Annual Report 2005

For the year ended March 31, 2005

Kao Corporation

Profile

Contents

Forward-Looking Statements

This report contains forward-looking statements that are based on management's estimates, assumptions and projections at the time of publication. Some factors, which include, but are not limited to, the risks and uncertainty associated with the worldwide economy, competitive activity and currency fluctuation, could cause actual results to differ materially from expectations.

Kao Corporation conducts continuing research and development in line with its basic policy of contributing to the total satisfaction and enrichment of the lives of its consumers around the world. We accomplish this by drawing on our creative and innovative strengths to develop products that offer excellent value and outstanding performance from the consumer's point of view. Kao constantly explores new avenues in science and technology, then integrates diverse elements in unique, ground-breaking ways to provide high-value products to consumers worldwide.

The Kao Way

Mission	Satisfaction and enrichment of the lives of people
Vision	To be closest to the consumer/customer
Values	*Yoki-Monozukuri* Innovation Integrity
Principles	Consumer Driven *Genba*-ism Respect & Teamwork Global Perspective

"The Kao Way" is based on "Kao Management Principles" (issued in 1995 and partly revised in 1999). We have reviewed and revised the Principles to reflect the changes that have occurred in our business environment internally and externally.

"*Yoki-Monozukuri*" means "a strong commitment by all Kao members to provide products and brands of excellent value for consumer satisfaction." This core concept distinguishes Kao from all others.

"*Genba*" literally means "actual spot." At Kao, this term refers to the importance of observing things in their actual location and environment so that we can understand our business and optimize performance.

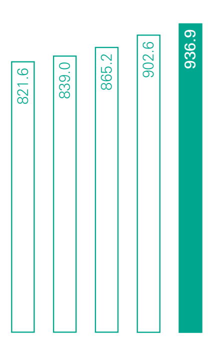
Further information on The Kao Way is available at http://www.kao.co.jp/en/company/kaoway/index.html

Financial Highlights

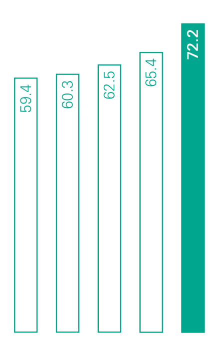
Kao Corporation and Consolidated Subsidiaries				Years ended March 31, 2005, 2004 and 2003	
	Billions of yen			Millions of U.S. dollars	Change
	2005	2004	2003	**2005**	**2005**/2004
For the year:					
Net sales	**¥936.9**	¥902.6	¥865.2	**$8,723.8**	3.8%
Consumer Products	**690.0**	670.4	646.4	**6,425.2**	2.9
Prestige Cosmetics	**78.3**	77.6	75.8	**729.1**	0.8
Chemical Products	**197.0**	181.6	170.9	**1,834.3**	8.5
Eliminations	**(28.4)**	(27.1)	(27.9)	**(264.8)**	–
Japan	**703.1**	673.7	654.6	**6,547.0**	4.4
Asia & Oceania	**100.3**	101.5	101.6	**933.8**	(1.2)
North America	**83.6**	79.9	75.8	**778.8**	4.7
Europe	**93.8**	84.9	67.8	**873.5**	10.5
Eliminations	**(44.0)**	(37.3)	(34.5)	**(409.3)**	–
Operating income	**121.4**	119.7	114.9	**1,130.3**	1.4
Net income	**72.2**	65.4	62.5	**672.1**	10.4
At year-end:					
Total assets	**¥689.0**	¥723.9	¥720.8	**$6,415.6**	(4.8)%
Total shareholders' equity	**448.2**	427.8	417.0	**4,174.0**	4.8
	Yen			U.S. dollars	Change
Per share:					
Net income	**¥131.16**	¥119.06	¥108.05	**$1.22**	10.2%
Cash dividends	**38.00**	32.00	30.00	**0.35**	18.8
Shareholders' equity	**821.47**	782.14	744.56	**7.65**	5.0

Notes: 1. The U.S. dollar amounts are translated, for convenience only, at the rate of ¥107.39=US$1, the approximate exchange rate at March 31, 2005.
2. Net sales by business and geographic segment include intersegment sales. Net sales of Chemical Products include intersegment sales to Consumer Products and Prestige Cosmetics.
3. Net income per share is computed based on the weighted average number of shares outstanding during the respective years. From the year ended March 31, 2003, the portion of net income unavailable to common shareholders, such as directors' bonuses, which is included in the appropriation of retained earnings, is deducted from net income for the calculation of net income per share. The same method is applied to the calculation of shareholders' equity per share.
4. Cash dividends per share are the amounts applicable to the respective years, including dividends to be paid after the end of the year.
5. Yen and U.S. dollar amounts are rounded to the nearest whole number or decimal.

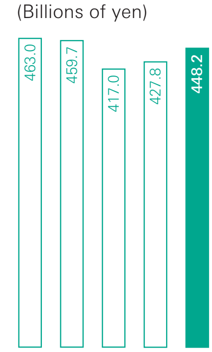
Net Sales
(Billions of yen)



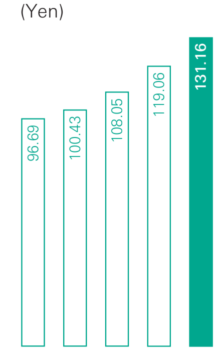
Net Income
(Billions of yen)



Total Shareholders' Equity
(Billions of yen)



Net Income per Share
(Yen)



An Interview with President and CEO Motoki Ozaki

Motoki Ozaki
President and CEO

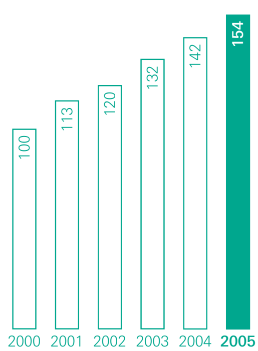
The Kao Way communicates the essence of Kao's unique corporate culture and spirit, developed over the 110 years since the Company's founding, to every employee of every company in the Kao Group. Shared by all employees, the Kao Way inspires us to understand and delight our consumers, fulfill our obligations to society and generate returns for shareholders. The Kao Way is the motive force driving Kao's growth and development, and is the key to our future.

What is the Kao Way, and what does it mean for shareholders and other stakeholders?

The Kao Way embodies our corporate culture and spirit. A refinement of Kao's stated management principles, it provides a guide to increasing shareholder returns, and therefore it is linked to profitable growth. Our operating environment has continued to change rapidly, and the Kao Way helps us respond to these changes appropriately in ways that result in profitable growth.

While we may modify the way we work to create new markets or respond to change, our bedrock values have not varied. As always, we want consumers to find great satisfaction and joy in our brands. At the same time, the maturity of the markets in Japan, North America and Europe means that function is not the only key to consumer delight. In a mature market, the ability to appeal to emotions and sensibilities is another key factor. We must use technology and qualitative input to create excellent products. To do so, Kao is going beyond its existing product development structures. We must impress and delight consumers as never before. We must get inside the minds of consumers, go to where they live and find out how and why they use products to understand how best to serve them. Product development cannot simply be a function of research and development if we are to stay at the forefront of emerging consumer desires and then meet them.

Enhanced EVA* = Value Creation
(EVA for 2000 = 100)



* EVA (Economic Value Added) is a registered trademark of Stern Stewart & Co.

The Kao Way serves to provide a shared platform for keeping this mission in mind in Kao's operations worldwide. It is an effective medium for transmitting information about Kao to employees worldwide to help us play our role as a global consumer products company. It engenders the shared feelings and experiences that help people work together throughout the organization, which is also relevant to the process of transferring our corporate DNA to the younger generation of employees.

Unlike most of its competitors, Kao has continued to gain market share and generate profitable growth in the challenging domestic market. How is Kao going to build on the brand equity that is the foundation of the Company's consistently sound performance?

The key concepts of our domestic business are health, beauty and cleanliness. Globalization is also important. Change is global, and so is the process of adapting to changing markets.

"We look closely at consumer lifestyles to make sure that our R&D is intimately related to how consumers actually use our products, rather than conducting detached R&D in a vacuum. This approach helps us lead change and stay at the forefront of our markets."

Japan is a mature society, and demand has moved from a quantitative to a qualitative stage. At the same time, maturity has brought with it enormous social change. For instance, more women are working, and more are marrying later. Consumer lifestyles are changing, so consumer products must also change. Functionality is still critical, and that will not change in the future. However, the emotive aspects of a product are increasingly important. Kao attaches importance to the satisfaction of consumers who use our products. This satisfaction is what defines added value.

The way consumers relate to a particular brand is embedded in our approach to brand management. We think carefully about how and why consumers use our products in determining the best approach, or mix of approaches, in each category. In our Consumer Products segment, we handle a variety of products, from laundry detergent to personal care products. For laundry detergent, functionality is important. However, nowadays even for hair care products that are targeted to individuals, we have to take different approaches depending upon the brand. Some hair care products, such as our *Merit* brand, are designed so that anyone in the family will find satisfaction in using them. Others, such as the *Asience* brand that is so popular among young women, are more personalized, meaning they are designed for specific consumer groups. Research and development is a competitive advantage in this regard, but remember, R&D is not just about function. We look closely at consumer lifestyles to make sure that our R&D is intimately related to how consumers actually use our products, rather than conducting detached R&D in a vacuum. This approach helps us lead change and stay at the forefront of our markets.

Distribution is also changing. For example, the chain drugstore channel is the only one that is generating sales growth. Taking change into account, we must become even better at doing what works for each channel, in a manner that is consistent with the Kao Way and our commitment to profitable growth.

The bottom line, however, is whether our products provide excellent value and satisfy consumers. As a core component of the Kao Way, we focus intently on developing and manufacturing truly excellent products. This is why we are committed to putting consumers first, why we spend so much time understanding consumer behavior in purchasing and using our products, and why we seek out fresh and innovative ideas. This is the Kao Way, and it has been the key to our consistent success in a highly competitive market.

Kao’s operations in North America and Europe generated profitable growth again in the past fiscal year. What is Kao Brands Company (KBC), and how has it contributed to performance gains?

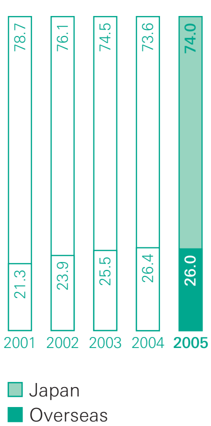
The markets of North America and Europe are mature, with many large competitors and retailers. We can’t win by simply relying on scale, so we looked for ways we could increase our participation in these markets profitably while building our presence, and decided on premium beauty care as the key to our strategy in these regions.

KBC is part of our program of focusing our brands on premium beauty care. Combining our growing portfolio of North American brands with European brand *Guhl* within KBC is enhancing our overall brand management, and is thus strengthening each individual brand. It has also sped the flow of technology exchange so that we can deploy our technological strengths to give our products unique, differentiating features.

As a result, the *John Frieda* brand is better able to offer solutions based on the hair of each individual consumer. Special product features come from Kao technology. Building on *Brilliant Brunette*, in 2005 we introduced *Radiant Red*, which as its name implies, is a hair care product for red hair. With those two products and *Sheer Blonde*, we now cover three major hair colors in North America and Europe with premium beauty products that have an outstanding cachet with consumers who are strongly interested in beauty care.

KBC has also done well in positioning *Bioré* as a total skin care brand. New products launched in 2004 as part of this brand strategy have performed well. By the same token, we are repositioning the *ban* brand to link it firmly to the premium beauty concept. *Jergens* body lotions, a stalwart product line in which we have attained market leadership in North America, fit in with the premium beauty strategy, but also position KBC in the higher-price brand category. Unified brand management is creating new opportunities to carry the *Jergens* brand to new channels and markets.

Overseas Sales Ratio*
(%)



* Excluding intersegment sales

How is Kao building for the future in Asia, and what is the projected outcome of various programs to restructure operations and raise competitiveness?

"During the past fiscal year, we also began construction of an R&D center in Shanghai, China that will help us get even closer to Chinese consumers by enhancing our ability to bring them joy. The center will focus mainly on personal care products, a key category in China."

Asia has excellent growth potential, but personal income varies from country to country. Many consumers are at a stage where they are collecting information and building their lifestyles as economic growth presents options for change. Markets are changing fast, and we need to be nimble. This was a key rationale behind our decision to reduce our brand focus to two – *Bioré* and *Laurier* – and focus on specific consumer toiletry needs. In select markets where competitive and demand conditions are favorable, we continue to market laundry detergent and hair care products.

Distribution in Asia is also challenging. The region is geographically enormous, and many retail outlets are small shops that are not part of consolidated supply chains. However, many of the small shops of today will likely be linked in some way to big retailers someday in the future. The situation is changing already, and competition from U.S. and European retailers is also increasing. We must manage categories globally, and Asia is a part of that global management. We must know Asian consumers well, understand distribution well, and apply the Kao Way to succeed in Asia. This includes deploying our own technology effectively to differentiate our brands.

In Asia, fundamental product development may be similar to that in Japan, but we must adapt to the ways that different consumers use products. We will need two or three more years to adjust our marketing and sales strategies to improve results in Asia.

I'd like to emphasize our long-term commitment to success in Asia. Kao has been building relationships with Asian consumers for some 40 years, and we are working on several exciting projects to deepen them. One is the Asian Business Synchronization project, which will standardize and integrate operations throughout Asia. This project will also harmonize operations throughout Asia with management in Japan, which will support more effective supply chain management and lower costs. During the past fiscal year, we also began construction of an R&D center in Shanghai, China that will help us get even closer to Chinese consumers by enhancing our ability to bring them joy. The center will focus mainly on personal care products, a key category in China, and plans to expand its target to a wider range of consumer products such as laundry detergent and sanitary napkins.

The Chemical Products segment also exemplifies Kao's success at competing in global markets. What approaches will generate future expansion?

Innovation will continue to be a cornerstone of our Chemical Products segment. We are not the world's largest chemical company by any means, so we pick our markets carefully, and then use our technological strengths to define profitable businesses. This has made us one of the world's largest suppliers of toner and toner binder, fatty alcohols and other profitable specialty chemicals that tend to perform well year in and year out.

We will enhance the ability of this business to generate Economic Value Added (EVA*) by investing approximately ¥10 billion in chemical production facilities, mainly in locations outside Japan, during 2005 and 2006. Our investments in expanding our chemical business have consistently contributed to profitable growth, and we expect this program to do the same.

*EVA is a registered trademark of Stern Stewart & Co.

How does corporate social responsibility (CSR) fit into the Kao Way, and how is CSR helping Kao manage change?

The Kao Way reaffirms our commitment to understanding our consumers and delighting them. CSR creates the network of relationships that is essential to the mutual understanding we seek, not only with consumers but also with society at large. These relationships are an essential part of our business, and are an important aspect of the Kao Way. Demonstrating the priority we place on CSR, we established a CSR Committee that I chair, and a new CSR Department to integrate and raise the effectiveness of management in this important area.

CSR is about being open. In a very real sense, management is about communication. So CSR raises corporate value when it ensures that we are communicating properly with stakeholders. CSR also has important ramifications for our relationships with shareholders and other stakeholders. The question is not whether to conduct CSR, but understanding that CSR is key to enhancing shareholder returns over the long term. We exist as part of society, not separately from it. Our products must therefore serve society to succeed. The Kao Way and our approach to CSR help us to do so. We must also work with our business partners to achieve this goal. When our stakeholders understand Kao, we can serve shareholders better, because we are better able to generate profits.

Exemplifying our commitment to CSR on a global basis, Kao has announced its support and undertaking of the ten principles of the Global Compact advocated by the United Nations and its continued intention to behave responsibly in international society. The Global Compact is a voluntary corporate citizenship initiative, and its ten principles relate to human rights, labor, the environment and anti-corruption, aiming for the sustainable growth of society.

What can shareholders expect from Kao in the current fiscal year?

Kao has consistently demonstrated a staunch commitment to aligning management with shareholder interests. During the fiscal year ended March 31, 2005, we continued our program of delivering value to shareholders by repurchasing 27 million shares of Kao stock worth a total of ¥69.9 billion. We also further increased income available to common stock by retiring 50 million shares of treasury stock. The repurchase of shares during the year complemented an increase of 10.2 percent in earnings per share as a result of profitable growth, and an increase of 18.8 percent in the annual cash dividend. In fact, annual cash dividends have increased for fifteen consecutive fiscal years, including past free share distributions in the form of stock splits, despite one of the most challenging economic environments Japan has ever experienced. In the current fiscal year, shareholders can expect more of the same, especially since we are also using stock options to compensate key managers and further align their interests with those of shareholders. In addition to internally generated expansion and further cost reductions, strategies for sustaining our record of profitable growth include more relationships with external partners that can speed entry into attractive markets. In doing so, we will look for win-win opportunities with partners that complement our competitive advantages.

The Kao Way Works for...

Consumers in Japan

Innovative Products, Real Value

Consumers Overseas

Premium Beauty Care Brands

Shareholders

Steady, Sustainable Growth in Returns

Communities

Integrity, Responsibility and Transparency

Innovative Products, Real Value

Takahiko Kagawa
Representative Director, Executive Vice President, Global Consumer Products

The criteria Japan's consumers use in selecting products and services are becoming more diverse, with the weighting of brands, design, advertising, and perceptions of comfort and value rising in comparison to the traditional emphasis on function. This has increased the importance of understanding value perceptions in target segments and conducting thorough marketing. For Kao, using technology to create high-quality, functional products has always been a core strategy. Now we are expanding this focus to emphasize product development that appeals to diversifying consumer sensibilities and perceptions of value.

Function and Fancy: *Asience* Delights Consumers

Asience exemplifies our success in appealing to the sensibilities of the modern Japanese consumer. Launched in fall 2003, this hair care brand made a strong contribution to results in the year ended March 2005 and has avoided the downward trend of retail prices. In creating *Asience*, Kao researched changes among consumers, and then incorporated the strength of each division involved, from research to sales, to ensure that *Asience* appealed to consumers in terms of both functionality and sensibility. We have promoted the brand's "Asian Beauty" concept with an advertising approach that is the complete opposite of that used by foreign companies competing in Japan, which has successfully differentiated *Asience* as well.

Distribution Strategies that Accommodate Change

Retail distribution in Japan is significantly less concentrated than in the United States. The top 10 retailers in Japan account for approximately 20 percent of consumer product sales, while in the United States and many European countries the top 5 retailers account for 60 to 70 percent. Japan's retail industry therefore tends to have an overabundance of outlets, and oligopolization is still in progress.

The rapidly expanding drugstore channel exemplifies this aspect of Japanese retail. Recently, the drugstore channel has been consolidating into chains. Manufacturers are determining how they will deal with these chains. Consumers in Japan exhibit a strong tendency to pursue successive new products. Consequently, manufacturers must take consumer desires fully into account in moving away from a medium- to long-term perspective in brand development toward implementing continuous new product launches and improvements.

An interdisciplinary project team generated the in-depth debate that drove success in developing the *Asience* brand.

Japanese retail also requires consumer product manufacturers to make product proposal decisions in a short time while maintaining a focus on building brands over the medium to long term. Finding the appropriate balance is critical for Kao in executing a strategy that revolves around frequent product launches and improvements.

Kao works closely with its exclusive sales company and with large retailers to efficiently respond to consumer needs. Kao initiated Efficient Consumer Response (ECR) activities approximately 10 years ago, and has been steadily expanding their scope. Close cooperation between manufacturers and retailers offers value to consumers, and properly structured ECR can therefore create a win-win situation.

Investing Resources in Growth Segments

The aging of society has accelerated, and heightened health consciousness has increased consumer needs in the health care and functional foods market. Kao has therefore been emphasizing high-value-added products that meet these emerging consumer desires. Kao created the healthy oil category with the launch of the *Econa* brand, and has generated steady additional growth in the Health Care (Functional Food) business by launching the *Healthya* beverage brand.

Global operations and the creation of new markets are other growth areas. The Kao Way helps new and overseas employees to embrace Kao's philosophy and understand the Company's goals. At the same time, the Kao Way gives employees a new sense of mission and reaffirms our commitment to innovation. As a result, Kao is better able to use its position of industry leadership not only to benefit the Company itself, but also to contribute to overall industry progress and consumer satisfaction, worldwide.

Econa Healthy Cooking Oil: A Growth Engine Since Its Launch in 1999

Econa Healthy Cooking Oil has received broad-based consumer support since its launch because of its ability to help prevent fat deposits and its light, delicious flavor, and has become synonymous with healthy oil in Japanese households. Over the past five years, sales of *Econa Healthy Cooking Oil* have increased at a double-digit annual rate, and Kao has extended the *Econa* brand lineup with dressings and mayonnaise. *Econa* has also become a brand of choice among consumers in the gift segment. Moreover, Kao is building on the success of this brand in Japan by extending it overseas, launching it as *Enova Oil* in the U.S. market in January 2005.

Premium Beauty Care Brands

Norihiko Takagi
Executive Officer, President, International Business - Consumer Products

Maintaining a global perspective is a core value of the Kao Way. It supports the creation and marketing of high-quality products through collaboration among our operations in Asia, North America and Europe. We are making outstanding progress in better meeting consumer needs around the world, with unified management that encourages greater awareness of consumer preferences. The result is a steady stream of consistently successful product launches and improvements in North America and Europe, and greater efficiency in growing operations in Asia.

Building Synergy in North America and Europe

At the beginning of 2004, Kao renamed The Andrew Jergens Company as Kao Brands Company (KBC), under which it consolidated its skin care brands, including the *Jergens*, *Bioré*, *Curél* and *ban* brands, with the *John Frieda* hair care brand and the *Guhl* brand of premium hair care products sold in Germany and increasingly throughout Europe. In its North American and European operations, Kao aims to increase the value of the brands handled by KBC and KPSS – Kao Professional Salon Services GmbH (KPSS).

In approaching the mass markets of North America and Europe, Kao is not trying to develop products that will be all things to all people. Instead, KBC is executing a premium beauty care strategy under which it can maximize its competitive strengths. This strategy entails targeting markets in which KBC can meld Kao technology with its expertise in designing products for the North American and European markets. The acquisition of John Frieda Professional Hair Care, Inc. has meshed seamlessly with this strategy and led to profitable growth in the premium hair care category.

In addition, KPSS is expanding from hair salons into total premium beauty services for women through partnerships with beauticians knowledgeable in the beauty needs of women in North America and Europe.

Selection and Concentration in Asia

In line with the Kao Way's aim of being the closest to consumers and customers in each market, Kao has reorganized operations in Southeast Asia to enhance its relationship with the region's consumers. A key component of our strategy for this region is to concentrate on developing two brands, *Bioré* and

The implementation of a new information infrastructure for operations in Asia that enhances responsiveness has proceeded on schedule.

Laurier. Returning to marketing fundamentals, Kao has also begun to quantify levels of brand awareness using a standardized brand rating system.

In China, Kao has restructured its operating base with the objective of achieving profitability in two to three years. We created a new business model that focuses on regions and product categories, and narrowed the number of urban areas we serve to 50 from 130. We are also working to strengthen relationships with distributors.

ABS Project to Unify Management

In order to better serve customers, Kao is moving ahead with its Asian Business Synchronization (ABS) project, implementing the information infrastructure needed to standardize and integrate operations throughout Asia. We launched a pilot program in Hong Kong and Thailand in July 2003, and expanded it to include Singapore in March 2004. By October 2004, we had also implemented the project in Taiwan, Indonesia, Malaysia, China and the Philippines, integrating the operations of 22 companies in eight countries or regions. The promotion of standardized business processes throughout Asia, the use of integrated software and the creation of an efficient operational system have enhanced cooperation among relevant divisions in Japan and companies in Asia. Moreover, KBC and KPSS have also begun similar projects.

Brilliant Brunette: Born of Global Collaboration

Brilliant Brunette was created through the union of Kao's hair beautifying technology and the *John Frieda* prestige brand, whose strong value stems from its association with celebrity beauticians. By adding the *John Frieda* brand to its portfolio, KBC gained powerful sales capabilities in mass-market channels such as drugstores, resulting in significant sales growth. At the same time, Kao has avoided brand image deterioration by concluding contracts with John Frieda and other celebrity beauticians. In this way, Kao has adeptly balanced growth in mass-market merchandising with an exclusive prestige image. Building on this position, Kao launched the *Radiant Red* product lineup to expand consumer appeal for the *John Frieda* brand.

Steady, Sustainable Growth in Returns

Toshio Hoshino
Representative Director, Senior Executive Vice President, Corporate Functions

The Kao Way supports our consistent focus on profitable growth and shareholder satisfaction. In emphasizing increased corporate value, Kao manages its businesses to respond quickly and flexibly to its operating environment and to achieve a new target for the dividend payout ratio of 40 percent from fiscal 2005. Disciplined investment in future growth is one means of ensuring returns to shareholders over the long term, while share repurchases have boosted shareholder value drivers such as earnings per share. Kao undertakes share repurchases when extra internal capital resources become available during periods where there are no large-scale capital investments or mergers and acquisitions.

The Benefits of EVA-based Management

Economic Value Added (EVA®), calculated as net profit after tax less a charge for the cost of capital, is a means of consistently increasing corporate value by using internal capital resources effectively. EVA provides a set of decision-making standards for avoiding unprofitable businesses, and Kao also uses EVA to efficiently deploy capital in new areas of opportunity. In addition to providing comparability in evaluating financial value over long periods, EVA is also easy for shareholders and other stakeholders to understand, and gives them a common yardstick for evaluating Kao. Since implementing EVA as a management metric, Kao has conducted programs to ensure that all employees understand EVA and how they can use it in their day-to-day work, which has resulted in widespread acceptance and appropriate use of EVA throughout the Company. In addition, capital markets widely accept EVA, making it a management metric that appeals to all stakeholders.

Total Cost Reduction Activities Enhance EVA

Total Cost Reduction (TCR) is an important driver for improving EVA. In a highly competitive operating environment, Kao has been carrying out TCR activities since 1986 to further increase profitability. These activities entail continuous process improvements to increase the efficiency of operations throughout the Company by eliminating waste and promoting effective resource management, and have a direct relationship to EVA. In addition, they strengthen Kao’s corporate culture because the consistent achievement of TCR goals over the years has given employees confidence that they can contribute

Taking the perspective of consumers helps Kao develop strongly profitable, high-value-added products, and creates a virtuous product development cycle that is consistently successful.

to improved EVA. Furthermore, directors and employees have an incentive to improve EVA because doing so increases wealth available for distribution directly to them. Since fiscal 2000, the Company has been expanding from TCR into value-creating activities under its Value Creating Revolution (VCR) banner, focusing not only on strengthening the earnings structure but also on making qualitative improvements that lead to growth.

EVA Guides Financial Policies

Kao's standard for evaluating financial policies, including investment, financing and distribution of profits to shareholders, is whether it creates value in terms of EVA. In using free cash flow, Kao places top priority on investing in projects that will increase EVA on a long-term basis, including acquisitions and capital investment to expand core businesses and build new ones. Kao believes that stable and consistent shareholder returns are also important, and will place greater emphasis on increasing shareholder returns in allocating free cash flow after meeting the above capital requirements. Kao was one of the first corporations in Japan to articulate a target dividend payout ratio and has increased annual dividends for fifteen consecutive years, including past free share distributions in the form of stock splits. Kao also uses free cash flow to implement share repurchases as a means of improving EVA and increasing shareholder value through higher earnings per share. Since 1999, the year Kao implemented EVA as a management standard, Kao has repurchased shares of its own stock totaling approximately ¥300 billion or 112 million shares, which has increased earnings per share by approximately 17 percent. Most treasury shares were retired or used for conversion of convertible bonds and other purposes, and remaining treasury stock as of March 31, 2005 totaled 4 million shares.

Aggressive Investment in the Chemical Products Segment

The Chemical Products segment, representing about 18 percent of net sales, generates strong EVA and is Kao's most global business. A program of investing in production facilities, scheduled to run through 2006 primarily in locations outside Japan, will add to the momentum of this segment while enhancing shareholder returns. Projected to total ¥10 billion, the series of investments will enhance Kao's competitiveness in serving external customers, as well as its ability to source raw materials crucial to the Company's competitive advantage. Products manufactured at the facilities include fatty alcohol, tertiary amines, toner and toner binder products for copiers and printers, and polyolester.

Integrity, Responsibility and Transparency

Shunichi Nakagawa
Executive Officer, Legal and Compliance - Global and Global Communications

Kao's mission is to strive for the wholehearted satisfaction and enrichment of the lives of people globally. Consistent with this mission, we conduct corporate social responsibility (CSR) activities to contribute to the sustainable development of society. We want to be a welcome member of the community, and to fully understand the cultures and sensibilities of the consumers who use our products. Good citizenship is good business — our brands and their position in their markets are stronger and more profitable because the communities we serve trust Kao.

Service, Integrity and Respect

The Kao Way guides our approach to CSR. It shows the way for employees to serve consumers in global markets by sharing our values and our commitment to providing outstanding products. Kao aims to generate profits by managing efficiently and providing outstanding products that help consumers lead comfortable lifestyles. We then invest these profits in people, research, product development and the other resources required to generate additional growth in the future. We build firm cooperative relationships with our business partners through mutual understanding and respect for the benefit of all parties.

We respect diversity and the individual, and promote a culture of merit in which all employees can fulfill their potential. We also seek to ensure the safety of our products and operations, and strive to protect the environment and contribute to the sustainable development of society.

Compliance and Corporate Governance

CSR supports corporate activities because it also includes compliance and corporate governance. We behave lawfully and ethically, and earn the respect and trust of all stakeholders through sound and honest business activities. Kao conducts swift, accurate and fair disclosure of necessary information to its diverse stakeholders, including consumers and shareholders. This interaction with our stakeholders allows us to regularly review our corporate activities from an external perspective, thus increasing fairness and transparency.
Kao promotes ethical practices and strict legal compliance in its global operations. We believe that our responsibilities go beyond simply complying

Kao supports over 100 citizens' groups and non-profit organizations active in the areas of society, culture and the environment. A representative project is Creating Forests for Everyone, a community greening program Kao has been conducting since 2000 in cooperation with the Urban Greening Foundation.

with laws and paying taxes. We strive for active interchange with the local communities in which we operate, giving full consideration to issues such as environmental protection and human rights. By doing so, we contribute to the development of each community as an integral member.

Sustainable Growth and Development

Kao works to evaluate and improve the economic, environmental and social aspects of each product from the standpoint of sustainable social development. This applies to every stage from product development to procurement, production, distribution, use and disposal.

The Kao Way helps us serve communities by calling on Kao to protect the environment at every stage of operations. We have aggressively implemented measures to reduce waste, counter global warming and promote recycling. In addition, we focus on appropriate management of chemical substances from raw materials to disposal. Moreover, for the period from 2005 to 2010, Kao has set aggressive targets in areas from energy consumption and greenhouse gas emissions to occupational safety. Progress toward achieving zero emissions in our Japanese operations by March 2006 is on schedule.

Swift Assistance for Asian Tsunami Victims

Being a member of a community means being ready to help in times of crisis. Through local governments and non-governmental and non-profit organizations, Kao Corporation has contributed more than ¥65 million in money and supplies to victims of typhoons and other natural disasters. Following the unprecedented earthquake and subsequent tsunami that occurred off Sumatra, Indonesia in December 2004, Kao Group companies quickly provided both funds and supplies. Products provided included soap, shampoo and sanitary napkins, according to the requests of each government concerned. Employee volunteers also raised relief funds matched by Kao Group companies, generating another ¥10 million in aid.

Research and Development

The R&D Division conducts wide-ranging research in areas that are fundamental to Kao's business. This research is integrated with production and process engineering to ensure consumer delight.

Cross-Fertilization of Ideas at Laboratories Yields Results

Kao undertakes dermatological research to better understand what makes skin beautiful. Through this research, Kao developed a composite particle, used in *Kao Sofina*, that replicates the optical properties of beautiful skin. The impetus for development of this composite particle came from a micro-control technology research team concentrating on the optical properties of skin that was loosely composed of members from the Skin Care Products Research Laboratories and other laboratories pursuing similar research.

Compared to skin with color irregularities and enlarged pores, beautiful skin exhibits greater elasticity and firmness. The team's research demonstrated how reflection and diffusion of light striking the skin accounts for these differences.

In order to commercialize this finding, the Materials Development Research Laboratories developed a smooth, water-repellent polymer that coats the surface of these composite particles, which color the skin. Meanwhile, the Processing Development Research Laboratories used innovative supercritical fluid technology, based on high-pressure technologies cultivated in the chemical products business, to develop a composite particle that replicates the optical properties of beautiful skin by employing nanotechnology for coating powder surfaces with polymer membranes made of compounded super ultrafine particles and template particles.

A researcher evaluates foundation that uses micro-control technology.

These results were achieved through collaboration among the Skin Care Products Research Laboratories, which conduct dermatological research based on the latest knowledge in the field; the Materials Development Research Laboratories, which seek to develop new materials through material science research; and the Processing Development Research Laboratories, which develop nano-level applications for advanced particulate material technologies.

After setting research themes, members from the laboratories form teams which meet to exchange opinions on the progress and results of research. New ideas often emerge from this process. If an idea is worthy of consideration as a theme, an ad hoc team is formed to work on it.

Large Laboratory Rooms Facilitate Information Exchange

Traditional large laboratory rooms are considered effective in facilitating this kind of dynamic exchange of a wide variety of knowledge and expertise. The open environment allows researchers to keep abreast of what their colleagues are working on, and inspires new ideas by facilitating everyday exchange of information among researchers working in different fields.

Intellectual Property

Laboratory Staff Fully Aware of Company Policies

A total of 100 employees are responsible for issues relating to Kao's intellectual property. Of these, 50 work in the Intellectual Property Center located within the Research and Development Division and approximately 40 are distributed among the various laboratories.

The large presence of such employees in the laboratories and their daily interaction with research staff contribute to a deeper awareness within Kao that intellectual property rights are an important corporate management resource, and help to create a corporate atmosphere in which the results of R&D are protected as valuable company assets through the acquisition of intellectual property rights.

One example of efforts to raise awareness of intellectual property rights is the introduction of the easily understood Kao slogan "Patents are everyone's business."

Presently, Kao holds 4,500 patents in Japan and 4,500 overseas. Patents and utility models contribute significantly to operations, and Kao has taken measures, including revision of employment regulations concerning employee inventions, to offer greater incentives to the employees behind the inventions.

Corporate Governance System and Activities

Basic Position on Corporate Governance

Kao's basic corporate governance policy is to develop a suitable managerial organization and system, and to take the necessary measures to realize its basic management policies in order to achieve continuous increases in corporate value through profitable growth and efficient, sound and transparent management. Kao considers corporate governance to be one of its most important managerial tasks.

Directors, Board of Directors, Executive Officers and Committees

In June 2002, Kao introduced the Executive Officer system to promote the separation of supervision and execution.

Currently, Kao has 15 Directors including two Outside Directors, and 17 Executive Officers including 12 who serve concurrently as Directors. Both Outside Directors are independent, with no special interest in Kao.

During fiscal 2004, meetings of the Board of Directors were held 17 times with an average attendance rate of 95.1% for Directors and 95.6% for Corporate Auditors.

Kao has established a "Compensation Advisory Committee" and a "Committee for the Examination of the Nominees for the Chairman of the Board of Directors and the President," which perform functions similar to the compensation and nominating committees of the "Company with three committees" system.

Audit System

Four Corporate Auditors including two Outside Corporate Auditors constitute the Board of Corporate Auditors. The Outside Corporate Auditors have no special interest in Kao. The auditing activities of Corporate Auditors include attendance at important meetings, auditing of key operations and investigations of affiliates. In addition, Corporate Auditors regularly conduct various meetings such as quarterly opinion exchange meetings with Representative Directors; briefing sessions on audit plans and audit results with accounting auditors; and biannual conferences of Corporate Auditors of domestic Group companies.

To further strengthen its audit system, Kao has established the Corporate Audit Services Department, which is responsible for conducting internal audits on the appropriateness of business processes and the propriety and efficiency of the management of Kao and its affiliates.

Kao employs the accounting firm, Tohmatsu & Co., to provide accounting services in accordance with the Japanese Commercial Code and perform audits in accordance with the Securities and Exchange Law. Tohmatsu & Co. voluntarily ensures that none of its employees is involved in auditing Kao for more than a prescribed period of time.

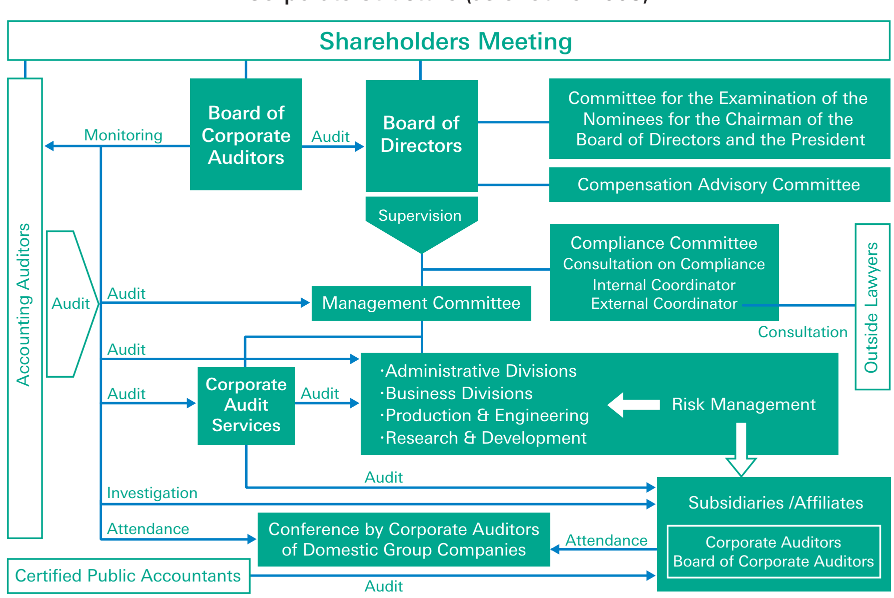
Internal Control and Risk Management System

Kao has established and distributed to its domestic and overseas affiliates an ethics policy based on the principles of "ethical conduct," "legal compliance" and "Kao's Business Conduct Guidelines." Kao has also organized the Compliance Committee, which is chaired by the Chairman of the Board of Directors and which routinely conducts activities for ensuring legal compliance, fairness, and ethical behavior in business activities.

In addition, business risk issues are discussed either at the Management Committee or the Board of Directors meeting as needed.

Kao has also established the Risk Management Office to manage company-wide operational risks.

Corporate Structure (as of June 2005)



Directors, Corporate Auditors and Executive Officers

From left: Takuya Goto, Toshio Hoshino, Motoki Ozaki, Takahiko Kagawa

Board of Directors

* Holds the post of Executive Officer concurrently ** Outside Director

Takuya Goto
Chairman of the Board

Motoki Ozaki*
Representative Director, President and Chief Executive Officer

Toshio Hoshino*
Representative Director, Senior Executive Vice President, Corporate Functions

Takahiko Kagawa*
Representative Director, Executive Vice President, Global Consumer Products

Akio Tsuruoka*
Executive Vice President, Global Procurement

Nobuatsu Higuchi*
Executive Vice President, Greater China

Naotake Takaishi*
Executive Vice President, Global R&D

Shunichi Nakagawa*
Executive Officer, Legal and Compliance – Global and Global Communications

Toshio Takayama*
Executive Officer, President and Chief Executive Officer, Kao Hanbai Company, Ltd.

Norihiko Takagi*
Executive Officer, President, International Business – Consumer Products

Takuo Goto*
Executive Officer, Global Production and Engineering

Hiroshi Kanda*
Executive Officer, President, Global Feminine and Baby Care

Toshihide Saito*
Executive Officer, President, Chemical Company

Akishige Okada**
Advisor, Sumitomo Mitsui Banking Corporation

Sakie T. Fukushima**
Regional Managing Director – Japan,
Leader Global Consumer Markets – Japan,
Member, Board of Directors,
Korn/Ferry International

Corporate Auditors

*** Outside Corporate Auditor

Tsuneo Ejiri
Full-time Corporate Auditor

Shoichi Otake
Full-time Corporate Auditor

Kohei Nasu***
Attorney at Law

Satoshi Itoh***
Certified Public Accountant

Executive Officers

Akio Kimura
Vice President, Global R&D

Shinichi Mita
Global Accounting and Finance

Tatsuo Takahashi
Vice President, Kao Hanbai Company, Ltd.

Masato Hirota
President, Global Prestige Cosmetics

Yoshitaka Nakatani
Vice President, Global Production and Engineering

Yoshiiku Hirai
Vice President, Global Marketing Service

Toshiharu Numata
Vice President, Global R&D

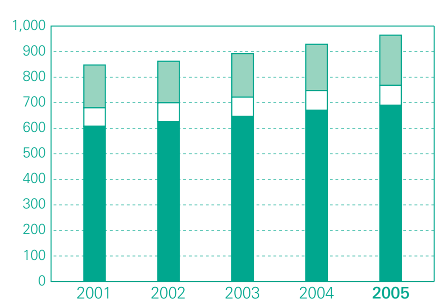
Shinichirou Hiramine
President, Global Baby and Feminine Care – ASEAN Region

(As of June 29, 2005)

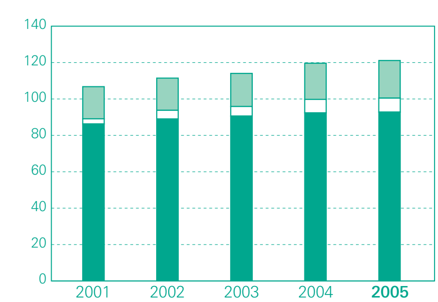
Kao at a Glance

Consumer Products Segment
– Japan

Net Sales
(Billions of yen)



Operating Income
(Billions of yen)

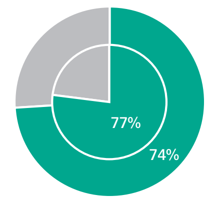


Consumer Products Prestige Cosmetics Chemical Products

(Years ended March 31)

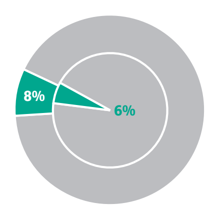
Note: Net sales to outside customers only. Operating income is net of eliminations.

– Overseas



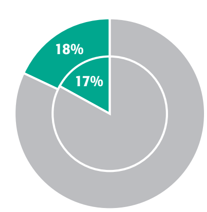
Outer circle: Net Sales*
Inner circle: Operating Income*

Prestige Cosmetics Segment



Outer circle: Net Sales*
Inner circle: Operating Income*

Chemical Products Segment



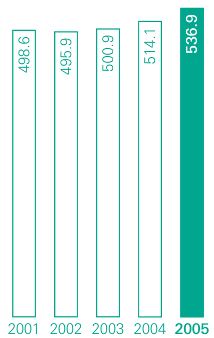
Outer circle: Net Sales*
Inner circle: Operating Income*

*Net sales to outside customers only. Operating income is net of eliminations.

Review of Operations

A tight focus on cleanliness, beauty, health and chemicals helps Kao deliver the value to consumers that has resulted in leadership in numerous categories. Innovation is key. We are adapting to change by keeping established brands strong and building successful new ones. In the Chemical Products segment, we focus on specialized strengths and intelligent investment in capacity expansion.

Net Sales
(Billions of yen)



Japan

Net sales of the Consumer Products segment in Japan increased 4.4 percent to ¥536.9 billion. Kao's Consumer Products segment in Japan delivers a wide range of products including home care products such as laundry detergents and fabric softeners, personal care products for hair care and skin care, baby diapers and feminine hygiene products. Kao also provides health care products such as cooking oils and tea drinks that include health functions.

Strengthening Existing Brands and Developing and Nurturing New Products

With the increasing competitiveness of distribution in Japan, heightened by the entry of foreign retailers, prices of toiletries are continuing to fall. Moreover, for the past several years sales at drugstore chains have been increasing at the highest rate among retail channels.

In response, Kao is reinforcing its established brands while developing and nurturing new products. With *Healthya Green Tea*, a healthy beverage for people concerned about body fat, Kao created a new market based on the concept of tea drinks with health functions.

During the last several years, Kao has been developing products suited to the rapidly growing drugstore sales channel, with a focus on personal care products. For example, Kao launched a *Curél* product for people with sensitive skin that is sold exclusively through the drugstore channel, and is supporting it with carefully targeted point-of-purchase promotion. In marketing activities, Kao is implementing Efficient Customer Response (ECR) in concert with distributors to respond efficiently to customers, and the shift of activities to the ECR strategy is becoming firmly established.

The *Healthya* brand has expanded the green tea channel, and Kao further strengthened it by launching an oolong tea product in March 2005.

Strong Contribution from *Asience* Hair Care Line and *Healthya Green Tea*

In fiscal 2004, Kao focused on further strengthening the *Asience* lineup of hair care products, and on expansion of sales channels and brand reinforcement for *Healthya Green Tea*. These two products contributed strongly to the increase in sales for the year.

For *Bioré U* body cleanser, Kao is effectively responding to consumer preferences by expanding product variations. In addition to making improvements, Kao introduced a new raspberry scented variety in spring 2004, and added lime and orange scents in spring 2005. *Bioré U Foam Hand Soap* was also added during fiscal 2004, and sales have grown quickly since its launch.

Family Kyukyutto dishwashing detergent appeals to consumers at both the functional and emotional levels.

In the Health Care (Functional Food) business, sales of *Econa Healthy Cooking Oil* and related products at stores were solid, and growth in gift sales also contributed to results.

Both sales and market share of *Merries* baby diapers were down in fiscal 2003 due to the effect of price declines, but rebounded strongly in fiscal 2004 to their levels of two years earlier. Among new products, *Family Kyukyutto* dishwashing detergent was promoted in television commercials that directly convey the product concept that users can achieve a "squeaky clean" finish immediately upon rinsing. Consumers responded positively, resulting in favorable sales. *Laurier F* sanitary napkins, launched in autumn 2004 as a product that alleviates stress on the skin, received an enthusiastic response from consumers and has good growth potential. Kao will continue to develop highly appealing new products, such as the *Asience* line and *Laurier F*, that combine traditional functions with qualities such as comfort and emotional appeal.

In the Fabric and Home Care business, factors including the substantial effect of falling market prices and a shrinking gift market had a negative impact on sales of laundry detergent and fabric softeners.

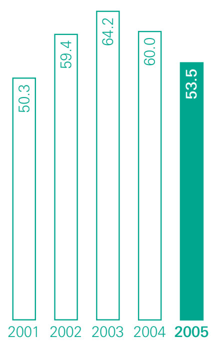
Energize the Market with Ongoing Product Development that Creates New Markets

Kao will continue to develop and launch products with high added value and nurture them into products that are supported by consumers. Because of present conditions in the toiletries market, where deflation remains a concern, retailers are urgently requesting new products, and Kao intends to speed up product development.

Actress and Asian beauty Zhang Ziyi is the perfect representative for *Asience* in television commercials and other advertising based on the theme of beautiful hair.

As growth sectors, Kao is eyeing products for the health, senior and pet care markets. The health market in particular is a focal point of research and development, and Kao will launch products which, like *Econa Healthy Cooking Oil* and *Healthya Green Tea*, have been approved in Japan by the Ministry of Health, Labour and Welfare for labeling as Foods for Specified Health Use. In the *Healthya* line, Kao launched *Healthya Oolong Tea* at the end of March 2005, which should contribute to sales expansion. In the hair care category, Kao reinforced the *Asience* product lineup with the addition of two new items, *Asience Hair Beautifying Mist* and *Asience Hair Beautifying Lotion*, in April 2005. Moreover, in the fabric care category, in spring 2005 Kao launched *Keeping Style Care*. This product is a new styling agent for fabric that prevents wrinkles and reshapes clothes while they are drying. This product addresses consumer requirements that conventional fabric softener and starch products do not meet, and strong sales will help to vitalize the Fabric and Home Care business.

Net Sales
(Billions of yen)



Asia and Oceania

Net sales of the Consumer Products segment in Asia and Oceania decreased 10.8 percent to ¥53.5 billion. Kao moved to adapt to change by focusing on building market share for core brands, implementing a new information infrastructure, taking new approaches in marketing and sales, and improving responsiveness in China.

Building a Swift, Responsive Information Infrastructure

In a highly competitive market, swift response to changing conditions and trends is critical for success. In February 2005, Kao completed implementation of its Asian Business Synchronization (ABS) project, launched in October 2000 as part of efforts to bolster the Company's ability to respond swiftly to such changes. The ABS project develops information systems for standardizing and optimizing regional operations and increasing efficiency.

By accurately grasping and rapidly responding to market movements, Kao will create a more robust infrastructure and manage its operations more efficiently. This will also support Kao's ability to meet the needs of global retailers.

In Asia, the *Laurier* brand exemplifies Kao's ability to differentiate its products.

Focus on Core *Bioré* Skin Care and *Laurier* Feminine Hygiene Lines

The market for consumer products in Asia is changing significantly with the entry of global retailers. In response to these changes, Kao has made continuing focus on its core *Laurier* and *Bioré* brands a key component of its differentiation strategy, and will concentrate marketing expenses on expanding their market share. By establishing successful business models that respond to market changes in each country in the region, the Kao Group will improve performance overall.

We are extending the *Bioré* lineup to satisfy an even broader array of consumer needs.

Overhauling Marketing and Sales Structures in Asia

Continuing double-digit growth makes Asia an attractive market. Getting back to marketing basics, Kao is standardizing its brand rating system with the introduction of numerical scores that indicate how products are viewed by customers in Asia. In addition, a support unit for operations in Asia has been set up in Kao Hanbai Company, Ltd. to introduce area analysis and other management tools used by other global retailers.

Ten years after commencing business in China, Kao is now in the process of restructuring, with the aim of improving responsiveness to market changes and customer needs. Kao cut the number of cities in which it operates by half, and is shifting from its previous emphasis on direct sales to greater distribution of products to retail outlets through local wholesalers. As in the ASEAN region, Kao is focusing on increasing market share for its core brands *Bioré* and *Laurier*. Consideration of regional business expansion will come once the Company has established a successful business model. Kao aims to achieve profitability in three years, and is enhancing its business structure through establishment of a research laboratory and other initiatives toward that end.

Net Sales
(Billions of yen)

North America and Europe

Net sales of the Consumer Products segment in North America and Europe increased 4.6 percent to ¥106.7 billion. Kao consolidated its North American skin and hair care business and its European premium hair care business under a new name, Kao Brands Company, to enhance focus on the premium beauty market.

Kao Brands Company Established to Integrate Operations in North America and Europe

In 2004, Kao changed the name of The Andrew Jergens Company, its long-running North American business, to Kao Brands Company (KBC). In addition to bringing Kao's North American skin care and hair care lines under the Kao name, the new company consolidated them with the business of Guhl Ikebana GmbH, which handles premium hair care products primarily in Germany and the Netherlands. As a premium beauty company, KBC is firmly focused on delivering premium value in the personal care business.

Sales of Restaged *Bioré* Skin Care Products Grow and Sales of Hair Care Products Favorable

The restaging of *Bioré* products involved a full design change and a renewed emphasis on the line as a specialist brand for pore cleansing. These initiatives led to better acceptance by large retailers, increased market share and steady expansion of sales in fiscal 2004.

The *John Frieda* premium hair care brand, centered on the *Brilliant Brunette* line, performed well in North America and Europe. The brand also contributed to sales growth in Europe, mainly in the United Kingdom, its strongest sales region.

KPSS – Kao Professional Salon Services GmbH (KPSS) launched *Color Glow*, a new line of shampoos and conditioners for individual color care. Sales exceeded original targets by a wide margin, contributing substantially to company-wide revitalization of KPSS.

Color Glow by KPSS is a hair care product lineup designed for consumers who color their hair.

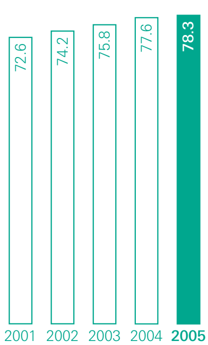
Major improvements to the *Bioré* skin care brand in fiscal 2004 were aimed at restaging *Bioré* as a premium brand.

Harnessing the Kao Group's R&D Capabilities to Develop Products for Europe and North America

In its overseas operations, Kao concentrated on developing and improving products under the KBC umbrella. In the *John Frieda* brand, Kao plans to further expand the *Radiant Red* line introduced in January 2005. In addition, Kao launched *Jergens Natural Glow*, a line of daily moisturizers for individual skin tones that provide a healthy summer glow all year long. Furthermore, the improvement and restaging of *Curél* and *ban* will establish and enhance the premium image of the brands handled by KBC.

The Kao Group will continue working to grow its business by capitalizing on research and development synergies among Kao Corporation, KBC and KPSS, and by developing products that take advantage of the Group's first-rate design talent in North America and Europe.

Net Sales
(Billions of yen)



Prestige Cosmetics Segment

Net sales of the Prestige Cosmetics segment increased 0.8 percent to ¥78.3 billion. Kao generated growth despite a challenging market environment through effective product renewals and development of new channels and customer segments. Steady expansion continued outside of Japan.

Focus on Enhancing Existing Brands and Developing New Markets

Despite hopes of recovery following a year of modest growth in the market for prestige cosmetic products, the year ended March 2005 saw a year-on-year drop in sales due to difficult market conditions. Products priced between ¥2,000 and ¥5,000, the target range of the *Sofina* line, were hardest hit. In this tough market, *Sofina* sales increased over the previous fiscal year, exceeding the market average.

Product renewals were carried out for the *Sofina Fine-Fit* foundation and *AUBE* color makeup lines as well as for *Grace Sofina* foundation cosmetics. Basic care brand *est*, which is sold exclusively in department stores, continued to perform well, supported by major line improvements.

We developed the new skin care series *Alblanc* to satisfy consumer desire for both quality and the sense that the brand is truly their own.

In response to changes in cosmetics distribution, Kao launched the *Alblanc* skin care brand in September 2004. Targeting a new customer segment, *Alblanc* products are distributed through general merchandisers and drugstores actively engaged in beauty counseling. During the same month, Kao launched the *ORIENA* brand in the mail-order market, an entirely new area where the Company plans to acquire know-how. In overseas markets, the

Core foundation product *Sofina Fine-fit* has continued to perform well following a major renewal in the fiscal year 2004.

Prestige Cosmetics business expanded from Hong Kong and Taiwan to Shanghai.

Grace Sofina, *Sofina Fine-Fit* and Other Major Contributors to Sales

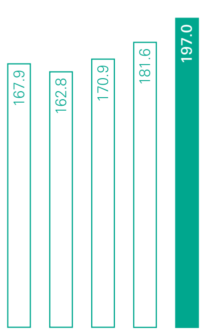
Existing skin care products and *Grace Sofina* foundation cosmetics, which underwent comprehensive renewal, performed solidly. Concentrated sales and marketing efforts for the *est* line supported strong results. Also contributing to sales were the October 2004 launch of *Repair Program*, a new special care essence for dry, powdery complexions, and improvements to *Sofina Very Very Powdery Pore Care*.

Continued Focus on Reinforcing Basic Care and Special Care Brands

Kao will continue to strengthen sales through ongoing improvements to established skin care brands. The April 2005 launch of *Sofina Pore Zone Care Essence*, a skin beautifying essence formulated to meet the special needs of women over twenty-five for cheek pore care products, will further reinforce the special care category. Building on its efforts in the year ended March 2005, Kao will work to achieve rapid growth of the *est* brand, promptly establish and grow a base for the *Alblanc* line and acquire know-how in the mail-order market through sales of *ORIENA*. Activities outside Japan will include expanding sales bases in Hong Kong, Taiwan and Shanghai.

Kao will work to achieve future growth by actively investing in existing products in Japan, and will continue striving to achieve top-line growth.

Net Sales
(Billions of yen)



Chemical Products Segment

Net sales of the Chemical Products segment increased 8.5 percent to ¥197.0 billion. Capacity expansion and innovative products contributed to growth, as did Kao’s focus on added value and markets where its products have a competitive advantage.

Expansion of Oleo Chemical Business and Development of High-Value-Added Products in Specialty Chemicals and Others

Although the Japanese economy moved toward recovery, uncertainty remained regarding the future of the world economy due to increased raw material costs caused by a steep rise in oil prices. In this environment, Kao’s oleo chemical business achieved further sales growth, supported by the 2002 capacity expansion for fatty alcohols at Fatty Chemical (Malaysia) Sdn. Bhd. In the specialty chemicals business, Kao concentrated on developing high-value-

Chemical Products Segment

One of every three color copies made worldwide uses Kao color toner and toner binder.

added products, mainly toner, toner binder and aroma chemicals. In performance chemicals, the third core business area, Kao focused on the markets where its products have a competitive edge.

Sales Growth in Oleo Chemicals, Toner and Toner Binder

Despite price hikes in fats and oils, Kao's oleo chemical business expanded globally, primarily in North America, due to careful price adjustments and a reputation among customers for high-quality alcohols and stable supply capability.

In specialty chemicals, toner and toner binder posted increases, while pigment auxiliaries for color inkjet printer ink continued to perform strongly in Japan. The aroma chemicals business also grew, primarily in Europe, with the addition of sales from operations acquired in 2003.

In Germany, a new production facility for high-performance concrete admixtures began operations, and is contributing to sales growth in both Europe and the U.S.

Global Expansion While Maintaining Basic Policies

In the oleo chemical business, Kao will build a new fatty alcohol plant in the Philippines to increase production capacity, in accordance with its global strategy.

In specialty chemicals, Kao will continue to develop new products based on original core technologies to meet customer needs, with a focus on toner and toner binder products for copiers and printers, pigment auxiliaries for color inkjet printer ink, slurries for use in polishing hard disks and aroma chemicals. To fulfill increasing customer demand, Kao has three dedicated production sites for toner and toner binder products, located in Japan, Spain and the United States.

In the performance chemical business, Kao will concentrate on developing and marketing high-performance products, primarily surfactants.

Kao will continue to make aggressive investments aimed at further business growth.

Principal Subsidiaries and Affiliates

Consumer Products, Prestige Cosmetics, Chemical Products and Professional Hair Care Products

Country Area	Company	Consumer Products/Prestige Cosmetics	Chemical Products	Professional Hair Care Products
Japan	Kao Cosmetics Sales Co., Ltd.	●		
	Kao Hanbai Company, Ltd.	●		
	Nivea-Kao Company Limited	●		
	Kao-Quaker Company, Limited		●	
China	Kao (China) Holding Co., Ltd.	●		
	Kao Corporation Shanghai	●		
	Kao Commercial (Shanghai) Co., Ltd.	●		
	Kao Transfar (Hangzhou) Co., Ltd.	●		
	Kao Chemical Corporation Shanghai		●	
	Zhongshan Kao Chemicals Limited		●	
Hong Kong	Kao (Hong Kong) Limited	●		
	Kao Chemicals (Hong Kong) Limited		●	
Indonesia	P.T. Kao Indonesia	●		
	P.T. Kao Indonesia Chemicals		●	
Malaysia	Kao (Malaysia) Sdn. Bhd.	●		
	Fatty Chemical (Malaysia) Sdn. Bhd.		●	
	Kao Soap (Malaysia) Sdn. Bhd.	●		
	Kao Oleochemical (Malaysia) Sdn. Bhd.		●	
	Kao Plasticizer (Malaysia) Sdn. Bhd.		●	
Philippines	Pilipinas Kao, Incorporated		●	
Singapore	Kao (Singapore) Pte. Ltd.	●	●	
Taiwan	Kao (Taiwan) Corporation	●	●	
Thailand	Kao Consumer Products (Southeast Asia) Co., Ltd.	●		
	Kao Industrial (Thailand) Company Limited	●	●	
	Kao Commercial (Thailand) Company Limited	●		
Vietnam	Kao Vietnam Co., Ltd.	●		
Australia	Kao (Australia) Marketing Pty. Ltd.	●		
Mexico	Quimi-Kao, S.A. de C.V.		●	
United States	Kao Brands Company	●		
	Kao Specialties Americas LLC		●	
	ADM Kao LLC	●	●	
France	Kao Corporation (France) SARL		●	
Germany	KPSS – Kao Professional Salon Services GmbH			●
	Kao Chemicals GmbH		●	
Spain	Kao Chemicals Europe, S.L.		●	
	Kao Corporation S.A.		●	

● Consumer Products/Prestige Cosmetics ● Chemical Products ● Professional Hair Care Products

Financial Section

Contents

Management's Discussion and Analysis

11-Year Summary

Kao Corporation and Consolidated Subsidiaries

Years ended March 31	2005	2004	2003	2002
For the year:				
Net sales	**¥936,851**	¥902,628	¥865,247	¥839,026
Consumer Products	**690,007**	670,438	646,413	626,047
Prestige Cosmetics	**78,294**	77,648	75,833	74,176
Chemical Products	**196,989**	181,621	170,935	162,802
Eliminations	**(28,439)**	(27,079)	(27,934)	(23,999)
Japan	**703,085**	673,657	654,595	648,188
Asia and Oceania	**100,282**	101,452	101,555	93,499
North America and Europe	**—**	—	—	—
North America	**83,638**	79,907	75,796	70,274
Europe	**93,804**	84,899	67,845	57,625
Eliminations	**(43,958)**	(37,287)	(34,544)	(30,560)
Operating income	**121,379**	119,706	114,915	111,728
Net income	**72,180**	65,359	62,462	60,275
Capital expenditures	**54,318**	51,823	84,544	49,537
Depreciation and amortization	**56,794**	58,166	58,310	58,484
Cash flows	**109,704**	106,430	104,436	103,657
Research and development expenditures	**39,764**	38,506	37,713	37,543
(% of Sales)	**4.2%**	4.3%	4.4%	4.5%
Advertising expenditures	**84,157**	82,773	74,277	66,069
(% of Sales)	**9.0%**	9.2%	8.6%	7.9%
At year-end:				
Total assets	**688,974**	723,891	720,849	772,145
Total shareholders' equity	**448,249**	427,757	417,031	459,731
Number of employees	**19,143**	19,330	19,807	19,923
Per share:				
Net income	**¥ 131.16**	¥ 119.06	¥ 108.05	¥ 100.43
Cash dividends	**38.00**	32.00	30.00	26.00
Shareholders' equity	**821.47**	782.14	744.56	779.44
Weighted average number of shares outstanding during the period (in thousands)	**549,626**	547,865	576,770	600,150
Key financial ratios:				
Return on sales	**7.7**	7.2	7.2	7.2
Return on equity	**16.5**	15.5	14.2	13.1
Equity ratio	**65.1**	59.1	57.9	59.5

Notes: 1. Net sales by business segment include intersegment sales starting from the year ended March 31, 2000. Net sales of Chemical Products include intersegment sales to Consumer Products and Prestige Cosmetics.
2. Prestige Cosmetics results for 1998 and prior years are consolidated under Consumer Products.
3. Net sales by geographic segment include intersegment sales. Net sales in North America and Europe are presented separately from 2002.
4. Cash flows are defined as net income plus depreciation and amortization minus cash dividends.
5. Net income per share is computed based on the weighted average number of shares outstanding during the respective years. From the year ended March 31, 2003, the portion of net income unavailable to common shareholders, such as directors' bonuses, which is included in the appropriation of retained earnings, is deducted from net income for the calculation of net income per share. The same method is applied to the calculation of shareholders' equity per share.
6. Cash dividends per share are the amounts applicable to the respective years, including dividends to be paid after the end of the year.

	Millions of yen					
2001	2000	1999	1998	1997	1996	1995
¥821,629	¥846,922	¥924,596	¥907,249	¥901,402	¥835,597	¥796,730
607,826	632,423	656,197	696,800	705,332	675,883	653,541
72,579	70,890	74,450	—	—	—	—
167,893	172,401	193,949	210,449	196,070	159,714	143,189
(26,669)	(28,792)	—	—	—	—	—
655,470	673,456	672,123	674,640	696,022	673,051	654,177
84,137	86,176	104,694	101,726	83,588	69,589	59,274
105,287	111,043	178,933	162,092	148,171	118,004	107,559
—	—	—	—	—	—	—
—	—	—	—	—	—	—
(23,265)	(23,753)	(31,154)	(31,209)	(26,379)	(25,047)	(24,280)
107,099	99,182	91,664	72,868	72,101	66,509	61,926
59,427	52,147	34,714	24,495	27,594	24,531	23,686
60,741	37,564	69,016	59,012	65,283	79,254	72,241
58,856	67,270	71,202	81,405	73,592	70,623	73,648
104,702	108,158	96,310	97,046	93,073	87,950	90,739
37,049	38,062	36,062	37,843	37,929	37,544	40,037
4.5%	4.5%	3.9%	4.2%	4.2%	4.5%	5.0%
65,758	64,354	71,752	65,404	61,012	58,592	55,574
8.0%	7.6%	7.8%	7,2%	6.8%	7.0%	7.0%
783,760	750,016	751,725	778,762	807,124	756,849	709,264
462,988	474,979	451,777	424,430	379,552	359,812	342,003
19,068	16,088	—	—	—	—	—
	Yen					
¥ 96.69	¥ 83.45	¥ 55.98	¥ 40.10	¥ 45.92	¥ 40.85	¥ 39.49
24.00	20.00	16.00	15.00	14.00	12.50	11.50
760.05	765.59	727.01	684.90	631.54	598.71	569.74
614,608	624,917	620,171	610,857	600,978	600,454	599,810
	%					
7.2	6.2	3.8	2.7	3.1	2.9	3.0
12.7	11.3	7.9	6.1	7.5	7.0	7.1
59.1	63.3	60.1	54.5	47.0	47.5	48.2

Overview of Consolidated Results

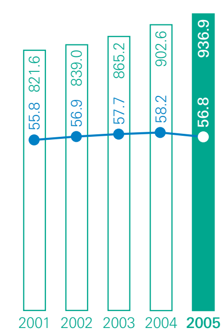
In the fiscal year ended March 31, 2005, the Japanese economy recovered moderately in the first half, supported by improved corporate earnings, stronger consumer spending and increased private capital investment in Japan. The pace of recovery began to slow in fall 2004, however, as crude oil prices rose sharply, exports declined and growth in consumer spending weakened. Deflationary trends persisted in Japan. As a result of these factors, the operating environment remained challenging.

Analysis of Income Statements

Net Sales and Operating Income

For the year ended March 31, 2005, consolidated net sales increased 3.8 percent year-on-year, or ¥34.2 billion, to ¥936.9 billion (US$8,723.8 million). Absent the year-on-year negative currency effect on overseas sales of ¥8.9 billion (US$83.2 million) due to the appreciation of the yen versus the U.S. dollar, sales would have increased 4.8 percent. Sales in Japan increased 4.4 percent year-on-year. Although lower sales prices resulting from intensifying market competition impacted the Consumer Products segment, Kao worked to expand sales by developing high-value-added products and executing efficient marketing strategies. In the Chemical Products segment, the favorable effect of economic recovery on sales of existing products and Kao's emphasis on new product development resulted in solid sales growth. Overseas sales increased 4.3 percent year-on-year. Successful new product launches in North America and Europe contributed to increased sales of Consumer Products and timely capital investments supported higher sales of Chemical Products. Sales of Consumer Products in Asia, however, were sluggish due to intense market competition.

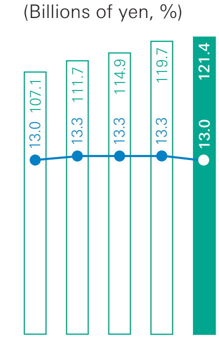
Net Sales/ Gross Profit Ratio
(Billions of yen, %)



Cost of sales increased to ¥404.8 billion (US$3,769.5 million) from ¥377.8 billion for the previous fiscal year. The cost of sales ratio increased 1.4 percentage points to 43.2 percent. Although the Company launched high-value-added new products and continued cost reduction programs, increase in the cost of sales ratio resulted from lower sales prices and higher raw material costs. However, gross profit increased 1.4 percent year-on-year, or ¥7.2 billion, to ¥532.0 billion (US$4,954.4 million) due to the effect of the increase in net sales.

Selling, general and administrative increased 1.4 percent year-on-year, or ¥5.5 billion, to ¥410.7 billion (US$3,824.1 million). A primary factor was aggressive investment in marketing, which supported increased sales from new product launches and programs to revitalize existing products. Advertising and packing and delivery expenses increased as a result. Performance-related bonuses decreased. R&D expenses increased slightly to ¥39.8 billion (US$370.3 million) because of Kao's emphasis on developing innovative, value-added new products. The ratio of R&D expenses to net sales was 4.2 percent.

Operating Income/ Operating Income Ratio
(Billions of yen, %)



As a result, operating income increased 1.4 percent year-on-year to ¥121.4 billion (US$1,130.3 million) from ¥119.7 billion for the previous fiscal year. Operating income from operations in Japan increased 2.5 percent, or ¥2.7 billion, to ¥107.5 billion (US$1,000.9 million). Operating income from overseas operations decreased 6.8 percent, or ¥1.0 billion, to ¥13.8 billion (US$128.6 million). A primary factor in the decline was reduced operating income resulting from lower sales of Consumer Products in Asia.

Non-Operating Expenses and Net Income

Other expenses totaled ¥1.7 billion (US$16.1 million), compared with ¥2.6 billion for the previous fiscal year. Equity in earnings of nonconsolidated subsidiaries and affiliates totaled ¥1.2 billion (US$11.3 million), compared to ¥0.5 billion for the previous fiscal year. Gain on sales of investment securities totaled ¥1.2 billion (US$11.0 million), compared to ¥0.8 billion for the previous fiscal year. Loss on sales or disposals of property, plant and equipment, net increased to ¥3.7 billion (US$34.4 million) from ¥1.5 billion for the previous fiscal year. The Company also recorded a loss of ¥2.5 billion (US$23.4 million) on impairment of long-lived assets of consolidated subsidiaries.

As a result, income before income taxes and minority interests increased 2.1 percent year-on-year to ¥119.7 billion (US$1,114.2 million). Income taxes net of deferrals decreased to ¥47.1 billion (US$438.8 million) from ¥50.4 billion for the previous fiscal year. The effective tax rate decreased to 39.4 percent from 43.0 percent for the previous fiscal year after the application of tax effect accounting, reflecting such factors as the introduction of the standard enterprise tax in Japan.

Net income increased 10.4 percent year-on-year to ¥72.2 billion (US$672.1 million). Net income per share increased 10.2 percent to ¥131.16 (US$1.22), reflecting factors such as higher net income, the repurchase of 27 million shares from the market and the conversion of convertible bonds to stock. Return on equity (ROE) increased 1.0 percentage point to 16.5 percent.

Cash dividends per share applicable to the year increased to ¥38.00 (US$0.35) from ¥32.00 for the previous fiscal year. EVA increased because of an increase in net operating profit after tax (NOPAT) and decreased capital charges resulting from Kao's share repurchase program. The EVA index stood at 154, compared to 100 for the fiscal year ended March 31, 2000, when Kao adopted its EVA management system.

Net Income/ Return on Sales
(Billions of yen, %)

Costs, Expenses and Income as Percentages of Net Sales

	2005		2004		2003
Cost of sales	**43.2%**		41.8%		42.3%
Gross profit	**56.8**	**(-1.4)**	58.2	(0.5)	57.7
Selling, general and administrative expenses	**43.8**	**(-1.1)**	44.9	(0.5)	44.4
Operating income	**13.0**	**(-0.3)**	13.3	(0.0)	13.3
Income before income taxes and minority interests	**12.8**	**(-0.2)**	13.0	(0.0)	13.0
Net income	**7.7**	**(0.5)**	7.2	(0.0)	7.2

Note: Figures in parentheses represent change in percentage points from the previous year.

Information by Business Segment

Sales of Consumer Products increased steadily in Japan, North America and Europe, but were sluggish in Asia as a result of an increasingly competitive environment. Sales of Prestige Cosmetics were firm. Sales of Chemical Products increased because of the generally strong economic environment and growth in targeted markets.

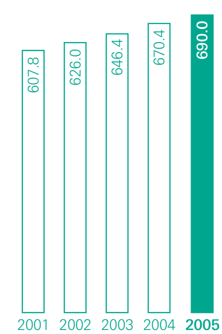
Operating income from Consumer Products increased in Japan but decreased overseas. Operating income from Prestige Cosmetics increased. Operating income from Chemical Products increased both in Japan and overseas, as steady growth in sales volume and sales of newly developed products offset the considerable impact of increased raw material prices.

Consumer Products Segment

Net sales of Consumer Products increased 2.9 percent from the previous fiscal year to ¥690.0 billion (US$6,425.2 million). Excluding the negative currency translation effect, sales increased 3.9 percent in real terms. Sales in Japan increased 4.4 percent year-on-year. Sales in North America and Europe also increased, but decreased in Asia.

Operating income increased ¥0.4 billion to ¥92.6 billion (US$862.3 million). Operating income increased in Japan, North America and Europe, but decreased in Asia.

Net Sales by Business Segment: Consumer Products
(Billions of yen)

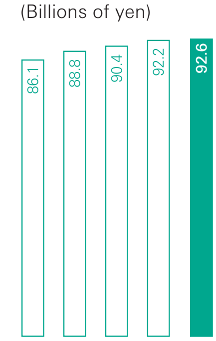


Japan

The overall market contracted in terms of the value of sales compared to the previous fiscal year due to a continued decline in retail prices. Kao took different approaches to the market: one based on distinguished product function and another based on emotional appeal.

Sales of the personal care products increased 5.3 percent compared to the previous fiscal year to ¥180.6 billion (US$1,681.9 million). Competition has remained intense in a mature market because of the increasing number of products launched in response to diversifying consumer perceptions of value. Kao focused on enhancing category strengths. In the shampoo, conditioner and treatment category, *Asience* continued to perform well and sales expanded strongly. Kao is developing *Bioré* into a total skin care brand. Sales of *Bioré U* body cleanser in particular expanded.

Operating Income by Business Segment: Consumer Products
(Billions of yen)



Competition was intense in the mature fabric and home care market, and prices continued to decrease in a deflationary environment. The gift market also contracted. Kao countered these market conditions by offering products that respond to changes in consumers' living environments. In the laundry detergent category, Kao introduced *New Beads Wash & Care* laundry detergent, which reduces fabric wear and wrinkling during washing. While market share increased, deteriorating market conditions resulted in lower year-on-year sales. In the dishwashing detergent category, *Family Kyukyutto* remained popular among consumers, and sales increased steadily. Overall sales of fabric and home care products decreased 2.8 percent compared with the previous fiscal year to ¥234.3 billion (US$2,181.3 million).

In the area of feminine care, baby care and other products, the market for adult incontinence products expanded, but the market for disposable baby diapers declined because of Japan's low birth rate and increasing average age. The market for feminine care products is also trending downward because of a decrease in the user population. Sales of *Merries* disposable baby diapers increased substantially year-on-year due to consumer support for this brand's high level of basic product performance. In the feminine hygiene category, Kao launched and expanded sales of *Laurier F*, which alleviates skin stress and features high absorbency and soft texture. *Healthya Green Tea* received strong support from consumers concerned about body fat. Kao enhanced this product's market presence by expanding sales channels and broadening the *Healthya* product lineup. Sales of the *Econa Healthy* cooking oil series, which holds a high share of the market for healthy cooking oil, continued to grow strongly in the gift market. As a result, sales of feminine care, baby care and other products increased 20.3 percent compared with the previous fiscal year to ¥122.1 billion (US$1,136.8 million).

Asia and Oceania

In Asian markets, improvement in consumers' standard of living is bringing about major changes. Kao is therefore focusing management resources on building strong core brands. For *Bioré*, Kao enhanced its lineup of facial cleansers while expanding basic care products. In the *Laurier* lineup of feminine care products, Kao launched products with distinctive features. Sales were essentially unchanged in the ASEAN region, but decreased from the previous fiscal year in China as Kao significantly reduced the number of cities in which it does business as part of restructuring. Sales in Asia decreased 10.8 percent year-on-year to ¥53.5 billion (US$498.3 million).

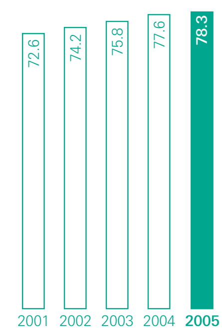
North America and Europe

Stronger consumer spending helped the markets of North America and Europe continue to improve despite weak employment conditions. In September 2004, The Andrew Jergens Company changed its name to Kao Brands Company as part of its efforts to maximize brand value. Sales of the *John Frieda* premium hair care brand increased substantially, supported by the launch of new products. Sales of the *Bioré* series of skin care products were also favorable due to major product improvements to restage this brand's market position. Positive response to the new product *Color Glow* and activation of existing brands contributed to growth in sales at KPSS – Kao Professional Salon Services GmbH. As a result, overall sales increased 4.6 percent compared to the previous fiscal year to ¥106.7 billion (US$993.9 million).

Prestige Cosmetics Segment

The market for lower-priced cosmetics grew in Japan, but conditions for prestige products were particularly challenging due to restrained consumer spending and the impact of unusual weather. Kao vigorously improved the *Sofina* brand in key categories, including *Grace Sofina* skin care, *Fine-fit* and *Raycious* foundation cosmetics, and *AUBE* makeup. For the *est* brand, which is sold exclusively at department stores, Kao improved basic care products and continued to implement aggressive marketing and sales activities, which included the launch of new foundation cosmetics. Moving to build business in new areas, Kao launched the *Alblanc* medicated skin care series for drugstores and supermarkets that actively engage in beauty counseling, and the *ORIENA* skin care series for the mail-order market. Kao also began to operate in China's growing cosmetics market in spring 2004. Sales increased 0.8 percent over the previous fiscal year to ¥78.3 billion (US$729.1 million), and operating income increased 3.6 percent, or ¥0.3 billion, to ¥7.7 billion (US$71.6 million).

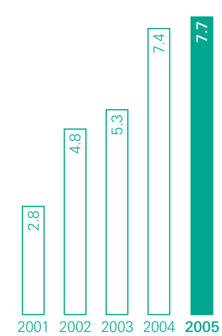
Net Sales by Business Segment: Prestige Cosmetics
(Billions of yen)



Chemical Products Segment

Global economic conditions were favorable, driven by expansion of the U.S. economy resulting from growth in consumer spending and capital investment. The Kao Group worked to expand its business in the core fields of oleo chemicals, specialty chemicals and performance chemicals. Sales in Japan increased steadily, supported by economic growth and higher sales of newly developed products. Outside Japan, Kao increased sales of fatty alcohol products and specialty chemicals, including toner and toner binder products for copiers and printers. As a result, sales increased 8.5 percent year-on-year to ¥197.0 billion (US$1,834.3 million). Excluding the negative currency translation effect, sales increased 10.0 percent. Operating income increased 3.6 percent, or ¥0.7 billion, to ¥20.7 billion (US$192.4 million), with higher sales volume, cost reductions and more efficient use of expenses offsetting increases in the cost of natural fats and oils and petrochemical raw materials.

Operating Income by Business Segment: Prestige Cosmetics
(Billions of yen)

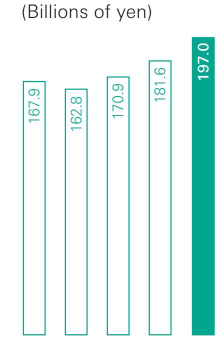


Japan

The manufacturing sector in general recovered moderately. However, the rising price of raw materials, particularly crude oil, is a major cause of uncertainty.

Kao continued to focus on increasing sales of products with unique features and newly developed products. In businesses related to specialty chemical products, sales of toner and toner binder grew substantially. In particular, the market for color toner expanded significantly. Sales of a pigment auxiliary for color inkjet printer ink remained favorable, reflecting high regard for the product's features. In the performance chemicals business, sales of cleaners to the semiconductor and electronic components industry expanded strongly. Sales of plastic additives that meet customers' export needs were also solid. As a result, sales increased by 6.3 percent compared with the previous fiscal year to ¥111.5 billion (US$1,038.0 million).

Net Sales by Business Segment: Chemical Products
(Billions of yen)



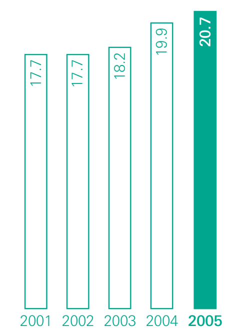
Asia

Sales of fatty alcohols in Malaysia and the Philippines increased substantially, reflecting customer regard for Kao's stable supply system and quality. Sales of surfactants also grew solidly in the ASEAN region, particularly in Thailand and Indonesia. As a result, sales increased by 12.9 percent compared with the previous fiscal year to ¥47.2 billion (US$439.8 million).

North America and Europe

Sales of toner and toner binder products for copiers and printers increased as Kao fortified its global business infrastructure in Japan, North America and Europe. In Germany, a production facility for high-performance concrete admixtures went into operation, which supported sales growth. Also, the aroma chemicals business in Spain increased because of an acquisition in the fiscal year ended March 2004. As a result, sales increased by 12.7 percent compared to the previous fiscal year to ¥64.0 billion (US$596.3 million).

Operating Income by Business Segment: Chemical Products
(Billions of yen)



Information by Geographic Segment

Japan

Total sales in Japan, including intersegment sales, increased 4.4 percent to ¥703.1 billion (US$6,547.0 million) and operating income increased 2.5 percent to ¥107.5 billion (US$1,000.9 million). Cost reductions and higher sales volume of newly launched products compensated for lower selling prices and higher raw material costs.

Asia and Oceania

Total sales elsewhere in Asia and Oceania, including intersegment sales, decreased 1.2 percent to ¥100.3 billion (US$933.8 million). Excluding currency translation effect, sales increased 5.1 percent. Operating income decreased 48.6 percent to ¥2.8 billion (US$25.7 million). Sales of fatty alcohol products were solid. However, sales of Consumer Products decreased due to intense competition.

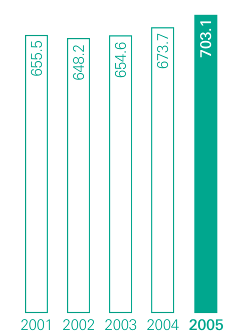
North America

Total sales in North America, including intersegment sales, increased 4.7 percent to ¥83.6 billion (US$778.8 million). Excluding currency translation effect, sales rose 12.5 percent. New and existing consumer products performed well. Operating income decreased 4.1 percent to ¥6.5 billion (US$60.1 million), but rose slightly excluding the effect of currency translation.

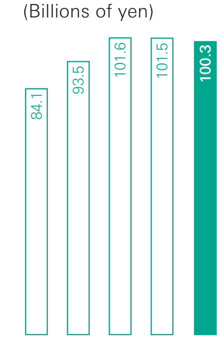
Europe

Total sales in Europe, including intersegment sales, increased 10.5 percent to ¥93.8 billion (US$873.5 million). Excluding currency translation effect, sales rose 8.1 percent. Operating income increased 68.5 percent to ¥4.6 billion (US$42.8 million). Positive response to newly launched professional hair care brands and existing products supported performance, and aroma chemicals and toner and toner binder products performed well.

Net Sales by Geographic Segment: Japan
(Billions of yen)



Net Sales by Geographic Segment: Asia and Oceania
(Billions of yen)



Cash Flows

During the year ended March 31, 2005, Kao supplemented the use of cash provided by operations with the use of cash and cash equivalents to fund increased capital investment in future growth and a substantial repurchase of shares. Cash and cash equivalents decreased ¥36.7 billion to ¥70.4 billion (US$655.6 million). Free cash flow, calculated as net cash provided by operating activities minus net cash used in investing activities, totaled ¥55.2 billion (US$513.7 million), compared to ¥80.6 billion for the previous fiscal year.

Net Cash Provided by Operating Activities

Net cash provided by operating activities decreased to ¥109.6 billion (US$1,020.3 million) from ¥117.9 billion in the previous fiscal year. Inventories increased ¥9.8 billion (US$91.1 million) due to expansion of business. Change in liability for employee retirement benefits reduced cash flow ¥13.0 billion (US$121.1 million) as a result of cash contributions to the corporate pension fund. However, cash paid for income taxes decreased mainly because these contributions are tax deductible, and totaled ¥42.6 billion (US$396.9 million) compared to ¥53.5 billion for the previous fiscal year. Income before income taxes and minority interests increased to ¥119.7 billion (US$1,114.2 million) from ¥117.1 billion for the previous fiscal year. Depreciation and amortization decreased to ¥56.8 billion (US$528.9 million), compared to ¥58.2 billion for the previous fiscal year.

Net Cash Used in Investing Activities

Net cash used in investing activities totaled ¥54.4 billion (US$506.6 million), compared to ¥37.3 billion in the previous fiscal year. This increase was mainly the result of investment in production facilities for new products in Japan and overseas, new plant construction in Thailand, capacity expansion in chemical products and expansion of research and development and distribution facilities. Increase in intangible assets, which included the installation of a new information system, was ¥4.0 billion (US$37.1 million).

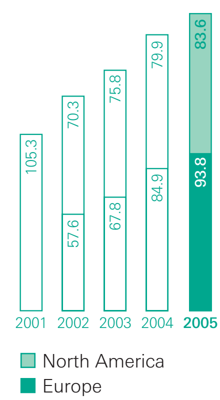
Net Cash Used in Financing Activities

Net cash used in financing activities totaled ¥90.7 billion (US$844.2 million), compared to ¥49.3 billion for the previous fiscal year. Kao employed cash totaling ¥71.6 billion (US$667.0 million) to repurchase shares of its outstanding stock, compared to ¥37.2 billion in the previous fiscal year. Cash dividends totaled ¥20.6 billion (US$191.7 million), compared to ¥18.2 billion for the previous fiscal year.

Financial Structure

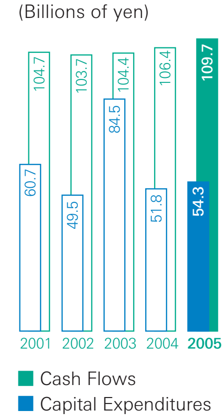
Total assets decreased 4.8 percent from the previous fiscal year end, or ¥34.9 billion, to ¥689.0 billion (US$6,415.6 million). Cash and cash equivalents decreased ¥36.7 billion primarily reflecting the repurchase of shares. Inventories and notes and accounts receivable – trade both increased, primarily reflecting higher net sales. Although the Company made capital expenditures, property, plant and equipment

Net Sales by Geographic Segment: North America and Europe
(Billions of yen)



Note: Net sales in North America and Europe are presented separately starting from the year ended March 31, 2002.

Cash Flows/ Capital Expenditures
(Billions of yen)



increased only slightly compared to the previous fiscal year because of decreases due to depreciation and the sale and disposal of facilities. Intangible assets decreased ¥12.1 billion due to amortization of trademarks and other intangibles. Moreover, deferred income taxes included in investments and other assets decreased for reasons including an increase in tax-deductible cash contributions to the corporate pension fund.

Total liabilities decreased 14.8 percent from a year earlier, or ¥40.6 billion, to ¥233.3 billion (US$2,172.6 million). The primary change was the conversion of convertible bonds into common stock totaling ¥27.9 billion (US$259.5 million). Liability for employee retirement benefits also decreased ¥12.9 billion (US$120.6 million) as a result of an increase in cash contributions to the corporate pension fund.

Minority interests decreased 66.6 percent, or ¥14.8 billion, to ¥7.4 billion (US$69.0 million) due mainly to the conversion of Kao Hanbai Company, Ltd. into a wholly owned subsidiary of the Company (see Note 18 to the consolidated financial statements).

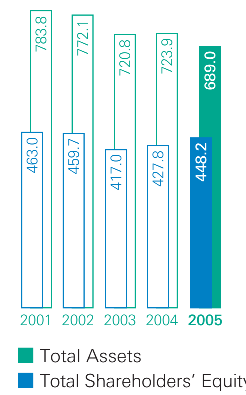
Shareholders' equity increased 4.8 percent, or ¥20.5 billion, to ¥448.2 billion (US$4,174.0 million) even as Kao enhanced shareholder returns. Net income increased to ¥72.2 billion (US$672.1 million), which offset the effect of the Company's use of internal capital resources totaling ¥71.6 billion (US$667.0 million) to repurchase its own shares and dividends totaling ¥19.3 billion (US$179.4 million). Moreover, the conversion of convertible bonds discussed above increased shareholders' equity by a net ¥27.9 billion (US$259.5 million), as Kao recorded a loss on transfers of treasury stock totaling ¥25.6 billion (US$238.4 million) in converting the convertible bonds into common stock using treasury stock valued at ¥53.5 billion (US$498.0 million). Kao also used treasury stock in executing a share exchange to convert Kao Hanbai Company, Ltd. into a wholly owned subsidiary, which increased shareholders' equity by ¥13.6 billion (US$126.7 million).

As of March 31, 2005, the ratio of shareholders' equity to total assets stood at 65.1 percent, compared to 59.1 percent at the previous fiscal year end. Return on equity improved to 16.5 percent, compared to 15.5 percent for the previous fiscal year. Shareholders' equity per share increased to ¥821.47 (US$7.65) from ¥782.14 at the end of the previous fiscal year.

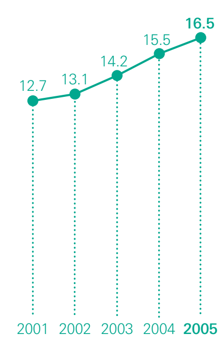
EVA

Economic Value Added (EVA®) is Kao's main management measure for evaluating business performance and for operational and strategic decision-making. EVA is defined as net operating profit after tax (NOPAT) less a charge for the cost of capital employed in the business. EVA provides managers with a tool for evaluating the trade-offs inherent between increasing profits and covering the cost of capital required to generate such profits. The aim of employing EVA is to create an organization focused at all levels on the enhancement of corporate value. During the fiscal year ended March 31, 2005, Kao achieved its sixth consecutive year of

Total Assets/Total Shareholders' Equity
(Billions of yen)



Return on Equity
(%)



improvement in EVA by continuing to focus on increasing NOPAT while simultaneously endeavoring to improve asset utilization. Expressed as an index, EVA increased to 154 from 100 for the year ended March 31, 2000. Kao has achieved consistent improvement by focusing attention on the three key areas outlined below.

Increasing Profit: Kao strives to increase the operating profits of its existing businesses while minimizing the additional capital investment required to generate such profits. During the past fiscal year, the Company was able to increase operating profit due to expansion of Consumer Products sales in Japan. Also, Total Cost Reduction (TCR) activities, which amounted to ¥8.0 billion (US$74.5 million), continued to contribute significantly to improved profitability. TCR activities involve gaining greater efficiencies in many different areas, from production to logistics.

Investing for Growth: Kao invested in the construction of the Health Care Research Center in Japan to further strengthen its research and development capabilities in the health care business. Kao also made timely investments in the Chemical Products segment including investment in manufacturing facilities for new products in Japan and a production facility for high-performance concrete admixtures and a tertiary amines plant in Germany. All of these investments are expected to contribute to future improvement of EVA.

Financial Improvement: In order to improve its financial structure and reduce capital costs, Kao continued to repurchase shares from the market at a total cost of ¥71.6 billion (US$667.0 million) during the fiscal year ended March 31, 2005. Over the past five years, Kao's total share repurchases from the market have amounted to ¥298.7 billion (US$2,782.2 million) accounting for more than 18 percent of shares outstanding at the beginning of the period.

Business Conduct Guidelines

Kao has established a Compliance Committee for the promotion of ethical corporate conduct and compliance with laws and regulations, and routinely implements activities for securing compliance with laws and regulations, fairness, and ethics. In addition, Kao has formulated and adheres to an ethics policy, "Kao's Business Conduct Guidelines." Kao has also announced its support and undertaking of the ten principles of the Global Compact advocated by the United Nations and its continued intention to behave responsibly in international society. The Global Compact is a voluntary corporate citizenship initiative composed of ten principles related to human rights, labor, the environment and anti-corruption, aiming for the sustainable growth of society.

Additional information is available at
http://www.kao.co.jp/en/company/guidelines/index.html

Business Risks and Other Risks

The Kao Group takes reasonable measures to reduce risk by eliminating exposure to, dispersing and hedging risks. However, unanticipated situations may occur that exert a significant impact on the Kao Group's business results and financial condition. For example, in quality management, the Kao Group designs and manufactures products from the viewpoint of customers, in compliance with related laws and regulations and in accordance with internationally recognized quality management standards. In the development stage prior to market launch, the Kao Group conducts thorough safety testing and survey research to ensure excellent product quality. After market launch, the Kao Group works to further improve quality by incorporating opinions and demands regarding products through its customer consultation offices. However, the unforeseen occurrence of a serious quality problem would not only cause difficulties for the relevant brand, but would also have a major impact on the reputation of all the Kao Group's products, and might cause sales to decline. This could have a major effect on the Kao Group's business results and financial condition.

In addition, there is believed to be a high probability that a major earthquake will occur in Japan in the Tokai region, in the ocean southeast of Tokyo, or directly under the Kanto region. The Kao Group has implemented various countermeasures, including earthquake resistance diagnosis and antiseismic retrofitting, at all of its production facilities, particularly the Toyohashi Plant, Wakayama Plant, Kawasaki Plant and Tokyo Plant, which are in these regions. In spite of these measures, however, in the event of a major earthquake, the Kao Group's ability to secure raw materials, maintain continuity of production and supply of products to the market may be disrupted, which could have a significant impact on the Kao Group's business results and financial condition.

Furthermore, foreign currency-denominated transactions, including export and import trade transactions and non-trade transactions such as dividends, are affected by changes in currency exchange rates. The Kao Group hedges foreign exchange risk through various measures such as settlement of transactions through foreign currency accounts, foreign exchange contracts and currency swaps to mitigate the effect on business results (see Notes 1.o and 16 to the consolidated financial statements). The Kao Group does not engage in derivative transactions for the purpose of speculation. However, items denominated in local currencies, including the sales, expenses and assets of overseas subsidiaries, are translated into Japanese yen for preparation of the consolidated financial statements (see Note 1.m to the consolidated financial statements). If the exchange rate at the time of conversion differs substantially from the expected rate, the value after translation into yen will change significantly, which will affect the Kao Group's business results and financial condition.

Consolidated Balance Sheets

Kao Corporation and Consolidated Subsidiaries
March 31, 2005 and 2004

	Millions of yen		Thousands of U.S. dollars (Note 2)
Assets	**2005**	2004	**2005**
Current assets:			
Cash and time deposits (Notes 3 and 6)	**¥ 32,026**	¥ 72,422	**$ 298,221**
Short-term investments (Notes 3 and 4)	**44,384**	38,439	**413,297**
Notes and accounts receivable:			
Trade (Note 6)	**102,000**	95,134	**949,809**
Nonconsolidated subsidiaries and affiliates	**3,024**	4,026	**28,159**
Other	**4,015**	3,949	**37,387**
Inventories:			
Finished goods	**53,169**	48,915	**495,102**
Work in process and raw materials	**28,613**	22,976	**266,440**
Deferred income taxes (Note 7)	**14,560**	14,039	**135,581**
Other current assets	**9,532**	9,721	**88,761**
Allowance for doubtful receivables	**(2,142)**	(2,366)	**(19,946)**
Total current assets	**289,181**	307,255	**2,692,811**
Property, plant and equipment, at cost (Notes 5 and 6)**:**			
Land	**62,523**	64,178	**582,205**
Buildings and structures	**290,847**	287,419	**2,708,325**
Machinery, equipment and other	**649,989**	652,039	**6,052,602**
Construction in progress	**18,400**	11,771	**171,338**
	1,021,759	1,015,407	**9,514,470**
Accumulated depreciation	**(761,536)**	(755,488)	**(7,091,312)**
	260,223	259,919	**2,423,158**
Intangible assets:			
Goodwill	**26,010**	31,035	**242,201**
Trademarks	**44,349**	51,516	**412,972**
Other intangible assets	**15,863**	15,821	**147,714**
	86,222	98,372	**802,887**
Investments and other assets:			
Investment securities (Note 4)	**17,349**	19,692	**161,551**
Investments in and advances to nonconsolidated subsidiaries and affiliates	**6,142**	5,121	**57,194**
Deferred income taxes (Note 7)	**16,925**	19,977	**157,603**
Other assets	**12,932**	13,555	**120,421**
	53,348	58,345	**496,769**
	¥ 688,974	¥ 723,891	**$ 6,415,625**

See notes to consolidated financial statements.

Liabilities and Shareholders' Equity	Millions of yen 2005	2004	Thousands of U.S. dollars (Note 2) 2005
Current liabilities:			
Short-term debt (Note 6)	**¥ 18,604**	¥ 17,626	**$ 173,238**
Current portion of long-term debt (Note 6)	**2,688**	215	**25,030**
Notes and accounts payable:			
Trade	**69,262**	66,821	**644,957**
Nonconsolidated subsidiaries and affiliates	**2,263**	2,314	**21,073**
Other	**18,596**	21,069	**173,163**
Accrued income taxes (Note 7)	**19,666**	19,543	**183,127**
Accrued expenses	**63,234**	64,551	**588,826**
Other current liabilities (Notes 6 and 7)	**17,229**	17,710	**160,434**
Total current liabilities	**211,542**	209,849	**1,969,848**
Long-term liabilities:			
Long-term debt (Note 6)	**1,427**	31,812	**13,288**
Liability for employee retirement benefits (Note 9)	**10,212**	23,158	**95,093**
Liability for director and corporate auditor retirement benefits	**180**	203	**1,676**
Other (Notes 6 and 7)	**9,950**	8,923	**92,653**
	21,769	64,096	**202,710**
Minority interests	**7,414**	22,189	**69,038**
Commitments and contingent liabilities (Notes 8, 10 and 16)			
Shareholders' equity (Notes 6, 11 and 12):			
Common stock:			
Authorized — 975,000,000 shares in 2005 and 1,000,000,000 shares in 2004			
Issued — 549,443,701 shares in 2005 and 599,443,701 shares in 2004	**85,424**	85,424	**795,456**
Capital surplus	**109,561**	108,889	**1,020,216**
Retained earnings	**299,346**	399,890	**2,787,466**
Unrealized gain on available-for-sale securities	**3,534**	4,318	**32,908**
Foreign currency translation adjustments	**(39,766)**	(37,942)	**(370,295)**
	458,099	560,579	**4,265,751**
Treasury stock, at cost (3,888,354 shares in 2005 and 52,705,378 shares in 2004)	**(9,850)**	(132,822)	**(91,722)**
	448,249	427,757	**4,174,029**
	¥688,974	¥ 723,891	**$6,415,625**

Consolidated Statements of Income

Kao Corporation and Consolidated Subsidiaries
Years ended March 31, 2005 and 2004

	Millions of yen		Thousands of U.S. dollars (Note 2)
	2005	2004	**2005**
Net sales (Note 13)	**¥936,851**	¥902,628	**$8,723,820**
Cost of sales	**404,803**	377,777	**3,769,467**
Gross profit	**532,048**	524,851	**4,954,353**
Selling, general and administrative expenses (Note 14)	**410,669**	405,145	**3,824,090**
Operating income (Note 13)	**121,379**	119,706	**1,130,263**
Other (income) expenses:			
Interest and dividend income	**(903)**	(1,125)	**(8,408)**
Interest expense	**933**	1,235	**8,688**
Foreign currency exchange gain	**(591)**	(320)	**(5,503)**
Equity in earnings of nonconsolidated subsidiaries and affiliates	**(1,217)**	(495)	**(11,333)**
Loss on impairment of long-lived assets (Note 5)	**2,509**	—	**23,363**
Other, net (Note 15)	**995**	3,268	**9,265**
	1,726	2,563	**16,072**
Income before income taxes and minority interests	**119,653**	117,143	**1,114,191**
Income taxes (Note 7):			
Current	**42,846**	44,204	**398,976**
Deferred	**4,272**	6,210	**39,780**
	47,118	50,414	**438,756**
Income before minority interests	**72,535**	66,729	**675,435**
Minority interests in earnings of consolidated subsidiaries	**355**	1,370	**3,305**
Net income	**¥ 72,180**	¥ 65,359	**$ 672,130**
Per share of common stock (Notes 1.p and 17):	Yen		U.S. dollars (Note 2)
Basic net income	**¥131.16**	¥119.06	**$1.22**
Diluted net income	**129.09**	113.98	**1.20**
Cash dividends applicable to the year	**38.00**	32.00	**0.35**

See notes to consolidated financial statements.

Consolidated Statements of Shareholders' Equity

Kao Corporation and Consolidated Subsidiaries
Years ended March 31, 2005 and 2004

	Thousands	Millions of yen					
	Outstanding number of shares of common stock	Common stock	Capital surplus	Retained earnings	Unrealized gain on available-for-sale securities	Foreign currency translation adjustments	Treasury stock, at cost
Balance at April 1, 2003	559,913	¥85,424	¥108,889	¥ 355,806	¥1,711	¥(30,461)	¥(104,338)
Decrease by newly consolidated companies and affiliates accounted for by the equity method				(7)			
Net income				65,359			
Changes in unrealized gain on available-for-sale securities, less applicable taxes					2,607		
Changes in foreign currency translation adjustments						(7,481)	
Cash dividends, ¥31.00 per share (Note 11)				(17,095)			
Directors' and corporate auditors' bonuses				(145)			
Loss on transfers of treasury stock related to conversion of convertible bonds and other	3,445			(4,028)			8,804
Treasury stock acquired, net	(16,620)						(37,288)
Balance at March 31, 2004	546,738	85,424	108,889	399,890	4,318	(37,942)	(132,822)
Increase by newly consolidated companies				43			
Net income				72,180			
Changes in unrealized gain on available-for-sale securities, less applicable taxes					(784)		
Changes in foreign currency translation adjustments						(1,824)	
Cash dividends, ¥35.00 per share (Note 11)				(19,270)			
Directors' and corporate auditors' bonuses				(123)			
Share-for-share exchange (Note 18)	5,717		672				12,930
Retirement of treasury stock				(127,775)			127,775
Loss on transfers of treasury stock related to conversion of convertible bonds and other	21,073			(25,599)			53,899
Treasury stock acquired, net	(27,973)						(71,632)
Balance at March 31, 2005	545,555	¥85,424	¥109,561	¥ 299,346	¥3,534	¥(39,766)	¥ (9,850)

	Thousands	Thousands of U.S. dollars (Note 2)					
	Outstanding number of shares of common stock	Common stock	Capital surplus	Retained earnings	Unrealized gain on available-for-sale securities	Foreign currency translation adjustments	Treasury stock, at cost
Balance at March 31, 2004	546,738	$795,456	$1,013,958	$ 3,723,717	$40,208	$(353,310)	$(1,236,819)
Increase by newly consolidated companies				400			
Net income				672,130			
Changes in unrealized gain on available-for-sale securities, less applicable taxes					(7,300)		
Changes in foreign currency translation adjustments						(16,985)	
Cash dividends, US$0.326 per share (Note 11)				(179,440)			
Directors' and corporate auditors' bonuses				(1,145)			
Share-for-share exchange (Note 18)	5,717		6,258				120,402
Retirement of treasury stock				(1,189,822)			1,189,822
Loss on transfers of treasury stock related to conversion of convertible bonds and other	21,073			(238,374)			501,900
Treasury stock acquired, net	(27,973)						(667,027)
Balance at March 31, 2005	545,555	$795,456	$1,020,216	$ 2,787,466	$32,908	$(370,295)	$ (91,722)

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

Kao Corporation and Consolidated Subsidiaries
Years ended March 31, 2005 and 2004

	Millions of yen		Thousands of U.S. dollars (Note 2)
	2005	2004	**2005**
Operating activities:			
Income before income taxes and minority interests	**¥119,653**	¥117,143	**$1,114,191**
Adjustments for:			
Income taxes paid	**(42,623)**	(53,501)	**(396,899)**
Depreciation and amortization	**56,794**	58,166	**528,858**
Loss on impairment of long-lived assets (Note 5)	**2,509**	—	**23,363**
Loss on sales or disposals of property, plant and equipment, net	**3,690**	1,474	**34,361**
Equity in earnings of nonconsolidated subsidiaries and affiliates	**(1,217)**	(495)	**(11,333)**
Unrealized foreign currency exchange gain	**(240)**	(408)	**(2,235)**
Change in trade receivables	**(5,922)**	(4,404)	**(55,145)**
Change in inventories	**(9,782)**	(1,369)	**(91,088)**
Change in trade payables	**2,636**	8,895	**24,546**
Change in liability for retirement benefits	**(13,009)**	(8,301)	**(121,138)**
Other, net	**(2,921)**	728	**(27,200)**
Net cash provided by operating activities	**109,568**	117,928	**1,020,281**
Investing activities:			
Purchase of marketable securities	**(11,999)**	(3,000)	**(111,733)**
Proceeds from the redemption of bonds	**9,172**	8,331	**85,408**
Purchase of property, plant and equipment	**(50,772)**	(39,583)	**(472,781)**
Proceeds from sales of property, plant and equipment	**2,435**	4,574	**22,674**
Increase in intangible assets	**(3,979)**	(8,903)	**(37,052)**
Proceeds from the redemption and sales of investment securities	**1,692**	3,479	**15,756**
Increase in investments in and advances to nonconsolidated subsidiaries and affiliates	**(810)**	(542)	**(7,543)**
Payment for acquisition of business	**—**	(1,584)	**—**
Change in other investments	**(146)**	(120)	**(1,359)**
Net cash used in investing activities	**(54,407)**	(37,348)	**(506,630)**
Financing activities:			
Change in short-term debt	**402**	4,517	**3,743**
Proceeds from long-term loans	**78**	706	**726**
Repayments of long-term loans	**(172)**	(236)	**(1,601)**
Purchase of treasury stock	**(71,632)**	(37,197)	**(667,027)**
Payments of cash dividends	**(20,591)**	(18,237)	**(191,740)**
Other, net	**1,258**	1,124	**11,714**
Net cash used in financing activities	**(90,657)**	(49,323)	**(844,185)**
Translation adjustments on cash and cash equivalents	**(1,247)**	(2,485)	**(11,612)**
Net increase (decrease) in cash and cash equivalents	**(36,743)**	28,772	**(342,146)**
Cash and cash equivalents of newly consolidated subsidiaries, beginning of year	**0**	2,695	**0**
Cash and cash equivalents, beginning of year (Note 3)	**107,152**	75,685	**997,784**
Cash and cash equivalents, end of year (Note 3)	**¥ 70,409**	¥107,152	**$ 655,638**
Non-cash financing activities:			
Transfers of treasury stock related to conversion of convertible bonds			
Decrease in treasury stock	**¥ 53,477**	¥ 8,293	**$ 497,970**
Decrease in retained earnings	**(25,605)**	(3,963)	**(238,430)**
Decrease in convertible bonds	**27,872**	4,330	**259,540**
Transfer of treasury stock related to share-for-share exchange (Note 18)			
Increase in capital surplus	**672**	—	**6,258**
Decrease in treasury stock	**12,930**	—	**120,402**

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

Kao Corporation and Consolidated Subsidiaries
Years ended March 31, 2005 and 2004

1. Summary of Significant Accounting Policies

a) Basis of presenting consolidated financial statements
The accompanying consolidated financial statements have been prepared in accordance with the provisions set forth in the Japanese Securities and Exchange Law and its related accounting regulations, and in conformity with accounting principles generally accepted in Japan, which are different in certain respects as to application and disclosure requirements of International Financial Reporting Standards.

In preparing the consolidated financial statements, certain reclassifications and rearrangements have been made to the consolidated financial statements issued in Japan in order to present them in a form that is more familiar to readers outside Japan. Certain 2004 financial statement items were reclassified to conform to the presentation for 2005.

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

b) Consolidation and accounting for investments in nonconsolidated subsidiaries and affiliates
The accompanying consolidated financial statements include the accounts of Kao Corporation (the "Company") and its significant subsidiaries (collectively, the "Companies"). Investments in most of the nonconsolidated subsidiaries and affiliates over which the Companies have the ability to exercise significant influence (mainly 20-50 percent owned companies) are accounted for using the equity method.

Under the control or influence concept, companies in which the parent company and/or its consolidated subsidiaries, directly or indirectly, are able to exercise control over operations are fully consolidated, and other companies over which the Company and/or its consolidated subsidiaries have the ability to exercise significant influence are accounted for by the equity method.

Investments in the remaining subsidiaries and affiliates are stated at cost except for write-downs recorded for the value of investments that have been permanently impaired. If the equity method of accounting had been applied to these investments, the effect on the accompanying consolidated financial statements would not be material.

All significant intercompany balances and transactions have been eliminated in consolidation. All material unrealized profit included in assets resulting from transactions within the Companies is eliminated. The excess of cost of investments in the subsidiaries and affiliates over the fair value of the net assets of the acquired subsidiary at the dates of acquisition is being amortized over an estimated period not exceeding 20 years, or 5 years in situations in which the useful lives cannot be estimated.

c) Cash equivalents
For purposes of the statements of cash flows, cash equivalents are short-term investments that are readily convertible into cash and that are exposed to insignificant risk of changes in value.

Cash equivalents include time deposits, commercial paper and investment trusts in bonds and receivables that are represented as short-term investments, all of which mature or become due within three months of the date of acquisition.

d) Inventories
Inventories are stated at the lower of cost or market. Cost is determined principally by the average method. The cost of inventories held by certain foreign consolidated subsidiaries is determined by the first-in, first-out method.

e) Short-term investments and investment securities
Short-term investments and investment securities are classified and accounted for, depending on management's intent, as follows: i) held-to-maturity debt securities, which are expected to be held to maturity with the positive intent and ability to hold to maturity, are reported at amortized cost and ii) available-for-sale securities, which are not classified as the aforementioned securities, are reported at fair value, with unrealized gains and losses, net of applicable taxes, reported in a separate component of shareholders' equity.

Non-marketable available-for-sale securities are stated at cost determined by the moving-average method.

For other than temporary declines in fair value, investment securities are reduced to net realizable value by a charge to income.

f) Property, plant and equipment
Property, plant and equipment are stated at cost. Depreciation of property, plant and equipment is computed under the declining-balance method for the assets located in Japan and principally under the straight-line method for the assets located outside Japan, using rates based upon the estimated useful lives, ranging from 21 to 35 years for buildings and structures and 7 or 9 years for machinery and equipment.

g) Intangible assets
Goodwill and trademarks are amortized on a straight-line basis over 15 or 20 years, and 10 years, respectively.

h) Long-lived assets
In August 2002, the Business Accounting Council issued a Statement of Opinion, Accounting for Impairment of Fixed Assets, and in October 2003 the Accounting Standards Board of Japan (ASB) issued ASB Guidance No. 6, Guidance for Accounting Standard for Impairment of Fixed Assets. These new pronouncements are effective for fiscal years beginning on or after April 1, 2005 with early adoption permitted for fiscal years ending on or after March 31, 2004.

The Companies adopted the new accounting standard for impairment of fixed assets as of April 1, 2004.

The Companies review its long-lived assets for impairment whenever events or changes in circumstance indicate the carrying amount of an asset or asset group may not be recoverable. An impairment loss would be recognized if the carrying amount of an asset or asset group exceeds the sum of the undiscounted future cash flows expected to result from the continued use and eventual disposition of the asset or asset group. The impairment loss would be measured as the amount by which the carrying amount of the asset exceeds its recoverable amount, which is the higher of the discounted cash flows from the continued use and eventual disposition of the asset or the net selling price at disposition.

The effect of adoption of the new accounting standard for impairment of fixed assets was to decrease income before income taxes and minority interests for the year ended March 31, 2005 by ¥2,509 million (US$23,363 thousand). The effect for the segment information is described on Note 13.

i) Retirement and pension plans

The Company and its domestic consolidated subsidiaries have a defined benefit pension plan and a defined contribution pension plan covering substantially all of their employees. The pension plan also covers employees of certain nonconsolidated subsidiaries and affiliates in Japan. Directors and corporate auditors are partially covered by the pension plan. Effective from June 1, 2003, the Company and its domestic consolidated companies amended the Kao retirement plan to establish the cash balance plan and implement a defined contribution pension plan for a portion of future reserved amount.

Certain foreign subsidiaries have local pension plans covering their employees. The policies for the funded pension plans are to fund and charge to income the pension costs determined on an actuarial basis.

Certain foreign subsidiaries also have local employees' retirement benefit plans and provide for the amount to state the liability for these employees' retirement benefits, primarily determined on an actuarial basis.

The unrecognized transitional obligation, the unrecognized net actuarial gain or loss and the unrecognized prior service cost are being amortized over 15, 10 and 15 years, respectively. These amortizations are presented as cost of sales and selling, general and administrative expenses in the consolidated statements of income. Retirement benefits for directors and corporate auditors are provided at the amount which would be required if all directors and corporate auditors retired at the balance sheet date. However, no additional provisions have been recorded for retirement benefits to be paid to the Company's directors and corporate auditors since July 2001. The liability for director and corporate auditor retirement benefits is the amount provided in proportion to the term that present director and corporate auditor had been in place before July 2001.

j) Income taxes

The Companies provide for income taxes applicable to all items included in the consolidated statements of income regardless of when such taxes are payable. Income taxes based on temporary differences between tax and financial reporting purposes are reflected as deferred income taxes in the consolidated financial statements using the asset and liability method.

k) Leases

All leases are accounted for as operating leases. Under Japanese accounting standards for leases, finance leases that deem to transfer ownership of the leased property to the lessee are to be capitalized, while other finance leases are permitted to be accounted for as operating lease transactions if certain "as if capitalized" information is disclosed (see Note 8).

l) Appropriation of retained earnings

Appropriations of retained earnings at each year end are reflected in the financial statements for the following year upon shareholders' approval.

m) Foreign currency transactions

All short-term and long-term monetary receivables and payables denominated in foreign currencies are translated into Japanese yen at the exchange rates at the balance sheet date. The foreign exchange gains and losses from translation are recognized in the consolidated statements of income to the extent that they are not hedged by foreign exchange derivatives.

n) Foreign currency financial statements

The balance sheet accounts of the consolidated foreign subsidiaries are translated into Japanese yen at the current exchange rate as of the balance sheet date except for shareholders' equity, which is translated at the historical rate. Differences arising from such translation are shown as "Foreign currency translation adjustments" in a separate component of shareholders' equity. Revenue and expense accounts of the consolidated foreign subsidiaries are translated into Japanese yen at the annual average exchange rate.

o) Derivatives and hedging activities

The Companies use derivative financial instruments to manage their exposures to fluctuations in foreign exchange and interest rates. Foreign exchange forward contracts, foreign currency swaps and interest rate swaps are utilized by the Companies to reduce foreign currency exchange and interest rate risks. The Companies do not enter into derivatives for trading purposes or speculative purposes.

Derivative financial instruments and foreign currency transactions are classified and accounted for as follows: a) all derivatives are recognized as either assets or liabilities and measured at fair value, and gains or losses on derivative transactions are recognized in the consolidated statements of income, and b) for derivatives used for hedging purposes, if derivatives qualify for hedge accounting because of high correlation and effectiveness between the hedging instruments and the hedged items, gains or losses on derivatives are deferred until maturity of the hedged transactions.

Short-term and long-term loan receivables denominated in foreign currencies, for which foreign exchange forward contracts or foreign currency swaps are used to hedge the foreign currency fluctuations, are translated at the contracted rate if the forward contracts or the swap contracts qualify for specific hedge accounting.

The interest rate swaps which qualify for hedge accounting and meet specific matching criteria are not remeasured at market value but the differential paid or received under the swap agreements are recognized and included in interest expense or income as incurred.

p) Per share information
Basic net income per share is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding for the period, retroactively adjusted for stock splits.

Diluted net income per share of common stock reflects the potential dilution that could occur if securities or other contracts to issue common stock were converted or exercised into common stock or resulted in the issuance of common stock.

Cash dividends per share presented in the accompanying consolidated statements of income are dividends applicable to the respective years including dividends to be paid after the end of the year.

2. Translation into United States Dollars

The Companies' accounts are maintained in or translated into Japanese yen. The United States dollar (US$) amounts included herein represent translations using the approximate exchange rate at March 31, 2005 of ¥107.39=US$1, solely for convenience. The translations should not be construed as representations that Japanese yen have been, could have been or could in the future be converted into United States dollars at that or any other rate.

3. Cash and Cash Equivalents

Cash and cash equivalents at March 31, 2005 and 2004 consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Cash and time deposits	**¥32,026**	¥ 72,422	**$298,221**
Short-term investments	**44,384**	38,439	**413,297**
Short-term loan receivables in other current assets	**—**	3	**—**
Less: time deposits and short-term investments which mature or become due over three months after the date of acquisition	**(6,001)**	(3,712)	**(55,880)**
Cash and cash equivalents	**¥70,409**	¥107,152	**$655,638**

4. Short-Term Investments and Investment Securities

Short-term investments and investment securities as of March 31, 2005 and 2004 consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	**2005**
Short-term investments:			
Government and corporate bonds	**¥ 6,508**	¥ 3,210	**$ 60,601**
Investment trust funds and other	**37,876**	35,229	**352,696**
	¥44,384	¥38,439	**$413,297**
Investment securities:			
Marketable equity securities	**¥ 8,882**	¥11,009	**$ 82,708**
Investment trust funds and other	**8,467**	8,683	**78,843**
	¥17,349	¥19,692	**$161,551**

The carrying amount and aggregate fair value of the securities classified as available-for-sale and held-to-maturity at March 31, 2005 and 2004 were as follows:

	Millions of yen			
	2005			
	Cost	Unrealized gains	Unrealized losses	Fair value
Securities classified as:				
Available-for-sale:				
Equity securities	**¥ 2,891**	**¥6,017**	**¥26**	**¥ 8,882**
Debt securities and other	**8,744**	**9**	**47**	**8,706**
Held-to-maturity:				
Debt securities and other	**¥11,000**	**¥ 7**	**¥ 1**	**¥11,006**

	Millions of yen			
	2004			
	Cost	Unrealized gains	Unrealized losses	Fair value
Securities classified as:				
Available-for-sale:				
Equity securities	¥3,358	¥7,686	¥35	¥11,009
Debt securities and other	8,211	6	32	8,185
Held-to-maturity:				
Debt securities and other	¥3,000	¥ —	¥ 1	¥ 2,999

	Thousands of U.S. dollars			
	2005			
	Cost	Unrealized gains	Unrealized losses	Fair value
Securities classified as:				
Available-for-sale:				
Equity securities	**$ 26,921**	**$56,029**	**$242**	**$ 82,708**
Debt securities and other	**81,423**	**84**	**438**	**81,069**
Held-to-maturity:				
Debt securities and other	**$102,430**	**$ 65**	**$ 9**	**$102,486**

Available-for-sale securities whose fair values are not readily determinable as of March 31, 2005 and 2004 were as follows:

	Carrying amount		
	Millions of yen		Thousands of U.S. dollars
	2005	2004	**2005**
Available-for-sale:			
Equity securities	**¥ 486**	¥ 690	**$ 4,526**
Other	**25,660**	19,748	**238,942**
	¥26,146	¥20,438	**$243,468**
Held-to-maturity:			
Debt securities and other	**¥ 6,999**	¥15,499	**$ 65,173**
	¥ 6,999	¥15,499	**$ 65,173**

Proceeds from sales of available-for-sale securities for the years ended March 31, 2005 and 2004 were ¥2,200 million (US$20,486 thousand) and ¥2,479 million, respectively. Gross realized gains and losses on these sales, computed on the moving average cost basis, for the year ended March 31, 2005 were ¥1,183 million (US$11,016 thousand) and ¥39 million (US$363 thousand), and for the year ended March 31, 2004 were ¥804 million and ¥64 million, respectively.

The carrying values of debt securities by contractual maturities for securities classified as available-for-sale and held-to-maturity at March 31, 2005 were as follows:

	Millions of yen		Thousands of U.S. dollars	
	2005		2005	
	Available-for-sale	Held-to-maturity	Available-for-sale	Held-to-maturity
Due within one year	¥ —	¥19,160	$ —	$178,415
Due after ten years	—	507	—	4,721
	¥ —	¥19,667	$ —	$183,136

5. Long-Lived Assets

The Companies reviewed their long-lived assets for impairment as of the year ended March 31, 2005 and, as a result, recognized an impairment loss of ¥2,509 million as follows:

Consolidated Subsidiary: Kao (Taiwan) Corporation

Location	Use	Type	Millions of yen 2005	Thousands of U.S. dollars 2005
Kao (Taiwan) Corporation	Production facility for disposable baby diapers	Buildings	¥ 288	$ 2,682
		Machinery, equipment and others	2,004	18,661
			¥2,292	$21,343

To clarify this impairment loss, Kao (Taiwan) Corporation ("Kao Taiwan") grouped assets according to their business classification under the management accounting system, which continuously monitors income and expenditures. Future market expansion is unlikely in Taiwan due to a declining number of births and other factors, and fierce market competition has eroded profits. Kao Taiwan has therefore reduced the carrying value of the assets to net selling price. For buildings, net selling price is determined by an appraisal from a real estate appraiser. For machinery and equipment, Kao Taiwan determines net selling price in consideration of difficulty in selling it due to its unique specifications.

Other Consolidated Subsidiary

	Millions of yen	Thousands of U.S. dollars
	2005	2005
Land and others to be sold	¥217	$2,020

6. Short-Term and Long-Term Debt

Short-term debt at March 31, 2005 and 2004 was comprised of the following:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Mortgage loans principally from banks	¥ 563	¥ 108	$ 5,243
Bank borrowings	18,041	17,518	167,995
	¥18,604	¥17,626	$173,238

The weighted average interest rates applicable to the bank borrowings were 2.79% and 2.72% at March 31, 2005 and 2004, respectively.

In addition to the above short-term debt, deposits payable to affiliates, included in other current liabilities, were ¥5,087 million (US$47,369 thousand) and ¥4,848 million at March 31, 2005 and 2004, respectively, and the applicable interest rate was 0.29% and 0.30% at March 31, 2005 and 2004, respectively.

Long-term debt at March 31, 2005 and 2004 consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	**2005**
Unsecured convertible bonds due 2006, 0.95%	**¥ 2,596**	¥30,468	**$ 24,173**
Mortgage loans principally from banks	**138**	215	**1,285**
Unsecured loans principally from banks	**1,381**	1,344	**12,860**
	4,115	32,027	**38,318**
Less current portion	**(2,688)**	(215)	**(25,030)**
	¥ 1,427	¥31,812	**$ 13,288**

In addition to the above long-term debt, deposits payable to customers, included in other long-term liabilities, were ¥4,571 million (US$42,564 thousand) and ¥4,545 million at March 31, 2005 and 2004, respectively, and the applicable interest rates were 0.11% and 0.06% at March 31, 2005 and 2004, respectively.

The aggregate annual maturities of long-term debt as of March 31, 2005 were as follows:

Years ending March 31	Millions of yen	Thousands of U.S. dollars
2006	¥2,688	$25,030
2007	845	7,869
2008	132	1,229
2009	42	391
2010	42	391
2011 and thereafter	366	3,408
Total	¥4,115	$38,318

The mortgage loans are collateralized by buildings and other having a book value of ¥970 million (US$9,032 thousand) and by accounts receivable of ¥232 million (US$2,160 thousand) at March 31, 2005.

The conversion price of the unsecured convertible bonds is ¥1,333.00 as of March 31, 2005, subject to adjustment to reflect stock splits and certain other events. Convertible bonds outstanding at March 31, 2005 would have been convertible into 1,947,486 shares of common stock of the Company on the basis of the above conversion price.

7. Income Taxes

The Company and its domestic subsidiaries are subject to Japanese national and local taxes based on income, which in the aggregate resulted in a normal statutory tax rate of approximately 41% and 42% for 2005 and 2004, respectively.

Foreign subsidiaries are subject to income taxes of the countries in which they operate.

Tax effects of significant temporary differences and tax loss carryforwards that resulted in deferred tax assets or liabilities at March 31, 2005 and 2004 were as follows:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	**2005**
Deferred tax assets:			
Depreciation	**¥ 23,672**	¥ 22,547	**$ 220,430**
Pension and severance costs	**3,341**	8,540	**31,111**
Accrued expenses	**8,034**	8,771	**74,811**
Enterprise taxes	**1,353**	1,854	**12,599**
Tax loss carryforwards	**6,306**	5,997	**58,721**
Other	**12,217**	10,580	**113,763**
Less valuation allowance	**(4,204)**	(4,229)	**(39,147)**
Deferred tax assets	**¥ 50,719**	¥ 54,060	**$ 472,288**
Deferred tax liabilities:			
Unrealized gain on available-for-sale securities	**¥ (2,425)**	¥ (3,097)	**$ (22,581)**
Undistributed foreign earnings	**(10,072)**	(9,006)	**(93,789)**
Deferred gains on sales of property	**(4,738)**	(4,860)	**(44,120)**
Other	**(4,419)**	(4,571)	**(41,149)**
Deferred tax liabilities	**¥(21,654)**	¥(21,534)	**$(201,639)**
Net deferred tax assets	**¥ 29,065**	¥ 32,526	**$ 270,649**

8. Leases

a) Finance leases:

The Companies lease certain buildings, machinery, computer equipment and other assets.

The pro forma information of leased property under finance leases that do not transfer ownership of the leased property to the lessee on an "as if capitalized" basis for the years ended March 31, 2005 and 2004 was as follows:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	**2005**
	Buildings, structures and other assets		
Acquisition cost	**¥10,572**	¥12,640	**$98,445**
Accumulated depreciation	**2,359**	3,334	**21,967**
Net leased property	**¥ 8,213**	¥ 9,306	**$76,478**

Obligations under finance leases as of March 31, 2005 and 2004 were as follows:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	**2005**
Due within one year	**¥ 894**	¥1,185	**$ 8,325**
Due after one year	**7,319**	8,121	**68,153**
	¥8,213	¥9,306	**$76,478**

Total rental expenses for the above leases were ¥1,193 million (US$11,109 thousand) and ¥1,311 million for the years ended March 31, 2005 and 2004, respectively.

The pro forma depreciation expense computed by the straight-line method was ¥1,193 million (US$11,109 thousand) and ¥1,311 million for the years ended March 31, 2005 and 2004, respectively.

The pro forma information above does not exclude the imputed interest portion because the remaining financial lease obligations are not material compared with the book values of property, plant and equipment.

b) Operating leases:

The minimum rental commitments under noncancellable operating leases as of March 31, 2005 and 2004 were as follows:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	**2005**
Due within one year	**¥ 2,506**	¥ 2,425	**$ 23,335**
Due after one year	**14,730**	15,312	**137,164**
	¥17,236	¥17,737	**$160,499**

9. Retirement Benefits

The Company and its domestic consolidated subsidiaries have a defined benefit pension plan and a defined contribution pension plan covering substantially all of their employees. Effective from June 1, 2003, the Company and its domestic consolidated companies amended the Kao retirement plan to establish the cash balance plan and implement a defined contribution pension plan for a portion of future reserved amount.

Certain foreign consolidated subsidiaries have local pension plans covering their employees. Certain foreign consolidated subsidiaries also have local employees' retirement benefit plans and provide for the amount to state the liability for these employees' retirement benefits, primarily determined on an actuarial basis.

The liability for employees' retirement benefits at March 31, 2005 and 2004 consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	**2005**
Projected benefit obligation	**¥ 183,874**	¥ 177,379	**$ 1,712,208**
Fair value of plan assets	**(143,514)**	(115,872)	**(1,336,381)**
Unrecognized prior service cost	**25,465**	28,586	**237,126**
Unrecognized actuarial loss	**(41,446)**	(50,346)	**(385,939)**
Unrecognized transitional obligation	**(17,919)**	(19,729)	**(166,859)**
Prepaid pension cost	**3,752**	3,140	**34,938**
Net liability for retirement benefits	**¥ 10,212**	¥ 23,158	**$ 95,093**

The components of net periodic benefit costs for the years ended March 31, 2005 and 2004 were as follows:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	**2005**
Service cost	**¥ 7,091**	¥ 8,656	**$ 66,030**
Interest cost	**3,654**	3,758	**34,025**
Expected return on plan assets	**(2,678)**	(2,137)	**(24,937)**
Amortization of prior service cost (credit)	**(2,429)**	(2,801)	**(22,618)**
Recognized actuarial loss	**6,801**	7,158	**63,330**
Amortization of transitional obligation	**1,791**	1,824	**16,678**
Net periodic benefit costs	**¥14,230**	¥16,458	**$132,508**

Assumptions used for the years ended March 31, 2005 and 2004 are set forth as follows:

	2005	2004
Discount rate	**Primarily 2.0%**	Primarily 2.0%
Expected rate of return on plan assets	**Primarily 2.0%**	Primarily 2.0%
Amortization period of prior service cost	**Primarily 15 years**	Primarily 15 years
Recognition period of actuarial gain/loss	**Primarily 10 years**	Primarily 10 years
Amortization period of transitional obligation	**15 years**	15 years

In addition to the above net periodic benefit costs, the costs for other retirement and pension plans such as a defined contribution plan and for supplemental retirement benefits were ¥1,800 million (US$16,761 thousand) for the year ended March 31, 2005 and ¥1,743 million for the year ended March 31, 2004, respectively.

10. Contingent Liabilities

The Companies' guarantees of borrowings, principally of affiliates and employees, were ¥3,872 million (US$36,055 thousand) as of March 31, 2005.

11. Shareholders' Equity

Japanese companies are subject to the Japanese Commercial Code (the "Code").

The Code requires that all shares of common stock are recorded with no par value and at least 50% of the issue price of new shares is required to be recorded as common stock and the remaining net proceeds as additional paid-in capital, which is included in capital surplus. The Code permits Japanese companies, upon approval of the Board of Directors, to issue shares to existing shareholders without consideration as a stock split. Such issuance of shares generally does not give rise to changes within the shareholders' accounts.

The Code allows Japanese companies to repurchase treasury stock and dispose of such treasury stock by resolution of the Board of Directors. The repurchased amount of treasury stock cannot exceed the amount available for future dividend plus the amount of common stock, additional paid-in capital or legal reserve to be reduced, in the case where such reduction was resolved at the shareholders meeting.

The Code also provides that an amount at least equal to 10% of the aggregate amount of cash dividends and certain other appropriations of retained earnings associated with cash outlays applicable to each period shall be appropriated as a legal reserve (a component of retained earnings) until the total amount of such reserve and additional paid-in capital equals 25% of common stock.

The amount of total additional paid-in capital and legal reserve which exceeds 25% of stated capital can be transferred to other capital surplus and retained earnings by resolution of the shareholders, which may be available for dividends. The Company's legal reserve amount, which is included in retained earnings, totals ¥14,117 million (US$131,455 thousand) at both March 31, 2005 and 2004, and its additional paid-in capital amount, which is included in capital surplus, totals ¥108,889 million (US$1,013,958 thousand) at both March 31, 2005 and 2004.

Year-end dividends are approved by the shareholders at a meeting held subsequent to the fiscal year to which the dividends are applicable. In addition, semi-annual interim dividends may also be paid upon resolution of the Board of Directors, subject to certain limitations imposed by the Code. Under the Code, the amount available for dividends is based on retained earnings as recorded on the Company's books. At March 31, 2005, retained earnings available for dividends recorded on the Company's books were ¥223,752 million (US$2,083,546 thousand).

The accompanying consolidated financial statements do not include any provision for the dividend of ¥19.0 (US$0.177) per share, aggregating ¥10,366 million (US$96,527 thousand), and directors' bonuses of ¥71 million (US$661 thousand) which were subsequently approved by the shareholders on June 29, 2005 as an appropriation of retained earnings in respect of the year ended March 31, 2005.

The Company retired 50 million shares of common stock by the decision of the Board of Directors for the year ended March 31, 2005.

The Company repurchased 27.3 million shares of common stock from the market during the fiscal year ended March 31, 2005, at an aggregate cost of ¥69,996 million (US$651,793 thousand). The Company subsequently repurchased 2.0 million shares of common stock from the market at an aggregate cost of ¥5,001 million (US$46,569 thousand) from April 1 to June 21, 2005.

Subsequently, on June 29, 2005, the shareholders of the Company approved the new stock repurchase program in accordance with the Code. Under this new stock repurchase program, the Company may acquire up to a total not exceeding 20 million common shares of the Company at the upper limit of the acquisition cost that shall not exceed ¥50 billion (US$466 million) not later than the end of the next ordinary general shareholders meeting.

12. Stock-Based Compensation Plans

The Company has a stock option plan. On June 28, 2001, the shareholders of the Company approved the issuance of stock options for the directors of the Company. The issued stock options are exercisable from July 28, 2003 to July 25, 2008. The number of shares to be transferred from treasury stock upon the exercise of the outstanding stock options as of March 31, 2005 was 99,000 shares of common stock of the Company. The options will be granted at ¥3,275 (US$30.50) per share as an exercise price of the Company's common stock at the date of option grant.

On June 27, 2002, the shareholders of the Company approved the issuance of stock options for the directors and employees of the Company and its affiliates. The issued stock options are exercisable from July 1, 2004 to June 30, 2009. The number of shares to be newly issued or transferred from treasury stock upon the exercise of the outstanding stock options as of March 31, 2005 was 507,000 shares of common stock of the Company. The options will be granted at ¥2,955 (US$27.52) per share as an exercise price of the Company's common stock at the date of option grant.

On June 27, 2003, the shareholders of the Company approved the issuance of stock options for the directors and employees of the Company and its affiliates. The issued stock options are exercisable from July 1, 2005 to June 30, 2010. The number of shares to be newly issued or transferred from treasury stock upon the exercise of the outstanding stock options as of March 31, 2005 was 1,043,000 shares of common stock of the Company. The options will be granted at ¥2,372 (US$22.09) per share as an exercise price of the Company's common stock at the date of option grant.

On June 29, 2004, the shareholders of the Company approved the issuance of stock options for the directors and employees of the Company and its affiliates. The stock options are exercisable from July 1, 2006 to June 30, 2011. The number of shares to be newly issued or transferred from treasury stock upon the exercise of the outstanding stock options as of March 31, 2005 was 1,151,000 shares of common stock of the Company. The issued stock options are exercisable from July 1, 2006 to June 30, 2011. The options will be granted at ¥2,695 (US$25.10) per share as an exercise price of the Company's common stock at the date of option grant.

The number of shares to be newly issued common stock or common stock transferred from treasury stock of the Company, which has been approved by stockholders in the previous years, decreased due to exercise of options or by the resignation of the directors and employees of the Company and its affiliates who have been granted stock options.

Subsequently, on June 29, 2005, the shareholders of the Company approved the issuance of stock options for the directors and employees of the Company and its affiliates. Under this approval, the maximum number of shares to be newly issued or transferred from treasury stock upon the exercise of stock options is 1,200,000 shares of common stock of the Company. The stock options are exercisable from July 1, 2007 to June 29, 2012.

13. Segment Information

The Companies operate in three reportable segments: Consumer Products, Prestige Cosmetics and Chemical Products. Operations within the Consumer Products segment include the manufacture and sale of personal care products such as shampoos and conditioners, laundry and cleaning products, and hygiene products. The Prestige Cosmetics segment manufactures and sells cosmetics under the brand name, *Kao Sofina*. The Chemical Products segment manufactures and sells fatty chemicals and specialty chemicals such as surface active agents.

Segment information by business of the Companies for the years ended March 31, 2005 and 2004 was as follows:

	Millions of yen				
	2005				
	Consumer Products	Prestige Cosmetics	Chemical Products	Eliminations/ Corporate	Consolidated
Sales to customers	¥690,007	¥78,294	¥168,550	¥ —	¥936,851
Intersegment sales	—	—	28,439	(28,439)	—
Total sales	690,007	78,294	196,989	(28,439)	936,851
Operating expenses	597,409	70,601	176,326	(28,864)	815,472
Operating income	¥ 92,598	¥ 7,693	¥ 20,663	¥ 425	¥121,379
Assets	¥434,008	¥31,654	¥164,839	¥ 58,473	¥688,974
Depreciation and amortization	43,610	2,647	10,848	(311)	56,794
Loss on impairment of long-lived assets	2,509	—	—	—	2,509
Capital expenditures	34,745	3,572	16,001	—	54,318

	Millions of yen				
	2004				
	Consumer Products	Prestige Cosmetics	Chemical Products	Eliminations/ Corporate	Consolidated
Sales to customers	¥670,438	¥77,648	¥154,542	¥ —	¥902,628
Intersegment sales	—	—	27,079	(27,079)	—
Total sales	670,438	77,648	181,621	(27,079)	902,628
Operating expenses	578,242	70,222	161,680	(27,222)	782,922
Operating income	¥ 92,196	¥ 7,426	¥ 19,941	¥ 143	¥119,706
Assets	¥450,971	¥27,376	¥153,975	¥ 91,569	¥723,891
Depreciation and amortization	44,800	2,520	11,265	(419)	58,166
Capital expenditures	33,595	3,420	14,808	—	51,823

	Thousands of U.S. dollars				
	2005				
	Consumer Products	Prestige Cosmetics	Chemical Products	Eliminations/ Corporate	Consolidated
Sales to customers	**$6,425,244**	**$729,063**	**$1,569,513**	**$ —**	**$8,723,820**
Intersegment sales	**—**	**—**	**264,820**	**(264,820)**	**—**
Total sales	**6,425,244**	**729,063**	**1,834,333**	**(264,820)**	**8,723,820**
Operating expenses	**5,562,986**	**657,426**	**1,641,922**	**(268,777)**	**7,593,557**
Operating income	**$ 862,258**	**$ 71,637**	**$ 192,411**	**$ 3,957**	**$1,130,263**
Assets	**$4,041,419**	**$294,757**	**$1,534,957**	**$ 544,492**	**$6,415,625**
Depreciation and amortization	**406,090**	**24,649**	**101,015**	**(2,896)**	**528,858**
Loss on impairment of long-lived assets	**23,363**	**—**	**—**	**—**	**23,363**
Capital expenditures	**323,540**	**33,262**	**148,999**	**—**	**505,801**

Geographic segment information of the Companies for the years ended March 31, 2005 and 2004 was as follows:

	Millions of yen					
	2005					
	Japan	Asia/ Oceania*	America**	Europe***	Eliminations/ Corporate	Consolidated
Sales to customers	**¥693,018**	**¥ 77,458**	**¥82,408**	**¥83,967**	**¥ —**	**¥936,851**
Intersegment sales	**10,067**	**22,824**	**1,230**	**9,837**	**(43,958)**	**—**
Total sales	**703,085**	**100,282**	**83,638**	**93,804**	**(43,958)**	**936,851**
Operating expenses	**595,600**	**97,525**	**77,184**	**89,208**	**(44,045)**	**815,472**
Operating income	**¥107,485**	**¥ 2,757**	**¥ 6,454**	**¥ 4,596**	**¥ 87**	**¥121,379**
Assets	**¥421,746**	**¥ 84,343**	**¥63,191**	**¥81,929**	**¥ 37,765**	**¥688,974**

	Millions of yen					
	2004					
	Japan	Asia/ Oceania*	America**	Europe***	Eliminations/ Corporate	Consolidated
Sales to customers	¥664,208	¥ 83,428	¥78,878	¥76,114	¥ —	¥902,628
Intersegment sales	9,449	18,024	1,029	8,785	(37,287)	—
Total sales	673,657	101,452	79,907	84,899	(37,287)	902,628
Operating expenses	568,838	96,089	73,175	82,172	(37,352)	782,922
Operating income	¥104,819	¥ 5,363	¥ 6,732	¥ 2,727	¥ 65	¥119,706
Assets	¥432,175	¥ 80,607	¥61,521	¥77,042	¥ 72,546	¥723,891

	Thousands of U.S. dollars					
	2005					
	Japan	Asia/ Oceania*	America**	Europe***	Eliminations/ Corporate	Consolidated
Sales to customers	$6,453,283	$721,278	$767,371	$781,888	$ —	$8,723,820
Intersegment sales	93,742	212,534	11,453	91,601	(409,330)	—
Total sales	6,547,025	933,812	778,824	873,489	(409,330)	8,723,820
Operating expenses	5,546,141	908,139	718,726	830,692	(410,141)	7,593,557
Operating income	$1,000,884	$ 25,673	$ 60,098	$ 42,797	$ 811	$1,130,263
Assets	$3,927,237	$785,390	$588,425	$762,911	$ 351,662	$6,415,625

*Asia/Oceania: Asia and Australia
**America: North America
***Europe: Europe and South Africa

Sales to foreign customers were as follows:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Asia/Oceania	¥ 81,792	¥ 89,965	$ 761,635
America	81,963	78,225	763,227
Europe	85,539	74,862	796,527
Sales to foreign customers	¥249,294	¥243,052	$2,321,389

14. Selling, General and Administrative Expenses

Selling, general and administrative expenses principally consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Advertising	¥84,157	¥82,773	$783,658
Promotion	36,720	34,025	341,931
Research and development	39,764	38,506	370,277
Salaries and bonuses	68,522	71,141	638,067
Packing and delivery expenses	50,282	46,968	468,219

15. Other (Income) Expenses

"Other, net" consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	2005	2004	2005
Gain on sales of investment securities	¥(1,183)	¥ (804)	$(11,016)
Loss on sales or disposals of property, plant and equipment, net	3,690	1,474	34,361
Loss on impairments of land	—	2,722	—
Nonrecurring depreciation related to relocation of plant in foreign subsidiary	—	1,072	—
Other, net	(1,512)	(1,196)	(14,080)
	¥ 995	¥ 3,268	$ 9,265

16. Derivatives

The Companies enter into foreign exchange forward contracts and foreign currency swaps to hedge foreign exchange risk associated with certain assets and liabilities denominated in foreign currencies. The Companies also enter into interest rate swap contracts to manage interest rate exposures on certain liabilities.

The Companies have purchased interest rate caps to limit the unfavorable impact from increases in interest rates on floating-rate long-term debt. The interest rate caps effectively limit the Companies' interest exposures of floating-rate long-term borrowings to the maximum rate.

All derivative transactions are entered into to hedge interest and foreign currency exposures incorporated within the Companies' business. Accordingly, market risk in these derivatives is basically offset by opposite movements in the value of hedged assets or liabilities. The Companies do not hold or issue derivatives for trading or speculative purposes. Because the counterparties to these derivatives are limited to major international financial institutions, the Companies do not anticipate any losses arising from credit risk.

Derivative transactions entered into by the Companies have been made in accordance with internal policies which regulate the authorization and credit limit amounts.

The Companies had the following derivatives contracts outstanding at March 31, 2005 and 2004:

	Millions of yen					
	2005			2004		
	Contract amount	Fair value	Unrealized gain/(loss)	Contract amount	Fair value	Unrealized gain/(loss)
Foreign exchange forward contracts:						
Buying U.S. Dollar	**¥2,802**	**¥2,534**	**¥(267)**	¥3,193	¥2,873	¥(320)
Buying Japanese Yen	**13**	**13**	**0**	—	—	—
Buying British Pound	**—**	**—**	**—**	13	13	0
Buying other currencies	**—**	**—**	**—**	8	8	0
Selling U.S. Dollar	**5,429**	**5,385**	**44**	3,925	3,913	12
Selling other currencies	**786**	**773**	**13**	844	842	2
Foreign currency options:						
Purchased put option	**—**			35		
(Premium)	**—**	**—**	**—**	0	3	3
Written call option	**—**			35		
(Premium)	**—**	**—**	**—**	0	0	0
Foreign currency swaps:						
Receiving Japanese Yen, paying U.S. Dollar	**4,293**	**263**	**263**	4,858	456	456
Receiving Japanese Yen, paying Euro	**3,508**	**(216)**	**(216)**	3,431	(14)	(14)
Receiving U.S. Dollar, paying Euro	**2,324**	**(337)**	**(337)**	2,372	(245)	(245)
Receiving Hong Kong Dollar, paying Euro	**999**	**(158)**	**(158)**	944	(85)	(85)
Receiving U.S. Dollar, paying Thai Baht	**1,660**	**(4)**	**(4)**	—	—	—
Interest rate swaps:						
Receiving fixed-rate, paying floating-rate	**708**	**(2)**	**(2)**	669	4	4
Interest rate caps:						
Buying	**—**	**—**	**—**	1,709	0	0

	Thousands of U.S. dollars		
	2005		
	Contract amount	Fair value	Unrealized gain/(loss)
Foreign exchange forward contracts:			
Buying U.S. Dollar	**$26,092**	**$23,596**	**$(2,486)**
Buying Japanese Yen	**121**	**121**	**0**
Selling U.S. Dollar	**50,554**	**50,144**	**410**
Selling other currencies	**7,319**	**7,198**	**121**
Foreign currency swaps:			
Receiving Japanese Yen, paying U.S. Dollar	**39,976**	**2,449**	**2,449**
Receiving Japanese Yen, paying Euro	**32,666**	**(2,011)**	**(2,011)**
Receiving U.S. Dollar, paying Euro	**21,641**	**(3,138)**	**(3,138)**
Receiving Hong Kong Dollar, paying Euro	**9,303**	**(1,471)**	**(1,471)**
Receiving U.S. Dollar, paying Thai Baht	**15,458**	**(37)**	**(37)**
Interest rate swaps:			
Receiving fixed-rate, paying floating-rate	**6,593**	**(19)**	**(19)**

17. Net Income per Share

Reconciliation of the differences between basic and diluted net income per share ("EPS") for the years ended March 31, 2005 and 2004 is as follows:

	Millions of yen	Thousands of shares	Yen	U.S. dollars
For the year ended March 31, 2005	Net income	Weighted average shares	EPS	
Basic EPS				
Net income available to common shareholders	**¥72,088**	**549,626**	**¥131.16**	**$1.22**
Effect of Dilutive Securities				
Warrants	**—**	**76**		
Convertible bonds	**30**	**8,948**		
Diluted EPS				
Net income for computation	**¥72,118**	**558,650**	**¥129.09**	**$1.20**

	Millions of yen	Thousands of shares	Yen
For the year ended March 31, 2004	Net income	Weighted average shares	EPS
Basic EPS			
Net income available to common shareholders	¥65,229	547,865	¥119.06
Effect of Dilutive Securities			
Convertible bonds	179	25,997	
Diluted EPS			
Net income for computation	¥65,408	573,862	¥113.98

18. Share-for-Share Exchange

At the meeting of the Board of Directors held on April 22, 2004, the Company decided to make Kao Hanbai Company, Ltd. ("Kao Hanbai") a wholly owned subsidiary of the Company, by way of a share-for-share exchange and executed the Share-for-share Exchange Agreement on the above date. The transaction became effective on July 2, 2004. Kao Hanbai is a company distributing consumer products manufactured by the Company and its affiliates to retailers, etc. in Japan. As for the share allocation ratio, 3.65 shares of the Company were exchanged for one share of Kao Hanbai. In this transaction, no new shares were issued. Instead, treasury stock of the Company (common stock: 5,716,867 shares) was transferred.

Independent Auditors' Report

Deloitte.

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To the Board of Directors of
Kao Corporation

We have audited the accompanying consolidated balance sheets of Kao Corporation and consolidated subsidiaries as of March 31, 2005 and 2004, and the related consolidated statements of income, shareholders' equity, and cash flows for the years then ended, all expressed in Japanese yen. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Kao Corporation and consolidated subsidiaries as of March 31, 2005 and 2004, 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.

Our audits also comprehended the translation of Japanese yen amounts into U.S. dollar amounts and, in our opinion, such translation has been made in conformity with the basis stated in Note 2. Such U.S. dollar amounts are presented solely for the convenience of readers outside Japan.

Deloitte Touche Tohmatsu

June 29, 2005

Member of
Deloitte Touche Tohmatsu

Investor Information (As of March 31, 2005)

Kao Corporation

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Chuo-ku, Tokyo 103-8210, Japan
Telephone: 81-3-3660-7111
Facsimile: 81-3-3660-8978

Date of Establishment
June 19, 1887

Common Stock
Authorized: 975,000,000 shares
Issued: 549,443,701 shares
Outstanding: 545,555,347 shares
Number of Shareholders: 46,557

Stock Listings
Tokyo Stock Exchange

Ticker Symbol Number
4452

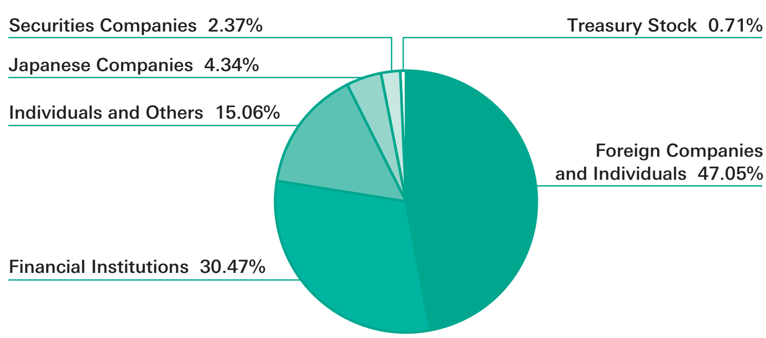
Transfer Agent
The Chuo Mitsui Trust and
Banking Company, Limited
8-4, Izumi 2-chome
Suginami-ku, Tokyo 168-0063, Japan

Depositary and Registration for American Depositary Receipts
JP Morgan Chase Bank
4 New York Plaza
New York, NY 10004, U.S.A.

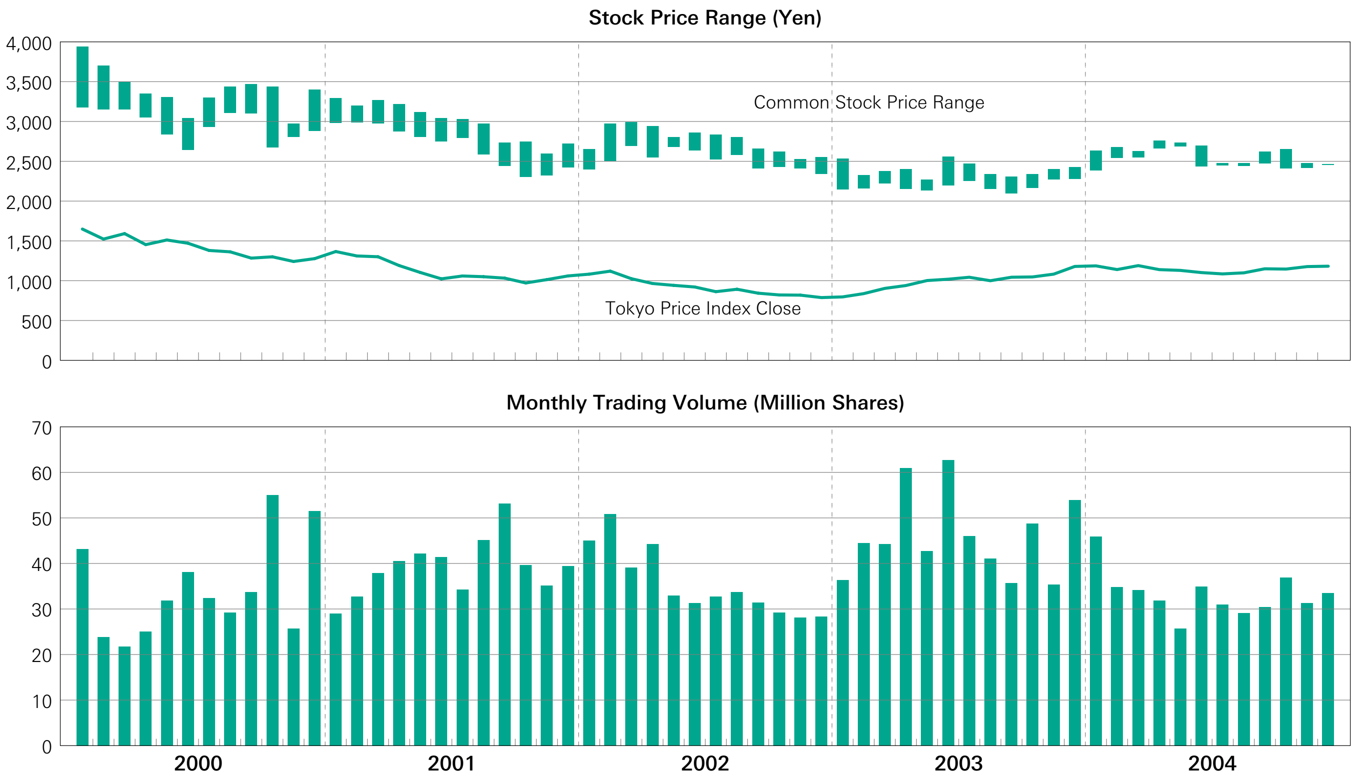
Major Shareholders

Name of Shareholders	Investment in Kao by the Shareholders	
	Number of shares (thousand shares)	Ratio of voting rights (percentage)
Japan Trustee Services Bank, Ltd. (Trust Account)	27,391	4.98
State Street Bank and Trust Company 505103	26,961	4.90
The Master Trust Bank of Japan, Ltd. (Trust Account)	22,901	4.16
Moxley and Company	19,859	3.61
Nippon Life Insurance Company	17,752	3.23

Composition of Shareholders



Stock Price Range & Trading Volume (Tokyo Stock Exchange)



Note: Fiscal years beginning April and ending March the following calendar year

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