in Eastern Europe, Sebald is responsible for a large and promising market – a task fraught with great responsibility which he rapidly had to make his own. "When I started, much of what I had to do was new to me. So we all had to find ways to grow into our responsibilities 'on the job'," Sebald says. "Currently we're dealing with the consolidation of structures. But the new tripartite division of the holding is also keeping us on our toes. It really is unbelievable how the Company developed in the past years – and how it continues to develop each day!"

No one knows better than Stefan Zapf how fast this development actually is. As Director for Corporate IT, Stefan Zapf, grandson of the Company's founder, is responsible for networking all of the



Company's offices worldwide. Twenty years ago, on his first day on the job in machine maintenance and production planning, the Company didn't even have computers. It was still called "Puppen- und Spielwarenfabrik Willi Zapf" at the time and had exactly 15 administrative employees. Since then, however, the Company has known only one direction: up, and Stefan Zapf has known only one pace: full speed ahead. He has moved seven times within the Company. He's had to revise the Company's organizational chart almost every six months because new people had been hired. "We couldn't have handled the expansion any other way," he says, "everything happened so fast," the passionate computer expert remembers during a coffee break in the hotel's lobby where the other participants have gathered too. "Take, for instance, our warehousing capacities. We built our first high-bay warehouse in 1987. It had to be significantly expanded just ten years later. These expanded capacities were supposed to last until 2005 – but they had already been used to full capacity by 1999! We opened our new logistics center a mere three years later – and so it goes, on and on."

That's how the small production facility of a family-owned company in southern Germany turned into the epicenter of a global group within a few years. In the past three years alone, the number of employees worldwide rose from 415 to 538, with most of the new employees working abroad. "We're very happy about our growth, of course," says Stefan Zapf, "but it does force us to live in a state of constant change. To use the construction of a house as a metaphor: we have to build the second floor before we've even completed the first floor and, at the same time, make plans for the attic." All of this means that these days people with qualifications

that were rather rare in the past – logistics experts, SAP consultants, managers with leadership qualities, to name just a few – are needed in the town of Roedental in Upper Franconia. It also means that many employees suddenly have the opportunity to take on executive roles and responsibilities. An employee survey conducted by Zapf Creation revealed that this is one of the key motivating factors. This observation corresponds to the insights of Professor Reinhold Würth of the Center for Entrepreneurship at the University of Karlsruhe in Germany. "People's emotional and intellectual attachment to their company is more important to them than any financial gain," he writes in a study entitled, "Motivation of Employees: Keys to Success." He complains that until now society has had a "surprisingly generous, if not carefree" approach to labor as a resource. "But the baby boomers have been in the workforce a long time already. It is our task to ensure in the medium term that the next generation produces sufficient and good labor."

But Zapf Creation is focused not only on the potential of its future workforce but especially on developing the promise of its current employees. "Qualified and motivated employees are our greatest asset," Thomas Eichhorn, CEO of Zapf Creation AG, confirms, adding, in the same breath, "I'm aware of the fact that many companies say that. But we really mean it. And you can tell how serious we are from the intensity, among other things, with which we encourage our most important capital on a variety of levels."

For example, the Company is increasing the number of international further training opportunities it offers for executives, either as seminars and workshops that people must attend in person or in the form of e-learning programs. Corporate culture is a hot topic, of course, as it must continue to develop among and between continents and cultures. In order to build and broaden people's understanding of each other in different branches and to promote their cooperation, the Company is now pushing a worldwide exchange program. Employees around the world will spend two to six months in offices located outside of their home country. Thanks to workshops such as the one offered at Lake Brombach, English has by now become the corporate language of what used to be a Franconian doll manufacturer and now is a cosmopolitan designer and marketer of dolls.

The company is also using a refined analysis of potential to gauge the suitability and interest of certain employees for executive level positions. "One of the advantages of rapid growth is that we can give an above-average number of people the opportunity to prove themselves in challenging positions," says Eichhorn. "What we've learned is this: many of the best minds are already working for us. We just have to discover them – and place them in the right job."

It is because Caroline Winning, Markus Sebald and Stefan Zapf have accepted such responsibilities that they are now participating, along with five others, in a development program geared specifically to executives. The program kicked off with a five-day leadership training program in November 2002 and it ends in 2004 with an evaluation workshop. In between, the eight participants meet several times to deal with real-life issues facing executives.

These discussions are monitored by an experienced organizational consultant. He guides the participants imperceptibly, encourages them, questions them. He sits among the group, one leg over the other, his index finger at his lips, commenting, interpreting, highlighting obvious differences, suggesting solutions. But in most cases he simply lets the group deal with the problem, asking questions such as: "What do you think? What did you notice in connection with this problem? What would you suggest to your teammate?"

Fundamentally, these problems concern a number of issues. Which methods are suitable for resolving conflicts in the Company? How do I mediate between people? What does my staff expect of me? And what does the Company expect of me?

"A leadership position by nature attracts conflict," says Bernd Piesch, Executive Vice President Human Resources. "Executives must satisfy a wide variety of expectations that come at them from every direction every day. To make matters worse, many of these expectations are contradictory." Good leadership thus consists of finding common ground among individuals and within groups, with the aim of achieving particular goals. These are the issues the workshop participants are discussing this morning. It is surprising that all of them are actively engaged in the discussions, even though the problems concern other people's departments. "The insights that we gain here about other areas of the Company are extremely valuable for all of us," Caroline Winning explains. "You notice all of a sudden that peo-

ple in completely different departments have similar objectives and problems. And then you help each other, by sharing experiences, making suggestions, and giving constructive criticism." In order to intensify this process, two group members each are teamed as "learning partners", who can talk to each other about their development in the time between the workshops. Caroline Winning, the partner of Markus Sebald, has also made it a practice to reflect on her thoughts and ideas in an "executive journal". "No one is born an executive," she says, "but you can learn to be one. And the coaching we get helps us a lot in that respect. It's obvious every time we get together for a workshop."

That's just the way it is: a company always is the sum total of its employees – no more, no less. And when you tap into the promise of these people, it can happen that this sum total suddenly turns into an exponential equation. That's what creates growth. Organic, sustainable, profitable growth. And that's what it's about on this cold day on Lake Brombach.

The Capital in Their Heads

Stefan Zapf
"We changed both the structure of our IT department and communication within the department so that it is developing rapidly into the Company's internal service provider. That's the most important thing I took away from the executive workshop."

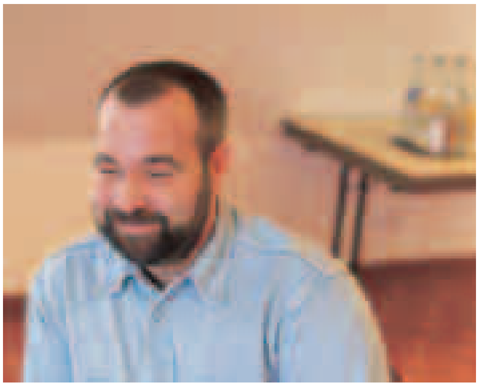
Markus Sebald
"One thing became perfectly clear: Zapf Creation lives by the enormous potential of its employees. At the end of the day, the Company's success is nothing but the sum total of its employees' successes. And boosting that potential is just about the best thing you can do."

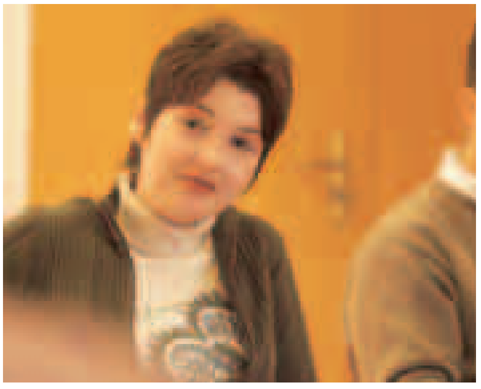
Reiner Geier
"Examples drawn from real life in connection with leadership, conflict resolution, or discussions with staff – these are topics that I was able to implement one to one in practice."

Jochen Wohlrab
"Globalizing the Company was the right step; after all, the export markets have huge growth potential. What we must do now is gain market leadership in those export markets and expand in our core markets. For that we obviously need motivated employees, competent executives, and the most efficient structures imaginable."

Michael Mäder
"Very few people are born with leadership qualities. But the nice thing is that you can learn and practice them. And the workshops did just that for me."

Jürgen Gerber
"I learned a lot about different ways of working, focusing on success, and the way our company operates in its different departments."





Thomas Haselbauer
"Human capital – that'll be the key to the future. Companies that use their employees' knowledge and support them in their professional development clearly increase their competitiveness. From this vantage point, further training measures such as the executive training program will translate into real competitive advantages."

Caroline Winning
"Learning what the responsibilities of other people in other departments are and what they think means, at the end of the day, learning to understand the Company better."

The Capital in Their Heads

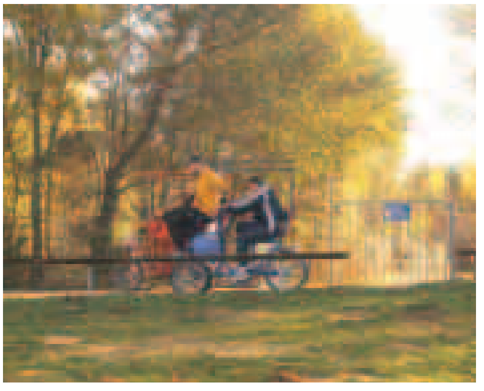
Stefan Raab
"The competitive climate is becoming harsher. This means for us that we must prevail on the basis of innovative, high-quality products, and excellent customer service."

Mark Collée
"It is sometimes hard for executives to find the right balance between necessary control and maximum motivation. Our workshops helped me enormously in that regard."

Carmen Löffler
"I learned that one cannot always be the 'good guy.' The need for harmony also translates into an inability to deal with conflict, and that doesn't help either the Company or its employees."

Stefan Lutz
"Zapf Creation is committed to supporting the development of its middle management. This training taught us not only technical know-how but also the ability to think and work across teams."

Sandra Eichhorn
"How do you learn to correctly gauge the reactions and characteristics of co-workers and supervisors alike? The ability to do that can be decisive to the success of a team, a department, even the Company. I learned some really useful things here."



Markus Priesner
"Where are we headed? What's my Company's vision? What are its perspectives? What can I contribute that would really benefit the Company? I'd venture that every single one of us is asking these questions every day. I found some very good answers here."

Christine Rehm
"We grew very fast in the past few years. Today the biggest challenge is to stabilize our processes and standards on a high level. Ideally, we should motivate our employees to solve a high percentage of challenges independently and effectively. That's what we're working on."

Consolidated Financial Statements and Notes

Consolidated Income Statement

of Zapf Creation AG, Roedental, for the period from January 1 through December 31, 2003

	2003 K€	2002 K€
Net sales	201,423	222,720
Cost of goods sold	– 85,796	– 99,237
Gross profit	**115,627**	**123,483**
Selling and distribution expenses	– 31,470	– 34,852
Marketing expenses	– 29,706	– 29,833
Administrative expenses, net	– 31,033	– 25,909
Costs of closing of production	– 3,620	0
Operating profit before interest and taxes	**19,798**	**32,889**
Interest income	158	779
Interest expense	– 3,933	– 3,044
Profit before income tax expense	**16,023**	**30,624**
Income tax expense	– 3,947	– 9,387
Net income	**12,076**	**21,237**
Earnings per share		
Basic €	1.53	2.70
Diluted €	1.52	2.69

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

Consolidated Financial Statements

Consolidated Balance Sheet

of Zapf Creation AG, Roedental, as of December 31, 2003

		Dec. 31, 2003 K€	Dec. 31, 2002 K€
Assets			
Cash and cash equivalents		15,342	14,850
Accounts receivable		47,899	57,674
(net of allowance for doubtful accounts of € 997,157 and € 1,408,267 at December 31, 2003 and 2002 respectively)			
Inventories	Note 2	29,118	29,682
Prepaid expenses	Note 3	5,700	2,444
Other current assets	Note 4	3,470	2,618
Deferred tax assets (short-term)	Note 5	1,625	2,487
Total current assets		**103,154**	**109,755**
Property, plant, equipment and software, net	Note 2	28,428	28,523
Intangible assets, net	Note 2	2,494	1,425
Deferred tax assets (long-term)	Note 5	347	182
Total long-lived assets		**31,269**	**30,130**
		134,423	**139,885**
Liabilities and stockholders' equity			
Current portion of long-term debt and short-term borrowings		40,506	22,914
Accounts payable		10,088	15,689
Accrued liabilities	Note 11	11,346	12,998
Income taxes payable		1,463	4,819
Deferred tax liabilities (short-term)	Note 5	497	1,320
Total current liabilities		**63,900**	**57,740**
Long-term debt	Note 6	14,780	20,317
Other long-term liabilities		67	68
Deferred tax liabilities (long-term)	Note 5	585	973
Total long-term liabilities		**15,432**	**21,358**
Commitments and contingencies	Note 9		
Common stock	Note 8	8,000	8,000
11,630,000 shares authorized			
8,000,000 shares issued			
7,427,322 shares outstanding at December 31, 2003			
7,873,836 shares outstanding at December 31, 2002			
Additional paid-in capital		8,052	8,406
Treasury stock		– 11,358	– 4,181
Accumulated other comprehensive income (loss)		– 4,304	– 1,987
Retained earnings		54,701	50,549
Total stockholders' equity		**55,091**	**60,787**
		134,423	**139,885**

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

Consolidated Statement of Cash Flows

of Zapf Creation AG, Roedental

	2003 K€	2002 K€
Cash flow from operating activities:		
Net income	12,076	21,237
Adjustments to reconcile net income to net cash flow from operating activities:		
Depreciation and amortization	6,764	5,743
Loss (gain) on sale of property, plant, equipment and software	– 11	– 82
Stock-based compensation expense	– 277	344
Increase (decrease) from changes in assets and liabilities:		
Accounts receivable	9,411	– 15,929
Inventories	295	– 4,557
Prepaid expenses and other assets	– 4,121	– 299
Accounts payable, accrued liabilities and other liabilities	– 7,548	3,243
Income taxes payable	– 3,389	920
Deferred taxes	– 515	– 487
Net cash flow from operating activities	**12,685**	**10,133**
Cash flow from investing activities:		
Proceeds from sale of property, plant, equipment and software	286	417
Capital expenditures	– 8,154	– 9,899
Net cash flow from investing activities	**– 7,868**	**– 9,482**
Cash flow from financing activities:		
Net borrowings under short- and long-term debt agreements	12,055	8,735
Purchases of treasury stock/proceeds from issuance of treasury stock	– 7,531	486
Payment of dividends	– 7,924	– 5,107
Net cash flow from financing activities	**– 3,400**	**4,114**
Effect of foreign exchange rate changes on cash	– 925	– 1,149
Net increase in cash	**492**	**3,616**
Cash at beginning of year	14,850	11,234
Cash at end of year	15,342	14,850

Consolidated Statement of Stockholders' Equity

of Zapf Creation AG, Roedental

	Shares outstanding number (thsds.)	Common stock K€	Additional paid-in capital K€
Balance at December 31, 2001:	**7,852**	**8,000**	**8,437**
Net income			
Other comprehensive income (loss)			
Total comprehensive income (loss)			
Dividend payments			
Purchase of treasury stock			
Issuance of treasury stock	22		– 31
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**

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

Consolidated Statement of Fixed Assets

of Zapf Creation AG, Roedental

	Movements of costs					
	Jan. 1, 2003 K€	Translation effect previous year K€	Additions K€	Disposals K€	Reclassifi-cations K€	Dec. 31, 2003 K€
Intangible assets	**2,188**	**29**	**1,392**	**0**	**0**	**3,609**
Property, plant and equipment						
1. Land and buildings	12,437	0	96	62	182	12,653
2. Technical installations and machinery	1,030	0	1	170	0	861
3. Other installations, plant, furniture and fixtures	37,284	– 395	6,665	5,280	– 182	38,092
	50,751	**– 395**	**6,762**	**5,512**	**0**	**51,606**
	52,939	**– 366**	**8,154**	**5,512**	**0**	**55,215**

Treasury stock K€	Retained earnings K€	Accumulated other comprehensive income (loss): Adjustments to currency translation K€	Accumulated other comprehensive income (loss): Derivative financial instruments K€	Total equity K€
– 4,698	**34,418**	**1,530**	**0**	**47,687**
	21,237			21,237
		– 3,517		– 3,517
	21,237	**– 3,517**		**17,720**
	– 5,106			– 5,106
				0
517				486
– 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**

Movements of depreciation						Net book value	
Jan. 1, 2003 K€	Translation effect previous year K€	Translation effect average exchange rate K€	Additions K€	Disposals K€	Dec. 31, 2003 K€	Dec. 31, 2003 K€	Dec. 31, 2002 K€
763	**2**	**2**	**348**	**0**	**1,115**	**2,494**	**1,425**
5,587	0	0	286	62	5,811	6,842	6,850
833	0	0	194	166	861	0	197
15,808	– 72	– 156	5,936	5,010	16,506	21,586	21,476
22,228	**– 72**	**– 156**	**6,416**	**5,238**	**23,178**	**28,428**	**28,523**
22,991	**– 70**	**– 154**	**6,764**	**5,238**	**24,293**	**30,922**	**29,948**

Notes

Note 1:
Nature of the Business

Zapf Creation AG (hereinafter also called "the Company") is Europe's largest distributor 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.

The Annual Stockholders' Meeting on May 7, 2003, authorized the Company to spin off the sales subsidiary Zapf Creation (Central Europe) GmbH & Co. KG and the logistics subsidiary Zapf Creation Logistics GmbH & Co. KG from Zapf Creation AG. The spun-off companies will commence operations in 2004.

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

Note 2:
Summary of Significant Policies

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 thirteen 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 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 an 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-off, 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 construction in progress or to the acquisition or production of an asset. Such capitalization ends when the asset begins to serve its purpose.

Financial Statements 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 *other administrative expenses* can be divided into finance, IT and other administrative expenses. Other administrative expenses include personnel expenses, depreciation in relation to the sub-categories, and expenses for in-house product development.

[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.

US GAAP requires that expenses must be offset against earnings from the same category. This means that all expenses must be shown net, i.e. after all attributable earnings have been deducted. For this reason, the Consolidated Income Statement does not contain a separate item stating operating earnings.

Closing of Production
On July 11, 2003, the Company announced its withdrawal from the segment of high-value artists' and collectors' dolls. In the past three years, involvement in this area in the form of the Designer Collection and Colette product lines, which were produced in Roedental, has suffered considerably from consumer restraint, particularly with regard to high-priced items. The continuing slump in consumer spending, the low order volume and the persistent weakness of the dollar caused the Management Board of Zapf Creation AG to discontinue the Designer Collection product line as of fiscal year 2003. The costs resulting from the closing of the production facility are stated separately under *costs of closing of production*.

The following explanations provide information required by FAS 146, para 20:

The costs of closing of production essentially comprise termination benefits, allowances for remaining raw materials, and supplies as well as finished and unfinished goods, expenses for partial retirement, and divestment costs for long-lived production assets that are no longer needed. The production closure will probably be completed by the second quarter of 2004. The costs are comprised as follows:

	2003
	K€
Inventory allowance	1,694
Personnel costs	1,642
Depreciation and amortization	164
Other expenses	120
	3,620

Provisions in connection with the production closure are comprised of the following items:

	2003 K€
Termination benefits	1,264
Partial retirement	166
Other	38
	1,468

A total of 88 jobs will be eliminated by May 31, 2004. The number of unavoidable terminations is reduced to 74 due to organizational restructuring, partial retirement etc.

The amount of the termination benefits has been specified by the Company and the works council of Zapf Creation AG in an agreement on the reconciliation of interests and the redundancy payments scheme.

Interest expenses of K€ 3,933 (previous year: K€ 3,044) comprise the following:
– checking account interest and interest on loans
– fees related to notes
– forfeiture costs.

Information pursuant to FAS 34[3]:

	2003 K€	2002 K€
Interest expenses, gross	3,933	3,370
Capitalization of interest costs for assets under construction	0	326
Interest expenses, net	**3,933**	**3,044**

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, 2002	0	9	9
Additions	4	0	4
Dec. 31, 2003	**4**	**9**	**13**

The following parties hold shares in Zapf Creation (Central Europe) GmbH & Co. KG, which is domiciled in Roedental, Germany, and is registered in the Commercial Register at the Coburg Local Court under HRA 4052:

a) as general partner:
"Zapf Creation (Central Europe) Verwaltungs GmbH" – registered in the Commercial Register at the Coburg Local Court under HRB 3673 – domiciled in Roedental, Germany, without equity interest

b) as limited partner:
Zapf Creation AG, domiciled in Roedental, Germany, with a fixed equity share of € 50,000.00.

Zapf Creation AG is the lone shareholder of Zapf Creation (Central Europe) Verwaltungs GmbH. Its share has a nominal value of € 25,000.00.

[3] However, the initial interest expenses were reduced by capitalizing K€ 326 in financing costs for the high-bay warehouse in fiscal year 2002, which is permitted by US GAAP. The high-bay warehouse was put into operation in 2003, so that the interest on the loan for this long-lived asset is no longer capitalized.

The following parties hold shares in the limited partnership Zapf Creation Logistics GmbH & Co. KG, which is domiciled in Roedental, Germany, and is registered in the Commercial Register at the Coburg Local Court under HRA 4051:

a) as general partner:
"Zapf Creation Logistics Beteiligungs GmbH" – registered in the Commercial Register at the Coburg Local Court under HRB 3674 – domiciled in Roedental, without equity interest

b) as limited partner:
Zapf Creation AG, domiciled in Roedental, Germany, with a fixed equity share of € 50,000.00.

Zapf Creation AG is the lone shareholder of Zapf Creation Logistics GmbH. Its share has a nominal value of € 25,000.00.

Affiliated companies as of December 31, 2003

Name	Headquarters	Date of formation	Percentage owned by parent company	Book value Dec. 31, 2003	Net income*) 2003	Equity*) 2003
Zapf Creation (H.K.), Ltd.	Causeway Bay, Hong Kong	Apr. 30, 1991	100 %	€ 785,472.15	HKD 40,837,257.13	HKD 128,572,400.89
Zapf Creation (U.S.), Inc.	Orlando, Florida, USA	Apr. 15, 1999	100 %	€ 93.40	USD – 3,051,203.00	USD – 2,508,067.09
Zapf Creation (France), S.a.r.l.	Limonest, France	Jan. 1, 2000	100 %	€ 50,000.00	€ – 161,913.21	€ – 335,271.84
Zapf Creation (U.K.), Ltd.	Corby, Northants, GB	Jan. 1, 2000	100 %	€ 153,964.00	GBP 3,440,884.47	GBP 3,540,884.47
Zapf Creation (Australia), Pty. Ltd.	Melbourne, Australia	Mar. 5, 2001	100 %	€ 263,573.54	AUD 359,350.05	AUD 1,282,468.19
Zapf Creation (CZ), s.r.o.	Prague, Czech Republic	July 26, 2001	100 %	€ 11,904.76	CZK 4,942,589.57	CZK 11,777,683.76
Zapf Creation (Italia), S.R.L.	Gallarate, Italy	July 31, 2001	100 %	€ 50,000.00	€ 35,390.17	€ – 195,299.22
Zapf Creation (Polska), Sp. z o.o.	Warsaw, Poland	Aug. 9, 2001	100 %	€ 13,794.62	PLN – 1,263,855.83	PLN – 1,452,517.99
Zapf Creation (España), S.L.	Alicante, Spain	Jan. 1, 2002	100 %	€ 129,075.13	€ 1,940,888.69	€ 2,896,412.70
Zapf Creation (Central Europe) GmbH & Co. KG	Roedental, Germany	Mar. 24, 2003	100 %	€ 50,000.00	€ – 2,276.19	€ 47,723.81
Zapf Creation (Central Europe) Verwaltungs GmbH	Roedental, Germany	Mar. 24, 2003	100 %	€ 25,000.00	€ – 1,486.02	€ 23,513.98
Zapf Creation Logistics GmbH & Co. KG	Roedental, Germany	Mar. 24, 2003	100 %	€ 50,000.00	€ – 2,288.76	€ 47,711.24
Zapf Creation Logistics Beteiligungs GmbH	Roedental, Germany	Mar. 24, 2003	100 %	€ 25,000.00	€ – 1,500.29	€ 23,499.71
				€ 1,607,877.60		

*) 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 under stockholders' equity as a separate item of "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€ 1,663 in 2003 and K€ 1,783 in 2002, 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]	0.5956	1.4172	0.1025	0.7931
Average exchange rate[6]	0.5760	1.4462	0.1137	0.8854

[4] FC = foreign currency
[5] As of December 31, 2003
[6] For the period from January 1 to December 31, 2003

Derivative Financial Instruments

As 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 2003, an impairment charge was taken on self-produced collectors' dolls and the related raw materials and supplies and unfinished goods because of the production closure scheduled for fiscal year 2004.

	2003 K€	2002 K€
Finished products and goods	27,849	26,856
Unfinished products	83	173
Raw materials and supplies	1,186	2,653
Inventories	**29,118**	**29,682**

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

*) Depending on the term of lease agreement

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 2003 amounted to K€ 6,416 (previous year: K€ 5,522). 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.

Due to the production closure which was decided by the management in fiscal year 2003 and which is scheduled for 2004, a write-down of K€ 164 was taken (previous year: K€ 0). This write-down primarily concerned furniture and fixtures as well as machinery.

	2003 K€	2002 K€
Land and buildings	12,653	12,437
Technical installations and machinery	861	1,030
Other installations, software, plant, furniture and fixtures	38,092	37,284
	51,606	**50,751**
Less accumulated depreciation	– 23,178	– 22,228
Property, plant, equipment and software, net	**28,428**	**28,523**

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€ 635 in 2003 and K€ 656 in 2002.

"Other installations, software, plant, furniture and fixtures" include construction in progress worth K€ 2,462 (previous year: K€ 420) and down payments for as yet incomplete projects in connection with the SAP-R/3 implementation in the amount of K€ 266 for 2003 and K€ 581 for 2002.

Intangible Assets

Intangible assets consist primarily of capitalized licenses aimed at protecting brand names. They are amortized over ten years. Accumulated amortization on intangible assets was K€ 1,115 as of December 31, 2003, and K€ 763 as of December 31, 2002. Of these, K€ 1,054 (previous year: K€ 734) related to the protection of rights to names.

The goodwill capitalized by Zapf Creation (Australia), Pty. Ltd. is also included in the intangible assets. It is amortized over ten years. Accumulated amortization was K€ 60 as of December 31, 2003, and K€ 29 as of December 31, 2002.

Research and Development

The Company always expenses research and development costs at the time they are incurred. The external R&D costs were K€ 347 in 2003 and K€ 392 in 2002; 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 30 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 all 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€ 26,114 in 2003 and K€ 26,278 in 2002.

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:

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

The calculation of earnings per share in detail:

		2003		2002	
		Basic	Diluted	Basic	Diluted
Net income	K€	12,076	12,076	21,237	21,237
Adjusted net income	K€	12,076	12,076	21,237	21,237
Average number of shares outstanding	thsds.	7,907	7,907	7,864	7,864
Options and warrants	thsds.	0	66	0	24
Shares and equivalent shares	thsds.	7,907	7,973	7,864	7,888
Earnings per share	**€**	**1.53**	**1.52**	**2.70**	**2.69**

In fiscal year 2003, stock options to purchase 421,121 shares of common stock were outstanding. However, the granting of options in fiscal year 2000 in connection with the 1999/2000 Stock Option Plan and the granting of options in 2003 in connection with the 2003/2005 Stock Option Plan were excluded from the computation of the diluted earnings per share because their effect was antidilutive.

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 Pronouncements

SFAS 149

In April 2003, the Financial Accounting Standards Board ("FASB") published the Statement of Financial Accounting Standard ("SFAS") 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities". This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (embedded derivatives) and for hedging activities under FASB Statement no. 133, "Accounting for Derivative Instruments and Hedging Activities". This Statement is effective for contracts entered into or modified after June 30, 2003.

SFAS 150

In May 2003, the FASB published SFAS 150 "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity". This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument which often was presented as equity, as a liability. This Statement also addresses questions about the classification of certain financial instruments that embody obligations to issue equity shares. Some of the provisions of this Statement are consistent with the current definition of liabilities in FASB Concepts Statement no. 6, "Elements of Financial Statements". This

Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003.

SFAS 132 (revised 2003)
In December 2003, the FASB published SFAS 132 "Employers' Disclosure about Pension and Other Postretirement Benefits – an amendment of FASB Statement no. 87, 88, and 106". This Statement revises employers' disclosures about pension and other postretirement benefit plans. It does not change the measurement or recognition of those plans according to SFAS 87, 88 and 106.

FIN 46
In January 2003, the FASB published Interpretation FIN 46, "Consolidation of Variable Interest Entities – an Interpretation of ARB no. 51". This Interpretation addresses consolidation by business enterprises of variable interest entities (VIE). FIN 46 (revised December 2003) introduced a new multi-step model for the consolidation of VIEs, in which a company has a controlling financial interest either through voting rights or variable interests. This Standard is applicable to VIEs, which were created after December 31, 2003. The Company does not hold any interests in a VIE.

Note 3:
Prepaid Expenses

Prepaid expenses primarily consist of prepaid marketing expenses, other administrative expenses, selling and distribution expenses, personnel expenses and factoring expenses.

Note 4:
Other Assets

Other assets comprise the following:

	2003 K€	2002 K€
Tax receivables due from the tax office	2,219	1,532
Other receivables	590	573
Employee loans	595	500
Payments on account	66	13
	3,470	2,618

Note 5:
Income Taxes

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

	2003 K€	2002 K€
Current taxes		
Germany	3,439	2,981
Foreign	1,413	7,148
	4,852	**10,129**
Deferred income taxes		
Germany	– 1,345	919
Foreign	440	– 1,661
	– 905	**– 742**
	3,947	9,387

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

	2003 K€	2002 K€
Deferred tax assets		
Operating loss carryforwards	390	264
Valuation allowances	979	1,184
Licenses	0	695
Interest	535	0
Other	68	526
Gross deferred tax assets	**1,972**	**2,669**
Deferred tax liabilities		
Net unrealized foreign exchange gains	– 175	– 958
Property, plant, equipment and software	– 718	– 780
Other	– 189	– 555
Gross deferred tax liabilities	**– 1,082**	**– 2,293**
	890	**376**

The expected tax expenses are computed by multiplying the total tax rate of 37.61 percent applicable for the fiscal year (previous year: 37.00 percent) by earnings before taxes. This results in anticipated tax expenses of K€ 6,023 for fiscal year 2003.

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: 10.70 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:

	2003 K€	2002 K€
Anticipated tax expense	6,023	11,331
Foreign earnings taxed at different rates	– 812	– 1,905
Federal trade and solidarity taxes	– 1,344	1,071
Non-deductible stock option expenses	– 40	– 20
Other	120	– 1,090
	3,947	**9,387**

As of December 31, 2003, the Company had net loss carryforwards from its foreign businesses totaling K€ 1,125.

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 € 123 million. Most of the short-term bank debts as of December 31, 2003 result from borrowings under the aforementioned lines of credit; the average interest rate in 2003 for the credit lines was 4.0 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, 2003

	Borrowing limit K€	Lending rate %	Due date	Status as of Jan. 1, 2003 €	Additions 2003 €
Long-term debts					
Bank loan no. 1		4.95	2003	502,471.63	
Bank loan no. 2		5.00	2006	223,690.22	
Bank loan no. 3		5.00	2006	1,342,141.16	
Bank loan no. 4		4.45	2008	766,937.80	
Bank loan no. 5		4.35	2011	5,000,000.00	
Bank loan no. 6		4.35	2011	5,000,000.00	
Bank loan no. 7		5.16	2006	9,000,000.00	
Bank loan no. 8		6.60	2003	30,677.48	
Bank loan no. 9		4.65	2003	327,226.81	
Bank loan no. 10		5.00	2003	766,937.82	
Bank loan no. 11		5.95	2003	255,645.90	
Bank loan no. 12		4.99	2004	1,998,287.42	
Bank loan no. 13		3.98	2007	0.00	2,100,000.00
Bank loan no. 14		6.35	2004	1,556,528.89	
Disagio			2011	– 382,633.25	
				26,387,911.88	**2,100,000.00**
Less current portion of long-term debts (without disagio)				6,071,210.04	
Long-term debts				**20,316,701.84**	
Lines of credit				**16,842,614.23**	
Overdraft	29,515,951	6.50	unlimited	0.00	
Overdraft	10,000,000	4.62	in part limited until June 11, 2004	2,313,993.12	
Overdraft	19,965,422	6.10	unlimited	6,849,199.82	
Overdraft	15,000,000	5.75	until June 1, 2004	0.00	
Overdraft	5,000,000	5.75	until Mar. 31, 2004	0.00	
Overdraft	5,000,000	5.50	until May 30, 2004	0.00	
Overdraft	5,000,000	6.50	unlimited	0.00	
Overdraft/other	33,745,967	6.25	in part limited until Feb. 29, 2004	7,679,421.29	
Current portion of long-term debts (without disagio)				6,071,210.04	
Short-term borrowings				**22,913,824.27**	

Redemption 2003	Status as of Dec. 31, 2003	Redemption 2004	2005	2006	2007	2008	2009+
€	€	€	€	€	€	€	€
502,471.63	0.00	0.00	0.00	0.00	0.00	0.00	0.00
63,911.48	159,778.74	63,911.48	63,911.48	31,955.78	0.00	0.00	0.00
383,468.92	958,672.24	383,468.92	383,468.92	191,734.40	0.00	0.00	0.00
127,822.98	639,114.82	127,822.97	127,822.97	127,822.97	127,822.97	127,822.94	0.00
0.00	5,000,000.00	625,000.00	625,000.00	625,000.00	625,000.00	625,000.00	1,875,000.00
312,500.00	4,687,500.00	625,000.00	625,000.00	625,000.00	625,000.00	625,000.00	1,562,500.00
2,250,000.00	6,750,000.00	2,250,000.00	2,250,000.00	2,250,000.00	0.00	0.00	0.00
30,677.48	0.00	0.00	0.00	0.00	0.00	0.00	0.00
327,226.81	0.00	0.00	0.00	0.00	0.00	0.00	0.00
766,937.82	0.00	0.00	0.00	0.00	0.00	0.00	0.00
255,645.90	0.00	0.00	0.00	0.00	0.00	0.00	0.00
1,057,672.38	940,615.04	940,615.04	0.00	0.00	0.00	0.00	0.00
363,707.29	1,736,292.71	508,633.32	529,801.71	551,461.06	146,396.62	0.00	0.00
788,514.21	768,014.68	768,014.68	0.00	0.00	0.00	0.00	0.00
70,933.15	– 311,700.10	– 58,662.15	– 58,662.16	– 58,662.15	– 43,323.40	– 43,323.39	– 49,066.85
7,301,490.05	**21,328,288.13**	**6,233,804.26**	**4,546,342.92**	**4,344,312.06**	**1,480,896.19**	**1,334,499.55**	**3,388,433.15**
	6,548,112.35						
	14,780,175.78						
	33,957,694.36						
	11,113,691.90						
	2,173,771.65						
	3,415,620.60						
	6,880,576.24						
	4,087,703.75						
	1,736,627.87						
	0.00						
	4,549,702.35						
	6,548,112.35						
	40,505,806.71						

The Company repaid the loans no. 1, 9, 10 and 11 ahead of schedule in 2003. In contrast to the repayment schedule presented in the Consolidated Financial Statements for fiscal year 2002, loan no. 12 is now subject to different repayment terms.

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

Loan no. 3	
Status as of December 31, 2003, gross	958,672.24
Disagio*)	– 18,406.51
Status as of December 31, 2003, net	**940,265.73**

*) Life: 10 years/remaining life: 3 years

Loan no. 4	
Status as of December 31, 2003, gross	639,114.82
Disagio*)	– 13,293.59
Status as of December 31, 2003, net	**625,821.23**

*) Life: 10 years/remaining life: 5 years

Loan no. 5	
Status as of December 31, 2003, gross	5,000,000.00
Disagio*)	– 140,000.00
Status as of December 31, 2003, net	**4,860,000.00**

*) Life: 10 years/remaining life: 8 years

Loan no. 6	
Status as of December 31, 2003, gross	4,687,500.00
Disagio*)	– 140,000.00
Status as of December 31, 2003, net	**4,547,500.00**

*) Life: 10 years/remaining life: 8 years

Disagio total	**– 311,700.10**

Long-term liabilities toward banks as of the end of fiscal year 2003 were secured by mortgages in the amount of K€ 8,781 (drawn in 2003: K€ 4,602). Although Zapf Creation submitted an application to cancel mortgages in the amount of K€ 4,180 in 2003 and the affected bank approved the cancellation, it was not yet entered in the land register as of the balance sheet date.

As of December 31, 2003, the Company forfaited receivables and wrote off the respective amount against the receivables shown in the balance sheet. Forfaiting is comprised as follows:

	2003 K€	2002 K€
Domestic customers	15,885	9,760
Foreign customers	15,964	18,098
	31,849	**27,858**

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 twelve 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, relative 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 a nominal value of K$ 5,000.

As of December 31, 2003, the Company's portfolio included derivative financial instruments to hedge against interest rate risks with a maximum maturity of five 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, 2003, the financial result does not include ineffective hedges or components of financial instruments which are excluded from the assessment of hedge effectiveness.

Note 8:
Stockholders' 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. The bearers of common stock are entitled to a dividend, provided that the payment of dividends is permitted under the law, the Management Board has declared that a dividend will be paid, and the respective issue does not violate the preference rights of the holders of all shares outstanding.

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) 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, 2003 was K€ 11,262. Account no. 1 as of December 31, 2003, comprised 569,593 shares of treasury stock, equaling 7.12 percent of the share capital. In May 2003, a total of 13,563 shares of treasury stock were issued at a subscription price of € 19.65 (previous year: 14,452 shares) under the Stock Option Plan 1999/2000, and in November 2003, a total of 4,720 subscription rights were issued at a subscription price of € 24.31 under the Stock Option Plan 2001/2003. In addition, the Company sold 27,103 shares directly through the stock exchange at a price of € 31.00 in May 2003. The total proceeds from disposal in 2003 were € 1,221,449.15.

On May 7, 2003, the stockholders authorized Zapf Creation AG to repurchase treasury stock up to an amount equaling 10 percent of the share capital, i.e. up to 800,000 shares. In December 2003, the Company added 542,000 shares equaling 6.78 percent of the share capital to its initial inventory of 72,979 shares of treasury stock at an average price of € 19.22, which in the future will be available to service the Stock Option Plan 2003/2005.

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 account (3,085) equals 0.04 percent of the share capital as of December 31, 2003. The related expenditure recognized under personnel expenses in 2003 amounts to K€ 0 (previous year: K€ 67). In fiscal year 2003, only 100 shares (previous year: 7,775 shares) were sold to employees at a price of € 16.19. A further 50,000 shares were sold through the stock exchange at a price of € 30.12. The total proceeds from such disposal in 2003 were € 1,507,619.

	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**

Disclosure Pursuant to Section 160 Number 8 German Stock Corporation Act
Schroder Investment Management Ltd, 31 Gresham Street, London EC2V 7QA, informed the Company that its voting share in Zapf Creation AG on November 24, 2003, reached the threshold of 5 percent and as of that date equaled 5.00 percent. The 400,000 voting shares are assigned to Schroders plc and Schroder Holding plc pursuant to Section 22 para 1 sentence 1 number 6, and sentences 2 and 3 German Securities Trading Act.

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 May 13, 2002, fell below the threshold of 10 percent and as of that date equaled 8.90 percent, representing 712,000 voting shares.

On Friday, December 19, 2003, Zapf Creation AG announced that it exceeded the five-percent threshold of voting shares. Zapf Creation AG now holds a voting share of 7.16 percent, i.e. 572,678 voting shares, in its own company.

Stock-based Compensation
As part of the further implementation of the German Corporate Governance Code (7.1.3), the presentation of the employee profit-sharing models in the Notes to the Consolidated Financial Statements was restructured. As of December 31, 2003, 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 1999/2000

In April 1999, the Supervisory Board and the Management Board recommended a stock option plan, which was approved by the Company's stockholders at its Extraordinary Stockholders' Meeting in 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. On July 31, 2001, the stockholders resolved to terminate the stock option plan prematurely. Due to an editorial oversight in the voting proposal for the Annual Stockholders' Meeting on July 31, 2001, the number of stock options to be granted which had been approved in 2000 retroactively was reduced from 380,000 to 80,000 options although the persons owning subscription rights had already been granted a total of 86,000 stock options from the partial option plan 2000. As a result, the total volume of stock options granted under the Stock Option Plan 1999/2000 is 126,000 because of the 95,000 stock options for fiscal year that were disclosed in the Notes, a total of 9,000 options grants were not legally effective due to a defect of form.

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, 2003, 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 300,000 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 2001/2003. 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 personal expenses pursuant to APB Opinion no. 25. Until December 31, 2003, 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 II, 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 expiration 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. Under Stock Option Plan 1999/2000, a total of 40,000 options were granted in 1999 and 86,000 options were granted in 2000. In addition, 95,160 options were legally granted in 2001 under Stock Option Plan 2001/2003 of Zapf Creation, as opposed to 99,240 which were reported in the Notes. As of December 31, 2003, the total volume of all stock options plans launched so far is 826,000 options. Of these, 463,725 options were granted and 42,604 options were exercised. One option under Stock Option Plan 2001/2003 can no longer be granted due to an expiration of the granting period.

In March 2003, a total of 87,539 options under Stock Option Plan 2001/2003 were issued at a subscription price of € 29.92, and in July 2003, a total 37,726 options under Stock Option Plan 2003/2005 were issued at a subscription price of € 36.75. In May 2003, a total of 13,563 options under Stock Option Plan 1999/2000 and 4,720 options from the first tranche of Stock Option Plan 2001/2003 were exercised.

	2003		2002	
	Options	**Weighted average exercise price**	**Options**	**Weighted average exercise price**
	Number	**€**	**Number**	**€**
Options outstanding at January 1	314,139	39.70	211,091	45.10
Options granted	125,265	31.98	117,300	28.01
Options exercised	– 18,283	23.77	– 14,252	23.58
Options expired	–	–	–	–
Options outstanding at December 31	**421,121**	**38.09**	**314,139**	**39.70**
Exercisable at December 31	86,448	58.31	31,011	71.67
Available for grant at December 31	362,274	–	87,540	–
No longer available for grant at December 31	1	–	–	–

The following table contains information about the remaining contractual life (in years) of and exercise prices for the stock options outstanding as of December 31, 2003:

Exercise price €	Number of shares	Remaining life in years
23.58 (Stock Option Plan 1999/2000 tranche 1999)	2,116	0.3
75.60 (Stock Option Plan 1999/2000 tranche 2000)	86,000	1.3
24.31 (Stock Option Plan 2001/2003 tranche 2001)	90,440	2.7
28.01 (Stock Option Plan 2001/2003 tranche 2002)	117,300	3.2
29.92 (Stock Option Plan 2001/2003 tranche 2003)	87,539	4.2
36.75 (Stock Option Plan 2003/2005 tranche 2003)	37,726	4.6
38.09[7)]	**421,121**	**3.0**

[7)] Weighted average

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 2003 and K€ 107 in 2002.

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:

		2003	2002
Reported net income	K€	12,076	21,237
Pro forma compensation expense, net of tax	K€	– 13	– 78
Pro forma net income	**K€**	**12,063**	**21,159**
Earnings per share			
Basic	€	1.53	2.70
Basic – pro forma	€	1.53	2.69
Diluted	€	1.52	2.69
Diluted – pro forma	€	1.51	2.68

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:

		2003	2002
Expected life (in years)		4.0	4.0
Risk-free interest rate	%	4.9	4.9
Expected volatility	%	36.0	36.0
Expected dividend yield	%	1.5	1.5

The market value of the issued options is € 5.67 per share for the 2000 stock option plan and € 22.50 for the 1999 stock option plan.

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 and 117,300 bonus units with performance goals of € 28.01 and € 24.31 were issued to the beneficiaries in 2003 and 2002, respectively. Due to a defect of form, only 95,160 bonus units were legally granted in 2001, as opposed to 99,240 as reported in the Notes, so that as of December 31, 2003, all but one bonus units under the plan were issued.

Due to the stock price development, a provision of K€ 0 and K€ 170 had to be set up in 2003 and 2002, respectively, which affected personnel expenses. Personnel expenses resulting from this bonus plan amounted to K€ 128 in fiscal year 2003. The remaining maximum additional personnel expenses of the bonus units issued under the Bonus Plan 2001/2003 until December 31, 2003, can amount to K€ 1,241 for the full term of the bonus plan (previous year: K€ 950).

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. Due to the stock price development as of December 31, 2003, no provision effecting personnel expenses needs to be set up. The maximum additional personnel expenses of the bonus units issued under the Bonus Plan 2001/2003 until December 31, 2003, can amount to K€ 320 for the full term of the bonus plan.

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

	2003			2002		
	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	212,460	26.35	4.39	95,160	24.31	4.05
Bonus units granted	125,265	31.98	6.04	117,300	28.01	4.67
Bonus units exercised	– 31,720	24.31	4.05	–	–	–
Bonus units expired	–	–	–	–	–	–
Bonus units outstanding at December 31	**306,005**	**28.87**	**5.10**	**212,460**	**26.35**	**4.39**
Available for grant at December 31	362,274	–	–	87,540	–	–
No longer available for grant at December 31	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€ 3,139 in fiscal year 2003 (previous year: K€ 2,201).

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

Operating leases	**K€**
2004	2,679
2005	2,076
2006	1,006
2007	287
2008	105
Thereafter	215
	6,368

Obligations stemming from long-term leasing contracts expire no later than in 2011. 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€ 8 as of December 31, 2003 (previous year: K€ 882).

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€ 3,266 in 2003 and K€ 5,019 in 2002. The decrease in licensing fees results from the product mix and from the amendment of license agreements with the licensors. In fiscal year 2003, the Company sold a smaller proportion of products subject to license fees and determined that it had a right of reclamation against the licensors.

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€ 270 were outstanding as of December 31, 2003 (previous year: K€ 500). The related interest agreement with a fixed interest rate of 4.75 percent expired on December 31, 2003. The subsequent interest rates for the loans are determined quarterly in advance at the end of each quarter. This credit line expires on December 31, 2004. During fiscal year 2003, a total of K€ 480 was repaid and a total of K€ 250 was newly extended under this credit line.

In addition, as part of a bank guarantee, Zapf Creation AG furnished a loan guarantee on behalf of a member of the Management Board, which had a maximum amount of K€ 350 during the fiscal year. As of the balance sheet date, this guarantee was reduced to K€ 0 and thus no longer exists. The cost of this bank guarantee in the amount of annually 1 percent of the guarantee amount is charged to the member of the Management Board.

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, 2003. The related interest agreement with a fixed interest rate of 4.5 percent remains unchanged until the loan becomes repayable on December 31, 2004. 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 assumes a number of centralized corporate functions and also invoices customers (through the Central Europe and Eastern Europe business units). The Parent Company thus accounts for the majority of operating expenses and assets in its 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 will greatly increase the comparability of the business units in 2004.

	Net sales from external customers K€	Affiliated revenues*) K€	Depreciation and amortization expense**) K€	Interest result K€
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**
2002				
Zapf Creation AG	90,490	24,957	4,727	4,988
Zapf Creation (España), S.L.	12,257	11	99	– 82
Zapf Creation (France), S.a.r.l.	9,281	132	33	– 97
Zapf Creation (U.K.), Ltd.	44,190	0	102	– 238
Zapf Creation (H.K.), Ltd.	5,226	76,910	468	332
Zapf Creation (U.S.), Inc.	50,160	63	135	– 672
Zapf Creation (Australia), Pty. Ltd.	7,809	0	116	– 113
Zapf Creation (Italia), S.R.L.	895	0	24	– 18
Zapf Creation (CZ), s.r.o.	2,412	0	39	– 25
Zapf Creation (Polska), Sp. z o.o.	0	623	0	– 81
Consolidation	**0**	**– 102,696**	**0**	**– 6,259**
Consolidation total	**222,720**	**0**	**5,743**	**– 2,265**

*) Excludes inter-company interest income

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

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.

The Parent Company and all 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:

Tax expense (income: –)	Operating profit***)	Capital expenditures	Long-lived assets (net of deferred taxes/long-term receivables)	Total assets
K€	K€	K€	K€	K€
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**
3,901	2,411	8,286	28,602	111,917
433	2,876	56	275	8,122
104	1,492	91	135	6,370
3,126	16,048	198	326	20,338
937	– 1,009	765	729	23,704
836	9,510	282	647	29,940
90	1,163	102	483	3,920
– 96	– 111	34	60	1,531
56	388	85	149	2,442
0	327	0	0	987
0	**– 206**	**0**	**– 1,458**	**– 69,386**
9,387	**32,889**	**9,899**	**29,948**	**139,885**

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

The following table shows the development of sales in the different product lines:

	2003 K€	2002 K€
BABY born® concept	95,759	113,963
Baby Annabell	47,690	38,687
CHOU CHOU	39,930	48,199
Other branded play concepts	18,046	21,598
Dolls total	**201,425**	**222,447**
Maritim/other	– 2	273
Net sales	**201,423**	**222,720**

Breakdown of net sales by business unit is as follows:

	2003 K€	2002 K€
Europe	**160,418**	**161,965**
Central Europe	83,187	88,134
Northern Europe	45,736	44,978
Southern Europe	23,600	23,033
Eastern Europe	7,895	5,820
The Americas	**32,775**	**50,160**
Asia/Australia	**8,230**	**10,595**
Net sales	**201,423**	**222,720**

Dependence on Product Lines and Major Customers

The Company's most profitable and successful product to date, BABY born®, accounted for 48 percent of total sales in 2003 (previous year: 51 percent).

The Company's sales to its two main customers accounted for 21 percent of total consolidated sales in 2003 (previous year: 21 percent). Sales to all top ten customers accounted for 46 percent of total consolidated sales in 2003 (previous year: 49 percent). The share of receivables attributable to these major customers in comparison to total receivables is 45 percent before forfaiting. This share is reduced to a net share of 11 percent as of the end of the fiscal year due to the forfaiting transactions affected.

Note 11: Supplemental Financial Information

	2003 K€	2002 K€
Supplemental disclosure of cash flow information		
Cash paid during the year for:		
Interest[8)]	3,919	2,784
Income taxes	7,101	3,976

8) Capitalized interest expenses totaled K€ 0 in 2003 and K€ 326 in 2002.

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.

	2003 K€	2002 K€
Accrued liabilities		
Advertising and public relations	3,692	6,117
Other accrued liabilities	3,471	2,412
Management bonuses	157	1,537
Tax liabilities (VAT, other)	1,874	1,286
Other liabilities employees	549	562
Commissions	552	475
License fees	1,051	332
Labor expenses (stock options)	0	277
	11,346	**12,998**

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.

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

The overview is given on pages 72 and 73.

2) Billings by Business Unit

The overview is given on pages 104 and 105.

3) Liabilities With Remaining Terms of More Than Five Years

In fiscal year 2003, the Company had liabilities with remaining terms of more than five years in the amount of K€ 3,438 (previous year: K€ 7,315). Taking into account the disagio, the liabilities with remaining terms of more than five years amounted to K€ 3,388 (previous year: K€ 7,195).

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

The cost of materials in 2003 and 2002 according to HGB was K€ 75,665 and K€ 89,411, respectively. The cost of materials comprises the cost of raw materials and supplies in the amount of K€ 3,582 (previous year: K€ 4,543) and the cost of goods purchased in the amount of K€ 72,083 (previous year: K€ 84,868).

Consolidated personnel expenses were K€ 25,743 (previous year: K€ 26,430). Besides salaries and wages of K€ 22,697 (previous year: K€ 23,433), this amount also includes social security contributions and benefits of K€ 3,047 (previous year: K€ 2,997).

5) Annual Average Number of Employees

	2003	2002
Salaried employees	390	326
Industrial workforce	140	186
Home workers	2	6
	532	**518**

Billings by Business Unit:

	Zapf Creation AG	Zapf Creation (España), S.L.	Zapf Creation (H.K.), Ltd.	Zapf Creation (U.S.), Inc.	Zapf Creation (U.K.), Ltd.	Zapf Creation (France), S.a.r.l.	Zapf Creation (Australia), Pty. Ltd.
	K€	K€	K€	K€	K€	K€	K€
2003							
Europe	**84,548**	**12,889**	**5,420**	**0**	**43,175**	**9,161**	**1**
Central Europe	80,337	0	2,831	0	0	19	0
Northern Europe	– 28	0	2,589	0	43,175	0	0
Southern Europe	495	12,889	0	0	0	9,142	1
Eastern Europe	3,744	0	0	0	0	0	0
The Americas	**0**	**0**	**0**	**32,775**	**0**	**0**	**0**
Asia/Australia	**108**	**0**	**1,840**	**0**	**0**	**0**	**6,282**
Net sales	**84,656**	**12,889**	**7,260**	**32,775**	**43,175**	**9,161**	**6,283**
2002							
Europe	**89,942**	**12,257**	**2,988**	**0**	**44,190**	**9,281**	**0**
Central Europe	85,410	0	2,721	0	0	3	0
Northern Europe	542	0	246	0	44,190	0	0
Southern Europe	582	12,257	21	0	0	9,278	0
Eastern Europe	3,408	0	0	0	0	0	0
The Americas	**0**	**0**	**0**	**50,160**	**0**	**0**	**0**
Asia/Australia	**548**	**0**	**2,238**	**0**	**0**	**0**	**7,809**
Net sales	**90,490**	**12,257**	**5,226**	**50,160**	**44,190**	**9,281**	**7,809**

Zapf Creation (Italia), S.R.L.	Zapf Creation (CZ), s.r.o.	Zapf Creation (Polska), Sp. z o.o.	Zapf Creation (Central Europe) GmbH & Co. KG	Zapf Creation Logistics GmbH & Co. KG	Zapf Creation (Central Europe) Verwaltungs GmbH	Zapf Creation Logistics Beteiligungs GmbH	Total net sales
K€	K€	K€	K€	K€	K€	K€	K€
1,073	**2,740**	**1,411**					**160,418**
0	0	0					83,187
0	0	0					45,736
1,073	0	0					23,600
0	2,740	1,411					7,895
0	**0**	**0**					**32,775**
0	**0**	**0**					**8,230**
1,073	**2,740**	**1,411**	**0**	**0**	**0**	**0**	**201,423**
895	**2,412**	**0**					**161,965**
0	0	0					88,134
0	0	0					44,978
895	0	0					23,033
0	2,412	0					5,820
0	**0**	**0**					**50,160**
0	**0**	**0**					**10,595**
895	**2,412**	**0**	**0**	**0**	**0**	**0**	**222,720**

6) Supervisory Board

The Supervisory Board of Zapf Creation AG consists of the following members:

Name	Member since	Function	Principal occupation	Further supervisory board membership
Dr. Dietmar Scheiter	March 18, 1999	Chairman	Chief Executive Officer 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 15, 1999	Full member	Managing Director Anders + Kern	GetAhead AG, Hamburg Chairman
Hans-Gerd Füchtenkort	July 31, 2001	Full member	Managing Partner and Partner Dr. Rochus Mummert & Partner	No further memberships

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) each for fiscal year 2003.

In addition, each ordinary member of the Supervisory Board received a variable, dividend-based cash compensation of K€ 5 in 2003 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 Company set up provisions in the amount of the total Supervisory board remuneration of K€ 135 (previous year: K€ 58) for fiscal year 2003 as of December 31, 2003.

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 require disclosure 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 the Company. This responsibility includes the management of Zapf Creation AG and all independent and dependent subsidiaries.

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

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 components. Total compensation in 2003 was K€ 953 (previous year: K€ 1,108). The variable component in fiscal year 2003, which mainly comprises stock options and bonus units, was approximately 30 percent (previous year: 43 percent). The deviation in the share of variable compensation as compared to the previous year is due to the fact that the members of the Management Board are unlikely to receive bonuses for fiscal year 2003.

In addition, the members of the Management Board received 21,000 stock options (previous year: 42,000) under the Stock Option Plan 2001/2003 and 16,380 stock options under the Stock Option Plan 2003/2005. Furthermore, a total of 21,000 bonus units (previous year: 42,000) under the Bonus Plan 2001/2003 and 16,380 bonus units under the Bonus Plan 2003/2005 were granted to the members of the Management Board. Further details regarding the individual plans are explained in Note 8 "Stock-based Compensation".

A variable credit line in the maximum amount of K€ 500 was granted to the members of the Management Board, of which K€ 270 were outstanding as of December 31, 2003 (previous year: K€ 500). The related interest agreement with a fixed interest rate of 4.75 percent expired on December 31, 2003. The subsequent interest rates for the loans are determined quarterly in advance at the end of each quarter. This credit line expires on December 31, 2004. During fiscal year 2003, a total of K€ 480 was repaid and a total of K€ 250 was newly extended under this credit line.

In addition, as part of a bank guarantee, Zapf Creation AG furnished a loan guarantee on behalf of a member of the Management Board, which had a maximum amount of K€ 350 during the fiscal year. As of the balance sheet date, this guarantee was reduced to K€ 0 and thus no longer exists. The Company charges the cost of this bank guarantee in the amount of annually 1 percent of the guarantee amount to the member of the Management Board.

Directors' Dealings

The following table lists the transactions of the members of the Management Board and their spouses and relatives in the first degree which require disclosure under Section 15a German Securities Trading Act since July 1, 2002.

Name	Type of transaction	Stock, security or right	Nominal value in €	Date of transaction	Number	Price in €
Thomas Eichhorn	Sale	Stock	1.00	May 12, 2003	2,666	32.00
				May 13, 2003	3,000	33.33
				May 14, 2003	3,000	34.50
				May 15, 2003	2,600	34.56
				May 16, 2003	1,400	34.88
Angelika Marr	Sale	Stock	1.00	May 12, 2003	2,000	32.00
Rudolf Winning	Sale	Stock	1.00	May 12, 2003	2,000	32.00

Roedental, Germany, February 18, 2004

Thomas Eichhorn
Chairman of the
Management Board

Christian Ewert
Member of the
Management Board

Angelika Marr
Member of the
Management Board

Rudolf Winning
Member of the
Management Board

Independent Auditors' Report

We have audited the Consolidated Financial Statements of Zapf Creation AG for the fiscal year from January 1, 2003 to December 31, 2003, 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 reasonable basis for 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, 2003 to December 31, 2003, 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, 2003 and ending December 31, 2003 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 18, 2004

Rödl & Partner GmbH
Wirtschaftsprüfungsgesellschaft
Steuerberatungsgesellschaft

Kastl	Schäfer
Wirtschaftsprüfer	Wirtschaftsprüfer
(Independent Auditor)	(Independent Auditor)

Report of the Supervisory Board

Ladies and Gentlemen,
There were no changes regarding the composition of the Supervisory Board and the Management Board of Zapf Creation AG in fiscal year 2003.

The Supervisory Board carried out its duties as provided by law and the Company's articles of incorporation in a total of four 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. The Supervisory Board meeting in September 2003 took place in Hong Kong in the premises of the local subsidiary, which is responsible for controlling production in China, the worldwide shipment of products, and product development. During this trip to Hong Kong, the Supervisory Board was able to gain a detailed insight into the production in China, quality control operations, and logistical processes. Key topics at the meetings of the Supervisory Board were the risk monitoring system including the assessment and treatment of existing risks (e.g. the infectious disease known as SARS), the efficiency review of the Supervisory Board, and the future strategic orientation of the Zapf Creation Group. In addition, the chairman of the Supervisory Board and the chairman of the Management Board usually met once a month for in-depth discussions of current issues. The Supervisory Board was informed comprehensively and in a timely manner of all essential business transactions.

The present Financial Statements for fiscal year 2003 and the Management Report including the accounts were audited by the auditors, Rödl & Partner GmbH Wirtschaftsprüfungsgesellschaft, Steuerberatungsgesellschaft, 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, 2004, 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, 2004, the Supervisory Board also thoroughly reviewed and approved the Consolidated Financial Statements as of December 31, 2003, which received an unqualified audit certificate from Rödl & Partner GmbH Wirtschaftsprüfungsgesellschaft, Steuerberatungsgesellschaft, Nuremberg, and the Group Management Report.

The Supervisory Board wishes to thank the Management Board and the Company's employees for their great commitment and their achievements in a difficult market environment in the past fiscal year.

Munich, Germany, March 16, 2004
For the Supervisory Board

Dr. Dietmar Scheiter
Chairman

Financial Calendar

Date		Event	Place
January 20, 2004		CAI Cheuvreux GCC	Frankfurt/Main
January 20, 2004	8:30 a.m.	Global conference call	
January 30, 2004		Toy Fair Cocktail	London
March 4, 2004		Dresdner KW GMCC	London
March 5, 2004		Roadshow London	London
March 25, 2004	10:00 a.m.	Financial statements press conference	Munich
March 25, 2004	4:00 p.m.	DVFA analyst conference	Frankfurt/Main
March 25, 2004	6:00 p.m.	Global conference call	Frankfurt/Main
March 29, 2004		Deutsche Bank GCC	Frankfurt/Main
April 22, 2004		Results Q1/2004	
April 22, 2004		Global conference call	
May 11, 2004		5th Annual Stockholders' Meeting	Roedental
May 11, 2004		Global conference call	
May 12, 2004		Dividend payment[1)]	
July 21, 2004		Results Q2/half-year 2004	
October 26, 2004		Results Q3/9 months 2004	

[1)] Subject to approval by the Annual Stockholders' Meeting

Communication and Contact

Zapf Creation AG
Moenchroedener Strasse 13
96472 Roedental, Germany
Phone: +49 (0) 95 63 / 725-0
Fax: +49 (0) 95 63 / 725-116
E-mail: info@zapf-creation.de

IR Contact:
Monika Collée
Phone: +49 (0) 95 63 / 725-195
E-mail: monika.collee@zapf-creation.de

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

Publishing Information:
Text: Zapf Creation AG, Roedental
Concept and realization: CAT CONSULTANTS, Hamburg
Photo design and photography: Peter Kaus, Hamburg

Zapf Creation AG ▪ Moenchroedener Strasse 13 ▪ 96472 Roedental, Germany
Phone: +49 (0) 95 63 / 725-0 ▪ Fax: +49 (0) 95 63 / 725-116 ▪ E-mail: info@zapf-creation.de ▪ Internet: www.zapf-creation.com