

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 (Aktengesetz), 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.