



2005 in Review

In 2005 we did what we said we would do.

We entered the year with serious issues to tackle. That is why we took on a focused, aggressive turnaround plan to restore profitability, improve our business processes and, most importantly, to grow the business. It has been difficult, but in 2005 we achieved a great deal against those plans. Here are some of the highlights:

Reduce Costs to Improve Profitability

Early in 2005, we embarked on lowering the fixed cost of the business. Our cost base had grown too rapidly, and we needed to take some aggressive actions. We completed the workforce reduction and we began to realize the full financial benefit of these actions by the end of the third quarter, exactly as planned.

Some of the cost savings were reinvested in improving business processes and growing our business. We have increased headcount in our SchoolHouse division and invested behind information technology, business processes and our supply chain. We also invested in the research and development and marketing of our new products, including our FLY Pentop Computer, Leapster L-MAX platform and SchoolHouse products. Even with these investments, operating expenses declined by \$14 million in 2005.

Improve Business Processes

Having grown from a small, focused, entrepreneurial organization, to a truly complex, broad reaching and successful educational products company, we needed to fix our business processes. Here, too, our results have been significant.

We have upgraded the most senior ranks of our organization and have reinforced the middle and lower management ranks in IT, Supply Chain, Finance and SchoolHouse. For example, in January 2006 we hired a new general manager for our Asian sourcing operations.

In August 2005, we completed the first phase of our Oracle 11i implementation. We have overhauled our financial systems; a necessary step to improving the quality of the information we have available to make decisions and strengthening our internal controls. The next phase of the systems overhaul will be to improve all of our supply chain systems. This implementation phase is scheduled to take place in the first half of this year, and thus not interfere with our business during our busiest season.

Of course, we did not simply sit back and wait until the new systems to come on line to make improvements in our supply chain. We have made improvements in our production planning processes and in our warehousing and distribution capabilities, significantly improving customer service levels. This year we have received high marks; in 2005 we shipped on time and accurately in the United States. Nonetheless, we still need to improve our deliveries for our international markets.

Grow the Business

At the very core of our company is innovation -- it is our life blood and it permeates our culture. That is why we are all very proud of the reaction of the revolutionary FLY Pentop Computer. It has been featured on virtually every major TV show, from *Good Morning America*, to *Dr. Phil*, and everything in between! Also, it was the first product ever



to win three awards at the 2006 Toy Industry Association Awards Ceremony – 2005's Most Innovative Toy of the Year, 2005's Best Educational Toy, and the overall 2005 Toy of the Year!

The FLY Pentop Computer was not our only major success this year. In addition, we saw our US screen-based business more than double. This was due to the introduction of our Leapster L-MAX products and the continued success of our Leapster handheld platform and software.

Perhaps our greatest accomplishment this year was the creation of a healthy, diverse, balanced product line in our US business. Previously we were too reliant on a single product line, namely the LeapPad family of products. We now have three large product categories in addition to the LeapPad family in the United States, and two of those categories are now larger than our LeapPad family of products. We will continue to bring that vibrant portfolio of products to our International markets.

2006 and Beyond

In thinking about the future, it is important to also remember that we are, first and foremost, an educational products company. We remain dedicated to our vision to become the leading brand for quality, technology-based educational products for school, work and home use, for all ages around the world. We work hard to develop products that solve education problems, and are typically aligned with state and national educational standards.

This is why *Fortune Magazine*, in their first "Breakaway Brands" study identified LeapFrog as one of ten "Break-Away Brands". This study, conducted by Landor Associates and BrandEconomics, featured the brands that demonstrated the capacity to "breakaway" from their competitors. In this distinction, we were happy to be in such esteemed group as Google and Apple iPod.

Our new products for 2006 build on this heritage of engaging, innovative educational products that meet our high standards. For the first time ever, LeapFrog is implementing global launches of two of our important new products this year. Because we have exceptionally demanding educational standards, this is not a matter of simply translating language and packaging, but truly localizing product in a culturally- and pedagogically-appropriate manner. So, these simultaneous launches represent a great deal of hard work on the part of our content, engineering and marketing teams, for which we are very proud.

The first of the two products that we will launch globally is the Little Leaps Grow-with-Me learning system. This is an engaging new platform that leverages DVD screen-based technology to gently, and creatively, introduce the building blocks of learning to children under three. Early response to this distinctive learning platform has been very positive and there has been particular enthusiasm regarding the quality of our original content and the interactive play experience. Consumers around the world will be able to choose American or Queen's English, Spanish, French or German language on all Little Leaps software out of the box. The Little Leaps Grow-with-Me learning system will be available in all of our markets this summer.

We are also introducing the LeapsterTV learning system globally. This new educational game console has chunky console buttons and an easy-to-use joystick, extending the Leapster brand to three year olds. The new platform works with the Leapster educational software library, which offers the quality of tutorials, individualized learning paths and rich content and activities now expected from the Leapster brand. Both the classic Leapster handheld and the LeapsterTV platforms will be available in our French and Spanish-speaking markets this summer.

For the FLY Pentop Computer, we are adding algebra, creative writing and in-classroom testing to the personalized homework series. We also have ten new entertaining FLY game products, including a title based on the popular Sudoku puzzle, to keep "t'weens" having fun, and learning during their free time.

In the past six years, our LeapFrog SchoolHouse division has successfully integrated our most innovative technology with our original, state-approved curriculum to create a diversified portfolio of technology-based learning tools for school use. This now reaches far beyond products that leverage the LeapPad technology. In fact, we recently announced the availability of the new Leapster Portable Technology Center, which is designed specifically for classrooms and after-school programs. We are also currently working with several educational organizations and schools in order to fast track the FLY pentop platform for classroom use.

Concluding Comment

In sum, we have made very good progress in our turnaround. Our cost structure has improved, our processes have been strengthened, and we continue to bring extraordinary innovation to the market. Additionally, our vision and brand fundamentals are extraordinary, providing an excellent foundation for the products we are introducing in 2006 and beyond.

The road ahead will be very challenging. Nonetheless we are confident we will continue to build our portfolio of effective, engaging educational products that are trusted by parents and teachers and loved by children.

Respectfully,



Tom Kalinske
Chief Executive Officer



Steven Fink
Chairman of the Board