



CHINABERRY INC.

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May 2005

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Dear Shareholders,

Early in 2004, we wrote a figure on the whiteboard in our employee break room: "\$200,000 pre-tax profit." We were all aware that this was the number we would be working to attain by year's end – a number that each of us knew by heart and that informed our decisions and dictated virtually every action we took. Having experienced a pre-tax *loss* of over \$41,000 in 2003, we were determined to improve.

The challenges of the previous year taught us a lot about our strengths and weaknesses, and in 2004 we finessed what we'd learned. Every department implemented more ways to creatively keep costs down. Those of us whose positions involved potentially increasing revenue and sales kept striving toward beating our goals. All the while every department remained acutely aware that superb customer service and respectful relationships with our customers and vendors are qualities for which our company is known in the industry.

A still-sluggish economy, consistently increasing paper and postage costs, and competition from larger companies whose volume buying allows them to offer similar products at lower prices were some of the hurdles we had to overcome last year. Nevertheless, day in and day out, our managers and employees never wavered in their determination to make 2004 profitable.

You *know* you are fortunate when you find yourself sitting next to a total stranger in an airplane, talking about your jobs, and telling him that you work with the most dedicated, loyal and enthusiastic people you could ever imagine. That happens to me frequently and having such a team goes a very long way in making a workplace productive and exciting. Not surprisingly, when the 2004 financials were finally in and the "actual" was entered on our break room's whiteboard, it read "\$210,000." We'd not only met our goal, we'd exceeded it. For that, I would like to thank everyone who has stood beside us – and that includes you, our shareholders.

Ann S. Ruethling
Founder, Chinaberry Inc.



Our Company

This past year offered us various opportunities to become more efficient as well as to improve customer service and our catalogs. We have remarkably enthusiastic employees and a management team comprised of people who not only care for their departments with an astounding commitment to go the extra mile, but also have the creativity and desire to do a superb job while minimizing their costs. Below are some of the highlights of the year for each department.

Customer Service

Our call center continued to concentrate on up-selling, cross-selling and the liquidation of inventory, resulting in a decrease of aged inventory from \$159,000 in 2003 to \$52,000 in 2004.

Cross-training of Customer Service personnel created a savings in reduced staffing, with employees now able to “wear different hats.” The longevity of our phone representatives is higher than it has ever been. They are experienced, professional, and continue to become increasingly knowledgeable about our merchandise, enabling them to answer a dizzying array of questions from customers.

Warehouse

Attention to efficiency rewarded our efforts to cut costs in the midst of an increased workload. While we had a 15.5% increase in orders shipped, and a 17% increase in merchandise received, our costs increased by only 4.45%. We continue to strive toward perfection with our Shipping and Receiving error prevention program, attaining an exceptional 99.86% accuracy rate (slightly more than our goal of 1 error per 1,000 orders).

Marketing

Mailing list rental income continued to grow, increasing to \$147,000 in 2004 from \$135,000 in 2003.

Web sales continue to grow, now accounting for 30% (up from 25% in 2003) of our total sales, an increase from \$2 million in 2003 to \$2.7 million in 2004. We completed our first full year of hosting our own websites, an endeavor that saves us money and gives us more flexibility and autonomy. We devoted resources to web marketing, which made a significant difference to our paid search results.

Merchandising

New merchandise helped to increase response from existing customers. Over 35% of Isabella catalog items were new throughout the year. 25% of Chinaberry catalog items were new in the spring and summer, rising to 37% in the holiday season. We continue to

see promising signs from seasonal merchandise. This category, though still relatively small, generates higher than average sales per page of catalog space. Complemented by seasonally appropriate catalog covers, particularly for Chinaberry, the seasonal merchandise category supports higher catalog response overall.

The sales analysis data we use continues to grow more sophisticated, allowing us to merchandise with more awareness of what works and what doesn't work.

Early in 2004, we re-categorized the merchandise on the Isabella website to make searching and shopping more user-friendly. These changes contributed to an increase in the ratio of web orders to phone and mail orders.

We continue to work with artisans, manufacturers and importers to include more exclusive items in our product mix.

Purchasing

Perhaps one of the greatest contributions a Purchasing Department can make is to maintain just the right balance of in-stock inventory -- not too little and not too much. The holiday season always presents us with the challenge of having items in stock, rather than having a backorder situation, which not only damages customer good will, but is also expensive. Creating good vendor relations is essential so that a supplier will go the extra mile to quickly replenish stock that is selling beyond expectations. However, this balancing act also requires having something akin to a crystal ball mentality in order to see into the future. In 2004, we were successful in reducing our number of backorders by 47%, down to 5,320 from 10,057 in 2003 -- a savings of \$28,000.

Accounting

We again improved our management of total inventory investment and cash in 2004 and concentrated on decreasing debt. We paid off the \$62,000 loan to our shareholder, as well as our \$211,111 term loan and \$53,822 in capital lease payments. Our unsecured \$80,000 loan from a shareholder is now a three-year amortizing loan accruing interest at prime + 6%.

Our Catalogs

The Chinaberry Catalog: We finished the year at \$275,000 over forecast. Total revenue for 2004 was up 2.6%, or \$110,400, from \$4,250,300 in 2003 to \$4,360,700. Because of Chinaberry's position in a very competitive marketplace with discount booksellers, the past several years have seen a change in the catalog's product mix to reflect more non-book items. It appears that in 2004 we found the optimal balance and can now tip the scale slightly more toward books than in the recent past.

The Isabella Catalog: For the third year in a row, Catalog Success magazine included the Isabella catalog in their list of the Top 200 fastest growing catalogs, ranking us at number

89. We finished the year at \$285,000 over forecast. Total revenue for 2004 was up 16.4%, or \$565,100, from \$3,454,300 in 2003 to \$4,019,400 in 2004. Early in 2004, we redesigned the Isabella catalog to create more continuity and visual appeal. Feedback, both verbal and from increased sales, indicates these changes were positive. Our customer base continues to grow because this catalog enjoys a more diverse market with less direct competition than that of Chinaberry. We believe that while the Chinaberry catalog continues to have a loyal customer base and is highly respected in the industry, Isabella has more opportunity for growth.

The Chinaberry Book Fair Catalog: After analyzing the costs and revenue associated with our Book Fairs, we concluded that they did not contribute financially to the profitability of the company. Instead, we devoted our resources to Web Marketing, an area that is vibrant and growing. As anticipated, the Chinaberry and Isabella catalogs' actual performance over forecast, a total of \$560,000, made up for the sales lost by the discontinuation of the Chinaberry Book Fair program.

Our Products

The sales analysis data we use continues to grow more sophisticated, allowing us to merchandise with more awareness of what does and doesn't sell. We work to stay current with scientific studies where applicable and offer products that conform to what we consider to be healthful for our customers. This means that when choosing new products, we do not knowingly offer anything that is made of PVC; that we search for products that help to support the right livelihood of those who make the items; and that we share, via our annotations, the information we've gathered about synthetic chemicals that have been linked to cancer and birth defects.



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March 31, 2005

Certificate of Corporate Officers

To the Shareholders of
Chinaberry Inc.
Spring Valley, California

We have completed the accompanying balance sheet of Chinaberry Inc. as of December 31, 2004 and 2003 and the related statements of income, changes in shareholders' equity, and cash flows for the years then ended.

We chose to complete the financial statements ourselves in order to save more than \$10,000 in outside services.

We, Edward J. Ruethling, President and Mary Jo R. Ray, Controller certify that the attached financial statements for fiscal year 2004 and 2003 were prepared without audit from the books and records of the corporation.

Edward J. Ruethling
President

Mary Jo R. Ray
Controller

Balance Sheet
Chinaberry Inc.

December 31,

	2004	2003
Assets		
Current assets:		
Cash and cash equivalents	\$ 859,072	\$ 1,030,232
Accounts receivable	6,203	10,103
Inventory	1,042,406	975,169
Prepaid expenses and other current assets	121,818	99,376
Direct response advertising costs	236,995	97,085
Total current assets	2,266,494	2,211,965
Property and equipment (net of accumulated depreciation of \$331,505)	94,407	139,830
Other assets (net of accumulated amortization of \$226,024)	110,215	172,118
Total assets	\$ 2,471,116	\$ 2,523,913
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	\$ 918,602	\$ 761,547
Unearned revenue	46,859	48,774
Note payable-current	-	211,111
Current portion of long-term debt	61,994	50,000
Other current liabilities	62,149	82,472
Total current liabilities	1,089,604	1,153,904
Long-term debt	0	46,382
Notes payable to a shareholder	51,753	133,189
Total liabilities	1,141,357	1,333,475
Shareholders' equity:		
Common stock, no par value: 10,000,000 shares authorized; 1,850,186 shares issued and outstanding	649,758	649,758
Paid-in capital	594,585	594,585
Stock subscriptions receivable	-	(6,468)
Accumulated retained earnings/(deficit)	85,416	(47,437)
Total shareholders' equity	1,329,759	1,190,438
Total liabilities and shareholders' equity	\$ 2,471,116	\$ 2,523,913

See accompanying notes

Statement of Income

Chinaberry Inc.

	Years ended December 31,	
	2004	2003
Revenues	\$ 9,914,703	\$ 9,464,040
Cost of sales	3,854,601	3,557,184
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Gross profit	6,060,102	5,906,856
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Fulfillment	2,032,421	1,980,046
Marketing	2,241,660	2,162,754
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Operation Expenses	4,274,081	4,142,800
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Administrative expenses:		
Salaries, wages, and related benefits	1,106,412	1,256,085
Rent, maintenance, telephone, and utilities	248,957	243,917
Depreciation and amortization	117,976	128,308
Insurance	86,343	86,790
Outside services	44,348	70,637
Office expenses	67,967	68,518
Other	20,612	36,745
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Total administrative expenses	1,692,615	1,891,000
	<hr/>	
Income (loss) from operations	93,406	(126,944)
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Other income (expense):		
Mailing list rentals	146,677	134,630
Interest income	531	5,880
Interest expense	(30,252)	(54,872)
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Total other income	116,956	85,638
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Net income (loss) before provision for income taxes	210,362	(41,306)
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Provision for income taxes	(77,509)	(5,000)
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Net income (loss)	132,853	\$ (46,306)
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Accumulated deficit at the beginning of the year	\$ (47,437)	(1,131)
	<hr/>	
Retained Earnings/(Accumulated deficit) at the end of the year	\$ 85,416	\$ (47,437)

See accompanying notes

Statement of Cash Flows
Chinaberry Inc.

	Years ended December 31,	
	2004	2003
Cash Flows from Operating Activities		
Net income (loss)	\$ 132,853	\$ (46,306)
Adjustments to reconcile net increase (loss) to net cash provided by operating activities:		
Depreciation and amortization	117,976	128,599
Changes in certain assets and liabilities:		
Accounts receivable	3,900	5,903
Inventory	(67,237)	159,451
Prepaid expenses and other current assets	(22,442)	12,001
Direct response advertising cost	(139,910)	199,029
Deposits	3,482	(4,667)
Accounts payable and accrued expenses	157,055	(52,108)
Deferred revenue	(1,915)	13,809
Other current liabilities	(20,323)	5,460
Net cash provided by operating activities	163,439	421,171
Cash Flows from Investing Activities		
Cash paid for purchase of equipment and software	(14,134)	(4,420)
Cash paid for website development costs	-	(4,650)
Net cash used by investing activities	(14,134)	(9,070)
Cash Flows from Financing Activities		
Proceeds from issuance of common stock		9,248
Collections on stock subscriptions receivable	6,468	7,888
Proceeds from borrowings on shareholder note payable	(62,000)	62,000
Principal payments on notes payable	(211,111)	(133,333)
Principal payments on capital lease obligations	(53,822)	(63,194)
Repayment of loan from shareholder		(4,496)
Net cash used by financing activities	(320,465)	(121,887)
Net increase (decrease) in cash and cash equivalents	(171,160)	290,214
Cash and cash equivalents at the beginning of the year	1,030,232	740,018
Cash and cash equivalents at the end of the year	\$ 859,072	\$ 1,030,232

See accompanying notes

Notes to Financial Statements

Chinaberry Inc.

1. Organization and significant accounting policies

A. Organization

Chinaberry Inc. (formerly known as Chinaberry Book Service, Inc.) was incorporated in March 1990. The company markets to customers throughout the United States with its consumer catalogs and websites. The Chinaberry brand name is used for products that support parents in raising their children with love, honesty, joy, and respect. The Isabella brand name is used for products that inspire deeper spiritual connections. The Company's book fair program provided fundraising opportunities for schools. The book fair program was discontinued in 2004.

B. Use of estimates

Management uses estimates and assumptions in preparing these financial statements. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported amounts of revenues and expenses. Actual results could vary from the estimates that were used.

C. Inventories

Inventories consist of finished goods held for resale and parts used in assembling kits and are stated at cost, with cost being determined by the average cost method. Shipping and handling costs of \$1,068,509 and \$1,027,167 for 2004 and 2003, respectively, are reported as fulfillment expenses in the accompanying statements of income.

D. Advertising

Generally, advertising costs are expensed as incurred. Catalog production and postage costs related to direct-response advertising are capitalized and amortized over the life of a catalog, based on the ratio of current revenues to current and estimated future revenues. The amount of advertising costs reported as assets in the accompanying balance sheets totaled \$236,995 and \$97,085 for 2004 and 2003, respectively.

The amount charged to advertising expense in the accompanying statements of income totaled \$2,241,660 and \$2,162,754 for 2004 and 2003, respectively.

E. Property and equipment

Property and equipment are stated at cost. Depreciation is provided using the straight-line method over the estimated useful lives of the assets. The estimated useful lives of equipment, furniture, and fixtures range

E. Property and equipment (continued)

from 3 to 7 years. The useful lives of building improvements have been estimated to be 15 years. Depreciation for 2004 and 2003 totaled \$57,704 and \$62,782, respectively.

F. Other assets

Costs incurred to modify purchased computer software to meet the Company's needs and to develop the Company's web sites are capitalized and amortized on a straight-line basis over three years. Amortization totaled \$60,272 and \$65,814 in 2004 and 2003, respectively.

G. Revenue recognition

The accompanying financial statements are prepared on the accrual basis of accounting, in accordance with generally accepted accounting principles. Accordingly, revenues are recorded as they are earned, and expenses as they are incurred. Deferred revenue represents gift certificates that were sold but not yet redeemed.

An estimate for returned sales in the subsequent period is recorded.

H. Retirement plan

The company has a 401(k) plan covering substantially all of its employees with three months of service. The company has a discretionary match which is currently not being implemented. The plan allows for a match up to 25% of the elected employee salary deferrals up to 6% of pay. There were no contributions in 2004. There was a \$1,046 contribution in 2003. At the discretion of the Board of Directors, matching may be resumed.

I. Statements of cash flows

For the purpose of the statements of cash flows, the Company considers all highly liquid cash investments purchased with an original maturity of three months or less as cash equivalents.

Cash paid for interest totaled \$36,000 and \$50,000 for 2004 and 2003, respectively. During 2003, a shareholder loaned the company \$62,000. The company repaid the money in 2004.

J. Credit risk

At December 31, 2004 and 2003, amount of cash on deposit in excess of federally insured limits totaled \$1,424,000, and \$1,372,000, respectively.

Notes to Financial Statements

Chinaberry Inc.

2. Property and equipment

Property and equipment consist of:

	2004	2003
Equipment	\$ 360,620	\$ 348,338
Office furniture	16,526	16,526
Leasehold improvements	48,766	48,766
	425,912	413,630
Less: accumulated depreciation	(331,505)	(273,801)
	\$ 94,407	\$ 139,830

3. Other assets

Other assets are comprised of:

	2004	2003
Software	\$ 252,910	\$ 251,058
Website development cost	60,791	60,791
Less: accumulated amortization	(226,024)	(165,752)
	87,677	146,097
Other deposits	22,538	26,022
	\$ 110,215	\$ 172,118

4. Accounts payable and accrued expenses

Accounts payable and accrued expenses consist of:

	2004	2003
Trade accounts payable	\$ 883,688	\$ 735,974
Accrued wages (Wages paid bi-weekly, three periods December 2003)	34,914	25,573
Other	\$ 918,602	\$ 761,547

5. Notes payable-current

Notes payable-current are composed of the following:

	2004	2003
Four-year note due July 2005, interest is 1% over the lender's prime rate; secured by substantially all of the Company's assets and personal guarantees from the majority shareholders.	\$ -	\$ 211,111
	\$ -	\$ 211,111

Notes to Financial Statements

Chinaberry Inc.

6. Line of credit

The Company has a revolving line of a maximum amount of \$300,000 due on demand or by November 2005. The line is secured by substantially all of the Company's assets and personal guarantees from the majority shareholders. Interest is at the bank's index rate plus a margin of 1.000%. There is no principal balance outstanding on the line of credit at either December 31, 2003 or December 31, 2004.

7. Long-term debt

The Company acquired equipment and software under capital leases whose terms range from three to five years, with maturities ranging from June 2005 to February 2006. Future minimum rental payments (exclusive of \$3,620 in imputed interest) are: \$42,000 in 2005, and \$2,000 in 2006.

8. Note payable to a shareholder

The Company borrowed \$80,000 from a shareholder under a five-year agreement maturing in May 2004. The loan was renegotiated and is now an amortizing note that will pay off in January of 2008. The interest on the note accrues at the prime rate plus 6%. The company borrowed an additional \$62,000 from a shareholder in 2003 and repaid the money in 2004. The interest on that note accrued at the prime rate plus 8%.

9. Other related party transactions

The company purchased \$16,804 and \$14,142 in inventory from a company owned by the child of a majority owner during 2004 and 2003 respectively. \$21,263 and \$10,478 was paid to this company in 2004 and 2003, and \$4,444 and \$3,664 were included in accounts payable at December 31, 2004 and December 31, 2003.

The company purchased \$150 and \$190 in book review services from a child of a majority owner during 2004 and 2003.

The company purchased \$600 of merchandising consulting from a shareholder.

The company sold a book that was written by two shareholders. The company sold 1,948 and 756 books in 2003 and 2004. The company had 306 books and 81 books on hand in 2003 and 2004 respectively.

10. Stock subscriptions receivable

The company granted some stock to an employee who helped found the Isabella Catalog. The ownership was vested over a period of time, concluding in 2004.

11. Operating leases

The Company leases its facilities under a three-year agreement expiring in January 2007. Rent expense for 2004 and 2003 totaled \$189,000 and \$188,000, respectively. Future minimum rental payments required under this lease are approximately \$194,000 in 2005 and \$194,000 in 2006.

12. Income taxes

In 2003, the company had a net loss and a loss carry forward of approximately \$31,000. All of the loss carry forward was offset against income in the 2004 income tax calculation.