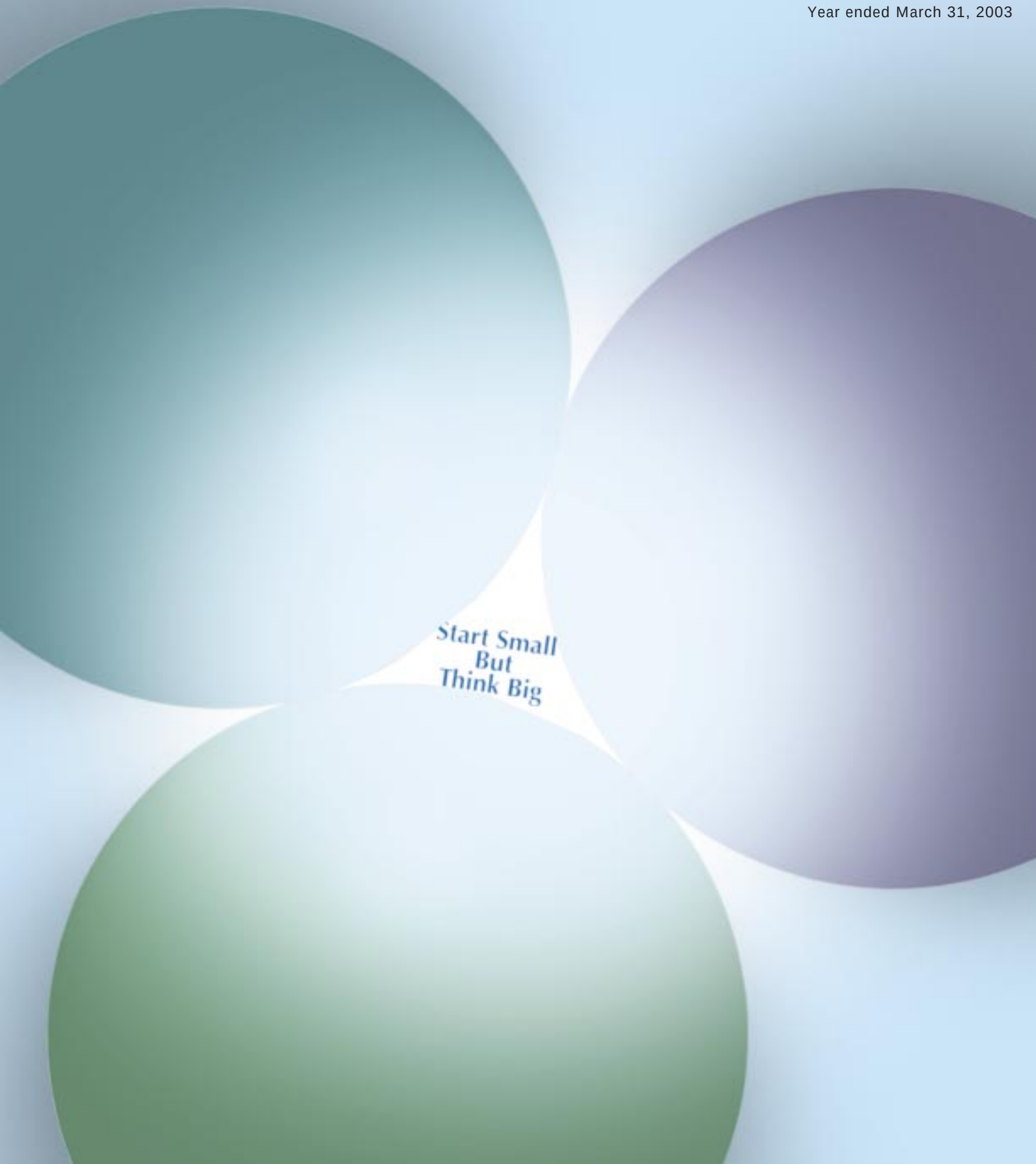
KOBAYASHI
PHARMACEUTICAL CO., LTD.

ANNUAL REPORT 2003

Year ended March 31, 2003



“Start small but think big”

is the concept underlying Kobayashi Pharmaceutical’s cultivation of niche markets.
Our strategy involves identifying completely new markets or tiny existing ones, introducing innovative products and services into these niches, and then expanding the markets by commercializing a stream of hit products. This strategy, the source of several blockbuster products, is the engine of Kobayashi Pharmaceutical’s growth.

Out-of-the-box thinking and a speedy development system will enable us to keep on creating new markets fulfilling the increasingly diversified needs of sophisticated contemporary consumers.

Contents

Forward-looking Statements
Plans and strategies concerning future business performance included in this annual report are forward-looking statements based not on historical facts but on management’s assumptions and beliefs in the light of the information currently available to it, and include risk and uncertainty.

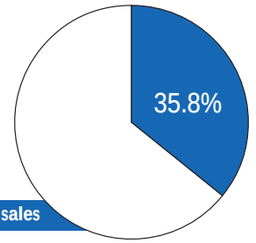
Profile

Ever since Kobayashi Pharmaceutical first opened for business in 1886, our management policy has been to provide people and society with wonderful comfort through “Creativity and Innovation”. Over the years the Company has expanded its scope, developing into a cluster of enterprises with three principal businesses: Consumer Products Operation, Wholesale Operation and Medical Devices Operation. In the fiscal year ended March 31, 2003, we achieved increases in sales and profits for the fifth consecutive year since the introduction of consolidated accounting.

Three principal businesses

Consumer Products Operation

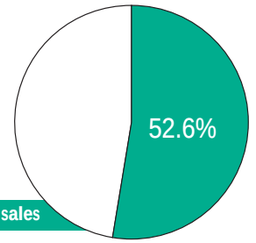
The Consumer Products Operation develops, manufactures and sells in-house products in seven categories such as OTC drugs, deodorizing air fresheners, sanitary products, etc. By developing products that create new markets and fostering existing brands, this operation is powering Kobayashi Pharmaceutical’s growth.



Component ratio of sales

Wholesale Operation

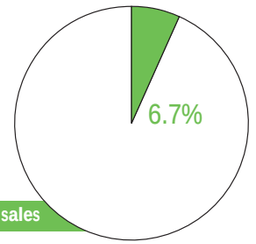
The Wholesale Operation, the origin of Kobayashi Pharmaceutical, supplies OTC drugs, contact lens care products, daily sundries, etc. to pharmacies and drugstores. We are the second largest wholesaler of OTC drugs in Japan.



Component ratio of sales

Medical Devices Operation

The Medical Devices Operation, the third pillar of Kobayashi Pharmaceutical, procures overseas cutting-edge medical devices for sale in Japan and markets medical supplies in the United States for care in the home.



Component ratio of sales

Development of profit-boosting products and services plus rigorous cost cutting lift operating income 16.3%

Fiscal year ended March 31, 2003, was defined by continuing deflationary pressure and lackluster personal consumption. Kobayashi Pharmaceutical responded decisively to this challenging business environment by tenaciously executing reforms to secure increases in both sales and profits. As a result, sales and profits rose for the fifth consecutive year since we introduced consolidated accounting. The outstanding achievement in the fiscal year under review was a remarkable rise in operating income. Spurred by introduction of our new management index, KOVA, we focused on reducing manufacturing costs to lift profits. The result attests to the wisdom of this approach.
Pursuing sustainable growth far into the future, we will maintain the speed of reform.

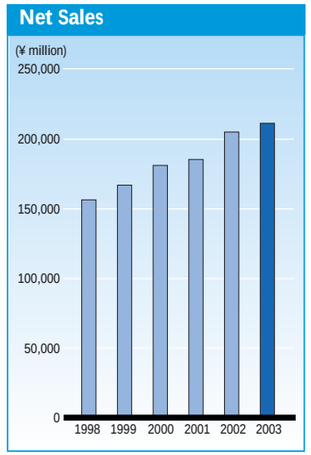
Note: KOVA is a management index unique to Kobayashi Pharmaceutical and calculated by subtracting 5% of capital costs from operating income after tax.

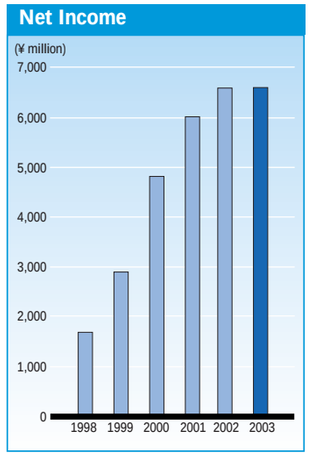
President and CEO
Kazumasa Kobayashi

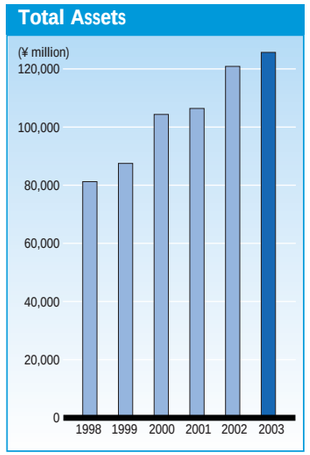
Consolidated Financial Highlights

Years ended March 31	Millions of yen 2003	Millions of yen 2002	% Change	Thousands of U.S. dollars 2003
For the Year				
Net Sales	**¥ 210,922**	¥ 204,647	3.1%	**$ 1,757,683**
Operating Income	**15,853**	13,630	16.3	**132,108**
Net Income	**6,606**	6,595	0.2	**55,050**
Per Share Data				
Net Income (Yen)	**231.25**	232.64	-0.6	**1.93**
Shareholders' Equity (Yen)	**1,748.66**	1,567.12	11.6	**11.78**
At Year End				
Total Assets	**125,680**	120,855	4.0	**1,047,333**
Shareholders' Equity	**49,267**	44,428	10.9	**410,558**
Ratios				
ROA (%)	**5.4**	5.8	-0.4	
ROE (%)	**14.1**	15.9	-1.8	

Note: U.S. dollar amounts have been translated from yen, for convenience only, at the rate of ¥120 = U.S. $1, the approximate Tokyo Foreign Exchange Market rate as of March 31, 2003.







Resurgence in sales of deodorizing air fresheners, our mainstay products

Consolidated net sales for the year under review were ¥210,922 million, up 3.1% from the previous year. The Wholesale Operation contributed most to this increase, lifting its sales 7.4% to ¥125,858 million.
Consumer Products Operation's sales, the source of the lion's share of profits, were ¥85,559 million, 1.8% higher year on year. Of the Company's seven product categories, four–deodorizing air fresheners, oral hygiene products, nutritional supplements, and body warmers–enjoyed higher sales. Especially significant was a 1.2% rise in sales of deodorizing air fresheners, the Company's mainstay products, a welcome turnaround after the previous year's drop in sales. Our drive to increase sales in the face of weak personal consumption and fierce price competition was ultimately successful. In a concerted effort to achieve higher sales, we implemented a raft of measures targeting new product development and more astute marketing. The fact that these measures had positive impacts renewed our confidence. Another promising development was the robust revenue growth from the two businesses we are fostering: the nutritional supplement food business launched in May 1999 and the body warmers marketed by subsidiary Kiribai Chemical Co., Ltd. acquired in June 2001.
Despite this progress, we need to do even better. Specifically, the ratio of new product sales to total sales reveals that the Consumer Products Operation's performance is not yet what I want it to be. Sales of new products launched during the year ended March 31, 2003, generated 11.4% of the Consumer Products Operation's total sales, satisfying our benchmark of 10% or higher. However, the ratio of the sales of products launched during the last four years to the operation's total sales was 33.0%, short of our benchmark of 35% or higher. Essentially, the Consumer Products Operation's growth strategy is to create new markets seeded by new products that address needs previously unmet. And then to continuously drive sales and profits upward by expanding the markets we pioneered. The fact that the contribution from sales of new products released during the last four years fell short of the target shows us that we still have a great deal to accomplish.

Cutting the Consumer Products Operation's manufacturing costs led to higher operating income

Operating income for the year under review soared 16.3% year on year to ¥15,853 million. All three segments recorded increased profits, with the Wholesale Operation moving into the black figure. The Consumer Products Operation did the heavy lifting, increasing its operating income 7.8% to ¥14,438 million and generating 91% of the Company's operating income for the fiscal year.

As a result of the Manufacturing Company's concerted efforts to improve the KOVA management index by cutting manufacturing costs, the cost to sales ratio was 1.7 percentage points or ¥1.4 billion lower than the previous year. I consider this reduction in manufacturing costs to be our greatest achievement during the term. Also, we succeeded in cutting selling, general and administrative expenses by implementing a highly efficient advertising strategy focused on those brands for which the biggest bang for the advertising costs can be expected.
Net income was ¥6,606 million, up 0.2% from the previous year, as proceeds form sale of investment in an affiliate declined due to our withdrawal from the Kobayashi Sofamor Danek Co., Ltd. joint venture and increased expenses associated with withdrawal from the employees' pension fund. Return on equity was 14.1%, slightly lower than the targeted 15%.

Growth strategies advance on two fronts

Since deflationary pressure and weak personal consumption will likely persist, we are not expecting a dramatic upturn in Kobayashi Pharmaceutical's business environment. In these circumstances, we are stepping up efforts to achieve our management goal of continuously increasing sales and profits. By unleashing the spirit expressed in our management policy of "Creativity and Innovation", we are determined to keep on innovating our path to success.
To achieve sustainable growth, while maintaining the Consumer Products Operation's position at the heart of our business, we pursue growth strategies on two fronts.
The first strategy aims to expand our operations, that is, to drive sales upward. We will reinforce the foundation of our existing businesses by strengthening new product development. Faithful to the "Creativity and Innovation" policy that has underpinned Kobayashi Pharmaceutical's development to date, we intend to innovate our path to success, and this will translate into the achievement of continuous sales growth. Specifically, we will adopt a more selective approach to new product development, aiming to enhance product quality and sharpen the focus of investment in marketing so as to increase sales and improve the ratio of the contribution of new products to net sales as well as the ratio of the contribution of products introduced in the last four years to net sales. While reinforcing the fundamentals of the existing businesses, we will maintain our efforts to enlarge product coverage through M&A and to expand markets by advancing overseas.
The aim of the second strategy is to achieve growth in profits by paring manufacturing costs while injecting greater efficiency into sales and marketing. In the year under review, the steps we took to cut manufacturing costs bore fruit. As well as redoubling our efforts on this front, we intend to tighten our investment focus on high-return businesses by emphasizing the cost of capital in order to improve KOVA. Efficient utilization of advertising expenditures through a more selective approach to new products, timely introduction of upgraded products, and integration of production systems overseas are expected to improve the overall efficiency of sales and marketing.
Moreover, in the Wholesale Operation, we intend to expand sales through M&A and improve operational efficiency by harnessing IT. Plans call for the Medical Devices Operation to make a greater contribution to the Company's performance in terms of both sales and profits through expanded procurement of new orthopedic products, a category with great growth potential, and in-house development, including OEM, of orthopedic, anesthetic, and respiratory products.

Corporate governance structure

Kobayashi Pharmaceutical's management is absolutely committed to enhancing shareholder value. Accordingly, management is endeavoring to swiftly disclose accurate information and achieve transparency.
Optimizing the number of directors, introducing the executive officer system and adopting the in-house company system are among the major steps we took in 2000 to reshape management. The aim is to vitalize the board of directors and put in place systems and procedures to facilitate swift decision-making and strengthened functions for execution of operations.
The board of directors meets monthly and also holds extraordinary meetings as necessary, in order to decide on issues relating to laws and regulations and critical management issues, as well as to supervise the execution of operations.
At present, the Company has no outside directors because people who have an excellent understanding of the Company's management philosophy and are able to put it into practice are making decisions from their vantage point at the forefront of the business. Meanwhile, the Company is enhancing the auditor system.
In April 2003, the Company established the Compliance Committee, chaired by an executive vice president with the aim of thoroughly implementing and reinforcing the principle of legal compliance in the Company's activities.

Stressing corporate brand management

In order to accomplish the key management objective of maximizing enterprise value, Kobayashi Pharmaceutical is stressing corporate brand management in a bid to become the first choice of consumers. Clearly, delivery of outstanding customer satisfaction is a prerequisite for success. We believe that our development of new products and services that not only fulfill consumer needs, but also deliver enriched customer satisfaction, will create a product community whose loyalty will fuel the Company's growth.
For our shareholders, we are redoubling our efforts to increase management transparency. Our basic policy on profit distribution is to ensure adequate internal reserves for high-growth-oriented business development and for strengthening the business fundamentals, while at the same time maintaining stable dividend payments.
By striving to enhance the satisfaction of our customers, shareholders, employees and all other stakeholders, we are determined to maximize enterprise value. In all these endeavors, we will be grateful for your continuing trust and support.

July 2003

President and CEO
Kazumasa Kobayashi

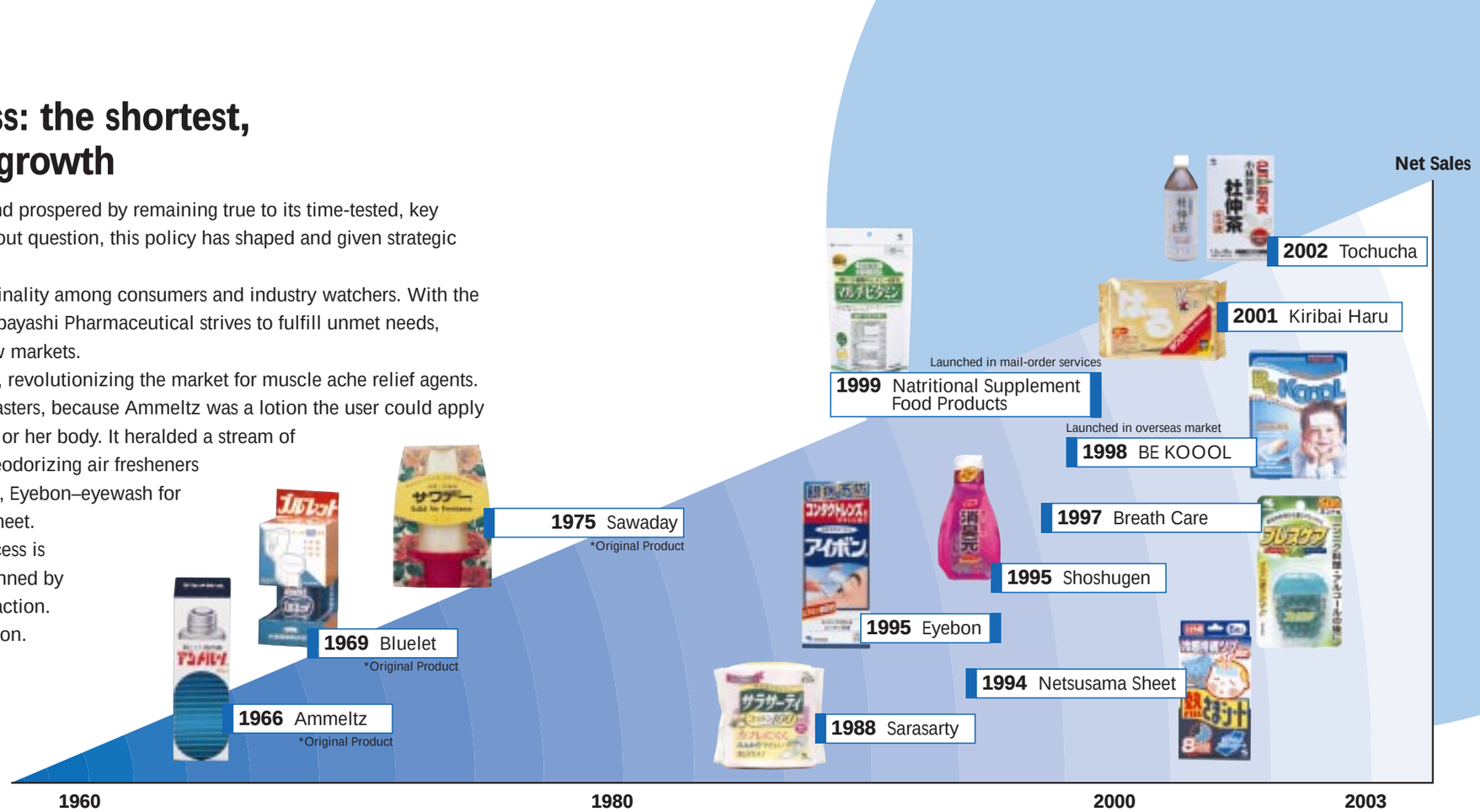
Innovating a path to success: the shortest, surest route to sustainable growth

From day one, Kobayashi Pharmaceutical has grown and prospered by remaining true to its time-tested, key management policy: “Creativity and Innovation”. Without question, this policy has shaped and given strategic thrust to the core Consumer Products Operation.

Our consumer products have won a reputation for originality among consumers and industry watchers. With the source of a stream of unique products and services, Kobayashi Pharmaceutical strives to fulfill unmet needs, deliver customer satisfaction, and create promising new markets.

Ammeltz was the first product to exhibit this originality, revolutionizing the market for muscle ache relief agents. Whereas traditional products involved cumbersome plasters, because Ammeltz was a lotion the user could apply it conveniently and effectively wherever needed on his or her body. It heralded a stream of innovative products such as Sawaday–pioneer of the deodorizing air fresheners market, Sarasarty–Japan’s first feminine protection pads, Eyebon–eyewash for contact lens users, and Netsusama Sheet–cooling gel sheet.

Experience has shown us that innovating a path to success is the shortest, surest route to sustainable growth underpinned by the consistent delivery of high levels of customer satisfaction. It’s nothing less than “Creativity and Innovation” in action.



New product development underpins growth

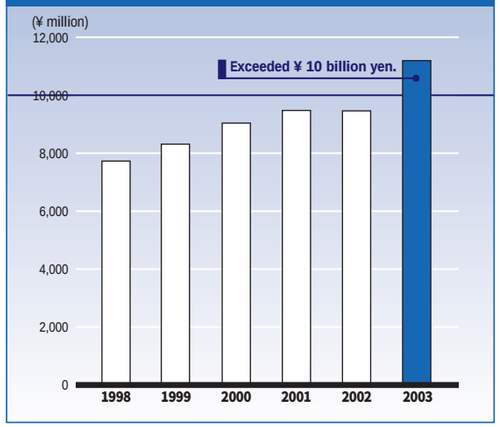
Innovative products create new markets

“Start small but think big” is the concept informing our product development. We view ourselves as a niche marketer whose ambition goes way beyond niche markets. Once a product we launch triggers a new market, other companies rush in. That’s fine because it leads to formation of a major market in which we can secure our position as the market innovator.

Good examples of our market-creating products include Bluelet deodorizing toilet bowl cleansers, Sawaday deodorizing air fresheners for toilets, and Netsusama Sheet cooling gel sheets.

New Products Launched in Autumn 2003

Sales Trend of Bluelet in the Market



Brand-based line extension fuels market growth

Having created a niche market, we have to make it bigger by identifying emerging needs and developing products attuned to the changing marketplace. Otherwise, likely scenarios are that the market we created will shrink or fall into the hands of competitors.

So we maintain the pace of development and periodically release new products with added value under the same brands. This brand-based line extension fuels market growth. For example, Bluelet deodorizing toilet bowl cleansers have grown to generate annual sales exceeding ¥10 billion under a single brand.

Something New

Something Different

Innovating a path to success sustains sales growth

The Consumer Products Operation has achieved double-digit growth in recent years. Now, with annual sales topping ¥85 billion, we are expanding sales by making new products even more attractive and through M&A.

Tighter focus on heavy-hitter new products

Kobayashi Pharmaceutical sets exacting numerical targets for new products: sales of new products released in any given fiscal year are to contribute at least 10% of total sales of the Consumer Products Operation during that fiscal year, and sales of new products released in the past four years are to contribute at least 35% of sales.

For the year under review, new products released during the year generated 11.4% of the Consumer Products Operation's sales, but the contribution of new products released in the past four years (from the year ended March 31, 2000, to the year ended March 31, 2003) was 33.0%, short of the 35% target. The main factor for this unsatisfactory result is lackluster sales of products launched in the initial three years of the four year period.

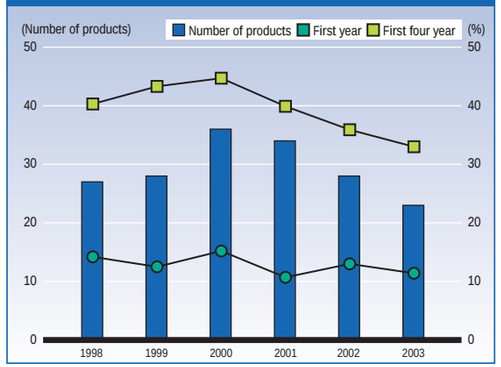
It has been suggested that the numerical targets for contributions of new products should be relaxed in view of the sheer size of the Consumer Products Operation with sales exceeding ¥85 million and rising. Nevertheless, convinced that achievement of these benchmarks is a prerequisite for sustainable growth, we have decided to retain them.

Why did the new products' contribution fall short of the target for the year under review? Our conclusion was that we had been spreading ourselves too thinly. So we are now concentrating on a select group of heavy-hitter new products capable of driving growth forward. This highly selective approach makes it possible for us to conduct more R&D and market research, both qualitative and quantitative, for each new product and concentrate on high-impact ad placement and in-store sales promotions.

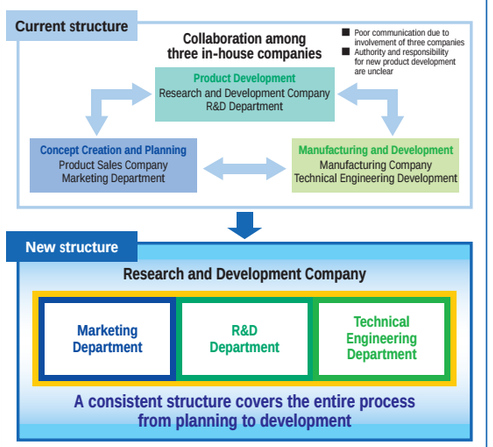
We launched seven new products in spring 2003, nine fewer than in the previous spring. The advantages of this selective approach are already evident. Most importantly, the new products are enjoying brisk sales.

Moreover, the Research and Development Company now has sole responsibility for the entire process of product development from planning onward. Previously, it was a collaborative endeavor involving the Marketing Department of the Product Sales Company, the Research & Development Department of the R&D Company, and the Technical Engineering Department of the Manufacturing Company. The new arrangement enables faster product development than the conventional structure. Also we have taken steps to maximize the impact of in-store product displays. Every month the sales personnel who create the best in-store displays are singled out for recognition (Monthly category championship). The entire sales force participates in these competitions covering all product lines. Award-winning presentations are replicated in other stores to boost sales of both new products and other lines.

Trend of New Products' Contribution



New Product Development from the Customers' Viewpoint



M&A strategy

Our "start small but think big" concept of new product development involves creating entirely new markets or championing existing tiny niche markets with good potential by introducing innovative products and then pursuing growth. This is what Kobayashi Pharmaceutical is all about. But once sales are on an upward trajectory, enhancement of investment efficiency to enrich the product line-up for the next round of sales growth becomes a vital task. From the viewpoint of investment efficiency, M&A is a promising strategy for expanding sales.

M&A at Kobayashi Pharmaceutical started in 1998 with the acquisition of the goodwill for Easy Fiber. Subsequently, we acquired White Hall Japan and Kiribai Chemical Co., Ltd. in 2001, and the goodwill for Tochucha from Hitachi Zosen Bio Corporation. in the year under review.

The brands we have gained with a high profile throughout Japan are Kimco deodorizer for refrigerators and Kiribai Haru body warmers. In contrast to our customary approach to product development that involves creation of new markets, M&A offers fast access to established brands and markets. We are building sales of these brands through value-added line extension, high-impact ad placement and nationwide sales promotions. We restrict M&A targets to brands and companies capable of generating synergies with our existing businesses.

Over the next three years, we intend to expand sales by channeling ¥20 billion of free cash flow into M&A of leading Japanese brands, American OTC and toiletry manufacturers.

Results of M&A in Consumer Products Operation

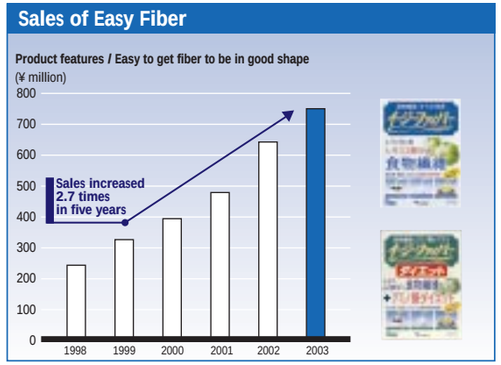
1998 Acquisition of the goodwill for Easy Fiber

2001 Acquisition of White Hall Japan
Kimco, Pretty, Aqua Filter, etc.

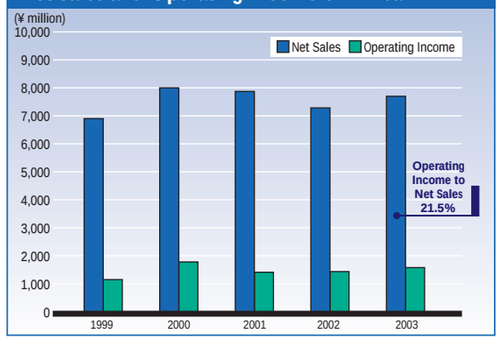
2001 Acquisition of Kiribai Chemical Co., Ltd.
Kiribai Haru (body warmer), Hand Warmer, etc.

2002 Acquisition of the goodwill for Tochucha from Hitachi Zosen Bio Corporation.

Sales of Easy Fiber



Net Sales and Operating Income of Kiribai



Innovating a path to success sustains profit growth

The Consumer Products Operation generated 91% of the Company's operating income for the year under review. For profit growth, improving the Operation's margin is a must. That's why Kobayashi Pharmaceutical is cutting manufacturing costs and making a production system work more efficiently.

Cutting manufacturing costs

Determined to achieve higher profits, we started by cutting manufacturing costs. Our measures cover improvement of productivity, including enhancement of yield, change of raw materials to less costly substitutes, adoption of the same raw materials for multiple products, review of packaging, and promotion of in-house production. These measures resulted in a ¥1.4 billion cost reduction and a 1.7 percentage points improvement in the cost to sales ratio in the year under review.

Pursuit of an efficient production system

▶ Production system in which each plant plays to its strengths

Kobayashi Pharmaceutical has ten plants, eight in Japan, including subsidiaries, and two overseas in Indonesia and China. Although regional allocation of tasks to production facilities is the common practice, in view of the Company's diverse product portfolio we have constructed a production system in which each plant plays to its strengths, that is, it specializes in the manufacture of those products for which it possesses particular advantages in terms of expertise and location.
For example, Sarasarty and other non-woven fabric-related products are manufactured at our plant in Ehime prefecture, the heartland of Japan's paper industry, whereas Eyebon, which requires a sterile production environment, is produced at our state-of-the-art Sendai plant.
Every plant acquired through M&A possesses accumulated know-how and it is efficient to deploy such a valuable asset for achievement of competitive advantage.
By having each plant do what it does best, we have established a highly effective, low-cost production system.

▶ Minimizing capital investment risks

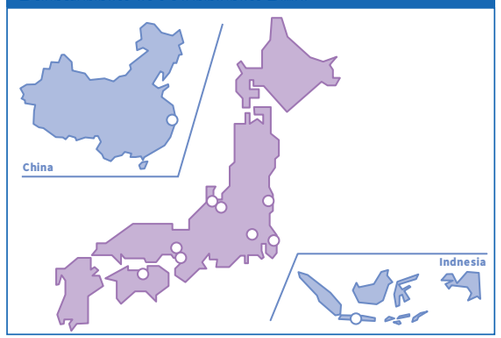
We have been introducing around 30 new products every year. In an era of rapidly changing consumer preferences, the tendency for products is to sell well for shorter periods. This makes a go it alone approach in which a company invests heavily in a host of new products too risky.
So we usually outsource production of new products whose sales are tricky to predict. While minimizing risks during the initial phase of commercialization by outsourcing, we start partial in-house production as soon as sales and profits become more predictable.

Cultivation of close relationships with subcontractors gives us the benefits of mass production without the burden of heavy investment in manufacturing. Also, with minimal time lag between product development and market debut, new products get to market much faster.

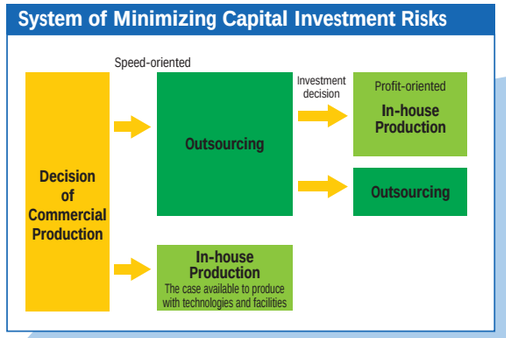
▶ Global production system to yield big gains in efficiency

Since cost competitiveness underpins growth, the Manufacturing Company is integrating production bases to enhance efficiency. To this end, we are putting together a high-performance global production system encompassing plants in Japan and overseas. For instance, because production of Bran Cologne deodorizing air freshener, a new product introduced in spring 2003, is labor intensive, it is manufactured in China where labor costs are highly competitive, for export to the Japanese market. As part of this shift to a global production system, the Chiba plant is scheduled to close in March 2004.

Distribution of Production Base



System of Minimizing Capital Investment Risks



More efficient sales and marketing

To achieve greater profits, the Company is working to enhance the efficiency of new product development and sales and marketing. We are concentrating on the following two measures.

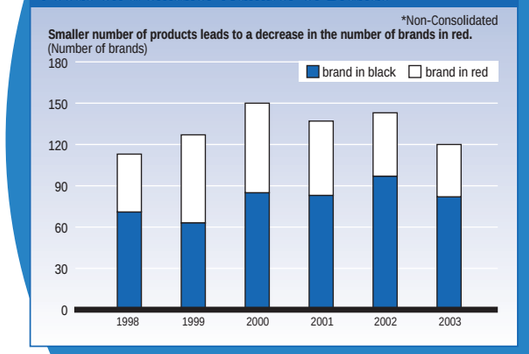
▶ Enhanced efficiency of new product development

Kobayashi Pharmaceutical has intensified product development by focusing on a smaller number of products. Previously, because our research efforts were spread too thin among too many new items, some of the products we commercialized did not take the market by storm. We have learned from that experience. Our aim is to enhance the quality of the new products we will release.
Enhanced quality requires more focused and more accurate research. Thorough evaluation of the attractiveness of new products and greater selectivity in picking those for commercialization leads to lower manufacturing costs and more concentrated deployment of advertising expenditures. The result is higher sales per brand and fewer duds.

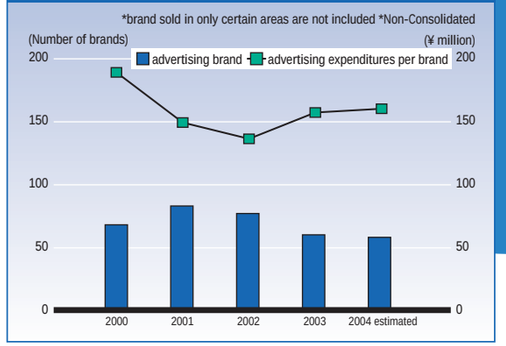
▶ Strengthened marketing at 8,300 retail outlets

We are strengthening follow-up marketing for drugstores, supermarkets and other retailers in order to secure prime shelf space. This program covers 8,300 stores accounting for more than 50% of the Consumer Products Operation's sales.
By sharing cases of excellent in-store product displays and sales promotions, our computerized sales force is helping retailers create a better environment for selling Kobayashi Pharmaceutical products.

Focus on a Smaller Number of Brands



Fewer Advertising Brands



*Examples of display

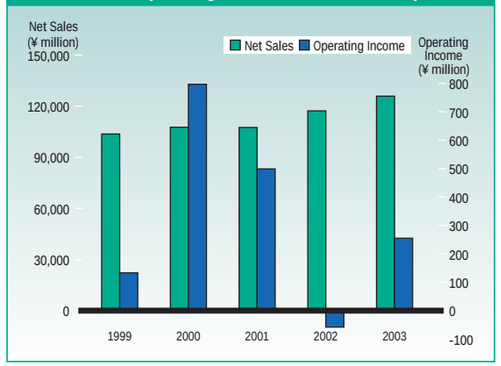
Exploit economies of scale by achieving sales of ¥300 million

Covering the Kanto, Kinki and Chugoku regions, the Wholesale Operation, comprising Kobasho Co., Ltd. and Kensho Co., Ltd., supplies OTC drugs, daily sundries and nutritional supplements food products to drugstores and other retailers. We are the second largest OTC drug wholesaler in Japan. For the year under review, sales of the Wholesale Operation were ¥125,859 million, up 7.4%, and operating income was ¥256 million, an improvement of ¥315 million from the previous year.

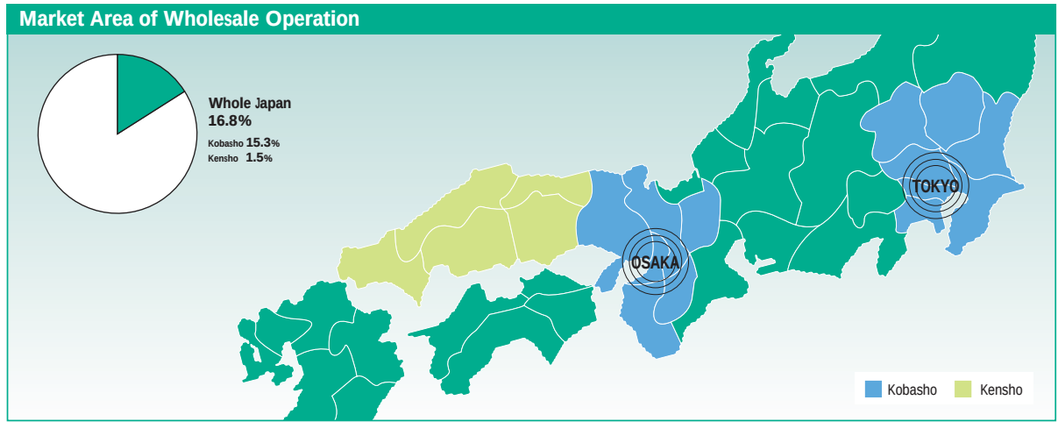
Business environment, policy and strategy

Drugstore chains, the Wholesale Operation's principal customers, as well as other customers are expanding their geographical coverage and increasingly operating nationwide. Naturally, wholesalers have to follow suit in order to retain the allegiance of their customers. Moreover, some drugstore operators have set up their own distribution centers to reduce costs. Thus, wholesalers are doing business in an increasingly challenging business environment.
Against this backdrop, targeting annual sales of ¥300 billion the Wholesale Operation is expanding its geographical reach step by step through M&A and tie-ups with other wholesalers so as to respond to customer needs and achieve economies of scale leading to improved efficiency. Also, to lift sales we are focusing on those product categories whose markets are growing the fastest. Meanwhile, to manage the operation more efficiently, we are working to improve KOVA, while to heighten efficiency of sales and marketing we are cutting the number of days required for collecting receivables and reducing the out-of-stock rate.

Net Sales and Operating Income of Wholesale Operation



Market Area of Wholesale Operation

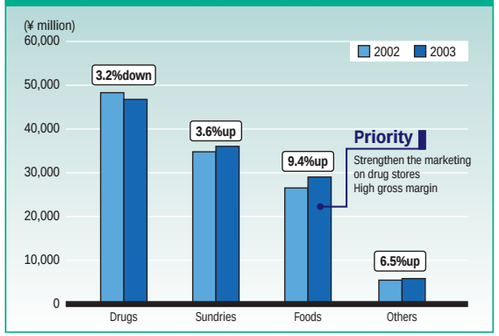


Measures and achievements in the year ended March 31, 2003, and future orientation

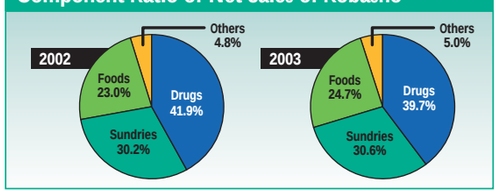
▶ M&A and tie-ups

To extend its geographical reach, in the previous year Kobayashi Pharmaceutical acquired Kensho Co., Ltd., which has a strong presence in the Chugoku region, as a subsidiary. Kobayashi Group's management streamlined Kensho's operations and increased its sales. Kensho is expected to become profitable in the year ending March 31, 2004.
In April 2003, Kobasho and three wholesalers in Shikoku, with which it formed partnerships in 2002, agreed to set up a joint venture company. The new company, scheduled to start operation in April 2004, is expected to have annual sales of ¥8 billion, making it the largest OTC drug wholesaler in Shikoku.

Breakdown of Net Sales of Kobasho



Component Ratio of Net Sales of Kobasho



▶ Strengthening marketing

We accorded priority to food products led by health foods, since their market is growing fast as drugstores step up efforts to respond to their customers' increasing preoccupation with wellness. As a result, sales of the food category grew 9.4% from the previous year. We intend to further strengthen the health foods business as well as that of contact lens care products, which are also aimed at a rapidly expanding market.

▶ Enhancement of management efficiency

From the viewpoint of cash flow-based management, we sought to reduce the number of days required for collection of trade receivables and achieved a 5-day reduction from 81 days to 76 days. We are also exploiting the potential of IT to enhance operational efficiency, as part of our ongoing efforts to increase the efficiency of marketing.

Sales and marketing support service utilizing IT "KOBA-FACE"

KOBA-FACE has two aspects: a Business Discussion System enabling our sales personnel to discuss business, whenever necessary, face-to-face with customers' personnel in charge of stores and a Conferencing System linking the Company's facilities in Japan and overseas.
Because the Business Discussion System allows sharing of data and image information on PCs, customers enjoy the benefits of high-quality support services. Also, updating of data virtually in real-time greatly facilitates prompt and accurate business negotiations.

KOBA-FACE

Expansion of the medical business centering on the orthopedic field

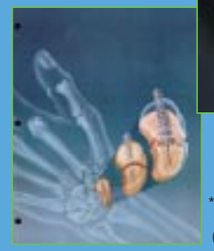
Kobayashi Medical Division of the Medical Devices Operation imports and distributes medical devices. As of March 31, 2003, we handled medical devices procured from 20 companies, 17 overseas and three in Japan. Separately, the Shield Healthcare Centers, Kobayashi Pharmaceutical's U.S. subsidiary, sell medical equipments for the treatment and care of patients in the home.
Sales of the Medical Devices Operation declined 19.2% year on year to ¥16,114 million, but operating income rose ¥388 million to ¥829 million. The drop in sales was largely a concequence of the divestiture of Kobayashi's interest in the Kobayashi Sofamor Danek Co., Ltd. joint venture, an importer and distributor of medical devices.

Business environment, policy and strategy

In Japan the great need for advanced medical technologies created by the aging society and the growing pursuit of wellness is opening up tremendous opportunities in the medical field. Having spotted the potential of the medical devices market, we established Medicon, Inc., a joint venture company with C. R. Bard, Inc. in 1972. Since then, we have been importing numerous excellent medical devices to Japan from leading manufacturers in the United States and other countries. This business has a successful track record, and following the initial heavy investment, profits have been growing.
We will continue to foster the Medical Devices Operation, a business with great potential for expansion and high profitability. For this purpose, we are stressing distribution of high quality products, beefing up marketing, and strengthening in-house product development. We will also vigorously promote M&A and other business opportunities with medical device manufacturers in Japan and overseas to enrich our product line-up.

*Impulse system for deep vein thrombosis prophylaxis (Orthofix, Ltd., UK)

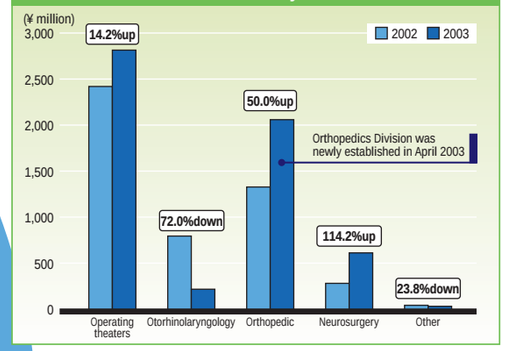
*Electric surgical unit (ConMed Corp., US)



*Headless compression screw system (Acumed, Inc., US)

Net Sales and Operating Income of Medical Devices Operation

Breakdown of Net Sales of Kobayashi Medical Division



Measures and achievements in the year ended March 31, 2003, and future orientation

▶ Strengthening marketing

We are focusing on medical devices in the orthopedic field where the pace of technology innovation is fast, creating great business opportunities. Sales of orthopedic products surged 50% year on year.
Besides the orthopedic field, we intend to introduce and cultivate products for operating theaters, otorhinolaryngology, neurosurgery, anesthesiology, and respiratory care fields.
In April 2003, the Orthopedics Division was set up within the Kobayashi Medical Division with the mission of further strengthening sales and marketing of orthopedic products.

▶ Expansion of the scope of business through M&A and other business opportunities

The market for Ceratite, bone prostheses and Neofix, synthetic bioabsorbable bone fixing devices—for which Kobayashi Pharmaceutical acquired the goodwill from Chugai Pharmaceutical Co., Ltd. in 2002 in expectation of synergies with our existing orthopedic and cranial nerve surgery products—is rapidly expanding the Medical Devices Operation's sales growth.
We intend to pursue M&A and other business opportunities to expand the scope of our business efficiently. Although at present our business model is weighted toward distribution of imported medical devices, we aim to become a medical device manufacturer through M&A targeting companies with development and manufacturing capabilities.

▶ In-house product development

We think that becoming a medical device manufacturer will place the Medical Devices Operation in a much better position to take full advantage of the business opportunities in this field. To this end, in tandem with M&A, we are promoting in-house product development.
Our target for products developed in house is to generate annual sales of ¥2 billion or more within three years. In Kobayashi Pharmaceutical's three areas of emphasis—orthopedics, anesthesiology and the respiratory care field—our aim is to develop innovative products with unique attributes, and thus fulfill unmet needs. We encourage our employees to be creative and look ahead. In return, they provide about 1,000 ideas for development themes each year.
For the time being, we will promote in-house product development in parallel with introduction of OEM products.

Products Acquired the Goodwill from Chugai Pharmaceutical Co., Ltd.

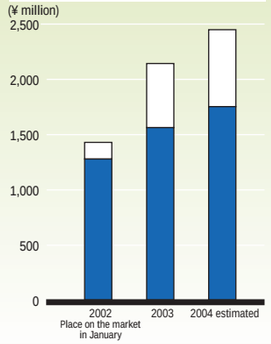
The market for bone prostheses and bone fixing devices with distinctive characteristics is growing

Expected synergy effect
▶ **Expansion of the scope of business in priority fields**
Orthopedic and neurosurgery related fields

Ceratite to compensate for damage due to skull fractures

Neofix for fixing fractures

Sales in the orthopedic field



Directors, Corporate Auditors and Officers

Left to Right: Masaaki Tanaka, Akira Horiguchi, Kazumasa Kobayashi, Yutaka Kobayashi, Yoshiharu Shimatani, Kouichi Watanabe

President and Representative Director, Chief Executive Officer
Kazumasa Kobayashi

Executive Vice President and Representative Director, Chief Operating Officer
Yutaka Kobayashi

Senior Executive Director
Yoshiharu Shimatani

Senior Executive Director
Akira Horiguchi
Executive Officer,
President, Medical Equipment Company

Senior Executive Director
Kouichi Watanabe
President and Chief Executive Officer,
Kobasho Co.,Ltd.

Director
Masaaki Tanaka
Executive Officer,
Senior General Manager,
Headquarters' Operations

Corporate Auditors
Toshiyuki Morii

Tetsuo Nakata

Tamotsu Sakota

Ikuo Hata

Executive Officers
Takashi Tsujino
President, Research and Development Company

Jyoji Miki
President, Product Sales Company

Akihiro Kobayashi
President, Manufacturing Company

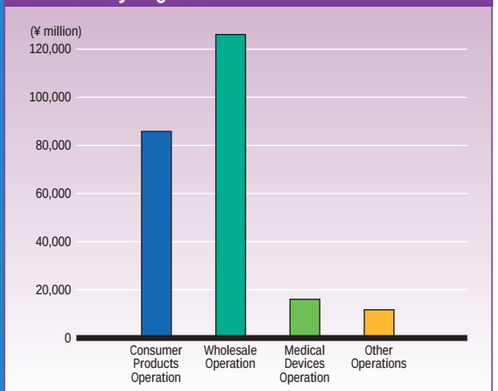
(As of June 27, 2003)

Financial Section

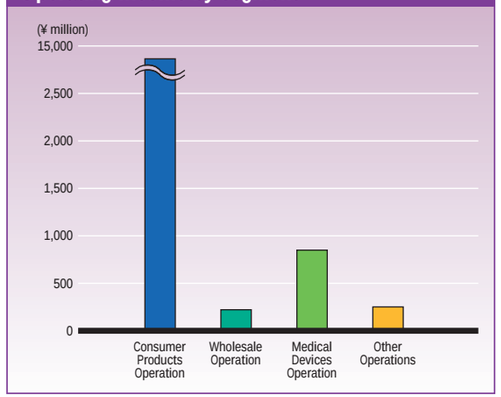
Contents

Management's Discussion and Analysis

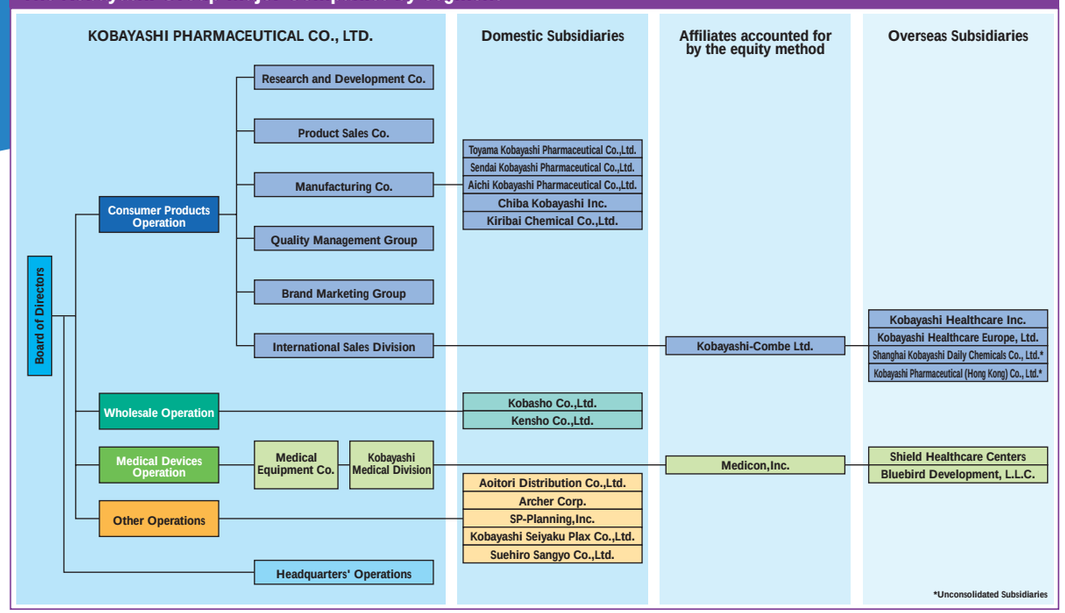
Net Sales by Segment



Operating Income by Segment



The Kobayashi Group Major Companies by Segment



Scope of Consolidation and Application of the Equity Method

Kobayashi Pharmaceutical has 19 consolidated subsidiaries (11 in Japan, 8 overseas) and 2 affiliates in Japan to which the equity method is applied. The Company classifies its business activities into four segments: Consumer Products Operation (8 consolidated subsidiaries and 1 affiliate to which the equity method is applied), Wholesale Operation (3 consolidated subsidiaries), Medical Devices Operation (5 consolidated subsidiaries and 1 affiliate to which the equity method is applied) and Other Operations (3 consolidated subsidiaries).

Overview

During the fiscal year under review, sentiment regarding the Japanese economy became gloomier. Despite indications of certain improvements in the economy at the beginning of the fiscal year, falling stock prices and sluggish private-sector capital investment persisted as the U.S. economy slowed while personal consumption remained lackluster owing to anxiety about employment and declining personal incomes.

In these trying circumstances, Kobayashi Pharmaceutical Group unleashed the spirit expressed by its management policy of "Creativity and Innovation". We cultivated potential customer needs by introducing new products and services to seed new markets while vitalizing existing markets by offering upgraded products and services. At the same time, we promoted M&A, acquisition of goodwill and overseas business development. As a result, net sales amounted to ¥210,922 million, an increase of ¥6,275 million or 3.1% from the previous year.

Regarding profits, Kobayashi Pharmaceutical Group made a concerted effort to improve the KOVA (Kobayashi Value Added) management index, which takes the efficiency of capital employed into account. As a result, operating income was ¥15,853 million, an increase of ¥2,223 million or 16.3% compared with the previous year.

A gain from the sale of equity upon withdrawal from a joint venture was reported and special contributions in connection with withdrawal from the employees' pension fund were reported as other expenses. As a result, net income was ¥6,606 million, an increase of ¥11 million or 0.2% from the previous year.

*KOVA is a management index unique to Kobayashi Pharmaceutical and is calculated by subtracting 5% of capital costs from operating income after taxes.

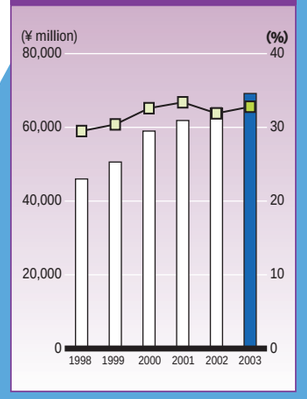
Income Statement Analysis

Consolidated net sales for the year under review were ¥210,922 million, 3.1% higher than for the previous year. Increases in sales of the Consumer Products Operation and of the Wholesale Operation as a consequence of the acquisition of Kensho Co., Ltd., which became a consolidated subsidiary in the previous year, were somewhat offset by a decline in sales of the Medical Devices Operation due to the withdrawal from the Kobayashi Sofarmor Danek Co., Ltd., a joint venture.

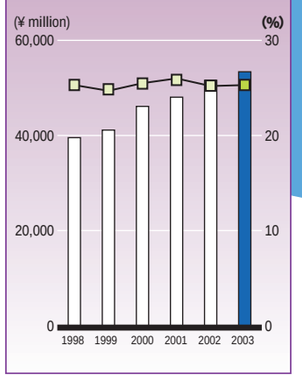
Cost of sales amounted to ¥141,675 million, up ¥2,271 million or 1.6% from the previous year. Since this increase was below the average increase of net sales, the ratio of cost of sales to net sales decreased 0.9 percentage points to 67.2%. This improvement was attributable to cost cutting at manufacturing operations and a decline in sales of Kobayashi Sofamor Danek Co., Ltd. whose ratio of gross profit to net sales was low. As a result, gross profit increased ¥4,004 million or 6.1% from the previous year to ¥69,247 million. The ratio of gross profit to net sales rose 0.9 percentage points from 31.9% for the previous year to 32.8%.

Selling, general and administrative expenses were ¥53,394 million, having increased ¥1,781 million or 3.5% from the previous year. As this increase was almost proportional to the increase in net sales, the ratio of selling, general, and administrative expenses to net sales was virtually unchanged from the previous year at 25.3%. A ¥803 million or 6.6% decrease in advertising expenditures thanks to a tighter focus on new products was offset by sales promotion expenses such as those for proposal-driven marketing.

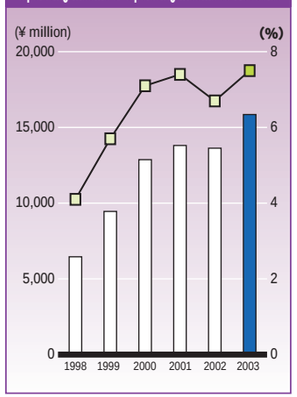
Gross Profit & GP to Net Sales



SG & A Expenses & SG & A Expenses to Net Sales



Operating Income & Operating Income to Net Sales



As a result, consolidated operating income surged ¥2,223 million or 16.3% from the previous year to ¥15,853 million. The ratio of operating income to net sales increased 0.8 percentage points from the previous year to 7.5%. The reduction in manufacturing costs at the high-margin Consumer Products Operation was the principal factor contributing to this decisive improvement. The interest coverage ratio improved from 12.3 for the previous year to 13.7.

*The above-mentioned interest coverage ratio was calculated by dividing the sum of operating income and interest and dividend income by the sum of interest expense and sales discount.

Although extraordinary losses such as special contributions associated with the withdrawal from the employees' pension fund were reported, income before income taxes and minority interests was ¥1,916 million or 17.5% increase in income before income taxes to ¥12,840 million thanks to the booking of a gain from the sale of equity in Kobayashi Sofamor Danek Co., Ltd. and other extraordinary income.

Consolidated net income was ¥6,606 million, having increased ¥11 million or 0.2% from the previous year. The improvement in net income was constrained by an 8.77 percentage points rise in the effective corporate tax rate from the previous year to 48.58% in line with the adoption of deferred tax accounting. As a result, the ratio of net income to net sales was 3.1%, having decreased 0.1 percentage points from the previous year.

Net income per share was ¥231.95, ¥1.39 or 0.6% lower than the previous year's figure.

* From the fiscal year ended March 31, 2003, the Company has adopted the "Accounting Standard for Earnings per Share" (Financial Accounting Standard No. 2) and the "Application Guidelines for the Accounting Standard for Earnings per Share" (Financial Accounting Standard Application Guidelines No. 4).

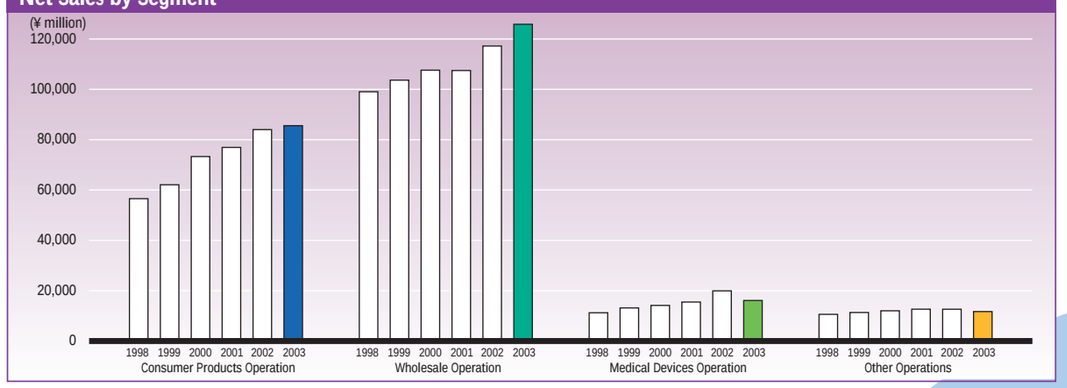
Segment Analysis

The Company's business is classified into four segments: Consumer Products Operation, Wholesale Operation, Medical Devices Operation, and Other Operations. As more than 90% of sales are recorded in Japan, this analysis does not include geographical segment information.

Internal sales and transfers among the Company's business segments are included in segment sales. These amounted to ¥29,141 million for the previous year and ¥28,316 million for the year under review.

For details of the review of operations, please see pages from 6 to 15.

Net Sales by Segment



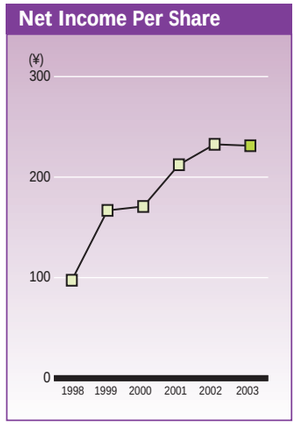
▶ Consumer Products Operation

Sales of the Consumer Products Operation increased ¥1,553 million or 1.8% from the previous year to ¥85,559 million, generating 35.8% of consolidated net sales.

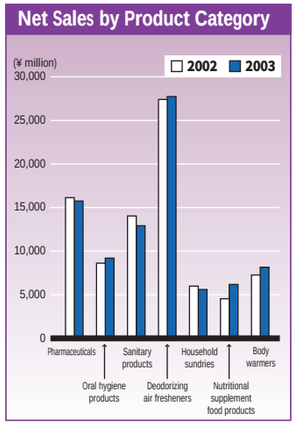
The breakdown of sales by product category reveals that sales of deodorizing air fresheners, the Company's mainstay products, staged a comeback, recording a 1.2% increase over the previous year, as beefed-up new product development, product upgrades and well-targeted marketing campaigns made substantial headway amid continuous intensifying competition. Sales of nutritional supplement food products and body warmers, two product categories we are vigorously cultivating, jumped 36.1% and 12.3%, respectively, while sales of oral hygiene products rose 6.7%. On the other hand, sales of sanitary products, household sundries and pharmaceuticals decreased 8.0%, 6.4% and 2.4% from the previous year, respectively.

Regarding profits, more efficient ad placement targeting a smaller number of key brands combined with thorough cost cutting measures led by the reduction in manufacturing costs contributed to higher income. While reducing total ad expenditures, we increased the ad expenditure per brand by adopting a more selective approach. As a result, operating income increased ¥1,041 million or 7.8% from the previous year to ¥14,438 million, generating 91.4% of consolidated operating income. The nutritional supplement food products business, launched in the year ended March 2000, became profitable in the year under review in terms of operating income.

Net Income Per Share

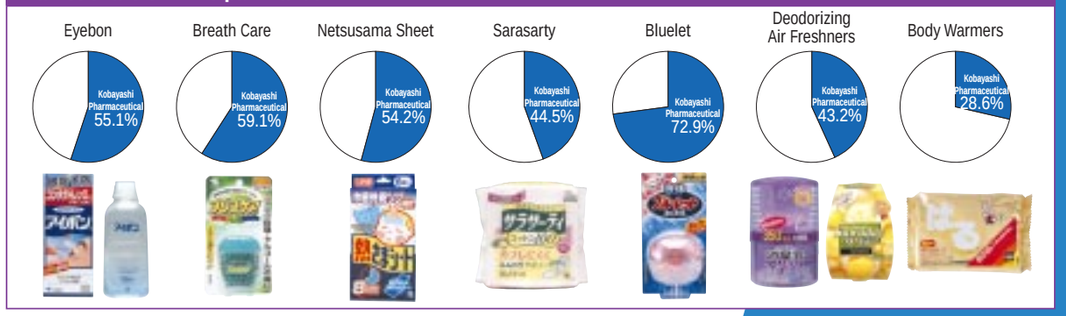


Net Sales by Product Category



Sales by Category	2002 (¥ million)	2003 (¥ million)	Changes (%)
Pharmaceuticals	16,137	15,757	(2.4)
Oral hygiene products	8,624	9,204	6.7
Sanitary products	14,037	12,918	(8.0)
Deodorizing air fresheners	27,404	27,730	1.2
Household sundries	5,987	5,604	(6.4)
Nutritional supplement food products	4,544	6,186	36.1
Body warmers	7,269	8,160	12.3
Total	84,005	85,559	1.8

Market Share of Principal Brands



▶ Wholesale Operation

Sales of the Wholesale Operation rose ¥8,641 million or 7.4% year on year to ¥125,859 million, contributing 52.6% of consolidated net sales.

Despite weak personal consumption and the continuing fall in product prices, sales of the Wholesale Operation rose because drugstore chains, our principal customers, continued to open new stores while consumers, increasingly preoccupied with wellness, are keen to enjoy the benefits of self-medication. Another positive factor was booking of a full year's sales for Kensho Co., Ltd., which became a consolidated subsidiary in the second half of the previous year.

The breakdown of sales by product category reveals that sales of drugs decreased 3.2% from the previous year, whereas sales of daily sundries increased 3.6%, sales of food products, the priority category, surged 9.4%, and other sales rose 6.5%.

Increased center fees (for the use of drugstore chains' distribution centers) levied by drugstore operators rose, together with reduced labor costs and lower selling, general and administrative expenses, resulted in operating income of ¥256 million, an improvement of ¥315 million from the previous year.

Sales by Category		2002 (¥ million)	2003 (¥ million)	Changes (%)
Drugs	Products	7,442	8,047	8.1
	Merchandise	44,864	45,082	0.5
Sundries and Foods	Products	12,625	13,749	8.9
	Merchandise	52,287	58,980	12.8
Total		117,218	125,858	7.4

▶ Medical Devices Operation

Sales of the Medical Devices Operation declined ¥3,818 million or 19.2% year on year to ¥16,114 million, accounting for 6.7% of consolidated net sales.
In Japan, the withdrawal from the joint venture Kobayashi Sofamor Danek Co., Ltd. resulted in a great decline in sales. On the other hand, sales of Kobayashi Medical Division excluding that of Kobayashi Sofamor Denek Co., Ltd. surged 16.4% from the previous year to ¥5,759 million, largely due to brisk sales of orthopedic products procured from Acumed, Inc. of the United States and a bone prosthesis, for which Kobayashi Pharmaceutical acquired the goodwill from Chugai Pharmaceutical Co., Ltd. during the second half of the previous year.
Overseas, the business of the Shield Healthcare Centers grew greatly thanks to locking-in of customers through the purchase of customer lists from other companies . As a result, overseas sales soared 28.2% to ¥9,143 million.
Operating income of the Medical Devices Operation was ¥829 million, having risen ¥388 million or 88.0% from the previous year.
The equity in earnings of Medicon Inc., an affiliate to which the equity method is applied, was ¥153 million, 49.7% lower than for the previous year.

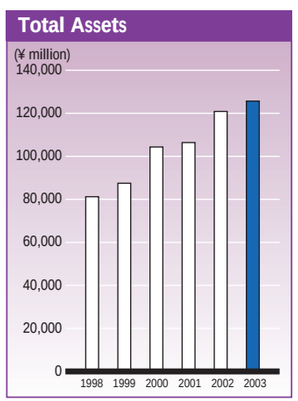
Sales breakdown	2002 (¥ million)	2003 (¥ million)	Changes (%)
Kobayashi Medical Division	11,781	5,760	(51.1)
Shield Healthcare Centers	7,132	9,143	28.2
Others	1,017	1,210	19.0
Total	19,931	16,113	(19.2)

▶ Other Operations

Other Operations are conducted by Kobayashi Pharmaceutical's subsidiaries and affiliates in support of the Company's three principal businesses and to contribute to the profits of those businesses. The Group reviewed the transfer values of the materials and services these subsidiaries and affiliates provide.
Sales of Other Operations were ¥11,706 million, a decrease of ¥926 million or 7.3% from the previous year, and operating income was ¥265 million, having improved ¥279 million from the previous year.

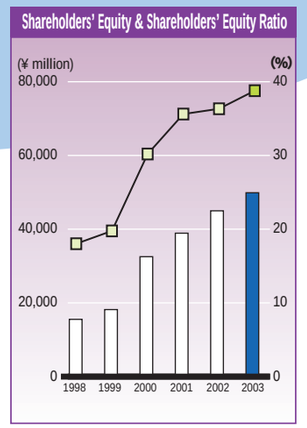
Analysis of Financial Position

Total assets were ¥125,680 million at March 31, 2003, ¥4,825 million or 4.0% higher than the figure at the end of the previous year. The increase was mainly attributable to a rise in current assets.
Current assets increased ¥4,556 million or 6.3% to ¥77,315 million at year-end, due to an increase in cash and time deposits from the selling of stocks and repayment of loans from overseas subsidiaries. A decrease in trade notes and accounts receivable was affected by the improvement in the KOVA index and the change in accounting titles of notes receivables due to the bankruptcies among wholesalers with which the Company did business.
Property, plant and equipment decreased ¥543 million or 1.9% to ¥27,758 million, primarily due to an increase in depreciation of buildings and structures.
Intangible fixed assets were ¥340 million or 4.3% lower at ¥7,566 million. This decrease was attributable to a decline in the consolidation goodwill relating to Kiribai Chemical Co., Ltd. and White Hall. Meanwhile, goodwill increased due to the Tochucha tea business acquired from Hitachi Zosen Bio Corporation.
Investments and other assets were ¥13,039 million at year-end, ¥1,151 million or 9.7% higher than the figure at the end of the previous year. This was mainly due to the transfer of notes and accounts receivable to investments and other assets as a result of the bankruptcies among wholesalers with which the Company did business. Investment in securities decreased as a consequence of the sale of affiliates in Kobayashi Sofamor Danek Co., Ltd.



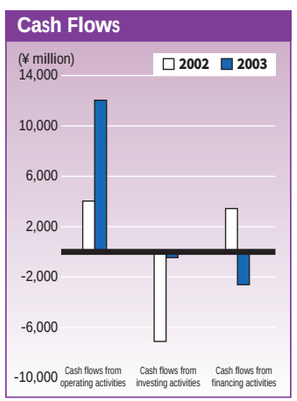
Total liabilities were ¥75,863 million at March 31, 2003, virtually unchanged from the figure at the end of the previous year.
Current liabilities increased ¥3,281 million or 5.2% to ¥65,926 million. The main factor contributing to this rise was an increase in short-term loans of overseas subsidiaries. The overseas subsidiaries procured funds locally starting from the year under review, whereas previously the Company made loans to them. As a result, the current ratio improved by 1.2 percentage points from the end of the previous fiscal year to 117.3%.
Long-term liabilities decreased ¥3,281 million or 24.8% to ¥9,937 million, mainly due to repayment of the long-term debt used for acquisition of Kiribai Chemical Co., Ltd. As a result, interest-bearing debt at the end of the fiscal year under review was ¥7,859 million, having decreased ¥1,335 million or 14.5% from the end of the previous year. The debt equity ratio improved from 0.21 times at the previous fiscal year-end to 0.16 times.
Minority interests amounted to ¥550 million at the end of March 2003, ¥14 million or 2.5% lower than the figure at the end of the previous year.
Shareholders' equity was ¥49,267 million at March 31, 2003, ¥4,839 million or 10.9% higher than the figure at the end of the previous year. The principal factor was an increase in retained earnings due to the rise in consolidated net income. Owing to the buyback of 197,648 shares, treasury stock amounted to ¥777 million.
As a result, the shareholders' equity ratio improved 2.4 percentage points from the end of the previous year to 39.2% at the end of the fiscal year under review. The return on shareholders' equity decreased 1.8 percentage points from 15.9% for the previous year to 14.1%. Shareholders' equity per share increased ¥181.54 or 11.6% from the end of the previous fiscal year to ¥1,748.66.

* From the fiscal year ended March 31, 2003, the Company has adopted the "Accounting Standard for Earnings per Share" (Financial Accounting Standard No. 2) and the "Application Guidelines for the Accounting Standard for Earnings per Share" (Financial Accounting Standard Application Guidelines No. 4).



Cash Flow Analysis

Net cash provided by operating activities jumped ¥8,007 million or 198.2% from the previous year, to ¥12,046 million. This great increase was largely attributable to a rise in income before income taxes accompanied by a decrease in working capital, including notes and accounts receivable and inventories, thanks to a reduction in the number of days required for collecting notes and accounts receivable. These results indicate an improvement in capital efficiency.
Net cash used in investing activities amounted to ¥276 million, having decreased ¥6,656 million or 96.0% from the previous year. This was attributable to proceeds from the sale of equity amounting to ¥3,480 million upon withdrawal from a joint venture, notwithstanding capital investment in connection with new product development.
As a result, free cash flow generated during the year under review amounted to ¥11,770 million, having increased ¥14,663 million compared with a cash outflow of ¥2,893 million for the previous year.
Net cash used in financing activities amounted to ¥2,605 million, a year-on-year increase of ¥6,044 million compared with net cash provided by financing activities amounting to ¥3,439 million for the previous year. This was attributable to a partial repayment of the debt amounting to ¥7,000 million used for the acquisition of Kiribai Chemical Co., Ltd. and purchase of treasury stock in the amount of ¥777 million.
As a result, cash and cash equivalents at year-end amounted to ¥17,752 million, ¥8,965 million or 102.0% higher than the figure at the end of the previous year.



KOBAYASHI PHARMACEUTICAL CO., LTD. and Subsidiaries

Consolidated Balance Sheets

March 31, 2003 and 2002

	Millions of yen		Thousands of U.S. dollars (Note 1)
	2003	2002	**2003**
ASSETS			
Current assets:			
Cash and time deposits (Note 4)	**¥ 17,762**	¥ 8,821	**$ 148,016**
Trade notes and accounts receivable	**39,504**	43,894	**329,200**
Inventories (Note 6)	**13,985**	13,544	**116,542**
Deferred income taxes (Note 15)	**1,971**	2,232	**16,425**
Other current assets	**4,506**	4,572	**37,550**
Allowance for doubtful accounts	**(413)**	(304)	**(3,441)**
Total current assets	**77,315**	72,759	**644,292**
Property, plant and equipment:			
Land (Note 7)	**11,960**	12,000	**99,667**
Buildings and structures (Note 7)	**23,864**	23,733	**198,867**
Machinery and equipment	**4,541**	4,528	**37,842**
Construction in progress	**251**	9	**2,091**
Other	**5,411**	5,466	**45,091**
	46,027	45,736	**383,558**
Accumulated depreciation	**(18,269)**	(17,435)	**(152,241)**
Property, plant and equipment, net	**27,758**	28,301	**231,317**
Investments and other assets:			
Investments in securities (Notes 2(e), 5, 7):			
Unconsolidated subsidiaries and affiliates	**2,679**	2,692	**22,325**
Other	**2,268**	3,080	**18,900**
Excess of cost over net assets acquired	**4,671**	5,359	**38,925**
Deferred income taxes (Note 15)	**2,696**	2,463	**22,466**
Other assets	**9,389**	6,687	**78,241**
Allowance for doubtful accounts	**(1,096)**	(486)	**(9,133)**
Total investments and other assets	**20,607**	19,795	**171,724**
	¥ 125,680	¥ 120,855	**$1,047,333**

The accompanying notes are an integral part of these statements.

	Millions of yen		Thousands of U.S. dollars (Note 1)
	2003	2002	**2003**
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities:			
Short-term loans (Note 7)	**¥ 5,999**	¥ 4,562	**$ 49,992**
Trade notes and accounts payable	**41,111**	42,694	**342,592**
Accrued income taxes (Note 15)	**3,864**	1,574	**32,200**
Accrued expenses	**3,546**	3,298	**29,550**
Other current liabilities	**11,406**	10,517	**95,050**
Total current liabilities	**65,926**	62,645	**549,384**
Long-term liabilities:			
Long-term debt (Note 7)	**1,860**	4,634	**15,500**
Accrued severance indemnities (Note 8)	**6,379**	6,870	**53,158**
Other liabilities	**1,698**	1,714	**14,150**
Total long-term liabilities	**9,937**	13,218	**82,808**
Total liabilities	**75,863**	75,863	**632,192**
Minority interests	**550**	564	**4,583**
Commitments and contingencies (Note 9)			
Shareholders' equity (Note 12):			
Common stock			
Authorized - 113,400,000 shares			
Issued - 28,350,000 shares	**3,450**	3,450	**28,750**
Additional paid-in capital	**4,183**	4,183	**34,858**
Retained earnings	**42,142**	36,118	**351,183**
Unrealized holding gain on securities	**843**	1,147	**7,025**
Foreign currency translation adjustments (Note2(d))	**(574)**	(470)	**(4,783)**
Treasury stock, at cost	**(777)**	(0)	**(6,475)**
Total shareholders' equity	**49,267**	44,428	**410,558**
	¥ 125,680	¥ 120,855	**$1,047,333**

The accompanying notes are an integral part of these statements.

KOBAYASHI PHARMACEUTICAL CO., LTD. and Subsidiaries

Consolidated Statements of Income

Years ended March 31, 2003 and 2002

	Millions of yen		Thousands of U.S. dollars (Note 1)
	2003	2002	**2003**
Net sales	**¥ 210,922**	¥ 204,647	**$1,757,683**
Cost of sales (Note 14)	**141,675**	139,404	**1,180,625**
Gross profit	**69,247**	65,243	**577,058**
Selling, general and administrative expenses (Notes 13 and 14)	**53,394**	51,613	**444,950**
Operating income	**15,853**	13,630	**132,108**
Other income (expenses):			
Interest and dividend income	**166**	232	**1,383**
Interest expense	**(134)**	(207)	**(1,117)**
Equity in earnings of affiliates	**117**	792	**975**
Exchange (loss) gain	**(532)**	45	**(4,433)**
Other, net	**(2,630)**	(3,568)	**(21,916)**
Income before income taxes and minority interests	**12,840**	10,924	**107,000**
Income taxes (Note 15):			
Current	**5,987**	5,588	**49,892**
Deferred	**251**	(1,240)	**2,091**
	6,238	4,348	**51,983**
Minority interests	**4**	19	**33**
Net income	**¥ 6,606**	¥ 6,595	**$ 55,050**

	Yen		U.S. dollars
	2003	2002	**2003**
Net income per share	**¥ 231.25**	¥ 232.64	**$ 1.93**
Cash dividends per share	**21.00**	18.50	**0.18**

The accompanying notes are an integral part of these statements.

KOBAYASHI PHARMACEUTICAL CO., LTD. and Subsidiaries

Consolidated Statements of Shareholders' Equity

Years ended March 31, 2003 and 2002

		Millions of yen					
	Number of shares issued (Thousands)	Common stock	Additional paid-in capital	Retained earnings	Unrealized holding gain (loss) on securities	Foreign currency translation adjustments	Treasury stock
Balance at March 31, 2001	**28,350**	**¥3,450**	**¥4,183**	**¥30,060**	**¥1,375**	**¥ (632)**	**¥ (0)**
Net income for the year				6,595			
Unrealized holding loss on securities					(228)		
Foreign currency translation adjustments						162	
Cash dividends				(496)			
Bonuses to directors and statutory auditors				(41)			
Net change in treasury stock							1
Balance at March 31, 2002	**28,350**	**3,450**	**4,183**	**36,118**	**1,147**	**(470)**	**(0)**
Net income for the year				6,606			
Unrealized holding loss on securities					(304)		
Foreign currency translation adjustments						(104)	
Cash dividends				(524)			
Bonuses to directors and statutory auditors				(58)			
Net change in treasury stock							(777)
Balance at March 31, 2003	**28,350**	**¥ 3,450**	**¥4,183**	**¥42,142**	**¥ 843**	**¥ (574)**	**¥ (777)**

	Thousands of U.S. dollars (Note 1)					
	Common stock	Additional paid-in capital	Retained earnings	Unrealized holding gain (loss) on securities	Foreign currency translation adjustments	Treasury stock
Balance at March 31, 2002	**$28,750**	**$34,858**	**$300,983**	**$ 9,558**	**$(3,917)**	**$ (0)**
Net income for the year			55,050			
Unrealized holding loss on securities				(2,533)		
Foreign currency translation adjustments					(866)	
Cash dividends			(4,367)			
Bonuses to directors and statutory auditors			(483)			
Net change in treasury stock						(6,475)
Balance at March 31, 2003	**$28,750**	**$34,858**	**$351,183**	**$ 7,025**	**$(4,783)**	**$(6,475)**

The accompanying notes are an integral part of these statements.

KOBAYASHI PHARMACEUTICAL CO., LTD. and Subsidiaries

Consolidated Statements of Cash Flows

Years ended March 31, 2003 and 2002

	Millions of yen		Thousands of U.S. dollars (Note 1)
	2003	2002	**2003**
Cash flows from operating activities:			
Income before income taxes and minority interests	**¥ 12,840**	¥ 10,924	**$107,000**
Adjustments for:			
Depreciation and amortization	**3,480**	3,227	**29,000**
Loss on sales or disposal of property, plant and equipment	**219**	214	**1,825**
Provision for allowance for doubtful accounts, net	**739**	191	**6,158**
Equity in earnings of affiliates	**(117)**	(792)	**(975)**
Loss on disposal or write-offs of obsolete inventories	**2,793**	2,964	**23,275**
Loss on devaluation of goodwill	**–**	762	**–**
Gain on sales of investments in a subsidiary and an affiliate	**(3,088)**	(1,472)	**(25,733)**
(Gain) loss on change in minority interest	**(16)**	174	**(133)**
Accrued severance indemnities, net	**(480)**	(429)	**(4,000)**
Interest and dividend income	**(166)**	(232)	**(1,383)**
Interest expense	**134**	207	**1,117**
Exchange gain	**–**	(89)	**–**
Gain on sale of goodwill	**(396)**	–	**(3,300)**
Changes in operating assets and liabilities:			
Decrease (increase) in trade notes and accounts receivable	**2,500**	(311)	**20,833**
Increase in inventories	**(3,280)**	(3,487)	**(27,334)**
(Decrease) increase in trade notes and accounts payable	**(1,310)**	380	**(10,917)**
Increase (decrease) in consumption taxes payable	**226**	(222)	**1,883**
Other	**1,631**	(351)	**13,592**
Subtotal	**15,709**	11,658	**130,908**
Interest and dividends received	**171**	411	**1,425**
Interest paid	**(137)**	(203)	**(1,142)**
Income taxes paid	**(3,697)**	(7,827)	**(30,808)**
Net cash provided by operating activities	**12,046**	4,039	**100,383**
Cash flows from investing activities:			
Proceeds from sales of securities	**–**	457	**–**
Payments for purchases of property, plant and equipment	**(1,676)**	(2,767)	**(13,966)**
Proceeds from sales of property, plant and equipment	**31**	105	**258**
Payments for purchases of intangible assets	**(1,117)**	(836)	**(9,308)**
Increase in investments in securities	**(19)**	(180)	**(158)**
Increase in other assets	**(556)**	(39)	**(4,634)**
Increase in short-term loans receivable	**(373)**	(93)	**(3,108)**
Decrease in long-term loans receivable	**4**	15	**33**
Acquisitions of investments in subsidiaries	**–**	(6,058)	**–**
Proceeds from sale of investment in an affiliate	**3,480**	2,645	**29,000**
Proceeds from sale of goodwill	**396**	–	**3,300**
Other	**(446)**	(181)	**(3,717)**
Net cash used in investing activities	**(276)**	(6,932)	**(2,300)**
Cash flows from financing activities:			
Increase (decrease) in short-term loans, net	**1,426**	(1,242)	**11,884**
Proceeds from long-term debt	**347**	7,000	**2,892**
Repayment of long-term debt	**(3,144)**	(2,208)	**(26,200)**
Issuance of stock of subsidiaries to minority shareholders	**67**	385	**558**
Dividends paid	**(524)**	(496)	**(4,367)**
(Increase) decrease in treasury stock	**(777)**	0	**(6,475)**
Net cash (used in) provided by financing activities	**(2,605)**	3,439	**(21,708)**
Effect of exchange rate changes on cash and cash equivalents	**(200)**	53	**(1,667)**
Net increase in cash and cash equivalents	**8,965**	599	**74,708**
Cash and cash equivalents at beginning of year	**8,787**	8,188	**73,225**
Cash and cash equivalents at end of year (Note 4)	**¥ 17,752**	¥ 8,787	**$147,933**

The accompanying notes are an integral part of these statements.

KOBAYASHI PHARMACEUTICAL CO., LTD. and Subsidiaries

Notes to Consolidated Financial Statements

1. Basis of Presentation of Consolidated Financial Statements

Kobayashi Pharmaceutical Co., Ltd. (the "Company") and its domestic subsidiaries maintain their accounts and records in accordance with the provisions set forth in the Commercial Code of Japan and the Securities and Exchange Law and in conformity with accounting principles and practices generally accepted and applied in Japan, which may differ in certain material respects from accounting principles and practices generally accepted in countries and jurisdictions other than Japan. The Company's overseas subsidiaries maintain their accounts and records in conformity with generally accepted accounting principles and practices prevailing in their respective countries of domicile.

The accompanying consolidated financial statements have been prepared based on the consolidated financial statements of the Company and its subsidiaries (the "Group") as required by the Securities and Exchange Law.

In preparing the accompanying consolidated financial statements, certain reclassifications have been made to the consolidated financial statements issued domestically in order to present them in a form which is more familiar to readers outside Japan. In addition, certain notes included herein are not required under accounting principles and practices generally accepted in Japan but are presented as additional information.

The U.S. dollar amounts included herein are presented solely for convenience and are translated, as a matter of arithmetic computation only, at the rate of ¥120 = $1.00, the approximate exchange rate in effect on March 31, 2003. This translation should not be construed as a representation that Japanese yen amounts have been, could have been, or could in the future be, converted into U.S. dollars at the above or any other rate.

Certain reclassifications of previously reported amounts have been made to the financial statements for the year ended March 31, 2002 to conform these to the 2003 presentation.

2. Summary of Significant Accounting Policies

(a) Principles of consolidation

The accompanying consolidated financial statements include the accounts of the Company and its significant subsidiaries. All significant intercompany transactions and accounts have been eliminated in consolidation. Investments in affiliates (companies over which the Company has the ability to exercise significant influence) are, with certain minor exceptions, accounted for by the equity method.

The difference between the cost and the underlying net equity in investments in consolidated subsidiaries and affiliates accounted for on an equity basis is allocated to identifiable assets based on their fair value at the respective dates of acquisition. Unallocated costs are deferred and amortized by the straight-line method over a five-year period, except for the difference related to Kiribai Chemical Co., Ltd. which is being amortized over a ten-year period.

(b) Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The actual results could differ from these estimates.

(c) Cash and cash equivalents

Cash and cash equivalents include cash on hand, deposits held at call with banks and all highly liquid investments with an original maturity of three months or less that are readily convertible to known amounts of cash and are so near maturity that they present insignificant risk of changes in their value as a result of any changes in interest rates.

(d) Foreign currency translation

Income and expenses denominated in foreign currencies are translated into Japanese yen at the exchange rates prevailing at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated into Japanese yen at the rate of exchange in effect at the balance sheet date except for those items covered by forward foreign exchange contracts including currency swap contracts.

The balance sheet accounts of the overseas subsidiaries are translated into Japanese yen at the rate of exchange in effect at the balance sheet date except

that the components of shareholders' equity are translated at their historical exchange rates. Income and expense accounts are translated at the average rate of exchange in effect during the year. Differences resulting from translating the financial statements of the foreign subsidiaries have not been included in the determination of net income, but are presented as foreign currency translation adjustments in the consolidated balance sheets.

(e) Investments in securities

Securities are classified into three categories; trading securities, held-to-maturity debt securities, or other securities. Trading securities, consisting of debt and marketable equity securities, are stated at fair value. Gain or loss, both realized or unrealized, is charged to income. Held-to-maturity debt securities are stated at their amortized cost. Marketable securities classified as other securities are carried at fair value with any changes in unrealized holding gain or loss, net of the applicable income taxes, reported as a separate component of shareholders' equity. Non-marketable securities classified as other securities are carried at cost.

If the fair value of other securities has declined significantly and the impairment in value is not deemed temporary, these securities are written down to fair value and the resulting loss is charged to income as incurred.

(f) Inventories

Commodities and raw materials are stated principally at cost determined by the moving average method. Finished goods, work in process and supplies are principally stated at cost determined by the total average method.

(g) Property, plant and equipment

Property, plant and equipment is stated at cost. The Company and its domestic subsidiaries compute depreciation by the declining-balance method except for buildings acquired after March 31, 1998, to which the straight-line method is applied. The overseas subsidiaries compute depreciation by the straight-line method.

(h) Allowance for doubtful accounts

The Company and its domestic subsidiaries provide for doubtful accounts principally at an amount computed based on the historical bad debt ratio. In addition, an estimate of uncollectible amounts from certain specific doubtful receivables is provided.

(i) Reserve for sales returns

The Company and one domestic subsidiary provide for sales returns based on the actual sales return ratio. The reserve for sales returns is included in other current liabilities.

(j) Accrued severance indemnities

The Company has a non-contributory unfunded defined retirement plan which provides for lump-sum payments determined by reference to basic salary, length of service and various other conditions covering substantially all its employees. In addition to the lump-sum payment, the Company has a non-contributory funded pension plan to cover benefits to be paid upon retirement at the mandatory retirement age.

Accrued severance indemnities for employees represents the estimated present value of the projected benefit obligation in excess of the fair value of the pension plan assets. Actuarial differences are amortized on a straight-line basis over a period which falls within the average estimated remaining years of service (ten years) of the participants commencing the year following.

Certain domestic subsidiaries have unfunded retirement allowance plans for their employees, which provide for lump-sum payments upon termination of employment. The liability for retirement benefits is stated at 100% of the amount which would be required if all eligible employees voluntarily retired at the balance sheet date.

Certain overseas subsidiaries have funded defined contribution plans for their employees.

Directors and statutory auditors are customarily entitled, subject to the shareholders' approval, to lump-sum payments under the unfunded retirement allowances plan. The provision for retirement allowances for these officers has been made at an estimated amount based on the Companies' internal regulations.

(k) Income taxes

Accrued income taxes are provided at the amount currently payable.

The Company and its consolidated subsidiaries adopt interperiod income tax allocation by the assets and liability method under which deferred tax assets and liabilities are recognized for the expected tax consequences attributable to the differences between the tax bases of the assets and liabilities and the amounts reported in the consolidated financial statements.

(l) Leases

The Company and its subsidiaries utilize offices and other facilities under various leases. Finance leases, except for those which transfer the legal title of the underlying property from the lessor to the lessee at the end of the lease term, are accounted for as operating leases.

(m) Research and development and computer software

Research and development costs are charged to income when incurred.

Expenditures relating to computer software developed for internal use are charged to income when incurred, except if they contribute to the generation of income or to future cost savings. Such expenditures are capitalized as assets and are amortized over their estimated useful life which is customarily 5 years.

(n) Net income and cash dividends per share

Until the year ended March 31, 2002, net income per share was computed based on the net income reported in the consolidated statements of income and the weighted average number of shares of common stock outstanding during each year.

In accordance with a new accounting standard for earnings per share which became effective April 1, 2002, net income per share was computed based on the net income available for distribution to shareholders of common stock and the weighted average number of shares of common stock outstanding during the year. If the previous method of computation had been followed for the year ended March 31, 2003, net income per share would have been ¥233.29($1.94).

Cash dividends per share reflected in the accompanying consolidated statements of income are the amounts applicable to each respective fiscal year.

(o) Appropriation of retained earnings

Cash dividends and bonuses to directors and statutory auditors are recorded in the fiscal year in which the proposed appropriation is approved at a meeting of the shareholders.

(p) Derivatives and hedging activities

Derivative financial instruments, which include forward foreign exchange contracts, currency options, and interest-rate swaps, are used to offset the Companies' risk of exposure to changes in interest and currency exchange rates.

Derivatives are carried at fair value with any changes in unrealized gain or loss charged or credited to income, except for those which meet the criteria for deferral hedge accounting under which the unrealized gain or loss is deferred as an asset or a liability. When a forward foreign exchange contract meets certain criteria, receivables and payables covered by these contracts are translated at the contracted rates. When an interest-rate swap meets certain criteria, the net amount to be paid or received under the contract is added or deducted from the interest on the underlying hedged item.

The Company evaluates the effectiveness of its hedging activities by reference to the accumulated gain or loss on each hedging instrument and on the related hedged item from the commencement of the hedge.

3. Termination of Joint Business

Revenue from sale of distribution rights:

In March 2002, the Company and Medtronic Sofamor Danek Inc. terminated their joint business in Japan. As a consequence, the Company will receive the proceeds by installments from the sale of the distribution rights in Japan. These revenues will be recorded in the Company's books of accounts on a cash basis as follows:

	Thousands of U.S. dollars
In April 2003	$ 6,000
In April 2004	$ 7,000
In April 2005	$ 10,000
In April 2006	$ 10,000
In April 2007	$ 11,000
In April 2008	$ 11,000

4. Cash and Cash Equivalents

A reconciliation of cash and time deposits in the balance sheets to cash and cash equivalents in the statements of cash flows is as follows:

	Millions of yen		Thousands of U.S. dollars
	2003	2002	**2003**
Cash and time deposits	**¥ 17,762**	¥ 8,821	**$148,016**
Time deposits with original maturity of more than three months	**(10)**	(34)	**(83)**
Cash and cash equivalents	**¥ 17,752**	¥ 8,787	**$147,933**

5. Investments in Securities

Securities classified as "other securities" are summarized as follows:

(a) Securities whose carrying value exceeds their acquisition cost

	Millions of yen					
	2003			2002		
	Acquisition cost	**Carrying value**	**Unrealized gain**	Acquisition cost	Carrying value	Unrealized gain
Equities	**¥ 383**	**¥ 1,872**	**¥ 1,489**	¥ 906	¥ 2,977	¥ 2,071

	Thousands of U.S. dollars		
	2003		
	Acquisition cost	**Carrying value**	**Unrealized gain**
Equities	**$ 3,192**	**$ 15,600**	**$ 12,408**

(b) Securities whose acquisition cost exceeds their carrying value

	Millions of yen					
	2003			2002		
	Acquisition cost	**Carrying value**	**Unrealized loss**	Acquisition cost	Carrying value	Unrealized loss
Equities	**¥ 284**	**¥ 216**	**¥ (68)**	¥ 549	¥ 398	¥ (151)
Debt securities	**–**	**–**	**–**	5	4	(1)
	¥ 284	**¥ 216**	**¥ (68)**	¥ 554	¥ 402	¥ (152)

	Thousands of U.S. dollars		
	2003		
	Acquisition cost	**Carrying value**	**Unrealized loss**
Equities	**$ 2,367**	**$ 1,800**	**$ (567)**
Debt securities	**–**	**–**	**–**
	$ 2,367	**$ 1,800**	**$ (567)**

For the year ended March 31, 2003, the Group recognized an impairment loss of ¥36 million ($300 thousand) on equity securities.

(c) Securities whose market value is not determinable

	Millions of yen		Thousands of U.S. dollars
	2003	2002	**2003**
Unlisted stock	**¥ 103**	¥ 110	**$ 858**
Investment trusts	**112**	–	**933**

(d) Redemption schedule for other securities with maturities and held-to-maturity debt securities

Due	Millions of yen		Thousands of U.S. dollars
	2003	2002	**2003**
Within one year	**–**	–	**–**
After one year but within five years	**–**	¥ 5	**–**
	–	¥ 5	**–**

6. Inventories

Inventories at March 31, 2003 and 2002 are summarized as follows:

	Millions of yen		Thousands of U.S. dollars
	2003	2002	**2003**
Commodities	**¥ 7,433**	¥ 6,869	**$ 61,942**
Finished goods	**5,192**	5,519	**43,267**
Raw materials, work in process and supplies	**1,360**	1,156	**11,333**
	¥ 13,985	¥ 13,544	**$116,542**

7. Short-term Loans and Long-term Debt

Long-term debt at March 31, 2003 and 2002 is summarized as follows:

	Millions of yen		Thousands of U.S. dollars
	2003	2002	**2003**
Loans from banks with average interest rates of 0.79% for 2003 and 1.10% for 2002	**¥ 4,410**	¥ 7,174	**$ 36,750**
Less amounts due within one year	**(2,550)**	(2,540)	**(21,250)**
	¥ 1,860	¥ 4,634	**$ 15,500**

The aggregate annual maturities of long-term debt subsequent to March 31, 2003, of which the final due date is September 2009, are summarized as follows:

Year ending March 31,	Millions of yen	Thousands of U.S. dollars
2004	¥ 2,550	$ 21,250
2005	1,152	9,600
2006	102	850
2007	93	775
2008 and thereafter	513	4,275
	¥ 4,410	$ 36,750

Assets pledged as collateral at March 31, 2003 are summarized as follows:

	Millions of yen	Thousands of U.S. dollars
Buildings	¥ 757	$ 6,308
Land	1,292	10,767
Investments in securities	175	1,458
	¥ 2,224	$ 18,533

Secured liabilities at March 31, 2003 are summarized as follows:

	Millions of yen	Thousands of U.S. dollars
Trade notes and accounts payable	¥ 5,003	$ 41,692
Short-term loans	1,100	9,166
Long-term loans, including current portion	327	2,725
	¥ 6,430	$ 53,583

Short-term bank loans generally represented notes payable at average interest rates of 0.81% and 0.46% in 2003 and 2002, respectively.

As is customary practice in Japan, short-term and long-term bank loans are made under general agreements which provide that, under certain circumstances, security and guarantees for present and future indebtedness will be given upon request of the bank, and that the bank shall have the right, as the obligations become due or in the event of their default, to offset cash deposits against such obligations due to the bank.

8. Accrued Severance Indemnities

The following table sets forth the funded and accrued status of the plans, and the amounts recognized in the consolidated balance sheets at March 31, 2003 and 2002 for the Group's defined benefit plans:

	Millions of yen		Thousands of U.S. dollars
	2003	2002	**2003**
Projected benefit obligation	**¥ 8,781**	¥ 8,750	**$ 73,175**
Fair value of pension plan assets	**(1,735)**	(1,024)	**(14,458)**
Unfunded retirement benefit obligation	**7,046**	7,726	**58,717**
Unrecognized actuarial differences	**(667)**	(856)	**(5,559)**
Accrued severance indemnities	**¥ 6,379**	¥ 6,870	**$ 53,158**

The components of net pension cost for the years ended March 31, 2003 and 2002 were as follows:

	Millions of yen		Thousands of U.S. dollars
	2003	2002	**2003**
Service cost	**¥ 554**	¥ 546	**$ 4,617**
Interest cost	**204**	215	**1,700**
Expected return on pension plan assets	**(25)**	(10)	**(208)**
Amortization of actuarial differences	**84**	(3)	**700**
Pension cost	**¥ 817**	¥ 748	**$ 6,809**

The assumptions used in determining the actuarial present value of the projected benefit obligation at March 31, 2003 and 2002 were as follows:

	2003	2002
Discount rate	**2.5 %**	2.5 %
Expected rates of return on plan assets	**2.5 %**	3.0 %
Period of amortization of actuarial differences	**10 years**	10 years

9. Contingencies

At March 31, 2003, contingent liabilities for guarantees of bank loans of a non-consolidated subsidiary amounted to ¥139 million ($1,158 thousand).

10. Leases

The following pro forma amounts present the acquisition cost and accumulated depreciation of property leased to the Group at March 31, 2003 and 2002, which would have been reflected in the consolidated balance sheets if finance leases other than those which transfer the ownership of the leased property (currently accounted for as operating leases) were capitalized.

	Millions of yen		Thousands of U.S. dollars
	2003	2002	**2003**
Machinery and equipment:			
Acquisition cost	**¥ 9,854**	¥ 9,050	**$ 82,117**
Accumulated depreciation	**(5,187)**	(4,089)	**(43,225)**
	¥ 4,667	¥ 4,961	**$ 38,892**
Furniture and fixtures:			
Acquisition cost	**¥ 2,065**	¥ 1,098	**$ 17,208**
Accumulated depreciation	**(1,142)**	(721)	**(9,516)**
	¥ 923	¥ 377	**$ 7,692**
Others:			
Acquisition cost	**¥ 2,554**	¥ 2,449	**$ 21,283**
Accumulated depreciation	**(1,191)**	(805)	**(9,925)**
	¥ 1,363	¥ 1,644	**$ 11,358**
Total	**¥ 6,953**	¥ 6,982	**$ 57,942**

Future minimum lease payments (including the interest portion thereon) subsequent to March 31, 2003 for finance leases other than those which transfer the ownership of the leased property were as follows:

Year ending March 31,	Millions of yen	Thousands of U.S. dollars
2004	¥ 2,273	$ 18,942
2005 and thereafter	4,827	40,225
Total	¥ 7,100	$ 59,167

The lease payments for such finance lease consisted of the following expenses:

	Millions of yen		Thousands of U.S. dollars
	2003	2002	**2003**
Lease expenses	**¥ 2,728**	¥ 2,169	**$ 22,733**
Estimated depreciation expense	**2,559**	2,032	**21,325**
Estimated interest expense	**181**	155	**1,508**

11. Derivatives and Hedging Activities

The Company utilizes forward foreign exchange contracts, currency options and interest-rate swaps as derivatives transactions. The Company's policy is to employ derivatives transactions to hedge risks resulting from future fluctuations in foreign currency exchange and interest rates and to achieve efficient fund management. The Company utilizes derivatives transactions to hedge against fluctuations in foreign currency exchange rates on monetary assets and liabilities denominated in foreign currencies and to reduce risks resulting from future fluctuations in interest rates.

Hedge effectiveness of currency-related transactions is evaluated based on the comparison between the fluctuations in fair value of a transaction when the transaction is not hedged and when the transaction is hedged. Evaluation of hedge effectiveness is not carried out for interest-rate swaps.

Forward foreign exchange contracts and currency options are exposed to risks from fluctuations in foreign currency exchange rates. The counterparties to the Company's derivative transactions are Japanese banks of high standing. The Company anticipates hardly any risk of nonperformance of contracts by the counterparties.

The Company's chief financial officer is responsible for decision-making concerning the Company's engagement in derivatives transactions and the Financial and Accounting Division is responsible for implementation and management of derivatives transactions.

The Company does not hold or issue derivatives for speculative trading purposes.

12. Legal Reserve

The Commercial Code of Japan (the "Code") provides that an amount equivalent to at least 10% of all cash appropriations of retained earnings be appropriated to the legal reserve until the sum of the legal reserve and additional paid-in capital equals 25% of common stock. The legal reserve is not available for dividends but may be used to eliminate or reduce a deficit by approval of the shareholders or may be transferred to common stock by resolution of the Board of Directors. The Code also stipulates that, to the extent that the sum of additional paid-in capital and the legal reserve exceeds 25% of the common stock account, the amount of any such excess is available for appropriation by resolution of the shareholders. Retained earnings include the legal reserve provided in accordance with the provisions of the Code.

The legal reserve of the Company, included in retained earnings at March 31, 2003 and 2002, amounted to ¥330 million ($2,750 thousand) and ¥330 million, respectively.

13. Selling, General and Administrative Expenses

The major components of selling, general and administrative expenses for the years ended March 31, 2003 and 2002 were as follows:

Account	Millions of yen		Thousands of U.S. dollars
	2003	2002	**2003**
Sales promotion activities	**¥ 4,080**	¥ 3,563	**$ 34,000**
Freight and storage	**7,953**	7,780	**66,275**
Advertising	**11,347**	12,150	**94,558**
Salaries and bonuses	**11,244**	10,712	**93,700**
Office rent and other rental charges	**2,565**	2,359	**21,375**
External services	**3,406**	3,244	**28,383**
Research and development	**1,785**	1,778	**14,875**

14. Research and Development Costs

Research and development cost included in selling, general and administrative expenses and manufacturing costs for the years ended March 31, 2003 and 2002 amounted to ¥1,785 million ($14,875 thousand) and ¥1,778 million, respectively.

15. Income Taxes

The Company and its domestic subsidiaries are subject to several taxes based on income which, in the aggregate, resulted in a statutory tax rate of approximately 42% for the years ended March 31, 2003 and 2002. The overseas subsidiaries are subject to the income taxes of their countries of domicile.

A reconciliation of the difference between the statutory tax rate and the effective tax rates in the accompanying consolidated statements of income is as follows:

	2003	2002
Statutory tax rate	**42.0 %**	42.0 %
Amortization of excess of cost over net assets acquired	**2.5**	–
Losses at subsidiaries	**1.5**	9.5
Equity in earnings of affiliates	**1.3**	(3.0)
Loss on devaluation of investments in subsidiaries	**–**	(7.2)
Expenses not deductible for tax purposes	**1.5**	1.6
Dividend income not taxable	**(1.3)**	(4.8)
Inhabitants' per capita taxes	**–**	0.5
Effect of change in statutory tax rate	**0.4**	–
Other	**0.7**	1.2
Effective tax rates	**48.6 %**	39.8 %

During the year ended March 31, 2003, the Japanese tax regulations were amended to reduce the statutory tax rate to 41.2% effective the year ending March 31, 2005. Accordingly, deferred tax assets and liabilities related to temporary differences which will be deductible or taxable in the year ending March 31, 2005 or thereafter have been reduced.

The tax effects of the temporary differences which gave rise to a significant portion of the deferred tax assets at March 31, 2003 and 2002 are presented below:

	Millions of yen		Thousands of U.S. dollars
	2003	2002	**2003**
Deferred tax assets:			
Accrued severance indemnities	**¥ 2,214**	¥ 2,359	**$ 18,450**
Net operating loss carryforwards	**1,046**	827	**8,717**
Loss on devaluation of investments in subsidiaries	**–**	713	**–**
Reserve for employees' bonuses	**625**	513	**5,208**
Reserve for directors' retirement allowance	**492**	467	**4,100**
Accrued expenses	**430**	399	**3,583**
Accrued enterprise tax	**324**	207	**2,700**
Intercompany unrealized profits	**294**	224	**2,450**
Unrealized loss on property	**258**	–	**2,150**
Allowance for bad debts	**235**	84	**1,958**
Other	**296**	227	**2,467**
Total gross deferred tax assets	**6,214**	6,020	**51,783**
Valuation allowance	**(903)**	(739)	**(7,525)**
Total deferred tax assets	**5,311**	5,281	**44,258**
Deferred tax liabilities:			
Unrealized holding gain on securities	**607**	587	**5,058**
Other	**37**	–	**308**
Deferred tax liabilities	**644**	587	**5,366**
Net deferred tax assets	**¥ 4,667**	¥ 4,694	**$ 38,892**

16. Segment Information

The Company and its consolidated subsidiaries are engaged primarily in the manufacturing and sales of products and wholesale operations mainly in Japan.

The business segment information for the Company and its consolidated subsidiaries for the years ended March 31, 2003 and 2002 is outlined as follows:

	2003 Millions of yen						
	Consumer Products Opeation	Wholesale Operation	Medical Operation	Other Operations	Total	Eliminations	Consolidated
I Sales and operating income							
Sales to third parties	¥ 66,027	¥125,858	¥ 16,114	¥ 2,923	¥210,922	¥ –	¥210,922
Inter-group sales and transfers	19,532	1	–	8,783	28,316	(28,316)	–
Total sales	85,559	125,859	16,114	11,706	239,238	(28,316)	210,922
Operating expenses	71,121	125,603	15,285	11,441	223,450	(28,381)	195,069
Operating income	¥ 14,438	¥ 256	¥ 829	¥ 265	¥ 15,788	¥ 65	¥ 15,853
II Assets, depreciation and capital expenditures							
Total assets	¥ 53,105	¥ 41,397	¥ 9,200	¥ 7,324	¥111,026	¥ 14,654	¥125,680
Depreciation	1,906	255	369	154	2,684	109	2,793
Capital expenditures	2,073	273	197	50	2,593	38	2,631

	Thousands of U.S. dollars						
	Consumer Products Opeation	Wholesale Operation	Medical Operation	Other Operations	Total	Eliminations	Consolidated
I Sales and operating income							
Sales to third parties	$550,225	$1,048,817	$134,283	$ 24,358	$1,757,683	$ –	$1,757,683
Inter-group sales and transfers	162,767	8	–	73,192	235,967	(235,967)	–
Total sales	712,992	1,048,825	134,283	97,550	1,993,650	(235,967)	1,757,683
Operating expenses	592,675	1,046,692	127,375	95,342	1,862,083	(236,508)	1,625,575
Operating income	$120,317	$ 2,133	$ 6,908	$ 2,208	$131,567	$ 541	$132,108
II Assets, depreciation and capital expenditures							
Total assets	$442,542	$344,975	$ 76,667	$ 61,033	$925,217	$122,117	$1,047,333
Depreciation	15,883	2,125	3,075	1,283	22,367	908	23,275
Capital expenditures	17,275	2,275	1,642	417	21,608	317	21,925

	2002 Millions of yen						
	Consumer Products Opeation	Wholesale Operation	Medical Operation	Other Operations	Total	Eliminations	Consolidated
I Sales and operating income							
Sales to third parties	¥ 64,977	¥117,214	¥ 19,932	¥ 2,524	¥204,647	¥ –	¥204,647
Inter-group sales and transfers	19,029	4	–	10,108	29,141	(29,141)	–
Total sales	84,006	117,218	19,932	12,632	233,788	(29,141)	204,647
Operating expenses	70,609	117,277	19,491	12,646	220,023	(29,006)	191,017
Operating income (loss)	¥ 13,397	¥ (59)	¥ 441	¥ (14)	¥ 13,765	¥ (135)	¥ 13,630
II Assets, depreciation and capital expenditures							
Total assets	¥ 57,109	¥ 41,700	¥ 11,874	¥ 7,283	¥117,966	¥ 2,889	¥120,855
Depreciation	1,964	218	136	177	2,495	103	2,598
Capital expenditures	2,934	420	648	226	4,228	101	4,329

Geographic Segment Information

Geographic segment information has been omitted because more than 90% of the consolidated sales are recorded in Japan and more than 90% of the assets are located in Japan.

Foreign Sales Information

Foreign sales information has been omitted because foreign sales, consisting of export sales of the Company and its domestic consolidated subsidiaries and sales of foreign consolidated subsidiaries, constitute less than 10% of the total consolidated sales.

17. Subsequent Event

The following appropriations of retained earnings of the Company were proposed and approved at a general meeting of the shareholders held on June 27, 2003:

	Millions of yen	Thousands of U.S. dollars
Cash dividends (¥21.00 = U.S.$0.18 per share)	¥ 591	$ 4,925
Bonuses to directors and statutory auditors	38	317

Report of Independent Auditors

The Board of Directors
Kobayashi Pharmaceutical Co., Ltd.

We have audited the accompanying consolidated balance sheets of Kobayashi Pharmaceutical Co., Ltd. and consolidated subsidiaries as of March 31, 2003 and 2002, and the related consolidated statements of income, shareholders' equity, and cash flows for the years then ended, all expressed in yen. These financial statements are the responsibility of the Company's management. Our responsibility is to independently express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards, procedures and practices generally accepted and applied in Japan. Those standards, procedures and practices require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Kobayashi Pharmaceutical Co., Ltd. and consolidated subsidiaries at March 31, 2003 and 2002, and the consolidated results of their operations and their cash flows for the years then ended in conformity with accounting principles and practices generally accepted in Japan.

The U.S. dollar amounts in the accompanying consolidated financial statements with respect to the year ended March 31, 2003 are presented solely for convenience. Our audit also included the translation of yen amounts into U.S. dollar amounts and, in our opinion, such translation has been made on the basis described in Note 1 to the consolidated financial statements.

Shin Nihon & Co.

June 27, 2003

See Note 1 to the consolidated financial statements which explains the basis of presentation of the consolidated financial statements of Kobayashi Pharmaceutical Co., Ltd. and consolidated subsidiaries under Japanese accounting principles and practices.

Six-Year Consolidated Financial Summary

KOBAYASHI PHARMACEUTICAL CO., LTD. and Subsidiaries
Years Ended March 31

	Millions of yen					
	2003	2002	2001	2000	1999	1998
For the Year						
Net Sales	**210,922**	204,647	185,001	180,731	166,585	156,062
Cost of Sales	**141,675**	139,404	123,140	121,739	115,993	110,061
Gross Profit	**69,247**	65,243	61,861	58,992	50,591	46,000
SG&A Expenses	**53,394**	51,613	48,054	46,121	41,137	39,541
Operating Income	**15,853**	13,630	13,807	12,871	9,453	6,458
Income before Income Taxes	**12,840**	10,924	11,453	9,389	8,001	4,534
Net Income	**6,606**	6,595	6,020	4,822	2,904	1,695
Per Share Data (Yen)						
Net Income	**231.25**	232.64	212.34	170.80	166.91	97.41
Cash Dividends	**21.0**	18.5	17.5	15.0	12.5	14.0
Cash Flows from Operating Activities	**12,046**	4,039	3,961	7,306	(data prior to 2000 not prepared)	
Free Cash Flows	**11,770**	(2,892)	(817)	2,662	(data prior to 2000 not prepared)	
Depreciation and Amortization Expenses	**2,793**	2,598	2,157	1,921	1,530	1,459
Capital Expenditures	**2,631**	4,329	4,926	3,667	3,730	3,987
R&D Expenses	**1,785**	1,778	1,774	1,292	1,183	1,098
At Year End						
Current Assets	**77,315**	72,759	64,849	69,248	57,656	53,983
Property, Plant and Equipment	**27,758**	28,301	26,000	23,513	21,906	19,923
Current Liabilities	**65,926**	62,645	57,871	62,977	57,857	57,732
Long-term Liabilities	**9,937**	13,218	10,068	9,197	11,623	7,982
Shareholders' Equity	**49,267**	44,428	38,436	32,142	17,990	15,377
Total Assets	**125,680**	120,855	106,391	104,331	87,485	81,214
Working Capital	**11,389**	10,114	6,978	6,271	(201)	(3,749)
Interest-bearing Debt	**7,859**	9,196	3,461	8,432	9,129	10,894
Financial Ratios (%)						
As a percent of net sales:						
Gross Profit	**32.8**	31.9	33.4	32.7	30.4	29.5
Operating Income	**7.5**	6.7	7.5	7.1	5.7	4.1
Net Income	**3.1**	3.2	3.3	2.7	1.7	1.1
Current Ratio	**117.3**	116.1	112.1	110.0	99.7	93.5
ROE	**14.1**	15.9	17.1	19.2	17.4	—
ROA	**5.4**	5.8	5.7	5.0	3.4	—
Shareholders' Equity Ratio	**39.2**	36.8	36.1	30.8	20.6	18.9
Debt–equity Ratio (times)	**0.16**	0.21	0.09	0.26	0.51	0.71

Note: Consolidated accounting has been adopted since the fiscal year ended March 1998.

Corporate Data / Investor Information

Corporate Data

(As of March 31, 2003)

- Corporate Name: KOBAYASHI PHARMACEUTICAL CO., LTD.
- Foundation: August 22, 1919
- Head Office: 3-6, Doshomachi 4 chome, Chuo-ku, Osaka 541-8507 Japan
- Representative Director: Kazumasa Kobayashi, President and CEO
- Number of Employees: 2,305 (Consolidated)
- Consolidated Subsidiaries: 19
- Non-consolidated Subsidiaries: 11
- Affiliates accounted for by the equity method: 2

Investor Information

(As of March 31, 2003)

- Common Stock: ¥3,450 million
- Number of Shares Authorized: 113,400,000
- Number of Shares Issued: 28,350,000
- Number of Shareholders: 4,275
- Stock Exchange Listing: Tokyo Stock Exchange 1st Section, Osaka Securities Exchange 1st Section
- Transfer Agent: UFJ Trust Bank Limited
- Annual Shareholders' Meeting: June
- Investor Relations: KOBAYASHI PHARMACEUTICAL CO., LTD.
  Management Planning Department
  Tel. 81-6-6222-0210
  Fax. 81-6-6222-4261
  E-mail. info@kobayashi.co.jp
  URL. http://www.kobayashi.co.jp/

KOBAYASHI PHARMACEUTICAL CO., LTD.

Head Office: 3-6, Doshomachi 4 chome, Chuo-ku, Osaka 541-8507 Japan
TEL. 81-6-6222-0897
Tokyo Office: 3-4, Nihonbashi Honcho 2 chome, Chuo-ku, Tokyo 103-0023 Japan
TEL. 81-3-3241-3151
URL. http://www.kobayashi.co.jp/

Printed on recycled paper in Japan