COLECO

1932 · 1982

1981 ANNUAL REPORT

About Coleco

Coleco Industries, Inc. is a major manufacturer of recreation and entertainment products for the entire family for use in and around the home. It is an innovator and industry leader in the field of portable, self-contained electronic games and has developed an advanced and modular expandable state of the art video game system. Coleco is the world's largest manufacturer of above ground swimming and wading pools. The Company also manufactures basic toys and games and a broad variety of plastic ride-ons for youngsters. Manufacturing and distribution facilities in the United States and Canada total nearly 2.5 million square feet, and peak employment totals approximately 3,000 people. With the home increasingly becoming a center for entertainment, recreation and information, Coleco believes it is well positioned in the marketplace to pursue attractive opportunities for continued growth.

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Stock Market Information

Market Price of Common Stock:

1981	Market Price High	Market Price Low
1st Quarter	10	6⅞
2nd Quarter	13	10⅝
3rd Quarter	11¾	7¾
4th Quarter	8	6¼

1980	Market Price High	Market Price Low
1st Quarter	7¼	4
2nd Quarter	7¾	4⅝
3rd Quarter	13¼	6⅞
4th Quarter	12½	7

STOCKHOLDERS MAY OBTAIN A COPY OF THE COMPANY'S 1981 ANNUAL REPORT ON FORM 10-K FILED WITH THE SECURITIES AND EXCHANGE COMMISSION BY WRITING TO MICHAEL S. SCHWEFEL, SECRETARY, COLECO INDUSTRIES, INC., 945 ASYLUM AVENUE, HARTFORD, CONNECTICUT 06105.

MATERIAL USUALLY CONTAINED IN THE ANNUAL REPORT MAY BE FOUND IN THE ACCOMPANYING BOOK COMMEMORATING THE FIFTIETH ANNIVERSARY OF COLECO'S FOUNDING.

Financial Summary

	1981	1980
	(Amounts in thousands, except per share amounts)	
Net Sales	**$178,031**	$162,907
Earnings Before Income Taxes and Extraordinary Credit	**$ 13,464**	$ 23,101
Net Earnings	**$ 7,711**	$ 13,037*
Earnings Per Share	**$ 1.01**	$ 1.83*
Average Number of Shares Outstanding	**7,632**	7,144
Working Capital	**$ 41,164**	$ 36,394
Current Ratio	**2.2 to 1**	2.7 to 1
Long-Term Debt	**$ 18,269**	$ 18,543
Stockholders' Equity	**$ 47,467**	$ 39,183

*Excludes an extraordinary credit resulting from the utilization of tax loss carryforwards of $3,612,000 or $.50 per share in 1980.

Management Report

Operating Results

Sales for 1981 totaled $178.0 million, a record for the Company, and an increase of 9% over 1980 sales of $162.9 million. Pretax earnings of $13.5 million compare with $23.1 million for 1980. Net income was $7.7 million or $1.01 per share in 1981, compared with $13.1 million or $1.83 per share, before giving effect to the tax credit of $3.6 million in 1980 arising from the utilization of the net operating loss carryforward.

Sales of swimming pools, ride-ons and basic toys and games were all significantly higher in 1981 than 1980, while electronic game sales, primarily hand held sports games, were substantially lower. Gross profit margins for swimming pools, ride-ons and basic toys and games also increased, but were not sufficient to offset the impact of reduced sales volume of the higher margin electronic games. As a result, the corporate gross profit margin was about 5% lower in 1981 than in 1980. Operating expenses as a percent of sales, including interest and other expenses, increased from 26% in 1980 to 28% in 1981. Net income of $7.7 million represented a return of 20% on beginning stockholders' equity.

Both Coleco's Canadian and Coastal chemical subsidiaries performed at budgeted levels for the year and achieved record levels of profitability.

Working Capital and Liquidity

Working capital totaled $41.2 million at the end of 1981, a $4.8 million increase over year-end 1980 levels. Once again, there was no short-term debt at year-end. The Company had a cash position of $7.7 million at year-end 1981 and a current ratio of 2.2:1.

Inventories of $42.6 million were $12.7 million higher than at year-end 1980. The increases occurred in the family leisure game and toy segment, with electronics representing the largest portion.

Coleco has reached agreement in principle with its banking group for a $72.5 million short-term credit facility covering the year beginning April 1, 1982. This compares with a $40 million facility for the past year. The new agreement carries a number of pricing options which should continue to enable Coleco to borrow at levels below the U.S. prime rate.

Marketing Outlook

The continued emphasis on physical fitness and children's increased exposure to instructional swimming should continue to stimulate the market for swimming pools. Sales of Coleco's swimming pools and water products in 1981 reached a record level of $68.1 million, compared with $49.8 million in 1980, the largest single year sales growth ever experienced for this segment. As a percentage of total sales, swimming pools and water products accounted for 38% in 1981 compared with 31% in 1980. In addition, gross profit margins increased over 1980 levels, the fourth consecutive year of continued margin growth.

Coleco's record pool sales in 1981 reflect increased television and other advertising, the continued strength of its *Mr. Turtle* franchise and a 67% increase in sales of its Coastal chemical subsidiary. Swimming continues to be the number one participation sport for Americans, and Coleco believes its market share and the market as a whole will continue to grow.

Coleco's ride-ons enjoyed unusual sales growth in 1981, reaching $24.9 million from $1.9 million in 1980. This growth was highlighted by a line of *Power Cycle* ride-on plastic tricycles, two models of which featured the popular *Dukes of Hazzard* license. Coleco also successfully introduced the *Gun It & Go Chopper,* a battery operated ride-on chopper with electronic sound effects. In 1982, the Company has introduced a fleet of new and varied ride-ons, many of which feature strong character licenses like *Smurf, Annie, Pac-Man, Dukes of Hazzard* and *G.I. Joe.* For toddlers, the line includes a *Super Smurf* Piggyback Rider, a combination walker/rider called the *Smurfs*-A-Poppin Train, and a *Dukes of Hazzard* Mini Chopper. Children can move up to a *Pac-Man* or *Annie Power Cycle* ride-on, or graduate to a *General Lee* four-wheeled pedal car with doors, trunk and hood that open, and an electronic horn that plays "Dixie". The Company believes that it will achieve a position of market leadership in children's ride-ons by the conclusion of the 1982 season.

Coleco's basic toys and games generated sales of $26.9 million in 1981 compared with $20.8 million in 1980. Included in this segment is a line of doll carriages, coaches and strollers which enjoyed extraordinary success in 1981, largely as a result of the *Strawberry Shortcake* license. Further growth is expected in 1982 with the addition of the *Smurf* license for Coleco's doll carriage line. Coleco also makes pool tables, home pinball machines, rod and air action hockey games, bake ovens, and plastic sleds and toboggans. Sales growth in this basic category should continue in 1982.

Sales of electronic games in 1981 of $58.1 million were significantly lower than the record 1980 level of $90.4 million. The sales decline in electronic sports games was primarily attributable to the liquidation by Coleco's competitors of excess inventory of early generation sports games at usually low prices. As a result, sales of Coleco's electronic sports games declined substantially, although the Company's *Play and Learn* and family action games experienced sales increases. The Company expects that sales of electronic sports games will continue to decline in 1982.

Notwithstanding the sales decline experienced in electronics last year, Coleco's position in the electronic games marketplace is significantly stronger in 1982 than ever before. Creative product development activity in three major segments of the electronic game area during 1981 has resulted in important new product introductions this year which have received a high degree of trade acceptance. These new products should prove unusually profitable in 1982 and also open opportunities for continued future growth.

We expect that 1982 will be by far our biggest year in the hand held or self-contained electronic game area. Coleco has introduced four portable table top arcade games making use of technologically advanced, multi-colored vacuum fluorescent displays. These games replicate the look and action of well known video coin-op favorites. Coleco has entered into advantageous licensing arrangements with the manufacturers of certain video coin-op games, and its line of home versions of *Pac-Man, Galaxian, Donkey Kong* and *Frogger* have already received the most enthusiastic trade reaction of any electronic products we have ever introduced. A substantial quantity of *Pac-Man* games has been shipped and the reaction of consumers has been equally positive. Coleco has already received orders in excess of 1.5 million units for this line of four games and expects that shipments for the year will be well in excess of 2 million units.

At the recently concluded American and Canadian Toy Fairs, the Company introduced *ColecoVision,* a third generation, state of the art video game system. *ColecoVision* features unsurpassed graphic resolution and game controllers which offer more interactive involvement and control of game action. A key feature of the *ColecoVision* system is its modular expandable design, which permits the addition of state of the art developments as they are introduced. As a result, *ColecoVision* offers the consumer the opportunity to avoid the risk of rapid obsolescence. Next year the Company expects to introduce a competitively priced keyboard that will connect with the *ColecoVision* video game system, thereby giving the unit the capability of a powerful personal computer. Later this year, Coleco will introduce a module that will enable cartridges designed for the *Atari Video Computer System* to be played on *ColecoVision.* Software for the *ColecoVision* system features popular licensed video arcade games, including *Donkey Kong,* currently number one in most arcade polls. Delivery of the *ColecoVision* system will begin in July.

We believe that *ColecoVision* offers an attractive opportunity to gain an important and profitable share of this expanding segment of the electronic game business. The attractive features of *ColecoVision* and its very competitive $160 wholesale price have already won enthusiastic trade support. We believe there is a significant opportunity to gradually develop the *ColecoVision* system into a center for family entertainment, information and education.

Coleco has also introduced a line of video game software that may be played on the *Atari Video Computer System,* and another group of cartridges that may be played on Mattel's *Intellivision.* Many of the popular licensed arcade favorites that are being offered as part of the *ColecoVision* software line are also being offered for the *Atari Video Computer System* and *Intellivision* systems. Consumer demand is unusually strong for licensed arcade software based on popular video coin-op games, and we believe that our entry into the third party software field will prove successful.

Management Development

The Company remains committed to the development of a broadened management structure with greater personnel depth in key areas. We are continuing to evolve our management structure from the format established in 1981 and have made several significant appointments to accomplish this objective.

Morton E. Handel has been promoted to Executive Vice President-Administration and Finance with expanded responsibilities at the senior management level. Michael S. Schwefel has been appointed Senior Vice President and will continue as Secretary and General Counsel. John A. Passante joined the Company as Vice President-Human Resources, providing a needed element to Coleco's management organization. Paul C. Meyer has been promoted to Vice President-Finance, and Charles H. Murphy has been promoted to Treasurer of the Company. Brian Sickler recently joined the Company as Corporate Controller. Also at Hartford corporate headquarters, Mark L. Yoseloff has been promoted to Vice President-Product Operations, and Lawrence J. Karam to Vice President-Operations Planning, Electronics.

At our upstate New York manufacturing complex, Frank Dempsey has been appointed Vice President-Purchasing. At our Coastal chemical subsidiary, Bruce Rindzuner has joined the Company as Vice President-Sales.

At our Coleco Canada subsidiary, Charles B. Steeley has joined the Company as President, Gene M. Florio has been promoted to Senior Vice President-Finance, and Georges Dussault has been promoted to Vice President-Operations.

Directors

John F. Moran, who has been a director of Coleco since it first became a publicly traded security in 1962, has announced his retirement from the Coleco Board and will not stand for re-election at our annual meeting in May. Through the 20 years that Coleco has been a public company, John has provided the management and Board of Directors with dedicated service, thoughtful counsel and unstinting devotion. He has earned the respect and admiration of both his fellow directors and the management of Coleco. We thank him for his years of service and welcome him to the position of Director Emeritus.

At its annual meeting on May 25, 1982, management will propose for election to the Board of Directors Seymour M. Leslie, Chairman and Chief Executive Officer of MGM/UA Home Entertainment Group. Mr. Leslie will soon resign as President of CBS Video Enterprises, a position he has held since February 1980. He was the founder and Chief Executive Officer of Pickwick International, Inc., one of the leading manufacturers and distributors of phonograph records in the country. We particularly welcome Cy Leslie's experience in the entertainment industry, and believe that he will be a valuable addition to Coleco's Board of Directors.

During 1981, there were nine meetings of the full Board of Directors, as well as four meetings of the Human Resources Committee and four meetings of the Audit Committee. All of Coleco's directors attended at least 93% of these meetings.

Corporate Headquarters

In March of 1982, Coleco's management announced the proposed relocation of its corporate headquarters from 4 different buildings on Asylum Avenue in Hartford to a corporate center of approximately 100,000 square feet located on 10 acres of land in West Hartford, Connecticut. By year-end, we will consolidate our various Hartford activities under one roof, making available facilities required for a greatly expanded research and development center, as well as providing our employees with a substantially improved work environment.

Outlook For The Future

Coleco continues to maintain a marketing strategy which positions the Company as a seasonally balanced, diversified manufacturer of recreational and entertainment products for use by the entire family, in and around the home. We invite your attention to the Fiftieth Anniversary Commemorative Book included with this Annual Report for a review of Coleco's marketing strategy and the opportunities we see for continued future growth.

The North American economy continues to experience considerable difficulties. Coleco, however, is enjoying a year very much contrary to general economic conditions. Through the end of March we have already received more orders than we did for all of 1981. Backlog at the end of March was $144 million, an all-time high, and more than $100 million above the year ago level. Sales and earnings for the first quarter were greater than those for any prior first quarter. As a result of this excellent response to our 1982 product line, we expect that sales for 1982 will be well in excess of $300 million.

As we contemplate what appears to be the most successful year in Coleco's history, we again acknowledge the support of stockholders, suppliers, bankers, customers and friends. The intense commitment to success shared by our fellow Coleco employees has been the bedrock upon which our growth has been achieved. We offer our deepest appreciation to all who have made our first fifty years something worth celebrating. With your continued support we can look forward to the next fifty years with confidence and enthusiasm.

Leonard E. Greenberg
Leonard E. Greenberg
Chairman

Arnold C. Greenberg
Arnold C. Greenberg
President

April 15, 1982

Coleco Industries, Inc.
Consolidated Balance Sheet
December 31, 1981 and 1980

ASSETS	1981	1980
	(Amounts in thousands)	
Current Assets:		
Cash (including short-term investments of $10,478 in 1980)	**$ 7,749**	$11,765
Accounts receivable, less allowances of $11,556 and $8,598 (Notes 2 and 9)	**21,236**	13,766
Inventories (Notes 3 and 9)	**42,629**	29,933
Prepaid advertising (Note 4)	**2,728**	2,310
Other prepaid expenses	**774**	432
Total current assets	**75,116**	58,206
Property, Plant & Equipment, at cost less accumulated depreciation of $30,270 and $27,814 (Notes 5, 6 and 9)	**20,340**	16,869
Other Assets:		
Intangible assets	**3,137**	3,325
Other noncurrent assets	**802**	817
Total other assets	**3,939**	4,142
	$99,395	$79,217

The accompanying notes are an integral part of the financial statements.

LIABILITIES AND STOCKHOLDERS' EQUITY	1981	1980
	(Amounts in thousands)	
Current Liabilities:		
Long-term debt — current portion (Note 9)	**$ 1,194**	$ 1,044
Accounts payable	**19,130**	7,689
Income taxes payable (Note 7)	**1,990**	4,105
Accrued expenses and other liabilities (Note 8)	**11,638**	8,974
Total current liabilities	**33,952**	21,812
Deferred Income Taxes (Note 7)	**901**	723
Long-Term Debt (Note 9)	**17,075**	17,499
Total liabilities	**51,928**	40,034
Contingencies (Note 10)		
Stockholders' Equity (Notes 9, 11 and 12):		
Preferred stock — $1 par value, 300,000 shares authorized; no shares issued		
Common stock — $1 par value, 20,000,000 shares authorized; 1981 — 7,648,852 shares issued, 1980 — 7,514,852 shares issued	**7,649**	7,515
Capital in excess of par value	**12,942**	12,503
Retained earnings	**26,876**	19,165
Total stockholders' equity	**47,467**	39,183
	$99,395	$79,217

Coleco Industries, Inc.
Consolidated Statement of Operations and Retained Earnings
Years Ended December 31, 1981, 1980 and 1979
(Dollar amounts in thousands, except per share amounts)

	1981	1980	1979
Net Sales	**$178,031**	$162,907	$136,495
Cost of Goods Sold	**115,172**	97,595	90,354
Gross Profit	**62,859**	65,312	46,141
Operating Expenses:			
Selling and administrative expenses	**45,281**	38,350	29,465
Interest expense	**4,470**	3,672	6,082
	49,751	42,022	35,547
Operating Profit	**13,108**	23,290	10,594
Other Income (Expense), Net	**356**	(189)	(443)
Earnings Before Income Taxes and Extraordinary Credit	**13,464**	23,101	10,151
Income Tax Provision (Note 7)	**5,753**	10,064	4,793
Earnings Before Extraordinary Credit	**7,711**	13,037	5,358
Extraordinary Credit Resulting from Utilization of Tax Loss Carryforwards (Note 7)		3,612	3,728
Net Earnings	**7,711**	16,649	9,086
Retained Earnings (Deficit) at Beginning of Year as Adjusted (Note 1)	**19,165**	2,516	(6,570)
Retained Earnings at End of Year	**$ 26,876**	$ 19,165	$ 2,516
Per Share Results (Note 1):			
Earnings Before Extraordinary Credit	**$ 1.01**	$ 1.83	$ .78
Extraordinary Credit Resulting from Utilization of Tax Loss Carryforwards		.50	.54
Net Earnings Per Share	**$ 1.01**	$ 2.33	$ 1.32

The accompanying notes are an integral part of the financial statements.

Coleco Industries, Inc.
Consolidated Statement of Changes in Financial Position
Years Ended December 31, 1981, 1980 and 1979
(Dollar amounts in thousands)

	1981	1980	1979
Financial Resources Were Provided by:			
Net earnings before extraordinary credit	**$ 7,711**	$ 13,037	$ 5,358
Add items not requiring working capital:			
Depreciation of plant and equipment	**3,000**	2,862	4,067
Amortization of intangibles	**205**	338	225
Noncurrent deferred tax provision	**178**	723	513
Other	**90**	73	318
Total provided by operations before extraordinary credit	**11,184**	17,033	10,481
Extraordinary credit (Note 7)		3,612	3,728
Total provided by operations	**11,184**	20,645	14,209
Proceeds from issuance of common stock, net (Note 11)	**568**	5,691	8
Disposal of property, plant and equipment, net	**80**	288	141
Proceeds from long-term debt (Note 9)	**70**	5,374	17,000
Decrease in other noncurrent assets	**54**	866	5,260
	11,956	32,864	36,618
Financial Resources Were Used for:			
Purchase of property, plant and equipment	**6,269**	3,838	2,691
Reduction of long-term debt	**494**	5,663	8,454
Increase in property under capital leases	**282**	459	
Reduction of short-term debt previously reclassified to long-term debt (Note 9)			9,625
Increase in other noncurrent assets	**141**	35	813
	7,186	9,995	21,583
Increase in Working Capital	**4,770**	22,869	15,035
Working Capital (Deficit) at beginning of year	**36,394**	13,525	(1,510)
Working Capital at end of year	**$41,164**	$36,394	$13,525
Changes in Working Capital Items:			
Increase (Decrease) in Current Assets:			
Cash and short-term investments	**$ (4,016)**	$11,727	$ (18)
Accounts receivable	**7,470**	1,755	(2,617)
Inventories	**12,696**	11,950	2,520
Prepaid advertising	**418**	(1,785)	1,880
Prepaid expenses and other current assets	**342**	(898)	(4,043)
(Increase) Decrease in Current Liablities:			
Short-term debt		4,167	13,970
Long-term debt — current portion	**(150)**	2	(148)
Accounts payable	**(11,441)**	2,783	4,266
Federal and state income taxes payable	**2,115**	(4,041)	379
Accrued expenses and other liabilities	**(2,664)**	(2,791)	(1,154)
Increase in Working Capital	**$ 4,770**	$22,869	$15,035

The accompanying notes are an integral part of the financial statements.

NOTE 1 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Principles of Consolidation — The consolidated financial statements include the accounts of the Company and all of its subsidiaries, including a Canadian subsidiary, after elimination of intercompany accounts and transactions.

Translation of Foreign Currency — The balance sheet accounts of the Canadian subsidiary have been translated using current exchange rates for current assets (excluding inventories), noncurrent receivables and liabilities and appropriate historical rates for all other balance sheet accounts. Revenue and expense accounts are translated at average exchange rates during the year, except for amounts related to balance sheet accounts which are translated at historic rates. Foreign currency translation gains and losses are included in income currently.

Accounts Receivable — The Company provides allowances for doubtful accounts, for advertising and other credits and for defective returns. The allowance for defective returns represents management's estimate of the amount of products sold which may be returned due to manufacturing defects, net of the estimated amount of cost recovery for these products.

Inventories — Inventories are valued at the lower of cost or market (estimated net realizable value). Costs are determined on the first-in, first-out method.

Property, Plant and Equipment — Depreciation is provided on the straight-line method for plant and equipment over estimated useful lives of the related assets (10 to 50 years for buildings and 3 to 12 years for machinery and equipment).

The costs of molds, dies and fixtures are capitalized and depreciated over a period up to three years depending upon estimated market life of the related products.

Intangible Assets — The excess of cost over the fair values of net assets of businesses acquired (goodwill) and patents and trademarks are amortized on the straight-line method over 5 to 40 years. Goodwill arising prior to October 1970 is being amortized over 20 years.

Income Taxes — Deferred income taxes are provided for income and expense items which are recognized in different years for tax purposes than for financial reporting purposes. No provision is made for taxes on undistributed earnings of subsidiaries not consolidated for U.S. income tax purposes inasmuch as it is the intention of the Company to reinvest such undistributed earnings.

Investment tax credits are recorded as reductions of income tax expense in the year they are realized.

Earnings Per Share — Net earnings per share of common stock are based upon the weighted average number of common shares outstanding during the respective periods, adjusted for dilutive common stock equivalents (7,632,000 shares in 1981, 7,143,500 shares in 1980 and 6,911,000 shares in 1979).

Accounting Change — Prior to 1981, the Company followed the common practice of accounting for the costs of vacation pay benefits in the period they were paid. Effective as of January 1, 1981, as a result of the Financial Accounting Standards Board's Statement No. 43, the Company began accruing such benefits as they are earned. Financial Statements for years prior to 1981 have been restated as required by the Statement, resulting in a decrease in retained earnings as of January 1, 1979 of $245,000 (net of income taxes of $205,000). The accounting change decreased previously reported net income by $28,000 for 1980 and $7,000 for 1979 and did not affect earnings per share in either year.

Reclassification — Certain amounts for 1979 and 1980 have been reclassified to conform with the 1981 financial statement presentation.

NOTE 2 — ACCOUNTS RECEIVABLE:

Accounts receivable and related allowances at December 31 consisted of the following:

	1981	1980
	(Amounts in thousands)	
Accounts Receivable	$32,792	$22,364
Less:		
Allowances for defective returns	(4,072)	(4,157)
Allowances for advertising and other credits	(6,996)	(3,960)
Allowances for doubtful accounts	(488)	(481)
	$21,236	$13,766

At December 31, 1981 and 1980, the allowance for defective returns was reduced by a cost recovery factor of $1,170,000 and $1,671,000, respectively, for products estimated to be returned subsequent to the end of the year.

NOTE 3 — INVENTORIES:

Inventories at December 31 consisted of the following:

	1981	1980
	(Amounts in thousands)	
Raw materials	$17,290	$11,870
Work-in-process	5,423	4,032
Finished goods	19,916	14,031
	$42,629	$29,933

NOTE 4 — PREPAID ADVERTISING:

During the period 1979 to 1981, the Company entered into agreements which provided for products and cash (generally 50% of the total contract) to be exchanged for media advertising. Sales for the years ended December 31, 1981, 1980 and 1979 included $2,372,000, $565,000 and $3,519,000, respectively, of shipments under these arrangements. The prepaid advertising expense resulting from these transactions was based on the fair value of the media advertising. The Company employs a process of matching advertising expense with sales revenue generated from advertised products. As a result, advertising expense is recognized as sales revenue is generated by the products advertised within the fiscal year.

NOTE 5 — PROPERTY, PLANT AND EQUIPMENT:

Property, plant and equipment at December 31 consisted of the following:

	1981	1980
	(Amounts in thousands)	
Land	$ 1,111	$ 1,103
Buildings	12,759	11,878
Machinery and equipment	24,390	20,565
Molds, dies and fixtures	12,350	11,137
Total, at cost	50,610	44,683
Less: accumulated depreciation	(30,270)	(27,814)
	$20,340	$16,869

At December 31, 1981 and 1980, machinery and equipment included $1,428,000 and $1,239,000, respectively, and accumulated depreciation included $602,000 and $443,000, respectively, relating to capitalized leases.

NOTE 6 — LEASE COMMITMENTS:

The Company and its subsidiaries are obligated, under noncancelable leases, for certain manufacturing facilities, sales offices, machinery, equipment and vehicles. These lease agreements expire at various dates through 1992. Management expects that in the normal course of business, leases that expire will be renewed or replaced by other leases. Certain leases also have purchase options.

Future minimum lease payments as of December 31, 1981 under all leases are summarized as follows:

	All Leases	Capital Leases
	(Amounts in thousands)	
Year Ended:		
December 31, 1982	$1,286	$ 352
December 31, 1983	986	246
December 31, 1984	765	232
December 31, 1985	622	231
December 31, 1986	475	224
Later Years	937	221
Total minimum payments	$5,071	1,506
Less amount representing interest and executory costs		(520)
Present value of minimum lease payments under capital leases		$ 986

Total rental expense under operating leases was as follows:

Year Ended:	
December 31, 1981	$950,000
December 31, 1980	$714,000
December 31, 1979	$594,000

In 1981 and 1980, the Company received sublease rental income of $124,000 and $83,000, respectively. Subsequent to 1981, the Company expects to receive sublease rental income of approximately $124,000 per year for a minimum period of four years.

NOTE 7 — INCOME TAXES:

The income tax provision (benefit) for the years ended December 31 consisted of the following:

	1981	1980	1979
	(Amounts in thousands)		
Current:			
Federal	$2,602	$ 6,705	$3,138
Canadian	2,578	968	
State	187	916	669
Total Current	5,367	8,589	3,807
Deferred:			
Canadian:			
Realization of Canadian tax loss carryforward benefits previously recognized for financial statement purposes		945	992
Differences between book and tax depreciation	162	113	
Other	(117)		
	45	1,058	992
Federal and State:			
Difference between book and tax depreciation	74	61	
Other	267	356	(6)
	341	417	(6)
Total Deferred	386	1,475	986
Total Provision	$5,753	$10,064	$4,793

The income tax provision for the years ended December 31, 1980 and 1979 contained charges in lieu of federal and state income taxes representing taxes which would have been required to be paid in the absence of operating loss carryforwards from 1978. The income tax benefits resulting from the utilization of the operating loss carryforwards for the years ended December 31, 1980 and 1979 have been presented as extraordinary credits totaling $3,612,000 and $3,728,000, respectively.

During 1980, the full benefit of the loss carryforwards was realized and, consequently, net deferred tax credits of $273,000 (relating principally to depreciation) as of December 31, 1979 were restored.

The differences between the Company's effective U.S. federal income tax rate and the statutory U.S. federal income tax rate for the years 1979 through 1981 were as follows:

	1981		1980		1979	
	$	%	$	%	$	%
	(Dollar amounts in thousands)					
Federal income tax provision on pre-tax income at the statutory federal rate of 46%	$3,433	46.0	$8,359	46.0	$3,565	46.0
Investment tax credits	(365)	(4.9)	(854)	(4.7)		
Federal income tax benefit of state income taxes	(100)	(1.3)	(430)	(2.4)	(309)	(4.0)
Miscellaneous	(45)	(.6)	29	.2	(124)	(1.6)
	$2,923	39.2	$7,104	39.1	$3,132	40.4

The difference between the effective Canadian income tax rates for the years 1979, 1980 and 1981 of 41.3%, 41.1% and 43.7%, respectively, and the statutory Canadian income tax rate of 46% were a result of the translation of the Canadian accounts into U.S. currency equivalents and the allowable manufacturing and inventory credits under Canadian income tax regulations. At December 31, 1981, the net undistributed earnings of subsidiaries not consolidated for U.S. income tax purposes was $11,589,000.

Income tax returns of the Company for the years 1972 through 1978 are being examined by the Internal Revenue Service, and while the examination has not been completed, the Company believes that any adjustments resulting from this examination will not have a material adverse effect on the Company's financial statements.

NOTE 8 — ACCRUED EXPENSES AND OTHER LIABILITIES:

Accrued expenses and other liabilities at December 31 consisted of the following:

	1981	1980
	(Amounts in thousands)	
Advertising	$ 3,083	$ 3,865
Payroll and other compensation	3,279	2,809
Taxes, other than income taxes	404	384
Royalties	1,275	371
Interest	210	159
Other liabilities	3,387	1,386
	$11,638	$ 8,974

NOTE 9 — DEBT:

Long-term debt at December 31 consisted of the following:

	1981	1980
	(Amounts in thousands)	
15 year term loan at 11%	$15,617	$16,183
Mortgage notes (5% to prime plus 2½%), with aggregate annual principal payments ranging from $202,000 in 1982 to $77,000 in 1989	1,053	1,258
Other obligations with aggregate annual payments of $143,000 in 1982 to $15,000 in 1989	613	200
Capitalized lease obligations	986	902
	18,269	18,543
Current portion	(1,194)	(1,044)
Total long-term debt, noncurrent portion	$17,075	$17,499

Short-term borrowings in 1981, 1980 and 1979 pursuant to the Company's revolving bank loans were as follows:

	1981	1980	1979
	(Dollar amounts in thousands)		
Average amount outstanding	$12,224	$ 6,562	$20,685
Maximum amount outstanding	$27,300	$15,154	$27,466
Average effective interest rate	18.9%	18.3%	16.6%

On June 24, 1981, the Company increased to $40,000,000 the borrowing limit under its consolidated short-term lines of credit. The primary increase took the form of a new $10,000,000 revolving loan agreement which expires December 31, 1983 providing for interest at a rate of 1% over the London InterBank Offered Rate (LIBOR) and a commitment fee of ½% on the unused portion of the line. In addition, the Company modified its existing revolving bank loan agreements to reduce the maximum interest rate to 1¼% over the prime rate, to extend the expiration date to April 1, 1983, and to provide for a $10,000,000 line of banker's acceptances and letters of credit. The lines of credit, which include the Company's outstanding letters of credit, are limited by a collateral formula, which is based upon levels of accounts receivable as defined in the agreements. The Company anticipates modifying its revolving bank loan agreements in 1982 to increase the amount of borrowings permitted.

On March 8, 1979, the Company borrowed $17,000,000 pursuant to a 15 year term loan agreement ("15 year term loan"). This loan (90% of which is guaranteed by the Farmers Home Administration) bears interest at 11% and is to be repaid by annual principal payments ranging from $632,000 in 1982 to $2,100,000 in 1994. The proceeds of this borrowing were used to refinance a term loan of $12,625,000 (including $5,250,000 current portion) outstanding at December 31, 1978, and to repay $4,375,000 of short-term borrowings under the revolving bank loan.

The long-term and short-term debt is collateralized by the Company's assets. The loan agreements contain various covenants including maintenance of working capital and net worth and a limit on fixed asset additions. These agreements also limit the payment of cash dividends to $750,000 plus 25% of net earnings subsequent to January 1, 1981. There were no compensating balance requirements under these borrowing arrangements.

Aggregate maturities of long-term debt at December 31, 1981, excluding capitalized lease obligations, are: 1983 — $1,073,000; 1984 — $1,024,000; 1985 — $1,089,000; 1986 — $1,127,000; 1987 — $1,224,000; 1988 through 1992 — $6,015,000; and 1993 through 1994 — $4,753,000.

NOTE 10 — CONTINGENCIES:

On September 14, 1979, Coleco Industries, Inc. filed an action against Mattel, Inc. seeking a declaratory judgment that Mattel Patent No. 4,162,792 is invalid and that, even if it were valid, Coleco's electronic football games do not infringe the patent. On September 28, 1979, Mattel filed a counterclaim alleging that Coleco's electronic football games infringed the patent and asked the Court for injunctive relief and an accounting for damages.

Even if Mattel were to be successful in the litigation, the Company believes that the marketing of its electronic football games will not be adversely affected because of the availability to the Company of technology outside the scope of the Mattel patent. However, because sales of electronic football games represented a substantial portion of total sales of the Company's Family Leisure Games and Toys segment in 1979 and 1980, in the event that Mattel were successful any damages assessed could adversely affect the Company. In the opinion of the Company's patent counsel, Mattel's patent should be held invalid by the Court.

On February 10, 1981, the Company was issued patents covering certain features of its *Electronic Quarterback* and *Head To Head* games. On February 10, 1981, the Company filed patent infringement actions against several competitors including Mattel, Inc. and Entex Industries, Inc. On November 4, 1981, the Company together with Midway Mfg. Co., a subsidiary of Bally Mfg. Co., settled all actions with Entex Industries, Inc. and entered into a License Agreement with Entex.

The agreement granted Entex the limited right during 1981, only, to sell a limited number of units of Entex's *Pac-Man* and/or *Galaxian* electronic hand held games.

The Company is also involved in a number of lawsuits incidental to its business. In the opinion of management, such proceedings in the aggregate, including the Mattel litigation, will not have a material adverse effect on the Company's consolidated financial position.

At December 31, 1981 and 1980, the Company was contingently liable for outstanding letters of credit in the amounts of $823,000 and $610,000, respectively.

NOTE 11 — COMMON STOCK AND CAPITAL IN EXCESS OF PAR VALUE:

Changes in common stock issued and capital in excess of par value were as follows:

	Common Stock $1 par value	Capital in excess of par value
	(Amounts in thousands)	
Balance — December 31, 1978	$6,884	$ 7,427
Stock options exercised	5	3
Compensation attributable to Incentive Stock Option Plan		3
Balance — December 31, 1979	6,889	7,433
Stock options exercised	76	174
Common stock issued	550	4,891
Compensation attributable to Incentive Stock Option Plan		5
Balance — December 31, 1980	7,515	12,503
Stock options exercised	134	434
Compensation attributable to Incentive Stock Option Plan		5
Balance — December 31, 1981	$7,649	$12,942

On October 8, 1980, the Company completed a public offering of 550,000 shares of its common stock at $10.875 per share. The net proceeds of the offering ($5,441,000) were used to prepay a term loan ($5,000,000) and a portion of short-term debt ($441,000) under the Company's revolving bank loan agreements.

Earnings per share, before the extraordinary credit on a pro forma basis for the year ended December 31, 1980, assuming that the 550,000 shares issued in connection with the public offering had been outstanding since the beginning of the year would have been $1.76. The pro forma earnings per share calculations reflect the reduction in interest expense that would have occurred if the proceeds from the public offering had been used to retire bank debt as of the beginning of the year.

NOTE 12 — STOCK OPTIONS:

On June 1, 1981, the Company adopted a Long-Term Incentive Plan for all officers and key employees of the Company which provides for various types of awards. These awards may include nonqualified stock options with or without related stock appreciation rights, performance units, restricted stock or options for restricted stock. A total of 350,000 shares are available for award. At December 31, 1981 no awards had been made under the plan.

Options granted under the Company's 1973 Qualified Stock Option Plan expired by operation of law on May 21, 1981. Qualified stock options were granted at prices equal to 100% of the fair market value of the common stock on the date of grant. Changes under the Company's 1973 Qualified Stock Option Plan were as follows:

	Number of Shares	Option Price Per Share	Option Price Total
Options outstanding at December 31, 1979	226,250	$3.06 - $ 6.94	$928,000
Granted	25,000	$4.75 - $11.88	227,000
Exercised	(65,700)	$3.06 - $ 5.19	(223,000)
Canceled	(19,300)	$3.06 - $ 6.57	(84,000)
Options outstanding at December 31, 1980	166,250	$3.38 - $11.88	848,000
Exercised	(126,500)	$3.38 - $ 8.31	(544,000)
Canceled	(7,500)	$11.81	(89,000)
Expired	(32,250)	$4.25 - $11.88	(215,000)
Options outstanding at December 31, 1981	0		$ 0

Options to purchase 4,750 shares were exercised during 1979 at prices between $1.57 and $2.00 per share.

Under the Company's 1971 Incentive Stock Option Plan, the Board of Directors was able to grant options to officers to purchase an aggregate of 147,852 shares of common stock at a price not less than 50% of the quoted market value at the date of grant. No options were available for future grant after December 31, 1979, as the plan expired on that date. Of the options to purchase 17,500 shares outstanding at December 31, 1979, 10,000 were exercised in 1980 at an option price of $2.63 and 7,500 were exercised in 1981 at an option price of $3.28.

For options granted under the plan, the excess of the aggregate estimated fair value at dates of grant over option prices is being charged against earnings as compensation expense over the employment terms specified in the option agreements. The excess at December 31, 1981 is not significant. Such compensation expense amounted to $5,000 in 1981 and 1980 and $3,000 in 1979.

NOTE 13 — BUSINESS SEGMENT INFORMATION:

Product Line Information — The Company's operations are conducted in two industry segments: Family Leisure Games and Toys, and Swimming Pools and Outdoor Products. A substantial portion of Family Leisure Games and Toys are manufactured for shipment all year, while a substantial portion of Swimming Pools and Outdoor Products are manufactured for shipment between late winter and midsummer. These operations are generally carried out in joint facilities and with common management; however, a significant portion of the Company's electronic games are manufactured, in whole or in part, by manfacturers in the Far East. Joint facilities are allocated on the basis of sales value of production. In other instances, where the separation of the Company's business segments is not determinable, allocations have been made based primarily upon management's judgment.

The following table sets forth selected financial information relating to industry segments for the years 1979 through 1981:

	1981	1980	1979
	(Amounts in thousands)		
Net Sales:			
Family Leisure Games and Toys	$109,946	$113,086	$ 87,992
Swimming Pools and Outdoor Products	68,085	49,821	48,503
	$178,031	$162,907	$136,495
Operating Profit Before Interest Expense:			
Family Leisure Games and Toys	$ 10,517	$ 21,825	$ 11,533
Swimming Pools and Outdoor Products	7,061	5,137	5,143
	17,578	26,962	16,676
Interest Expense	(4,470)	(3,672)	(6,082)
Operating Profit	$ 13,108	$ 23,290	$ 10,594
Identifiable Assets:			
Family Leisure Games and Toys	$ 65,242	$ 49,763	$ 32,319
Swimming Pools and Outdoor Products	30,801	26,119	21,465
	$ 96,043	$75,882	$ 53,784
Capital Expenditures:			
Family Leisure Games and Toys	$ 4,536	$ 2,774	$ 708
Swimming Pools and Outdoor Products	2,015	1,768	471
	$ 6,551	$ 4,542	$ 1,179
Depreciation Expense:			
Family Leisure Games and Toys	$ 2,072	$ 1,899	$ 2,928
Swimming Pools and Outdoor Products	928	963	1,139
	$ 3,000	$ 2,862	$ 4,067

In the Family Leisure Games and Toys segment there are three major product categories: Electronics, Toys and Games, and Ride-On Vehicles. The following table sets forth net sales information with respect to these categories for the last three years:

	1981	1980	1979
	(Amounts in thousands)		
Electronics	$ 58,148	$ 90,412	$ 63,892
Toys and Games	26,941	20,779	23,707
Ride-On Vehicles	24,857	1,895	393
	$109,946	$113,086	$ 87,992

The difference between product line identifiable assets and total assets in the consolidated balance sheet represents unallocable and corporate assets (1981-$3,352,000, 1980-$3,335,000, 1979-$2,774,000), principally goodwill and other noncurrent assets.

Geographical Information — The Company's operations are conducted primarily in the U.S. and Canada. Generally, intercompany sales are at prices normally approximating those which the selling entity is able to obtain on sales of similar products to unaffiliated customers.

The following table sets forth selected information relating to U.S. and foreign (primarily Canadian) operations, including export sales, for the years 1979 through 1981:

	1981	1980	1979
	(Amounts in thousands)		
Net Sales:			
United States	$155,679	$139,006	$115,109
Foreign	32,565	30,907	27,758
	$188,244	$169,913	$142,867
Intercompany Sales between Geographic Areas:			
United States	$ 2,403	$ 1,578	$ 2,561
Foreign	7,810	5,428	3,811
	$ 10,213	$ 7,006	$ 6,372
Net Sales to Unaffiliated Customers:			
United States	$153,276	$137,428	$112,548
Foreign	24,755	25,479	23,947
	$178,031	$162,907	$136,495
Operating Profit Before Interest Expense:			
United States	$ 12,382	$ 22,190	$ 13,453
Foreign	5,196	4,772	3,223
	17,578	26,962	16,676
Interest Expense	(4,470)	(3,672)	(6,082)
Operating Profit	$ 13,108	$ 23,290	$ 10,594
Net Income:			
United States	$ 4,325	$ 13,848	$ 7,680
Foreign	3,386	2,801	1,406
	$ 7,711	$ 16,649	$ 9,086
Identifiable Assets:			
United States	$ 77,325	$ 60,667	$ 44,109
Foreign	22,070	18,550	12,449
	$ 99,395	$ 79,217	$ 56,558
Working Capital:			
United States	$ 29,078	$ 25,585	$ 8,940
Foreign	12,086	10,809	4,585
	$ 41,164	$ 36,394	$ 13,525

NOTE 14 — PENSION PLAN:

The Company has a noncontributory pension plan covering U.S. salaried, clerical and administrative employees. Pension expense is actuarially computed and includes amortization of past service cost over a ten year period. Pension expense for the years ended December 31, 1981, 1980 and 1979 was $296,000, $268,000 and $212,000, respectively.

The Company makes annual contributions to the plan equal to the amounts accrued for pension expense. As of January 1, 1982, the Company amended its plan to provide substantial benefit improvements. Although the 1982 valuation has not been completed, the Company's actuaries estimate that 1982 pension expense will approximate $500,000.

The actuarial present value of accumulated benefits to participants of the plan and the net assets available for those benefits (at the valuation date of January 1) were as follow:

	1981	1980
	(Amounts in thousands)	
Actuarial present value of accumulated plan benefits:		
Vested	$1,006	$ 752
Nonvested	378	327
Total	$1,384	$1,079
Net assets available for benefits	$1,421	$1,132

An assumed weighted average rate of return of 8% was used for 1980 and 1981 in determining the actuarial present value of accumulated plan benefits.

NOTE 15 — SUPPLEMENTARY INFORMATION TO STATEMENT OF OPERATIONS:

	1981	1980	1979
	(Amounts in thousands)		
Advertising costs	$16,226	$14,007	$7,932
Product development costs	$ 5,568	$ 4,235	$2,373
Maintenance and repairs	$ 2,429	$ 1,727	$1,088
Royalties	$ 2,477	$ 992	$1,483
Foreign currency:			
Translation gains (losses)	$ 9	$ (98)	$ 13
Exchange gains (losses)	$ (14)	$ (16)	$ (264)

NOTE 16 — SELECTED QUARTERLY INFORMATION (Unaudited):

	1981 QUARTER ENDED					1980 QUARTER ENDED (1)				
	March 31	June 30	Sept. 30	Dec. 31	For the Year	March 31	June 30	Sept. 30	Dec. 31 (2)	For the Year
	(Amounts in thousands, except per share amounts)					(Amounts in thousands, except per share amounts)				
Net Sales	$36,570	$57,454	$49,059	$34,948	$178,031	$40,309	$49,100	$47,346	$26,152	$162,907
Gross Profit	$12,712	$21,204	$18,588	$10,355	$ 62,859	$14,785	$19,793	$19,098	$11,636	$ 65,312
Earnings (Loss) Before Taxes and Extraordinary Credit	$ 4,441	$ 7,428	$ 3,574	$ (1,979)	$ 13,464	$ 5,696	$ 8,735	$ 6,482	$ 2,188	$ 23,101
Tax Provision (Benefit)	$ 2,077	$ 3,440	$ 1,554	$ (1,318)	$ 5,753	$ 2,362	$ 4,041	$ 2,882	$ 779	$ 10,064
Extraordinary Credit						$ 1,758	$ 1,854			$ 3,612
Net Earnings (Loss)	$ 2,364	$ 3,988	$ 2,020	$ (661)	$ 7,711	$ 5,092	$ 6,548	$ 3,600	$ 1,409	$ 16,649
Per Share Results (3):										
Earnings (Loss) Before Extraordinary Credit	$ .31	$ .52	$ .27	$ (.09)	$ 1.01	$ .48	$ .68	$ .51	$ .19	$ 1.83
Utilization of Tax Loss Carryforwards						.25	.27			.50
Net Earnings (Loss)	$ .31	$ .52	$ .27	$ (.09)	$ 1.01	$ .73	$ .95	$ .51	$ .19	$ 2.33

(1) See Note 1 regarding restatement for vested vacation pay in accordance with Financial Accounting Standards Board Statement No. 43.

(2) Includes gains of $1,465,000 ($.19 per share) resulting from physical inventory and standard cost adjustments.

(3) The quarterly per share results are based on weighted average shares outstanding during the respective quarter, whereas annual results are based on weighted average shares outstanding during the entire year. On October 8, 1980, a public offering of stock (see Note 11) had the effect of significantly increasing shares outstanding at the beginning of the fourth quarter of 1980. Consequently, the sum of quarterly earnings per share for 1980 does not equal the reported earnings per share for the year.

Report Of Independent Certified Public Accountants

To the Stockholders and
Board of Directors of
Coleco Industries, Inc.:

We have examined the consolidated balance sheets of Coleco Industries, Inc. and subsidiaries at December 31, 1981 and 1980, and the related consolidated statements of operations and retained earnings and changes in financial position for the years ended December 31, 1981, 1980 and 1979. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of Coleco Industries, Inc. and subsidiaries at December 31, 1981 and 1980, and the consolidated results of their operations and changes in their financial position for the years ended December 31, 1981, 1980 and 1979, in conformity with generally accepted accounting principles applied on a consistent basis after restatement for the change, with which we concur, in the method of accounting for compensated absences as described in Note 1 to the financial statements.

Hartford, Connecticut
February 19, 1982

Coopers & Lybrand

Five Year Summary (Amounts in thousands, except per share amounts)

For the Year:	1981	1980*	1979*	1978*	1977*
Net Sales	$178,031	$162,907	$136,495	$107,011	$137,149
Cost of Goods Sold	115,172	97,595	90,354	95,086	101,410
Gross Profit	62,859	65,312	46,141	11,925	35,739
Selling and administrative expenses	45,281	38,350	29,465	31,400	29,174
Interest expense	4,470	3,672	6,082	6,733	3,293
Operating Expense	49,751	42,022	35,547	38,133	32,467
Operating Profit (Loss)	13,108	23,290	10,594	(26,208)	3,272
Other Income (Expense), Net	356	(189)	(443)	(697)	(164)
Earnings (Loss) Before Income Taxes and Extraordinary Credit	13,464	23,101	10,151	(26,905)	3,108
Income Tax Provision (Benefit)	5,753	10,064	4,793	(4,645)	1,468
Earnings (Loss) Before Extraordinary Credit	7,711	13,037	5,358	(22,260)	1,640
Extraordinary Credit Resulting from Utilization of Tax Loss Carryforwards		3,612	3,728		
Net Earnings (Loss)	$ 7,711	$ 16,649	$ 9,086	$ (22,260)	$ 1,640
Average Common Shares Outstanding	7,632	7,144	6,911	6,884	6,942
Net Earnings (Loss) Per Share:					
Earnings (Loss) Before Extraordinary Credit	$ 1.01	$ 1.83	$ .78	$ (3.24)	$ .24
Extraordinary Credit Resulting from Utilization of Tax Loss Carryforwards		.50	.54		
Net Earnings (Loss) Per Share	$ 1.01	$ 2.33	$ 1.32	$ (3.24)	$ .24
At Year-End:					
Working capital	$ 41,164	$ 36,394	$ 13,525	$ (1,510)	$ 16,271
Current ratio	2.21 to 1	2.67 to 1	1.62 to 1	.96 to 1	1.3 to 1
Inventories	$ 42,629	$ 29,933	$ 17,983	$ 17,563	$ 33,284
Average turnover	2.9 times	3.7 times	4.9 times	2.9 times	3.4 times
Accounts receivable	$ 21,236	$ 13,766	$ 12,011	$ 14,628	$ 30,143
Average days outstanding	60 days	47 days	47 days	70 days	97 days
Total assets	$ 99,395	$ 79,217	$ 56,558	$ 65,853	$ 92,693
Short-term bank debt			$ 4,167	$ 18,137	$ 21,076
Long-term debt	$ 18,269	$ 18,543	$ 18,834	$ 19,765	$ 16,508
Stockholders' equity	$ 47,467	$ 39,183	$ 16,838	$ 7,741	$ 29,995

*Restated to give effect to Financial Accounting Standards Board Statement No. 43 (see Note 1). The restatement did not have a material effect in any year. The cumulative effect on retained earnings as of January 1, 1977 was a decrease of $249,000 (net of income taxes of $208,000).

Financial Condition — 1979-1981

The financial condition of the Company has improved significantly since 1978. In 1979, working capital increased by $15.0 million from a deficit of $1.5 million to $13.5 million at year-end. The increase in working capital was primarily a result of net earnings of $9.1 million, including $3.7 million resulting from the utilization of the tax loss carryforward from 1978. In addition, $1.4 million of the working capital increase was a result of depreciation in excess of capital expenditures. The return on average stockholders' equity for 1979 was 78.3%. As a result of the Company's improved liquidity, short-term borrowing levels were reduced during 1979. Short-term debt at the end of 1979 was $4.2 million, a reduction of $14.0 million from 1978. Total bank debt at the end of 1979 was $23.0 million, including a $16.7 million term loan for 15 years at 11% which was used to refinance existing borrowings.

During 1980, working capital continued to improve, increasing by $22.9 million to $36.4 million. As in 1979, the most significant component of the increase was net earnings of $16.6 million, including $3.6 million resulting from the utilization of the tax loss carryforward from 1978. The return on average stockholders' equity in 1980 was 57.7%. Also during 1980 the Company generated $5.4 million in working capital through a public offering of common stock, its first such offering in nine years.

The continued improvement in working capital during 1980 allowed the company to repay its short-term bank debt and increase its cash position to $11.8 million by year-end. At December 31, 1980, the Company also had available a $26.0 million short-term line of credit expiring on April 1, 1982.

In 1981, the Company's working capital position improved although not at the same magnitude as in the prior two years. Working capital increased by $4.8 million to $41.2 million with net earnings continuing to provide the largest part of the increase. As an offset, working capital was reduced by $3.3 million as a result of capital expenditures in excess of depreciation. The return on average stockholders' equity in 1981 was 17.3%.

As in 1980, the Company repaid all of its short-term bank debt and had a cash position of $7.7 million by year-end. At December 31, 1981 the Company had available a $40.0 million short-term line of credit expiring in 1983.

The Company expects to modify its short-term revolving loan agreements to provide for an increased line of credit consisting of a number of financing options. The Company's effective interest rate on 1981 short-term borrowings was slightly less than the prime rate as compared with 2½% over the prime rate in 1980. The Company expects that its effective interest rate on 1982 short-term borrowings will again be less than the prime rate.

In 1982, the Company expects to continue the trends established in prior years by generating a significant portion of its additional working capital requirements internally from net earnings and using its short-term lines of credit to support interim financing requirements. The Company had no material outstanding commitments for capital expenditures at December 31, 1981.

Inflation

The rate of inflation in recent years, although abating in 1982, has caused continued deterioration of the purchasing power of the dollar. While an inflationary trend generally distorts the conventional measures of financial performance, the Company believes that its gross profit margins have improved on an inflation adjusted basis. The price of raw materials, the major cost component of the Company's product, has not increased at the same rate as inflation. The Company expects that its continuing efforts to increase productivity and control costs will lessen the impact of inflation on its future operations.

Selling price increases in both segments of the Company's business have normally been less than the inflation rate. In 1981, the change in revenues in both of the Company's industry segments was primarily a result of a change in unit volume. The Company was able to forego or limit price increases on many of its products in 1981, in part, as a result of its cost reduction program.

Results of Operations

1981 versus 1980

Net sales were $178.0 million, an increase of $15.1 million (9.3%). The increase consisted of an $18.3 million (36.7%) increase in sales of Swimming Pools and Outdoor Products partially offset by a $3.2 million (2.8%) decrease in sales of Family Leisure Games and Toys. The increase in Swimming Pools and Outdoor Products was substantially due to increased unit volume resulting from an expanded product line and more extensive television and print advertising. The decrease in sales of Family Leisure Games and Toys was primarily due to a substantial decline in sales of electronic sports games offset by significant increases in sales of other self-contained electronic games, vehicles and basic toys and games. The sales decline in electronic sports games was primarily attributable to the liquidation by competitors of excess inventory of early generation games at unusually low prices. The sales increases in the vehicle and basic toy and game categories resulted primarily from the growth of *Power Cycle* plastic tricycles and the Company's effective use of product licenses particularly for the *Power Cycle* and doll carriage lines.

Costs of goods sold was $115.2 million, an increase of $17.6 million (18.0%) as a result of higher sales volume and a change in sales mix. The overall gross profit margin declined in 1981 to 35.3% compared with 1980's 40.1% reflecting a change in sales mix in which sales of higher margin electronic products decreased. However, margins in all other categories increased in 1981 as compared to 1980.

Selling and administrative expenses were $45.3 million, an increase of $6.9 million (18.1%). The increase resulted primarily from higher advertising expenses consistent with the Company's decision to expand its television advertising program and from the significant change in sales mix. Increases in licensing fees, freight, distribution and selling expenses were attributable principally to the sales mix change. Selling and administrative expenses as a percent of net sales increased to 25.4% from 23.5% in 1980.

Interest expense was $4.5 million, an increase of $.8 million (21.8%). The increase resulted from significantly higher average short-term borrowing levels and a significant increase in the average prime rate.

Product development costs increased by $1.3 million (31.5%) to $5.6 million as the Company continued to devote more resources to the development and introduction of new products. Maintenance and repair expenses increased by $.7 million (40.6%) as a result of expanded manufacturing capacity utilization. Royalties increased by $1.5 million (149.7%) due to the Company's increased use of product licenses.

As a result of the foregoing, earnings before income taxes declined by $9.6 million (41.7%) to $13.5 million. The provision for income taxes was $5.8 million, a decrease of $4.3 million. Net earnings decreased by $5.3 million to $7.7 million before giving effect to an extraordinary credit of $3.6 million realized in 1980 resulting from the utilization of the remaining tax loss carryforwards from 1978.

1980 versus 1979

Net sales were $162.9 million, an increase of $26.4 million (19.4%). The increase consisted of a $25.1 million (28.5%) increase in sales of Family Leisure Games and Toys and a $1.3 million (2.7%) increase in sales of Swimming Pools and Outdoor Products. The increase in sales of Family Leisure Games and Toys was primarily attributable to increased unit volume of electronic products, especially the *Head To Head* series of games, most of which were in their second year of production. In addition, the Company introduced a new line of plastic tricycles in mid-1980. The sales increase in Swimming Pools and Outdoor Products was substantially a result of increased selling prices.

Cost of goods sold was $97.6 million, an increase of $7.2 million (8.0%).Expressed as a percentage of net sales, cost of goods sold decreased from 66.2% to 59.9%. While this change reflected increased sales of higher margin electronic products, higher margins were achieved in all product areas in part as a result of operating efficiencies and continued vertical integration of certain manufacturing processes. Consequently gross profit as a percent of net sales increased to 40.1% from 33.8%.

Selling and administrative expenses were $38.4 million, an increase of $8.9 million (30.2%), primarily consisting of a $6.1 million (76.6%) increase in advertising expenses consistent with the Company's plan to advertise its products more extensively in 1980 than in prior years. The other increases were accounted for by expenses which vary directly with sales volume, such as commissions and selling expenses. Selling and administrative expenses as a percent of net sales increased to 23.5% from 21.6%.

Interest expense was $3.7 million, a decrease of $2.4 million (39.6%). The increase in the average cost of borrowing during the year was more than offset by reduced borrowing levels due to the ability of the Company to generate more of its working capital requirements internally as well as a $5.4 million issuance of common stock. In October 1980, the Company paid off the balance of its short-term debt and by year-end had approximately $11.8 million invested at interest rates up to 19%.

Depreciation and amortization expense decreased by $1.1 million (25.4%) due primarily to a lower level of fixed asset additions since 1977 and accelerated depreciation of certain assets related to electronic video game products acquired in 1977 and 1978. Maintenance and repair expenses increased $.6 million (58.7%) mainly as a result of the increase in the utilization of the Company's manufacturing facilities. Product development costs increased by $1.9 million (78.5%) due to the Company's continuing program of development and introduction of new products, as well as improvements of existing products in both industry segments.

As a result of the foregoing, earnings before income taxes increased by $13.0 million (127.6%) to $23.1 million. The provision for income taxes was $10.1 million, an increase of $5.3 million (110.0%) and represents, in part, taxes which would have been required in the absence of operating loss carryforwards from 1978. An extraordinary credit of $3.6 million, resulting from the utilization of remaining tax loss carryforwards, was realized. Net earnings increased by $7.6 million (83.2%) to $16.6 million.

1979 versus 1978

Net sales were $136.5 million, an increase of $29.5 million (27.6%). The increase consisted of a $28.1 million (47.0%) increase in sales of Family Leisure Games and Toys and a $1.4 million (2.9%) increase in sales of Swimming Pools and Outdoor Products. The sales increase in Family Leisure Games and Toys was attributable to demand for the Company's electronic products, especially the *Electronic Quarterback* game and the newly introduced *Head To Head* series of games, which more than offset the decline in sales of nonelectronic products in this segment.

Cost of goods sold was $90.4 million, a decrease of $4.7 million (5.0%). Included in cost of goods sold in 1978 were nonrecurring costs of $19.3 million resulting from sales below cost, fulfillments of purchase commitments, additional returns and write downs in value of 1977 video products, offset by $4.6 million related sales revenue, resulting in a loss from 1977 video products of $14.7 million. Excluding these charges from the 1978 results, cost of goods sold increased by $14.6 million (19.2%). As a percentage of net sales, cost of goods sold (excluding the 1978 charges) decreased from 74.0% to 66.2%, reflecting the rising sales of higher margin electronic games both on an absolute basis and as a percentage of total Company sales. Consequently, gross profit as a percent of net sales increased to 33.8% from 26.0% (excluding the 1978 video game related charges).

Selling and administrative expenses were $29.5 million, a decrease of $1.9 million (6.2%). Advertising expenses decreased $1.1 million (11.6%) due largely to the nonrecurrence of advertising expense required to stimulate consumer purchases of unsold retail inventories of 1977 video game products. Royalty expense decreased by $.3 million (16.9%) as a result of reduced sales of items under license. Commissions and selling expenses increased by $.4 million (8.5%) primarily resulting from the increased sales volume. All other selling and administrative expenses decreased by $.9 million (6.3%) as a result of cost reduction efforts initiated in 1978 and continued in 1979.

Interest expense was $6.1 million, a decrease of $.6 million (9.7%) due to lower average borrowing levels, reduced effective interest rates and a refinancing of certain bank borrowings with the proceeds of a lower cost bank term loan.

Depreciation and amortization expense decreased by $.9 million (16.7%) due primarily to the nonrecurrence in 1979 of the $.5 million accelerated depreciation of certain assets related to electronic video game products and the $.3 million accelerated amortization of goodwill, both of which were recorded in 1978. Maintenance and repair expenses decreased $.4 million (26.0%) mainly as a result of a reduction in repair expenses related to molds and dies.

As a result of the foregoing, earnings before income taxes improved by $37.1 million to $10.2 million in 1979. The provision for income taxes was $4.8 million in 1979, compared with a credit of $4.6 million in 1978. The 1979 income tax provision represents taxes which would have been required in the absence of operating loss carryforwards from 1978. The recognition in 1979 of such carryforwards was recorded as a $3.7 million extraordinary credit. Net earnings improved by $31.3 million to $9.1 million in 1979.

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