COLECO

Annual Report 1984

Coleco Industries, Inc.

About Coleco

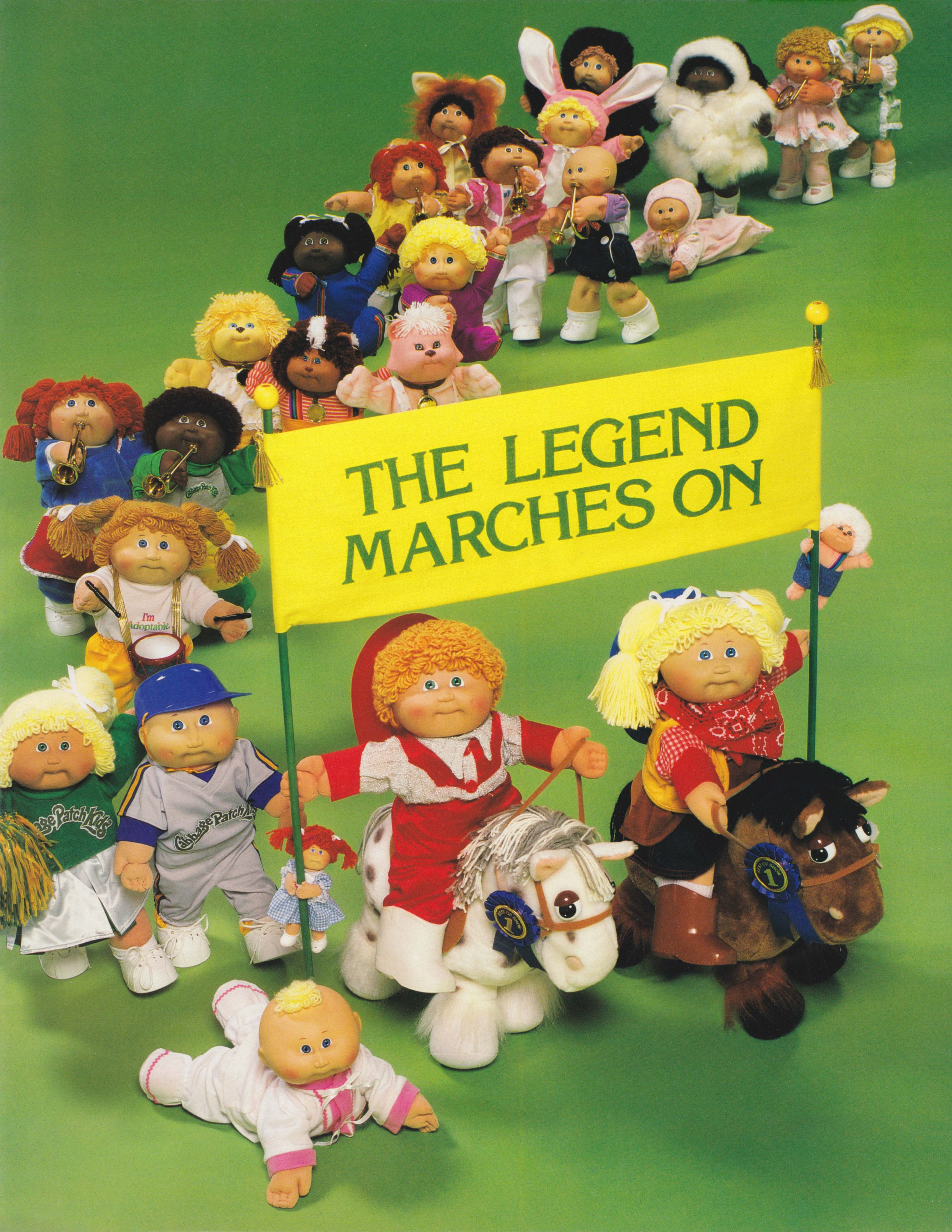
Coleco Industries, Inc. is a leading manufacturer of toys and entertainment products for the family.

Coleco markets *Cabbage Patch Kids* dolls and related accessories, *Sectaurs* action figures, a broad variety of ride-on vehicles for children, plastic wading pools, children's backyard play and furniture products and other traditional toys.

Manufacturing and distribution facilities in the United States and Canada now total approximately 3 million square feet, and average employment during 1984 was approximately 6,000 people.

Coleco believes that the toy industry offers an opportunity for substantial additional growth, and plans to broaden the base of its business through continued development of existing product lines and introduction of new product categories.

Contents:


THE LEGEND
MARCHES ON
I'm
Adoptable

Management Report

Summary

Sales of *Cabbage Patch Kids* products of more than $540 million led our Toy segment to a year of record sales and operating profit. However, losses in our Consumer Electronics segment more than offset Toy segment profit and resulted in a substantial loss for 1984.

Through the continued expansion of our *Cabbage Patch Kids* line and major new product introductions, Coleco plans to continue to strengthen the strategic foundation of its business and maintain its important position as a toy industry leader.

Operating Results

Sales for 1984 were $774.9 million, an increase of 30% over 1983 sales of $596.5 million. The Company incurred a loss of $79.8 million for the year compared with a loss of $7.4 million in 1983.

Due to the loss in 1984, the Company has available substantial tax loss carryforwards for financial reporting purposes which will be used to offset future federal income tax liabilities (see Note 3 to the Consolidated Financial Statements).

Coleco's Toy segment enjoyed record sales of $676.3 million, three and one-half times as great as 1983 sales of $192.6 million. Operating profit for the Toy segment was $208.6 million in 1984 compared with $17 million in 1983, and we believe represented one of the highest levels of operating profit ever enjoyed by any toy company. Sales of *Cabbage Patch Kids* products were more than $540 million, 8 times the 1983 level of $67 million, and were primarily responsible for the strong performance. Licensing income of approximately $13 million was earned from sales of *Cabbage Patch Kids* products sold by other manufacturers throughout the world.

Sales in the Consumer Electronics segment were $98.6 million in 1984, well below sales of $403.9 million in 1983. An operating loss of $140 million and a loss from the disposition of the *ADAM Family Computer System* of $118.6 million resulted primarily from the sale of *ADAM* inventory at prices well below cost and the writedown in value of accounts receivable, inventories, other current assets and plant and equipment. These 1984 operating results also provide for costs associated with the disposition of *ADAM* which are expected to occur in 1985.

The Company has contracted to sell its year-end *ADAM* inventory of $24.7 million and expects to conclude shipments during 1985. After having been written down to the anticipated level of collectibility in 1985, *ADAM* accounts receivable were $18.7 million, less than 10% of total accounts receivable.

Operating Summary

(Amounts in millions)	**1984**	1983
Net Sales:		
Toys	**$ 676.3**	$192.6
Consumer Electronics	**98.6**	403.9
	$ 774.9	$596.5
Operating Profit — Toys	**$ 208.6**	$ 17.0
Operating Loss — Consumer Electronics	**$(140.0)**	$(22.3)
Loss from Disposition of *ADAM*	**$(118.6)**	
Net Loss	**$ (79.8)**	$ (7.4)

After writedowns, the total of *ColecoVision* inventory and accounts receivable was $40.5 million at December 31, 1984. During 1985 it is expected that year-end accounts receivable will be converted to cash and the balance of *ColecoVision* inventory sold.

As a result of the 1984 loss, the Company's working capital has been reduced by $26.5 million to $81.3 million. Although net worth declined to $10.5 million at year-end, it increased substantially as a result of 1985 first quarter earnings. Strengthening Coleco's capital position are subordinated debentures totaling $105.1 million, of which $52.8 million was sold in the summer of 1984. The debenture sale helped the Company reduce short-term bank debt by $60.4 million to the level of $106 million at year-end. Current operating results have enabled the Company to further reduce bank debt by approximately $40 million since the beginning of 1985.

An agreement has been concluded with the Company's banking group to extend the present credit facility through the end of this year and to amend the agreement to reflect 1984 operating results. The current agreement should provide adequate resources to enable Coleco to achieve its operating objectives for 1985.

The Company's subsidiary, Coleco (Canada) Limited, continues as the leading toy company in Canada. Sales in 1984 were $102.5 million compared with sales of $98.7 million in 1983, and the subsidiary was marginally profitable for the year.

Marketing Review

During 1984 the demand for *Cabbage Patch Kids* products continued to accelerate and was far from satisfied even though Coleco delivered nearly 20 million *Cabbage Patch Kids, Preemies* and *'Koosas.* That large base of dolls supports an accessory business which accounted for approximately 25% of Coleco's 1984 *Cabbage Patch Kids* sales.

Sales of Coleco's other toy products, including plastic pools, inflatable water toys, backyard play and furniture items, ride-on vehicles and other traditional toys exceeded $130 million in 1984.

Early in 1985 Coleco announced its withdrawal from the home computer business and the disposition of its *ADAM* inventory. Retail sales of *ADAM* had increased significantly during the fourth quarter of 1984 as a result of price reductions and other promotional programs, as well as favorable reaction from consumers and professional reviewers to the system and its software. However, unstable conditions in the home computer marketplace, including rapidly changing consumer preferences, frequent technological developments, overproduction and significant price cutting were continuing to create an unusually volatile business environment. It was no longer in the Company's best interests to continue to incur the significant costs and risks necessary to keep *ADAM* competitive, and the Company accordingly contracted to sell its complete inventory of *ADAM* hardware, peripherals and software at prices below cost.

Toy Industry Opportunities

The toy industry enjoyed its strongest year in 1984. Manufacturers' shipments of toy products (excluding video games and home computers) increased by about 50% to over $8 billion, and retail sales rose to approximately $12 billion.

Major toy companies are increasingly creating complete product concepts that can be developed into multi-product lines, rather than introducing individual products. Increases in sales volume have tended to be concentrated within these product concepts, and this trend has measurably benefited the companies developing them. Licensing is also playing a key role in this expansion, as approximately 50% of all toys on the market are licensed items. At the same time large toy retail chains are commanding a larger percentage of retail sales and are gradually reducing the seasonality of overall industry sales.

Further strengthening the industry are favorable demographic and sociological trends. The number of children under the age of 5 is expected to rise to 19.2 million by 1990, a gain of 10.3% over the 1982 number. The number of 5 to 9 year olds is expected to increase by 16.3% over the same period. Almost half of the babies born between now and 1990 will be first births, and parents and grandparents have been found to spend substantially more on toys for a first child.

Toy spending per child is also increasing considerably. In part this is due to the rising number of two income households, resulting in greater discretionary income. This trend toward increased toy spending is also influenced by the growth in extended families and multiple gift giving, arising from larger numbers of divorces and remarriages.

All of these trends provide Coleco with attractive opportunities for growth by broadening the base of its business through the development of product concepts in high volume toy categories.

Independent research studies conducted by Market Facts, Inc. have indicated that the market for *Cabbage Patch Kids* products is continuing to expand with boys, older children and adults constituting an important segment of the market. Studies also show that *Cabbage Patch Kids* owners are expressing a high degree of interest in purchasing both additional *Cabbage Patch Kids* and accessory items.

For 1985 Coleco has expanded its *Cabbage Patch Kids* line to include a variety of new dolls and accessory items (described on pages 6-8). Trade response to the *Cabbage Patch Kids* line continues to be particularly positive, and major customers have indicated that they expect to do even more *Cabbage Patch Kids* business this year than last.

Coleco has also introduced its line of *Sectaurs* action figures (described on page 9), which combine an unusual science fiction concept with a unique "hands-in-play" feature that allows the child to totally control the figure's movement. *Sectaurs* are considered one of the most exciting new entries into the male action figure category, which is the second fastest growing segment in the toy industry (behind dolls and accessories).

Sectaurs have received an extremely enthusiastic trade response and provide the basis for additional product development and lucrative licensing opportunities.

Executive Officer Changes

In February 1985, Coleco appointed David J. Ruggles Executive Vice President–Finance and Chief Financial Officer. Ruggles came to Coleco with 24 years of diversified experience in financial management, and was most recently Vice President and Chief Financial Officer of Pneumo Corporation.

Earlier this year, Melvin Y. Gershman, Vice Chairman of the Company, retired after 35 years of service. Gershman played a significant part in developing Coleco's recreational products business, and through his commitment and effort made an important contribution to the Company's growth. Although he also resigned as a member of the Board of Directors, he will continue to serve as a consultant to the Company.

J. Brian Clarke
Executive Vice President

Arnold C. Greenberg
President and
Chief Executive Officer

Leonard E. Greenberg
Chairman

Executive Officer Developments

At the time of the Annual Meeting of Stockholders in June, the Board of Directors plans to elect J. Brian Clarke President and Chief Operating Officer of Coleco. Arnold C. Greenberg will become Chairman and remain Chief Executive Officer, and Leonard E. Greenberg will become Chairman of the Executive Committee.

We believe that as a result of the new roles and responsibilities being assumed by the three senior executive officers of the Company, our management structure will be strengthened and Coleco will be better positioned to take advantage of opportunities for profitable growth.

Clarke is unusually well qualified for his new position, with over 17 years of varied experience at Coleco and a record of important accomplishments at the senior executive level.

He was Vice President – Marketing of Coleco's Canadian subsidiary when the Company acquired it in 1968. Over a period of years Clarke took on significant additional responsibilities and became Chairman, President and Chief Executive Officer of Coleco (Canada) Limited, developing it into the largest toy company in Canada. During this period Clarke was also Vice President – International Marketing of Coleco. He became Executive Vice President of Coleco in 1981 and was assigned increasing corporate responsibilities in the United States in preparation for this position.

We specifically acknowledge and appreciate the untiring dedication of our employees during 1984. The continued loyalty of our many suppliers, customers, bankers and stockholders has also made it possible to assure our prompt return to substantial profitability in 1985.

To one and all — thank you for your help and support. We look forward to sharing with you a profitable and satisfying future.

Arnold C. Greenberg

Arnold C. Greenberg
President and
Chief Executive Officer

Leonard E. Greenberg

Leonard E. Greenberg
Chairman

April 3, 1985

Cabbage Patch Kids

The *Cabbage Patch Kids* line has been expanded to include a variety of new dolls and an assortment of accessory and clothing items.

The *Cabbage Patch Kids* are considered one of the most successful product lines the toy industry has ever known. Their tremendous success is demonstrable not only in terms of sales and the continued acceleration of consumer demand, but in the unprecedented impact they continue to have on the American lifestyle.

Last year the *'Kids* were prominent in the Macy's Thanksgiving Day Parade, where they sang and danced with actor Tim Conway atop the *Cabbage Patch Kids* Clubhouse float. And millions of viewers enjoyed watching the *'Kids* in their first animated TV special "*Cabbage Patch Kids* First Christmas" which aired last December.

The *Cabbage Patch Kids* have already become an integral part of our culture. The magnitude of this phenomenon can best be measured by observing the depth to which people have integrated the *'Kids* into their daily lives.

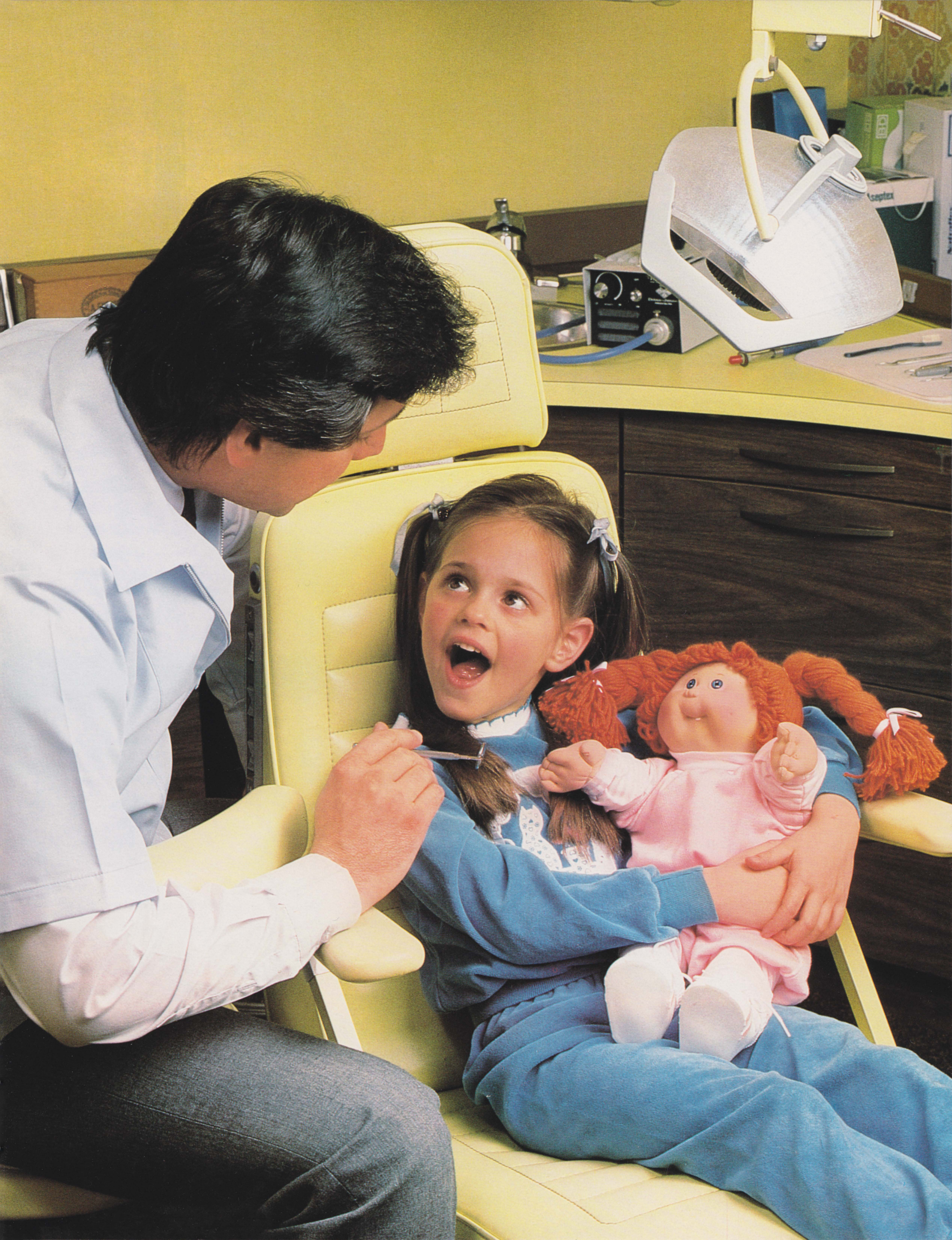
It has become accepted and expected that *Cabbage Patch Kids* go almost everywhere their "parents" go — to the theater, the dentist's office, restaurants and even to school. Independent market studies involving *Cabbage Patch Kids* owners reveal that these "parents" are exhibiting an intensity in their play never before seen in connection with a doll.

This intense involvement is also expressed by "parents" through their own initiation of *Cabbage Patch Kids* events, such as birthday parties, beauty contests and weddings for the *'Kids*. There are even those (usually adults) who are establishing themselves as *Cabbage Patch Kids* experts and are collecting dozens of *Cabbage Patch Kids* and all available accessories and memorabilia.

Many of the "parents" have proven their commitment to the *Cabbage Patch Kids* program by joining the *Cabbage Patch Kids* Parents Association. Started earlier this year, the club now has a membership ranging in age from 1 to 93, with the majority of the "parents" choosing a 3 year membership plan.

In their attempts to understand this cultural phenomenon, observers conclude that the expressed vulnerability of the dolls is the very essence of their appeal. Unlike fashion dolls, the *Cabbage Patch Kids* are not designed to be beautiful — rather, they are imperfect and different, like all of humanity.

Their waif-like faces, chubby bodies and outstretched arms elicit strong emotional responses of caring and affection, and provide an interesting mixture of fantasy and reality. While realistic in their toddler-like appearance, the *Cabbage Patch Kids* are devoid of moving parts that can often inhibit the imaginative play of children.



The *Cabbage Patch Kids* give the child an opportunity to have a doll that is uniquely his or her own. This special experience is the basis for the development of an unusual bond between the child and the doll.

This bond is further strengthened by the adoption process, in which the child promises to be "a good and kind parent" to the *Cabbage Patch Kid*. The expression of commitment contributes to the longevity of the relationship.

It has been said that the *Cabbage Patch Kids* have an important positive effect on children — certainly in their play enjoyment, and also in their emotional development. The *Cabbage Patch Kids* were of particular service to children in 1984, when Coleco engaged them in two charitable programs, both of which relied on the popularity of the *'Kids* for the attainment of their fund raising goals. Through Coleco's donations of *Cabbage Patch Kids*, over $1,000,000 was raised in the 'Share the Love' Program, benefiting the March of Dimes Birth Defects Foundation, and in the Children's Miracle Network Telethon, benefiting children's hospitals across the United States.

The *Cabbage Patch Kids* have also overcome the traditional age and sex barriers associated with doll play. Through an extensive market research survey conducted by the national research firm Market Facts, Inc. of Chicago, it has been determined that about 42% of all *Cabbage Patch Kids* "parents" are over 8 years old, 20% are over the age of 18 and approximately 15% of all owners are males.

Consumer demand for the *Cabbage Patch Kids* remains far from satisfied, even though Coleco delivered nearly 20 million *Cabbage Patch Kids, Preemies* and *'Koosas* last year. Market research studies have confirmed our belief in the continuity of the demand and reveal a high degree of interest on the part of *Cabbage Patch Kids* owners to purchase both additional *Cabbage Patch Kids* dolls and accessory items.

Coleco has expanded its *Cabbage Patch Kids* line to include a number of new dolls and accessories. In keeping with real childhood trends and occurrences, the 1985 *Cabbage Patch Kids* have updated hairstyles and clothing, and some have a first tooth or wear eye glasses. There are limited edition *Cabbage Patch Kids* Twins, sets of identical or fraternal *'Kids* wearing matching outfits and having special twin birth certificates, and *Cabbage Patch Kids* World Travelers, who have vacationed in Scotland, China, Holland, Russia or Spain and returned home wearing the native costume of the country visited.

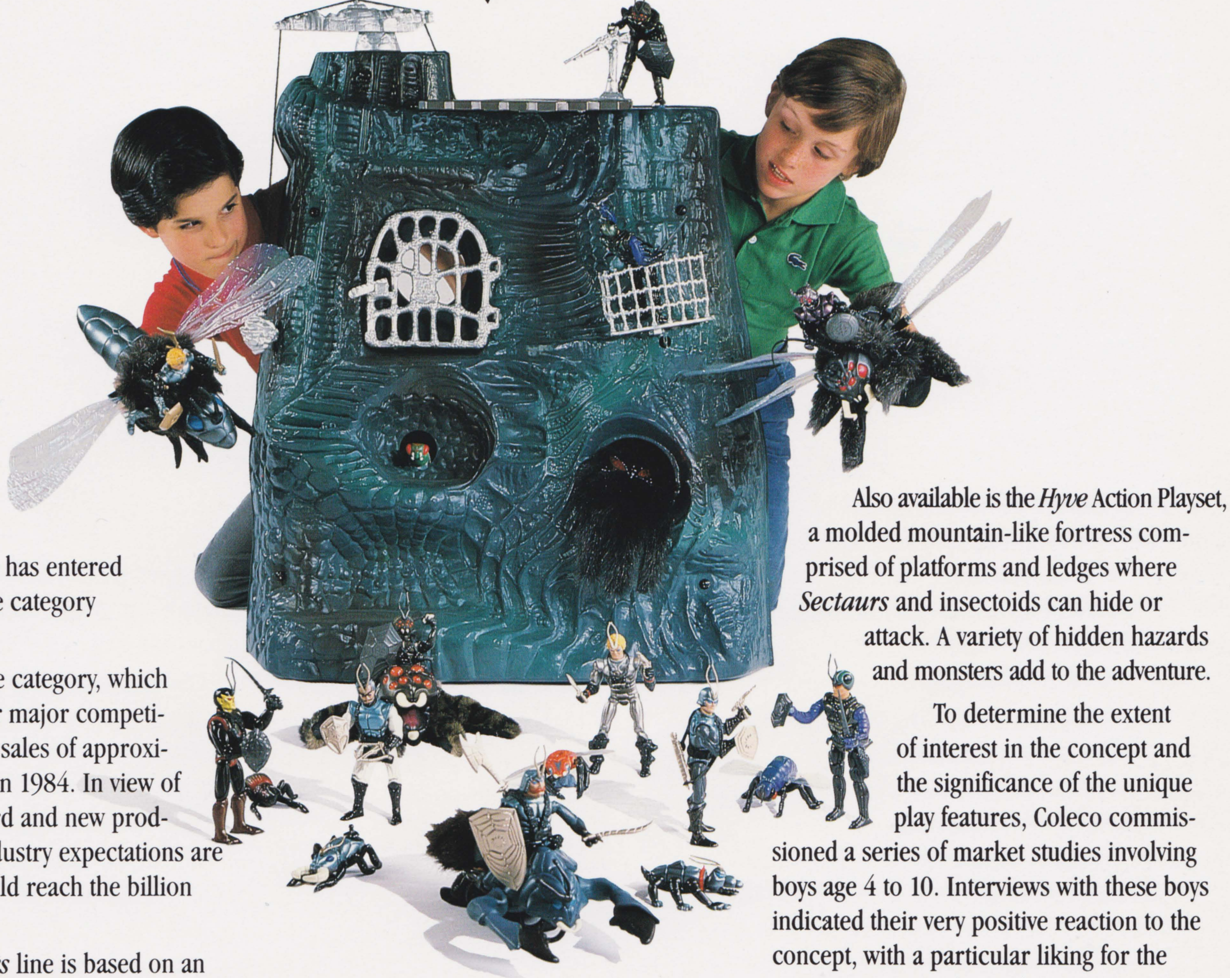
Also new for 1985 are the collectible *Cabbage Patch Kids* and *'Koosas* Playmates, miniature versions of the *'Kids* and pets which are fully dressable in their included outfits or separately purchased clothes. Accessory items are available for fantasy play with the Playmates, including a Musical Merry-Go-Round and Musical Buggy.

The *Cabbage Patch Kids* accessory line now includes "purebred" Show Ponies, complete with papers and registration certificates, as well as a new Twins Stroller, Travel Bed, Playpen and Carrier. New clothing is available for the *'Kids*, including Fun Fur coats, costume Sleepers and a wide variety of playtime and dress-up outfits.

Plans are near completion for Coleco's 1986 *Cabbage Patch Kids* line, featuring important new product introductions which will add an entirely new and exciting dimension to the *Cabbage Patch Kids* program.

Sectaurs

SECTAURS™ WARRIORS OF SYMBION™



With the 1985 introduction of the *Sectaurs* line, Coleco has entered the male action figure category of the toy industry.

This high volume category, which has also attracted our major competitors, generated retail sales of approximately $800 million in 1984. In view of the past growth record and new product introductions, industry expectations are that this category could reach the billion dollar level in 1985.

Coleco's *Sectaurs* line is based on an unusual science fiction concept involving the distant planet of *Symbion,* where genetic experiments failed long ago. The result was the development of a race of humans with some insect-like characteristics, and several species of insects of enormous size. These *Sectaurs* and insectoids have become "telebonded" — sharing resemblances, thoughts and instincts for survival. Divided into two factions — the good warriors of the Shining Realm and the evil warriors of the Dark Domain, the *Sectaurs* engage in the ultimate battle for survival.

The *Sectaurs* Flyers are different from competitive action figures in that they have a glove-like hand enclosure built into the figure which allows the child to actually control the figure's movement. They also have battery operated iridescent wings which add to the fantasy play.

The *Sectaurs* action figure line combines an unusual science fiction concept with a unique "hands-in-play" feature that allows the child to totally control the figure's movement.

Sectaurs Crawlers also feature "hands-in-play" control, but are designed for ground crawling. The *Sectaurs* Warriors come with an insectoid companion that has a particular play-action ability such as "climbing," "biting," "soaring" or "shooting."

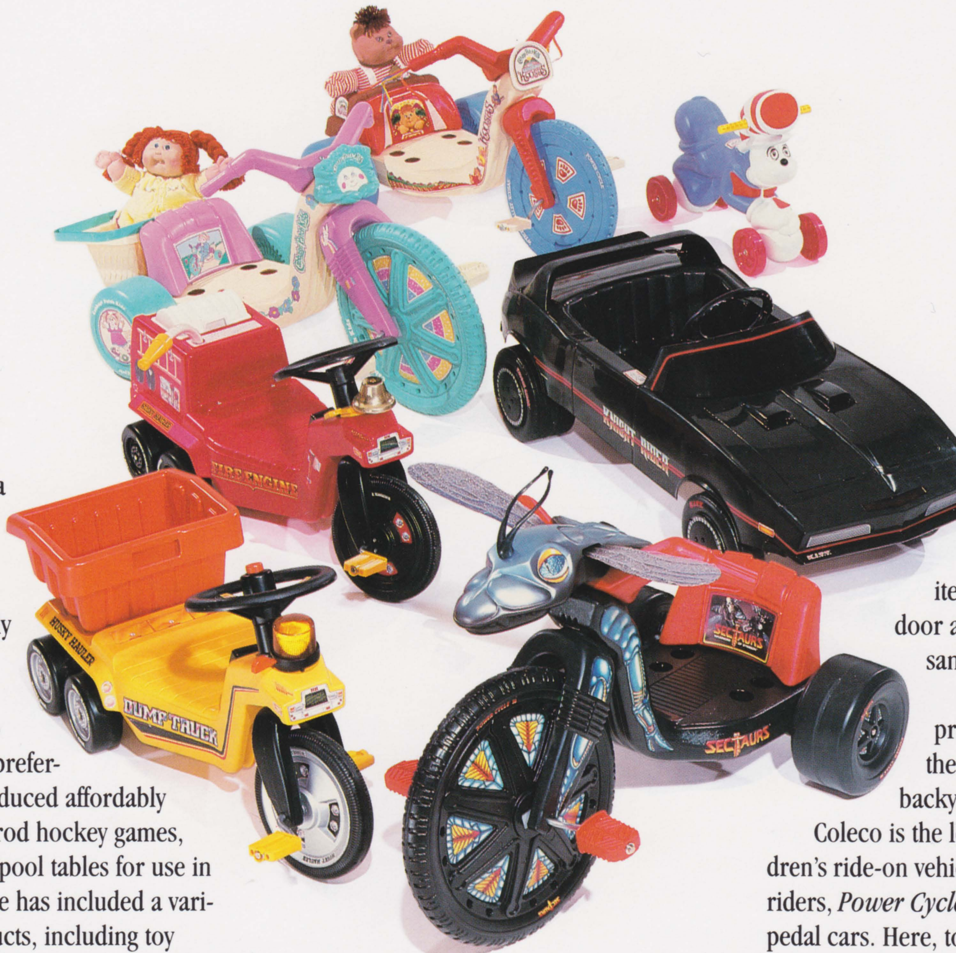
Also available is the *Hyve* Action Playset, a molded mountain-like fortress comprised of platforms and ledges where *Sectaurs* and insectoids can hide or attack. A variety of hidden hazards and monsters add to the adventure.

To determine the extent of interest in the concept and the significance of the unique play features, Coleco commissioned a series of market studies involving boys age 4 to 10. Interviews with these boys indicated their very positive reaction to the concept, with a particular liking for the *Sectaurs*/insectoids combination as a means for broad imaginative play. The boys perceived both the "hands-in-play" capability and the battery operated wings as unique features which would add dramatically to their involvement with and interest in the product.

A major advertising and promotional campaign continuing through the year will be initiated this spring when shipments of *Sectaurs* begin. This campaign will be the largest introductory program in the Company's history.

Marvel Comics Group has already published the first of its series of *Sectaurs* comic books. A two hour, live action TV special is planned for the fall.

Toys



Coleco's ride-on vehicle line includes popular licensed preschool riders, *Power Cycle* plastic tricycles, pedal cars and the *Husky Hauler* trucks.

Coleco has been a major manufacturer of a variety of traditional toys and games for decades. Frequently using the coin-operated arcade as a research laboratory to determine consumer preferences, Coleco has produced affordably priced air-action and rod hockey games, pinball machines and pool tables for use in the home. Coleco's line has included a variety of basic play products, including toy appliances, mechanical games, riding vehicles, plastic wading pools and a variety of other outdoor recreational products.

Coleco has long been the industry's largest producer of wading pools and now manufactures an extensive line of plastic and inflatable wading pools and swimming pools up to 12 feet in diameter. Included in this line is a broad range of inflatable water toys, including beach balls, swim rings, floats and accessories. The use of licensed characters such as *Cabbage Patch Kids* and *Care Bears* adds decorative appeal to these items.

The Company also makes an extensive line of children's play and backyard furniture, such as the popular *Cabbage Patch Kids* Clubhouse and the *Care Bears* Play Table and Slide. Other items include playboxes, outdoor activity centers and sandboxes. The use of licensed themes in these product groups encourages the coordination of complete backyard play environments.

Coleco is the leading producer of children's ride-on vehicles, including preschool riders, *Power Cycle* plastic tricycles and pedal cars. Here, too, Coleco integrates the appeal of licenses into the design of the ride-ons, creating products with appropriate and meaningful play features. Examples include the *Cabbage Patch Kids Power Cycle,* which features a basket on the back for a *Cabbage Patch Kids* doll to ride in, and the *K.I.T.T. Knight Rider* Car, which duplicates the famous car in detail and features a recorded version of *K.I.T.T.'s* voice.

Additional licenses, including *Transformers, My Little Pony, Sesame Street* and Coleco's *Sectaurs,* are utilized throughout the ride-on line. For 1985 Coleco has introduced the *Husky Hauler* Fire Truck and Dump Truck, recognizable vehicles having a particular appeal for children. The *Husky Hauler* trucks are loaded with play features and built to withstand the toughest of use.

Coleco's plastic pools, furniture and ride-on vehicles are mass produced at the Company's upstate New York and Montreal manufacturing plants, which have extensive extrusion, vacuum forming, injection molding and blow molding capabilities. As a result the Company can produce high volume, quality plastic products efficiently and inexpensively, and can react quickly to meet seasonal demands.

Coleco's toy line also includes electronic entertainment products such as the *Coleco-Vision* video game system and its large library of entertainment and educational software. Coleco's phone series features the *Private Call* Phone for teens and the new *Cabbage Patch Kids* Phone for all *Cabbage Patch Kids* fans. Also new for 1985 is *Songster* — the portable "recording studio," a double cassette player which enables would-be vocalists to record themselves alone or along with their favorite singers or groups.

Coleco's toy line includes plastic and inflatable pools, water toys, backyard play and furniture items and other traditional toys.

Coleco's traditional toy line includes the well-known *Dr. Seuss* characters, featuring a variety of *Cat in the Hat* plush figures, as well as the *Grinch.* Coleco is currently engaged in licensing these characters to other major manufacturers for related products.

Coleco's line of den games includes *Power Jet* hockey tables, rod hockey games and pool tables. A broad line of snow products features plastic coasters, sleds and toboggans.

Coleco Industries, Inc.

Consolidated Statement of Operations

Years Ended December 31, 1984, 1983 and 1982

(Amounts in thousands, except per share data)	**1984**	1983	1982
Net Sales	**$774,860**	$596,498	$510,380
Costs and Expenses:			
Cost of goods sold	**504,650**	403,793	279,840
Selling and administrative expenses	**201,598**	197,959	135,386
Interest expense	**39,188**	19,595	9,707
Loss from disposition of *ADAM*	**118,602**		
	864,038	621,347	424,933
Earnings (Loss) Before Income Taxes	**(89,178)**	(24,849)	85,447
Income Tax Provision (Benefit)	**(9,360)**	(17,416)	40,551
Net Earnings (Loss)	**$(79,818)**	$ (7,433)	$ 44,896
Net Earnings (Loss) Per Share	**$ (4.95)**	$ (.48)	$ 2.90

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

Coleco Industries, Inc.

Consolidated Statement of Stockholders' Equity

Years Ended December 31, 1984, 1983 and 1982

(Amounts in thousands)	Common Stock	Capital in Excess of Par Value	Retained Earnings
Balances at December 31, 1981	$ 7,649	$12,942	$ 26,876
Net earnings			44,896
Two-for-one stock split	7,649	(7,649)	
Increase under long-term incentive plan		1,134	
Cumulative foreign currency translation adjustment			(844)
Balances at December 31, 1982	15,298	6,427	70,928
Net earnings (loss)			(7,433)
Issuance of common stock for subscriptions	716	(716)	
Increase under long-term incentive plan		4,324	
Foreign currency translation adjustment			(125)
Balances at December 31, 1983	16,014	10,035	63,370
Net earnings (loss)			(79,818)
Issuance of common stock for subscriptions and awards	141	(141)	
Increase under long-term incentive plan		2,439	
Foreign currency translation adjustment			(1,538)
Balances at December 31, 1984	$16,155	$12,333	$(17,986)

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

Coleco Industries, Inc.

Consolidated Balance Sheet

December 31, 1984 and 1983

(Amounts in thousands, except share data)	1984	1983
Assets		
Current Assets:		
Cash	**$ 1,506**	$ 5,931
Accounts receivable, less allowances of $53,696 and $42,549	**206,712**	158,022
Inventories	**86,474**	164,664
Income tax refund		40,200
Other current assets	**30,716**	38,273
Total current assets	**325,408**	407,090
Property, Plant and Equipment, at cost less accumulated depreciation of $43,951 and $35,649	**49,947**	58,183
Other Assets	**13,649**	12,259
	$389,004	$477,532
Liabilities and Stockholders' Equity		
Current Liabilities:		
Long-term debt — current portion	**$ 5,087**	$ 3,669
Notes payable to banks	**106,047**	166,420
Accounts payable	**86,358**	81,385
Income taxes payable	**148**	2,732
Accrued expenses	**46,458**	45,107
Total current liabilities	**244,098**	299,313
Long-Term Debt	**28,594**	26,485
Deferred Liabilities	**700**	10,028
Subordinated Debentures due 2002	**52,359**	52,287
Convertible Subordinated Debentures due 1989	**52,751**	
Stockholders' Equity:		
Preferred stock — $1 par value, 300,000 shares authorized; no shares issued		
Common stock — $1 par value, 75,000,000 shares authorized; 1984 — 16,154,704 shares issued, 1983 — 16,013,704 shares issued	**16,155**	16,014
Capital in excess of par value	**12,333**	10,035
Retained earnings (deficit)	**(17,986)**	63,370
Total stockholders' equity	**10,502**	89,419
	$389,004	$477,532

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, 1984, 1983 and 1982

(Amounts in thousands)	1984	1983	1982
Financial Resources Were Provided by:			
Net earnings (loss)	**$(79,818)**	$ (7,433)	$ 44,896
Add items not requiring working capital:			
Depreciation and amortization	**20,582**	7,655	6,028
Non-current deferred tax provision	**(9,778)**	6,953	2,189
Increase in stockholders' equity under long-term incentive plan	**2,439**	4,324	1,134
Total provided by operations	**(66,575)**	11,499	54,247
Reduction of property, plant and equipment	**1,808**	2,609	24
Proceeds from long-term debt	**60,733**	14,340	55,774
	(4,034)	28,448	110,045
Financial Resources Were Used for:			
Additions to property, plant and equipment	**13,863**	36,981	16,862
Reduction of long-term debt	**6,086**	4,461	3,749
Increase in long-term prepaid advertising	**3,000**	7,000	
Other, net	**(516)**	1,836	991
	22,433	50,278	21,602
Increase (Decrease) in Working Capital	**(26,467)**	(21,830)	88,443
Working Capital at beginning of year	**107,777**	129,607	41,164
Working Capital at end of year	**$ 81,310**	$107,777	$129,607
Changes in Working Capital Items:			
Increase (Decrease) in Current Assets:			
Cash	**$ (4,425)**	$(46,543)	$ 44,725
Accounts receivable	**48,690**	50,219	86,567
Inventories	**(78,190)**	95,515	26,520
Income tax refund	**(40,200)**	40,200	
Other current assets	**(7,557)**	16,784	17,987
(Increase) Decrease in Current Liabilities:			
Long-term debt — current portion	**(1,418)**	(65)	(2,410)
Notes payable to banks	**60,373**	(166,420)	
Accounts payable	**(4,973)**	(16,997)	(45,258)
Income taxes payable	**2,584**	7,219	(7,961)
Accrued expenses	**(1,351)**	(1,742)	(31,727)
Increase (Decrease) in Working Capital	**$(26,467)**	$ (21,830)	$ 88,443

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

Notes to Consolidated Financial Statements

Note 1 — Summary of Significant Accounting Policies:

Principles of Consolidation — The consolidated financial statements include the accounts of the Company and its subsidiaries after elimination of intercompany accounts and transactions.

Translation of Foreign Currency — In 1982, the Company changed its accounting policy for the translation of foreign currency to comply with the provisions of the Financial Accounting Standards Board's Statement No. 52. No restatement of the prior periods was made because the amounts involved were immaterial. The assets and liabilities of foreign subsidiaries are translated at the current exchange rate, and revenue and expense accounts are translated at the average exchange rate during the period. Gains or losses from foreign currency transactions are included in earnings and gains or losses from translation of foreign subsidiary financial statements are included as adjustments to retained earnings.

Accounts Receivable — The Company provides allowances for doubtful accounts, estimated returns for defective product, price reductions and discounts and other credits.

Inventories — Inventories are valued at cost, determined on the first-in, first-out method, or market, whichever is lower.

Prepaid Advertising — The Company enters into agreements under which it exchanges products and cash primarily for media advertising. Prepaid advertising is recorded based on the fair value of the Company's products and the cash exchanged and is charged to expense at such time as the advertising is utilized.

Property, Plant and Equipment — Property, plant and equipment are recorded at cost. Depreciation is provided on the straight-line method over the estimated useful lives of the related assets. Major improvements to existing plant and equipment are capitalized. Expenditures for maintenance and repairs which do not extend the useful lives of the assets are charged to expense as incurred. The costs of molds, dies and fixtures are depreciated over the estimated market life of the related products, but not more than three years. The cost of assets sold or retired and the related amounts of accumulated depreciation are eliminated from the accounts in the year of disposal, and any resulting gain or loss is included in earnings.

Product Warranties — The Company provides at the time of sale for the estimated costs to repair or replace certain electronic products which are warranted for various periods of time from the original purchase date against defective workmanship or materials.

Income Taxes — Deferred income taxes are provided for income and expense items which are recognized for tax purposes in different years than for financial reporting purposes. Investment tax credits are recorded as reductions of income tax expense in the year they are realized except for the investment tax credit resulting from a safe harbor tax lease. The Company accounts for the purchase of tax benefits in connection with safe harbor tax leases as an investment. The investment is reduced over the lease period by realized tax savings, and deferred income taxes resulting from the transaction are appropriately recorded.

Earnings Per Share — Net earnings (loss) per share of common stock is based upon the weighted average number of common shares outstanding during the respective periods, adjusted for dilutive common stock equivalents (16,140,000 shares in 1984, 15,656,000 shares in 1983 and 15,470,000 shares in 1982).

Pension — Pension costs are actuarially computed and include current service costs and the amortization of prior service costs and actuarial gains and losses over periods of up to fifteen years.

Note 2 — Loss from Disposition of *ADAM*:

At the end of 1984, the Company discontinued its *ADAM* Family Computer product line, and has contracted to sell its remaining inventory. The consolidated statement of operations for the year ended December 31, 1984 includes a provision of $118,602,000 for losses resulting from this decision. The provision is comprised of writedowns to anticipated net realizable value of inventory of $103,914,000, property, plant and equipment of $8,013,000 and receivables and other current assets of $6,675,000. The operating losses resulting from the manufacture and sale of the *ADAM* prior to the decision to terminate the product line are included in the results of the Consumer Electronics segment. *ADAM* net accounts receivable and inventory amounted to $18,728,000 and $24,748,000, respectively, at December 31, 1984.

Note 3 — Income Taxes:

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

(Amounts in thousands)	**1984**	1983	1982
Current:			
Federal		$(31,367)	$26,789
Foreign	**$ 2,350**	4,545	2,534
State	**(701)**	(2,660)	4,625
Total Current	**1,649**	(29,482)	33,948
Deferred:			
Prepaid royalties		5,208	1,213
Safe harbor tax lease		4,067	7,586
Deferred royalty income		3,242	(3,750)
Depreciation		1,741	411
Compensation under incentive plans		(1,027)	2,648
Reversal of prior year deferred tax credits	**(9,298)**		
Other	**(1,711)**	(1,165)	(1,505)
Total Deferred	**(11,009)**	12,066	6,603
Total Provision (Benefit)	**$(9,360)**	$(17,416)	$40,551

The differences between the income tax provision (benefit) and the amount computed using the statutory federal rate for years ended December 31 were as follows:

(Amounts in thousands)	**1984**		1983		1982	
	$	**%**	$	%	$	%
Income tax provision (benefit) at the statutory federal rate of 46%	**$(41,022)**	**(46.0)**	$(11,431)	(46.0)	$39,306	46.0
Research and development credits			(1,400)	(5.6)	(850)	(1.0)
Investment tax credits			(1,291)	(5.2)	(920)	(1.1)
Difference between statutory federal rate and foreign effective rate	**285**	**.3**	(1,163)	(4.7)	(469)	(.5)
State income taxes (net of federal tax benefit)	**(379)**	**(.4)**	(1,085)	(4.4)	2,440	2.9
Reversal of prior year deferred tax credits	**(9,298)**	**(10.4)**				
Operating loss and tax credit carryforwards	**40,889**	**45.9**				
Other	**165**	**.1**	(1,046)	(4.2)	1,044	1.2
	$ (9,360)	**(10.5)**	$(17,416)	(70.1)	$40,551	47.5

As a result of the loss in 1984, the Company had available for financial reporting purposes approximately $96,000,000 of operating loss and equivalent tax credit carryforwards of which approximately $20,000,000 was recognized in 1984 to reduce deferred tax credits and $76,000,000 may be used to reduce future tax liabilities through the year 1999. Operating loss carryforwards for financial reporting purposes of approximately $38,000,000 exceed carryforwards for income tax purposes of approximately $14,000,000 primarily as a result of losses recognized currently in the financial statements, substantially all of which are expected to be deducted for income tax purposes in 1985. In addition, investment tax and other credit carryforwards amounted to approximately $17,000,000 which expire in the following years: 1985-1989, $1,000,000; 1992-1996, $1,200,000; 1997-1999, $14,800,000. Utilization of the operating loss carryforwards and unused tax credits is dependent upon the Company's ability to generate sufficient taxable income during the carryforward period.

No provision is required for taxes on the undistributed earnings of subsidiaries not consolidated for domestic income tax purposes since it is the intention of the Company to reinvest such undistributed earnings in the foreign location. At December 31, 1984, the net undistributed earnings of subsidiaries not consolidated for domestic income tax purposes was $21,158,000. Foreign tax credits may be available as a reduction of domestic income taxes in the event of distribution.

Note 4 — Long-Term Obligations and Credit Lines:

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

(Amount in thousands)	1984	1983
11% Term loan due 1988	**$10,692**	$12,709
Mortgage and equipment loans due in years through 1998	**14,970**	14,781
Capitalized lease obligations	**8,019**	2,664
	33,681	30,154
Current portion	**(5,087)**	(3,669)
Long-term debt	**$28,594**	$26,485

The term loan bears interest at 11% with annual principal payments increasing from $2,251,000 in 1985 to $3,127,000 in 1988. The mortgage and equipment loans bear interest at rates up to 1% over the prime rate with annual principal payments ranging from $2,500,000 in 1985 to $326,000 in 1998. The term loan and the mortgage and equipment loans are collateralized by substantially all of the Company's domestic property, plant and equipment.

Scheduled Maturities — Aggregate annual principal payments under long-term debt (excluding capitalized leases described in Note 5) are 1985–$4,751,000, 1986–$4,993,000, 1987–$5,200,000, 1988–$5,205,000, 1989–$1,692,000.

Subordinated Debentures — In September, 1982, the Company publicly offered $60,500,000 of 14⅜% Subordinated Debentures due 2002. The Debentures were issued at 89.39% of face value resulting in a yield to maturity of 16.16% with net proceeds of $52,215,000 after deducting underwriting discount and other issue costs. The Debentures are redeemable at any time at the option of the Company, except that they may not be redeemed prior to November 1, 1987 with money borrowed at an annual interest cost of less than 16.16%. Annual sinking fund requirements of $6,050,000 in cash or acquired Debentures commence in 1993.

Convertible Subordinated Debentures — On August 31, 1984, the Company placed privately $13,500,000 of 11% Convertible Subordinated Debentures due 1989 and exchanged and retired $41,500,000 of 10% Convertible Subordinated Debentures due 1989 issued in May 1984 with $41,500,000 of the new 11% Convertible Subordinated Debentures. The Company incurred issue costs of $2,458,000 which reduced the carrying value of the Debentures.

The Debentures are convertible into shares of the Company's common stock at an initial conversion price of $13.75 per share. If the entire $55,000,000 principal amount of the Debentures are converted, the Company will be required to issue 4,000,000 shares of common stock. The Company may at its option terminate the convertibility of the Debentures if the last reported sale price of the Company's common stock on the New York Stock Exchange is at least 150% of the then conversion price for twenty consecutive trading days. After such termination of convertibility the Company may at its option redeem the Debentures at par.

Credit Lines — At December 31, 1984, the Company's consolidated lines of credit totaled $142,000,000, of which $98,000,000 represented a domestic line of credit and $44,000,000 represented a line of credit of the Company's Canadian subsidiary. Subsequently, the credit agreement covering the domestic line was amended to reflect the Company's current financial condition, and the Company agreed to reduce that line of credit periodically during the year with expiration at December 31, 1985. The credit agreement covering the Canadian line expires in the third quarter of 1985. Both credit lines are expected to be renewed or replaced when they expire. Borrowings under the credit agreements range from ¾% over the LIBOR rate in Canada to 3% over the prime rate for domestic loans. The lines carry facility fees of up to ½%.

The lines of credit are collateralized by the accounts receivable and inventory of the Company. The lines of credit are limited by a collateral formula based on levels of accounts receivable as defined in the agreements. There are no compensating balance requirements under any of the borrowing agreements.

The credit agreements contain various covenants including maintenance of working capital, net worth and pretax income, ratio of debt to net worth, restrictions on unsecured indebtedness and prohibition of the payment of cash dividends.

Supplemental Information — Short-term borrowings pursuant to the Company's lines of credit were as follows:

(Amounts in thousands)	1984	1983	1982
Average amount outstanding	**$159,469**	$ 81,314	$25,262
Maximum amount outstanding	**$189,869**	$171,164	$59,779
Average effective interest rate	**13.1%**	10.3%	14.4%
Effective interest rate at end of year	**12.4%**	10.6%	

Note 5 — Leases:

The Company leases certain facilities and machinery and equipment under both capital and operating leases.

Capital leases are essentially installment purchases and expire at various dates through 1992. Amortization of assets acquired under capital leases is included with depreciation expense.

Future minimum lease payments as of December 31, 1984 under all leases with initial or remaining non-cancelable terms in excess of one year are summarized as follows:

(Amounts in thousands)	All Leases	Capital Leases
Year Ended:		
December 31, 1985	$3,915	$1,550
December 31, 1986	4,104	1,949
December 31, 1987	3,905	1,866
December 31, 1988	3,751	1,863
December 31, 1989	3,279	1,848
Subsequent years	7,803	4,078
Total minimum payments	$26,757	13,154
Less amount representing interest and executory costs		(5,135)
Present value of minimum lease payments under capital leases		$ 8,019

Rental expense under operating leases amounted to $2,461,000, $1,556,000 and $1,136,000 for the years ended December 31, 1984, 1983 and 1982, respectively.

In December, 1984, the Company's Canadian subsidiary entered into a sale and leaseback agreement for substantially all of its machinery and related equipment for a total consideration of $6,000,000. The obligation under this capital lease, which expires in June, 1992, is secured by the subsidiary's real property and a floating charge on its other assets.

The Company leases its corporate headquarters from a partnership of which Arnold C. Greenberg and Leonard E. Greenberg together own a 50% interest. The lease, entered into on August 3, 1982, is for an initial period of ten years at an annual rent of $180,900 for the first five years and $189,945 for the remaining five years plus the annual debt service of $837,528 payable by the partnership on its first mortgage. The Company has the right to extend the lease for four additional terms of five years and the right to purchase the leased premises at any time after the fifth year. Based on two independent appraisals it received, the Company believes that the annual rent under the lease is less than the rent which would be paid for similar property in the Greater Hartford area.

Note 6 — Long-Term Incentive Plan:

The 1981 Long-Term Incentive Plan for officers and key employees of the Company provides for various types of awards. These awards include stock subscription rights, restricted stock and non-qualified and incentive stock options. The number of shares authorized under the Plan is 2,000,000 of which 547,000 shares were available for award at December 31, 1984. Grants have been made as follows: Subscription Rights — 1,168,000 shares; Incentive Stock Options — 180,000 shares; Restricted Stock Awards — 105,000 shares.

Stock Subscription Rights granted under the Plan generally provide for a subscription price equal to one-third of the fair market value of the common stock on the date of grant. Changes in Stock Subscription Rights under the Plan were as follows:

(Amounts in thousands, except per share data)	Number of Shares	Subscription Price Per Share	Total
Subscription Rights outstanding at December 31, 1982	1,030	$2.96	$3,047
Granted	150	$1.00–$7.54	216
Exercised	(716)	$1.00–$2.96	(1,863)
Subscription Rights outstanding at December 31, 1983	464	$2.96–$7.54	1,400
Granted	60	$13.25	265
Exercised	(36)	$2.96–$13.25	(128)
Canceled	(72)	$2.96	(213)
Subscription Rights outstanding at December 31, 1984	416	$2.96–$13.25	$1,324

Subscription Rights represent receivables which bear interest at rates up to 12% and are generally payable in four equal annual installments through 1987.

Incentive Stock Options granted under the Plan expire in 1992 and are generally exercisable in three cumulative annual installments beginning one year after the date of grant. Options are granted at prices equal to 100% of the fair market value of the common stock on the date of grant. Changes in Incentive Stock Options were as follows:

(Amounts in thousands, except per share data)	Number of Shares	Option Price Per Share	Total
Options outstanding at December 31, 1982	77	$17.35	$1,336
Granted	3	$27.50–$37.25	92
Canceled	(8)	$17.35	(139)
Options outstanding at December 31, 1983	72	$17.35–$37.25	1,289
Granted	122	$15.69–$18.00	1,913
Canceled	(14)	$17.35	(243)
Options outstanding at December 31, 1984	180	$15.69–$37.25	$2,959

Outstanding Incentive Stock Options for 20,200 shares were exercisable at December 31, 1984.

Restricted Stock Awards made under the Plan provide for the issuance of shares two years after the date of award. In addition, shares awarded are subject to reacquisition by the Company for a period of five years from the date of award. In 1984, a Restricted Stock Award of 10,000 shares made in 1983 was canceled.

Note 7 — Pension Plans:

The Company and its Canadian subsidiary have pension plans covering substantially all of their salaried, clerical and administrative employees. Pension expense for the years ended December 31, 1984, 1983 and 1982 was $1,207,000, $813,000 and $752,000, respectively. The Company makes annual contributions to the plans equal to the amounts accrued for pension expense.

Notes to Consolidated Financial Statements

(continued)

The actuarial present value of accumulated benefits to participants of the plans and the net assets available for those benefits (at the valuation date of January 31) were as follows:

(Amounts in thousands)	1984	1983
Actuarial present value of accumulated plan benefits:		
Vested	**$3,789**	$3,002
Nonvested	**897**	429
Total	**$4,686**	$3,431
Net assets available for benefits	**$3,795**	$2,899

The maximum rate of return used in determining the actuarial present value of accumulated plan benefits was 9% in 1984 and 8½% in 1983.

Note 8 — Commitments and Contingencies:

Minimum royalty commitments and guarantees under certain licensing agreements aggregated approximately $13,600,000 at December 31, 1984 and are payable principally over a five year period.

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

At December 31, 1984 and 1983, the Company was contingently liable for outstanding letters of credit in the amounts of $1,400,000 and $4,400,000, respectively.

Note 9 — Supplementary Financial Information:

(Amounts in thousands)	1984	1983
Inventories consist of the following:		
Raw materials	**$28,494**	$ 72,657
Work-in-process	**8,162**	41,634
Finished goods	**49,818**	50,373
	$86,474	$164,664
Other current assets consist of the following:		
Prepaid advertising, less non-current portion of $10,000 and $7,000	**$20,039**	$ 20,295
Other	**10,677**	17,978
	$30,716	$ 38,273
Property, plant and equipment consists of the following:		
Land	**$ 1,187**	$ 1,178
Buildings	**25,400**	23,275
Machinery and equipment	**43,971**	46,348
Molds, dies and fixtures	**20,078**	20,133
Capital leases	**3,262**	2,898
	93,898	93,832
Less: accumulated depreciation	**(43,951)**	(35,649)
	$49,947	$ 58,183
Accrued expenses consist of the following:		
Advertising	**$13,485**	$ 10,801
Other, principally royalties and compensation	**32,973**	34,306
	$46,458	$ 45,107

(Amounts in thousands)	1984	1983	1982
Other supplementary financial information:			
Advertising expense	**$57,004**	$75,770	$46,456
Royalty expense	**$46,782**	$28,985	$27,001
Product development expense	**$24,801**	$29,083	$13,085

Note 10 — Business Segment Information:

The Company operates in two industry segments: Toys and Consumer Electronics. The Toy segment consists of dolls and accessories, ride-on vehicles, wading/splasher pools, outdoor recreational products, and toys and games. The Consumer Electronics segment consists principally of the *ADAM* Family Computer product line, discontinued at the end of 1984, and video game systems, accessories and software.

The following sets forth selected financial information relating to industry segments for the years 1982 through 1984. In instances where the segregation of the information by segment was indefinite, allocations were made primarily on the basis of segmented net sales.

(Amounts in thousands)	1984	1983	1982
Net Sales:			
Toys	**$676,336**	$192,568	$136,833
Consumer Electronics	**98,524**	403,930	373,547
	$774,860	$596,498	$510,380
Operating Profit (Loss):			
Toys	**$208,594**	$ 17,011	$ 13,671
Consumer Electronics	**(139,982)**	(22,265)	81,483
	68,612	(5,254)	95,154
Interest Expense	**(39,188)**	(19,595)	(9,707)
Loss from Disposition of *ADAM*	**(118,602)**		
Earnings (Loss) Before Income Taxes	**$(89,178)**	$(24,849)	$ 85,447
Identifiable Assets:			
Toys	**$281,177**	$119,608	$ 70,149
Consumer Electronics	**99,597**	348,650	209,649
Corporate and Unallocable	**8,230**	9,274	6,067
	$389,004	$477,532	$285,865
Capital Expenditures:			
Toys	**$ 7,451**	$ 7,024	$ 7,981
Consumer Electronics	**6,412**	29,957	8,881
	$ 13,863	$ 36,981	$ 16,862
Depreciation Expense:			
Toys	**$ 6,749**	$ 2,502	$ 3,454
Consumer Electronics	**13,100***	4,780	1,578
	$ 19,849	$ 7,282	$ 5,032

*Includes $8,013,000 of additional depreciation resulting from the disposition of *ADAM*.

Geographical Information — The Company's operations are conducted primarily in the United States and Canada. Generally, intercompany sales are at prices approximating those which the selling entity is able to obtain on sales of similar products to unaffiliated customers reduced by advertising, selling and other expenses of sale to be incurred by the purchasing entity.

The following table sets forth selected information relating to United States and foreign (primarily Canadian) operations, including export sales, for the years 1982 through 1984.

(Amounts in thousands)	**1984**	1983	1982
Net Sales:			
United States	**$707,975**	$526,051	$472,504
Foreign	**102,460**	98,652	55,470
Intergeographic	**(35,575)**	(28,205)	(17,594)
	$774,860	$596,498	$510,380
Operating Profit (Loss):			
United States	**$ 65,846**	$ (17,513)	$ 87,863
Foreign	**2,766**	12,259	7,291
	68,612	(5,254)	95,154
Interest Expense	**(39,188)**	(19,595)	(9,707)
Loss from Disposition of *ADAM*	**(118,602)**		
Earnings (Loss) Before Income Taxes	**$ (89,178)**	$ (24,849)	$ 85,447
Identifiable Assets:			
United States	**$333,193**	$420,237	$251,006
Foreign	**55,811**	57,295	34,859
	$389,004	$477,532	$285,865

Net sales to the Company's largest customer were approximately 12% of consolidated net sales in 1984.

Note 11 — Selected Quarterly Information (Unaudited):

(Amounts in thousands, except per share data)

1984 Quarter Ended	**Mar 31**	**June 30**	**Sept 29**	**Dec 31**	**For the Year**
Net Sales	**$186,104**	**$166,606**	**$181,268**	**$240,882**	**$774,860**
Gross Profit	**$ 58,393**	**$ 57,083**	**$ 75,654**	**$ 79,080**	**$270,210**
Net Earnings (Loss)	**$ 4,441**	**$ 5,138**	**$ 3,778**	**$(93,175)**	**$(79,818)**
Net Earnings (Loss) Per Share	**$ .27**	**$ .32**	**$ .23**	**$ (5.77)**	**$ (4.95)**

1983 Quarter Ended	Apr 2	July 2	Oct 1	Dec 31	For the Year
Net Sales	$180,170	$126,338	$114,480	$175,510	$596,498
Gross Profit	$ 78,574	$ 60,405	$ 46,370	$ 7,356	$192,705
Net Earnings (Loss)	$ 16,210	$ 9,065	$ 2,302	$(35,010)	$ (7,433)
Net Earnings (Loss) Per Share	$ 1.01	$ .56	$ .14	$ (2.19)	$ (.48)

Note: The fourth quarters of 1984 and 1983 were adversely affected by certain costs associated with the *ADAM* Family Computer System. See Note 2 and Management's Discussion and Analysis of Results of Operations and Financial Condition.

Note 12 — Inflation Accounting (Unaudited):

The following supplemental information is supplied in accordance with the requirements of Statement of Financial Accounting Standards No. 33 "Financial Reporting and Changing Prices", for the purpose of providing certain information about the effects of changing prices. It should be viewed as an estimate of the approximate effect of inflation, rather than as a precise measure.

In accordance with the Statement of Financial Accounting Standards No. 82 the Company has substituted historical cost/constant purchasing power information to measure the effects of inflation on the Company for current cost/constant purchasing power information as there was no material difference between the amount of income (loss) from continuing operations that would be disclosed by the two methods.

Historical cost/constant purchasing power information provides data adjusted for general inflation using the Consumer Price Index for all Urban Consumers (CPI-U) as the measure of the general inflation rate. The objective of this approach is to provide financial information in dollars of equivalent value of purchasing power (constant dollars).

The effects of inflation under the constant dollar method were determined by adjusting the historical cost of inventories, property, plant and equipment, cost of sales, and depreciation expense to average 1984 dollars by use of the CPI-U. Income taxes were not adjusted from the amount in the primary financial statements.

Statement of Income from Continuing Operations Adjusted for Changing Prices for the Year 1984

(Amounts in thousands)	As reported in Consolidated Statement of Operations	Constant Dollar (adjusted for general inflation)*
Net Sales	$774,860	$774,860
Costs and Expenses:		
Cost of goods sold (excluding depreciation)	492,814	498,453
Depreciation	19,849	21,090
Selling and administrative expenses	201,598	201,598
Interest expense	39,188	39,188
Loss from disposition of *ADAM* (excluding depreciation)	110,589	110,589
	864,038	870,918
Earnings (Loss) Before Income Taxes	(89,178)	(96,058)
Income Tax Provision (Benefit)	(9,360)	(9,360)
Net Earnings (Loss)	$(79,818)	$(86,698)
Gain from decline in purchasing power of net monetary liabilities		$ 6,339

*In average 1984 dollars.

Notes to Consolidated Financial Statements

(continued)

Five Year Comparison of Selected Supplementary Financial Data Adjusted for Effects of Changing Prices

(Amounts in thousands, except per share data)	Years Ended December 31 **1984**	1983	1982	1981	1980
Net Sales:					
Historical	**$774,860**	$596,498	$510,380	$178,031	$162,907
Adjusted for general inflation*	**$774,860**	$621,885	$549,219	$203,324	$205,350
Historical cost information adjusted for general inflation*:					
Earnings (loss) from continuing operations	**$(86,698)**	$(12,068)			
Earnings (loss) from continuing operations per common share	**$ (5.37)**	$ (.77)			
Net assets at year-end	**$ 33,477**	$112,937			
Other Information:					
Gain from decline in purchasing power of net monetary liabilities*	**$ 6,339**	$ 3,336			
Market price per common share at year-end:					
Historical	**$ 12.13**	$ 19.50	$ 18.38	$ 3.44	$ 3.94
Adjusted for general inflation*	**$ 11.96**	$ 19.99	$ 19.55	$ 3.80	$ 4.74
Average consumer price index — (CPI-U)	**311.1**	298.4	289.1	272.4	246.8

*In average 1984 dollars.

Report of Independent Certified Public Accountants

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

We have examined the consolidated balance sheet of Coleco Industries, Inc. and subsidiaries as of December 31, 1984 and 1983, and the related consolidated statements of operations, stockholders' equity and changes in financial position for each of the three years in the period ended December 31, 1984. 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 as of December 31, 1984 and 1983, and the consolidated results of their operations and the changes in their financial position for each of the three years in the period ended December 31, 1984, in conformity with generally accepted accounting principles applied on a consistent basis.

Coopers & Lybrand

Hartford, Connecticut
March 7, 1985

Coleco Industries, Inc.

Five Year Financial Summary

(Amounts in thousands, except per share data)	**1984**	1983	1982	1981	1980
Operating Data:					
Net Sales	**$774,860**	$596,498	$510,380	$178,031	$162,907
Cost of Goods Sold	**504,650**	403,793	279,840	115,172	97,595
Selling and Administrative Expenses	**201,598**	197,959	135,386	44,925	38,539
Interest Expense	**39,188**	19,595	9,707	4,470	3,672
Loss from Disposition of *ADAM*	**118,602**				
Earnings (Loss) Before Income Taxes and Extraordinary Credit	**(89,178)**	(24,849)	85,447	13,464	23,101
Income Tax Provision (Benefit)	**(9,360)**	(17,416)	40,551	5,753	10,064
Earnings (Loss) Before Extraordinary Credit	**(79,818)**	(7,433)	44,896	7,711	13,037
Extraordinary Credit Resulting from Utilization of Tax Loss Carryforwards					3,612
Net Earnings (Loss)	**$(79,818)**	$ (7,433)	$ 44,896	$ 7,711	$ 16,649
Average Common Shares Outstanding	**16,140**	15,656	15,470	15,264	14,287
Net Earnings (Loss) Per Share:					
Earnings (Loss) Before Extraordinary Credit	**$ (4.95)**	$ (.48)	$ 2.90	$ .51	$ .92
Extraordinary Credit Resulting from Utilization of Tax Loss Carryforwards					.25
Net Earnings (Loss) Per Share	**$ (4.95)**	$ (.48)	$ 2.90	$ .51	$ 1.17
Balance Sheet Data:					
Working Capital	**$ 81,310**	$107,777	$129,607	$ 41,164	$ 36,394
Current Ratio	**1.3 to 1**	1.4 to 1	2.1 to 1	2.2 to 1	2.7 to 1
Capital Expenditures	**$ 13,863**	$ 36,981	$ 16,862	$ 6,269	$ 3,838
Depreciation	**$ 19,849**	$ 7,282	$ 5,032	$ 3,000	$ 2,862
Total Assets	**$389,004**	$477,532	$285,865	$ 99,395	$ 79,217
Long-Term Obligations	**$133,704**	$ 78,772	$ 68,829	$ 17,075	$ 17,499
Stockholders' Equity	**$ 10,502**	$ 89,419	$ 92,653	$ 47,467	$ 39,183
Book Value per Common Share	**$ .65**	$ 5.58	$ 6.06	$ 3.10	$ 2.61

Management's Discussion and Analysis of Results of Operations and Financial Condition

Overview

At the end of 1984, the Company discontinued its *ADAM* Family Computer product line introduced in June, 1983, and has contracted to sell the remaining inventory. Costs associated with the manufacture and distribution of *ADAM* products during this period substantially exceeded sales revenues, resulting in significant operating losses in the Company's Consumer Electronics business segment in 1983 and 1984. The negative impact on earnings in 1984 was further increased by a provision for losses resulting from the disposition of the product line. The effect on earnings of the *ADAM* losses was substantially reduced by the *Cabbage Patch Kids* line of dolls and accessories, which resulted in record sales and earnings in the Toy segment of the Company's business in 1984.

Results of Operations

1984 Compared with 1983

Net sales in 1984 were a record $774.9 million, an increase of 30% over 1983. Toy sales increased by 251% to $676.4 million while Consumer Electronics sales decreased by 76% to $98.5 million. The increase in Toys resulted primarily from higher unit sales of *Cabbage Patch Kids* dolls and accessories. Sales of this product line exceeded $540 million in 1984 compared with approximately $67 million in 1983. The decline in sales of Consumer Electronics was primarily due to reduced sales of *ColecoVision* products. The increase in shipments of the *ADAM* Family Computer System in 1984 was largely offset by provisions for price reductions and returns recorded in the last half of the year.

Cost of goods sold increased by 25% to $504.7 million primarily as a result of increased sales volume. The Consumer Electronics segment incurred a gross margin loss in 1984 primarily as a result of high manufacturing and rework costs associated with *ADAM* and price reductions on products sold in 1983. Despite this loss, gross profit as a percent of sales increased to 35% from 32% in 1983 primarily as a result of increased sales of high margin *Cabbage Patch Kids* products.

Selling and administrative expenses increased by 2% to $201.6 million. Advertising expenses declined in 1984 primarily as a result of a reduction in the promotion of electronic products. Extensive advertising of the *Cabbage Patch Kids* line was not required as it has remained in short supply since its introduction. Other selling, distribution and promotional costs relating to the Toy segment increased in 1984 over the previous year. Royalty expense increased substantially in 1984 primarily as a result of the writeoff of certain prepaid royalty fees relating to electronics, whereas royalty income earned from the *Cabbage Patch Kids* license increased in 1984. Selling and administrative expenses as a percent of sales decreased to 26% from 33% in 1983.

As a result of the significant increase in sales of *Cabbage Patch Kids* products, operating profit of the Toy segment in 1984 increased to $208.6 million. The profitability of the Toy segment in 1984 was more than offset by the operating loss of $140.0 million from the Consumer Electronics segment and a loss of $118.6 million associated with the disposition of the *ADAM* Family Computer product line (see Note 2 to Consolidated Financial Statements). In 1983, the operating profit from the Toy segment was $17.0 million while the Consumer Electronics segment incurred an operating loss of $22.3 million.

Interest expense increased from $19.6 million to $39.2 million, primarily as a result of higher average short-term borrowings and the Convertible Subordinated Debentures issued in May and August, 1984. In addition, the average interest rate on short-term borrowings increased from 10.3% in 1983 to 13.1%.

As a result of the foregoing, the loss before income taxes increased from $24.8 million to $89.2 million in 1984. Due to a limitation on available tax loss carrybacks, the tax benefit in 1984 was only 11% of the loss. However, the tax benefit in 1983 was 70% of the loss, as substantially all available carryback benefits were utilized. The net loss for the year increased by $72.4 million over 1983 to $79.8 million.

1983 Compared with 1982

Net sales in 1983 were $596.5 million, an increase of 17% over 1982. Sales of Consumer Electronics increased by 8% to $403.9 million and sales of Toys increased by 41% to $192.6 million. The increase in Consumer Electronics resulted primarily from the introduction of the *ADAM* Family Computer System. In addition, increased shipments of *ColecoVision* substantially offset lower sales of software for competing home video game systems and portable table top arcade games. The increase in Toys was due to the successful introduction of the *Cabbage Patch Kids* line of dolls and accessories with more than three million dolls shipped in 1983.

Cost of goods sold increased by 44% to $403.8 million as a result of the high costs associated with bringing the *ADAM* Family Computer System to market and higher sales volume. The overall gross profit margin decreased from 45% to 32%. The decrease was substantially due to start-up costs, manufacturing and overhead variances and warranty costs associated with *ADAM*. Decreased sales of higher margin electronic products including home video game software also contributed to the reduced margin.

Selling and administrative expenses increased by 46% to $198.0 million. The increase was primarily due to higher advertising for electronics and product development costs principally related to *ADAM*. Selling and administrative expenses as a percent of net sales were 33% compared with 26% in 1982.

The costs associated with the introduction of *ADAM* and lower margins on other electronic products caused the operating profit of the Consumer Electronics segment to decline from $81.5 million to a loss of $22.3 million in 1983. The operating profit from the Toy segment increased from $13.7 million to $17.0 million in 1983.

Interest expense increased from $9.7 million to $19.6 million, primarily as a result of significantly higher average short-term borrowings and the 14⅜% Subordinated Debentures issued in September, 1982.

The Company sustained a loss before income taxes of $24.8 million compared with a pretax profit of $85.4 million in 1982. The provision for income taxes was a benefit of 70% compared to a provision of 48% in 1982. The full income tax benefit was realized from the carryback of the loss to prior years. The net loss of $7.4 million compared with net earnings of $44.9 million in 1982.

Financial Condition

The Company's working capital and capital structure were weakened in 1984 due to operating losses incurred in Consumer Electronics and the loss from the disposition of *ADAM*, partially offset by operating profits in Toys and the net proceeds of the Convertible Subordinated Debenture offering. At year-end, working capital was $81.3 million, a decline of $26.5 million during the year, and stockholders' equity was $10.5 million, a decline of $78.9 million.

The Company expects to improve its financial condition during 1985 through net earnings, continuing reductions in short-term debt and other management actions to reduce working capital requirements. In addition, the tax carryforwards from 1984 will be available to offset future federal income tax liabilities (see Note 3 to Consolidated Financial Statements).

Inventory levels at December 31 were as follows:

(Amounts in thousands)	**1984**	1983	1982
Inventories	**$86,474**	$164,664	$69,149

Inventories decreased by $78.2 million during 1984 or 47% since the prior year-end. *ADAM* inventories decreased by $52.9 million due to the write-down to anticipated net realizable value of the *ADAM* Family Computer System and related *ADAM* products. Year-end *ADAM* inventory of $24.7 million has been contracted for sale in 1985. Inventories of other Consumer Electronics products decreased by $36.0 million primarily as a result of lower video game system and software production volumes and the disposal and writedown of excess inventories. *ADAM* inventories were primarily responsible for the increase in inventories in 1983.

Inventories of Toys increased by $10.7 million, or 43% since the prior year-end. This increase was due to significantly higher volumes in the Toy segment compared with 1983, primarily as a result of the *Cabbage Patch Kids* product line. In 1985, the Company anticipates that higher levels of Toy inventories will be required during the year than at year-end, with a seasonal peak expected during the latter half of the year.

Accounts receivable and the related allowances were as follows:

(Amounts in thousands)	**1984**	1983	1982
Accounts Receivable	**$260,408**	$200,571	$163,244
Allowances	**(53,696)**	(42,549)	(55,441)
Net Accounts Receivable	**$206,712**	$158,022	$107,803

Accounts receivable increased by $59.8 million over 1983 primarily as a result of substantially increased fourth quarter volume.

The Company establishes allowances against accounts receivable for doubtful accounts, defective returns, price reductions and discounts and other credits. Allowances are accumulated throughout the year based on sales levels for the Company's products and generally are at their highest levels at year-end. Allowances as a percentage of accounts receivable were approximately the same at the end of 1984 as they were at December 31, 1983, as a result of the change in sales mix in favor of *Cabbage Patch Kids* products which require lower allowances, offset by provisions for expected returns and price reductions in the Consumer Electronics segment.

The decrease in allowance levels in 1983 compared with 1982 primarily reflects the establishment of a warranty repair program for Consumer Electronics products, as a result of which the allowance for defective returns declined and the warranty liability increased.

At year-end 1983, the Company had an income tax refund receivable of $40.2 million which was collected in 1984.

Capital expenditures (including capitalized lease acquisitions) were $13.9 million in 1984 and $37.0 million in 1983. Capital spending in 1983 included spending related to production of the *ADAM* Family Computer. The Company's continuing product lines require lower levels of investment in capital equipment due to the production processes and the fact that a significant portion of these items are produced by contract manufacturers. The Company expects 1985 expenditures will approximate 1984 levels.

At December 31, 1984 the Company's consolidated lines of credit totaled $142.0 million. Notes payable to banks decreased by $60.4 million during the year to $106.0 million at year-end, primarily due to net proceeds of the Convertible Subordinated Debentures.

Subsequent to December 31, 1984, the agreement covering the Company's domestic line of credit was amended to require periodic reductions in amounts outstanding thereunder, with expiration of the agreement at December 31, 1985 (see Note 4 to Consolidated Financial Statements).

During 1984 the Company's cash resources were constrained due to the high levels of *ADAM* inventory and accounts receivable. The Company's withdrawal from the home computer business and the diminished importance of Consumer Electronics are expected to reduce working capital requirements and eliminate erosion of working capital due to operating losses in that segment.

The Company has emphasized the management of working capital in order to minimize funds required in the business and to achieve its operating and financial objectives. The *Cabbage Patch Kids* product line is expected to provide a substantial portion of the Company's profit and cash flow. Levels of short-term debt were reduced substantially in 1984 and a further significant decline and reduced reliance thereon are expected in 1985. The Company believes its credit facilities will be sufficient to satisfy operating requirements and expects to renew or replace the credit agreements when they expire.

The Company plans to finance future operations, a portion of which have seasonal working capital requirements, through a combination of net earnings, long-term debt and short-term credit facilities.

Common Stock Information

The Company's common stock is listed on the New York and Toronto Stock Exchanges (trading symbol "CLO"). The following table sets forth the range of reported high and low sale prices of the stock on the New York Stock Exchange for the periods indicated:

		High	Low
1984	**1st Quarter**	**22 1/8**	**10 1/8**
	2nd Quarter	**16 3/4**	**11 1/2**
	3rd Quarter	**16 3/4**	**9 5/8**
	4th Quarter	**19 1/8**	**11 3/8**
1983	1st Quarter	28 5/8	16 3/4
	2nd Quarter	65	20 5/8
	3rd Quarter	48	29 1/2
	4th Quarter	33 1/4	16

The number of registered holders of the Company's common stock as of March 22, 1985 was 10,487.

The Company has not paid any cash dividends on its stock since 1974, and is currently prohibited by its financing agreements from paying any cash dividends.

Facilities

Corporate Headquarters

Coleco Corporate Center
999 Quaker Lane South
West Hartford, Connecticut 06110
(203) 725-6000

Manufacturing Facilities and Distribution Centers

21 West Main Street
Mayfield, New York 12117

Coleco Park
Mayfield, New York 12117

80 Lincoln Street
Gloversville, New York 12078

Operations Center
2 Park Street
Amsterdam, New York 12010

37 Prospect Street
Amsterdam, New York 12010

50 Park Street
Amsterdam, New York 12010

31-35 Willow Street
Amsterdam, New York 12010

50 Willow Street
Amsterdam, New York 12010

Corporation Park
Scotia, New York 12302

1231 Warner Avenue
Tustin, California 92680

4000 St. Ambroise Street
Montreal, Quebec, Canada H4C 2C8

Subsidiary

Coleco (Canada) Limited
4000 St. Ambroise Street
Montreal, Quebec, Canada H4C 2C8

Company Sales Offices

New York
200 Fifth Avenue
New York, New York 10010

Chicago
4825 North Scott
Schiller Park, Illinois 60176

Los Angeles
1231 Warner Avenue
Tustin, California 92680

New England
886 Washington Street
Dedham, Massachusetts 02026

Montreal
4000 St. Ambroise Street
Montreal, Quebec, Canada H4C 2C8

Toronto
5149 Bradco Boulevard
Mississauga, Ontario, Canada L4W 2A6

Operating Executives

Coleco – United States

Corporate Center

Marvin L. Belsky
Vice President – Corporate Purchasing

Ray L. Eigenbrode
Vice President – Product Engineering, Toys and Dolls

James V. Gordon
Vice President – Creative Services

Harvey R. Johnson
Vice President – Marketing Services

Lawrence J. Karam
Vice President – International Operations Control

John P. McNett
Vice President – Design and Development

James J. Pasquale
Vice President – Information Services/Systems Planning

Raymond H. Ringston
Vice President – Marketing Planning

Judith A. Smith
Vice President – Customer Service

William A. Spencer
Vice President – Product Operations

Harvey H. Zelman
Vice President – Marketing, Dolls

Manufacturing

Michael A. Appel
Vice President – Materials

Robert P. Baker
Vice President – Manufacturing

John J. Driska
Vice President – Manufacturing Planning and Services

Douglas L. Glaspie
Vice President – Manufacturing

Edmund M. Houlihan
Controller – Operations

Ralph R. Liguori
Vice President – Operations Control

Victor J. Ragusa
Vice President – Industrial Relations

Urban S. Reininger
Vice President – Distribution and Transportation

Dino G. Zampini
Vice President – Technical Services

Sales

Marvin Berger
Vice President

Michael R. Kirsch
Vice President

Ralph Lancellotti
Vice President

Robert Rosenbaum
Vice President

Sidney Silverman
Vice President

Coleco (Canada) Limited

J. Brian Clarke
Chairman and Chief Executive Officer

Tom van Duynhoven
President

Donald V. Taylor
Executive Vice President – Sales and Marketing

Georges Dussault
Senior Vice President – Operations

Gene M. Florio
Senior Vice President and Chief Financial Officer

Denis Durnin
Vice President – Controller

Gerry Goldenberg
Vice President – Information Services

Bruce D. Morrow
Vice President – Sales

Michael F. Richards
Vice President – Marketing

Pierre Rouette
Vice President – Manufacturing

Pierre Tanguay
Vice President – Human Resources

M.U. (Rich) Tanner
Vice President – Materials Management

Executive Officers

Arnold C. Greenberg
President and Chief Executive Officer

Leonard E. Greenberg
Chairman

J. Brian Clarke
Executive Vice President

At the time of the Annual Meeting of Stockholders in June, Arnold C. Greenberg will become Chairman and remain Chief Executive Officer, J. Brian Clarke will become President and Chief Operating Officer, and Leonard E. Greenberg will become Chairman of the Executive Committee.

Philip Cohen
Executive Vice President – Sales

George V. Goudreault
Executive Vice President – Operations

Morton E. Handel
Executive Vice President – Corporate Communications

Alfred R. Kahn
Executive Vice President – Toys

David J. Ruggles
Executive Vice President – Finance and Chief Financial Officer

Charles B. Winterble
Group Vice President – Product Engineering

Paul C. Meyer
Senior Vice President – Operations Planning and Control

John A. Passante
Senior Vice President – Human Resources

Bert L. Reiner
Senior Vice President – Quality Assurance

Michael S. Schwefel
Senior Vice President and General Counsel

William H. Sobieski
Senior Vice President – Marketing, Toys

Jerry D. Wood
Senior Vice President – Creative Development

Charles H. Murphy
Vice President – Treasurer

Thomas P. Sande
Vice President – Controller

Richard A. Blumenthal
Secretary; Assistant General Counsel

Design:
Bloch Graulich Whelan Inc.
New York

Board of Directors

Christopher W. Carriuolo[1,2,3]
President
C & D Enterprises
Farmington, Connecticut

J. Brian Clarke

Arnold C. Greenberg[1,2]

Leonard E. Greenberg[1]

Mary Anne Krupsak[1,3,4]
Attorney at Law
Albany, New York

Seymour M. Leslie[1,3,4]
Chairman, President
and Chief Executive Officer
MGM/UA Home Entertainment Group, Inc.
New York, New York

Omer S.J. Williams[1,2,4]
Attorney at Law, Partner
Thacher, Proffitt & Wood
New York, New York

[1]Member of Executive Committee.
[2]Member of Nominating Committee.
[3]Member of Human Resources Committee.
[4]Member of Audit Committee.

Mario J. Formichella, Executive Consultant and retired Senior Partner of Arthur Young & Company, has been nominated for election to the Board of Directors at the Annual Meeting of Stockholders in June.

Transfer Agent and Registrar

Manufacturers Hanover Trust Company
450 West 33rd Street
New York, New York 10001

Independent Certified Public Accountants

Coopers & Lybrand
280 Trumbull Street
Hartford, Connecticut 06103

Stock Exchange Listings

The Company's Common Stock is listed on the New York Stock Exchange and the Toronto Stock Exchange.
Ticker Symbol: CLO

Stockholders may obtain a copy of the Company's 1984 Annual Report on Form 10-K filed with the Securities and Exchange Commission by writing to
Barbara C. Wruck
Director – Corporate Communications
Coleco Industries, Inc.
Coleco Corporate Center
999 Quaker Lane South
West Hartford, Connecticut 06110

Coleco Industries, Inc.
Coleco Corporate Center
999 Quaker Lane South
West Hartford
Connecticut 06110