

JAKKS PACIFIC INC  
Form 10-Q  
November 09, 2009

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

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(Mark one)

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

For the quarterly period ended September 30, 2009

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 0-28104

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JAKKS Pacific, Inc.  
(Exact Name of Registrant as Specified in Its Charter)

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Delaware  
(State or Other Jurisdiction of Incorporation or Organization)

95-4527222  
(I.R.S. Employer Identification No.)

22619 Pacific Coast Highway  
Malibu, California  
(Address of Principal Executive Offices)

90265  
(Zip Code)

Registrant's Telephone Number, Including Area Code: (310) 456-7799

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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

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Non-accelerated filer

Large accelerated filer

Accelerated filer

(Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
Yes  No

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The number of shares outstanding of the issuer's common stock is 27,905,994 as of November 6, 2009.

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## JAKKS PACIFIC, INC. AND SUBSIDIARIES

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Quarter Ended September 30, 2009

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## DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

This report includes "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. For example, statements included in this report regarding our financial position, business strategy and other plans and objectives for future operations, and assumptions and predictions about future product demand, supply, manufacturing, costs, marketing and pricing factors are all forward-looking statements. When we use words like "intend," "anticipate," "believe," "estimate," "plan", "expect" or words of similar import, we are making forward-looking statements. We believe that the assumptions and expectations reflected in such forward-looking statements are reasonable and are based on information available to us on the date hereof, but we cannot assure you that these assumptions and expectations will prove to have been correct or that we will take any

action that we may presently be planning. We are not undertaking to publicly update or revise any forward-looking statement if we obtain new information or upon the occurrence of future events or otherwise.

## JAKKS PACIFIC, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

	December 31, 2008 (*)	September 30, 2009 (Unaudited)
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 169,520	\$ 153,795
Marketable securities	195	201
Accounts receivable, net of allowances for uncollectible accounts of \$2,005 and \$2,599, respectively	147,587	251,631
Inventory	87,944	71,145
Prepaid expenses and other current assets	29,670	22,826
Income tax receivable	22,288	26,823
Deferred income taxes	17,993	83,884
Total current assets	475,197	610,305
Property and equipment		
Office furniture and equipment	12,390	13,035
Molds and tooling	63,075	65,438
Leasehold improvements	5,947	7,383
Total	81,412	85,856
Less accumulated depreciation and amortization	52,914	60,117
Property and equipment, net	28,498	25,739
Investment in video game joint venture	53,184	527
Goodwill, net	427,693	—
Trademarks, net	10,491	2,308
Intangibles and other, net	33,061	42,727
Total assets	\$ 1,028,124	\$ 681,606
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities		
Accounts payable	\$ 57,432	\$ 91,307
Accrued expenses	61,780	62,793
Reserve for sales returns and allowances	23,317	35,503
Capital lease obligation	417	246
Income taxes payable	7,190	—
Convertible senior notes	—	98,000
Total current liabilities	150,136	287,849
Deferred income taxes	26,237	17,135
Income tax payable	4,686	4,686
Other liabilities	2,112	6,732
Convertible senior notes	98,000	—
Total liabilities	281,171	316,402
Stockholders' equity		
Preferred stock, \$.001 par value; 5,000,000 shares authorized; nil outstanding	—	—
Common stock, \$.001 par value; 100,000,000 shares authorized; 27,521,278 and 27,908,711 shares issued and outstanding, respectively	28	28

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Additional paid-in capital	292,809	294,711
Retained earnings	458,345	74,693
Accumulated comprehensive loss	(4,229)	(4,228)
Total stockholders' equity	746,953	365,204
Total liabilities and stockholders' equity	\$ 1,028,124	\$ 681,606

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(\*) Derived from audited financial statements

See notes to condensed consolidated financial statements.

## JAKKS PACIFIC, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	(Unaudited)		(Unaudited)	
	2008	2009	2008	2009
	As Adjusted		As Adjusted	
	(Note 13)		(Note 13)	
Net sales	\$ 357,824	\$ 351,438	\$ 634,050	\$ 604,932
Cost of sales	231,145	235,729	405,949	458,318
Gross profit	126,679	115,709	228,101	146,614
Selling, general and administrative expenses	62,651	63,363	157,476	171,673
Write-down of intangible assets	9,076	—	9,076	8,221
Write-down of goodwill	—	—	—	407,125
Income (loss) from operations	54,952	52,346	61,549	(440,405)
Profit (loss) from video game joint venture	743	(1,919)	4,470	(21,924)
Interest Income	709	28	2,802	277
Interest Expense, net of benefit	2,013	(1,267)	(1,187)	(3,800)
Income (loss) before provision (benefit) for income taxes	58,417	49,188	67,634	(465,852)
Provision (benefit) for income taxes	5,879	15,480	8,737	(82,200)
Net income (loss)	\$ 52,538	\$ 33,708	\$ 58,897	\$ (383,652)
Earnings (loss) per share – basic	\$ 1.95	\$ 1.24	\$ 2.14	\$ (14.11)
Earnings (loss) per share – diluted	\$ 1.65	\$ 1.06	\$ 1.87	\$ (14.11)

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See notes to condensed consolidated financial statements.

## JAKKS PACIFIC, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In thousands)

	Nine Months Ended September 30, (Unaudited)	
	2008	2009
	As Adjusted (Note 13)	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income (loss)	\$ 58,897	\$ (383,652)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	19,670	27,026
Share-based compensation expense	6,026	3,302
(Profit) loss from video game joint venture	(4,801)	52,403
Loss on disposal of property and equipment	51	2,377
Deferred income taxes	504	(74,993)
Write-down of intangible assets	9,076	8,221
Write-down of goodwill	—	407,125
Changes in operating assets and liabilities:		
Accounts receivable	(55,555)	(104,044)
Inventory	(35,342)	14,160
Prepaid expenses and other current assets	(11,749)	7,146
Income tax receivable	—	(4,535)
Accounts payable	59,314	33,876
Accrued expenses	1,530	13,361
Income taxes payable	(20,832)	(7,190)
Reserve for sales returns and allowances	(8,555)	12,186
Other liabilities	(4,380)	4,620
Total adjustments	(45,043)	395,041
Net cash provided by operating activities	13,854	11,389
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of property and equipment	(17,608)	(16,160)
Change in other assets	143	2,876
Cash paid for net assets of business acquired	(15,193)	(12,253)
Net purchase of marketable securities	(5)	(6)
Net cash used in investing activities	(32,663)	(25,543)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net proceeds from stock options exercised	4,030	—
Common stock surrendered	(3,070)	(1,400)
Common stock repurchased	(30,002)	—
Repayment of capital lease obligation	—	(171)
Net cash used in financing activities	(29,042)	(1,571)
Effect of exchange rate changes on cash	(792)	—
Net decrease in cash and cash equivalents	(48,643)	(15,725)
Cash and cash equivalents, beginning of period	241,250	169,520
Cash and cash equivalents, end of period	\$ 192,607	\$ 153,795



Cash paid during the period for:

Income taxes	\$	31,719	\$	4,875
Interest	\$	2,342	\$	2,825

Non cash investing and financing activity:

In January and March 2008, two executive officers surrendered an aggregate of 122,202 shares of restricted stock at a value of \$3.0 million to cover their income taxes due on the 2008 vesting of restricted shares granted to them in 2006, 2007 and 2008. This restricted stock was subsequently retired by the Company.

In January 2009, two executive officers surrendered an aggregate of 74,836 shares of restricted stock at a value of \$1.4 million to cover their income taxes due on the 2009 vesting of restricted shares granted to them in 2007 and 2008. This restricted stock was subsequently retired by the Company. Also in January 2009, an employee surrendered 551 shares of restricted stock at a value of \$11,367 to cover his income taxes due on the December 31, 2008 vested shares. In August 2009, certain employees surrendered an aggregate of 920 shares of restricted stock at a value of \$10,608 to cover their income taxes due on the 2009 vesting of the restricted shares granted to them in 2006.

See Notes 8 and 9 for additional supplemental information to the condensed consolidated statements of cash flows.

See notes to condensed consolidated financial statements.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

September 30, 2009

Note 1 — Basis of Presentation

The accompanying unaudited interim condensed consolidated financial statements included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures are adequate to prevent the information presented from being misleading. These financial statements should be read in conjunction with Management’s Discussion and Analysis of financial condition and results of operations and the financial statements and the notes thereto included in the Company’s Annual Report on Form 10-K, which contains audited financial information for the three years in the period ended December 31, 2008.

The information provided in this report reflects all adjustments (consisting solely of normal recurring items) that are, in the opinion of management, necessary to present fairly the financial position and the results of operations for the periods presented. Interim results are not necessarily indicative of results to be expected for a full year.

Certain reclassifications have been made to prior year balances in order to conform to the current year presentation.

The condensed consolidated financial statements include the accounts of JAKKS Pacific, Inc. and its wholly-owned subsidiaries (collectively “the Company”).

Note 2 — Business Segments, Geographic Data, Sales by Product Group, and Major Customers

The Company is a worldwide producer and marketer of children’s toys and other consumer products, principally engaged in the design, development, production, marketing and distribution of its diverse portfolio. The Company’s reportable segments are Traditional Toys, Craft/Activity/Writing Products, and Pet Products, each of which includes worldwide sales.

The Traditional Toys segment includes action figures, vehicles, playsets, plush products, dolls, accessories, pretend play products including Halloween costumes and accessories, dress-up costumes and accessories, electronic products, novelty toys, collectibles, construction toys, compounds, infant and pre-school toys, water toys, kites, and related products.

Craft/Activity/Writing Products include do-it-yourself kits, pens, pencils, stationery products, crayons, markers, paints, and other related craft and activity products.

Pet Products include pet toys, treats, apparel and related pet products.

Segment performance is measured at the operating income level. All sales are made to external customers, and general corporate expenses have been attributed to the various segments based on sales volumes. Segment assets are comprised of accounts receivable and inventories, net of applicable reserves and allowances, goodwill and other assets.



## JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

## Note 2 — Business Segments, Geographic Data, Sales by Product Group, and Major Customers - (continued)

Results are not necessarily those that would be achieved were each segment an unaffiliated business enterprise. Information by segment and a reconciliation to reported amounts as of December 31, 2008 and September 30, 2009 and for the three and nine months ended September 30, 2008 and 2009 are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
<b>Net Sales</b>				
Traditional Toys	\$ 332,395	\$ 324,092	\$ 583,040	\$ 548,142
Craft/Activity/Writing Products	20,616	23,787	37,274	46,165
Pet Products	4,813	3,559	13,736	10,625
	\$ 357,824	\$ 351,438	\$ 634,050	\$ 604,932

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
	As Adjusted (Note 13)		As Adjusted (Note 13)	
<b>Operating Income (Loss)</b>				
Traditional Toys	\$ 50,877	\$ 48,273	\$ 57,009	\$ (341,451)
Craft/Activity/Writing Products	3,304	3,543	3,667	(87,469)
Pet Products	771	530	873	(11,485)
	\$ 54,952	\$ 52,346	\$ 61,549	\$ (440,405)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008 As Adjusted	2009
	As Adjusted (Note 13)		(Note 13)	
<b>Depreciation and Amortization Expense</b>				
Traditional Toys	\$ 9,010	\$ 14,133	\$ 18,665	\$ 24,577
Craft/Activity/Writing Products	351	1,247	844	1,998
Pet Products	26	229	161	451
	\$ 9,387	\$ 15,609	\$ 19,670	\$ 27,026

	December 31, 2008	September 30, 2009
<b>Assets</b>		
Traditional Toys	\$ 877,606	\$ 633,147
Craft/Activity/Writing Products	128,036	40,245
Pet Products	22,482	8,214
	\$ 1,028,124	\$ 681,606



## JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

## Note 2 — Business Segments, Geographic Data, Sales by Product Group, and Major Customers - (continued)

The following tables present information about the Company by geographic area as of December 31, 2008 and September 30, 2009 and for the three and nine months ended September 30, 2008 and 2009 (in thousands):

	December 31,		September 30,					
	2008		2009					
<b>Long-lived Assets</b>								
United States	\$	26,179	\$	23,350				
Hong Kong		2,319		2,389				
	\$	28,498	\$	25,739				
	Three Months Ended		Nine Months Ended					
	September 30,		September 30,					
	2008	2009	2008	2009				
<b>Net Sales by Geographic Area</b>								
United States	\$	280,523	\$	288,320	\$	500,775	499,199	
Europe		22,383		16,473		38,825	28,761	
Canada		19,495		15,732		28,783	25,700	
Hong Kong		15,835		18,193		32,435	27,732	
Other		19,588		12,720		33,232	23,540	
	\$	357,824	\$	351,438	\$	634,050	\$	604,932

## Major Customers

Net sales to major customers for the three and nine months ended September 30, 2008 and 2009 were as follows (in thousands, except for percentages):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2008		2009		2008		2009	
	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales
Wal-Mart	\$ 90,733	25.4%	\$ 93,521	26.6%	\$ 171,670	27.0%	\$ 152,074	25.1%
Toys 'R' Us	50,612	14.1	39,111	11.1	72,933	11.5	64,945	10.7
Target	29,617	8.3	50,956	14.5	75,234	11.9	100,888	16.7
	\$ 170,962	47.8%	\$ 183,588	52.2%	\$ 319,837	50.4%	\$ 317,907	52.5%

No other customer accounted for more than 10% of the Company's total net sales.

At December 31, 2008 and September 30, 2009, the Company's three largest customers accounted for approximately 74.0% and 49.8%, respectively, of net accounts receivable. The concentration of the Company's business with a

relatively small number of customers may expose the Company to material adverse effects if one or more of its large customers were to experience financial difficulty. The Company performs ongoing credit evaluations of its top customers and maintains an allowance for potential credit losses.

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## JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

## Note 3 — Inventory

Inventory, which includes the ex-factory cost of goods, in-bound freight, duty and warehouse costs, is stated at the lower of cost (first-in, first-out) or market and consists of the following (in thousands):

	December 31, 2008	September 30, 2009
Raw materials	\$ 3,778	\$ 6,035
Finished goods	84,166	65,110
	\$ 87,944	\$ 71,145

## Note 4 — Revenue Recognition and Reserve for Sales Returns and Allowances

Revenue is recognized upon the shipment of goods to customers or their agents, depending on terms, provided that there are no uncertainties regarding customer acceptance, the sales price is fixed or determinable, and collectability is reasonably assured and not contingent upon resale.

Generally, the Company does not allow for product returns. It provides a negotiated allowance for breakage or defects to its customers, which is recorded when the related revenue is recognized. However, the Company does make occasional exceptions to this policy and consequently accrues a return allowance in gross sales based on historic return amounts and management estimates. The Company also will occasionally grant credits to facilitate markdowns and sales of slow moving merchandise. These credits are recorded as a reduction of gross sales at the time of occurrence.

The Company also participates in cooperative advertising arrangements with some customers, whereby it allows a discount from invoiced product amounts in exchange for customer purchased advertising that features the Company's products. Typically, these discounts range from 1% to 6% of gross sales, and are generally based on product purchases or on specific advertising campaigns. Such amounts are accrued when the related revenue is recognized or when the advertising campaign is initiated. These cooperative advertising arrangements are accounted for as direct selling expenses.

The Company's reserve for sales returns and allowances amounted to \$23.3 million as of December 31, 2008, compared to \$35.5 million as of September 30, 2009. This increase was primarily due to additional allowances booked for returns and markdowns for certain products and the timing of when deductions are taken by customers.

## Note 5 — Convertible Senior Notes

In June 2003, the Company sold an aggregate of \$98.0 million of 4.625% Convertible Senior Notes due June 15, 2023 and received net proceeds of approximately \$94.4 million. The notes are convertible into shares of the Company's common stock at an initial conversion price of \$20.00 per share, or 50 shares per note, subject to certain circumstances. The notes may be converted in each quarter subsequent to any quarter in which the closing price of the Company's common stock is at or above a prescribed price for at least 20 trading days in the last 30 trading day period of the quarter. The prescribed price for the conversion trigger is \$24.00 through June 30, 2010, and increases



nominally each quarter thereafter. Cash interest is payable at an annual rate of 4.625% of the principal amount at issuance, from the issue date to June 15, 2010, payable on June 15 and December 15 of each year. After June 15, 2010, interest will accrue on the outstanding notes until maturity. At maturity, the Company will redeem the notes at their accreted principal amount, which will be equal to \$1,811.95 (181.195%) per \$1,000 principal amount at issuance, unless redeemed or converted earlier. The notes were not convertible as of September 30, 2009 and are not convertible during the fourth quarter of 2009.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 5 — Convertible Senior Notes (continued)

The Company may redeem the notes at its option in whole or in part beginning on June 15, 2010, at 100% of their accreted principal amount plus accrued and unpaid interest, if any, payable in cash. Holders of the notes may also require the Company to repurchase all or part of their notes on June 15, 2010, for cash, at a repurchase price of 100% of the principal amount per note plus accrued and unpaid interest, if any. Accordingly, the notes have been reclassified as a short-term liability as of September 30, 2009. Holders of the notes may also require the Company to repurchase all or part of their notes on June 15, 2013 and June 15, 2018 at a repurchase price of 100% of the accreted principal amount per note plus accrued and unpaid interest, if any, and may be paid in cash, in shares of common stock or a combination of cash and shares of common stock. See Note 17 – Subsequent Events for additional information on the Company's convertible senior notes.

Note 6 — Income Taxes

The Company's income tax benefit, which includes federal, state and foreign income taxes, and discrete items, was \$82.2 million, or an effective tax benefit rate of 17.6% for the nine months ended September 30, 2009. During the comparable period in 2008, the income tax provision was \$8.7 million, or an effective tax provision rate of 12.9%.

In 2009, the impairment of goodwill and trademarks, totaling \$64.5 million, the THQ/Jakks joint venture settlement of \$9.1 million, and uncertain tax positions, were reductions to the tax benefit rate realized. Exclusive of the discrete items, the third quarter 2009 effective tax benefit rate would be 57.4%. In 2008, the discrete adjustments were mainly the 2007 income tax provision to the actual income tax liability of \$4.0 million, and the recognition of a previously recorded potential income tax liability of \$9.3 million for uncertain tax positions that are no longer subject to audit due to the closure of the audit period. Exclusive of the discrete items, the third quarter 2008 effective tax provision rate would be 35.4%.

As of September 30, 2009, the Company had net deferred tax assets of approximately \$66.7 million for which an allowance of \$3.6 million has been provided since, in the opinion of management, realization of the future benefit is uncertain.

Approximately \$2.1 million of United States based and \$0.8 million of Hong Kong based unrecognized tax positions (UTPs) were recognized in the quarter ended September 30, 2009. These UTPs are primarily a result of the ongoing audits. The Company has also recognized an additional liability of \$1.1 million for penalties and \$0.5 million for interest on the potential tax liability. The tax years 2000 through 2006 are still subject to examination in Hong Kong. Tax years 2003 and 2005 through 2008 are still subject to examination in the United States and tax years 2005 through 2008 are still subject to examination in California.

Current interest on previously booked uncertain income tax liabilities is recognized as interest expense in the consolidated statement of operations. During the nine months ended September 30, 2009, the Company recognized \$0.4 million of current year interest expense.

## JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

## Note 7 — Earnings Per Share

The following table is a reconciliation of the weighted average shares used in the computation of basic and diluted earnings per share for the periods presented (in thousands, except per share data):

	Three Months Ended September 30,					
	2008 As Adjusted (Note 13)			2009		
	Income	Weighted Average Shares	Per-Share	Income / (Loss)	Weighted Average Shares	Per-Share
<b>Earnings per share - basic</b>						
Income available to common stockholders	\$ 52,538	26,981	\$ 1.95	\$ 33,708	27,183	\$ 1.24
<b>Effect of dilutive securities:</b>						
Convertible senior notes	737	4,900		737	4,900	
Options and warrants	—	119		—	14	
Unvested restricted stock grants	—	257		—	408	
<b>Earnings per share - diluted</b>						
Income available to common stockholders plus assumed exercises and conversion	\$ 53,275	32,257	\$ 1.65	\$ 34,445	32,505	\$ 1.06
<b>Nine Months Ended September 30,</b>						
2008 As Adjusted (Note 13)			2009			
	Income	Weighted Average Shares	Per-Share	Income / (Loss)	Weighted Average Shares	Per-Share
<b>Earnings (loss) per share - basic</b>						
Income available to common stockholders	\$ 58,897	27,465	\$ 2.14	\$(383,652 )	27,193	\$ (14.11)
<b>Effect of dilutive securities:</b>						
Convertible senior notes	2,210	4,900		—	—	
Options and warrants	—	161		—	—	
Unvested restricted stock grants	—	202		—	—	

Earnings (loss) per share						
- diluted						
Income available to common stockholders plus assumed exercises and conversion	\$ 61,107	32,728	\$ 1.87	\$(383,652 )	27,193	\$ (14.11)

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 7 — Earnings Per Share (continued)

Basic earnings per share has been computed using the weighted average number of common shares outstanding. Diluted earnings per share has been computed using the weighted average number of common shares and common share equivalents outstanding (which consist of warrants, options and convertible debt to the extent they are dilutive). For the nine months ended September 30, 2009, the convertible notes interest and related common share equivalent of 4,900,000, diluted options and warrants of 26,121 and unvested restricted stock grants outstanding of 352,315 were excluded from the diluted earnings per share calculation because they were anti-dilutive. Potentially dilutive stock options of 12,250 and 439,792 for the three months ended September 30, 2008 and 2009, respectively, were excluded from the computation of diluted earnings per share as the average market price of the Company's common stock did not exceed the weighted average exercise price of such options and to have included them would have been anti-dilutive. Potentially dilutive stock options of 3,257 and 397,780 for the nine months ended September 30, 2008 and 2009, respectively, were excluded from the computation of diluted earnings per share as the average market price of the Company's common stock did not exceed the weighted average exercise price of such options and to have included them would have been anti-dilutive.

Note 8 — Common Stock and Preferred Stock

The Company has 105,000,000 authorized shares of stock consisting of 100,000,000 shares of \$.001 par value common stock and 5,000,000 shares of \$.001 par value preferred stock.

In January 2009, the Company issued an aggregate of 240,000 shares of restricted stock at an aggregate value of approximately \$5.0 million to two of its executive officers, which vest, subject to certain Company financial performance criteria, in January 2010, an aggregate of 30,340 shares of restricted stock to its five non-employee directors, which vest in January 2010, at an aggregate value of approximately \$0.6 million, and an aggregate of 206,500 shares of restricted stock to its employees at an aggregate value of approximately \$3.8 million, which vest over a three to five-year period. Additionally, 74,836 shares of restricted stock previously received by two executive officers were surrendered at a value of \$1.4 million to cover their income taxes due on the 2009 vesting of the restricted stock granted to them in 2007 and 2008. This restricted stock was subsequently retired by the Company. Also, in January 2009, an employee surrendered 551 shares of restricted stock at a value of \$11,367 to cover his income taxes due on the December 31, 2008 vested shares. In February 2009, the Company issued 3,000 shares of restricted stock at a value of approximately \$0.05 million to an employee, which vest over a five-year period. In June 2009, the Company issued 2,500 shares of restricted stock at a value of approximately \$0.03 million to an employee, which vest over a five-year period. In August 2009, certain employees surrendered an aggregate of 920 shares of restricted stock at a value of \$10,608 to cover their income taxes due on the 2009 vesting of the restricted shares granted to them in 2006.

In January 2008, the Company issued an aggregate of 240,000 shares of restricted stock at an aggregate value of approximately \$5.7 million to two of its executive officers, which vested 50% in each of January 2009 and 2010 and an aggregate of 25,340 shares of restricted stock to its five non-employee directors, which vested in January 2009, at an aggregate value of approximately \$0.6 million. In February 2008, the Company issued an aggregate of 41,134 shares of restricted stock as 2007 bonus compensation to two of its executive officers, which vested immediately, at an aggregate value of approximately \$1.0 million. In February 2008, the Company issued 3,593 shares of restricted stock as 2007 bonus compensation at a value of approximately \$0.1 million to an executive officer, which vests 50%

on each of March 1, 2009 and 2010. During the nine months ended June 30, 2008, the Company also issued 208,871 shares of common stock on the exercise of options at a value of \$2.8 million, and 122,202 shares of restricted stock previously received by two executive officers were surrendered at a value of \$3.0 million to cover their income taxes due on the 2008 vesting of the restricted shares granted to them in 2006, 2007 and 2008. This surrendered restricted stock was subsequently retired by the Company. In February 2008, the Company's Board of Directors authorized it to repurchase up to \$30.0 million of its common stock. In April and May 2008, the Company repurchased an aggregate of 1,259,300 shares of its common stock at an average price of \$23.82 per share for a total cost of \$30.0 million. The repurchased stock represented approximately 4.4% of the Company's then outstanding shares of common stock at the time of the repurchase and was subsequently retired by the Company. In July 2008, the Company issued 7,500 shares of restricted stock at a value of \$0.2 million to an employee, which vests 15% on July 1, 2008, 15% on each of December 2008 and 2009, 25% on December 31, 2010, and 30% on December 2011. This employee surrendered 489 shares at a value of \$10,484 to cover his income taxes due on the July 1, 2008 vested shares. In August 2008, certain employees surrendered an aggregate of 2,299 shares of restricted stock at a value of \$54,854 to cover their income taxes due on the 2008 vesting of the restricted shares granted to them in 2006.

All issuances of common stock, including those issued pursuant to stock option and warrant exercises, restricted stock grants and acquisitions, are issued from the Company's authorized but not issued and outstanding shares.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 9 — Business Combinations

The Company acquired the following entities to further enhance its existing product lines and to continue diversification into other toy categories and seasonal businesses:

In October 2008, the Company acquired substantially all of the assets of Tollytots Limited. The total initial consideration of \$25.7 million consisted of \$12.0 million in cash and the assumption of liabilities in the amount of \$13.7 million, and resulted in goodwill of \$3.1 million. In addition, the Company agreed to pay an earn-out of up to an aggregate amount of \$5.0 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. Tollytots is a leading designer and producer of licensed baby dolls and baby doll pretend play accessories based on well-known brands, and was included in its results of operations from the date of acquisition. Pro forma results of operations are not provided since the amounts are not material to the consolidated results of operations.

In October 2008, the Company acquired all of the stock of Kids Only, Inc. and a related Hong Kong company, Kids Only Limited (collectively, “Kids Only”). The total initial consideration of \$23.3 million consisted of \$20.4 million in cash and the assumption of liabilities in the amount of \$2.9 million, and resulted in goodwill of \$12.7 million. In addition, the Company agreed to pay an earn-out of up to an aggregate amount of \$5.6 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. Kids Only is a leading designer and producer of licensed indoor and outdoor kids’ furniture, and has an extensive portfolio which also includes baby dolls and accessories, room décor and a myriad of other children’s toy products, and was included in its results of operations from the date of acquisition. Pro forma results of operations are not provided since the amounts are not material to the consolidated results of operations.

In December 2008, the Company acquired certain assets of Disguise, Inc. and a related Hong Kong company, Disguise Limited (collectively, “Disguise”). The total initial consideration of \$60.6 million consisted of \$38.6 million in cash and the assumption of liabilities in the amount of \$22.0 million, and resulted in goodwill of \$30.6 million. The Company has not finalized its purchase price allocation for Disguise and has engaged a third party to perform studies and valuations of the estimated fair value of assets and liabilities assumed. Disguise is a leading designer and producer of Halloween and everyday costume play and was included in our results of operations from the date of acquisition. Pro forma results of operations are not provided since the amounts are not material to the consolidated results of operations.

Refer to Note 11 for information on the write-down of goodwill.

Note 10 — Joint Venture

The Company owns a fifty percent interest in a joint venture with THQ Inc. (“THQ”) which develops, publishes and distributes interactive entertainment software for the leading hardware game platforms in the home video game market. The joint venture has entered into a license agreement with an initial license period expiring December 31, 2009 and a renewal period at the option of the joint venture expiring December 31, 2014 under which it acquired the exclusive worldwide right to publish video games based on the WWE franchise on all hardware platforms. The Company’s investment is accounted for using the cost method due to the financial and operating structure of the

venture and its lack of significant influence over the joint venture. The Company's basis consists primarily of organizational costs, license costs and recoupable advances and is being amortized over the term of the initial license period. The joint venture agreement provides for the Company to receive guaranteed preferred returns through June 30, 2006 at varying rates of the joint venture's net sales depending on the cumulative unit sales and platform of each particular game. The preferred return is accrued in the quarter in which the licensed games are sold and the preferred return is earned. The preferred return was subject to change after June 30, 2006 and was to be set for the distribution period beginning July 1, 2006 and ending December 31, 2009 (the "Next Distribution Period"). The agreement provides that the parties will negotiate in good faith and agree to the preferred return not less than 180 days prior to the start of the Next Distribution Period. It further provides that if the parties are unable to agree on a preferred return, the preferred return will be determined by arbitration. The parties did not reach an agreement with respect to the preferred return for the Next Distribution Period and the preferred return for the Next Distribution Period was determined through arbitration (see Note 16). On July 24, 2009 a decision was rendered by the arbitrator setting the preferred return rate at 6 %. Based on this lower rate, a cumulative adjustment in the amount of \$23.5 million was made and \$33.5 million was paid by THQ for the cumulative preferred return for the period from July 1, 2006 to June 30, 2009. As of December 31, 2008 and September 30, 2009, the balance of the investment in the video game joint venture includes the following components (in thousands):



## JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

## Note 10 — Joint Venture (continued)

	December 31, 2008	September 30, 2009
Preferred return receivable	\$ 52,845	\$ 442
Investment costs, net	339	85
	\$ 53,184	\$ 527

The Company's joint venture partner retains the financial risk of the joint venture and is responsible for the day-to-day operations, including development, sales and distribution, for which they are entitled to any remaining profits. During the three months ended September 30, 2008 and 2009, the Company earned a profit of \$0.7 million and incurred a loss of \$1.9 million, respectively, from the joint venture. During the nine months ended September 30, 2008 and 2009, the Company earned a profit of \$4.5 million and incurred a loss of \$21.9 million, respectively, from the joint venture. The losses in 2009 were due to the reduction from approximately \$56.2 million to approximately \$32.7 million in the accrual of the receivable from the joint venture that resulted from the arbitration setting the preferred return rate at 6%, instead of the 10% rate that had been accrued.

## Note 11 — Goodwill

The changes in the carrying amount of goodwill for the nine months ended September 30, 2009 are as follows (in thousands):

	Traditional Toys	Craft/Activity/ Writing Products	Pet Products	Total
Balance at beginning of the period	\$ 335,083	\$ 82,826	\$ 9,784	\$ 427,693
Adjustments to goodwill during the period	(20,568)	—	—	(20,568)
Write-down of goodwill	(314,515)	(82,826)	(9,784)	(407,125)
Balance at end of the period	\$ —	\$ —	\$ —	\$ —

As of June 30, 2009, the Company reclassified \$21.0 million from goodwill to intangibles and other assets for its Disguise acquisition. The Company is in the process of finalizing its purchase price allocation for its Disguise Acquisition and is working with a third party to perform studies and valuations to the estimated fair value of assets and liabilities assumed. Furthermore, the Company paid out an additional working capital adjustment of \$0.9 million for its Disguise acquisition.

The Company applies a fair value-based impairment test to the net book value of goodwill and indefinite-lived intangible assets on an annual basis and, if certain events or circumstances indicate that an impairment loss may have been incurred, on an interim basis. The analysis of potential impairment of goodwill requires a two-step process. The first step is the estimation of fair value. If step one indicates that an impairment potentially exists, the second step is performed to measure the amount of impairment, if any. Goodwill impairment exists when the estimated fair value of goodwill is less than its carrying value.

As of June 30, 2009, the Company determined that the significant decline in its market capitalization is likely to be sustained. The Company's market capitalization was not significantly affected by the dismissals subject to appeal of

the WWE lawsuit, and the lower revenue expectations for 2009 versus 2008 were factors that indicated that an interim goodwill impairment test was required. As a result, the Company determined that \$407.1 million, or all of the goodwill related to previous acquisitions, including the acquisition of Disguise in December 2008, was impaired. This amount is included in "Write-down of Goodwill" in the accompanying condensed consolidated statements of operations.

## JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

## Note 12 — Intangible Assets Other Than Goodwill

Intangible assets consist primarily of licenses, product lines, customer relationships, debt offering costs from the issuance of the Company's convertible senior notes and trademarks. Amortized intangible assets are included in the Intangibles and other, net, in the accompanying balance sheets. Trademarks are disclosed separately in the accompanying balance sheets. Intangible assets are as follows (in thousands, except for weighted useful lives):

	Weighted Useful Lives (Years)	December 31, 2008			September 30, 2009		
		Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
<b>Amortized Intangible Assets:</b>							
Acquired order backlog	0.50	\$ 2,393	\$ (2,165)	\$ 228	\$ 2,393	\$ (2,393)	\$ —
Licenses	4.84	67,088	(46,638)	20,450	85,788	(55,090)	30,698
Product lines	3.62	17,700	(17,700)	—	19,100	(18,267)	833
Customer relationships	5.33	4,096	(2,301)	1,795	6,796	(3,258)	3,538
Non-compete/Employment contracts	4.56	2,748	(2,703)	45	3,133	(2,789)	344
Debt offering costs	20.00	3,705	(1,033)	2,672	3,705	(1,172)	2,533
Total amortized intangible assets		97,730	(72,540)	25,190	120,915	(82,969)	37,946
<b>Unamortized Intangible Assets:</b>							
Trademarks	indefinite	10,491	—	10,491	2,308	—	2,308
		\$ 108,221	\$ (72,540)	\$ 35,681	\$ 123,223	\$ (82,969)	\$ 40,254

Amortization expense related to limited life intangible assets was \$2.1 million and \$6.5 million for the three months ended September 30, 2008 and 2009, respectively. Amortization expense related to limited life intangible assets was \$6.4 million and \$10.4 million for the nine months ended September 30, 2008 and 2009, respectively.

During the third quarter of 2008, the Company discontinued the use of the "Toymax" and "Trendmaster" tradenames on products and market these products under the JAKKS Pacific trademark. Consequently, the intangible assets associated with these tradenames were written off to Write-down of Intangible Assets, resulting in a charge of \$3.5 million. Also, the Company adjusted the value of the Child Guidance trademark to reflect lower sales expectations for this tradename, resulting in a charge to Write-down of Intangible Assets of \$5.6 million.

As of June 30, 2009, the Company determined that the tradenames "Child Guidance" and "Play Along" and certain tradenames associated with its Craft and Activity product lines would either be discontinued, or were under-performing. Consequently, the intangible assets associated with these tradenames were written off to "Write-down of Intangible Assets," resulting in a non-cash charge of \$8.2 million.

Note 13 — Property and Equipment

Property and equipment have historically been stated at cost and are being depreciated using the straight-line method over their estimated useful lives as follows:

Office equipment	5 years
Automobiles	5 years
Furniture and fixtures	5 - 7 years
Molds and tooling	2 years
Leasehold improvements	Shorter of length of lease or 10 years

## JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

## Note 13 — Property and Equipment (continued)

Effective January 1, 2009, the Company changed its depreciation methodology for molds and tools used in the manufacturing of its products from a straight-line basis to a usage basis, which is more closely correlated to production of goods. While both methods of depreciation allocation are acceptable, the Company believes that the usage method more accurately matches costs with revenues. Furthermore, the useful estimated life of molds and tools was maintained at two years. The following financial statement line items for the three and nine months ended September 30, 2008 were affected by the change in accounting principle:

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	Three Months Ended September 30, 2008			Nine Months Ended September 30, 2008		
	As Computed under usage method	As Reported under Straight- line method	Effect of Change	As Computed under usage method	As Reported under Straight- line method	Effect of Change
Net sales	\$ 357,824	\$ 357,824	\$ —	\$ 634,050	\$ 634,050	\$ —
Cost of sales	231,145	228,759	2,386	405,949	405,486	463
Gross Margin	\$ 126,679	\$ 129,065	\$ (2,386)	\$ 228,101	\$ 228,564	\$ (463)
Income from operations	\$ 54,952	\$ 57,338	\$ (2,386)	\$ 61,549	\$ 62,012	\$ (463)
Income before provision for income taxes	\$ 58,417	\$ 60,803	\$ (2,386)	\$ 67,634	\$ 68,097	\$ (463)
Provision for income taxes	5,879	6,658	(779)	8,737	8,919	(182)
Net income	\$ 52,538	\$ 54,145	\$ (1,607)	\$ 58,897	\$ 59,178	\$ (281)
Earnings per share – basic	\$ 1.95	\$ 2.01	\$ (0.06)	\$ 2.14	\$ 2.15	\$ (0.01)
Earnings per share - diluted	\$ 1.65	\$ 1.70	\$ (0.05)	\$ 1.87	\$ 1.88	\$ (0.01)

## JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

## Note 13 — Property and Equipment (continued)

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

	As of September 30, 2008		
	As Computed under usage method	As Reported under Straight- line method	Effect of Change
Property and Equipment			
Office furniture and equipment	\$ 10,953	\$ 10,953	\$ —
Molds and tooling	59,293	59,293	—
Leasehold improvements	5,298	5,298	—
Total	75,544	75,544	—
Less accumulated depreciation and amortization	49,364	48,901	463
Property and equipment, net	\$ 26,180	\$ 26,643	\$ (463)
Income taxes payable	\$ 1,164	\$ 1,346	\$ (182)
Retained earnings	\$ 441,185	\$ 441,466	\$ (281)

As a result of the accounting method change, there was a minimal cumulative effect to the Company's retained earnings as of January 1, 2009.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Nine Months Ended September 30, 2008		
	As Computed under usage method	As Reported under Straight- line method	Effect of Change
Cash flow provided in operations	\$ 13,854	\$ 13,854	\$ —
Cash Flow items impacted by change:			
Net income	58,897	59,178	(281)
Depreciation and amortization	19,670	19,207	463
Income tax payable	(20,832)	(20,650)	(182)
Total adjustments	57,735	57,735	—
Net cash provided by operating activities	13,854	13,854	—
Net cash used by investing activities	(32,663)	(32,663)	—
Net cash used in financing activities	(29,042)	(29,042)	—
Effect of exchange rate changes on cash	(792)	(792)	—
Net decrease in cash and cash equivalents	(48,643)	(48,643)	—

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Cash and cash equivalents, beginning of period	241,250	241,250	—
Cash and cash equivalents, end of period	\$ 192,607	\$ 192,607	\$ —

## JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

## Note 14 — Share-Based Payments

The Company's 2002 Stock Award and Incentive Plan (the "Plan") provides for the awarding of stock options and restricted stock to employees, officers and non-employee directors. The Plan is more fully described in Notes 14 and 16 to the Consolidated Financial Statements in the Company's 2008 Annual Report on Form 10-K.

The following table summarizes the total share-based compensation expense and related tax benefits recognized for the three and nine months ended September 30, 2008 and 2009 (in thousands):

	Three Months Ended September 30, 2008		2009		Nine Months Ended September 30, 2008		2009	
Stock option compensation expense	\$	155	\$	95	\$	465	\$	181
Tax benefit related to stock option compensation	\$	50	\$	29	\$	157	\$	63
Restricted stock compensation expense	\$	1,860	\$	(772)	\$	5,561	\$	3,121
Tax benefit related to restricted stock compensation	\$	695	\$	(340)	\$	2,072	\$	1,137

Stock option activity pursuant to the Plan for nine months ended September 30, 2009 is summarized as follows:

	Plan Stock Options (*)	
	Number of Shares	Weighted Average Exercise Price
Outstanding, December 31, 2008	477,515	\$ 19.55
Granted	—	\$ —
Exercised	—	\$ —
Cancelled	(22,750)	\$ 18.90
Outstanding, September 30, 2009	454,765	\$ 19.58

\* The stock option activity excludes 100,000 of fully vested warrants issued during 2003 with an initial exercise price of \$11.35 per share, which expire August 14, 2013 and are outstanding at September 30, 2009.

Restricted stock award activity pursuant to the Plan for the nine months ended September 30, 2009 is summarized as follows:

	Restricted Stock Awards	
	Number of Shares	Weighted Average Exercise Price
Outstanding, December 31, 2008	460,533	\$ 21.93



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Awarded	482,340	\$	19.55
Released	(168,750)	\$	22.56
Forfeited	(7,000)	\$	17.12
Outstanding, September 30, 2009	767,123	\$	20.34

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## JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

## Note 15 — Comprehensive Income (Loss)

The table below presents the components of the Company's comprehensive income (loss) for the three and nine months ended September 30, 2008 and 2009 (in thousands):

	Three Months Ended September 30, 2008		Nine Months Ended September 30, 2008	
	As Adjusted (Note 13)	2009	As Adjusted (Note 13)	2009
Net income (loss)	\$ 52,538	\$ 33,708	\$ 58,897	\$ (383,652)
Other comprehensive income (loss):				
Foreign currency translation adjustment	(804)	1	(784)	1
Comprehensive income (loss)	\$ 51,734	\$ 33,709	\$ 58,113	\$ (383,651)

## Note 16 — Litigation

In October 2004, the Company was named as a defendant in a lawsuit commenced by World Wrestling Entertainment, Inc. ("WWE") (the "WWE Action"). The complaint also named as defendants, among others, the joint venture with THQ Inc., certain of the Company's foreign subsidiaries and the Company's three executive officers. The Complaint was amended, the antitrust claims were dismissed and, on grounds not previously considered by the Court, a motion to dismiss the RICO claim, the only remaining basis for jurisdiction, was argued and submitted in September 2006. In December 2007 the Court dismissed the WWE Action (the "Dismissal Order") and WWE appealed. The Company sought reconsideration of that portion of the Dismissal Order which rejected the argument based on WWE's release; that application was granted in September 2008 and the Court held that the issue of the applicability of a January 2004 release executed by WWE in favor of the Company would not be determined in connection with the motion to dismiss. On May 19, 2009, the United States Court of Appeals for the Second Circuit unanimously affirmed dismissal of the WWE Action on statute of limitations grounds and, with no further appeal taken, that order ended the WWE Action.

In November 2004, several purported class action lawsuits were filed in the United States District Court for the Southern District of New York, alleging damages associated with the facts alleged in the WWE Action (the "Class Action"). A motion to dismiss was filed, was fully briefed and argument occurred on November 30, 2006. The motion was granted without prejudice to seeking leave to amend; such leave was granted to plaintiffs, an amended complaint was filed and briefing was completed with respect to a motion to dismiss, which was scheduled for argument in October 2008. That date was adjourned by the Court. The parties thereafter reached an agreement to settle this matter. The agreement, which is subject to Court approval, will settle the matter for \$3.9 million, without any admission of liability on the part of the Company, or its officers and directors. Three shareholder derivative actions were also filed against the Company, nominally, and against certain of the Company's Board members (the "Derivative Actions"). The Derivative Actions seek to hold the individual defendants liable for damages allegedly caused to the Company by their actions, and, in one of the Derivative Actions, seeks restitution to the Company of profits, benefits and other compensation obtained by them. These actions are currently stayed or the time to answer has been extended, and have been dismissed without prejudice. Agreement to resolve the Derivative Actions has been reached, but it is

subject to Court approval. A Company insurer has agreed to provide the \$4.1 million that will be used to settle the Class Action and the Derivative Actions.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 16 — Litigation (continued)

The Company received notice from WWE alleging breaches of the video game license in connection with sales of WWE video games in Japan and other countries in Asia. The joint venture responded that WWE acquiesced in the arrangements, and separately released any claim against the joint venture in connection therewith and accordingly there is no breach of the joint venture's video game license. While the joint venture does not believe that WWE has a valid claim, it tendered a protective "cure" of the alleged breaches with a full reservation of rights. WWE "rejected" that cure and reserved its rights. On October 12, 2006, WWE commenced a lawsuit in Connecticut state court against THQ and the joint venture, involving the claim set forth above concerning allegedly improper sales of WWE video games in Japan and other countries in Asia (the "JV Action"). The lawsuit seeks, among other things, a declaration that WWE is entitled to terminate the video game license and monetary damages. A motion to strike one claim was argued on March 12, 2007 and submitted to the Court. Thereafter, WWE amended the complaint to import state law claims from the WWE Action. A motion to strike and for summary judgment with respect to these additional claims (the "Dispositive Motion") was briefed and argument took place on May 19, 2008. The Judge ordered the parties to file supplemental briefing on May 23, 2008, upon which filing the motion was submitted to the Court for decision. WWE filed a cross-motion for partial summary judgment with respect to the Company's Release defense. At the end of August, the Court granted the Dispositive Motion. WWE moved to reargue that decision and that motion was denied. WWE filed an appeal, which was assigned to the Supreme Court of Connecticut. Briefing on the appeal was completed in September 2009, with argument to be held at a date still to be determined. THQ filed a cross-complaint which asserts claims by THQ and Mr. Farrell for indemnification from the Company in the event that WWE prevails on any of its claims against THQ and Farrell and also asserts claims by THQ that the Company breached its fiduciary duties to THQ in connection with the videogame license between WWE and THQ/JAKKS Pacific LLC and seeks equitable and legal relief, including substantial monetary and exemplary damages against the Company in connection with this claim. The Company has moved to sever and stay the cross-claims pending WWE's appeal of its dismissed claims to which the cross-claims relate. The Company has also moved for summary judgment and to strike the cross-claims, but these motions have not yet been adjudicated. In the event the Company does not prevail in having THQ's cross-claims summarily dismissed, the Company intends to vigorously contest them.

WWE filed a motion for partial summary judgment with respect to the claims remaining in the JV Action which seeks a declaration that WWE may terminate the joint venture's videogame license. The joint venture has opposed this motion and has filed a motion for summary judgment dismissing the JV Action as a matter of law on multiple grounds. Discovery issues arose, a Court conference was held on August 4, 2009 and a further order of the Court is expected.

In connection with the joint venture with THQ (see Note 10), the Company receives its profit through a preferred return based on net sales of the joint venture, which was to be reset as of July 1, 2006 for the period through December 31, 2009 (the "Next Distribution Period"). The preferred return is accrued in the quarter in which the licensed games are sold and the preferred return is earned. The agreement with THQ provides for the parties to agree on the reset of the preferred return or, if no agreement is reached, for arbitration of the issue. No agreement was reached, and the preferred return for the Next Distribution Period was determined through arbitration. On July 24, 2009 a decision was rendered by the arbitrator setting the preferred return rate at 6 %. Based on this lower rate, a cumulative adjustment in the amount of \$23.5 million was made and \$33.5 million was paid by THQ for the cumulative preferred return for the period from July 1, 2006 to June 30, 2009.

In order to exercise the joint venture's right to renew the WWE videogame license for the renewal period running from January 1, 2010 through December 31, 2014, the Company, on behalf of the joint venture, sent out a Notice of Renewal to WWE on June 30, 2009 (the "Renewal Notice"). THQ has commenced an action in California Superior Court (the "California Action") seeking a declaratory judgment that JAKKS cannot renew the videogame license without THQ's consent and that THQ is not obligated to consent. THQ also seeks a declaratory judgment that the restrictive covenant contained in the joint venture agreement is unenforceable. The Company has filed a demurrer in the California Action which has been fully briefed and will be argued on November 16, 2009. THQ has brought a summary judgment motion seeking a declaration that the restrictive covenant is not enforceable. In the event that the demurrer is not granted, the Company has sought an adjournment of THQ's summary judgment motion pending discovery. WWE has also commenced an action in California seeking the same relief as THQ, namely, to declare THQ's restrictive covenant unenforceable, and the Company has filed a demurrer seeking to dismiss the action on the grounds that WWE has no standing and the relief is otherwise not available. THQ also filed an arbitration in California seeking a declaratory judgment that the same restrictive covenant is unenforceable (the "California Arbitration"). The Company commenced an arbitration in New York (the "New York Arbitration") seeking, among other things, a declaratory judgment that (a) it is empowered to serve the Renewal Notice and (b) THQ's restrictive covenant is enforceable. In the New York arbitration, the Company also seeks to hold THQ liable for its breach of fiduciary duty with respect to its dealings with the Company and the LLC. The Company also commenced an action in New York Supreme Court to enjoin the California Arbitration. The application to enjoin the California Arbitration has been argued and is awaiting decision. The Company has requested of the American Arbitration Association that the New York Arbitration proceed and the California Arbitration not proceed and those proceedings have been successively adjourned by stipulation between the parties.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 16 — Litigation (continued)

The Company is a party to, and certain of its property is the subject of, various other pending claims and legal proceedings that routinely arise in the ordinary course of its business. Other than with respect to the claims in the JV Action and the matter of the preferred return from THQ in connection with the joint venture, with respect to which the Company cannot give assurance as to the outcome, the Company does not believe that any of these claims or proceedings will have a material effect on its business, financial condition or results of operations.

Note 17 — Subsequent Events (through November 9, 2009)

On November 5, 2009 the Company announced the pricing of \$85.0 million principal amount of 4.50% convertible senior notes due 2014 (the “Notes”). The Notes are senior unsecured obligations of JAKKS, will pay interest semi-annually at a rate of 4.50% per annum and will mature on November 1, 2014. The conversion rate will initially be 63.2091 shares of JAKKS common stock per \$1,000 principal amount of notes (equivalent to an initial conversion price of approximately \$15.82 per share of common stock), subject to adjustment in certain circumstances. Prior to August 1, 2014, holders of the Notes may convert their Notes only upon specified events. Upon conversion, the Notes may be settled, at the Company’s election, in cash, shares of its common stock, or a combination of cash and shares of its common stock. Holders of the Notes may require the Company to repurchase for cash all or some of their Notes upon the occurrence of a fundamental change (as defined). The Company anticipates closing the offering of the Notes on November 10, 2009. It also granted the initial purchaser of the Notes a 30-day option to purchase up to an additional \$15.0 million in principal amount of additional Notes to cover over-allotments, if any, which they advised the Company that they were exercising for the full \$15.0 million.

The Company intends to use the net proceeds from the offering, along with cash on hand, to repurchase all or a portion of its 4.625% convertible senior notes due 2023. In the event the Company is unable to repurchase such Notes on satisfactory terms, it may use such proceeds for general corporate purposes.

No assurance can be given that this proposed financing will be consummated on these or any other terms.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of financial condition and results of operations should be read together with our Condensed Consolidated Financial Statements and Notes thereto which appear elsewhere herein.

### Critical Accounting Policies and Estimates

The accompanying consolidated financial statements and supplementary information were prepared in accordance with accounting principles generally accepted in the United States of America. Significant accounting policies are discussed in Note 2 to the Consolidated Financial Statements set forth in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2008. Inherent in the application of many of these accounting policies is the need for management to make estimates and judgments in the determination of certain revenues, expenses, assets and liabilities. As such, materially different financial results can occur as circumstances change and additional information becomes known. The policies with the greatest potential effect on our results of operations and financial position include:

**Allowance for Doubtful Accounts.** Our allowance for doubtful accounts is based on management's assessment of the business environment, customers' financial condition, historical collection experience, accounts receivable aging, customer disputes and the collectability of specific customer accounts. If there were a deterioration of a major customer's creditworthiness, or actual defaults were higher than our historical experience, our estimates of the recoverability of amounts due to us could be overstated, which could have an adverse impact on our operating results. The allowance for doubtful accounts is also affected by the time at which uncollectible accounts receivable balances are actually written off.

Major customers' accounts are monitored on an ongoing basis; more in depth reviews are performed based on changes in customer's financial condition and/or the level of credit being extended. When a significant event occurs, such as a bankruptcy filing by a specific customer, and on a quarterly basis, the allowance is reviewed for adequacy and the balance or accrual rate is adjusted to reflect current risk prospects.

**Revenue Recognition.** Our revenue recognition policy is to recognize revenue when persuasive evidence of an arrangement exists, title transfer has occurred (product shipment), the price is fixed or readily determinable, and collectability is probable. Sales are recorded net of sales returns and discounts, which are estimated at the time of shipment based upon historical data. JAKKS routinely enters into arrangements with its customers to provide sales incentives, support customer promotions, and provide allowances for returns and defective merchandise. Such programs are based primarily on customer purchases, customer performance of specified promotional activities, and other specified factors such as sales to consumers. Accruals for these programs are recorded as sales adjustments that reduce gross revenue in the period the related revenue is recognized.

**Goodwill and other indefinite-lived intangible assets.** Goodwill and indefinite-lived intangible assets are not amortized, but are tested for impairment at least annually at the reporting unit level.

Factors we consider important which could trigger an impairment review include the following:

- significant underperformance relative to expected historical or projected future operating results;
- significant changes in the manner of our use of the acquired assets or the strategy for our overall business; and
- significant negative industry or economic trends.

Due to the subjective nature of the impairment analysis significant changes in the assumptions used to develop the estimate could materially affect the conclusion regarding the future cash flows necessary to support the valuation of long-lived assets, including goodwill. The valuation of goodwill involves a high degree of judgment and consists of a

comparison of the fair value of a reporting unit with its book value. Based on the assumptions underlying the valuation, impairment is determined by estimating the fair value of a reporting unit and comparing that value to the reporting unit's book value. If the implied fair value is more than the book value of the reporting unit, an impairment loss is not indicated. If impairment exists, the fair value of the reporting unit is allocated to all of its assets and liabilities excluding goodwill, with the excess amount representing the fair value of goodwill. An impairment loss is measured as the amount by which the book value of the reporting unit's goodwill exceeds the estimated fair value of that goodwill.



As of June 30, 2009, the Company determined that the significant decline in its market capitalization is likely to be sustained. The Company's market capitalization was not significantly affected by the substantial resolution of the WWE lawsuit, and the lower revenue expectations for 2009 versus 2008 were factors that indicated that an interim goodwill impairment test was required. As a result, the Company determined that \$407.1 million, or all of the goodwill related to previous acquisitions, including the acquisition of Disguise in December 2008, was impaired. This amount is included in "Write-down of Goodwill" in the accompanying consolidated statements of operations.

As of June 30, 2009, the Company determined that the tradenames "Child Guidance" and "Play Along" and certain tradenames associated with our Craft and Activity product lines would either be discontinued, or were under performing. Consequently, the intangible assets associated with these tradenames were written off to "Write-down of Intangible Assets", resulting in a non-cash charge of \$8.2 million.

Intangible assets amounted to \$40.3 million as of September 30, 2009.

**Reserve for Inventory Obsolescence.** We value our inventory at the lower of cost or market. Based upon a consideration of quantities on hand, actual and projected sales volume, anticipated product selling prices and product lines planned to be discontinued, slow-moving and obsolete inventory is written down to its net realizable value.

Failure to accurately predict and respond to consumer demand could result in the Company under producing popular items or over producing less popular items. Furthermore, significant changes in demand for our products would impact management's estimates in establishing our inventory provision.

Management estimates are monitored on a quarterly basis and a further adjustment to reduce inventory to its net realizable value is recorded, as an increase to cost of sales, when deemed necessary under the lower of cost or market standard.

**Income Allocation for Income Taxes.** Our quarterly income tax provision and related income tax assets and liabilities are based on estimated annual income as allocated to the various tax jurisdictions based upon our transfer pricing study, US and foreign statutory income tax rates, and tax regulations and planning opportunities in the various jurisdictions in which the Company operates. Significant judgment is required in interpreting tax regulations in the US and foreign jurisdictions, and in evaluating worldwide uncertain tax positions. Actual results could differ materially from those judgments, and changes from such judgments could materially affect our consolidated financial statements.

**Discrete Items for Income Taxes.** Significant discrete tax items were recognized in the nine months ended September 30, 2009. As previously indicated in the Income Taxes note, the discrete items included goodwill impairment, trademark impairment, the THQ/Jakks joint venture settlement, and uncertain tax positions. A portion of the goodwill impairment is treated as a permanent adjustment for the tax provision and is considered non-deductible for tax purposes. Further explanation of the impairment can be found in the Goodwill and other indefinite-lived intangible assets section above. Further explanation on the THQ/Jakks joint venture settlement can be found in the Litigation note.

**Income taxes and interest and penalties related to income tax payable.** We do not file a consolidated return with our foreign subsidiaries. We file federal and state returns and our foreign subsidiaries each file Hong Kong returns, as applicable. Deferred taxes are provided on an asset and liability method whereby deferred tax assets are recognized as deductible temporary differences and operating loss and tax credit carry-forwards 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.

As of January 1, 2007, we adopted a threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. As of the date of adoption, tax benefits that are subject to challenge by tax authorities are analyzed and accounted for in the income tax provision. The cumulative effect of the potential liability for unrecognized tax benefits prior to the adoption of threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return, along with the associated interest and penalties, are recognized as a reduction in the January 1, 2007 balance of retained earnings.

We accrue a tax reserve for additional income taxes and interest, which may become payable in future years as a result of audit adjustments by tax authorities. The reserve is based on management's assessment of all relevant information, and is periodically reviewed and adjusted as circumstances warrant. As of September 30, 2009, our income tax reserves are approximately \$14.8 million and relate to the potential income tax audit adjustments, primarily in the areas of income allocation and transfer pricing.

We recognize current period interest expense and the reversal of previously recognized interest expense that has been determined to not be assessable due to the expiration of the related audit period or other compelling factors on the income tax liability for unrecognized tax benefits as interest expense, and penalties and penalty reversals related to the income taxes payable as other expense in our consolidated statements of operations.

**Share-Based Compensation.** We grant restricted stock and options to purchase our common stock to our employees (including officers) and non-employee directors under our 2002 Stock Award and Incentive Plan (the “Plan”), which incorporated the shares remaining under our Third Amended and Restated 1995 Stock Option Plan. The benefits provided under the Plan are share-based payments. We estimate the value of share-based awards on the date of grant using the Black-Scholes option-pricing model. The determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by our stock price, as well as assumptions regarding a number of complex and subjective variables. These variables include our expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, cancellations, terminations, risk-free interest rates and expected dividends.

#### Recent Developments

In October 2008, we acquired substantially all of the assets of Tollytots Limited. The total initial consideration of \$25.7 million consisted of \$12.0 million in cash and the assumption of liabilities in the amount of \$13.7 million, and resulted in goodwill of \$3.1 million. In addition, we agreed to pay an earn-out of up to an aggregate amount of \$5.0 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. Tollytots is a leading designer and producer of licensed baby dolls and baby doll pretend play accessories based on well-known brands and was included in our results of operations from the date of acquisition.

In October 2008, we acquired all of the stock of Kids Only, Inc. and a related Hong Kong company, Kids Only Limited (collectively, “Kids Only”). The total initial consideration of \$23.3 million consisted of \$20.4 million in cash and the assumption of liabilities in the amount of \$2.9 million, and resulted in goodwill of \$12.7 million. In addition, we agreed to pay an earn-out of up to an aggregate amount of \$5.6 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. Kids Only is a leading designer and producer of licensed indoor and outdoor kids’ furniture, and has an extensive portfolio which also includes baby dolls and accessories, room décor and a myriad of other children’s toy products and was included in our results of operations from the date of acquisition.

In December 2008, we acquired certain assets of Disguise, Inc. and a related Hong Kong company, Disguise Limited (collectively, “Disguise”). The total initial consideration of \$60.6 million consisted of \$38.6 million in cash and the assumption of liabilities in the amount of \$22.0 million, and resulted in goodwill of \$30.6 million. We have not finalized our purchase price allocation for Disguise and have engaged a third party to perform studies and valuations of the estimated fair value of assets and liabilities assumed. Disguise is a leading designer and producer of Halloween and everyday costume play and was included in our results of operations from the date of acquisition.

The goodwill from all of these acquisitions (as well as all other acquisitions) has been written down. See Note 11 of the Notes to Condensed Consolidated Financial Statements, *supra*.

## Results of Operations

The following unaudited table sets forth, for the periods indicated, certain statement of income data as a percentage of net sales.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
	As Adjusted		As Adjusted	
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	64.6	67.1	64.0	75.8
Gross profit	35.4	32.9	36.0	24.2
Selling, general and administrative expenses	17.5	18.0	24.8	28.3
Write-down of intangible assets	2.5	—	1.4	1.4
Write-down of goodwill	—	—	—	67.3
Income (loss) from operations	15.4	14.9	9.8	(72.8)
Profit (loss) from video game joint venture	0.2	(0.5)	0.7	(3.6)
Interest income	0.2	—	0.4	—
Interest expense, net of benefit	0.6	(0.4)	(0.2)	(0.6)
Income (loss) before provision (benefit) for income taxes	16.4	14.0	10.7	(77.0)
Provision (benefit) for income taxes	1.7	4.4	1.4	(13.6)
Net income (loss)	14.7%	9.6%	9.3%	(63.4)%

The following unaudited table summarizes, for the periods indicated, certain income statement data by segment (in thousands).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
	As Adjusted		As Adjusted	
<b>Net Sales</b>				
Traditional Toys	\$ 332,395	\$ 324,092	\$ 583,040	\$ 548,142
Craft/Activity/Writing Products	20,616	23,787	37,274	46,165
Pet Products	4,813	3,559	13,736	10,625
	357,824	351,438	634,050	604,932
<b>Cost of Sales</b>				
Traditional Toys	218,240	216,873	375,299	412,961
Craft/Activity/Writing Products	8,939	15,344	20,263	34,335
Pet Products	3,966	3,512	10,387	11,022
	231,145	235,729	405,949	458,318
<b>Gross Profit (Loss)</b>				
Traditional Toys	114,155	107,219	207,741	135,181
Craft/Activity/Writing Products	11,677	8,443	17,011	11,830
Pet Products	847	47	3,349	(397)
	\$ 126,679	\$ 115,709	\$ 228,101	\$ 146,614



## Comparison of the Three Months Ended September 30, 2009 and 2008

## Net Sales

**Traditional Toys.** Net sales of our Traditional Toys segment were \$324.1 million in 2009, compared to \$332.4 million in 2008, representing a decrease of \$8.3 million, or 2.5%. The decrease in net sales was primarily due to lower unit sales of our WWE®, Narnia® and Pokemon® action figures and accessories, and other JAKKS products, including Plug It In & Play TV Games™, UltiMotion™, G2 Game Girl™ and EyeClops® electronics, Neopets®, Cabbage Patch Kids® and Care Bears® plush, JAKKS™ dolls and pretend play products based on Hannah Montana®, Camp Rock™ dolls, our role-play and dress-up toys, including those based on Disney classic princesses and fairies characters, and junior sports products. This was offset in part by increases in unit sales of some products, including Club Penguin™, Hello Kitty® and Smurfs® plush, In My Pocket & Friends™, SpongeBob SquarePants® and Discovery Kids® toys, Fly Wheels®, Lucky BeeBee™ activities and Nascar® vehicles, and the contribution to sales from our Tollytots, Kids Only and Disguise acquisitions of \$106.3 million.

**Craft/Activity/Writing Product.** Net sales of our Craft/Activity/Writing Products were \$23.8 million in 2009, compared to \$20.6 million in 2008, representing an increase of \$3.2 million, or 15.5%. The increase in net sales was primarily due to increases in unit sales of our Girl Gourmet™ and our Flying Colors® and Vivid Velvet® activities products, offset in part by decreases in unit sales of Spa Factory™ activity toys, Creepy Crawlers® activities products, our Spinz™ writing instruments and our Pentech™ and Color Workshop® writing instruments and related products.

**Pet Products.** Net sales of our Pet Products were \$3.6 million in 2009, compared to \$4.8 million in 2008, representing a decrease of \$1.2 million, or 25.0%. The decrease is mainly attributable to the less available shelf space for pet products at some of our major customer retail stores, and lower unit sales of consumable pet products. Sales of pet products were led by our AKG® licensed line of products.

## Cost of Sales

**Traditional Toys.** Cost of sales of our Traditional Toys segment was \$216.9 million, or 66.9% of related net sales, in 2009, compared to \$218.2 million, or 65.7% of related net sales, in 2008, representing a decrease of \$1.3 million, or 0.6%. This decrease primarily consisted of a decrease in royalty expense for our Traditional Toys segment of \$5.2 million and as a percentage of net sales due to changes in the product mix to more products with lower royalty rates or proprietary products with no royalty rates from products with higher royalty rates. This was partially offset by an increase in product costs of \$2.8 million due to the mix of the product sold with higher product cost and higher sales of closeout product. Our depreciation of molds and tools increased by \$1.0 million primarily due to increased purchases of molds and tools in this segment.

**Craft/Activity/Writing Products.** Cost of sales of our Craft/Activity/Writing Products segment was \$15.3 million, or 64.5% of related net sales, in 2009, compared to \$8.9 million, or 43.4% of related net sales, in 2008, representing an increase of \$6.4 million, or 71.9%. This increase primarily consisted of an increase in product costs of \$4.7 million, which is in line with the higher volume of sales and higher sales of closeout product. Product costs as a percentage of net sales increased primarily due to the mix of the product sold and higher sales of closeout product. Royalty expense increased by \$1.2 million and as a percentage of net sales due to changes in the product mix to more products with higher royalty rates from products with lower royalty rates or proprietary products with no royalty rates. Our depreciation of molds and tools increased by \$0.5 million primarily due to increased purchases of molds and tools in this segment.

**Pet Product.** Cost of sales of our Pet Pal line of products was \$3.5 million, or 98.7% of related net sales, in 2009, compared to \$4.0 million, or 82.4% of related net sales, in 2008, representing a decrease of \$0.5 million, or

12.5%. This decrease primarily consisted of a decrease in products costs of \$0.4 million, which is in line with the lower volume of sales. Product costs as a percentage of net sales increased primarily due to the mix of the product sold and higher sales of closeout product. Royalty expense decreased by \$0.2 million and as a percentage of sales due to changes in the product mix to products with lower royalty rates or proprietary products with no royalty rates from more products with higher royalty rates. Our depreciation of molds and tools increased by \$0.1 million primarily due to increased purchases of molds and tools in this segment.

### Selling, General and Administrative Expenses

Selling, general and administrative expenses were \$63.4 million in 2009 and \$62.7 million in 2008, constituting 18.0% and 17.5% of net sales, respectively. The overall increase of \$0.7 million in such costs was primarily due to the addition of overhead related to the operations of Tollytots, Kids Only and Disguise (\$12.7 million) and an increase in depreciation and amortization (\$3.8 million), offset in part by decreases in general and administrative expenses (\$3.2 million), product development (\$2.5 million), share-based compensation (\$2.7 million) and direct selling expenses (\$7.3 million). The increase in the acquired companies' overhead is mainly due to the fixed overhead and high seasonality of the Disguise acquisition, with the majority of its sales booked in the third quarter of 2009. The increase in depreciation and amortization is mainly due to an increase in amortization expensed related to intangible assets other than goodwill (\$4.4 million), offset in part by a decrease in depreciation of tangible assets. The decrease in general and administrative expenses is primarily due to decreases in bonus expense (\$6.5 million) and travel and entertainment expense (\$1.1 million), offset in part by increases in legal expense (\$1.1 million), net of insurance reimbursements, the reversal of penalty reserves related to uncertain tax positions taken or expected to be taken in a tax return (\$1.9 million) in 2008 with no such reversals in 2009 and foreign currency expense (\$0.9 million). Product development expenses decreased (\$2.5 million) as a result of tighter control of spending on product development, offset in part by higher product testing expenses. The decrease in direct selling expenses is primarily due to decreases in advertising and promotional expenses of \$2.6 million in 2009 in support of several of our product lines), sales commissions (\$1.4 million) and other direct selling expenses of \$3.4 million. From time to time, we may increase or decrease our advertising efforts, if we deem it appropriate for particular products.

### Write-down of Intangible Assets

As of June 30, 2009, we determined that the tradenames "Child Guidance," "Play Along" and certain tradenames associated with our Crafts and Activities product lines would either be discontinued, or were under-performing. Consequently, the intangible assets associated with these tradenames were written off to "Write-down of Intangible Assets", resulting in a non-cash charge of \$8.2 million. During the third quarter of 2008, the Company discontinued the use of the "Toymax" and "Trendmaster" tradenames on products and market these products under the JAKKS Pacific trademark. Consequently, the intangible assets associated with these tradenames were written off to Write-down of Intangible Assets, resulting in a charge of \$3.5 million. Also, the Company adjusted the value of the Child Guidance trademark to reflect lower sales expectations for this tradename, resulting in a charge to Write-down of Intangible Assets of \$5.6 million.

### Write-down of Goodwill

As of June 30, 2009, we determined that the significant decline in our market capitalization is likely to be sustained. Our market capitalization did not change significantly despite the dismissals subject to appeal of the WWE lawsuit, and the lower revenue expectations for 2009 versus 2008 were factors that indicated that an interim goodwill impairment test was required. As a result, we determined that \$407.1 million, or all of the goodwill related to previous acquisitions, including the acquisition of Disguise in December 2008, was impaired. This amount is included in "Write-down of Goodwill" in the accompanying condensed consolidated statements of operations

### Profit from Video Game Joint Venture

We incurred a loss from our video game joint venture in 2009 of \$1.9 million, as compared to profit of \$0.7 million in 2008, primarily due to an additional write-down of \$1.1 million as a result of the arbitration ruling which lowered the preferred return payment from a rate of 10% of net sales of the WWE video games sold by the joint venture to a rate of 6% of net sales and to legal fees of \$1.2 million which was partially offset by the joint venture's profit of \$0.4 million. Net loss for 2009 was \$0.8 million before the additional write-down to the receivable. The joint venture's



right to renew the WWE video game license expires December 31, 2009 subject to renewal through December 31, 2014. If extended, the amount of the preferred return we will receive from the joint venture after December 31, 2009 is subject to change (see “Risk Factors”, infra, and Note 16 of the Notes to Condensed Consolidated Financial Statements, supra).

#### Interest Income

Interest income in 2009 was \$28,219, as compared to \$0.7 million in 2008. The decrease is due to lower interest rates during 2009 compared to 2008 and lower average cash balances.

## Interest Expense

Interest expense was \$1.3 million in 2009, as compared to income of 2.0 million in 2008. In 2009, we booked interest expense of \$1.1 million related to our convertible senior notes payable and net interest expense of \$0.1 million related to uncertain tax positions taken or expected to be taken in a tax return. In 2008, we booked a net benefit of \$3.1 million related to uncertain tax positions taken or expected to be taken in a tax return, offset in part by interest expense of \$1.1 million related to our convertible senior notes payable.

## Provision for Income Taxes

Our income tax provision, which includes federal, state and foreign income taxes, and discrete items, was \$15.5 million, or an effective tax benefit rate of 31.5% for the three months ended September 30, 2009. During the comparable period in 2008, the income tax provision was \$5.9 million, or an effective tax provision rate of 10.1%.

In 2009, the discrete adjustments were mainly uncertain tax positions of \$4.5 million (see Note 6 of the Notes to Condensed Consolidated Financial Statements, supra). Exclusive of the discrete items, the 2009 effective tax provision rate would be 19.4%. In 2008, the discrete adjustments were mainly the 2007 income tax provision to the actual income tax liability of \$4.0 million, and the recognition of a previously recorded potential income tax liability of \$9.3 million for uncertain tax positions that are no longer subject to audit due to the closure of the audit period. Exclusive of the discrete items, the 2008 effective tax provision rate would be 36.2%.

As of September 30, 2009, the Company had net deferred tax assets of approximately \$66.7 million for which an allowance of \$3.6 million has been provided since, in the opinion of management, realization of the future benefit is uncertain.

## Comparison of the Nine Months Ended September 30, 2009 and 2008

### Net Sales

**Traditional Toys.** Net sales of our Traditional Toys segment were \$548.1 million in 2009, compared to \$583.0 million in 2008, representing a decrease of \$34.9 million, or 6.0%. The decrease in net sales was primarily due to lower unit sales of our WWE®, Narnia® and Pokemon® action figures and accessories, and other JAKKS products, including Plug It In & Play TV Games™, G2 Game Girl™ and EyeClops® electronics, Neopets®, Doodle Bears® and Care Bears® plush, Cabbage Patch Kids®, Speedstacks® and pretend play products based on Hannah Montana®, Camp Rock™ dolls, and role-play and dress-up toys, including those based on Disney classic princesses and fairies characters, Sweet Secrets, In My Pocket & Friends™, Fly Wheels®, JAKKS vehicles and junior sports products. This was offset in part by increases in unit sales of some products, including Club Penguin™, Hello Kitty® and Smurfs® plush, SpongeBob SquarePants®, Lucky BeeBee™ activities and Discovery Kids® toys and the contribution to sales from our Tollytots, Kids Only and Disguise acquisitions of \$145.0 million.

**Craft/Activity/Writing Products.** Net sales of our Craft/Activity/Writing Products were \$46.2 million in 2009, compared to \$37.3 million in 2008, representing an increase of \$8.9 million, or 27.6%. The increase in net sales was primarily due to increases in unit sales of our Girl Gourmet™, Spa Factory™ and JAKKS activity toys, offset in part by decreases in unit sales of our Creepy Crawlers® activities products, our Spinz™ writing instruments and our Pentech™ and Color Workshop® writing instruments and related products.

**Pet Products.** Net sales of our Pet Products were \$10.6 million in 2009, compared to \$13.7 million in 2008, representing a decrease of \$3.1 million, or 22.6%. The decrease is mainly attributable to the less available shelf space for pet products at some of our major customer retail stores, and lower unit sales of consumable pet products. Sales of

pet products were led by our AKG® licensed line of products.

#### Cost of Sales

Traditional Toys. Cost of sales of our Traditional Toys segment was \$413.0 million, or 75.3% of related net sales, in 2009, compared to \$375.3 million, or 64.4% of related net sales, in 2008, representing an increase of \$37.7 million, or 10.0%. This dollar increase is primarily due to charges of \$18.8 million related to the write-down of certain excess and impaired inventory and \$32.6 million related to the write-down of license advances and minimum guarantees that are not expected to be earned through sales of that licensed product. Excluding these one time charges, cost of sales decreased by \$13.7 million to \$361.6 million, or 66.0% of net sales, which primarily consisted of a decrease in product costs of \$7.0 million, which is in line with the lower volume of sales. Product costs as a percentage of sales increased primarily due to the mix of the product sold with lower product cost. Furthermore, royalty expense for our Traditional Toys segment decreased by \$8.7 million and as a percentage of net sales due to lower volume of sales and to changes in the product mix to more products with lower royalty rates or proprietary products with no royalty rates from products with higher royalty rates. Our depreciation of molds and tools increased by \$1.9 million primarily due to increased purchases of molds and tools in this segment.

Craft/Activity/Writing Products. Cost of sales of our Craft/Activity/Writing Products segment was \$34.3 million, or 74.4% of related net sales, in 2009, compared to \$20.3 million, or 54.4% of related net sales, in 2008, representing an increase of \$14.0 million, or 69.0%. This increase is partially due to charges of \$4.5 million related to the write-down of certain excess and impaired inventory and \$0.3 related to the write-down of license advances and minimum guarantees that are not expected to be earned out through sales of that licensed product. Excluding these one time charges, cost of sales increased by \$9.3 million to \$29.6 million, or 64.1% of net sales, which primarily consisted of an increase in product costs of \$6.6 million, which is in line with the higher volume of sales and higher sales of closeout product. Product costs as a percentage of net sales increased primarily due to the mix of the product sold and higher sales of closeout product. Royalty expense increased by \$2.0 million and as a percentage of net sales due to changes in the product mix to more products with higher royalty rates from products with lower royalty rates or proprietary products with no royalty rates. Our depreciation of molds and tools increased by \$0.6 million primarily due to increased purchases of molds and tools in this segment.

Pet Products. Cost of sales of our Pet Pal line of products was \$11.0 million, or 103.7% of related net sales, in 2009, compared to \$10.4 million, or 75.6% of related net sales, in 2008, representing an increase of \$0.6 million, or 5.8%. This increase is partially due to charges of \$0.8 million related to the write-down of certain excess and impaired inventory and \$0.4 related to the write-down of license advances and minimum guarantees that are not expected to be earned out through sales of that licensed product. Excluding these one time charges, cost of sales decreased by \$0.5 million to \$9.9 million, or 93.2% of net sales, which primarily consisted of a decrease in product costs of \$0.3 million, which is in line with the lower volume of sales and the higher sales of closeout product. Product costs as a percentage of net sales increased primarily due to the mix of the product sold and higher sales of closeout product. Royalty expense decreased by \$0.3 million and as a percentage of sales due to changes in the product mix to more products with lower royalty rates or proprietary products with no royalty rates from products with higher royalty rates. Our depreciation of molds and tools increased by \$0.1 million primarily due to increased purchases of molds and tools in this segment.

#### Selling, General and Administrative Expenses

Selling, general and administrative expenses were \$171.7 million in 2009 and \$157.5 million in 2008, constituting 28.4% and 18.0% of net sales, respectively. The overall increase of \$14.2 million in such costs was primarily due to the addition of overhead related to the operations of Tollytots, Kids Only and Disguise (\$29.7 million) and an increase in depreciation and amortization (\$2.3 million), offset in part by decreases in general and administrative expenses (\$3.3 million), product development (\$3.1 million), share-based compensation (\$2.7 million) and direct selling expenses (\$8.7 million). The increase in the acquired companies' overhead is mainly due to the fixed overhead and high seasonality of the Disguise acquisition, with the majority of its sales projected in the third quarter of 2009. The increase in depreciation and amortization is mainly due to an increase in amortization expensed related to intangible assets other than goodwill (\$4.0 million), offset in part by a decrease in depreciation of tangible assets. The decrease in general and administrative expenses is primarily due to decreases in bonus expense (\$7.0 million) and travel and entertainment expense (\$2.2 million), offset in part by increases in legal expense (\$1.2 million), net of insurance reimbursements, the reversal of penalty reserves (\$1.9 million) in 2008 with no such reversals in 2009, a loss incurred from disposal of molds and tools used for production of our inventory (\$2.3 million) and foreign currency expense (\$2.3 million). Product development expenses decreased as a result of tighter control of spending on product development, offset in part by higher product testing expenses. The decrease in direct selling expenses is primarily due to decreases in advertising and promotional expenses of \$5.6 million in 2009 in support of several of our product lines, sales commissions (\$1.1 million) and other direct selling expenses of \$2.1 million to support the increase in domestic sales. From time to time, we may increase or decrease our advertising efforts, if we deem it appropriate for particular products.

#### Write-down of Intangible Assets

As of June 30, 2009, we determined that the tradenames “Child Guidance,” “Play Along” and certain tradenames associated with our Crafts and Activities product lines would either be discontinued, or were under-performing. Consequently, the intangible assets associated with these tradenames were written off to “Write-down of Intangible Assets”, resulting in a non-cash charge of \$8.2 million. During the third quarter of 2008, the Company discontinued the use of the “Toymax” and “Trendmaster” tradenames on products and market these products under the JAKKS Pacific trademark. Consequently, the intangible assets associated with these tradenames were written off to Write-down of Intangible Assets, resulting in a charge of \$3.5 million. Also, the Company adjusted the value of the Child Guidance trademark to reflect lower sales expectations for this tradename, resulting in a charge to Write-down of Intangible Assets of \$5.6 million.

#### Write-down of Goodwill

During the three months ended June 30, 2009, we determined that the significant decline in our market capitalization is likely to be sustained. Our market capitalization did not change significantly despite the dismissals subject to appeal of the WWE lawsuit, and the lower revenue expectations for 2009 versus 2008 were factors that indicated that an interim goodwill impairment test was required. As a result, we determined that \$407.1 million, or all of the goodwill related to previous acquisitions, including the acquisition of Disguise in December 2008, was impaired. This amount is included in “Write-down of Goodwill” in the accompanying condensed consolidated statements of operations.

### Profit from Video Game Joint Venture

We incurred a loss from our video game joint venture in 2009 of \$21.9 million, as compared to a profit of \$4.5 million in 2008, primarily due to a cumulative \$23.5 million write-down as a result of the arbitration ruling which lowered the preferred return payment from a rate of 10% of net sales of the WWE video games sold by the joint venture to a rate of 6% of net sales and to legal fees of \$2.7 million which was partially offset by profit of \$4.4 million. Net profit for 2009 was \$1.7 million before the cumulative write-down to the receivable. The joint venture's right to renew the WWE video game license expires December 31, 2009 subject to renewal through December 31, 2014. If extended, the amount of the preferred return we will receive from the joint venture after December 31, 2009 is subject to change (see "Risk Factors", *infra*, and Note 16 of the Notes to Condensed Consolidated Financial Statements, *supra*).

### Interest Income

Interest income in 2009 was \$0.3 million, as compared to \$2.8 million in 2008. The decrease is due to lower interest rates during 2009 compared to 2008 and lower average cash balances.

### Interest Expense

Interest expense was \$3.8 million in 2009, as compared to \$1.3 million in 2008. In 2009, we booked interest expense of \$3.3 million related to our convertible senior notes payable and net interest expense of \$0.4 million related to uncertain tax positions taken or expected to be taken in a tax return. In 2008, we booked interest expense of \$3.3 million related to our convertible senior notes payable, off set in part by a net benefit of \$2.3 million related to uncertain tax positions taken or expected to be taken in a tax return.

### Provision for Income Taxes

Our income tax benefit, which includes federal, state and foreign income taxes, and discrete items, was \$82.2 million, or an effective tax benefit rate of 17.6% for the nine months ended September 30, 2009. During the comparable period in 2008, the income tax provision was \$8.7 million, or an effective tax provision rate of 12.9%.

In 2009, the impairment of goodwill and trademarks, totaling \$64.5 million, and the THQ/Jakks joint venture settlement of \$9.1 million, were reductions to the tax benefit rate realized, partially offset by discrete adjustments for uncertain tax positions of \$4.5 million (see Note 6 of the Notes to Condensed Consolidated Financial Statements, *supra*). Exclusive of the discrete items, the third quarter 2009 effective tax benefit rate would be 57.4%. In 2008, the discrete adjustments were mainly the 2007 income tax provision to the actual income tax liability of \$4.0 million, and the recognition of a previously recorded potential income tax liability of \$9.3 million for uncertain tax positions that are no longer subject to audit due to the closure of the audit period. Exclusive of the discrete items, the third quarter 2008 effective tax provision rate would be 35.4%.

As of September 30, 2009, the Company had net deferred tax assets of approximately \$66.7 million for which an allowance of \$3.6 million has been provided since, in the opinion of management, realization of the future benefit is uncertain.

### Seasonality and Backlog

The retail toy industry is inherently seasonal. Generally, our sales have been highest during the third and fourth quarters, and collections for those sales have been highest during the succeeding fourth and first fiscal quarters. Sales of writing instrument products are likewise seasonal, with sales highest during the second and third quarters, as are our Go Fly a Kite®, Fun noodle® pool toys and junior sports products, which are largely sold in the first and second

quarters. Our working capital needs have been highest during the third and fourth quarters.

While we have taken steps to level sales over the entire year, sales are expected to remain heavily influenced by the seasonality of our toy products. The result of these seasonal patterns is that operating results and demand for working capital may vary significantly by quarter. Orders placed with us for shipment are cancelable until the date of shipment. The combination of seasonal demand and the potential for order cancellation makes accurate forecasting of future sales difficult and causes us to believe that backlog may not be an accurate indicator of our future sales. Similarly, financial results for a particular quarter may not be indicative of results for the entire year.

## Liquidity and Capital Resources

As of September 30, 2009, we had working capital of \$322.5 million, compared to \$325.1 million as of December 31, 2008. This slight decrease was primarily attributable to the reclassification of our \$98.0 million convertible senior notes payable from long-term to short-term liabilities and earn-out and working capital adjustment payments related to our recent acquisitions, offset in part by our operating activities.

Operating activities provided net cash of \$11.4 million in 2009, as compared to \$13.9 million in 2008. Net cash was provided primarily by non-cash charges and changes in working capital. Our accounts receivable turnover as measured by days sales for the quarter outstanding in accounts receivable was 64 days as of September 30, 2009, an increase from 58 days as of September 30, 2008. Other than open purchase orders issued in the normal course of business, we have no obligations to purchase finished goods from our manufacturers. As of September 30, 2009, we had cash and cash equivalents of \$153.8 million.

Our investing activities used net cash of \$25.5 million in 2009, as compared to \$32.7 million in 2008, consisting primarily of cash paid for the Creative Designs earn-out of \$5.7 million, the working capital adjustment for Tollytots of \$1.8 million, the working capital adjustment for Kids Only of \$3.5 million, the working capital adjustment for Disguise of \$1.2 million, and the purchase of office furniture and equipment and molds and tooling of \$16.2 million used in the manufacture of our products, offset in part by the change in other assets of \$2.9 million. In 2008, our investing activities consisted primarily of cash paid for the Creative Designs earn-out of \$6.7 million, the Play Along earn-out of \$6.7 million, the Pet Pal earn-out of \$1.7 million and the purchase of office furniture and equipment and molds and tooling of \$17.6 million used in the manufacture of our products and other assets. As part of our strategy to develop and market new products, we have entered into various character and product licenses with royalties generally ranging from 1% to 14% payable on net sales of such products. As of September 30, 2009, these agreements required future aggregate minimum guarantees of \$104.0 million, exclusive of \$50.5 million in advances already paid. Of this \$104.0 million future minimum guarantee, \$45.6 million is due over the next twelve months.

Our financing activities used net cash of \$1.6 million in 2009, consisting of cash paid for the repurchase of restricted stock. In 2008, financing activities used net cash of \$29.0 million, consisting of cash paid for the repurchase of our common stock and restricted shares, partially offset by proceeds from the exercise of stock options.

On November 5, 2009, we announced the pricing of \$85.0 million principal amount of 4.50% convertible senior notes due 2014 (the "Notes"). The Notes are senior unsecured obligations of JAKKS, will pay interest semi-annually at a rate of 4.50% per annum and will mature on November 1, 2014. The conversion rate will initially be 63.2091 shares of JAKKS common stock per \$1,000 principal amount of notes (equivalent to an initial conversion price of approximately \$15.82 per share of common stock), subject to adjustment in certain circumstances. Prior to August 1, 2014, holders of the Notes may convert their Notes only upon specified events. Upon conversion, the Notes may be settled, at our election, in cash, shares of its common stock, or a combination of cash and shares of its common stock. Holders of the Notes may require us to repurchase for cash all or some of their Notes upon the occurrence of a fundamental change (as defined). We anticipate closing the offering of the Notes on November 10, 2009. We also granted the initial purchaser of the Notes a 30-day option to purchase up to an additional \$15.0 million in principal amount of additional Notes to cover over-allotments, if any, which they advised us they were exercising for the full \$15.0 million.

We intend to use the net proceeds from the offering, along with cash on hand, to repurchase all or a portion of its 4.625% convertible senior notes due 2023. In the event we are unable to repurchase such Notes on satisfactory terms, we may use such proceeds for general corporate purposes.

No assurance can be given that this proposed financing will be consummated on these or any other terms.



In October 2008, we acquired substantially all of the assets of Tollytots Limited. The total initial consideration of \$25.7 million consisted of \$12.0 million in cash and the assumption of liabilities in the amount of \$13.7 million, and resulted in goodwill of \$3.1 million. In addition, we agreed to pay an earn-out of up to an aggregate amount of \$5.0 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. Tollytots is a leading designer and producer of licensed baby dolls and baby doll pretend play accessories based on well-known brands and was included in our results of operations from the date of acquisition. Pro forma results of operations are not provided since the amounts are not material to the consolidated results of operations.

In October 2008, we acquired all of the stock of Kids Only, Inc. and a related Hong Kong company, Kids Only Limited (collectively, "Kids Only"). The total initial consideration of \$23.3 million consisted of \$20.4 million in cash and the assumption of liabilities in the amount of \$2.9 million, and resulted in goodwill of \$12.7 million. In addition, we agreed to pay an earn-out of up to an aggregate amount of \$5.6 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. Kids Only is a leading designer and producer of licensed indoor and outdoor kids' furniture, and has an extensive portfolio which also includes baby dolls and accessories, room décor and a myriad of other children's toy products and was included in our results of operations from the date of acquisition. Pro forma results of operations are not provided since the amounts are not material to the consolidated results of operations.

In December 2008, we acquired certain assets of Disguise, Inc. and a related Hong Kong company, Disguise Limited (collectively, "Disguise"). The total initial consideration of \$60.6 million consisted of \$38.6 million in cash and the assumption of liabilities in the amount of \$22.0 million, and resulted in goodwill of \$30.6 million. We have not finalized its purchase price allocation for Disguise and have engaged a third party to perform studies and valuations of the estimated fair value of assets and liabilities assumed. Disguise is a leading designer and producer of Halloween and everyday costume play and was included in our results of operations from the date of acquisition. Pro forma results of operations are not provided since the amounts are not material to the consolidated results of operations.

In September 2003, we sold an aggregate of \$98.0 million of 4.625% Convertible Senior Notes due September 15, 2023 and received net proceeds of approximately \$94.4 million. The notes are convertible into shares of our common stock at an initial conversion price of \$20.00 per share, or 50 shares per note, subject to certain circumstances. The notes may be converted in each quarter subsequent to any quarter in which the closing price of our common stock is at or above a prescribed price for at least 20 trading days in the last 30 trading day period of the quarter. The prescribed price for the conversion trigger is \$24.00 through September 30, 2010, and increases nominally each quarter thereafter. Cash interest is payable at an annual rate of 4.625% of the principal amount at issuance, from the issue date to June 15, 2010, payable on June 15 and December 15 of each year. After June 15, 2010, interest will accrue on the outstanding notes until maturity. At maturity, we will redeem the notes at their accreted principal amount, which will be equal to \$1,811.95 (181.195%) per \$1,000 principal amount at issuance, unless redeemed or converted earlier. The notes were not convertible as of September 30, 2009 and are not convertible during the fourth quarter of 2009.

We may redeem the notes at our option in whole or in part beginning on June 15, 2010, at 100% of their accreted principal amount plus accrued and unpaid interest, if any, payable in cash. Holders of the notes may also require us to repurchase all or part of their notes on June 15, 2010, for cash, at a repurchase price of 100% of the principal amount per note plus accrued and unpaid interest, if any. Accordingly, the notes have been reclassified as a short-term liability as of September 30, 2009. Holders of the notes may also require us to repurchase all or part of their notes on June 15, 2013 and June 15, 2018 at a repurchase price of 100% of the accreted principal amount per note plus accrued and unpaid interest, if any, and may be paid in cash, in shares of common stock or a combination of cash and shares of common stock.

We believe that our cash flow from operations and cash and cash equivalents on hand will be sufficient to meet our working capital and capital expenditure requirements and provide us with adequate liquidity to meet our anticipated operating needs for at least the next 12 months. Although operating activities are expected to provide cash, to the extent we grow significantly in the future, our operating and investing activities may use cash and, consequently, this growth may require us to obtain additional sources of financing. There can be no assurance that any necessary additional financing will be available to us on commercially reasonable terms, if at all. We intend to finance our long-term liquidity requirements out of net cash provided by operations and cash on hand.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk represents the risk of loss that may impact our financial position, results of operations or cash flows due to adverse changes in financial and commodity market prices and rates. We are exposed to market risk in the areas of changes in United States and international borrowing rates and changes in foreign currency exchange rates. In addition, we are exposed to market risk in certain geographic areas that have experienced or remain vulnerable to an economic downturn, such as China. We purchase substantially all of our inventory from companies in China, and, therefore, we are subject to the risk that such suppliers will be unable to provide inventory at competitive prices. While we believe that, if such an event were to occur we would be able to find alternative sources of inventory at competitive prices, we cannot assure you that we would be able to do so. These exposures are directly related to our normal operating and funding activities. Historically, we have not used derivative instruments or engaged in hedging activities to minimize our market risk.

#### Interest Rate Risk

In June 2003, we issued convertible senior notes payable of \$98.0 million with a fixed interest rate of 4.625% per annum, which remain outstanding as of September 30, 2009. Accordingly, we are not generally subject to any direct risk of loss arising from changes in interest rates.

#### Foreign Currency Risk

We have wholly-owned subsidiaries in Hong Kong, China and the United Kingdom. Sales made by the Hong Kong subsidiaries are denominated in U.S. dollars. However, purchases of inventory are typically denominated in Hong Kong dollars and local operating expenses are denominated in the local currency of the subsidiary, thereby creating exposure to changes in exchange rates. Changes in the local currency/U.S. dollar exchange rates may positively or negatively affect our operating results. We do not believe that near-term changes in these exchange rates, if any, will result in a material effect on our future earnings, fair values or cash flows, and therefore, we have chosen not to enter into foreign currency hedging transactions. We cannot assure you that this approach will be successful, especially in the event of a significant and sudden change in the value of the Hong Kong dollar or Chinese Yuan relative to the U.S. dollar. We incorporated a subsidiary in the United Kingdom in late 2008 and have limited operations and, therefore, we have a nominal currency translation risk at this time.

### Item 4. Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Report, have concluded that as of that date, our disclosure controls and procedures were effective. There were no changes in our internal control over financial reporting identified in connection with the evaluation required by Exchange Act Rule 13a-15(d) that occurred during the period covered by this Report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II  
OTHER INFORMATION

Item 1. Legal Proceedings

On October 19, 2004, we were named as defendants in a lawsuit commenced by WWE in the U.S. District Court for the Southern District of New York concerning our toy licenses with WWE and the video game license between WWE and the joint venture company operated by THQ and us, encaptioned World Wrestling Entertainment, Inc. v. JAKKS Pacific, Inc., et al., 1:04-CV-08223-KMK (the "WWE Action"). The complaint also named as defendants THQ, the joint venture, certain of our foreign subsidiaries, Jack Friedman (our Chairman and Co-Chief Executive Officer), Stephen Berman (our Co-Chief Executive Officer, President and Secretary and a member of our Board of Directors), Joel Bennett (our Executive Vice President and Chief Financial Officer), Stanley Shenker and Associates, Inc., Bell Licensing, LLC, Stanley Shenker and James Bell.

WWE sought treble, punitive and other damages (including disgorgement of profits) in an undisclosed amount and a declaration that the video game license with the joint venture, which is scheduled to expire in 2009 (subject to the joint venture's right to extend that license for an additional five years), and an amendment to our toy licenses with WWE, which are scheduled to expire in 2009, are void and unenforceable. This action alleged violations by the defendants of the Racketeer Influenced and Corrupt Organization Act ("RICO") and the anti-bribery provisions of the Robinson-Patman Act, and various claims under state law. On November 30, 2007, the Court indicated that the WWE Action would be dismissed. On December 21, 2007 the Court dismissed the WWE Action with prejudice (the "December 2007 Order") based on (1) the failure to plead RICO injury; (2) the bar of the RICO statute of limitations; (3) the denial of WWE's motion for reconsideration of the Sherman Act claim; and (4) the lack of subject matter jurisdiction with respect to the pendent state law claims. Thereafter, WWE filed an appeal to the Second Circuit Court of Appeals. We filed a motion for reconsideration of the part of the December 2007 Order that stated that the January 2004 release executed by WWE in favor of the Company (the "Release") did not bar the WWE Action. That motion was fully briefed and submitted to the Court. In September 2008, the Court granted the motion and held that the applicability of the Release would not be determined in connection with the motion to dismiss the action. On May 19, 2009, the Second Circuit Court of Appeals unanimously affirmed dismissal of the WWE Action on statute of limitations grounds. No further appeal was taken such that the Second Circuit order ended the WWE Action.

In November 2004, several purported class action lawsuits were filed in the United States District Court for the Southern District of New York: (1) Garcia v. JAKKS Pacific, Inc. et al., Civil Action No. 04-8807 (filed on November 5, 2004), (2) Jonco Investors, LLC v. JAKKS Pacific, Inc. et al., Civil Action No. 04-9021 (filed on November 16, 2004), (3) Kahn v. JAKKS Pacific, Inc. et al., Civil Action No. 04-8910 (filed on November 10, 2004), (4) Quantum Equities L.L.C. v. JAKKS Pacific, Inc. et al., Civil Action No. 04-8877 (filed on November 9, 2004), and (5) Irvine v. JAKKS Pacific, Inc. et al., Civil Action No. 04-9078 (filed on November 16, 2004) (the "Class Actions"). The complaints in the Class Actions alleged that defendants issued positive statements concerning increasing sales of our WWE licensed products which were false and misleading because the WWE licenses had allegedly been obtained through a pattern of commercial bribery, our relationship with the WWE was being negatively impacted by the WWE's contentions and there was an increased risk that the WWE would either seek modification or nullification of the licensing agreements with us. Plaintiffs also alleged that we misleadingly failed to disclose the alleged fact that the WWE licenses were obtained through an unlawful bribery scheme. The plaintiffs in the Class Actions were described as purchasers of our common stock, who purchased from as early as October 26, 1999 to as late as October 19, 2004. The Class Actions sought compensatory and other damages in an undisclosed amount, alleging violations of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 promulgated thereunder by each of the defendants (namely the Company and Messrs. Friedman, Berman and Bennett), and violations of Section 20(a) of the Exchange Act by Messrs. Friedman, Berman and Bennett. On January 25, 2005, the Court consolidated the Class Actions under the caption In re JAKKS Pacific, Inc. Shareholders Class Action Litigation, Civil Action No. 04-8807.

On May 11, 2005, the Court appointed co-lead counsels and provided until July 11, 2005 for an amended complaint to be filed; and a briefing schedule thereafter with respect to a motion to dismiss. The motion to dismiss was fully briefed and argument occurred on November 30, 2006. The motion was granted in January 2008 to the extent that the Class Actions were dismissed without prejudice to plaintiffs' right to seek leave to file an amended complaint based on statements that the WWE licenses were obtained from the WWE as a result of the long-term relationship with WWE. A motion seeking leave to file an amended complaint was granted and an amended complaint filed. Briefing was completed with respect to a motion to dismiss that was scheduled for argument in October 2008. The Court adjourned the argument date. The parties have notified the Court that an agreement to resolve this action has been reached. The agreement, which is subject to Court approval, will settle the matter for \$3.9 million, without any admission of liability on the part of the Company, or its officers and directors.

On December 2, 2004, a shareholder derivative action was filed in the Southern District of New York by Freeport Partner, LLC against us, nominally, and against Messrs. Friedman, Berman and Bennett, Freeport Partners v. Friedman, et al., Civil Action No. 04-9441 (the "Derivative Action"). The Derivative Action seeks to hold the individual defendants liable for damages allegedly caused to us by their actions and in particular to hold them liable on a contribution theory with respect to any liability we incur in connection with the Class Actions. On or about February 10, 2005, a second shareholder derivative action was filed in the Southern District of New York by David Oppenheim against us, nominally, and against Messrs. Friedman, Berman, Bennett, Blatte, Glick, Miller and Skala, Civil Action 05-2046 (the "Second Derivative Action"). The Second Derivative Action seeks to hold the individual defendants liable for damages allegedly caused to us by their actions as a result of alleged breaches of their fiduciary duties. On or about March 16, 2005, a third shareholder derivative action was filed. It is captioned Warr v. Friedman, Berman, Bennett, Blatte, Glick, Miller, Skala, and JAKKS (as a nominal defendant), and it was filed in the Superior Court of California, Los Angeles County (the "Third Derivative Action"). The Third Derivative Action seeks to hold the individual defendants liable for (1) damages allegedly caused to us by their alleged breaches of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment; and (2) restitution to us of profits, benefits and other compensation obtained by them. Stays and/or extensions of time to answer are in place with respect to the derivative actions, and have been dismissed without prejudice. Agreement to resolve the Derivative Actions has been reached, but it is subject to Court approval. A Company insurer has agreed to provide the \$4.1 million that will be used to settle the Class Action and the Derivative Actions.

On March 1, 2005, we delivered a Notice of Breach of Settlement Agreement and Demand for Indemnification to WWE (the "Notification"). The Notification asserted that WWE's filing of the WWE Action violated a Covenant Not to Sue contained in a January 15, 2004 Settlement Agreement and General Release ("General Release") entered into between WWE and us and, therefore, that we were demanding indemnification, pursuant to the Indemnification provision contained in the General Release, for all losses that the WWE's actions have caused or will cause to us and our officers, including but not limited to any losses sustained by us in connection with the Class Actions. On March 4, 2005, in a letter from its outside counsel, WWE asserted that the General Release does not cover the claims in the WWE Action.

On March 30, 2006, WWE's counsel wrote a letter alleging breaches by the joint venture of the video game agreement relating to the manner of distribution and the payment of royalties to WWE with respect to sales of the WWE video games in Japan. WWE has demanded that the alleged breaches be cured within the time periods provided in the video game license, while reserving all of its rights, including its alleged right of termination of the video game license.

On April 28, 2006 the joint venture responded, asserting, among other things, that WWE had acquiesced in the manner of distribution in Japan and the payment of royalties with respect to such sales and, in addition, had separately released the joint venture from any claims with respect to such matter, including the payment of royalties with respect to such sales, and that there is therefore no basis for an allegation of a breach of the license agreement. While the joint venture does not believe that WWE has a valid claim, it tendered a protective "cure" of the alleged breaches with a full reservation of rights. WWE "rejected" that cure and reserved its rights.

On October 12, 2006, WWE commenced a lawsuit in Connecticut state court against THQ and THQ/JAKKS Pacific LLC (the "LLC"), involving a claim set forth above concerning allegedly improper sales of WWE video games in Japan and other countries in Asia (the "Connecticut Action"). The lawsuit seeks, among other things, a declaration that WWE is entitled to terminate the video game license and monetary damages and raised Connecticut Unfair Trade Practices Act ("CUTPA") and contract claims against THQ and the LLC. A motion to strike the CUTPA claim was denied in May 2007. Cross-motions for summary judgment were filed. Discovery issues arose, a Court conference to address issues relating to discovery occurred on August 4, 2009, and a further order of the Court is expected.

In March 2007, WWE filed a motion seeking leave to amend its complaint in the Connecticut Action to add the principal part of the state law claims present in the WWE Action to the Connecticut Action. That motion further sought, inter alia, to add our Company and Messrs. Friedman, Berman and Bennett (the "Individual Defendants") as defendants in the Connecticut Action. The motion was argued on May 8, 2007 and was granted from the bench, subject to a decision that the schedule was suspended and no discovery matters would be addressed until pleading motions were resolved. In June 2007, our Company and the Individual Defendants moved for a stay of the Connecticut Action, inter alia, based on the pendency of the WWE Action. On July 30, 2007, in light of the pending motion to dismiss in the WWE Action, the Court ordered a 120-day stay of the Connecticut Action (the "Stay"). In November 2007 we moved for a continuation of the Stay. WWE served discovery and sought leave to file an amended complaint alleging the state law claims from the WWE Action. Thereafter we moved for a conference and a stay of discovery. A conference was held on January 14, 2008 at which WWE was allowed to amend its complaint to assert the state law claims set forth in the WWE Action and a briefing schedule was established with respect to a combined motion to strike and a motion for summary judgment (the "Dispositive Motion"). This motion was briefed and argument was held on May 19, 2008. WWE cross-moved for partial summary judgment striking our Release defense. In August 2008, the Dispositive Motion was granted. WWE filed a motion for reargument which was denied. Thereafter, WWE filed an appeal. This appeal was assigned to the Connecticut Supreme Court. Briefing on the appeal was completed in September 2009, with argument to be held at a date still to be determined. In July 2008, THQ filed a cross-complaint which asserts claims by THQ and Mr. Farrell for indemnification from the Company in the event that WWE prevails on any of its claims against THQ and Farrell and also asserts claims by THQ that the Company breached its fiduciary duties to THQ in connection with the videogame license between WWE and THQ/JAKKS Pacific LLC and seeks equitable and legal relief, including substantial monetary and exemplary damages against the Company in connection with this claim. The Company requested that THQ revise its claims and THQ objected to this request. The Company moved to sever and stay the cross-claims pending WWE's appeal of its dismissed claims to which the cross-claims relate. That motion has been fully briefed and submitted for decision unless the Court deems argument necessary. On July 31, 2009, the Company withdrew the request to revise and moved for summary judgment and to strike the cross-complaint. This matter has not yet been resolved. In the event the Company does not prevail in having THQ's cross-claims summarily dismissed, the Company intends to vigorously contest them.

We believe that the claims in the Connecticut Action are without merit and we intend to defend vigorously against them. However, because this action is subject to appeal, we cannot assure you as to the outcome of the action, nor can we estimate the range of our potential losses. THQ and the LLC have stated that they believe the claims in the Connecticut Action prior to the additional claims in the amended complaint are without merit and have filed an opposition to WWE's motion for partial summary judgment and filed a motion for summary judgment dismissing the remaining claims in the Connecticut Action as a matter of law on multiple grounds and they intend to continue to defend themselves vigorously. In connection with the above motion and cross-motions for summary judgment, discovery issues arose and, as set forth above, were addressed at a court conference on August 4, 2009, and a further Court order is expected. However, because this action is in its preliminary stage, we cannot assure you as to the outcome, nor can we estimate the range of our potential losses, if any.

Our agreement with THQ provides for payment of a preferred return to us in connection with our joint venture. The preferred return was subject to change after June 30, 2006 and was to be set for the distribution period beginning July 1, 2006 and ending December 31, 2009 (the "Next Distribution Period"). The agreement provides that the parties will negotiate in good faith and agree to the preferred return not less than 180 days prior to the start of the Next Distribution Period. It further provides that if the parties are unable to agree on a preferred return, the preferred return will be determined by arbitration. The parties were unable to reach an agreement with respect to the preferred return for the Next Distribution Period and the preferred return was submitted for determination through arbitration. On July 24, 2009, a decision was rendered by the arbitrator setting the preferred return rate at 6%. That decision was made final and payment of the preferred return was made by THQ for the period from July 1, 2006 through June 30, 2009.

In order to exercise the joint venture's right to renew the WWE videogame license for the renewal period running from January 1, 2010 through December 31, 2014, the Company, on behalf of the joint venture, sent out a Notice of Renewal to WWE on June 30, 2009 (the "Renewal Notice"). THQ has commenced an action in California Superior Court (the "California Action") seeking a declaratory judgment that JAKKS cannot renew the videogame license without THQ's consent and that THQ is not obligated to consent. THQ also seeks a declaratory judgment that the restrictive covenant contained in the joint venture agreement is unenforceable. The Company has filed a demurrer in the California Action which has been fully briefed and will be argued on November 16, 2009. THQ has brought a summary judgment motion seeking a declaration that the restrictive covenant is not enforceable. In the event that the demurrer is not granted, the Company has sought an adjournment of THQ's summary judgment motion pending discovery. WWE has also commenced an action in California seeking the same relief as THQ, namely, to declare THQ's restrictive covenant unenforceable, and the Company has filed a demurrer seeking to dismiss the action on the grounds that WWE has no standing and the relief is otherwise not available. THQ also filed an arbitration in California seeking a declaratory judgment that the same restrictive covenant is unenforceable (the "California Arbitration"). The Company commenced an arbitration in New York (the "New York Arbitration") seeking, among other things, a declaratory judgment that (a) it is empowered to serve the Renewal Notice and (b) THQ's restrictive covenant is enforceable. In the New York Arbitration, the Company also seeks to hold THQ liable for its breach of fiduciary duty with respect to its dealings with the Company and the LLC. The Company also commenced an action in New York Supreme Court to enjoin the California Arbitration. The application to enjoin the California Arbitration has been argued and is awaiting decision. The Company has requested of the American Arbitration Association that the New York Arbitration proceed and the California Arbitration not proceed and those proceedings have been successively adjourned by stipulation between the parties.

While the parties have been in contact with each other to begin negotiations with respect to the Preferred Return for the Distribution Period beginning January 1, 2010 and ending December 31, 2014 (the "Renewal Distribution Period"), no agreement has been reached to date with respect to the preferred return to us in connection with the Renewal Distribution Period.

We are a party to, and certain of our property is the subject of, various other pending claims and legal proceedings that routinely arise in the ordinary course of our business, but we do not believe that any of these claims or proceedings



will have a material effect on our business, financial condition or results of operations.

## Item 1A. Risk Factors

From time to time, including in this Quarterly Report on Form 10-Q, we publish forward-looking statements, as disclosed in our Disclosure Regarding Forward-Looking Statements beginning immediately following the Table of Contents of this Report. We note that a variety of factors could cause our actual results and experience to differ materially from the anticipated results or other expectations expressed or anticipated in our forward-looking statements. The factors listed below are the risks and uncertainties that may arise and that may be detailed from time to time in our public announcements and our filings with the Securities and Exchange Commission, such as on Forms 8-K, 10-Q and 10-K. We undertake no obligation to make any revisions to the forward-looking statements contained in this Report to reflect events or circumstances occurring after the date of the filing of this report.

The outcome of litigation in which we have been named as a defendant is unpredictable and a materially adverse decision in any such matter could have a material adverse affect on our financial position and results of operations.

We are defendants in litigation matters, as described under “Legal Proceedings” in our periodic reports filed pursuant to the Securities Exchange Act of 1934, including the Connecticut Action commenced by WWE (see “Legal Proceedings”). These claims may divert financial and management resources that would otherwise be used to benefit our operations. Although we believe that we have meritorious defenses to the claims made in each and all of the litigation matters to which we have been named a party, and intend to contest each lawsuit vigorously, no assurances can be given that the results of these matters will be favorable to us. A materially adverse resolution of any of these lawsuits could have a material adverse effect on our financial position and results of operations.

Our inability to redesign, restyle and extend our existing core products and product lines as consumer preferences evolve, and to develop, introduce and gain customer acceptance of new products and product lines, may materially and adversely impact our business, financial condition and results of operations.

Our business and operating results depend largely upon the appeal of our products. Our continued success in the toy industry will depend on our ability to redesign, restyle and extend our existing core products and product lines as consumer preferences evolve, and to develop, introduce and gain customer acceptance of new products and product lines. Several trends in recent years have presented challenges for the toy industry, including:

- Age Compression: The phenomenon of children outgrowing toys at younger ages, particularly in favor of interactive and high technology products;
- Increasing use of technology;
- Shorter life cycles for individual products; and
- Higher consumer expectations for product quality, functionality and value.

We cannot assure you that:

- our current products will continue to be popular with consumers;
- the product lines or products that we introduce will achieve any significant degree of market acceptance; or
- the life cycles of our products will be sufficient to permit us to recover licensing, design, manufacturing, marketing and other costs associated with those products.

Our failure to achieve any or all of the foregoing benchmarks may cause the infrastructure of our operations to fail, thereby adversely affecting our business, financial condition and results of operations.

The failure of our character-related and theme-related products to become and/or remain popular with children may materially and adversely impact our business, financial condition and results of operations.

The success of many of our character-related and theme-related products depends on the popularity of characters in movies, television programs, live wrestling exhibitions, auto racing events and other media. We cannot assure you that:

- media associated with our character-related and theme-related product lines will be released at the times we expect or will be successful;
- the success of media associated with our existing character-related and theme-related product lines will result in substantial promotional value to our products;
- we will be successful in renewing licenses upon expiration on terms that are favorable to us; or
- we will be successful in obtaining licenses to produce new character-related and theme-related products in the future.

Our failure to achieve any or all of the foregoing benchmarks may cause the infrastructure of our operations to fail, thereby adversely affecting our business, financial condition and results of operations.

There are risks associated with our license agreements.

- Our current licenses require us to pay minimum royalties

Sales of products under trademarks or trade or brand names licensed from others account for substantially all of our net sales. Product licenses allow us to capitalize on characters, designs, concepts and inventions owned by others or developed by toy inventors and designers. Our license agreements generally require us to make specified minimum royalty payments, even if we fail to sell a sufficient number of units to cover these amounts. In addition, under certain of our license agreements, if we fail to achieve certain prescribed sales targets, we may be unable to retain or renew these licenses.

- Some of our licenses are restricted as to use

Under the majority of our license agreements the licensors have the right to review and approve our use of their licensed products, designs or materials before we may make any sales. If a licensor refuses to permit our use of any licensed property in the way we propose, or if their review process is delayed, our development or sale of new products could be impeded.

- New licenses are difficult and expensive to obtain

Our continued success will depend substantially on our ability to obtain additional licenses. Intensive competition exists for desirable licenses in our industry. We cannot assure you that we will be able to secure or renew significant licenses on terms acceptable to us. In addition, as we add licenses, the need to fund additional royalty advances and guaranteed minimum royalty payments may strain our cash resources.

- A limited number of licensors account for a large portion of our net sales

We derive a significant portion of our net sales from a limited number of licensors. If one or more of these licensors were to terminate or fail to renew our license or not grant us new licenses, our business, financial condition and results of operations could be adversely affected.

The toy industry is highly competitive and our inability to compete effectively may materially and adversely impact our business, financial condition and results of operations.

The toy industry is highly competitive. Globally, certain of our competitors have financial and strategic advantages over us, including:

- greater financial resources;
- larger sales, marketing and product development departments;
- stronger name recognition;
- longer operating histories; and
- greater economies of scale.

In addition, the toy industry has no significant barriers to entry. Competition is based primarily on the ability to design and develop new toys, to procure licenses for popular characters and trademarks and to successfully market products. Many of our competitors offer similar products or alternatives to our products. Our competitors have obtained and are likely to continue to obtain licenses that overlap our licenses with respect to products, geographic areas and markets. We cannot assure you that we will be able to obtain adequate shelf space in retail stores to support our existing products or to expand our products and product lines or that we will be able to continue to compete effectively against current and future competitors.

An adverse outcome in the litigation commenced against us and against our video game joint venture with THQ by WWE, or with respect to the extension of the joint venture's license, or a decline in the popularity of WWE, could adversely impact our interest in that joint venture.

The joint venture with THQ depends entirely on a single license, which gives the venture exclusive worldwide rights to produce and market video games based on World Wrestling Entertainment characters and themes. An adverse outcome against us, THQ or the joint venture in the lawsuit commenced by WWE, or an adverse outcome against THQ or the joint venture in the lawsuit commenced by WWE against THQ and the joint venture (see the first Risk Factor, above, and "Legal Proceedings"), would adversely impact our rights under the joint venture's single license, which would adversely affect the joint venture's and our business, financial condition and results of operation.

As disclosed in "Legal Proceedings" there are several proceedings relating to renewal of the joint venture's license from WWE with respect to the period January 1, 2010 through December 31, 2014. If the extension is determined to be invalid and the license expires on December 31, 2009, our business, financial condition and results of operations will be adversely affected commencing in fiscal 2010.

Furthermore, the popularity of professional wrestling, in general, and World Wrestling Entertainment, in particular, is subject to changing consumer tastes and demands. The relative popularity of professional wrestling has fluctuated significantly in recent years. A decline in the popularity of World Wrestling Entertainment could adversely affect the joint venture's and our business, financial condition and results of operations.

The termination of THQ's manufacturing licenses and the inability of the joint venture to otherwise obtain these licenses from other manufacturers would materially adversely affect the joint venture's and our business, financial condition and results of operations.

The joint venture relies on hardware manufacturers and THQ's non-exclusive licenses with them for the right to publish titles for their platforms and for the manufacture of the joint venture's titles. If THQ's manufacturing licenses were to terminate and the joint venture could not otherwise obtain these licenses from other manufacturers, the joint venture would be unable to publish additional titles for these manufacturers' platforms, which would materially adversely affect the joint venture's and our business, financial condition and results of operations.

The failure of the joint venture or THQ to perform as anticipated could have a material adverse affect on our financial position and results of operations.

The joint venture's failure to timely develop titles for new platforms that achieve significant market acceptance, to maintain net sales that are commensurate with product development costs or to maintain compatibility between its personal computer CD-ROM titles and the related hardware and operating systems would adversely affect the joint venture's and our business, financial condition and results of operations.

Furthermore, THQ controls day-to-day operations of the joint venture and all of its product development and production operations. Accordingly, the joint venture relies exclusively on THQ to manage these operations

effectively. THQ's failure to effectively manage the joint venture would have a material adverse effect on the joint venture's and our business and results of operations. We are also dependent upon THQ's ability to manage cash flows of the joint venture. If THQ is required to retain cash for operations, or because of statutory or contractual restrictions, we may not receive cash payments for our share of profits, on a timely basis, or at all.

The amount of preferred return that we now receive from the joint venture is subject to change, which could adversely affect our results of operations.

The joint venture agreement and the arbitration determination (see Note 17) provide for us to receive guaranteed preferred returns for the period from July 1, 2006 through December 31, 2009 at 6% of the joint venture's net sales. The preferred return is subject to change after December 31, 2009 and is to be set for the distribution period beginning January 1, 2010 and ending December 31, 2014 (the "Renewal Distribution Period"). The agreement provides that the parties will negotiate in good faith and agree to the preferred return not less than 180 days prior to the start of the Renewal Distribution Period. It further provides that if the parties are unable to agree on a preferred return, the preferred return will be determined by arbitration. To date the parties have not reached an agreement with respect to the preferred return for the Renewal Distribution Period.

Any adverse change to the preferred return for the Renewal Distribution Period as well as the ongoing performance of the joint venture may result in our experiencing reduced net income, which would adversely affect our results of operations.

We may not be able to sustain or manage our rapid growth, which may prevent us from continuing to increase our net revenues.

We have experienced rapid growth in our product lines resulting in higher net sales over the last nine years, which was achieved through acquisitions of businesses, products and licenses. For example, revenues associated with companies we acquired since 2006 were approximately \$10.5 million and \$145.0 million, for the year ended December 31, 2008 and the nine months ended September 30, 2009, respectively, representing 1.2% and 24.0% of our total revenues for those periods. As a result, comparing our period-to-period operating results may not be meaningful and results of operations from prior periods may not be indicative of future results. We cannot assure you that we will continue to experience growth in, or maintain our present level of, net sales.

Our growth strategy calls for us to continuously develop and diversify our toy business by acquiring other companies, entering into additional license agreements, refining our product lines and expanding into international markets, which will place additional demands on our management, operational capacity and financial resources and systems. The increased demand on management may necessitate our recruitment and retention of qualified management personnel. We cannot assure you that we will be able to recruit and retain qualified personnel or expand and manage our operations effectively and profitably. To effectively manage future growth, we must continue to expand our operational, financial and management information systems and to train, motivate and manage our work force. There can be no assurance that our operational, financial and management information systems will be adequate to support our future operations. Failure to expand our operational, financial and management information systems or to train, motivate or manage employees could have a material adverse effect on our business, financial condition and results of operations.

In addition, implementation of our growth strategy is subject to risks beyond our control, including competition, market acceptance of new products, changes in economic conditions, our ability to obtain or renew licenses with commercially reasonable terms and our ability to finance increased levels of accounts receivable and inventory necessary to support our sales growth, if any. Accordingly, we cannot assure you that our growth strategy will continue to be implemented successfully.

If we are unable to acquire and integrate companies and new product lines successfully, we will be unable to implement a significant component of our growth strategy.

Our growth strategy depends in part upon our ability to acquire companies and new product lines. Revenues associated with our acquisitions since 2006 represented approximately 1.2% and 24.0% of our total revenues for the year ended December 31, 2008 and the nine months ended September 30, 2009, respectively. Future acquisitions will succeed only if we can effectively assess characteristics of potential target companies and product lines, such as:

- attractiveness of products;
- suitability of distribution channels;
- management ability;
- financial condition and results of operations; and



- the degree to which acquired operations can be integrated with our operations.

We cannot assure you that we can identify attractive acquisition candidates or negotiate acceptable acquisition terms, and our failure to do so may adversely affect our results of operations and our ability to sustain growth. Our acquisition strategy involves a number of risks, each of which could adversely affect our operating results, including:

- difficulties in integrating acquired businesses or product lines, assimilating new facilities and personnel and harmonizing diverse business strategies and methods of operation;
- diversion of management attention from operation of our existing business;
- loss of key personnel from acquired companies; and
- failure of an acquired business to achieve targeted financial results.

A limited number of customers account for a large portion of our net sales, so that if one or more of our major customers were to experience difficulties in fulfilling their obligations to us, cease doing business with us, significantly reduce the amount of their purchases from us or return substantial amounts of our products, it could have a material adverse effect on our business, financial condition and results of operations.

Our three largest customers accounted for 52.5% and 56.5% of our net sales for the nine months ended September 30, 2009 and the year ended December 31, 2008, respectively. Except for outstanding purchase orders for specific products, we do not have written contracts with or commitments from any of our customers. A substantial reduction in or termination of orders from any of our largest customers could adversely affect our business, financial condition and results of operations. In addition, pressure by large customers seeking price reductions, financial incentives, changes in other terms of sale or for us to bear the risks and the cost of carrying inventory also could adversely affect our business, financial condition and results of operations. If one or more of our major customers were to experience difficulties in fulfilling their obligations to us, cease doing business with us, significantly reduce the amount of their purchases from us or return substantial amounts of our products, it could have a material adverse effect on our business, financial condition and results of operations. In addition, the bankruptcy or other lack of success of one or more of our significant retailers could negatively impact our revenues and bad debt expense.

We depend on our key personnel and any loss or interruption of either of their services could adversely affect our business, financial condition and results of operations.

Our success is largely dependent upon the experience and continued services of Jack Friedman, our Chairman and Co-Chief Executive Officer, and Stephen G. Berman, our President and Co-Chief Executive Officer and Chief Operating Officer. We cannot assure you that we would be able to find an appropriate replacement for Mr. Friedman or Mr. Berman if the need should arise, and any loss or interruption of Mr. Friedman's or Mr. Berman's services could adversely affect our business, financial condition and results of operations.

We depend on third-party manufacturers, and if our relationship with any of them is harmed or if they independently encounter difficulties in their manufacturing processes, we could experience product defects, production delays, cost overruns or the inability to fulfill orders on a timely basis, any of which could adversely affect our business, financial condition and results of operations.

We depend on many third-party manufacturers who develop, provide and use the tools, dies and molds that we own to manufacture our products. However, we have limited control over the manufacturing processes themselves. As a result, any difficulties encountered by the third-party manufacturers that result in product defects, production delays, cost overruns or the inability to fulfill orders on a timely basis could adversely affect our business, financial condition and results of operations.

We do not have long-term contracts with our third-party manufacturers. Although we believe we could secure other third-party manufacturers to produce our products, our operations would be adversely affected if we lost our relationship with any of our current suppliers or if our current suppliers' operations or sea or air transportation with our overseas manufacturers were disrupted or terminated even for a relatively short period of time. Our tools, dies and molds are located at the facilities of our third-party manufacturers.

Although we do not purchase the raw materials used to manufacture our products, we are potentially subject to variations in the prices we pay our third-party manufacturers for products, depending on what they pay for their raw materials.

We have substantial sales and manufacturing operations outside of the United States subjecting us to risks common to international operations.

We sell products and operate facilities in numerous countries outside the United States. For the nine months ended September 30, 2009 and the year ended December 31, 2008 sales to our international customers comprised approximately 17.5% and 17.9%, respectively, of our net sales. We expect our sales to international customers to account for a greater portion of our revenues in future fiscal periods. Additionally, we utilize third-party manufacturers located principally in China which are subject to the risks normally associated with international operations, including:

- currency conversion risks and currency fluctuations;
- limitations, including taxes, on the repatriation of earnings;
- political instability, civil unrest and economic instability;
- greater difficulty enforcing intellectual property rights and weaker laws protecting such rights;
- complications in complying with laws in varying jurisdictions and changes in governmental policies;
- greater difficulty and expenses associated with recovering from natural disasters;
- transportation delays and interruptions;
- the potential imposition of tariffs; and
- the pricing of intercompany transactions may be challenged by taxing authorities in both Hong Kong and the United States, with potential increases in income taxes.

Our reliance on external sources of manufacturing can be shifted, over a period of time, to alternative sources of supply, should such changes be necessary. However, if we were prevented from obtaining products or components for a material portion of our product line due to medical, political, labor or other factors beyond our control, our operations would be disrupted while alternative sources of products were secured. Also, the imposition of trade sanctions by the United States against a class of products imported by us from, or the loss of “normal trade relations” status by China, could significantly increase our cost of products imported from that nation. Because of the importance of our international sales and international sourcing of manufacturing to our business, our financial condition and results of operations could be significantly and adversely affected if any of the risks described above were to occur.

Our business is subject to extensive government regulation and any violation by us of such regulations could result in product liability claims, loss of sales, diversion of resources, damage to our reputation, increased warranty costs or removal of our products from the market, and we cannot assure you that our product liability insurance for the foregoing will be sufficient.

Our business is subject to various laws, including the Federal Hazardous Substances Act, the Consumer Product Safety Act, the Flammable Fabrics Act and the rules and regulations promulgated under these acts. These statutes are administered by the Consumer Products Safety Commission (“CPSC”), which has the authority to remove from the market products that are found to be defective and present a substantial hazard or risk of serious injury or death. The CPSC can require a manufacturer to recall, repair or replace these products under certain circumstances. We cannot assure you that defects in our products will not be alleged or found. Any such allegations or findings could result in:

- product liability claims;
- loss of sales;
- diversion of resources;
- damage to our reputation;
- increased warranty and insurance costs; and
- removal of our products from the market.

Any of these results may adversely affect our business, financial condition and results of operations. There can be no assurance that our product liability insurance will be sufficient to avoid or limit our loss in the event of an adverse outcome of any product liability claim.

We depend on our proprietary rights, and our inability to safeguard and maintain the same, or claims of third parties that we have violated their intellectual property rights, could have a material adverse effect on our business, financial condition and results of operations.

We rely on trademark, copyright and trade secret protection, nondisclosure agreements and licensing arrangements to establish, protect and enforce our proprietary rights in our products. The laws of certain foreign countries may not protect intellectual property rights to the same extent or in the same manner as the laws of the United States. We cannot assure you that we or our licensors will be able to successfully safeguard and maintain our proprietary rights. Further, certain parties have commenced legal proceedings or made claims against us based on our alleged patent infringement, misappropriation of trade secrets or other violations of their intellectual property rights. We cannot assure you that other parties will not assert intellectual property claims against us in the future. These claims could divert our attention from operating our business or result in unanticipated legal and other costs, which could adversely affect our business, financial condition and results of operations.

Market conditions and other third-party conduct could negatively impact our margins and implementation of other business initiatives.

Economic conditions, such as rising fuel prices, increased competition and decreased consumer confidence, may adversely impact our margins. Such a weakened economic and business climate could create uncertainty and adversely affect our sales and profitability. Other conditions, such as the unavailability of electronics components, may impede our ability to manufacture, source and ship new and continuing products on a timely basis. Significant

and sustained increases in the price of oil could adversely impact the cost of the raw materials used in the manufacture of our products, such as plastic.

We may not have the funds necessary to purchase our outstanding convertible senior notes upon a fundamental change or other purchase date, as required by the indenture governing the notes.

On September 15, 2010, September 15, 2013 and September 15, 2018, holders of our convertible senior notes may require us to purchase their notes, which repurchase may be made for cash. In addition, holders may also require us to purchase their notes for cash upon the occurrence of certain fundamental changes in our board composition or ownership structure, if we liquidate or dissolve under certain circumstances or if our common stock ceases being quoted on an established over-the-counter trading market in the United States. If we do not have, or have access to, sufficient funds to repurchase the notes, then we could be forced into bankruptcy. In fact, we expect that we would require third-party financing, but we cannot assure you that we would be able to obtain that financing on favorable terms or at all.

We have a history of making acquisitions which resulted in material amounts of goodwill. Any future acquisitions may also result in material amounts of goodwill which, if it becomes impaired, would result in a reduction in our net income.

Goodwill is the amount by which the cost of an acquisition exceeds the fair value of the net assets we acquire. Current accounting standards require that goodwill no longer be amortized but instead be periodically evaluated for impairment based on the fair value of the reporting unit. As of June 30, 2009, we have recognized a 100% impairment of our goodwill, for a non-cash charge to income of \$407.1 million. Any goodwill associated with future acquisitions is subject to the same impairment risk.

Item 4. Submission of Matters to a Vote of Security Holders

We mailed a Proxy Statement on or about August 19, 2009 to our stockholders of record as of July 31, 2009 in connection with our 2009 Annual Meeting of Stockholders, which was held on September 25, 2009 at the Sherwood Country Club, 320 West Stafford Road, Thousand Oaks, California, 91361. At the Meeting, the stockholders voted on two matters, both of which were approved.

The first matter was the election of the members of the Board of Directors. The seven directors elected and the tabulation of the votes (both in person and by proxy) was as follows:

Nominees for	For	Against	Withheld
Directors			
Jack Friedman	23,185,555	0	848,888
Stephen G. Berman	23,351,507	0	682,936
Dan Almagor	21,613,843	0	2,420,600
David C. Blatte	23,586,219	0	448,224
Robert E. Glick	23,534,312	0	500,131
Michael G. Miller	23,536,341	0	498,102
Murray L. Skala	21,039,315	0	2,995,128

There were no broker held non-voted shares represented at the Meeting with respect to this matter.

The second matter upon which the stockholders voted was the proposal to ratify the appointment by the Board of Directors of BDO Seidman, LLP, as our independent certified public accountants for 2009. The tabulation of the votes (both in person and by proxy) was as follows:

For	Against	Abstentions
23,963,162	65,217	6,064

There were no broker held non-voted shares represented at the Meeting with respect to this matter.

Item 6. Exhibits

Number	Description
3.1	Amended and Restated Certificate of Incorporation of the Company(1)
3.2.1	By-Laws of the Company(2)
3.2.2	Amendment to By-Laws of the Company(3)
4.1	Indenture, dated as of September 9, 2003, by and between the Registrant and Wells Fargo Bank, N.A.(4)
4.2	Form of 4.625% Convertible Senior Note(4)
18	Auditor Preferability Letter(5)
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer(5)
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer(5)
31.3	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer(5)
32.1	Section 1350 Certification of Chief Executive Officer(5)
32.2	Section 1350 Certification of Chief Executive Officer(5)
32.3	Section 1350 Certification of Chief Financial Officer(5)

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- (1) Filed previously as Appendix 2 to the Company's Schedule 14A Proxy Statement filed August 23, 2002 and incorporated herein by reference.
- (2) Filed previously as an exhibit to the Company's Registration Statement on Form SB-2 (Reg. No. 333-2048-LA), effective May 1, 1996, and incorporated herein by reference.
- (3) Filed previously as an exhibit to the Company's Registration Statement on Form SB-2 (Reg. No. 333-22583), effective May 1, 1997, and incorporated herein by reference.
- (4) Filed previously as an exhibit to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, filed on August 14, 2003, and incorporated herein by reference.
- (5) Filed herewith.



SIGNATURES

Pursuant to the requirements 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.

JAKKS PACIFIC, INC.

Date: November 9, 2009

By: /s/ JOEL M. BENNETT  
Joel M. Bennett  
Executive Vice President and Chief Financial Officer  
(Duly Authorized Officer and Principal Financial Officer)

EXHIBIT INDEX

Number	Description
3.1	Amended and Restated Certificate of Incorporation of the Company(1)
3.2.1	By-Laws of the Company(2)
3.2.2	Amendment to By-Laws of the Company(3)
4.1	Indenture, dated as of September 9, 2003, by and between the Registrant and Wells Fargo Bank, N.A.(4)
4.2	Form of 4.625% Convertible Senior Note(4)
18	Auditor Preferability Letter(5)
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer(5)
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer(5)
31.3	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer(5)
32.1	Section 1350 Certification of Chief Executive Officer(5)
32.2	Section 1350 Certification of Chief Executive Officer(5)
32.3	Section 1350 Certification of Chief Financial Officer(5)

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- (1) Filed previously as Appendix 2 to the Company's Schedule 14A Proxy Statement filed August 23, 2002 and incorporated herein by reference.
- (2) Filed previously as an exhibit to the Company's Registration Statement on Form SB-2 (Reg. No. 333-2048-LA), effective May 1, 1996, and incorporated herein by reference.
- (3) Filed previously as an exhibit to the Company's Registration Statement on Form SB-2 (Reg. No. 333-22583), effective May 1, 1997, and incorporated herein by reference.
- (4) Filed previously as an exhibit to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, filed on August 14, 2003, and incorporated herein by reference.
- (5) Filed herewith.