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Event Transcript

LF - Q4 2003 LeapFrog Enterprises, Inc. Earnings Conference Call

Event Date/Time: Feb. 11, 2004 / 9:00AM ET
Please stand by. The event is about to begin. good day, and welcome to the LeapFrog Enterprises, Inc. fourth quarter fiscal year 2003 earnings conference call. Today’s call is being recorded. With us from the company is the director of investor relations. Please go ahead, sir.

Unknown Speaker*

Good morning and welcome to LeapFrog’s conference call for fourth quarter fiscal year 2003 which ended December 31, 2003. I am Christopher bond, the director of investor relations. After the close of the market yesterday we issued a press release detailing our fourth quarter and year results. We will discuss our performance shortly and our — Jeff Curley will outline expectations for the year 2004. Finally we will conduct a question and answer session. Before I begin with formal remarks, certain statements may include forward-looking statements about management’s expectations, strategic objectives, anticipated financial performance and other similar matters. Forward-looking statements during this conference call may anticipate sales, operating margins, earnings per share, shelf space, ability to develop markets, cap -- interest income and expense and SG&A expense. In addition, we expect the question and answers posed during the Q&A portion of this call may prompt answers that contain additional forward-looking statements that we have not anticipated and are not contemplated in our prepared statements. This cautionary language concerning forward-looking statements applies to both our prepared comments and our answers on this conference call. A variety of factors beyond the control affect the business strategy and performance of LeapFrog and could cause results to differ materially from the forward-looking statements. Some of these factors are described in our 2002 10K filed with the S.E.C. on March 28 and other filings made with the S.E.C. from time to time as well as LeapFrog's other published statements. LeapFrog does not update forward-looking statements and we expressly disclaim any obligation to do so. Now I would like to introduce Mike Wood.

Unknown Speaker*

Thank you,

Chris.

Unknown Speaker*

2003 was a remarkable year for LeapFrog. Worldwide net sales grew 28% to 680 million. Net income grew 67% to 72.7 million, and net income per share grew 40% to $1.20 per share. We achieved these results with strong performances in each of our three divisions, U.S. customer net sales were up 19%, international net sales were up 80% and education and training net sales were up 86%. I would like to discuss the -- performance of each of these divisions briefly. I will begin with our U.S. customer division. According to the NPD, the U.S. toy industry was down nearly 3% in 2003. Against this background, our net sales were up 19%, and our sell through was up 22%. At the 22 accounts, including our top four retail partners, which report their sale through results to us. I will refer to these as our 22 reporting accounts. These 22 reporting accounts represented 93% of our sales in 2002, and 96% of our sales in 2003. Our success in 2003 is reflected in the NPD full-year report. According to NPD, our market share in the preschool category grew from 18 to 22% for the full year. More importantly, in the critical fourth quarter our preschool market share grew to 27.5%. As a result, in the fourth quarter, for the first time ever, LeapFrog became the market share leader in the entire U.S. preschool category. We believe this is a major statement of the accelerating strength of the LeapFrog brand and our educational products. In the preschool electronic learning, a subcategory of preschool, NPD reported that our market share more than doubled from 8.3 to 17.2% for the full year, and was 21.2% in the fourth quarter. This reflects the remarkable on going strength of the My First LeapPad, basic LeapFrog and LeapFrog plus writing platforms against all competition in this category. In the infant category, which is distinct from the preschool category, NPD reported that our market share grew from 18.3 to 22% for the full year, and was 21.2% in the fourth quarter. This remarkable growth reflects the success of our launch of the little touch LeapPad platform and its software in this category. LeapFrog now is number 2 in market share in the infant category and closing fast on number one. In the nonpreschool ELA category, which includes our Quantum Pad and iQuest, NPD
reported our market share decline slightly from 68.5 to 64.1% for the year and our market share in the fourth quarter was 64.8%. We are going to do something about that this year. Now, I would like to turn to U.S. sales of the LeapPad family, which includes our little touch LeapPad, any any -- My First LeapPad, our classic LeapPad, leap plus writing and the Quantum Pad. Sell through of the LeapPad family in our 22 reporting accounts was up 27% for the year, and sell through of our LeapPad family software in those accounts was up 33% for the year, another remarkable result for the LeapPad family. For 2004, the LeapPad family will become even more dynamic and engaging. This year we plan to introduce over 40 new software titles for the LeapPad family. We are also launching three new LeapPad interactive educational games and LeapPad interactive educational playing cards, which will turn the LeapPad, LeapPad plus writing, our new LeapPad plus microphone and full tie media learning player platforms. I would like to discuss a -- in more detail the results of the three new platforms which we launched in 2003. The sales of each new platform which we launched significantly exceeded our expectations. We launched a little touch LeapPad platform so parents could introduce their infants and toddlers to a love of reading. We know that the more infants and toddlers are exposed to reading, the more likely they will become good readers. We launched little touch with five software titles. From its launch, we could not keep up with demand. Our efforts to chase this demand were reported on the front page of the "Wall Street Journal" on December 18 of last year. For 2004, we will be launching three new little touch titles, including Dr. SEUSS and the classics, "where the wild things are" and the "little engine that could." We launched a LeapPad plus writing platform because we know that kids learn to read and to write at roughly the same stage, and that the process of learning to read and learning to write compliment each other. We were able to turn the LeapPad magic pen into the LeapPad magic writing pen. The LeapPad plus writing was the most successful first-year launch of any platform we have ever introduced at LeapFrog. In 2004, we are introducing exciting new writing recognition software for the LeapPad plus writing which we believe will elevate this platform to a whole new level. We will unveil this at toy fair. In addition, we plan to launch five new LeapPad plus software writing titles. Of course, all 56 of our classic LeapPad titles will also run on the LeapPad plus writing platform. Finally, the launch of leap -- LEAPSTER. Kids in the United States spend an inordinate amount of what some would call unproductive time playing hand held games. A couple of years ago LeapFrog made a commitment to see if we could create a hand-held multimedia platform built around making learning as exciting and engaging as games built around stealing cars. I know this goal seems I am problemable -- I am problem able but recall with me that LeapFrog was committed five years ago to creating a platform that would make reading fun and engaging and this goal seemed equally I am problem able five-year -- year as. Our first problem was to develop software that would enable interactive games, books and an art studio. As you know we built a 4-inch color back lit display that runs on a 32-bit processor with 8 channel and you had and dual input touch screen and directional pad. This is one of the advantages of having your own in-house technology group. We called the leapSTER a multimedia learning system because we have developed interactive educational games, interactive educational books, interactive educational videos and an interactive art, -- studio, and our goal was achieved. I would like to quote from Amazon.com. "I bought the system for Christmas for my son. He has not let it go he opened his gift. I was having trouble during school reading time trying to make tens but now with the leapSTER he just gets words and is overjoyed. I am so pleased with this product. The painting section is a delight, the pictures come to life with the animation and sound is wonderful. I am going to buy another for his sister, because they just can't seem to get their hands off it. PS. Thank you very much, LeapFrog. You really scored with this one. Ms. DEE, Brooklyn, New York." we launched it with four titles and in 2004 we plan to launch an additional four titles, including JUNIE Jones, Spiderman and justice league. All of which are built around PEDAGOGY and school. We will also expand titles that will offer content from preK to third grade grade of the leapSTER. Finally, I am very proud of our learning videos. We launched our learning video line because we believe that individual I don'ts and DVDs for kids can be fun and really educational. Again, we subbing ed. He is a quote, another quote from Amazon.com. Several months ago my 4-year-old daughter began asking me to teach her to read. As we all know, sound recognition are learning blocks to read. I spent the last four-months rather successfully teaching her how letters are made. I bought the letter factory. After watching the DVD three times she now knows 95% of all the letter sounds. I am not kidding. Please
come out with more DVDs of this nature. Gale C, Salisbury, North Carolina. In 2004 we plan to double the size of our video line. Finally, in the U.S. in addition to all of our other initiatives, we are entering a new category, the juvenile product line, with four new products. Now I will turn to our international division where we increased net sales for the year, 80% to 96 million. In the United Kingdom, in 2003, LeapFrog sold its 1 million LeapFrog, according to NPD, my first books and LeapPad were the top three toys in the category for the year. In December LeapPad books were the top two books selling in the British industry, and for the year, LeapFrog became the market share leader in bring tan in the preschool -- bring tan -- -- for the Canadian industry report LeapFrog market share in the preschool category grew from 13% to 24%. The LeapPad, My First LeapPad and pink LeapPad were the top three selling toys in the Canadian preschool category. In Korea, our sales were up 278%. In France our sales were up 242% and we successful successfully opened our own office and launched LeapFrog learning centers in Mexico. We are proud that our model is working, not only in English-speaking countries, but also in French, Spanish and Asian language speaking countries. In addition we are entering the German-speaking markets in 2004 through our partnership. We anticipate a very strong 2004 with international division, as we launch little touch, LeapPad plus writing and leap STER in various international markets and continue to grow our localized software titles. I will now turn to the education and training division which grew 86% to 37.5 million in 2003. We had major sales in the Los Angeles, Chicago, Dallas and Las Vegas school districts. We anticipate a very strong 2004 as we add to our educational sales team and introduce our fourth generation leap. A LeapPad summer reading program and a Spanish version of our links program. In summary, looking forward to 2004 in the U.S. we plan to launch two new platforms, the Turbo Twist extreme and LeapPad plus my row phone. We are sing -- our little touch software and introducing LeapPad plus writing and redesigning the hardware and software of the iQuest and the Quantum Pad hardware platform. We are excited about the opportunities which lie ahead of us in 2004 and beyond. We are especially excited about our platform products and our new product line for 2004. We believe that when we do our job producing and throwing educational products for home and cool, kids, parents and teachers all win. Let me now turn the call over to Jim Curley.

Unknown Speaker*

Thank you, Mike, and thank you all for joining us today. Net sales for the fourth quarter of 2003 were up 33% to 331.4 million as compared with 248.4 million in the fourth quarter of 2002. Each of our business segments had solid increases. Net sales from our U.S. customer segment were up 25% to

273.4 million as compared with 218.5 million in the fourth quarter of 2002. Net sales from our international segment were up 96% to 46.8 million as compared with 23.9 million of net sales in last year's fourth quarter education and training segment net sales 89% as compared to 11.1 Persian Gulf as compared to the fourth quarter of 2002. Regarding our segment sales mix for the fourth quarter, the U.S. customer segment was 83% of our revenue, the international segment was 14% of our revenue, and the education and training segment was 3% of our quarterly revenue. This is the same segment sales mix as last year's fourth quarter. In the fourth quarter, our platform sales increased 30% versus last year. Software sales increased 33% and standard software sales increased 39%. The particularly strong growth in both platforms and software sales attest to the strength of our hardware/software model. Our fourth quarter sales mix was as follows. Hardware comprised 41%, -- % of the total, software 33% and stand alone, 25%. And for comparison, last year's sales mix was fairly close at 42% for the hardware, 33% for software and stand alone at 24%. Our fourth quarter fourth quarter gross profit was up to 159 million. Our gross profit profit margin was 47 boy 9% in the quarter, down 310 basis points from 51% last year. We estimate that leap STER had a 330 basis point negative impact on consolidated fourth quarter gross profit margin which included the cost of air freight to expedite delivery of our new platform late in the quarter. Fourth quarter operating expenses were 90.5 million, only 14.3% higher than last year. As a percent of sales, fourth quarter operating expenses decreased from 31.9% last year to 27.3% this year. A 460 basis point improvement. Our advertising expense increased significantly in dollars As expected, both SG&A and R&D declined as a percent of sales. Our operating income for the quarter was 68.4 million or 20.6% of sales, up 140 basis points from last year's fourth quarter. Interest income for the fourth quarter was essentially flat at 233,000 compared with the fourth quarter of 2002. Other income increased 1.6 million in the fourth quarter compared with 966,000 in the fourth quarter of 2002 due to foreign currency exchange gains. Net income for the fourth quarter of 2003 was up 50% to 44.2 million as compared with
29.4 million in the fourth quarter of last year, and our fourth quarter net income per share was 72 cents compared with last year's 50 cents, a 44% increase. Now I would like to recap the full year 2003 net sales 680 million up 25.1% of 38 million for for 2002 for full year 2003 our U.S. U.S. customer segment up 19%, international segment up 80% and education and training segment was up 86%. Our full-year gross profit margin was 50.0% versus 50.8% in 2002. We achieved 350 basis points of leverage on our operating expenses with 2003 expenses of 33.9% of sales compared with 37.4% in the prior year. 2003 operating income was 109.5 million, up 53.4% over last year's 71.4 million. This operating income for the full year was 16.1% of sales, up 270 basis points from 2002. And our net income for 2003 was 272.7 million, up 67% from 43.4 million in 2002. Our 2003 net income per share was $1.20 versus 86 cents last year, up 40%. Let's now turn to the balance sheet. Cash and cash equivalents at December 31, 2003, totaled 112.6 million, an increase of 39.3 million from last year's position. We achieved positive cash flow from operations of 26.8 million for the full year of 2003. Additionally, the shift in sales from the third quarter to the fourth quarter negatively affected full-year cash flow as we ended the year with high-end accounts receivable. This is the short-term timing effect and the collection of these receivables will positively impact fourth quarter -- first quarter 2004 cash flow. 281.8 million, accounts receivable, increase of 112.8 million from last year's year-end position. On a percentage basis accounts receivable increased 66% over last year. As quarter end, we were 77 day sales outstanding compared to 65 days outstanding last year. The increase is primarily related to the timing of sales occurring later in the fourth quarter of 2003 versus last year's fourth quarter of 2002. Our net inventory of December 31 was 90.9 million, up 6.4 million from the same period last year, or up 8% year over year, and we are debt free as of December 1, 2003, as we were all of last year. And before I turn the call over to Mike Wood, I would like to review our guidance for the 2004 fiscal year. As stated in the press release the company's financial guidance for 2004 is s. Net sales of 800 to 850 million, effective tax rate of approximately 34%, net income of 88 to 95 million, fully diluted share count from approximately 63 million shares and diluted net income per share of $1.39 to $1.51. Consistent with reported trends, we expect that our 2004 sales growth will be lower in the first half and higher in the second half as compared to 2003. We are guiding 2004 sales seasonality to about 22% of full-year sales in the first half and 50% in each of the quarters. Operating expenses will grow approximately 20 to 25% for the full year, but the rate of growth of operating expenses in the first quarter of 2004 is expected to be 10 to 15% over the first quarter of 2003. Remember that this guidance is reflective of the company's current expectations which are based on information available at the time of this release and are subject to changing conditions, many of which are outside the company's control. This include is the review of our recent financial performance and our guidance. I will now turn the call back to Mike Wood.
platform launches in the past two quarters, 2003 was a remarkable year in many respects. We have lots of exciting initiatives. School house and international have never been better. In my opinion, content development creative active -- creative has never been stronger, the LeapFrog brand has never been stronger. This is the right time to make a change. I couldn't be be prouder of what we have done. I couldn't be more excited about what we are planning to do and I could not be more pleased with the management team that we are putting in place, the team that will take us to the next level. I will now turn it over to our new CEO, Tom Kalinske.

Unknown Speaker*

Thanks, Mike. I look forward to assuming my new duties and I want to thank Mike for his great leadership, the tremendous job he has done and for turning over a company with such great momentum and promise. First, let me say that to increase shareholder value faster, it is absolutely correct to allow Mike to return to spending 100% of his time and energy on creative product development and thinking about future strategies. As he said, while he has been president and CEO he could probably only spend about 10% of his time in that capacity and 90% on management, finance, investor relations, tasks he was not as passionate about. So this change is better for Mike and for the company. I am happy and excited to be back in the CEO hot seat, because I am convinced with as strong as as a year as we had last year, we are just beginning on our path to lead in technology-based education products for home and school in the U.S. and around the world. Remember, we have come from nothing to 680 million in nine years, but I am convinced that far more growth opportunities still lie ahead of us. My focus is getting ready, is getting LeapFrog ready to become a truly world class company in terms of internal business processes, planning, systems, management, long-term strategies and execution. I am very pleased with the strength of our management team, with Jim Curley as CFO with his great retail experience background, with Fred as COO, cities wished -- distinguished background at GE, Tim as marketing leader coming from LEGO. Bob, our educational institutional leader and now we are adding Jerry PEREZ to the senior management team. I have known Jerry for several years and admire what he has accomplished. He brings to LeapFrog 22 years of brand, marketing and customer product experience from quaker oats -- and most recently as executive vice president of marketing, sales and design at Fisher-Price. We have also recently had the privilege of getting to know Jerry closer, as a consultant to LeapFrog. And in that capacity, we have learned that Jerry is a very capable leader who knows the business of children's products well, and that he appreciates the unique opportunities that we have at LeapFrog for creating and marketing great educational products. In the short time that Jerry has been with us, he has already made a strong contribution to LeapFrog. I am pleased that Jerry has agreed to join us full time in the role of president of LeapFrog. Jerry is president today, it is my pleasure to introduce him to you. LeapFrog really is positioned to the next level of growth. Jerry.

Unknown Speaker*

Thanks, Tom. First of all, let me say that I am very excited to be a permanent part of LeapFrog. The time that that I have spent here has convinced me this is an incredible company with significant opportunities to grow, fueled by an incredibly strong brand, terrific market momentum and exceptional resources. With a key understanding of how kids learn, LeapFrog is uniquely positioned to continue to lead the field of education on educational learning products. It is also apparent to me that LeapFrog's unique brand promise that a positive learning experience is within the grass trend of every child -- grasp of every child has never been more child. With school systems and an increasing desire of parents to supplement their parent -- children's education, we have both the vision and the means necessary for continued success. LeapFrog began the learning phenomenon and will continue to lead it and my focus in working with this talented management team will be on continuing to develop this great brand with effective business planning, increased global reach, innovative products, and exciting new marketing and sales initiatives to help LeapFrog reap the rewards of future promises. I am excited to be working closely with Tom and Mike and I look forward to an exciting time for LeapFrog and our shareholders.

Unknown Speaker*

Thank you, Jerry. We are in good hands. Now, operator, let's begin with question and answer -- Q&A portion of the call. ++++
Unknown Speaker*

At this time, I would like to inform everyone, in order to ask a question please press star then the number 1 on your telephone key pad. We will pause for just a moment to compile the Q&A roster. Your first question comes from Merrill Lynch.

Unknown Speaker*

Thank you very much. I guess, you know, given the surge in receivables at the end of the year, and the cash flow really not improving barring exercise of stock option proceeds, it has the feel that sales were very, very late in the quarter, and I am wondering if you could address this from the scope of the first quarter given your guidance of equal revenue second quarter which has not been the historic pattern, and then I have a followup question.

Unknown Speaker*

Why don't we split that answer in two parts. Jim, why don't you discuss the first half and I will address the second half.

Unknown Speaker*

Yes. The increase in receivables, you know, and specifically, how it equates down to DSOs, really does relate solely to the timing of both sales shipped in the third quarter and into the fourth quarter, the fourth quarter much bigger. But then since our terms are less than the 90 days of the fourth quarter, it really happened within the quarter. There was a shift in sales later in the quarter, especially leap STEP, product, that put, you know, a bigger shift year over year at the back end of the fourth quarter. That is just timing, and it will be collected, you know, in the first quarter of next year. And so of the 15 days increase in day sales outstanding, you know, I calculated about 12 days of the increase was just about related to that timing. We had another day related to KB, which is still included in our receivables, and obviously that is not getting paid, you know, at current and we had about two days of shipping issue auto -- issues that are working through this time of year but are pretty normal leverage to customers. Aging standpoint, we actually had a more current receivable balance this year at year end than we did last year. When you look at receivables over one day past due, and so I feel very good about our receivable balance and collect. It did impact cash flow in the current year, but if you look at the collection through the, you know, the whole collection into the first quarter, we are going to have very, very strong cash flows next year because of this carryover. Lauren, as the second part of your question, is it affecting first quarter sales, and we believe that the primary effect on first quarter sales is the consolidation and contraction of KB and the the closure of FAO Schwarz. The orders of retailers in those two last year were significant and won't be in the first quarter of this year, although they will be reallocated, we believe, as the industry assimilates this in the following three quarters. But that's, that's really the primary first quarter factor in the first quarter of sales guidance.

Unknown Speaker*

Thanks, just a couple more administrative. I know that you gave us the revenue break down across the company for platform software and stand alone. I am wondering if you could do it for the U.S. customer division, and then I am also wondering if you could give us the growth margins as you typically have in the passed by segment?

Unknown Speaker*

Jim?

Unknown Speaker*

Okay. The U.S. customer, the mix for the quarter, platforms, up 25%, software, up 31%, stand alone, up 18%. For the year, U.S. customer platforms up 12%, if software up 26%, stand alone up 23%.

Unknown Speaker*

Net sell in.

Unknown Speaker*

Net sell in.

Unknown Speaker*

Thanks, Jim.
Unknown Speaker*
Okay, and the gross margin, if you could? By segment?

Unknown Speaker*
Right. By segment, for the quarter, U.S. gross profit, 46.3%, international, 53.6%, and education and training, 63.7%.

Unknown Speaker*
Great, thank you.

Unknown Speaker*
You are welcome.

Unknown Speaker*
Your next question comes from David with ham securities — bum ham securities.

Unknown Speaker*
Hello.

Unknown Speaker*
Hi, David.

Unknown Speaker*
Two questions, totally related to each other. What is the school house number right now, the number of classrooms you are in in the U.S. year over year?

Unknown Speaker*
Right -- I believe it is up to 25,000.
Unknown Speaker*
Also, with the two big bankruptcy, well, FAO isn't a big bankruptcy, but KB, did you have enough reserved in your markdown money and other allocations, or did that come on top of the moneys that you had already set aside?

Unknown Speaker*
Yes. We reserved approximately 50% of our exposure and that impacted the quarter by 1 cent.

Unknown Speaker*
And is it going to be an impact into this year as well?

Unknown Speaker*
We have additional reserves, so we think we are provided for, you know, the remaining exposure, and we think there will be some collect of some portion of that amount.

Unknown Speaker*
Also, in giving the figures, and I may have missed this, did you indicate how much the weakness of the dollar helped your overseas sales and what it meant for both top and bottom line for last year?

Unknown Speaker*
You know, Q4 sales benefitted in the international segment by 10%, and it was 1% on a total consolidated basis.

Unknown Speaker*
And the EPS side of the ledger?

Unknown Speaker*
You know, in the 1% range.

Unknown Speaker*
Okay. And, lastly, there have been questions raised by those who seem to be nonpositively on their outlook for the company, that returns were very high last year on software, and, B, you would be getting less shelf space this year than last year. Does management have any comment to try to refute those statements or are they inaccurate?

Unknown Speaker*
Yes, neither of them are accurate.

Unknown Speaker*
Let me say thank you very much.

Unknown Speaker*
Thank you, Dave.

Unknown Speaker*
Your next question comes from Sean with , Nesbitt -- with Harris Nesbitt.

Unknown Speaker*
A couple of questions as well. Can you comment on the profitability of the education segment during the year?

Unknown Speaker*
Yes. Thanks for bringing that up. That is very good news. Last year, you know on 20 million in sales we lost 9 million, operating loss of 9 million on the education and training segment. This year, on the 37.5 million in sales, we actually had a small loss of 200,000, so just about break even. So it was a huge success in education and training.

Unknown Speaker*
How did we do in the fourth quarter?
Unknown Speaker*

In the fourth quarter, we actually had our second, you know, profitable quarter of the year for education and training. 11 million of sales, actually made 1.1 million and operating income versus last year loss of 2.9 million at the operating level.

Unknown Speaker*

Let me just calculate that. If you have another question while I calculate that, we will get back to you on that.

Unknown Speaker*

Okay, thank you. And can you give us an idea of what the gross margin in the quarter might have looked like without the impact of the KB writedown of receivables and without the air freight, so we can get a sense of what the true margin was there?

Unknown Speaker*

Jim. So — 10-K B did not get impacted in the gross profit margin?

Unknown Speaker*

You don't have that, writing down those net sales?

Unknown Speaker*

No.

Unknown Speaker*

On the — so it's an operating expense, you know, that got charged for the 1 cent, approximately $1 million.

Unknown Speaker*

And what was the other part of your question?

Unknown Speaker*

Gross margin without the air freight.
Unknown Speaker*
Hi, good morning, and welcome to your new position, Tom.

Unknown Speaker*
Thanks.

Unknown Speaker*
I have three questions. Could you, one, within your guidance for revenue growth, could you segment that by region for us or by, you know, by the three major categories. The second question is, talk about tie ratio trends, which you saw in '03 versus '02, and then focusing on the ad budget for the year. I wonder if you could kind of give us a sense of what you expect to grow by and how you are going to segment it by age or category, just give us a sense of where the increase is really going to be concentrated. Thank you.

Unknown Speaker*
Okay. Thank you. And then, on the -- you are talking about doing some redesign work on hardware and software. Do you expect that to affect average selling prices at retail once it's all said and done?
Unknown Speaker*

No. The average selling prices should not be affected by the design work or the rework. It will be affected by other factors in the market, but not what we are doing in terms of the design and improvements in software.

Unknown Speaker*

Well, have you realized any meaningful sort of cost savings that would allow you to work on wholesale prices as you go forward?

Unknown Speaker*

In general, as we have said in the past, as platforms mature, we are generally able to achieve cost savings, and that continues to be true, although when we do a redesign, sometimes we will give back some of those savings.

Unknown Speaker*

Okay, and then last question, in terms of sell through at retail, how are you feeling about retail inventories and are there any concentrated issues out there in terms of products, individual products?

Unknown Speaker*

Yes, two things. We are comfortable with the level of inventory at retail. Obviously, and, as will always be true, there are some pockets of some products in sum -- some retailers that those retailers are working through. The good news is that our products, when they address those, move through quickly. On a broader level, and I am reluctant to get into too much much detail on this, because we are only five weeks into the quarter, and, of course, what I am going to tell you is affected by retailer's attempts to move through merchandise, our POS numbers are very good. In fact, comparable to last year's numbers at the same time.
so that will be a big part of the impact. I don't think we want to get into any other mix issues. In terms of pricing, our pricing is, you know, normal to the marketplace, where we are competitive, where we have cost improvements. We have improved our price to retailers. But other than that, I don't want to talk about pricing on this call, because every time we talk about something on this call, one of our competitors does exactly what we are doing.

**Unknown Speaker**

Just one followup with Tom. The reason that we are willing to enter this leap STER and adversely affect the gross margin, is that in the long run, the leap STER software is our highest margin software, and we believe we have opportunity to increase the tie ratio for leap STER above our other platforms. So this is a strong go forward initiative, where we think the implications of getting substantial installed lays of -- base of leap STERs will be positive for us in our total margin as we move forward.

**Unknown Speaker**

Should we assume that the mix of stand alone software is similar in '04 to '03 or will there be similar moves.

**Unknown Speaker**

Again, Tony, I would rather not get to that level of granularity.

**Unknown Speaker**

Any sell changes changes in 2004 that you can talk to at this point?

**Unknown Speaker**

Well, we anticipate continued increases in shelf spaces in the first half of the year, and although this is confirmed in the spring set, in the fall set we are still working through the retailers but the signs are encouraging. As you would expect, if you look at what we did in market share, you would anticipate that the retailers with their allocation would take that into consideration.

**Unknown Speaker**

Could you characterize that change a little more? I mean historically, you have done a little bit more, 40% in shelf space for the holidays last year. Are there any more parameters that you can put on it?

**Unknown Speaker**

No, I am going to stick with the general guidance I just gave, although two encouraging things, we will have incremental shelf space around the juvenile product lines which we are launching and obviously things like the video line, which are outside of our traditional space. We are encouraged about the opportunity and space there.

**Unknown Speaker**

Okay, thanks. Tom, welcome aboard.

**Unknown Speaker**

Your next question comes from Mr. Parachinti of Deutsche Banc security -- Mr. PATEL On bank securities.

**Unknown Speaker**

Hi, guys, I had a couple of questions. You had about a 19% growth in the U.S. customer business in '03. Can you give us a sense of, you know, how fast the U.S. customer business grows in '04. Is it probably within the same level of growth that you saw in the period. Second, can you give us a sense of what the
top sellers were, just by list, you know, in terms of revenue or anything, but just trying to get a qualitative list of the top versus the second tier down. Finally if you look at the 4 to 8-year-old segment, LeapPad, LeapPad plus, can you talk about whether that 4 to 8-year-old segment growth was, was that flat, or up, can you comment on how much it was up, say, in the fourth quarter in '03 and in general?

Unknown Speaker*

Yes, a -- you asked a lot of questions. The first one, in terms of U.S. growth. I am not -- we are not going to give any further guidance, except as you have seen our overall growth guidelines, you know what we did last year in the U.S. You can put certain parameters around the growth on international and school house, because they are a much smaller number and you can work back backwards on getting a general idea of the continued strong growth that we anticipate in the U.S, in the U.S. customer division. In terms of top sellers, as you can see, we remain strong across all three of our, the way we would characterize those. Our hardware, our software and our, and our stand alone platforms. Are the most notable of our successes are really our three new platform launches, the little touch, which we think was constrained by our inability to meet demand, the LeapPad plus writing, and the leap STER. Obviously we had very strong experience with the My First LeapPad, and we were pleased with the continuing strength of the classic LeapPad, notwithstanding the fact, obviously, that it is affected by both the LeapPad growth on the plus side and the LeapPad plus writing growth on the other side. In terms of growth in the 4 to 8-year-oldings, would you mind repeating the question for me?

Unknown Speaker*

Hi, two questions, are you pleased with your distribution channels and do you expect to enter any new ones this year and secondly why such a wide range of operating guidance, shouldn't some of that be broken down?

Unknown Speaker*

Let me address two and Jim why don't you address the new channels and --
Unknown Speaker*

Sure, when we are talking about new channel, we are talking about things we had mentioned before, general bookstore category, electronic retailer category and office supply category. I don't want to break them down specifically, again for competitive reasons, but, yes, we are pleased with what has gone on there. We had good growth there. Now, having said that, they represent only 4 or 5% of our overall business. So it is still a relatively small part but we are happy with what occurred there. In terms of the earnings per share. Well

EPS, well, Jim.

Unknown Speaker*

What I would like to repeat, we are sort of burdened by our own success. That is, as we continue to have substantial shelf space increases in the Wal-Marts and the targets and the Toys "R" Us, etc, it is very difficult for the alternative channels in which we had growth last year to gain percentage market share. But that’s not bad news, that is actually a reflection of the good news in the strength and larger channels. Jim, you were going to talk about the change of guidance on the EPS on the EPS?

Unknown Speaker*

Yes, Jennifer, we gave an 11% range last year on EPS guidance. We think that the range we have we have out there right now is, -- is a fair and representative range, starting at the outset of the year, you know during the year it tightened, at this stage, we are going to be comfortable with that broader range.

Unknown Speaker*

Okay. Maybe, let me ask another way. The low end of your guidance you are actually projecting margin deterioration, shouldn't your supply chain initiatives and the mix shift improve your margins Sr. -- or is that offset by maybe retail pricing pressure?

Unknown Speaker*

On the operating expense side, we are planning, you know, for significantly higher legal over '03 in the '04 guidance. We have higher R&D with so many opportunities, we are, you know, moving ahead with more spending in those key categories, we will have a great ROI in the future, and then, you know, growth internationally is also, you know, finally building some SG&A growth. I think the range we have out there is indicative of all of those factors and gives us, you know, ample room to deliver with them.

Unknown Speaker*

I think we have time for just one more question, please.

Unknown Speaker*

Your next question comes from Sara with Merrill Lynch.

Unknown Speaker*

Hi, Sara.

Unknown Speaker*

I just had what I think are a couple of quick numbers. First, the sell through numbers that you gave for the entire year for 2003, I know those were for the LeapPad family only. But when I look at those versus the sell through numbers that you have given in in Q3 or platform sales being up 40% and software up 80%. I wonder if you could help us reconcile the difference in those numbers to help us what sell through will look like in Q4

Unknown Speaker*

Sure, I believe a macro level what we said -- sell through for the third quarter was up 35% and for the year it was up 22% of -- 22%. That reflects a very strong fourth quarter, although the sell through is lower, the significant majority of our
sales are obviously in the fourth quarter. But we anticipated it in our guidance, we anticipated it in -- internally. We met our internal projections, and in the -- and the retailers were obviously very happy with our sell through. And the most important thing is you can see with the sell through we had in the fourth quarter, that was what was reflected in the significant market share gains reported by NPD. But, so, we had, you know, sing can't sell through growth in the fourth quarter and multiplied by the percentage of our annual sells which is sell through, which is really fourth quarter heavily weighted. That is what gives you a blended percentage of the 22%.

Unknown Speaker*

Okay, but in Q4, would that imply that that number would be below the 35%?

Unknown Speaker*

Of course.

Unknown Speaker*

Okay.

Unknown Speaker*

In fact, it's our percentage, which you know about 75% fourth quarter on sell through times, times the increase in sell through, times, plus the 35%, times the sell through in the first three quarters, and that weighted average gets you the 22%.

Unknown Speaker*

Okay, thank you. And then can you talk about what the LeapPad family was as a percentage of sales for the quarter during the year?

Unknown Speaker*

Have you calculated that, Jim?
look forward to seeing many of you at toy fair. I think it will be another very exciting trip through our toy fair show room, and I hope you will participate in our next quarterly earnings conference call in April. thank you for participating in today's conference call. You may now disconnect.
Operator: Good afternoon. My name is Tamara, and I will be your conference facilitator today. At this time I would like to welcome everyone to LeapFrog Enterprises Second Quarter Earnings Results Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question and answer period. If you would like to ask a question during this time, simply press "+", then the number "1" on your telephone keypad. If you would like to withdraw your question, press the pound key. Thank you. Cherie Stewart, Senior Director of Corporate Communications, you may begin your conference.

Cherie Stewart, Senior Director of Corporate Communications

Good afternoon, everyone, and welcome to LeapFrog Enterprises conference call for our second quarter 2004, which ended June 30th. I'm Cherie Stewart, Senior Director of Corporate Communications. After the close of market today, we issued a press release detailing our second quarter results. In a minute, Tom Kalinske, our CEO, will discuss LeapFrog's performance in the second quarter and our outlook. Bob Lally, President of our SchoolHouse Division, will discuss results from our Education and Training group. And then Jim Curley, our CFO, will discuss our financial results in detail. And finally, we will conduct a question and answer session.

Before we begin our formal remarks, I remind you that certain statements made today will include forward-looking statements about management's expectations, strategic objectives, anticipated financial performance, and other similar matters. Forward-looking statements during this conference call will include statements regarding anticipated sales, margins, expenses, earnings, share counts, and retail shelf space, our ability to invent, develop, and produce products and their acceptance in the markets, planned supply chain and other business initiatives, and expected capital expenditures, inventory levels, receivables, and tax rates.

In addition, we expect that questions posed during the question and answer portion of this call may prompt answers that contain additional forward-looking statements that we have not discussed in our prepared statements. This cautionary language concerning forward-looking statements applies to both our prepared comments and our impromptu answers to questions posed on this conference call. A variety of factors, many of which are beyond our control, affect our operations, performance, business strategy and results, and could cause actual results to differ materially from those projected in forward-looking statements. Some of these factors are described in the 2004 Annual Report filed with the SEC on March 12th, as well as LeapFrog's other published statements and SEC filings. LeapFrog does not update forward-looking statements, and we expressly disclaim any obligation to do so.

Now I would like to introduce LeapFrog’s CEO, Tom Kalinske.

Thomas J. Kalinske, Chief Executive Officer

Thank you, Cherie. Thank you all for joining us. Good afternoon. I'm pleased to share with you the results of our second quarter. Let me begin by framing our results this quarter. We believe the growth and success of both our business groups, Consumer, and Education and Training, supports our vision to become a diversified learning company. Many of you are familiar with our success at retail, and as we will discuss today, our school business is really gaining momentum too. This afternoon I'm going to briefly cover high-level financial results for the total company, and then we'll discuss highlights from our Consumer business, both domestically and internationally. I'll then turn
the call over to Bob Lally, who will provide an update on our Education and Training business, focusing on the SchoolHouse success.

But first, let's turn to the highlights of our company-wide performance improvements for the second quarter. As you will see, gains in our Consumer business are supported by an over 20% increase in over-the-counter US sales year to date, and continued strong sales expansion internationally. We are also very excited to share that our SchoolHouse division was profitable for the first half of 2004, and we expect this business to be profitable for the full year.

The specific results of the second quarter of 2004 compared with the second quarter of 2003 were: for the entire company, total net sales up 19%. Each division had record sales during Q2. For the Consumer business, US consumer net sales were up 4%. International net sales increased 51%. For our Education and Training business, SchoolHouse net sales grew 47%.

While our gross margin in the quarter improved slightly, to 45.1% from 44.6% in the first quarter of 2004, we fully expect further improvement in the second half of this year, as our new software titles are released, as retailers restock their software sections with our new packaging, and we begin to realize expected efficiencies in producing our new learning platform products.

In an update from our last call, I would like to report that we are making progress with improvements to our supply chain management initiatives. Several of our new supply chain management software programs are up and running. We are also continuing to consolidate our distribution centers, and will complete our move into our new warehouse and begin shipping from it at the end of this month. We will maintain a level of redundancy with our warehouses until the new facility has been fully tested.

Last year we believed that too little available inventory resulted in lost opportunity with our retailers. Consequently, we have planned thoroughly and provided for contingencies, including redundant shipping capacity and a larger amount of inventory entering the third quarter. We are focused on improving our delivery and our fulfillment performance in the critical second half of this year. Next year, we will shed this warehouse redundancy and the need for an inventory buffer, and expect to reap additional operational performance benefits.

Next I would like to highlight some of the initiatives and accomplishments we are particularly excited about in our Consumer group, both domestically and internationally. First, let's focus on the US. With about 80% of the sales year still ahead of us, we have several strong key marketing initiatives launching in early fall. This includes an enhancement of our ongoing advertising campaign that just received the highest honor in marketing, the GRAND EFFIE award. In addition to winning the category of Best Marketing Campaign for Children's Products, LeapFrog also won the GRAND EFFIE for the Most Effective US Advertising Campaign of the Year for all companies. The GRAND EFFIE is not simply for creativity, it's based on proven sales results and share of market increases. Having been measured against some of the most prominent successful companies in many industries, including past winners such as IBM, Apple, Nissan, and Reebok, we believe this is a noteworthy affirmation of the strength and long-term viability of LeapFrog as a global learning brand.

We have several innovative marketing campaigns teed up that focus on supporting software sales, and we will be unveiling them over the next coming months. One of the programs I can share with you is the complete revamping of the packaging for our LeapPad family software. We have conducted extensive testing to improve package communication, and we know that parents are thrilled with the new packaging because it also serves as a simple storage case for the books and cartridges. We also know that our key retailers are excited about this program. In addition, early reads on over 30 new learning titles across all our learning platforms are very good, and include several successful presale programs by our retailers.
Demand and excitement do not simply surround our new software titles. We have actually secured an over 10% shelf space increase this fall with our top retailers, and this space will include our best-selling LittleTouch LeapPad, LeapPad Plus Writing, and Leapster platforms, as well as our brand new learning platforms, several standalone learning products, and our entirely new juvenile product line for the littlest learner.

As you know, last year we successfully introduced the LittleTouch LeapPad and LeapPad Plus Writing Learning System to the LeapPad family. This year we have another new platform to add to our LeapPad line, the Read Aloud LeapPad Plus Microphone, which begins shipping this week. In addition, we have two new play patterns for the LeapPad, including interactive cards and multiplayer learning games, and over 20 new titles, including Dr. Seuss, Shrek 2, Spiderman, and The Incredibles.

We are also energized about introducing an entirely new innovative learning platform, My Own Learning Leap. This is the first ever soft and huggable learning platform and software from LeapFrog that introduces preschoolers to an entirely new curriculum - new curriculum category for the company, that is, social skills, emotional development, and life lessons. From personalized potty training to phonics, Leap engages and teaches each child with personalized, interactive lessons based on their own learning levels and individual interests.

Our Leapster multimedia learning system continues to make both parents and kids happy, and we regularly receive letters and comments raving about this product. The Leapster library will total 18 interactive learning titles for the holidays, including Finding Nemo, Disney Princesses, Spiderman, and The Incredibles.

Let me now turn to the International segment of our consumer group. We are equally pleased with the current growth and potential of this segment, with sales up 51% in the second quarter. We expect this upward trend to continue as we launch even more new learning products into our international markets.

For the first half of the year, Canada net sales are up 12%, UK net sales are up 99%, Australia net sales are up 188%, and we continue to build our business in Mexico, and this effort is complemented north of the border with the launch of a Hispanic line of LeapFrog learning products that will be placed in over 500 major US retail stores. As many of you know, 1 in 5 births in the US are to Hispanic women, and this will be an increasingly important market in the near future.

The three learning platforms that were launched so successfully in the US last year, the Leapster, the LeapPad Plus Writing, and the LittleTouch LeapPad, will be introduced into many of these international markets by year-end, and a full line of LeapFrog learning products, including these three platforms, will be launched for the first time into the German-speaking markets of Europe this fall, with our partner Stadlbauer.

I would like now to turn to our SchoolHouse Division, which is part of our Education and Training group. We have invested a great deal in this division because we knew it had great potential from a revenue side, but equally important is the value this division brings to our overall global learning brand. The SchoolHouse Division is actually growing at a faster rate than our consumer business did in its first 5 years.

Let me turn the call over to Bob Lally, a co-founder of LeapFrog and President of our SchoolHouse Division, to highlight some of the achievements and potential of the SchoolHouse Division. Bob?
Robert W. Lally, Executive Vice President, Education and Training Group, and President of the SchoolHouse Division

Thank you, Tom. I'm pleased to announce a breakthrough quarter for LeapFrog SchoolHouse, in which we achieved $19.3 million in net sales, a 47% increase from last year, and we generated an operating profit of 7.2 million, an increase of 279% over last year. Fueling the success is a significant increase in large district implementations, including 3 in excess of $1 million. Unlike LeapFrog's Consumer business, slow buying cycles, a long evaluation process, and lengthy budgeting and funding cycles characterize the school marketplace. Many school districts test trial new programs for 1 to 2 years before making large-scale investments. The pilots that LeapFrog SchoolHouse has been conducting over the past several years with school districts throughout the country are beginning to pay off by generating larger purchases, from both existing and new customers. For example, earlier this month we announced a $1 million contract with Prince George's County, Maryland, where our LeapTrack system will be installed in every Title-1 kindergarten classroom, together with a one-to-one ratio of LeapPad platforms to students. This one-to-one ratio with extend learning from the classroom to the family room by allowing students to take their own LeapPad platforms home for more focused practice and instruction.

Additionally, we are gaining traction with teachers and with school administrators with our flagship product, the LeapTrack system, which recently won the Inaugural Technology Leadership Award from the Association of Educational Publishers and AOL at School. For those of you not familiar with this learning system, it enables teachers to administer formative, diagnostic assessments for each student in reading, language arts, and math, grades K through 5. The LeapTrack system helps students master critical learning skills by delivering personalized instruction based on the results of the assessment that leverages LeapFrog's personal learning tools, or PLTs. This system not only promotes student achievement, but also facilitates classroom management with test results available at the student, classroom, and district level. All of which facilitate data-driven instruction decisions, a key aspect of the No Child Left Behind Act.

I would like to highlight the fact that the SchoolHouse Division was formed in 1999 in response to requests from educators who were using LeapFrog Consumer products in their schools and needed additional features, curriculum, and teacher support to make them most effective in the classroom environment. After having shipped our first curriculum product in April 2000, the SchoolHouse Division has since built an entire line of products that are customized exclusively for the pre-K through 8th grade classroom, focusing on early child development, reading instruction and intervention, assessment in individualized learning, and English as a second language. Since our debut, we have sold approximately $100 million in SchoolHouse materials through Q2 '04, and our products are an estimated 40,000-plus classrooms throughout all 50 states. In fact, in 2003 we emerged as the fastest growing K-12 educational software provider of the top 10 companies in the supplemental education industry, as reported by Simba.

As we move forward, the Education and Training group at LeapFrog will continue to combine LeapFrog's innovative, affordable, technology-based PLTs with our educational curriculum and expertise, where we believe we offer superior learning solutions compared to traditional print materials or more expensive computer-based programs. We believe these strategic advantages will help us to continue to expand the reach of the LeapFrog brand in schools, as well as to lead us to additional education and training opportunities beyond the classroom.

Now I would like to turn the call over to Jim Curley, our CFO, for a review of our financial performance in the second quarter.
Thank you, Bob and thank you all for joining us today. Net sales for the second quarter of 2004 were 80.8 million, up 19% from last year's 68 million performance. Our business segment sales results for the second quarter were: US Consumer segment net sales 47.7 million, up 4% from last year, and International segment net sales, 13.8 million, up 51% from last year. In our Education and Training business, the SchoolHouse Division had net sales of 19.3 million, up 47% from last year. Total company sales mix was 59% US Consumer, 17% International, and 24% SchoolHouse. A highlight of the quarter was the strength shown by the Education and Training business, with their SchoolHouse Division showing a record operating profit of 7.2 million for the June quarter. This is a business that is much less seasonal than our Consumer business, and as Bob just discussed, we think that this performance means we are gaining momentum on that side of our total business.

Second quarter 2004 total company gross profit margin was 45.1%, compared with 52.7% last year. Gross margin declined largely due to lower gross profit margins in the US Consumer segment. We saw a shift in the mix of products sold in the quarter, from higher margin software to newer, lower margin platforms. For the US Consumer segment, platform sales increased 9%, while software sales decreased 14%, and standalone product sales increased 9%. The Company expects its gross margins to improve in the second half of the year as new software titles and new software packaging become increasingly available, and software sales comprise a larger portion of the company's total sales mix.

Second quarter operating expenses were 48.1 million, up 4.4 million, or 10% from last year. SG&A expenses were up about 5.5 million over last year, due to increased international spending, higher commissions, increased legal, Sarbanes-Oxley, and facilities expenses. Our operating loss for the quarter was 11.7 million, compared with a 7.9 million operating loss last year. The net loss for the second quarter of 2004 was 7.4 million, as compared with a 3.9 million net loss in the prior year. And our second quarter net loss per share was 12 cents, compared with last year's 7-cent loss.

Now let's discuss the balance sheet. Our cash and short-term investments at June 30, 2004 were 169 million, that's up 31% from last year's 129 million level. Accounts receivable at June 30, 2004 were 65.3 million, up 18% from 55.2 million last year. Our day sales outstanding improved by about 14 days from the first quarter of this year. So our DSOs were flat at 73 days for both second quarter of 2004 and the prior year.

Our net inventory at June 30, 2004 was 177.4 million, up 85% from 96.1 million last year. A couple of comments overall on inventory levels, and then I'll give you some details. In hindsight, we feel that we had too little inventory entering the second half of last year, and last year's second half proved to be quite challenging. We found ourselves chasing to keep up with retailer demand, and incurred a significant amount of expedited freight and handling costs. To avoid that situation repeating itself, we have flowed manufacturing and finished goods earlier this year, and ramped up our raw materials inventory. This is especially important because we are seeing significantly increased ordering lead times on many of our critical electronic raw materials such as ASICs, ROMs, and LCD touch screens. While this earlier inventory build is a short-term drain on cash flow, we feel that it's the smart thing to do, and the payback in increased availability for our key retail customers should be very compelling.

That being said, a few specific insights. Of the 81 million inventory increase, about 36 million is finished goods, 24 million is raw materials, and 21 million is work in process. Our finished goods inventory days of supply are about 86 days, compared with 73 days last year. Again, this increase relates to better seasonal timing of our inventory for meeting customer demand in the second half. The raw materials inventory increase is related to the higher levels of ASICs, ROMs, and LCD screens that we planned.
We are debt-free and our cash flow is very strong in the first half of 2004. Our net cash provided by operating activities was 76.5 million, up 57% from 48.7 million in the first half of last year. The increase in cash flow from operations was due primarily to the collection of year-end accounts receivable.

And now before we start the Q&A session, I would like to address going forward guidance. Our full year 2004 guidance remains unchanged and is as follows: for 2004 full year, net sales of 770 to 800 million; gross profit margin of 48% to 49% of net sales; operating expenses of 33% to 35% of net sales. We assume a fully diluted share count of approximately 63 million, and diluted net income per share in the range of $1.18 to $1.28.

This concludes the review of our recent financial performance and our guidance. I'll now turn the call back over to Tom.

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Thomas J. Kalinske, Chief Executive Officer

Thanks, Jim. In closing, let me emphasize that not many companies can boast year to date 20%-plus consumer sell-through growth at point of sale, and a 10%-plus shelf space gain for this coming fall over fall. We've experienced this very strong POS growth sale in 2004, even with most of our new products and marketing programs not reaching retail until this coming September. We continue to strategically expand our product line within both our Consumer group and our Education and Training group. Our progress in penetrating the public school market and the beginnings of our adult learning efforts are particularly encouraging, and in a mature business model, will support a more even year-round selling cycle over the longer term.

We believe we are improving our infrastructure to become a world-class supplier of learning products around the world, and we're looking forward to completing our infrastructure upgrades, and we're working hard to respond to a tightening raw material market. We believe we have done appropriate contingency planning to make this a successful year for LeapFrog. We're committed to delivering solid second half, with well-managed inventory, good cash flow, and a strong balance sheet at the end of the year.

We are pleased with our progress in the second quarter, and with about 80% of the sales year still ahead of us, we're prepared for the second half of the year. We at LeapFrog are building a complete line of learning products for kids and adults around the world. It's a big job, and we are not done yet. We believe the work we're doing in 2004 to build our brand, company, infrastructure, and product line will position LeapFrog to become a globally recognized education leader in the future, and increase our value.

Now, operator, let's begin the question and answer portion of the call.
Operator: At this time, I would like to remind everyone in order to ask a question, please press “*”, then the number “1” on your telephone keypad. We'll pause for just a moment to compile the Q&A roster.

Your first question comes from Lauren Fine [Merrill Lynch].

<Q – Lauren Fine>: Thank you, very much. Couple of questions for you. In the guidance that you’ve provided what kind of expectations for Toys R Us store closures are built into that? And then I’ll ask my follow-up.

<A – Thomas Kalinske>: Okay. Hi, Lauren. Obviously, we know no more than anyone else does about what Toys R Us is going to do. We’re enjoying a good relationship with Toys R Us year to date. And I would say that we’re not going to reveal what we have built into our guidance regarding Toys R Us as we would not on - comments on any other specific retailer.

<Q – Lauren Fine>: Well then let me rephrase. Have you built something in for a potential reorganization there?

<A – Thomas Kalinske>: We’ve made assumptions in light with - working with the buying and merchandising staff there.

<Q – Lauren Fine>: Okay. And then I'm wondering, on the shelf space gains that you’re talking about, for some reason I remember you having said double digit before. Maybe you all had meant 10% when you said double digit. But has there been a change in the shelf space outlook?

<A – Thomas Kalinske>: Not really. I said 10% to 15% before and we’re now – we just rephrased it to 10%-plus, I believe.

<Q – Lauren Fine>: Okay. And then, Jim, I guess predictably I’m going to ask if you can tell us what percent of Consumer was platform software and standalone and if you could share the margins on those businesses, and also the gross and operating margins by the US Consumer, International, and Education and Training?

<A – James Curley>: Okay. For US Consumer platforms, you want to know what the mix is?

<Q – Lauren Fine>: Yeah.

<A – James Curley>: 56% platforms, 16% software, and 28% standalone.

<Q – Lauren Fine>: Okay. And then the margins, gross margins on those businesses?


<Q – Lauren Fine>: Last one I'll throw in, and turn it over to somebody else. If you can tell us what impact foreign exchange had on revenues and earnings? And you also didn’t comment on trends in France and Japan.

<A – James Curley>: Okay. On the foreign exchange, the impact on sales to our International segment was about 4.6%. On total company, it was slightly under 1%. It was about 0.8% on sales and was positively impacting sales. On net income, for total company, it was about 3.6% favorable.
<A - Thomas Kalinske>: By the way, Lauren, I didn't mention France just because it's smaller as a market than the others, but it has a big increase as well. I don't remember the percentage but it's a large increase.

<Q - Lauren Fine>: And was anything of note in Japan?

<A - Thomas Kalinske>: Yes. Of note in Japan is that the Japanese retail side of our business isn't particularly strong as, I guess as most aren't in Japan, and the other side of our business, the home tutoring school business is quite strong.

<Q - Lauren Fine>: Thank you very much.

<A - Thomas Kalinske>: You're welcome.

Operator: Your next question comes from Sean McGowan [Gerard Klauer Mattison].

<A - Thomas Kalinske>: Hi, Sean.

<Q - Sean McGowan>: Hi, guys. Two questions if I can. One goes back to comments I think that the Company made earlier in the year regarding expectations for higher spending in R&D. So I was a little surprised to see that line not up more. Can you talk a little bit about whether there was a change, or what we can expect for the balance of the year? And secondly, on inventory what - for the balance of the year, you know, you made comments about having some redundancies and wanting to be in a better position relative to last year. When do you think we can expect to see a more, a closer relationship between inventory and - increasing inventory and increasing sales? Can we expect that to be, kind of, balance of third quarter or year-end or first quarter of next year?

<A - Thomas Kalinske>: Let me comment, and then turn it over to Jim. Firstly on the R&D, we still are expecting to show a significant increase. I think this has been timing on R&D, and Jim will comment on that. And on inventory I think we - as Jim and I both said, we were really too low on inventory entering third quarter last year and that caused us some issues. So I think we'll see a better situation perhaps relative to total sales expectations the rest of this year, after the third and fourth - and into the third and fourth quarter. Jim?

<A - James Curley>: On R&D, we are expecting full year increase in R&D, and that's in our guidance. On a full year basis, we're expecting actually to be up low double digits in R&D spending. A lot of that comes in the form of 2005 products that we have to spend for in second half of 2004.

<Q - Sean McGowan>: Okay. Then, just kind of bouncing back to the inventory question. I understand what you're saying Tom about having too little, so I guess that another way to ask the question is at what point do you feel like you no longer had too little and were chasing things? Was that just the beginning of this year?

<A - James Curley>: You mean on our books, Sean?

<Q - Sean McGowan>: Yeah. Relative to what you needed to have to meet retailers' demands.

<A - James Curley>: Well, you know, I broke it out in the section when I talked about, you know, what our days of supply were on finished goods. We have kind of an interesting model. We have so much - every product we have has electronics in it. So, the lead times have gone out - what we would have told you two quarters ago has already changed. And our LCD screen lead times have gone from 13 weeks to 26 weeks. That's half a year. So we have been scrambling to add that to our models. So right now, we could actually use more chips. We're very fortunate that we have started to plan, take some of the pressure off the supply chain system changes that we're going
through in the second half. We wanted to get as much inventory in, take some of the pressure off of that. So I mean, I think, clearly where we are right now, while it looks like a big increase, to frame it, it's got two components: it's compared against a small base last year, that we know is very problematic for us, so we didn't want to make that mistake again. And then the second piece is, most of our inventory increase is in raw materials and work in progress. So we're ahead of the game this year, and that's good because last year we couldn't meet the demand that started in the third quarter.

I think to frame it, we're targeting for the end of the year, which I think is the best metric of - it's one thing to have a lot of inventory going into the, you know, your strong selling season. It's another thing to end the year, after Christmas is over, with too much inventory. So our guidance for the full year would be that we're going to look to have inventories at year-end no more than 100 million at cost, which would be comparable to the 91 million we had last year.

<Q - Sean McGowan>: Okay. That's helpful. Could I ask what's causing this dramatic increase in lead times? What reasons are they giving you?

<A - James Curley>: Really, the biggest reason they're giving us is the phone industry, you know, putting pressure on the chip market, and foundries not having capacity.

<A - Thomas Kalinske>: There's also a large increase in demand for color LCD screens, and particularly touch LCD screens.

<Q - Sean McGowan>: Okay. Thank you.

<A - Thomas Kalinske>: Sure, Sean.

Operator: Again to ask a question, please press “*”, then the number “1” on your telephone keypad. Your next question comes from Jill Krutick [Salomon Smith Barney].

<A - Thomas Kalinske>: Hi, Jill.

Operator: Ms. Krutick, your line is now open.

<Q - Jill Krutick>: Hi, sorry, can you hear me?

<A - Thomas Kalinske>: Hi, Jill.

<Q - Jill Krutick>: Hi there. I had a couple of questions. You know, obviously the industry continues to evolve, and the differential you see between over-the-counter sales and the rate of shipments into the channel, you know historically it's a catch-up in the third quarter, but you know increasingly it doesn't ever seem to be catching up. Can you talk about why you expect your 20% sell-through to really be reflected in your shipments? And within that light, maybe talk a little bit about the inventory that you're seeing at retail and the competitive landscape that you continue to see, you know, evolving?

<A - James Curley>: Okay. Well, Jill, I think you're aware that the - while we don't consider ourselves just a, competing in the toy market, but the toy market is down 4% to 5% year to date. Our business is up over 20% year to date. So obviously we're - two things are happening. We're depleting the inventory that we had in the market from the end of last year, and that, obviously, we've shipped so far this year, and we're gaining share. I don't know how else I can, you know, comment on it. I mean, obviously that's a good sign and good trends, and we're doing fine relative to the market. We rely mostly, this time of year, on the over-the-counter sales data we get from almost every retailer. So we know exactly how our business is doing with consumers. The less-
precise data, of course, comes from NPD, and we don't really rely on that, but even that would show the same trends, and show us gaining share of market.

<Q - Jill Krutick>: But in that light, how are you measuring retail at, you know, inventories at the retail level? How would you sort of characterize those, and have you seen any measurable change in the competitive landscape in products similar to yours? I know you're indicating rising market share, but if retailers perceive it to become more competitive in the second half, they may be disinclined to sort of restock at that faster rate?

<A - James Curley>: Yeah, right. Well, clearly we are gaining share of market because you know our competition is not growing at the same rate we are. So by any standard of measurement, we would have to be gaining share of market. In terms of the - and that's occurring on both the platform side and the standalone side, and the software side. In terms of the software side, I would like to make one comment. You know, we have been quiet about this, but we have been doing a large packaging change on software. So if you were a US retailer in April, May and June, you did not have any incentive to purchase software from us, because we were about to implement the change of new packaging, which isn't available until August to ship into the market. So we have clearly been depleting our inventory of software in the marketplace up until now, and start changing that situation as we go into August. In terms of competitive product, I really can't comment any more on it, other than what I've said, we're gaining share of market and they aren't.

<Q - Jill Krutick>: Sure. In terms of full year targets for hardware and software, can you give us a sense of where you're thinking those will go? And also on pricing on software and hardware, what kind of trends are you seeing?

<A - James Curley>: In our guidance, we're looking for positive sales in all three categories, platforms, software, and standalone. Haven't given specific guidance, we're going to stay away from that, but that assumes software especially is going to increase significantly.

<Q - Jill Krutick>: And finally, Bob, I was curious about the repetitive nature of school purchases, and as you build in a base of business, is there naturally a recycling of that same kind of level of business going forward, or is it much more challenging than that?

<A - Robert Lally>: It is more expansion into additional classrooms. As I noted, our contract with Prince George's County was covering just their Title-1 kindergarten classrooms, with a program that has K-5 capacity. And so many of these schools will start in selected grade levels with selected schools, depending upon funding resources, and they will grow into expanding more systems in more classrooms.

<Q - Jill Krutick>: Thank you very much.

<A - Thomas Kalinske>: Thanks, Jill.

Operator: Your next question comes from Jennifer Childe [Bear Stearns].

<Q - Jennifer Childe>: Thank you. Couple of questions. First, I was wondering why your advertising expense was so low. Is it a timing issue or a change in strategy? And then, secondly, with respect to the gross margins, I'm wondering what you didn't anticipate, and what gives you confidence that you'll be able to meet the full year guidance in light of this quarter's miss. Thanks.

<A - Thomas Kalinske>: Jim will answer those.

<A - James Curley>: The advertising was really just timing. We had the Easter shift this year, so we spent - we were over in the first quarter, under in the second. On a full year basis, I think we were up 12% in advertising for the year to date. And what was -
<A - Thomas Kalinske>: Gross margin.

<A - James Curley>: What was the question on gross margin?

<Q - Jennifer Childe>: What didn't you anticipate, relative to your guidance? And what gives you confidence that you'll be able to meet the full year guidance?

<A - James Curley>: In the guidance, you know, clearly the thing that we didn't anticipate was the sales mix. We have seen weaker software sales this year than we were initially anticipating, but that's pretty much explained by the packaging change that we're going out to retail with. Our whole second half initiatives are very exciting. And they're largely targeted around software, because that's really the key to driving the margins and the tie ratio. So we shared with retailers what new packaging was going to look like. We had an old blister pack that took more space up on the pegs, and resulted in less productive space than the new design. The new design is a package that allows - you're hearing this from the finance guy, but a package that allows for a storage container to be reused by the customer. It allows selling tips in there for parents so they can keep and look at what other titles, if they like this one, might be appropriate for their kids. And when the retailers saw the quality of this new package design, most of them held off on their software orders, we feel, to look at getting that as soon as it's available. And most of it's come available right now with new line space.

<Q - Jennifer Childe>: So would you say that software inventory at retail is pretty late?

<A - James Curley>: I would say the demand for software is very grave right now from us, especially the new titles. Leapster has got an excellent tie ratio. But we only have 5 titles at retail. We're coming out with triple that. People are waiting for that to happen. So that, you know, we're waiting to be able to ship those, and they're just starting to come online. LittleTouch as well. We're going to double the LittleTouch library. That's a big opportunity. So I'd say the demand is very great. That's probably the biggest demand for our products right now is software.

<Q - Jennifer Childe>: Thank you.

<A - James Curley>: And welcome back.

<Q - Jennifer Childe>: Thank you.

Operator: At this time, there are no further questions. Mr. Kalinske, are there any closing remarks?

Thomas J. Kalinske, Chief Executive Officer

Yes, thank you. Our next conference call covering the third quarter of 2004 will be in October. Thank all of you for joining us today. Have a good summer.

Operator: This concludes today's LeapFrog Enterprise conference call. You may now disconnect.
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2003

Commission file number 001–31396

LEAPFROG ENTERPRISES, INC.
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

6401 Hollis Street, Suite 150
Emeryville, CA 94608
(Address of principal executive offices)

(510) 420–5000
(Registrant's telephone number, including area code)

SEcurities registered pursuant to Section 12(b) of the Act:

Title of each class Name of each exchange on which registered

Class A common stock, par value $0.0001 per share New York Stock Exchange

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. ☑ Yes ☐ No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S–K is not contained herein, and will not be contained, to the best of registrant’s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10–K or any amendment to this Form 10–K. ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b–2 of the Act). ☑ Yes ☐ No

The aggregate market value of the common equity held by non–affiliates of the registrant calculated using the market price as of the close of business on June 30, 2003 was approximately $719,166,000. The registrant does not have non–voting common stock outstanding.

The number of shares of Class A common stock and Class B common stock, outstanding as of March 1, 2004, was 31,517,258 and 27,882,817, respectively.

DOCUMENTS INCORPORATED BY REFERENCE
The registrant has incorporated by reference in Part III of this report on Form 10–K portions of its definitive Proxy Statement for the Annual Meeting of Stockholders, to be filed by April 29, 2004.
SPECIAL NOTE ON FORWARD−LOOKING STATEMENTS

This report on Form 10−K, including the sections entitled “Item 1. Business,” and “Item 7. Management’s Discussion and Analysis of Financial Condition and Result of Operations,” contains forward−looking statements. These statements relate to future events or our future financial performance and involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to differ materially from any future results, levels of activity, performance or achievements expressed or implied by these forward−looking statements. These risks and other factors include those listed under “Risk Factors That May Affect Our Results and Stock Price” in Item 7 of this Form 10−K and those found elsewhere in this Form 10−K. In some cases, you can identify forward−looking statements by terminology such as “may,” “will,” “should,” “expect,” “intend,” “plan,” “anticipate,” “believe,” “estimate,” “predict,” “potential,” “continue” or the negative of these terms or other comparable terminology. Although we believe that the expectations reflected in the forward−looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. We undertake no obligation to update or revise publicly any forward−looking statements, whether as a result of new information, future events or otherwise after the date of this report.

TRADEMARKS AND SERVICE MARKS

“LeapFrog,” the Leapfrog Logo, “LeapPad,” “Above & Beyond,” “Alphabet Pal,” “Hug & Learn,” “Imagination Desk,” “iQuest,” “Leap,” the Leaping Frog Design, “LeapTrack,” “Learning Something New Everyday,” “Learning Friend,” “Mind Station,” “NearTouch,” “Odyssey,” “Phonics Desk,” “Quantum Pad” and “Turbo Twist” are our registered trademarks or our service marks. “Baby Tad,” “Fridge Phonics,” “Great Reader,” “Language First!,” the LeapFrog SchoolHouse design, “Leap’s Pond,” “LeapStart,” “Fun−Damental,” “Ready, Set, Leap!,” the green GO circle, and the Bouncing Frog Logo are some of our trademarks or our service marks. This report on Form 10−K also includes other trademarks and service marks, as well as trade dress and trade names of ours. Other trademarks in this report on Form 10−K are property of their respective owners.
We believe that our ability to establish and maintain long−term relationships with consumers and retailers depends, in part, on the strength of our customer service and support operations. We encourage and utilize frequent communication with and feedback from our customers and retailers to continually improve our products and service. Our customer service center operates 24 hours a day, 7 days a week during peak periods, specifically from November through January, and 14 hours on weekdays, and 9 hours on Saturdays during off−peak periods. We offer toll−free telephone support for consumers and retailers who prefer to talk directly with a customer service representative. We also respond to email inquiries received through our website, and we have a team of in−house customer service representatives who oversee and coordinate our customer service activities with our third−party customer service provider. In addition, on our website, we have a knowledge resource link that directs consumers to a frequently asked questions section, which we update as we receive consumer feedback. We also have a dedicated retail sales service team. This team works with our top retailers and provides point−of−sale related analysis for better forecasting and inventory plans. Our service operations are based in our Emeryville, California facility.

Customer Service

We believe that our ability to establish and maintain long−term relationships with consumers and retailers depends, in part, on the strength of our customer service and support operations. We encourage and utilize frequent communication with and feedback from our customers and retailers to continually improve our products and service. Our consumer service center operates 24 hours a day, 7 days a week during peak periods, specifically from November through January, and 14 hours on weekdays, and 9 hours on Saturdays during off−peak periods. We offer toll−free telephone support for consumers and retailers who prefer to talk directly with a customer service representative. We also respond to email inquiries received through our website, and we have a team of in−house customer service representatives who oversee and coordinate our customer service activities with our third−party customer service provider. In addition, on our website, we have a knowledge resource link that directs consumers to a frequently asked questions section, which we update as we receive consumer feedback. We also have a dedicated retail sales service team. This team works with our top retailers and provides point−of−sale related analysis for better forecasting and inventory plans. Our service operations are based in our Emeryville, California facility.

Competition

We compete primarily in the infant and toddler category, preschool category and the electronic learning aids category of the U.S. toy industry and, to some degree, in the overall U.S. and international toy industries. We believe the principal competitive factors impacting the market for our products in retail stores are brand, design, features, educational soundness, quality and price. We believe that we compare favorably with many of our current competitors with respect to some or all of their products or using some of our trademarks.
these factors. Our current principal competitors in the toy industry compete in the preschool category and include Hasbro, Inc., Mattel, Inc. and VTech Corporation. In 2003, Mattel introduced a product under the name “PowerTouch” under Mattel’s Fisher−Price brand, and Publications International, Ltd. introduced a product under the name “ActivePAD,” each having functionality similar to that of some of the platforms in our LeapPad family of platforms. In June 2002, Toshiba Corporation began selling an interactive educational platform product in Japan under the name “Ex−Pad.” We also compete with educational software publishers, such as Knowledge Adventure (a studio of Vivendi Universal Games), whose products have distribution at mass retailers and electronics and toy stores, and with producers of popular handheld game platforms, such as Nintendo Co., Ltd. and Sony Corporation, whose products may compete with our Leapster platform. We believe that producers of smart mobile devices, such as personal digital assistants, non−mobile game platforms and computer−based software may be able to compete effectively in our primary markets by developing engaging educational products that run on their platforms. These companies have significantly larger installed bases than we do. We are also beginning to cross over into their markets with products such as our iQuest handheld device. In addition, a number of major hardware and software makers have developed pen−based portable computers like the Tablet PC that could compete with some of our products, such as our LeapPad family of platforms. Consequently, competitors may include companies like Acer Inc., Apple Computer, Inc., Fujitsu Limited, Hewlett−Packard Company, Microsoft Corporation, NEC Corporation, palmOne, Inc., PalmSource, Inc., Sega Corporation, and Toshiba. Many of our direct, indirect and potential competitors have significantly longer operating histories, greater brand recognition and substantially greater financial, technical and marketing resources than we do.

Our SchoolHouse division competes in the U.S. supplemental educational materials market. We believe the principal competitive factors affecting the market for our products in the school market are educational soundness, proven effectiveness, brand, features and price. Our SchoolHouse division faces competition in the supplemental curriculum market from major textbook publishers such as Harcourt (a division of Reed Elsevier), Houghton Mifflin Company, McGraw−Hill, Pearson plc and Scholastic Corporation, as well as electronic educational material and service providers such as Knowledge Adventure, PLATO Learning, Inc., Renaissance Learning and Riverdeep Group plc. Many of the companies with whom we compete have significantly more experience in the supplemental educational materials market and greater resources than we do.

In the future, large entertainment companies such as Viacom International, Inc. and Walt Disney Co. may begin to target the school markets. For a discussion of the possible effects that competition could have on our business, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Risk Factors That May Affect Our Results and Stock Price — If we are unable to compete effectively with existing or new competitors, our net sales and market share could decline.”

Seasonality

Our business is subject to significant seasonal fluctuations. For more information, see “Seasonality and Quarterly Results of Operations” and “Risk Factors That May Affect Our Results and Stock Price — Our business is seasonal, and therefore our annual operating results will depend, in large part, on sales relating to the brief holiday season” in Item 7 of this Form 10−K.

Employees

As of December 31, 2003, we had 869 full−time employees. We intend to hire additional employees as needed at each of our facilities. We also retain independent contractors to provide various services, primarily in connection with our software development and sales activities. We are not subject to any collective bargaining agreements and we believe that our relationship with our employees is good.

Executive Officers of the Registrant

The following table sets forth information with respect to our executive officers as March 1, 2004:

<table>
<thead>
<tr>
<th>Name</th>
<th>Age</th>
<th>Position Held</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thomas J. Kalinske</td>
<td>59</td>
<td>Chief Executive Officer and Director</td>
</tr>
<tr>
<td>Jerome J. Perez</td>
<td>46</td>
<td>President and Director</td>
</tr>
<tr>
<td>Paul A. Rioux</td>
<td>58</td>
<td>Vice Chairman and Director</td>
</tr>
<tr>
<td>Michael C. Wood</td>
<td>51</td>
<td>Chief Vision &amp; Creative Officer, Vice Chairman and Director</td>
</tr>
<tr>
<td>James P. Curley</td>
<td>48</td>
<td>Chief Financial Officer, Treasurer and Secretary</td>
</tr>
<tr>
<td>G. Frederick Forsyth</td>
<td>59</td>
<td>Chief Operating Officer</td>
</tr>
<tr>
<td>Timothy M. Bender</td>
<td>43</td>
<td>President, Worldwide Consumer Group</td>
</tr>
<tr>
<td>Robert W. Lally</td>
<td>42</td>
<td>President, SchoolHouse Division and Executive Vice President, Education and Training Group</td>
</tr>
<tr>
<td>Mark B. Flowers</td>
<td>44</td>
<td>Executive Vice President, Chief Technology Officer</td>
</tr>
<tr>
<td>L. James Marggraff</td>
<td>45</td>
<td>Executive Vice President, Content</td>
</tr>
<tr>
<td>Madeline T. Schroeder</td>
<td>44</td>
<td>Executive Vice President, Publishing Services</td>
</tr>
</tbody>
</table>
Our business is seasonal, and therefore our annual operating results depend, in large part, on sales relating to the brief holiday season. Sales of consumer electronics and toy products in the retail channel are highly seasonal, causing the substantial majority of our sales to U.S. retailers to occur during the third and fourth quarters. In 2003, approximately 79% of our total net sales occurred during this period. This percentage of total sales may increase as retailers become more efficient in their control of inventory levels through just-in-time inventory management systems. Generally, retailers time their orders so that suppliers like us will fill the orders closer to the time of purchase by consumers, thereby reducing their need to maintain larger on-hand inventories throughout the year to meet demand. While these techniques reduce retailers’ investments in their inventory, they increase pressure on suppliers to fill orders promptly and shift a significant portion of inventory risk and carrying costs to suppliers like us. The logistics of supplying more product within shorter time periods will increase the risk that we fail to meet tight shipping schedules, which could damage our relationships with retailers, increase our shipping costs or cause sales opportunities to be delayed or lost. For example, in the second half of 2003, one of our largest retail customers changed its order pattern to occur later in the holiday season, which we believe delayed a significant portion of our net sales to this customer from the third quarter of 2003 to the fourth quarter of 2003. The seasonal pattern of sales in the retail channel requires significant use of our working capital to manufacture and carry inventory in anticipation of the holiday season, as well as early and accurate forecasting of holiday sales. Failure to predict accurately and respond appropriately to consumer demand on a timely basis to meet seasonal fluctuations, or any disruption of consumer buying habits during this key period, would harm our business and operating results.

We rely on a limited number of manufacturers, virtually all of which are located in China, to produce our finished products, and our reputation and operating results could be harmed if they fail to produce quality products in a timely manner and in sufficient quantities.

We outsource substantially all of our finished goods manufacturing to eight manufacturers, all of whom manufacture our products at facilities in the southeastern region of China. One of these manufacturers, Jetta Company Limited, was the sole manufacturer of all our LeapPad platforms in 2002. We depend on these manufacturers to produce sufficient volumes of our products in a timely fashion and at satisfactory quality levels. We generally allow retailers and distributors to return or receive credit for defective or damaged products. If our manufacturers fail to produce quality products on time and in sufficient quantities due to capital shortages, late payments from us, political instability, labor shortages, intellectual property disputes, natural disasters, energy shortages, terrorism or other disruptions to their businesses, our reputation and operating results would suffer. In addition, if our manufacturers decide to increase production for their other customers, they may be unable to manufacture sufficient quantities of our products and our business could be harmed.

If we are unable to compete effectively with existing or new competitors, our sales and market share could decline.

We currently compete primarily in the infant and toddler and preschool categories and electronic learning aids category of the U.S. toy industry and, to some degree, in the overall U.S. and international toy industry. Our SchoolHouse division competes in the supplemental educational materials market. Each of these markets is very competitive and we expect competition to increase in the future. For example, in July 2003, Mattel, Inc. introduced under its Fisher-Price brand a product called “PowerTouch” having functionality similar to that of our LeapPad platform. We believe that we are beginning to compete, and will increasingly compete in the future, with makers of popular game platforms and smart mobile devices such as personal digital assistants. These companies are well situated to compete effectively in our primary markets. Additionally, we are beginning to cross over into their markets with products such as our Leapster platform and iQuest handheld device. Many of our direct, indirect and potential competitors have significantly longer operating histories, greater brand recognition and substantially greater financial, technical and marketing resources than we do. These competitors may be able to respond more rapidly than we can to changes in consumer requirements or preferences or to new or emerging technologies. They may also devote greater resources to the development, promotion and sale of their products than we do. We cannot assure you that we will be able to compete effectively in our markets.

Our quarterly operating results are susceptible to fluctuations that could cause our stock price to decline.

Historically, our quarterly operating results have fluctuated significantly. For example, our net income (loss) for the first through fourth quarters of 2003 was $(1.0) million, $(3.9) million, $33.4 million and $44.2 million, respectively. Our net income (loss) for the first through fourth quarters of 2002 was $(5.1) million, $(7.5) million, $26.7 million and $29.4 million, respectively. We expect these fluctuations to continue for a number of reasons, including:

- seasonal influences on our sales, such as the holiday shopping season and back-to-school purchasing;
- unpredictable consumer preferences and spending trends;
- the need to increase inventories in advance of our primary selling season;
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- timing of new product introductions;
- general economic conditions;
- the results of legal proceedings;
- changes in our pricing policies, the pricing policies of our competitors and general pricing trends in consumer electronics and toy markets;
- international sales volume and the mix of such sales among countries with similar or different holidays and school years than the United States;
- the impact of strategic relationships;
- the sales cycle to schools, which may be uneven depending on budget constraints, the timing of purchases and other seasonal influences; and
- the timing of orders by our customers and our ability to fulfill those orders in a timely manner, or at all.

For example, FAO, Inc. filed for bankruptcy protection in December 2003 and KB Toys, Inc. filed for bankruptcy in January 2004. These and other retailers may elect to close a significant number of stores in 2004, and such actions would affect the timing and amounts of orders of our products from these retailers. In turn, the effects of any changes in orders from these retailers could have a material effect on our quarterly operating results, particularly in the first two quarters of the year, when our sales are generally much lower than in the second half of the year.

We expect that we will continue to incur losses during the first and second quarters of each year for the foreseeable future. We do not have sufficient operating experience to predict the overall effect of various seasonal factors and their effect on our future quarterly operating results. If we fail to meet our projected net sales or other projected operating results, or if we fail to meet analysts’ or investors’ expectations, the market price of our Class A common stock could decrease.

We currently rely, and expect to continue to rely, on our LeapPad family of platforms and related interactive books for a significant portion of our sales.

Our LeapPad, LeapPad Plus Writing and Quantum Pad platforms, each of which is based on our NearTouch technology, together with interactive books related to those platforms that are generally compatible with any of those platforms, accounted for an aggregate of approximately 47% of our net sales in 2003. Our My First LeapPad platform and My First LeapPad interactive books accounted for an aggregate of approximately 12% of our net sales in 2003. No other product line, together with any related software, accounted for more than approximately 10% of our net sales in 2003. A significant portion of our future sales will depend on the continued commercial success of our LeapPad, LeapPad Plus Writing, Quantum Pad platforms and compatible interactive books, and our My First LeapPad platforms and related interactive books. If the sales for our LeapPad, LeapPad Plus Writing, Quantum Pad and My First LeapPad platforms are below expected sales or if sales of their related interactive books do not grow as we anticipate, sales of our other products may not be able to compensate for these shortfalls and our overall sales would suffer.

Our business depends on three retailers that together accounted for approximately 68% of our net sales in 2003, and our dependence upon a small group of retailers may increase.

Wal-Mart (including Sam’s Club), Toys “R” Us and Target accounted in the aggregate for approximately 68% of our net sales in 2003. We expect that a small number of large retailers will continue to account for a significant majority of our sales and that our sales to these retailers may increase as a percentage of our total sales. At December 31, 2002, Wal-Mart (including Sam’s Club) accounted for approximately 33% of our accounts receivable and Toys “R” Us accounted for approximately 30% of our accounts receivable. If any of these retailers experience significant financial difficulty in the future or otherwise fail to satisfy their accounts payable, our allowance for doubtful accounts receivable could be insufficient. If any of these retailers reduce their purchases from us, change the terms on which we conduct business with them or experience a future downturn in their business, our business and operating results could be harmed.

We do not have long-term agreements with our retailers and changes in our relationships with retailers could significantly harm our business and operating results.

We do not have long-term agreements with any of our retailers. As a result, agreements with respect to pricing, shelf space, cooperative advertising or special promotions, among other things, are subject to periodic negotiation with each retailer. Retailers make no binding long-term commitments to us regarding purchase volumes and make all purchases by delivering one-time purchase orders. If the number of our products increases as we have planned or the roll out of versions of our Learning Center shelf displays in selected retail stores proceeds as we anticipate, we will require more retail shelf space to display our various products. Any retailer could reduce its overall purchases of our products, reduce the number and variety of our products
The design, development and manufacture of our products could suffer if a significant number of our employees or the employees of our manufacturers or their suppliers contract SARS or Asian bird flu or otherwise are unable to fulfill their responsibilities or quarantine or other disease-mitigation measures disrupt operations. In the event of any significant outbreak, quarantine or other disruption, we may be unable to quickly identify or secure alternate suppliers or manufacturing facilities and our results of operations would be adversely affected.

Our products are shipped from China and any disruption of shipping could harm our business.

We rely on four contract ocean carriers to ship virtually all of the products that we import to our primary distribution centers in California. Retailers that take delivery of our products in China rely on a variety of carriers to import those products. Any disruption or slowdown of service on importation of products caused by SARS-related issues, labor disputes, terrorism, international incidents, quarantines, lack of available shipping containers or otherwise could significantly harm our business and reputation. For example, in 2002, a key collective bargaining agreement between the Pacific Maritime Association and the International Longshore and Warehouse Union affecting shipping of products to the Western United States, including our products, expired and, after a temporary extension, resulted in an eleven-day cessation of work at West Coast docks. This cessation of work cost us approximately $3.0 million in additional freight expenses. Although the Pacific Maritime Association and International Longshore and Warehouse Union have entered into a new collective bargaining agreement, any further disruption or slowdown of service on importation of products caused by labor disputes, terrorism, international incidents, lack of available shipping containers or otherwise could significantly harm our business and reputation.

We do not have long-term agreements with our major suppliers, and they may stop manufacturing our components at any time.

We presently order our products on a purchase order basis from our component suppliers, and we do not have long-term manufacturing agreements with any of them. The absence of long-term agreements means that, with little or no notice, our suppliers could refuse to manufacture some or all of our components, reduce the number of units of a component that they will manufacture or change the terms under which they manufacture our components. If our suppliers stop manufacturing our components, we may be unable to find alternative suppliers on a timely or cost-effective basis, if at all, which would harm our operating results. In addition, if any of our suppliers changes the terms under which they manufacture for us, our costs could increase and our profitability would suffer.

We depend on our suppliers for our components, and our production would be seriously harmed if these suppliers are not able to meet our demand and alternative sources are not available.

Some of the components used to make our products, including our ASICs, currently come from a single supplier. Additionally, the demand for some components such as liquid crystal displays, integrated circuits or other electronic components is volatile, which may lead to shortages. If our suppliers are unable to meet our demand for our components and if we are unable to obtain an alternative source or if the price available from our current suppliers or an alternative source is prohibitive, our ability to maintain timely and cost-effective production of our products would be seriously harmed and our operating results would suffer.

If we do not correctly anticipate demand for particular products, we could incur additional costs or experience manufacturing delays, which would reduce our gross margins or cause us to lose sales.

Historically, we have seen steady increases in demand for our products and have generally been able to increase production to meet that demand. However, the demand for our products depends on many factors such as consumer preferences, including children’s preferences, and the introduction or adoption of new hardware platforms for interactive educational products, and can be difficult to forecast. We expect that it will become more difficult to forecast demand for specific products as we introduce and support additional products, enter additional markets and as competition in our markets intensifies. If we misjudge the demand for our products, we could face the following problems in our operations, each of which could harm our operating results:

- If our forecasts of demand are too high, we may accumulate excess inventories of components and finished products, which could lead to markdown allowances or write-offs affecting some or all of such excess inventories. We may also have to adjust the prices of our existing products to reduce such excess inventories.
- If demand for specific products increases beyond what we forecast, our suppliers and third-party manufacturers may not be able to increase production rapidly enough to meet the demand. Our failure to meet market demand would lead to missed opportunities to increase our base of users, damage our relationships with retailers and harm our business.
Any errors or defects contained in our products, or our failure to comply with applicable safety standards, could result in delayed shipments or rejection of our products, damage to our reputation and expose us to regulatory or other legal action.

We have experienced, and in the future may experience, delays in releasing some models and versions of our products due to defects or errors in our products. Our products may contain errors or defects after commercial shipments have begun, which could result in the rejection of our products by our retailers, damage to our reputation, lost sales, diverted development resources and increased customer service and support costs and warranty claims, any of which could harm our business. Children could sustain injuries from our products, and we may be subject to claims or lawsuits resulting from such injuries. There is a risk that these claims or liabilities may exceed, or fall outside the scope of, our insurance coverage. Moreover, we may be unable to retain adequate liability insurance in the future. We are subject to the Federal Hazardous Substances Act, the Flammable Fabrics Act, regulation by the Consumer Product Safety Commission, or CPSC, and other similar federal and state rules and regulatory authorities. Our products could be subject to involuntary recalls and other actions by such authorities. Concerns about potential liability may lead us to recall voluntarily selected products. In December 2000, the CPSC announced our voluntary repair program for the approximately 900,000 units of our Alphabet Pal product sold prior to that date. We had instituted the repair proceedings with the CPSC because we were concerned that the product could cause injury. Our costs in connection with the repair were approximately $1.1 million. Any recalls or post-manufacture repairs of our products could harm our reputation, increase our costs or reduce our net sales.

Our rapid growth has presented significant challenges to our management systems and resources, and we may experience difficulties managing our growth.

Since 2001, we have grown rapidly, both domestically and internationally. Our net sales have grown from $314.2 million in 2001 to $680.0 million in 2003. During this period, the number of different products we offered at retail also increased significantly, and we have opened offices in Canada, France, Macau and Mexico. At December 31, 2001, we had 438 full-time employees and at December 31, 2003, we had 869 full-time employees. In addition, we plan to hire a significant number of new employees in 2004. We are upgrading existing and implementing new operational software systems, including supply chain management systems. Further, we are planning on consolidating multiple third party distribution warehouses into a single distribution warehouse to handle our needs. This expansion has presented, and continues to present, significant challenges for our management systems and resources. If we fail to develop and maintain management systems and resources sufficient to keep pace with our planned growth, our operating results could suffer.

Changes in economic conditions, which can result in reduced demand for our products or higher prices for necessary commodities, could harm our business and operating results.

Recent weak economic conditions in the United States and elsewhere have adversely affected consumer confidence and consumer sales generally. In addition, the September 11, 2001 terrorist attacks significantly and negatively affected general economic conditions. Any future attacks and the responses to such attacks, including military action in the Middle East, or other significant events could further impact the economy. Further weakening of the economy could damage our sales in our U.S. Consumer and other segments. Other changes in general economic conditions, such as greater demand or higher prices for plastic, electronic components, liquid crystal displays and fuel, may delay manufacture of our products, increase our costs or otherwise harm our margins and operating results.

Earthquakes or other events outside of our control may damage our facilities or the facilities of third parties on which we depend.

Our two primary U.S. distribution centers, our Silicon Valley engineering office and our corporate headquarters are located in California near major earthquake faults that have experienced earthquakes in the past. An earthquake or other natural disasters could disrupt our operations. Additionally, the loss of electric power, such as the temporary loss of power caused by power shortages in the grid servicing our facilities in California, could disrupt operations or impair critical systems. Any of these disruptions or other events outside of our control could impair our distribution of products, damage inventory, interrupt critical functions or otherwise affect our business negatively, harming our operating results. Our existing earthquake insurance relating to our distribution center may be insufficient and does not cover any of our other operations. If the facilities of our third party finished goods or component manufacturers are affected by earthquakes, power shortages, floods, monsoons, terrorism or other events outside of our control, our business could suffer.
SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

LEAPFROG ENTERPRISES, INC.

By: /s/ James P. Curley
James P. Curley,
Chief Financial Officer

Date: March 10, 2004

POWER OF ATTORNEY

Each individual whose signature appears below constitutes and appoints Thomas J. Kalinske and James P. Curley, and each of them, his or her true and lawful attorneys-in-fact and agents with full power of substitution, for him or her and in his or her name, place and stead, in any and all capacities, to sign any and all amendments to this report on Form 10-K, and to file the same, with all exhibits thereto and all documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he or she might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents or any of them, or his, her or their substitute or substitutes, may lawfully do or cause to be done or by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<table>
<thead>
<tr>
<th>Signatures</th>
<th>Title</th>
<th>Date</th>
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<tbody>
<tr>
<td>/s/ Thomas J. Kalinske</td>
<td>Chief Executive Officer (Principal Executive Officer)</td>
<td>March 10, 2004</td>
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<tr>
<td>Thomas J. Kalinske</td>
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<tr>
<td>/s/ James P. Curley</td>
<td>Chief Financial Officer (Principal Financial and Accounting Officer)</td>
<td>March 10, 2004</td>
</tr>
<tr>
<td>James P. Curley</td>
<td></td>
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<tr>
<td>/s/ Steven B. Fink</td>
<td>Chairman and Director</td>
<td>March 10, 2004</td>
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<td>Steven B. Fink</td>
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<tr>
<td>/s/ Michael C. Wood</td>
<td>Chief Creative and Vision Officer, Vice Chairman and Director</td>
<td>March 10, 2004</td>
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<tr>
<td>Michael C. Wood</td>
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<tr>
<td>/s/ Paul A. Rioux</td>
<td>Vice Chairman and Director</td>
<td>March 10, 2004</td>
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<tr>
<td>Paul A. Rioux</td>
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<tr>
<td>/s/ Jerome J. Perez</td>
<td>President and Director</td>
<td>March 10, 2004</td>
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<tr>
<td>Jerome J. Perez</td>
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<tr>
<td>/s/ Jeffrey Berg</td>
<td>Director</td>
<td>March 10, 2004</td>
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<tr>
<td>Jeffrey Berg</td>
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<tr>
<td>/s/ Stanley E. Maron</td>
<td>Director</td>
<td>March 10, 2004</td>
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<tr>
<td>Stanley E. Maron</td>
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<tr>
<th>Signature</th>
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</thead>
<tbody>
<tr>
<td>/s/ E. Stanton McKee</td>
<td>E. Stanton McKee</td>
<td>Director</td>
<td>March 10, 2004</td>
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<tr>
<td>/s/ Barry Munitz</td>
<td>Barry Munitz</td>
<td>Director</td>
<td>March 10, 2004</td>
</tr>
<tr>
<td>/s/ Stewart A. Resnick</td>
<td>Stewart A. Resnick</td>
<td>Director</td>
<td>March 10, 2004</td>
</tr>
<tr>
<td>/s/ Sarina D. Simon</td>
<td>Sarina D. Simon</td>
<td>Director</td>
<td>March 10, 2004</td>
</tr>
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Report of Ernst & Young LLP, Independent Auditors

The Board of Directors
LeapFrog Enterprises, Inc.

We have audited the accompanying consolidated balance sheets of LeapFrog Enterprises, Inc. (the “Company”), as of December 31, 2003 and 2002, and the related consolidated statements of income, stockholders’ equity and cash flows for each of the three years in the period ended December 31, 2003. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of LeapFrog Enterprises, Inc. at December 31, 2003 and 2002, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in the Note 2 to the consolidated financial statements, in 2002 the Company changed its method of accounting for goodwill and other indefinite lived intangible assets.

San Francisco, California
February 4, 2004

/s/     ERNST & YOUNG LLP
EXHIBIT 15
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

FORM 10-Q

☐ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2004

OR

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission File Number 001-31396

LeapFrog Enterprises, Inc.
(Exact Name of Registrant, As Specified in its Charter)

Delaware
(State of Incorporation) 95-4652013
(I.R.S. Employer Identification No.)

6401 Hollis Street, Suite 150, Emeryville, California 94608-1071
(Address of Principal Executive Offices, Including Zip Code)

Registrant’s Phone Number, Including Area Code: (510) 420-5000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes ☐ No ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☐

The number of shares of Class A common stock, par value $0.0001, and Class B common stock, par value $0.0001, outstanding as of April 30, 2004, was 31,684,384 and 27,881,497, respectively.
We have access to an unsecured credit line to fund our operations if needed. This unsecured credit facility of $30 million was entered into on December 31, 2002, with an option to increase the facility to $50 million, for working capital purposes. This agreement was amended in February 2004 to raise the allowable limit of investment in our foreign subsidiaries. The agreement requires that we comply with certain financial covenants, including the maintenance of a minimum quick ratio on a quarterly basis and a minimum level of EBITDA on a rolling quarterly basis. We were in compliance with these covenants at March 31, 2004. The level of a certain financial ratio maintained by us determines interest rates on borrowings. The interest rate will be between prime and prime plus 0.25% or LIBOR plus 1.25% and LIBOR plus 2.00%. We had outstanding letters of credit of $13.6 million as of March 31, 2004, of which $13.4 million was cash collateralized and $0.2 million was secured by our credit line. Our outstanding letters of credit at March 31, 2003 were $0.4 million. At March 31, 2004, $29.8 million of unused borrowings were available to us.

Commitments

We have provided irrevocable standby letters of credit to several of our inventory manufacturers and one technology partner. The standby letters of credit guarantee performance of the obligations of certain of our foreign subsidiaries to pay for trade payables and contractual obligations of up to $13.4 million and are fully secured by cash deposits with the issuer. Of the $13.4 million in outstanding letters of credit, $8.4 million expires in December 2004 and $5.0 million expires in December 2005. The cash collateral related to the $8.4 million is classified in “restricted cash” and the $5.0 million is included in “other assets (long term)” on our balance sheet.

In April 2004, we entered into a lease for a distribution center located in the Fontana area of unincorporated San Bernardino County, California. The lease is for a building with approximately 600,000 square feet and has a term of 77 months. Our minimum lease obligations over the term of the lease are $13.9 million.

Risk Factors That May Affect Our Results and Stock Price

Our business and our stock price are subject to many risks and uncertainties that may affect our future financial performance. Some of the risks and uncertainties that may cause our operating results to vary or that may materially and adversely affect our operating results are as follows:

If we fail to predict consumer preferences and trends accurately, develop and introduce new products rapidly or enhance and extend our existing core products, our sales will suffer.

Sales of our platforms, related software and stand–alone products typically have grown in the periods following initial introduction, but we expect sales of specific products to decrease as they mature. The introduction of new products and the enhancement and extension of existing products, through the introduction of additional software or by other means, are critical to our future sales growth. For example, in December 2003, we introduced a line of educational videos, and in 2004, we plan to enter the juvenile products category. The successful development of new products and the enhancement and extension of our current products will require us to anticipate the needs and preferences of consumers and educators and to forecast market and technological trends accurately. Consumer preferences, and particularly children’s preferences, are continuously changing and are difficult to predict. In addition, educational curricula change as states adopt new standards. The development of new interactive learning products requires high levels of innovation and this process can be lengthy and costly. To remain competitive, we must continue to develop enhancements of our NearTouch and other technologies successfully, as well as successfully integrate third party technology with our own. In 2004, we intend to introduce a number of new platforms, stand–alone products and interactive books and other software for each of our three business segments. We cannot assure you that these or other future products will be introduced or, if introduced, will be successful. The failure to enhance and extend our existing products or to develop and introduce new products that achieve and sustain market acceptance and produce acceptable margins would harm our business and operating results.

Our business is seasonal, and therefore our annual operating results depend, in large part, on sales relating to the brief holiday season.

Sales of consumer electronics and toy products in the retail channel are highly seasonal, causing the substantial majority of our sales to U.S. retailers to occur during the third and fourth quarters. In 2003, approximately 79% of our total net sales occurred during this period. This percentage of total sales may increase as retailers become more efficient in their control of inventory levels through just–in–time inventory management systems. Generally, retailers time their orders so that suppliers like us will fill the orders closer to the time of purchase by consumers, thereby reducing their need to maintain larger on–hand inventories throughout the year to meet demand. While these techniques reduce retailers’ investments in their inventory, they increase pressure on suppliers to fill orders promptly and shift a significant portion of inventory risk and carrying costs to suppliers like us. The logistics of supplying more product within shorter time periods will increase the risk that we fail to meet tight shipping schedules, which could damage our relationships with retailers, increase our shipping costs or cause sales opportunities to be delayed or lost. For example, in the second half of 2003, one of our largest retail
customers changed its order pattern to occur later in the holiday season, which we believe delayed a significant portion of our net sales to this customer from the third quarter of 2003 to the fourth quarter of 2003. The seasonal pattern of sales in the retail channel requires significant use of our working capital to manufacture and carry inventory in anticipation of the holiday season, as well as early and accurate forecasting of holiday sales. Failure to predict accurately and respond appropriately to consumer demand on a timely basis to meet seasonal fluctuations, or any disruption of consumer buying habits during this key period, would harm our business and operating results.

We rely on a limited number of manufacturers, virtually all of which are located in China, to produce our finished products, and our reputation and operating results could be harmed if they fail to produce quality products in a timely and cost-effective manner and in sufficient quantities. We outsource substantially all of our finished goods manufacturing to nine manufacturers, all of whom manufacture our products at facilities in the Guangdong province in the southeastern region of China. In 2003, our LeapPad and Leapster platforms were manufactured by two manufacturers, while our remaining products were sole-sourced. We depend on these manufacturers to produce sufficient volumes of our products in a timely fashion and at satisfactory quality and cost levels. As part of our global sourcing initiative, we have added more resources in Asia to improve operating efficiencies and to work more closely with our suppliers. We generally allow retailers and distributors to return or receive credit for defective or damaged products. If our manufacturers fail to produce quality products on time, at expected cost targets and in sufficient quantities due to capital shortages, late payments from us, political instability, labor shortages, health epidemics, intellectual property disputes, changes in international economic policies, natural disasters, energy shortages, terrorism or other disruptions to their businesses, our reputation and operating results would suffer. In addition, if our manufacturers decide to increase production for their other customers, they may be unable to manufacture sufficient quantities of our products and our business could be harmed.

If we are unable to compete effectively with existing or new competitors, our sales and market share could decline. We currently compete primarily in the infant and toddler and preschool categories and electronic learning aids category of the U.S. toy industry and, to some degree, in the overall U.S. and international toy industry. Our SchoolHouse division competes in the supplemental educational materials market. Each of these markets is very competitive and we expect competition to increase in the future. For example, in July 2003, Mattel, Inc. introduced under its Fisher-Price brand a product called “PowerTouch” having functionality similar to that of our LeapPad platform. We believe that we are beginning to compete, and will increasingly compete in the future, with makers of popular game platforms and smart mobile devices such as personal digital assistants. These companies are well situated to compete effectively in our primary markets. Additionally, we are beginning to cross over into their markets with products such as our Leapster platform and iQuest handheld device. Many of our direct, indirect and potential competitors have significantly longer operating histories, greater brand recognition and substantially greater financial, technical and marketing resources than we do. These competitors may be able to respond more rapidly than we can to changes in consumer requirements or preferences or to new or emerging technologies. They may also devote greater resources to the development, promotion and sale of their products than we do. We cannot assure you that we will be able to compete effectively in our markets.

Our quarterly operating results are susceptible to fluctuations that could cause our stock price to decline. Historically, our quarterly operating results have fluctuated significantly. For example, our net loss for the first quarter of 2004 was $(11.8) million. Our net income (loss) for the first through fourth quarters of 2003 was $(1.0) million, $(3.9) million, $33.4 million and $44.2 million, respectively. We expect these fluctuations to continue for a number of reasons, including:

- seasonal influences on our sales, such as the holiday shopping season and back-to-school purchasing;
- unpredictable consumer preferences and spending trends;
- the need to increase inventories in advance of our primary selling season;
- timing of new product introductions;
- general economic conditions;
- the financial condition of our retail customers;
- the results of legal proceedings;
- changes in our pricing policies, the pricing policies of our competitors and general pricing trends in consumer electronics and toy markets;
- international sales volume and the mix of such sales among countries with similar or different holidays and school years than the United States;
- the impact of strategic relationships;
- the sales cycle to schools, which may be uneven, depending on budget constraints, the timing of purchases and other seasonal influences; and
For example, FAO, Inc. filed for bankruptcy protection in December 2003 and KB Toys, Inc. filed for bankruptcy in January 2004. These and other retailers may elect to close a significant number of stores in 2004, and such actions would affect the timing and amounts of orders of our products from these retailers. In turn, the effects of any changes in orders from these retailers could have a material effect on our quarterly operating results, particularly in the first two quarters of the year, when our sales are generally much lower than in the second half of the year.

We expect that we will continue to incur losses during the first and second quarters of each year for the foreseeable future. We do not have sufficient operating experience to predict the overall effect of various seasonal factors and their effect on our future quarterly operating results. If we fail to meet our projected net sales or other projected operating results, or if we fail to meet analysts’ or investors’ expectations, the market price of our Class A common stock could decrease.

We currently rely, and expect to continue to rely, on our LeapPad family of platforms and related interactive books for a significant portion of our sales. Our LeapPad, LeapPad Plus Writing and Quantum Pad platforms, each of which is based on our NearTouch technology, together with interactive books related to those platforms that are generally compatible with any of those platforms, accounted for an aggregate of approximately 47% of our net sales in 2003. Our My First LeapPad platform and My First LeapPad interactive books accounted for an aggregate of approximately 12% of our net sales in 2003. No other product line, together with any related software, accounted for more than approximately 10% of our net sales in 2003. A significant portion of our future sales will depend on the continued commercial success of our LeapPad, LeapPad Plus Writing, Quantum Pad platforms and compatible interactive books, and our My First LeapPad platforms and related interactive books. If the sales for our LeapPad, LeapPad Plus Writing, Quantum Pad and My First LeapPad platforms are below expected sales or if sales of their related interactive books do not grow as we anticipate, sales of our other products may not be able to compensate for these shortfalls and our overall sales would suffer.

Our business depends on three retailers that together accounted for approximately 68% of our net sales in 2003, and our dependence upon a small group of retailers may increase. Wal-Mart (including Sam’s Club), Toys “R” Us and Target accounted in the aggregate for approximately 68% of our net sales in 2003. We expect that a small number of large retailers will continue to account for a significant majority of our sales and that our sales to these retailers may increase as a percentage of our total sales. At December 31, 2002, Wal-Mart (including Sam’s Club) accounted for approximately 33% of our accounts receivable and Toys “R” Us accounted for approximately 30% of our accounts receivable. If any of these retailers experience significant financial difficulty in the future or otherwise fail to satisfy their accounts payable, our allowance for doubtful accounts receivable could be insufficient. If any of these retailers reduce their purchases from us, change the terms on which we conduct business with them or experience a future downturn in their business, our business and operating results could be harmed.

We do not have long-term agreements with our retailers and changes in our relationships with retailers could significantly harm our business and operating results.

We do not have long-term agreements with any of our retailers. As a result, agreements with respect to pricing, shelf space, cooperative advertising or special promotions, among other things, are subject to periodic negotiation with each retailer. Retailers make no binding long-term commitments to us regarding purchase volumes and make all purchases by delivering one-time purchase orders. If the number of our products increases as we have planned or the roll out of versions of our Learning Center shelf displays in selected retail stores proceeds as we anticipate, we will require more retail shelf space to display our various products. Any retailer could reduce its overall purchases of our products, reduce the number and variety of our products that it carries and the shelf space allotted for our products, decide not to incorporate versions of our Learning Center shelf displays in its stores or otherwise materially change the terms of our current relationship at any time. Any such change could significantly harm our business and operating results.

Our future growth will depend in part on our SchoolHouse division, which may not be successful.

We launched our SchoolHouse division in June 1999, and to date the division, which accounts for substantially all of the results of our Education and Training segment, has incurred cumulative losses. Although the division reported an operating profit for the second quarter of 2003, it incurred operating losses in the third and fourth quarters of 2003 and the first quarter of 2004, and we anticipate that it may incur additional operating losses in the near term. Sales from our SchoolHouse division’s curriculum–based products will depend principally on broadening market acceptance of those products, which in turn depends on a number of factors, including:

- our ability to demonstrate to teachers and other key educational institution decision–makers the usefulness of our products to supplement traditional teaching practices;
We do not have long-term agreements with our major suppliers, and they may stop manufacturing our components at any time.

We presently order our products on a purchase order basis from our component suppliers, and we do not have long-term manufacturing agreements with any of them. The absence of long-term agreements means that, with little or no notice, our suppliers could refuse to manufacture some or all of our components, reduce the number of units of a component that they will manufacture or change the terms under which they manufacture our components. If our suppliers stop manufacturing our components, we may be unable to find alternative suppliers on a timely or cost-effective basis, if at all, which would harm our operating results. In addition, if any of our suppliers changes the terms under which they manufacture for us, our costs could increase and our profitability would suffer.

We depend on our suppliers for our components, and our production would be seriously harmed if these suppliers are not able to meet our demand and alternative sources are not available.

Some of the components used to make our products, including our ASICs, currently come from a single supplier. Additionally, the demand for some components such as liquid crystal displays, integrated circuits or other electronic components is volatile, which may lead to shortages. If our suppliers are unable to meet our demand for our components and if we are unable to obtain an alternative source or if the price available from our current suppliers or an alternative source is prohibitive, our ability to maintain timely and cost-effective production of our products would be seriously harmed and our operating results would suffer.

If we do not correctly anticipate demand for particular products, we could incur additional costs or experience manufacturing delays, which would reduce our gross margins or cause us to lose sales.

Historically, we have seen steady increases in demand for our products and have generally been able to increase production to meet that demand. However, the demand for our products depends on many factors such as consumer preferences, including children’s preferences, and the introduction or adoption of new hardware platforms for interactive educational products, and can be difficult to forecast. We expect that it will become more difficult to forecast demand for specific products as we introduce and support additional products, enter additional markets and as competition in our markets intensifies. If we misjudge the demand for our products, we could face the following problems in our operations, each of which could harm our operating results:

- If our forecasts of demand are too high, we may accumulate excess inventories of components and finished products, which could lead to markdown allowances or write-offs affecting some or all of such excess inventories. We may also have to adjust the prices of our existing products to reduce such excess inventories.
- If demand for specific products increases beyond what we forecast, our suppliers and third-party manufacturers may not be able to increase production rapidly enough to meet the demand. Our failure to meet market demand would lead to missed opportunities to increase our base of users, damage our relationships with retailers and harm our business.
- Rapid increases in production levels to meet unanticipated demand could result in increased manufacturing errors, as well as higher component, manufacturing and shipping costs, including increased air-freight, all of which could reduce our profit margins and harm our relationships with retailers and consumers.

Any errors or defects contained in our products, or our failure to comply with applicable safety standards, could result in delayed shipments or rejection of our products, damage to our reputation and expose us to regulatory or other legal action.

We have experienced, and in the future may experience, delays in releasing some models and versions of our products due to defects or errors in our products. Our products may contain errors or defects after commercial shipments have begun, which could result in the rejection of our products by our retailers, damage to our reputation, lost sales, diverted development resources and increased customer service and support costs and warranty claims, any of which could harm our business. Children could sustain injuries from our products, and we may be subject to claims or lawsuits resulting from such injuries. There is a risk that these claims or liabilities may exceed, or fall outside the scope of, our insurance coverage. Moreover, we may be unable to retain adequate liability insurance in the future. We are subject to the Federal Hazardous Substances Act, the Flammable Fabrics Act, regulation by the Consumer Product Safety Commission, or CPSC, and other similar federal and state rules and regulatory authorities. Our products could be subject to involuntary recalls and other actions by such authorities. Concerns about potential liability may lead us to recall voluntarily selected products. For example, in December 2000, the CPSC announced our voluntary repair program for the approximately 900,000 units of our Alphabet Pal product sold prior to that date. We had instituted the repair proceedings with the CPSC because we were concerned that the product could cause injury. Our costs in connection with the repair were approximately $1.1 million. Any recalls or post-manufacture repairs of our products could harm our reputation, increase our costs or reduce our net sales.
Our rapid growth has presented significant challenges to our management systems and resources, and we may experience difficulties managing our growth.

Since 2001, we have grown rapidly, both domestically and internationally. Our net sales have grown from $314.2 million in 2001 to $680.0 million in 2003. During this period, the number of different products we offered at retail also increased significantly, and we have opened offices in Canada, France, Macau and Mexico. At December 31, 2001, we had 438 full-time employees and at December 31, 2003, we had 869 full-time employees. In addition, we plan to hire a significant number of new employees in our Asia-based offices in 2004. We are upgrading existing and implementing new operational software systems, including supply chain management systems. Further, in mid-2004, we are planning on consolidating multiple third party distribution warehouses into a single distribution warehouse to handle our needs. This warehouse will be operated by a new third party logistics service provider. This expansion has presented, and continues to present, significant challenges for our management systems and resources. If we fail to develop and maintain management systems and resources sufficient to keep pace with our planned growth, our operating results could suffer.

Changes in economic conditions, which can result in reduced demand for our products or higher prices for necessary commodities, could harm our business and operating results.

Recent weak economic conditions in the United States and elsewhere have adversely affected consumer confidence and consumer sales generally. In addition, the September 11, 2001 terrorist attacks significantly and negatively affected general economic conditions. Any future attacks and the responses to such attacks, including military action in the Middle East, or other significant global events could further impact the economy. Further weakening of the economy could damage our sales in our U.S. Consumer and other segments. Other changes in general economic conditions, such as greater demand or higher prices for plastic, electronic components, liquid crystal displays and fuel, may delay manufacture of our products, increase our costs or otherwise harm our margins and operating results.

Earthquakes or other events outside of our control may damage our facilities or the facilities of third parties on which we depend.

Our two current primary U.S. distribution centers, our planned distribution center in Fontana, California, our Silicon Valley engineering office and our corporate headquarters are located in California near major earthquake faults that have experienced earthquakes in the past. An earthquake or other natural disasters could disrupt our operations. Additionally, the loss of electric power, such as the temporary loss of power caused by power shortages in the grid servicing our facilities in California, could disrupt operations or impair critical systems. Any of these disruptions or other events outside of our control could impair our distribution of products, damage inventory, interrupt critical functions or otherwise affect our business negatively, harming our operating results. Our existing earthquake insurance relating to our distribution center may be insufficient and does not cover any of our other operations. If the facilities of our third party finished goods or component manufacturers are affected by earthquakes, power shortages, floods, monsoons, terrorism or other events outside of our control, our business could suffer.

We are subject to international, federal, state and local laws and regulations that could impose additional costs on the conduct of our business.

In addition to being subject to regulation by the CPSC and similar state regulatory authorities, we must also comply with other laws and regulations. The Children’s Online Privacy Protection Act, as implemented, requires us to obtain verifiable, informed parental consent before we collect, use or disclose personal information from children under the age of 13. Additionally, the Robinson–Patman Act requires us to offer non-discriminatory pricing to similarly situated customers and to offer any promotional allowances and services to competing retailers and distributors within their respective classes of trade on proportionally equal terms. Our SchoolHouse division is affected by a number of laws and regulations regarding education and government funding. We are subject to other various laws, including international and U.S. immigration laws, wage and hour laws and laws regarding the classification of workers. Compliance with these and other laws and regulations impose additional costs on the conduct of our business, and failure to comply with these and other laws and regulations or changes in these and other laws and regulations may impose additional costs on the conduct of our business.

One stockholder controls a majority of our voting power as well as the composition of our board of directors.

Holders of our Class A common stock will not be able to affect the outcome of any stockholder vote. Our Class A common stock entitles its holders to one vote per share, and our Class B common stock entitles its holders to ten votes per share on all matters submitted to a vote of our stockholders. As of April 30, 2004, Lawrence J. Ellison and entities controlled by him beneficially owned approximately 17.0 million shares of our Class B common stock, which represents approximately 55% of the combined voting power of our Class A common stock and Class B common stock. As a result, Mr. Ellison controls all stockholder voting power, including with respect to:

- the composition of our board of directors and, through it, any determination with respect to our business direction and policies, including the appointment and removal of officers;
Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

LeapFrog Enterprises, Inc.  
(Registrant)

/s/ THOMAS J. KALINSKE

Thomas J. Kalinske  
Chief Executive Officer (Authorized Officer)

Dated: May 7, 2004


/s/ JAMES P. CURLEY

James P. Curley  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

Dated: May 7, 2004