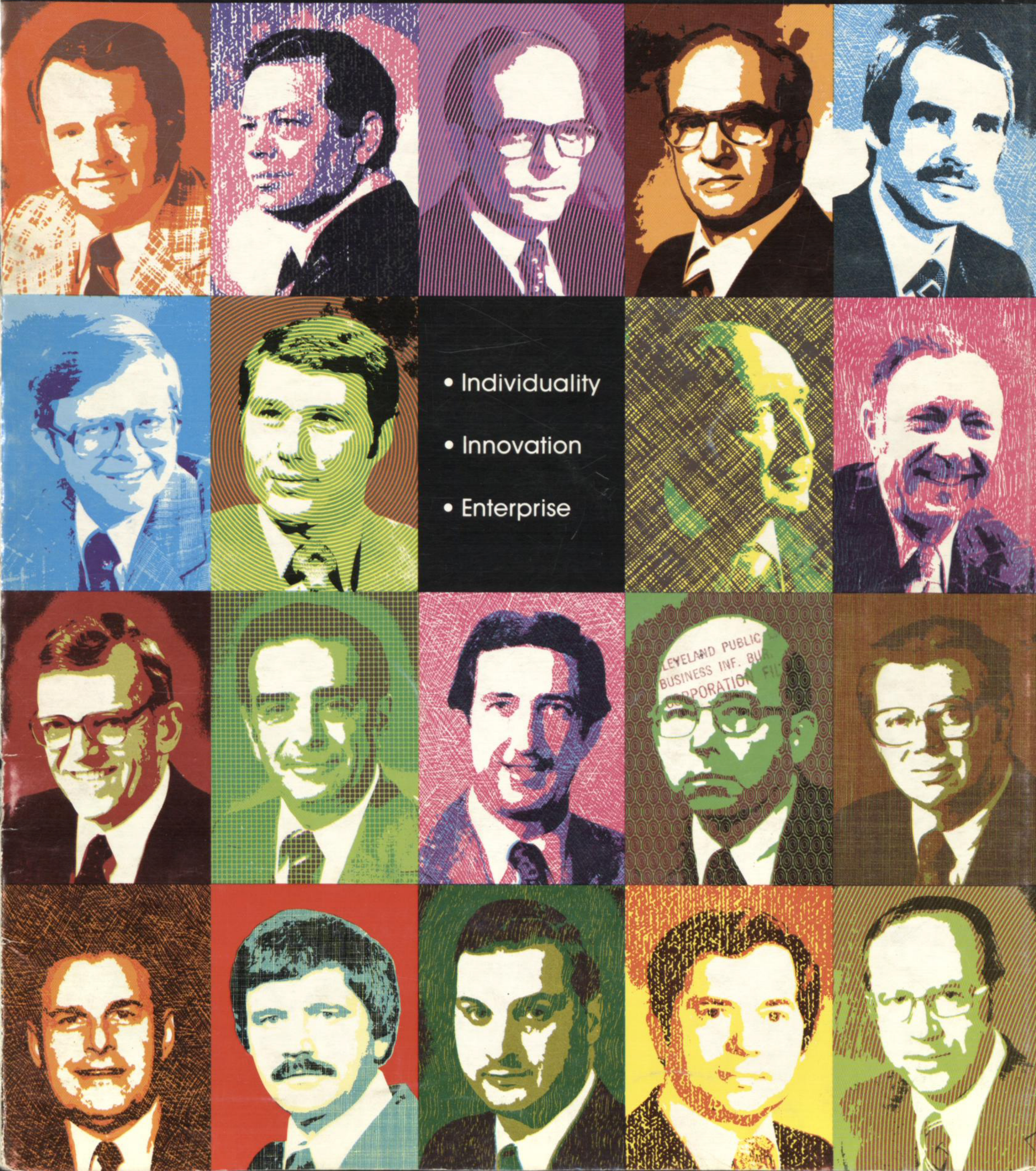
THE SCOTT & FETZER COMPANY 1977 ANNUAL REPORT



• Individuality

• Innovation

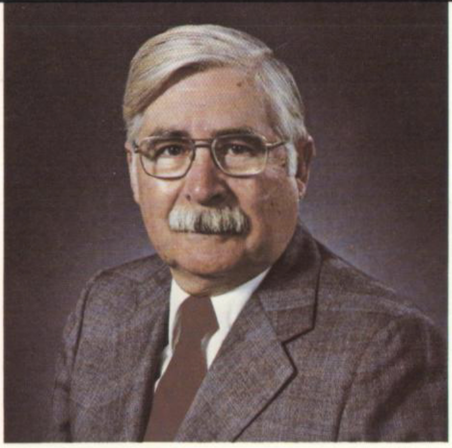
• Enterprise

LEVELAND PUBLIC
BUSINESS INF. BU
RPORATION

A TRIBUTE TO QUIGG LOHR — SENIOR EXECUTIVE VICE PRESIDENT

When Quigg Lohr joined Scott & Fetzer nearly 13 years ago, he already had completed a career as a successful manufacturing business executive spanning 24 years, the last four as president. Earlier, he had been a practicing attorney and also taught evening law courses for 10 years at Cleveland-Marshall Law School, now the College of Law, Cleveland State University. At that time, Scott & Fetzer was just beginning its program to diversify through acquisitions. Quigg became the first executive to join the corporate staff of the "new" Scott & Fetzer, and, in his position as vice president-corporate relations, was immediately and deeply involved with the newly acquired companies.

The mark of his administrative influence remains evident in such early acquisitions as PLM, Adalet, Quikut, Stahl Metal Products, American-Lincoln, and others. Scott & Fetzer's first acquisition in 1964 — PLM Products — was a company that Quigg had co-founded with two business friends many years earlier, in his spare time, to manufacture terminal fittings for armored cable, still a prime product. The company name, PLM, came from the first letters of the founders' names.



QUIGG LOHR
Senior Executive Vice President

As Scott & Fetzer grew rapidly in the Sixties, so did its need for greater expertise in legal matters. With his legal background, Quigg was given full corporate legal responsibilities upon his appointment as vice president and secretary in 1967. During ensuing years, he was elected an executive vice president and became a director. In 1972, he was named senior executive vice president.

Apart from his three careers, Quigg has found time to serve others, through such organizations as Rotary — a 30-year member, president of his local club, and a former district governor — and, currently, as president of the Lakewood Little Theatre-Beck Center for the Cultural Arts, an institution that has attained national prominence.

Quigg Lohr retired on February 1, 1978. Benefits from his contributions, which came during the company's period of greatest growth, will accrue for years to come. For Scott & Fetzer, Quigg Lohr was the right man in the right place at the right time.

The Officers and Employees of
The Scott & Fetzer Company

THE SCOTT & FETZER COMPANY

Corporate Office

14600 Detroit Avenue
Lakewood, Ohio 44107
Telephone: area 216/228-6200

Annual Meeting

The annual meeting of shareholders will be held on Tuesday, March 28, 1978, at 10:30 a.m., at the Lakewood City Hall Auditorium, 12650 Detroit Avenue, Lakewood, Ohio.

Form 10-K Report

Copies of Scott & Fetzer's Form 10-K report, filed with the Securities and Exchange Commission, are available without charge upon written request to Robert C. Weber, Secretary of the company.

Transfer Agent and Registrar

The Cleveland Trust Company
P. O. Box 6477
Cleveland, Ohio 44101

Common Stock

Scott & Fetzer common shares are traded on the New York Stock Exchange, the Midwest Stock Exchange, and the Pacific Stock Exchange. The ticker symbol for the shares is SFZ.

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THE YEAR AT A GLANCE

(Dollar Amounts in Thousands Except Per Share Data)

	1975 (Restated)*	1976 (Restated)*	1977	Per Cent Change 1977 vs. 1976
Net Sales	$247,249	$301,918	$351,187	16%
Income Before Taxes —				
Continuing Operations	30,181	42,367	56,108	32%
Per cent to Sales	12.2%	14.0%	16.0%	
Net Income —				
From Continuing Operations	$ 15,690	$ 21,103	$ 26,802	27%
From Discontinued Operations	1,218	1,618	(496)	
Total	$ 16,908	$ 22,721	$ 26,306	16%
Per cent to Sales — Continuing Operations	6.3%	7.0%	7.6%	
Per Share Earnings —				
From Continuing Operations	$ 2.08	$ 2.78	$ 3.63	31%
From Discontinued Operations	.16	.21	(.07)	
Total	$ 2.24	$ 2.99	$ 3.56	19%
Dividends Per Share ‡	$ 1.02	$ 1.17	$ 1.30	11%
Book Value Per Share	$ 14.43	$ 16.26	$ 18.23	12%
Total Assets	$192,919	$215,277	$225,411	5%
Shares Outstanding (000's) ‡	7,556	7,577	7,317	
Number of Shareholders ‡	10,105	9,377	8,852	

‡ As Reported

** The term "restated" as used throughout this report refers to revisions in previously reported data to recognize the effects of two major accounting changes made in 1977 reporting. Details of both changes are in Notes 1 and 4 to the Financial Statements.*

COMMON STOCK MARKET PRICE AND DIVIDEND INFORMATION

	Market Price of Common Shares				Dividends Per Share	
	1977		1976			
Fiscal Quarter	High	Low	High	Low	1977	1976
First	$28	$23⅞	$26¼	$17⅝	$ .30	$ .27
Second	27⅛	22¾	29⅜	23⅜	.30	.30
Third	29	22⅞	26⅝	23¼	.35	.30
Fourth	28	24⅞	25⅜	21½	.35	.30
Closing price at December 30, 1977	$27¼					

TO THE SHAREHOLDERS

1977 was a challenging and rewarding year for Scott & Fetzer. In this letter I would like to review for you some of the important developments, accomplishments, and unrealized expectations for the year. We had a favorable economic climate during 1977 which resulted in good business conditions for most of our operating units. The group and division management teams achieved our overall corporate sales and earnings objectives and improved Scott & Fetzer's fundamental competitive position in most of the markets we serve. Looking back, I would characterize 1977 as a transition year in Scott & Fetzer's history, in which Phase I was the development of the Kirby vacuum cleaner business. Phase II involved expansion through acquisitions in the 1964-1973 period. The years 1974-77 have been Phase III in which we have refined our operating procedures, reorganized the operating units and identified for disposition those businesses that did not fit into our future plans. The next phase will commence in 1978 with plans for acquiring several larger businesses which will expand the overall scope of Scott & Fetzer. Specifically in 1977 we:

- Made the transition to a new chief executive officer;
- Established new records in sales, net income and earnings per share;
- Consolidated a number of divisions to enhance the continuing divisions' operating performance and future marketing opportunities;
- Strengthened the corporate management group with the addition of two new group vice presidents;
- Completed a critical analysis of Scott & Fetzer's strengths, weaknesses, and future market opportunities. Five divisions were

- identified for disposition, three of which were sold at year end;
- Neared completion of our long-range strategic plan with the identification of several new business areas of interest.

A major unrealized expectation for 1977 was our inability to consummate a significant acquisition, even though several candidates met our market and financial criteria. This remains a major objective for 1978.

These principal developments are discussed in greater detail in subsequent sections of this report.

Results of Operations. During 1977, we identified five divisions that do not fit into our future plans, and accounting rules required these to be classified as "discontinued businesses." Three divisions (Virden-U.S., Rembrandt Lamp, and Atlas Lighting) were sold effective November 30, 1977, and negotiations are underway for the sale of the other two divisions.

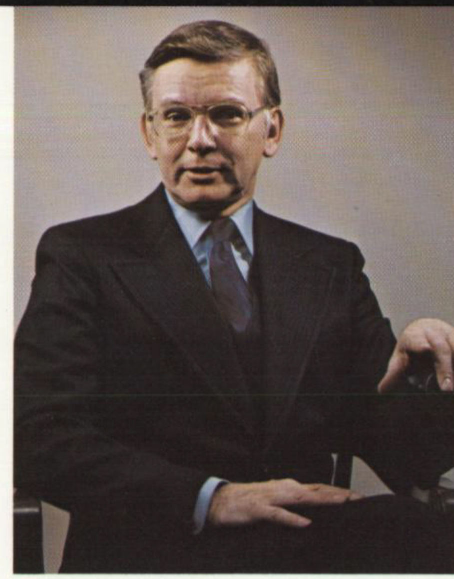
Our 1977 financial statements, in accordance with the requirements of the Financial Accounting Standards Board (FASB), reflect these actual and planned dispositions as "discontinued businesses." 1977 financial data is reported on this basis and all prior fiscal years have been restated to reflect this required accounting treatment. In addition, we are required to change the accounting treatment for certain leases. These changes are discussed in detail in the Business and Financial Review section of this report.

Our reported results for 1977 were as follows: consolidated sales totalled $351.2 million, 16% above the $301.9 million restated for 1976. Net income after taxes amounted to $26.3 million compared with the restated $22.7 million last year, an increase of 16%. Earnings per share rose 19% to $3.56 from a restated $2.99 in 1976.

The results achieved in 1977 were very favorably affected by the substantial operating recovery of our Campbell-Hausfeld group, which is the largest operating unit in the company. Despite weather problems early in 1977 and a two-week strike in June resulting in some severe customer delivery problems, Campbell-Hausfeld achieved its budgeted level of sales and earnings and established new records. This group, which had sales of about $21 million in 1971 — the year it was acquired by Scott & Fetzer — grew to more than $90 million sales in 1977. This rapid growth created a number of management and operating problems during the 1974-76 period. To a large extent, these have been overcome, and Campbell-Hausfeld now has a sound base for future growth and profitability.

Many other operating units contributed to 1977's results. The Kirby group had an excellent year with new sales and earnings records. Including these two groups, 13 of our 19 continuing operating units achieved higher earnings during 1977. The Leisure Time market classification, with a sales increase of 18%, and an earnings improvement of 109%, had the largest growth. The Floor Care product lines also achieved substantial sales and earnings gains.

As I have discussed in previous reports, we have not been satisfied with our lighting businesses.



Sales and operating earnings during 1977 were below even our modest expectations. We effected several writedowns during the year of the lighting divisions' assets preparatory to disposing of these operations. Three lighting divisions were sold at year end. The lighting classification will be eliminated in our 1978 reporting and we plan to reclassify our continuing businesses.

Dividends. The Board of Directors increased the dividend rate to 35 cents per share from 30 cents effective with the payment made on August 31, 1977. This was an increase of 17% in the quarterly rate. Dividend payments totalled $1.30 per share in 1977 compared with $1.17 per share last year, an increase of 11%. It is our management objective to achieve consistent earnings growth which allows an average annual dividend increase of approximately 10% and a pay-out to shareholders of approximately 35-40% of average earnings.

Management Reorganization. During 1977, we undertook to combine some of our divisions, whose operations or markets were relatively compatible, to form more viable, productive and efficient operating units. The consolidation of these divisions enables us to attract or retain the caliber of management and technical people required to achieve expected growth rates of the businesses. It also permits more efficient utilization of the people and other assets of the company. These combinations were:

- The Metalsmiths and Flex-N-Gate divisions were consolidated into the Stahl division. Mr. Kenneth J. Semelsberger is the division president.
- The Adalet and PLM Products divisions were merged to form the Adalet-PLM division, with Mr. Wayne E. Helfrich as president. Mr. Raymond E. Horrocks, former president of PLM, will serve as Corporate Director of Facilities.
- The Kingston and Douglas divisions were reorganized, with the Kokomo, Indiana, plant of Kingston and the Bronson, Michigan, plant of Douglas forming the new Douglas division. Mr. H. Vincent Kornstien is the division president. The Smithville, Tennessee, plant of Kingston, which manufactures electrical timers, was combined with the France division. Mr. Thomas A. Patterson is division president. The Walnut Ridge, Arkansas, plant of the former Douglas division, which

manufactures vacuum cleaners, was combined with the Cardinal division, with Mr. Kearney K. Kier as president.

- The Cleveland Wood Products and Scot Laboratories divisions were merged to form the Klevac division, with Mr. Leonard C. Soros as president.
- The S & A Electronics division was consolidated into the Valley Industries division, with Mr. William E. Dotterweich as president.
- The Kirby and Campbell-Hausfeld units, because of their size and importance to Scott & Fetzer, were given operating group status. Mr. Adrian E. Budlong, Jr., and Mr. James D. Dodson were designated operating group presidents.

In addition, we reorganized the divisional reporting relationships with the addition of two new group vice presidents. We believe that these changes will enhance our principal corporate objective of growing businesses within Scott & Fetzer. A new consumer products group was formed with Mr. Arthur M. Bylin as group vice president. He joined Scott & Fetzer in August, 1977. Previously, Mr. Bylin was president of Club Aluminum Products, a division of Standex International Corporation.

In October, 1977, Mr. Joseph P. Marsalka joined Scott & Fetzer as a group vice president. He has an extensive background in business management, entrepreneurship and has co-founded several business enterprises. As part of our long-term corporate strategy, we have identified the measuring and control markets as areas of significant future interest to Scott & Fetzer. Mr. Marsalka has the assignment of acquiring and developing a new group of product lines and businesses in these markets.

Discontinued Businesses. Over the last two years, we have undertaken a critical analysis of each of our operating units for competitive position, operating performance, future market potential, fit into Scott & Fetzer's future strategy and divisional management strengths and weaknesses. We have combined and consolidated some divisions, made appropriate management changes in others and identified five divisions as candidates for near-term disposition. As previously discussed, the lighting businesses did not meet our expectations for future growth requirements. The Virden Lighting (U.S.), Rembrandt Lamp and Atlas Lighting divisions were sold effective November 30, 1977. Additionally, two other divisions have been classified as discontinued businesses and are in the process of being sold. Negotiations are underway, at this writing, for the sale of these two divisions. When these dispositions are completed, Scott & Fetzer will have 19 operating units.

Unrealized Expectations. Part of our management style is to require that individuals in corporate management, as well as those in the divisions and operating groups,clearly identify objectives for the forthcoming year and beyond. This enables us to better identify our priorities and to determine how well our expectations are being realized. Most of the 1977 objectives were met, including our operating results, management changes, division consolidations, divestitures, and product line acquisitions. A principal objective of 1977, however, was to add to Scott & Fetzer a major business enterprise which was outside the consumer products area in order to strengthen our long-term earnings base. Efforts were underway during most of the year to do this but we were unable to conclude such a transaction during 1977. With the dispositions and consolidations completed, we will concentrate our efforts on this objective in 1978 in order to make it a reality.

Outlook for 1978. Our detailed operational planning for 1978 was completed in early December. Based on the consensus economic projections that generally favorable business conditions will exist in 1978, Scott & Fetzer could experience continued growth in sales and earnings. I would be remiss, however, if I did not indicate that we have considerably less confidence in the economic outlook for 1978 than we had a year ago looking ahead to 1977. Our country faces significant monetary and inflationary problems. If the federal government and particularly Congress fail to take positive actions to correct these problems, we could experience adverse business conditions in late 1978.

Other than the general economy, Scott & Fetzer also has several specific areas of concern. The severe winter weather in the east and south in January has had a significant impact on a number of our plants' production and delivery schedules as well as the Kirby marketing activities. In addition, our Campbell-Hausfeld group, which historically has been a major supplier of air compressors to Sears, Roebuck & Co., lost a portion of this business when Sears elected to add another supplier. Sears will remain Campbell-Hausfeld's largest customer and we will continue to have the major share of Sears' compressor business. Because the air compressor market has grown rapidly over the past five years, we are confident that the lost future sales volume will be recovered through more concentrated sales programs with other retailers. We have taken a number of important steps to retain our overall position, including increased sales representation, product redesign using professional assistance, and an increased effort to remain the lowest cost producer.

We are planning a major capital expenditure program in 1978 with expenditures that may approach $15 million, depending on the timing for several new plant projects. We are planning a new plant for the France division early this year and are now working on the preliminary designs for a new Campbell-Hausfeld plant that should commence later this year. The approval of a number of these expansion programs will depend on continuing favorable economic conditions.

Our management group is committed to sound and profitable growth. We are placing a great deal of emphasis on internally generated growth in our continuing operations. We are planning for and expecting to achieve higher sales and earnings in 1978. Conversely, we have placed equal emphasis on our operating units having detailed contingency plans. If inflationary pressures accelerate, our operating cost controls become increasingly critical. We believe that the operating units are adequately prepared to anticipate and react decisively and vigorously in the event that adverse economic trends develop.

As I complete my first year as Scott & Fetzer's chief executive officer, I want to take this opportunity to express my appreciation for the counsel and support of our directors, the dedication and competence of the corporate and operating unit management groups, the positive efforts of our many fine employees, and the contributions of numerous other groups of people outside our company who have helped make 1977 our best year in business.

Ralph Schey

RALPH SCHEY
President and
Chief Executive Officer

Subsequent Event

On February 7, 1978, the Humphreys Leather Goods division, one of two divisions referred to in the foregoing letter for which sale negotiations were in progress, was sold at book value for cash and notes. For accounting purposes, in this report, the Humphreys division is considered a "discontinued business," as explained in Note 1 of the Notes to Financial Statements.

February 8, 1978

OPERATING UNIT PRESIDENTS

OUR MANAGEMENT RESOURCES

Individuality, Innovation, Enterprise — three important words which characterize the management philosophy of Scott & Fetzer. We are striving to create a business environment which enables individuals to maximize their personal growth through innovation and enterprise. An individual challenged by ambitious personal goals will be similarly challenged by ambitious company goals if he participates in establishing such goals. Individual initiative coupled with a commitment of various corporate resources is a major ingredient in the formula for Scott & Fetzer corporate growth.

All organizations emphasize the importance of people in their statements of corporate philosophy. We believe that corporate goals can be best accomplished by enlarging the opportunity for individuals and groups of individuals to build their own businesses with the assistance of Scott & Fetzer.

We have attempted to clearly define the relationship of our corporate management with the operating unit management in order to assist them to achieve maximum growth. Corporate management has responsibility for the following functions:

- To efficiently and profitably manage the assets of the various groups of businesses we own, somewhat as an investment manager would manage a portfolio of investments over a long term. The review and appraisal of our portfolio has resulted in decisions to dispose of various businesses and to consolidate others in order to meet the market and financial criteria we have established.
- To do the research and planning to determine those areas of business which we feel have the best long-range potential for the corporation. If we are already engaged in a chosen area of business, corporate management will work closely with the operating unit management to expand the base of such selected businesses. A new area of business interest is the responsibility of corporate management to add it to our existing portfolio of businesses and to select the management team who will operate the new business.
- To function as a board of directors for each of our decentralized individual business units with each corporate group vice president serving as chairman of the board. The board's function is to review the strategy and the operational plans of the individual businesses to insure that these plans are compatible with the corporate strategy and to select those individuals who can build their divisional businesses to meet Scott & Fetzer's growth requirements.
- To function as a prudent and knowledgeable banker who appraises the operating units' use of corporate assets and, with perception, insight, experience, and persuasion, allocates on a realistic and objective basis the monetary and other resources of the corporation to best achieve Scott & Fetzer's goals. All major financial decisions are carefully scrutinized to be certain that the risk-reward relationship is consistent with Scott & Fetzer objectives.
- To establish practical and effective early warning internal control systems which regularly monitor division performance and initiate prompt corrective action where necessary.
- To recruit and develop highly motivated individuals with excellent management experience and potential, who share our objective of building substantial businesses within Scott & Fetzer. The individuals' personal opportunities in their operating units and a compensation structure geared to the performance of each unit will be strong inducements for management continuity in a growing business.

OPERATING UNIT PRESIDENTS (From top, left to right, opposite page)

ADRIAN E. BUDLONG, JR.
Kirby Group

JAMES D. DODSON
Campbell-Hausfeld Group

WAYNE E. HELFRICH
Adalet-PLM Division

CLARENCE D. FAYLING
American-Lincoln Division

ROBERT H. WILKINSON
Canada Lighting Division

KEARNEY K. KIER
Cardinal Division

PETER M. QUATROCHI
Carefree of Colorado Division

LEONARD C. SOROS
Klevac Division

H. VINCENT KORNSTIEN
Douglas Division

THOMAS A. PATTERSON
France Division

MERLE FROMSON
Halex Division

WARREN E. McHALE
Meriam Instrument Division

JOHN R. DORNER
Northland Division

THOMAS F. KILEY
Powerwinch/Ja-Son Division

JAMES D. LACY
Quikut Division

KENNETH J. SEMELSBERGER
Stahl Division

JOSEPH DiGIACOMO, JR.
Streamway Division

WILLIAM DOTTERWEICH
Valley Industries Division

RONALD P. DRICKHAMER
Western Enterprises Division

Operating unit managers are encouraged to use their own initiative to aggressively seek ways to build their own business. The central theme at all management meetings is, "Grow Your Own Business." We have placed great emphasis on internally generated growth for each operating unit which we believe can be best achieved by product and market development activities at that level. As part of an operating unit growth plan, it is occasionally desirable to acquire a product line rather than develop it internally. We had several such acquisitions in 1977 which were initiated by operating unit management. We believe that this practice will become a more important feature in our operating unit growth plans.

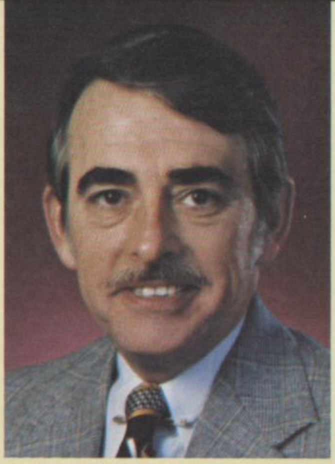
While occasional product line acquisitions play an important role, we stress the need to cultivate and nurture our existing businesses so that they are not ignored in the excitement of becoming deeply involved in something new. Our growth plans must require extensive planning to increase market share for existing products through programs to become the lowest unit cost producer in the industry and to offer engineered products with ever increasing reliability and a minimum of design obsolescence. Our pledge to all customers, whether consumer, commercial, or industrial, is to offer product value which is commensurate to the price paid for the product.

It is our goal to create opportunities for management which provide maximum personal job satisfaction and some of the financial rewards which accrue to managers who also own part of the business they operate. Total management compensation is under constant study and review in order to devise unique systems which will attract and retain management personnel of the caliber who are motivated to, and can, successfully build a business. We have spent a great deal of time to better understand what we believe are the optimum growth rates for each of our businesses and what constitutes superior asset management. Meeting or exceeding such goals over a period of time will permit us to equitably share the benefits of superior performance between successful managers and our shareholders. If our individual operating unit management groups can accomplish these ambitious goals, their compensation and equity interests will be well above average. At the same time, the shareholders benefit through higher dividends and hopefully an enhanced market evaluation of Scott & Fetzer shares.

We have defined a number of ambitious goals for our management — individually and collectively — but we have inspired, enthusiastic people who will respond positively to the opportunities before them. Scott & Fetzer has always been an exciting company, but the future holds even more excitement than the past.

BUSINESS AND FINANCIAL REVIEW

The reported results for 1977 as well as the comparative figures for 1976 and the prior fiscal years shown on the Five-Year Historical Record reflect two accounting changes. First, during 1977 five divisions were identified for disposal and as such are classified as "discontinued businesses." Three of these were sold at year end and negotiations are currently underway for the sale of the other two. Accounting rules require that the sales made by these five "discontinued businesses" be eliminated from total sales and that their earnings or losses be separately stated. Consequently, Scott & Fetzer's 1977 sales and earnings are reported on a "continuing operations" basis with the results of discontinued operations shown separately in determining total reported net income and earnings per share. On the statement of income, page 13, the 1976 figures have been comparably restated.

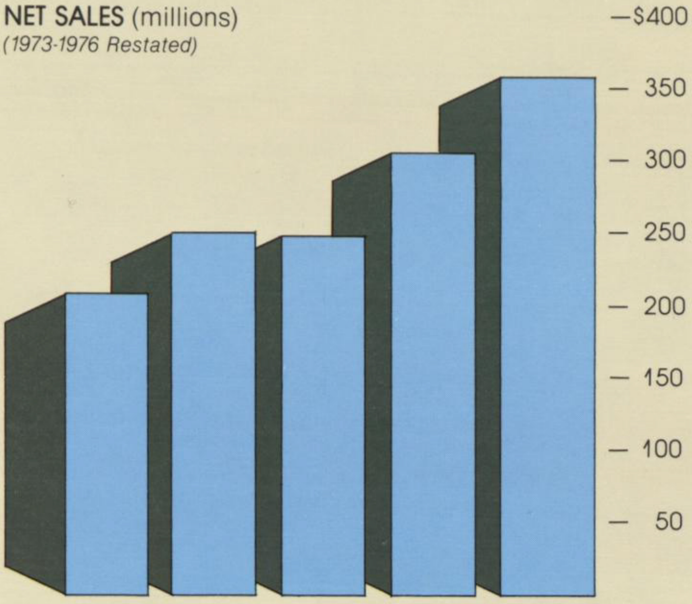


J. F. BRADLEY
Executive Vice President - Finance

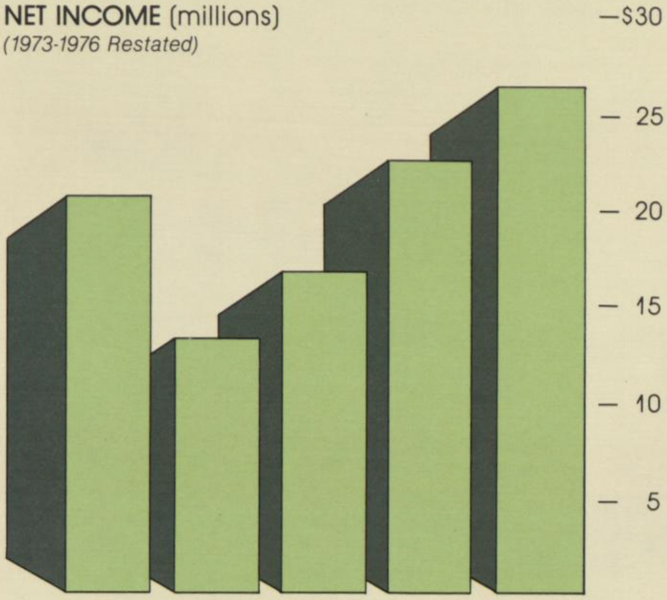
The Financial Accounting Standards Board (FASB) has issued a new accounting rule regarding the treatment of certain leases which caused the second accounting change. The applicable leased facilities and equipment must now be accounted for as though they were owned by the company. As the fictitious owner, it is assumed that the company would incur depreciation charges and interest costs based on the estimated original value of the property. If the depreciation and interest charges exceed the actual lease payments, earnings are reduced by those excess costs. This accounting change reduced 1977 and restated 1976 earnings by approximately two cents per share. The reported previous fiscal years also have been restated.

Sales, income before taxes, net income, earnings per share and dividend payments all were at record levels in 1977. Consolidated sales for continuing operations were $351.2 million, up 16% from restated sales of $301.9 million in 1976. Income before taxes amounted to $56.1 million compared with the restated $42.4 million last year, an increase of 32%. Income after taxes from continuing operations grew 27% to $26.8 million from a restated $21.1 million in the prior year. After inclusion of the income or loss from discontinued operations, net income for 1977 was $26.3 million, 16% above the restated $22.7 million last year. Earnings per share from continuing operations were $3.63 compared with the restated $2.78 per share in 1976. After including the results of discontinued operations, reported earnings per share for 1977 amounted to $3.56, 19% above the restated $2.99 for the prior year.

NET SALES (millions)
(1973-1976 Restated)



NET INCOME (millions)
(1973-1976 Restated)



The net profit margin of the continuing operations improved to 7.6% from 7.0% in 1976. After including the results of discontinued operations, the net profit margin was 7.5%, the same as in 1976. Return on shareholders' equity improved to 19.7% from 18.4% last year.

Sales and income before taxes by market classification are shown on page 12. The 1977 sales for the five classifications include sales made by the discontinued operations for comparability with prior fiscal periods. The sales total $394.7 million compared with $343 million in 1976. After eliminating the sales for the five discontinued businesses, which amounted to $43.5 million in 1977 and $41.1 million for 1976, the sales for continuing operations were as reported above.

Floor Care. The product lines in this classification had an excellent year with sales of $99.5 million, 16% above last year's $85.9 million. Income before taxes increased 23% to $25.6 million from $20.9 million last year. The pre-tax profit margin improved to 25.7%, up from 24.3% in 1976. The Kirby group enjoyed an excellent year with record sales and earnings well above 1976. The American-Lincoln division experienced a good volume increase which coupled with improved operations substantially increased earnings in 1977. These two units accounted for most of the sales and earnings growth.

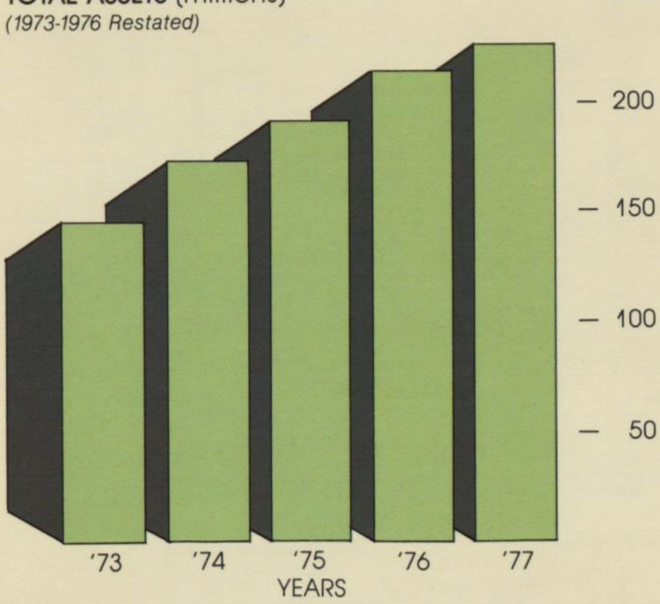
Commercial/Industrial. Sales in this classification increased 17% to $108.1 million from $92.7 million a year ago. Income before taxes amounted to $8.8 million, 12% above the last year's $7.9 million. With the exception of two divisions, which are discontinued operations, all product lines had higher sales and, with one exception, increased earnings. The 1977 results were enhanced by the volume growth and substantial operating improvement achieved by the Campbell-Hausfeld group. Other divisions making significant contributions were Stahl, Douglas, Streamway, Western Enterprises and Quikut. Overall, it was an excellent year for these operating units.

Leisure Time. All operating units in these markets had record volume with sales increasing 18% to $105.7 million from $89.4 million in 1976. Income before taxes amounted to $12.1 million, more than double the prior year's $5.8 million. Sales in the recreational market were very strong and above expectations. Combined with the substantial increase in sales volume of Campbell-Hausfeld's air compressors, this classification contributed the largest sales growth to Scott & Fetzer. The sharply higher earnings growth reflected the sales volume growth in all product lines and the significant operating improvements achieved by both the Campbell-Hausfeld group and Valley Industries division.

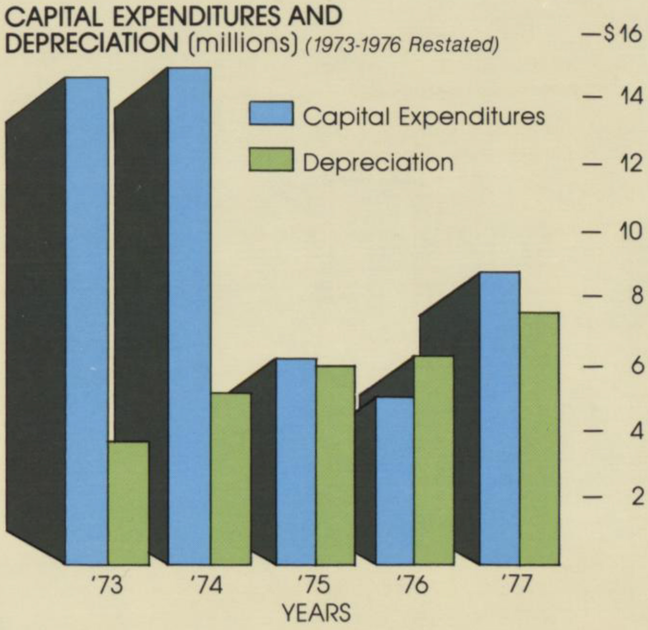
Electrical. Sales of the electrical product lines were $55.2 million compared with $47.5 million in 1976, an increase of 16%. Income before taxes of $10.9 million was 8% above the $10 million earned last year. The higher sales and earnings principally reflected the significant volume increase of the France division, including the Smithville plant's electrical timer business. The Northland division also experienced good volume growth and the Douglas division had improved operating earnings. The other divisions in this category were either modestly below 1976 or approximately at the year earlier level.

Lighting. Sales were $26.2 million, 5% below 1976. While the Virden-U.S. division continued to be profitable, the 1977 loss for this classification was $2.3

TOTAL ASSETS (millions)
(1973-1976 Restated)



CAPITAL EXPENDITURES AND DEPRECIATION (millions) *(1973-1976 Restated)*



million, including asset write-downs effected during or at year end. With the sale of the Virden-U.S., Rembrandt Lamp and Atlas Lighting divisions, this classification will be eliminated commencing with the 1978 first quarter report.

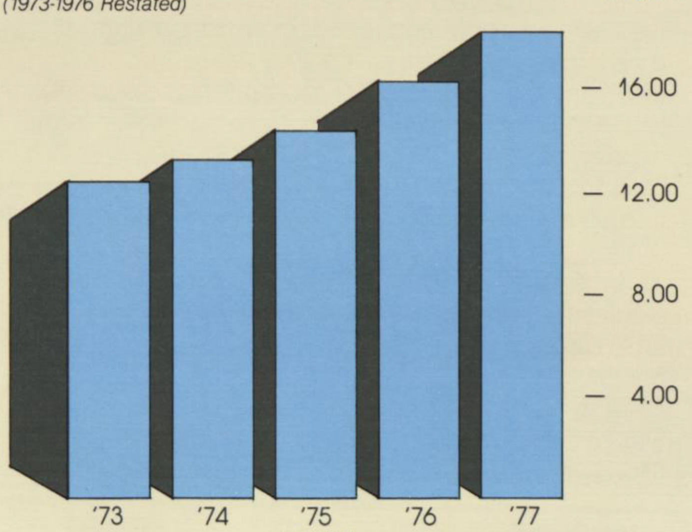
Analysis of Earnings. Income before taxes from continuing operations was $56.1 million, 32% above the restated $42.4 million in 1976. The substantial growth in income before taxes reflected the 16% increase in sales volume and an improved cost of goods sold relationship to sales. In 1977, cost of goods sold was 71.1% of sales, down from 73.6% in the prior year. Selling, general and administrative expenses remained at 12.1% of sales in 1977 and the operating profit improved to 16.8% of sales, well above the 14.3% last year. Other 1977 non-operating expenses totalled $3 million before taxes compared with $0.9 million in the prior year, resulting in a $2.1 million higher deduction from operating profit. Included in these other non-operating expenses were net interest costs (interest expense less interest income) of $1.1 million which compared with $1.2 million for 1976, a decrease of $120,000. The higher non-operating expenses resulted primarily from the loss on disposal of fixed assets and Canadian losses resulting from the sale of an investment in an associated 50%-owned company, the write-off of the goodwill related to the Canadian Lighting division and exchange losses incurred due to the lower value of the Canadian dollar.

Income Taxes. The provision for all income taxes, as shown on the statement of income, page 13, in 1977 was $29.3 million or 52.2% of income before taxes from continuing operations. This compared with $21.3 million in the prior year or 50.2% of restated income before taxes. The factors affecting the tax provision are shown below.

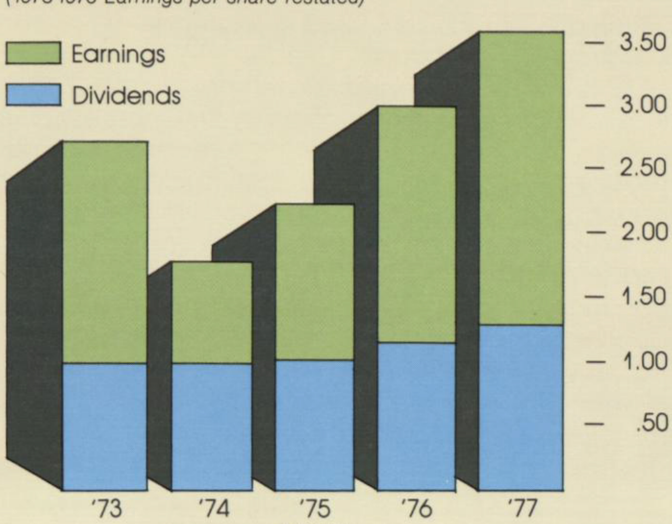
	1977	1976
Income before taxes	$56,108	$42,367
Less state and local	3,164	2,147
Income before Federal and Canadian taxes	$52,944	$40,220
Income taxes at 48% statutory rate	$25,413	$19,306
Adjustments: Add (Deduct)		
Investment tax credit	(300)	(390)
Export "DISC" credit	(286)	(183)
Canadian tax effect	993	(24)
All other, net	322	408
Provision for federal and Canadian income taxes	$26,142	$19,117

The investment tax credit declined to $300,000 this year from $390,000 in 1976 due to lower capital expenditures that qualified for the tax credit. Conversely, the 1977 export "DISC" tax credit increased to $286,000 from $183,000 in the prior year because of higher export sales. The impact on 1977 earnings from the net change in these two tax credits was minimal. The principal cause of the higher effective 1977 tax rate was the change in the provision for Canadian income taxes. In 1976, Scott & Fetzer had a $24,000 tax credit reflecting the lower Canadian corporate income tax rate. However, in 1977 there was no prior years' income against which to offset this year's operating losses. In addition, the goodwill write-off was not deductible for tax purposes. These losses cannot be applied against U. S. income.

BOOK VALUE PER SHARE
(1973-1976 Restated)



EARNINGS AND DIVIDENDS PER SHARE
(1973-1976 Earnings per share restated)



Net Income and Earnings Per Share. The restated quarterly net income and earnings per share for 1977 and 1976 are included in Note 9 to the financial statements on page 20. Each quarter in 1977 was a new record for Scott & Fetzer. Income after taxes for 1977 was $26.8 million from continuing operations, 27% above the comparable $21.1 million in the prior year. After including the results from discontinued operations, net income this year amounted to $26.3 million, 16% higher than the restated $22.7 million a year ago. The discontinued operations had a net loss of $496,000 in 1977 compared with $1.6 million profit in 1976. Note 1 on page 18 shows the composition of the 1977 discontinued operations figure. The principal factors affecting the change in 1977 net income and earnings per share compared with 1976 are as follows:

	Net Income ($000's)	Earnings Per Share
1976 — As reported	$22,861	$3.01
Deduct effect of lease accounting change	140	.02
1976 — Restated	22,721	2.99
Increase (Decrease) in 1977 from:		
Continuing operations	6,636	.87
Lower net interest costs	62	.01
Higher effective income tax rates	(999)	(.13)
Lower number of common and common equivalent shares	—	.10
Change in results of discontinued operations	(2,114)	(.28)
Net change	3,585	.57
1977 — As reported	$26,306	$3.56

The reported net income for 1976 was restated to include the effect of the lease accounting change which amounted to a $140,000 decrease, or two cents per share. The restated figures for 1976 are net income of $22.7 million and earnings per share of $2.99. Earnings from continuing operations in 1977 increased $6.6 million, or 87 cents per share. Net interest costs were reduced $62,000 (after taxes), contributing one cent of earnings per share. The higher effective income tax rate decreased net income $999,000, or 13 cents per share. In early 1977, Scott & Fetzer purchased 267,308 common shares for $6.7 million from the former president of Campbell-Hausfeld. These shares became treasury shares, reducing the number of outstanding common shares. The effect of this transaction was to increase 1977 earnings per share by 10 cents. The five divisions classified as discontinued businesses had net earnings of $1.6 million in 1976 and a loss of $496,000 in the past year. This was a profit decrease of $2.1 million and reduced earnings per share 28 cents. The combined result of these various factors was an increase in 1977 net income of $3.6 million, or 57 cents per share.

Financial Position. The consolidated balance sheet is shown on pages 14-15. The assets and liabilities for 1976 have been restated to reflect the lease accounting change. The effect of this change was to add to the assets under property, plant and equipment, capitalized leased buildings and equipment of $11.8 million less additional accumulated depreciation of $3.7 million for a net increase of $8.1 million. Correspondingly, various current and non-current liabilities were increased $8.7 million and retained earnings were decreased by $0.6 million for a net change of $8.1 million.

In 1977, total assets increased to $225.4 million, up $10.1 million from 1976's restated $215.3 million. Working capital (current assets less current liabilities) increased $9.8 million to $125.2 million from $115.4 million last year. Cash and securities were $12.9 million higher than the prior year. Trade and other receivables were $45.9 million at the end of 1977, $2.1 million below the November 30, 1976, level. Inventories totalled $61.2 million, slightly below the previous year-end level.

Intangible assets declined to $144,000 from $2.1 million at the end of 1976 as a result of the write-off of goodwill. Other assets increased to $3.6 million at the end of 1977 compared with $1 million a year earlier. This increase was due to inclusion of the notes receivable associated with the sale of the Virden Lighting (U.S.) division.

Total long-term debt amounted to $41.8 million, down from $42.7 million at the end of 1976. Included in long-term debt is $10.7 million of debt-equivalent related to capitalized leases compared with $11.3 million last year. Prior to the 1977 lease accounting change referred to earlier, only obligations under lease/purchase agreements were capitalized and treated as debt. This amounted to $3 million in 1976 and $2.8 million this year. In the 1977 and restated 1976 financial statements, the "capitalized leases" item in the long-term debt section of the balance sheet, page 15, includes certain capital leases for buildings and equipment required to be capitalized under the new FASB accounting statement. These amounted to $7.9 million in 1977 and $8.3 million restated for last year. Total shareholders' equity rose to $133.4 million or $18.23 per share compared with $123.2 million and $16.26 per share at the end of 1976, as restated.

SUMMARY OF OPERATIONS

(1976-1973 Restated)

(Dollar Amounts in Thousands Except Per Share Data)

	Years Ended November 30				
	1977	1976	1975	1974	1973
Net sales	$351,187	$301,918	$247,249	$247,539	$222,795
Cost of goods sold	249,521	222,225	185,742	192,186	162,127
Interest expense, capitalized leases	1,056	1,117	1,142	960	497
Interest expense, other	2,904	2,941	2,625	2,532	582
Interest income	2,881	2,859	1,305	132	429
Income taxes	29,306	21,264	14,491	11,126	16,353
Net income	$ 26,306	$ 22,721	$ 16,908	$ 13,559	$ 20,790
Per share					
Earnings per common and common equivalent share	$3.56	$2.99	$2.24	$1.80	$2.75
Dividends*	1.30	1.17	1.02	1.00	1.00
Average number of common and common equivalent shares (000's)*	7,384	7,594	7,559	7,553	7,571

** As reported*

MANAGEMENT'S DISCUSSION AND ANALYSIS OF THE SUMMARY OF OPERATIONS

1977 VERSUS 1976

Consolidated net sales for 1977 were up 16% over restated 1976, reflecting price increases and higher unit volume in most product lines.

Cost of goods sold as a per cent of sales declined to 71.1% from the previous year's 73.6%, the result of improved operating performance and cost reductions.

Provision for income taxes increased 38% over last year, reflecting the increased income before taxes of the U. S. operations and a pre-tax loss incurred by a Canadian subsidiary with no offsetting tax relief.

The 16% gain in net income for 1977 is attributable to volume growth and lower operating costs, partially offset by a higher effective income tax rate. The increase in earnings per share of 19% was higher than the percentage increase in net income as a result of the company's purchase of 267,308 shares of its stock in January of 1977.

1976 VERSUS 1975 (RESTATED)

The company's consolidated net sales increased 22% over the prior year level, reflecting unit volume growth and generally higher selling prices.

Cost of goods sold was 20% higher than in 1975 due to growth in unit volume and increased costs of purchased materials. Interest expense, other, was up 12% over the prior year due primarily to the $30-million 9% ten-year note issue (which replaced bank loans) being outstanding for the full year compared with about six months in 1975. Interest income was substantially higher in 1976 as a result of the interest earned on the company's short-term investments which were well above the 1975 level due to the favorable cash flow from operations.

Total state, local, federal and Canadian income tax provisions were up 47% in 1976 principally reflecting the increased income before taxes, higher state and local tax rates and lower tax credits relative to the level of income before taxes. The effective tax rate for 1976 was 50.2% compared to 48% in the prior year.

Net income for 1976 was up 34% due to the growth in sales volume, improved gross margins and lower net interest costs partially offset by the higher effective income tax rates. The increase in earnings per share of 33% was slightly less than the rate of increase in net income due to a larger number of common and common equivalent shares in 1976.

SALES AND INCOME BEFORE TAXES BY MARKET CLASSIFICATIONS*

(Dollar Amounts in Thousands)

	Floor Care		Commercial/ Industrial		Leisure Time		Electrical		Lighting	
	Amount	Per Cent	Amount	Per Cent	Amount	Per Cent	Amount	Per Cent	Amount	Per Cent
SALES										
1977	**$99,520**	**25%**	**$108,059**	**27%**	**$105,756**	**27%**	**$55,178**	**14%**	**$26,224**	**7 %**
1976	85,873	25%	92,751	27%	89,455	26%	47,478	14%	27,486	8 %
1975	71,955	25%	82,839	29%	68,255	24%	37,226	13%	23,745	9 %
1974	72,885	25%	80,625	28%	64,206	22%	42,279	14%	31,263	11 %
1973	75,303	28%	77,032	29%	54,745	20%	33,016	12%	30,618	11 %
INCOME BEFORE TAXES										
1977	**$25,622**	**46%**	**$ 8,836**	**16%**	**$ 12,058**	**22%**	**$10,868**	**20%**	**$ (2,307)**	**(4)%**
1976	20,855	46%	7,887	17%	5,773	13%	10,035	22%	1,035	2 %
1975	16,247	50%	5,935	18%	3,324	10%	7,010	22%	7	—
1974	11,547	45%	3,220	13%	4,212	16%	5,937	23%	752	3 %
1973	16,578	42%	10,060	25%	7,013	18%	4,589	11%	1,673	4 %

* *Before restatement for elimination of discontinued operations. Income figures have been restated for the change in accounting for leases.*

A DESCRIPTION OF THE COMPANY

The Scott & Fetzer Company is a diversified marketing-oriented manufacturing company selling products in the floor care, leisure time, commercial/industrial and electrical markets. The company has 19 operating units composed of independent businesses, most of which were acquired subsequent to 1963. The operating units are organized and managed as separate decentralized profit centers within Scott & Fetzer. The company was founded in 1914 and was incorporated under the laws of the State of Ohio on November 30, 1917.

CONSOLIDATED STATEMENT OF INCOME

The Scott & Fetzer Company and Subsidiary Companies

(Dollar Amounts in Thousands Except Per Share Data)

	Year Ended November 30	
	1977	1976 (Restated)
NET SALES	$351,187	$301,918
Cost of goods sold	249,521	222,225
Gross profit	101,666	79,693
Selling, general and administrative expenses	42,534	36,409
Operating profit	59,132	43,284
Other income (deductions)		
Interest expense, capitalized leases (Note 4)	(1,056)	(1,117)
Interest expense, other	(2,904)	(2,941)
Interest income	2,881	2,859
Other, net	(1,945)	282
	(3,024)	(917)
Income from continuing operations before income taxes	56,108	42,367
Provision for income taxes:		
State and local	3,164	2,147
Federal and Canadian		
Current	25,464	18,419
Deferred	678	698
Total taxes	29,306	21,264
Income from continuing operations	26,802	21,103
Income (loss) from discontinued operations (Note 1)	(496)	1,618
NET INCOME	$ 26,306	$ 22,721
EARNINGS PER SHARE		
From continuing operations	$ 3.63	$ 2.78
From discontinued operations	(.07)	.21
Total earnings per common and common equivalent share	$ 3.56	$ 2.99
DIVIDENDS PER SHARE	$ 1.30	$ 1.17
Average number of common and common equivalent shares outstanding (000's)	7,384	7,594

The accompanying Notes to Financial Statements and Summary of Accounting Policies are integral parts of these financial statements.

CONSOLIDATED BALANCE SHEET

The Scott & Fetzer Company and Subsidiary Companies

(Dollar Amounts in Thousands)

ASSETS	November 30 1977	November 30 1976 (Restated)
CURRENT ASSETS:		
Cash	$ 7,279	$ 298
Certificates of deposit	24,404	26,689
Short-term investments	28,611	20,444
Trade receivables, less allowance for doubtful accounts 1977 — $793 1976 — $834	44,114	47,121
Other receivables	1,826	929
Inventories (Note 3):		
Raw material and supplies	30,684	32,169
Work in process	16,295	13,999
Finished goods	14,221	15,212
	61,200	61,380
Prepaid expenses	4,054	3,955
TOTAL CURRENT ASSETS	171,488	160,816
PROPERTY, PLANT AND EQUIPMENT:		
Land and land improvements	1,526	1,539
Buildings	11,998	12,528
Machinery and equipment	58,042	56,972
Capitalized leases	15,097	14,930
	86,663	85,969
Accumulated depreciation	36,487	34,646
TOTAL PROPERTY, PLANT AND EQUIPMENT (Note 4)	50,176	51,323
INTANGIBLE ASSETS ARISING FROM ACQUISITIONS	144	2,120
OTHER ASSETS	3,603	1,018
	$225,411	$215,277

The accompanying Notes to Financial Statements and Summary of Accounting Policies are integral parts of these financial statements.

LIABILITIES	November 30 1977	1976 (Restated)
CURRENT LIABILITIES:		
Current portion of long-term debt (Note 2)	$ 1,233	$ 1,113
Accounts payable, trade	20,571	20,822
Accounts payable, other	1,261	1,730
Federal and Canadian income taxes	7,952	7,549
Accrued taxes, other	2,747	2,643
Accrued liabilities	12,537	11,556
TOTAL CURRENT LIABILITIES	46,301	45,413
LONG-TERM DEBT (Notes 2 & 4):		
9% Notes, due 1985	30,000	30,000
Mortgage notes and insurance company loan	1,102	1,397
Capitalized leases	10,736	11,339
TOTAL LONG-TERM DEBT	41,838	42,736
DEFERRED INCOME TAXES	3,907	3,900
TOTAL LIABILITIES	92,046	92,049

SHAREHOLDERS' EQUITY	1977	1976 (Restated)
SERIAL PREFERENCE STOCK:		
Authorized 1,000,000 shares, without par value; none issued		
COMMON STOCK:		
Authorized 15,000,000 shares, without par value (Notes 5 & 7)		
Stated value of issued shares: $1.25 per share		
1977 — 7,576,924 less 260,371 in treasury		
1976 — 7,576,924	9,146	9,471
ADDITIONAL CAPITAL (Note 7)	5,863	5,992
RETAINED EARNINGS (Note 2)	118,356	107,765
TOTAL SHAREHOLDERS' EQUITY	133,365	123,228
	$225,411	$215,277

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

The Scott & Fetzer Company and Subsidiary Companies

(Dollar Amounts in Thousands)

	Year Ended November 30	
	1977	1976 (Restated)
SOURCE OF FUNDS		
From continuing operations:		
Income after taxes	$26,802	$21,103
Depreciation and amortization	5,499	5,366
Writedown of intangible assets	654	—
Deferred federal income taxes	678	698
	33,633	27,167
From discontinued operations:		
Income (loss) after taxes	(496)	1,618
Depreciation and amortization	2,044	881
Writedown of intangible assets and provision for future costs	919	—
Deferred federal income taxes	(671)	(53)
	1,796	2,446
Total from operations	35,429	29,613
Long-term financing arising from capitalized lease obligations	486	423
Proceeds from disposition of divisions, less non-current note receivable of $2,762 received	5,783	—
Sale of common stock under stock options	91	311
Disposal of property, plant and equipment	1,662	490
Other, net	102	(74)
	43,553	30,763
APPLICATION OF FUNDS		
Cash dividends	9,510	8,864
Disposal of net current assets of discontinued divisions	7,309	—
Additions to property, plant and equipment	8,816	5,059
Decrease in long-term debt	1,384	1,296
Acquisition of treasury shares	6,750	—
	33,769	15,219
INCREASE IN WORKING CAPITAL	$ 9,784	$15,544

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION (continued)

(Dollar Amounts in Thousands)

	Year Ended November 30 1977	Year Ended November 30 1976 (Restated)
INCREASE (DECREASE) IN COMPONENTS OF WORKING CAPITAL		
Current assets:		
Cash and certificates of deposit	$ 4,696	$ (7,340)
Short-term investments	8,167	16,394
Trade and other receivables	(2,110)	8,026
Inventories	(180)	5,801
Prepaid expenses	99	1,081
	10,672	23,962
Current liabilities:		
Current portion of long-term debt	120	18
Trade and other payables	(720)	1,962
Accrued liabilities, including taxes	1,488	6,438
	888	8,418
INCREASE IN WORKING CAPITAL	$ 9,784	$15,544

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

(Dollar Amounts in Thousands)

	Year Ended November 30 1977	Year Ended November 30 1976 (Restated)
Retained earnings, beginning of year, as previously reported	$108,341	$ 94,344
Less cumulative effect on prior years of a change in accounting for leases (Note 4)	(576)	(436)
Retained earnings, beginning of year, as restated	107,765	93,908
Net income	26,306	22,721
	134,071	116,629
Cash dividends	9,510	8,864
Excess of cost of treasury stock over amount allocated to common stock and additional capital — 260,371 shares	6,205	—
	15,715	8,864
Retained earnings, end of year	$118,356	$107,765

The accompanying Notes to Financial Statements and Summary of Accounting Policies are integral parts of these financial statements.

NOTES TO FINANCIAL STATEMENTS

1. Discontinued Operations

On November 30, 1977 the Company completed the sale of its domestic lighting divisions (Atlas, Virden and Rembrandt) for cash and notes receivable. Also, the Company has actively entered into a program to sell two additional divisions.

Income and expenses related to discontinued divisions have been removed from the appropriate categories in the statement of income for both years and the net income therefrom included in income (loss) from discontinued operations, as follows (thousands of dollars):

	1977	1976
Results of Operations		
Net sales	$43,550	$41,125
Cost and expenses	42,814	37,908
Income taxes	313	1,599
Operating income	423	1,618
Incurred and anticipated loss on disposal of assets and closing costs, net of income tax benefit of $848	(919)	—
Net (loss) income	$ (496)	$ 1,618

Assets of the two additional divisions are expected to be sold or realized during the ensuing year. The accompanying consolidated balance sheet includes the following estimated net assets for these two divisions in 1977 and the five discontinued divisions in 1976, which are not part of continuing operations of the Company (thousands of dollars):

	1977	1976
Accounts receivable	$ 4,594	$ 7,103
Inventories	5,470	9,257
Property, plant and equipment	3,753	3,656
	13,817	20,016
Liabilities	2,734	3,032
Net assets	$11,083	$16,984

2. Long-Term Borrowing

The indenture for the 9% Notes contains provisions regarding increases in debt, minimum asset-to-debt ratios, and the extent to which dividends may be paid. At November 30, 1977 retained earnings unrestricted for the payment of dividends amounted to $55,134,000. Original issue discount and costs of issuance amounting to $640,000 are being amortized over the life of the notes on a straight-line basis. The effective interest rate approximates 9.19% after deducting original issue discount.

The Company has unused lines of credit with seven banks amounting to $16,000,000. Although withdrawal is not legally restricted, the Company is expected to, and does, maintain compensating balances equal to 10% of the lines of credit.

Aggregate maturities of long-term debt during the five-year period November 30, 1977 through 1982 are $1,233,100, $1,087,900, $987,200, $1,643,700 and $1,074,100, respectively.

For continuing operations, interest and debt expense on long-term debt was $3,906,000 and $3,913,000 for the years ended November 30, 1977 and 1976, respectively.

3. Inventories

If the first-in, first-out cost method of inventory valuation had been used for those inventories presently valued using the last-in, first-out method, inventories presented in the balance sheet would have been $10,099,000 and $9,438,000 higher than reported at November 30, 1977 and 1976, respectively.

Inventories used in the computation of costs of goods sold for continuing operations were as follows (thousands of dollars):

November 30, 1975	$45,631
November 30, 1976	52,123
November 30, 1977	55,730

4. Long-Term Leases

The Company leases certain production and warehouse facilities for terms ranging from 8 to 20 years. The majority of facility leases are for 15 years or more and contain renewal options, generally for 15 years. In addition, the Company leases transportation and other equipment, substantially all for three- to five-year terms. A substantial portion of the equipment leases contains purchase options. In accordance with Financial Accounting Standards Board Statement No. 13, the Company has capitalized all leases in effect at November 30, 1977 and 1976 which meet the criteria for classification as capital leases as defined in the Statement. The capitalized leases are accounted for and depreciated as Company-owned property, with lease payments accounted for as interest and debt reduction. Prior to the change in the method of accounting for leases, substantially all lease payments were charged to rent expense. Leases for property, plant and equipment acquired with the proceeds from industrial revenue bonds have been consistently capitalized. Financial statements for prior years have been restated to apply the new method of accounting retroactively. The effect of the change was to decrease net income by $111,000 and $140,000 in 1977 and 1976, respectively. Earnings per share were decreased by $.02 in each year. For federal income tax reporting purposes, lease costs will continue to be charged to current expense.

Capital leases included in property, plant and equipment at November 30 are comprised of the following (thousands of dollars):

	1977	1976
Land and land improvements	$ 449	$ 449
Buildings	12,506	12,506
Machinery and equipment	2,142	1,975
	15,097	14,930
Less accumulated depreciation	4,708	3,870
	$10,389	$11,060

Future minimum lease payments under noncancelable leases at November 30, 1977 are summarized below (thousands of dollars):

Years Ending November 30,	Capitalized Leases	Operating Leases
1978	$ 2,194	$ 2,995
1979	2,003	2,282
1980	1,759	1,849
1981	2,087	1,656
1982	1,943	1,606
Later years	9,207	9,242
Total minimum lease payments	19,193	19,630
Less minimum sublease rents	—	773
Net minimum lease payments	$19,193	$18,857

The present value of net minimum lease payments for capitalized leases was $11,673,000 after deducting estimated taxes, maintenance, insurance and other costs of $87,000 and interest of $7,433,000. Interest is computed at rates implicit in the leases, and the rates range from 4¼% to 15¾%. Included in minimum sublease rents for operating leases are estimates of future rents under leases to be assumed by the purchasers of discontinued operations.

Net rent expense for noncancelable operating leases for the years ended November 30, 1977 and 1976 amounted to $2,992,000 and $2,905,000, respectively, after deducting sublease rents of $95,000 and $42,000, respectively.

5. Stock Options

The Company adopted common stock option plans in 1967 and 1973 for which 40,000 shares and 175,775 shares, respectively, are reserved for issuance under outstanding options at November 30, 1977. Shares reserved for future grants at November 30, 1977 and 1976 were 411,938 and 239,600, respectively.

The 1973 stock option plan provides for the granting of either qualified or nonqualified options to officers and key employees to purchase shares of common stock at a price not less than 100% of the fair market value of the stock on the date options are granted. Options are exercisable one-fourth each year and expire five years after grant for qualified options, and 10 years after grant for nonqualified options.

On March 22, 1977 the shareholders approved modifications to the 1973 stock option plan which increased the number of shares available under the plan by 250,000 common shares and permits the granting of stock appreciation rights to optionees under the plan. As of November 30, 1977, no stock appreciation rights have been granted.

Information relating to options is set forth below:

		Option Price		Market Price	
	Number of Shares	Average Per Share	Total	Average Per Share	Total
Options granted:					
1977	94,975	$24.88	$2,363,240	$24.88	$2,363,240
Options becoming exercisable:					
1976	49,182	26.10	1,283,885	22.22	1,092,733
1977	38,834	24.06	934,262	26.01	1,009,987
Options exercised:					
1976	20,900	14.90	311,500	20.10	420,000
1977	6,937	13.06	90,584	25.67	178,041
Options outstanding:					
1976	165,700	26.21	4,343,638	26.21	4,343,638
1977	215,775	25.78	5,562,622	25.78	5,562,622

Certain options granted under the plans have corresponding contingent options under the 1973 plan which may be exercised only upon the lapsing of existing options.

During 1977 and 1976, options for 37,963 shares and 30,300 shares, respectively, were cancelled. No options were granted during 1976. The Company has made no charges against income with respect to options.

6. Pension and Retirement Plans

The majority of the Company's employees are covered by various non-contributory trusteed pension and profit-sharing plans. Contributions under the plans charged to continuing operations were $2,268,000 and $2,336,000 for the years ended November 30, 1977 and 1976, respectively. These include, as to certain of the plans, amortization of past service costs over periods ranging from 24 to 40 years. The amount required to fund past service costs is estimated at $11,859,000. The Company's policy is to fund pension costs accrued. The aggregate actuarially computed value of vested benefits exceeded the total pension fund assets and balance sheet accruals by approximately $2,670,000 at November 30, 1977.

7. Capital Stock

Changes in the common stock and additional capital accounts during the two years ended November 30, 1977 and 1976 were as follows (dollars in thousands):

	Common Stock			
	Treasury Shares	Issued Shares	Stated Value	Additional Capital
Balance, November 30, 1975	(2,161)	7,558,185	$9,445	$5,707
Sale of stock under options	2,161	18,739	26	285
Balance, November 30, 1976	—	7,576,924	9,471	5,992
Purchase of stock	(267,308)	—	(334)	(211)
Sale of stock under options	6,937	—	9	82
Balance, November 30, 1977	(260,371)	7,576,924	$9,146	$5,863

8. Contingent Liabilities

Any liability that may result from lawsuits and other claims pending against the Company will not be material in the opinion of management of the Company.

9. Quarterly Earnings Data (Unaudited)

The quarterly earnings data presented below has been adjusted for continuing operations and restated for the change in accounting for leases. The data has been subjected to a limited review by the Company's independent accountants in accordance with the standards prescribed by the American Institute of Certified Public Accountants. Their limited review did not constitute an audit and, accordingly, they do not express an opinion on this interim financial information.

(Dollar Amounts in Thousands Except Per Share Data)

	1977 Fiscal Year by Quarter			
	First	Second	Third	Fourth
Net sales	$80,009	$98,147	$88,331	$84,700
Gross profit	22,446	27,881	23,648	27,691
Income from continuing operations	5,530	8,324	6,038	6,910
Income (loss) from discontinued operations	86	(886)	801	(497)
Net income	$ 5,616	$ 7,438	$ 6,839	$ 6,413
Earnings per share				
From continuing operations	$ .74	$1.13	$ .82	$ .94
From discontinued operations	.01	(.12)	.11	(.07)
Total	$ .75	$1.01	$ .93	$ .87

	1976 Fiscal Year by Quarter			
	First	Second	Third	Fourth
Net sales	$66,071	$82,878	$77,656	$75,313
Gross profit	17,664	21,017	19,642	21,370
Income from continuing operations	4,886	5,959	5,204	5,054
Income (loss) from discontinued operations	(53)	388	699	584
Net income	$ 4,833	$ 6,347	$ 5,903	$ 5,638
Earnings per share				
From continuing operations	$ .65	$ .78	$ .68	$ .67
From discontinued operations	(.01)	.05	.10	.07
Total	$ .64	$ .83	$ .78	$ .74

10. Current Replacement Costs (Unaudited)
The Company is required to report to the Securities and Exchange Commission in its Form 10K, beginning for fiscal 1977, certain information relating to current replacement cost of productive capacity (primarily buildings, machinery, and equipment), replacement cost of inventories at year-end, and the effect during the year on Cost of Goods Sold, if costs were used that were in effect at the time of sale. This information basically is intended to show the effects of inflation on current operations and the future effects of replacing productive capacity at current costs and should be looked upon only as an indication of the state of the general economy as it relates to the Company at the present time. It does not purport to show the future operating performance of the Company, since productive capacity would not be replaced at one time and future costs are dependent on ever changing economic conditions and management control of all economic factors affecting the Company.

Management is constantly aware of the effects of inflation on production costs and the ability to maintain and improve productive capacity and is continually taking steps to reduce costs and upgrade its productive assets to take advantage of technological improvements and innovations in order to maintain a modern, efficient manufacturing operation.

The calculation of the current replacement cost data was based on estimates and various assumptions. The value of this analysis is limited to the validity of the estimates and assumptions and is of minimal usefulness to the Company.

A copy of the annual report to the Securities and Exchange Commission on Form 10K, which includes the complete replacement cost analysis for fiscal 1977, may be obtained from the Company upon request.

SUMMARY OF ACCOUNTING POLICIES

The following is a summary of significant accounting policies followed in the preparation of these financial statements. The policies conform to generally accepted accounting principles and have been consistently applied in the preparation of the financial statements.

Principles of Consolidation — Consolidated financial statements include the accounts of all subsidiaries, all of which are wholly owned. Intercompany balances, transactions and stockholdings have been eliminated in consolidation.

Short-Term Investments — Short-term investments, principally United States Treasury obligations, are carried at cost, which approximates market value.

Inventory Valuation — The last-in, first-out method of inventory valuation is used for a majority of domestic inventories. The remaining inventory is valued principally at average standard cost. Inventory valuations are at the lower of cost or market.

Property, Plant and Equipment — Items capitalized as part of land, buildings and equipment, including significant betterments to existing facilities, are valued at cost. When property is retired or is otherwise disposed of, the cost and accumulated depreciation are removed from the appropriate accounts and any gain or loss included in current income. Maintenance, repair and ordinary renewals are charged to expense as incurred.

Depreciation — Straight-line and accelerated methods are used in the computation of depreciation for financial reporting purposes, the straight-line method being used for the majority of the assets.

Deferred Income Taxes — Deferred income taxes arise from timing differences between the recognition of income and expense items for financial and tax reporting purposes. The principal timing differences are for depreciation and capitalized lease costs.

Investment Tax Credit — In the year it arises, investment tax credit is recorded as a reduction of the provision for federal income taxes.

Business Combinations — Where combinations qualify as "poolings of interest," the current results of operations include those of acquisitions for the entire year and financial statements of the preceding year are restated. Acquisitions which constitute "purchases" are included from the date of acquisition, and amounts assigned to intangibles are amortized on a straight-line basis over a 40-year period. There were no combinations during 1977.

Earnings Per Share — Earnings per common share are determined by dividing net income by the weighted average number of shares of common stock outstanding plus common share equivalents (shares issuable for certain stock options granted).

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

To the Board of Directors and Stockholders
The Scott & Fetzer Company

We have examined the consolidated balance sheet of The Scott & Fetzer Company and subsidiary companies as at November 30, 1977 and 1976 and the related consolidated statements of income, retained earnings and changes in financial position for the years then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the consolidated financial position of The Scott & Fetzer Company and subsidiary companies at November 30, 1977 and 1976, the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis after restatement for the change, with which we concur, in the method of accounting for long-term leases as described in Note 4 to the financial statements.

Coopers & Lybrand

Cleveland, Ohio
January 24, 1978

REPORT OF THE BOARD OF DIRECTORS' AUDIT COMMITTEE

Scott & Fetzer's Audit Committee of the Board of Directors has four members, all outside directors. During the 1977 fiscal year, the committee met four times to review the company's operating results, news releases and shareholder reports. At each meeting, we also monitored and discussed the financial control system with the company's senior management, public auditors — Coopers & Lybrand, and the manager of internal audits.

Each year, we have seen continued improvement and refinement in the company's divisional financial control systems. Most of the weaknesses that we observed in prior years have been corrected with new financial personnel and more sophisticated cost and accounting procedures. While there will be continued improvements in the future, we are satisfied that the company's operations are under adequate control.

The committee has received the full cooperation of the public and internal auditors and the senior financial officers. We believe that the company's management has kept us adequately informed on current problem areas and we have complete access to any information or personnel that may be required for us to discharge our responsibilities. We are not aware of anything of a materially adverse nature that has not been properly reported and discussed. We will continue to monitor Scott & Fetzer's management and financial control systems and general business practices to satisfy the Board of Directors that obligations both to the public and to the shareholders are being adequately met.

On behalf of the committee, I want to thank all of the personnel involved who have helped us meet our obligations.

For the Audit Committee

J. T. Bailey

Cleveland, Ohio
January 24, 1978

Joseph T. Bailey
Chairman

HISTORICAL RECORD, 1973-1977

(Dollar Amounts in Thousands Except Per Share Data)

AS REPORTED*	1977	1976	1975	1974	1973
Net Sales	$351,187	$343,043	$284,020	$291,258	$270,714
Income Before Taxes	56,108	45,855	32,791	25,931	40,064
Net Income	26,306	22,861	17,048	13,696	20,869
Cash Dividends	9,510	8,864	7,706	7,554	7,456
Per cent Payout of Net Income	36.2	38.8	45.2	55.2	35.7
Earnings Retained and Reinvested	16,796	13,997	9,342	6,142	13,413
Capital Expenditures	8,816	4,636	6,064	12,473	12,753
Working Capital	125,187	116,180	100,602	84,496	60,505
Long-Term Debt	41,838	34,350	34,772	27,424	3,334
Total Assets	225,411	207,223	184,177	162,729	136,076
Shareholders' Equity	133,365	123,804	109,496	100,137	93,837
Per cent Return on Shareholders' Equity	19.7	18.5	15.6	13.7	22.2
Per Share					
Earnings	3.56	3.01	2.26	1.81	2.76
Dividends	1.30	1.17	1.02	1.00	1.00
Book Value	18.23	16.34	14.49	13.25	12.44
Market Price Range	29-22¾	29⅜-17⅝	22-8⅛	25⅝-8⅜	44¾-24⅛
Price Earnings Ratio	8-6	10-6	10-4	14-5	16-9
Year-End Data					
Shares Outstanding (000's)	7,317	7,577	7,556	7,555	7,544
Number of Shareholders of Record	8,852	9,377	10,105	9,896	8,498
Number of Employees	7,255	7,500	7,084	7,481	8,296
RESULTS RESTATED**					
Net Sales	$351,187	$301,918	$247,249	$247,539	$222,795
Income Before Taxes	56,108	42,367	30,181	23,586	34,132
Per cent to Sales	16.0	14.0	12.2	9.5	15.3
Income from Continuing Operations	26,802	21,103	15,690	12,460	17,779
Per cent to Sales	7.6	7.0	6.3	5.0	8.0
Income (Loss) from Discontinued Operations	(496)	1,618	1,218	1,099	3,011
Net Income	26,306	22,721	16,908	13,559	20,790
Earnings Per Share:					
From Continuing Operations	3.63	2.78	2.08	1.65	2.35
From Discontinued Operations	(.07)	.21	.16	.15	.40
Total	3.56	2.99	2.24	1.80	2.75

* *"As Reported" for 1976 and prior years includes discontinued operations and certain leases not capitalized.*

** *"Results Restated" reflects a change in accounting for leases and the net sales and income before taxes of continuing operations.*

FLOOR CARE

Vacuum cleaners and other floor maintenance equipment and supplies for residential, industrial and institutional use.

Cardinal Division
815 E. Tallmadge Avenue
Akron, Ohio 44310

New line of "Douglas" Family Concept Vacuum Cleaners, introduced in 1978

Klevac Division
3881 W. 150th Street Cleveland, Ohio 44111

Left: Packaged replacement parts for popular model vacuum cleaners
Above: Floor shampoos, polishes, cleansers and other household products

Kirby Group
1920 W. 114th Street
Cleveland, Ohio 44102

Kirby West
N. Main Road
Andrews, Texas 79714

Kirby of Canada
1009 Burns Street East
Whitby, Ontario, Canada

Top: Kirby Classic III Vacuum Cleaner
Center: Kirby canister with extension wand and cleaning attachments
Bottom: Kirby Deep Cleaning Hand Portable

American-Lincoln Division
1100 Haskins Road
Bowling Green, Ohio 43402

The "Sweep Dream" — for large interior and exterior sweeping jobs

LEISURE TIME

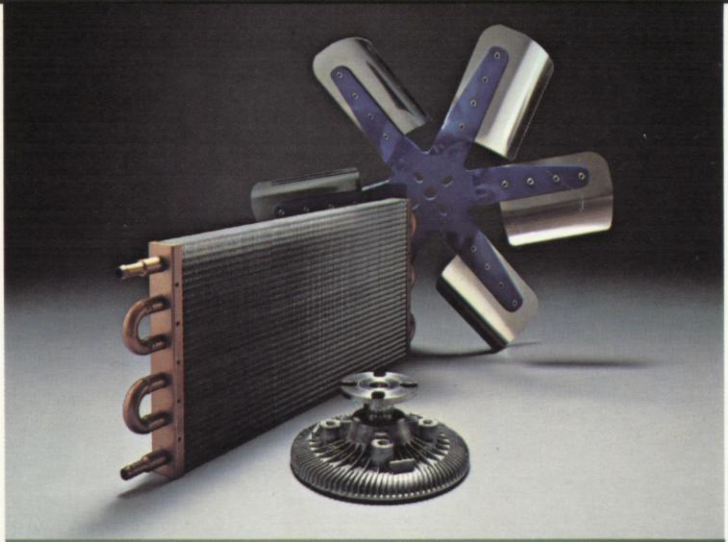
Air compressors and paint spray equipment for home, farm and commercial use; hitching and towing equipment, accessories and awnings for recreational vehicles; mechanical winches, electric power winches and hoists for boats and trailers.

Carefree of Colorado Division
2760 Industrial Lane
Broomfield, Colorado 80020

Upper: "Shadow Box" awning
Lower: "Breezeway" screen enclosure

Powerwinch/Ja-Son Division
217 Long Hill Cross Road
Shelton, Connecticut 06484

Powerwinch mounted on Jeep



Valley Industries Division
1313 S. Stockton Street
Lodi, California 95240

Valley Industries-East
P. O. Box 444
Shelbyville, Kentucky 40065

Upper: Oil cooler fan and fan clutch products
Lower: Trailer towing products

Campbell-Hausfeld Group
801 Production Drive
Harrison, Ohio 45030

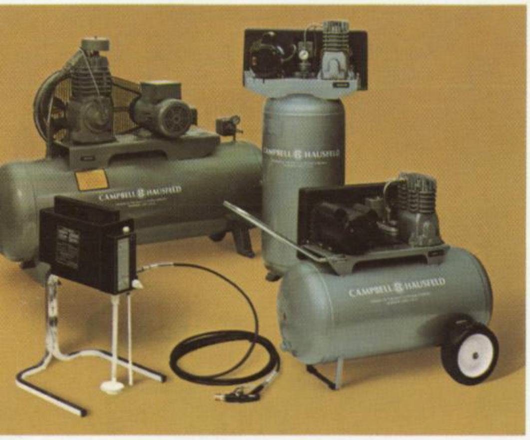
Portable air compressor

COMMERCIAL/INDUSTRIAL

Water system fixtures for mobile homes and other plumbing applications; compressed gas connectors and fittings; utility truck bodies; truck bumpers; hydraulic valves; steering column components for trucks and off-the-road equipment; telephone exchange metal mounting frames; air compressors, paint spray equipment, and foundry products; household cutlery; plastic food containers; manometric measuring instruments; cold forged scissors for the home, school and office.

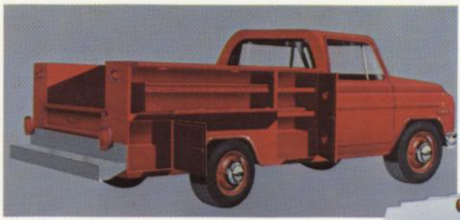
Meriam Instrument Division
10920 Madison Avenue
Cleveland, Ohio 44102

"Accutube" gauge line with indicating switch unit
Inset: flow meter



Campbell-Hausfeld Group
801 Production Drive
Harrison, Ohio 45030

Air compressors and airless paint sprayer



Stahl Division
4750 West 160th Street
Cleveland, Ohio 44135

Top: The "Challenger" utility service body
Center: Utility service van
Bottom: TowSweeper

Cardinal Division
815 E. Tallmadge Avenue
Akron, Ohio 44310

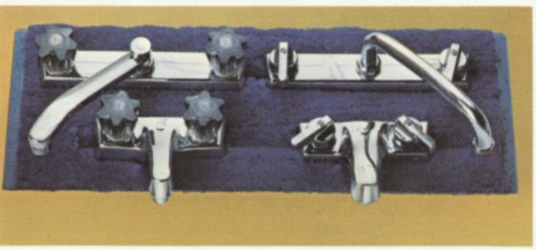
Molded plastic containers for food products

Powerwinch/Ja-Son Division
217 Long Hill Cross Road
Shelton, Connecticut 06484

Scissors for school, home and office

Quikut Division
1100 Napoleon Street
Fremont, Ohio 43420

Steak and carving set



Streamway Division
835 Sharon Drive
Westlake, Ohio 44145

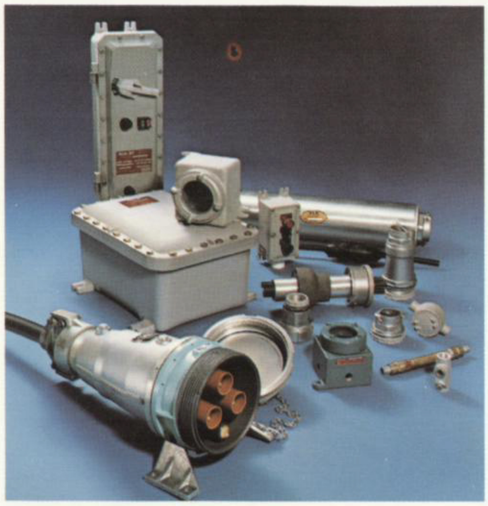
Water system fixtures

Western Enterprises Division
33672 Pin Oak Parkway
Avon Lake, Ohio 44012

Medical pressure regulator

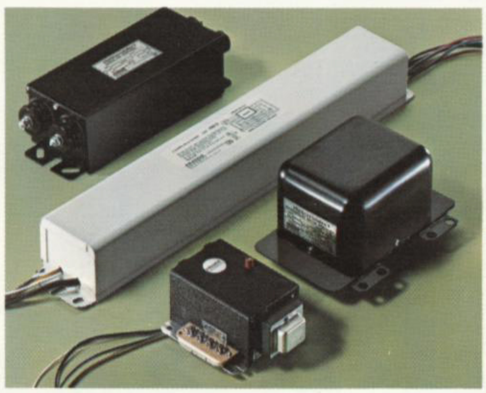
ELECTRICAL

Fractional horsepower motors; fittings, transformers, ballasts, furnace ignition systems; timers for automatic laundry equipment; high voltage cable fittings and couplers; explosion-proof housings; conduit fittings; television and CB antennas.



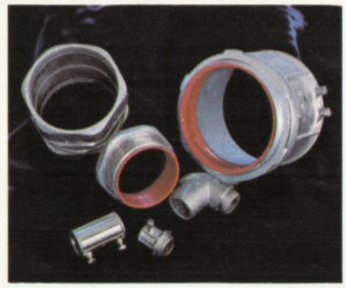
Adalet-PLM Division
4799-4801 W. 150th Street
Cleveland, Ohio 44135

Electrical products for energy related markets



France Division
875 Bassett Road
Westlake, Ohio 44145

Electrical controls

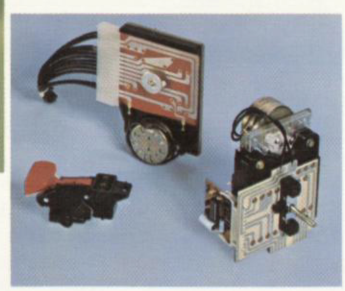


Halex Division
23901 Aurora Road
Bedford Heights, Ohio 44146

Conduit fittings

Northland Division
968 Bradley Street
Watertown, New York 13601

Motor for vacuum cleaner

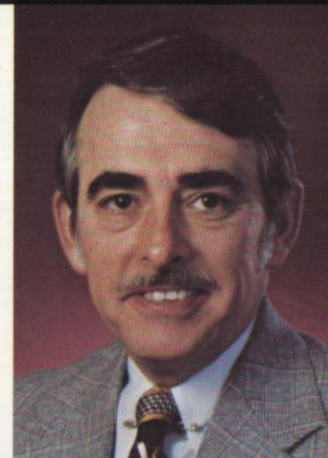


Kingston Timer Plant
Miller Road
Smithville, Tennessee 37166

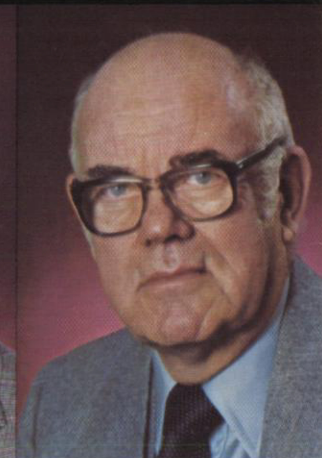
Controls for automatic laundry equipment

DIRECTORS AND

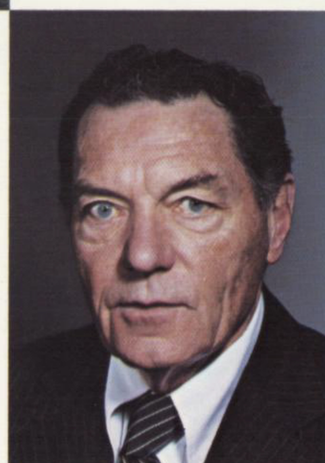
JOSEPH T. BAILEY
Chairman and
Chief Executive Officer,
The Warner & Swasey Co.,
Manufacturer of machine tools, construction equipment, and textile machinery
Audit Committee, chairman; Compensation and Organization Committee



J. F. BRADLEY
Executive Vice President - Finance
Investment Committee, chairman; Executive Committee



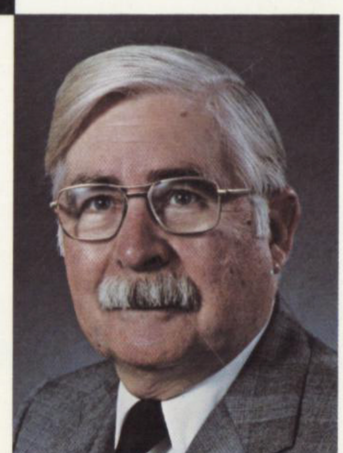
NILES H. HAMMINK
Formerly Chairman and
Chief Executive Officer,
The Scott & Fetzer Co.
Executive Committee, chairman; Investment Committee



JAMES A. HUGHES
Director and former
Chairman, Diamond
Shamrock Corporation,
Producer of chemicals, petroleum and related products
Audit Committee, Compensation and Organization Committee

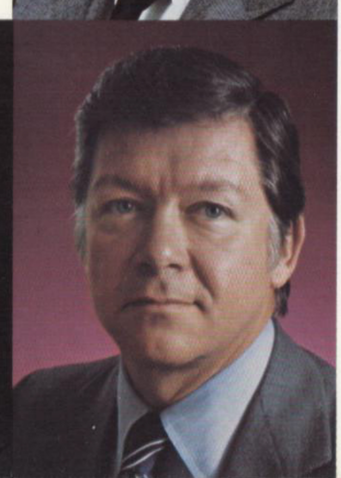
LAWRENCE C. JONES
Chairman and President,
Van Dorn Company,
Manufacturer of special purpose containers and plastic injection molding machinery, and heat treating of steel
Audit Committee, Investment Committee

DELMAR W. KARGER
Professor of Management,
Rensselaer Polytechnic
Institute
Compensation and Organization Committee



QUIGG LOHR
Senior Executive
Vice President
(Retired February 1, 1978)

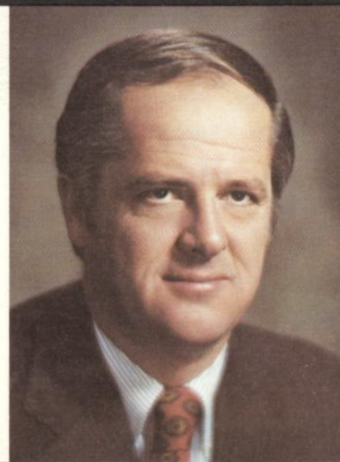
RALPH SCHEY
Chairman, President and
Chief Executive Officer
Executive Committee



THOMAS W. SMITH
Private Investor
Compensation and Organization Committee, chairman; Audit Committee

CORPORATE MANAGEMENT

JOHN BEBBINGTON

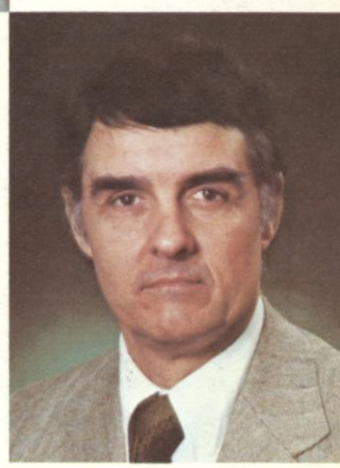


ARTHUR M. BYLIN

JOSEPH P. MARSALKA

WALTER A. RAJKI

KENNETH D. HUGHES



ROBERT C. WEBER

CORPORATE MANAGEMENT

RALPH SCHEY
Chairman, President and Chief Executive Officer

J. F. BRADLEY
Executive Vice President - Finance

JOHN BEBBINGTON
Group Vice President

ARTHUR M. BYLIN
Group Vice President

JOSEPH P. MARSALKA
Group Vice President

WALTER A. RAJKI
Group Vice President

KENNETH D. HUGHES
Treasurer and Controller

ROBERT C. WEBER
Secretary and General Counsel

The Scott & Fetzer Company
14600 Detroit Avenue
Lakewood, Ohio 44107

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