ANNUAL REPORT 2006

The new Zapf Creation is gathering speed …

Zapf Creation®

Product Portfolio

To be a princess just once – that's what many little girls dream of! They are fascinated by a world of horse-drawn carriages and horse riding in the castle grounds, shimmering clothes, and glittering crowns. The new "Horse & Princess" BABY born® product series invites little princesses into these fairytale worlds. Magnificent dresses for BABY born® with lavish details, along with many glamorous accessories, are an integral part of this romantic series. Every princess has to have a prince, of course, and here he is: BABY born® BOY with a matching princely outfit.

She is every doll mother's little darling. Her lifelike functions make her react like a real infant, which promotes young girls' sense of responsibility and empathy. Baby Annabell® can make babbling sounds, suck on a pacifier, laugh, cry, yawn, sleep, and drink from a water bottle. She slowly closes and opens her eyes when she's drinking and burps when she's finished. She sheds real tears when she's awakened by loud noises but quickly calms down when you sing to her. And Baby Annabell® will turn her head in the direction of the sound when you talk to her.

The new CHOU CHOU can get sick just like a real baby. Her cheeks turn red and she develops a fever. She does not feel well and starts to cry but recovers quickly once she's been given her medicine with a special spoon. You can even hear her swallow like a good little girl. CHOU CHOU's fever falls and her red cheeks disappear. Her doll mother can listen to her heartbeat using the heart-shaped stethoscope. Of course, professionally taking care of a baby's aches and pains also requires syringes and band aids. Yet cuddling a lot with her doll mother is still the best medicine for curing any baby's illness.

Contents

Consolidated Key Figures (IFRS)

in € million	2006	2005	+/– %
Adjusted earnings situation (without restructuring costs and one-off effects)			
Continued operations			
EBITDA	10.7	0.6	—
EBIT	5.4	– 6.2	—
EBIT margin (in %)	4.7	– 5.1	—
EBT	– 0.9	– 12.0	93
Result from continued operations	– 0.6	– 14.7	—
Discontinued operations			
Result from discontinued operations	– 4.9	– 5.2	6
Group			
Net profit or loss for the period	– 5.6	– 19.9	72
Earnings per share (in €) [1]	– 0.74	– 2.68	73
Earnings situation according to the income statement (including restructuring costs and one-off effects)			
Continued operations			
Net sales	116.1	120.7	– 4
Gross margin (in %)	45.4	41.3	—
EBITDA	4.8	– 5.5	—
EBIT	– 0.5	– 12.3	96
EBIT margin (in %)	– 0.4	– 10.2	—
EBT	– 6.8	– 18.1	62
Result from continued operations	– 6.5	– 20.8	69
Included restructuring costs and one-off effects	5.9	6.1	– 3
Included depreciation and amortization	5.3	6.8	– 22
Discontinued operations			
Result from discontinued operations	– 6.1	– 6.9	12
Included restructuring costs and one-off effects	1.2	1.7	– 29
Included depreciation and amortization	0.0	0.2	– 100
Group			
Net profit or loss for the period	– 12.7	– 27.7	54
Earnings per share (in €) [1]	– 1.67	– 3.73	55

1) undiluted = diluted; average number of shares outstanding: 2006: 7.59 million; 2005: 7.43 million

in € million	2006	2005	+/− %
Balance Sheet			
Total assets	115.6	133.1	− 13
Non-current assets	26.3	28.9	− 9
Investments	1.8	2.7	− 33
Current assets	89.3	104.2	− 14
Equity	3.6	10.2	− 65
Equity ratio (in %)	3.1	7.7	—
Liabilities to banks	65.1	82.3	− 21
Net debts	53.3	73.0	− 27
Cash flow			
Cash flow from operating activities	20.3	− 8.4	—
Cash flow from operating activities per share (in €) 1)	2.68	− 1.14	—
Net cash flow	2.4	− 7.7	—
Employees			
Number as of the closing date (Dec. 31) 2)	322	408	− 21

1) undiluted = diluted; average number of shares outstanding: 2006: 7.59 million; 2005: 7.43 million
2) excluding Management Board and trainees

The key figures are based on rounded values in € million. The calculation of sums and ratios can therefore result in differences when compared to the annual financial statements.

Jens U. Keil
Member of the Management Board
(Finance, Capital Market, Restructuring, Human Resources, IT, Logistics and Supply Chain Operations)

Thomas Pfau
Member of the Management Board
(Sales, Marketing, Design and Product Development)

Zapf Creation AG is Europe's leading brand manufacturer of play and functional dolls including accessories. The Company's most popular brands are BABY born®, Baby Annabell® and CHOU CHOU. All branded play concepts share a high standard in terms of design, quality, safety and play value. The Company's branded play concepts are sold in more than 65 countries throughout the world.

Dear Shareholders,

In many respects, the financial year ended December 31, 2006, was a truly eventful one for Zapf Creation – and yet another year during which the Group both consolidated and strategically reoriented its operations. The road to recovery did not always follow a straight line because there was always this or that impediment that had to be overcome. In the end, however, Zapf Creation made important steps in the right direction, and that is what ultimately counts. We are firmly committed to concluding the Group's restructuring in the course of this year.

The restructuring will bring forth a "new" Zapf Creation. We will be in the position – as the leading European manufacturer of play and functional dolls with a competitive cost structure – to work our markets more efficiently than has been possible to date thanks to a stabilized financial base and, not least, new innovative products. The new Zapf Creation will once again generate growth and sustainable profitability in international toy markets. Hence it is not an overstatement to say that, in 2006, we succeeded in turning the corner.

What are the measures that permitted us to do so?

- The restructuring program, which was implemented in the spring of 2006 and entailed a total of eight projects, was on target. It allowed us to further reduce our operating costs, streamline both structures and processes yet again, and adjust them to lower revenue flows.

- In the second half of 2006, we entered into a long-term strategic partnership in sales, procurement, and licensing with the US toy manufacturer, MGA Entertainment, Inc. The terms of the agreement took effect at the start of 2007 and have been put into practice since then. Our collaboration with one of the most successful companies in the toy industry, which has also been the largest shareholder of Zapf Creation AG since 2006, is intended to contribute substantially to our Group's recovery.

- But we also set the course for our products in the 2006 financial year. Product innovations such as the fairytale "Horse & Princess" BABY born® series, additional interactive functions for Baby Annabell®, and the "Mommy, Make Me Better" Baby CHOU CHOU for girls up to four years of age met with highly positive responses at the relevant toy industry trade fairs. We are also already reaping the first fruits of the creative give-and-take with MGA.

- As far as financing is concerned, it took longer than expected to place Zapf Creation back on a solid footing. Negotiating a new syndicated loan in the spring, as well as the capital increase of just under 10 % (subject to the exclusion of shareholders' subscription right) in the fall, were the main events in 2006 in this connection. In July 2007, we finally managed, after intense negotiations, to arrive at an agreement with the banks and our major shareholders on both long-term new financing and an interim solution until the relevant contracts have been finalized. This financing package – which essentially entails a new, long-term syndicated loan, as well as a capital contribution by the Group's major shareholders – will help us to establish a workable equity basis for the Zapf Creation Group in the long term.

But the figures for 2006 only hint at or fail to reflect our progress in both strategic and operational terms. Consolidated sales (excluding the US business, which was discontinued at year's end) were € 116.1 million and thus 4% below the previous year. We are pleased, however, that even in the fourth quarter of 2006 revenues exceeded the level achieved the same quarter of the previous year by about 10%, thus putting a stop to the downward sales spiral in the important Christmas business.

EBIT (excluding one-off extraordinary expenses) was € 5.4 million, up from € −6.2 million the previous year. This shows that, in terms of operating income, the Zapf Creation Group clearly achieved an earnings turnaround. The 4.1% increase in the gross profit margin, which documents the efficiency improvements across all stages of the value chain, was an important factor in this development. One-off expenses, especially in connection with the failed takeover offer of the Japanese Namco Bandai Group for Zapf Creation AG and the implementation of our close collaboration with MGA, largely account for the fact that, even though the Group posted after-tax losses of € −12.7 million, they are considerably lower than in the previous year (2005: € −27.7 million).

Implementing our strategic cooperation with MGA will take center stage in 2007. Given the great significance of this partnership, we would like to explain in greater detail what was agreed to and how our Company will benefit from this collaboration:

- In regards to sales, MGA was given the exclusive right to market absolutely all Zapf Creation products in North, Central, and South American markets, allowing us to shut down our own US subsidiary. For one thing, this made it possible to eliminate a company that had been a drain on the Group's resources for years, while, for another, MGA's contractual commitment in terms of minimum sales from our products already exceeds the volume we attained in the Americas on our own by more than 50%.

- In return, MGA will use Zapf Creation's strong sales network in important continental European markets, thus ensuring better capacity utilization. This means that the two companies' geographical sales organizations perfectly complement each other.

- In regards to procurement, MGA has taken over the entire process of selecting and monitoring the Asian suppliers of Zapf Creation products, the coordination and processing of deliveries to sales units, as well as technical product development. The activities of our subsidiary, Zapf Creation (H.K.) Ltd., were transferred to MGA in that connection. This new structure will lead to more favorable purchasing terms and lower costs, which will ultimately have a positive impact on our gross profit margin. Zapf Creation remains tightly integrated into all procurement and delivery processes through its own on-site manager.

- In addition, we now also have the ability to use our strong brands to create products for the non-toy segment. MGA has been given the right to grant corresponding licenses to third parties in the future. This licensing business will expand both the product range and the target groups of Zapf Creation. The first product ideas are already in the works.

All these measures have necessarily led to yet more restructurings within the Group. At the start of 2007, all marketing and sales were bundled in Darmstadt, the seat of MGA's German subsidiary, while design was bundled at the Company's seat in Roedental and enhanced by additional staff. The net result overall of these restructuring measures is that Group staffing levels were reduced yet again in the first six months of 2007 to about 240 individuals, more than one half of which now work in Roedental. This shows the depth of restructuring we had to undergo, given that the Group had more than 500 employees just a few years ago.

It is all the more noteworthy that we rapidly came to an agreement regarding a reconciliation of interests and a redundancy payments scheme with the German Works Council at the start of 2007 in regards to further personnel reductions. The Works Council's constructive and responsible attitude allowed us to execute the restructuring measures that were so critical to the Group. The Management Board would like to use this occasion to expressly thank both its staff and the Works Council for their extraordinary commitment in the financial year ended December 31, 2006.

Optimism clearly governs Zapf Creation's outlook for the 2007 financial year. Business has developed as expected during the first few months of the year. The strategic cooperation with MGA has enabled us to focus on our core competencies – design and development, sales and marketing – and to continue enriching our product range through innovative theme-based approaches. The financing we have obtained for the Group gives us new entrepreneurial leeway. Thanks to the successful restructuring measures, the new Zapf Creation now possesses a streamlined and powerful structure that makes it possible to work our main markets more intensively than before and to consistently open up new markets – in Eastern Europe, for instance. All of this serves to both secure and expand our leading position in the European market for play and functional dolls. This, along with our enhanced presence in the Americas and the step-by-step establishment of the licensing business, permits us to forecast that revenues from Zapf Creation products will substantially exceed current levels in the medium term.

We are optimistic that we will be able to further improve earnings in the 2007 financial year and finally turn the corner in terms of Group profits. The groundwork we have laid in recent years now gives us every opportunity to achieve this goal.

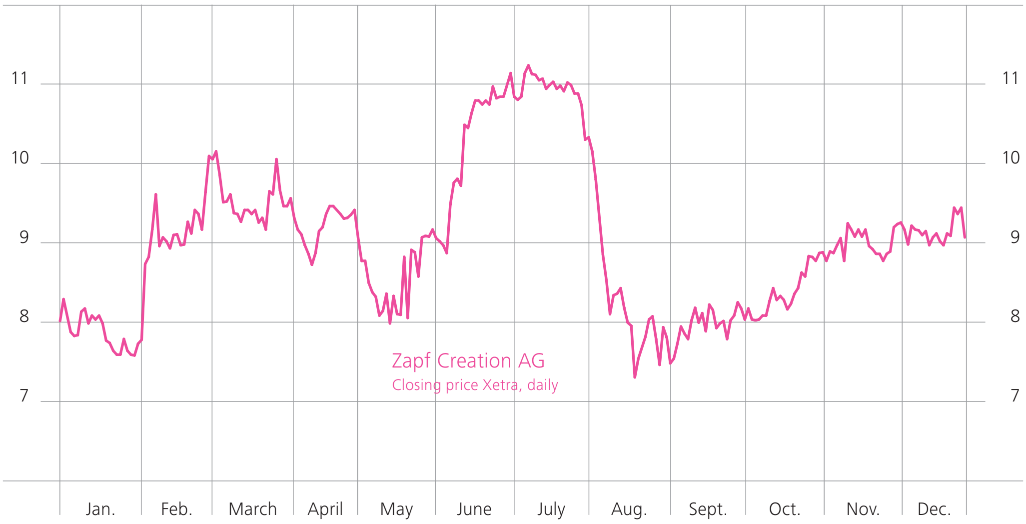
Roedental, Germany, September 26, 2007

Sincerely,

Jens U. Keil
Member of the Management Board

Thomas Pfau
Member of the Management Board

2006 at a Glance



February 1	The Supervisory Board appoints Dr. Georg Kellinghusen the Company's Chief Financial Officer (CFO) and thus to the Management Board effective February 15.
February 27	The special audit jointly initiated by the Management Board and the Supervisory Board and performed by the auditing firm KPMG uncovers intentional violations of statutory accounting rules and regulations by some of the Company's executives.
Spring	The Management Board initiates another restructuring program because the measures executed the previous year were insufficient; this restructuring program addresses all important operating areas, as well as the Group's financing.
May 17	The Supervisory Board dismisses Thomas Eichhorn from the Company's Management Board as both its chairman and ordinary member effective May 18.
June 13	The Japanese toy company Namco Bandai announces that it will submit a voluntary takeover bid to the shareholders of Zapf Creation.
June 19	The Supervisory Board appoints Dr. Georg Kellinghusen, who is already serving as the Company's CFO, to the chairmanship of the Management Board.
June 28	Bandai GmbH submits its voluntary takeover bid to the shareholders of Zapf Creation as previously announced.
June 28	Dr. Peter Klein declares his resignation as a member of the Supervisory Board.

July 6	US toy manufacturer MGA Entertainment, Inc. announces that it has acquired an 18.05 % stake in Zapf Creation AG.
July 27	Martin Gruschka resigns his post as ordinary member and chairman of the Supervisory Board. The Supervisory Board of Zapf Creation elects Miguel Perez-Carballo Villar to serve as its new chairman and Francesc Robert to serve as deputy chairman.
August 4	The takeover bid of Bandai GmbH fails to receive the required 75 % approval of Zapf Creation AG's share capital. Its takeover bid thus is rejected.
August 11	Zapf Creation and MGA Entertainment agree in principle to a long-term sales cooperation.
August 24	Isaac Larian, CEO of MGA Entertainment, and Ron Brawer, Executive Vice President Marketing & Sales Strategic Planning of MGA USA, become members of the Supervisory Board.
August 28	The Supervisory Board of Zapf Creation appoints Thomas Pfau, Managing Director of MGA Entertainment in Germany, to the Company's Management Board. Thomas Pfau assumes responsibility for marketing and sales.
September 5	Zapf Creation and MGA Entertainment agree in principle to an extensive cooperation in procurement and technical product development.
September 28	The Management Board and the Supervisory Board jointly resolve to increase the Company's share capital of € 8,000,000 by close to 10 %, subject to the exclusion of shareholders' subscription rights, in order to fortify the Group's equity base. The new shares are acquired by the Supervisory Board members, Isaac Larian, Ron Brawer, and Gustavo Perez.
November 2	Angelika Marr, Management Board member responsible for design and product development, resigns effective immediately. Her responsibilities are taken over by Thomas Pfau.
December 20	The Supervisory Board and Dr. Georg Kellinghusen agree that the CEO will leave the Company effective immediately. Thomas Pfau takes on his responsibilities on an interim basis.

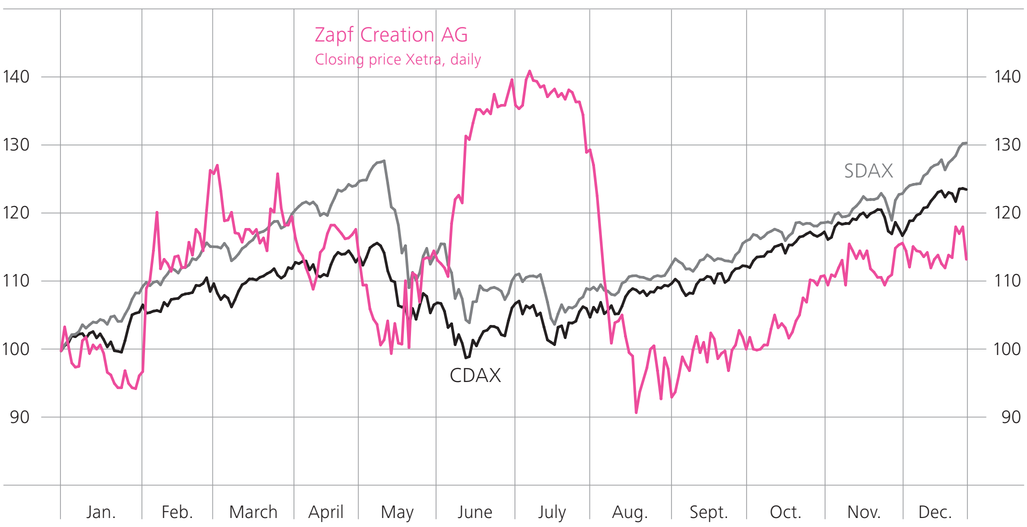
Investor Relations

The Share

The share of Zapf Creation opened the 2006 financial year – which turned out to be yet another turbulent one for the Company – at a price of € 8.11 on January 2, 2006. News of the special audit, the restructuring program, and matters relating to board members determined the great volatility of the share price until the beginning of June. But the share price rose to € 11.10, its high for the year, on the announcement by Bandai GmbH that it was going to make an offer to take over all outstanding shares of Zapf Creation AG. The offer's failure caused the share price to slide to € 7.11, its low for the year, on August 18, 2006. Zapf Creation's shares were taken out of the SDAX in the interim, specifically, on June 19, 2006.

Until the middle of August, the Company's share price barely managed to keep pace with the two performance indices, SDAX und CDAX, showing little sensitivity to market developments. Only in September did it begin to follow the market's upward trend, especially on the positive news regarding the Company's strategic cooperation with MGA and its successful capital increase. For the 2006 financial year as a whole, Zapf Creation's share did rise by 14 % while the SDAX gained 31 % and the CDAX 24 %. The share closed the year at € 8.90 on December 29, 2006. Its trading volume across all stock exchanges rose to 15.38 million shares, surpassing the previous year's level by approximately 7 %. The market capitalization at year's end was € 78 million.

Share Price Performance



Annual Shareholders' Meeting

The Seventh Annual Shareholders' Meeting of Zapf Creation AG was held in Roedental on August 29, 2006. It was attended by approximately 360 shareholders or their proxies, representing about 33 % of all voting shares.

Key Share Figures

	2002	2003	2004	2005	2006
Number of shares (Dec. 31)	8,000,000	8,000,000	8,000,000	8,000,000	8,799,998
Market capitalization (Xetra, Dec. 31) in € million	204	153	117	63	78
High (Xetra) in €	29.50	37.65	23.79	18.24	11.10
	(21.6.)	(5.9.)	(18.2.)	(1.2.)	(7.7.)
Low (Xetra) in €	16.80	17.18	14.25	7.05	7.11
	(8.10.)	(26.11.)	(21.12.)	(15.12.)	(18.8.)
Year-end price (Xetra, Dec. 31) in €	25.54	19.13	14.60	7.83	8.90
Daily trading volume (average no. of shares)	16,478	47,180	33,508	49,918	53,774
P/E ratio (Xetra, Dec. 31) in €	9.0	12.5	—	—	—
EPS in €	2.70	1.53	−3.73	−3.73	−1.67
CFPS in €	1.29	1.61	−1.14	−1.14	2.68
Dividend per share in €	1.00	1.00	0.00	0.00	0,00
Dividend yield (Xetra, Dec. 31) in %	3.9	5.2	—	—	—

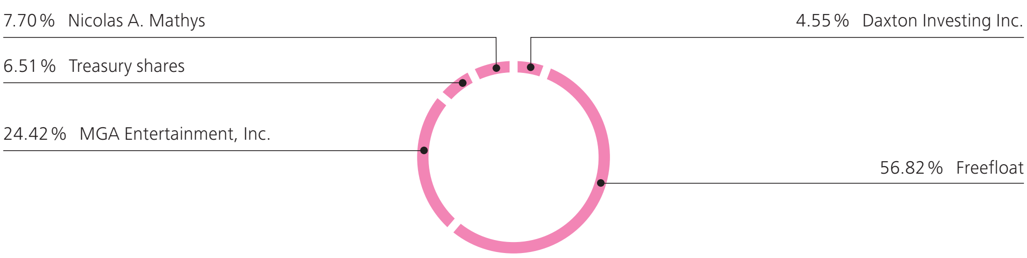
Capital Measures

To support its ongoing restructuring, on September 28, 2006, Zapf Creation AG resolved a capital increase by just under 10 % of the share capital. A total of 799,998 new shares were issued. The capital increase from authorized capital was recorded in the German Commercial Register on October 19, 2006. The Company's share capital now is € 8,799,998. The members of its Supervisory Board – Ron Brawer, Isaac Larian, and Gustavo Perez – acquired the shares at a price of € 7.45 per share in OTC trading through companies attributable to them. Zapf Creation received proceeds of roughly € 5.9 million.

Treasury Shares

Zapf Creation AG continues to hold treasury shares for its Employee Stock Option Program ("ESOP"). The ESOP is underwritten by 572,678 treasury shares, which corresponds to 6.51 % of the share capital following its increase to a total of 8,799,998 no-par shares.

Shareholder Structure



As of August 31, 2007

Corporate Governance Report

A. Corporate Governance

1. Preliminary Remark

The Zapf Creation Group attaches great importance to compliance with and implementation of the principles enshrined in the Corporate Governance Code with regard to good and responsible management.

They determine corporate communications and efforts to maintain transparency in corporate affairs in the interest of shareholders, business partners, and employees. It is in this sense that both the Management Board and the Supervisory Board of the Company regularly review the management principles with the goal of exercising and developing the Company's corporate governance in the long term.

Below, important activities related to corporate governance in the 2006 financial year are listed.

We also refer to the report of the Supervisory Board for the 2006 financial year.

2. Shareholders and Annual Shareholders' Meeting

At the 7th Annual Shareholders' Meeting of the Company on August 29, 2006, Article 22 para 1 sentence 7 of the articles of incorporation ("Right to attend the Annual Shareholders' Meeting") was amended.

Article 22 para 1 of the articles of incorporation now is as follows:

"Only those shareholders registered before the Shareholders' Meeting by way of fax or in text form shall be authorized to participate in the meeting and to exercise their voting rights. Such registration must be received at the place notified in the calling of the meeting by the end of the seventh day before the Shareholders' Meeting. The right to participate at the Shareholders' Meeting and to exercise voting rights must be proven to the Company. Evidence of possession of shares shall be in writing by fax or in text form. Confirmation of the institute at which the shares are deposited shall be sufficient proof. Evidence must be presented in German or English. Such evidence shall relate to [the status] at 00:00 a.m. on the twenty-first day prior to the Shareholders' Meeting and must arrive at the address specified in the notice convening the Meeting by the end of the seventh day prior to the Annual Shareholders' Meeting."

3. Collaboration of the Management Board and the Supervisory Board

As required under the German Stock Corporation Act (Aktiengesetz), the Zapf Creation Group uses a dual management system that assigns the management of the Company to the Management Board and supervisory authority to the Supervisory Board. These two boards jointly coordinate the Company's strategic orientation and the Supervisory Board regularly reviews its implementation by the Management Board. The Management Board provides comprehensive and timely information to the Supervisory Board on all issues relevant to the Company in terms of planning, development of the business, as well as risks and risk management. Both corporate bodies work closely with each other in the Company's interest but are strictly separated from each other in terms of both their personnel composition and the responsibilities assigned to the relevant board members.

If there are conflicts of interest with regard to pending decisions due to overlapping membership on the corporate bodies of Zapf Creation AG and its shareholder MGA Entertainment, Inc., Van Nuys, California, USA, including its affiliates, the relevant boards are immediately notified thereof on a case-by-case basis by means of a formal statement, and the relevant board members are asked to recuse themselves from the discussion and decision. In this regard, please also see the Company's voluntary Report on Dependent Companies and Relations with Affiliates.

4. Management Board

As of March 1, 2007, the Management Board of Zapf Creation AG was composed of Messrs. Jens U. Keil and Thomas Pfau; these two Management Board members jointly manage the Company in accordance with Section 77 German Stock Corporation Act. The tasks of each of them follow from the Company's distribution of responsibilities, which is defined as follows: Mr. Jens U. Keil is responsible for Finance, Capital Market, Restructuring, Human Resources, IT, Logistics and Supply Chain Operations. Mr. Pfau is responsible for Sales and Marketing, and Design and Product Development.

The following changes with regard to the composition of the Management Board occurred during the period under review: Dr. Georg Kellinghusen was appointed the Company's new chief financial officer by the Supervisory Board of Zapf Creation AG effective February 15, 2006. On June 19, 2006, the Supervisory Board also appointed Dr. Georg Kellinghusen chairman of the Management Board. Based on a Supervisory Board resolution of May 17, 2006, Mr. Thomas Eichhorn on May 18, 2006 was dismissed as member and chairman of the Management Board effective immediately. Based on a Supervisory Board resolution of August 28, 2006, Mr. Thomas Pfau was appointed to the Company's Management Board for a period of three years effective immediately. On November 2, 2006, Ms. Angelika Marr, member of the Management Board, resigned from the Management Board effective immediately and left the Company as of that date. During her time with the Company, she was responsible for Design and Product Development. On December 20, 2006, the Supervisory Board of Zapf Creation AG and Dr. Georg Kellinghusen, chairman of the Management Board and chief financial officer, reached an agreement that Dr. Kellinghusen would resign from all of his posts and leave the Company effective immediately. On January 16, 2007, the Supervisory Board of Zapf Creation AG appointed Mr. Jens U. Keil as the Company's new chief financial officer for a term of three years. Mr. Keil took over as CFO effective March 1, 2007.

The Company was not notified of any transactions made by members of the Management Board, their spouses or immediate relatives requiring disclosure pursuant to Section 15a German Securities Trading Act. As of December 31, 2006, the Management Board does not hold any shares issued by the Company. All members of the Management Board have been informed in detail regarding the disclosure requirement.

5. Supervisory Board

Since February 12, 2007, the Supervisory Board has been composed as follows: Dr. Harald Rieger, chairman of the Supervisory Board since February 27, 2007, member since February 12, 2007; Francesc Robert, vice chairman since July 28, 2006, member since May 11, 2005; Gustavo Perez, regular member, vice chairman until July 28, 2006, member since May 11, 2005; Miguel Perez-Carballo Villar, regular member, chairman of the Supervisory Board from July 28, 2006, to February 27, 2007, member since September 14, 2005; Isaac Larian, regular member, and Ron Brawer, regular member, both members of the Supervisory Board since August 24, 2006.

The following changes with regard to the composition of the Supervisory Board occurred during the period under review: In a letter dated June 28, 2006, Dr. Peter Klein announced his resignation from the Supervisory Board effective immediately. On July 27, 2006, Mr. Martin Gruschka resigned as member and chairman of the Supervisory Board effective immediately. As of July 28, 2006, Mr. Miguel Perez-Carballo Villar, regular member of the Supervisory Board until July 27, 2006, took over as chairman of the Supervisory Board. Also, as of the same date Mr. Francesc Robert has been vice chairman of the

Supervisory Board. Mr. Gustavo Perez, who held this position from May 11, 2005, to July 27, 2006, has been a regular member of the Supervisory Board since July 28, 2006. In a court order dated August 23, 2006, and issued August 24, 2006, the Coburg Local Court appointed Mr. Isaac Larian and Mr. Ron Brawer regular members of the Supervisory Board effective immediately. On February 27, 2007, Dr. Harald Rieger, who had been appointed a regular member of the Supervisory Board by order dated February 12, 2007, of the Coburg Local Court, was elected chairman of the Supervisory Board. The previous chairman of the Supervisory Board, Mr. Miguel Perez-Carballo Villar, has been serving as a regular member of Supervisory Board since that date.

The Company was notified of the following transactions made by members of the Supervisory Board, their spouses or immediate relatives requiring disclosure pursuant to Section 15a German Securities Trading Act:

Attorneys for the Isaac Larian and Angela Larian Trust, a company belonging to the Supervisory Board member Isaac Larian, notified Zapf Creation AG on October 4, 2006, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on September 28, 2006, Mr. Larian had purchased a total of 10,000 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 8.08 per share for a total transaction volume of € 80,800.00.

Attorneys for Mr. Ron Brawer notified the Company on October 12, 2006, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on October 9, 2006, Mr. Brawer had purchased a total of 25,000 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 7.45 per share for a total transaction volume of € 186,250.00.

Attorneys for "The Isaac Larian Qualified Annuity Trust 2004 DTD 6/30/04," a company belonging to the Supervisory Board member Isaac Larian, notified Zapf Creation AG on October 12, 2006, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on October 9, 2006, Mr. Larian had purchased a total of 374,999 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 7.45 per share for a total transaction volume of € 2,793,742.55.

Daxton Investing Inc., a company related to the Supervisory Board member Mr. Gustavo Perez, notified Zapf Creation AG on November 13, 2006, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on November 6, 2006, it had purchased a total of 399,999 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 7.45 per share for a total transaction volume of € 2,979,992.55.

Attorneys for the Isaac Larian Annuity Trust, a company belonging to the Supervisory Board member Isaac Larian, notified Zapf Creation AG on March 6, 2007, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on March 5, 2007, it had purchased a total of 2,000 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 9.00 per share for a total transaction volume of € 18,000.00.

Attorneys for the Isaac Larian Annuity Trust, a company belonging to the Supervisory Board member Isaac Larian, notified Zapf Creation AG on March 21, 2007, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on March 19, 2007, it had purchased a total of 751 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 8.95 per share for a total transaction volume of € 6,721.45.

Attorneys for the Isaac Larian Annuity Trust, a company belonging to the Supervisory Board member Isaac Larian, notified Zapf Creation AG on March 21, 2007, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on March 20, 2007, it had purchased a total of

3,586 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 9.05 per share for a total transaction volume of € 32,453.30.

Attorneys for the Isaac Larian and Angela Larian Trust, a company belonging to the Supervisory Board member Isaac Larian, notified Zapf Creation AG on July 23, 2007, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on July 18, 2007, it had purchased a total of 119,988 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 4.593 per share for a total transaction volume of € 551,104.88.

The Company was not notified of any other transactions made by members of the Supervisory Board, their spouses or immediate relatives requiring disclosure pursuant to Section 15a German Securities Trading Act (Wertpapierhandelsgesetz). The Company has no information available regarding the percentage of shares issued that are attributable to members of the Supervisory Board, or companies related to them, as of December 31, 2006. All members of the Supervisory Board have been informed in detail regarding the disclosure requirement.

6. Transparency

Zapf Creation values active corporate communications. New and significant information is made available to shareholders, analysts, employees, and the public immediately and comprehensively. In its corporate communications, the Management Board is guided by principles of transparency, timeliness, openness, comprehensibility, and equal treatment for all. All such information is transmitted via electronic media, in particular, the Internet, and is available in English as well.

7. Accounting and Audit of Financial Statements

Share-based Payment

The Zapf Creation Group employs compensation systems based on the performance of its stock, given its orientation toward activities designed to ensure that the enterprise value is increased in the long term in shareholders' interests. In contrast to employee stock option plans (ESOPs), so-called virtual share-price-based compensation does not constitute real equity interests but rather salary and/or bonus payments that are contingent on the development of the Company's stock. Cash compensation claims are granted to the beneficiaries during specific periods based on the difference between the underlying share's current price and the base price of the stock appreciation rights assigned.

In the 2006 financial year, a virtual share-price-based compensation system was established for the members of the Management Board of Zapf Creation AG. Virtual stock options at defined base prices were allocated under this plan in 2006; the exercise of these options is not linked to achievement of specific performance targets. At the time they exercise their options, beneficiaries are paid the difference per exercised option between the closing price of the share on its issue date and on the date the virtual stock option is exercised.

As of December 31, 2006, the Group maintained two other virtual share-price-based compensation schemes for the members of its Management Board, as well as for executives of Zapf Creation AG and its affiliates, in addition to the compensation system that was newly established in the 2006 financial year and outlined above. The 2001/2003 Bonus Plan was set up in the 2001 financial year and the 2003/2005 Bonus Plan in the 2003 financial year. These two additional compensation systems provide for allocation of virtual stock options to the relevant beneficiaries in several tranches pursuant to individual contracts. Depending on whether performance targets linked to the share price have been achieved and following the expiration of waiting periods contingent on the relevant tranches, the beneficiaries are paid one-time cash consideration per virtual stock option that reflects a particular percentage (20% for the 2001/2003 Bonus Plan and 30% for the 2003/2005 Bonus Plan) of the performance target as an additional component of their cash compensation.

Audit of Financial Statements

KPMG Deutsche Treuhand-Gesellschaft Aktiengesellschaft, Wirtschaftsprüfungsgesellschaft, Nuremberg, Germany, is the auditor of the single-entity and consolidated financial statements of Zapf Creation AG as of December 31, 2006; Rödl & Partner GmbH, Wirtschaftsprüfungsgesellschaft, Nuremberg, Germany was the previous year's auditor.

B. Declaration of Conformity Regarding the German Corporate Governance Code

1. Preliminary Remark

The Company's 2006 declaration of conformity required under Section 161 German Stock Corporation Act regarding the recommendations of the Government Commission on the German Corporate Governance Code was jointly issued by the Management Board and the Supervisory Board and is permanently available to the Company's shareholders on its Website.

The declaration follows below verbatim.

2. Declaration of Conformity 2006

(Beginning of the declaration of conformity)

I. Declaration of the Management Board and the Supervisory Board of Zapf Creation AG regarding the German Corporate Governance Code as amended on June 12, 2006, pursuant to Section 161 German Stock Corporation Act

The "German Corporate Governance Code" as amended on June 12, 2006, was published in the official section of the electronic Federal Gazette on July 24, 2006.

Both the Management Board and the Supervisory Board of Zapf Creation AG declare pursuant to Section 161 German Stock Corporation Act that the Company is in compliance with the recommendations of the Government Commission on the German Corporate Governance Code as amended on June 12, 2006, and as published by the German Ministry of Justice on July 24, 2006, in the official section of the electronic Federal Gazette, with the exception of the following items and/or topics:

Item 3.8, para 2

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

Item 4.2.3, para 1 and para 2, sentence 1

"The total compensation of Management Board members comprises the monetary compensation elements, pension awards, other awards, especially in the event of termination of activity, fringe benefits of all kinds and benefits by third parties which were promised or granted in the financial year with regard to Management Board work.

The monetary compensation elements shall comprise fixed and variable elements."

Item 4.2.4

"The total compensation of each member of the Management Board is to be disclosed by name, divided into non-performance-related, performance-related and long-term incentive components, unless decided otherwise by the Shareholders' Meeting by three-quarters majority."

Item 4.2.5

"Disclosure shall be made in a compensation report which as part of the Corporate Governance Report describes the compensation system for Management Board members in a generally understandable way.

The presentation of the concrete form of a stock option plan or comparable schemes for components with a long-term incentive effect and risk character shall include the value thereof. In the case of pension plans, the allocation to accrued pension liabilities or pension funds shall be stated each year.

The substantive content of severance awards for Management Board members shall be disclosed if in legal terms the awards differ not insignificantly from the awards granted to employees. The compensation report shall also include information on the nature of the fringe benefits provided by the company."

Item 5.4.7, para 3, sentence 2

"Also payments made by the enterprise to the members of the Supervisory Board or advantages extended for services provided individually, in particular, advisory or agency services shall be listed separately in the Corporate Governance Report."

After issuing last year's declaration of conformity pursuant to Section 161 German Stock Corporation Act in connection with Section 15 Introductory Law to the Stock Corporation Act, the Company has been in compliance with the recommendations made by the Government Commission on the German Corporate Governance Code as amended on June 12, 2006, and as published in the electronic Federal Gazette on July 24, 2006, with the exception of the following items, as stated above: 3.8, para 2; 4.2.3, para 1, and para 2 sentence 1; 4.2.4, 4.2.5 and 5.4.7 para 3 sentence 2.

II. Reasons for the Deviations

Regarding item 3.8, para 2

The D&O insurance purchased by Zapf Creation AG does not require the members of the Company's Management and Supervisory Boards to pay a deductible. This insurance is a group insurance policy that was concluded for numerous executives at home and abroad and it did not seem appropriate to differentiate according to board members and other executives. Considering that an insurance policy can never cover more than negligent actions, deductibles are usually unsuitable for preventing losses and thus are generally taken into account by the insurance industry only in the calculation of the premium.

Regarding items 4.2.3, para 1 and para 2 sentence 1, 4.2.4, 4.2.5 and 5.4.7, para 3 sentence 2

The Company was unable to satisfy these requirements for the 2005 financial year due to the lack of specific legal regulations. Once the German Management Board Compensation Disclosure Act (Gesetz über die Offenlegung der Vorstandsvergütung - VorstOG), has become effective, compliance will be ensured with regard to the current financial year.

Zapf Creation AG

Roedental, Germany, December 12, 2006

The Management Board The Supervisory Board

(End of the declaration of conformity)

C. Compensation Report

1. Preliminary Remark

In accordance with the requirements of the German Commercial Code and the German Management Board Compensation Disclosure Act, this report contains disclosures that are an integral part of both the single-entity and consolidated financial statements of Zapf Creation AG.

Hence please also see all disclosures on the compensation paid to the members of the Management Board and the Supervisory Board in the single-entity and consolidated financial statements of Zapf Creation AG.

2. Management Board

The compensation paid to the members of the Company's Management Board in the 2006 financial year comprised both fixed and performance-based components. The responsibilities of the relevant board members and their personal performance are the criteria that govern the suitability of the compensation paid.

With regard to its compensation components, the compensation system for the Company's Management Board was as follows in 2006:

	Short-term compensation		Share-based
	Fixed compensation	Bonus	compensation
	K€	K€	K€
Dr. Georg Kellinghusen	Yes	Yes	Yes
Angelika Marr	Yes	Yes	Yes
Thomas Pfau	Yes	Yes	Yes
Thomas Eichhorn	Yes	Yes	Yes

The total compensation of K€ 976 (previous year: K€ 820) paid to the Management Board comprises all cash compensation due, as well as all monetary benefits from in-kind compensation. It includes both fixed and variable components but excludes the one-time consideration paid to former members of the Management Board.

Below is an overview of the compensation paid to each individual member of the Management Board in the 2006 financial year:

	Short-term compensation		Share-based	Total
	Fixed compensation	Bonus	compensation	compensation
	K€	K€	K€	K€
Dr. Georg Kellinghusen	278	0	217	495
Angelika Marr	173	25	0	198
Thomas Pfau	69	25	101	195
Thomas Eichhorn	88	0	0	88
Total	608	50	318	976
Percentage in 2006		67.42 %	32.58 %	100.00 %

	Short-term	Share-based	Total
	compensation	compensation	compensation
	K€	K€	K€
Total compensation in 2005	820	0	820

In the 2006 financial year, a virtual share-price-based compensation system was established for the members of the Management Board of Zapf Creation AG. A total of 113,000 virtual stock options at base prices of € 7.49 and € 7.29 were allocated to these board members in 2006 under this plan; the exercise of these options is not linked to achievement of specific performance targets. At the time they exercise their options, beneficiaries are paid the difference per exercised option between the closing price of the share on its issue date and on the date the virtual stock option is exercised. Dr. Kellinghusen was granted 80,000 virtual options at a base price of € 7.49. Mr. Thomas Pfau was granted 33,000 virtual options at a base price of € 7.29.

In addition to the total aforementioned compensation paid to the Management Board in the 2006 financial year, one-time payments totaling K€ 313 (previous year: K€ 163) were made to former members of the Management Board, specifically, K€ 250 to Dr. Kellinghusen and K€ 63 to Ms. Angelika Marr.

One former member of the Management Board was granted a variable credit line in the maximum amount of K€ 625 until December 31, 2007, which was fully used as of December 31, 2006. The agreed interest rate is 4.25 % and is fixed until December 31, 2007, the loan's due date.

3. Supervisory Board

The compensation of the Supervisory Board is determined by the Annual Shareholders' Meeting, on recommendation of the Management Board and the Supervisory Board. It is regulated by Article 20 of the articles of incorporation of Zapf Creation AG. The cash compensation includes a fixed and a dividend-based component, as well as compensation linked to the long-term success of the Company.

Since August 2006, the fixed compensation component has been set at K€ 35 net for the chairman of the Supervisory Board, K€ 26.25 for the vice chairman of the Supervisory Board, and K€ 17.50 net each for all other members of the Supervisory Board. The compensation paid to Supervisory Board members who were not in office for a full financial year is pro rated in accordance with the duration of their membership on the Supervisory Board. The two Supervisory Board members Mr. Isaac Larian and Mr. Ron Brawer waived the compensation to which they are entitled under the articles of incorporation; expenses were reimbursed.

The variable bonus is calculated as follows: € 100.00 for each € 0.01 of dividend in excess of € 0.50 per no-par value share which is distributed to the shareholders for the expired financial year. In addition, the members of the Supervisory Board are entitled to annual compensation based on the Company's long-term performance. This compensation entails payment of K€ 1 per K€ 1,000 in consolidated net annual income that exceeds an average consolidated annual income of K€ 22,237 for the last three financial years.

The total obligation for the compensation of the Supervisory Board in the 2006 financial year was K€ 97 (previous year: K€ 88).

No loans were extended to members of the Supervisory Board.

Report of the Supervisory Board for the 2006 Financial Year

In the 2006 financial year, the Supervisory Board diligently supervised the activities of the Management Board, providing advice and support as needed. This work was based on the regular written and oral reports of the Management Board. Given the economic difficulties of the Company and its affiliates, the Supervisory Board ensured that the Management Board kept it abreast – even outside its meetings – in both writing and verbally, of current and strategic developments in the Company's condition, as well as of important business events. The Supervisory Board thoroughly reviewed the reports that were submitted to it and discussed them with the Management Board in detail, as necessary. In addition, the Supervisory Board initiated inspections of the Company's books and records in regards to individual issues related to the special audit of the Company.

Besides issues related to business development and planning, the Supervisory Board's reviews and discussions with the Management Board focused especially on the continued restructuring of the Zapf Creation Group (including additional cost-cutting measures), as well as on efforts to stabilize the Company in financial terms by both extending the bank loans and raising fresh capital through capital increases. The Supervisory Board also substantially concerned itself with the takeover offer by Bandai GmbH, as well as with the special audit of the Company that the Supervisory Board itself had initiated and the legal consequences of this audit.

Some of the other material activities of the Supervisory Board and its newly constituted Personnel Committee arose, furthermore, from a variety of issues related to former, current, and future members of the Management Board of Zapf Creation AG. The Supervisory Board also extensively discussed, among other things, the approval requirements regarding the Management Board; an amendment of the Supervisory Board's own by-laws designed to facilitate the process of adopting resolutions; corporate governance; preparations for the Annual Shareholders' Meeting; risks and risk management; as well as the distribution of responsibilities among the members of the Management Board.

Given the special situation of Zapf Creation AG in the 2006 financial year, overall the Supervisory Board held a total of 17 plenary sessions, either in person or by means of telephone conferences. These meetings took place on January 26; February 20; March 2, 16, and 24; May 17; June 19; July 7 and 28; August 4 and 28; September 5 and 25; November 13 and 27; as well as December 13 and 18, 2006. In addition, the Supervisory Board also adopted two resolutions by circular letter.

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

Group Financing and Restructuring

During the entire reporting period, the Supervisory Board dealt extensively with the subsequent financing of the Zapf Creation Group because its financing was assured only through April 2007 – provided the Group complied with the terms of the loan – and because there was a need for an infusion of fresh capital. In this connection, the Supervisory Board continually discussed the Group's financing needs and various financing scenarios with the Management Board, including options for raising funds through capital increases. Furthermore, given the financial reporting required by the banks, the Supervisory Board succeeded in getting the financing banks to sign separate confidentiality agreements in accordance with the standards of the Loan Market Association.

The Supervisory Board also regularly communicated with the Management Board on the issue of the banks' continued willingness to provide financing – which was not resolved until a basic agreement was reached in July 2007 – and the Management Board kept it informed of significant developments in the negotiations with the banks. Among other things, the Supervisory Board was informed that a change of control in the Company would trigger an early loan repayment obligation. The contractual documentation related to the subsequent financing has not yet been finalized.

On September 28, 2006, the Supervisory Board approved tapping into authorized capital in order to strengthen the Company's capital basis in the short term. The Company's share capital of € 8,000,000.00 was subsequently raised by just under ten percent. The new shares were issued, at an issue price of € 7.45 per share, subject to the exclusion of shareholders' subscription rights, to the Supervisory Board members, Messrs. Isaac Larian, Ron Brawer, and Gustavo Perez (Daxton Investing Inc.). The option to execute additional capital increases and the related costs were also discussed.

Against the backdrop of the required continuing restructuring of the Zapf Creation Group, the Supervisory Board advised and supported the Management Board in its implementation of the restructuring program and proposed additional cost-cutting measures to it. It also addressed additional business potentials with the Management Board. In addition, staggered approval requirements tied to particular cost thresholds were also discussed with the Management Board.

Special audit

The special audit – which had already been initiated in 2005 – of facts and circumstances relevant to both the consolidated financial statements and certain subsidiaries' 2004 and 2005 single-entity statements, as well as its consequences for individual members of the Management Board in both legal and professional terms, constituted yet another focal point of the Supervisory Board's activities in the reporting period. Because the special audit of the Company had led to the conclusion that intentional violations of statutory requirements had occurred, in March 2006 the Supervisory Board extended the special audit through April 2006, adding a forensic audit aimed, in particular, at unearthing facts related to the personal responsibility of individual members of the Management Board. The relevant members of the Management Board were given an opportunity in that connection to state their position on the facts in detail. In addition, the Company has also cooperated with the relevant investigatory and regulatory authorities regarding the facts that the special audit brought to light.

The special audit gave rise to the need for corrections of the financial statements for 2004 and 2005. Expert attorneys, who had been brought into the process, also performed comprehensive assessments and analyses of the special forensic audit in regards to both civil and criminal litigation. They considered it mostly likely that some of the former members of the Management Board had breached their duties. Hence the Supervisory Board saw to it that claims for damages were brought against the relevant former Management Board members, especially in connection with the costs arising from the special audit, and notified the D&O insurer accordingly. However, to date we have been unable to arrive at an amicable settlement with the insurer and/or the relevant former members of the Management Board. Indeed, the Company is already engaged in litigation with one of the former Management Board members in connection with the special audit.

Finally, the Supervisory Board also conducted a critical review of the Company's risk management system against the backdrop of the special audit, in order to preclude any future accounting manipulations to the greatest extent possible.

Changes on the Management Board

The Company's Management Board was reconstituted in its entirety during the year under review.

On February 1, 2006, the Supervisory Board had appointed Dr. Georg Kellinghusen the Company's new CFO effective February 15, 2006, and on June 19, 2006, had appointed him chairman of the Company's Management Board effective immediately. Dr. Kellinghusen's employment contract provided for damages in the event of a change of control, but this provision was not relevant in the end.

On May 18th, 2006, Mr. Thomas Eichhorn was dismissed effective immediately as both member and chairman of the Management Board. Dr. Georg Kellinghusen took over his responsibilities, i.e. marketing and sales, albeit on an interim basis.

Mr. Thomas Pfau was appointed to the Management Board on August 28, 2006, effective immediately. He assumed responsibility for marketing and sales from Dr. Georg Kellinghusen, who had dealt with these areas on an interim basis. Mr. Pfau also is the managing director of MGA Entertainment GmbH. The Supervisory Board approved this position in light of the Company's strategic partnership with MGA Entertainment, Inc. This approval becomes void if this partnership is terminated, and both parties have the right to terminate their contracts and/or to resign from their positions or remove certain individuals from their positions at that time. Mr. Pfau undertook, among other things, to immediately disclose any conflicts of interest arising from his involvement in MGA Entertainment, Inc., to the Supervisory Board, specifically, to its chairman.

Ms. Angelika Marr, Management Board member responsible for design and product development, resigned from her position on November 2, 2006, with the approval of the Supervisory Board and effective immediately, in order to take on new tasks. Mr. Thomas Pfau took over her responsibilities as well.

On December 20, 2006, the Supervisory Board and Dr. Georg Kellinghusen came to an agreement that Dr. Kellinghusen would resign from his office with immediate effect. Mr. Thomas Pfau exercised his responsibilities (without taking over the chairmanship) on an interim basis until a new CFO was appointed.

On January 16, 2007, Mr. Jens U. Keil was appointed Chief Financial Officer (CFO) effective March 1, 2007. He is now responsible for finance, capital markets, restructuring, HR, IT, logistics, and supply chain operations.

Changes on the Supervisory Board

The following changes were made on the Supervisory Board during the reporting period:

Mr. Martin Gruschka declared on July 24, 2006, that he would resign and he relinquished his post as both ordinary member and chairman of the Supervisory Board on July 27, 2006. The Supervisory Board subsequently elected Mr. Miguel Perez-Carballo Villar as its new chairman and Mr. Francesc Robert as its deputy chairman at is meeting on July 28, 2006. The previous deputy chairman of the Supervisory Board, Mr. Gustavo Perez, has been serving as an ordinary member of the Supervisory Board since then.

A total of three Supervisory Board positions were vacant because Dr. Peter Klein had already declared by letter dated June 28, 2006, that he would resign from his office in order to avoid any conflicts of interest in connection with the findings of the special audit. Upon application of both the Management Board and the chairman of the Supervisory Board, on August 24, 2006, the Coburg Local Court [Amtsgericht] thus appointed Messrs. Isaac Larian and Ron Brawer to serve as members of the Company's Supervisory Board. Both gentlemen are executives of MGA Entertainment, Inc., which had announced on July 6, 2006, that it had acquired an interest of 18.05 % in the Company's share capital.

The last vacancy on the Supervisory Board was finally filled when Dr. Harald Rieger was appointed to the Supervisory Board on February 12, 2007, by the Coburg Local Court. Dr. Harald Rieger has extensive experience in restructuring and he was elected the new chairman at the Supervisory Board's meeting on February 27, 2007. The previous chairman of the Supervisory Board, Mr. Miguel Perez-Carballo Villar, has since then remained on the Supervisory Board as a regular member. Mr. Francesc Robert continues to serve as deputy chairman of the Supervisory Board.

Constitution of Committees and their Activities

Mr. Martin Gruschka's position on the Audit Committee had to be filled following his resignation from the Company's Supervisory Board. Consequently, at its meeting on February 27, 2007, the Supervisory Board appointed Dr. Harald Rieger to serve on the Audit Committee alongside its chairman, Mr. Gustavo Perez, and Mr. Francesc Robert. The Audit Committee met on January 31; February 7; and June 19, 2006 (financials meeting). The main agenda items at these meetings were the Company's consolidated financial statements, the annual financial statements and the combined management report as well as the ramifications of the findings of the special audit for the Company's financial statements.

Pursuant to a Supervisory Board resolution dated February 27, 2007, Dr. Harald Rieger took over the chairmanship of the Personnel Committee – which had been established by the Supervisory Board on March 16, 2006, and had been vested with decision-making power – from Mr. Miguel Perez-Carballo Villar who, in turn, had taken over from Mr. Martin Gruschka after the latter had resigned as chairman on July 28, 2006. Mr. Francesc Robert was also appointed to the Personnel Committee while Mr. Gustavo Perez has remained its deputy chairman. In the 2006 financial year, the Personnel Committee conducted 12 meetings, specifically, on March 24; May 17 and 23; June 19; July 7 and 28; August 4 and 28; September 5 and 25; as well as December 18 and 19, 2006. The main agenda items included personnel matters related to the Management Board, as well as bringing claims for damages against former Management Board members in connection with the findings of the special audit.

Corporate Governance

The Management Board and the Supervisory Board have jointly issued a Statement of Compliance in accordance with Section 161 German Stock Corporation Act [Aktiengesetz (AktG)]. This Statement is available on the Company's Web site. Finally, the Supervisory Board adopted an amendment of its by-laws for reasons of efficiency aimed at facilitating its resolution process. However, the efficiency review of the Supervisory Board's activities, which was supposed to have been conducted in 2006, was not executed because other urgent issues took precedence. For further details, we refer to the Corporate Governance Report that is included in the 2006 annual report.

Audit and Adoption of both the Annual and Consolidated Financial Statements

KPMG Deutsche Treuhand-Gesellschaft Aktiengesellschaft, Wirtschaftsprüfungsgesellschaft, Nuremberg, Germany, audited the annual financial statements that were prepared for the financial year from January 1 through December 31, 2006, in accordance with the German Commercial Code [Handelsgesetzbuch (HGB)] and the consolidated financial statements for the same financial year that were prepared in accordance with the International Financial Reporting Standards (IFRS). KPMG issued unqualified auditor's opinions for each.

The annual financial statements and the management report, the consolidated financial statements and the Group management report, as well as the audit reports, were made available to all members of the Supervisory Board. The audit paid close attention to the following: the assumption that the Company will continue as a going concern and the process of preparing the consolidated financial statements; the basis of consolidation; the propriety of the annual financial statements included in the consolidated financial statements; the previous year's figures; the treatment and recognition of discontinued operations; the determination and recoverability of deferred taxes, especially with regard to loss carryforwards; the propriety of the consolidated cash flow statement; and the propriety of the Group's segment reporting. Finally, the financial statements documents were discussed in detail on September 18, 2007, by the Supervisory Board in its financials meeting – in the presence of the auditor and following the latter's report – taking the findings of the special audit into account. The Supervisory Board approved the results of the audit and the opinion of the auditing firm on the basis of these deliberations on October 1, 2007, and accepted the audit reports for both the annual financial statements and the consolidated financial statements.

At its meeting on September 18, 2007, the Supervisory Board also reviewed the annual financial statements and the management report of Zapf Creation AG prepared in accordance with the German Commercial Code for the 2006 financial year. In particular, this review focused on the discontinuation of the business operations of Zapf Creation USA, the introduction of a new intercompany pricing model, and extraordinary expenses. There was no reason to raise any objections based on the final result of this examination. The Supervisory Board approved the annual financial statements for 2006 on October 1, 2007, thus adopting the annual financial statements.

The Supervisory Board reviewed both the consolidated financial statements and the Group management report that were prepared for the 2006 financial year in accordance with IFRS/IAS at its meeting on September 18, 2007. The review focused on the equity situation, inventories and the recoverability of the deferred tax assets. The final outcome of this review did not give rise to any objections either. The consolidated financial statement and the Group management report were also approved by the Supervisory Board on October 1, 2007.

Remarks on the Disclosures Pursuant to Section 289 IV and 513 IV German Commercial Code

To date, the share capital of Zapf Creation AG has been € 8,000,000.00, denominated in an equal number of shares. The Management Board of Zapf Creation AG was authorized at the Annual Shareholders' Meeting on May 7, 2003, to increase the Company's share capital until May 6, 2008, once or repeatedly, subject to the approval of the Supervisory Board, by up to € 4,000,000.00 by issuing new no-par bearer shares in return for contributions in cash or in kind.

An additional 799,998 shares were issued in October 2006 following a cash capital increase under Section 186 German Stock Corporation Act. The share capital of Zapf Creation AG now is € 8,799,998.00 and denominated in 8,799,998 no-par bearer shares of common stock with a pro rata interest in the share capital of 1.00 € per share. The capital increase was recorded in the Commercial Register [Handelsregister] on October 19, 2006. This corresponds to an increase of the share capital by just under 10%. The total of € 5.9 million that flowed to the Company in connection with this capital increase was allocated to capital reserves. The new shares were listed for trading on the Official Market of the Frankfurt/Main stock exchange and are fully entitled to share in profits.

Given the aforementioned capital increase, the remaining authorized capital is € 3,200,002.00, for which an equivalent number of no-par shares may be issued. This authorized capital will be used in full pursuant to the basic resolution of the Management Board, which it adopted in July 2007 with the approval of the Supervisory Board, from mid-August 2007 at an issue price of 4.50 € per share; shareholders will be granted subscription rights.

Zapf Creation AG was notified of an equity interest that exceeds 10% of all voting rights. As of December 31, 2006, 22.98% of the voting shares were attributable to MGA Entertainment, Inc., Van Nuys, California, USA, in accordance with Section 22 para 2 German Securities Trading Act (Wertpapierhandelsgesetz – WpHG); this corresponds to 2,022,318 voting shares. This interest includes 5.75% of the voting shares held by the Isaac and Angela Larian Trust, USA, and 13.71% of the voting shares held by the Isaac Larian Annuity Trust, USA. According to the Company's knowledge, a total of 2,148,643 voting shares (representing 24.42%) are attributable to MGA Entertainment, Inc. on August 31, 2007.

The nomination or removal of Management Board members is governed by Section 84 and 85 et seq. German Stock Corporation Act while amendments to the Company's Articles of Incorporation are subject to Section 133 and 179 et seq. German Stock Corporation Act.

Remarks on the Review of the Report on Relations with Affiliates pursuant to Section 314 Para 2 and 3 German Commercial Code

The Supervisory Board also reviewed the report of the Management Board of Zapf Creation AG under Section 312 German Stock Corporation Act regarding the Company's relations with affiliates in the 2006 financial year.

In its report on relations with affiliates in the 2006 financial year in accordance with Section 312 German Stock Corporation Act, the Management Board has issued the following statement:

"We declare that our Company was paid appropriate consideration in connection with the legal transactions and measures described in this report on relations with affiliates, given the circumstances known to us at the time the relevant legal transactions or measures were executed or omitted, and that the execution or omission of any such measures did not cause the Company to suffer any disadvantage."

The Supervisory Board's review of this report did not give rise to any objections. In conducting its review, the Supervisory Board asked the Management Board to discuss both the benefits and potential risks arising from the transactions described in the report on relations with affiliates and weighed these factors on its own. The Supervisory Board also asked the Management Board to explain the principles that were applied to the determination of the Company's services and the consideration it received in return. The Supervisory Board agrees with the audit findings of the auditing firm. In light of the audit report and the final results of its own review, the Supervisory Board does not raise any objections to the Management Board's declaration at the end of the report on relations with affiliates.

Takeover Bid from Bandai

The Supervisory Board issued a reasoned statement after conducting a comprehensive review and analysis of Bandai GmbH's offer to the shareholders of Zapf Creation AG dated June 28, 2006, to acquire all outstanding shares at a price of € 10.50 per share and of the offer documents. Contrary to the Company's Management Board, however, the Supervisory Board came to the conclusion in its comprehensive review that it would not support the offer. In its view, the offer price failed to address the potential inherent in the Company's shares. Particularly the fact that MGA Entertainment, Inc. acquired a substantial minority stake in Zapf Creation AG – for which it had to have paid a higher price, assuming, as it were, that it had acted in accordance with the law – showed in the Supervisory Board's view that Bandai's offer price did not adequately reflect the potential of Zapf Creation.

The chairman of the Supervisory Board, Mr. Martin Gruschka, had a different view and issued a separate statement according to which he was unable to support the assessments and recommendations set forth in the Supervisory Board's statement absent an additional review and comprehensive analysis. In the end, Bandai GmbH was not willing to raise its offer, and the offer was rejected by the Company's shareholders.

Cooperation with MGA Entertainment, Inc.

On August 11, 2006, Zapf Creation AG and MGA Entertainment, Inc. agreed on a long-term joint sales venture pursuant to a Letter of Intent. In particular, the parties agreed that MGA Entertainment, Inc. would take over the entire process of selecting and monitoring the Asian suppliers of Zapf Creation products, the coordination and processing of deliveries to Zapf Creation's distribution companies, as well as technical product development. In return, Zapf Creation (H.K.) Ltd. – the Company's subsidiary in Hong Kong – transferred its activities to MGA. The Supervisory Board approved the service contract with MGA Entertainment (HK) Ltd., which had been negotiated on the basis of these parameters, at its meeting on February 7, 2007, following intensive deliberations and discussions with the parties participating in the negotiations; the Supervisory Board members, Isaac Larian and Ron Brawer, abstained from the vote. The only active member of the Management Board at the time, Mr. Thomas Pfau, had recommended entering into this agreement, taking all risks and rewards into account, but had asked the Supervisory Board to provide its approval, given a potential conflict of interest on his part in this matter.

The service contract with MGA Entertainment (HK) Ltd. is part of a broad strategic relationship with MGA Entertainment, Inc., of which the Supervisory Board was informed by the Management Board. The Management Board has informed the Supervisory Board, in particular, of the fact that the Consignment and Services Agreement with MGA International Holdings Cooperatief grants the latter a right of termination in the event that a third party acquires at least 20% of the Company's shares or voting rights, as long as MGA continues to hold a (direct or indirect) stake of at least 1,597,000 shares in the Company; in certain cases, the threshold is lowered to 10% or even 5% if the relevant third party competes with the Company.

Shareholder Lawsuit Against Resolution of the Annual Shareholders' Meeting

One shareholder has filed suit against the resolution of the Annual Shareholders' Meeting on August 29, 2006, regarding the approval of the Supervisory Board's actions in the 2005 financial year, on grounds that the resolution was defective. The suit is pending before the Regional Court [Landgericht] in Nuremberg-Fuerth, Germany. Just as the Management Board, the Supervisory Board, too, is unable to perceive any grounds for an action seeking the resolution's cancellation and annulment, and hence is defending the resolution that was adopted by the Annual Shareholders' Meeting.

The Supervisory Board thanks the Management Board, as well as the staff of the Zapf Creation Group, for their commitment in the 2006 financial year.

Frankfurt/Main,Germany, October 1, 2007

Dr. Harald Rieger
Chairman of the Supervisory Board

Management Report of the Company and the Group

I. General

Business Concept and Corporate Structure

The Zapf Creation Group develops and markets high-value branded play concepts comprising its world-famous play and functional dolls that are supplemented by a comprehensive world of matching accessories. The Company's most popular brands and concepts are BABY born®, Baby Annabell® and CHOU CHOU. High standards in terms of quality, design, safety, and play value are common to all of these play concepts. Girls aged three to eight years constitute our core target group.

In this connection, Zapf Creation AG largely fulfills the functions of a holding company focused mainly on financing, IT, personnel, accounting, controlling, and general administration. Zapf Creation AG also takes care of strategic marketing, product development and design.

The Zapf Creation Group consists of the parent company, Zapf Creation AG, which is headquartered in Roedental, Germany, as well as wholly-owned subsidiaries both in Germany and abroad that are tasked with marketing and selling the Group's brand portfolio.

Five Group subsidiaries were domiciled in Germany in the financial year just ended:
- Zapf Creation (Central Europe) GmbH & Co. KG,
- Zapf Creation (Central Europe) Verwaltungs GmbH,
- Zapf Creation Logistics GmbH & Co. KG,
- Zapf Creation Logistics Beteiligungs GmbH, as well as
- Zapf Creation Auslandsholding GmbH.

Effective January 1, 2007, Zapf Creation (Central Europe) GmbH & Co. KG was reintegrated into Zapf Creation AG by means of accrual. The assets and liabilities of Zapf Creation (Central Europe) GmbH & Co. KG were transferred to Zapf Creation AG at that time. This represents an important step in view of reducing the complexity of the Group's corporate structure. Zapf Creation AG now is also responsible for sales in Central Europe.

Executing the strategic cooperation with the US toy manufacturer, MGA Entertainment, Inc., Van Nuys, California/USA, in 2006 entailed transferring the sales activities of our US subsidiary, as well as the procurement activities of our Hong Kong subsidiary, to MGA Entertainment (HK) Ltd. These activities have been ongoing since January 1, 2007.

We closed our Czech distribution subsidiary in 2006. Its sales functions were transferred to Group companies in Germany.

As of the December 31, 2006, cut-off date, the Zapf Creation Group had a total of 322 employees (excluding the members of the Management Board and trainees), 151 of which worked for the Group's foreign subsidiaries. As of the December 31, 2005, cut-off date, the Zapf Creation Group had 408 employees (excluding the members of the Management Board and trainees), 175 of which worked for the Group's foreign subsidiaries.

Key Performance Indicators

The Zapf Creation Group manages its business based on the segments shown in segment reporting, as well as substantially in accordance with the following financial ratios: sales by product line; earnings before interest, taxes, depreciation, and amortization (EBITDA); and earnings before interest and taxes (EBIT).

Non-financial performance indicators essentially include the following:
- **Brand strength:** For many years, the products of the Zapf Creation Group have stood for high quality in design, quality, safety, and play value. These properties form the core of the Zapf Creation Group's brands. Maintaining this core for our brands by means of comprehensive quality management, for instance, is a prerequisite for both gaining and securing customers' trust.
- **Innovations:** The Zapf Creation Group has been reaching a saturation point in its traditional markets for play and functional dolls. Potential for growth now arises mainly from new products and product innovations embodied, for example, in the dolls' new technical functions or corresponding accessories. Hence our employees' creativity and product know-how, especially in design, are decisive factors in our ability to remain competitive.
- **Retail Presence:** A strong presence in European retail markets is equally decisive to the success of the Zapf Creation Group. Maintaining good and trusting relationships to toy stores and orienting sales on consumers' changing purchasing patterns thus are critical factors in our ability to maintain and possibly expand our market share.

Economic Situation Overall

The world economy remained in good shape in 2006. At about 5.1 %, worldwide GDP growth once again attained the previous year's high levels [Source: Association of German Banks, Economic Report, March 2007]. This positive development was driven especially by the highly dynamic economies of emerging Asian markets. But the economy in the euro zone also followed a clear upward trend in 2006. This was due, in particular, to rising investments in equipment and, increasingly, higher personal consumption. GDP growth in the euro zone was 2.8 %, up from 1.5 % the previous year [Source: OECD, Economic Outlook, May 2007].

Germany also experienced marked growth in 2006. Based on both increasing investments in equipment and a significant rise in exports, GDP growth was 2.8 % [Source: Federal Statistical Office, press release dated May 24, 2007]. After stagnating the previous year, private consumption rose by 0.6 %.

Market Environment

In 2006, the traditional European toy market as a whole – the top four markets are Germany, France, the UK, and Spain – attained sales growth of 1.9 %. The US market, which is the largest single market, registered slight growth of 0.3 %, following a decline of 4 % the previous year. In Germany, however, the overall market for toys shrank for the fifth consecutive year and sales fell by 1.8 % in 2006. According to the Company's own research, competition in the market for girls' toys is intense.

Toy Market Top 4 Europe, Based on Sales Prices

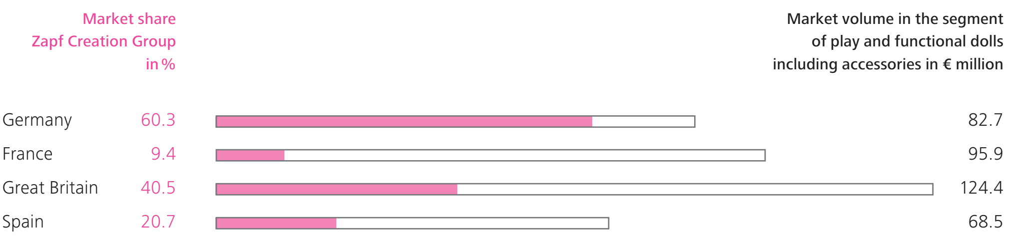
	2006 in € million	2005 in € million
Germany	2,133.0	2,171.4
France	2,599.4	2,593.7
Great Britain	3,317.7	3,163.7
Spain	1,052.2	1,002.5
Total	**9,102.3**	**8,931.3**

Source: NPD / Eurotoys 2006

The play and functional doll segment, including accessories – the core market of the Zapf Creation Group – has largely been declining throughout Europe. In 2006, the market volume in Germany decreased by 18.2 %. The French market fell by 10.3 % in spite of highly beneficial demographic developments while the British market shrank by 11.5 %. In contrast, the volume of the Spanish market expanded by 11.4 %.

In mostly declining target markets, the Zapf Creation Group managed to keep market shares of its play and functional toys stable in 2006. In Germany, the Company's market share was 60.3 % and thus at the previous year's level; the same applies to France (9.4 %) and the UK (40.5 %). In Spain, however, the market share of the Zapf Creation Group fell to 20.7 % in 2006 from 23 % the previous year.

Market Share in the Segment of Play and Functional Dolls including Accessories Top 4 Europe 2006



Source: NPD / Eurotoys 2006, Zapf Creation AG

II. Noteworthy Occurrences during the Financial Year

Completion of the Special Audit

In light of concrete evidence in the fall of 2005 that accounting irregularities had occurred, the Management Board and the Supervisory Board of Zapf Creation AG jointly initiated a special audit of the Group's consolidated financial statements, as well as of the single-entity financial statements of certain subsidiaries for the 2004 financial year. This special audit was concluded in April 2006. The audit of the consolidated financial statements for the 2005 financial year gave rise to additional findings with regard to accounting irregularities.

Given the findings of the special audit, we must assume that former executives of the Zapf Creation Group knowingly violated the law. These violations made it necessary to make corrections in the financial statements for the 2004 and 2005 financial years, substantially impacting the net assets and financial position of the Zapf Creation Group as a result. The Zapf Creation Group informed the public in detail about the preliminary findings of the special audit by means of an ad hoc release on February 27, 2006, and the 2005 annual report.

Changes in the Management Board and the Supervisory Board

Comprehensive changes took place in the reporting year with regard to the composition of both the Management Board and the Supervisory Board of Zapf Creation AG.

- Effective February 15, Dr. Georg Kellinghusen was appointed chief financial officer.
- Based on a Supervisory Board resolution of May 17, 2006, Mr. Thomas Eichhorn on May 18, 2006, was dismissed as member and chairman of the Management Board effective immediately. Dr. Georg Kellinghusen was also appointed chairman of the Management Board on June 19.
- In a letter dated June 28, 2006, Dr. Peter Klein announced his resignation from the Supervisory Board effective immediately.
- On July 27, 2006, Mr. Martin Gruschka resigned as member and chairman of the Supervisory Board effective immediately. Mr. Miguel Perez-Carballo Villar was elected new chairman of the Supervisory Board; Mr. Francesc Robert was elected his deputy. Mr. Gustavo Perez, who was deputy chairman until that date, became a regular member of the Supervisory Board.
- Based on a court order dated August 23, 2006, and issued August 24, 2006, Mr. Isaac Larian and Mr. Ron Brawer became regular members of the Supervisory Board.
- On August 28, 2006, the Supervisory Board appointed Mr. Thomas Pfau to the Management Board with responsibility for sales and marketing.
- On November 2, 2006, Ms. Angelika Marr resigned her post as member of the Management Board responsible for design and product development; her responsibilities have been taken over by Mr. Thomas Pfau.
- On December 20, 2006, Dr. Georg Kellinghusen and the Supervisory Board agreed that he would resign from the Company effective immediately.

Restructuring Measures

The Management Board implemented a comprehensive restructuring program in the spring of 2006 in order to put the Zapf Creation Group back onto a profitable growth trajectory that is sustainable in the long term. This program, which was divided into eight separate projects, addressed all of the Group's operating activities: enhancing its product portfolio; optimizing procurement; stabilizing revenues; strengthening sales and marketing; boosting margins; increasing cost efficiency; enhancing profitability; as well as improving management of the working capital. All projects were realized during 2006 as planned, further improving the Group's cost base. Moreover, all corporate structures and processes were streamlined and adapted to the Group's reduced sales. The restructuring program also entailed eliminating about 80 jobs in the Group.

In the fall of 2006, it was decided to adjust the processes and structures of the Zapf Creation Group yet again in view of its strategic cooperation with the US toy manufacturer, MGA Entertainment, Inc. Implementation of these measures continued into 2007. The marketing and sales departments, which had previously been located in Roedental, were bundled in Darmstadt, Germany, the headquarters of the German subsidiary of MGA Entertainment, Inc., and additional staff was hired. The organizational structure at the Group's headquarters in Roedental was further streamlined. The Groupwide design department, which previously was mainly located in Hong Kong, was consolidated in Roedental and expanded by means of new personnel. The sales entities in both France and Spain also hired new staff. However, once all restructuring measures have been completed, the total number of employees in the Group should be down to about 240. A balancing of interests was rapidly achieved with the German Works Council, and a redundancy payments scheme was signed in January 2007. Optimizing the Group's structures and processes made it possible to launch the broad cooperation with MGA Entertainment, Inc. as scheduled.

Takeover Bid from the Namco Bandai Group

On June 13, 2006, Bandai GmbH, Nuremberg, a company belonging to the Japanese toy manufacturer, Namco Bandai Holdings Inc., announced its offer to acquire all shares of Zapf Creation AG at a cash price of € 10.50 per share. The offer documents according to Section 27 of the German Securities Acquisition and Takeover Act (Wertpapiererwerbs- und Übernahmegesetz; WpÜG) were published on June 28, 2006.

On July 31, 2006, the deadline for the acceptance of the bid from Bandai GmbH expired. On August 4, 2006, the bidder announced that it had acquired 4.38% of the share capital of Zapf Creation AG, thus missing the minimum share of 75% required in the offer, which rendered the offer void.

Strategic Cooperation with MGA Entertainment, Inc.

In the course of 2006, MGA Entertainment, Inc. acquired approximately 23% of the share capital of Zapf Creation AG. In the third quarter of 2006, the two parties agreed to cooperate closely in several areas and both parties expect their collaboration to bring about synergy effects in procurement and intensified penetration of the respective markets.

Starting in 2007, MGA will be solely responsible as a licensee for selling Zapf Creation's products in the Americas (North, Central and South); MGA guarantees that the sales volume will exceed the revenue generated by Zapf Creation's own subsidiaries in this region by more than 50%. In return, the parties agreed that the Zapf Creation Group will sell MGA products in particular European markets in exchange for payment of a distribution fee. The Zapf Creation Group expects this activity to improve the utilization of its sales team and of its logistics center.

Furthermore, in 2007 MGA took over the entire process of selecting and monitoring the Asian suppliers of Zapf Creation products, the coordination and handling of merchandise shipments to the sales units, and technical product development. For this purpose, essential elements of the respective procurement organization of the Zapf Creation Group in Hong Kong were transferred to MGA Entertainment (HK) Ltd. The Zapf Creation Group has bundled the design operations for its products at its Roedental headquarters.

III. Economic Report

These consolidated financial statements for 2006 of Zapf Creation AG, as well as the comparative figures for the previous year, were prepared in accordance with Section 315a German Commercial Code (HGB) and in compliance with both the International Financial Reporting Standards (IFRS) and the relevant interpretations of the International Financial Reporting Interpretations Committee (IFRIC) – as applicable within the European Union under Article 4 of EC Regulation 1606/2002 dated July 19, 2002, of the European Parliament and the European Council.

The 2006 financial statements for Zapf Creation AG adhere both to German accounting standards and the requirements of the German Commercial Code.

In accordance with the specific requirements of IFRS 5, the operations of the Zapf Creation Group in both North and South America that were discontinued as of the end of December 31, 2006, are shown separately in the consolidated income statement under the result from discontinued operations. The comparative figures for the previous year have been adjusted. No adjustments were necessary in the consolidated balance sheet.

Development of Sales

Development of Sales within the Zapf Creation Group

In 2006, the Zapf Creation Group posted consolidated sales of € 116.1 million after adjusting for sales revenue from the discontinued operations of Zapf Creation USA. This corresponds to a decline of 4% compared to the previous year's result, which had also been adjusted (2005: € 120.7 million). The decline was due primarily to the downturn in business in Central Europe during the first nine months.

*Development of Sales of the Zapf Creation Group (in € Million)**

*without sales region North, Central and South America, previous year's figure adjusted

Development of Sales by Region

In the Central Europe region – which includes Germany, Austria, Switzerland, the Netherlands, and Luxembourg – sales fell in 2006 by 11% to € 38.2 million (2005: € 43.0 million). This stemmed substantially from the ongoing weakness of the market, especially with regard to play and functional dolls, as well as from the disproportional weakness of the traditional retail toy stores, which customarily account for a major portion of the Zapf Creation Group's sales. In addition, the newly launched Talking CHOU CHOU product did not perform as successfully in 2006 as had been expected.

In Northern Europe – which includes the UK and Ireland, as well as Scandinavia – the Zapf Creation Group achieved sales of € 37.9 million in 2006, i.e. 7% less year-on-year (2005: € 40.6 million). This downturn is due to the general weakness of the market, as well as to diminished clearance sales compared to the previous year. At a market share of 40.5%, the Zapf Creation Group succeeded nonetheless in maintaining its leading position in the play and functional doll segment in Great Britain/Ireland, Europe's largest toy market.

Total sales of € 21.0 million in Southern Europe (significant countries: Spain, France, Belgium, Italy) in 2006 were 3 % below the previous year's level (2005: € 21.6 million). Sales in Spain declined slightly by 2 % and Zapf Creation had to cede market share to an up-and-coming competitor. In France / Belgium, sales remained almost stable (– 1 %) in a difficult market environment. In Italy, sales were off by 15 % due to the change from self-factoring to sales by distributors.

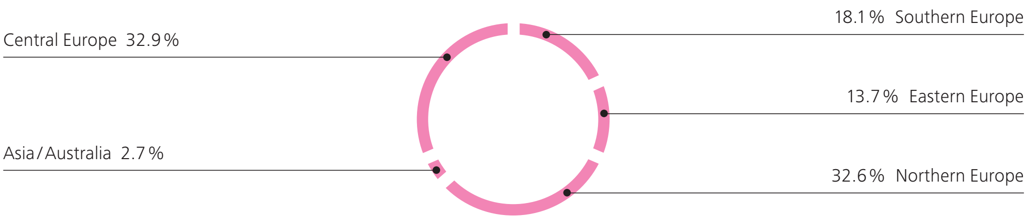
Development of Sales of the Zapf Creation Group by Region

	2006 K€	2005 K€
Europe	**113,013**	**117,961**
Central Europe	38,241	42,965
Northern Europe	37,889	40,571
Southern Europe	20,999	21,571
Eastern Europe	15,884	12,854
Asia / Australia	**3,093**	**2,696**
Total	116,106	120,657

At € 15.9 million (2005: € 12.9 million), sales in Eastern Europe continued to develop at a rapid pace in 2006, attaining a growth rate of 24 %. In a generally positive environment with growing markets, enhanced marketing activities and the acquisition of new distributors contributed to the growth in sales, particularly in Russia and the Czech Republic.

At € 3.1 million, sales in Asia / Australia in 2006 exceeded the year-on-year figure by 15 % (2005: € 2.7 million). The Zapf Creation Group succeeded once again in boosting sales in Australia in 2006 following the downturn the previous year that had been triggered by the change from internal distribution to sales by external distributors.

Breakdown of Sales of the Zapf Creation Group by Region 2006



Development of Sales by Product Line

The development of the BABY born® play concept in 2006 was slightly positive. This was due to the successful launch of BABY born® Magic Eyes, particularly in both Great Britain and Ireland. In the ranking of the top 10 best-selling toys, the BABY born® doll was in fifth place in Germany and in sixth place in Great Britain (Source: NPD / Eurotoys 2006).

In 2006, sales of the Baby Annabell® concept declined for the very first time by 11 %. This decline was due to the fact that Baby Annabell® entered its second year of production. Nevertheless, in the 2006 ranking of best-selling toys, Baby Annabell® ranked tenth in Germany and even second in Great Britain (Source: NPD / Eurotoys 2006).

There was a slight decline in sales of the CHOU CHOU doll concept in 2006. This development resulted substantially from the disappointing sales of the newly launched Talking CHOU CHOU.

*Development of Sales of the Zapf Creation Group by Product Line**

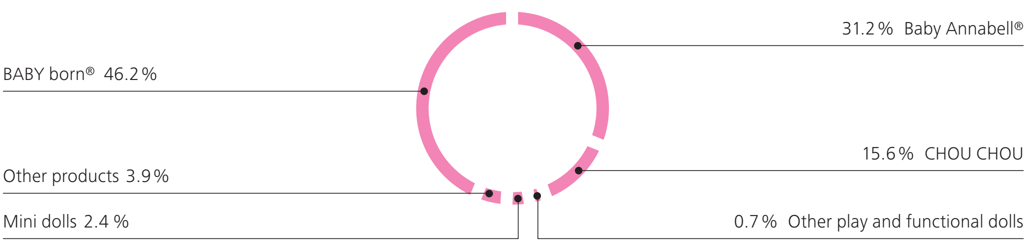
	2006 K€	2005 K€
Play and functional dolls	**108,873**	**114,153**
BABY born®	53,689	53,041
Baby Annabell®	36,269	40,958
CHOU CHOU	18,116	18,850
Other play and functional dolls	799	1,304
Mini dolls	**2,761**	**1,610**
Other products	**4,472**	**4,894**
Total	116,106	120,657

* without sales region North, Central and South America, previous year's figures adjusted

Sales of the product line, Other play and functional dolls, declined substantially. This item includes discontinued product lines such as Maggie Raggie where just the remaining inventories were sold off. Sales of other products also declined mainly due to the downturn in the My Model product line.

In contrast, the mini dolls registered strong sales growth from € 1.6 million in the previous year to € 2.8 million in 2006, due primarily to the launch of the Missy Milly® mini doll product line. However, as this product line failed to meet expectations, it was discontinued in the 2007 financial year.

*Breakdown of Sales of the Zapf Creation Group by Product Line 2006**



* without sales region North, Central and South America

Sales Development of Zapf Creation AG

In 2006, Zapf Creation AG recorded sales of € 0.5 million on par with the previous year's level.

The services that Zapf Creation AG renders within the Group include product development, design, and global management of both marketing and sales, as well as such centralized management functions as IT, finance, personnel, and general administration. These services are billed to the subsidiaries on the basis of fixed contractual agreements. Moreover, Zapf Creation AG also holds the rights to the brands and collects a pro-rated license fee from its subsidiaries in that connection. These revenues are included in the figures of Zapf Creation AG under the item, Other operating income. Finally, the Company also generates income from investments.

Earnings

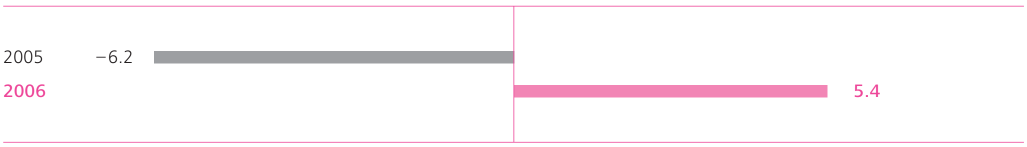
Earnings of the Zapf Creation Group

The gross profit of the Zapf Creation Group rose in 2006 by 5.8 % to € 52.8 million (2005: € 49.9 million). This represents a year-on-year improvement in the gross margin by 4.1 % to 45.4 % (2005: 41.3 %).

There was a marked decline in the Group's operating costs. Selling and distribution expenses fell by 22.1 % to € 14.8 million (2005: € 19.0 million). Marketing expenses decreased by € 11.3 % to € 15.9 million (2005: € 17.9 million). Administrative expenses fell by 10.7 % to € 23.6 million (2005: € 26.4 million). These cost reductions reflect the effects of the restructuring measures that were successfully implemented during the reporting year.

Consolidated earnings before interest and taxes (EBIT) before restructuring costs and one-off items rose by € 11.6 million to € 5.4 million (2005: € −6.2 million). This shows that in terms of operating income, the Zapf Creation Group clearly turned the corner in 2006.

Development of Earnings (EBIT, adjusted) of the Zapf Creation Group (in € Million)*



*before restructuring costs and one-off items, without sales region North, Central and South America, previous year's figure adjusted

The restructuring costs included in the operating result totaled € 3.4 million in the reporting year (previous year: € 6.1 million). These expenses comprise the costs for the eight restructuring projects that were implemented Groupwide and were successfully completed in the 2006 financial year (please see the item, Noteworthy Occurrences during the Financial Year).

The one-off items of € 2.6 million are essentially attributable to consulting expenses incurred as a result of the M&A process (takeover offer from Namco Bandai) and the special audit.

Taking both the restructuring costs and one-off items into account, the Group recorded earnings before interest and taxes (EBIT) of € −0.5 million compared to a loss of € 12.3 million the previous year.

At € 7.0 million, finance costs were 15.7 % higher than in the previous year (2005: € 6.0 million). They stem substantially from interest expenses and one-off costs for the syndicated loan.

Pre-tax earnings from continued operations were € –6.8 million. Earnings thus increased significantly compared to the previous financial year (€ –18.1 million).

In 2006, income taxes made a positive contribution to earnings from continued operations in the amount of € 0.3 million compared to income tax expenses of € 2.7 million in 2005. This positive contribution to earnings resulted substantially from domestic deferred taxes.

At € –6.1 million, pre-tax earnings from discontinued operations (Zapf Creation USA) were € 1.1 million below the previous year's figure of € –5.0 million.

The Group's net result for the period thus amounted to € –12.7 million in 2006. In the previous year, the net loss had totaled € 27.7 million.

The net loss for the period results in earnings per share of € –1.67, up from € –3.73 the previous year.

Earnings by Region

The Zapf Creation Group reports the earnings of its regions based on EBITDA (earnings before interest, taxes, depreciation and amortization).

In Europe as a whole, EBITDA rose by € 2.2 million from € 9.8 million the previous year to € 12.0 million in 2006. Earnings in Central Europe (which comprises Germany, Austria, Switzerland, the Netherlands, and Luxembourg) were € 4.5 million (2005: € 5.0 million). In Northern Europe, earnings were € 3.5 million (2005: € 3.9 million) and in Southern Europe they rose to € 0.6 million (2005: € –0.8 million). Eastern Europe recorded a jump in earnings to € 3.4 million, due especially to increased sales in the financial year (2005: € 1.7 million). In Asia/Australia, EBITDA in the reporting year climbed by € 0.3 million to € 1.7 million (2005: € 1.4 million).

Development of Earnings (EBITDA) of the Zapf Creation Group by Region

	2006 € million	2005 € million
Europe	**12.0**	**9.8**
Central Europe	4.5	5.0
Northern Europe	3.5	3.9
Southern Europe	0.6	–0.8
Eastern Europe	3.4	1.7
Asia/Australia	**1.7**	**1.4**
Total	13.7	11.2

Earnings from Discontinued Operations

The Group discontinued its operations in North and South America as of December 31, 2006. Overall, a loss of € 6.1 million before taxes was posted for this region in 2006, up from a loss of € 5.0 million the previous year.

Sales in the American markets were € 10.6 million in 2006, down from € 20.1 million the previous year.

Earnings of Zapf Creation AG

In 2006, Zapf Creation AG substantially improved its result from ordinary activities by € 29.4 million to € −0.5 million (2005: € −29.9 million). As in the previous year, however, one-off items had a significant impact on this result.

Other operating income climbed by € 4.4 million to € 22.1 million (2005: € 17.7 million). This includes extraordinary income of € 2.9 million from the write-up of the interest in Zapf Creation (Central Europe) GmbH & Co. KG in the run-up to the latter's reintegration by means of accrual as of January 1, 2007. Moreover, the change in currency adjustments within the Group resulted in income of € 1.8 million from other periods (exchange rate gains from the offsetting of loans between Group companies).

Selling and marketing expenses declined by € 2.2 million to € 6.4 million (2005: € 8.6 million). This stemmed mainly from the reductions in expenses for licensed products resulting from the downturn in sales. Other operating expenses fell by € 15.8 million to € 4.0 million (2005: € 19.8 million). Income from investments declined by € 7.2 million to € 3.0 million (2005: € 10.2 million). In contrast to the previous year, in 2006 there were no writedowns of financial assets and securities included in current assets.

Earnings in the reporting year were affected by an extraordinary loss of € 5.9 million. Extraordinary income of € 9.1 million was offset by extraordinary expenses of € 15.0 million.

The extraordinary income resulted in large part from fair value adjustments in connection with the sale to Zapf Auslandsholding GmbH of equity interests in the Group's British and Spanish subsidiaries.
The extraordinary expenses were due, in particular, to the discontinuation of sales activities in the US following Zapf Creation's strategic cooperation with MGA Entertainment, Inc. Based on the existing letter of comfort, Zapf Creation AG assumed all losses of € 4.7 million from the business of Zapf Creation (U.S.) Inc. in 2006 and waived receivables of € 5.3 million. In addition, the redundancy payments scheme, which was stipulated with the Works Council on January 16, 2007, in connection with the implementation of Zapf Creation's cooperation with MGA Entertainment, Inc. depressed earnings by another € 2.0 million. A total of € 1.0 million in expenses were incurred for consulting services related to the takeover offer from the Namco Bandai Group. Finally, extraordinary expenses of € 2.0 million arose in connection with contractual liabilities toward banks.

Taking the extraordinary result into account, in 2006 Zapf Creation AG incurred a net loss for the period of € 7.2 million (2005: € −34.8 million).

Net Assets and Financial Position

Net Assets and Financial Position of the Zapf Creation Group

Balance Sheet Structure of the Zapf Creation Group as of December 31 (in € Million)

Assets	2006	2005	Equity and liabilities	2006	2005
			Equity	3.6	10.2
Non-current assets	26.3	28.9	Non-current liabilities	0.2	21.6
Current assets	89.3	104.2	Current liabilities	111.8	101.3
Total assets	115.6	133.1	Total equity and liabilities	115.6	133.1

At € 115.6 million, total assets of the Zapf Creation Group as of December 31, 2006, declined by € 17.5 million year-on-year (December 31, 2005: € 133.1 million).

In terms of assets, cash and cash equivalents rose in 2006 by € 2.4 million to € 11.7 million, also as a result of the inflow of funds from the capital increase in the third quarter of 2006. In contrast, trade receivables fell considerably by € 11.1 million to € 57.4 million. Inventories also declined markedly by € 4.3 million to € 12.7 million. These developments document that the Group has made further strides in its management of working capital thanks to the restructuring.

Other assets declined by € 1.3 million to € 3.7 million.

The Group's deferred tax assets rose by € 2.0 million to € 4.0 million. This is primarily due to the capitalization of domestic deferred taxes.

In terms of liabilities and equity, equity fell by € 6.6 million to € 3.6 million as of December 31, 2006. At the end of the second quarter of 2006, equity still was negative at € –0.3 million. The cash capital increase that was executed in October 2006 and generated cash proceeds of approximately € 5.9 million essentially helped the Group achieve an equity ratio of 3.1 % at year's end (December 31, 2005: 7.7 %).

The Group concluded a new syndicated loan agreement in March 2006 after the extant loan agreement had been rescinded due to noncompliance with its covenants. This secured the Group's financing in the reporting year. Regarding follow-up financing in 2007, we refer to the report on events after the balance sheet date (item IV).

Current liabilities to banks rose by € 3.8 million to € 65.1 million (December 31, 2005: € 61.3 million). This increase resulted especially from the recognition of the syndicated loan agreed in March 2006 in this item, as well as from the increase in interest not yet paid.

There no longer were any long-term Group liabilities to banks at the close of the financial year just ended. The syndicated loan that had previously been reported in this item was reclassified to current liabilities. The Zapf Creation Group managed to reduce its liabilities to banks considerably by a total of € 17.3 million in 2006.

Disclosures Regarding Derivative Financial Instruments

As a rule, the Group only employs derivative financial instruments (forward exchange transactions and options as well as interest rate swaps) for hedging purposes (currency and interest rate risks). Cash flow hedging to hedge interest and currency risks is only performed when required by the financing structure. The process of hedging future variable cash flows against fluctuations is called cash flow hedging. Changes in the fair value of derivative financial instruments intended for hedging a cash flow risk are documented. If the hedging relationships are classified as effective, the changes in the fair value are recognized directly in equity. Fluctuations in value from financial instruments classified as ineffective are recognized directly in the income statement.

As of December 31, 2006, the other recognized income results exclusively from currency translation differences recognized in equity. In the 2006 financial year, the current value of the derivative financial instruments held by the Company is fully recognized as interest income in the income statement.

Adjustments from Derivative Financial Instruments

As of December 31, 2006, no adjustment item from derivative financial instruments had to be recognized because the Group terminated its hedge accounting in connection with both the refinancing of its liabilities to banks during the reporting period and the significant reductions in the residual maturities. The remeasurement gains/losses from hedging transactions for hedging against interest rate risks in the form of interest rate swaps and the remeasurement gains/losses from forward exchange transactions and options used as hedging instruments that had to be classified as cash flow hedges had been recognized directly in equity the previous year; they were reversed to income in the financial year just ended. This also applies to the effects of deferred taxes attributable to these amounts. Resulting deferred tax liabilities of K€ 28 had been recognized as of the previous year's balance sheet date.

The derivative financial instruments held as of the balance sheet date are listed in tabular form in section B no. 2.6.3 in the notes to the consolidated financial statements, and in section B, no. 12 in the notes to the parent company's annual financial statements.

Net Assets and Financial Position of Zapf Creation AG

Total assets of Zapf Creation AG as of December 31, 2006, declined by 6.5% to € 98.2 million compared to December 31, 2005 (€ 105.1 million).

Non-current assets increased by € 35.7 million to € 74.0 million (December 31, 2005: € 38.3 million), particularly due to financial assets that rose by € 37.3 million to € 68.7 million (December 31, 2005: € 31.4 million). This increase was due substantially to fair value adjustments from the disposal of equity interests in the Group's UK and Spanish subsidiaries, as well as considerable increases in loans to affiliates. These figures reflect the structural responsibilities of a holding company.

In contrast, current assets fell by € 42.7 million to € 24.0 million (December 31, 2005: € 66.7 million), substantially due to the decline in receivables from affiliates by € 43.3 million to € 14.4 million. This decline results from the reclassification to loans to affiliates (long-term loans) of the following companies: Zapf Creation Logistics GmbH & Co. KG in the amount of € 10.2 million, Zapf Creation (España) S.L.

in the amount of € 2.7 million, as well as Zapf Creation (U.K.) Ltd. in the amount of € 12.7 million. Furthermore, the Company waived receivables from Zapf Creation (U.S.) Inc. totaling € 5.3 million. The remaining reduction by € 12.5 million results from the payment or offsetting of outstanding receivables.

In terms of liabilities and equity, equity decreased by € 1.3 million to € 14.1 million (December 31, 2005: € 15.4 million). Both the inflow of funds from the cash capital increase in October 2006 and fair value adjustments had a corresponding effect on capital. The equity ratio as of December 31, 2006, was 14.3 %, up from 14.6 % at the close of the previous year.

Other provision climbed by € 7.5 million to € 12.5 million (December 31, 2005: € 5.0 million). This was primarily due to the personnel reductions planned for 2006 and 2007 as part of the restructuring measures, and to the one-off costs of the syndicated loan that was agreed in March 2006.

Current liabilities to banks decreased by € 10.8 million to € 52.2 million (December 31, 2005: € 63.0 million). The change is essentially due to the capital increase.

Investments

Investments by the Zapf Creation Group

Total investments by the Zapf Creation Group in 2006 fell by € 0.9 million to € 1.8 million. Of this amount, € 0.1 million were invested in intangible assets (2005: € 0.3 million). Investments in plant, property, and equipment totaled € 1.7 million (2005: € 2.3 million).

Investments by Zapf Creation AG

Total investments by Zapf Creation AG in 2006 declined by € 0.2 million to € 0.1 million (2005: € 0.3 million). Investment in intangible assets was low (2005: € 0.2 million). Investments in property, plant and equipment totaled € 0.1 million (2005: € 0.1 million).

Cash Flow

Cash Flow of the Zapf Creation Group

The Zapf Creation Group posted cash flow of € 20.3 million from operating activities in the 2006 financial year, up from a negative cash flow of € 8.4 million the previous year. The clear improvement stems especially from both the decline in the annual loss and reductions in receivables related to improved management of working capital.

Investment activities resulted in cash flow of € – 1.5 million (2005: € – 1.9 million. €). Financing activities caused an outflow of funds in the amount of € 16.3 million compared to an inflow of funds in the amount of € 2.1 million the previous year. Payments to banks on both current and non-current liabilities were offset by the increase in the share capital by just under 10 %. Overall, taking effects from changes in foreign exchange rates into account, cash and cash equivalents in the reporting period rose by € 2.4 million (2005: reduction by € 7.7 million).

Employees

Development of Employee Figures of the Zapf Creation Group

As of the December 31, 2006, cut-off date, the Zapf Creation Group had 322 employees worldwide (excluding the members of the Management Board and trainees), 151 of which worked for the Group's foreign subsidiaries.

Annual Average Number of Employees of the Zapf Creation Group

	2006	2005
Salaried employees	297	387
Hourly workers	39	70
Employees	**336**	**457**

As a result of the strategic cooperation agreed with MGA Entertainment, Inc., the sales and marketing department of the Zapf Creation Group (which had been located at the Company's headquarters in Roedental) was moved to Darmstadt (the seat the German subsidiary of MGA Entertainment, Inc.), bundled there, and expanded in terms of personnel. This entailed eliminating a total of 45 jobs in Roedental. In exchange, the design department was bundled in Roedental and expanded by six new hires. Ninety jobs were eliminated in Hong Kong and mainland China in connection with the transfer of procurement and technical product development to MGA Entertainment, Inc. About one half of these employees were absorbed by MGA Entertainment (HK) Ltd.

In the wake of these developments, a smaller team must now continue to master both existing tasks and new projects in a demanding environment. The employees of the Zapf Creation Group have excelled against this backdrop by virtue of their unwavering commitment and they are making a major contribution to assuring that the Company remains competitive in the long term.

The responsibilities of executives have also been expanded in consequence of the aforementioned developments. Our executives have been dealing intensely with the Group's restructuring on a day-to-day basis. The Group's executive development program, which aims to ensure successful personnel management in the future as well, is being maintained.

Disclosures regarding the compensation system for executives are included in the notes to the consolidated financial statements, specifically in section A no. 2.3.13., section B no. 2.5.6., and section C no. 3.1.

Development of Employee Figures at Zapf Creation AG

Zapf Creation AG had 71 employees (excluding the members of the Management Board and trainees) as of December 31, 2006.

Annual Average Number of Employees of Zapf Creation AG

	2006	2005
Salaried employees	80	108
Hourly workers	0	0
Employees	**80**	**108**

Research and Development

Research and Development Activities of the Zapf Creation Group

Product innovation is the engine that drives the Group's business development and thus has always been at the very center of the Zapf Creation Group's focus. In terms of the Groupwide division of labor, Zapf Creation AG is responsible for ongoing development of the product portfolio through activities in research, development, and design. Our subsidiaries themselves do not engage in R&D activities but focus on marketing and distribution instead.

Research and Development Activities of Zapf Creation AG

Zapf Creation AG excels through its creativity and know-how in the development and design of high-quality play and functional dolls and the corresponding world of matching accessories. The Company developed various new products in the past financial year, among them the "Horse & Princess" BABY born® series, additional interactive functions for Baby Annabell®, and the Baby CHOU CHOU doll for girls one to four years of age. The new products met with a positive response at the important Nuremberg Toy Fair.

The dovetailing of the Company's activities with those of MGA Entertainment, Inc. – one of the most successful manufacturers of toys for girls – is aimed at further enhancing the capacities of the Zapf Creation Group in regards to product development and innovation management. Initial indications were already visible in the product development for the 2007 financial year.

Groupwide product design was bundled in Roedental and enhanced by the addition of new personnel in connection with the implementation of the strategic cooperation with MGA Entertainment, Inc.

Quality Management

The Group's quality management in Germany is focused on the importance, as well as the practical and strategic ramifications, of national and international laws and regulations. The experts of the Zapf Creation Group also participate in the development of relevant standards. In 2006, the Group's quality management in Hong Kong/China was focused on the practical implementation of these standards, as well as on consistent monitoring of local manufacturers' compliance with these requirements.

Close cooperation between the quality assurance departments in Germany and Hong Kong thus enabled the Zapf Creation Group to ensure ongoing, timely and high-quality implementation of customer and market requirements in its manufacturing processes in 2006. After the transfer of the activities of the subsidiary Zapf Creation (H.K.) Ltd. to MGA Entertainment (HK) Ltd., the latter ensures compliance with the high quality standards from 2007 onwards.

Compliance with Ethical Standards in both Production and Procurement

The Zapf Creation Group has almost completely outsourced the production of its play and functional dolls, including accessories, to select suppliers in China. These business relationships are focused on long-term and collaborative partnerships and on ensuring appropriate workplace and social standards. High claims to quality, design, and play value are key to absolutely all of Zapf Creation's branded toy concepts. The Company therefore collaborates solely with suppliers that satisfy these high quality requirements and undertake to comply with uniform social standards.

The Group's relationships with outside suppliers are governed by the Code of Conduct issued by the International Council of Toy Industries (ICTI), which codifies binding principles and provides a system for independent monitoring. This Code has been in effect since October 2002. Suppliers that undertake to abide by this Code are subject to an auditing process that leads to an ICTI certificate issued by the International Toy Association. Sustained compliance with the Code of Conduct is regularly reviewed, by both independent institutes and the staff of the Zapf Creation Group.

In the 2006 reporting period, the Zapf Creation Group procured almost all of its purchasing volume from suppliers that either already possessed an ICTI certification or were undergoing the auditing process. This means that the Group's product portfolio is manufactured almost entirely in accordance with safe and social work standards.

Compliance with International Standards and Regulations

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

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

Shifting Production to Phthalate-free Plasticizers

The Zapf Creation Group has shifted production of its entire product portfolio to plasticizers that are free of phthalates. The Group uses a phthalate-free substitute for all new products manufactured in 2006 using soft PVC – irrespective of the recommended age group. Production of pass-through products was also shifted to alternative plasticizers in the first quarter of 2006. All branded play concepts of the Zapf Creation Group that were distributed in Europe in 2006 were generally free of phthalates and will remain so in the future.

IV. Events after the Balance Sheet Date

Zapf Creation (Central Europe) GmbH & Co. KG was integrated into Zapf Creation AG effective January 1, 2007, by means of accrual. This means that the assets and liabilities of Zapf Creation (Central Europe) GmbH & Co. KG were transferred to Zapf Creation AG as of said date. This measure served to streamline the Group's structure and further reduce its complexity. Zapf Creation AG has been carrying out sales on behalf of Zapf Creation (Central Europe) GmbH & Co. KG since then.

The Company announced on January 16, 2007, that Mr. Jens U. Keil would take over as Management Board member responsible for the finances of Zapf Creation AG effective March 1, 2007.

On February 13, 2007, it was resolved to transfer the lead management of the syndicate from Deutsche Bank AG to Deloitte & Touche GmbH, Wirtschaftsprüfungsgesellschaft, Munich, Germany.

In February 2007, Zapf Creation AG and MGA Entertainment (HK) Ltd., Hong Kong, China, signed the "Hong Kong/China Services Agreement" effective January 1, 2007. This contract governs the cooperation of the aforementioned two companies in connection with administrative activities related to procurement. In particular, this includes production planning and monitoring; merchandise and general procurement; quality assurance and quality control; logistical activities in both Hong Kong and China; as well as technical product development. The contract has a term of ten years.

On February 27, 2007, Dr. Harald Rieger, lawyer, who had been appointed a regular member of the Supervisory Board by order dated February 12, 2007, of the Coburg Local Court, was elected chairman of the Supervisory Board. The previous chairman of the Supervisory Board, Mr. Miguel Perez-Carballo Villar, has been serving as a regular member of Supervisory Board since that date.

On May 9, 2007, the Company announced that the syndicated loan agreement for about € 90 million, which had expired on April 30, 2007, had been extended for two months until June 30, 2007.

On May 29, 2007, Zapf Creation Logistics GmbH & Co. KG and MGA International Holdings Cooperatief, the Netherlands, signed a Logistics Services Agreement. This agreement governs the provision of logistics services by Zapf Creation for the MGA Group, including, in particular, transferring, palletizing, storing, packaging, labeling, and preparing goods belonging to the MGA Group for shipment. This agreement, which runs for three years, took effect retroactively as of January 1, 2007.

On July 20, 2007, Zapf Creation AG announced that it had reached agreement regarding the Company's long-term follow-up financing with an international banking syndicate and the major shareholders of Zapf Creation AG (MGA Entertainment, Inc. and its chief executive officer, Mr. Isaac Larian, as well as Messrs. Nicolas Mathys and Gustavo Perez).

On September 21, 2007, the existing financing agreement of July 20, 2007, was modified and replaced to the extent that the deadline agreed as a prerequisite to the agreements was changed from October 31, 2007 to November 30, 2007. Furthermore, on September 4/5, 2007, the existing financing agreement of July 20, 2007 had already been modified and replaced to the extent that the share of the capital contribution to be made by the major shareholders that was to be provided by Mr. Gustavo Perez will now also be provided by MGA Entertainment, Inc., or its chief executive officer, Mr. Isaac Larian, or companies affiliated with him. This modification was contingent upon the Federal Financial Supervisory Authority (BaFin) exempting MGA Entertainment, Inc. from the obligation to submit a takeover bid. This condition has been fulfilled in the meantime.

The financing concept calls for a new, long-term syndicated € 65 million loan. This loan is based on the condition precedent that an equity contribution of € 30 million is made by November 30, 2007 in a way to be determined by the shareholders named above (MGA Entertainment, Inc., or its chief executive officer, Mr. Isaac Larian, or companies affiliated with him, and Mr. Nicolas Mathys). Alternatively, and in part, such contribution may also be effected by way of subordinated shareholder loans. The Company's major shareholders have assured the Company in writing that they guarantee this equity contribution. For this purpose, it is initially planned to fully utilize the existing authorized capital of up to € 3.2 million. The gap between the amount thus raised and the guaranteed amount of € 30 million, which is expected to arise due to the low share price, is to be closed by way of another capital increase of the Company, which is to be carried out until November 30, 2007 by utilizing authorized capital to be approved by the next Annual Shareholders' Meeting. In addition, the possibility of utilizing treasury shares as part of the planned capital measures is also taken into consideration.

Already on July 25, 2007, the Management Board of Zapf Creation AG, with the approval of the Supervisory Board, adopted a basic resolution regarding the pending capital increase. According to the resolution, up to 3.2 million new shares are to be issued from authorized capital at an issue price of € 4.50, and shareholders will be granted a subscription right. The infusion of new equity capital is part of the concept to secure the long-term financing of the Company that has been agreed with the banks and the Company's major shareholders.

Furthermore, the shareholders mentioned above undertake to provide a bridging loan of up to € 10 million, € 7.5 million of which have already been drawn down.

The previous syndicate of banks of Zapf Creation AG has agreed to allow repayment of the loan with credit lines used in the amount of approx. € 45 million, which has been due since June 30, 2007, to be deferred until November 30, 2007. To finance peak capital needs in the course of the Company's operations, the lead manager of the new syndicate of banks has also agreed to providing interim financing of up to € 20 million until November 30, 2007. These funds can be utilized as defined and depending on the equity contributions made at such a time. All agreements are subject to the proviso that there is no material adverse change to the economic situation of the Group until November 30, 2007. Furthermore, they are subject to signature of the final documents.

This comprehensive refinancing will sustainably secure the solvency of the Zapf Creation Group.

The German parliament, i.e. the Bundestag and the Bundesrat, passed the 2008 Business Tax Reform Act [Unternehmenssteuerreformgesetz] by resolutions dated May 24 and July 6, 2007, respectively. From January 1, 2008, there will be a flat corporation tax rate of 15.00 % plus a solidarity surcharge of 5.50 %. The trade tax rate will be 12.60 %. Based on the assessment bases applicable as of December 31, 2006, the application of the tax rates applicable from January 1, 2008, would result in a reduction of deferred tax assets by € 0.8 million.

New information in the 2007 financial year that primarily become known during the height of the crisis (see press release dated May 9, 2007, and ad hoc release dated July 3, 2007) had a negative impact on the price of the shares of Zapf Creation AG. In 2007, the price fell to a low of € 4.44 per share (July 17, 2007). In the meantime, the price has recovered somewhat and was € 4.67 per share on August 31, 2007. This negative development has resulted in an impairment loss of approx. € 2.4 million with regard to the treasure shares recognized in the single-entity financial statements of Zapf Creation AG under German commercial law. This impairment loss has reduced the result of Zapf Creation AG pursuant to German commercial law accordingly. As these events are of a non-adjusting nature, they did not have an effect on the measurement of the treasury shares in the annual financial statements of Zapf Creation AG as of December 31, 2006.

V. Risk Report

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

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

Risk Management System

The Zapf Creation Group has developed parameters for doing business that include the identification, measurement, controlling, and documentation of risks in a risk management system. This system serves to ensure that the Company's decision makers are notified of existing and newly occurring risks, directly and immediately. Zapf Creation AG also uses software that systematically records and analyzes individual risks, the probabilities of their occurring, as well as the probable extent of any resulting damage.

Risk identification is ongoing, while risk measurement is effected monthly. Both are supervised by a risk management officer appointed by the Company. This risk management officer immediately and directly informs the Management Board as soon as strong increases in risks that might even threaten the Company's continuation are detected.

All risks are categorized as follows:

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

Operational Risks
- Procurement risks
- Risks from operational processes

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

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

The analysis and representation of risks within the risk management system is not limited to existing risks. For purposes of Group controlling, the risk management system also analyzes and represents opportunities as they arise.

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

External Risks

Economic Risks

The world economy was in good shape in 2006. This positive development was due not least to the highly dynamic economies of Asian emerging markets, especially China and India, as well as some South American countries. The economies in the euro zone also continued to gain momentum last year. Even Germany experienced a pronounced economic upswing.

However, private consumption in Germany, the largest individual market of the Zapf Creation Group, remained restrained, failing to stimulate demand for the Company's products as a result. Sales remained below the previous year's levels. In addition, demand for play and functional dolls declined in other Central European markets as well.

We do not perceive any new risks stemming from the economic environment, given forecasts that the economy in both Germany and Europe as a whole will continue to improve and resulting expectations that consumption will increase.

Industry-specific risks

The international toy market is particularly dependent on both demographic trends and consumption patterns. Declining birth rates are triggering an overall decline in the market for toys, particularly in Germany. And consumption patterns have also changed. The increase in both spontaneous purchasing decisions in the low-price segment and consumers' sensitivity to prices could undermine the sales of the Zapf Creation Group. Now, more than ever, business is concentrated on the strong Christmas season.

In Germany, the core market of the Zapf Creation Group, according to estimates of the Federal Statistical Office in Wiesbaden, Germany, the number of births fell from about 686,000 in 2005 to about 680,000 in 2006. Declining population growth could lead, in the medium and long term, to a substantially reduced demand for play and functional dolls and corresponding declines in sales for the Zapf Creation Group. In contrast, birth rates in the France, Great Britain, Italy and Spain – important toy markets all – are higher than the German average. Measured against population figures, demographic developments in France and Great Britain are particularly positive.

The rise of such new play trends as electronic toys will cause a long-term drop in the ratio of dolls relative to other toys. In addition, girls tend to develop, i.e. grow up, faster these days, which affects their playing habits. Over time, both of these developments could lead to a decline in purchases of Zapf Creation products.

The Zapf Creation Group is focused on its core business, which enabled it to gain leading market share in several European markets in the process. The numbers published by NPD/Eurotoys, a market research institute, for the 2006 financial year prove the strength of the Zapf Creation brand: Despite a decline in sales, the Zapf Creation Group essentially managed to maintain its market position in the European target markets of Germany, France, Great Britain and Spain.

In 2006, the Zapf Creation Group also entered into a long-term partnership with the US toy manufacturer, MGA Entertainment, Inc., in regards to worldwide distribution, procurement, and licensing. This created a basis for improving our ability to control and compensate for various influences specific to the industry in the relevant national markets.

Legal Risks

The international business of the Zapf Creation Group requires the Group to take a multitude of international standards and regulations into consideration and abide by them. Tax rules and regulations in individual countries usually have a direct effect on the results of operations and assets of both Zapf Creation AG and the Group as a whole.

The Group's quality specifications contain binding definitions of all relevant guidelines, norms, and standards – as well as customer-specific requirements – that apply to its entire product portfolio. No legal risks are discernible in that regard.
The Company is currently involved in two legal disputes that entail claims of more than € 1 million each. To the best of our knowledge, neither Zapf Creation AG nor any of its subsidiaries are party to any other proceedings before regular courts, arbitral tribunals, or administrative agencies that could have a significant impact on the financial situation of the Zapf Creation Group, and no such proceedings have been threatened. The Company has created provisions which, in its view, are sufficient to cover the extant risks from the legal disputes.

Ethical and Environmental Risks

As part of its comprehensive quality management, the Zapf Creation Group accords great significance to compliance with ethical standards in both procurement and production; for more detail, please see the disclosures on quality management in the "quality management" paragraph. Hence the Zapf Creation Group is committed to maintaining strict and ongoing compliance with the ICTI Code of Conduct through which the international toy association works toward getting suppliers to institute reasonable working hours, as well as comply with both social and environmental standards. Against this backdrop, at the present time we do not discern any risks in this respect.

The entire product portfolio of the Zapf Creation Group is produced without using phthalate-based plasticizers. As of December 31, 2005, the Group cleared out product inventories deemed no longer marketable. This was due to the strategic realignment of the Company's product portfolio as part of its restructuring program and after taking into account the current developments with regard to phthalates. The remaining inventories will be sold in the 2006 reporting year via distribution channels which at that time were not subject to regulations regarding phthalates. These measures minimized the obvious risks from the utilization of substances containing phthalates.

Operational Risks

Procurement Risks

In 2006, almost all of the goods sold by the Zapf Creation Group were procured and produced in China. The Zapf Creation Group has distributed procurement and production among several business partners, mostly of long standing. In addition, most of them maintain physically separated manufacturing sites. This limits the risk of losing several suppliers simultaneously.

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

Procurement prices rose in the 2006 financial year due to rising staff and material costs. In addition to higher raw materials prices due to crude oil prices, this is also due to tightened environmental legislation in the EU, for example, the prohibition of phthalates in toys. Under the relevant EU regulation, as of January 14, 2007, toys containing phthalates may no longer be sold in EU member states. On the other hand, the dollar's ongoing weakness is favorable to gross profits earned in the euro zone, thus diluting the impact of current price increases.

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

Nonetheless, supplying the Zapf Creation Group with the goods that have been produced on its behalf requires a substantial amount of time. A total of 12 to 16 weeks can elapse between order placement and availability of the relevant goods on the German market. This basically means that Zapf Creation is unable to respond to short-term, unplanned orders from its business partners.

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

Beginning in 2007, all procurement and technical product development for the Zapf Creation Group is being bundled at MGA Entertainment (HK) Ltd. with the aim of ensuring high levels of efficiency and certainty in the procurement process. The takeover of Zapf Creation's procurement activities enables MGA Entertainment (HK) Ltd. to control the worldwide availability of Zapf Creation products via procurement and shipping. Zapf Creation cannot directly influence the prices paid to suppliers, and it can no longer select suppliers itself. The Zapf Creation Group would have to completely rebuild and reorganize its procurement system in China within a very short time if the strategic cooperation with MGA were to be terminated early. Any reorganization of the procurement system that is carried out too quickly and not up to standard could result in declining sales for the Zapf Creation Group. Zapf Creation continues to be closely involved in all procurement and delivery processes through its own manager on site.

Risks from Operational Processes

In the future, internal audits will be performed by an external company specialized in such tasks. The aim of such internal audits will be to perform critical analyses of operational procedures on a regular basis in view of supporting the Zapf Creation Group's risk management.

In 2006, process efficiency and security were strengthened in the long term in connection with the restructuring of all of the Group's operational procedures. Operational planning, as well as all internal control systems (including risk management), were subjected to detailed reviews and improved by means of comprehensive measures.

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

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

Financial Risks

Equity Risks

The equity situation of the Zapf Creation Group depends substantially on the equity of Zapf Creation AG recognized under German accounting standards and legislation. The main difference is that the legal restructuring of investments in selected subsidiaries, which resulted in the recognition of fair value adjustments of € 8.9 million in the annual financial statements, did not have any impact on the Group level.

The losses incurred from the operating business, as well as from extraordinary effects in the past, directly or indirectly affected the equity of Zapf Creation AG.

The downturn in the Zapf Creation Group's worldwide sales and the resulting absence of contribution margins gave rise to operating losses in the financial year. Various extraordinary charges also depressed earnings. We largely succeeded in adjusting fixed costs, especially in relation to personnel, yet these adjustments in turn gave rise to restructuring costs. Hence there still is the risk – in spite of the capital increase executed in October 2006 and fair value adjustments – that further losses might erode the equity of Zapf Creation AG. The July 2007 agreement with a new banking syndicate and the Company's major shareholders for a new financing package includes, among other things, enhancing equity by € 30 million, which may also be effected by way of subordinated shareholder loans. This would once again give the Company a sufficient capital basis.

The basic risk that the agreed equity infusion of € 30 million, alternatively, and in part, to be effected by way of subordinated shareholder loans, might not occur at all or not in due time and thus cause the banking syndicate to cancel its financing commitment is limited in that the major shareholders of MGA Entertainment, Inc. and its chief executive officer, Mr. Isaac Larian, as well as Mr. Nicolas Mathys, have guaranteed the Company the amount of the capital infusion.

Zapf Creation AG's current income stems not just from investment income but especially from license income contingent on sales that Zapf Creation receives from its subsidiaries for creating and maintaining both the brands and the corporate name.

This means that the development of Zapf Creation AG's equity as recognized under German accounting standards and legislation is contingent, directly and indirectly, on developments in subsidiaries' sales and earnings. There also is the risk, moreover, that the carrying amount of investments in subsidiaries and affiliates recognized in the balance sheet of Zapf Creation AG might also have to be written down. This risk also concerns the recoverability of intercompany loans granted by and between the subsidiaries and Zapf Creation AG. The equity basis of Zapf Creation AG must be fortified for these reasons, as called for in the financing package stipulated with the banks and the Company's major shareholders on July 20, 2007.

There are no control and profit and loss transfer agreements between Zapf Creation AG (the Group parent company) and its subsidiaries pursuant to Section 291 German Stock Corporation Act. Hence the Company is not obligated under Section 302 German Stock Corporation Act to absorb any losses its subsidiaries might incur. However, as the Group parent company, French law might require Zapf Creation AG to offset a loss of equity that its French subsidiary, Zapf Creation (France) S.à.r.l., might incur by up to one half of the latter's subscribed capital. Sales of Zapf Creation (France) in both the 2006 financial year and the first six months of 2007 fell substantially short of our expectations. If sales remain poor during the remainder of the 2007 financial year, at worst, Zapf Creation AG would have the obligation to offset such loss of equity.

Liquidity and Financing Risks

Consolidated sales of the Zapf Creation Group declined in 2006. However, the restructuring measures executed in 2006, as well as the strategic cooperation with MGA Entertainment, Inc., have enabled the Zapf Creation Group to permanently reduce its cost basis, which has already begun to have a positive effect in the financial year.

Zapf Creation AG has purchased comprehensive insurance from a well-known credit insurance company that covers non-payment risks from receivables in relation to the large majority of our customers. Non-payment risks thus have been minimized.

The equity ratio of the Zapf Creation Group remains low and its borrowings remain high. The financing package that was stipulated on July 20, 2007, and modified on September 21, 2007, and that must be implemented by November 30, 2007, provides for increasing equity by € 30 million with the aim of ensuring that both Zapf Creation AG and the Group once again have a sufficient equity base.

The current banking syndicate has promised that it will ensure that both the Zapf Creation Group and Zapf Creation AG remain solvent until November 30, 2007. However, a capital increase or shareholder loans will be needed by November 30, 2007, to ensure the follow-up financing. These requirements are essential to the new financing package offered by the new banking syndicate from November 30, 2007.

The Management Board expects the described financing concept, which, among others, includes a new long-term syndicated € 65 million loan, to be implemented as planned. Essentially, this requires that the funds of € 30 million to be raised through the planned equity measures are made available to the Company by November 30, 2007. If the planned equity measures are delayed beyond November 30, 2007, the two major shareholders of the Company have promised subordinated shareholder loans to bridge any such gap. It the equity infusion does not take as planned, the Company's existence to continue as a going concern will be jeopardized.

Furthermore, to secure the existence of Zapf Creation AG it is necessary that the key financial figures (covenants) agreed with the banks are met as any failure to meet these figures as a result of a significant deterioration of the Company's development could lead to financing problems because the banks would then be entitled to call in the loan.

Zapf Creation AG alone bears the joint and several risk for all consolidated Group companies' liabilities to banks under the syndicated loan agreement.

Currency and Interest Rate Risks

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

Corporate guidelines for the foreign exchange and interest rate hedging policies minimize the risks resulting from the use of financial instruments. These include the separation of the trading, processing, and posting functions, as well as the voluntary restriction to a small defined group of banks with high creditworthiness and the authorization of only a few qualified employees. All derivatives entered into exclusively serve hedging purposes. (Please also see the detailed presentation in the notes to the consolidated financial statements, section B no. 2.6.3., and in the notes to the financial statements of the parent company, section B no. 12.)

As of December 31, 2006, to hedge interest rate risks the Zapf Creation Group held interest rate swaps with a nominal volume of € 36.7 million (previous year: € 68.4 million). This includes a volume of USD 8.8 million (previous year: USD 7.5 million). The decline of € 24.2 million in the nominal volume as of December 31, 2006, as compared to the previous year, results from the sale of derivative financial instruments in the financial year.

Currency risk hedges in the 2006 financial year concerned only the US dollar (previous year: both the US dollar and the British pound sterling). As of December 31, 2006, no derivative financial instruments to hedge currency risks were held (previous year: € 22.7 million including a volume of USD 20.0 million).

Strategic Risks

Brand Image Risks

The Zapf Creation Group focuses on its core business – play and functional dolls including accessories – and has successfully maintained a leading market position in several European markets. The numbers published by NPD/Eurotoys, a market research institute, for the 2006 financial year prove the strength of the Zapf Creation brand yet again. The Company essentially succeeded in maintaining its market shares in its European core markets – Germany, France, the UK, and Spain – despite declining sales in the reporting period.

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

Sales Risks

The trade has also changed its ordering patterns in light of long-term changes in consumer's spending patterns – a growing sensitivity to prices, restrained consumption, and a decline in spontaneous purchasing decisions. This has translated into relatively late and short-term orders for smaller unit numbers in order to limit inventory risks, in turn increasing the requirements that the Zapf Creation Group must meet in terms of its flexibility within tightly circumscribed time windows.

All of this has been compounded by a significant change in market structures. Large chains and aggressive discounters have been expanding both their private label product range and their presence in the toy segment. The figures published by the industry clearly show that traditional retail toy stores are faced with declining sales and market share. The market is essentially dominated by major toy chains, branch retailers, as well as purchasing associations, all of which exercise considerable buying power due solely to the sheer volume of their orders with the Company. This, in turn, might undermine prices and the margins Zapf Creation might be able to attain.

Given its tight finances, Zapf Creation is constrained in the amount of money it can spend on marketing activities. It might be unable to increase its marketing budgets in order to advertise its products on a sufficient scale if the cost of marketing activities were to rise, especially in the growing Eastern European markets. This could reduce purchases of Zapf Creation products in these markets.

The Zapf Creation Group has adapted to these changes by clearing out its warehouses and increasing its flexibility in both distribution and deliveries. The strategic cooperation with MGA Entertainment, Inc. also aims to significantly reduce development cycles for new products and thus enhance the Group's ability to respond rapidly to new demand trends. In addition, the cooperation with MGA Entertainment, Inc. will boost sales of Zapf Creation's products in the US in the long term.

Zapf Creation has contractually agreed with the MGA Group not to develop, sell, or otherwise dispose of dolls that the MGA Group would reasonably have to consider to be competing products. The Zapf Creation Group is currently not engaged in these market segments and, based on today's perspective, does not plan to engage in them in the future. This undertaking could impede the Zapf Creation Group's product development in the future and possibly lead to a situation where it cannot respond to a new market trend because the new product would compete with products of MGA Entertainment. Such a development would have a negative impact on the Company's net assets, financial position, and results of operations.

The success of Zapf Creation is largely based on the recognition the brands it uses enjoy. While Zapf Creation has purchased the rights to the BABY born® brand in full, the use of its two other major brands, Baby Annabell® and Rock-A-Bye CHOU CHOU, is based on licensing agreements. We cannot exclude that underlying agreements might be terminated or that Zapf Creation might lose its right to use the brands due to infringement of third-party rights or on other grounds. In turn, this would have a significant negative impact on the Group's business. However, at present there are no indications that any such scenario will come to pass.

Development and Quality Risks

The toy market as a whole and hence the market for play and functional dolls is subject to extremely high pressure from customers to innovate. The development department of the Zapf Creation Group responds to this pressure by regularly launching new collections and product innovations. As a provider of sensitive consumer goods, the Zapf Creation Group is always subject to the risk of product defects. The companies of the Zapf Creation Group are insured against the financial risks of such defects. Nevertheless, it is necessary to improve the Company's quality management system continually to protect the Group from potentially negative repercussions of such defects for its brand image and reputation, which could negatively impact demand and sales.

The quality management of the Zapf Creation Group in Germany is focused on the relevance, as well as the practical and strategic ramifications, of national and international laws and regulations. Zapf Creation's own experts also participate in the development of relevant standards. In 2006, the Group's quality management in Hong Kong/China focused on the practical implementation of these standards, as well as on consistent monitoring of local manufacturers' compliance with these requirements. Close cooperation between the quality management departments in Germany and Hong Kong thus enables the Zapf Creation Group to ensure ongoing and timely implementation of both customer and market requirements in its manufacturing processes.

The success of the Zapf Creation Group on the market largely depends on timely deliveries of the goods it has ordered from the Zapf Creation Group and the latter's Chinese suppliers. In 2006, procurement was coordinated by Zapf Creation (H.K.) Ltd., which worked closely with suppliers in China in order to lower the risk of defective quality and ensure the security of supplies. The activities of Zapf Creation (H.K.) Ltd. were transferred to MGA Entertainment (HK) Limited in connection with the implementation of Zapf Creation's strategic cooperation with MGA Entertainment, Inc. The new structure is intended to ensure a high-quality procurement process and, at the same time, lower costs and improve procurement terms.

Personnel Risks

Though the Zapf Creation Group was compelled to impose considerable changes on its personnel in the 2006 financial year as well, it was able to count on the loyalty and high commitment of its employees throughout. Experienced employees, who were with the Company for many years, also left in the wake of the restructuring activities carried out in recent years and the related reductions in personnel. This resulted in a corresponding loss of know-how. Recruiting and retaining qualified specialists and executives for the Company remains an ongoing challenge.

Overall Risks

In addition to the risks described in the "Financial Risks" section, at the present time no risks that might undermine the development of or pose a direct threat, individually or jointly, to the existence of Zapf Creation AG or the Zapf Creation Group are known to the Company or presented in this risk report.

VI. Opportunities

The Management Board believes that the Zapf Creation Group has a good opportunity – following its successful restructuring and reorientation – to turn the changes in the industry to its advantage and return to a positive growth trajectory in the medium term. These opportunities arise from the Company's own development potential; the strength of its brands; its knowledge of specific markets; the efficiency gains all along its value chain; as well as the long-term perspective that flows from its strategic partnership with MGA Entertainment, Inc.

Internationalization

Experts expect the world economy to maintain strong growth. The growth momentum will be particularly pronounced in Asian markets and domestic demand will continue to expand steadily in countries such as China and India. Eastern Europe will be an additional center of economic growth, mainly due to strong domestic demand.

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

The North and South American markets will once again turn into promising markets for the Zapf Creation Group as a result of its strategic partnership with MGA Entertainment, Inc.

Stabilization of Market Share in Saturated Markets

In the partially saturated markets of Europe and, in particular, Germany, the Company's goal is to maintain its market share. A study published in March 2006 by NPD/Eurotoys shows that the Company's target group continues to enjoy playing with dolls and that mothers view such play as supporting their child's development in meaningful ways.

Zapf Creation's brands – BABY born®, Baby Annabell®, and CHOU CHOU including, in particular, the product innovations introduced in 2007 – provide realistic options for the Group to maintain and even expand its position in the market for play and functional dolls.

Optimizing Operational Processes

The Company is using its internal "reloading" program – which was launched in early 2006 and serves to optimize all operational processes with the aim of increasing efficiency, transparency, and quality in the long term – to advance these objectives internally. A total of eight projects restructured the Company's entire process chain, and execution of the strategic cooperation with MGA Entertainment, Inc. in the fall of 2006 led to additional adjustments in Group structures.

These far-reaching measures brought about significant improvements in the efficiency of processes and organizational structures. In turn, this will make it possible for Zapf Creation to react more rapidly to market demands and thus to become more competitive.

Opening up New Distribution Channels

The Zapf Creation Group will continue to focus on developing new distribution channels and expanding its key account structures. The aim is to achieve full coverage of the market through a comprehensive product range.

Cooperating with MGA Entertainment, Inc.in sales will help the Zapf Creation Group achieve the aforementioned objective. While the latter started in January 2007 to sell MGA's products in Europe – which also improves capacity utilization of the Group's own sales network – MGA Entertainment, Inc. has taken over sales and distribution of Zapf Creation's products in North, Central and South America.

Launching the Licensing Business

The cooperation between the Zapf Creation Group and MGA Entertainment, Inc. offers the former the opportunity to utilize the Company's brands for products outside the framework of the traditional toy market. Corresponding licenses can be granted by MGA Entertainment, Inc. to others in the future. The licensing business will permit the Zapf Creation Group to expand its product range and gain access to new target groups without exposing itself to the risk of working these markets on its own.

Product Innovation

Thanks to its development department's successful management policies, in the past the Zapf Creation Group has always detected trends early on and rapidly translated them into product innovations, especially in regards to functional dolls and accessories. Innovations are critical to kindling the interest of both the trade and customers in the Company's products.

Its innovation strategy still offers untapped potential, especially with regard to its brand name and broad range of related accessories. In addition, the creative exchange with MGA Entertainment, Inc. opens up new opportunities for product design and reduces development cycles.

VII. Anticipated Developments

Development of the Zapf Creation Group

The Zapf Creation Group underwent consolidation in 2006 and successfully executed a comprehensive restructuring program in the process. The Group also negotiated and established its strategic cooperation with MGA Entertainment, Inc. in sales, procurement, and the licensing business during that period.

Fundamental changes have swept the Group as a result. Its cost base has been improved and both its structures and processes have been streamlined. The resulting efficiency gains and its enhanced competitiveness will allow the Zapf Creation Group to focus on its core competencies in the future:

- Development of innovative products that respond to or trigger demand trends, all the while maintaining the Zapf Creation Group's traditional claims to quality, design, and play value;
- Efficient sales management on international target markets. This also includes opening up new markets in Eastern Europe and Russia, for instance, as well as;
- Creative global marketing that taps into the high brand value of Zapf Creation's products with the aim of maintaining and expanding the Company's leading position in the market for play and functional dolls.

Cooperating with MGA Entertainment, Inc. also enables Zapf Creation to enhance the presence of its brands on the North, Central and South American markets in the 2007 financial year without incurring the risk of losses as in the past. Plans are also to tap into the brands' fame to launch products outside of the toy industry and grant the requisite licenses. This will enable the Group to expand its product range and reach new target groups.

The product universe of the Zapf Creation Group was enhanced by several innovations in 2006, all of which were greeted with much enthusiasm at the toy industry's major trade fairs. This includes the "Horse & Princess" BABY born® series, which is inspired by fairy tales, new interactive functions for

Baby Annabell®, as well as the new Baby CHOU CHOU doll for girls one to four years of age. The positive effects of the cooperation with MGA Entertainment, Inc. are also being felt on the product side of the Zapf Creation Group.

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

Outlook

Outlook for the Zapf Creation Group

The Management Board expects sales of Zapf Creation's products to surpass current levels in the medium term. Brand sales will become increasingly significant; besides consolidated sales, this also includes income from licensed products billed by licensees.

The up-and-coming markets in Eastern Europe and Russia offer great growth potential for the Zapf Creation Group. This also applies to Southern European markets such as Spain, Portugal, and Italy, as well as to the Scandinavian countries. Additional profitable opportunities for growth will arise from the licensing business that we plan to establish in cooperation with MGA Entertainment, Inc. However, we do not expect any significant effects from this business until the 2008 financial year.

The Management Board is optimistic that earnings will further improve in 2007 and that the Group will finally turn the corner in terms of profits. This assessment is supported by the generally positive economic climate in Europe, which will provide the corresponding stimulus for consumption.

Furthermore, strengthening the equity base of Zapf Creation AG and securing the Group's financing in accordance with the financing concept agreed between major shareholders and a new banking syndicate on July 20, 2007, is of great importance.

Outlook for Zapf Creation AG

The integration of Zapf Creation (Central Europe) GmbH & Co. KG into Zapf Creation AG by means of accrual effective January 1, 2007, will significantly increase the operating business of Zapf Creation AG in the 2007 financial year; sales will clearly exceed the previous year's level. Earnings should continue to improve due to license income resulting from the cooperation with MGA Entertainment, Inc., higher investment income, and the elimination of extraordinary expenses.

VIII. Other

Disclosures Under Section 289 Para 4 and Section 315 Para 4 German Commercial Code

To date, the share capital of Zapf Creation AG has been € 8,000,000.00, denominated in the same number of no-par shares. The Management Board of Zapf Creation AG was authorized at the Annual General Meeting on May 7, 2003, to increase the Company's share capital until May 6, 2008, subject to the approval of the Supervisory Board, once or several times by a total of € 4,000,000.00 by issuing new no-par bearer shares in return for contributions in cash or in kind.

In October 2006, another 799,998 shares were issued subsequent to a cash capital increase in accordance with Section 186 German Stock Corporation Act. The share capital of Zapf Creation AG now is € 8,799,998.00 and it is denominated in 8,799,998 no-par bearer shares each with an interest in capital of € 1.00 per share. This capital increase corresponds to an increase of the share capital by just under 10%; it was recorded in the German Commercial Register on October 19, 2006. A total of € 5.9 million flowed to the Company in connection with this capital increase, € 5.1 million of which was allocated to capital reserves. The new shares may also be traded on the Official Market of the Frankfurt/Main stock exchange and participate fully in the Company's profits.

Given the aforementioned capital increase, the remaining authorized capital is € 3,200,002.00, for which an equivalent number of no-par shares may be issued.

Zapf Creation AG was notified of an equity interest that exceeds 10% of all voting rights. As of December 31, 2006, 22.98% of the voting shares were attributable to MGA Entertainment, Inc., Van Nuys, California, USA, in accordance with Section 22 para 2 German Securities Trading Act (Wertpapierhandelsgesetz – WpHG); this corresponds to 2,022,318 voting shares. The above percentage includes 5.75% of the voting shares held by the Isaac and Angela Larian Trust, USA, and 13.71% of the voting shares held by the Isaac Larian Annuity Trust, USA.

The nomination of Management Board members is governed by Section 84 and 85 et seq. German Stock Corporation Act; amendments to the Company's Articles of Incorporation are subject to Section 133 and 179 et seq. German Stock Corporation Act.

Regarding important agreements with affiliated companies such as MGA Entertainment, Inc., the employment contract concluded with a Management Board member contains a change of control provision that stipulates special termination rights in the event of a significant change in the Company's shareholder structure.

Report of the Management Board on Relations with Affiliates

In its report on relations with affiliates in the 2006 financial year in accordance with Section 312 German Stock Corporation Act, the Management Board has issued the following statement:

"We declare that our Company was paid appropriate consideration in connection with the legal transactions and measures described in this report on relations with affiliates, given the circumstances known to us at the time the relevant legal transactions or measures were executed or omitted, and that the execution or omission of any such measures did not cause the Company to suffer any disadvantage."

Roedental, Germany, September 26, 2007

Jens U. Keil
Member of the Management Board

Thomas Pfau
Member of the Management Board

Consolidated Financial Statements

Consolidated Income Statement

for the Financial Year from January 1 to December 31, 2006

	Note Section	2006 K€	2005 K€
Revenue	B no. 1.1.	116,106	120,657
Cost of sales	B no. 1.2.	−63,348	−70,775
Gross profit		**52,758**	**49,882**
Selling and distribution expenses	B no. 1.3.	−14,768	−18,968
Marketing expenses	B no. 1.4.	−15,878	−17,910
Administrative expenses	B no. 1.5.	−23,573	−26,395
Other income	B no. 1.6.	1,524	2,325
Other expenses	B no. 1.7.	−559	−1,270
Operating result		**−496**	**−12,336**
(Restructuring costs included therein	*B no. 1.8.*	*−3,357*	*−6,111)*
(One-off costs, mainly consultancy, included therein	*B no. 1.8.*	*−2,576*	*0)*
(Adjusted operating result derived therefrom		***5,437***	***−6,225)***
Finance income	B no. 1.9.	655	230
Finance costs	B no. 1.9.	−6,961	−6,019
Result from continued operations before income taxes		**−6,802**	**−18,125**
Taxes on income	B no. 1.10.	276	−2,696
Result from continued operations		**−6,526**	**−20,821**
Result from discontinued operations before income taxes	B no. 1.11.	−6,093	−4,993
Income taxes on discontinued operations	B no. 1.10.	−54	−1,906
Net profit or loss for the period		**−12,673**	**−27,720**
Earnings per share (basic / diluted)	B no. 1.12.	**−1.67 €**	**−3.73 €**
Earnings per share, continued operations	B no. 1.12.	−0.86 €	−2.80 €
Earnings per share, discontinued operations	B no. 1.12.	−0.81 €	−0.93 €
Average number of shares outstanding, in thousands	B no. 1.12.	7,586	7,427

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

Consolidated Balance Sheet

as of December 31, 2006

	Note Section	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Assets			
Current assets		**89,300**	**104,202**
Cash	B no. 2.1.1.	11,710	9,353
Trade receivables	B no. 2.1.2.	57,375	68,496
Inventories	B no. 2.1.3.	12,663	16,956
Income tax receivables	B no. 2.1.4.	3,824	4,411
Other assets	B no. 2.1.5.	3,728	4,986
Non-current assets		**26,260**	**28,934**
Property, plant and equipment	B no. 2.2.1.	17,475	20,194
Intangible assets	B no. 2.2.2.	4,785	6,523
Other assets	B no. 2.2.3.	20	217
Deferred tax assets	B no. 2.2.4.	3,980	2,000
Total assets		115,560	133,136

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

	Note Section	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Equity and liabilities			
Current liabilities		**111,806**	**101,337**
Liabilities to banks	B no. 2.3.1.	65,055	61,266
Trade payables	B no. 2.3.2.	35,616	30,388
Income tax liabilities	B no. 2.3.3.	1,718	732
Other liabilities	B no. 2.3.4.	3,044	5,341
Provisions	B no. 2.3.5.	6,373	3,610
Non-current liabilities		**176**	**21,560**
Liabilities to banks	B no. 2.4.1.	0	21,060
Deferred tax liabilities	B no. 2.4.2.	176	500
Equity		**3,578**	**10,239**
Issued capital	B no. 2.5.1.	8,800	8,000
Capital reserves	B no. 2.5.2.	12,961	8,052
Net profit or loss for the period and profit brought forward	B no. 2.5.3.	−7,109	5,564
Other recognized income and expense	B no. 2.5.4.	284	−19
Treasury shares	B no. 2.5.5.	−11,358	−11,358
Total equity and liabilities		**115,560**	**133,136**

Consolidated Statement of Changes in Equity

for the Financial Year from January 1 to December 31, 2006

	Shares outstanding	Issued capital	Capital reserves
	thsds	K€	K€
Balance at December 31, 2004:	7,427	8,000	8,052
Net profit or loss for the period			
Change in other recognized income and expense			
Total net income or loss for the period			
Balance at December 31, 2005:	7,427	8,000	8,052
Net profit or loss for the period			
Change in other recognized income and expense			
Total net income or loss for the period			
Issuance of treasury shares	800	800	4,909
Balance at December 31, 2006:	8,227	8,800	12,961

Please also see the disclosures in the notes (Section B no. 2.5.). The included notes are an integral part of the consolidated financial statements.

	Other recognized income and expense			
Net profit or loss for the period and retained earnings brought forward	Adjustments from currency translation	Derivative financial instruments	Treasury shares	Total equity
K€	K€	K€	K€	K€
33,284	77	−168	−11,358	37,887
−27,720				−27,720
	−143	215		72
−27,720	−143	215		−27,648
5,564	−66	47	−11,358	10,239
−12,673				−12,673
	350	−47		303
−12,673	350	−47		−12,370
				5,709
−7,109	284	0	−11,358	3,578

Consolidated Cash Flow Statement

for the Financial Year from January 1 to December 31, 2006

	2006 K€	2005 K€
Cash flow from operating activities:		
Earnings before income taxes	−12,895	−23,118
Depreciation of non-current assets	5,335	6,961
Losses/gains from the disposal of non-current assets	357	692
Finance costs/income	8,050	6,801
Other non-cash income/expenses	367	962
Increase/decrease in assets and liabilities:		
Trade receivables	10,751	−17,898
Inventories	4,324	12,267
Other assets	1,327	−2,362
Liabilities and provisions	3,133	8,562
Income tax payments	−448	−1,298
Cash flow from operating activities	**20,301**	**−8,431**
Cash flow from investing activities:		
Cash receipts from sales of property, plant and equipment and intangible assets	308	762
Cash payments for investments in property, plant and equipment and intangible assets	−1,823	−2,669
Cash flow from investing activities	**−1,515**	**−1,907**
Cash flow from financing activities:		
Cash receipts from non-current bank borrowings	0	25,863
Cash payments for the repayment of non-current bank borrowings	−6,400	−13,804
Change in liabilities due to current borrowings	−10,871	−3,026
Interest paid	−5,484	−7,199
Interest received	488	236
Dividend payments	5,933	0
Cash flow from financing activities	**−16,334**	**2,070**
Effects of exchange rate changes	−95	580
Net change in cash and cash equivalents	**2,357**	**−7,688**
Cash and cash equivalents at the beginning of the period	9,353	17,041
Cash and cash equivalents at the end of the period	11,710	9,353

Please also see the disclosures in the notes (Section B no. 3.). The included notes are an integral part of the consolidated financial statements.

A. General Disclosures regarding the Consolidated Financial Statements

1. Nature of the Business

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

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

All these branded toys have in common the highest standards of design, quality, safety and play value. In designing doll accessories and clothes, Zapf Creation takes its lead from trends in children's fashions and general lifestyle products and incorporates them into new products. The doll's bodies conceal cutting-edge and creatively applied technology. The branded play concepts of Zapf Creation place no limits on a girl's imagination. Playing with dolls also addresses and supports social skill such as loving, caring, empathy and accepting responsibility.

Zapf Creation AG, as the Company is currently known, was originally established in 1932 by Max Zapf and his wife Rosa as "Max Zapf Puppen- und Spielwarenfabrik". The Company went public on April 26, 1999. Zapf Creation AG is listed on the Official Market of the Frankfurt Stock Exchange. Its shares are traded in the Prime Standard segment.

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

2. Accounting and Measurement Principles

2.1. Overview

2.1.1. General Information

These consolidated financial statements of Zapf Creation AG were prepared in accordance with Section 315a German Commercial Code ("Consolidated Financial Statements According to International Accounting Principles") and in compliance with both the International Financial Reporting Standards (IFRS) of the International Accounting Standards Board (IASB) and the relevant interpretations of the International Financial Reporting Interpretations Committee (IFRIC) – all of them as applicable within the European Union under Article 4 of EC Directive 1606/2002 dated July 19, 2002, of the European Parliament and the European Council.

The provisions of Section 315a para 1 German Commercial Code were also observed in preparing the consolidated financial statements. Please see Section C item 5., for the disclosures required under Section 315a German Commercial Code.

All IFRS, as well as all attendant interpretations, applicable to the financial year just ended were used in the preparation of the consolidated financial statements of Zapf Creation AG as of December 31, 2006, inasmuch as they were adopted by the EU.

With the exception of certain financial instruments that are reported using fair values, the consolidated financial statements of the Zapf Creation Group were drawn up based on historical costs.

The euro (€) is the reporting currency because it is the currency used in the great majority of the Group's financial transactions. Unless otherwise indicated, all amounts are stated in thousands of euros (K€). Deviations from amounts that have not been rounded up or down may occur.

The Management Board of Zapf Creation AG released the consolidated financial statements as of December 31, 2006, to the Supervisory Board on September 26, 2007. The Supervisory Board is tasked with reviewing the consolidated financial statements and declaring whether or not it approves them.

2.1.2. Published Standards, Interpretations and Amendments Not Yet Applied

As outlined below, the IASB (International Accounting Standards Board) and the IFRIC (International Financial Reporting Interpretations Committee) have published standards, interpretations, and amendments of existing standards and interpretations that are not yet subject to mandatory application. There has been no voluntary early application of these requirements on the part of the Zapf Creation Group.

IFRS 7 ("Financial Instruments: Disclosures") replaces IAS 30 ("Disclosures in the Financial Statements of Banks and Similar Financial Institutions") and portions of IAS 32 ("Financial Instruments: Disclosures and Presentation"). This standard was adopted by the European Union in January 2006 and its application is mandatory for financial years beginning on or after January 1, 2007. Earlier application is recommended. IFRS 7 requires comprehensive information on the significance of financial instruments to the reporting company's economic position. Further, this standard also contains new requirements regarding both qualitative and quantitative reporting on risks associated with financial instruments. Initial application of IFRS 7 will result in expanded disclosures in the notes to the consolidated financial statements of the Zapf Creation Group.

IFRS 8 ("Operating Segments") was published in November 2006 but has not yet been adopted by the EU. Its mandatory application for financial years beginning on or after January 1, 2009, is planned. Earlier application is permitted. IFRS 8 entails changes with regard to the identification of segments in segment reporting. This standard completes the shift from a risk and reward approach to a management approach, which also entails shifting from a financial accounting approach to a management approach in the measurement of segments. Initial application of IFRS 8 will not have any substantial effects on future consolidated financial statements of the Zapf Creation Group.

IFRIC 7 ("Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economics") addresses two specific application issues with regard to IAS 29. This interpretation specifies how to adjust comparative figures in IFRS financial statements if the reporting company's functional currency or the country where the relevant currency is used satisfy the hyperinflation criteria. Application of this interpretation is mandatory for financial years beginning on or after March 1, 2006. Initial application of IFRIC 7 will not have any substantial effects on future consolidated financial statements of the Zapf Creation Group.

IFRIC 8 ("Scope of IFRS 2") must be applied to financial years beginning on or after May 1, 2006. This interpretation supplements IFRS 2 ("Share-based Payment") in that IFRS 2 must also be applied to those transactions in which a company grants share-based compensation in exchange for no or inadequate return compensation. At present, the Zapf Creation Group does not believe that initial application of IFRIC 8 will substantially affect its future consolidated financial statements.

IFRIC 9 (“Reassessment of Embedded Derivatives”) was published in March 2006 and has already been adopted by the EU. This interpretation must be applied to financial years beginning on or after June 1, 2006. IFRIC 9 provides specifics with regard to accounting for embedded derivatives under IAS 39. According to the knowledge currently available to us, application of IFRIC 9 will not have any effect on future consolidated financial statements of the Zapf Creation Group.

IFRIC 10 (“Interim Financial Reporting and Impairment”) was published in July 2006 and specifies the interplay between the requirements of IAS 34 (“Interim Financial Reporting”) and the applicable rules regarding the recognition of impairment losses on goodwill, as well as on certain financial assets. Application of IFRIC 10 is mandatory for financial years beginning on or after November 1, 2006. Under IFRIC 10, impairment losses that have been recognized in an interim financial statement and are subject to the prohibitions on reversal under IAS 36 or IAS 39 cannot be reversed in subsequent interim or annual financial statements and/or consolidated financial statements. According to the knowledge currently available to us, application of IFRIC 10 will not have any effect on future consolidated financial statements of the Zapf Creation Group.

IFRIC 11 (“IFRS 2: Group and Treasury Share Transactions”) addresses the accounting of group-wide share-based compensation and clarifies both questions related to personnel turnover within the Group and how to treat share-based compensation when the company issues treasury shares or must purchase stock from third parties. This interpretation was published in late 2006 and must be applied to financial years beginning on or after March 1, 2007. Earlier application is recommended. The EU adopted IFRIC 11 in June 2007. According to the knowledge currently available to us, application of IFRIC 11 will not have any effect on future consolidated financial statements of the Zapf Creation Group.

IFRIC 12 (“Service Concession Arrangements”) was published at the end of 2006. This interpretation focuses on the treatment of infrastructure services by private companies. IFRIC 12 provides for mandatory application of its rules to financial years beginning on or after January 1, 2008. Earlier application of this interpretation is permitted but it has not yet been adopted by the EU. Currently, we do not expect initial application of IFRIC 12 to have any consequences for future consolidated financial statements of the Zapf Creation Group.

In June 2007, IFRIC 14 (“The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction”) was published. This interpretation essentially addresses the interaction between the requirement as of a balance sheet date to pay additional amounts into a pension plan and the relevant provisions of IAS 19 regarding the maximum positive balance between plan assets and a defined-benefit obligation. Application of this IFRIC 14 is mandatory for financial years beginning on or after January 1, 2008. IFRIC 14 has not yet been adopted by the European Union. Initial application of IFRIC 14 is not expected to have any effects on the consolidated financial statements of the Zapf Creation Group.

Also in June 2007, the IASB published IFRIC 13 (“Customer Loyalty Programmes”). This interpretation addresses accounting of customer loyalty programs operated by manufacturers or service providers, or by third parties. IFRIC 13 must be applied to financial years beginning on or after July 1, 2008. The EU has not yet adopted this interpretation. Possible effects on the consolidated financial statements of the Zapf Creation Group are currently being examined.

2.2. Consolidation

2.2.1. General Information

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

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

In accordance with the control concept, the consolidated financial statements include all companies which are directly or indirectly controlled by Zapf Creation AG, the Group's parent company. Control exists when the parent company has the possibility to determine a company's financial and business policy with the aim of deriving a benefit from this.

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

2.2.2. Basis of Consolidation

In addition to Zapf Creation AG, the Group's parent company, all direct and indirect subsidiaries of the Group are included in the consolidated financial statements. With the exception of Zapf Creation (U.K.) Ltd., Corby, Northants, Great Britain, and Zapf Creation (España) S.L., Alicante, Spain, Zapf Creation AG directly holds a 100 % stake in all of its subsidiaries. Since September 2006, Zapf Creation AG has held its shares in these two subsidiaries in Great Britain and Spain through its subsidiary Zapf Creation Auslandsholding GmbH, Roedental, Germany. Zapf Creation AG holds a 100 % stake in Zapf Creation Auslandsholding GmbH, which in turn holds a 100 % stake in each of the two sales subsidiaries mentioned above.

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

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

	Domestic	Abroad	Total
December 31, 2005	4	8	12
Disposals in the 2006 financial year	0	1	1
Additions in the 2006 financial year	1	0	1
December 31, 2006	5	7	12

In June 2006, the elimination of Zapf Creation (CZ) s.r.o., Prague, Czech Republic, from the commercial register became effective. Consequently, the company was deconsolidated in the consolidated financial statements as of June 30, 2006, and is no longer included in the Group's consolidated accounts since that time, contrary to the same period the previous year during which the liquidation of this Group subsidiary had been initiated but not completed.

In September 2006, Zapf Creation Auslandsholding GmbH, Roedental, Germany, was included in the consolidated financial statements for the first time.

The Group subsidiary, Zapf Creation (U.S.) Inc., discontinued operations as of December 31, 2006. MGA Entertainment, Inc., Van Nuys, California, USA, alone has been in charge of the entire American market via a strategic partnership effective January 1, 2007. However, Zapf Creation (U.S.) Inc. was still treated as a consolidated company as of the balance sheet date.

As of December 31, 2006, the Group subsidiary, Zapf Creation (Central Europe) GmbH & Co. KG, was reintegrated into the Group's parent company, Zapf Creation AG, by means of accrual. Zapf Creation AG has been directly responsible for carrying out the activities of Zapf Creation (Central Europe) GmbH & Co. KG effective January 1, 2007. The Group subsidiary, Zapf Creation (Central Europe) GmbH & Co. KG, was still treated as a consolidated company as of the balance sheet date.

The Group subsidiary, Zapf Creation (Australia) Pty. Ltd., Melbourne, Australia, was still included in the previous year's comparative information as of June 30, 2005. This company was sold effective July 1, 2005, and deconsolidated accordingly.

The treatment of the discontinuation of the activities of the Group subsidiary, Zapf Creation (U.S.) Inc., is subject to IFRS 5 ("Non-current Assets Held for Sale and Discontinued Operations"). Because the Group initiated key restructuring steps in 2006, in the consolidated financial statements for the 2006 financial year, the "Americas" segment must already be treated as a discontinued operation pursuant to the definition in IFRS 5.

2.2.3. Consolidation Methods

All companies are fully consolidated.

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

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

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

Intercompany profits and losses are eliminated.

The euro (€) is the reporting currency.

Currency translation within the Zapf Creation Group is executed in accordance with the functional currency method. The Group's functional currency also is its reporting currency.

Any transaction in a foreign currency is initially accounted for in the functional currency by translating it at the exchange rate on the transaction date. During subsequent measurement, assets and liabilities linked to foreign currencies are translated into the reporting currency at end of period exchange rates, and differences for currency translation are recognized in the income statement.

Gains and losses from currency translation are reported in the consolidated income statement under the expense and income items under which the transaction triggering the exchange rate effect is subsumed.

The financial statements for the foreign subsidiaries that are included in the consolidated financial statements but whose functional currency is not the euro are translated from their respective functional currency (local currency) into the Group's functional currency, i.e. into euros. Assets and liabilities are translated at the applicable end of period exchange rate while income and expense items are translated at average exchange rates during the reporting period. All differences from currency translation are recognized directly in equity.

Currency translation differences arising from consolidation are recognized directly in equity.

The exchange rates for the currencies relevant to the Zapf Creation Group have changed as shown below (one foreign currency unit = x euro units):

Consolidation as of December 31, 2006:

	USD	HKD	GBP	PLN
Closing rate as of Dec. 31, 2006	0.7582	0.0978	1.4908	0.2608
Average exchange rate from Jan. 1 to Dec. 31, 2006	0.7970	0.1026	1.4673	0.2575
Historical average exchange rate	0.9388	0.1137	1.5336	0.2452

Consolidation as of December 31, 2005:

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

2.3. Accounting Principles

2.3.1. Revenue Recognition

IAS 18 ("Revenue") prescribes the accounting treatment of revenue arising from the sale of goods, the rendering of services, and the use by others of enterprise assets yielding interest, rent or other royalties. The Company recognizes revenue and other income in accordance with IAS 18 ("Revenue") at the time the services are rendered or the goods are delivered, significant risks and rewards of ownership have been transferred to the customer, and the amount of the realizable revenue can be measured reliably.

Interest income is recognized on a pro rata temporis basis, taking both the unpaid principal and the applicable interest rate into account.

2.3.2. Research and Development

Development expenses are capitalized as internally generated intangible assets if the applicable requirements of IAS 38 ("Intangible Assets") have been satisfied cumulatively. These requirements include the technical feasibility of production, the intended completion and realization of the project, as well as evidence that the outcome of the project is suitable for the company's own use or for sale as an asset. In addition, both the future economic benefits flowing from the project and the availability of the resources needed to complete the project must also be shown. Finally, development expenses may be capitalized only if the costs allocable to the intangible asset in question during the development phase can be measured reliably. Capitalized development expenses related to a completed project are recognized at cost less cumulative amortization. If a project has not yet been completed, the capitalized amounts are subject to an annual impairment test unless there are indications of an impairment at other times.

Development expenses are recognized as an expense in the income statement analogous to research expenses if the requirements of IAS 38 have not been met.

2.3.3. Defined Contribution Plans

The Zapf Creation Group's reinsured pension plan must be classified as a defined contribution plan pursuant to IAS 19. Mandatory contributions thus are recognized as an expense and offset directly against the corresponding liability.

2.3.4. Adjusted Operating Income

In addition to reporting its operating income, the Zapf Creation Group also reports "adjusted operating income" in its consolidated income statement.

The adjusted operating income is based on the Group's internal key performance indicators and adjusts the Group's operating income by the restructuring expenses and one-off items shown in the income statement. Reporting this accounting parameter in the consolidated income statement serves to increase transparency in terms of the sustainability of the income the Company achieves from its current operating processes.

2.3.5. Taxes on Income

Income tax expenses include both current and deferred income taxes. In accordance with IFRS 5, income taxes related to operations not to be continued are reported in the income statement as income taxes on operations not to be continued.

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

Deferred income taxes are recognized using the liability method for all temporary differences between the amounts of assets and liabilities recognized in the consolidated financial statements and the amounts recognized in tax accounts. Deferred tax assets on taxable loss carryforwards are also taken into account. Deferred taxes are measured on the basis of all tax regulations applicable or enacted as of the closing date.

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

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

2.3.6. Earnings per Share

Basic earnings per share are calculated by dividing the net annual result available to shareholders by the weighted average of all shares outstanding; changes in the number of shares outstanding are considered on a pro rata temporis basis.

Any dilution effect (existence of potential shares) is reported as diluted earnings per share; however, this does not apply to the Zapf Creation Group at present.

2.3.7. Financial Instruments

According to IAS 32 ("Financial Instruments: Disclosure and Presentation") and IAS 39 ("Financial Instruments: Recognition and Measurement"), financial instruments are agreements that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Pursuant to IAS 32, this includes original financial instruments such as cash and cash equivalents, trade receivables and trade payables, as well as financial receivables and financial liabilities. Furthermore, derivative financial instruments such as options or swaps must also be subsumed under financial instruments. The Zapf Creation Group uses these instruments as hedging transactions to hedge against risks from changes in foreign currency and interest rates.

Original financial assets and financial liabilities are accounted for in the consolidated balance sheet as of the date on which at least one of the parties has rendered the services it has undertaken to render as part of the agreement. Derivative financial instruments are taken into account from the point in time at which the Group becomes a party to the agreement.

Original Financial Instruments

Accounting according to IFRS defines four categories of original financial instruments: loans and receivables, financial investments held to maturity, financial assets or liabilities held for trading or speculation purposes, and financial assets available for sale. In the Zapf Creation Group, original financial instruments currently only fall under "Loans and receivables" or "Other liabilities" categories.

- *Financial Assets*

  The balance sheet item "Cash" includes cash and term deposits. Cash also includes highly liquid financial investments with an original maturity of up to 90 days. Cash is measured at nominal value.

  Loans, trade receivables, and other receivables are initially recognized at cost, including transaction costs. Non- or below-market interest-bearing receivables with an expected maturity of more than one year are discounted. Subsequent measurements of loans, trade receivables, and other receivables are made in accordance with the effective interest method at adjusted costs.

The Zapf Creation Group sells receivables as part of its receivables management. Such factoring is treated in accordance with IAS 39 ("Financial Instruments: Recognition and Measurement"). This means that a financial asset is generally recognized by the entity assuming the main related risk. The non-payment risk is the key criterion for recognizing receivables in connection with factoring. If the factor purchasing the receivables assumes the entire non-payment risk, then the receivable is recognized by such factor (non-recourse factoring). If not, the receivable is still recognized by the company selling it (recourse factoring). Under the factoring program the Zapf Creation Group uses, the factor purchases the receivables and assumes the entire non-payment risk for them. These transactions are thus accounted for analogous to the procedure outlined in the preceding paragraph.

In accordance with the requirements of IAS 39, an impairment test is conducted at each balance sheet date on the basis of both internal and external indicators to assess whether impairment of the financial assets is objectively indicated. If the present value of the relevant financial asset is less than its carrying amount, then the impairment loss is recognized in income and the financial instrument is reported at cost less adjustments. Such adjustments are also reversed in income if the impairment has declined due to an event that occurred subsequent to the recognition of the impairment loss. If the reasons for the adjustment no longer exist, a write-up to no more than the cost is made.

- *Financial Liabilities*

Financial liabilities contain interest-bearing liabilities of a financing nature, in particular, loans from banks and other lenders, as well as other interest-bearing liabilities. Non-interest-bearing liabilities and liabilities subject to below-market rates are measured at their present value. All subsequent measurements are made at adjusted costs using the effective interest method. Any difference between the net loan amount and the repayment value is distributed over the term of the financial liabilities and recognized in the income statement.

Both trade liabilities and other liabilities are measured at their repayment amount. Non- or below-market interest-bearing long-term liabilities are discounted and measured at their present value if the discounted amount is substantial.

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

The fair value of financial assets and financial liabilities usually corresponds to the (stock) market value as of the balance sheet date. If no active market exists, the fair value is determined by means of mathematical methods and checked against confirmations from the banks that handle the transactions.

The fair value of original financial instruments essentially corresponds to the carrying amount.

Derivative Financial Instruments
As a rule, the Group only employs derivative financial instruments (forward exchange transactions and options as well as interest rate swaps) for hedging purposes (currency and interest rate risks). Please see Section B no. 2.6., for additional information on derivative financial instruments and their measurement.

Depending on the nature of the underlying transactions being hedged, IFRS accounting distinguishes between fair value hedges, cash flow hedges, and hedging of a net investment in a foreign operation. The Zapf Creation Group uses cash flow hedges to hedge the risk of fluctuations in future cash flows related to previously reported transactions or anticipated transactions if the structure of the financing so requires. Changes in the fair value of derivative financial instruments intended for hedging a cash flow risk are documented. If the hedging relationships are classified as effective, the changes in the fair value are recognized directly in equity. In contrast, fluctuations in value from financial instruments classified as ineffective are recognized directly in the income statement. For more information on hedge accounting in the 2006 financial year, please see Section B no. 2.5.4.

2.3.8. Inventories
Additions to goods, raw materials, and consumables are measured at cost in accordance with IAS 2 using sliding average prices.

The cost of inventories includes all acquisition costs, as well as all costs incurred for keeping the inventories at their current storage location and in their current state. For purchased merchandise, this comprises in particular the purchase price, freight and customs duties. Discounts, rebates and similar amounts are deducted when determining the acquisition costs.

In subsequent measurements, if necessary, inventory assets are written down to their net realizable value. The net realizable value of the goods corresponds to the estimated selling price of the item that is achievable in the course of ordinary business less estimated selling costs.

All identifiable risks related to inventory assets resulting from the inventories' reduced marketability or obsolescence are taken into account; analogous adjustments are made for items that are no longer marketable.

2.3.9. Property, Plant and Equipment
The Group measures all property, plant and equipment subject to wear and tear at cost less cumulative depreciation, i.e. both normal depreciation and any impairments. Depreciation on property, plant and equipment is made on a straight-line basis according to the assets' estimated useful life using the following schedule:

Buildings and building equipment	3 to 50 years
Machinery	2 to 20 years
Motor vehicles, furniture and fixtures, and office equipment	2 to 18 years

The useful life of property, plant and equipment subject to depreciation is tested annually; if necessary, the remaining useful life is adjusted based on the changed estimate.

The depreciation period for property, plant and equipment, which the Group uses under capital leases or in connection with rental agreements (leasehold improvements), always begins with the date the asset is put into service. The depreciation period corresponds to the duration of the rental or lease agreements if this is shorter than the asset's economic life.

Leases are accounted for in accordance with IAS 17 ("Leases"). IAS 17 makes a fundamental distinction between finance leases and operating leases. Under IAS 17, whether the leased property is recognized by the lessor or the lessee depends on who assumes the substantial risks and rewards associated with such leased property. The Zapf Creation Group is an operating lessee. This means that its leased property is accounted for by the lessor; regular lease payments are recognized as a lease expense in the income statement.

If the relevant leased property is scrapped or disposed of, the costs of the relevant asset and the cumulative depreciation are written off; any resulting gain or loss is shown in the income statement under other income or expenses.

Depreciation is reported in the income statement as a cost of the relevant operational area to which the underlying property, plant and equipment is allocable.

Under the components approach, substantial components of an asset classified as property, plant and equipment with different useful lives are depreciated over the useful life of the relevant component. Current maintenance and repair costs are expensed immediately unless they are capitalized in connection with the components approach.

Borrowing costs are included in the costs of fixed assets in accordance with IAS 23 if the asset is considered a qualifying asset.

2.3.10. Intangible Assets

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

Patents, brand names and licenses	5 to 10 years
Computer software	2 to 5 years

The useful life of an intangible asset is tested annually; if necessary, the remaining useful life is adjusted based on the changed estimate.

Depreciation is reported in the income statement as a cost of the relevant operational area to which the underlying property, plant and equipment is allocable.

If the requirements of IAS 38 ("Intangible Assets") are satisfied, portions of the Company's own costs for customizing SAP's ERP software are capitalized. Intangible assets are amortized as of their completion date.

Borrowing costs are included in the costs of an intangible asset in accordance with IAS 23 if the asset is considered a qualifying asset.

2.3.11. Impairment

Intangible assets, as well as property, plant and equipment, are tested as of each balance sheet date to assess whether any triggering events might have occurred that entail an impairment as defined in IAS 36 ("Impairment of Assets"). Intangible assets under construction, i.e. assets that are not subject to normal amortization, are reviewed for impairment annually. An adjustment is required if the recoverable amount of the relevant asset is less than its carrying amount.

The recoverable amount is the higher of its fair value less costs of disposal and its value in use.

If it is impossible to determine the recoverable amount of an individual asset, then the recoverable amount is determined for the smallest identifiable cash generating unit that can be attributed to the relevant asset. In such cases, the impairment test is shifted from the individual asset to the cash generating unit.

The recognizable fair value is the amount that could be achieved by disposing of an asset in an arm's length transaction between knowledgeable, willing parties after deducting the costs to sell.

The value in use results from the present value of future cash flows that are expected to be derived from the asset. Determination of the present value is based on an interest rate reflecting market conditions.

Valuation allowances in an amount equivalent to the amount by which the carrying amount of the asset exceeds its recoverable amount are recognized in income. If, following an allowance, the recoverable amount increases, then a write-up to no more than such recoverable amount is made in the income statement. The write-up is limited to the asset's adjusted carrying amount which would have been obtained in the past absent the allowance.

2.3.12. Provisions

Provisions are recognized as a liability in accordance with IAS 37 ("Provisions, Contingent Liabilities and Contingent Assets") if the Group has a current legal or constructive obligation vis-à-vis third parties resulting from a past event and if it is probable (more likely than not) that this past event will result in an outflow of resources embodying economic benefits that can be measured reliably; no provisions are set up for internal obligations. The disclosure as a provision in the balance sheet is oriented on the extent of the uncertainty with regard to the timing and/or the amount of the future outlays required to fulfill the obligation. Obligations that do not meet the requirements for provisions under IFRS (in particular outstanding invoices and current personnel liabilities) are not recognized as provisions, but rather as liabilities. If the interest rate effect related to the provisions is material, they are discounted by a market interest rate adequate to their risk.

2.3.13. Share-Based Compensation Systems

The Zapf Creation Group employs compensation systems based on the performance of its stock, given its orientation toward activities designed to ensure that the enterprise value is increased in the long term in shareholders' interests. In contrast to employee stock option plans (ESOPs), so-called virtual share-price-based compensation does not constitute real equity interests but rather salary and/or bonus payments that are contingent on the development of the Company's stock. Cash compensation claims are granted to the beneficiaries during specific periods based on the difference between the underlying share's current price and the base price of the stock appreciation rights assigned.

Additions to the liabilities of the Zapf Creation Group under virtual share-price-based compensation systems are measured in accordance with IFRS 2 ("Share-based Payment") on the basis of the fair value. The latter is determined based on a stock option model, taking both the terms of each individual promise and personnel turnover into account. All consideration to be paid in cash in connection with virtual share-price-based compensation systems must be shown as liabilities and charged against the corresponding personnel expense.

The liability to be reported at the end of each subsequent period reflects the newly determined fair value of the virtual equity instruments at such date. The effects of such periodic fair value determinations must be recognized in the income statement.

2.4. Use of Estimates

Consolidated financial statements require management to make assumptions and perform estimates, which might affect the application of accounting standards in the Group, as well as both the amount and the disclosure of recognized assets, liabilities, income, expenses, and contingent liabilities.

The Company's management regularly reviews both the estimates and the underlying assumptions. Although the estimates are made to the best of management's knowledge based on current events and measures, actual amounts may deviate from these estimates. Adjustments related to the estimates relevant to the accounting are considered in the period in which the adjustment was made if it concerns only the period in question. If an adjustment concerns both the reporting period and later periods, then it is accounted for in both.

B. Explanations of Items in the Consolidated Financial Statements

1. Explanation of Income Statement Items

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

Income and expenses that are attributable to the Group subsidiary Zapf Creation (U.S.) Inc. are reported separately under the result of operations to be discontinued in accordance with IFRS 5 ("Non-current Assets Held for Sale and Discontinued Operations"). Previous year's comparative figures were adjusted accordingly.

1.1. Revenue

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

Gains and losses on changes in exchange rates realized on sales transactions and those arising from measurement of trade receivables on the closing date are recognized under revenue. In addition, please see the table of exchange rates in Section A no. 2.2.3.

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

1.2. Cost of Sales

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

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

Gains and losses on changes in exchange rates realized on purchase transactions and those arising from measurement of trade payables on the closing date are recognized under cost of sales. In addition, please see the table of exchange rates in Section A no. 2.2.3.

1.3. Selling and Distribution Expenses

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

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

The following are also recognized in selling and distribution expenses: staff costs totaling K€ 6,066 (previous year: K€ 7,612) and depreciation/amortization of the sales and distribution units totaling K€ 2,455 (previous year: K€ 2,555), as well as license fees, activities at the point-of-sale for the end consumer, and expenses resulting from the Company's receivables management.

1.4. Marketing Expenses

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

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

The following are also recognized under marketing expenses: staff costs totaling K€ 1,733 (previous year: K€ 2,312) and depreciation/amortization of the marketing unit totaling K€ 641 (previous year: K€ 827), as well as those expenses resulting from communication with end customers. Among others, this concerns expenses for the design of mini catalogs, for conducting sweepstakes and competitions, as well as the BABY born® CLUB, a tool for creating customer loyalty and maintaining customer contact.

1.5. Administrative Expenses

The Company's other administrative expenses include expenses incurred by the finance, controlling and IT units as well as general administrative expenses. This includes staff costs totaling K€ 7,047 (previous year: K€ 9,061) and depreciation/amortization of these units totaling K€ 2,194 (previous year: K€ 3,390).

In addition, other administrative expenses also include development and design expenses if such expenses do not qualify for capitalization under IAS 38. Product development is the responsibility of both the Company's development department, which was located at Roedental and Hong Kong in the 2006 financial year and which will again be located at the Company's headquarters in Roedental in 2007, and external developers and designers, primarily those of the strategic partner MGA Entertainment, Inc.

1.6. Other Income

Exchange rate gains realized on transactions that are not directly allocable to the purchasing and sales process, and exchange rate gains arising from the measurement of assets and liabilities on the closing date that are not directly allocable to the purchasing and sales process, are offset against corresponding exchange rate losses and reported under other income if the resulting balance shows income. There was no income from exchange rate gains in the 2006 financial year (previous year: K€ 1,697).

The Company's miscellaneous other income totaling K€ 1,524 (previous year: K€ 628) essentially comprises income of K€ 676 (previous year: K€ 0) from its restructuring; license income of K€ 179 (previous year: K€ 203) from the BABY born® brand; income of K€ 173 from the deconsolidation of the Group subsidiary, Zapf Creation (CZ) s.r.o. (previous year: K€ 113 from the deconsolidation of Zapf Creation (Australia) Pty. Ltd.); income of K€ 104 (previous year: K€ 0) from expenses passed on to other parties for delayed deliveries; and income of K€ 68 (previous year: K€ 92) from disposals of fixed assets.

1.7. Other Expenses

Exchange rate losses realized on transactions that are not directly allocable to the purchasing and sales process, and exchange rate losses arising from the measurement of assets and liabilities on the closing date that are not directly allocable to the purchasing and sales process totaling K€ 4,283 (previous year: K€ 3,940) are offset against corresponding exchange rate gains totaling K€ 4,224 (previous year: K€ 5,637) and reported under other expenses if the resulting balance shows an expense. While an expense of K€ 59 from changes in foreign exchange rates was incurred in the 2006 financial year, changes in foreign exchange rates had generated income of K€ 1,697 in the previous year.

The Company's miscellaneous other expenses of K€ 500 (previous year: K€ 1,270) comprise, in particular, interest and currency hedging fees of K€ 184 (previous year: K€ 213); expenses of K€ 142 (previous year: K€ 188) on disposals of fixed assets; expenses of K€ 120 (previous year: K€ 0) resulting from reviews during the reporting period of non-current assets' useful lives; as well as adjustments of K€ 20 of existing interest receivables on loans extended (previous year: adjustment of loans made to members of corporate bodies and employees in the amount of K€ 685).

1.8. Restructuring Costs and One-off Items

Expenses from the restructuring of the Zapf Creation Group, as well as other extraordinary one-off expenses, are shown in the income statement under the operational areas giving rise to such expenses.

In addition, these expenses are also reported separately in the adjusted operating income. Expenses from the Company's restructuring in the reporting period were K€ 3,357 (previous year: K€ 6,111) and one-off expenses in the financial year just ended were K€ 2,576 (previous year: K€ 0).

The largest portion of restructuring costs is comprised of severance payments totaling K€ 1,891 (previous year: K€ 2,889) for personnel measures in connection with the Company's realignment, which were either conducted in the 2006 financial year or are pending for the 2007 financial year. Restructuring costs also include consultancy services totaling K€ 1,278 (previous year: K€ 2,949) that are also directly connected to the realignment program, as well as other costs incurred in connection with the restructuring totaling K€ 188 (previous year: K€ 273).

The one-off expenses in the 2006 financial year comprise expenses for consultancy services totaling K€ 1,570 and expenses of K€ 1,006 resulting from the preparation of measures aimed at enhancing the Company's equity base.

1.9. Finance Income and Costs

The finance income totaling K€ 655 (previous year: K€ 230) arises from short-term liquid assets in connection with cash management.

The finance expenses totaling K€ 6,961 (previous year: K€ 6,019) comprise interest on bank overdrafts and loans, fees for factoring conducted during the financial year as well as syndication fees.

1.10. Taxes on Income

The tax expenses recognized in the consolidated financial statements of Zapf Creation AG are comprised as follows:

	2006 K€	2005 K€
Current taxes		
Domestic	926	715
Abroad	1,102	1,802
	2,028	**2,517**
Deferred taxes		
Domestic	−2,797	814
Abroad	547	1,271
	−2,250	**2,085**
Income tax income/expense	−222	4,602

The loss of K€ 6,147 from discontinued operations in the 2006 financial year (previous year: loss of K€ 6,899) contains expenses of K€ 54 (previous year: K€ 1,906) from both current and deferred income taxes.

In the 2006 financial year, deferred tax liabilities of K€ 28 (previous year: K€ 0) were reversed against equity at the level of Zapf Creation AG; please also see Section B no. 2.5.4.

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

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

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

	2006		2005	
	K€	%	K€	%
Earnings before income taxes	**−12,895**	**100.00**	**−23,118**	**100.00**
Expected income tax refund/expected income tax expense	4,850	−37.61	8,695	−37.61
Different tax assessment basis	−1,072	8.31	2,201	−9.52
Different tax rate	−93	0.72	613	−2.65
Uncapitalized deferred taxes on loss carryforwards	−4,991	38.71	−13,554	58.63
Deferred taxes loss carryforwards, subsequently capitalized/Use of existing loss carryforwards	2,146	−16.64	192	−0.83
Valuation allowance on deferred taxes capitalized in prior years	−1,119	8.68	−2,272	9.83
Tax expense, previous years	500	−3.88	−677	2.93
Other	1	−0.01	200	−0.87
Recognized income tax income/expense	222	−1.72	−4,602	19.91

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

	Dec. 31, 2006	Dec. 31, 2005
	K€	K€
Corporation tax		
Domestic	58,188	45,071
Abroad	5,809	5,950
Total	63,997	51,021
Trade tax (domestic only)		
Total	58,746	46,069

Of the corporation tax loss carryforwards, K€ 58,176 relate to Zapf Creation AG (previous year: K€ 45,071); K€ 2,944 relate to Zapf Creation (France) S.à.r.l. (previous year: K€ 2,493); K€ 1,503 relate to Zapf Creation (Italia) S.R.L. (previous year: K€ 1,541); and K€ 1,362 relate to Zapf Creation (H.K.) Ltd. (previous year: K€ 0); further corporation tax loss carryforwards totaling K€ 12 relate to Zapf Creation (Central Europe) Verwaltungs GmbH, Zapf Creation Logistics Beteiligungs GmbH, and Zapf Creation Auslandsholding GmbH (previous year: K€ 0). In contrast to the previous year, no loss carryforward has been recognized for Zapf Creation (U.S.) Inc. as of December 31, 2006. The corporation tax loss carry-forward of Zapf Creation (U.S.) Inc. totaling K€ 1,916, which in the previous year could be carried forward until 2024, and which, following a review of the underlying tax law facts, was increased to K€ 4,622 in the 2006 financial year, has been used up completely at the end of the 2006 assessment period.

Of the corporation tax loss carryforwards, K€ 63,107 (previous year: K€ 48,177) may be carried forward indefinitely, and the remaining K€ 890 (previous year: K€ 928) may be carried forward until 2008 and 2009 (previous year: 2009 and 2010). As of December 31, 2006, there were no further corporation tax loss carryforwards which may be carried forward for a definite period of time (previous year: K€ 1,916, to be carried forward until 2024).

Of the trade tax loss carryforwards, K€ 53,121 relate to Zapf Creation AG (previous year: K€ 37,319), K€ 4,725 relate to Zapf Creation (Central Europe) GmbH & Co. KG (previous year: K€ 6,609), and K€ 884 relate to Zapf Creation Logistics GmbH & Co. KG (previous year: K€ 2,141). Further trade tax loss carryforwards totaling K€ 16 relate to Zapf Creation (Central Europe) Verwaltungs GmbH, Zapf Creation Logistics Beteiligungs GmbH, and Zapf Creation Auslandsholding GmbH (previous year: K€ 0).

The trade tax loss carryforwards may be carried forward indefinitely.

Due to the insufficient probability of an earnings turnaround in future accounting periods, no deferred taxes were recognized on corporation tax loss carryforwards totaling K€ 54,025 (previous year: K€ 40,481) and on trade tax loss carryforwards totaling K€ 50,065 (previous year: K€ 40,043).

Deferred tax assets on loss carryforwards are recognized only if it is probable that future taxable income will be available, as well as if there are substantive indications as to the Company's corresponding future income. Deferred tax assets are also recognized for companies belonging to the Zapf Creation Group that are currently in the loss zone if it is sufficiently probable that they will turn a profit in future periods.

As in the previous year, no deferred tax assets are shown for the Group subsidiary, Zapf Creation (U.S.) Inc., in the consolidated financial statements as of December 31, 2006, in regards to temporary differences between the carrying amounts of assets/liabilities and amounts recognized for tax purposes.

1.11. Discontinued Operations

Under IFRS 5 ("Non-current Assets Held for Sale and Discontinued Operations"), a discontinued operation constitutes a component of the company that will be discontinued in accordance with a single coordinated plan. The discontinued operations must be identifiable and distinct from the continued operations. If a component is to be classified as a discontinued operation pursuant to IFRS 5, then the income from such discontinued operations must be shown separately in the consolidated income statement.

In the 2006 financial year, IFRS 5 was applied to the Group subsidiary, Zapf Creation (U.S.) Inc., whose operating business was discontinued as of December 31, 2006. The component to be discontinued constitutes a geographical area or segment as defined in IAS 14 ("Segment Reporting"), which means that the requirements of IFRS 5 regarding both the identifiability of the given operations and their delineation from ongoing operations have been met.

The income and expenses attributable to discontinued operations are as follows:

	2006 K€	2005 K€
Revenue	10,610	20,060
Cost of Sales	–9,964	– 16,423
Selling and distribution expenses	– 2,118	– 1,577
Marketing expenses	– 1,498	– 3,348
Administrative expenses	– 996	– 2,069
Other income	156	256
Other expenses	– 539	– 880
Finance income	0	0
Finance costs	– 1,744	– 1,012
Result from discontinued operations before income taxes	– 6,093	– 4,993
Income taxes on discontinued operations	– 54	– 1,906
Result from discontinued operations	**– 6,147**	**– 6,899**

Selling and distribution expenses related to the discontinued operations contain staff costs of K€ 385 (previous year: K€ 848), as well as depreciation, amortization and write-downs of K€ 29 (previous year: K€ 125).

Marketing expenses related to the discontinued operations contain staff costs of K€ 50 (previous year: K€ 165), as well as depreciation, amortization and write-downs of K€ 5 (previous year: K€ 21).

Administrative expenses related to the discontinued operations contain staff costs of K€ 226 (previous year: K€ 282), as well as depreciation, amortization and write-downs of K€ 11 (previous year: K€ 43).

Exchange rate losses realized on transactions not directly allocable to the purchasing and sales process, as well as exchange rate losses resulting from the measurement on the closing date of the assets and liabilities arising from these events, are to be reported under other expenses. In the 2006 financial year, this resulted in exchange rate losses of K€ 483 related to discontinued operations. In the previous year, an exchange rate gain of K€ 249 was recognized in connection with discontinued operations.

Other expenses in the previous year attributable to discontinued operations mainly included adjustments of K€ 862 with regard to existing receivables from barter transactions.

Restructuring costs and one-off items resulting from the discontinued operations of Zapf Creation (U.S.) Inc. as of the end of December 31, 2006, totaled K€ 1,151 (previous year: K€ 1,642). Please also see Section B no. 1.8.

Please see the disclosures in Section B no. 1.10., with regard to income taxes on discontinued operations.

The earnings per share attributable to the discontinued operations are shown in Section B no. 1.12.

The cash flow from operating, investing and financing activities attributable to discontinued operations, is as follows:

	2006 K€	2005 K€
Cash flow from operating activities	3,441	7,184
Cash flow from investing activities	– 3	– 91
Cash flow from financing activities	–3,750	–7,602
Effects of exchange rate changes	– 53	134
Cash flow from discontinued operations	**– 365**	**– 375**

1.12. Earnings per Share

As of December 31, 2006, and as of the balance sheet date of the previous year, no options and subscription rights to purchase common shares were outstanding. This means that basic and diluted earnings per share are identical in the reporting periods.

The basic earnings per share are determined in accordance with IAS 33 ("Earnings per Share") by dividing the net profit or loss for the period by the average number of shares outstanding during the relevant period.

The calculation of the basic earnings per share is based on the following parameters:

Basic earnings per share:

	2006	2005
Net profit or loss for the period (in K€)	– 12,673	–27,720
Average number of shares outstanding (in thsds)	7,586	7,427
Earnings per Share (in €)	**–1.67**	**–3.73**

Basic earnings per share from continued operations:

	2006	2005
Result from continued operations (in K€)	–6,526	–20,821
Earnings per share from continued operations (in €)	**– 0.86**	**–2.80**

Basic earnings per share from discontinued operations:

	2006	2005
Result from discontinued operations (in K€)	–6,147	–6,899
Earnings per share from discontinued operations (in €)	**–0.81**	**–0.93**

1.13. Other Disclosures Regarding the Income Statement

Staff costs included in the operating expenses of the Zapf Creation Group totaled K€ 15,507 (previous year: K€ 20,280) in the 2006 financial year.

Staff costs by functional areas are comprised as follows:

	2006 K€	2005 K€
Sales and distribution	6,451	8,460
Marketing	1,783	2,477
Other administration	7,273	9,343
Personnel expense	15,507	20,280

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

	2006	2005
Salaried employees	297	387
Hourly workers	39	70
Employees	336	457

Expenses for defined contribution pension plans in the 2006 financial year totaled K€ 2,041 (previous year: K€ 2,826). This includes the Company's contributions to the statutory pension scheme totaling K€ 1,803 (previous year: K€ 2,520).

In the 2006 financial year, expenses under operating leases totaling K€ 3,246 (previous year: K€ 5,198) were recognized. They essentially comprised leases for IT hardware, software and passenger cars, as well as lease payments made by the Zapf Creation Group for external warehouse, office and presentation space. Please also see Section C item 1.

2. Explanation of Balance Sheet Items

2.1. Current Assets

2.1.1. Cash

Cash comprises the following items:

	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Cash on hand	40	14
Bank balances	11,670	9,339
Cash	11,710	9,353

Cash includes an offsetting of current liabilities from bank overdrafts totaling K€ 1,024 (previous year: K€ 2,087) as these represent an integral part of the Company's cash planning.

2.1.2. Trade Receivables

Trade receivables, all of which are due within less than one year, as of the balance sheet are comprised as follows:

	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Trade receivables before valuation allowance	59,771	69,525
Valuation allowance	−2,396	−1,029
Trade receivables	57,375	68,496

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

	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Domestic	1,975	2,909
Abroad	0	0
Factoring	1,975	2,909

Please also see the remarks in Section A no. 2.3.7.

2.1.3. Inventories

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

	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Goods	12,505	15,881
Raw materials and supplies	158	1,075
Inventories	12,663	16,956

The following valuation allowances were made with regard to inventories:

	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Inventories before valuation allowance	15,080	21,375
Valuation allowance	−2,417	−4,419
Inventories	12,663	16,956

Inventory and sales risks resulting from the reduced marketability of inventories are taken into account by recognizing appropriate valuation allowances.

Due to the strategic realignment of the Company's product portfolio as part of its restructuring program and after taking into account the current developments with regard to phthalates and the German ordinance on electronic scrap, merchandise that was deemed unsalable was removed from inventories as of December 31, 2005. As of December 31, 2006, remaining inventories of items containing phthalate were written off in full because goods containing phthalate may no longer be marketed in the EU as of January 16, 2007.

Valuation allowances were also recognized as of December 31, 2006, for inventories no longer included in the Company's current 2007 product range.

2.1.4. Income Tax Receivables

Income tax receivables are comprised as follows:

	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Domestic	3,357	3,368
Abroad	467	1,043
Income tax receivables	3,824	4,411

2.1.5. Other Assets

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

	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Other tax assets	1,731	2,391
Loans to members of corporate boards or employees	705	685
Advances	415	744
Barter transactions	239	300
Other	1,343	1,551
Other assets before valuation allowance	**4,433**	**5,671**
Valuation allowance on loans granted	−705	−685
Other assets	3,728	4,986

The loan of K€ 625 that was granted to a former member of the Management Board (previous year: K€ 625) and a loan of K€ 60 (previous year: K€ 60) that was granted to an employee were already written off in the 2005 financial year. The interest receivables of K€ 20 increasing the loan receivable in the 2006 reporting period were also written off as of the 2006 balance sheet date.

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

2.2. Non-current Assets

2.2.1. Property, Plant and Equipment

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

	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Land and buildings	6,230	6,682
Machinery	751	1,009
Motor vehicles, furniture and fixtures, and office	10,227	12,137
Assets under construction	267	366
Property, plant and equipment	**17,475**	**20,194**

Depreciation in the 2006 financial year totaled K€ 3,679 (previous year: K€ 4,170). Depreciation in the 2006 financial year includes impairment losses totaling K€ 59 (previous year: K€ 243).

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

Regarding the Company's operating leases, we refer to Section B item 1.13., and Section C item 1.

2.2.2. Intangible Assets

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

	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Patents, brand names and licenses	3,856	4,610
Computer software	894	1,807
Assets under construction	35	106
Intangible assets	**4,785**	**6,523**

Amortization in the 2006 financial year totaled K€ 1,656 (previous year: K€ 2,791). Amortization in the 2006 financial year does not include any impairment losses (previous year: K€ 43).

The amortization of patents, licenses and brand names is based on an useful life of five years (previous year: six years).

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

2.2.3. Other Assets

In the 2006 financial year, the other non-current assets comprise solely non-current financial assets consisting of a loan from the Company in the amount of K€ 20 (previous year: K€ 30).

All of the K€ 187 in receivables from barter transactions reported in the previous year have now been classified as current assets; please also see Section B no. 2.1.5.

2.2.4. Deferred Tax Assets

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

	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Loss carryforwards	3,672	3,715
Provisions	378	94
Inventories	78	24
Property, plant and equipment and intangible assets	65	102
Trade payables	22	0
Other liabilities	21	0
Trade receivables	4	564
Other	5	56
Deferred tax assets before offsetting	**4,245**	**4,555**
Offsetting with deferred tax liabilities	−265	−2,555
Deferred tax assets	3,980	2,000

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

2.3. Current Liabilities

2.3.1. Liabilities to Banks

The current liabilities to banks are comprised as follows:

	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Overdrafts	43,995	54,866
Current portion of non-current bank loans	21,060	6,400
Liabilities to banks	65,055	61,266

In July 2005, the Company concluded a syndicated loan agreement for a total financing volume of K€ 112,053; this agreement was originally supposed to expire on March 31, 2008. The first supplement concluded in June 2006 (effective date: May 1, 2006) shortened the term of the loan agreement in regards to certain partial loans to February 16, 2007, and April 30, 2007, respectively, and reduced the total volume of the syndicated loan to K€ 90,403. The second supplement dated November 15, 2006 (effective date) served to make further adjustments, especially in regards to the stipulated terms. Finally, the third supplement dated February 5, 2007, served to transfer the management of the syndicate from Deutsche Bank AG to Deloitte & Touche GmbH, Wirtschaftsprüfungsgesellschaft, Munich, Germany, as of February 13, 2007. The average interest rate for the drawdown in 2006 was 7.37 % (previous year: 6.39 %).

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

The following essential collateral was furnished by the Group companies included in the collateral pool in connection with the syndicated loan agreement:

- Pledge of the bank deposits of the Group subsidiaries Zapf Creation (Central Europe) GmbH & Co. KG and Zapf Creation Logistics GmbH & Co. KG
- Assignment of the receivables from deliveries of goods and other services
- Assignment of the claims from the existing trade credit insurance and from other operating insurance
- Pledge of the shares of the Group parent company Zapf Creation AG in the Group companies included in the collateral pool
- Pledge of the rights to current and future trademarks owned by Zapf Creation AG
- Chattel mortgage of current and non-current assets stored in specific places
- Encumbrance of real estate with mortgages totaling K€ 9,601 (previous year: K€ 9,601).

2.3.2. Trade Payables

Trade payables in the reporting period totaled K€ 35,616 (previous year: K€ 30,388). They are essentially comprised of vendor invoices already submitted and still outstanding as of the balance sheet date as well as obligations of the Company from sales deductions granted.

2.3.3. Income Tax Liabilities

Income tax liabilities are comprised as follows:

	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Domestic	1,245	714
Abroad	473	18
Income tax liabilities	1,718	732

2.3.4. Other Liabilities

Other current liabilities are comprised as follows:

	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Other liabilities to employees	1,630	3,031
Other taxes	1,198	1,617
Other	216	693
Other liabilities	3,044	5,341

The other liabilities toward personnel in the 2006 financial year contain severance pay of K€ 196 (previous year: K€ 1,300) in connection with personnel measures the Zapf Creation Group plans to execute; these liabilities cannot be considered a provision under IFRS criteria but must already be recognized as Other Liabilities.

2.3.5. Provisions

Provisions in the reporting period developed as follows:

	Jan. 1, 2006	Use	Reversal	Addition	Dec. 31, 2006
	K€	K€	K€	K€	K€
Returned goods	1,789	1,767	22	3,132	3,132
Restructuring	1,460	1,425	35	2,534	2,534
Others	361	361	0	707	707
Provisions	3,610	3,553	57	6,373	6,373

Returned goods

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

Restructuring

Restructuring obligations are recognized as liabilities if there is a detailed formal plan for the restructuring and the public announcement or beginning of implementation awakens a justified expectation among the affected parties that the restructuring will actually be carried out. Restructuring provisions are recognized using the value that corresponds to the best possible estimate of all costs directly related to the restructuring. The Company's restructuring obligations as of the balance sheet date contain severance pay of K€ 1,961 that the Company must pay but in regards to which no individual contracts had yet been concluded as of the balance sheet date.

Please also see the remarks in Section B no. 1.8.

Others

Other provisions concern personnel obligations, e.g. obligations arising from the granting of share-based compensation, and risk provisions for ongoing processes.

2.4. Non-current Liabilities

2.4.1. Liabilities to Banks

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

	Dec. 31, 2006	Dec. 31, 2005
	K€	K€
Non-current bank loans	0	27,460
Current portion of non-current bank loans	0	−6,400
Liabilities to banks	0	21,060

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

2.4.2. Deferred Tax Liabilities

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

	Dec. 31, 2006 K€	Dec. 31, 2005 K€
Property, plant and equipment and intangible assets	276	489
Trade receivables	39	447
Other assets	37	0
Treasury shares	0	1,106
Provisions	0	588
Trade payables	0	335
Other	89	90
Deferred tax liabilities before offsetting	**441**	**3,055**
Offsetting with deferred tax assets	−265	−2,555
Deferred tax liabilities	176	500

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

2.5. Equity

The statement of changes in equity shows the development of each item of shareholders' equity for the 2006 and 2005 financial years; it also reports on the change in outstanding shares in both the reporting period and the same period the previous year.

The individual items of shareholders' equity are explained in detail below:

2.5.1. Issued Capital

The Company's share capital is € 8,799,998.00 (previous year: € 8,000,000.00). It is divided into 8,799,998 bearer shares of no par value (previous year: 8,000,000).

In September 2006, Zapf Creation AG initiated the increase in its issued capital by issuing 799,998 new shares from the capital authorized for this purpose. The capital increase was entered in the Commercial Register on October 19, 2006.

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

Authorized Capital I

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 shareholders 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 shareholders:

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

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

If the Management Board has not availed itself of the authorization to exclude subscription rights, the subscription rights of shareholders 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.

Contingent 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 Shareholders' Meeting of April 26, 2000, under the Company's stock option plan exercise their subscription rights and if the Company does not grant treasury shares to fulfill such stock options. The new shares arising from the aforementioned exercise of stock options shall participate in the Company's profits as of the beginning of the financial year in which the shares are issued.

Contingent Capital II
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 Shareholders' Meeting of July 31, 2001, under the Company's stock option plan exercise their subscription rights and if the Company does not grant treasury shares to fulfill the stock options. The new shares arising from the aforementioned exercise of stock options shall participate in the Company's profits as of the beginning of the financial year in which the shares are issued.

Contingent Capital III

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

The Supervisory Board is authorized to amend the articles of incorporation to reflect the capital increases under Contingent Capital I (Section 5 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.

2.5.2. Capital Reserves

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

In the 2006 financial year, the Company's capital reserves increased by K€ 4,909, from K€ 8,052 to K€ 12,961. The change in the capital reserves is the result of a capital increase carried out in the reporting period, which was entered in the Commercial Register on October 19, 2006 (impact on the capital reserves: K€ 5,133), and of a reduction in the capital increase by K€ 224, which was expensed for the preparation of further capital increases during the reporting period.

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

As in the previous year, in the 2006 financial year this item includes the net profit or loss for the period and the profit brought forward.

Again, as in the previous year, there were no dividend distributions in the 2006 reporting period.

2.5.4. Other Recognized Income and Expense

As of December 31, 2006, the other recognized income results exclusively from currency translation differences recognized in equity.

The adjustments from foreign currency translation result from the translation of foreign financial statements from the respective functional currency into the Group's functional and reporting currency, the euro. The currency translation differences arising from this process are allocated directly to equity in adjustments from foreign currency translation. Following the disposal of a foreign business, the currency translation differences that have accumulated until such time are either recognized in income or included in income from disposals.

As of December 31, 2006, there was no need for offsetting entries from derivative financial instruments because the Company terminated its hedge accounting by both refinancing its liabilities to banks and substantially decreasing residual maturities. Remeasurement gains/losses from hedging transactions for hedging against interest rate risks in the form of interest rate swaps, as well as remeasurement gains/ losses from forward exchange transactions and options used as hedging instruments that had been classified as cash flow hedges, were reversed in income. This also applies to the effects of deferred taxes attributable to these amounts; deferred tax liabilities of K€ 28 were recognized as of the previous year's balance sheet date.

2.5.5. Treasury Shares

By resolution of the Annual Shareholders' Meeting dated August 29, 2006, the Company is authorized to purchase treasury shares in order to:

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

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

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

d) retire such shares.

The authorization dated August 29, 2006, is limited to a maximum of ten percent (10 %) of the Company's share capital of € 8,000,000.00 as reported at the time of the authorization and expires on February 28, 2008. The authorization to acquire treasury shares resolved in the Company's Annual Share-holders' Meeting on May 11, 2005, ends when the new version comes into force.

As of December 31, 2006, the new authorization granted by the Annual Shareholders' Meeting on August 29, 2006, to acquire treasury shares had not been exercised.

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

a) Account no. 1 serves to back the Company's stock option plan. The carrying amount as of December 31, 2006 was K€ 11,262 (previous year: K€ 11,262). As of the balance sheet date, the account included 569,593 treasury shares (previous year: 569,593). This corresponds to 6.47 % of the share capital reported as of the balance sheet date (previous year: 7.12 %).

b) Account No. 2 serves to grant shares to employees based on special performance or based on a positive development of the company's business. The carrying amount as of December 31, 2006, was K€ 96 (previous year: K€ 96). As of the balance sheet date, the account included 3,085 treasury shares (previous year: 3,085). This corresponds to 0.04 % of the share capital reported as of the balance sheet date (previous year: 0.04 %).

Gains or losses from the sale of treasury shares are recognized directly in equity. There were no changes to either deposit account in the year under review and in the previous year.

The treasury shares acquired by the Company are measured at cost and deducted separately from equity. Cost is not adjusted to fair value.

2.5.6. Share-Based Compensation Systems

True Share-price-based Compensation Systems

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

Any compensation for the waiver was contractually excluded.

Virtual Share-price-based Compensation Systems

In the 2006 financial year, a virtual share-price-based compensation system was established for the members of the Management Board of Zapf Creation AG. A total of 113,000 virtual stock options at base prices of € 7.49 and € 7.29 were allocated to these board members in 2006 under this plan; the exercise of these options is not linked to achievement of specific performance targets. At the time they exercise their options, beneficiaries are paid the difference per exercised option between the closing price of the share on its issue date and on the date the virtual stock option is exercised.

The following summary contains details regarding the number and weighted average base prices of the virtual stock options:

	2006		2005	
	Number of options	Weighted average base prices	Number of options	Weighted average base prices
	Number	€	Number	€
Options outstanding at the beginning of the reporting period	0	—	0	—
Options granted during the reporting period	113,000	7.43	0	—
Options exercised during the reporting period	0	—	0	—
Options expired during the reporting period	0	—	0	—
Options outstanding at the end of the reporting period	**113,000**	**7.43**	**0**	**—**
Options exercisable at the end of the reporting period	**0**	**—**	**0**	**—**

The consideration payable by the Zapf Creation Group in connection with this compensation system, which is determined on the basis of the stock price, must be recognized as an obligation and expensed over the term of the obligation. The obligation to be reported as of each balance sheet date reflects the newly determined fair value of the virtual options at such date. As of December 31, 2006, this obligation was K€ 318 (previous year: K€ 0); the average fair value per option outstanding as of the balance sheet date was € 2.81 (previous year: € 0.00).

The weighted average of the fair value of the virtual stock options granted during the reporting period as of the measurement date is determined using the Black-Scholes option pricing model. The calculation is based on the following assumptions:

	2006	2005
Risk-free interest rate	4.00 %	—
Expected volatility	33.01 %	—
Share price as of December 31	€ 8.90	—
Weighted average exercise price as of December 31	€ 7.43	—
Weighted average remaining life	822 days	—

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

As of December 31, 2006, the Group maintained two other virtual share-price-based compensation schemes for the members of its Management Board, as well as for executives of Zapf Creation AG and its affiliates, in addition to the compensation system that was newly established in the 2006 financial year and outlined above. The 2001/2003 Bonus Plan was set up in the 2001 financial year and the 2003/2005 Bonus Plan in the 2003 financial year.

These two additional compensation systems provide for allocation of virtual stock options to the relevant beneficiaries in several tranches pursuant to individual contracts. Depending on whether performance targets linked to the share price have been achieved and following the expiration of waiting periods contingent on the relevant tranches, the beneficiaries are paid one-time cash consideration per virtual stock option that reflects a particular percentage (20 % for the 2001/2003 Bonus Plan and 30 % for the 2003/2005 Bonus Plan) of the performance target as an additional component of their cash compensation.

With the exception of one bonus unit, the total volume of 300,000 bonus units available under the 2001/2003 Bonus Plan was utilized as of December 31, 2003. The total volume of the 2003/2005 Bonus Plan is 400,000 bonus units. The 247,774 units not granted as of December 31, 2005, were no longer available for grant as of that date as a result of the expiration the granting periods.

The following summary contains details regarding the number and weighted average exercise prices of the virtual stock options:

	2006		2005	
	Number of options	Weighted average exercise prices	Number of options	Weighted average exercise prices
	Number	€	Number	€
Options outstanding at the beginning of the reporting period	262,882	27.35	389,205	27.46
Options granted during the reporting period	0	—	0	—
Options exercised during the reporting period	0	—	0	—
Options expired during the reporting period	– 148,625	26.72	– 126,323	27.68
Options outstanding at the end of the reporting period	**114,257**	**28.18**	**262,882**	**27.35**
Options exercisable at the end of the reporting period	**0**	**—**	**0**	**—**

The exercise prices for the 114,257 virtual stock options outstanding as of December 31, 2006, range from € 24.00 to € 36.75.

The consideration payable by the Zapf Creation Group in connection with the said compensation systems must be recognized as an obligation and expensed over the term of the obligation. The obligation to be reported as of each balance sheet date reflects the newly determined fair value of the virtual options at such date.

The weighted average of the fair value of the virtual stock options granted during the reporting period as of the measurement date is determined using a binomial option pricing model. The calculation is based on the following assumptions:

	2006	2005
Risk-free interest rate	4.00 %	2.70 %
Expected volatility	33.01 %	38.00 %
Share price as of December 31	€ 8.90	€ 7.83
Weighted average exercise price as of December 31	€ 28.18	€ 27.35
Weighted expected remaining life (rounded)	1 year	2 years

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

Given the development of the share price as of the December 31, 2006, balance sheet date, there was no need to recognize a provision for staff costs (previous year: K€ 11). The provision in the amount of K€ 11 that had been set up as of the previous year's balance sheet was reversed in full in the 2006 financial year. Provisions of K€ 78 had been recognized in the 2005 financial year. The bonus units outstanding as of the balance sheet date are impaired (previous year: K€ 21).

2.6. Disclosures regarding Financial Instruments

2.6.1. Risk Management Policies and Hedging Strategies

Cash, as well as trade receivables and payables, comprise the main original financial instruments the Zapf Creation Group uses in its operating business; this is supplemented by such original financial instruments as liabilities to banks and equity instruments.

Existing risks from interest rate and foreign currency fluctuations constitute the principal risks the Zapf Creation Group encounters both in its operating business and with regard to its financing. Corporate policy is to exclude or limit these risks by concluding hedging transactions. All hedging measures are coordinated and conducted centrally at the Group's parent company. Primarily derivative financial instruments are employed as hedging measures.

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

2.6.2. Explanations of the Risks from Financial Instruments

Interest Rate Risk

Interest rate risks arise from possible fluctuations in the value of, and the resulting cash flows from, original financial instruments due to changes in market rates; this applies particularly to interest-bearing medium- and long-term receivables and liabilities subject to variable interest rates. The Zapf Creation Group employs interest rate swaps as necessary, given the market situation, to hedge its interest rate risk position.

Currency Risks

Currency risks existence in that, over time, exchange rate fluctuations change the values of items posted in foreign currency. To hedge the currency risk, the Zapf Creation Group, as a rule, uses possibilities for balancing out currency risks naturally as well as forward exchange transactions and options. These transactions and options relate to the exchange rate hedging of significant items in foreign currency from the Company's operating activities.

Liquidity Risk

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

Default Risk

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

2.6.3. Derivative Financial Instruments

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

	Dec. 31, 2006		Dec. 31, 2005	
	Nominal-volume	Market values	Nominal-volume	Market values
	K€	K€	K€	K€
Interest rate swaps (term > one year)	29,641	94	68,397	75
Interest rate swaps (term < one year)	7,100	26	0	0
Total	**36,741**	**120**	**68,397**	**75**
Option transactions (term < one year)	0	0	22,692	184

Interest Rate Risk

As of December 31, 2006, to hedge interest rate risks the Zapf Creation Group held interest rate swaps with a nominal volume of K€ 36,741 (previous year: K€ 68,397); this includes USD-denominated interest rate swaps with a nominal volume of K$ 8,750 (previous year: K$ 7,500). The decline of K€ 24,227 in the nominal volume as of December 31, 2006, as compared to the previous year, results from the sale of derivative financial instruments in the 2006 financial year.

Currency Risks

Currency risk hedges through option transactions in the 2006 financial year concerned only the US dollar (previous year: both the US dollar and the British pound sterling). As of December 31, 2006, the Zapf Creation Group did not employ any derivative financial instruments to hedge currency risks, in contrast to the previous year (K€ 22,692, including USD-denominated derivatives with a nominal volume of K$ 20,000).

3. Explanation of the Items in the Cash Flow Statement

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

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

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

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

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

With respect to collateral for existing liabilities to banks, please see Section B no. 1.11.

4. Explanation of the Items in Segment Reporting

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

The activities of the Zapf Creation Group are described in the segment reporting, taking the requirements of IAS 14 ("Segment Reporting") into account.

The structure of segment reporting in the Zapf Creation Group arises from the Group's organizational structure and takes into account its internal reporting structure, both of which are oriented on the main origin and type of the Company's risks and income. The primary reporting format is therefore determined by geographical segments. The allocation of external sales is determined by the customer's business domicile.

The segments are delineated as follows in accordance with the Company's internal controlling and reporting: Central Europe, Northern Europe, Southern Europe, Eastern Europe, the Americas, and Asia/Australia.

The delineation of the European segments is based on the following allocation of countries (significant countries):

Central Europe	Germany, Austria, Switzerland, the Netherlands and Luxembourg
Northern Europe	Great Britain, Ireland and Scandinavia
Southern Europe	Spain, France, Belgium and Italy
Eastern Europe	Russia, Poland, Czech Republic and Slovakia

As in the previous year, the Central Europe sales region was primarily supplied through the German subsidiary Zapf Creation (Central Europe) GmbH & Co. KG in the 2006 financial year. Effective January 1, 2007, sales and distribution for this region has been taken over directly by Zapf Creation AG as a result of the German sales subsidiary's integration by way of accrual into the Group's parent company. In this context, we refer to the disclosures regarding the basis of consolidation in Section A no 2.2.2.

The Northern European market is serviced by the sales company Zapf Creation (U.K.) Ltd.

The Southern European markets are supplied through our own subsidiaries Zapf Creation (España) S.L., Zapf Creation (France) S.à.r.l. and Zapf Creation (Italia) S.R.L.

As in the previous year, in the 2006 financial year goods for the Eastern European market were supplied through Zapf Creation (Polska) Sp. z o.o. and Zapf Creation (Central Europe) GmbH & Co. KG. In this geographical market segment, the sales and distribution tasks previously carried out by the German company Zapf Creation (Central Europe) GmbH & Co. KG were taken over directly by Zapf Creation AG on January 1, 2007. The liquidation of the subsidiary Zapf Creation (CZ) s.r.o., which previously was responsible for this segment, has been completed. In this context, we refer to the disclosures regarding the basis of consolidation in Section A no 2.2.2.

The subsidiary Zapf Creation (U.S.) Inc. was responsible for the entire American market in the 2006 and 2005 financial years. The active operations of this subsidiary were discontinued at the end of December 31, 2006. In this context, we refer to the disclosures regarding the basis of consolidation in Section A no 2.2.2.

The Asia/Australia region was serviced by Zapf Creation (H.K.) Ltd. in the 2006 and 2005 financial years.

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

All disclosures in segment reporting are generally subject to the same recognition and measurement methods as the consolidated financial statements of the Zapf Creation Group. Inter-segment receivables and liabilities, provisions, as well as expenses and income, are eliminated in the segment reporting consolidation column. All transactions between segments are executed at market rates. The column Other contains figures not allocable to individual segments.

The sales generated by the relevant segments are separated into internal and external sales. This item includes revenue and other segment income allocable to the relevant segment's operating business.

Segment assets include the carrying amount of the assets that have contributed to achieving the segment result and are allocable to the segments, directly or reasonably.

The item Investments reflects investments in non-current segment assets, i.e. property, plant and equipment, as well as intangible assets.

The item Segment Liabilities comprises all liabilities directly or reasonably allocable to the segments, inasmuch as they stem from the relevant segment's operating activities.

The segment result shows earnings before interest, taxes, depreciation, and amortization (EBITDA).

Depreciation and amortization includes the amount of straight-line depreciation on property, plant and equipment, and straight-line amortization on intangible assets attributable to a particular segment.

Additions to the provisions constitute the main item under non-cash expenses.

C. Other Disclosures regarding the Consolidated Financial Statements

1. Other Financial Obligations

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

	Dec. 31, 2006 K€	Dec. 31, 2005 K€
2006	—	7,444
2007	3,758	716
2008 and beyond	1,310	280
Financial obligations	5,068	8,440

As of the balance sheet date, the Company had various lease and rental agreements (operating leases). The agreements cover the use of warehouse, office and presentation space as well as the use of furniture, fixtures and office equipment in connection with the Company's operations.

The obligations stemming from non-current lease and rental agreements total K€ 2,720 (previous year: K€ 2,505). Of these, K€ 1,606 are attributable to 2007 (previous year: 2006, K€ 1,644), K€ 516 are attributable to 2008 (previous year: 2007, K€ 603), K€ 310 are attributable to 2009 (previous year: 2008, K€ 187), and K€ 288 are attributable to 2010 and later (previous year: 2009 and later, K€ 71). As in the previous year, the contractual obligations as of December 31, 2006, expired no later than in 2015.

As of the balance sheet date, the Company was a contractual partner in several license agreements with external developers in order to be able to utilize technical solutions created by these developers for its own products. Some of these agreements contain provisions for payment of a guaranteed annual minimum license payment if the license fees payable based on the sale of the licensed item remains below a certain guaranteed amount. Although these obligations exist for an unlimited period or time, they become inapplicable until final expiration of the agreement, if the license agreement is terminated prior to a specified cutoff date. The Company's annual minimum license payments totaled K€ 27 (previous year: K€ 60).

As shown below, total liabilities from purchase order commitments were K€ 2,321 (previous year: K€ 5,875), mainly from purchase commitments for goods, legal and consulting fees, as well as obligations under maintenance contracts. Contrary to the previous year (K€ 100), as of December 31, 2006, there were no purchase commitments for media services.

As of December 31, 2006, the Company had a minimum purchase obligation for goods, which is allocable to the ongoing purchasing process with suppliers in China. In this connection, the Company, beginning with the month of September of each reporting period, orders goods that are scheduled for delivery to customers in the first quarter of the respective following year. The total amount of the purchase order commitment as of December 31, 2006 was K€ 1,501 (previous year: K€ 5,153).

As of December 31, 2006, the Company had a minimum purchase commitment for legal consulting services totaling K€ 188 (previous year: K€ 369), of which K€ 158 relate to the 2007 calendar year (previous year: 2006, K€ 234). In 2008, the Company will have to pay K€ 30 for legal consulting services (previous year: 2007, K€ 113 and 2008, K€ 22). The main part of the financial obligations arising from legal consultancy services, which ends on March 31, 2008, results from a consulting agreement signed by the Company on February 12, 2005, which became effective April 1, 2005, and has a term of three years.

As of December 31, 2006, the Company had a minimum purchase commitment for maintenance services totaling K€ 136 (previous year: K€ 253) resulting from several maintenance contracts signed by the Company. Of the purchase commitment, K€ 121 relate to the 2007 calendar year, and K€ 15 relate to the 2008 calendar year (previous year: 2006, K€ 253).

As of December 31, 2006, the Company had a minimum purchase commitment for other consulting services totaling K€ 75 (previous year: K€ 0), all of which are attributable to the 2007 calendar year. Furthermore, the Company has other financial obligations arising from orders placed totaling K€ 421 (previous year: K€ 0), of which K€ 270 are attributable to 2007, K€ 116 are attributable to 2008, K€ 23 are attributable to 2009, and K€ 12 are attributable to 2010 and later.

2. Litigation

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

As in the previous year, there were no other contingent liabilities requiring disclosure as of the balance sheet date.

3. Related Party Relationships

Disclosures of relationships and business transactions with related parties, as well as of open accounts with related parties, are all subject to IAS 24 ("Related Party Disclosures").

IAS 24 defines a related party as a person capable of controlling or significantly influencing another person, either alone or together with a third party, or as a person on whom such control or significant influence can be exercised. This definition of related parties covers companies and natural persons. In our case, both the Management Board and the Supervisory Board of the Zapf Creation Group have been identified as related parties.

All transactions involving deliveries and services from and to related parties that occur in the ordinary course of Zapf Creation's business are executed at market rates.

3.1. Management Board

The total compensation of K€ 976 (previous year: K€ 820) paid to the Management Board comprises all cash compensation due, as well as all monetary benefits from in-kind compensation. It includes both fixed and variable components but excludes the one-time consideration paid to former members of the Management Board.

Below is an overview of the compensation paid to each individual member of the Management Board in the 2006 financial year:

	Short-term compensation		Share-based	Total
	Fixed compensation	Bonus	compensation	compensation
	K€	K€	K€	K€
Dr. Georg Kellinghusen	278	0	217	495
Angelika Marr	173	25	0	198
Thomas Pfau	69	25	101	195
Thomas Eichhorn	88	0	0	88
Total	608	50	318	976
Percentage in 2006		67.42 %	32.58 %	100.00 %

	Short-term compensation	Share-based compensation	Total compensation
	K€	K€	K€
Total compensation in 2005	820	0	820

On December 15, 2004, all members of the Management Board of Zapf Creation AG in office at that time signed an irrevocable waiver of their right to exercise the options they were granted under the Company's previous stock option plans. Any compensation for the waiver was contractually excluded.

In the 2006 financial year, a virtual share-price-based compensation system was established for the members of the Management Board of Zapf Creation AG. A total of 113,000 virtual stock options at base prices of € 7.49 and € 7.29 were allocated to these board members in 2006 under this plan; the exercise of these options is not linked to achievement of specific performance targets. At the time they exercise their options, beneficiaries are paid the difference per exercised option between the closing price of the share on its issue date and on the date the virtual stock option is exercised. Dr. Kellinghusen was granted 80,000 virtual options at a base price of € 7.49. Mr. Thomas Pfau was granted 33,000 virtual options at a base price of € 7.29.

The provision for obligations to be recognized as expense under the aforementioned virtual options as of December 31, 2006, was K€ 318 (previous year: K€ 0); of this amount, K€ 217 and K€ 101 were attributable to the options granted, respectively, to Dr. Kellinghusen and Mr. Thomas Pfau.

The virtual options granted to Dr. Kellinghusen will be canceled unless they are exercised by February 15, 2009. The rights granted to Mr. Thomas Pfau will be void on September 1, 2009, if none of them are exercised by that date.

In addition to the total aforementioned compensation paid to the Management Board in the 2006 financial year, one-time payments totaling K€ 313 (previous year: K€ 163) were made to former members of the Management Board, specifically, K€ 250 to Dr. Kellinghusen and K€ 63 to Ms. Angelika Marr.

One former member of the Management Board was granted a variable credit line in the maximum amount of K€ 625 (previous year: K€ 625) until December 31, 2007, of which K€ 625 was used as of December 31, 2006 (previous year: K€ 625). The agreed interest rate is 4.25 % and is fixed until December 31, 2007, the loan's due date. As in the previous year, no repayments were made in the 2006 financial year. No amount was newly extended in 2006 (previous year: K€ 125). Because of interest receivables totaling K€ 20, the total amount due to the Company increased to K€ 645 in the reporting period. The loan is secured by a mortgage in the amount of K€ 200 (previous year: K€ 200); it was written off including the interest receivables.

With respect to further disclosures regarding the plans, please see Section A no 2.3.13. and Section B no 2.5.6.

3.2. Supervisory Board

The compensation of the Supervisory Board is determined by the Annual Shareholders' Meeting, on recommendation of the Management Board and the Supervisory Board. It is regulated by Article 20 of the articles of incorporation of Zapf Creation AG. The cash compensation includes a fixed and a dividend-based component, as well as compensation linked to the long-term success of the Company.

The fixed component of the compensation paid to the members of the Supervisory Board was modified as follows by resolution dated August 29, 2006: the chairman of the Supervisory Board will be paid fixed annual compensation of K€ 35 net (previous year: K€ 28), the vice chairman K€ 26.25 net (previous year: K€ 21), and all other members of the Supervisory Board K€ 17.50 net (previous year: K€ 14). The compensation paid to Supervisory Board members who were not in office for a full financial year is pro rated in accordance with the duration of their membership on the Supervisory Board. The two Supervisory Board members Mr. Isaac Larian and Mr. Ron Brawer waived the compensation to which they are entitled under the articles of incorporation; expenses were reimbursed.

As before, under the resolution adopted May 7, 2003, the variable compensation paid to the Supervisory Board members will be € 100.00 for each € 0.01 in excess of € 0.50 in dividends per no-par value share distributed to the shareholders for the financial year just ended. In addition, the members of the Supervisory Board are entitled to annual compensation based on the Company's long-term performance. This compensation entails payment of K€ 1 per K€ 1,000 in consolidated net annual income that exceeds an average consolidated annual income of K€ 22,237 for the last three financial years. As in the previous year, in the financial year just ended no provisions for the variable component of the compensation were recognized because no payment obligation arises from the Company's performance.

The total obligation for the compensation of the Supervisory Board in the 2006 financial year was K€ 97 (previous year: K€ 88).

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

4. Events after the Balance Sheet Date

In IFRS accounting, the recording and reporting of events after the balance sheet date is governed by IAS 10 ("Events after the Balance Sheet Date").

The following significant events had occurred as of September 26, 2007, the date on which the annual financial statements are released by the Supervisory Board for publication:

As of December 31, 2006, the Group subsidiary Zapf Creation (Central Europe) GmbH & Co. KG was reintegrated into the Group parent company, Zapf Creation AG, by means of accrual; the latter assumed responsibility for the former's operating business effective January 1, 2007. Zapf Creation AG is the legal successor of Zapf Creation (Central Europe) GmbH & Co. KG. Please also see the disclosures in Section A no. 2.2.2., regarding the basis of consolidation.

On January 16, 2007, the Company announced that the Supervisory Board had appointed Mr. Jens U. Keil to the Management Board as of said date and that he would begin to serve as the chief financial officer of Zapf Creation AG effective March 1, 2007. This position had been vacant since the resignation of Dr. Georg Kellinghusen, who had served as both chairman of the Management Board and chief financial officer, on December 20, 2006.

Effective February 13, 2007, the management of the loan syndicate was transferred from Deutsche Bank AG to Deloitte & Touche GmbH, Wirtschaftsprüfungsgesellschaft, Munich, Germany, by means of a third supplement to the existing syndicated loan contract dated February 5, 2007.

In February 2007, Zapf Creation AG and MGA Entertainment (H.K.) Ltd., Hong Kong, China, signed the "Hong Kong/China Services Agreement" effective January 1, 2007. This contract governs the cooperation of the aforementioned two companies in connection with administrative activities related to procurement. In particular, this includes production planning and monitoring; merchandise and general procurement; quality assurance and quality control; logistical activities in both Hong Kong and China; as well as technical product development. The contract has a term of ten years.

On February 27, 2007, Dr. Harald Rieger, lawyer, domiciled in Bad Homburg, Germany, who had been appointed a regular member of the Supervisory Board by order dated February 12, 2007, of the Coburg Local Court, was elected chairman of the Supervisory Board. The previous chairman of the Supervisory Board, Mr. Miguel Perez-Carballo Villar, has been serving as a regular member of Supervisory Board since that date.

On May 9, 2007, the Company announced that the syndicated loan agreement for about € 90 million, which had expired on April 30, 2007, had been extended for two months until the end of June 2007.

On May 29, 2007 Zapf Creation Logistics GmbH & Co. KG and MGA International Holdings Cooperatief, the Netherlands, signed a Logistics Services Agreement. This agreement governs the provision of logistics services by Zapf Creation for the MGA Group, including, in particular, transferring, palletizing, storing, packaging, labeling, and preparing goods belonging to the MGA Group for shipment. This agreement, which runs for ten years, took effect retroactively as of January 1, 2007.

On July 20, 2007, Zapf Creation AG announced that it had reached agreement regarding the Company's long-term follow-up financing with an international banking syndicate and the major shareholders of Zapf Creation AG (MGA Entertainment, Inc. and its chief executive officer, Mr. Isaac Larian, as well as Messrs. Nicolas Mathys and Gustavo Perez).

On September 21, 2007, the existing financing agreement of July 20, 2007, was modified and replaced to the extent that the deadline agreed as a prerequisite to the agreements was changed from October 31, 2007 to November 30, 2007. Furthermore, on September 4/5, 2007, the existing financing agreement of July 20, 2007 had already been modified and replaced to the extent that the share of the capital contribution to be made by the major shareholders that was to be provided by Mr. Gustavo Perez will now also be provided by MGA Entertainment, Inc., or its chief executive officer, Mr. Isaac Larian, or companies affiliated with him. This modification was contingent upon the Federal Financial Supervisory Authority (BaFin) exempting MGA Entertainment, Inc. from the obligation to submit a takeover bid. This condition has been fulfilled in the meantime.

The financing concept calls for a new, long-term syndicated € 65 million loan. This loan is based on the condition precedent that an equity contribution of € 30 million is made by November 30, 2007 in a way to be determined by the shareholders named above (MGA Entertainment, Inc., or its chief executive officer, Mr. Isaac Larian, or companies affiliated with him, and Mr. Nicolas Mathys). Alternatively, and in part, such contribution may also be effected by way of subordinated shareholder loans. The Company's major shareholders have assured the Company in writing that they guarantee this equity contribution. For this purpose, it is initially planned to fully utilize the existing authorized capital of up to € 3.2 million. The gap between the amount thus raised and the guaranteed amount of € 30 million, which is expected to arise due to the low share price, is to be closed by way of another capital increase of the Company, which is to be carried out until November 30, 2007 by utilizing authorized capital to be approved by the next Annual Shareholders' Meeting. In addition, the possibility of utilizing treasury shares as part of the planned capital measures is also taken into consideration.

Already on July 25, 2007, the Management Board of Zapf Creation AG, with the approval of the Supervisory Board, adopted a basic resolution regarding the pending capital increase. According to the resolution, up to 3.2 million new shares are to be issued from authorized capital at an issue price of € 4.50, and shareholders will be granted a subscription right. The infusion of new equity capital is part of the concept to secure the long-term financing of the Company that has been agreed with the banks and the Company's major shareholders.

Furthermore, the shareholders mentioned above undertake to provide a bridging loan of up to € 10 million, € 7.5 million of which have already been drawn down.

The previous syndicate of banks of Zapf Creation AG has agreed to allow repayment of the loan with credit lines used in the amount of approx. € 45 million, which has been due since June 30, 2007, to be deferred until November 30, 2007. To finance peak capital needs in the course of the Company's operations, the lead manager of the new syndicate of banks has also agreed to providing interim financing of up to € 20 million until November 30, 2007. These funds can be utilized as defined and depending on the equity contributions made at such a time. All agreements are subject to the proviso that there is no material adverse change to the economic situation of the Group until November 30, 2007. Furthermore, they are subject to signature of the final documents.

The German parliament, i.e. the Bundestag and the Bundesrat, passed the 2008 Business Tax Reform Act [Unternehmenssteuerreformgesetz] by resolutions dated May 24 and July 6, 2007, respectively. From January 1, 2008, there will be a corporation tax rate of 15.00% plus a solidarity surcharge of 5.50%. The trade tax will be 12.60%. Based on the assessment bases applicable as of December 31, 2006, the application of the tax rates applicable from January 1, 2008, would result in a reduction of deferred tax assets by € 0.8 million.

New information in the 2007 financial year that primarily become known during the height of the crisis (see ad hoc releases dated May 9 and July 3) had a negative impact on the price of the shares of Zapf Creation AG. In 2007, the price fell to a low of € 4.44 per share (July 17, 2007). In the meantime, the price has recovered somewhat and was € 4.67 per share on August 31, 2007. This negative development has resulted in an impairment loss of approx. € 2.4 million with regard to the treasury shares recognized in the single-entity financial statements of Zapf Creation AG under German commercial law. This impairment loss has reduced the result of Zapf Creation AG pursuant to German commercial law accordingly. As these events are of a non-adjusting nature, they did not have an effect on the measurement of the treasury shares in the annual financial statements of Zapf Creation AG as of December 31, 2006.

5. Disclosures pursuant to Section 315a German Commercial Code

5.1. Shareholdings

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

5.2. Management Board

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

Jens U. Keil, member of the Management Board, appointed until February 28, 2010
• Finance, Capital Market, Restructuring, Human Resources, IT, Logistics and Supply Chain Operations

Thomas Pfau, member of the Management Board, appointed until August 28, 2009
• Sales, Marketing, Design and Product Development

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

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

Based on a Supervisory Board resolution of May 17, 2006, Mr. Thomas Eichhorn on May 18, 2006, was dismissed as member and chairman of the Management Board effective immediately. Mr. Eichhorn was appointed as a member of the Company's Management Board until December 31, 2007.

Based on a Supervisory Board resolution of August 28, 2006, Mr. Thomas Pfau was appointed to the Company's Management Board for a period of three years effective immediately. He is responsible for Sales and Marketing. The term of office ends on August 28, 2009.

On November 2, 2006, Ms. Angelika Marr, member of the Management Board, resigned from the Management Board effective immediately and left the Company as of that date. During her time with the Company, she was responsible for Design and Product Development. Ms. Marr was appointed as a member of the Company's Management Board until December 31, 2007. Mr. Thomas Pfau has since assumed responsibility for Design and Product Development.

On December 20, 2006, the Supervisory Board of Zapf Creation AG and Dr. Georg Kellinghusen, chairman of the Management Board and chief financial officer, reached an agreement that Dr. Kellinghusen would resign from all of his posts and leave the Company effective immediately. Dr. Kellinghusen had served as the Company's chief financial officer since February 15, 2006; he had also been appointed chairman of the Management Board on June 19, 2006. Mr. Thomas Pfau had taken over Dr. Kellinghusen's responsibilities in the interim, without serving as the Management Board's chairman.

On January 16, 2007, the Supervisory Board of Zapf Creation AG appointed Mr. Jens U. Keil as the Company's new chief financial officer for a term of three years. Mr. Keil assumed his post as of March 1, 2007, and is now responsible for Finance, Capital Market, Restructuring, Human Resources, IT, Logistics and Supply Chain Operations.

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

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

5.3. Supervisory Board

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

Dr. Harald Rieger, chairman of the Supervisory Board since February 27, 2007, regular member since February 12, 2007
- Main occupation: Lawyer
- No further offices.

Francesc Robert, vice chairman since July 28, 2006, member since May 11, 2005
- Main occupation: Chief executive officer and chairman of the Supervisory Board, Octapris Investments S.L.
- Further offices: Daren Motorsport S.L., chairman; Irbe Xarxa 2001 S.L., chairman; La Seda de Barcelona S.A., vice chairman; Nominalia Internet S.L., vice chairman; Centric Software S.L., regular member; Kroopier S.L., regular member; USAP S.A., regular member; Angels Business & Financial Corporation, chairman.

Gustavo Perez, regular member, vice chairman until July 28, 2006, member since May 11, 2005
- Main occupation: Chief executive officer, Betham Capital Investment
- No further offices.

Miguel Perez-Carballo Villar, regular member since September 14, 2005, chairman of the Supervisory Board from July 28, 2006, to February 27, 2007
- Main occupation: Chief executive officer and managing director, Norte Motor S.A., and managing director, Uria Motor S.A.
- No further offices.

Isaac Larian, regular member since August 24, 2006
- Main occupation: Chief executive officer, MGA Entertainment, Inc.
- Further offices: Hielx (USA), member of the board

Ron Brawer, regular member since August 24, 2006
- Main occupation: Executive vice president Marketing & Sales Strategic Planning, MGA Entertainment, Inc.
- No further offices.

The Company was not notified of further offices, changes in the offices listed above, or main occupations of the members of the Supervisory Board. All members of the Supervisory Board have been informed in detail regarding the disclosure requirement.

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

In a letter dated June 28, 2006, Dr. Peter Klein, regular member of the Supervisory Board since April 15, 1999, announced his resignation from the Supervisory Board effective immediately. The membership of Dr. Peter Klein was inactive from February 22, 2005, to October 17, 2005. During that time, Dr. Klein served as a deputy member of the Company's Management Board. At the time of his departure from the Supervisory Board, Dr. Klein's main occupation was that of managing partner of Klein & Partner Company GmbH. At the time of leaving the Supervisory Board, he also held the following offices: GetAhead AG, chairman.

On July 27, 2006, Mr. Martin Gruschka resigned as member and chairman of the Supervisory Board effective immediately. Mr. Gruschka was managing member of Springwater Capital LLC. In addition to this office on the Supervisory Board of Zapf Creation, Mr. Gruschka held the following offices: Fontaine Holdings Ltd., director; Medicforma AG, Supervisory Board member; SSCP Plastics Holding S.A., director; SSCP Coatings S.à.r.l., Advisory Board member; Springwater Holdings S.à.r.l., Advisory Board member; Springwater Property Holdings S.à.r.l., Advisory Board member; The Carbo Group GmbH, Advisory Board member; SWC Property S.à r.l., Advisory Board member; SWC I, Inc., Advisory Board member; SWC Research Ltd., director; MW Zander Luxembourg Holdings S.A., director; MWZ Beteiligungs GmbH, managing director.

As of July 28, 2006, Mr. Miguel Perez-Carballo Villar, regular member of the Supervisory Board until July 27, 2006, took over as chairman of the Supervisory Board. Also, as of the same date Mr. Francesc Robert has been vice chairman of the Supervisory Board. Mr. Gustavo Perez, who held this position from May 11, 2005, to July 27, 2006, has been a regular member of the Supervisory Board since July 28, 2006.

In a court order dated August 23, 2006, and issued August 24, 2006, the Coburg Local Court appointed Mr. Isaac Larian and Mr. Ron Brawer, both having their business domicile in Van Nuys, California/USA, regular members of the Supervisory Board effective immediately.

On February 27, 2007, Dr. Harald Rieger, lawyer, domiciled in Bad Homburg, Germany, who had been appointed a regular member of the Supervisory Board by order dated February 12, 2007, of the Coburg Local Court, was elected chairman of the Supervisory Board. The previous chairman of the Supervisory Board, Mr. Miguel Perez-Carballo Villar, has been serving as a regular member of Supervisory Board since that date.

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

Disclosures pursuant to Section 15a German Securities Trading Act
Attorneys for the Isaac Larian and Angela Larian Trust, a company belonging to the Supervisory Board member Isaac Larian, notified Zapf Creation AG on October 4, 2006, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on September 28, 2006, it had purchased a total of 10,000 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 8.08 per share for a total transaction volume of € 80,800.00.

Attorneys for Mr. Ron Brawer notified the Company on October 12, 2006, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on October 9, 2006, he had purchased a total of 25,000 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 7.45 per share for a total transaction volume of € 186,250.00.

Attorneys for "The Isaac Larian Qualified Annuity Trust 2004 DTD 6/30/04," a company belonging to the Supervisory Board member Isaac Larian, notified Zapf Creation AG on October 12, 2006, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on October 9, 2006, it had purchased a total of 374,999 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 7.45 per share for a total transaction volume of € 2,793,742.55.

Daxton Investing Inc., a company related to the Supervisory Board member Mr. Gustavo Perez, notified Zapf Creation AG on November 13, 2006, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on November 6, 2006, it had purchased a total of 399,999 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 7.45 per share for a total transaction volume of € 2,979,992.55.

Attorneys for the Isaac Larian Annuity Trust, a company belonging to the Supervisory Board member Isaac Larian, notified Zapf Creation AG on March 6, 2007, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on March 5, 2007, it had purchased a total of 2,000 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 9.00 per share for a total transaction volume of € 18,000.00.

Attorneys for the Isaac Larian Annuity Trust, a company belonging to the Supervisory Board member Isaac Larian, notified Zapf Creation AG on March 21, 2007, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on March 19, 2007, it had purchased a total of 751 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 8.95 per share for a total transaction volume of € 6,721.45.

Attorneys for the Isaac Larian Annuity Trust, a company belonging to the Supervisory Board member Isaac Larian, notified Zapf Creation AG on March 21, 2007, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on March 20, 2007, it had purchased a total of 3,586 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 9.05 per share for a total transaction volume of € 32,453.30.

Attorneys for the Isaac Larian and Angela Larian Trust, a company belonging to the Supervisory Board member Isaac Larian, notified Zapf Creation AG on July 23, 2007, in accordance with Section 15a German Securities Trading Act (Wertpapierhandelsgesetz) that on July 18, 2007, it had purchased a total of 119,988 shares of Zapf Creation AG stock (ISIN DE 0007806002) at a price of € 4.593 per share for a total transaction volume of € 551,104.88.

The Company was not notified of any other transactions requiring disclosure made by members of the Supervisory Board, their spouses or immediate relatives. All members of the Supervisory Board have been informed in detail regarding the disclosure requirement.

5.4. Disclosure of the Auditor's Fee

KPMG Deutsche Treuhand-Gesellschaft Aktiengesellschaft, Wirtschaftsprüfungsgesellschaft, Nuremberg, Germany, is the auditor of the consolidated financial statements of Zapf Creation AG (previous year: Rödl & Partner GmbH, Wirtschaftsprüfungsgesellschaft, Nuremberg, Germany).

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

	2006 K€	2005 K€
Audits of financial statements	192	467
Other auditing and valuation services	0	0
Tax consultancy services	0	34
Other services	621	273
Auditor's fee	813	774

5.5. Declaration of Conformity regarding the German Corporate Governance Code

The Company points out that it has issued the Declaration of Conformity for 2006 regarding the recommendations of the Government Commission German Corporate Governance Code as required by Section 161 of the German Stock Corporation Act and made this declaration permanently available to the shareholders on the Company's Web site.

6. Disclosures pursuant to Section 264b German Commercial Code

Zapf Creation (Central Europe) GmbH & Co. KG and Zapf Creation Logistics GmbH & Co. KG, both domiciled in Roedental, Germany, avail themselves of the exemption provisions of Section 264b German Commercial Code. Under this provision, the companies are exempt from preparing and publishing annual financial statements and a management report in accordance with the provisions of Section 264 ff. German Commercial Code governing stock corporations, and from having such annual financial statements and the management report audited.

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

Roedental, Germany, September 26, 2007

Jens U. Keil
Member of the Management Board

Thomas Pfau
Member of the Management Board

Group Subsidiaries

as of December 31, 2006

Company	Headquarters on December 31, 2006	Date of formation
Zapf Creation (H.K.) Ltd.	Causeway Bay, Hong Kong (in 2007: Kowloon)	Apr. 30, 1991
Zapf Creation (U.S.) Inc.	Orlando, Florida, USA	Apr. 15, 1999
Zapf Creation (France) S.à.r.l.	Limonest, France (in 2007: Rungis)	Jan. 1, 2000
Zapf Creation (U.K.) Ltd.	Corby, Northants, GB	Jan. 1, 2000
Zapf Creation (Italia) S.R.L.	Milan, Italy	July 31, 2001
Zapf Creation (Polska) Sp. z o.o.	Warsaw, Poland	Aug. 9, 2001
Zapf Creation (España) S.L.	Alicante, Spain (in 2007: Madrid)	Jan. 1, 2002
Zapf Creation (Central Europe) GmbH & Co. KG	Roedental, Germany	Mar. 24, 2003
Zapf Creation (Central Europe) Verwaltungs GmbH	Roedental, Germany	Mar. 24, 2003
Zapf Creation Logistics GmbH & Co. KG	Roedental, Germany	Mar. 24, 2003
Zapf Creation Logistics Beteiligungs GmbH	Roedental, Germany	Mar. 24, 2003
Zapf Creation Auslandsholding GmbH	Roedental, Germany	Sep. 15, 2006

The results for the 2006 accounting period and the resulting equity as of December 31, 2006, are based on IFRS.
Zapf Creation AG has held an indirect share in the Group subsidiaries Zapf Creation (U.K.) Ltd. and Zapf Creation (España) S.L. through Zapf Creation Auslandsholding GmbH, Roedental, Germany, since September 2006.

Percentage held in issued capital	Carrying amounts of Zapf Creation AG as of Dec. 31, 2006 after allowance	Net profit or loss for the period, 2006	Equity as at Dec. 31, 2006
		Local currency	Local currency
100 %	795,979.77 €	−32,053,153.78 HKD	−22,242.088.11 HKD
100 %	93.40 €	4,187,129.23 USD	−5,781,757.74 USD
100 %	0.00 €	−1,415,189.08 €	−2,604,833.25 €
100 %	0.00 €	1,305,684.41 GBP	1,405,684.41 GBP
100 %	50,000.00 €	356,315.61 €	−83,142.56 €
100 %	13,794.62 €	1,114,096.92 PLN	3,771,499.37 PLN
100 %	0.00 €	311,856.61 €	2,884,492.90 €
100 %	29,914,410.01 €	2,262,183.98 €	30,603,667.44 €
100 %	25,000.00 €	−2,012.66 €	20,209.75 €
100 %	2,965,852.09 €	713,692.78 €	2,996,884.80 €
100 %	25,000.00 €	−1,687.91 €	20,395.67 €
100 %	9,227,600.00 €	−2,000.00 €	9,223,000.00 €
	43,017,729.89 €		

Statement of Changes in Property, Plant and Equipment and Intangible Assets

from January 1 to December 31, 2006

	Cost					
	Jan. 1, 2006	Additions	Disposals	Transfers	Currency translation	Dec. 31, 2006
	K€	K€	K€	K€	K€	K€
Property, plant and equipment						
Land and buildings	13,503	13	142	0	−29	13,345
Machinery	3,914	587	31	415	−362	4,523
Motor vehicles, furniture and fixtures, and office equipment	25,736	688	1,407	53	−61	25,009
Assets under construction	366	402	0	−468	−33	267
	43,519	1,690	1,580	0	−485	43,144
Intangible assets						
Patents, brand names and licenses	7,177	0	0	0	0	7,177
Goodwill	0	0	0	0	0	0
Computer software	10,523	58	656	134	−24	10,035
Assets under construction	106	75	12	−134	0	35
	17,806	133	668	0	−24	17,247

from January 1 to December 31, 2005

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

	Depreciation/amortization						Residual values	
	Jan. 1, 2006	Additions	Disposals	Transfers	Currency translation	Dec. 31, 2006	Dec. 31, 2006	Dec. 31, 2005
	K€	K€	K€	K€	K€	K€	K€	K€
	6,821	342	22	0	−26	7,115	6,230	6,682
	2,905	1,167	1	−30	−269	3,772	751	1,009
	13,599	2,170	979	30	−38	14,782	10,227	12,137
	0	0	0	0	0	0	267	366
	23,325	3,679	1,002	0	−333	25,669	17,475	20,194
	2,567	754	0	0	0	3,321	3,856	4,610
	0	0	0	0	0	0	0	0
	8,716	902	462	0	−15	9,141	894	1,807
	0	0	0	0	0	0	35	106
	11,283	1,656	462	0	−15	12,462	4,785	6,523

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

Consolidated Segment Reporting

as of December 31, 2006

Segment Reporting by Region

	Central Europe		Northern Europe		Southern Europe		Eastern Europe		The Americas	
	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005
	K€	K€	K€	K€	K€	K€	K€	K€	K€	K€
External revenue	38,241	42,965	37,889	40,571	20,999	21,571	15,884	12,854	10,610	20,060
Internal revenue	19,407	18,730	14,828	14,555	10,705	8,152	1,504	3,075	6,248	8,000
Total segment revenue	57,648	61,695	52,717	55,126	31,704	29,723	17,388	15,929	16,858	28,060
Segment assets	53,709	71,366	16,031	19,619	22,647	24,449	3,978	3,165	8,920	14,840
Investments in property, plant and equipment and intangible assets	535	624	54	80	111	22	50	8	24	91
Segment liabilities*	21,543	24,970	7,595	10,795	18,343	12,096	3,201	2,993	3,689	11,002
Earnings before interest taxes, depreciation and amortisation (EBITDA)	4,543	4,954	3,522	3,901	604	−821	3,404	1,721	−5,139	−5,357
Depreciation/amortisation	−3,616	−5,207	−148	−190	−89	−134	−33	−67	−45	−189
Financial result	—	—	—	—	—	—	—	—	—	—
Taxes on income	—	—	—	—	—	—	—	—	—	—
Net profit or loss for the period	—	—	—	—	—	—	—	—	—	—
Non-cash expenses	2,033	1,639	452	239	986	26	195	0	173	0

* Columns “Other” and “Group” including shareholders’ equity.

Segment Reporting by Product Line

	Play and functional dolls					
	BABY born®		Baby Annabell®		CHOU CHOU	
	2006	2005	2006	2005	2006	2005
	K€	K€	K€	K€	K€	K€
External revenue from continued operations	53,689	53,041	36,269	40,958	18,116	18,850
Segment assets	53,437	58,526	36,098	45,194	18,031	20,800
Investments in property, plant and equipment and intangible assets	844	1,173	569	906	284	417

Asia/Australia		Other		Consolidation		Group total		Discontinued operations		Continued operations	
2006	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005
K€	K€	K€	K€	K€	K€	K€	K€	K€	K€	K€	K€
3,093	2,696	0	0	0	0	126,716	140,717	10,610	20,060	116,106	120,657
61	54	0	0	−52,753	−52,566	0	0	0	0	0	0
3,154	2,750	0	0	−52,753	−52,566	126,716	140,717	10,610	20,060	116,106	120,657
7,337	14,868	108,801	82,818	−105,865	−97,989	115,560	133,136	—	—	—	—
1,047	1,844	0	0	0	0	1,823	2,669	—	—	—	—
7,260	8,418	110,506	129,687	−56,576	−66,825	115,560	133,136	—	—	—	—
1,696	1,391	−8,140	−15,145	0	0	490	−9,356	−4,304	−3,792	4,794	−5,564
−1,404	−1,174	0	0	0	0	−5,335	−6,961	−45	−189	−5,290	−6,772
—	—	—	—	—	—	−8,050	−6,801	−1,744	−1,012	−6,306	−5,789
—	—	—	—	—	—	222	−4,602	−54	−1,906	276	−2,696
—	—	—	—	—	—	−12,673	−27,720	−6,147	−6,899	−6,526	−20,821
0	0	6,386	1,460	−3,852	0	6,373	3,364	—	—	—	—

Other play and functional dolls		Mini dolls		Other products		Group total		Continued operations	
2006	2005	2006	2005	2006	2005	2006	2005	2006	2005
K€	K€	K€	K€	K€	K€	K€	K€	K€	K€
799	1,304	2,761	1,610	4,472	4,894	—	—	116,106	120,657
795	1,439	2,748	1,777	4,451	5,400	115,560	133,136	—	—
13	29	43	36	70	108	1,823	2,669	—	—

Auditor's Opinion

We have audited the consolidated financial statements comprising the balance sheet, income statement, statement of changes in equity, statement of cash flows and notes to the financial statements, of Zapf Creation AG, Roedental, and their report on the position of the Company and the Group for the business year from January 1 to December 31, 2006. The preparation of the consolidated financial statements and group management report in accordance with IFRSs, as adopted by the EU, and the additional requirements of German commercial law pursuant to § 315a (1) HGB are the responsibility of the Company's management. Our responsibility is to express an opinion on the consolidated financial statements and the group management report based on our audit.

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

Our audit has not led to any reservations.

In our opinion, based on the findings of our audit, the consolidated financial statements comply with IFRSs, as adopted by the EU, and the additional requirements of German commercial law pursuant to § 315a (1) HGB and give a true and fair view of the net assets, financial position and results of operations of the Group in accordance with these requirements. The group management report is consistent with the consolidated financial statements and as a whole provides a suitable understanding of the Group's position and suitably presents the opportunities and risks of future development.

Without qualifying this opinion, we refer to the comments in the management report. There it is stated in the section on "financing risks" that the continuation of Zapf Creation AG, Roedental, and therefore also of the Group as a going concern is dependent on the implementation, as agreed, of the longterm financing concept agreed on July 20, 2007 and modified on September 21, 2007. This foresees primarily the provision of a syndicated loan of € 65 million by a new banking syndicate, on condition that an equity injection of € 30 million guaranteed by the main stockholders has been carried out by November 30, 2007. In the event that the injections of capital or other financing by the main stockholders do not result in the expected inflow of funds, are not carried out or are carried out late, the promise of the new banking syndicate of a syndicated loan of € 65 million would be void or would at least have to be re-negotiated. Based on the current status, Zapf Creation AG, Roedental, and the Group would in this event not be adequately funded. In this event, the continuation of the Company as a going concern would be jeopardized. Moreover, it is possible, in the event of further losses, that Zapf Creation AG, Roedental, and the Group would also have insufficient equity. Furthermore, the financial ratios agreed with the banks must be complied with. On account of these matters, the equity and liquidity situation represent risks to the continuation of Zapf Creation AG, Roedental, and the group companies as a going concern.

Nuremberg, Germany, September 26, 2007

KPMG Deutsche Treuhand-Gesellschaft
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

Kozikowski
Wirtschaftsprüfer
(Independent auditor)

Herr
Wirtschaftsprüfer
(Independent auditor)

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

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

Income Statement

for the Financial Year from January 1 to December 31, 2006

	2006 €	2005 €
1. Sales	497,330.24	458,585.60
2. Cost of sales	−504,172.34	−396,636.58
3. Gross profit (loss)	**−6,842.10**	**61,949.02**
4. Distribution costs	−6,361,511.59	−8,563,646.67
5. General administration expenses	−11,150,549.69	−11,174,780.55
6. Other operating income	22,084,455.49	17,711,568.19
7. Other operating expenses	−4,027,914.69	−19,771,488.52
8. "Income from investments	3,000,000.00	10,207,303.01
– of which from affiliated companies: € 3,000,000.00 (previous year: € 10,207,303.01)"		
9. "Income from lending financial assets	711,960.01	62,829.10
– of which from affiliated companies: € 711,960.01 (previous year: € 62,829.10)"		
10. Income from investments in cooperative societies	0.00	33.15
11. "Other interest and similar income	620,611.02	1,456,571.92
– of which from affiliated companies: € 180,395.38 (previous year: € 1,342,622.75)"		
12. Write-downs on financial assets and marketable securities	0.00	−13,827,578.11
13. "Interest and similar expenses	−5,416,637.78	−6,055,873.27
- of which payable to affiliated companies: € 685,310.55 (previous year: € 339,653.25)"		
14. Profit on ordinary activities before taxes	**−546,429.33**	**−29,893,112.73**
15. Extraordinary profit (loss)		
– of which income: € 9,113,946.15 (previous Year: € 0.00) – of which expense: € 15,002,047.41 (previous Year: € 4,145,700.17)	−5,888,101.26	−4,145,700.17
– of which from affiliated companies: € 3,851,685.20 (previous year: € 0.00)		
16. Taxes on income	−789,910.56	−718,820.29
17. Other taxes	−11,735.51	−16,718.04
18. Net loss	**−7,236,176.66**	**−34,774,351.23**
19. Loss brought forward/Retained earnings brought forward	−6,441,259.69	24,450,334.70
20. Transfer to reserve for treasury shares	−612,765.46	0.00
21. Withdrawal from/transfer to reserve for treasury shares	0.00	3,882,756.84
22. Accumulated deficit	−14,290,201.81	−6,441,259.69

Balance Sheet

as of December 31, 2006

		Dec. 31, 2006		Dec. 31, 2005
	€	€	€	€
Assets				
A. Fixed assets		73,998,105.41		38,279,584.66
I. Intangible assets				
1. Concessions, patents, licenses, trademarks and similar rights and assets	4,018,119.15		5,271,372.24	
2. Prepayments	36,684.99	4,054,804.14	106,583.19	5,377,955.43
II. Property, plant and equipment				
1. Land and buildings	406,174.20		415,186.20	
2. Plant and machinery	4.00		4.00	
3. Fixtures, fittings, tools and equipment	786,879.50		1,100,288.50	
4. Prepayments and assets under construction	8,378.85	1,201,436.55	8,378.85	1,523,857.55
III. Financial assets				
1. Investments in affiliated companies	43,017,729.89		31,163,169.02	
2. Loans to affiliated companies	25,703,874.83		184,342.66	
3. Investments in cooperative societies	260.00		260.00	
4. Other loans	20,000.00	68,741,864.72	30,000.00	31,377,771.68
B. Current assets		23,998,984.64		66,717,377.64
I. Inventories				
1. Finished goods and merchandise	388.49	388.49	5,833.89	5,833.89
II. Receivables and other assets				
1. Accounts receivable	0.00		2,215.95	
2. Amounts owed by affiliated companies	14,433,780.35		57,703,045.25	
3. Other assets	3,079,571.09	17,513,351.44	4,187,603.27	61,892,864.47
III. Securities				
Treasury stock		5,096,834.20		4,484,068.74
IV. Cash at bank and on hand		1,388,410.51		334,610.54
C. Prepaid expenses		236,547.08		110,196.28
Total assets		98,233,637.13		105,107,158.58

	Dec. 31, 2006 €	€	Dec. 31, 2005 €	€
Liabilities				
A. Shareholders' equity		14,091,617.49		15,367,809.05
I. Subscribed capital		8,799,998.00		8,000,000.00
Nominal value of contingent capital € 3,200,002.00				
II. Capital reserves		14,484,987.10		9,325,000.00
III. Revenue reserves				
Reserve for treasury stock		5,096,834.20		4,484,068.74
IV. Unappropriated surplus		–14,290,201.81		–6,441,259.69
B. Accruals		13,718,344.09		5,687,602.71
1. Tax accruals	1,208,000.00		690,000.00	
2. Other accruals	12,510,344.09	13,718,344.09	4,997,602.71	5,687,602.71
C. Payables		70,423,675.55		84,051,746.82
1. Due to banks	52,208,295.22		63,012,861.21	
2. Accounts payable	1,561,155.86		1,410,835.42	
3. Payables to affiliated companies	16,622,367.11		19,628,050.19	
4. Other payables including	31,857.36	70,423,675.55	0.00	84,051,746.82
– of which from taxes: € 30.853.86 (previous year: € 0.00)				
– of which from social security: € 1,003.50 (previous year: € 0.00)				
Total liabilities		98,233,637.13		105,107,158.58

Financial Calendar

Date	Event	Place
October 2, 2007	Annual Report 2006 in PDF format on the website	
October 2, 2007	Results Q2/half-year 2007	
November 8, 2007	Results Q3/9 months 2007	
November 12, 2007	German Equity Forum	Frankfurt/Main
November 2007	8th Annual Shareholders' Meeting	Roedental

Contact

Published by:
Zapf Creation AG
Moenchroedener Strasse 13
96472 Roedental, Germany

Phone: +49 (0) 9563/72 51-0
Fax: +49 (0) 9563/72 51-116
E-mail: info@zapf-creation.de
Internet: www.zapf-creation.com

Text:
Zapf Creation AG, Roedental
Frank Elsner Kommunikation für Unternehmen GmbH, Westerkappeln

Concept, Consulting and Realization:
CAT CONSULTANTS GmbH & Co., Hamburg

Contact Investor Relations:
Jens U. Keil (CFO)
Phone: +49 (0) 9563/72 51-513
E-mail: investor.relations@zapf-creation.de

Contact Press:
Frank Elsner Kommunikation für Unternehmen GmbH, Westerkappeln
Phone: +49 (0) 5404/9192-0
E-mail: office@elsner-kommunikation.de

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

...come and join us!

Zapf Creation AG
Moenchroedener Strasse 13
96472 Roedental
GERMANY

Phone: +49 (0) 9563/72 51-0
Fax: +49 (0) 9563/72 51-116
E-mail: info@zapf-creation.de
Internet: www.zapf-creation.de