Something New, Something Different

KOBAYASHI PHARMACEUTICAL CO., LTD.

ANNUAL REPORT 2004

Consolidated Financial Highlights

Years ended March 31

For the Year	2002	2003	Millions of yen 2004	% Change
Net Sales	¥204,647	¥210,922	¥211,670	0.4%
Operating Income	13,630	15,853	16,123	1.7
Net Income	6,595	6,606	6,677	1.1
Per Share Data (Yen)				
Net Income	232.64	231.25	157.25	–
Shareholders' Equity	1,567.12	1,747.98	1,307.16	–
Dividends	18.50	21.00	21.00	–
At Year-End				
Total Assets	120,855	125,680	128,326	2.1
Shareholders' Equity	44,428	49,267	54,454	10.5
Ratios (%)				
ROA	5.8	5.4	5.3	(0.1)
ROE	15.9	14.1	12.9	(1.2)
Shareholders' Equity	36.8	39.2	42.4	3.2

Notes: 1. On November 20, 2003, the Company conducted a 1.5-for-1 stock split. Net income per share and shareholders' equity per share for the year ended March 31, 2004 are calculated assuming that the stock split took place at the beginning of the year.

2. Net income per share and shareholders' equity per share for the year ended March 31, 2003 were ¥154.17 and ¥1,165.32, respectively, if calculated assuming the Company split its stock at the beginning of that fiscal year.

Contents

Forward-looking Statements

Plans, strategies, beliefs and other statements concerning future business operations of Kobayashi Pharmaceutical Co., Ltd. included in this annual report are forward-looking statements based not on historical facts but on management's assumptions and beliefs in light of information currently available. These forward-looking statements include risks, known and unknown, and uncertainties. Actual management achievements and business results may therefore differ significantly from forecasts in this annual report.

Something New, Something Different

Ever since Kobayashi Pharmaceutical opened for business in 1886, our management policy has been to provide people and society with 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.

As a pioneer in new markets, Kobayashi Pharmaceutical has brought a stream of new products, merchandise and services to consumers as well as developed new business methods that give shape to our management policy of "Something New, Something Different," thus contributing to a better world.

Today, our sales networks cover all important markets, including the U.K., U.S. and China. Unfettered by tradition and hidebound thinking and with a speedy development system, we will continue to create new markets and differentiate our brand.

Message From the CEO

Chairman and Chief Executive Officer **Kazumasa Kobayashi**

Solid Business Results

In a challenging operating environment, which continues to be characterized by lackluster personal consumption, Kobayashi Pharmaceutical achieved growth in its three core businesses: Consumer Products Operation, Wholesale Operation and Medical Devices Operation. I am pleased to report that in the fiscal year ended March 31, 2004 we posted our sixth consecutive increase in sales and earnings since we began releasing consolidated business results.

Net sales edged up 0.4% to ¥211.6 billion, operating income rose 1.7% to ¥16.1 billion, and net income increased 1.1% to ¥6.6 billion.

Separation of Supervision and Execution Functions

In the 28 years that I have been at the helm as president, Kobayashi Pharmaceutical has continued to increase sales and profit. I now feel that the time is right for extensive management reform that will assure that we remain a strong company and firmly on a growth track.

In April 2004, we reformed our management organization and established a Business Headquarters to separate management supervision and execution functions. As chairman of the Board I shall devote my energies to overseeing operations, with a tight focus on strengthening the supervisory functions of and improving the Board of Directors. Execution will be the responsibility of the president and executive officers.

Taking this opportunity, I intend to build a management system defined by "Self Responsibility" that will allow all employees to realize their potential to the fullest, driven by a sense of mission and responsibility. I believe that each of our employees can realize their potential if they feel a sense of urgency, think for themselves and fulfill their responsibilities.

Raising Corporate Brand Value

I am convinced that commitment to organizational reform and raising the awareness of individual employees will help us build a stronger corporate brand. Corporate brand management is focused on raising the satisfaction of all stakeholders, including customers, stockholders and employees. Problem awareness and suggestions for solutions by employees at the frontline who are close to customers leads to more accurate management decisions, which in turn raises customer satisfaction and corporate brand value.

Kobayashi Pharmaceutical has a long history of providing a broad range of products—from daily necessities to specialized medical products. We are determined to continue to introduce creative products that have come to define us as a company—and in the process raise the level of satisfaction of all stakeholders and maximize Kobayashi Pharmaceutical's corporate brand value.

July 2004

Kazumasa Kobayashi

Chairman and Chief Executive Officer

To Our Stakeholders

President and Chief Operating Officer **Yutaka Kobayashi**

A New Era of Management

In the 28 years that he guided the Company, former President Kazumasa Kobayashi made a significant contribution to the growth of the Kobayashi Pharmaceutical Group. As his successor, I will do all that I can to build on his work, to achieve further growth and raise corporate value.

Kobayashi Pharmaceutical started out in business in 1886. Over the ensuing 118 years, our mission has been to provide people with a more comfortable life through the development and marketing of innovative products that meet customers' needs and in the process create new markets. My predecessor gave final shape to this ideal, transforming Kobayashi Pharmaceutical into a firm with excellent growth potential and overseeing our listing as a publicly owned company in April 1999.

Through powerful leadership, Kazumasa Kobayashi clearly defined the direction we should take and raised employee motivation to new levels. In doing so, he fostered the ability to bring to market a series of innovative products, achieving a degree of success that other companies found extremely difficult to duplicate. However, over time, management, including Mr. Kobayashi himself, became increasingly concerned about the growing dependence on his leadership. Corporate management is like a relay race: now that I have taken the baton, my job is to develop and implement management policies that will build on the strengths that have been created in order to achieve an undisputed competitive position.

"Creativity and Differentiation"—Our Identity

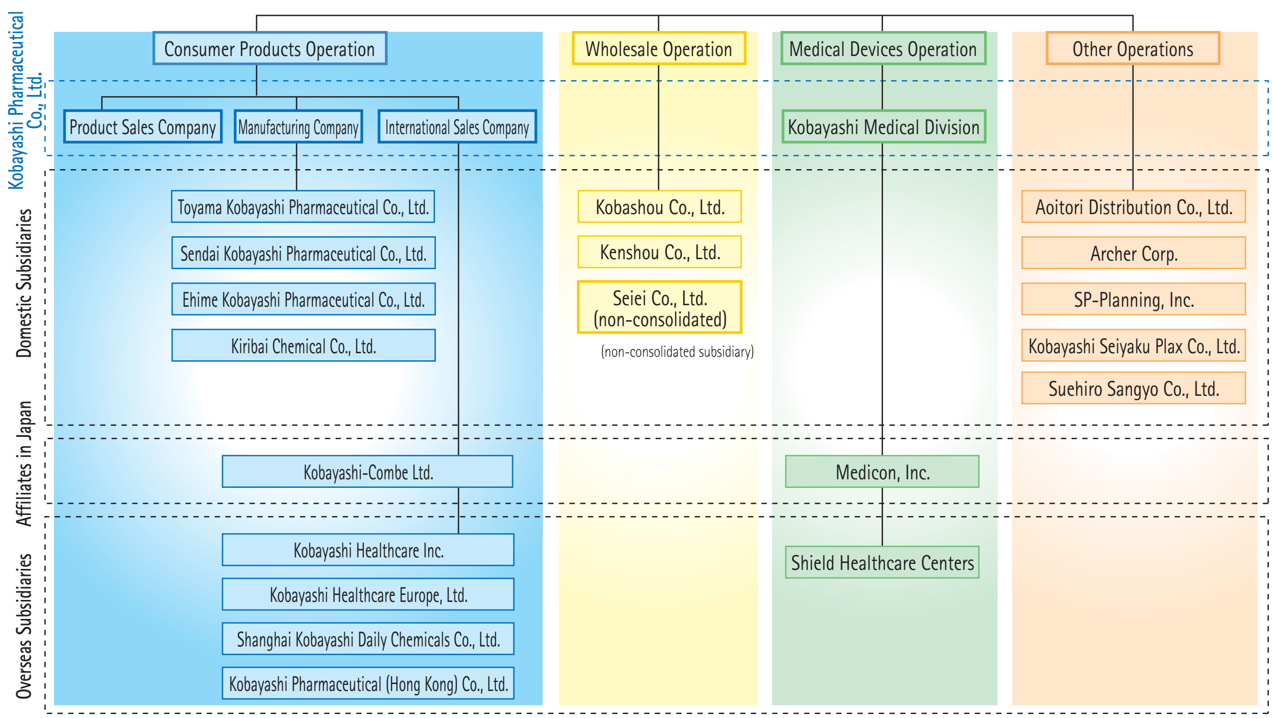
From Nothing to Market Dominance

The growth strategy of our core Consumer Products Operation is to develop products that create entirely new markets, and then continuously grow earnings through market expansion. Our unique business model is based on introducing groundbreaking products in completely new markets or untapped ones, and then expanding those markets and quickly winning dominant market shares.

True Differentiation Is Not Based on Products Alone

It is natural to expect new entrants to the markets that we create and nurture. We welcome this because it contributes to the formation of a major market in which we can secure our leadership position. In fact, our market development strategies assume market growth in this fashion. During this development stage, we consider that it is important to continue generating the earnings of a first mover. Good examples of our market-creating products include the *Bluelet* deodorizing toilet bowl cleanser, a 25-year long seller; *Netsusama Sheet* cooling gel sheets; and *Eyebon* eyewash. Several factors underpin the ability to be successful as competition intensifies. These are strategies to stave off competing products and measures to strengthen our brand to prevent competitors from catching up. We combine these with innovative sales and marketing methods and proprietary manufacturing processes as factors that differentiate our products from those of our competitors.

The Kobayashi Pharmaceutical Group—Major Companies by Segment



A Well-balanced Portfolio of Three Businesses Centered on the Consumer Products Operation

Positioning of Three Core Operations

Kobayashi Pharmaceutical has three pillars of operations: Consumer Products Operation, Wholesale Operation and Medical Devices Operation. We assure a well-balanced portfolio by leveraging the unique strengths and features of each operation.

The strength of our Consumer Products Operation is its potent ability to develop innovative products that create new markets, which it then expands to generate high earnings. This is our core operation, contributing 90% of the total operating income, even though it represents just over 30% of total sales.

Wholesale Operation, our original business, generates 60% of total sales, supplying pharmaceuticals, health foods, daily sundries and other products to drugstore chains, its principal customers. Kobayashi Pharmaceutical is the second largest pharmaceutical wholesaler in Japan. Consolidated subsidiaries, Kobashou Co., Ltd. and Kenshou Co., Ltd., manage our wholesale business. With the OTC drug market having matured and now experiencing a shakeout amid intense price competition, profitability is a priority issue. Kobayashi Pharmaceutical is thus transforming itself into a company with the ability to generate strong earnings through operational streamlining and M&A-based expansion.

In our Medical Devices Operation, we have made up-front investments in assembling an impressive product portfolio and in other areas. These investments are now starting to pay off. Having moved into the black in the fiscal year ended March 31, 2001, our Medical Devices Operation is now positioned to expand sales and profit. This will be accomplished by investing actively in this business such as by developing products in-house.

Consumer Products Operation–The Growth Driver

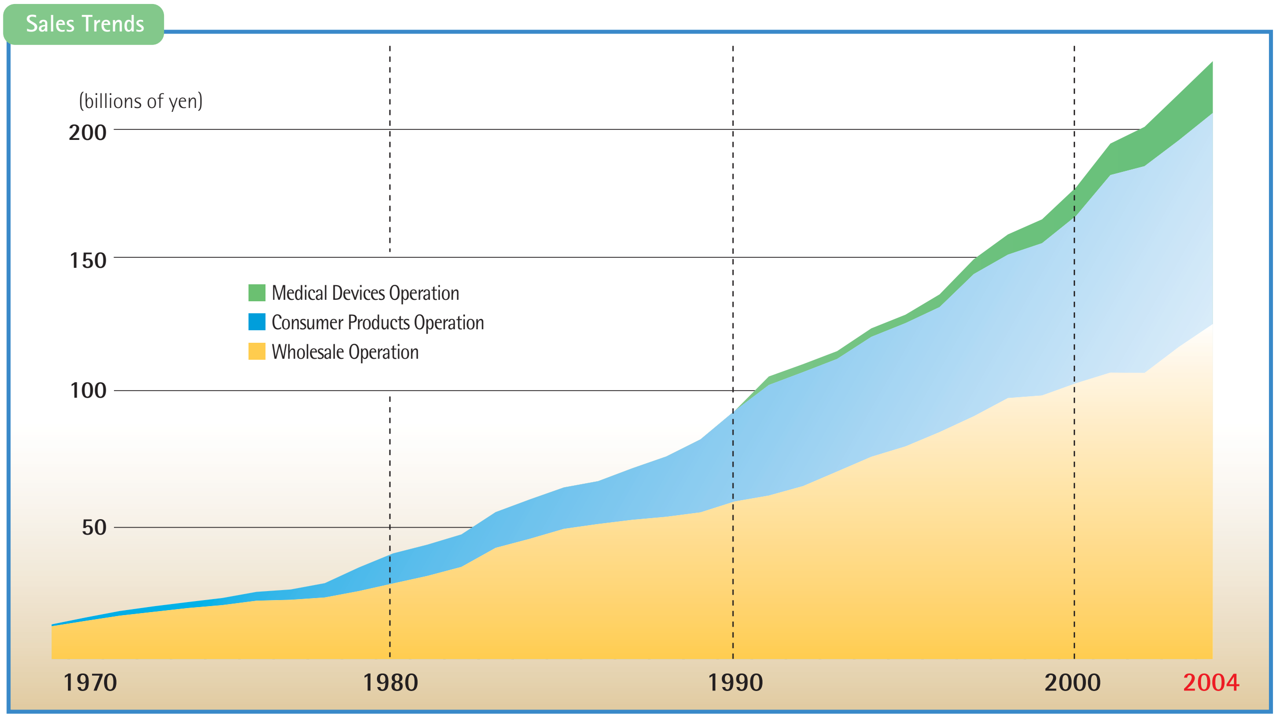
The core strengths of our Consumer Products Operation are its ability to create markets and then to differentiate its products from competitors. We will continue to channel management resources to this operation to strengthen this competitive advantage and create new markets. We continue to make progress expanding sales and our market share through various means, including the acquisition of well-known brands with large market shares, mergers and acquisitions of outstanding companies, and expansion into overseas markets. We will combine these approaches with measures to enhance the efficiency of our in-house production lines and cultivate closer relationships with outsourcing service firms to tap benefits of mass production, thus raising profit margins and maximizing profit.

Wholesale Operation–Becoming the Choice of Customers

The pharmaceutical wholesaling sector faces a very difficult operating environment due to escalating price-based competition in the drug store industry, its main target market. As drugstore chains expand their geographical coverage and increasingly operate nationwide, we naturally have to follow suit and expand our services in order to retain the allegiance of our customers and become their business partner of choice.

Against this backdrop, the Wholesale Operation is accelerating efforts on various fronts such as M&A and tie-ups with other wholesalers to gain economies of scale, enhancing sales and planning proposal capabilities, and making business processes more efficient.

In October 2003, Kobashou and three wholesalers in Shikoku set up Seiei Co., Ltd., a joint venture company. Business activities in the Shikoku region are already under way. In an unrelated development, we also formed a business alliance with Mitsubishi Corporation and Ryoshoku Ltd. in March 2004.



Medical Devices Operation–Excellent Growth Potential

The Kobayashi Medical Division in Japan and equity-method affiliate Medicon, Inc. import and distribute medical devices and supplies. Separately, Shield Healthcare Centers, our U.S. subsidiary, sells locally medical supplies for the home treatment and care of patients.

For the Kobayashi Medical Division (KMD), orthopedics is a priority market. This is a field of rapid advances where new treatments and medical devices and supplies are continuously being developed, creating significant business opportunities.

KMD has steadily expanded the range of medical devices it handles by building networks and relationships with medical institutions, and through advanced specialization, underpinned by research capabilities in the U.S. Until recently, our Medical Devices Operation was in its early growth phase, a time of large start-up costs that held back profitability. But this operation clearly entered an earnings growth phase beginning in the fiscal year ended March 31, 2001. Our plans now call for expanding the scope of business through mergers and acquisitions and business alliances and for combining this with the development and manufacture of our own products to accelerate sales and profit growth.

Reconfirming Commitment to Our Corporate Philosophy and Corporate Brand Management

In order to accomplish the key management objective of maximizing enterprise value, Kobayashi Pharmaceutical is stressing corporate brand management, a style of management rooted in raising the satisfaction of all stakeholders, including customers, stockholders and employees. Satisfaction, however, means different things to different stakeholders. Customers value quality and price. Stockholders want to see a rising stock price. We take the position that we can ultimately satisfy all our stakeholders by being customer-focused. Supplying products and services that satisfy customers boosts sales, which in turn brings in more profit and raises our share price. This also brings job satisfaction to our employees, thus triggering a virtuous cycle. With regard to corporate brand management, we use capital efficiency as the major parameter to measure corporate value. Our management policies are tuned to generating maximum value with minimum assets, while at the same time building up intangible assets. We have positioned corporate brand management as the guiding principle to realize our management goal of providing people and society with true comfort through "Creativity and Innovation."

I am thus committed to pursuing a management style that will raise the satisfaction level of all our stakeholders while maximizing our enterprise value.

I am confident that I can look forward to your support and encouragement as we push ahead to achieve our goals.

July 2004

President and Chief Operating Officer

Corporate Brand Strategy

Corporate Brand Management

The volume of assets used to be a key benchmark for evaluating companies in the past. The key to evaluating management's performance from now on will be to measure how effectively assets are utilized, instead of merely noting the size of a company's asset base. Maximizing the value of intangible assets such as intellectual property, human resources and brands, without increasing tangible assets, will be crucial. The corporate brand concept represents a new measure of corporate value. It embodies the unique identity that shapes a company's public image. Following the development of several valuation methods, corporate brands have become a key management indicator at many companies.

Since April 2003, Kobayashi Pharmaceutical has implemented corporate brand management initiatives to raise its corporate value by building a stronger corporate brand.

Implementing Corporate Brand Management

Corporate brand management is difficult because corporate value means different things to different stakeholders. Customers value quality products and the convenience they afford. Stockholders want to see a rising stock price. Employees are seeking job satisfaction. We take the position that we can ultimately satisfy all our stakeholders by being customer-focused. Bringing satisfaction to a broader range of customers leads to increasing profits and raises our share price. This also brings more job satisfaction to our employees. That is why the core concept behind our corporate brand management initiatives is the relentless pursuit of customer satisfaction.

Kobayashi Pharmaceutical created a brand charter and a brand slogan when it began corporate brand management initiatives. Our brand charter reflects the beliefs of all group employees regarding Kobayashi Pharmaceutical's defining traits, as well as our relationships of trust with customers and society, aspirations and corporate stance. Each in-house company is formulating action plans based on our brand charter. The goal of these action plans is to first satisfy customers and then all other stakeholders, with the overriding aim to consistently improve corporate value.

あったらいいな
をカタチにする

"You make a wish and we make it real."

The Kobayashi Pharmaceutical Brand Slogan

Kobayashi Pharmaceutical Group Brand Charter

Going beyond merely satisfying our customers' fast-evolving needs, our mission is to create new products that our customers have always wanted. True to our brand slogan of "You make a wish and we make it real," we will deliver these products as early as possible.

Products and services will be developed from the standpoint of customers to the highest standard of quality, in order to live up to the trust placed in us by society and our customers.

Our dream is to share small discoveries from everyday life with people all over the world.

We are committed to being a development-focused company that contributes to society by building lasting relationships with customers and delivering new forms of satisfaction.

Shifting to a Business Headquarters System

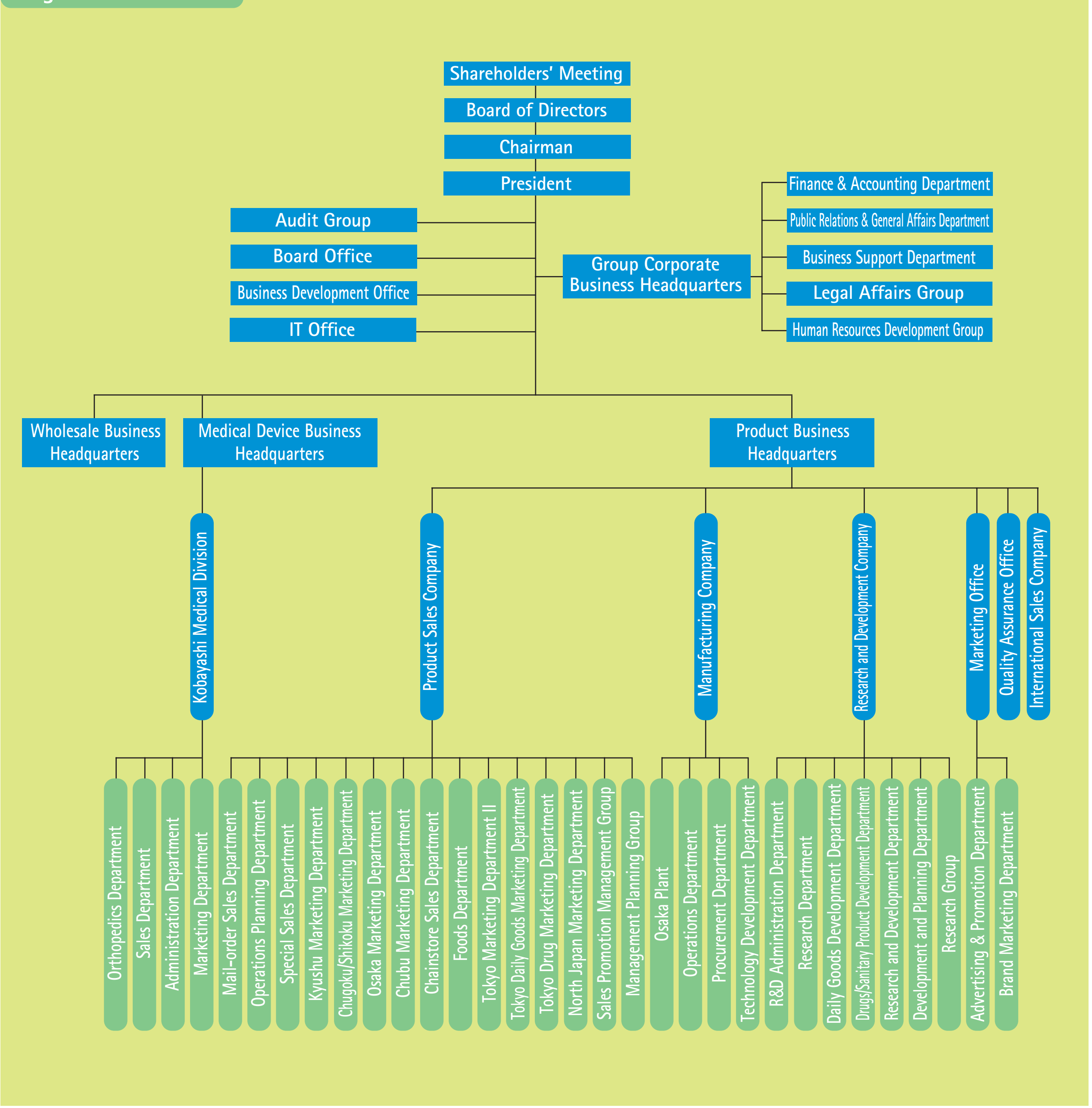
Aiming for Faster Management by Delegating Authority

Organizational reforms implemented in April 2004 saw Kobayashi Pharmaceutical establish four business headquarters for each of its businesses. Under the new structure, each business headquarters will oversee the management of their respective businesses and is authorized to establish systems and procedures that match the requirements of each business, and formulate and execute business strategies.

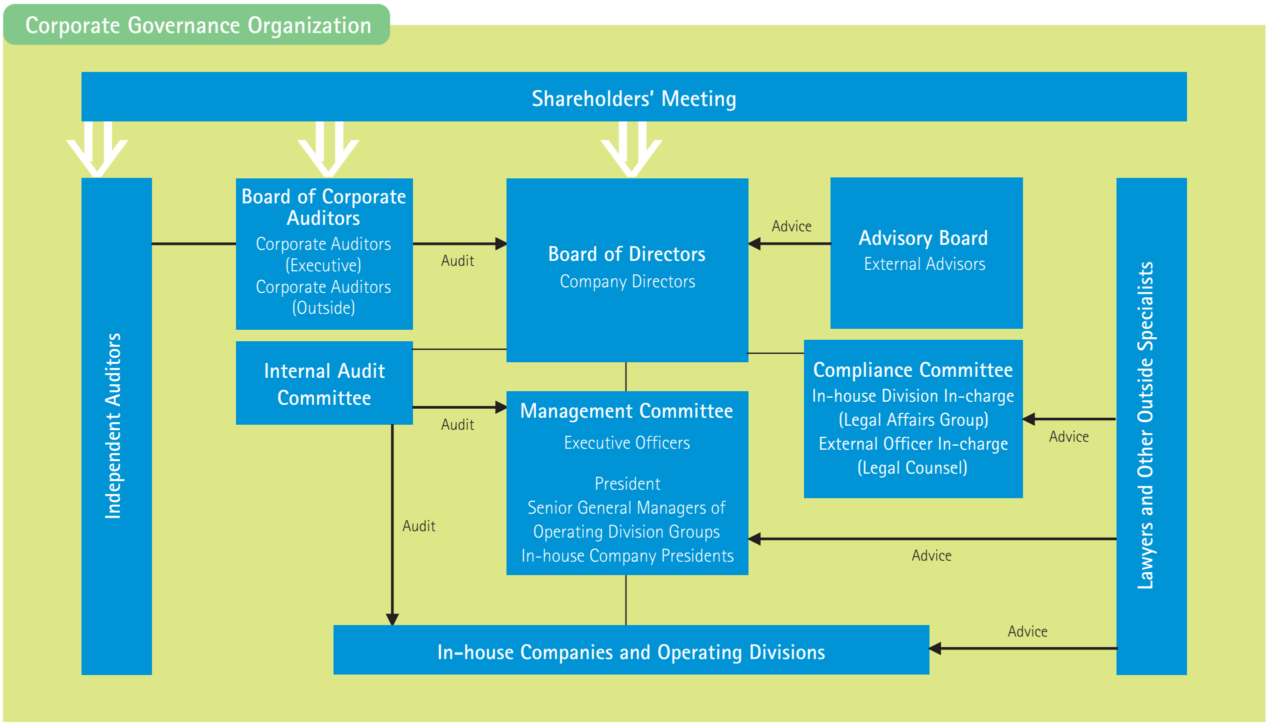
The four business headquarters are the Product Business Headquarters, which oversees the company's three businesses, the Medical Device Business Headquarters, the Wholesale Business Headquarters and the Group Corporate Business Headquarters, which oversees various corporate sections. Broad-ranging authority has been vested in each business headquarters to formulate plans, invest, execute strategies, control budgets and carry out many more responsibilities. Kobayashi Pharmaceutical will work to ensure that these business headquarters become autonomous decision-making units to strengthen overall group-wide management.

We have also established the Business Development Office and IT Office, which report directly to the president. The Business Development Office will specialize in rapidly and proactively implementing M&A to advance growth strategies. Meanwhile, the IT Office will promote the adoption of IT systems that raise group-wide efficiency, with the aim to innovate operating procedures and improve cost competitiveness.

Organizational Chart



Corporate Governance



Corporate Governance

Kobayashi Pharmaceutical believes that raising shareholder value is a key priority for achieving our fundamental management policy of maximizing corporate value. For this reason, we are committed to providing timely and accurate disclosure, along with making management more transparent.

Following approval by the general shareholders' meeting held in June 2001, several measures were implemented to reshape the management structure. These included reducing the number of directors (from seven to six), improving the executive officer system (while executive officers still number 13, the number of concurrent directors has been reduced from seven to five) and introducing an in-house company system. The aim was to vitalize the Board of Directors and put in place systems and procedures that facilitate swift decision-making and strengthen functions for the execution of operations.

The Board of Directors holds regular meetings once a month, and holds special meetings as necessary. The Board decides on important matters relating to management and other issues required by law and regulations, and regularly monitors the execution of operations.

Under this new management structure, the Company has taken a number of actions in accordance with its growth strategies. These have included the spin-off of wholesale operations at Kobashou Co., Ltd. in April 2002, and the acquisition of the medical device operations of Chugai Pharmaceutical Co., Ltd. in October 2002 and health foods business of Hitachi Zosen Corporation in December 2003. Also noteworthy was the business alliance formed by wholesale subsidiary Kobashou Co., Ltd. with Mitsubishi Corporation and Ryoshoku Ltd. in March 2004. In parallel with these steps, we have also made progress with the withdrawal from and realignment of unprofitable businesses.

The Company has not appointed outside directors, but is confident that decision-making authority rests with those who understand and can faithfully implement our management philosophy. However, reinforcing our governance structure based on corporate auditors remains a key priority. The Board of Corporate Auditors consists of four corporate auditors, two of whom are outside corporate auditors. There are no equity relationships or business ties between the Company and its outside auditors.

The Company exchanges views on improving its operations with independent auditor Shin Nihon & Co. through regular meetings held every month and other means. As part of the decision-making process, management also refers to advice from legal counsel and other experts on issues related to company management and day-to-day business affairs, as necessary.

In April 2003, the Company established a Compliance Committee to foster a strong spirit of compliance with laws and regulations behind all our activities. In September 2003, the Compliance Committee formulated Basic Policies on Corporate Behavior and Standards of Conduct for Directors and Employees. We plan to raise awareness of these policies and standards throughout the organization. In January 2003, Employee Consulting Centers were established both inside and outside the Company to facilitate internal reporting and ensure that the Company gathers and responds effectively to the latest information.

Directors, Corporate Auditors and Officers

From left : Masaaki Tanaka (Executive Director), Yoshiharu Shimatani (Senior Executive Director), Kazumasa Kobayashi (Chairman and CEO), Yutaka Kobayashi (President and COO), Akira Horiguchi (Senior Executive Director), Akihiro Kobayashi (Director)

Directors

Chairman and Chief Executive Officer

Kazumasa Kobayashi

President and Chief Operating Officer

Yutaka Kobayashi
(Senior General Manager, Product Business Headquarters)

Senior Executive Directors

Yoshiharu Shimatani
(Officer In-charge, Product Business Headquarters)

Akira Horiguchi
(Senior General Manager, Medical Device Business Headquarters)

Executive Director

Masaaki Tanaka
(Senior General Manager, Group Corporate Business Headquarters)

Director

Akihiro Kobayashi
(President, International Sales Company and Manager, Marketing Office)

*Yutaka Kobayashi, Yoshiharu Shimatani, Akira Horiguchi, Masaaki Tanaka and Akihiro Kobayashi concurrently serve as executive officers.

Corporate Auditors

Statutory Auditors

Toshiyuki Morii

Tetsuo Nakata

Auditors

Tadashi Ishikawa

Hiroshi Hayashi

Executive Officers

Senior Executive Officers

Takashi Tsujino
(President, Research and Development Company)

Jyoji Miki
(President, Product Sales Company)

Executive Officers

Hiroshi Nomoto
(President, Kiribai Chemical Co., Ltd.)

Takafumi Sakaguchi
(President, Kobayashi Medical Division)

Hidetsugu Yamamoto
(Manager, Information Technology Office)

Satoshi Yamane
(Manager, Business Development Office; and Manager, Board Office)

Tomoharu Nagahara
(President, Manufacturing Company)

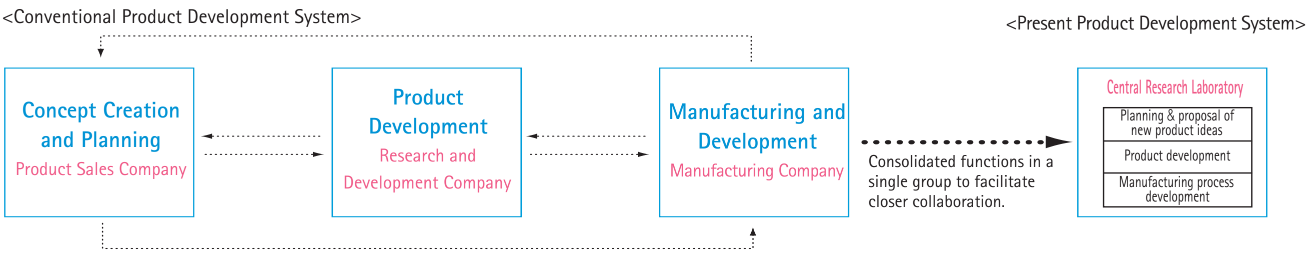
Haruyoshi Kosaka
(Officer In-charge, Wholesale Business Headquarters)

(As of June 29, 2004)

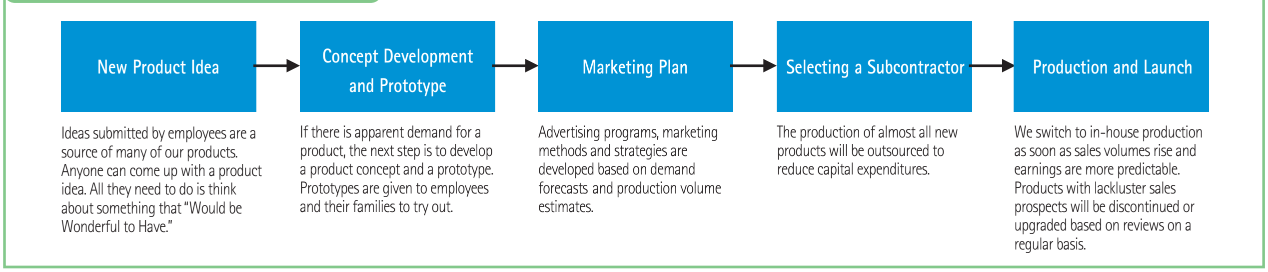
Research & Development

Research and development is a core operation for a company like Kobayashi Pharmaceutical, which has the primary mission of bringing a constant stream of innovative new products to market. "Come Up With Products That Will Contribute 10% of Total Sales" is our catchword. Our determined, uncompromising emphasis on niche products is the motive force behind powerful new products.

Speedy New Product Development System



New Product Development Process



R&D System Designed to Speed Up Product Development

Kobayashi Pharmaceutical has taken several measures to hone sensitivity to changing market needs and gives top priority to establishing systems that will speed development in our research and development, technology and production divisions. In 2000, we established the Central Research Laboratory in Osaka. Today, new product development is integrated in the Central Research Laboratory's Research and Development Company, which now has the sole responsibility for the entire process from planning onward.

One of our core strengths in R&D is our ability to speed up the product development cycle and hold down development costs. We employ the so-called "concurrent method" in which planning, development, prototypes, quality assurance, preparation for mass production, and sales planning are carried out concurrently. Unlike in the conventional relay system, these processes are vertically integrated. This allows us to start mass production and put a new product on the shelf just 13 months after an original product idea is conceived.

Our Strengths—New Ideas and Speed

Kobayashi Pharmaceutical is renowned for the speed at which it brings a steady stream of new products to the market. An integrated technology development and production system allows us to turn ideas into products in just 13 months.

The source of new ideas is the market and our employees. In 1982, we introduced a system to encourage employees to submit new ideas. Now two-thirds of the new ideas that our employees submit every year are for new products, equating to roughly 20,000 ideas per year. Ideas come in from throughout the Company and are considered and refined by the research laboratory, where they go through a multi-stage screening process. The laboratory takes raw suggestions and turns them into the innovative products we bring to the market. Since the source of ideas is customer suggestions picked up by employees in the course of their daily activities, they lead to products that are welcomed by consumers. This ability has become one of our core strengths.

In our concurrent product development system, planning, development, prototypes, quality assurance, preparation for mass production, and sales planning are carried out simultaneously, with close collaboration between all the divisions concerned, significantly shortening the product development cycle.

New Product Development Concept

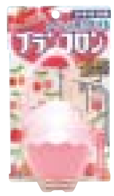
Kobayashi Pharmaceutical is active in a range of categories: pharmaceuticals such as *Ammeltz* and *Eyebon* eyewash, deodorizing air fresheners like *Bluelet* and *Sawaday*, oral hygiene products like *Toughdent* and *Breath Care*, sanitary products like *Netsusama Sheet*, and household sundries such as *Potto Senjochu*, in addition to nutritional supplements, including *Kensetsu Help*. Our product development changes in response to the changing definition of "comfort."

New product ideas come from insights into the daily life and activities of consumers. People are, throughout their lives, consumers first and foremost, and Kobayashi Pharmaceutical is convinced that

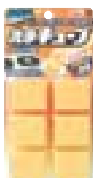
Major New Products Launched in the Fiscal Year Ended March 31, 2004

Urinaaru

Breath Care Film



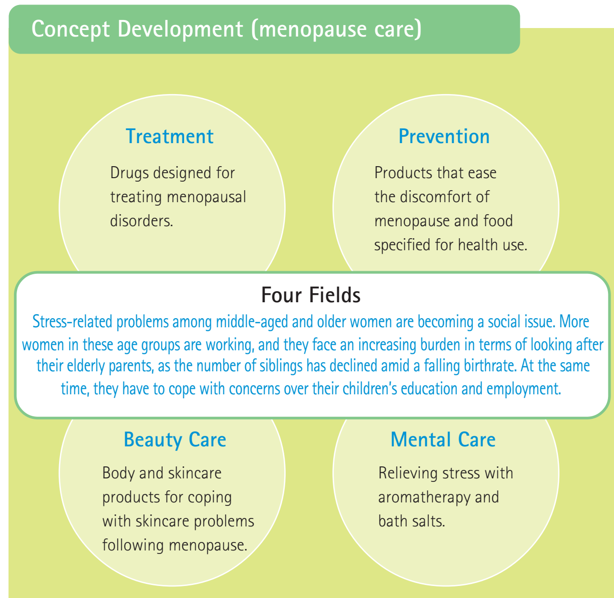
Bran Cologne



Senjo Cube

Moromi Kurozutsubu

BADIET



there is an endless stream of new product ideas that we can tap. To come up with hit products, we must first identify consumer needs and wants and develop products that really fill these needs; then combine this with packaging, naming and advertising that highlights the product's functions. Our policy is not to go for mega-products but to aim at bringing a stream of heavy-hitter new products to the market. Recently our policy has been to reduce the number of products being developed and refine our research to raise our success rate further.

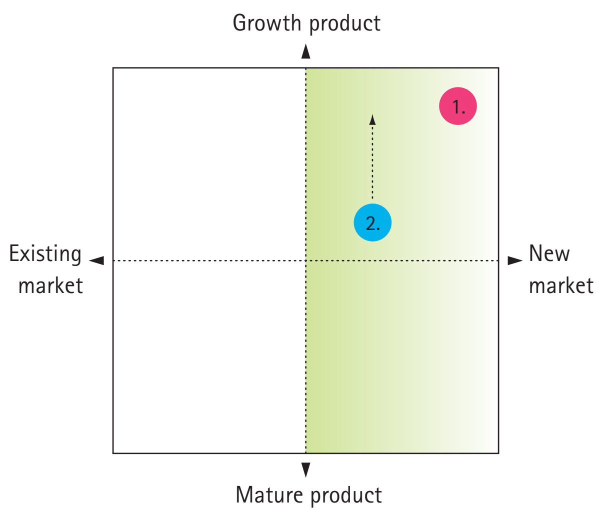
Since most of the products we launch have never been on the market before, and consumers are not familiar with them, the strategies we follow in packaging, naming and advertising focus on making it easy for consumers to understand our products. We name products in a way that allows consumers to easily identify their applications and functions.

A Product Development Model That Stays in Step With Changing Times

In the past, we faced little competition for innovative products developed to create new markets, and this allowed us to build a strong position. It also freed funds that would have normally gone into product promotions, allowing us to channel them into the development and promotion of successor products. This model worked well up to around 1997. However, increasing competition has shortened the period during which we can look forward to a first-mover's profit, leading to an increase in sales promotion expenses and raising the cost of the investment necessary to develop products to take on the competition. The result has been scarcer resources available for investment in future growth and the development of innovative products.

The "Mother Concept" approach to development will help us break this deadlock and strengthen our competitive position. The idea is to identify needs created by major social trends and then concentrate resources on developing a steady stream of products based on the identified concept in areas where barriers to entry are high. This will enable us to establish a strong market position, which will be leveraged to steadily expand our markets. One promising area in this model is treatment of menopause-related problems. Stress-related problems among middle-aged and older women are becoming a social issue. As more women in these age groups are working, they face an increasing burden in terms of looking after their elderly parents, as the number of siblings has declined amid a falling birthrate. At the same time, they have to cope with concerns over their children's education and employment. If we develop a group of products that prove efficacious in such a broad category, we will be in a position where we can effectively market, advertise and promote them.

Consumer Products Operation
Creating Markets



1. **Something New (for creating new markets)**
Creating entirely new markets by introducing innovative products and then expanding them is what Kobayashi Pharmaceutical does best.

2. **Something New (for expanding markets)**
Developing and introducing new products in existing markets or championing existing niches and then pursuing growth is another Kobayashi Pharmaceutical forte.

Developing Products to Create New Markets
New product development is the growth driver in our Consumer Products Operation, where principal activities are planning, R&D, production, and marketing of Kobayashi Pharmaceutical's original products. Kobayashi Pharmaceutical pursues the development of new products on two fronts, "Something New" and "Something Different," but the focus is on the former.

"Something New" products fall into two categories: products designed for creating new markets, and products designed for expanding markets. The former aim at meeting needs that have been overlooked, thus creating entirely new markets. This is Kobayashi Pharmaceutical's core strength. The latter aim to quickly launch powerful products to expand small existing markets or market niches whose growth potential has not been fully exploited since products attractive to consumers are not available. Competitors follow quickly once we have introduced new products and created markets in this way. We welcome this since it leads to a bigger market. Our strategy is to stay committed to products with clearly defined concepts. The goal is to offer functions that live up to the expectations of consumers and in doing so capture a large market share and establish a leading presence befitting a pioneer.

New Product Development and Winning Acceptance in the Market
Kobayashi Pharmaceutical sets exacting standards for new product development: sales of new products released in any given fiscal year are to contribute at least 10% of total parent-company 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.

1. Something New, Something Different

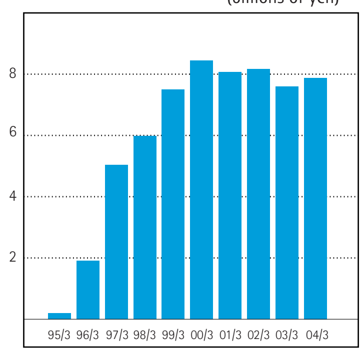
Saho Takajo
Research and Development Company

"I was concerned about wearing contact lenses. Removing them at night was a relief. As I washed my contact lenses, I was worried that my eyes could be just as oily and dusty as my contact lenses. It seemed just as important to develop a product to wash the entire eye. That was the motivation for developing this product."

"When you wear contact lenses, your eyes can become irritated or start to itch. My concern is that rubbing the eyes may scratch the eyeball. *Eyebon* eyewash cleanses the eyes of any protein dirt and dust, creating a fine and refreshed feeling."

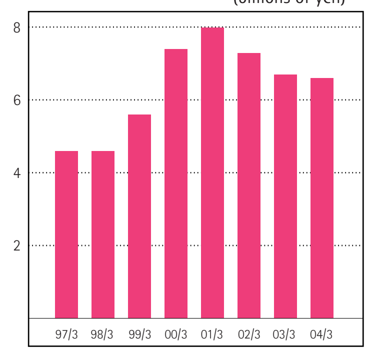
Cooling Gel Sheet Market

(billions of yen)



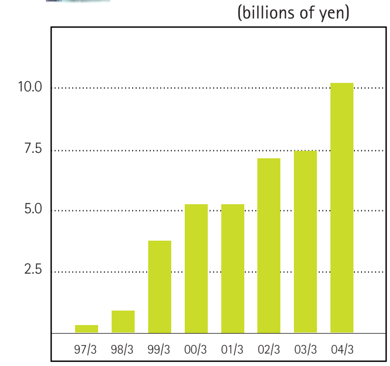
Eyewash Market

(billions of yen)



Oral Hygiene Products Market

(billions of yen)



Creating and then expanding new markets are the core strengths of our Consumer Products Operation. Our strategy is to win overwhelming acceptance in the first year, turn first-time customers into regular users, and thereby encourage them to buy value-added products of the same brand. New products have a vital role to play in our operations because their continuous launch leads to stable earnings growth. The development of powerful new products thus gets the highest priority at Kobayashi Pharmaceutical and we channel management resources into maintaining and strengthening new product development capabilities.

A Tight Focus on New Product Launches and Sophisticated Brand Management

The contribution of new products as a percentage of our total sales has declined over the past four years, mainly because we overextended our lineup of new products, spreading management resources too thinly. We have now tightened our market launch standards with the view to developing stronger new products. This highly selective approach, which concentrates on a select group of heavy-hitter new products capable of driving growth forward, makes it possible for us to conduct more R&D and market research for each new product and to concentrate on high impact ad placements and sales promotions in retail stores. This approach led us to launch only 15 new products in the fiscal year ended March 31, 2004, eight fewer than in the previous fiscal year. Despite fewer product launches, new product sales have largely contributed the targeted level of 10% of sales in the first year and our return on investment has sharply improved.

We are also reviewing our brand management strategy, with brand managers closely monitoring sales-promotion and brand-building strategies for each of our 120 brands. Products that fail to contribute to earnings are either promptly renewed or withdrawn from the market to ensure profitability as part of a continuing process of improving the quality of our overall product portfolio.

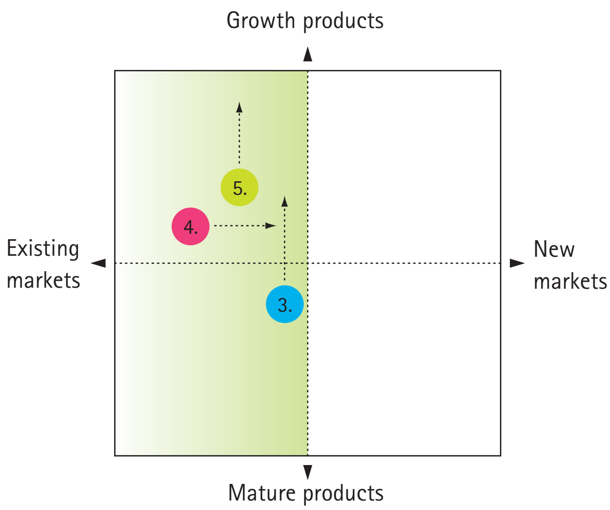
Strengthening New Product Development

Our Research and Development Company now has sole responsibility for the entire process of product development. Previously, this was a collaborative endeavor involving the Product Sales Company, the Research and Development Company, and the Manufacturing Company. This new arrangement, which integrates every stage from planning to development in the Research and Development Company, promotes more flexible and faster product development than before. The benefits are already evident. The new system has yielded better communication, a must for successful product development, and shortening of the new product development cycle.

Consumer Products Operation

Bolstering Competitiveness

Capturing and Increasing Market Share



3. Competitive New Products (Products for Entering Markets)
These are value-added products designed to enable us to enter existing markets, create new demand, and in the process win market share. They are growth products for niche markets.

4. Competitive New Products (Products for Taking on Competition)
These are products designed specifically to compete with like products launched by the competition and to protect our brand. They are also aimed at improving our brand positioning.

5. Competitive New Products (Products for Brand-based Line Extension)
Here, we add variations in terms of formulation and functionality to products with established market positions to grow brands. This is the successful pattern for "Something New" products.

Expanding Markets We Have Created

To continuously grow niche markets created with new products, it is essential to constantly develop and launch products attuned to market changes. Otherwise, likely scenarios are that the market we worked hard to create will contract or fall into the hands of competitors.

It is natural to expect competitors to enter markets we create and foster once they have grown to a certain size. But we also enter existing markets with new value-added products. We therefore feel that the development of new products that clearly set us apart from competition—"Something Different" products—is the key to competing successfully.

Our "Something Different" products fall into three categories. The first is "Products for Entering Markets," which have added value designed to increase market share or to create new niches in an existing market. The second is "Products for Taking on Competition," which are designed to assert our competitiveness in terms of price, efficacy and other qualities. This category includes products developed specifically to protect our brand in markets where the competition is introducing me-too type products. The third is "Products for Brand-based Line Extension." This is achieved by adding variations to products with established market positions, such as by switching to superior ingredients and improving functionality.

Unique Products Even for Established Markets

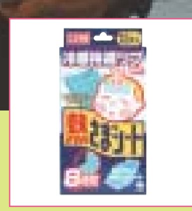
When entering established markets, we must develop "Something Different" products with greater appeal than the products of other companies. Our strategy here is to identify unfilled market needs and introduce innovative products to fill these niche markets.

One such product is *Shouyou* toothpaste, which we introduced in spring 2002. Toothpaste is a highly competitive and mature market. However, our *Shouyou* toothpaste not only cleans teeth but also prevents gum disease, thereby offering more value and new appeal, which differentiates it from other products on the market. We developed *Shouyou* to respond to growing awareness of well-being and concerns over prevention of periodontal disease.

Product Development Prowess Seen Also in Brand-based Line Extension

While developing entirely new products is a focus, we place the same emphasis on adding value to current products to achieve brand-based line extension. This approach has led to the creation of several major brands, including *Bluelet* and *Netsusama Sheet*. We carefully monitor market responses to our new products, identifying emerging needs and improving products or adding functions that match changing market needs. This is an important marketing strategy for raising the value and extending the life of a brand.

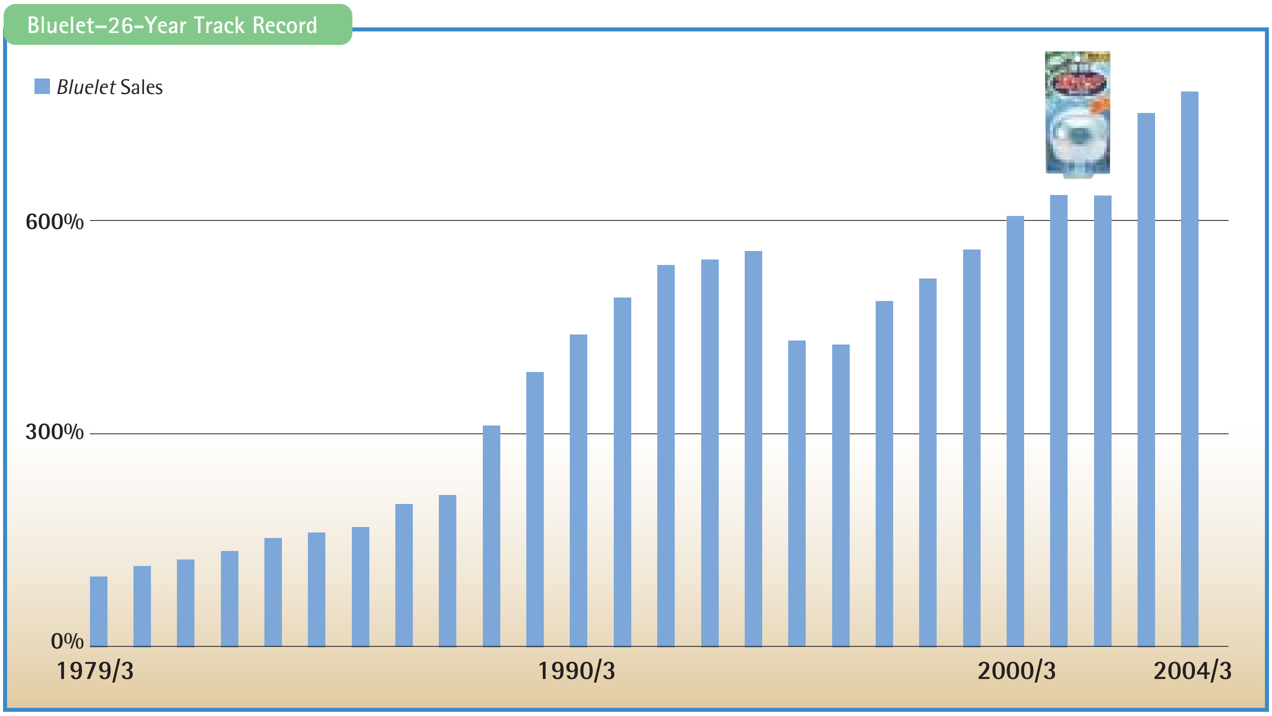
2. Something New, Something Different



Masaaki Hashima
Marketing Office

"It is normal practice in Japan to cool the forehead of a patient with a high temperature to relieve discomfort. The traditional method is to use a well-squeezed wet towel to bring down the fever. This approach has problems, not least of all that the towel often falls off while asleep. *Netsusama Sheet* was developed to solve this problem."

"A sudden fever is a trying experience, even for an adult. When a child has a fever, parents naturally want to do all they can to bring it down. *Netsusama Sheet* is there to help. It is always a relief to see a child with a fever recover. I also appreciate the fact that this product can be purchased almost anytime, anywhere."



*Base year: Fiscal year ended March 31, 1979=100

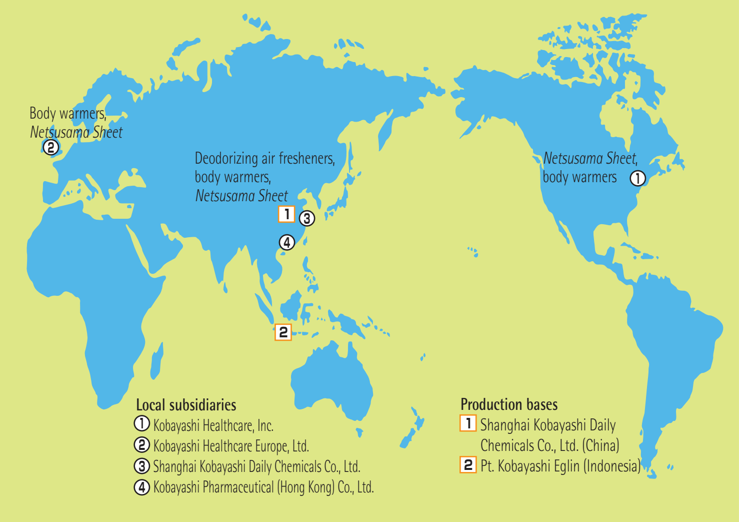
Take *Bluelet*, for example. This deodorizing toilet bowl cleanser, which debuted in 1969, continues to find a steadily expanding base of regular users. Our strategy of improving the product composition, design and functions has turned *Bluelet* into one of our longest-selling brands, supporting a broad line of products. The blue color of this product is the most distinguishing feature of this brand. However, to meet the needs of people who want to get a quick sense of their health based on urine color, we introduced a colorless version of *Bluelet* as a line extension. Since the cleanser is colorless, its effectiveness is not easily apparent to users. To overcome this, we changed to a type that froths when cleansing the toilet bowl. The new product, called *Ekitai Bluelet Okudake*, was developed and launched in fall 2001 and was a huge success.

Consumer Products Operation

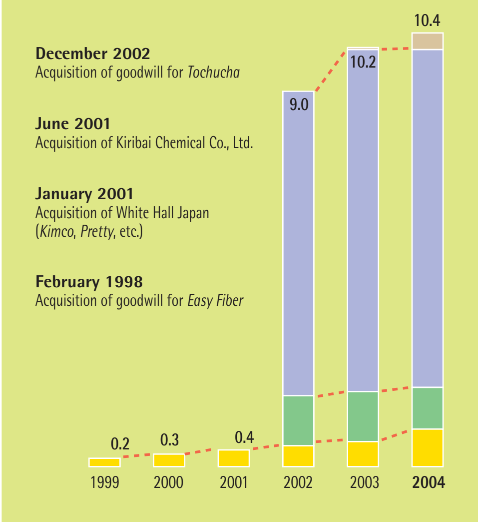
Improving Results

Simultaneously Expanding Sales and Earnings

International Expansion and Major Products



Boosting Sales Through M&A



Easy Fiber sales
White Hall Japan sales (*Kimco*, *Pretty*, etc.)
Kiribai Chemical sales
Tochucha sales

Strategy for Raising Sales

Expanding the Product Line Through M&A

Our concept of new product development is centered on developing innovative products to create entirely new markets. However, we also actively conduct mergers and acquisitions to shorten the time required for development and nurturing brands, thereby enhancing investment efficiency.

M&A activity at Kobayashi Pharmaceutical started in 1998 with the acquisition of the goodwill for *Easy Fiber*. Subsequently, in 2001, we made two acquisitions: White Hall Japan, gaining *Kimco* deodorizers for refrigerators, and Kiribai Chemical Co., Ltd., adding a line of body and hand warmers. In 2002, we purchased the goodwill for *Tochucha* from Hitachi Zosen Bio Corporation. These acquisitions have helped us to gain access to brands and companies well known throughout Japan. M&A thus offers the advantages of shortening time to develop products that create markets while reducing capital investment for production facilities and brand building.

We restrict M&A targets to brands and companies capable of generating synergies with our existing businesses, but we are also open to positively studying other promising opportunities. We intend to expand sales by targeting leading Japanese companies and brands, and U.S. OTC and toiletry manufacturers for possible M&A opportunities.

Expanding International Operations

Expanding our presence overseas is as promising as expanding the line of products we offer. Globalization is therefore a part of our growth strategy. We have marketing subsidiaries in the U.S., U.K., China and Hong Kong. In China, we manufacture and sell seven products, including deodorizing air fresheners, body warmers, cooling gel sheets for the forehead and Medicon's urine bags. In response to steadily growing sales of deodorizing air fresheners in China, we developed new products specially designed for the local market, further stimulating the air freshener market. We are also hoping to create a market in China for body warmers as a new product proposal for beating the cold.

We market cooling gel sheets for the forehead in the U.K. and the U.S. Plans call for expanding sales in these markets while introducing our original products to Southeast Asian markets, thus promoting global sales.

Bottom Line—Boosting Earnings

Optimizing Production With a Global Production System

The Manufacturing Company oversees all our manufacturing facilities and operations. In the past fiscal year, we closed our Chiba Plant to

Major Products Marketed Overseas

U.S./U.K.　　China

3.

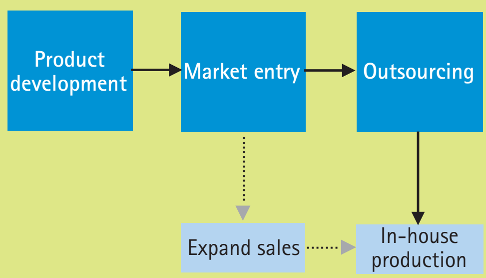
Something New, Something Different

Noriko Matsumoto
Manufacturing Company

"There are many delicious foods I'd like to try, but I worry about bad breath. This can be a serious problem the day after a night of eating spicy foods, particularly dishes with garlic, or drinking alcohol. Although we might be unaware of any lingering effects ourselves, other people aren't. Our research found strong demand among women for a product that lets them eat anything they want without having to worry about bad breath. *Breath Care*, the product we launched to meet this demand, quickly became a hot-seller among women. And not only women; it has also proved unexpectedly popular with older men.'

"I'm a fan of Italian cuisine and grilled meat. But since garlic is an essential ingredient of these dishes, concerns about "morning-after breath" kept me from enjoying them fully. Not now thanks to *Breath Care*. The great thing about *Breath Care* is that it removes odors at their source, in the stomach. It's so effective that I don't have to worry at all about my breath when I'm talking. The thing is, *Breath Care* also gets rid of the next-day smell of alcohol, so now I'm afraid I might start drinking more."

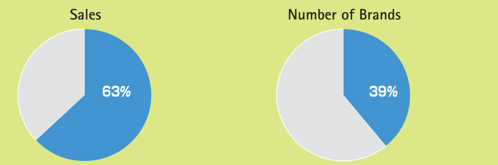
Minimizing Initial Capital Investment While Quickly Bringing New Products to Market



When launching new products, we limit initial investment, mainly by outsourcing production. This enables us to quickly bring new products to market without the burden of a heavy upfront investment in manufacturing. After market launch, we gradually switch to in-house production as soon as sales and profits become more predictable.

Distribution of Production Bases in Japan

Share of In-house Production



Fiscal year ended March 31, 2004

improve the efficiency of our overall production network and from the standpoint of anticipated future needs. We now operate nine manufacturing facilities, seven in Japan, including subsidiaries, and two overseas (Shanghai and Indonesia).

We have fashioned a system for manufacturing products that best utilizes the know-how and production assets of each plant. Given that we manufacture a variety of products in a wide range of categories, our production system is designed to make full use of our global production facilities, including those acquired through M&A, by having each plant manufacture those products for which it possesses particular advantages. For example, labor-intensive products are manufactured at our China plant, whereas products that require a sterile production environment are produced at our state-of-the-art Sendai Plant. To reduce risk, we manufacture all our major products at a minimum of two plants.

Enhancing Manufacturing Efficiency

The Manufacturing Company is developing a structure that will assure earnings growth even when production volume declines. All shop floor employees are encouraged to submit proposals for reforming manufacturing processes to reduce costs. We take these suggestions seriously, evaluate them with care and implement promising ones. This approach contributes to reducing costs. In the fiscal year ended March 31, 2004, we reduced costs by just over ¥1.2 billion year on year.

In addition, we have slashed inventories by implementing a manufacturing system that can flexibly handle changes in volume. Production volumes of new items tend to fluctuate significantly, since it is difficult to forecast demand. We actively encourage periodic consultations between the manufacturing and marketing groups to better estimate production requirements. Production plans are based on sales forecasts and are fine tuned in a timely manner to reflect changes in demand. The goal is to produce only what we can sell, avoiding any build-up of dead inventory, while at the same time making sure that there are no shortages by producing as and when required.

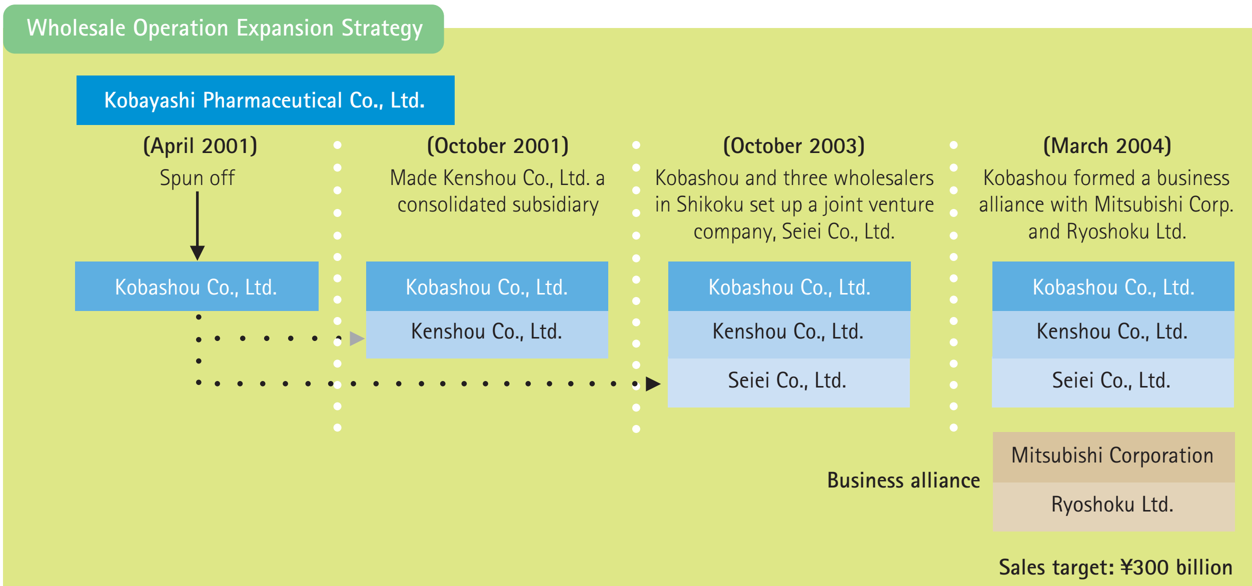
Minimizing Capital Investment Risks While Shortening Development Lead Times

The Manufacturing Company limits initial investment mainly by outsourcing production of new products and then moves to 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 any heavy investment in manufacturing. The result is that we are able to bring new products to market much faster.

Wholesale Operation

Expanding Business

Expanding Business in a Mature Market



Wholesale Operation and the Kobashou Spin-off

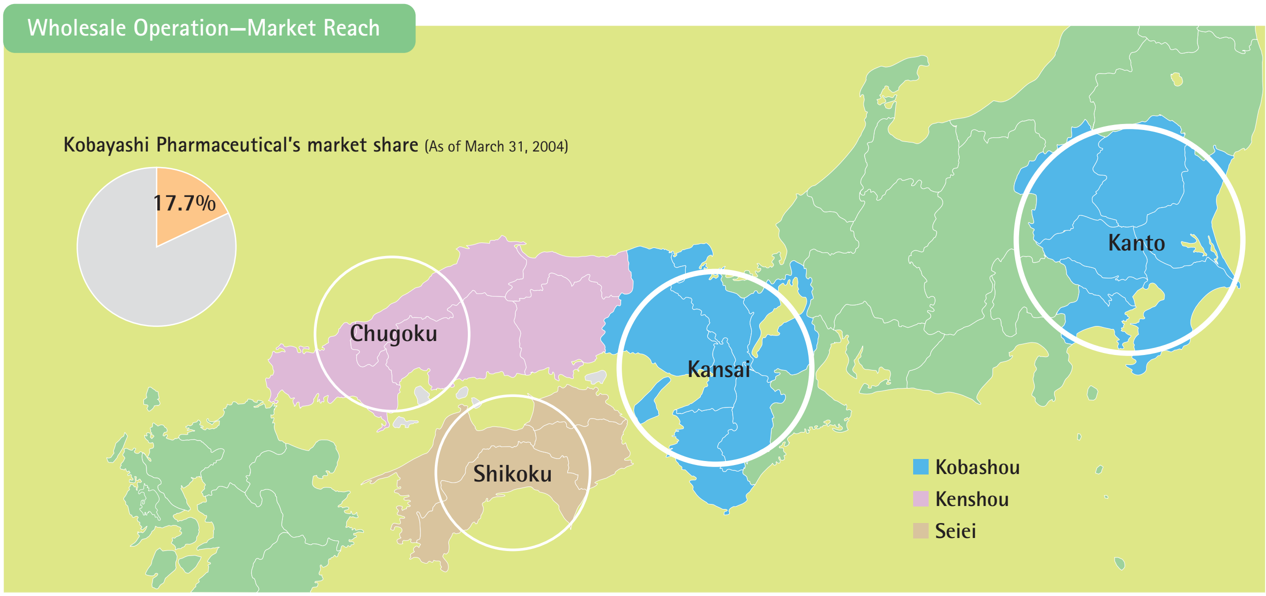
Kobayashi Pharmaceutical started out as a wholesaler of pharmaceutical products. Later we expanded operations to cover the manufacture and sale of pharmaceutical products and daily sundries. But it is our wholesaling business that has supported growth. We spun off this business as Kobashou Co., Ltd. to assure its sustained expansion. Although the efficiency resulting from conducting manufacturing and wholesaling under a single roof was one of our core strengths, as sales of products manufactured in-house rose, it became even more important to maintain neutrality in marketing on behalf of outside customers and other areas.

While this was happening, retailers were expanding their service areas, which meant that we had to build a nationwide wholesale network. It was against this backdrop that in April 2001 we spun off our wholesale business as a subsidiary. Kobashou was thus established as a pure wholesaler, independent of manufacturing operations, allowing it to build a nationwide service network by forging alliances with regional wholesalers.

Expanding Business and Service Areas

To respond to the geographical expansion of our customers, our Wholesale Operation has actively expanded business and service areas. In October 2001, Shikoku-based Kenshou Co., Ltd. was made a consolidated subsidiary. In 2003, Kobashou and three Shikoku-based wholesalers set up Seiei Co., Ltd., which started operations in April 2004. These moves extended our original service area, which centered on the Kanto and Kansai regions, to Chugoku and Shikoku.

In March 2004, Kobashou formed a business alliance with Mitsubishi Corp. and Ryoshoku Ltd. This gave us access to Mitsubishi Corp.'s business management know-how as well as to its global distribution network, and also introduced us to Ryoshoku's advanced management know-how in the wholesale business. Drugstore chains are expanding their lineup of foods, health foods in particular. The alliance with Ryoshoku will allow food products to be supplied through our drugstore channel. Taking the opportunity of this tie-up, Kobashou is now focusing on bolstering its marketing strength, enhancing its wholesaling functions and expanding its product lineup to become a general food distributor in order to reach its next sales target of ¥300.0 billion in annual sales as soon as possible.



Advantages of Greater Scale and a Broader Product Lineup

Expanding the scale of our operations enables us to purchase products in bulk quantities. This in turn gives us more bargaining power relative to drug manufacturers, which helps us lower purchasing prices. Increasing the number of products we handle by doing business with more drug manufacturers also enables us to improve our product lineup, and provide strong-selling products and the latest information to customers.

Strengthening Product Offerings in Expanding Markets

Expanding business is an important management issue for any wholesale business and it is therefore natural for us to focus on product categories with good growth potential. Drugstore chains have been adding foods, health foods in particular, in response to increasing health consciousness in recent years. In response, we have accorded priority to this product category as well as contact lens care products. As a result, food category sales rose 6.5% year on year in the fiscal year ended March 31, 2004. We will continue to concentrate on categories with good growth potential while working on raising management efficiency in this sector.

Leveraging IT

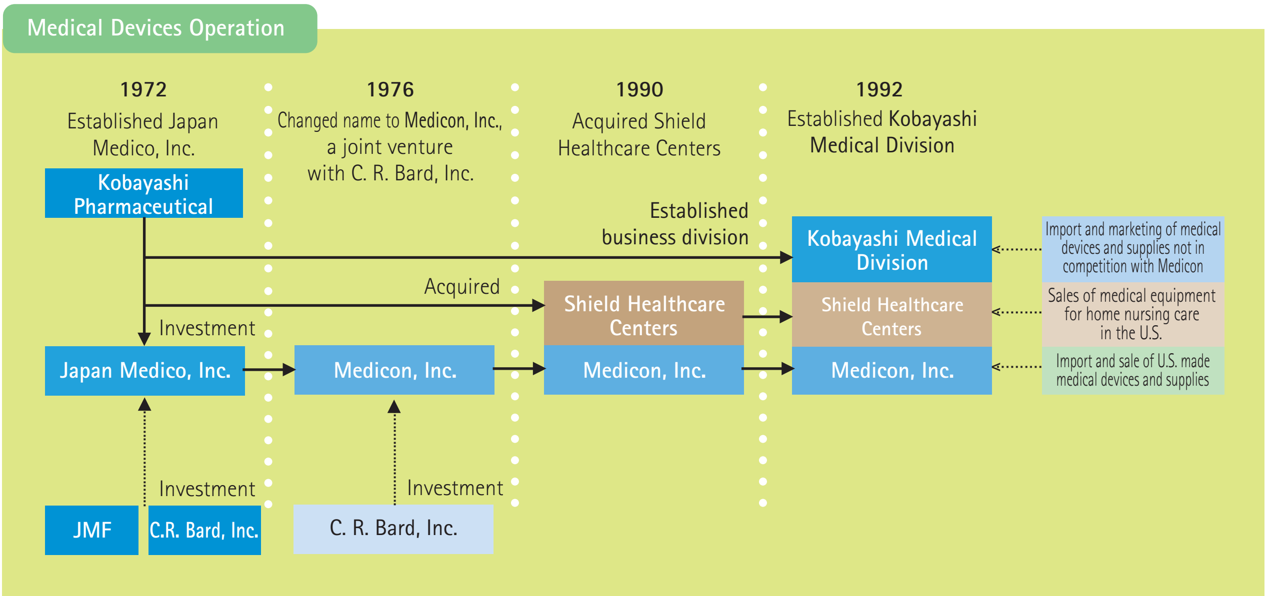
The most important management issue in our Wholesale Operation is to build a framework that will enhance efficiency and steadily boost profit.

For this, we are exploiting the potential of IT. We are working to reduce the out-of-stock rate to minimize opportunity loss, and IT is having a major part to play in this in supporting sales. KOBA-FACE, our sales support service, allows our sales corps to discuss business, regardless of where they are, face to face with customers' store managers via notebook PCs. The benefits of this system are real-time updates of store sales information and faster product delivery. Since the system also allows sharing of information and images, we can provide customers with high-quality support services, such as suggested store product layouts and examples of sales promotion strategies.

Medical Devices Operation

Focusing on Strengths

Capturing a Greater Market Share Through Differentiation



Overview of Medical Devices Operation

The Medical Devices Operation comprises Kobayashi Medical Division, U.S. subsidiary Shield Healthcare Centers, and equity-method affiliate Medicon, Inc.

Kobayashi Medical Division specializes in medical devices and supplies for the orthopedics, surgery room, anesthesiology, neurosurgery, and otorhinolaryngology domains. Separately, Shield Healthcare Centers sells medical devices for home care and treatment of patients. Medicon, Inc., a joint venture with C.R. Bard, Inc. of the U.S., specializes in urological, gastrointestinal and cardiovascular devices and supplies developed by C.R. Bard.

Our management principle of providing comfort to individuals and society is a central tenet of the medical devices operation. Here, our mission is to help raise the quality of life of patients and improve medical care in Japan by delivering state-of-the-art medical technologies and products to the frontline of healthcare that meet the needs of the Japanese market.

History of Medical Devices Operation

Around 30 years ago, we spotted the potential of the medical devices market while attending a JMF study seminar on the U.S. market for pharmaceutical wholesalers. This led us to set up in 1972 Japan Medico, Inc., a joint venture with JMF, to import and market C.R. Bard disposable medical supplies in Japan. In 1976, we changed the name of the company to Medicon, Inc. following the transfer of all shares held by JMF to C.R. Bard. This move gave us a framework for providing state-of-the-art medical devices and related information from the U.S. to medical facilities in Japan. Subsequently, in 1992, we established the Kobayashi Medical Division to import advanced medical devices in areas in which Medicon was not involved. Set against this background, our Medical Devices Operation currently has strengths in the areas described as follows.

Powerful and Unique Competitive Advantages

Research Capabilities Needed to Introduce Advanced Medical Devices

Medical device technology involves a number of disciplines and technological advances are rapid, which makes it necessary to stay on top of U.S. products and company trends. We have established a local subsidiary to collect U.S. industry data and to research medical devices manufacturers. This positions us to introduce superior U.S. products ahead of our competitors, and to invest in or build alliances with promising firms.

Advanced Specialization

In the medical devices business, it is imperative to provide highly specialized medical professionals with the latest medical information, along with medical devices. Kobayashi Pharmaceutical has thus

Products Handled by Medicon

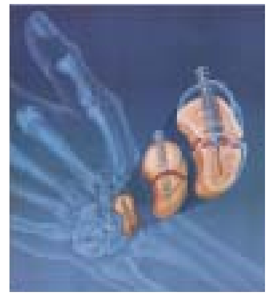
Bard I.C. Silver Foley Tray (Foley Catheter)

Bard The LUMINEXX Biliary Stent System (Biliary Stent)

Bard Button Replacement Gastrostomy Device (Button Replacement Gastrostomy Catheter)

Bard PerFix Plug (Groin Hernia Mesh)

Products Handled by Kobayashi Medical Division



ACUTRAK Headless Compression Screw

Instruments for minimum incision surgery (Developed under our first proprietary brand, Kobamed)

CERATITE (Artificial Bone)

A-V impulse system (Intermittent pneumatic compression)

adopted a "divisional" approach whereby dedicated salespeople are assigned to each field of medicine. These salespeople receive thorough specialized training in their fields before they are sent out to the medical frontline.

Education and Training Programs for Medical Professionals

Ever since we became involved in the medical devices business, we have held regular seminars and study sessions for medical professionals on the latest medical devices and technologies. Through these activities not directly linked to sales, we feel that we have been able to contribute to safer medical care and the advance of medical technology. This passion has deepened the relationship of trust with our customers, which now underpins our Medical Devices Operation.

How We Foster New Markets With Innovative Products

We have delivered numerous successful products with high market shares to the medical frontline. For example, Kobayashi Medical Division's A-V Impulse (a device for preventing deep vein thrombosis, widely publicized through reports on "long flight thrombosis") currently has a market share of 45%. In this manner, this operation concentrates on areas with excellent growth potential, launching unique products to capture commanding market shares while fostering such markets.

Outlook for the Medical Devices Operation

Developing Kobayashi Pharmaceutical Brand Products

In addition to traditional trading functions, we are strengthening our in-house R&D capabilities. The goal is to meet a need that has been voiced to us from the medical frontlines over the years—the need for products that better respond to the requirements of Japan with its different medical system and lifestyles. In April 2004, Kobayashi Medical Division launched its first proprietary product under the *Kobamed* brand. We actively encourage employees to make new product suggestions for developing products in-house that reflect the needs of frontline medical practitioners for novel products, as well as product upgrades and improvements, and as a result receive more than 1,000 ideas every year.

Expanding and Strengthening Trading Functions

Introduction of advanced products is essential for a company that wants to win a large market share. Our efforts to identify advanced medical devices have met with success owing to our information gathering skills sharpened over many years. In 2000, we introduced products made by U.S.-based Acumed, Inc., and in 2002 we acquired goodwill in bone prostheses-related products from Chugai Pharmaceutical Co., Ltd. Both product lines are contributing significantly to our sales growth. In April 2004, we signed an exclusive agency agreement with Orthofix Inc., a U.S. corporation with a global network in orthopedic products, to strengthen our presence in this area in Japan.

Environmental Protection

Kobayashi Pharmaceutical formulated an environmental action plan based on its Environmental Protection Charter to pursue business activities in a manner that minimizes environmental impact and promotes efficient use of resources. This plan has guided our environmental protection activities since 1997.

Basic Policy on Environmental Protection

Kobayashi Environmental Declaration

To protect the environment, the Kobayashi Pharmaceutical Group will effectively use finite energy and natural resources, while taking steps to prevent environmental pollution and make regular improvements.

Environmental Action Guidelines

1. Compliance and Numerical Goals

The Group will ensure compliance with environmental protection-related laws, regulations and agreements in each business domain, while formulating and meeting environmental goals and voluntary standards.

2. Reduce Waste and Improve Recycling

The Group will reduce waste volumes, taking actions to recycle waste materials that are recyclable or reusable in each stage of operations.

3. Conserve Natural Resources and Energy

The Group will actively promote the efficient use of energy and recyclable materials to make effective use of finite natural resources.

4. Provide Environmentally Sound Products and Services

The Group will carefully consider the types of materials and how they are used in all business activities in order to develop products and provide services with a lower environmental impact.

5. Common Action Guidelines and Improved Environmental Awareness

The Group will make these guidelines known to all Group employees, and hold educational and promotional programs to raise the environmental awareness of each and every employee.

Overall Environmental Load and Our Response

Kobayashi Pharmaceutical uses chemical substances and consumes resources and energy derived from fossil fuels in its manufacturing operations. As a result, we produce waste and release carbon dioxide gas into the atmosphere, thus affecting the environment. However, we are implementing energy-saving and recycling measures designed to effectively use fossil fuels, a finite natural resource, as well as appropriately controlling and reducing waste and carbon dioxide emissions from our business activities. We have set concrete numerical goals for annual reductions in carbon dioxide emissions and waste and for raising the recycling ratio, all of which are carefully monitored.

Actions to Reduce Industrial Waste

Kobayashi Pharmaceutical disposed of 244 tons of waste at landfills during the fiscal year ended March 31, 2004, representing a reduction of approximately 56% from 550 tons in the prior fiscal year, and a roughly 85.2% reduction compared with 1,644 tons in the fiscal year ended March 31, 1998. These reductions reflect efforts to rigorously sort a variety of waste from plants, including cardboard, paper, glass, plastics, metals and solvents, and promote recycling. Centered on the reuse of waste materials, our goal is to achieve annual reductions of 10% in the future by lowering waste volumes by compacting and sorting waste.

Actions to Promote Recycling

In the fiscal year ended March 31, 2004, the recycling rate was roughly 92.3%, representing an 11% improvement from the previous fiscal year. The Company uses both thermal recycling, which reuses waste as thermal energy, and conventional recycling, which mainly involves sorting waste materials. Particularly noteworthy is the high recycling rate of 98.75% at the Osaka Plant, putting the achievement of zero emissions well within reach.

Actions for Preventing Global Warming

We are actively involved in preventing global warming. In 1997, we started measuring our carbon dioxide emissions and since fiscal 2000, ended March 31, 2001, we have been monitoring such emissions per production unit.

In the fiscal year ended March 31, 2004, by transporting more products by railway, we have reduced CO_2 emissions by roughly 362.5 tons, representing 2.75% of total CO_2 emissions from manufacturing processes at the Kobayashi Pharmaceutical Group. We plan to continue to choose low-emission transportation methods.

Environmental Considerations in Product Development

Kobayashi Pharmaceutical is working to reduce the weight of product containers by changing materials used for existing product containers and taking other steps. In the fiscal year ended March 31, 2002, we reduced the container weight of our *Oheyano Shoushugen* deodorizer by roughly 29%. In the fiscal year ended March 31, 2003, the weight of packaging for nutritional supplements was lowered by approximately 2%. In the fiscal year ended March 31, 2004, containers for *Biko Kukan* deodorizers were made 71.9% lighter through a switch in materials used for pouches.

Environmental Goals and Results for the Fiscal Year Ended March 31, 2004

Goals for FY2004	Results for FY2004
1. Actions for Conserving Energy Reduce CO_2 emissions per production unit by 15% from the previous fiscal year.	CO_2 emissions per production unit in the fiscal year ended March 31, 2004 rose roughly 8% year on year. However, total emissions were lowered by roughly 3%.
2. Actions to Reduce Industrial Waste Reduce the volume of waste by 10% from the previous fiscal year.	Waste volume was lowered by 55.6% year on year in the fiscal year ended March 31, 2004.
3. Actions to Promote Recycling Improve the recycling rate by 5% year on year.	The recycling rate was improved by roughly 11% in the fiscal year ended March 31, 2004 .
4. Safety Management of Chemical Substances Reduce emissions of PRTR substances at each plant to 100kg or less.	Goals were achieved at all plants.

Financial Section

Contents

Management's Discussion and Analysis

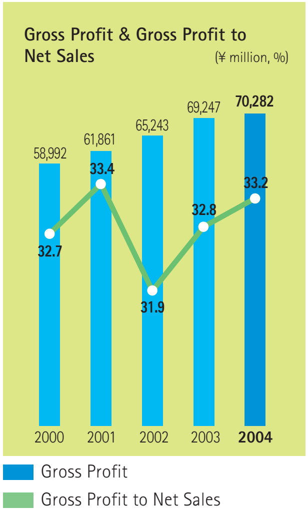
Scope of Consolidation and Application of the Equity Method

Kobayashi Pharmaceutical has 18 consolidated subsidiaries, 11 in Japan and 7 overseas, and 2 affiliates in Japan accounted for by the equity method. The Company classifies its business activities into four segments: Consumer Products Operation (6 consolidated subsidiaries and 1 equity-method affiliate), Wholesale Operation (2 consolidated subsidiaries), Medical Devices Operation (5 consolidated subsidiaries and 1 equity-method affiliate) and Other Operations (5 consolidated subsidiaries).

Overview

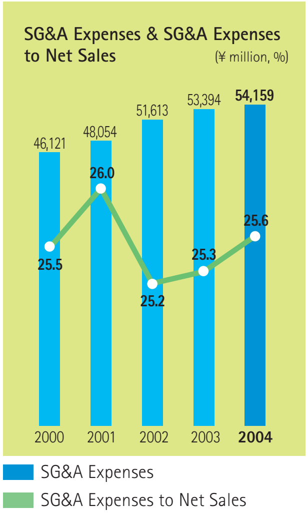
During the fiscal year under review, the operating environment remained uncertain, and it was unclear which way consumer sentiment might move. The weather, a relatively cool summer and warm winter not seen in recent years, had an impact on business performance in many industries in Japan.

In this challenging environment, the Kobayashi Pharmaceutical Group gave full play to the spirit expressed in its management policy, "Creativity and Innovation." We cultivated potential customer needs by introducing new products and services that seeded new markets, while vitalizing existing markets with value-added products and services. Alongside these moves, we actively promoted overseas business development. Underpinned by application of KOVA (Kobayashi Value Added), our proprietary management index introduced last fiscal year, we reported our sixth year of consecutive sales and earnings gains since we began releasing consolidated business results.



Net Sales

Consolidated net sales for the year under review were ¥211,670 million, 0.4% higher than in the previous year. Sales of the Consumer Products Operation rose on the contribution of new products, more focused marketing operations targeting selected individual stores and the expansion of our lineup of nutritional supplement food products. The Wholesale Operation benefited from favorable sales of health foods and the purchase by Kenshou Co., Ltd., our pharmaceutical products wholesaling subsidiary in the Chugoku region, of goodwill from a local wholesaler. Sales rose in the Medical Devices Operation as the Kobayashi Medical Division concentrated on products related to orthopedics in Japan and executed highly specialized marketing activities. Overseas sales were up on a U.S.-dollar basis but were lower in yen terms due to the yen's appreciation.



Gross Profit and Operating Income

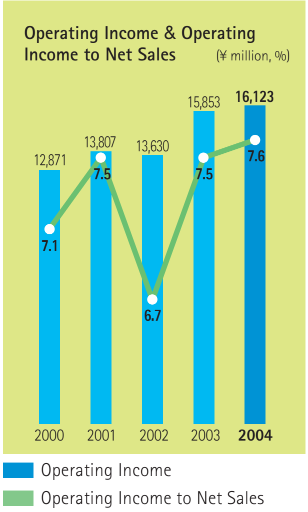
The cost of sales declined ¥287 million, or 0.2%, from the previous year, reflecting rising productivity and the benefits of cost-cutting measures. Boosted in part by higher sales, gross profit rose 1.5% to ¥70,282 million. Selling, general and administrative expenses were curbed due to a review of costs, including freight and storage charges and advertising expenses. As a result, operating income increased 1.7% from the previous fiscal year to ¥16,123 million. The ratio of gross profit to net sales rose from 32.8% to 33.2%. The ratio of operating income to net sales increased from 7.5% to 7.6%.

Income Before Income Taxes and Net Income

Income before income taxes and minority interests decreased 7.9% to ¥11,825 million, mainly due to the loss on disposal of property, plant and equipment. However, consolidated net income increased 1.1% to ¥6,677 million as special tax-credits on testing and research expenses and other items lowered the effective tax rate from 48.58% to 44.09%.

Net income per share, after adjustment for a 1.5-for-1 stock split on November 20, 2003, was ¥157.25.

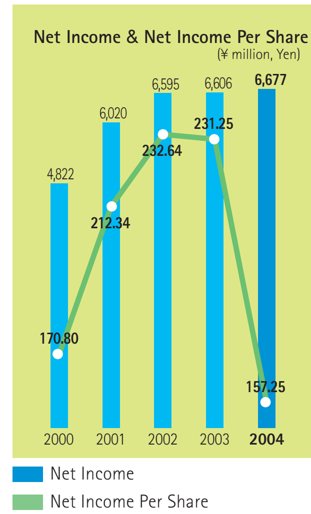
Note: On November 20, 2003, the Company split its common stock 1.5 for 1.
Assuming that the stock split had been conducted at the beginning of the previous fiscal year, net income per share for the year under review would have been ¥154.17.



Segment Information

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 consolidated net 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 ¥28,316 million in the previous year and ¥28,933 million in the year under review.



Net Sales and Operating Income by Segment

Net Sales

(¥ million)	2000	2001	2002	2003	2004
Consumer Products Operation	¥ 73,301	¥ 76,934	¥ 84,005	¥ 85,559	**¥ 87,055**
Wholesale Operation	107,616	107,485	117,218	125,859	**126,080**
Medical Devices Operation	14,150	15,490	19,931	16,114	**15,609**
Other Operations	12,010	12,653	12,631	11,706	**11,859**

Operating Income

(¥ million)	2000	2001	2002	2003	2004
Consumer Products Operation	¥12,321	¥12,764	¥13,397	¥14,438	**¥14,631**
Wholesale Operation	797	499	(58)	256	**535**
Medical Devices Operation	(491)	259	440	829	**645**
Other Operations	173	82	(14)	265	**153**

■Consumer Products Operation

Personal consumption remained sluggish as a whole, although the slide in product prices seems to have been arrested. Despite the challenging operating environment, the segment focused on creating new markets and expanding its presence in existing markets, launching 15 new products, excluding nutritional supplement food products. A new version of our deodorizing air freshener, *Bran Cologne*, that can be hung anywhere without getting in the way, and *Urinaaru*, a treatment for urination-related problems, such as increased urinary frequency or constant urge to urinate during the night, contributed to sales growth. In a move to boost sales, the Consumer Products Operation focused on marketing to 8,300 selected leading stores in Japan, and combined this with an expansion of our line of nutritional supplement food products, sold through two channels (mail order and drug stores), by launching eight new products.

Net Sales and Operating Income

Net sales of the Consumer Products Operation rose 1.7% from the previous year to ¥87,055 million, generating 31.4% of consolidated net sales, up from 31.3% in the previous year.

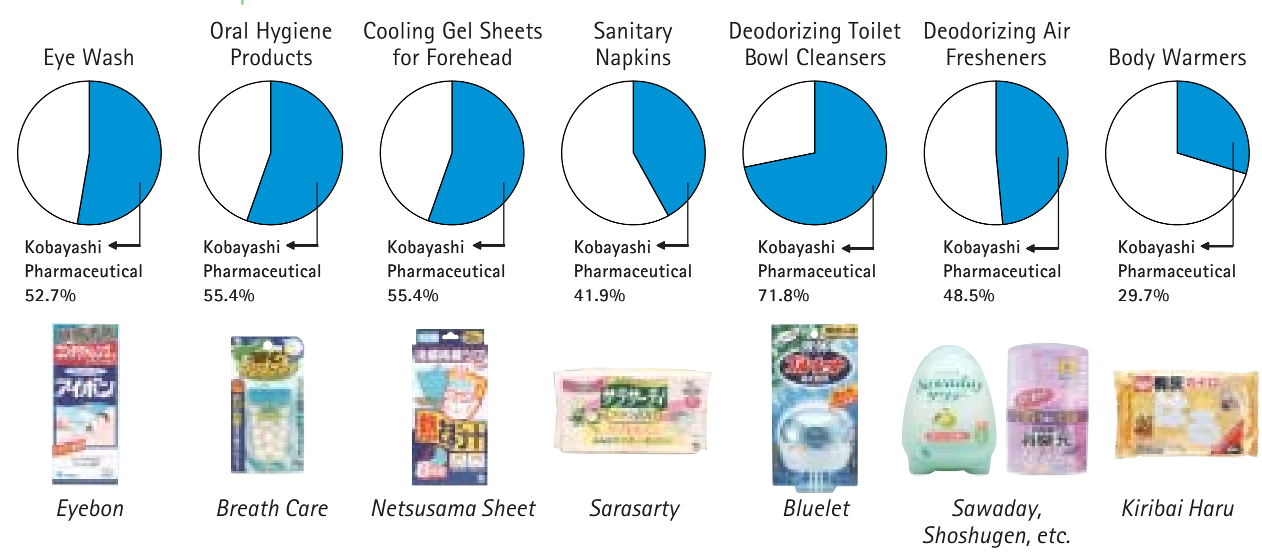
By product category, sales of pharmaceuticals dropped 5.1% from the previous year, the result of unseasonable summer and winter weather. Sales of deodorizing air fresheners were 1.7% lower due to sluggish sales of the *Sawaday* brand of scentless air-freshener. Sales of household sundries declined 10.6% as we streamlined our brand lineup in this category. On the other hand, line extension of the *Breath Care* brand and higher sales of *Netsusama Sheet* lifted sales of oral hygiene products and sanitary products by 7.5% and 3.9%, respectively. Sales of nutritional supplement food products, which moved into the black in the previous fiscal year, recorded more strong growth, rising 36.0%.

Sales by Category

(¥ million)

	2003		**2004**		Changes	
	Sales	% of total sales (%)	Sales	% of total sales (%)	Amount	Change (%)
Pharmaceuticals	¥15,757	18.4%	**¥14,957**	**17.2%**	**¥ (800)**	**(5.1)%**
Oral hygiene products	9,204	10.8	**9,891**	**11.4**	**687**	**7.5**
Sanitary products	12,918	15.1	**13,421**	**15.4**	**503**	**3.9**
Deodorizing air fresheners	27,730	32.4	**27,258**	**31.3**	**(472)**	**(1.7)**
Household sundries	5,604	6.6	**5,008**	**5.7**	**(596)**	**(10.6)**
Nutritional supplement food products	6,186	7.2	**8,416**	**9.7**	**2,230**	**36.0**
Body warmers	8,160	9.5	**8,104**	**9.3**	**(56)**	**(0.7)**
Total	¥85,559	100.0%	**¥87,055**	**100.0%**	**¥1,496**	**1.7%**

Market Shares of Principal Brands



Operating income rose 1.3% to ¥14,631 million, reflecting successful brand building and enhanced cost competitiveness. In specific terms, Kobayashi Pharmaceutical stepped up its selection and concentration on profitable brands by focusing on a smaller number of brands in development and sales and combining this with line extension. The Consumer Products Operation worked to build an efficient production system that strikes a balance between subcontracting production and in-house manufacturing. At the same time, it carried out a thorough review of its manufacturing network, which resulted in the closure of the Chiba Kobayashi Plant at the end of March 2004.

Number of Profitable and Unprofitable Brands

	1999	2000	2001	2002	2003	**2004**
Profitable brands	63	85	83	97	82	**83**
Unprofitable brands	64	65	54	46	38	**34**

New Products as a Percentage of Sales (%)

	1999	2000	2001	2002	2003	**2004**
First year	12.5%	15.2%	10.7%	13.0%	11.4%	**9.8%**
First four years	43.3	44.7	39.9	35.9	33.0	**30.7**

Issues to Be Addressed in Current Fiscal Year

Kobayashi Pharmaceutical has set clear targets for new products: sales of products released in any given fiscal year are to contribute at least 10% of total non-consolidated 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. Sales of new products released in the fiscal year under review contributed 9.8% of non-consolidated sales and sales of new products released in the past four years contributed 30.7%.

The contribution of new products to sales fell short of the target for two reasons: increasing competition and the inability to sufficiently develop new products for creating new markets. In response, we consolidated research and development operations at our new Research and Development Company, bringing all R&D staff under a single roof. Now our focus will be on developing heavy-hitter social theme-related products, such as medications for the treatment of menopause and of stress-related problems.

In existing products, the focus is on maintaining and expanding current market share by strengthening sales of core brands, expanding sales overseas and seeking M&A opportunities.

■Wholesale Operation

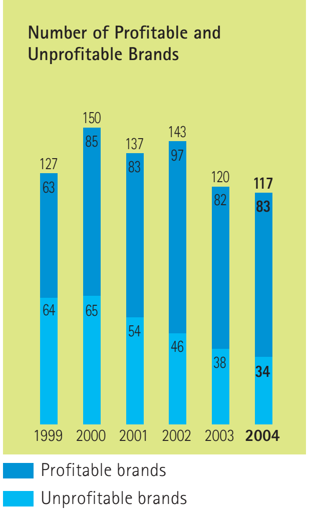
Unlike last fiscal year, when we benefited from new store openings by our principal customers and a shift toward self-medication, the operating environment in the year under review was difficult. This was characterized by sluggish personal consumption, the insolvency of certain customers and unseasonable weather in both summer and winter. In response, the Wholesale Operation concentrated on accelerating and expanding sales of health foods as well as cutting costs.

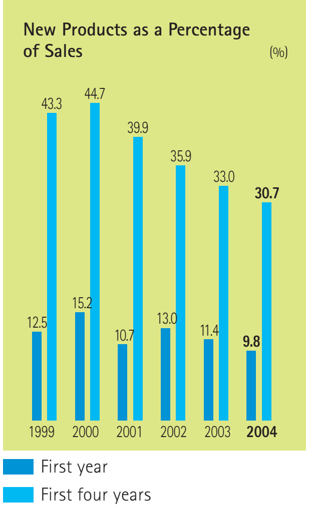
Net Sales and Operating Income

Sales of the Wholesale Operation edged up 0.2% to ¥126,080 million, but its contribution to consolidated net sales declined from 59.7% in the previous year to 59.6%.

By product, in the drugs category, sales of products declined 5.5% and sales of merchandise were off 4.3%, largely reflecting a relatively cool summer and a warm winter. Higher sales of health foods and contact lens care products in expanding markets underpinned sales in the sundries and foods category, driving up product sales by 6.1% and merchandise sales by 2.9%.

Operating income rose 109.0% to ¥535 million, reflecting a lower cost of sales from economies of scale generated by business expansion and reductions of transportation, packing and other expenses through firm cost control.





Net Sales by Category

(¥ million)

		2003		2004		Changes	
		Sales	% of total sales (%)	Sales	% of total sales (%)	Amount	Change (%)
Drugs	Products	¥ 8,047	6.4%	¥ 7,606	6.0%	¥ (441)	(5.5)%
	Merchandise	45,082	35.8	43,165	34.2	(1,917)	(4.3)
Sundries and foods	Products	13,749	10.9	14,594	11.6	845	6.1
	Merchandise	58,980	46.9	60,715	48.2	1,735	2.9
Total		¥125,858	100.0%	¥126,080	100.0%	¥ 222	0.2%

Issues to Be Addressed in Current Fiscal Year

Retailers, the Wholesale Operation's principal customers, are expanding their geographical coverage, meaning wholesalers are increasingly having to follow suit if they are to retain the allegiance of their customers. There is also expected to be an increase in the pace of industry consolidation as operators focus on expanding the scale of their operations. In response, Kobashou Co., Ltd. and three wholesalers in Shikoku formed a joint venture company, Seiei Co., Ltd. Operations started in April 2004. In another move, in March 2004, Kobayashi Pharmaceutical forged alliances with Mitsubishi Corporation and Ryoshoku Ltd. to strengthen wholesaling and distribution functions.

■Medical Devices Operation

The Medical Devices Operation concentrated on rapidly expanding the lineup of products related to selected specialized fields, such as orthopedics, operating theaters, neurosurgery and otorhinolaryngology. To concentrate on sales in the expanding market for products related to orthopedics, we established the Orthopedics Division in April 2003. During the year under review, this division conducted highly specialized marketing activities.

Overseas, Shield Healthcare Centers (three firms), Kobayashi Pharmaceutical's U.S. subsidiaries, continue to sell medical devices for the care and treatment of patients in the home.

Net Sales and Operating Income

Sales of the Medical Devices Operation declined 3.1% to ¥15,609 million. Its contribution to consolidated net sales thus declined from 7.6% in the previous year to 7.4%.

By category, sales of Kobayashi Medical Division, known for its special strengths in products for orthopedics, operating theaters, neurosurgery and otorhinolaryngology, increased 3.1%. Overseas, despite a negative impact from changes in California's insurance system, the three Shield Healthcare Centers saw significant growth, with sales rising to US$1,632 thousand on expansion of business areas and an increase in the number of items offered. However, this growth was negated by a stronger yen, with sales translated into Japanese yen falling 5.5% to ¥8,639 million.

Operating income declined 22.2% to ¥645 million. Equity in earnings of Medicon Inc., an equity-method affiliate, was ¥279 million.

Sales by Category

(¥ million)

	2003		2004		Changes	
	Sales	% of total sales (%)	Sales	% of total sales (%)	Amount	Change (%)
Kobayashi Medical Division	¥ 5,760	35.8%	¥ 5,937	38.0%	¥ 177	3.1%
Shield Healthcare Centers (3 firms)	9,143	56.7	8,639	55.3	(504)	(5.5)
Others	1,210	7.5	1,032	6.7	(178)	(14.7)
Total	¥16,113	100.0%	¥15,608	100.0%	¥(505)	(3.1)%

Issues to Be Addressed in Current Fiscal Year
The Medical Devices Operation has moved from the up-front investment stage to a point where it is expected to start contributing to profits. As it works to identify advanced technology products in Japan and overseas, the Medical Devices Operation will also work to develop innovative original brand products.

■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 ¥11,859 million, an increase of 1.3% from the previous year, and operating income was ¥153 million, down 42.3% from the previous year.

Analysis of Financial Position

Assets

Total assets were ¥128,326 million as of March 31, 2004, 2.1% higher than at the end of the previous year. This increase was primarily attributable to a rise in current assets and investments in securities.

Current assets increased 3.5% to ¥80,031 million at year-end. Cash and time deposits and inventories were largely unchanged from the previous fiscal year-end, but trade notes and accounts receivable rose 5.7%, or ¥2,268 million, as Kobashou stopped discounting.

Property, plant and equipment, net decreased 11.5% to ¥24,567 million. The main component of the decrease was a ¥2,011 million, or 16.8%, decline in land, as we sold off land holdings not required for our core business following the introduction of the KOVA management index, which focuses on efficiency of capital employed.

Investments and other assets were ¥9,539 million at year-end, 92.8% higher than at the end of the previous year. This was mainly due to an increase in investments in securities due to a revaluation gain and purchase of Japanese government bonds. Unrealized gains or losses are included directly in shareholders' equity. Other securities whose market value is not determinable amounted to ¥769 million.

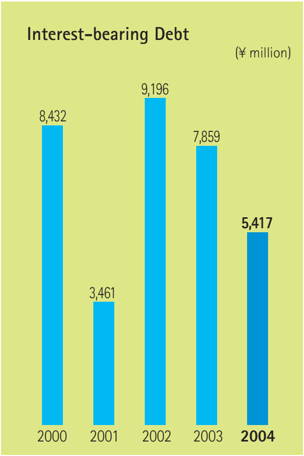
Liabilities

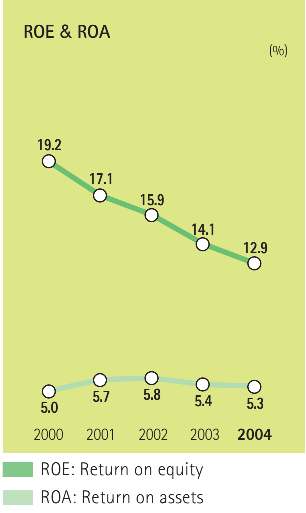
Total liabilities were ¥73,392 million at March 31, 2004, 3.3% down on the previous fiscal year-end. Current liabilities decreased 2.5% to ¥64,298 million. The main factor contributing to this decrease was a decrease in short-term loans accompanying the repayment of funds used for the acquisition of Kiribai Chemical Co., Ltd. Short-term loans declined 24.8% to ¥4,512 million. As a result, the current ratio improved by 7.2 percentage points from the end of the previous fiscal year to 124.5%.

Long-term liabilities decreased 8.5% to ¥9,094 million. Like the decline in current liabilities, the decline in long-term liabilities also reflects repayment of the long-term debt used for the acquisition of Kiribai Chemical. As a result, long-term debt at the end of the fiscal year under review was ¥905 million, a decrease of 51.3% from the end of the previous fiscal year.

Shareholders' Equity

Shareholders' equity was ¥54,454 million at March 31, 2004, 10.5% higher than at the end of the previous year. The principal factor was an increase in retained earnings of ¥6,044 million due to a rise in consolidated net income. Owing to the buyback of 597,000 shares held by financial institutions, treasury stock, at cost increased ¥1,540 million to ¥2,317 million. As a result, the shareholders' equity ratio improved 3.2 percentage points from 39.2% to 42.4% at the end of the fiscal year under review. The return on shareholders' equity (ROE) decreased 1.2 percentage points from 14.1% to 12.9%. Return on assets (ROA) decreased 0.1 percentage point from 5.4% to 5.3%.





Cash Flow Analysis

Cash Flows From Operating Activities

Net cash provided by operating activities in the year under review declined ¥5,075 million to ¥6,971 million. This decrease was largely attributable to an increase in trade notes and accounts receivable due to the suspension of discounting Kobashou's notes and accounts receivable. This had the effect of increasing trade notes and accounts receivable by approximately ¥2,000 million. In the previous year, there was a reclassification of ¥2,000 million in receivables as a result of the bankruptcies among manufacturers with which Kobayashi Pharmaceutical did business. When this factor is taken into account, notes and accounts receivable increased approximately ¥4,000 million on the effect of factors other than regular business transactions. Income taxes paid increased, mainly because of a decline in taxes to a below average level in the year ended March 2003, as a result of the Company no longer being subject to taxation on retained earnings of personal holding companies in the year ended March 2002.

Cash Flows From Investing Activities

Net cash used in investing activities amounted to ¥2,358 million, an increase of ¥2,082 million from the previous year. While proceeds from sales of property, plant and equipment, mostly land, amounted to ¥2,391 million, this was offset by an increase in investments in securities due to the purchase of ¥3,000 million in Japanese government bonds.

As a result, free cash flow generated during the year under review amounted to ¥4,613 million, a decrease of ¥7,157 million from the previous year.

Cash Flows From Financing Activities

Net cash used in financing activities amounted to ¥4,574 million, a year-on-year increase of ¥1,969 million. This was due to repayment of long-term debt used for the acquisition of Kiribai Chemical and outflows for the purchase of treasury stock.

As a result, cash and cash equivalents at end of year amounted to ¥17,663 million, ¥89 million lower than the figure at the end of the previous year.

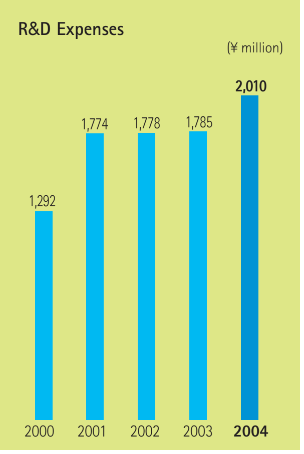
Cash Flows

(¥ million)

	2003	**2004**	Change	
	Sales	Sales	Amount	Change (%)
Cash flows from operating activities	¥12,046	**¥ 6,971**	**¥(5,075)**	**(42.1)%**
Cash flows from investing activities	(276)	**(2,358)**	**(2,082)**	**–**
Free cash flows	11,770	**4,613**	**(7,157)**	**(60.8)**
Cash flows from financing activities	(2,605)	**(4,574)**	**(1,969)**	**–**
Cash and cash equivalents at end of year	17,752	**17,663**	**(89)**	**(0.5)**

R&D Expenses

R&D underpins new product development, Kobayashi Pharmaceutical Group's core strength. R&D expenses, included in selling, general and administrative expenses, increased ¥225 million, or 12.6%, from the previous year to ¥2,010 million.



Risk Factors

Kobayashi Pharmaceutical's Unique Management Policies

At this time of intensifying competition and volatility, the Kobayashi Pharmaceutical Group's growth hinges on continuously providing new products and services to meet customer needs through our policy of "Something New, Something Different." Through this approach, we aim to raise enterprise value and meet the expectations of all our stakeholders. To assure stable growth, the benchmark for new product development is a 35% or higher contribution to total sales of products launched during the previous four years.

To develop businesses with high growth rates and strengthen the operational base, Kobayashi Pharmaceutical will continue to expand the Consumer Products Operation and Medical Devices Operation through M&A and overseas expansion.

Significant Changes in Financial Position and Operating Results

In the year under review, the Group provided a ¥974 million allowance for doubtful receivables related to the bankruptcy of a major customer, in addition to booking a ¥332 million allowance for loss on devaluation of securities.

Furthermore, the Company closed the Chiba Kobayashi Plant in order to streamline manufacturing operations, and sold idle land to increase liquidity of funds. It also purchased treasury stock.

Significant Changes in Cash Flows

The Company sold idle land to improve the KOVA management index, generating cash of ¥2,391 million. Funds surplus to requirement were used to purchase Japanese government bonds.

High Dependence on Certain Customers With Whom Continuity of Business Is Uncertain

Kobayashi Pharmaceutical is not overly dependent on any particular customer with whom there is uncertainty of business continuity. Nevertheless, the Company may have to provide for doubtful receivables owing to bankruptcies of customers and uncertainties about their financial positions.

High Dependence on Products and Technologies With an Uncertain Future

The Company is not highly dependent on specific products and technologies with an uncertain future.

Legal Constraints

Our Consumer Products Operation and Medical Devices Operation are subject to the Pharmaceutical Affairs Law.

Major Lawsuits

There are no pending major lawsuits that are likely to have a significant impact on operations.

Consolidated Balance Sheets

KOBAYASHI PHARMACEUTICAL CO., LTD. and Consolidated Subsidiaries
March 31, 2004 and 2003

	Millions of yen		Thousands of U.S. dollars (Note 1)
	2004	2003	2004
ASSETS			
Current assets:			
Cash and time deposits (Note 4)	¥ 17,663	¥ 17,762	$ 168,219
Trade notes and accounts receivable (Note 7)	41,772	39,504	397,829
Inventories (Note 6)	14,094	13,985	134,228
Deferred income taxes (Note 15)	2,453	1,971	23,362
Other current assets	4,578	4,506	43,600
Allowance for doubtful accounts	(529)	(413)	(5,038)
Total current assets	80,031	77,315	762,200
Property, plant and equipment:			
Land (Note 7)	9,949	11,960	94,752
Buildings and structures (Note 7)	23,570	23,864	224,476
Machinery and equipment	4,063	4,541	38,695
Construction in progress	361	251	3,438
Other	4,511	5,411	42,962
	42,454	46,027	404,323
Accumulated depreciation	(17,887)	(18,269)	(170,352)
Property, plant and equipment, net	24,567	27,758	233,971
Investments and other assets			
Investments in securities (Notes 5 and 7):			
Unconsolidated subsidiaries and affiliates	3,317	2,679	31,590
Other	6,554	2,268	62,419
Allowance for loss on devaluation of securities	(332)	–	(3,162)
	9,539	4,947	90,847
Excess of cost over net assets acquired	3,759	4,671	35,800
Deferred income taxes (Note 15)	2,460	2,696	23,428
Other assets	10,080	9,389	96,001
Allowance for doubtful accounts	(2,110)	(1,096)	(20,095)
Total investments and other assets	23,728	20,607	225,981
	¥128,326	¥125,680	$1,222,152

The accompanying notes are an integral part of these statements.

	Millions of yen		Thousands of U.S. dollars (Note 1)
	2004	2003	2004
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities:			
Short-term loans (Note 7)	¥ 4,512	¥ 5,999	$ 42,971
Trade notes and accounts payable (Note 7)	41,069	41,044	391,133
Accrued income taxes (Note 15)	3,479	3,864	33,133
Accrued expenses	2,705	3,546	25,762
Other current liabilities	12,533	11,473	119,362
Total current liabilities	64,298	65,926	612,361
Long-term liabilities:			
Long-term debt (Note 7)	905	1,860	8,619
Accrued retirement benefits for employees (Note 8)	6,320	6,379	60,190
Accrued retirement benefits for directors and statutory auditors	1,158	1,066	11,029
Other liabilities	711	632	6,771
Total long-term liabilities	9,094	9,937	86,609
Total liabilities	73,392	75,863	698,970
Minority interests	480	550	4,572
Contingencies (Note 9)			
Shareholders' equity (Note 12)**:**			
Common stock			
Authorized – 113,400,000 shares			
Issued – 42,525,000 shares in 2004 and 28,350,000 shares in 2003	3,450	3,450	32,857
Additional paid-in capital	4,183	4,183	39,838
Retained earnings	48,186	42,142	458,914
Unrealized holding gain on securities	1,640	843	15,619
Foreign currency translation adjustments	(688)	(574)	(6,552)
Treasury stock, at cost	(2,317)	(777)	(22,066)
Total shareholders' equity	54,454	49,267	518,610
	¥128,326	¥125,680	$1,222,152

The accompanying notes are an integral part of these statements.

Consolidated Statements of Income

KOBAYASHI PHARMACEUTICAL CO., LTD. and Consolidated Subsidiaries
Years ended March 31, 2004 and 2003

	Millions of yen		Thousands of U.S. dollars (Note 1)
	2004	2003	2004
Net sales (Note 16)	¥211,670	¥210,922	$2,015,904
Cost of sales (Note 14)	141,388	141,675	1,346,552
Gross profit	70,282	69,247	669,352
Selling, general and administrative expenses (Notes 13, 14 and 16)	54,159	53,394	515,800
Operating income	16,123	15,853	153,552
Other income (expenses):			
Interest and dividend income	115	166	1,095
Equity in earnings of affiliates	280	117	2,667
Interest expense	(72)	(134)	(686)
Sales discounts	(1,025)	(1,033)	(9,762)
Exchange loss	(47)	(532)	(447)
Loss on disposal or write-offs of inventories	(2,197)	(2,793)	(20,924)
Gain on sales of property, plant and equipment	1,310	71	12,476
Loss on disposal of property, plant and equipment	(1,993)	(219)	(18,981)
Other, net	(669)	1,344	(6,371)
Income before income taxes and minority interests	11,825	12,840	112,619
Income taxes (Note 15)**:**			
Current	5,993	5,987	57,076
Deferred	(779)	251	(7,419)
	5,214	6,238	49,657
Minority interests	66	4	628
Net income	¥ 6,677	¥ 6,606	$ 63,590

	Yen		U.S. dollars
	2004	2003	2004
Net income per share	¥ 157.25	¥ 231.25	$ 1.49
Cash dividends per share	21.00	21.00	0.20

The accompanying notes are an integral part of these statements.

Consolidated Statements of Shareholders' Equity

KOBAYASHI PHARMACEUTICAL CO., LTD. and Consolidated Subsidiaries
Years ended March 31, 2004 and 2003

	Number of shares issued (Thousands)	Millions of yen					
		Common stock	Additional paid-in capital	Retained earnings	Unrealized holding gain on securities	Foreign currency translation adjustments	Treasury stock
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)
Net income for the year				**6,677**			
Stock split	**14,175**						
Unrealized holding gain on securities					**797**		
Foreign currency translation adjustments							**(114)**
Cash dividends				**(591)**			
Bonuses to directors and statutory auditors					**(42)**		
Net change in treasury stock							**(1,540)**
Balance at March 31, 2004	**42,525**	**¥ 3,450**	**¥ 4,183**	**¥ 48,186**	**¥ 1,640**	**¥ (688)**	**¥ (2,317)**

	Thousands of U.S. dollars (Note 1)					
	Common stock	Additional paid-in capital	Retained earnings	Unrealized holding gain on securities	Foreign currency translation adjustments	Treasury stock
Balance at March 31, 2003	$ 32,857	$ 39,838	$ 401,352	$ 8,029	$ (5,467)	$ (7,400)
Net income for the year			**63,590**			
Unrealized holding gain on securities				**7,590**		
Foreign currency translation adjustments					**(1,085)**	
Cash dividends			**(5,628)**			
Bonuses to directors and statutory auditors			**(400)**			
Net change in treasury stock						**(14,666)**
Balance at March 31, 2004	**$32,857**	**$39,838**	**$458,914**	**$15,619**	**$(6,552)**	**$(22,066)**

The accompanying notes are an integral part of these statements.

Consolidated Statements of Cash Flows

KOBAYASHI PHARMACEUTICAL CO., LTD. and Consolidated Subsidiaries
Years ended March 31, 2004 and 2003

	Millions of yen		Thousands of U.S. dollars (Note 1)
	2004	2003	2004
Cash flows from operating activities:			
Income before income taxes and minority interests	¥11,825	¥12,840	$112,619
Adjustments for:			
Depreciation and amortization	3,350	3,480	31,905
Allowance for doubtful accounts, net	1,159	739	11,038
Reversal of accrued retirement benefits	(59)	(480)	(562)
Interest and dividend income	(115)	(166)	(1,095)
Interest expense	72	134	686
Equity in earnings of affiliates	(280)	(117)	(2,667)
Loss on disposal or write-offs of obsolete inventories	2,197	2,793	20,924
Gain on sales of investments in a subsidiary and an affiliate	—	(3,088)	—
Gain on sale of goodwill	(714)	(396)	(6,800)
Loss on sales or disposal of property, plant and equipment	2,458	219	23,410
Allowance for loss on devaluation of securities	332	—	3,162
Changes in operating assets and liabilities:			
(Increase) decrease in trade notes and accounts receivable	(3,254)	2,500	(30,990)
Increase in inventories	(2,355)	(3,280)	(22,429)
Increase (decrease) in trade notes and accounts payable	54	(1,310)	514
Increase in consumption taxes payable	129	226	1,228
Other	(1,492)	1,615	(14,210)
Subtotal	13,307	15,709	126,733
Interest and dividends received	118	171	1,123
Interest paid	(77)	(137)	(733)
Income taxes paid	(6,377)	(3,697)	(60,733)
Net cash provided by operating activities	6,971	12,046	66,390
Cash flows from investing activities:			
Payments for purchases of property, plant and equipment	(1,288)	(1,676)	(12,267)
Proceeds from sales of property, plant and equipment	2,391	31	22,771
Payments for purchases of intangible assets	(574)	(1,117)	(5,467)
Increase in investments in securities	(3,542)	(19)	(33,733)
Increase in other assets	(232)	(556)	(2,209)
Decrease (increase) in short-term loans receivable	274	(373)	2,609
Proceeds from sale of investment in an affiliate	—	3,480	—
Proceeds from sale of goodwill	714	396	6,800
Other	(101)	(442)	(961)
Net cash used in investing activities	(2,358)	(276)	(22,457)
Cash flows from financing activities:			
(Decrease) increase in short-term loans, net	(145)	1,426	(1,381)
Proceeds from long-term debt	212	347	2,019
Repayment of long-term debt	(2,508)	(3,144)	(23,886)
Issuance of stock of subsidiaries to minority shareholders	—	67	—
Dividends paid	(591)	(524)	(5,629)
Increase in treasury stock	(1,539)	(777)	(14,657)
Other	(3)	—	(28)
Net cash used in financing activities	(4,574)	(2,605)	(43,562)
Effect of exchange rate changes on cash and cash equivalents	(128)	(200)	(1,219)
Net (decrease) increase in cash and cash equivalents	(89)	8,965	(848)
Cash and cash equivalents at beginning of year	17,752	8,787	169,067
Cash and cash equivalents at end of year (Note 4)	¥17,663	¥17,752	$168,219

The accompanying notes are an integral part of these statements.

Notes to Consolidated Financial Statements

KOBAYASHI PHARMACEUTICAL CO., LTD. and Consolidated Subsidiaries

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 generally accepted in Japan, which are different in certain respects as to the application and disclosure requirements of International Financial Reporting Standards. The Company's overseas subsidiaries maintain their accounts and records in conformity with generally accepted accounting principles 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 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 ¥105 = U.S.$1.00, the approximate exchange rate in effect on March 31, 2004. 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, 2003 to conform these to the 2004 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 certain 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 an insignificant risk of change 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) Investment 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 historical sales return ratio. The reserve for sales returns is included in other current liabilities.

(j) Accrued retirement benefits

The Company has a non-contributory unfunded defined retirement benefit 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 retirement benefits for employees represents the estimated present value of the projected benefit obligation in excess of the fair value of the pension plan assets.

Prior service costs are being amortized by the straight-line method over ten years which is shorter than the average remaining years of service of the participants.

Actuarial differences are amortized in the year following the year in which the difference is recognized by the straight-line method over ten years which is shorter than the average remaining years of service of the participants.

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 (the "officers") 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 Company's and a consolidated subsidiary's internal regulations.

(k) Allowance for loss on devaluation of securities

An allowance for loss on devaluation of securities is provided to cover possible future losses on investments in securities at a level determined by considering the financial position of the individual unconsolidated subsidiaries.

(l) Income taxes

Accrued income taxes are provided at the amount currently payable.

The Company and its consolidated subsidiaries have adopted 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.

(m) Leases

The Company and its subsidiaries lease offices and other facilities. 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.

(n) 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, customarily 5 years.

(o) Net income and cash dividends per share

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.

On November 20, 2003, the Company made a three-for-two stock split by way of a free share distribution. If the stock split had been made at the beginning of the year ended March 31, 2003, the per share amount of net assets at March 31, 2003 and the net income for the year ended March 31, 2003 would have been ¥1,165.32 and ¥154.17, respectively.

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

(p) Appropriation of retained earnings

Under the Commercial Code of Japan, the appropriation of retained earnings with respect to a given financial period is made by resolution of the shareholders at a general meeting held subsequent to the close of such financial period. The accounts for that period do not, therefore, reflect such appropriations (see Note 17).

(q) Derivatives and hedging activities

Derivative financial instruments, which include forward foreign exchange contracts, currency options, and interest-rate swaps, are used to offset the Group's risk of exposure to fluctuation 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.

(r) New accounting pronouncement

A new Japanese accounting standard called "Impairment of Fixed Assets" was issued in August 2002, which will go into effect for fiscal years beginning on or after April 1, 2005. Early adoption is allowed from fiscal years beginning on or after April 1, 2004 and application from fiscal years ending from March 31, 2004 through March 30, 2005 is also permitted. The new standard requires that tangible and intangible fixed assets be carried at cost less depreciation, and be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. A company will be required to recognize an impairment loss in its statement of income if certain indicators of asset impairment exist and the book value of an asset exceeds the undiscounted sum of the future cash flows of the asset. The Company is currently assessing the impact of this new accounting standard on its financial position and results of operations.

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 by installments the proceeds 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 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
	2004	2003	2004
Cash and time deposits	¥17,663	¥17,762	$168,219
Time deposits with original maturity of more than three months	–	(10)	–
Cash and cash equivalents	¥17,663	¥17,752	$168,219

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					
	2004			2003		
	Acquisition cost	Carrying value	Unrealized gain	Acquisition cost	Carrying value	Unrealized gain
Equities	¥ 591	¥ 3,415	¥ 2,824	¥383	¥1,872	¥1,489

	Thousands of U.S. dollars		
	2004		
	Acquisition cost	Carrying value	Unrealized gain
Equities	$5,629	$32,524	$26,895

(b) Securities whose acquisition cost exceeds their carrying value

	Millions of yen					
	2004			2003		
	Acquisition cost	Carrying value	Unrealized loss	Acquisition cost	Carrying value	Unrealized loss
Equities	¥ 79	¥ 70	¥ (9)	¥284	¥216	¥ (68)
Debt securities	3,309	3,305	(4)	–	–	–
	¥ 3,388	¥ 3,375	¥ (13)	¥284	¥216	¥ (68)

	Thousands of U.S. dollars		
	2004		
	Acquisition cost	Carrying value	Unrealized loss
Equities	$ 753	$ 667	$ (86)
Debt securities	31,514	31,476	(38)
	$32,267	$32,143	$(124)

For the year ended March 31, 2004, the Group recognized an impairment loss of ¥13 million ($124 thousand) on equity securities.

(c) Securities whose market value is not determinable

	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Unlisted stock	¥595	¥103	$5,667
Investment trusts	174	112	1,657

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

	Millions of yen		Thousands of U.S. dollars
Due	2004	2003	2004
Within one year	¥ 999	¥ –	$ 9,515
After one year but within five years	2,307	–	21,971
	¥3,306	¥ –	$31,486

6. Inventories

Inventories at March 31, 2004 and 2003 are summarized as follows:

	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Commodities	¥ 7,628	¥ 7,433	$ 72,648
Finished goods	5,191	5,192	49,438
Raw materials, work in process and supplies	1,275	1,360	12,142
	¥14,094	¥13,985	$134,228

7. Short-Term Loans and Long-Term Debt

The average interest rates on short-term bank loans for the years ended March 31, 2004 and 2003 were 1.03% and 0.81%, respectively.

Long-term debt at March 31, 2004 and 2003 is summarized as follows:

	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Loans from banks with average interest rates of 0.81% for 2004 and 0.79% for 2003	¥ 2,114	¥ 4,410	$ 20,133
Less amounts due within one year	(1,209)	(2,550)	(11,514)
	¥ 905	¥ 1,860	$ 8,619

The aggregate annual maturities of long-term debt subsequent to March 31, 2004 are summarized as follows:

Year ending March 31,	Millions of yen	Thousands of U.S. dollars
2005	¥1,209	$11,514
2006	159	1,514
2007	146	1,391
2008	172	1,638
2009 and thereafter	428	4,076
	¥2,114	$20,133

Assets pledged as collateral at March 31, 2004 are summarized as follows:

	Millions of yen	Thousands of U.S. dollars
Notes receivable	¥ 109	$ 1,038
Buildings	1,141	10,867
Land	2,122	20,210
Investments in securities	100	952
	¥3,472	$33,067

Secured liabilities at March 31, 2004 are summarized as follows:

	Millions of yen	Thousands of U.S. dollars
Trade notes and accounts payable	¥7,071	$67,342
Short-term loans	389	3,706
	¥7,460	$71,048

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 Retirement Benefits

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, 2004 and 2003 for the Group's defined benefit plans:

	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Projected benefit obligation	¥(10,602)	¥(8,781)	$(100,971)
Fair value of pension plan assets	2,861	1,735	27,248
Unfunded retirement benefit obligation	(7,741)	(7,046)	(73,723)
Unrecognized prior service cost	933	—	8,885
Unrecognized actuarial differences	599	667	5,705
Net retirement benefit obligation	(6,209)	(6,379)	(59,133)
Prepaid pension cost	111	—	1,057
Accrued retirement benefits for employees	¥ (6,320)	¥(6,379)	$ (60,190)

The components of net pension cost for the years ended March 31, 2004 and 2003 were as follows:

	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Service cost	¥617	¥554	$5,876
Interest cost	224	204	2,133
Expected return on pension plan assets	(43)	(25)	(409)
Amortization of prior service cost	103	—	981
Amortization of actuarial differences	74	84	704
Pension cost	¥975	¥817	$9,285

The assumptions used in determining the actuarial present value of the projected benefit obligation at March 31, 2004 and 2003 were as follows:

	2004	2003
Discount rates	2.0%	2.5%
Expected rates of return on plan assets	2.0%	2.5%

9. Contingencies

At March 31, 2004, contingent liabilities for guarantees of bank loans of an unconsolidated subsidiary amounted to ¥184 million ($1,753 thousand).

10. Leases

The following pro forma amounts present the acquisition cost and accumulated depreciation of property leased to the Group at March 31, 2004 and 2003, 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
	2004	2003	2004
Machinery and equipment:			
Acquisition cost	¥ 8,300	¥ 9,854	$ 79,047
Accumulated depreciation	(4,312)	(5,187)	(41,066)
	¥ 3,988	¥ 4,667	$ 37,981
Furniture and fixtures:			
Acquisition cost	¥ 2,413	¥ 2,065	$ 22,981
Accumulated depreciation	(1,408)	(1,142)	(13,410)
	¥ 1,005	¥ 923	$ 9,571
Others:			
Acquisition cost	¥ 2,561	¥ 2,554	$ 24,390
Accumulated depreciation	(1,580)	(1,191)	(15,047)
	¥ 981	¥ 1,363	$ 9,343
Total	¥ 5,974	¥ 6,953	$ 56,895

Future minimum lease payments (including the interest portion thereon) subsequent to March 31, 2004 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
2005	¥2,187	$20,828
2006 and thereafter	3,923	37,362
Total	¥6,110	$58,190

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

	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Lease expenses	¥2,556	¥2,728	$24,343
Estimated depreciation expense	2,315	2,559	22,047
Estimated interest expense	129	181	1,229

11. Derivatives and Hedging Activities

The Company utilizes forward foreign exchange contracts, currency options and interest-rate swaps as derivatives transactions to reduce the risk of fluctuation in its interest rates and foreign exchange rates. The Company has established a control environment which includes policies and procedures for risk assessment and for the approval, reporting and monitoring of transactions involving derivatives. The Company does not hold or issue derivatives for speculative trading purposes.

12. Shareholders' Equity

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, 2004 and 2003, amounted to ¥330 million ($3,143 thousand) and ¥330 million, respectively.

In accordance with the Code, a stock option plan for directors, certain employees of the Company and certain subsidiaries was approved at the annual general meeting of the shareholders held on June 27, 2003. Under the terms of this plan, the issuance of 197,000 shares of common stock has been authorized. The eligible participants may purchase these stock options at 1.05 times the exercise price calculated as the average of the closing market price of the Company's shares on the Tokyo Stock Exchange for all trading for the month immediately preceding the month of the date of the grant. However, if the exercise price referred to above is less than the closing market price of the Company's shares on the Tokyo Stock Exchange on the day preceding the date on which the rights are granted, the closing market price is to be used as the exercise price. The lower limit of the exercise price is determined at ¥3,930. The options become exercisable on July 1, 2005 and are scheduled to expire on June 30, 2008.

13. Selling, General and Administrative Expenses

The major components of selling, general and administrative expenses for the years ended March 31, 2004 and 2003 were as follows:

	Millions of yen		Thousands of U.S. dollars
Account	2004	2003	2004
Sales promotion activities	¥ 4,395	¥ 4,080	$ 41,858
Freight and storage	7,741	7,953	73,724
Advertising	10,820	11,347	103,048
Salaries and bonuses	11,474	11,244	109,277
Office rent and other rental charges	2,717	2,565	25,877
External services	3,505	3,406	33,381
Research and development	2,010	1,785	19,143

14. Research and Development Costs

Research and development costs included in selling, general and administrative expenses and manufacturing costs for the years ended March 31, 2004 and 2003 amounted to ¥2,010 million ($19,143 thousand) and ¥1,785 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, 2004 and 2003. 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:

	2004	2003
Statutory tax rate	42.0%	42.0%
Tax loss carryforwards of consolidated subsidiaries	5.2	1.5
Utilization of tax loss carryforward	(3.4)	–
Tax credits on research and development costs	(2.2)	–
Amortization of excess of cost over net assets acquired	2.0	2.5
Dividend income not taxable	(1.6)	(1.3)
Expenses not deductible for tax purposes	1.5	1.5
Effect of changes in statutory tax rate	0.9	(0.8)
Equity in earnings of affiliates	(0.6)	1.3
Other	0.2	1.9
Effective tax rates	44.0%	48.6%

The tax effects of the temporary differences which gave rise to a significant portion of the deferred tax assets at March 31, 2004 and 2003 are presented below:

	Millions of yen		Thousands of U.S. dollars
	2004	2003	2004
Deferred tax assets:			
Accrued retirement benefit	¥ 2,231	¥2,214	$21,248
Net operating loss carryforwards	1,166	1,046	11,105
Reserve for employees' bonuses	743	625	7,076
Reserve for directors' retirement allowances	544	492	5,181
Allowance for doubtful accounts	501	235	4,771
Accrued expenses	498	430	4,743
Accrued enterprise tax	326	324	3,105
Intercompany unrealized profits	272	294	2,591
Other	863	296	8,218
Gross deferred tax assets	7,144	6,214	68,038
Valuation allowance	(1,032)	(903)	(9,829)
Total deferred tax assets	6,112	5,311	58,209
Deferred tax liabilities:			
Unrealized holding gain on securities	1,142	607	10,876
Other	57	37	543
Total deferred tax liabilities	1,199	644	11,419
Net deferred tax assets	¥ 4,913	¥4,667	$46,790

16. Segment Information

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

The business segment information of the Company and its consolidated subsidiaries for the years ended March 31, 2004 and 2003 is outlined as follows:

	Millions of yen						
	2004						
	Household products – manufacturing and sales	Household products – wholesale	Medical operations	Other	Total	Eliminations	Consolidated
I Sales and operating income							
Sales to third parties	¥ 66,523	¥ 126,080	¥ 15,609	¥ 3,458	¥ 211,670	¥ —	¥ 211,670
Inter-group sales and transfers	20,532	—	—	8,401	28,933	(28,933)	—
Total sales	87,055	126,080	15,609	11,859	240,603	(28,933)	211,670
Operating expenses	72,424	125,545	14,964	11,706	224,639	(29,092)	195,547
Operating income	¥ 14,631	¥ 535	¥ 645	¥ 153	¥ 15,964	¥ 159	¥ 16,123
II Assets, depreciation and capital expenditures							
Total assets	¥ 51,968	¥ 43,320	¥ 9,082	¥ 7,334	¥ 111,704	¥ 16,622	¥ 128,326
Depreciation	1,765	208	408	149	2,530	132	2,662
Capital expenditures	1,648	500	173	83	2,404	37	2,441

	Thousands of U.S. dollars						
	2004						
	Household products – manufacturing and sales	Household products – wholesale	Medical operations	Other	Total	Eliminations	Consolidated
I Sales and operating income							
Sales to third parties	$633,552	$1,200,762	$148,657	$ 32,933	$2,015,904	$ —	$2,015,904
Inter-group sales and transfers	195,543	—	—	80,010	275,553	(275,553)	—
Total sales	829,095	1,200,762	148,657	112,943	2,291,457	(275,553)	2,015,904
Operating expenses	689,752	1,195,667	142,514	111,485	2,139,418	(277,066)	1,862,352
Operating income	$139,343	$ 5,095	$ 6,143	$ 1,458	$ 152,039	$ 1,513	$ 153,552
II Assets, depreciation and capital expenditures							
Total assets	$494,933	$ 412,572	$ 86,495	$ 69,848	$1,063,848	$ 158,304	$1,222,152
Depreciation	16,809	1,981	3,886	1,419	24,095	1,257	25,352
Capital expenditures	15,695	4,762	1,648	790	22,895	352	23,247

	Millions of yen						
	2003						
	Household products — manufacturing and sales	Household products — wholesale	Medical operations	Other	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

Geographic Segment Information

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

Overseas Sales Information

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

17. Subsequent Event

The following appropriations of retained earnings of the Company, which have not been reflected in the consolidated financial statements for the year ended March 31, 2004, were approved at a general meeting of the shareholders held on June 29, 2004:

	Millions of yen	Thousands of U.S. dollars
Cash dividends (¥21.00 = U.S.$0.2 per share)	¥874	$8,324
Bonuses to directors and statutory auditors	38	362

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, 2004 and 2003, 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 express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in Japan. Those standards 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, 2004 and 2003, and the consolidated results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in Japan.

The U.S. dollar amounts in the accompanying consolidated financial statements with respect to the year ended March 31, 2004 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.

Ernst & Young ShinNihon

Osaka, Japan
June 29, 2004

Six-year Consolidated Financial Summary

KOBAYASHI PHARMACEUTICAL CO., LTD. and Consolidated Subsidiaries
Years ended March 31

	Millions of yen					
	2004	2003	2002	2001	2000	1999
For the Year						
Net Sales	¥211,670	¥210,922	¥204,647	¥185,001	¥180,731	¥166,585
Cost of Sales	141,388	141,675	139,404	123,140	121,739	115,993
Gross Profit	70,282	69,247	65,243	61,861	58,992	50,591
Selling, General and Administrative Expenses	54,159	53,394	51,613	48,054	46,121	41,137
Operating Income	16,123	15,853	13,630	13,807	12,871	9,453
Income before Income Taxes and Minority Interests	11,825	12,840	10,924	11,453	9,389	8,001
Net Income	6,677	6,606	6,595	6,020	4,822	2,904
Per Share Data (Yen)						
Net Income	157.25	231.25	232.64	212.34	170.80	166.91
Cash Dividends	21.0	21.0	18.5	17.5	15.0	12.5
Cash Flows from Operating Activities	6,971	12,046	4,039	3,961	7,306	–
Free Cash Flows	4,613	11,770	(2,892)	(817)	2,662	–
Depreciation and Amortization Expenses	3,350	3,480	2,598	2,157	1,921	1,530
Capital Expenditures*1	2,441	2,631	4,329	4,926	3,667	3,730
R&D Expenses	2,010	1,785	1,778	1,774	1,292	1,183
At Year-End						
Current Assets	80,031	77,315	72,759	64,849	69,248	57,656
Property, Plant and Equipment, Net	24,567	27,758	28,301	26,000	23,513	21,906
Current Liabilities	64,298	65,926	62,645	57,871	62,977	57,857
Long-term Liabilities	9,094	9,937	13,218	10,068	9,197	11,623
Shareholders' Equity	54,454	49,267	44,428	38,436	32,142	17,990
Total Assets	128,326	125,680	120,855	106,391	104,331	87,485
Working Capital	15,733	11,389	10,114	6,978	6,271	(201)
Interest-bearing Debt	5,417	7,859	9,196	3,461	8,432	9,129
Financial Ratios (%)						
As a percent of net sales:						
Gross Profit	33.2%	32.8%	31.9%	33.4%	32.7%	30.4%
Operating Income	7.6	7.5	6.7	7.5	7.1	5.7
Net Income	3.2	3.1	3.2	3.3	2.7	1.7
Current Ratio	124.5	117.3	116.1	112.1	110.0	99.7
ROE	12.9	14.1	15.9	17.1	19.2	17.4
ROA	5.3	5.4	5.8	5.7	5.0	3.4
Shareholders' Equity Ratio	42.4	39.2	36.8	36.1	30.8	20.6
Debt-equity Ratio (times)*2	0.10	0.16	0.21	0.09	0.26	0.51

*1 Capital expenditures as shown in Segment Information in the Notes to Consolidated Financial Statements.
*2 Debt-equity ratio: Interest-bearing debt at the fiscal year-end divided by Shareholders' equity.

Corporate Data / Investor Information

Corporate Data

(As of March 31, 2004)

- 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: Yutaka Kobayashi, President (Appointed president on June 29, 2004)
- Number of Employees: 2,310 (Consolidated)
- Consolidated Subsidiaries: 18
- Non-consolidated Subsidiaries: 11
- Affiliates Accounted for by the Equity Method: 4

Investor Information

(As of March 31, 2004)

- Common Stock: ¥3,450 million
- Number of Shares Authorized: 170,100,000 (As of June 29, 2004)
- Number of Shares Issued: 42,525,000
- Number of Shareholders: 8,295
- 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.
  Finance & Accounting Department
  Tel. 81-6-6222-0089
  Fax. 81-6-6222-0114
  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/

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