

SECURITIES AND EXCHANGE COMMISSION

FORM 10-K

Annual report pursuant to section 13 and 15(d)

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FILER

APPLIANCE RECYCLING CENTERS OF AMERICA INC /MN

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SIC: **5090** Misc durable goods

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended January 2, 1999

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File No. 0-19621

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
(Exact name of registrant as specified in its charter)

MINNESOTA
(State or other jurisdiction of
incorporation or organization)

41-1454591
(I.R.S. Employer
Identification No.)

7400 EXCELSIOR BOULEVARD, MINNEAPOLIS, MINNESOTA
(Address of principal executive offices)

55426-4517
(Zip Code)

Registrant's telephone number, including area code: 612-930-9000

Securities registered pursuant to Section 12(b) of the Act: NONE

Securities registered pursuant to Section 12(g) of the Act:

COMMON STOCK, WITHOUT PAR VALUE
(Title of class)

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.

As of March 12, 1999, the aggregate market value of the voting stock held by nonaffiliates of the registrant, computed by reference to the average of the high and low prices on such date as reported by the OTC Bulletin Board, was \$1,416,715.

As of March 12, 1999, there were outstanding 2,266,744 shares of the registrant's Common Stock, without par value.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement dated March 23, 1999, are incorporated by reference into Part III hereof.

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PART I

ITEM 1. BUSINESS

GENERAL

Appliance Recycling Centers of America, Inc., together with its operating subsidiaries ("ARCA" or the "Company"), provides a comprehensive range of services for the large-scale resale and recycling of major household appliances in an environmentally sound manner. The Company provides its customers with integrated processes and programs addressing the solid waste management, environmental and energy conservation issues involved with appliance disposal and recycling. The Company generates revenues from the sale of reconditioned and distressed appliances through a chain of Company-owned retail stores called Encore(R) Recycled Appliances ("Encore") and Appliance\$mart(R), fees charged for the disposal of appliances, and the sale of materials generated from processed appliances (byproduct revenues).

The Company was incorporated in Minnesota in 1983, although through its predecessors it commenced the appliance recycling business in 1976. The Company's principal office is located at 7400 Excelsior Boulevard, Minneapolis, Minnesota 55426-4517. References herein to the Company include its operating subsidiaries. (See Exhibit 21.1.)

INDUSTRY BACKGROUND

There are more than 500 million major household appliances, such as refrigerators, freezers, ranges, dishwashers, microwaves, washers, dryers, room air conditioners, water heaters and dehumidifiers, currently in use in the United States. It is estimated by the Steel Recycling Institute that in 1995, 42 million major household appliances were taken out of use in the United States. Industry sources estimate that 50 to 55 million major household appliances will be disposed of each year between the years 1997 and 2000. The disposal of these appliances has become a serious problem as a result of a number of factors including: (i) decreasing landfill capacity in many parts of the country; (ii) the inability of incinerators, composting facilities and other landfill alternatives to process appliances; and (iii) the presence in appliances of certain hazardous and other environmentally harmful materials that require special processing.

Legislation affecting appliance disposal has been adopted in more than 30 states. This legislation includes landfill restrictions, disposal bans, advance disposal fees and other types of restrictions. As a result, appliances must be dealt with outside the ordinary municipal solid waste stream.

Landfill restrictions arise in part because some appliance components contain certain hazardous and other environmentally harmful materials, including polychlorinated biphenyls (PCBs), mercury, refrigerants such as chlorofluorocarbons (CFCs) and sulfur dioxide, and oils. PCBs are suspected as carcinogens, are resistant to degradation when deposited in landfills and can cause groundwater contamination. The production of PCBs was banned by the EPA in 1979, although businesses were allowed to continue using remaining inventories of components that contained PCBs. Mercury is toxic to humans and can enter the body through inhalation, skin absorption or ingestion, and it vaporizes at high temperatures forming extremely toxic fumes. CFCs are believed to cause long-term damage to the earth's stratospheric ozone layer and may contribute to global warming when released into the atmosphere. The 1990 Amendments to the Clean Air Act prohibit the venting of CFCs and since July 1,

1992 have required the recovery of CFC refrigerants during the service, repair and disposal of appliances. See Business - Government Regulation.

In addition to these solid waste management and environmental issues, utility companies, motivated by economic and environmental factors to control energy consumption, sponsor various programs to encourage and assist residential consumers to conserve energy, including programs for turning in surplus, energy-inefficient appliances. Many residential consumers own and operate room air conditioners, freezers or more than one refrigerator, contributing significantly to residential energy use and peak energy demand. In addition, many of the refrigerators manufactured in the 1960s and early 1970s consume up to 1,750 kilowatt-hours of electricity each year. The National Appliance Energy Conservation Act requires that a typical 18-cubic-foot refrigerator manufactured after 1992 have an energy consumption rate not exceeding 700 kilowatt-hours per year. As new, more efficient appliances become available, utility companies have begun to encourage the use of newer models and the disposal of older, less efficient models.

The Federal Energy Policy Act of 1992 gives individual states the option of deregulating their electric utility industry. The potential of deregulation has caused uncertainty about the future and form of energy conservation programs sponsored by electric utilities. Some electric utility companies are delaying new energy conservation programs, including the Company's refrigerator recycling program. The Company believes, however, that energy conservation and efficiency programs will remain a long-term component of the nation's electric utility industry. See Business - Government Regulation.

A developing market for the Company is handling distressed appliances for new appliance manufacturers ("manufacturers"). Manufacturers generate distressed product in a variety of ways: discontinued models, customer returns, freight damaged units and warranty exchanges. Historically, manufacturers disposed of the majority of their distressed product through their small dealer network. The manufacturer normally discounts the product and provides warranties and financing. Large retailers do not want to handle distressed appliances because the majority of the merchandise is out of carton, requires special handling and pricing, and may require some repair. As small dealers are having an increasingly more difficult time competing with large chains (the top 10 chains have 80% of the appliance sales market), manufacturers are seeing their traditional distribution channel for distressed appliances shrink. Manufacturers also anticipate that small appliance retailers will be negatively impacted as manufacturers begin selling directly to the consumer over the Internet.

COMPANY BACKGROUND

The Company began business in 1976 as a retailer of reconditioned appliances. Initially, the Company contracted with national and regional retailers of appliances such as Sears, Roebuck & Company, Inc. ("Sears") and Montgomery Ward & Co. ("Montgomery Ward") to collect major appliances in Minneapolis/Saint Paul and two other metropolitan areas. As part of their new appliance sales efforts, these customers arrange for the removal of old appliances from consumers' residences. The Company collects old appliances on behalf of its customers, reconditions and sells suitable used appliances through its own retail stores and sells the remaining appliances to scrap metal processors.

In the late 1980s, in response to stricter environmental protection laws, the Company developed and marketed programs to process and dispose of appliances in an environmentally sound manner. These programs are offered to new appliance manufacturers and retailers, waste management companies and the general public. See Business - Customers and Source of Supply.

In 1989, the Company expanded its appliance recycling concept to the utility industry when it established an appliance processing center in Milwaukee, Wisconsin, pursuant to a contract with a utility company. From 1989 to 1994 the Company focused its resources on the expansion of its business with electric utility companies. During this time period the Company opened nine centers throughout the U.S. and Canada, primarily serving seventeen electric utility customers. The Company's electric utility business has been negatively impacted by the potential of electric utility industry deregulation. The potential of deregulation has caused electric utilities to decrease their sponsorship of energy conservation programs like the one the Company offers. Currently, the Company expects to have only one major contract with an electric utility customer.

During fiscal year 1998, that customer, Southern California Edison Company ("Edison"), accounted for approximately 29% or \$3.5 million of the Company's total revenues. The Company is anticipating that it will have a program with Edison for 1999. Edison recently received budget approval from the California Public Utilities Commission ("CPUC") for a 1999 program. The Company is currently in final contract negotiations with Edison. Edison has continued its appliance recycling program through the first quarter of 1999 while waiting for CPUC approval and final contract negotiations with the Company.

In February 1999, the Company entered into an 18-month refrigerator recycling contract with the Los Angeles Department of Water and Power ("DWP"). Under this program, the Company will recycle, from low income housing units in Los Angeles, refrigerators that have been replaced with new energy-efficient models. The DWP program contains no minimum guarantees and is expected to start at relatively low levels in this year's second quarter.

In response to the decrease in demand for services from electric utilities, the Company has increased its marketing of services to appliance manufacturers and retailers, waste management companies and property management companies. The Company also has increased its focus on the sale of reconditioned appliances. In 1995, under the name Encore(R) Recycled Appliances, the Company began operating a chain of Company-owned retail stores. In 1998, the Company began using the name Appliance\$mart(R) for its retail stores. The retail stores offer reconditioned and manufacturers' distressed appliances to value-conscious individuals and property managers.

During 1996 the Company continued to expand its focus on its Encore retail stores and had more than 30 retail stores open at one point during the year. Due to substantial losses in certain markets, the Company closed centers and stores in three markets in the fourth quarter of 1996. Write-offs and other significant expenses related to these closings caused the Company to report a significant loss for the year.

In 1997, the Company entered into pilot program agreements with Whirlpool Corporation, the nation's largest manufacturer of major household appliances, to develop a program for handling distressed appliances for Whirlpool. In 1998, the Company entered into a contract with Whirlpool to acquire its distressed appliances (including "scratch and dent" units with only cosmetic imperfections) from distribution centers serving the Midwest and certain western states. Under the contract, the Company purchases distressed appliances from Whirlpool, reconditions suitable units and sells them through ARCA's network of Encore and Appliance\$mart retail stores. With increased supply of product, the Company began opening larger stores and closing its smaller ones. Appliances that cannot be reconditioned are recycled in accordance with all applicable environmental regulations. The Company recently scaled back its agreement with Whirlpool to a level consistent with its current financial resources. The Company will now buy inventory mainly from Whirlpool's Ohio distribution

center. The Company believes that this contract will provide an adequate quantity of high quality appliances that can be sold through its retail stores.

In late 1998, the Company decided to close its St. Louis, Missouri operations and close one store in the Minneapolis/St. Paul market. The Company currently has three recycling centers located in Columbus, Ohio, Minneapolis, Minnesota and Los Angeles, California. Also, the Company currently has eight retail stores: four in Minneapolis/St. Paul, two in California and two in Columbus, Ohio.

CUSTOMERS AND SOURCE OF SUPPLY

The Company offers its services to entities that, as part of their operations, become responsible for disposing of large quantities of used and distressed appliances. These entities include new appliance manufacturers and retailers, waste management companies, property management companies and utility companies.

NEW APPLIANCE MANUFACTURERS AND RETAILERS. The Company began its business by offering appliance recycling programs to Sears, Montgomery Ward and other new appliance retailers to collect appliances from either the retailers' facilities or from their consumers. Recently the Company has focused its marketing efforts to new appliance manufacturers, including Whirlpool Corporation, a primary source of product that can be reconditioned and sold in the Company's stores.

WASTE MANAGEMENT COMPANIES. The Company provides services to waste management companies and the general public for the collection and recycling of appliances for specified fees.

PROPERTY MANAGEMENT COMPANIES. The Company provides comprehensive appliance exchange and recycling services to property managers of apartment complexes as well as local housing authorities.

UTILITY COMPANIES. The Company contracts with utility companies to provide comprehensive appliance recycling services tailored to the needs of the particular utility. The contracts historically have had terms of one to four years, with provisions for renewal at the option of the utility company. Under some contracts, the utility retains the Company to manage all aspects of its appliance recycling program, while under other contracts, the Company provides only specified services. Pricing for the Company's services is on a per-appliance basis and depends upon several factors, including the total number of appliances processed, the length of the contract term and the specific services selected by the utility. Contracts with electric utility customers require that the Company does not recondition for resale appliances received from utility company energy conservation programs. Currently, the Company expects to have only one major contract with an electric utility customer.

The Company believes its sources are adequate to supply the current number of retail stores and allow the Company to grow its retail sales.

COMPANY OPERATIONS

The Company provides an integrated range of collection, reuse and recycling services. Appliances are collected from a variety of sources, including new appliance retailers and manufacturers, solid waste management companies, property managers, local governments and electric utilities. Some appliances are reconditioned and sold through the Company's retail network of Encore and ApplianceSmart stores. The remaining appliances are disposed of in an environmentally responsible manner at the Company's recycling centers. Environmentally harmful substances---including CFCs,

PCBs and mercury---are removed and properly managed. After all appliance processing is completed, scrap materials are sold for recycling.

The Company believes 10 to 15% of all used appliances collected can be reconditioned. Appliances identified for resale are thoroughly inspected for wear-and-tear and broken or damaged parts. Worn parts are replaced and appliances are tested to ensure they are fully operational and function safely under proper conditions. Appliances are professionally cleaned and touched-up or repainted. Reconditioned appliances are then sold in the Company's chain of retail stores. Each appliance has a 90-day or one year warranty, with an additional extended warranty available for purchase. The Company offers a money-back guarantee and provides delivery and repair services on products that it sells.

Appliances that don't meet the Company's standards are processed and recycled in an environmentally sound manner. Appliances identified to be recycled are processed per federal, state and local environmental regulations. They are inspected and categorized according to the types of hazardous materials they may contain. After the appliances are moved to the processing area, the Company's processing technicians remove electrical capacitors and fluorescent light ballasts that may contain PCB dielectric fluid, and components that may contain mercury. The Company's processing technicians are trained to locate and remove such components from all makes and models of appliances.

When processing at the Company's centers has been completed and the appliances are free of environmentally hazardous components and materials, they

are delivered to qualified metals processing facilities for shredding. Shredded materials from the processed appliances are sold to steel mini-mills or other metal recovery facilities for appropriate reuse.

Management believes that the uncertainties in the electric utility industry regarding deregulation will persist at least through 1999. The reaction to deregulation among states and utilities has been varied. The Company believes, however, that energy conservation and efficiency programs will remain a long-term component of the nation's electric utility industry.

The Company does not expect to expand its retail business into new geographic markets at this time. The Company plans to close three to four of its smaller stores while opening 1 to 2 larger stores in its existing markets. The Company believes that the growth of its business in the near future will likely occur primarily through the expansion of revenues from the Company's current retail stores and the generation of revenues from the expected contract with Edison.

PRINCIPAL PRODUCT AND SERVICES

The Company generates revenues from three sources: recycling fees, appliance sales and byproduct sales. The following table reflects the percentage of total revenues from each source.

| | 1998 | 1997 | 1996 |
|--------------------|--------|--------|--------|
| | ---- | ---- | ---- |
| Retail revenues | 57.6% | 34.6% | 36.7% |
| Recycling revenues | 35.6% | 52.4% | 48.4% |
| Byproduct revenues | 6.8% | 13.0% | 14.9% |
| | 100.0% | 100.0% | 100.0% |

SALES AND MARKETING

The Company uses various means to promote awareness of its services and the need for environmentally sound recycling of appliances and believes it is recognized as a leader in the appliance recycling industry.

The Company's strategy for its retail stores is to present a large warehouse image in convenient, high-traffic locations. Store interiors are bright and clean. In every market, the Company actively promotes its stores through various forms of print advertising, including daily classified ads in major newspapers, telephone yellow pages ads and direct mail. In addition, the Company uses radio and television advertisements in some markets, in addition to other types of promotions.

SEASONALITY

The Company experiences seasonal fluctuations in operating results, with revenues generally higher during the second and third calendar quarters than in the first and fourth calendar quarters. The lower levels in the first and fourth quarters reflect consumer purchasing cycles, which result in lower sales of major household appliances during such quarters and corresponding reductions in the demand for appliance recycling services. Furthermore, utility companies that sponsor appliance turn-in programs generally reduce their promotional efforts for such programs during the first and fourth calendar quarters. The Company expects that it will continue to experience lower revenues in the first and fourth quarters of future years as compared to the second and third quarters of such years.

COMPETITION

Competition for the Company's retail stores comes from new appliance manufacturers and retailers and other reconditioned and used appliance retailers. Each retail location will compete not only with local and national chains of new appliance retailers, many of whom have been in business longer than the Company and who may have significantly greater assets than the Company, but will also be required to compete with numerous independently owned retailers of used and reconditioned appliances.

Many factors, including existing and proposed governmental regulation, may affect competition in the waste management and environmental services industry. The Company generally competes with two or three other companies which are based in the geographic area to be served under the contract and which generally offer only some of the services provided by the Company.

The Company expects its primary competition for contracts with

existing or new customers to come from entrepreneurs entering the appliance recycling business, energy management consultants, current recycling companies, major waste hauling companies, scrap metal processors and used appliance dealers. In addition, customers such as utility companies and local governments may operate appliance recycling programs internally rather than contracting with the Company or other third parties. There can be no assurance that the Company will be able to compete profitably in any of its chosen markets.

GOVERNMENT REGULATION

The business of recycling major appliances is subject to certain governmental laws and regulations and is becoming increasingly regulated. These laws and regulations include landfill disposal restrictions, hazardous waste management requirements and air quality standards, as well as special permit and license conditions for the recycling of appliances. In some instances, there are bonding, insurance and other conditions for bidding on appliance recycling contracts.

The Company's appliance recycling centers are subject to various federal, state and local laws, regulations and licensing requirements relating to the collection, processing and recycling of household appliances. Requirements for registrations, permits and licenses vary among the Company's market areas. The Company's centers are registered with the EPA as hazardous waste generators and are licensed, where required, by appropriate state and local authorities. The Company has agreements with approved and licensed hazardous waste companies for transportation and disposal of PCBs from its centers.

The 1990 Amendments to the Clean Air Act provide for the phaseout of the production of CFCs over a period of years. Effective July 1, 1992, the Act prohibited the venting of CFCs in the course of maintaining, servicing, repairing or disposing of an appliance. The Act also requires the recovery of CFC refrigerants from appliances prior to their disposal or delivery for recycling. In 1995, the venting of CFC substitute refrigerants was also prohibited.

In 1992, Congress adopted the Energy Policy Act of 1992 to encourage energy efficiency. Requirements under this act establish, among other things, mandatory energy performance standards that affect the manufacture and sale of major household appliances. Another component of this act allows for deregulation of the nation's energy providers, including the electric utility industry. The ultimate impact of deregulation on the electric utility industry is yet unknown; therefore, there can be no assurance that the Company will be able to continue certain of its current operations in a deregulated environment.

Company management believes that further government regulation of the appliance recycling industry could have a positive effect on the Company's business; however, there can be no assurance what course future regulation could have. Under some circumstances, further regulation could materially increase the costs of the Company's operations and have an adverse effect on the Company's business. In addition, as is the case with all companies handling hazardous materials, under some circumstances, the Company may be subject to contingent liability.

EMPLOYEES

At March 1, 1999, the Company had 118 full-time employees, of whom approximately 60 percent were involved in the collection, transportation and processing of appliances at the Company's centers and approximately 40 percent were in sales, administration and management. The Company has not experienced any work stoppages and believes its employee relations are good.

ITEM 2. PROPERTIES

The Company's executive offices are located in Minneapolis, Minnesota, in a Company owned facility which includes approximately 11 acres of land. The building contains approximately 122,000 square feet, including 27,000 square feet of office space and 95,000 square feet of operations and processing space. The Southern California center building, which also is owned by the Company, is located in Compton, California, and consists of 44,000 square feet: 6,000 square feet of office space and 38,000 square feet of warehouse space. In addition, the Company owns a 14,000-square-foot facility in Saint Paul, Minnesota, which contains a retail store at which it sells reconditioned and distressed appliances. All properties and equipment owned by the Company currently secure outstanding loans of the Company.

The Company generally leases the other facilities it operates. The Company usually attempts to negotiate lease terms that correspond to the term of the principal contract or contracts in connection with which the center is to be operated. The Company's recycling centers typically range in size from 12,000

to 40,000 square feet. The Company's retail stores have been typically 2,500 to 5,000 square feet. With the move toward larger retail stores, future stores are anticipated to be 30,000 to 40,000 square feet.

The Company believes that the facilities and equipment at each of its centers are adequate to meet its anticipated needs for the near term and believes that alternate facilities will readily be available to the Company to meet its future needs.

ITEM 3. LEGAL PROCEEDINGS

The Company and its subsidiaries are involved in various legal proceedings arising in the normal course of business, none of which is expected to result in any material loss to the Company or any of its subsidiaries.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Company did not submit any matters to a vote of security holders during the last quarter of the fiscal year covered by this report.

PART II

ITEM 5. MARKET FOR THE COMPANY'S COMMON EQUITY AND RELATED SHAREHOLDER MATTERS

MARKET FOR COMMON STOCK

The Company's Common Stock began trading on the OTC Bulletin Board September 8, 1998. Prior to that time, the Common Stock traded as follows: on the Nasdaq SmallCap Market from February 26, 1997 to September 7, 1998; on the Nasdaq National Market from January 8, 1993 to February 25, 1997; on the Nasdaq SmallCap Market from January 7, 1991 to January 7, 1993; and on the local over-the-counter market prior thereto. The following table sets forth, for the periods indicated, the high and low closing bid quotations for the Common Stock, as reported by the Nasdaq SmallCap Market and the OTC Bulletin Board, as applicable. The table gives effect to the one-for-four reverse stock split effective February 21, 1997.

| | HIGH | LOW |
|---------------------|----------|----------|
| | ---- | --- |
| 1997 | | |
| First Quarter..... | \$ 4 | \$ 2 |
| Second Quarter..... | 3 3/8 | 2 3/8 |
| Third Quarter..... | 3 1/4 | 2 1/2 |
| Fourth Quarter..... | 4 1/4 | 2 1/8 |
| 1998 | | |
| First Quarter..... | \$ 2 3/4 | \$ 1 1/2 |
| Second Quarter..... | 4 | 2 |
| Third Quarter..... | 3 | 3/4 |
| Fourth Quarter..... | 1 1/8 | 1/2 |

On March 12, 1999, the last reported sale price of the Common Stock was \$0.63 per share. As of March 12, 1999, there were approximately 1,775 beneficial holders of the Company's Common Stock.

The Common Stock trades under the symbol "ARCI."

During 1998, the Company issued 100,000 unregistered shares and 893,750 warrants to purchase shares.

During February 1999, the Company issued 1,030,000 unregistered shares, and 83,000 warrants to purchase shares.

In May 1998, the Company sold in a private placement 100,000 shares of Common Stock at a price of \$2.00 per share. The sale, which represented approximately 8% of the Common Stock outstanding after such sale, was made to an institutional investor. The proceeds were used for additional working capital.

In July 1998, the Company issued 12% subordinated promissory notes in the principal amount of \$275,000, plus an aggregate of 68,750 warrants to purchase the Company's Common Stock at \$2.25 per share, subject to adjustment. The notes were repaid in September 1998.

In September 1998, the Company entered into a loan agreement with a lender resulting in gross proceeds of \$3.5 million. The loan also provides for non-voting attendance at board meetings. The Company issued to the lender, in connection with the loan, a warrant to purchase 700,000 shares of Common Stock at \$2.50 per share, which price was adjustable under certain circumstances, including the issuance of stock at or below \$2.00 per share. As a result of the February 1999 stock issuance described below, the current exercise price of this warrant is \$0.60 per share. If exercised in full, this warrant would represent approximately 24% of the Common Stock after such exercise. The Company also issued to an investment banker associated with this transaction a warrant to purchase 125,000 shares of Common Stock at \$2.50 per share, subject to adjustment. The portion of the gross loan proceeds ascribed to the aforementioned warrants in conjunction with debt was \$307,000.

In February 1999, the Company sold in a private placement 1,030,000 shares of Common Stock at a price of \$0.50 per share. The sale represented approximately 45% of Common Stock outstanding after such sale. The Company paid \$31,500 of the proceeds and issued warrants to purchase 83,000 shares of Common Stock at \$0.50 per share, subject to adjustment, to an investment banker as a placement fee. The remaining proceeds were used to repay certain indebtedness, to purchase inventory and for other general corporate purposes.

ITEM 6. SELECTED FINANCIAL DATA

The selected financial information set forth below should be read in conjunction with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 8. Financial Statements and Supplementary Data."

<TABLE>

<CAPTION>

| Fiscal Years Ended | 1998 | 1997 | 1996 | 1995 | 1994 |
|--|------------|------------|------------|------------|-----------|
| (In thousands, except per share data) | | | | | |
| <S> | <C> | <C> | <C> | <C> | <C> |
| STATEMENT OF OPERATIONS | | | | | |
| Total revenues | \$ 13,612 | \$ 11,979 | \$ 14,030 | \$ 16,241 | \$ 20,327 |
| Gross profit | \$ 3,981 | \$ 4,990 | \$ 2,744 | \$ 5,630 | \$ 8,360 |
| Operating income (loss) | \$ (2,744) | \$ (489) | \$ (6,899) | \$ (1,538) | \$ 1,753 |
| Net income (loss) | \$ (3,056) | \$ (748) | \$ (7,269) | \$ (943) | \$ 877 |
| Basic and diluted income (loss) per common share | \$ (2.55) | \$ (0.66) | \$ (6.53) | \$ (0.90) | \$ 0.82 |
| Weighted average number of common shares outstanding | 1,200 | 1,137 | 1,114 | 1,052 | 1,071 |
| BALANCE SHEET | | | | | |
| Working capital (deficit) | \$ (471) | \$ (1,959) | \$ (1,671) | \$ 3,503 | \$ 4,700 |
| Total assets | \$ 8,843 | \$ 8,569 | \$ 9,992 | \$ 15,890 | \$ 16,912 |
| Long-term liabilities | \$ 4,965 | \$ 1,633 | \$ 1,711 | \$ 2,084 | \$ 2,741 |
| Shareholders' equity | \$ 816 | \$ 3,365 | \$ 4,113 | \$ 10,188 | \$ 10,932 |

</TABLE>

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

OVERVIEW

The Company's 1998 fiscal year (1998) ended January 2, 1999, its 1997 fiscal year (1997) ended January 3, 1998 and its 1996 fiscal year (1996) ended December 26, 1996.

The Company generates revenues from three sources: retail revenues, recycling revenues and byproduct revenues. Retail revenues are sales of appliances, extended warranty sales and delivery fees. Recycling revenues are fees charged for the disposal of appliances. Byproduct revenues are sales of materials generated from processed appliances. The Company experiences seasonal fluctuations in operating results, with revenues generally higher during the second and third calendar quarters than in the first and fourth quarters. The lower levels in the first and fourth quarters reflect consumer purchasing cycles, which result in lower demand for appliances and recycling services.

In 1998, the Company focused on increasing its sales of Whirlpool products in its retail stores. The increase in total revenues was due to an increase in retail sales offset by decreases in both recycling revenues and byproduct revenues. In 1998, same-store sales for its reconditioned and distressed appliance business increased by 108%. Retail revenues accounted for 57.6% of total revenues in 1998.

REVENUES

The Company's total revenues for 1998 were \$13,612,000 compared to \$11,979,000 in 1997.

Retail revenues increased to \$7,835,000 in 1998 from \$4,149,000 in 1997. The increase was primarily due to increased sales of Whirlpool product. Same-store retail sales for 1998 increased 108% (a sales comparison of 10 stores open for full years in both 1998 and 1997). The Company operated 11 stores throughout 1998. In December 1998, the Company decided to withdraw from a market and close one center and two retail stores in 1999. Also, the Company decided to close a retail store in another market as of December 31, 1998.

In 1998, the Company entered into a contract with Whirlpool Corporation to acquire its distressed appliances (including "scratch and dent" units with only cosmetic imperfections) from distribution centers serving the Midwest and certain western states.

Recycling revenues decreased to \$4,842,000 in 1998 from \$6,274,000 in 1997. The decrease was primarily due to lower volume of appliances related to the contract with Southern California Edison Company ("Edison"). Edison accounted for approximately 29% of the Company's total revenues for 1998 and 38% for 1997. The Company is anticipating that it will have a program with Edison for 1999. Edison recently received budget approval from the California Public Utilities Commission for a 1999 program. The Company is currently in final contract negotiations with Edison and believes its 1999 recycling revenues level is dependent on such an agreement and the resulting volume of appliances from such arrangement.

Byproduct revenues decreased to \$935,000 in 1998 from \$1,556,000 in 1997. The decrease was primarily due to lower sales of reclaimed chlorofluorocarbons due to fewer refrigerators being recycled and lower scrap revenue due to a decrease in scrap prices.

The Company's total revenues for 1997 were \$11,979,000 compared to \$14,030,000 in 1996.

Retail revenues decreased to \$4,149,000 in 1997 from \$5,148,000 in 1996. The decrease was primarily due to a reduction in the number of the Company's retail stores to 13 in 1997 from 26 in the fourth quarter of 1996. Due to substantial losses in 1996, the Company withdrew from three markets during the fourth quarter of 1996, closing 12 retail locations and three recycling centers. The Company operated 13 stores throughout 1997. Same-store sales (for six stores open for the full years 1997 and 1996) increased 19% in 1997.

Recycling revenues decreased to \$6,274,000 in 1997 from \$6,785,000 in 1996. The decrease was primarily due to the Company's closing four recycling centers in late 1996 and early 1997, partially offset by increased recycling revenues from the Company's Edison contract.

Byproduct revenues decreased to \$1,556,000 in 1997 from \$2,097,000

in 1996. The decrease was primarily due to fewer appliances recycled in 1997 compared to 1996, which resulted from the closing of three recycling centers in the fourth quarter of 1996.

In 1997, the Company entered into pilot program agreements with Whirlpool Corporation to purchase Whirlpool's distressed, discontinued and returned products.

GROSS PROFIT

The Company's overall gross profit decreased to 29.2% in 1998 from 41.7% in 1997. The decrease was primarily due to retail revenues, which have a lower gross profit than recycling revenues, being a higher percentage of total revenues and a decrease in recycling revenues related to the Edison contract. Gross profit as a percentage of total revenues for future periods can be affected favorably or unfavorably by numerous factors, including the volume of appliances recycled from the expected Edison contract, the volume of Whirlpool products sold during the period and the price and volume of byproduct revenues. The Company expects gross profit percentages to continue to decline as retail revenues become a higher percentage of total revenues.

The Company's overall gross profit rate increased to 41.7% in 1997 from 19.6% in 1996. The increase was primarily due to the closing of under-performing recycling centers and retail stores in the fourth quarter of 1996 and increased operating efficiencies in the remaining centers.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Selling, general and administrative expenses were 45.2% of sales in 1998 compared to 45.7% and 68.7% in 1997 and 1996, respectively. Selling, general and administrative expenses increased to \$6,152,000 in 1998 from \$5,479,000 in 1997, a 12.3% increase. Selling expenses increased to \$2,028,000 in 1998 from \$1,498,000 in 1997. The increase in selling expenses was primarily due to an increase in sales commissions and advertising and costs associated with opening an additional retail store in 1998. General and administrative expenses increased to \$4,124,000 in 1998 from \$3,981,000 in 1997. The increase in general and administrative expenses was primarily due to increased expenses related to temporary personnel costs.

Selling, general and administrative expenses decreased to \$5,479,000 in 1997 from \$9,643,000 in 1996, a 43.2% decrease. Selling expenses decreased to \$1,498,000 in 1997 from \$3,275,000 in 1996. The decrease in selling expenses was primarily due to operating fewer retail stores in 1997 compared to 1996. General and administrative expenses decreased to \$3,981,000 in 1997 from \$6,368,000 in 1996. The decrease was primarily due to operating fewer recycling centers in 1997 compared to 1996 and incurring lower costs associated with the closed markets.

In June 1998, the Company took a one-time charge of \$518,000 related to a loss on impaired equipment associated with the Company's decision to curtail the appliance shredding operation of its recycling business located primarily at the Company's Minneapolis center. Also, in December 1998, the Company took a one-time charge of \$55,000 related to a loss on impaired assets associated with the Company's decision to withdraw from a market and close one center and two retail stores in 1999.

INTEREST EXPENSE

Interest expense increased to \$601,000 in 1998 from \$347,000 in 1997. The increase was primarily due to a higher average borrowed amount outstanding in 1998 compared to 1997.

Interest expense increased slightly in 1997 compared to 1996 due to a higher average borrowed amount outstanding in 1997 than 1996.

INCOME TAXES AND NET OPERATING LOSSES

As of its 1998 and 1997 year-ends, the Company recorded a valuation allowance of \$4,190,000 and \$2,952,000, respectively, against its net deferred tax assets due to the uncertainty of their realization. The realization of deferred tax assets is dependent upon sufficient future taxable income during the periods when deductible temporary differences and carryforwards are expected to be available to reduce taxable income.

The Company has net operating losses of approximately \$8,114,000 at January 2, 1999, which are available to reduce taxable income and in turn income taxes payable in future years. These carryforwards may be subject to certain limitations under the provisions of the Internal Revenue Code, Section 382, which relate to a 50 percent change in control over a three-year period. In addition, any future changes of control may result in the expiration of a portion of the carryforwards before they can be used and are also dependent upon the Company attaining profitable operations in the future. To the extent the Company is able to generate taxable income in a period in which this net operating loss carryforward is available, the Company's cash requirements for the payment of income taxes would be reduced.

MINORITY INTEREST IN NET INCOME OF SUBSIDIARY

The Company was an 80% shareholder in its California subsidiary, and accordingly, recorded the minority shareholder's interest in the subsidiary's net income during 1997. No minority interest was recorded in 1996 since the subsidiary had an accumulated net loss. During the fourth quarter of 1997, the Company purchased all the minority shareholder's stock in the California subsidiary.

LIQUIDITY AND CAPITAL RESOURCES

At January 2, 1999, the Company had a working capital deficit of \$471,000 compared to a working capital deficit of \$1,959,000 at January 3, 1998. Cash and cash equivalents increased to \$14,000 at January 2, 1999 from \$13,000 at January 3, 1998. Net cash used in operating activities was \$3,078,000 in 1998 compared to net cash provided by operating activities of \$308,000 in 1997. The increase in cash used in operating activities was primarily due to an increase in the Company's net loss net of a one-time non-cash expense for impaired assets, plus an increase in inventories.

Net cash used in investing activities was \$18,000 in 1998 compared to \$467,000 in 1997. The decrease in net cash used in investing activities in 1998 from 1997 was due to higher proceeds from selling excess equipment in 1998 and cash used for the purchase of the minority interest in the California subsidiary in 1997.

Net cash provided by financing activities was \$3,097,000 compared to net cash used in financing activities of \$108,000 in 1997. The increase in cash provided by financing activities was primarily due to net proceeds from long-term obligations received in 1998 offset by a decrease in net borrowings under the line of credit and increased payments on long-term obligations. In September 1998, the Company entered into a loan agreement with a lender resulting in gross proceeds of \$3.5 million.

The Company's capital expenditures were approximately \$289,000 in 1998 and \$299,000 in 1997. The 1998 and 1997 capital expenditures were primarily related to building improvements. The Company did not have any material purchase commitments for assets as of January 2, 1999.

As of January 2, 1999, the Company had a \$2.0 million line of credit with a lender. The interest rate as of January 2, 1999 was 12.75%. The amount of borrowings available under the line of

credit is based on a formula using receivables and inventories. The line of credit has a stated maturity date of August 30, 1999, if not renewed, and provides that the lender may demand payment in full of the entire outstanding balance of the loan at any time. The line of credit is secured by substantially all the Company's assets, is guaranteed by the President of the Company and requires minimum monthly interest payments of \$5,625 regardless of the outstanding principal balance. The Lender is also secured by an inventory repurchase agreement with Whirlpool Corporation. The loan also requires that the Company meet certain financial covenants, provides payment penalties for noncompliance, limits the amount of other debt the Company can incur, limits the amount of spending on fixed assets and limits payments of dividends. At January 2, 1999, the Company's unused borrowing capacity was \$65,000 and at March 1, 1999 was \$335,000.

In May 1998, the Company sold 100,000 shares of its Common Stock in a private placement at a price of \$2.00 per share. The sale was made to an institutional investor. The proceeds were used for additional working capital.

In June 1998, the Company entered into a ten-year, 9.88% mortgage loan with a bank for \$250,000. The proceeds from the mortgage loan were used to

remodel one of its retail stores.

In July 1998, the Company issued 12% subordinated promissory notes plus 68,750 warrants to purchase the Company's Common Stock at \$2.25 per share for \$275,000. The loan proceeds were used to purchase inventory and provide additional working capital. The notes were repaid in September 1998 with part of the proceeds of the September 1998 loan (as defined below).

In September 1998, the Company entered into a loan agreement with a lender resulting in gross proceeds of \$3.5 million ("September 1998 Loan"). The maturity date for the loan is September 30, 2005 and the annual interest rate is 13%. The loan is secured by all the Company's personal property and all of its real estate, and provides for non-voting attendance at board meetings. The Company issued to the lender, in connection with the loan, a warrant to purchase 700,000 shares of Common Stock at \$2.50 per share, which price was adjustable under certain circumstances, including the issuance of stock at or below \$2.00 per share. As a result of the February 1999 stock issuance described below, the current price of this warrant is \$0.60 per share. The Company also issued to an investment banker, in connection with the September 1998 Loan, a warrant to purchase 125,000 shares of Common Stock at \$2.50 per share and paid a placement fee of \$180,000. The Company used the proceeds to repay certain indebtedness (including approximately \$1,500,000 of outstanding indebtedness), to finance inventory and for other general corporate purposes. The portion of the gross loan proceeds ascribed to the aforementioned warrants in conjunction with debt was \$307,000.

In February 1999, the Company sold in a private placement 1,030,000 shares of Common Stock at a price of \$0.50 per share. The Company paid \$31,500 of the proceeds and issued warrants to purchase 83,000 shares of Common Stock at \$0.50 per share, subject to adjustment, to an investment banker as a placement fee. The remaining proceeds were used to repay certain indebtedness, to purchase inventory and for other general corporate purposes.

The Company believes, based on anticipated revenues from the expected Edison contract, the anticipated sales per retail store and the anticipated gross profit, that its cash balance, anticipated funds generated from operations, its current line of credit if renewed in August 1999, and the proceeds from the sale of its Common Stock in February 1999 will be sufficient to finance its operations and capital expenditures through December 1999. The Company's total capital requirements will depend, among other things as discussed below, on the number of recycling centers operating and the number and size of retail stores operating during the fiscal year. Currently, the Company has three centers and eight

stores in operation. If revenues are lower than anticipated or expenses are higher than anticipated or the line of credit cannot be maintained, the Company may require additional capital to finance operations. Sources of additional financing, if needed in the future, may include further debt financing or the sale of equity (common or preferred stock) or other securities. There can be no assurance that such additional sources of financing will be available or available on terms satisfactory to the Company or permitted by the Company's current lenders.

YEAR 2000

Based on a recent assessment of the Year 2000 Issue, the Company determined that it will be required to modify or replace significant portions of its software so that its computer systems will properly utilize dates beyond December 31, 1999. The Company believes that with modifications to existing software and conversions to new software, the Year 2000 Issue will not have a material adverse impact on the Company's operations. However, if such modifications and conversions are not made, or are not completed in a timely manner, the Year 2000 Issue could have a material impact on the operations of the Company. The Company has determined it has no exposure to contingencies related to the Year 2000 Issue for products it has sold.

The Company will utilize both internal and external resources to replace and test the software for Year 2000 modifications. The Company plans to complete the Year 2000 Project no later than September 30, 1999. The costs of the project are expected to be funded through operating cash flows. A portion of the costs will be used to purchase new software, which will be capitalized. The remaining portion of the costs will be expensed as incurred over the course of the project. The overall cost of the project is expected to be approximately \$250,000 in 1999. To date, the Company has incurred and expensed approximately \$10,000 related to the assessment of, and preliminary efforts in connection with, its Year 2000 Project and development of a remediation plan. The Company's

cost and estimates to complete the Year 2000 Project include the estimated costs and time associated with accessing the impact of a third party's Year 2000 Issue, and are based on presently available information.

The Company has initiated communications with all of its significant suppliers and large customers to determine the extent to which the Company is vulnerable to those third parties' failure to remediate their own Year 2000 Issue. However, there can be no guarantee that the systems of other companies on which the Company's systems rely will be timely converted, or that a failure to convert by another company, or a conversion that is incompatible with the Company's systems, would not have material adverse effect on the Company.

At this time, the Company believes that its most reasonable likely worst case scenario is that the Company could experience delays in receipt of inventory and/or key customers could experience a delay in accounts receivable payments to the Company. In the event that either of these scenarios occur, management believes that it would not have a long-term material adverse effect on the Company's financial condition and results of operations.

The Company does intend to prepare contingency plans so that the Company's critical business processes can be expected to continue to function on January 1, 2000 and beyond. The Company's contingency plans are expected to address modification of the Company's systems and components as well as overall business operating risks. These plans are intended to mitigate both internal risks as well as potential risks in the supply chain of the Company's suppliers and customers, and will likely include identifying and securing alternative supplies of inventory and sources of financing. The Company intends to begin working on a contingency plan in early 1999 and to have it substantially finalized by September 1999.

The costs of the project and the date by which the Company plans to complete the Year 2000 modifications and contingency plans are based on management's best estimates, which were derived utilizing numerous assumptions of future events, including the continued availability of certain resources, third party modification plans and other factors. However, there can be no assurances that these estimates will be achieved and actual results could differ materially from those plans. Specific factors that might cause such material differences include, but are not limited to, the availability and cost of personnel trained in this area, the ability to locate and correct all relevant computer codes, and similar uncertainties.

FORWARD-LOOKING STATEMENTS

Statements contained in this annual report regarding the Company's future operations, performance and results, and anticipated liquidity discussed herein are forward-looking and therefore are subject to certain risks and uncertainties, including those discussed herein. In addition, any forward-looking information regarding the operations of the Company will be affected by the ability of individual stores to meet planned revenue levels, the speed at which individual stores reach profitability, costs and expenses being realized at higher than expected levels, the continued ability to purchase product from Whirlpool at acceptable prices, the Company's ability to secure an adequate supply of used appliances for resale, the continued availability of the Company's current line of credit, the renewal of the contract with Edison for 1999 and the ability and timing of Edison to deliver units under its expected contract with the Company.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Not applicable.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Description

Independent Auditor's Report
Consolidated Balance Sheets as of January 2, 1999
and January 3, 1998
Consolidated Statements of Operations for the three years
ended January 2, 1999
Consolidated Statements of Shareholders' Equity for the three years

ended January 2, 1999
 Consolidated Statements of Cash Flows for the three years
 ended January 2, 1999
 Notes to Consolidated Financial Statements

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Shareholders
 Appliance Recycling Centers of America, Inc.
 Minneapolis, Minnesota

We have audited the accompanying consolidated balance sheets of Appliance Recycling Centers of America, Inc. and subsidiaries as of January 2, 1999 and January 3, 1998, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the years in the three year period ended January 2, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Appliance Recycling Centers of America, Inc. and subsidiaries as of January 2, 1999 and January 3, 1998, and the results of their operations and their cash flows for each of the years in the three year period ended January 2, 1999, in conformity with generally accepted accounting principles.

McGLADREY & PULLEN, LLP

Minneapolis, Minnesota
 February 19, 1999

APPLIANCE RECYCLING CENTERS OF AMERICA, INC. AND SUBSIDIARIES
 CONSOLIDATED BALANCE SHEETS

<TABLE>
 <CAPTION>

| | JANUARY 2, 1999 | January 3, 1998 |
|---|--------------------|--------------------|
| -----<S> | <C> | <C> |
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 14,000 | \$ 13,000 |
| Accounts receivable, net of allowance of \$18,000 and \$35,000, respectively (Notes 4 and 10) | 498,000 | 765,000 |
| Inventories, net of reserves of \$40,000 and \$20,000, respectively (Note 4) | 1,979,000 | 694,000 |
| Other current assets | 100,000 | 140,000 |
| Total current assets | \$ 2,591,000 | \$ 1,612,000 |
| PROPERTY AND EQUIPMENT, AT COST (Notes 4, 5 and 11) | | |
| Land | \$ 2,103,000 | \$ 2,103,000 |
| Buildings and improvements | 3,957,000 | 3,955,000 |
| Equipment | 3,597,000 | 5,461,000 |
| | \$ 9,657,000 | \$ 11,519,000 |
| Less accumulated depreciation | 3,876,000 | 4,807,000 |

| | | |
|--|--------------|--------------|
| Net property and equipment | \$ 5,781,000 | \$ 6,712,000 |
| OTHER ASSETS | \$ 319,000 | \$ 55,000 |
| GOODWILL, NET OF AMORTIZATION OF \$38,000 AS OF JANUARY 2, 1999 | 152,000 | 190,000 |
| Total assets | \$ 8,843,000 | \$ 8,569,000 |

LIABILITIES AND SHAREHOLDERS' EQUITY

| | | |
|--|---------------|---------------|
| CURRENT LIABILITIES | | |
| Line of credit (Note 4) | \$ 1,081,000 | \$ 1,513,000 |
| Current maturities of long-term obligations (Note 5) | 79,000 | 101,000 |
| Accounts payable | 1,202,000 | 1,136,000 |
| Accrued expenses (Note 6) | 700,000 | 821,000 |
| Total current liabilities | \$ 3,062,000 | \$ 3,571,000 |
| LONG-TERM OBLIGATIONS, LESS CURRENT MATURITIES (Note 5) | 4,965,000 | 1,633,000 |
| Total liabilities | \$ 8,027,000 | \$ 5,204,000 |
| COMMITMENTS (Note 7) | | |
| SHAREHOLDERS' EQUITY (Notes 3, 4, and 9) | | |
| Common Stock, no par value; authorized 10,000,000 shares; issued and outstanding 1,237,000 shares and 1,137,000 shares, respectively | \$ 10,857,000 | \$ 10,350,000 |
| Accumulated deficit | (10,041,000) | (6,985,000) |
| Total shareholders' equity | \$ 816,000 | \$ 3,365,000 |
| Total liabilities and shareholders' equity | \$ 8,843,000 | \$ 8,569,000 |

</TABLE>

See Notes to Consolidated Financial Statements.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

<TABLE>
<CAPTION>

| | For the fiscal year ended | | |
|--|---------------------------|--------------------|----------------------|
| | JANUARY 2, 1999 | January 3, 1998 | December 28, 1996 |
| <S> | <C> | <C> | <C> |
| REVENUES (Note 10) | | | |
| Retail revenues | \$ 7,835,000 | \$ 4,149,000 | \$ 5,148,000 |
| Recycling revenues | 4,842,000 | 6,274,000 | 6,785,000 |
| Byproduct revenues | 935,000 | 1,556,000 | 2,097,000 |
| Total revenues | \$ 13,612,000 | \$ 11,979,000 | \$ 14,030,000 |
| COST OF REVENUES | 9,631,000 | 6,989,000 | 11,286,000 |
| Gross profit | \$ 3,981,000 | \$ 4,990,000 | \$ 2,744,000 |
| SELLING, GENERAL AND ADMINISTRATIVE EXPENSES (Note 2) | 6,152,000 | 5,479,000 | 9,643,000 |
| LOSS ON IMPAIRED ASSETS (Note 11) | 573,000 | -- | -- |
| Operating loss | \$ (2,744,000) | \$ (489,000) | \$ (6,899,000) |
| OTHER INCOME (EXPENSE) | | | |
| Other income | 319,000 | 134,000 | 122,000 |
| Interest income | 1,000 | 8,000 | 37,000 |
| Interest expense | (601,000) | (347,000) | (294,000) |
| Loss before provision for (benefit of) income taxes and minority interest | \$ (3,025,000) | \$ (694,000) | \$ (7,034,000) |

| | | | |
|--|----------------|--------------|----------------|
| PROVISION FOR (BENEFIT OF) INCOME TAXES (Note 8) | 31,000 | (31,000) | 235,000 |
| | ----- | ----- | ----- |
| Loss before minority interest | \$ (3,056,000) | \$ (663,000) | \$ (7,269,000) |
| MINORITY INTEREST IN NET INCOME OF SUBSIDIARY | -- | 85,000 | -- |
| | ----- | ----- | ----- |
| Net loss | \$ (3,056,000) | \$ (748,000) | \$ (7,269,000) |
| | ===== | ===== | ===== |
| BASIC AND DILUTED LOSS PER COMMON SHARE | \$ (2.55) | \$ (0.66) | \$ (6.53) |
| | ===== | ===== | ===== |
| WEIGHTED AVERAGE NUMBER OF COMMON SHARES | 1,200,000 | 1,137,000 | 1,114,000 |
| | ===== | ===== | ===== |

</TABLE>

See Notes to Consolidated Financial Statements.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

<TABLE>
<CAPTION>

| | Common Stock | | Retained Earnings (Accumulated Deficit) | Accumulated Other Comprehensive Income (Loss) | Total |
|--|--------------|---------------|--|--|---------------|
| | Shares | Amount | | | |
| | ----- | ----- | ----- | ----- | ----- |
| <S> | <C> | <C> | <C> | <C> | <C> |
| BALANCE, DECEMBER 30, 1995 | 1,057,000 | \$ 9,177,000 | \$ 1,032,000 | \$ (21,000) | \$ 10,188,000 |
| Issuance of Common Stock (Notes 3 and 9) | 73,000 | 1,118,000 | -- | -- | 1,118,000 |
| Exercise of Common Stock Options and Warrants (Note 9) | 7,000 | 55,000 | -- | -- | 55,000 |
| Comprehensive loss: | | | | | |
| Net loss | -- | -- | (7,269,000) | -- | -- |
| Other comprehensive income: | | | | | |
| Foreign currency translation adjustment | -- | -- | -- | 21,000 | -- |
| Comprehensive loss | -- | -- | -- | -- | (7,248,000) |
| ----- | | | | | |
| BALANCE, DECEMBER 28, 1996 | 1,137,000 | \$ 10,350,000 | \$ (6,237,000) | \$ -- | \$ 4,113,000 |
| Net loss | -- | -- | (748,000) | -- | (748,000) |
| ----- | | | | | |
| BALANCE, JANUARY 3, 1998 | 1,137,000 | \$ 10,350,000 | \$ (6,985,000) | \$ -- | \$ 3,365,000 |
| Issuance of Common Stock (Note 9) | 100,000 | 200,000 | -- | -- | 200,000 |
| Proceeds ascribed to warrants issued in conjunction with long-term debt (Note 9) | -- | 307,000 | -- | -- | 307,000 |
| Net loss | -- | -- | (3,056,000) | -- | (3,056,000) |
| ----- | | | | | |
| BALANCE, JANUARY 2, 1999 | 1,237,000 | \$ 10,857,000 | \$ (10,041,000) | \$ -- | \$ 816,000 |
| ===== | | | | | |

</TABLE>

See Notes to Consolidated Financial Statements.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

<TABLE>
<CAPTION>

For the fiscal year ended

| | JANUARY 2, 1999 | January 3, 1998 | December 28, 1996 |
|--|--------------------|--------------------|----------------------|
| <S> | <C> | <C> | <C> |
| CASH FLOWS FROM OPERATING ACTIVITIES | | | |
| Net loss | \$ (3,056,000) | \$ (748,000) | \$ (7,269,000) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | | |
| Depreciation and amortization | 704,000 | 1,027,000 | 2,477,000 |
| Minority interest in net income of subsidiary | -- | 85,000 | -- |
| Common Stock issued for services | -- | -- | 30,000 |
| Gain on sale of equipment | (266,000) | (80,000) | (118,000) |
| Deferred income taxes | -- | -- | 650,000 |
| Loss on impaired assets | 573,000 | -- | -- |
| Change in current assets and liabilities, net of effects from acquisition of Universal Appliance Company, Inc., and Universal Appliance Recycling, Inc. in 1996: | | | |
| Receivables | 238,000 | 391,000 | 510,000 |
| Inventories | (1,285,000) | (250,000) | 37,000 |
| Other current assets | 40,000 | 106,000 | 88,000 |
| Refundable income taxes | 29,000 | 371,000 | (294,000) |
| Accounts payable | 66,000 | (255,000) | (327,000) |
| Accrued expenses | (121,000) | (339,000) | 87,000 |
| Income taxes payable | -- | -- | (13,000) |
| Net cash provided by (used in) operating activities | \$ (3,078,000) | \$ 308,000 | \$ (4,142,000) |
| CASH FLOWS FROM INVESTING ACTIVITIES | | | |
| Purchases of property and equipment | \$ (289,000) | \$ (299,000) | \$ (1,285,000) |
| Purchase of minority interest in California subsidiary | -- | (275,000) | -- |
| Cash acquired in 1996 business acquisition | -- | -- | 26,000 |
| Proceeds from disposals of property and equipment | 271,000 | 107,000 | 415,000 |
| Payments for non-compete agreements | -- | -- | (110,000) |
| Net cash used in investing activities | \$ (18,000) | \$ (467,000) | \$ (954,000) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | | |
| Net borrowings (payments) under line of credit | \$ (432,000) | \$ 123,000 | \$ 1,390,000 |
| Payments on long-term obligations | (408,000) | (231,000) | (1,412,000) |
| Proceeds and tax benefit from stock options exercises | -- | -- | 55,000 |
| Proceeds from long-term obligations | 3,718,000 | -- | 17,000 |
| Proceeds ascribed to warrants issued in conjunction with long-term debt obligations | 307,000 | -- | -- |
| Deferred financing costs | (288,000) | -- | -- |
| Proceeds from issuance of Common Stock | 200,000 | -- | 700,000 |
| Net cash provided by (used in) financing activities | \$ 3,097,000 | \$ (108,000) | \$ 750,000 |
| Effect of foreign currency exchange rate changes on cash and cash equivalents | \$ -- | \$ -- | \$ 21,000 |
| Increase (decrease) in cash and cash equivalents | \$ 1,000 | \$ (267,000) | \$ (4,325,000) |
| CASH AND CASH EQUIVALENTS | | | |
| Beginning | 13,000 | 280,000 | 4,605,000 |
| Ending | \$ 14,000 | \$ 13,000 | \$ 280,000 |

</TABLE>

APPLIANCE RECYCLING CENTERS OF AMERICA, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

<TABLE>
<CAPTION>

For the fiscal year ended

| | JANUARY 2, 1999 | January 3, 1998 | December 28, 1996 |
|-----|--------------------|--------------------|----------------------|
| <S> | <C> | <C> | <C> |

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

Cash payments for (receipts of):

| | | | |
|--------------|------------|------------|------------|
| Interest | \$ 562,000 | \$ 346,000 | \$ 285,000 |
| Income taxes | 2,000 | (399,000) | (103,000) |
| | ===== | ===== | ===== |

SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES

| | | | |
|---|-------|-----------|------------|
| Long-term obligations incurred on purchase of equipment | \$ -- | \$ 27,000 | \$ -- |
| | ===== | ===== | ===== |
| Acquisition of Universal Appliance Company, Inc. and Universal Appliance Recycling, Inc. | | | |
| Working capital acquired, including cash and cash equivalents of \$26,000 | \$ -- | \$ -- | \$ 118,000 |
| Fair value of other assets acquired, principally property and equipment and a non-compete agreement | -- | -- | 176,000 |
| Purchase price assigned to goodwill | -- | -- | 301,000 |
| Long-term debt assumed | -- | -- | (207,000) |
| | ----- | ----- | ----- |
| Total consideration, 21,000 shares of Common Stock | \$ -- | \$ -- | \$ 388,000 |
| | ===== | ===== | ===== |

</TABLE>

See Notes to Consolidated Financial Statements.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. NATURE OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES

NATURE OF BUSINESS: Appliance Recycling Centers of America, Inc. and subsidiaries (the "Company") is in the business of selling reconditioned and distressed appliances and providing recycling services in an environmentally sound manner for major household appliances throughout the United States. The Company sells reconditioned appliances through a chain of Company-owned stores under the names "Encore(R) Recycled Appliances" and "Appliance\$mart(R)." The Company provides recycling services on a credit basis to utilities, local governments, appliance retailers and waste management companies.

A SUMMARY OF THE COMPANY'S SIGNIFICANT ACCOUNTING POLICIES IS AS FOLLOWS:

PRINCIPLES OF CONSOLIDATION: The consolidated financial statements include the accounts of Appliance Recycling Centers of America, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

FAIR VALUE OF FINANCIAL INSTRUMENTS: The following methods and assumptions are used to estimate the fair value of each class of financial instrument:

CASH EQUIVALENTS, ACCOUNTS RECEIVABLE AND ACCOUNTS PAYABLE: Due to their short-term maturities, the carrying amounts approximate fair value.

SHORT- AND LONG-TERM DEBT: The fair value of short- and long-term debt has been estimated based on discounted cash flows using interest rates being offered for similar debt having the same or similar remaining maturities and collateral requirements.

No separate comparison of fair values versus carrying values is presented for the aforementioned financial instruments since their fair values are not significantly different than their balance sheet carrying amounts. In addition, the aggregate fair values of the financial instruments would not represent the underlying value of the Company.

FISCAL YEAR: The Company's 1998 fiscal year (1998) ended January 2, 1999, its 1997 fiscal year (1997) ended January 3, 1998 and its 1996 fiscal year (1996) ended December 26, 1996. The fiscal years 1998 and 1996 include 52 weeks. The fiscal year 1997 includes 53 weeks.

REVENUE RECOGNITION: The Company recognizes revenue from appliance sales in the period the appliance is sold. Recycling revenue is recognized when a unit is

collected and processed. Byproduct revenue is recognized upon shipment.

The Company provides allowances for uncollectable revenues receivable based on management's periodic assessment of the need for such allowances. The Company defers revenue under appliance extended warranty arrangements and recognizes it over the terms of the warranty contracts. The Company accrues the estimated cost of initial warranty arrangements at the time of the appliance sale.

CASH AND CASH EQUIVALENTS: For purposes of reporting cash flows, the Company considers all cash and any treasury bills, commercial paper and money-market funds with an initial maturity of three months or less to be cash equivalents. The Company maintains its cash in bank deposits and money-market accounts which, at times, exceed federally insured limits. The Company has not experienced any losses in such accounts.

INVENTORIES: Inventories, consisting primarily of reconditioned and distressed appliances, are stated at the lower of cost, first-in, first-out (FIFO), or market.

Inventories consisted of the following:

| | 1998 | 1997 |
|---------------------|-------------|-----------|
| ----- | ----- | ----- |
| Finished goods | \$1,830,000 | \$605,000 |
| Work-in-process- | | |
| unrefurbished units | 189,000 | 109,000 |
| Less reserves | (40,000) | (20,000) |
| | ----- | ----- |
| | \$1,979,000 | \$694,000 |
| | ===== | ===== |

DEFERRED FINANCING COSTS: In connection with financing transactions in 1998 under notes payable arrangements, the Company incurred \$288,000 of costs which have been recorded in other assets and are being amortized using the straight line method over the terms of the related debt.

GOODWILL: The Company was an 80% shareholder in its California subsidiary, and accordingly, recorded the minority shareholder's interest in the subsidiary's net

income. During the fourth quarter of 1997, the Company purchased all of the minority shareholder's stock in the California subsidiary. This transaction resulted in the Company recording goodwill of \$190,000. Goodwill is being amortized by the straight-line method over a period of five years.

PROPERTY AND EQUIPMENT: Depreciation is computed using straight-line and accelerated methods over the following estimated useful lives:

| | Years |
|----------------------------|---------|
| | ----- |
| Buildings and improvements | 18 - 30 |
| Equipment | 3 - 8 |

ACCOUNTING FOR LONG-LIVED ASSETS: The Company reviews its property, equipment and goodwill periodically to determine potential impairment by comparing the carrying value of the long-lived assets with the estimated future net undiscounted cash flows expected to result from the use of the assets, including cash flows from disposition. Should the sum of the expected future net cash flows be less than the carrying value, the Company recognizes an impairment loss at that date. An impairment loss is measured by comparing the amount by which the carrying value exceeds the fair value (estimated discounted future cash flows or appraisal of assets) of the long-lived assets. In 1998, the Company recorded a loss on impairment of certain assets (See Note 11).

ADVERTISING EXPENSE: Advertising is expensed as incurred.

INCOME TAXES: Deferred taxes are provided on an asset and liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carryforwards, and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

BASIC AND DILUTED NET LOSS PER SHARE: Basic per-share amounts are computed, generally, by dividing net income or loss by the weighted-average number of common shares outstanding. Diluted per-share amounts assume the conversion, exercise or issuance of all potential common stock instruments unless their effect is antidilutive, thereby reducing the loss or increasing the income per common share.

As described in Note 9, at January 2, 1999, and January 3, 1998, the Company had stock options and warrants outstanding to purchase a total of 1,038,000 and 93,000 shares of Common Stock, respectively. However, because the Company has incurred a loss in all periods presented, the inclusion of those potential common shares in the calculation of diluted loss per-share would have an antidilutive effect. Therefore, basic and diluted loss per-share amounts are the same in each period presented.

REPORTING COMPREHENSIVE INCOME: As of January 1, 1998, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 130, REPORTING COMPREHENSIVE INCOME. SFAS No. 130 establishes new rules for the reporting and display of comprehensive income and its components. SFAS No. 130 requires unrealized gains or losses, which prior to adoption were reported separately in shareholders' equity, to be included in other comprehensive income. For the Company, reporting comprehensive income would be equivalent to reporting operating results in the statement of operations for the years ended January 2, 1999 and January 3, 1998. Comprehensive income for the year ended December 28, 1996 is presented in the consolidated statements of shareholders' equity.

SEGMENT INFORMATION: Effective January 1, 1998, the Company adopted Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information" ("SFAS 131"). SFAS 131 requires that a company report financial and descriptive information about its reportable operating segments, defined as those components of an enterprise about which separate financial information is available and is evaluated regularly by management in deciding how to allocate resources and in assessing performance. The adoption of SFAS No. 131 did not affect the Company's results of operations or financial position. The Company believes that it has one operating segment, although certain separate financial information by retail store, or retail store and recycling center, is available to management. The Company is managed as a unit. Specifically, it does not measure profit or loss or maintain assets separately for its products/revenue sources (reconditioned appliance sales, appliance recycling and recycling services for utilities).

ESTIMATES: The preparation of financial statements in conformity with generally accepted accounting principles

requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

NOTE 2. MARKET CLOSINGS AND CORPORATE LIQUIDITY

In December 1998, the Company decided to withdraw from the under-performing St. Louis, Missouri market. The Company closed its recycling center and two retail stores in February 1999. For the year ended January 2, 1999, the Company incurred expenses of approximately \$130,000 which included the write-off of leasehold improvements of approximately \$55,000 and inventory and the accrual of remaining lease payments and other costs of approximately \$75,000.

The Company withdrew from three under-performing markets in the fourth quarter of 1996. The Company closed three recycling centers and nine retail stores in Hartford, Connecticut; Washington, D.C./Baltimore, Maryland; and Oakland, California. In addition, the Company closed its three retail stores in Los Angeles, California. In connection therewith, the Company incurred charges of approximately \$2.0 million which included the write-off of leasehold improvements, deferred tax assets, goodwill, and certain non-compete agreements, receivables and inventories, and the accrual of potential lease contingencies and other costs.

The Company believes, based on anticipated revenues from an expected Southern California Edison Company contract, the anticipated sales per retail store and the anticipated gross profit, that its cash balance, anticipated funds generated from operations, its current line of credit if renewed, and the proceeds from the sale of its Common Stock in February 1999 will be sufficient to finance its operations and capital expenditures through December 1999. The Company's total capital requirements will depend, among other things as discussed below, on the number of recycling centers operating and the number and size of retail stores

operating during the fiscal year. Currently, the Company has three recycling centers and eight stores in operation. If revenues are lower than anticipated or expenses are higher than anticipated or the line of credit cannot be maintained, the Company may require additional capital to finance operations. Sources of additional financing, if needed in the future, may include further debt financing or the sale of equity or other securities. There can be no assurance that such additional sources of financing will be available or available at terms satisfactory to the Company or permitted by the Company's current lenders.

NOTE 3. BUSINESS COMBINATIONS

On January 2, 1996, the Company acquired Universal Appliance Company, Inc. and Universal Appliance Recycling, Inc., Washington, D.C.-based companies, by exchanging a total of 21,000 shares of its Common Stock for 100% ownership of the respective companies. The acquisitions were accounted for under the purchase method of accounting. Also, the selling shareholders received \$110,000 under non-compete agreements. In December 1996, the Company withdrew from the Washington D.C./Baltimore, Maryland market and closed the center and three retail locations. Accordingly, the related goodwill and non-compete agreements were written off in the fourth quarter of 1996.

NOTE 4. LINE OF CREDIT

At January 2, 1999, the Company had a \$2.0 million line of credit with a lender. The interest rate as of January 2, 1999 was 12.75%. The amount of borrowings available under the line of credit is based on a formula using receivables and inventories. The line of credit has a stated maturity date of August 30, 1999 unless renewed and provides that the lender may demand payment in full of the entire outstanding balance of the loan at any time. The line of credit is secured by substantially all the Company's assets, is guaranteed by the President of the Company and requires minimum monthly interest payments of \$5,625 regardless of the outstanding principal balance. The lender is also secured by an inventory repurchase agreement with Whirlpool Corporation. The loan also requires that the Company meet certain financial covenants, provides payment penalties for noncompliance, limits the amount of other debt the Company can incur, limits the amount of spending on fixed assets and limits payments on dividends. At January 2, 1999 the Company's unused borrowing capacity under this line was \$65,000.

NOTE 5. LONG-TERM OBLIGATIONS

Long-term obligations consisted of the following:

| | 1998 | 1997 |
|--|------------|------------|
| 9.00% mortgage, due in monthly installments of \$11,411, including interest, balance due February 2004, secured by land and building | \$ 911,000 | \$ 962,000 |
| 8.75% mortgage, due in monthly installments of \$7,027, including interest, balance due January 2003, secured by land and building | 678,000 | 700,000 |
| 13.00% note payable, monthly interest payments of \$37,917 until September 2000, monthly principal and interest payments of \$52,259 beginning September 2000, balance due September 2005, secured by equipment, land and building | 3,203,000 | -- |
| 9.88% mortgage, due in monthly installments of \$3,286, including interest, balance due September 2008, secured by land and building | 231,000 | -- |
| Other | 21,000 | 72,000 |

| | | |
|-------------------------|-------------|-------------|
| | \$5,044,000 | \$1,734,000 |
| Less current maturities | 79,000 | 101,000 |
| | ----- | ----- |
| | \$4,965,000 | \$1,633,000 |
| | ===== | ===== |

The future annual maturities of long-term obligations are as follows:

| | |
|-------------|-------------|
| Fiscal year | |
| ----- | |
| 1999 | \$ 79,000 |
| 2000 | 134,000 |
| 2001 | 271,000 |
| 2002 | 305,000 |
| 2003 | 867,000 |
| Thereafter | 3,388,000 |
| | ----- |
| | \$5,044,000 |
| | ===== |

NOTE 6. ACCRUED EXPENSES

Accrued expenses were as follows:

| | | |
|--|-----------|------------|
| | 1998 | 1997 |
| ----- | ----- | ----- |
| Compensation | \$139,000 | \$ 167,000 |
| Warranty | 157,000 | 74,000 |
| Lease contingencies and closing costs | 124,000 | 289,000 |
| Other | 280,000 | 291,000 |
| | ----- | ----- |
| | \$700,000 | \$ 821,000 |
| | ===== | ===== |

NOTE 7. COMMITMENTS

OPERATING LEASES: The Company leases certain of its recycling center facilities and equipment and retail stores under noncancelable operating leases. The leases require the payment of taxes, maintenance, utilities and insurance.

In the fourth quarter of 1996, the Company withdrew from three under-performing markets and closed its retail locations in the Los Angeles, California, market. At January 2, 1999, the Company had \$69,000 accrued for the remaining settlement of these leases.

In December 1998, the Company decided to withdraw from the St. Louis, Missouri market. The Company accrued approximately \$42,000 for the remaining lease payments on these leases.

Minimum rental commitments under noncancelable operating leases as of January 2, 1999 were as follows:

| | |
|-------------|-------------|
| Fiscal Year | |
| ----- | |
| 1999 | \$ 510,000 |
| 2000 | 431,000 |
| 2001 | 241,000 |
| 2002 | 199,000 |
| 2003 | 199,000 |
| | ----- |
| | \$1,580,000 |
| | ===== |

Rent expense for the fiscal years ended January 2, 1999, January 3, 1998 and December 28, 1996 was \$482,000, \$433,000 and \$1,585,000, respectively.

NOTE 8. INCOME TAXES

The provision for (benefit of) income taxes consisted of the following:

| | | | |
|----------|----------|-------------|--------------|
| | 1998 | 1997 | 1996 |
| ----- | ----- | ----- | ----- |
| Current: | | | |
| Federal | \$ -- | \$ -- | \$ (415,000) |
| State | 31,000 | (31,000) | -- |
| Deferred | -- | -- | 650,000 |
| | ----- | ----- | ----- |
| | \$31,000 | \$ (31,000) | \$ 235,000 |

A reconciliation of the Company's income tax expense (benefit) with the federal statutory tax rate is shown below:

| | 1998 | 1997 | 1996 |
|---|----------------|--------------|----------------|
| Income tax benefit at statutory rate | \$ (1,049,000) | \$ (236,000) | \$ (2,462,000) |
| State taxes, net of federal tax effect | (192,000) | (26,000) | (208,000) |
| Permanent differences | 34,000 | 74,000 | 110,000 |
| Change in valuation allowance | 257,000 | (289,000) | 235,000 |
| Effect of NOL with no current tax benefit | 981,000 | 446,000 | 2,560,000 |
| | \$ 31,000 | \$ (31,000) | \$ 235,000 |

The tax effects of principal temporary differences are as follows:

| | 1998 | 1997 |
|----------------------------------|--------------|--------------|
| Deferred tax assets: | | |
| Net operating loss carryforwards | \$ 3,300,000 | \$ 2,319,000 |
| Loss on asset impairment | 658,000 | 429,000 |
| Federal and state tax credits | 250,000 | 250,000 |
| Accrued expenses | 236,000 | 246,000 |
| Gross deferred tax assets | \$ 4,444,000 | \$ 3,244,000 |
| Deferred tax liability: | | |
| Accelerated tax depreciation | (254,000) | (292,000) |
| Valuation allowance | (4,190,000) | (2,952,000) |
| Net deferred tax assets | \$ -- | \$ -- |

At January 2, 1999, the Company recorded a valuation allowance of \$4,190,000 against deferred tax assets to reduce the total to an amount management believes is appropriate. Realization of deferred tax assets is dependent upon sufficient future taxable income during the periods when deductible temporary differences and carryforwards are expected to be available to reduce taxable income.

At January 2, 1999, the Company had net operating loss carryforwards consisting of the following:

| Expiration | Amount |
|------------|-------------|
| 2011 | \$4,515,000 |
| 2012 | \$1,115,000 |
| 2018 | \$2,484,000 |

These carryforwards may be subject to certain limitations under the provisions of the Internal Revenue Code, Section 382, which relate to a 50 percent change in control over a three-year period. In addition, any future changes of control may result in the expiration of a portion of the carryforwards before they can be used and are also dependent upon the Company attaining profitable operations in the future.

NOTE 9. SHAREHOLDERS' EQUITY

STOCK OPTIONS: The Company has two Stock Option Plans (the "Plans") that permit the granting of "incentive stock options" meeting the requirements of Section 422 of the Internal Revenue Code of 1986, as amended, and nonqualified options which do not meet the requirements of Section 422. The Plans have 150,000 and 100,000 shares, respectively, available for grant. The options that have been granted under the Plans are exercisable for a period of five to ten years from the date of grant and vest over a period of six months to three years from the date of grant.

The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation."

Accordingly, no compensation cost has been recognized for the Plans. Had compensation cost for the Plans been determined based on the fair value at the grant date consistent with the provisions of SFAS No. 123, the Company's net loss and basic and diluted loss per share would have been increased to the pro forma amounts indicated below:

| | 1998 | 1997 |
|-----------------------------------|----------------|--------------|
| Net loss: | | |
| As reported | \$ (3,056,000) | \$ (748,000) |
| Pro forma | \$ (3,136,000) | \$ (847,000) |
| Basic and diluted loss per share: | | |
| As reported | \$ (2.55) | \$ (0.66) |
| Pro forma | \$ (2.61) | \$ (0.75) |

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

| | 1998 | 1997 |
|----------------------------------|--------|--------|
| Expected dividend yield | -- | -- |
| Expected stock price volatility | 83.22% | 50.43% |
| Risk-free interest rate | 5.50% | 6.00% |
| Expected life of options (years) | 3 | 3 |

Additional information relating to all outstanding options is as follows:

| | Shares | Weighted Average Exercise Price |
|----------------------------------|----------|---------------------------------|
| Outstanding at December 30, 1995 | 64,000 | \$27.08 |
| Granted | 37,000 | \$12.72 |
| Exercised | (9,000) | \$ 9.60 |
| Cancelled | (12,000) | \$20.72 |
| Outstanding at December 28, 1996 | 80,000 | \$23.36 |
| Granted | 44,000 | \$ 2.54 |
| Cancelled | (31,000) | \$31.31 |
| Outstanding at January 3, 1998 | 93,000 | \$10.93 |
| Granted | 78,000 | \$ 1.50 |
| Cancelled | (27,000) | \$13.22 |
| Outstanding at January 2, 1999 | 144,000 | \$ 5.37 |

The weighted average fair value per option of options granted during 1998, 1997 and 1996 was \$0.85, \$0.96 and \$4.92 respectively.

The following tables summarize information about stock options outstanding as of January 2, 1999:

OPTIONS OUTSTANDING

| Range of Exercise Prices | Number of Options Outstanding | Weighted Average Remaining Contractual Life in Years | Weighted Average Exercise Price |
|--------------------------|-------------------------------|--|---------------------------------|
| \$45.52 | 2,000 | 1.9 | \$ 45.52 |
| \$17.50 | 22,000 | 2.6 | \$ 17.50 |
| \$10.52 to \$12.76 | 10,000 | 4.5 | \$ 10.58 |
| \$2.38 to \$3.00 | 32,000 | 5.8 | \$ 2.60 |
| \$0.75 to \$2.06 | 78,000 | 6.9 | \$ 1.50 |
| | 144,000 | | |

OPTIONS EXERCISABLE

| Range of | Number | Weighted |
|----------|--------|----------|
|----------|--------|----------|

| Exercise Prices | Options Exercisable | Average Exercise Price |
|--------------------|---------------------|------------------------|
| \$45.52 | 2,000 | \$45.52 |
| \$17.50 | 21,000 | \$17.50 |
| \$10.52 to \$12.76 | 10,000 | \$10.58 |
| \$2.38 to \$3.00 | 16,000 | \$2.60 |
| | ----- | |
| | 49,000 | \$12.37 |
| | ===== | |

The following table summarizes options exercisable for stock options outstanding as of January 2, 1998 and December 26, 1996:

| | 1997 | 1996 |
|---------------------------------|---------|---------|
| Number of options exercisable | 40,000 | 45,000 |
| Weighted average exercise price | \$19.44 | \$31.77 |

WARRANTS: In July 1998, the Company issued 12% subordinated promissory notes in the principal amount of \$275,000, plus an aggregate of 68,750 warrants to purchase the Company's Common Stock at \$2.25 per share.

In September 1998, the Company entered into a loan agreement with a lender resulting in gross proceeds to the Company of \$3.5 million. In connection with this loan, the Company issued the lender a warrant to purchase 700,000 shares of Common Stock at an adjustable exercise price, which is currently \$0.60 per share. The Company also issued to an investment banker associated with this transaction, a warrant to purchase 125,000 shares of Common Stock at \$2.50 per share.

The portion of the gross loan proceeds ascribed to the aforementioned warrants issued in conjunction with debt was \$307,000 as determined using the Black-Scholes method.

PREFERRED STOCK: In April 1998, the Company's shareholders approved an amendment to the Company's Articles of Incorporation authorizing two million shares of Preferred Stock of the Company ("Preferred Stock") which may be issued from time to time in one or more series having such rights, powers, preferences and designations as the Board of Directors may determine.

PRIVATE PLACEMENT: In May 1998, the Company sold in a private placement, 100,000 shares of Common Stock at a price of \$2.00 per share. The sale, which represented approximately 8% of the Common Stock outstanding

after such sale, was made to an institutional investor. The proceeds were used for additional working capital.

In May 1996, \$700,000 was raised in a private placement of Common Stock to an institutional investor by selling 50,000 shares at \$14.00 per share.

NOTE 10. MAJOR CUSTOMERS AND SUPPLIERS

MAJOR CUSTOMER:

Net revenues include sales to one major customer as follows:

| | 1998 | 1997 | 1996 |
|---------------------|-------|-------|-------|
| REVENUE PERCENTAGE: | | | |
| Customer | 28.8% | 37.8% | 22.1% |

As of January 2, 1999, the receivable from this customer on the Company's balance sheet was \$208,000.

MAJOR SUPPLIER:

The Company purchases substantially all of its scratch and dent (distressed) appliances from one original equipment manufacturer under a contractual arrangement. Management believes that should this arrangement be terminated other original equipment manufacturers would be available for alternate sources of supply.

NOTE 11. LOSS ON IMPAIRED ASSETS

In June 1998, the Company elected to curtail its appliance shredding operation and intensify its strategic focus on appliance retailing. As a result, the

Company recorded a \$518,000 loss on impaired equipment. In addition, as discussed in Note 2, the Company also recorded an impairment loss of \$55,000 in December 1998 related to withdrawing from an under-performing market.

NOTE 12. SUBSEQUENT EVENT

In February 1999, the Company sold in a private placement 1,030,000 shares of Common Stock at a price of \$0.50 per share. The Company paid \$31,500 of the proceeds and issued warrants to purchase 83,000 shares of Common Stock at \$0.50 per share, subject to adjustment, to an investment banker as a placement fee. The remaining proceeds were used to repay certain indebtedness, to purchase inventory and for other general corporate purposes.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

No changes in or disagreements with accountants have occurred within the two-year period ended January 2, 1999, which required reporting on Form 8-K.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE COMPANY

Information regarding directors and executive officers of the Company is set forth under Information Concerning Directors, Nominees and Executive Officers and under Beneficial Ownership Reporting Compliance in the Company's definitive Proxy Statement for its 1999 Annual Meeting of Shareholders to be held April 29, 1999, and is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

Information regarding Executive Compensation set forth under Executive Compensation in the Company's definitive Proxy Statement for its 1999 Annual Meeting of Shareholders to be held April 29, 1999, other than the subsections captioned Report of the 1998 Compensation and Benefits Committee and Performance Graph, is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

Information regarding security ownership of certain beneficial owners and management is set forth under Beneficial Ownership of Common Stock in the Company's definitive Proxy Statement for its 1999 Annual Meeting of Shareholders to be held April 29, 1999, and is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information regarding certain relationships and related transactions is set forth under Information Concerning Directors, Nominees and Executive Officers in the Company's definitive Proxy Statement for its 1999 Annual Meeting of Shareholders to be held April 29, 1999, and is incorporated herein by reference.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) FINANCIAL STATEMENTS, FINANCIAL STATEMENT SCHEDULES AND EXHIBITS

1. FINANCIAL STATEMENTS

See Index to Financial Statements under Item 8 of this report.

2. FINANCIAL STATEMENT SCHEDULES

To the Board of Directors
Appliance Recycling Centers of America, Inc.
Minneapolis, Minnesota

Our report on the consolidated financial statements of Appliance Recycling Centers of America, Inc. and subsidiaries is included

in this Form 10-K. In connection with our audits of such financial statements, we have also audited the related financial statement schedule listed immediately following. This financial schedule is the responsibility of the Company's management. Our responsibility is to express an opinion based on our audit.

In our opinion, the financial statement schedule referred to above, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information required to be included therein.

McGLADREY & PULLEN, LLP

Minneapolis, Minnesota
February 19, 1999

Schedule II - Valuation and qualifying accounts

| | Accounts Receivable Allowance | Inventory Allowance |
|----------------------------------|----------------------------------|------------------------|
| Balance, December 30, 1995 | \$ -- | \$ -- |
| Additional allowance | 90,000 | -- |
| Write-off of accounts receivable | (6,000) | -- |
| Balance, December 28, 1996 | \$ 84,000 | \$ -- |
| Additional allowance | 60,000 | 20,000 |
| Write-off of accounts receivable | (109,000) | -- |
| Balance, January 3, 1998 | \$ 35,000 | \$ 20,000 |
| Additional allowance | 50,000 | 20,000 |
| Write-off of accounts receivable | (67,000) | -- |
| BALANCE, JANUARY 2, 1999 | \$ 18,000 | \$ 40,000 |

3. EXHIBITS

See Index to Exhibits in this report.

(b) REPORTS ON FORM 8-K

No reports on Form 8-K were filed during the last quarter of the fiscal year covered by this report.

SIGNATURES

Pursuant to the requirements of Section 13 or Section 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.

Dated: March 22, 1999

APPLIANCE RECYCLING CENTERS OF
AMERICA, INC.
(Registrant)

By /s/ Edward R. Cameron

Edward R. Cameron
President and Chief Executive Officer

By /s/ Kent S. McCoy

Kent S. McCoy
Chief Financial Officer

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

| SIGNATURE ----- | TITLE ----- | DATE ----- |
|---|---|----------------|
| /s/ Edward R. Cameron ----- Edward R. Cameron | Chairman of the Board, President and Chief Executive Officer | March 22, 1999 |
| /s/ Kent S. McCoy ----- Kent S. McCoy | Chief Financial Officer (Principal Accounting Officer) | March 22, 1999 |
| /s/ George B. Bonniwell ----- George B. Bonniwell | Director | March 22, 1999 |
| /s/ Duane S. Carlson ----- Duane S. Carlson | Director | March 22, 1999 |
| /s/ Harry W. Spell ----- Harry W. Spell | Director | March 22, 1999 |
| /s/ Marvin Goldstein ----- Marvin Goldstein | Director | March 22, 1999 |

INDEX TO EXHIBITS

| Exhibit No. | Description |
|----------------|--|
| +3.1 | Restated Articles of Incorporation of Appliance Recycling Centers of America, Inc. |
| +3.2 | Amended and Restated Bylaws of Appliance Recycling Centers of America, Inc. |
| *10.1 | Amended Appliance Recycling Centers of America, Inc. Restated 1989 Stock Option Plan [filed as Exhibit 19.3 to the Company's Form 10-Q for the quarter ended June 30, 1993 (File No. 0-19621) and incorporated herein by reference]. |
| 10.2 | Agreement dated December 17, 1992, between Appliance Recycling Centers of America, Inc. and TCF Savings Bank [filed with the Company's Form 8-K, dated December 17, 1992 (File No. 0-19621) and incorporated herein by reference]. |
| 10.3 | Agreement dated January 19, 1994, between Appliance Recycling Centers of America, Inc. and Standard Insurance Corporation [filed as Exhibit 10.29 to the Company's Form 10-K for the year ended December 31, 1993 (File No.0-19621) and incorporated herein by reference]. |
| 10.4 | Line of credit dated August 30, 1996, between Appliance Recycling Centers of America, Inc. and Spectrum Commercial Services, a division of Lyons Financial Services, Inc. [filed as exhibit 10.15 to the Company's Form 10-Q for the quarter ended September 28, 1996 (File No. 0-19621) and incorporated herein by reference]. |
| 10.5 | Amended line of credit dated November 8, 1996, between Appliance Recycling Centers of America, Inc. and Spectrum Commercial Services, a division of Lyons Financial Services, Inc. [filed as exhibit 10.16 to the Company's Form 10-Q for the quarter ended September 28, 1996 (File No. 0-19621) and incorporated herein by reference]. |
| *10.6 | 1997 Stock Option Plan and Amendment [filed as Exhibits 28.1 and 28.2 to the Company's Registration Statement on Form S-8 (Registration No. 333-28571) and incorporated herein by reference]. |
| 10.7 | Amended line of credit dated February 12, 1998 between Appliance |

Recycling Centers of America, Inc. and Spectrum Commercial Services, a division of Lyons Financial Services, Inc., Amended Revolving Note and Amended Guarantor Acknowledgements [filed as Exhibit 10.10 to the Company's Form 10-K for year ended January 3, 1998 (File No. 0-19621) and incorporated herein by reference].

- 10.8 Agreement dated February 13, 1998 between Western Bank and Appliance Recycling Centers of America, Inc. [filed as Exhibit 10.11 to the Company's Form 10-K for the year ended January 3, 1998 (File No 0-19621) and incorporated herein by reference].
- *10.9 Amendment, effective April 24, 1997, to 1989 Stock Option Plan [filed as Exhibit 28.2 to the Company's Post-Effective Amendment No. 1 (June 5, 1997) to Registration Statement on Form S-8 (Registration No. 33-68890) and incorporated herein by reference].

- 10.10 Reverse Logistics Master Service Agreement between Whirlpool Corporation and Appliance Recycling Centers of America, Inc. [filed as Exhibit 10 to the Company's Form 10-Q for the quarter ended July 4, 1998 (File No. 0-19621) and incorporated herein by reference].
- 10.11 Loan Agreement between Medallion Capital, Inc. and Appliance Recycling Centers of America, Inc. dated September 10, 1998 [filed as Exhibit 10.1 to the Company's Form 10-Q for the quarter ended October 3, 1998 (File No. 0-19621) and incorporated herein by reference].
- 10.12 Promissory note of the Company to Medallion Capital, Inc. in the principal amount of \$3,500,000 due September 30, 2005 [filed as Exhibit 10.2 to the Company's Form 10-Q for the quarter ended October 3, 1998 (File No. 0-19621) and incorporated herein by reference].
- 10.13 Security Agreement of the Company [filed as Exhibit 10.3 to the Company's Form 10-Q for the quarter ended October 3, 1998 (File No. 0-19621) and incorporated herein by reference].
- +10.14 Warrant of the Company in favor of Medallion Capital, Inc. for 700,000 shares of the Company's Stock [corrected copy].
- +10.15 Amendment to the line of credit dated September 10, 1998 between Appliance Recycling Centers of America, Inc. and Spectrum Commercial Services, a division of Lyons Financial Services, Inc., Amendment to General Credit and Security Agreement and Amended Guarantor Acknowledgement.
- +10.16 Amendment to the line of credit dated September 17, 1998 between Appliance Recycling Centers of America, Inc. and Spectrum Commercial Services, a division of Lyons Financial Services, Inc., Amendment to General Credit and Security Agreement, Amended Guarantor Acknowledgement and Amended and Restated Revolving Note.
- + 21.1 Subsidiaries of Appliance Recycling Centers of America, Inc.
- + 23.1 Consent of McGladrey & Pullen, LLP, Independent Public Accountants.
- + 27.0 Financial Data Schedule.

* Items that are management contracts or compensatory plans or arrangements required to be filed as an exhibit pursuant to Item 14(a)3 of this Form 10-K.

+ Filed herewith.

RESTATED ARTICLES OF INCORPORATION
OF
APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

The undersigned, Edward R. Cameron, President of Appliance Recycling Centers of America, Inc., a corporation subject to the provisions of Chapter 302A, Minnesota Statutes, hereby certifies that the following resolutions were duly adopted by the Board of Directors of the Corporation on the 5th day of March, 1999:

RESOLVED, that the Corporation's existing Restated Articles of Incorporation, as amended to date, are hereby restated in their entirety, but without any changes thereto, as follows:

RESTATED ARTICLES OF INCORPORATION
OF
APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

ARTICLE 1. NAME

The name of the Corporation is Appliance Recycling Centers of America, Inc.

ARTICLE 2. REGISTERED OFFICE

The location and post office address of the Corporation's registered office in the State of Minnesota shall be 7400 Excelsior Boulevard, Minneapolis, Minnesota 55426.

ARTICLE 3. AUTHORIZED SHARES

The total number of shares of capital stock which the corporation shall have authority to issue is twelve million (12,000,000) shares, of which ten million (10,000,000) shares shall be Common Stock, without par value, and two million (2,000,000) shares shall be preferred stock.

The Preferred Stock may be issued from time to time in one or more series. The Board of Directors is expressly authorized, in the resolution or resolutions providing for the issuance of any wholly unissued series of Preferred Stock to fix, state and express the powers, rights, designations, preferences, qualifications, limitations and restrictions thereof, including without limitation: the par value; the rate of dividends upon which and the times at which dividends of shares of such series shall be payable and the preference, if any, which such dividends shall have relative to dividends on

shares of any other class or classes or any other series of stock of the corporation; whether such dividends shall be cumulative or noncumulative, and if cumulative, the date or dates from which dividends on shares of such series shall be cumulative; the voting rights, if any, to be provided for shares of such series; the rights, if any, which the holders of

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shares of such series shall have in the event of any voluntary or involuntary liquidation, dissolution or winding up of the affairs of the corporation; the rights, if any, which the holders of shares of such series shall have to convert such shares into or exchange such shares for shares of stock of the corporation, and the terms and conditions, including price and rate of exchange of such conversion or exchange; and the redemption rights (including sinking fund provisions), if any, for shares of such series; and such other powers, rights, designations, preferences, qualifications, limitations and restrictions as the Board of Directors may desire to so fix. The Board of Directors is also expressly authorized to fix the number of shares constituting such series and to increase or decrease the number of shares of any series prior to the issuance of shares of that series and to increase or decrease the number of shares of any series subsequent to the issuance of shares of that series, but not to decrease such number below the number of shares outstanding. In case the number of shares of any series shall be so decreased, the shares constituting such decrease shall resume the status which they had prior to the adoption of the resolution originally fixing the number of shares of such series.

ARTICLE 4. NO CUMULATIVE VOTING

There shall be no cumulative voting by the shareholders of the Corporation.

ARTICLE 5. NO PREEMPTIVE RIGHTS

The shareholders of the Corporation shall not have preemptive rights.

ARTICLE 6. DIRECTOR LIABILITY

A director of the Corporation shall not be personally liable to the Corporation or its shareholders for monetary damages for breach of fiduciary duty as a director, except for (i) liability based on a breach of the director's duty of loyalty to the Corporation or its shareholders; (ii) liability for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law; (iii) liability based on the payment of an improper dividend or an improper repurchase of the Corporation's stock under Section 302A.559 of the Minnesota Business Corporation Act or on violations of federal or state securities laws; (iv) liability for any act or omission occurring prior to the date this Article was originally effective. If Chapter 302A, the Minnesota Business Corporation Act, is amended to authorize the further

elimination or limitation of the liability of directors, then the liability of a director of the Corporation in addition to the limitation on personal liability provided herein, shall be limited to the fullest extent permitted by the amended Chapter 302A, the Minnesota Business Corporation Act. Any repeal or modification of this Article by the shareholders of the Corporation shall be prospective only and shall not adversely affect any limitation on the personal liability of a director of the Corporation existing at the time of such repeal or modification.

RESOLVED FURTHER, that the President of the Corporation is hereby authorized and directed to make, execute and file for record with the Secretary of State of the State of Minnesota, Restated Articles of Incorporation, setting forth the foregoing restated articles of incorporation, and to pay all fees and charges in connection therewith, all as required by law.

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IN WITNESS WHEREOF, the undersigned has signed these Restated Articles of Incorporation as of the 5th day of March, 1999.

/s/ EDWARD R. CAMERON
Edward R. Cameron, President

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AMENDED AND RESTATED BYLAWS
OF
APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

ARTICLE 1.
OFFICES

1.1. Registered Office. The registered office of the corporation shall be 7400 Excelsior Boulevard, Minneapolis, Minnesota 55426. The Board of Directors shall have authority to change the registered office of the corporation from time to time, and any such change shall be registered by the Secretary with the Secretary of State of Minnesota.

1.2. Offices. The corporation may have such other offices, including its principal business office, either within or without the State of Minnesota, as the Board of Directors may designate or as the business of the corporation may require from time to time.

ARTICLE 2.
SHAREHOLDERS

2.1. Regular Meeting. Regular meetings of the shareholders of the corporation, shall be held at the principal business office of the corporation, or at such place as is designated by the Board of Directors at which time the shareholders, voting as provided in the Articles of Incorporation, shall elect a Board of Directors for the ensuing year, and shall transact such other business as shall properly come before them.

2.2. Frequency of Regular Meetings. Regular meetings which may also be referred to as annual meetings of shareholders may be called at any time by a majority of the Board of Directors. If a regular meeting of shareholders has not been held during the immediately preceding thirteen (13) months, a shareholder or shareholders holding three percent (3%) or more of all voting shares may demand a regular meeting of shareholders by written notice of demand given to the Chief Executive Officer or Secretary of the corporation within thirty (30) days after receipt of the demand by one of those officers, the Board shall cause a regular meeting of shareholders to be called and held on notice no later than ninety (90) days after receipt of the demand, all at the expense of the corporation.

2.3. Special Meetings. Special meetings of the shareholders may be called by the Secretary at any time upon request of the Chief Executive Officer, or two of the members of the Board of Directors, or upon a written request of shareholders holding ten percent (10%) or more of the capital stock entitled to

vote. The written request shall be given to the Chief Executive Officer and shall contain the purpose of the meeting. Notice shall be given in accordance with the provisions of Section 2.7 hereof.

2.4. Quorum. The holders of a majority of the shares outstanding and entitled to vote, represented either in person or by proxy, shall constitute a quorum for the transaction of business. The shareholders present at a duly called or held meeting, at which a quorum of the shareholders is present, may continue to transact business until adjournment notwithstanding the withdrawal of enough shareholders to leave less than a quorum. In case a quorum is not present at any meeting, those present shall have the power to adjourn the meeting from time to time, without notice or other announcement at the meeting, until the requisite number of voting shares shall be represented; any business may be transacted at such reconvened meeting which might have been transacted at the meeting which was adjourned.

2.5. Voting. At each meeting of the shareholders, every shareholder having the right to vote shall be entitled to vote in person or by proxy duly appointed by an instrument in writing subscribed by such shareholder. Each shareholder shall have one (1) vote for each share having voting power standing in his name on the books of the corporation. Upon the demand of any shareholder, the vote for director, or the vote upon any question before the meeting shall be by ballot. All elections shall be had and all questions decided by a majority vote of the number of shares entitled to vote and represented at any meeting at which there is a quorum, except in such cases as shall otherwise be required or permitted by statute, the Articles of Incorporation, these Bylaws or by agreement approved by a majority of all shareholders.

2.6. Voting of Shares by Certain Holders. Shares standing in the name of another corporation may be voted by such officer, agent or proxy as the articles or bylaws of such corporation may prescribe, or in the absence of such provision, as that corporation's board of directors may prescribe. Shares under control of a personal representative, administrator, guardian, conservator, attorney-in-fact, or other similar person may be voted by that person, either in person or by proxy, without registration of those shares in the name of that person. Shares under the control of a trustee in bankruptcy or a receiver may be voted by the trustee or receiver if authority to do so is contained in an appropriate order of the court by which the trustee or receiver was appointed. A shareholder whose shares are pledged may vote those shares until the shares are registered in the name of the pledgee. Shares held by a trust shall be registered in the name of a trustee, as trustee for the trust, and may be voted by that named trustee in person or by proxy.

2.7. Notice of Meeting. There shall be mailed to each shareholder shown by the books of the corporation to be a holder of record of voting shares, at his address as shown by the books of the corporation, a notice setting out the time and place of the regular meeting or any special meeting, which notice shall be mailed at least ten (10) days prior thereto. Every notice of any special meeting

shall state the purpose or purposes of the proposed meeting, and the business transacted at any special meetings shall be confined to purposes stated in the call. Notice thereof may be waived in writing either before, at, or after such meeting.

2.8. Proxies. At all meetings of shareholders, a shareholder may vote by proxy executed in writing by the shareholder or by his duly authorized attorney-in-fact. Such proxies shall be filed with the Secretary of the corporation before or at the time of the meeting. No proxy shall be valid after eleven (11) months from the date of its execution, unless otherwise provided in the proxy.

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2.9. Record Date. The Board of Directors may fix in advance a date, not exceeding sixty (60) days preceding the date of any of the aforesaid events, as a record date for the determination of shareholders entitled to notice of and to vote at any such meeting and any adjournment thereof, or to receive any such dividend or allotment of rights, or to exercise the rights in respect to any change, conversion or exchange of capital stock or to give such consent, and in such case only such shareholders on the record date so fixed shall be entitled to notice of and to vote at such meeting and any adjournment thereof, or to receive such dividend or allotment of rights, or to exercise such rights, or to give such consent, as the case may be, notwithstanding any transfer of any stock on the books of the corporation after any such record date so fixed. If the stock transfer books are not closed and no record date is fixed for such determination of the shareholders of record, the date on which notice of the meeting is mailed, or the date of adoption of a resolution of the Board of Directors declaring a dividend, allotment of rights, change, conversion or exchange of capital stock or to give such consent, whichever is earlier, shall be the record date for such determination of shareholders. The determination of shareholders entitled to vote at the meeting as called shall apply to any adjournment of such meeting except when the date of determination or the closing of the stock transfer book is more than ninety (90) days prior to such adjourned meeting, in which event a new meeting must be called.

2.10. Presiding Officer. The appropriate officers of the corporation shall preside over all meetings of the shareholders; provided, however, that in the absence of an appropriate corporate officer at any meeting of the shareholders, the meeting shall choose any person present to act as presiding officer of the meeting.

2.11. Conduct of Meetings of Shareholders. Subject to the following, meetings of shareholders generally shall follow accepted rules of parliamentary procedure:

a. The chairman of the meeting shall have absolute authority over matters of procedure and there shall be no appeal from the ruling of the

chairman. If the chairman, in his absolute discretion, deems it advisable to dispense with the rules of parliamentary procedure as to any one meeting of shareholders or part thereof, the chairman shall so state and shall clearly state the rules under which the meeting or appropriate part thereof shall be conducted.

b. If disorder should arise which prevents continuation of the legitimate business of the meeting, the chairman may quit the chair and announce the adjournment of the meeting; and upon his so doing, the meeting is immediately adjourned.

c. The chairman may ask or require that anyone not a bona fide shareholder or proxy leave the meeting.

2.12. Order of Business. The suggested order of business at the annual meeting of shareholders, and so far as possible at all other meetings of the shareholders, shall be:

a. Reading and disposal of any unapproved minutes.

b. Annual reports of all officers and committees.

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c. Election of directors.

d. Unfinished business.

e. New business.

f. Adjournment.

2.13. Inspectors of Election. The Board of Directors in advance of any meeting of shareholders may appoint inspectors to act at such meeting or any adjournment thereof. If inspectors of election are not so appointed, the officer or person acting as chairman of any such meeting may, and on the request of any shareholder or his proxy, shall make such appointment. In case any person appointed as inspector shall fail to appear or act, the vacancy may be filled by appointment made by the Board of Directors in advance of the meeting, or at the meeting by the officer or person acting as chairman. The inspectors of election shall determine the number of shares outstanding, the voting power of each, the shares represented at the meeting, the existence of a quorum, the authenticity, validity and effect of proxies, receive votes, ballots, assents or consents, hear and determine all challenges and questions in any way arising and announce the result, and do such acts as may be proper to conduct the election or vote with fairness to all shareholders.

a. No inspector whether appointed by the Board of Directors or by the officer or person acting as chairman need be a shareholder.

ARTICLE 3.
DIRECTORS

3.1. General Powers. The property, affairs, and business of the corporation shall be managed by the Board of Directors.

3.2. Number. The number of directors shall be two (2) but the number of directors may be increased or diminished by a majority vote of the board of directors.

3.3. Qualifications and Term of Office. Directors need not be shareholders or residents of the State of Minnesota. Directors shall be elected by the shareholders at a regular meeting for an indefinite term until the next regular meeting of shareholders and until a successor shall have been elected and qualified. Each of the directors of the corporation shall hold office until the regular meeting next following or closely coinciding with the expiration of his term of office and until his successor shall have been elected and shall qualify, or until he shall resign, or shall have been removed as provided by statute.

3.4. Quorum. A majority of the Board of Directors shall constitute a quorum for the transaction of business; provided, however, that if any vacancies exist by reason of death, resignation or otherwise, a majority of the remaining directors shall constitute a quorum for the conduct of business. If less than a quorum is present at any meeting, a majority of the directors present may adjourn the meeting from time to time without further notice.

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3.5. Regular Meetings. As soon as practical after each regular meeting of shareholders, the Board of Directors shall meet for the purposes of organization, choosing the officers of the corporation and for the transaction of other business at the place where the shareholders meeting is held or at the place where regular meetings of the Board of Directors are held. No notice of such meeting need be given. Such first meeting may be held at any other time and place which shall be specified in a notice given as hereinafter provided for special meetings or in a consent and waiver of notice signed by all the directors.

Other regular meetings of the Board of Directors shall be held from time to time at such time and place as may from time to time be fixed by resolution adopted by a majority of the whole Board of Directors. Unless notice shall be waived by all directors entitled to notice, notice shall be given in the same manner as prescribed for notice of special meetings.

3.6. Special Meetings. Special meetings of the Board of Directors may be held at such time and place as may from time to time be designated in the notice

or waiver of notice of the meeting. Special meetings of the Board of Directors may be called by the Chief Executive Officer, or by any director. Unless notice shall be waived by all directors entitled to notice, notice of the special meeting shall be given by the Secretary, who shall give at least twenty-four (24) hours notice thereof to each director by mail, telegraph, telephone, or in person.

3.7. Electronic Communications. A Board of Directors meeting may be had entirely or partially by any means of communication through which the directors may simultaneously hear each other, provided notice is given of the meeting pursuant to Section 3.9 and there are a sufficient number of participants to constitute a quorum.

3.8. Absent Director. A director may give advance written consent or opposition to a proposal to be acted on at a board of directors meeting. Such written consent or opposition does not constitute presence for purposes of determining the existence of a quorum. Written consent or opposition shall be counted as a vote on the proposal if the proposal acted on is substantially the same or has substantially the same effect as the proposal to which the director has consented or objected.

3.9. Notice. Unless notice is waived by all directors entitled to notice, a regular meeting of the Board of Directors may be called by giving ten (10) days notice to all directors. A special meeting of the Board of Directors may be called by giving at least twenty-four (24) hours notice to all directors. Notice may be given by mail, telegraph, telephone, or in person. If given by mail such notice shall be deemed given when deposited in the United States mails. Notice by mail may not be used if the meeting is called less than four (4) days from the date of notice. The notice must specify the date, time and place of the meeting, and if a special meeting, the purpose of the meeting.

3.10. Manner of Acting. The act of a majority of the directors present at a meeting at which a quorum is present shall be the act of the Board of Directors.

3.11. Compensation. Directors and any members of any committee of the corporation contemplated by these Bylaws or otherwise provided for by resolution of the Board of Directors, shall receive such compensation therefor as may be determined from time to time by resolution

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of the Board of Directors. Nothing herein contained shall be construed to preclude any director from serving the corporation in any other capacity and receiving proper compensation therefor.

3.12. Salaries. Salaries and other compensation of all officers of the corporation shall be fixed by the Board of Directors, which action may be taken informally without the benefit of written resolutions. Nothing herein contained

shall be construed to preclude any officer from serving the corporation as a director, consultant or in any other capacity and receiving proper compensation therefor.

3.13. Executive Committee. A two-thirds (2/3) majority vote of the Board of Directors present at a meeting may pass a resolution establishing committees having the authority of the Board to the extent provided in the resolution. A committee shall consist of three or more persons who need not be members of the Board. A majority of the committee present at a meeting shall constitute a quorum for the purpose of transacting business. In all other respects committees shall conduct meetings in the same manner prescribed for the Board of Directors. Committees shall be subject at all times to the control and direction of the Board.

3.14. Vacancies. A director may resign at any time by giving written notice of same to the Board of Directors, or to the President. Such resignation shall be effective upon receipt unless a later date is specified in the notice. If at any time and for any reason, including the creation of a new directorship, a vacancy occurs in the Board of Directors, the remaining directors of the Board, though less than a quorum, may elect a successor to fill such vacancy, or the Board may leave the vacancy unfilled until the next regular meeting of the shareholders, or until an intervening special meeting of the shareholders is called and held for the purpose of electing a successor. A director elected to fill the vacancy shall hold his office for the unexpired term of his predecessor, or until his successor is duly elected and qualified.

3.15. Order of Business. The meetings shall be conducted in accordance with Roberts Rules of Order, Revised, and the suggested order of business at any meeting of the directors shall be:

- a. Roll call.
- b. Proof of due notice of meeting, or unanimous consent, or unanimous presence and declaration by president.
- c. Reading and disposal of any unapproved minutes.
- d. Reports of officers and committees.
- e. Election of officers.
- f. Unfinished business.
- g. New Business.
- h. Adjournment.

3.16. Informal Action by Directors. Any action required to be taken at a meeting of the directors, or any other action which may be taken at a meeting of the directors, may be taken without a meeting and notice thereof if a consent in writing, setting forth the action so taken, shall be signed by all of the directors entitled to vote with respect to the subject matter set forth.

ARTICLE 4.
OFFICERS

4.1. Number. The officers of the corporation may include a Chief Executive Officer, a Chief Financial Officer, and such other officers as may from time to time be chosen by the Board of Directors. Any number of offices may be held by one person.

4.2. Election, Term of Office and Qualifications. At any regular meeting of the Board of Directors, the board may elect a Chief Executive Officer, a Chief Financial Officer, and such other officers and assistant officers as may be deemed advisable. Such officers shall hold office until their successors are elected and qualify; provided, however, that any officer may be removed with or without cause by the affirmative vote of a majority of the whole Board of Directors.

4.3. The Chief Executive Officer. The Chief Executive Officer, who may also be referred to as the President shall: (a) have general active management of the business of the corporation; (b) when present, preside at all meetings of the Board and of the shareholders; (c) see that all orders and resolutions of the Board are carried into effect; (d) sign and deliver in the name of the corporation any deeds, mortgages, bonds, contracts or other instruments pertaining to the business of the corporation, except in cases in which the authority to sign and deliver is required by law to be exercised by another person or is expressly delegated by the articles or bylaws or by the Board to some other officer or agent of the corporation; (e) maintain records of and, whenever necessary, certify all proceedings of the Board and the shareholders; and (f) perform other duties prescribed by the Board. The Chief Executive Officer may also be referred to as the President.

4.4. Assistant Executive Officers. Each assistant executive officer shall have such powers and shall perform such duties as may be prescribed by the Board of Directors. In the event of absence or disability of the Chief Executive Officer, an assistant executive officer shall succeed to his powers and duties in the order in which they are elected or as otherwise prescribed by the Board of Directors. The Assistant Executive Officers may also be referred to as Vice Presidents.

4.5. Secretary. The Secretary shall be secretary of and shall attend all meetings of the shareholders and Board of Directors. The Secretary shall act as clerk thereof and shall record all the proceedings of such meetings in the minute book of the corporation. The Secretary shall give proper notice of meetings of shareholders and directors. The Secretary shall keep the seal of the corporation, if any, and shall affix the same to any instrument requiring it and

shall attest the seal by his signature. The Secretary shall, with the Chief Executive Officer or Chief Financial Officer, acknowledge all certificates for shares of the corporation and shall perform such other duties as may be prescribed from time to time by the Board of Directors.

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4.6. Chief Financial Officer. The Chief Financial Officer, who may also be referred to as the Treasurer, shall: (a) keep accurate financial records for the corporation; (b) deposit all money, drafts, and checks in the name of and to the credit of the corporation in the banks and depositories designated by the Board; (c) endorse for deposit all notes, checks, and drafts received by the corporation as ordered by the Board, making proper vouchers therefor; (d) disburse corporate funds and issue checks and drafts in the name of the corporation, as ordered by the Board; (e) render to the Chief Executive Officer and the Board, whenever requested, an account of all transactions by the Chief Financial Officer and of the financial condition of the corporation; and (f) perform other duties prescribed by the Board or by the Chief Executive Officer. The Chief Financial Officer may also be referred to as the Treasurer.

4.7. Assistant Officers. In the event of absence or disability of any officer, assistants to such officers shall succeed to the powers and duties of the absent officer in the order in which they are elected or as otherwise prescribed by the Board of Directors until such principal officer shall resume his duties or a replacement elected by the Board of Directors. Such assistant officers shall exercise such other powers and duties as may be delegated to them from time to time by the Board of Directors, but they shall be subordinate to the principal officer they are designated to assist.

4.8. Officers Shall Not Lend Corporate Credit. Except for the proper use of the corporation, no officer of this corporation shall sign or endorse in the name or on behalf of this corporation, or in his official capacity, any obligations for the accommodation of any other party or parties, nor shall any check, note, bond, stock certificate or other security or thing of value belonging to this company be signed by any officer or director as collateral for any obligation other than valid obligations of this corporation.

ARTICLE 5. INDEMNIFICATION

5.1. Authority of the Board of Directors. The corporation acting through its Board of Directors or as otherwise provided in this bylaw, shall exercise as fully as may be permitted from time to time by the statutes and decisional law of the State of Minnesota or by any other applicable rules or principles of law its power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit, or proceeding, wherever brought, whether civil, criminal, administrative, or investigative, by reason of the fact that he is or was a director, officer,

employee, or agent of the corporation, or is or was serving at the request of the corporation, as a director, officer, employee, or agent of another corporation, partnership, joint venture, trust, or other enterprise, against expenses, including attorneys' fees, judgments, fines and amounts paid in settlement actually and reasonably incurred by him in connection with such action, suit or proceeding.

5.2. Standard for Indemnification. Any person described in Section 5.1 may be indemnified by the corporation if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceedings, had no reasonable cause to believe his conduct was unlawful.

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5.3. No Presumptions Resulting From Termination of Actions. The determination of any action, suit, or proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, have reasonable cause to believe that his conduct was unlawful.

5.4. Mandatory Indemnification. To the extent that any such person has been successful on the merits or otherwise in defense of any action, suit, or proceeding referred to in this bylaw, or in defense of any claim, issue, or matter within this bylaw, he shall be indemnified against expenses, including attorneys' fees, actually and reasonably incurred by him in connection therewith.

5.5. Determination. Any indemnification under Section 5.1, unless ordered by a court, shall be made by the corporation only as authorized in the specific case upon a determination that indemnification of the director, officer, employee, or agent is proper in the circumstances because he has met the applicable standard of conduct set forth in Section 5.2. Such determination shall be made (1) by the Board of Directors by a majority vote of a quorum consisting of directors who are not parties to such action, suit, or proceeding, or (2) if such a quorum is not obtainable, or, even if obtainable in a quorum of disinterested directors so directs, by independent legal counsel in a written opinion, or (3) by a majority vote of disinterested shareholders.

5.6. Advance Payment. The expenses incurred in defending a civil or criminal action, suit, or proceeding may be paid by the corporation in advance of the final disposition of such action, suit, or proceeding as authorized by the Board of Directors in the manner provided in Section 5.5 upon receipt of an undertaking by or on behalf of the director, officer, employee, or agent to repay such amount unless it shall ultimately be determined that he is entitled to be indemnified by the corporation as authorized in this bylaw.

5.7. Continuance of Indemnification. The indemnification provided by this bylaw shall continue as to a person has ceased to be a director, officer, employee, or agent and shall inure to the benefit of the heirs, executors, and administrators of such a person.

5.8. Not Exclusive Remedy. The indemnification provided by this bylaw shall not exclude any other right to which an officer may be entitled under any agreement, vote of stockholders or disinterested directors, or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office, and shall not imply that the corporation may not provide lawful indemnification not expressly provided for in this bylaw. Nothing contained in this bylaw shall effect any rights to indemnification to which corporate personnel other than directors and officers may be entitled by contract or otherwise under law.

5.9. Insurance. The corporation may purchase and maintain insurance on behalf of any person who is or was a director, officer, employee, or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against him and incurred by him in any such capacity, provided, that no indemnification shall be

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made under any policy of insurance for any act which could not be indemnified by the corporation under this bylaw.

5.10. Notice of Indemnification. If, under this bylaw, any expenses or other amounts are paid by way of indemnification, otherwise than by Court order or action by the shareholders, the corporation shall, not later than the next annual meeting of shareholders unless such meeting is held within three (3) months from the date of such payment, and in any event, within fifteen (15) months from the date of such payment, mail to its shareholders of record at the time entitled to vote for the election of directors a statement specifying the persons paid, the amounts paid, and the nature and status of the litigation or threatened litigation at the time of such payment.

ARTICLE 6. SHARES AND THEIR TRANSFER

6.1. Certificates of Stock. There shall be no uncertificated shares of stock. Every owner of stock of the corporation shall be entitled to a certificate, to be in such form as the Board of Directors prescribes, certifying the number of shares of stock of the corporation owned by him. The certificates for such stock shall be numbered in the order in which they shall be issued and shall be signed in the name of the corporation by the Chief Executive Officer,

and by the Secretary or any other proper officer of the corporation authorized by the Board of Directors. A record shall be kept of the name of the person, firm or corporation owning the stock represented by each such certificate, the number of shares represented by each such certificate, and the respective issue date thereof, and in the case of cancellation, the respective dates of cancellation. Every certificate surrendered to the corporation for exchange or transfer shall be cancelled and no other certificate or certificates shall be issued in exchange for any existing certificates until such existing certificate shall have been so cancelled except in cases provided for in Section 6.5 of this Article 6.

6.2. Facsimile Signature. Where any certificate is manually signed by a transfer agent, a transfer clerk or by a registrar appointed by the Board of Directors to perform such duties, a facsimile or engraved signature of the president and Secretary or other proper officer of the corporation authorized by the Board of Directors may be inscribed on the certificate in lieu of the actual signature of such officer. The fact that a certificate bears the facsimile signature of an officer who has ceased to hold office shall not affect the validity of such certificate if otherwise validly issued.

6.3. Establishment and Issuance of Shares. Subject to the provisions of the Articles of Incorporation and as provided by law, the Board of Directors is authorized to designate and cause to be issued, classes and series of shares of the corporation, with designated voting rights, preferences, and other characteristics, at such times and for such consideration as the Board of Directors may determine.

6.4. Transfer of Shares. Transfer of shares on the books of the corporation may be authorized only by the shareholder named in the certificate, or by the shareholder's legal representative, or duly authorized attorney-in-fact, and upon surrender for cancellation of the certificate or certificates for such shares. The shareholder in whose name shares of stock stand

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on the books of the corporation shall be deemed the owner thereof for all purposes as regards the corporation; provided, that when any transfer of shares shall be made as collateral security, and not absolutely, such facts, if known to the Secretary of the corporation, or to the transfer agent, shall be so expressed in the entry of transfer.

6.5. Lost Certificates. Any shareholder claiming a certificate of stock to be lost or destroyed shall make an affidavit or affirmation of that fact in such form as the Board of Directors may require, and shall, if the directors so require, give the corporation a bond of indemnity in form and with one or more sureties satisfactory to the Board, in an amount determined by the Board of Directors not exceeding double the value of the stock represented by such certificate to indemnify the corporation, against any claim that may be made of

such certificate; whereupon a new certificate may be issued in the same tenor and for the same number of shares as the one alleged to have been destroyed or lost.

6.6. Treasury Stock. Treasury stock shall be held by the corporation subject to disposal by the Board of Directors, in accordance with the Articles of Incorporation and these Bylaws, and shall not have voting rights nor participate in dividends.

6.7. Inspection of Books by Shareholders. Upon written demand shareholders shall for any purpose, as provided by statute, be permitted to examine and copy the share register; records of shareholder and Board proceedings; the articles of incorporation and amendments; the bylaws and amendments; reports made to shareholders within the last three (3) years; voting trust agreements; a statement of names and addresses of its Directors and principal officers; and financial statements prepared for distribution to the shareholders or to a government agency as a matter of public record. Shareholders shall for any proper purpose and upon written demand be permitted to examine and copy other corporate records.

6.8. Transfer Agent and Registrar. The Board of Directors may appoint one or more Transfer agents or transfer clerks, and may require all certificates for shares to bear the signature or signatures of any of them.

ARTICLE 7.
DIVIDENDS, DISTRIBUTIONS, ETC.

7.1. Dividends. Subject to the Provisions of the Articles of Incorporation, these bylaws, and the applicable laws, the Board of Directors may declare a distribution in the form of a dividend whenever, and in such amounts as, in its opinion, the condition and the affairs of the corporation shall render it advisable.

7.2. Other Distributions, Reserves. Subject to the provisions of the Articles of Incorporation and of these bylaws, the Board of Directors in its discretion may purchase or acquire any of the shares of the capital stock of this corporation in accordance with law, or any of its bonds, debentures, notes, scrip or other securities or evidences of indebtedness, or from time to time may set aside from its net assets or net profits such sum or sums as it, in its absolute discretion, may think proper as a reserve fund to meet contingencies, or for the purpose of maintaining or increasing the property or business of the corporation or for any other purpose it may think conducive to the best interests of the corporation.

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ARTICLE 8.
FINANCIAL AND PROPERTY MANAGEMENT

8.1. Fiscal Year. The fiscal year of the corporation shall be set by the Board of Directors.

8.2. Audit of Books and Accounts. The books and accounts of the corporation shall be audited at such times as may be ordered by the Board of Directors.

8.3. Contracts. The Board of Directors may authorize any officer or officers, agent or agents, to enter into any contract or execute and deliver any instrument in the name of and on behalf of the corporation, and such authority may be general or confined to specific instances.

8.4. Checks. All checks, drafts, or other orders for the payment of money, notes, or other evidences of indebtedness issued in the name of the corporation shall be signed by the treasurer or such other officer or officers, agent or agents of the corporation and in such manner as shall from time to time be determined by resolution of the Board of Directors.

8.5. Deposits. All funds of the corporation not otherwise employed shall be deposited from time to time to the credit of the corporation in such banks, trust companies, or other depositories as the Board of Directors may select.

8.6. Voting Securities Held by Corporation. The Chief Executive Officer or other agent designated by the Board of Directors shall have full power and authority on behalf of the corporation to attend, act and vote at any meeting of security holders of other corporations in which this corporation may hold securities. At such meeting the Chief Executive Officer, or such other agent, shall possess and exercise any and all rights and powers incident to the ownership of such securities which the corporation might possess and exercise.

ARTICLE 9.

WAIVER OF NOTICE

9.1. Requirement of Waiver in Writing. Whenever any notice whatever is required to be given by these Bylaws or the Articles of Incorporation of the corporation or any of the corporate laws of the State of Minnesota, a waiver thereof in writing, signed by the person or persons entitled to said notice, either before, at, or after the time stated therein, shall be deemed equivalent thereto. Attendance by a director at a meeting of the Board of Directors or attendance by a shareholder at a meeting of the shareholders shall constitute a waiver of the notice of said meeting.

ARTICLE 10.

AMENDMENTS

10.1. Action by Board of Directors. The Board of Directors of the corporation is expressly authorized to make bylaws of the corporation and from time to time to alter or repeal bylaws so made. In so acting, the Board of Directors may do so only upon vote of a majority of

the entire Board of Directors then in office and present at any meeting called for that purpose, provided that notice of such proposed amendment shall have been given to the directors in the notice of such meeting. Such authority in the Board of Directors is subject to the powers of the voting shareholders to enact, change or repeal such bylaws by majority vote of the shareholders to enact, change or repeal such bylaws by majority vote of the shareholders present and represented at any annual meeting or at any special meeting called for that purpose, and the Board of Directors shall not make or alter any bylaws fixing the number, qualifications or term of office of members of the Board.

Exhibit 1.4 to the
Loan Agreement
dated September 10, 1998

THE SECURITIES REPRESENTED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933 (THE "1933 ACT") OR UNDER THE SECURITIES LAWS OF ANY STATE. THEY MAY NOT BE SOLD, TRANSFERRED OR OTHERWISE DISPOSED OF FOR VALUE EXCEPT PURSUANT TO REGISTRATION OR OPERATION OF LAW WITHOUT AN OPINION OF COUNSEL SATISFACTORY TO THE COMPANY THAT SUCH TRANSFER MAY LAWFULLY BE MADE WITHOUT REGISTRATION UNDER THE STATE SECURITIES LAWS AND/OR THE 1933 ACT.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
STOCK PURCHASE WARRANT
700,000 SHARES
OF COMMON STOCK

For value received MEDALLION CAPITAL, INC., a Licensee under the Small Business Investment Act of 1958 ("Investor"), or its assigns, is entitled to subscribe for and purchase, upon written notice given any time prior to the later of September 10, 2007 or two years after the repayment in full of the Note dated September 10, 1998 issued to Investor, 700,000 shares (subject to adjustment as provided below) of the no par Common Stock, fully paid and nonassessable, of APPLIANCE RECYCLING CENTERS OF AMERICA, INC., a Minnesota corporation (the "Company"), at the price of \$2.50 per share (subject to adjustment as provided below, the "Warrant Price"), subject to the terms and conditions set forth below.

1. LOAN AGREEMENT. This Warrant is issued pursuant to, and is subject to all of the terms and conditions of the Loan Agreement between the Company and Investor, dated September 10, 1998 (the "Loan Agreement").

2. METHOD OF EXERCISE: TRANSFER AND EXCHANGE.

A. CASH EXERCISE. The holder may exercise the purchase right represented by this Warrant, by surrendering this Warrant, properly endorsed, together with a written request specifying the number of shares to be purchased and the purchase price in cash or by check, at the principal office of the Company. Thereupon, this Warrant shall be deemed exercised and the person exercising this Warrant shall be deemed to have become a holder of record of shares of Common Stock (or other securities or property to

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which such person is entitled under the terms of this Warrant upon such exercise). Certificates for the shares of stock purchased shall be delivered to the holder within 14 days after such exercise. Unless this Warrant has expired, a new Warrant representing the balance of shares not issued under this Warrant shall also be issued to the holder.

B. NET EXERCISE. In lieu of paying the Warrant Price to exercise this Warrant pursuant to Section 2(A) above, the holder may elect to receive shares of Common Stock equal to the value of this Warrant (or of any portion thereof remaining unexercised) by surrender of this Warrant at the principal office of the Company together with notice of such election, in which event the holder shall be deemed to have become a holder of record of shares of Common Stock (or other securities or property to which such person is entitled under the terms of this Warrant in lieu thereof) computed using the following formula:

$$X = \frac{Y (A-B)}{A}$$

Where X = the number of shares of common stock to be issued to the holder.

Y = the number of shares of common stock purchasable under this Warrant (at the date of such calculation).

A = the fair market value of one share of the Company's common stock (at the date of such calculation).

B = Warrant exercise price (as adjusted to the date of such calculation).

For purposes of this Section 2(B), fair market value of one share of the Company's common stock shall mean:

(i) The average of the closing bid price of the Common Stock on the over-the-counter market (or closing sale price if the common stock is listed on the Nasdaq National Market or a national exchange), as published in The Wall Street Journal or any other reputable publication, for the ten (10) trading days prior to the date of determination of fair market value; or

(ii) If the common stock is not traded over-the-counter or on an exchange, the per share fair market value of the common stock shall be as determined by agreement of the Company and the holder of this Warrant, or if they cannot agree, by an independent appraiser selected in good faith by the Company's Board of Directors and reasonably acceptable to the exercising holder of this Warrant (the cost of such appraisal shall be borne by the Company).

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Exhibit 1.4 to the
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dated September 10, 1998

C. TRANSFER. Subject to the terms and provisions of this Warrant and Article Six of the Loan Agreement, the holder may transfer this Warrant and its rights, in whole or in part, by surrendering this Warrant at the principal office of the Company, properly endorsed, and paying any necessary governmental tax or transfer Charge. Upon any partial transfer, the Company shall deliver to the holder an appropriate new Warrant certificate. Each holder of this Warrant agrees that when this Warrant is endorsed in blank, it shall be deemed negotiable and the holder may be treated by the Company and all other persons dealing with this Warrant as the absolute owner having the right to transfer of ownership on the books of the Company, any notice to the contrary notwithstanding. However, until the transfer is recorded on the books, the Company may treat the registered holder as the owner.

D. EXCHANGE. This Warrant is exchangeable at the principal office of the Company for Warrants for the purchase of the some aggregate number of shares of Common Stock, each new Warrant to represent the right to purchase the number of shares of Common Stock, as the holder designates at the time of exchange. All Warrants issued on transfers or exchanges shall be dated the date hereof and shall be identical to this Warrant except as to the number of shares of Common Stock issuable.

3. STOCK FULLY PAID; RESERVATION OF SHARES. The Company covenants that all shares which may be issued upon the exercise by this Warrant will be fully paid and nonassessable and free from all taxes, liens and charges. The Company further covenants that during the time this Warrant may be exercised, the Company will at all times have authorized and reserved the number of shares of its Common Stock issuable upon exercise of this Warrant.

4. ADJUSTMENT OF PURCHASE PRICE AND NUMBER OF SHARES. The number and kind of securities purchasable upon the exercise of this Warrant and the Warrant Price shall be subject to adjustment upon the happening of the following events:

A. CONSOLIDATION, MERGER OR RECLASSIFICATION. If the Company

consolidates or merges into any other corporation, or sells, transfers or disposes of all or substantially all the property, assets, business and/or goodwill of the Company to another corporation, or in any manner changes the securities to be purchased upon the exercise of this Warrant, appropriate provisions shall be made in writing to protect the holder of this Warrant against dilution of the holder's interest and rights. A new Warrant evidencing any changes necessary to protect the holder shall be issued by the Board of Directors.

B. SUBDIVISION OR COMBINATION OF SHARES. In case of subdivision of shares, the Warrant price shall be proportionately reduced and the number of shares purchasable upon the exercise of this Warrant proportionately increased. In the case of combination of shares, the Warrant Price shall be proportionately increased and the number of shares purchasable upon the exercise of this Warrant proportionately decreased.

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Exhibit 1.4 to the
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C. CERTAIN DIVIDENDS AND DISTRIBUTIONS. If the Company takes a record of the holders of its Common Stock for the purpose of:

(i) STOCK DIVIDENDS. Entitling them to receive a dividend payable in, or other distribution of, Common Stock, then the Warrant Price shall be adjusted to that price determined by multiplying the Warrant Price in effect immediately prior to the record date by a fraction; the numerator of which shall be the total number of shares of Common Stock outstanding immediately prior to the record date, and the denominator of which shall be the total number of shares of Common Stock outstanding (including for this purpose fractions of shares which would have been distributed in connection with such dividend or distribution had cash not been paid or script issued in lieu thereof) immediately after the dividend or distribution. The number of shares purchasable upon the exercise of this Warrant shall be adjusted to that number determined by multiplying the number of shares purchasable upon the exercise of this Warrant immediately prior to the record date by a fraction, the numerator of which shall be the Warrant Price adjusted as aforesaid and the denominator of which shall be the Warrant Price immediately prior to the record date; or

(ii) LIQUIDATING DIVIDENDS, ETC. Making a distribution of its assets to the holders of its Common Stock as a dividend in liquidation or partial liquidation or by way of return of capital or other than as a dividend payable out of the Company's earnings during the current and prior fiscal quarter, the holders of this Warrant shall, upon its

exercise, be entitled to receive, in addition to the number of shares of Common Stock receivable, a sum equal to the amount of assets as would have been payable to them as owners of that number of shares of Common Stock this Warrant represents had this Warrant been exercised immediately prior to the record date for such distribution.

D. ADJUSTMENT FOR LOW PRICED ISSUANCE OF SHARES. In the event that at any time after this Warrant is issued and while it remains outstanding, the Company issues more than an aggregate of 500,000 shares of Common Stock for a consideration (however paid) of \$2.00 per share or less, then the Warrant Price shall be reduced to a per share amount equal to 120% of the lowest price per share at which the Company issues Common Stock after issuance of the 500,000 shares which are referred to earlier in this sentence. In computing whether the Company has issued 500,000 shares of Common Stock so as to trigger the provisions of this paragraph, there shall be included the number of shares of Common Stock which become subject, through the issuance by the Company while this Warrant is outstanding, of any rights or securities which are exercisable, exchangeable or convertible into shares of Common Stock for an exercise, exchange or conversion price of less than \$2.00 per share, except for Common Stock issued or

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issuable upon exercise of options or warrants to purchase Common Stock currently outstanding or as contemplated to be issued to John White as set forth on the Disclosure Schedule to Loan Agreement, which Common Stock shall not be considered in computing such number; and if any such rights or securities expire before they are exercised, exchanged or converted, then upon such expiration such rights or securities shall be considered never to have been issued for purposes of determining whether or not the provisions of this paragraph have been triggered.

E. TREASURY SHARES EXCLUDED. The number of shares of Common Stock at any time outstanding shall not include any shares then directly or indirectly owned by the Company.

F. OTHER ACTION AFFECTING COMMON STOCK. In the event the Company shall take any action affecting its Common Stock, other than an action described in subsections A through C, which would have a materially adverse effect upon the rights of the holder of this Warrant, the Warrant Price and the number of shares of Common Stock purchasable shall be adjusted in such manner and at such time as the Board of Directors may in good faith determine to be equitable under the circumstances to protect the interests of the holder of this Warrant.

5. NOTICE OF ADJUSTMENTS. Whenever any Warrant Price and/or the number of shares of Common Stock purchasable is to be adjusted pursuant to Section 4, the Company shall promptly provide to the holder of this Warrant, a certificate signed by its President and by its Treasurer or Secretary setting forth the event requiring the adjustment, the amount of the adjustment, the method by which such adjustment was calculated (including a description of the basis on which the Company's Board of Directors made any determination), and the Warrant Price or Prices and number of shares of Common Stock purchasable after giving effect to such adjustment. Except as hereinafter provided, no adjustment of the Warrant Price hereunder shall be made if such adjustment results in a change in the Warrant Price then in effect of less than five cents (\$.05). Any adjustment of less than five cents (\$.05) shall be carried forward and shall be made at the time of and together with any subsequent adjustment which, together with any adjustment or adjustments so carried forward, amounts to five cents (\$.05) or more. However, upon the exercise of this Warrant, the Company shall make all necessary adjustments (to the nearest cent) not theretofore made to the Warrant Price up to and including any date upon which this Warrant is exercised.

6. NOTICES OF RECORD DATE, ETC. In the event the Company takes a record of the holders of any class of its securities concerning any proposed capital reorganization, reclassification, recapitalization, transfer of substantially all the assets of the Company, consolidation, merger, voluntary or involuntary dissolution, liquidation or winding-up, then the Company shall mail to each holder of a Warrant a notice specifying (i) the date on which any

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record is to be taken, (ii) the date on which any reorganization, reclassification, recapitalization, transfer, consolidation, merger, dissolution, liquidation or winding-up is to take place, (iii) the proposed terms thereof, and (iv) if applicable, the time as of which the holders or record of Common Stock (or other securities) shall be entitled to exchange their shares of Common Stock (or other securities) for securities or other property. The notice shall be mailed at least 15 days prior to the earlier of the date referred to in (i) or (ii) above. If any right to subscribe for or purchase securities is offered to the holders of Common Stock, the holder of a Warrant shall similarly receive rights with respect to any shares purchasable under the Warrant to the same extent as if the Warrant had been duly exercised.

7. REGISTRATION RIGHTS. This Warrant shall have all of the registration rights that are contained in Article Six of the Loan Agreement, whether or not the indebtedness under the Loan Agreement has been repaid.

Dated and delivered on September 10, 1998.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

By: /s/ Edward R. Cameron, Pres.

Edward R. Cameron
President

By: /s/ Kent S. McCoy

Chief Financial Officer

FOURTH AMENDMENT
TO
GENERAL CREDIT AND SECURITY AGREEMENT

THIS AGREEMENT, dated as of September 10, 1998, between SPECTRUM Commercial Services, a division of Lyon Financial Services, Inc., a Minnesota Corporation, having its mailing address and principal place of business at 7900 International Drive, Suite 800, Bloomington, Minnesota 55425 (herein called "Lender" or "SCS"), and Appliance Recycling Centers of America, Inc., a Minnesota corporation, having the mailing address and principal place of business at 7400 Excelsior Boulevard, Minneapolis, MN 55426 (herein called "Borrower"), amends that certain General Credit and Security Agreement dated August 30, 1996, ("Credit Agreement") as amended. Where the provisions of this Agreement conflict with the Credit Agreement, the intent of this Agreement shall control.

1. The definition of "Maximum Principal Amount" under paragraph 2 of the Credit Agreement is hereby deleted and replaced with the following:

"Maximum Principal Amount" shall mean, at any date, Two Million and No/100ths Dollars (\$2,000,000).

2. The definition of "Borrowing Base" appearing in Paragraph 2 are respectively amended in their entirety to read as follows:

"Borrowing Base" shall mean the sum of (i) Eighty percent (80%) of the net amount of Eligible Receivables or such greater or lesser percentage as Lender, in its sole discretion, shall deem appropriate, plus (ii) the lesser of (x) One Hundred Fifty Thousand and No/100ths Dollars (\$150,000.00) or (y) Twenty Five percent (25%) of the net amount of Eligible Inventory (excluding Eligible Whirlpool Inventory), or such greater or lesser dollars and/or percentage as Lender, in its sole discretion, shall deem appropriate, plus (iii) the lesser of (x) Nine Hundred Thousand and No/100ths Dollars (\$900,000.00) or (y) Seventy Five percent (75%) of the net amount of Eligible Whirlpool Inventory, or such greater or lesser dollars and/or percentage as Lender, in its sole discretion, shall deem appropriate.

IN WITNESS WHEREOF, the parties have executed this Agreement as of the

date first above written.

SPECTRUM COMMERCIAL SERVICES

APPLIANCE RECYCLING CENTERS
OF AMERICA, INC.

By /s/ Steven Lowenthal

By /s/ Edward R. Cameron

Steven I. Lowenthal, Senior Vice President

Its President

GUARANTOR ACKNOWLEDGMENT

The undersigned (collectively the "Guarantor") has entered into certain Guaranties of various dates (collectively the "Guaranty;" capitalized terms not otherwise defined herein being used herein as therein defined), pursuant to which each Guarantor has guaranteed the payment and performance of certain Indebtedness of Appliance Recycling Centers of America, Inc., a Minnesota corporation ("Borrower") to SPECTRUM Commercial Services, a division of Lyon Financial Services, Inc., a Minnesota corporation, ("SCS"), which Indebtedness includes, without limitation, all obligations of Borrower under that certain Revolving Note dated as of August 30, 1996 between the Borrower and SCS as subsequently amended (as so amended the "Original Loan Agreement").

Each Guarantor hereby acknowledges that it has received a copy, of: (a) the Fourth Amendment to General Credit and Security Agreement and Waiver dated as of the date hereof (the "Loan Agreement") between the Borrower and SCS amending and restating the Original Loan Agreement;

Each Guarantor hereby:

(a) agrees and acknowledges that:

(i) the Guaranty applicable to the Guarantor shall be of an UNLIMITED AMOUNT, including without limitation all of Lender's fees, costs, expenses and attorneys' fees incurred in enforcing the Guarantee; and

(b) confirms that:

(i) by the Guaranty, the Guarantor continues to guarantee the full payment and performance of all of the Indebtedness owed to SCS, including, without limitation, all obligations of Borrower under the Original Loan Agreement as amended and restated by the Loan Agreement; and

(ii) the Guaranty remains in full force and effect,
enforceable against the Guarantor in accordance with its terms.

/s/ Edward R. Cameron

Edward R. Cameron
Guarantor

ARCA-MARYLAND INC.

By /s/ Edward R. Cameron

Its President

APPLIANCE RECYCLING CENTERS
OF AMERICA-CALIFORNIA, INC.

By /s/ Edward R. Cameron

Its President

ARCA OF ST. LOUIS, INC.

By /s/ Edward R. Cameron

Its President

Accepted and Agreed to this 4th day of June, 1998

SPECTRUM COMMERCIAL SERVICES

By: /s/ Steven I. Lowenthal

Its Senior Vice President

FIFTH AMENDMENT TO
GENERAL CREDIT AND SECURITY AGREEMENT

THIS AGREEMENT, dated as of September 17, 1998, between SPECTRUM Commercial Services, a division of Lyon Financial Services, Inc., a Minnesota Corporation, having its mailing address and principal place of business at 7900 International Drive, Suite 890, Bloomington, Minnesota 55425 (herein called "Lender" or "SCS"), and Appliance Recycling Centers of America, Inc., a Minnesota corporation, having the mailing address and principal place of business at 7400 Excelsior Boulevard, Minneapolis. MN 55426, (herein called "Borrower"), amends that certain General Credit and Security Agreement dated August 30, 1996, ("Credit Agreement") as amended. Where the provisions of this Agreement conflict with the Credit Agreement, the intent of this Agreement shall control.

1. Paragraph 5 of the Credit Agreement which is entitled "Interest" is hereby deleted and replaced with the following:

INTEREST. Borrower agrees to pay interest on the outstanding principal amount of the Note at the close of each day at a fluctuating rate per annum (computed on the basis of actual number of days elapsed and a year of 360 days) which is at all times equal to Five Percent (5%) in excess of the Prime Rate; each change in such fluctuating rate caused by a change in the Prime Rate to occur simultaneously with the change in the Prime Rate; provided, however, that (i) in no event shall the interest rate in effect hereunder at any time be less than 10% per annum; and (ii) interest payable hereunder with respect to each calendar month shall not be less than \$5,625.00 regardless of the amount of loans, Advances or other credit extensions that actually may have been outstanding during the month. Interest accrued through the last day of each month will be due and payable to Lender on the next Monthly Payment Date, commencing October 1, 1996. Interest shall also be payable on the Maturity Date or on any earlier Termination Date. Interest accrued after the Maturity Date or earlier Termination Date shall be payable on Demand. Interest may be charged to Borrower's loan account as an Advance at Lender's option, whether or not Borrower then has the right to obtain an Advance pursuant to the terms of this Agreement. Notwithstanding the foregoing, after an Event of Default, this Note shall bear interest until paid at 5% per annum in excess of the rate otherwise then in effect, which rate shall continue to vary based on further changes in the Prime Rate; provided, however, that after an Event of Default, (i) in no event shall the interest rate in effect hereunder at any time be less than 15% per annum; and (ii) interest payable hereunder with respect to each calendar month shall not be less than \$7,700.00 regardless of the amount of loans, Advances or other credit extensions that actually may have been outstanding during the month. The undersigned also shall pay the holder of this Note a late fee equal to 10% of any payment under this Note that is more than 10 days past

due.

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date first above written.

SPECTRUM COMMERCIAL SERVICES

APPLIANCE RECYCLING CENTERS
OF AMERICA, INC.

By /s/ Steven Lowenthal

By /s/ Edward R. Cameron

Steven I. Lowenthal, Senior Vice President

Its President

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GUARANTOR ACKNOWLEDGMENT

The undersigned (collectively the "Guarantor") has entered into certain Guaranties of various dates (collectively the "Guaranty;" capitalized terms not otherwise defined herein being used herein as therein defined), pursuant to which each Guarantor has guaranteed the payment and performance of certain Indebtedness of Appliance Recycling Centers of America, Inc., a Minnesota corporation ("Borrower") to SPECTRUM Commercial Services, a division of Lyon Financial Services, Inc., a Minnesota corporation, ("SCS"), which Indebtedness includes, without limitation, all obligations of Borrower under that certain Revolving Note dated as of August 30, 1996 between the Borrower and SCS as subsequently amended and/or restated (as so amended the "Original Loan Agreement").

Each Guarantor hereby acknowledges that it has received a copy of: (a) the Fifth Amendment to General Credit and Security Agreement dated as of the date hereof (the "Loan Agreement") between the Borrower and SCS amending and restating the Original Loan Agreement:

Each Guarantor hereby confirms that:

(i) by the Guaranty, the Guarantor continues to guarantee the full payment and performance of all of the Indebtedness owed to SCS, including, without limitation, all obligations of Borrower under the Original Loan Agreement as amended and restated by the Loan Agreement; and

(ii) the Guaranty remains in full force and effect, enforceable against the Guarantor in accordance with its terms.

/s/ Edward R. Cameron

Edward R. Cameron
Guarantor

ARCA-MARYLAND, INC.

By /s/ Edward R. Cameron

Its President

APPLIANCE RECYCLING CENTERS
OF AMERICA-CALIFORNIA, INC.

ARCA OF ST. LOUIS, INC.

By /s/ Edward R. Cameron

Its President

By /s/ Edward R. Cameron

Its President

Accepted and Agreed to this 17th day of September, 1998

SPECTRUM COMMERCIAL SERVICES

By /s/ Edward R. Cameron

Its President

THIRD AMENDED AND RESTATED REVOLVING NOTE

\$2,000,000.00

September 17, 1998
Bloomington, Minnesota

FOR VALUE RECEIVED, the undersigned, Appliance Recycling Centers of America, Inc. promises to pay to the order of SPECTRUM COMMERCIAL SERVICES, a division of Lyon Financial Services Inc, a Minnesota corporation, (the "Lender") at its office in Bloomington, Minnesota, or at such other place as any present or future holder of this Note may designate from time to time, the principal sum of (i) Two Million and 00/100 Dollars (\$2,000,000.00), or (ii) the aggregate unpaid principal amount of all advances and/or extensions of credit made by the Lender to the undersigned pursuant to this Note as shown in the records of any present or future holder of this Note, whichever is less, plus interest thereon from the date of each advance in whole or in part included in such amount until this Note is fully paid. Interest shall be computed on the basis of the actual number of days elapsed and a 360-day year, at an annual rate equal to 5.0% per annum in excess of the Prime Rate of Norwest Bank Minnesota, NA, and that shall change when and as said Prime Rate shall change; provided, however that (i) in no event shall the interest rate in effect hereunder at any time be less than 10% per annum; and (ii) interest payable hereunder with respect to each calendar

month shall not be less than \$5,625 regardless of the amount of loans, advances or other credit extensions that actually may have been outstanding during the month. Interest is due and payable on the first day of each month and at maturity. The term "Prime Rate" means the rate established by Norwest Bank in its sole discretion from time to time as its Prime or Base Rate, and the undersigned acknowledges that Norwest Bank and/or Lender may lend to its customers at rates that are at, above or below the Prime Rate. Notwithstanding the foregoing, after an Event of Default, this Note shall bear interest until fully paid at 5% per annum in excess of the rate otherwise then in effect, which rate shall continue to vary based on further changes in the Prime Rate; provided, however, that after an Event of Default, (i) in no event shall the interest rate in effect hereunder at any time be less than 15% per annum; and (ii) interest payable hereunder with respect to each calendar month shall not be less than \$7,700 regardless of the amount of loans, advances or other credit extensions that actually may have been outstanding during the month. The undersigned also shall pay the holder of this Note a late fee equal to 10% of any payment under this Note that is more than 10 days past due.

All interest, principal, and any other amounts owing hereunder are due on August 30, 1999 or earlier UPON DEMAND by Lender or any holder hereof, and Lender specifically reserves the absolute right to demand payment of all such amounts at any time, with or without advance notice, for any reason or no reason whatsoever. Lender's right to make such demand is not exclusive and Lender may coincidentally or separately from such demand make further demand for payment pursuant to the terms hereof (including but not limited to upon the occurrence of an Event of Default), and further, amounts may become due hereunder without a demand by Lender.

All or any part of the unpaid balance of this Note may be prepaid at any time, provided however, that if this Note is completely repaid after August 30, 1997 and on or before August 30, 1998, then there shall be a prepayment charge equal to \$40,000.00; provided further, however, that if this Note is completely repaid after August 30 1998 and on or before August 30, 1999, then there shall be a prepayment charge equal to \$35,000.00; provided further, however, that if Borrower completely repays this Note prior to August 30, 1999 and repays all amounts owing hereunder completely from funds borrowed from Western State Bank (and not from any other source of funds), then no prepayment charge shall be due. At the option of the then holder of this Note, any payment

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under this Note may be applied first to the payment of other charges, fees and expenses under this Note and any other agreement or writing in connection with this Note, second to the payment of interest accrued through the date of payment, and third to the payment of principal. Amounts may be advanced and readvanced under this Note at the Lender's sole and absolute discretion, provided the principal balance outstanding shall not exceed the amount first above written. Neither the Lender nor any other person has any obligation to make any advance or readvance under this Note.

The occurrence of any of the following events shall constitute an Event of Default under this Note: (i) any default in the payment of this Note; or (ii) any other default under the terms of any now existing or hereafter arising debt, obligation or liability of any maker, endorser, guarantor or surety of this Note or any other person providing security for this Note or for any guaranty of this Note, including, but not limited to, that certain General Credit and Security Agreement dated August 30, 1996 as it may have been subsequently, amended and/or restated; or (iii) the insolvency (other than the insolvency of the undersigned), death dissolution, liquidation, merger or consolidation of any such maker, endorser, guarantor, surety or other person; or (iv) any appointment of a receiver, trustee or similar officer of any property of any such maker, endorser, guarantor, surety or other person; or (v) any assignment for the benefit of creditors of any such maker, endorser, guarantor, surety or other person; or (vi) any commencement of any proceeding under any bankruptcy, insolvency, dissolution, liquidation or similar law by or against any such maker, endorser, guarantor, surety or other person, provided however, that if such a proceeding is commenced against the maker hereof or any Guarantor on an involuntary basis, then only if such action is not dismissed within 60 days of first being filed; or (vii) the sale, lease or other disposition (whether in one transaction or in a series of transactions) to one or more persons of all or a substantial part of the assets of any such maker, endorser, guarantor, surety or other person; or (viii) any such maker, endorser, guarantor, surety or other person takes any action to revoke or terminate any agreement, liability or security in favor of the Lender; or (ix) the entry of any judgment or other order for the payment of money in the amount of \$10,000.00 or more against any such maker, endorser, guarantor, surety or other person which judgment or order is not discharged or stayed in a manner acceptable to the then holder of this Note within 10 days after such entry; or (x) the issuance or levy of any writ, warrant, attachment, garnishment, execution or other process against any property of any such maker, endorser, guarantor, surety or other person; or (xi) the attachment of any tax lien to any property of any such maker, endorser, guarantor, surety or other person which is other than for taxes or assessments not yet due and payable; or (xii) any statement, representation or warranty made by any such maker, endorser, guarantor, surety or other person (or any representative of any such maker, endorser, guarantor, surety or other person) to any present or future holder of this Note at any time shall be false, incorrect or misleading in any material respect when made; or (xiii) there is a material adverse change in the condition (financial or otherwise), business or property of any such maker, endorser, guarantor, surety or other person. Upon the occurrence of an Event of Default and at any time thereafter while an Event of Default is continuing, the then holder of this Note may, at its option, declare this Note to be immediately due and payable and thereupon this Note shall become due and payable for the entire unpaid principal balance of this Note plus accrued interest and other charges on this Note without any presentment, demand, protest or other notice of any kind.

The undersigned: (i) waives demand, presentment, protest, notice of protest, notice of dishonor and notice of nonpayment of this Note; (ii) agrees to promptly provide all present and future holders of this Note from time to time with financial statements of the undersigned and such other information

respecting the financial condition, business and property of the undersigned as any such holder of this Note may reasonably request, in form and substance acceptable to such holder of this Note; (iii) agrees that when or at any time after this Note becomes due the then holder of this note

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may offset or charge the full amount owing on this note against any account then maintained by the undersigned with such holder of this Note without notice; (iv) agrees to pay on demand all fees, costs and expenses of all present and future holders of this Note in connection with this Note and any security and guaranties for this Note, including but not limited to audit fees and expenses and reasonable attorneys' fees and legal expenses, plus interest on such amounts at the rate set forth in this Note; and (v) consents to the personal jurisdiction of the state and federal courts located in the State of Minnesota in connection with any controversy related in any way to this Note or any security of guaranty for this Note, waives any argument that venue in such forums is not convenient, and agrees that any litigation initiated by the undersigned against the Lender or any other present or future holder of this Note relating in any way to this Note or any security or guaranty for this Note shall be venued (at the sole option of Lender or the holder hereof) in either the District Court of Dakota or Hennepin County, Minnesota, or the United States District Court, District of Minnesota. Interest on any amount under this Note shall continue to accrue, at the option of any present or future holder of this Note, until such holder receives final payment of such amount in collected funds in form and substance acceptable to such holder. The maker agrees that, if it brings any action or proceeding arising out of or relating to this Agreement, it shall bring such action or proceeding in the District Court of Hennepin County, Minnesota.

No waiver of any right or remedy under this Note shall be valid unless in writing executed by the holder of this Note, and any such waiver shall be effective only in the specific instance and for the specific purpose given. All rights and remedies of all present and future holders of this Note shall be cumulative and may be exercised singly, concurrently or successively. The undersigned, if more than one, shall be jointly and severally liable under this Note, and the term "undersigned," wherever used in this Note, shall mean the undersigned or any one or more of them. This Note shall bind the undersigned and the successors and assigns of the undersigned. This Note shall be governed by and construed in accordance with the laws of the State of Minnesota.

This Note amends and restates, but does not repay, that certain Second Amended and Restated Revolving Note dated as of June 4, 1998 made by the undersigned payable to the order of Lender in the original principal amount of \$2,900,000.00.

THE UNDERSIGNED REPRESENTS, CERTIFIES, WARRANTS AND AGREES THAT THE UNDERSIGNED HAS READ ALL OF THIS NOTE AND UNDERSTANDS ALL OF THE PROVISIONS OF

THIS NOTE. THE UNDERSIGNED ALSO AGREES THAT COMPLIANCE BY ANY PRESENT OR FUTURE HOLDER OF THIS NOTE WITH THE EXPRESS PROVISIONS OF THIS NOTE SHALL CONSTITUTE GOOD FAITH AND SHALL BE CONSIDERED REASONABLE FOR ALL PURPOSES.

APPLIANCE RECYCLING CENTERS
OF AMERICA, INC.

By /s/ Edward R. Cameron

Edward R. Cameron
President

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APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

SUBSIDIARIES AS OF JANUARY 2, 1999

| NAME OF SUBSIDIARY ----- | JURISDICTION OF INCORPORATION ----- | PERCENT VOTING SECURITIES OWNED ----- |
|--|---|---|
| Appliance Recycling Centers of America-California, Inc. | California | 100% |
| ARCA of St. Louis, Inc. | Missouri | 100% |

CONSENT OF INDEPENDENT ACCOUNTANT'S

We hereby consent to the incorporation by reference in the Registration Statements on Form S-8 (commission file No. 33-51584), on Form S-8 (commission file No. 33-68890), and on Form S-8 (commission file No. 333-28571) of our report dated February 19, 1999 with respect to the consolidated financial statements of Appliance Recycling Centers of America, Inc., and subsidiaries appearing in this Annual Report on Form 10-K for the year ended January 2, 1999.

McGLADREY & PULLEN, LLP

Minneapolis, Minnesota
March 26, 1999

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