

JAKKS PACIFIC INC
Form 10-K
March 02, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Fiscal Year Ended December 31, 2008

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

For the transition period from _____ to _____

Commission File Number 0-28104

JAKKS PACIFIC, INC.

(Exact name of registrant as specified in its charter)

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

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

Title of each class	Name of each exchange on which registered
Common Stock, \$.001 par value per share	Nasdaq Global Select

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

Title of Class

Common Stock, \$.001 par value per share

Edgar Filing: JAKKS PACIFIC INC - Form 10-K

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15 of the Act. Yes No

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

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

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

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer Small Reporting Company
(Do not check if a 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

The aggregate market value of the voting and non-voting common equity (the only such common equity being Common Stock, \$.001 par value per share) held by non-affiliates of the registrant (computed by reference to the closing sale price of the Common Stock on February 27, 2009 of \$12.67) is \$345,211,090.

The number of shares outstanding of the registrant's Common Stock, \$.001 par value (being the only class of its common stock), is 27,934,231 (as of February 27, 2009).

Documents Incorporated by Reference

None.

JAKKS PACIFIC, INC.

INDEX TO ANNUAL REPORT ON FORM 10-K

For the Fiscal Year ended December 31, 2008

Items in Form 10-K

	Page
PART I	
Item 1. Business	2
Item 1A. Risk Factors	11
Item 1B. Unresolved Staff Comments	None
Item 2. Properties	18
Item 3. Legal Proceedings	18
Item 4. Submission of Matters to a Vote of Security Holders	None
PART II	
Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	22
Item 6. Selected Financial Data	25
Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations	26
Item 7A. Quantitative and Qualitative Disclosures About Market Risk	36
Item 8. Financial Statements and Supplementary Data	37
Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	None
Item 9A. Controls and Procedures	62
Item 9B. Other Information	None
PART III	
Item 10. Directors, Executive Officers and Corporate Governance	64
Item 11. Executive Compensation	66
Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	77
Item 13. Certain Relationships and Related Transactions, and Director Independence	79
Item 14. Principal Accountant Fees and Services	79
PART IV	
Item 15. Exhibits and Financial Statement Schedules	81
Signatures	83
Certifications	87

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" or "expect," we are making forward-looking statements. We believe that the assumptions and expectations reflected in such forward-looking statements are reasonable, 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 have disclosed certain important factors that could cause our actual results to differ materially from our current expectations elsewhere in this report. You should understand that forward-looking

statements made in this report are necessarily qualified by these factors. 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.

PART I

Item 1. Business

In this report, “JAKKS,” the “Company,” “we,” “us” and “our” refer to JAKKS Pacific, Inc. and its subsidiaries.

Company Overview

We are a leading multi-line, multi-brand toy company that designs, produces, markets and distributes toys and related products, writing instruments and related products, pet toys, consumables and related products, electronics and related products, and other consumer products. We focus our business on acquiring or licensing well-recognized trademarks and brand names, most with long product histories (“evergreen brands”). We seek to acquire these evergreen brands because we believe they are less subject to market fads or trends. We also develop proprietary products marketed under our own trademarks and brand names. Our products are typically lower-priced toys and accessories, and include:

Traditional Toys

- Action figures and accessories, including licensed characters, principally based on World Wrestling Entertainment ® (“WWE”), The Chronicles of Narnia: Prince Caspian™ and Pokemon® franchises;
- Toy vehicles, including Road Champs®, RC Racers™ and MXS® toy vehicles and accessories, as well as those based on Nascar®;
- Electronics products, including Plug It In & Play TV Games™, EyeClops™ Bionic Eye products, and Laser Challenge®, as well as others based on Disney® and Discovery Kids® brands;
- Role-play, dress-up and novelty products featuring entertainment and consumer products properties such as Dirt Devil®, Subway®, Pizza Hut® and McDonalds® pretend play products, Disney Princess®, Hannah Montana™, Barbie® and Dora the Explorer® playsets for girls and Black & Decker® and Pirates of the Caribbean™ playsets for boys;
- Infant and pre-school toys and plush toys featuring Care Bears®, Barney®, The Wiggles®, and slumber bags;
- Dolls including large, fashion and mini dolls and related accessories based on Cabbage Patch Kids®, Hannah Montana, Puppy in My Pocket and Friends™ and Disney Princess® dolls and private label fashion dolls for other retailers;
- Seasonal and outdoor toys and leisure products, including Go Fly A Kite®, Air Creations®, and other kites, Funnoodle® pool toys, The Storm® water guns and Fly Wheels® XPV® and Flight™ vehicles; and
- Junior sports and toy paintball products, including Gaksplat® and The Storm;
- Baby dolls and baby doll pretend play accessories based on well-known licensed brands including Graco®, Fischer Price® and Disney Princess®;
- Licensed and non-licensed indoor and outdoor kids’ furniture, accessories and room décor; and
- Innovative Halloween and everyday costumes based on licensed and non-licensed brands including Spiderman®, Power Rangers® and Disney Princesses®, and stylized Home Décor product lines for

Halloween.

Prior to 2007, we had accounted for seasonal and outdoor products as a separate category. During 2007, we restructured our internal operations and have consolidated this product group within the Traditional category. These products share key characteristics, including common management, distribution and marketing strategies. We have restated our prior segment reporting to reflect this change.

Craft, Activity and Writing Products

- Craft, activity and stationery products, including Flying Colors® activity sets, compounds, playsets and lunch boxes based on Nickelodeon®, Dora the Explorer, Pokémon and others, and Color Workshop® craft products such as Blopens®, Vivid Velvet®, and Pentech® writing instruments, stationery and activity products, and non-licensed brands including Girl Gourmet™ and The Spa Factory™.

2

Pet Products

- Pet products, including toys, consumables, beds, clothing and accessories, with licenses used in conjunction with these products, including American Kennel Club®, The Cat Fanciers' Association™, Arm & Hammer® and The Humane Society of the United States® brands, as well as entertainment properties, including Disney, and private label brands.

We continually review the marketplace to identify and evaluate evergreen brands that we believe have the potential for significant growth. We endeavor to generate growth within these brands by:

- creating innovative products under established brand names;
- focusing our marketing efforts to enhance consumer recognition and retailer interest;
- linking them with our evergreen portfolio of brands;
- adding new items to the branded product lines that we expect will enjoy greater popularity; and
- adding simple innovation and technology to make them more appealing to today's kids.

Our Business Strategy

In addition to developing our proprietary brands and marks, licensing popular brands enables us to use these high-profile marks at a lower cost than we would incur if we purchased these marks or developed comparable marks on our own. By licensing marks, we have access to a far greater range of marks than would be available for purchase. We also license technology produced by unaffiliated inventors and product developers to improve the design and functionality of our products.

We have obtained an exclusive worldwide license for our joint venture with THQ Inc. ("THQ"), which develops, publishes and distributes video games based on WWE characters and themes. Since the joint venture's first title release in 1999, it has released 41 new titles. We have recognized approximately \$110.4 million in profit from the joint venture through December 31, 2008. We and the joint venture are named as defendants in lawsuits commenced by WWE, pursuant to which WWE is seeking 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 and an amendment to our toy licenses with WWE are void and unenforceable (see "Legal Proceedings").

We sell our products through our in-house sales staff and independent sales representatives to toy and mass-market retail chain stores, department stores, office supply stores, drug and grocery store chains, club stores, toy specialty stores and wholesalers. Our three largest customers are Wal-Mart, Target and Toys 'R' Us, which account for approximately 30.1%, 13.2% and 13.2%, respectively, of our net sales in 2008. No other customer accounted for more than 10.0% of our net sales in 2008.

Our Growth Strategy

The execution of our growth strategy has resulted in increased levels of revenues and earnings. In 2007 and 2008, we generated net sales of \$857.1 million and \$903.4 million, respectively, and net income of \$89.0 million and \$76.1 million, respectively. Approximately 1.4% and 1.2% of our increased net sales in 2007 and 2008, respectively, were attributable to our acquisitions since 2006. Key elements of our growth strategy include:

- **Expand Core Products.** We manage our existing and new brands through strong product development initiatives, including introducing new products, modifying existing products and extending existing product lines to maximize their longevity. Our marketing teams and product designers strive to develop new products or product lines to offer added technological, aesthetic and functional improvements to our extensive portfolio. We use multiple methods including real-scan technology, articulated joints and a flexible rubberized coating to enhance the life-like feel of our action toys, and expanded to classic characters and special techniques such as vinyl figures. These innovations appeal to collectors and/or produce higher quality and better likenesses of the representative characters.
- **Enter New Product Categories.** We use our extensive experience in the toy and other consumer product industries to evaluate products and licenses in new product categories and to develop additional product lines. We began marketing licensed classic video games for simple plug-in use with television sets and expanded into several related categories through the licensing of this category from our current licensors, such MTV Networks which owns Nickelodeon .
- **Pursue Strategic Acquisitions.** We intend to supplement our internal growth with selected strategic acquisitions. Most recently, in February 2006, we acquired the business of Creative Designs International, Ltd., a leading manufacturer of girls' dress-up and role-play toys, in October 2008 we acquired the businesses of Tollytots Limited, a leading manufacturer of licensed baby doll accessories and Kids Only, a leading manufacturer of licensed indoor and outdoor kids' furniture and in December 2008, we acquired the business of Disguise, Inc. a leading Halloween costume and home décor company. We will continue focusing our acquisition strategy on businesses or brands that have compatible product lines and offer valuable trademarks or brands.

- **Acquire Additional Character and Product Licenses.** We have acquired the rights to use many familiar corporate, trade and brand names and logos from third parties that we use with our primary trademarks and brands. Currently, among others, we have license agreements with WWE, Nickelodeon, Disney®, and Warner Bros®, as well as with the licensors of the many popular licensed children's characters previously mentioned, among others. We intend to continue to pursue new licenses from these entertainment and media companies and other licensors. We also intend to continue to purchase additional inventions and product concepts through our existing network of product developers.
- **Expand International Sales.** We believe that foreign markets, especially Europe, Australia, Canada, Latin America and Asia, offer us significant growth opportunities. In 2008, our sales generated outside the United States were approximately \$161.9 million, or 17.9% of total net sales. We intend to continue to expand our international sales by establishing a sales office and distribution center and capitalizing on our experience and our relationships with foreign distributors and retailers. We expect these initiatives to continue to contribute to our international growth in 2009.
- **Capitalize On Our Operating Efficiencies.** We believe that our current infrastructure and operating model can accommodate significant growth without a proportionate increase in our operating and administrative expenses, thereby increasing our operating margins.

The execution of our growth strategy, however, is subject to several risks and uncertainties and we cannot assure you that we will continue to experience growth in, or maintain our present level of, net sales (see "Risk Factors," beginning on page 12). For example, our growth strategy 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 additional 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.

Moreover, 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 on commercially reasonable terms and our ability to finance increased levels of accounts receivable and inventory necessary to support our sales growth, if any.

Furthermore, 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.

Finally, 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.

Recent Acquisitions

On October 7, 2008, we acquired substantially all of the assets of Tollytots Limited. The total initial consideration of \$25.5 million consisted of \$11.8 million in cash and the assumption of liabilities in the amount of \$13.7 million, and resulted in goodwill of \$3.0 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.

On October 8, 2008, we acquired substantially 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 \$23.2 million consisted of \$20.3 million in cash and the assumption of liabilities in the amount of \$2.9 million, and resulted in goodwill of \$12.5 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.

On December 29, 2008, we acquired certain assets of Disguise, Inc. and a related Hong Kong company, Disguise Limited (collectively, "Disguise"). The total initial consideration of \$61.9 million consisted of \$39.9 million in cash and the assumption of liabilities in the amount of \$22.0 million, and resulted in goodwill of \$51.6 million. We have not finalized our purchase price allocation for Disguise and will engage a third party to perform studies and valuations to 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.

Industry Overview

According to Toy Industry Association, Inc., the leading toy industry trade group, the United States is the world's largest toy market, followed by Japan and Western Europe. Total retail sales of toys, excluding video games, in the United States, were approximately \$21.6 billion in 2008. We believe the two largest United States toy companies, Mattel and Hasbro, collectively hold a dominant share of the domestic non-video toy market. In addition, hundreds of smaller companies compete in the design and development of new toys, the procurement of character and product licenses, and the improvement and expansion of previously introduced products and product lines. In the United States video game segment, total retail sales of video game software were approximately \$11.0 billion in 2008.

Over the past few years, the toy industry has experienced substantial consolidation among both toy companies and toy retailers. We believe that the ongoing consolidation of toy companies provides us with increased growth opportunities due to retailers' desire to not be entirely dependent on a few dominant toy companies. Retailer concentration also enables us to ship products, manage account relationships and track retail sales more effectively and efficiently.

Products

We focus our business on acquiring or licensing well-recognized trademarks or brand names, and we seek to acquire evergreen brands which are less subject to market fads or trends. Generally, our license agreements for products and concepts call for royalties ranging from 1% to 14% of net sales, and some may require minimum guarantees and advances. Our principal products include:

Traditional Toys

Electronics Products

Our electronic products category includes our Plug It In & Play TV Games, EyeClops™ Bionic Eye products and Laser Challenge® product lines. Our current Plug It In & Play TV Games titles include licenses from Namco®, Disney, Marvel® and Nickelodeon, and feature such games as SpongeBob SquarePants®, Dora the Explorer, Disney Princess®, Ms. Pac-Man® and Pac-Man®.

We regularly release new Plug It In & Play TV Games titles for the pre-school and leisure gamer segments including Wheel of Fortune®, Deal or No Deal®, Jeopardy®, Sesame Street® and Thomas the Tank™.

Wheels Division Products

- Toy and activity vehicles

Our toy vehicle line includes toy and activity vehicles and other toys. We also produce radio controlled vehicles. Our toy vehicle line is comprised of an assortment of rugged die-cast and plastic vehicles that range in size from four-and three-quarter inch to big-wheeled seventeen inch vehicles. The breadth of the line is extensive, with themes ranging from emergency, fire, farm and construction, to racing and jungle adventure.

- Road Champs ® die-cast collectible and toy vehicles

The Road Champs product line consists of highly detailed, die-cast replicas of new and classic cars, trucks, motorcycles, emergency vehicles and service vehicles, primarily in 1/43 scale (including police cars, fire trucks and ambulances), buses and aircraft. Through licenses, we produce replicas of well-known vehicles including those from Ford®, Chevrolet® and Porsche®. We believe that these licenses increase the perceived value of the products and enhance their marketability.

- Extreme sports die-cast collectibles and toy vehicles and action figures

Our extreme sports offerings include our MXS line of motorcycles with riders, off-road vehicles, personal watercraft, surfboards and skateboards, which are sold individually and with playsets and accessories.

Action Figures and Accessories

We have an extensive toy license with the WWE pursuant to which we have the right, until December 31, 2009, to develop and market a full line of toy products based on the popular WWE professional wrestlers. These wrestlers perform throughout the year at live events that attract large crowds, many of which are broadcast on free and cable television, including pay-per-view specials. We launched this product line in 1996 with various series of 6 inch articulated action figures that have movable body parts. We continually expand and enhance this product line by using technology in the development and in the products themselves. The 6 inch figures currently make up a substantial portion of our overall WWE line, which has since grown to include many other new products including playsets. Our strategy has been to release new figures and accessories frequently and to offer many exclusive programs to our retail partners to keep the line fresh and relevant to WWE's television programming, and to retain the interest of the consumers.

We also develop, manufacture and distribute other action figures and action figure accessories including those based on the animated series Pokemon, and the Disney feature film The Chronicles of Narnia: Prince Caspian. In 2009, we expect to launch a line of action figures and accessories based on Ultimate Fighting Championship and in 2010, a product line of action figures and accessories based on TNA (“Total Non-stop Action”) wrestling.

Role-play and Dress-up Products

Our line of role-play and dress-up products features entertainment and consumer products properties such as Disney Princess, Hannah Montana and Dora the Explorer for girls and Black & Decker and Pirates of the Caribbean for boys. These products generated a significant amount of sales in 2008, and we expect that level of sales to continue in 2009.

Infant and Pre-school Toys

Our pre-school toys include plush and electronic toys based on Care Bears, The Wiggles, Barney licenses and more, some branded under Child Guidance ® and others under Play Along ®.

- Slumber bags

Our line of children’s indoor slumber bags features Dora the Explorer, SpongeBob SquarePants and Pokémon brands, in addition to our own proprietary designs.

Dolls

Dolls include large, fashion and mini dolls and related accessories based on Cabbage Patch Kids®, Hannah Montana, The Cheetah Girls, Puppy in My Pocket and Friends, Hairspray the movie and Disney Princess dolls and private label fashion dolls for other retailers and sold to Disney Stores and Disney Parks and Resorts.

Seasonal/ Outdoor Products

We have a wide range of seasonal toys and outdoor and leisure products. Our Go Fly A Kite product line includes youth and adult kites and a wide array of decorative flags, windsocks, and windwheels. Our Funnoodle pool toys include the basic Funnoodle pool floats and a variety of other pool toys. Our The Storm product line includes water guns, gliders and sport balls. Another outdoor product is our Fly Wheels XPV and Flight, extensions of our original Fly Wheels vehicle line.

Junior Sports Products

Our junior sports products include Gaksplat, toy paintball products and The Storm, which include a variety of mini sport balls and activity products.

Baby Dolls and Baby Doll Pretend Play Accessories

We have an extensive line of licensed baby dolls and baby doll pretend play accessories based on Graco®, Fischer-Price®, Disney Princess® and other known brands. The high-quality realistic-looking lines feature baby doll strollers, high chairs, bouncers, play yards, doll swings, travel seats and travel bags, along with other accessories that emulate real baby products that mothers today use.

Indoor and Outdoor Kids’ Furniture

We produce licensed indoor and outdoor kids' furniture, with an extensive portfolio which includes baby dolls and accessories and room decor. Our licensed portfolio includes character licenses, including Disney Princesses® Toy Story®, Mickey Mouse®, High School Musical®, SpongeBob Squarepants®, Dora the Explorer®, Batman® and many others, as well as several licenses new to JAKKS' portfolio. Products include children's puzzle furniture, tables and chairs to activity sets, trays, stools and more,

6

Halloween and Everyday Costume Play

We produce Halloween costume and décor with an expansive and innovative line which includes non-licensed Halloween costumes based on everything from horror, pirates, historical figures and aliens to animals, vampires, angels and more, as well as popular licensed characters from top intellectual property owners including Disney®, Marvel®, Sesame Workshop®, Mattel®, and many others.

Craft, Activity and Writing Products

We market products into the toy activity category which contain a broad range of activities, such as make and paint your own characters, jewelry making, art studios, posters, puzzles and other projects. These activities, which feature popular characters, such as Nickelodeon's Dora the Explorer, among others, have immediate visual appeal and brand recognition. Our product lines also include stationery, back-to-school and office pens, pencils, markers, notebooks and craft products such as Blopens and Vivid Velvet activities. These products are primarily marketed under our Flying Colors and Pentech brands, in addition to various private label and other brands.

Pet Products

We entered the Pet Products category with our acquisition of Pet Pal, whose products include pet toys, treats, beds, clothes and related pet products. These products are marketed under JAKKS Pets™ and licenses include American Kennel Club, The Cat Fanciers' Association, Bratz®, Disney and Marvel, as well as numerous other entertainment and consumer product properties.

World Wrestling Entertainment Video Games

In June 1998, we formed a joint venture with THQ, a developer, publisher and distributor of interactive entertainment software for the leading hardware game platforms in the home video game market. The joint venture entered into a license agreement with the WWE under which it acquired the exclusive worldwide right to publish WWE video games on all hardware platforms. The term of the license agreement expires on December 31, 2009, and the joint venture has a right to renew the license for an additional five years provided that there is an absence of a material breach of the license agreement and that certain royalty minimums are met. Those minimums have been met. We and the joint venture are named as defendants in lawsuits commenced by WWE, pursuant to which WWE is claiming that there have been material breaches with respect to the video game license and is seeking 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 and an extension of our toy licenses with WWE are void and unenforceable (see "Legal Proceedings").

The games are designed, developed, manufactured and distributed by or through THQ. THQ arranges for the manufacture of the CD-ROMs and game cartridges used in the various video game platforms under non-exclusive licenses with Sony, Nintendo and Microsoft. No other licenses are required for the manufacture of the personal computer titles.

The joint venture agreement provides for us to have received 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 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. Since the parties have not reached an agreement with respect to the preferred return for the Next Distribution Period, the preferred return for the Next distribution Period is to be determined through arbitration. The preferred return is accrued in the quarter in which the licensed games are sold and the

preferred return is earned. Based on the same rates as set forth under the original joint venture agreement, an estimated receivable of \$52.8 million has been accrued for the period from July 1, 2006 to December 31, 2008, pending the resolution of this outstanding issue. JAKKS seeks to retain the same rates as set forth under the original joint venture agreement, while THQ seeks to pay a substantially lower rate. In the event the arbitration results in a lower rate to us, there would be a material charge to earnings and reduction in the receivable from THQ.

7

Edgar Filing: JAKKS PACIFIC INC - Form 10-K

The joint venture currently publishes titles for the Sony, Nintendo and Microsoft consoles, Sony® and Nintendo® hand-held platforms, mobile/wireless and personal computers. It will also publish titles for new hardware platforms when, and as they are introduced to the market and have established a sufficient installed base to support new software. These titles are marketed to our existing customers as well as to game, electronics and other specialty stores, such as Electronics Boutique and Best Buy.

The following table presents our results with the joint venture since its inception:

	New Game Titles		Profit from video game joint venture (1) (In millions)
	Console Platforms	Hand- held Platforms	
1999	1	1	\$ 3.6
2000	4	1	15.9
2001	1	2	6.7
2002	3	1	8.0
2003	5	—	7.4
2004	2	1	7.9
2005	3	1	9.4
2006	2	1	13.2
2007	4	2	21.2
2008	4	2	17.1

-
- (1) Profit from the video game joint venture reflects our preferred return on joint venture revenue less certain costs incurred directly by us and payments made by us to THQ for their share of the profit on Plug It In & Play TV Games based on WWE content.

Wrestling video games have demonstrated consistent popularity. We believe that the success of WWE titles is dependent on the graphic look and feel of the software, the depth and variation of game play and the popularity of WWE. We believe that as a franchise property, WWE titles have brand recognition and sustainable consumer appeal, which may allow the joint venture to use titles over an extended period of time through the release of sequels and extensions and to re-release such products at different price points in the future.

Sales, Marketing and Distribution

We sell all of our products through our own in-house sales staff and independent sales representatives to toy and mass-market retail chain stores, department stores, office supply stores, drug and grocery store chains, club stores, toy specialty stores and wholesalers. Our three largest customers are Wal-Mart, Target and Toys 'R' Us, which accounted for approximately 58.5% of our net sales in 2007 and 56.5% of our net sales in 2008. With the addition of the Pet Pal® product line, we began to distribute pet products to key pet supply retailers Petco and Petsmart in addition to many other pet retailers and our existing customers. Except for purchase orders relating to products on order, we do not have written agreements with our customers. Instead, we generally sell products to our customers pursuant to letters of credit or, in some cases, on open account with payment terms typically varying from 30 to 90 days. From time to time, we allow our customers credits against future purchases from us in order to facilitate their retail markdown and sales of slow-moving inventory. We also sell our products through e-commerce sites, including Toysrus.com and Amazon.com.

We contract the manufacture of most of our products to unaffiliated manufacturers located in The People's Republic of China ("China"). We sell the finished products on a letter of credit basis or on open account to our customers, many of whom take title to the goods in Hong Kong or China. These methods allow us to reduce certain operating costs and working capital requirements. A portion of our sales originate in the United States, so we hold certain inventory in our warehouse and fulfillment facilities. To date, a significant portion of all of our sales has been to domestic customers. We intend to continue expanding distribution of our products into foreign territories and, accordingly, we have:

- engaged representatives to oversee sales in certain territories,
- engaged distributors in certain territories,
- established direct relationships with retailers in certain territories, and
- expanded in-house resources dedicated to product development and marketing of our lines internally.

Outside of the United States, we currently sell our products primarily in Europe, Australia, Canada, Latin America and Asia. Sales of our products abroad accounted for approximately \$126.1 million, or 14.7% of our net sales, in 2007 and approximately \$161.9 million, or 17.9% of our net sales, in 2008. We believe that foreign markets present an attractive opportunity, and we plan to intensify our marketing efforts and further expand our distribution channels abroad.

We establish reserves for sales allowances, including promotional allowances and allowances for anticipated defective product returns, at the time of shipment. The reserves are determined as a percentage of net sales based upon either historical experience or on estimates or programs agreed upon by our customers and us.

We obtain, directly, or through our sales representatives, orders for our products from our customers and arrange for the manufacture of these products as discussed below. Cancellations generally are made in writing, and we take appropriate steps to notify our manufacturers of these cancellations. We may incur costs or other losses as a result of cancellations.

We maintain a full-time sales and marketing staff, many of whom make on-site visits to customers for the purpose of showing product and soliciting orders for products. We also retain a number of independent sales representatives to sell and promote our products, both domestically and internationally. Together with retailers, we occasionally test the consumer acceptance of new products in selected markets before committing resources to large-scale production.

We publicize and advertise our products in trade and consumer magazines and other publications, market our products at international, national and regional toy, stationery and other specialty trade shows, conventions and exhibitions and carry on cooperative advertising programs with toy and mass market retailers and other customers which include the use of print and television ads and in-store displays. We also produce and broadcast television commercials for several of our product lines, including our WWE action figure line, Disney large role playsets, Plug It In & Play TV Games, Puppy in My Pocket and Friends, EyeClops, Hannah Montana and Cabbage Patch Kids. We may also advertise some of our other products on television, if we expect that the resulting increase in our net sales will justify the relatively high cost of television advertising.

Product Development

Each of our product lines has an in-house manager responsible for product development. The in-house manager identifies and evaluates inventor products and concepts and other opportunities to enhance or expand existing product lines or to enter new product categories. In addition, we create proprietary products to fully exploit our concept and character licenses. Although we do have the capability to create and develop products from inception to production, we generally use third-parties to provide a portion of the sculpting, sample making, illustration and package design required for our products in order to accommodate our increasing product innovations and introductions. Typically, the development process takes from three to nine months from concept to production and shipment to our customers.

We employ a staff of designers for all of our product lines. We occasionally acquire our other product concepts from unaffiliated third parties. If we accept and develop a third party's concept for new toys, we generally pay a royalty on the toys developed from this concept that are sold, and may, on an individual basis, guarantee a minimum royalty. In addition, we engage third party developers to program our line of Plug it in & Play TV Games. Royalties payable to inventors and developers generally range from 1% to 2.5% of the wholesale sales price for each unit of a product sold by us. We believe that utilizing experienced third-party inventors gives us access to a wide range of development talent. We currently work with numerous toy inventors and designers for the development of new products and the enhancement of existing products.

Safety testing of our products is done at the manufacturers' facilities by quality control personnel employed by us or by independent third-party contractors engaged by us. Safety testing is designed to meet or exceed regulations imposed by federal and state, as well as applicable international governmental authorities, our retail partners, licensors and the Toy Industry Association. We also closely monitor quality assurance procedures for our products for safety purposes. In addition, independent laboratories engaged by some of our larger customers and licensors test certain of our products.

Manufacturing and Supplies

Most of our products are currently produced by overseas third-party manufacturers, which we choose on the basis of quality, reliability and price. Consistent with industry practice, the use of third-party manufacturers enables us to avoid incurring fixed manufacturing costs, while maximizing flexibility, capacity and production technology. Substantially all of the manufacturing services performed overseas for us are paid for on open account with the manufacturers. To date, we have not experienced any material delays in the delivery of our products; however, delivery schedules are subject to various factors beyond our control, and any delays in the future could adversely affect our sales. Currently, we have ongoing relationships with over eighty different manufacturers. We believe that alternative sources of supply are available to us, although we cannot be assured that we can obtain adequate supplies of manufactured products.

Although we do not conduct the day-to-day manufacturing of our products, we are extensively involved in the design of the product prototype and production tools, dyes and molds for our products and we seek to ensure quality control by actively reviewing the production process and testing the products produced by our manufacturers. We employ quality control inspectors who rotate among our manufacturers' factories to monitor the production of substantially all of our products.

The principal raw materials used in the production and sale of our toy products are plastics, zinc alloy, plush, printed fabrics, paper products and electronic components, all of which are currently available at reasonable prices from a variety of sources. Although we do not manufacture our products, we own the tools, dies and molds used in the manufacturing process, and these are transferable among manufacturers if we choose to employ alternative manufacturers. Tools, dyes and molds represent a substantial portion of our property and equipment with a net book value of \$14.4 million in 2007 and \$19.6 million in 2008. Substantially all of these assets are located in China.

Trademarks and Copyrights

Most of our products are produced and sold under trademarks owned by or licensed to us. We typically register our properties, and seek protection under the trademark, copyright and patent laws of the United States and other countries where our products are produced or sold. These intellectual property rights can be significant assets. Accordingly, while we believe we are sufficiently protected, the loss of some of these rights could have an adverse effect on our business, financial condition and results of operations.

Competition

Competition in the toy industry is intense. Globally, certain of our competitors have greater financial resources, larger sales and marketing and product development departments, stronger name recognition, longer operating histories and benefit from greater economies of scale. These factors, among others, may enable our competitors to market their products at lower prices or on terms more advantageous to customers than those we could offer for our competitive products. Competition often extends to the procurement of entertainment and product licenses, as well as to the marketing and distribution of products and the obtaining of adequate shelf space. Competition may result in price reductions, reduced gross margins and loss of market share, any of which could have a material adverse effect on our business, financial condition and results of operations. In each of our product lines we compete against one or both of the toy industry's two dominant companies, Mattel and Hasbro. In addition, we compete in our Flying Colors and Pentech product categories, with Mega Brands (Rose Art®), Hasbro (Play-Doh®) and Binney & Smith (Crayola®), and in our toy vehicle lines, with RC2. We also compete with numerous smaller domestic and foreign toy manufacturers, importers and marketers in each of our product categories. Our joint venture's principal competitors in the video game market are Electronic Arts and Activision.

Seasonality and Backlog

In 2008, approximately 69.4% of our net sales were made in the third and fourth quarters. Generally, the first quarter is the period of lowest shipments and sales in our business and the toy industry generally and therefore the least profitable due to various fixed costs. Seasonality factors may cause our operating results to fluctuate significantly from quarter to quarter. However, our writing instrument and activity products generally are counter-seasonal to the traditional toy industry seasonality due to the higher volume generally shipped for back-to-school beginning in the second quarter. In addition, our seasonal products are primarily sold in the spring and summer seasons. Our results of operations may also fluctuate as a result of factors such as the timing of new products (and related expenses) introduced by us or our competitors, the advertising activities of our competitors, delivery schedules set by our customers and the emergence of new market entrants. We believe, however, that the low retail price of most of our products may be less subject to seasonal fluctuations than higher priced toy products.

We ship products in accordance with delivery schedules specified by our customers, which usually request delivery of their products within three to six months of the date of their orders for orders shipped FOB China or Hong Kong and within three days on orders shipped domestically. Because customer orders may be canceled at any time without penalty, our backlog may not accurately indicate sales for any future period.

Government and Industry Regulation

Our products are subject to the provisions of the Consumer Product Safety Act ("CPSA"), the Federal Hazardous Substances Act ("FHSA"), the Flammable Fabrics Act ("FFA") and the regulations promulgated thereunder. The CPSA and the FHSA enable the Consumer Products Safety Commission ("CPSC") to exclude from the market consumer products that fail to comply with applicable product safety regulations or otherwise create a substantial risk of injury, and articles that contain excessive amounts of a banned hazardous substance. The FFA enables the CPSC to regulate and enforce flammability standards for fabrics used in consumer products. The CPSC may also require the repurchase by the manufacturer of articles. Similar laws exist in some states and cities and in various international markets. We maintain a quality control program designed to ensure compliance with all applicable laws.

Employees

As of February 27, 2009, we employed 998 persons, all of whom are full-time employees, including three executive officers. We employed 503 people in the United States, 359 people in Hong Kong, 135 people in China and 1 person in the United Kingdom. We believe that we have good relationships with our employees. None of our employees are represented by a union.

Environmental Issues

We are subject to legal and financial obligations under environmental, health and safety laws in the United States and in other jurisdictions where we operate. We are not currently aware of any material environmental liabilities associated with any of our operations.

Available Information

We make available free of charge on or through our Internet website, www.jakkspacific.com, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to these reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

Our Corporate Information

We were formed as a Delaware corporation in 1995. Our principal executive offices are located at 22619 Pacific Coast Highway, Malibu, California 90265. Our telephone number is (310) 456-7799 and our Internet Website address is www.jakkspacific.com. The contents of our website are not incorporated in or deemed to be a part of this Annual Report or Form 10-K.

Item 1A. Risk Factors

From time to time, including in this Annual Report on Form 10-K, we publish forward-looking statements, as disclosed in our Disclosure Regarding Forward-Looking Statements, beginning immediately following the Table of Contents of this Annual 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 illustrative of 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 Annual Report on Form 10-K 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 lawsuit commenced by WWE and the purported securities class action and derivative action claims stemming from the WWE lawsuit (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:

- 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. Our toy license with the WWE expires on December 31, 2009.

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 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.

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 provides for us to have received 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 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. Since the parties have not reached an agreement with respect to the preferred return for the Next Distribution Period, the preferred return for the Next Distribution Period is to be determined through arbitration. The preferred return is accrued in the quarter in which the licensed games are sold and the preferred return is earned. Based on the same rates as set forth under the original joint venture agreement, an estimated receivable of \$52.8 million has been accrued for the period from July 1, 2006 to December 31, 2008, pending the resolution of this outstanding issue. JAKKS seeks to retain the same rates as set forth under the original joint venture agreement, while THQ seeks to pay a substantially lower rate. In the event the arbitration results in a lower rate to us, there would be a material charge to earnings and reduction in the receivable from THQ.

Any adverse change to the preferred return for the next 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 six years, which was achieved through acquisitions of businesses, products and licenses. For example, revenues associated with companies we acquired since 2006 were approximately \$11.8 million and \$10.5 million, in 2007 and 2008, respectively, representing 1.4% and 1.2% 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 on 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 1.4% and 1.2% of our total revenues in 2007 and 2008, 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 56.5% of our net sales in 2008. 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. 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 year ended December 31, 2008 sales to our international customers comprised approximately 17.9% 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 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 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 and decreased consumer confidence, may adversely impact our margins. In addition, general economic conditions were significantly and negatively affected by the September 11th terrorist attacks and could be similarly affected by any future attacks. Such a weakened economic and business climate, as well as consumer uncertainty created by such a climate, could 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 June 15, 2010, June 15, 2013 and June 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 material amount 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 accounted for using the purchase method 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 December 31, 2008, we have not had any impairment of Goodwill, which is reviewed on a quarterly basis and formally evaluated on an annual basis.

At December 31, 2008, approximately \$427.7 million, or 41.6%, of our total assets represented goodwill. Declines in our profitability may impact the fair value of our reporting units, which could result in a write-down of our goodwill. Reductions in our net income caused by the write-down of goodwill would adversely affect our results of operations.

Item 2. Properties

The following is a listing of the principal leased offices maintained by us as of February 27, 2009:

Property	Location	Approximate Square Feet	Lease Expiration Date
Domestic			
Corporate Office	Malibu, California	29,500	February 28, 2015
Design Center	Malibu, California	26,700	August, 31, 2015
Showroom	Santa Monica, California	18,000	August 31, 2015
Distribution Center	City of Industry, California	800,000	January 31, 2013
Distribution Center	St. Clair, Michigan	69,000	January 31, 2013
Distribution Center	St. Clair, Michigan	50,000	December 14, 2009
Disguise Showroom	New York, New York	11,700	November 1, 2015
Disguise Office / Warehouse	Poway, California	206,000	January 1, 2011
Creative Designs Office	Treose, Pennsylvania	14,700	June 30, 2009
Sales Office / Showroom	New York, New York	11,500	April 30, 2012
Sales Offices	Bentonville, Arkansas	4,400	Month-to-Month
	Palatine, Illinois	2,100	Month-to-Month
International			
JAKKS / Play Along Hong Kong	Kowloon, Hong Kong	36,600	June 30, 2010
Arbor Toys	Kowloon, Hong Kong	21,000	May 31, 2011
Production Inspection Office	Shanghai, China	1,200	April 30, 2010
Production Inspection and Testing Office	Shenzhen, China	5,400	May 14, 2010
Kids Only Limited Office	Kowloon, Hong Kong	9,200	May 15, 2009
Tollytots Limited Office	Kowloon, Hong Kong	3,000	February 28, 2011
Tollytots Limited Warehouse	Tuen Mun, Hong Kong	7,400	October 9, 2009
Disguise Limited Office	Kowloon, Hong Kong	7,900	July 14, 2010
JAKKS Nanjing Office	Nanjing, China	2,000	September 15, 2009

Item 3. 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, captioned 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 Chief Executive Officer), Stephen Berman (our Executive Vice President and Chief Operating Officer, President and Secretary and a member of our Board of Directors), Joel Bennett (our 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 February 16, 2005, we filed a motion to dismiss the WWE Action. On March 30, 2005, the day before WWE's opposition to our motion was due, WWE filed an Amended Complaint seeking, among other things, to add the Chief Executive Officer of THQ as a defendant and to add a claim under the Sherman Act. The Court allowed the filing of the Amended Complaint and ordered a two-stage resolution of the viability of the Complaint, with motions to dismiss the federal jurisdiction claims based on certain threshold issues to proceed and all other matters to be deferred for consideration if the Complaint survived scrutiny with respect to the threshold issues. The Court also stayed discovery pending the determination of the motions to dismiss.

The motions to dismiss the Amended Complaint based on these threshold issues were fully briefed and argued and, on March 31, 2006, the Court granted the part of our motion seeking dismissal of the Robinson-Patman Act and Sherman Act claims and denied the part of our motion seeking to dismiss the RICO claims on the basis of the threshold issue that was briefed (the "March 31 Order").

On April 7, 2006, we sought certification to appeal from the portion of the March 31 Order denying our motion to dismiss the RICO claim on the one ground that was briefed. Shortly thereafter, WWE filed a motion for reargument with respect to the portion of the March 31 Order that dismissed the Sherman Act claim and, alternatively, sought judgment with respect to the Sherman Act claim so that it could pursue an immediate appeal. At a court conference on April 26, 2006 the Court deferred the requests for judgment and for certification and set up briefing schedules with respect to our motion to dismiss the RICO claim on grounds that were not the subject of the first round of briefing, and our motion to dismiss the action based on the release contained in a January 15, 2004 Settlement Agreement and General Release between WWE and the Company (the "Release"). The Court also established a briefing schedule for WWE's motion for reargument of the dismissal of the Sherman Act claim. These motions were argued and submitted in September 2006. Discovery remained stayed.

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 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 a January 2004 release executed by WWE in favor of the Company would not be determined in connection with the motion to dismiss the action. We also filed a cross-appeal based on the Court's earlier order denying our request to dismiss based on the lack of a cognizable enterprise and based on the December 2007 Order's statement with respect to the Release. WWE moved to dismiss our cross-appeal. It has been withdrawn without prejudice to our right to argue these issues as grounds for affirmance of the December 2007 Order. The appeal briefing has been completed and argument will be scheduled.

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 in principle to resolve this action has been reached. The agreement, which is subject to documentation and 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.

We believe that the claims in the WWE Action are without merit and we intend to continue to defend vigorously against the WWE Action. However, because the WWE Action is on appeal, we cannot assure you as to the outcome of it, nor can we estimate the range of our potential losses.

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.

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.

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. 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 requested that THQ revise its claims and THQ objected to this request. This matter has not yet been resolved. Discovery is currently proceeding in this matter. The Company intends to contest all of these claims vigorously.

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. 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 is subject to change after June 30, 2006 and is 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 have not reached an agreement with respect to the preferred return for the Next Distribution Period and the preferred return is to be determined through arbitration. On April 30, 2007, THQ filed an action in the Superior Court, Los Angeles County, to compel arbitration and to appoint an arbitrator pursuant to the relevant provisions of the agreement. An order was issued that identified five potential arbitrators. The parties did not agree on an arbitrator. The Company served notices of disqualification on four of the potential arbitrators; THQ objected; the Court struck the disqualification notices and appointed an arbitrator, who was then stricken by JAKKS. The Company appealed the Court's order with respect to the disclosure and disqualification process and the appellate court took the appeal and stayed the proceedings. The Court rendered a decision on the matter on February 28, 2008 which affirmed the lower court's decision ruling that disclosure was not required until after the arbitrator was nominated to serve by the Court. The matter was remanded for further proceedings and the parties agreed on an arbitrator and the baseball-style arbitration is scheduled to be concluded by April 2009. JAKKS seeks to retain the same rates as set forth under the original joint venture agreement while THQ seeks to pay a substantially lower rate.

All matters in connection with the application by Jax, Ltd. for registration of the trademark JAX with respect to "board games" in class 28 with the United States Patent and Trademark Office ("PTO"), and the Jax, Ltd. counterclaim seeking cancellation of the Company's registration for the mark JAKKS PACIFIC have been dismissed with prejudice.

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.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information

Our common stock is traded on the Nasdaq Global Select exchange under the symbol "JAKK." The following table sets forth, for the periods indicated, the range of high and low sales prices for our common stock on this exchange.

	Price Range of Common Stock	
	High	Low
2007:		
First quarter	\$ 25.96	19.31
Second quarter	28.93	23.58
Third quarter	31.42	18.19
Fourth quarter	28.48	23.12
2008:		
First quarter	29.70	20.18
Second quarter	30.55	21.65
Third quarter	27.12	20.10
Fourth quarter	25.99	15.46

Performance Graph

The graph and tables below display the relative performance of our common stock, the Russell 2000 Price Index (the "Russell 2000") and a peer group index, by comparing the cumulative total stockholder return (which assumes reinvestment of dividends, if any) on an assumed \$100 investment in our common stock, the Russell 2000 and the peer group index over the period from January 1, 2004 to December 31, 2008.

In accordance with recently enacted regulations implemented by the Securities and Exchange Commission, we retained the services of an expert compensation consultant. In the performance of its services, such consultant used a peer group index for its analysis of our compensation policies. We believe that these companies represent a cross-section of publicly-traded companies with product lines and businesses similar to our own throughout the comparison period and, accordingly, we are using the same peer group for purposes of the performance graph. Our peer group index includes the following companies: Activision, Inc., Electronic Arts, Inc., EMak Worldwide, Inc., Hasbro, Inc., Leapfrog Enterprises, Inc., Marvel Enterprises, Inc., Mattel, Inc., Russ Berrie and Company, Inc., RC2 Corp., Take-Two Interactive, Inc. and THQ Inc.

The historical performance data presented below may not be indicative of the future performance of our common stock, any reference index or any component company in a reference index.

Annual Return Percentage

	December 31, 2004	December 31, 2005	December 31, 2006	December 31, 2007	December 31, 2008
JAKKS Pacific	68.2%	(5.3) %	4.3%	8.1%	(12.6) %
Peer Group	14.7	(10.1)	18.2	8.9	(45.2)
Russell 2000	18.3	4.6	18.4	(1.6)	(33.8)

Indexed Returns

	January 1, 2004	December 31, 2004	December 31, 2005	December 31, 2006	December 31, 2007	December 31, 2008
JAKKS Pacific	\$ 100.00	\$ 168.2	\$ 159.3	\$ 166.1	\$ 179.6	\$ 156.9
Peer Group	100.00	114.7	103.1	121.9	132.7	72.7
Russell 2000	100.00	118.3	123.7	146.4	144.2	95.4

Security Holders

To the best of our knowledge, as of February 27, 2009, there were 151 holders of record of our common stock. We believe there are numerous beneficial owners of our common stock whose shares are held in "street name."

Dividends

We have never paid any cash dividends on our common stock. We currently intend to retain our future earnings, if any, to finance the growth and development of our business and/or buy back in the market some of our outstanding common stock, but may consider implementing a plan to pay cash dividends on our common stock in the future.

Equity Compensation Plan Information

The table below sets forth the following information as of the year ended December 31, 2008 for (i) all compensation plans previously approved by our stockholders and (ii) all compensation plans not previously approved by our stockholders, if any:

- (a) the number of securities to be issued upon the exercise of outstanding options, warrants and rights;
- (b) the weighted-average exercise price of such outstanding options, warrants and rights; and
- (c) other than securities to be issued upon the exercise of such outstanding options, warrants and rights, the number of securities remaining available for future issuance under the plans.

Plan Category	Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights (a)	Weighted- Average Exercise Price of Outstanding Options, Warrants and Rights (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c)
Equity compensation plans approved by security holders	477,511	\$ 19.55	513,459
Equity compensation plans not approved by security holders	100,000	11.35	—
Total	577,511	\$ 18.13	513,459

Equity compensation plans approved by our stockholders consists of the 2002 Stock Award and Incentive Plan. Equity compensation plans not approved by our security holders consist of a fully-vested warrant issued by us in 2003 (and expiring in 2013) in connection with license costs relating to our video game joint venture.

Item 6. Selected Financial Data

You should read the financial data set forth below in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and our consolidated financial statements and the related notes (included in Item 8).

	Years Ended December 31,				
	2004	2005	2006	2007	2008
(In thousands, except per share data)					
Consolidated Statement of Income Data:					
Net sales	\$ 574,266	\$ 661,536	\$ 765,386	\$ 857,085	\$ 903,397
Cost of sales	348,259	394,829	470,592	533,435	582,184
Gross profit	226,007	266,707	294,794	323,650	321,213
Selling, general and administrative expenses	172,282	178,722	202,482	216,652	241,301
Write-down of intangible assets	—	—	—	—	9,076
Income from operations	53,725	87,985	92,312	106,998	70,836
Profit from video game joint venture	7,865	9,414	13,226	21,180	17,092
Other expense	—	(1,401)	—	—	-
Interest income	2,052	5,183	4,930	6,819	3,396
Interest expense	(4,550)	(4,544)	(4,533)	(5,456)	(2,425)
Income before provision for income taxes	59,092	96,637	105,935	129,541	88,899
Provision for income taxes	15,533	33,144	33,560	40,550	12,842
Net income	\$ 43,559	\$ 63,493	\$ 72,375	\$ 88,991	\$ 76,057
Basic earnings per share	\$ 1.69	\$ 2.37	\$ 2.66	\$ 3.22	\$ 2.78
Basic weighted average shares outstanding	25,797	26,738	27,227	27,665	27,379
Diluted earnings per share	\$ 1.49	\$ 2.06	\$ 2.30	\$ 2.77	\$ 2.42
Diluted weighted average shares and equivalents outstanding	31,406	32,193	32,714	33,149	32,637

During the fourth quarter of 2008, we acquired Tollytots, Kids Only and Disguise.

During the third quarter of 2008, we decided to discontinue 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, we 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.

In February 2006, we acquired Creative Designs. Also, effective January 1, 2006, we implemented SFAS 123R, which requires the expensing of share-based compensation.

In June 2005, we acquired the Pet Pal line of products.

In June 2004, we acquired Play Along.

	2004	2005	At December 31, 2006 (In thousands)	2007	2008
Consolidated Balance Sheet Data:					
Cash and cash equivalents	\$ 176,544	\$ 240,238	\$ 184,489	\$ 241,250	\$ 169,520
Working capital	229,543	301,454	280,363	352,452	325,061
Total assets	696,762	753,955	881,894	983,664	1,028,124
Long-term debt, net of current portion	98,000	98,000	98,000	98,000	98,000
Total stockholders' equity	451,485	524,651	609,288	690,997	746,953

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors. You should read this section in conjunction with our consolidated financial statements and the related notes (included in Item 8).

Critical Accounting Policies

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, Item 8. 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. We recognize revenue in accordance with Staff Accounting Bulletin No. 104, "Revenue Recognition." 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. 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. In accordance with Statement of Financial Accounting Standards 142 ("FAS 142"), Goodwill and Other 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.

FAS 142 requires that goodwill be allocated to various reporting units, which are either at the operating segment level or one reporting level below the operating segment, for purposes of evaluating whether goodwill is impaired. For 2008, JAKKS' reporting units are: Traditional Toys, Craft and Writing, and Pet products. Goodwill is allocated within JAKKS' reporting units based on an allocation of brand-specific goodwill to the reporting units selling those brands. As of October 1, 2008, JAKKS performed the annual impairment test required by FAS 142 and determined that its goodwill was not impaired. There were no events or circumstances that indicated the impairment test should be performed again at December 31, 2008.

During the third quarter of 2008, we decided to discontinue 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, we 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.

To determine the fair value of our reporting units, we generally use a present value technique (discounted cash flow) corroborated by market multiples when available and as appropriate. The factor most sensitive to change with respect to our discounted cash flow analyses is the estimated future cash flows of each reporting unit which is, in turn, sensitive to our estimates of future revenue growth and margins for these businesses. If actual revenue growth and/or margins are lower than our expectations, the impairment test results could differ. We applied what we believe to be the most appropriate and consistent valuation methodology for each of the reporting units. If we had established different reporting units or utilized different valuation methodologies, the impairment test results could differ.

Goodwill and intangible assets amounted to \$463.4 million as of December 31, 2008.

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 overproducing 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 forecasted 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.

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 a 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 the provisions of FASB Interpretation No. 48 (“FIN 48”), Accounting for Uncertainty in Income Taxes , which prescribes a recognition 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 FIN 48, 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 December 31, 2008, our income tax reserves are approximately \$11.9 million and relate to the potential income tax audit adjustments, primarily in the areas of income allocation, foreign depreciation allowances 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 subject to the provisions of revised Statement of Financial Accounting Standards No. 123 (Revised) (FAS 123R), Share-Based Payment . Effective January 1, 2006, we began to use the fair value method to apply the provisions of FAS 123R. 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

On October 7, 2008, we acquired substantially all of the assets of Tollytots Limited. The total initial consideration of \$25.5 million consisted of \$11.8 million in cash and the assumption of liabilities in the amount of \$13.7 million, and resulted in goodwill of \$3.0 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.

On October 8, 2008, we acquired substantially 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 \$23.2 million consisted of \$20.3 million in cash and the assumption of liabilities in the amount of \$2.9 million, and resulted in goodwill of \$12.5 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.

On December 29, 2008, we acquired certain assets of Disguise, Inc. and a related Hong Kong company, Disguise Limited (collectively, "Disguise"). The total initial consideration of \$61.9 million consisted of \$39.9 million in cash and the assumption of liabilities in the amount of \$22.0 million, and resulted in goodwill of \$51.6 million. We have not finalized our purchase price allocation for Disguise and will engage a third party to perform studies and valuations to 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

Results of Operations

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

	Years Ended December 31,				
	2004	2005	2006	2007	2008
Net Sales	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of Sales	60.6	59.7	61.5	62.2	64.4
Gross profit	39.4	40.3	38.5	37.8	35.6
Selling, general and administrative expenses	30.0	27.0	26.5	25.3	26.7
Write-down of intangible assets	—	—	—	—	1.0
Income from operations	9.4	13.3	12.0	12.5	7.9
Profit from video game joint venture	1.4	1.4	1.7	2.5	1.9
Other expense	—	(0.2)	—	—	—
Interest income	0.4	0.8	0.6	0.7	0.4
Interest expense	(0.8)	(0.7)	(0.6)	(0.6)	(0.3)
Income before income taxes	10.4	14.6	13.7	15.1	9.9
Provision for income taxes	2.7	5.0	4.4	4.7	1.4
Net income	7.7%	9.6%	9.3%	10.4%	8.5%

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

	Years Ended December 31,		
	2006	2007	2008
Net Sales			
Traditional Toys	\$ 692,498	\$ 792,998	\$ 816,852
Craft/Activity/Writing Products	52,834	39,632	65,888
Pet Products	20,054	24,455	20,657
	765,386	857,085	903,397
Cost of Sales			
Traditional Toys	429,411	490,279	526,989
Craft/Activity/Writing Products	29,044	26,970	38,693
Pet Products	12,137	16,186	16,502
	470,592	533,435	582,184
Gross Margin			
Traditional Toys	263,087	302,719	289,862
Craft/Activity/Writing Products	23,790	12,662	27,196
Pet Products	7,917	8,269	4,155
	\$ 294,794	\$ 323,650	\$ 321,213

Comparison of the Years Ended December 31, 2008 and 2007

Net Sales

Traditional Toys. Net sales of our Traditional Toys segment were \$816.9 million in 2008, compared to \$793.0 million in 2007, representing an increase of \$23.9 million, or 3.0%. The increase in net sales was primarily due to the contribution to sales from our Tollytots and Kids Only acquisitions of \$10.4 million and strong sales of JAKKS™ dolls

based on Hannah Montana®, Camp Rock™, Puppy In My Pocket & Friends™ and Narnia®, electronics based on JAKKS' Eye Clops®, G2 Game Girl™ and UltiMotion™ brands, role-play and dress-up toys, including those based on Disney characters Hannah Montana® and classic princesses, and other products including Neopets® plush, offset in part by decreases in sales of some products, including WWE® and Pokemon® action figures and accessories, and other JAKKS products, including Plug It In & Play TV Games™, Fly Wheels® XPV products®, Doodle Bears®, Care Bears®, Cabbage Patch Kids®, Speedstacks®, The Cheetah Girls™ toys and junior sports products.

Craft/Activity/Writing Product. Net sales of our Craft/Activity/Writing Products were \$65.9 million in 2008, compared to \$39.6 million in 2007, representing an increase of \$26.3 million, or 66.4%. The increase in net sales was primarily due to increases in sales of our Girl Gourmet™ and Spa Factory™ activity toys and our Spinz™ writing instruments, offset in part by decreases in sales of our Flying Colors® and Vivid Velvet® activities products and our Pentech™ and Color Workshop® writing instruments and related products.

Pet Products. Net Sales of our Pet Products were \$20.7 million in 2008, compared to \$24.5 million in 2007, representing a decrease of \$3.8 million, or 15.5%. The decrease is mainly attributable to the less available shelf space for pet products at some of our major customer retail stores, and lower 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 \$527.0 million, or 64.5% of related net sales, in 2008, compared to \$490.3 million, or 61.8% of related net sales, in 2007, representing an increase of \$36.7 million, or 7.5%. The increase primarily consisted of an increase in product costs of \$26.9 million, which is in line with the higher volume of sales. Product costs as a percentage of sales increased primarily due to the mix of the product sold with higher product cost. Furthermore, royalty expense for our Traditional Toys segment increased by \$3.6 million, but remained consistent as a percentage of net sales. Our depreciation of molds and tools increased by \$6.2 million due to the increased number of new products being sold in this segment in 2008.

Craft/Activity/Writing Products . Cost of sales of our Craft/Activity/Writing Products segment was \$38.7 million, or 58.7% of related net sales, in 2008, compared to \$27.0 million, or 68.1% of related net sales, in 2007, representing an increase of \$11.7 million, or 43.3%. Product costs increased by \$13.7 million, which is in line with the higher volume of sales. Product costs as a percentage of net sales decreased primarily due to the mix of the product sold and lower sales of closeout product. Royalty expense decreased by \$2.3 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. Our depreciation of molds and tools increased by \$0.4 million due to the increased number of new products being sold in this segment in 2008.

Pet Products .. Cost of sales of our Pet Pal line of products was \$16.5 million, or 79.9% of related net sales, in 2008, compared to \$16.2 million, or 66.2% of related net sales, in 2007, representing an increase of \$0.3 million, or 1.9%. Product costs as a percentage of net sales increased primarily due to the mix of the product sold and sell-off of closeout product. Royalty expense decreased by \$0.1 million and as a percentage of sales. Additionally, our depreciation of molds and tools decreased by \$0.3 million in 2008 due to less new products requiring molds and tools.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were \$241.3 million in 2008 and \$216.7 million in 2007, constituting 26.7% and 25.3% of net sales, respectively. The overall increase of \$24.6 million in such costs was primarily due to the addition of overhead related to the operations of Tollytots, Kids Only and Disguise (\$3.4 million) and increases in general and administrative expenses (\$5.3 million), product development (\$11.4 million), and other selling expenses (\$11.0 million), offset in part by decreases in amortization expense related to intangible assets other than goodwill (\$5.1 million) and share-based compensation expense (\$1.8 million). The increase in general and administrative expenses is primarily due to increases in salary and payroll taxes (\$4.7 million) to support our growing business, travel and entertainment expense (\$1.1 million), legal expense (\$5.7 million), net of insurance reimbursements, bad debt expense (\$1.0 million) due to refunds in 2007 of customer bankruptcies that had been previously written off and rent expense (\$1.1 million), offset in part by offset in part by the reversal of FIN 48 penalty reserves (\$1.4 million) related to income taxes and bonus expense (\$9.1 million) due to the Company achieving a lower EPS growth. The increase in direct selling expenses is primarily due to an increase in advertising and promotional expenses of \$7.5 million in 2008 in support of several of our product lines and other direct selling expenses of \$4.4 million to support

the increase in domestic sales, offset in part by decreases in sales commissions (\$1.0 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

Write-down of intangible assets was \$9.1 million in 2008, as compared to nil in 2007. We decided to discontinue 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, we 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.

Profit from Video Game Joint Venture

Profit from our video game joint venture in 2008 decreased to \$17.1 million, as compared to \$21.2 million in 2007, due to the lower sales of video games. In 2008, the Smackdown vs. Raw 2008 game and video games on the new Wii game platform were introduced. The amount of the preferred return we will receive from the joint venture after June 30, 2006 became subject to change (see “Risk Factors” and “World Wrestling Entertainments Video Games”).

Interest Income

Interest income in 2008 was \$3.4 million, as compared to \$6.8 million in 2007. The decrease is due to lower interest rates during 2008 compared to 2007 and lower average cash balances.

Interest Expense

Interest expense was \$2.4 million in 2008, as compared to \$5.5 million in 2007. In 2008, we booked interest expense of \$4.5 million related to our convertible senior notes payable, off set in part by a net benefit of \$2.2 million related to FIN 48 pursuant to our January 1, 2007 adoption of the provisions of FIN 48. In 2007, we booked interest expense of \$4.5 million related to our convertible senior notes payable and net interest expense \$0.9 million related to FIN 48 pursuant to our January 1, 2007 adoption of the provisions of FIN 48.

Provision for Income Taxes

Provision for income taxes includes federal, state and foreign income taxes at effective tax rates of 31.3% in 2007, and 14.4% in 2008, benefiting from a flat tax rate of 17.5% and 16.5% for 2007 and 2008, respectively, on the Company's income arising in, or derived from, Hong Kong. The decrease in the effective rate in 2008 is primarily due to the recognition of certain discrete income tax adjustments recognized in the quarter ended September 30, 2008 and a change in the federal tax code which reduced the amount of foreign income includible on the federal income tax return. These discrete adjustments included the reconciliation of the 2007 income tax provision to the actual income tax liability as reflected in the Company's income tax return in the amount of \$5.0 million, and the reduction in income tax expense due to the recognition of a previously recorded potential income tax liability for uncertain tax positions that are no longer subject to audit due to the closure of the audit period. As of December 31, 2008, the Company had net deferred tax liability of approximately \$8.2 million, inclusive of an allowance of \$0.9 million that has been provided since, in the opinion of management, realization of the future benefit is uncertain.

Comparison of the Years Ended December 31, 2007 and 2006

Net Sales

Traditional Toys. Net sales of our Traditional Toys segment were \$793.0 million in 2007, compared to \$692.5 million in 2006, representing an increase of \$100.5 million, or 14.5%. The increase in net sales was primarily due to impact of sales related to our Creative Designs line of products for the full twelve months ended December 31, 2007, as compared to only a part of the twelve months ended December 31, 2006 (as a result of the February 2006 acquisition of Creative Designs), which had incremental sales of \$17.4 million, and increases in sales of WWE and Pokemon action figures and accessories, role-play and dress-up toys, Bio Bytes™, Eye Clops™ Bionic Eye, Child Guidance pre-school toys, Hannah Montana dolls and accessories, In My Pocket toys, Cheetah Girls toys, Sweet Secrets toys, Funnoodle pool toys and our Fly Wheels XPV® toys, offset in part by decreases in sales of Dragonball Z® action figures, JAKKS™ dolls, Plug It In & Play TV Games, wheels products, Telestory®, Vmigo®, Sky Dancers®, Doodle Bears® Dragon Flyz™, Trolls™, Care Bears®, Cabbage Patch Kids®, Speedstacks®, Snugglers™, RC Flight toys and our Go Fly A Kite® and junior sports products.

Craft/Activity/Writing Products. Net Sales of our Craft/Activity/Writing Products were \$39.6 million in 2007, compared to \$52.8 million in 2006, representing a decrease of \$13.2 million, or 25.0%. The decrease in net sales was primarily due to decreases in sales of our Flying Colors and Vivid Velvet activities products and our Pentech and Color Workshop writing instruments and related products.

Pet Products. Net Sales of our Pet Pal line of products were \$24.5 million in 2007, compared to \$20.1 million in 2006, representing an increase of \$4.4 million, or 21.9%. The increase is attributable to the expanding line of products and expanding distribution.

Cost of Sales

Traditional Toys. Cost of sales of our Traditional Toys segment was \$490.3 million, or 61.8% of related net sales, in 2007, compared to \$429.4 million, or 62.0% of related net sales, in 2006, representing an increase of \$60.9 million, or 14.2%. The increase primarily consisted of an increase in product costs of \$41.1 million, which is in line with the higher volume of sales. Product costs as a percentage of sales decreased primarily due to the mix of the product sold with lower product cost. Furthermore, royalty expense for our Traditional Toys segment increased by \$16.9 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. Additionally, certain royalty advances and guarantees were written off for licensed product whose sell-off period had expired or was projected to not recoup the advances through future sales or meet its contractual minimum guaranty. Our depreciation of molds and tools increased by \$2.9 million due to the increased number of new products being sold in this segment in 2007.

Craft/Activity/Writing Products. Cost of sales of our Craft/Activity/Writing Products segment was \$27.0 million, or 68.1% of related net sales, in 2007, compared to \$29.0 million, or 55.0% of related net sales, in 2006, representing a decrease of \$2.0 million, or 6.9%. The decrease consisted of a decrease in product costs of \$2.2 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 sell-off of closeout product. Royalty expense increased by \$0.3 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. Additionally, certain royalty advances and guarantees were written off for licensed product whose sell-off period had expired or was projected to not recoup the advances through future sales or meet its contractual minimum guaranty. Our depreciation of molds and tools decreased by \$0.2 million in 2007 due to lower level of product in this segment requiring molds and tools.

Pet Products. Cost of sales of our Pet Pal line of products was \$16.2 million, or 66.2% of related net sales, in 2007, compared to \$12.1 million, or 60.5% of related net sales, in 2006, representing an increase of \$4.1 million, or 33.9%. The increase primarily consisted of an increase in product costs of \$3.5 million, which is in line with the higher volume of sales. Product costs as a percentage of net sales increased primarily due to the mix of the product sold. Royalty expense increased by \$0.4 million, which was in line with the higher volume of sales. Additionally, our depreciation of molds and tools was comparable year-over-year.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were \$216.7 million in 2007 and \$202.5 million in 2006, constituting 25.3% and 26.5% of net sales, respectively. The overall increase of \$14.2 million in such costs was primarily due to increases in general and administrative expenses (\$16.8 million), the incremental overhead related to a full quarter impact of operations of Creative Designs (\$1.5 million) for the three months ended March 31, 2007 (as compared to a partial quarter of operations for the three months ended March 31, 2006 as a result of the February 2006 acquisition thereof), product development (\$2.2 million) and stock based compensation (\$2.6 million), offset in part by decreases in other selling expenses (\$7.0 million), and amortization expense related to intangible assets other than goodwill (\$1.9 million). The increase in general and administrative expenses is primarily due to an increase in salary and payroll taxes (\$5.8 million) to support our growing business which includes a lower allocation of JAKKS' overhead to the video game joint venture (\$1.2 million), bonus expense (\$10.6 million) based on a stronger EPS growth in 2007 compared to 2006, donations expense (2.1 million), rent expense (\$1.1 million) and travel and entertainment expense (\$0.8 million), offset in part by decreases in other expenses as a result of the reversal of FIN 48 penalties related to income taxes payable (\$0.6 million) and the buyout of our New York showroom lease (\$1.3 million) and legal and other professional fees (\$1.4 million). The decrease in direct selling expenses is primarily due to a decrease in advertising and promotional expenses of \$10.9 million in 2007 in support of several of our product lines, offset in part by an increase in sales commissions (\$1.2 million) and other direct selling expenses (\$2.7 million). From time to time, we may increase or decrease our advertising efforts, if we deem it appropriate for particular products.

Profit from Video Game Joint Venture

Profit from our video game joint venture in 2007 increased to \$21.1 million, as compared to \$13.2 million in 2006, due to the strong performance of the new Smackdown vs. Raw 2007 game and stronger sales of existing titles in 2007 compared to 2006. Furthermore, we devoted and allocated \$1.2 million less of JAKKS' overhead to the video game joint venture. The amount of the preferred return we will receive from the joint venture after June 30, 2006 became subject to change (see "Risk Factors", infra, and Note 4 of the Notes to Consolidated Financial Statements, supra).

Interest Income

Interest income in 2007 was \$6.8 million, as compared to \$4.9 million in 2006. The increase is due to higher average cash balances and higher interest rates during 2007 compared to 2006.

Interest Expense

Interest expense was \$5.5 million and \$4.5 million for 2007 and 2006, respectively. The increase is due to net interest accrued pursuant to our January 1, 2007 adoption of the provisions of FIN 48. Interest expense of \$4.5 million related to our convertible senior notes payable were comparable in 2007 and 2006.

Provision for Income Taxes

Provision for income taxes includes federal, state and foreign income taxes at effective tax rates of 31.7% in 2006, and 31.3% in 2007, benefiting from a flat 17.5% tax rate on the Company's income arising in, or derived from, Hong Kong for each of 2006 and 2007. The effective rate in 2007 reflects the recognition of certain discrete income tax

adjustments recognized in the quarter ended September 30, 2007. These adjustments included the reconciliation of the 2006 income tax provision to the actual income tax liability as reflected in the Company's income tax return, and the reduction in income tax expense due to the recognition of a previously recorded potential income tax liability for uncertain tax positions that are no longer subject to audit due to the closure of the audit period. These discrete items resulted in approximately a 2.1% reduction in the effective income tax rate for the twelve months ended December 31, 2007. As of December 31, 2007, the Company had net deferred tax assets of approximately \$7.3 million for which an allowance of \$0.9 million has been provided since, in the opinion of management, realization of the future benefit is uncertain.

Quarterly Fluctuations and Seasonality

We have experienced significant quarterly fluctuations in operating results and anticipate these fluctuations in the future. The operating results for any quarter are not necessarily indicative of results for any future period. Our first quarter is typically expected to be the least profitable as a result of lower net sales but substantially similar fixed operating expenses. This is consistent with the performance of many companies in the toy industry.

The following table presents our unaudited quarterly results for the years indicated. The seasonality of our business is reflected in this quarterly presentation.

	2007				2008			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net sales	\$ 124,062	\$ 129,547	\$ 318,391	\$ 285,085	\$ 130,935	145,291	357,824	269,347
As a % of full year	14.5%	15.1%	37.1%	33.3%	14.5%	16.1%	39.6%	29.8%
Gross Profit	45,508	45,295	124,050	108,797	47,441	52,058	129,065	92,649
As a % of full year	14.1%	14.0%	38.3%	33.6%	14.8%	16.2%	40.2%	28.8%
As a % of net sales	36.7%	35.0%	39.0%	38.2%	36.2%	35.8%	36.1%	34.4%
Income (loss) from operations	3,324	6,488	65,057	32,129	(894)	5,568	57,338	8,824
As a % of full year	3.1%	6.1%	60.8%	30.0%	-1.3%	7.9%	80.9%	12.5%
As a % of net sales	2.7%	5.0%	20.4%	11.3%	-0.7%	3.8%	16.0%	3.3%
Income before income taxes	4,762	7,403	67,087	50,289	1,300	5,994	60,803	20,802
As a % of net sales	3.8%	5.7%	21.1%	17.6%	1.0%	4.1%	17.0%	7.7%
Net income	3,238	5,034	47,318	33,401	877	4,156	54,145	16,879
As a % of net sales	2.6%	3.9%	14.9%	11.7%	0.7%	2.9%	15.1%	6.3%
Diluted earnings per share	\$ 0.12	\$ 0.17	\$ 1.45	\$ 1.03	\$ 0.03	0.15	1.70	0.55
Weighted average shares and equivalents outstanding	27,985	33,133	33,145	33,251	28,453	32,594	32,257	32,312

During 2007, we recorded net interest expense of \$0.9 million related to FIN 48

During the third quarter of 2008, we decided to discontinue 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, we 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.

Recent Accounting Standards

In December 2007, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 141 (Revised) (“FAS 141(R)”), Business Combinations. This statement contains specific guidance regarding the accounting for costs of business acquisitions and for estimating contingent consideration provisions at the time of acquisition. This new guidance replaces the previous guidance in FAS 141. We will adopt FAS 141(R) in calendar year 2009.

In September 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 157 (“FAS 157”) Fair Value Measurements . This standard provides new definitions for fair value and establishes a framework for measuring fair value in financial statements. FAS 157 became effective for us as of January 1, 2008 and the effect of the adoption of FAS 157 has been immaterial to our financial statements.

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48 (“FIN 48”), Accounting for Uncertainty in Income Taxes, which prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Under FIN 48, the tax benefit of uncertain tax positions may be recognized only if it is more likely than not that the tax position will be sustained, based solely on its technical merits presuming the tax authority has full knowledge of all relevant information. Additionally, FIN 48 provides guidance on the de-recognition, classification, and accounting in interim periods and disclosure requirements for uncertain tax positions. In the first quarter of 2007, we adopted FIN 48 which resulted in the recognition of an increased current and non-current income tax payable for unrecognized tax benefits of \$15.6 million. We have also recognized an additional liability of \$2.5 million for penalties and \$2.8 million for interest on the income tax liability. These increases to the liabilities resulted in a reduction of \$19.1 million to the January 1, 2007 balance of retained earnings, net of related tax benefits. Current interest on income tax liabilities is recognized as interest expense and penalties on income tax liabilities are recognized as other expense in the consolidated statement of income. During the year ended December 31, 2008, we reduced our net interest expense accrual by \$2.2 million.

Liquidity and Capital Resources

As of December 31, 2008, we had working capital of \$325.1 million, compared to \$352.5 million as of December 31, 2007. This decrease was primarily attributable to acquisitions of Tollytots, Kids Only and Disguise, the repurchase of common stock, offset in part by net cash provided by our operating activities.

Operating activities provided net cash of \$60.8 million in 2008, as compared to \$91.9 million in 2007. Net cash was provided primarily by net income and non-cash charges, offset in part by changes in working capital. Our accounts receivable turnover as measured by days sales for the quarter outstanding in accounts receivable for the three months ended December 31, 2008 decreased from approximately 55 days as of December 31, 2007 to approximately 49 days as of December 31, 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 December 31, 2008, we had cash and cash equivalents of \$169.5 million.

Our investing activities used net cash of \$104.9 million in 2008, as compared to \$37.9 million in 2007, consisting 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 goodwill and other intangibles assets purchased in the acquisition of Tollytots for \$10.1 million, Kids Only for \$17.0 million, and Disguise for \$37.9 million; and the purchase of office furniture and equipment and molds and tooling of \$22.3 million used in the manufacture of our products and other assets. In 2007, 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 \$2.0 million and the purchase of office furniture and equipment and molds and tooling of \$18.1 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 December 31, 2008, these agreements required future aggregate minimum guarantees of \$57.9 million, exclusive of \$38.6 million in advances already paid. Of this \$57.9 million future minimum guarantee, \$22.2 million is due over the next twelve months.

Our financing activities used net cash of \$27.6 million in 2008, consisting of cash paid for the repurchase of our common stock and restricted shares, partially offset by proceeds from the exercise of stock options and the tax benefit from the stock options exercised. In 2007, financing activities provided net cash of \$2.8 million, consisting of proceeds from the exercise of stock options and the tax benefit from the stock options exercised.

The following is a summary of our significant contractual cash obligations for the periods indicated that existed as of December 31, 2008 and is based on information appearing in the notes to the consolidated financial statements (in thousands):

	2009	2010	2011	2012	2013	Thereafter	Total
Long-term debt	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 98,000	\$ 98,000
Interest on long-term debt	4,533	4,533	4,533	4,533	4,533	42,870	65,535
Operating leases	13,661	11,986	8,271	7,217	3,783	5,419	50,337
Minimum guaranteed license/royalty payments	22,170	22,019	9,119	2,863	206	1,500	57,877
Employment contracts	3,989	2,755	475	—	—	—	7,219
Total contractual cash obligations	\$ 44,353	\$ 41,293	\$ 22,398	\$ 14,613	\$ 8,522	\$ 147,789	\$ 278,968

The above table excludes any potential uncertain income tax liabilities that may become payable upon examination of the Company's income tax returns by taxing authorities. Such amounts and periods of payment cannot be reliably estimated. See Note 12 to the financial statements for further explanation of the Company's uncertain tax positions. The above table also excludes our contractual obligation with one of our executives regarding his retirement plan. Such amounts and periods of payment cannot be reliably estimated. See Note 15 to the financial statements for further explanation of the Company's retirement plan commitment.

In October 2004, we were named as a defendant in a lawsuit commenced by WWE (the “WWE Action”). The complaint also named as defendants, among others, the joint venture with THQ Inc., certain of our foreign subsidiaries and our three executive officers. The complaint was dismissed and an appeal has been filed with respect to the Judgment dismissing 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. In January 2008, the complaint was dismissed without prejudice to seeking leave to file an amended complaint. Such leave was sought in February 2008. Three shareholder derivative actions have also been filed against us, nominally, and against certain of our Board members (the “Derivative Actions”). The Derivative Actions seek to hold the individual defendants liable for damages allegedly caused to our Company by their actions, and, in one of the Derivative Actions, seeks restitution to our Company of profits, benefits and other compensation obtained by them. In October 2006, WWE commenced a lawsuit against THQ and the joint venture concerning allegedly improper sales of WWE video games in Japan and other countries in Asia, seeking among other things, a declaration that WWE is entitled to terminate its video games license with the joint venture and monetary damages (the “Connecticut Action”). In spring 2007, WWE amended the complaint in the Connecticut Action to allege the matters set forth in the WWE Action. Thereafter, WWE amended the complaint in the Connecticut Action to allege state claim laws that had been alleged in the WWE Action. WWE submitted a proposed case management order in February 2008 and it provided for a trial on or after October 2009. On February 22, 2008, we submitted a response in which we requested that no case management order be adopted prior to the determination of the motion to strike and for summary judgment (the “Dispositive Motion”) because it would moot such a case management order but that if a case management order is to be adopted it should provide for a trial, if the matter is not fully dismissed, not before June 2010. The Dispositive Motion was made and granted and WWE is now appealing the dismissal with respect to the state law causes of action from the WWE Action. See “Legal Proceedings.”

In June 2005, we purchased substantially all of the operating assets and assumed certain liabilities relating to the Pet Pal line of pet products, including toys, treats and related pet products. The total initial purchase price of \$10.6 million was paid in cash. In addition, we agreed to pay an earn-out of up to an aggregate amount of \$25.0 million in cash over the three years ending June 30, 2008 following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. During the years ended December 31, 2006 and 2007, \$1.5 million and \$2.0 million, respectively, of the earn-out was earned and recorded as goodwill. Goodwill of \$4.6 million arose from this transaction, which represents the excess of the purchase price over the fair value of assets acquired less liabilities assumed. This acquisition expands our product offerings and distribution channels. Our results of operations have included Pet Pal from the date of acquisition.

In February 2006, we acquired substantially all of the assets of Creative Designs. The total initial purchase price of \$111.1 million consisted of \$101.7 million in cash, 150,000 shares of our common stock at a value of approximately \$3.3 million and the assumption of liabilities in the amount of \$6.1 million. In addition, we agreed to pay an earn-out of up to an aggregate amount of \$20.0 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. For the years ended December 31, 2006, 2007 and 2008, \$6.9 million, \$6.7 million and \$5.7 million, respectively, of the earn-out was earned and recorded as goodwill. Creative Designs is a leading designer and producer of dress-up and role-play toys and is included in our results of operations from the date of acquisition.

In February 2008, our Board of Directors authorized us to repurchase up to \$30.0 million of our common stock. In April and May 2008, we repurchased a total of 1,259,300 shares of our common stock at an average price of \$23.82 per share for a total cost of \$30.0 million. The stock repurchased represents approximately 4.4% of our outstanding shares of common stock.

In February 2009, parties to our class action lawsuit notified the Court that an agreement in principle to settle this matter has been reached. The agreement, which is subject to documentation and 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. The Company expects for a significant portion of this settlement to be covered by insurance. See "Legal Proceedings."

On October 7, 2008, we acquired substantially all of the assets of Tollytots Limited. The total initial consideration of \$25.5 million consisted of \$11.8 million in cash and the assumption of liabilities in the amount of \$13.7 million, and resulted in goodwill of \$3.0 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.

On October 8, 2008, we acquired substantially 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 \$23.2 million consisted of \$20.3 million in cash and the assumption of liabilities in the amount of \$2.9 million, and resulted in goodwill of \$12.5 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.

On December 29, 2008, we acquired certain assets of Disguise, Inc. and a related Hong Kong company, Disguise Limited (collectively, "Disguise"). The total initial consideration of \$61.9 million consisted of \$39.9 million in cash and the assumption of liabilities in the amount of \$22.0 million, and resulted in goodwill of \$51.6 million. We have not finalized our purchase price allocation for Disguise and will engage a third party to perform studies and valuations to 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

In June 2003, we sold an aggregate of \$98.0 million of 4.625% Convertible Senior Notes due June 15, 2023. The notes may be converted 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 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, commencing on December 15, 2003. After June 15, 2010, interest will accrue at the same rate 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 December 31, 2008, and are not convertible in the first 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. 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. Any repurchases at June 15, 2013 and June 15, 2018 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 flows from operations and cash and cash equivalents 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 net cash and cash equivalents. As of December 31, 2008, we do not have any off-balance sheet arrangements.

Exchange Rates

Sales from our United States and Hong Kong operations are denominated in U.S. dollars and our manufacturing costs are denominated in either U.S. or Hong Kong dollars. Operations and operating expenses of all of our operations are denominated in local currency, thereby creating exposure to changes in exchange rates. Changes in the Hong Kong dollar/U.S. dollar exchange rate may positively or negatively affect our operating results. The exchange rate of the Hong Kong dollar to the U.S. dollar has been fixed by the Hong Kong government since 1983 at HK\$7.80 to US\$1.00 and, accordingly, has not represented a currency exchange risk to the U.S. dollar. We cannot assure you that the exchange rate between the United States and Hong Kong currencies will continue to be fixed or that exchange rate fluctuations between the United States and Hong Kong currencies will not have a material adverse effect on our business, financial condition or results of operations.

Item 7A. 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. To date, 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 December 31, 2008. 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 and China. Sales are made by these operations on FOB China or Hong Kong terms and are denominated in U.S. dollars. However, purchases of inventory and Hong Kong operating expenses are typically denominated in Hong Kong dollars and local operating expenses in China are denominated in local currency, thereby creating exposure to changes in exchange rates. Changes in the Chinese Yuan or Hong Kong dollar/U.S. dollar exchange rates may positively or negatively affect our gross margins, operating income and retained earnings. A gain in Hong Kong dollars gave rise to the other comprehensive loss in the balance sheet at December 31, 2007. The exchange rate of the Hong Kong dollar to the U.S. dollar has been fixed by the Hong Kong government since 1983 at HK\$7.80 to US\$1.00 and, accordingly, has not represented a currency exchange risk to the U.S. dollar. 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.

Item 8. Consolidated Financial Statements and Supplementary Data

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
JAKKS Pacific, Inc.
Malibu, California

We have audited the accompanying consolidated balance sheets of JAKKS Pacific, Inc. (the “Company”) as of December 31, 2008 and 2007 and the related consolidated statements of income, other comprehensive income, stockholders’ equity and cash flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of JAKKS Pacific, Inc. as of December 31, 2008 and 2007, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America.

As more fully described in Note 2 to the consolidated financial statements, effective January 1, 2007, the Company changed the manner in which it accounts for uncertain tax positions, due to the adoption of FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109.”

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), JAKKS Pacific, Inc.’s internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated February 28, 2009 expressed an unqualified opinion thereon.

/s/ BDO Seidman, LLP
BDO Seidman, LLP
Los Angeles, California
February 28, 2009

JAKKS PACIFIC, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31,	
	2007	2008
	(In thousands, except share data)	
Assets		
Current assets		
Cash and cash equivalents	\$ 241,250	\$ 169,520
Marketable securities	218	195
Accounts receivable, net of allowance for uncollectible accounts of \$1,354 and \$2,005, respectively	174,451	147,587
Inventory	75,486	87,944
Income tax receivable	—	22,288
Deferred income taxes	13,921	17,993
Prepaid expenses and other	17,531	29,670
Total current assets	522,857	475,197
Property and equipment		
Office furniture and equipment	9,961	12,390
Molds and tooling	44,333	63,075
Leasehold improvements	5,186	5,947
Total	59,480	81,412
Less accumulated depreciation and amortization	38,073	52,914
Property and equipment, net	21,407	28,498
Intangibles and other, net	30,402	33,061
Investment in video game joint venture	36,090	53,184
Goodwill, net	353,340	427,693
Trademarks, net	19,568	10,491
Total assets	\$ 983,664	\$ 1,028,124
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	\$ 52,287	\$ 57,432
Accrued expenses	70,085	61,780
Reserve for sales returns and allowances	26,036	23,317
Short-term debt	—	417
Income taxes payable	21,997	7,190
Total current liabilities	170,405	150,136
Convertible senior notes	98,000	98,000
Other liabilities	6,432	2,112
Income taxes payable	11,294	4,686
Deferred income taxes	6,536	26,237
Total liabilities	292,667	281,171
Commitments and contingencies		
Stockholders' equity		
Preferred shares, \$.001 par value; 5,000,000 shares authorized; nil outstanding	—	—
Common stock, \$.001 par value; 100,000,000 shares authorized 28,275,116 and 27,521,278 shares issued and outstanding, respectively	28	28
Additional paid-in capital	312,127	292,809
Retained earnings	382,288	458,345

Edgar Filing: JAKKS PACIFIC INC - Form 10-K

Accumulated other comprehensive loss	(3,446)	(4,229)
Total stockholders' equity	690,997	746,953
Total liabilities and stockholders' equity	\$ 983,664	\$ 1,028,124

See notes to consolidated financial statements.

38

JAKKS PACIFIC, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31,		
	2006	2007	2008
	(In thousands, except per share amounts)		
Net sales	\$ 765,386	\$ 857,085	\$ 903,397
Cost of sales	470,592	533,435	582,184
Gross profit	294,794	323,650	321,213
Selling, general and administrative expenses	202,482	216,652	241,301
Write-down of intangible assets	—	—	9,076
Income from operations	92,312	106,998	70,836
Profit from video game joint venture	13,226	21,180	17,092
Interest income	4,930	6,819	3,396
Interest expense	(4,533)	(5,456)	(2,425)
Income before provision for income taxes	105,935	129,541	88,899
Provision for income taxes	33,560	40,550	12,842
Net income	\$ 72,375	\$ 88,991	\$ 76,057
Basic earnings per share	\$ 2.66	\$ 3.22	\$ 2.78
Basic weighted number of shares	27,227	27,665	27,379
Diluted earnings per share	\$ 2.30	\$ 2.77	\$ 2.42
Diluted weighted number of shares	32,714	33,149	32,637

See notes to consolidated financial statements.

JAKKS PACIFIC, INC. AND SUBSIDIARIES
 CONSOLIDATED STATEMENTS OF OTHER COMPREHENSIVE INCOME

	Years Ended December 31,		
	2006	2007	2008
	(In thousands)		
Other comprehensive income:			
Net income	\$ 72,375	\$ 88,991	\$ 76,057
Foreign currency translation adjustment	(638)	(19)	(783)
Other comprehensive income	\$ 71,737	\$ 88,972	\$ 75,274

See notes to consolidated financial statements.

JAKKS PACIFIC, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 2006, 2007 AND 2008
(In thousands)

	Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
	Number of Shares	Amount				
Balance, December 31, 2005	26,945	\$ 27	\$ 287,356	\$ 240,057	\$ (2,789)	\$ 524,651
Exercise of options	333	—	4,382	—	—	4,382
Stock option income tax benefit	—	—	1,509	—	—	1,509
Restricted stock grants	473	1	4,579	—	—	4,580
Compensation for vested stock options	—	—	1,902	—	—	1,902
Retirement of common stock	(124)	—	(2,798)	—	—	(2,798)
Issuance of common stock for Creative Designs	150	—	3,325	—	—	3,325
Net income	—	—	—	72,375	—	72,375
Foreign currency translation adjustment	—	—	—	—	(638)	(638)
Balance, December 31, 2006	27,777	28	300,255	312,432	(3,427)	609,288
Adoption of FIN 48	—	—	—	(19,135)	—	(19,135)
Exercise of options	391	—	6,470	—	—	6,470
Stock option income tax benefit	—	—	1,053	—	—	1,053
Restricted stock grants	323	—	8,082	—	—	8,082
Compensation for vested stock options	—	—	972	—	—	972
Retirement of common stock	(191)	—	(4,675)	—	—	(4,675)
Retirement of Restricted Stock	(25)	—	(30)	—	—	(30)
Net income	—	—	—	88,991	—	88,991
Foreign currency translation adjustment	—	—	—	—	(19)	(19)
Balance, December 31, 2007	28,275	28	312,127	382,288	(3,446)	690,997
Exercise of options	315	—	4,171	—	—	4,171
Stock option income tax benefit	—	—	1,338	—	—	1,338
Restricted stock grants	318	1	7,764	—	—	7,765
Compensation for vested stock options	—	—	537	—	—	537
Retirement of common stock	(1,259)	(1)	(30,000)	—	—	(30,001)
Retirement of Restricted Stock	(128)	—	(3,128)	—	—	(3,128)
Net income	—	—	—	76,057	—	76,057
Foreign currency translation adjustment	—	—	—	—	(783)	(783)
Balance, December 31, 2008	27,521	\$ 28	\$ 292,809	\$ 458,345	\$ (4,229)	\$ 746,953

See notes to consolidated financial statements.

41

JAKKS PACIFIC, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
	2006	2007	2008
	(In thousands)		
Cash flows from operating activities			
Net income	\$ 72,375	\$ 88,991	\$ 76,057
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	26,166	26,663	27,566
Share-based compensation expense	6,482	9,054	7,302
Profit from video game joint venture	(5,147)	(21,856)	(17,507)
Loss on disposal of property and equipment	48	1,781	99
Write-down of intangible assets	—	—	9,076
Deferred income taxes	(1,043)	2,644	14,367
Changes in operating assets and liabilities, net of acquisitions			
Accounts receivable	(52,885)	(21,334)	46,204
Inventory	(8,352)	1,329	(6,553)
Prepaid expenses and other	(8,293)	9,019	(6,329)
Income tax receivable	—	—	(22,288)
Accounts payable	12,608	(13,061)	(31,324)
Accrued expenses	1,882	14,493	(6,573)
Income taxes payable	14,756	(891)	(21,415)
Reserve for sales returns and allowances	5,253	(6,489)	(2,718)
Other liabilities	(140)	1,519	(5,169)
Total adjustments	(8,665)	2,871	(15,262)
Net cash provided by operating activities	63,710	91,862	60,795
Cash flows from investing activities			
Purchases of property and equipment	(11,204)	(18,116)	(22,274)
Change in other assets	46	(4,208)	(2,155)
Change in deposits	(701)	17	(901)
Cash paid for net assets of businesses acquired	(109,845)	(15,605)	(79,598)
Net (purchases) sales of marketable securities	(210)	(7)	23
Net cash used by investing activities	(121,914)	(37,919)	(104,905)
Cash flows from financing activities			
Proceeds from stock options exercised (net of cashless exercises of \$ 2.8 million, \$4.7 million and \$3.1 million in 2006, 2007 and 2008, respectively)	1,584	1,765	1,043
Common stock repurchased	—	—	(30,001)
Tax benefit from stock options exercised	1,509	1,053	1,338
Net cash provided by (used in) financing activities	3,093	2,818	(27,620)
Impact of foreign currency translation	(638)	—	—
Net increase (decrease) in cash and cash equivalents	(55,749)	56,761	(71,730)
Cash and cash equivalents, beginning of year	240,238	184,489	241,250
Cash and cash equivalents, end of year	\$ 184,489	\$ 241,250	\$ 169,520
Cash paid during the period for:			
Interest	\$ 4,533	\$ 4,533	\$ 4,610
Income taxes	\$ 19,496	\$ 32,198	\$ 43,408

See Notes 5 and 18 for additional supplemental information to consolidated statements of cash flows.

See notes to consolidated financial statements.

JAKKS PACIFIC, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2008

Note 1—Principal Industry

JAKKS Pacific, Inc. (the “Company”) is engaged in the development, production and marketing of consumer products, including toys and related products, stationery and writing instruments and pet toys and related products, some of which are based on highly-recognized entertainment properties and character licenses. The Company commenced its primary business operations in July 1995 through the purchase of substantially all of the assets of a Hong Kong toy company. The Company markets its product lines domestically and internationally.

The Company was incorporated under the laws of the State of Delaware in January 1995.

Note 2—Summary of Significant Accounting Policies

Principles of consolidation

The consolidated financial statements include accounts of the Company and its wholly-owned subsidiaries. In consolidation, all significant inter-company balances and transactions are eliminated.

Cash and cash equivalents

The Company considers all highly liquid assets, having an original maturity of less than three months, to be cash equivalents. The Company maintains its cash in bank deposits which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant credit risk of cash and cash equivalents.

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the dates of the financial statements, and the reported amounts of revenue and expenses during the reporting periods. Actual future results could differ from those estimates.

Revenue recognition

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. The Company 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’s reserve for sales returns and allowances decreased by \$2.7 million from \$26.0 million as of December 31, 2007 to \$23.3 million as of December 31, 2008. This decrease is primarily due to certain customers taking their year-end allowances related to

2007 and 2008 during 2008 and lower sales in the fourth quarter of 2008 compared to the fourth quarter of 2007.

43

Inventory

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

	December 31,	
	2007	2008
Raw materials	\$ 1,694	\$ 3,778
Finished goods	73,792	84,166
	\$ 75,486	\$ 87,944

Fair value of financial instruments

The Company's cash and cash equivalents, marketable securities, accounts receivable, accounts payable and accrued expenses represent financial instruments. The carrying value of these financial instruments is a reasonable approximation of fair value. The fair value of the \$98.0 million of convertible senior notes payable at December 31, 2007 and 2008 was approximately \$137.7 million and \$103.8 million, respectively, based on the most recent quoted market price.

Property and equipment

Property and equipment are 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 - 4 years
Leasehold improvements	Shorter of length of lease or 10 years

For the years ended December 31, 2006, 2007, and 2008, the Company's aggregate depreciation expense related to property and equipment was \$8.5 million, \$11.4 million and \$17.7 million, respectively.

Advertising

Production costs of commercials and programming are charged to operations in the period during which the production is first aired. The costs of other advertising, promotion and marketing programs are charged to operations in the period incurred. Advertising expense for the three years in the period ended December 31, 2008, was approximately \$36.7 million, \$22.3 million and \$28.0 million, respectively.

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.

Income taxes

The Company does not file a consolidated return with its foreign subsidiaries. The Company files federal and state returns and its 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.

Translation of foreign currencies

Assets and liabilities denominated in Hong Kong dollars are translated into United States dollars at the rate of exchange ruling at the balance sheet date. Transactions during the period are translated at the rates ruling at the dates of the transactions.

Profits and losses resulting from the above translation policy are recognized in the statements of other comprehensive income.

Accounting for the impairment of finite-lived intangible assets

Long-lived assets with finite lives, which include property and equipment and intangible assets other than goodwill, are evaluated at least annually for impairment when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable through the estimated undiscounted future cash flows from the use of these assets. When any such impairment exists, the related assets will be written down to fair value. Finite-lived intangible assets consist primarily of product technology rights, acquired backlog, customer relationships, product lines and license agreements. These intangible assets are amortized over the estimated economic lives of the related assets. Accumulated amortization as of December 31, 2007 and 2008 was \$63.1 million and \$72.5 million, respectively.

Goodwill and other indefinite-lived intangible assets

In accordance with Statement of Financial Accounting Standards (“SFAS”) 142, Goodwill and Other Intangible Assets, goodwill and indefinite-lived intangible assets are not amortized, but are tested for impairment at least annually at the reporting unit level. Losses in value are recorded when and as material impairment has occurred in the underlying assets or when the benefits of the identified intangible assets are realized. Indefinite-lived intangible assets other than goodwill consist of trademarks.

During the third quarter of 2008, the Company decided to discontinue 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 December 31, 2008, there was no impairment to the underlying value of goodwill.

The carrying value of goodwill and trademarks are based on cost which is subject to management’s current assessment of fair value. Management evaluates fair value recoverability using both objective and subjective factors. Objective factors include management’s best estimates of projected future earnings and cash flows and analysis of recent sales and earnings trends. Subjective factors include competitive analysis and the Company’s strategic focus.

Share-based Compensation

In December 2004, the FASB issued SFAS 123 (Revised), Share-Based Payment, (“SFAS 123R”) which amends SFAS 123, Accounting for Stock Based Compensation, and SFAS 95, Statement of Cash Flows. SFAS 123R requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its consolidated financial statements, and requires additional accounting and disclosure related to the income tax and cash flow effects resulting from share-based payment arrangements. SFAS 123R was effective for the Company beginning as of January 1, 2006, and the Company recorded \$1.9 million, \$1.0 million and \$0.5 million of stock option expense in 2006, 2007 and 2008, respectively, and \$4.6 million, \$8.1 million and \$6.8 million of restricted stock expense, respectively, in 2006, 2007 and 2008. See Note 16 for further details relating to share based compensation.

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 (“EPS”) for the periods presented (in thousands, except per share data):

	Income	2006 Weighted Average Shares	Per Share
Basic EPS			
Income available to common stockholders	\$ 72,375	27,227	\$ 2.66
Effect of dilutive securities			
Assumed conversion of convertible senior notes	2,946	4,900	
Options and warrants	—	362	
Diluted EPS	—	225	
Income available to common stockholders plus assumed exercises and conversion	\$ 75,321	32,714	\$ 2.30

45

	Income	2007 Weighted Average Shares	Per Share
Basic EPS			
Income available to common stockholders	\$ 88,991	27,665	\$ 3.22
Effect of dilutive securities			
Assumed conversion of convertible senior notes	2,946	4,900	
Options and warrants	—	328	
Unvested restricted stock grants	—	256	
Diluted EPS			
Income available to common stockholders plus assumed exercises and conversion	\$ 91,937	33,149	\$ 2.77

	Income	2008 Weighted Average Shares	Per Share
Basic EPS			
Income available to common stockholders	\$ 76,057	27,379	\$ 2.78
Effect of dilutive securities			
Assumed conversion of convertible senior notes	2,946	4,900	
Options and warrants	—	134	
Unvested restricted stock grants	—	224	
Diluted EPS			
Income available to common stockholders plus assumed exercises and conversion	\$ 79,003	32,637	\$ 2.42

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, restricted stock and convertible debt to the extent they are dilutive). Potentially dilutive stock options of 406,612, nil and 14,892 for the years ended December 31, 2006, 2007 and 2008, respectively, were not included in 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 restricted stock of nil, 13,907 and nil for the years ended December 31, 2006, 2007 and 2008, respectively, were not included in 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 restricted stock and to have included them would have been anti-dilutive.

Recent Accounting Standards

In December 2007, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 141 (Revised) ("FAS 141(R)", Business Combinations. This statement contains specific guidance regarding the accounting for costs of business acquisitions and for estimating contingent consideration provisions at the time of acquisition. This new guidance replaces the previous guidance in FAS 141. The Company will adopt FAS 141(R) in calendar year 2009.

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48 ("FIN 48"), Accounting for Uncertainty in Income Taxes, which prescribes a recognition threshold and measurement process for recording in the

financial statements uncertain tax positions taken or expected to be taken in a tax return. Under FIN 48, the tax benefit of uncertain tax positions may be recognized only if it is more likely than not that the tax position will be sustained, based solely on its technical merits presuming the tax authority has full knowledge of all relevant information. Additionally, FIN 48 provides guidance on the de-recognition, classification, and accounting in interim periods and disclosure requirements for uncertain tax positions. In the first quarter of 2007, the Company adopted FIN 48 which resulted in the recognition of an increased current and non-current income tax payable for unrecognized tax benefits of \$15.6 million. The Company has also recognized an additional liability of \$2.5 million for penalties and \$2.8 million for interest on the income tax liability. These increases to the liabilities resulted in a reduction of \$19.1 million to the January 1, 2007 balance of retained earnings, net of related tax benefits. Current interest on income tax liabilities is recognized as interest expense and penalties on income tax liabilities are recognized as other expense in the consolidated statement of income.

Edgar Filing: JAKKS PACIFIC INC - Form 10-K

In September 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 157 (“FAS 157”) Fair Value Measurements. This standard provides new definitions for fair value and establishes a framework for measuring fair value in financial statements. FAS 157 became effective for the Company as of January 1, 2008 and the effect of the adoption of FAS 157 has been immaterial to its financial statements.

Reclassifications

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

Note 3—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, electronic products, novelty toys, construction toys, compounds, infant and pre-school toys, water toys, kites, squirt guns, and related products.

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

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 for the three years in the period ended December 31, 2008 are as follows (in thousands):

	Years Ended December 31,		
	2006	2007	2008
Net Sales			
Traditional Toys	\$ 692,498	\$ 792,998	\$ 816,852
Craft/Activity/Writing Products	52,834	39,632	65,888
Pet Products	20,054	24,455	20,657
	\$ 765,386	\$ 857,085	\$ 903,397

	Years Ended December 31,		
	2006	2007	2008
Operating Income			
Traditional Toys	\$ 83,521	\$ 100,227	\$ 65,133
Craft/Activity/Writing Products	6,372	4,079	4,604
Pet Products	2,419	2,692	1,099
	\$ 92,312	\$ 106,998	\$ 70,836

Years Ended December 31,

Edgar Filing: JAKKS PACIFIC INC - Form 10-K

	2006	2007	2008
Depreciation and Amortization Expense			
Traditional Toys	\$ 24,780	\$ 25,339	\$ 25,332
Craft/Activity/Writing Products	995	829	1,182
Pet Products	391	495	185
	\$ 26,166	\$ 26,663	\$ 26,699

47

	December 31,	
	2007	2008
Assets		
Traditional Toys	\$ 840,232	\$ 877,606
Craft/Activity/Writing Products	115,893	128,036
Pet Products	27,539	22,482
	\$ 983,664	\$ 1,028,124

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

	December 31,	
	2007	2008
Long-lived Assets		
United States	\$ 19,372	\$ 26,179
Hong Kong	2,035	2,319
	\$ 21,407	\$ 28,498

	Years Ended December 31,		
	2006	2007	2008
Net Sales by Geographic Area			
United States	\$ 666,294	\$ 730,971	\$ 741,486
Europe	30,169	37,585	46,832
Canada	27,067	29,155	36,929
Hong Kong	17,500	30,175	38,318
Other	24,356	29,199	39,832
	\$ 765,386	\$ 857,085	\$ 903,397

Major Customers

Net sales to major customers were as follows (in thousands, except for percentages):

	2006		2007		2008	
	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales
Wal-Mart	\$ 210,758	27.5%	\$ 219,145	25.5%	\$ 272,211	30.1%
Target	134,347	17.6	142,026	16.6	118,850	13.2
Toys 'R' Us	104,392	13.6	140,387	16.4	119,125	13.2
	\$ 449,497	58.7%	\$ 501,558	58.5%	\$ 510,186	56.5%

No other customer accounted for more than 10% of our total net sales.

At December 31, 2007 and 2008, the Company's three largest customers accounted for approximately 82.2% and 74.0%, 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.

Note 4—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 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 have not reached an agreement with respect to the preferred return for the Next Distribution Period and the preferred return for the Next Distribution Period is to be determined through arbitration. The preferred return is accrued in the quarter in which the licensed games are sold and the preferred return is earned. Based on the same rates as set forth under the original joint venture agreement, an estimated receivable of \$52.8 million has been accrued for the period from July 1, 2006 to December 31, 2008, pending the resolution of this outstanding issue. JAKKS seeks to retain the same rates as set forth under the original joint venture agreement, while THQ seeks to pay a substantially lower rate. In the event the arbitration results in a lower rate to the Company, there would be a material charge to earnings and reduction in the receivable from THQ. As of December 31, 2007 and 2008, the balance of the investment in the video game joint venture includes the following components (in thousands):

	December 31,	
	2007	2008
Preferred return receivable	\$ 35,338	\$ 52,845
Investment costs, net	752	339
	\$ 36,090	\$ 53,184

The Company’s joint venture partner retains the financial risk of the joint venture and is responsible for day-to-day operations, including development, sales and distribution, for which they are entitled to any remaining profits. In addition, THQ is entitled to receive a preferred return based on the sale by the Company of its WWE-themed TV Games. During 2006, 2007 and 2008, the Company earned \$13.2 million, \$21.2 million and \$17.1 million, respectively, in net profit from the joint venture.

Note 5—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:

On October 7, 2008, the Company acquired substantially all of the assets of Tollytots Limited. The total initial consideration of \$25.5 million consisted of \$11.8 million in cash and the assumption of liabilities in the amount of \$13.7 million, and resulted in goodwill of \$3.0 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 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.

On October 8, 2008, the Company acquired substantially 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 \$23.2 million consisted of \$20.3 million in cash and the assumption of liabilities in the amount of \$2.9 million, and resulted in goodwill of \$12.5 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 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.

On December 29, 2008, the Company acquired certain assets of Disguise, Inc. and a related Hong Kong company, Disguise Limited (collectively, "Disguise"). The total initial consideration of \$61.9 million consisted of \$39.9 million in cash and the assumption of liabilities in the amount of \$22.0 million, and resulted in goodwill of \$51.6 million. The Company has not finalized its purchase price allocation for Disguise and will engage a third party to perform studies and valuations to 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 February 2006, the Company acquired substantially all of the assets of Creative Designs International, Ltd. and a related Hong Kong company, Arbor Toys Company Limited (collectively, "Creative Designs"). The total initial consideration of \$111.1 million consisted of cash paid at closing in the amount of \$101.7 million, the issuance of 150,000 shares of the Company's common stock valued at approximately \$3.3 million and the assumption of liabilities in the amount of \$6.1 million, and resulted in the recording of goodwill in the amount of \$53.6 million. Goodwill represents anticipated synergies to be gained via the combination of Creative Designs with the Company. In addition, the Company agreed to pay an earn-out of up to an aggregate of \$20.0 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. For the years ended December 31, 2006, 2007 and 2008, \$6.9 million, \$6.7 and \$5.7 million, respectively, of the earn-out was earned and recorded as goodwill. Creative Designs is a leading designer and producer of dress-up and role-play toys. This acquisition expands the Company's product offerings in the girls role-play and dress-up area and brings it new product development and marketing talent. The Company's results of operations have included Creative Designs from the date of acquisition.

Edgar Filing: JAKKS PACIFIC INC - Form 10-K

The amount of goodwill from the Creative Designs acquisition that is expected to be deductible for federal and state income tax purposes is approximately \$51.4 million. The total purchase price was allocated based on studies and valuations performed to the estimated fair value of assets acquired and liabilities assumed. The purchase price allocation including an aggregate earn-out amount of \$19.3 million earned through December 31, 2008 is set forth in the following table (in thousands):

Estimated fair value of net assets:	
Current assets acquired	\$ 15,655
Property and equipment, net	1,235
Other assets	103
Liabilities assumed	(6,081)
Intangible assets other than goodwill	40,488
Goodwill	72,853
	\$ 124,253

The following unaudited pro forma information represents the Company's consolidated results of operations as if the acquisition of Creative Designs had occurred on January 1, 2006 and after giving effect to certain adjustments including the elimination of certain general and administrative expenses and other income and expense items not attributable to ongoing operations, interest expense, and related tax effects. Such pro forma information does not purport to be indicative of operating results that would have been reported had the acquisition of Creative Designs actually occurred on January 1, 2006 or on future operating results (in thousands, except per share data).

	Year Ended December 31, 2006
Net sales	\$ 778,269
Net income	\$ 75,221
Basic earnings per share	\$ 2.73
Weighted average shares outstanding	27,512
Diluted earnings per share	\$ 2.38
Weighted average shares and equivalents outstanding	32,777

Note 6—Goodwill

The changes in the carrying amount of goodwill for the years ended December 31, 2007 and 2008 are as follows (in thousands):

	Traditional	Craft/Activity /Writing	Pet	Total
	Toys	Products	Products	
Balance, December 31, 2006	\$ 249,049	\$ 82,826	\$ 6,124	\$ 337,999
Adjustments to goodwill during the year	13,341	—	2,000	15,341
Balance, December 31, 2007	262,390	82,826	8,124	353,340
Adjustments to goodwill during the year	72,693	—	1,660	74,353
Balance December 31, 2008	\$ 335,083	\$ 82,826	\$ 9,784	\$ 427,693

During 2007, adjustments to goodwill include earn-outs of \$6.7 million, \$6.6 million and \$2.0 million earned during 2007 related to the Company's Play Along, Creative Designs, an Pet Pal acquisitions, respectively. During 2008 adjustments to goodwill include earn-outs of \$1.7 million and \$5.7 million earned during 2008 related to the Company's Pet Pal and Creative Designs acquisitions, respectively. Please refer to Note 5 for goodwill for current

year acquisitions.

50

Note 7—Intangible Assets Other Than Goodwill

Intangible assets other than goodwill consist primarily of licenses, product lines, debt offering costs from 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):

	Weighted Useful Lives (Years)	December 31, 2007			December 31, 2008		
		Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
Amortized Intangible Assets:							
Acquired order backlog	0.50	\$ 1,298	\$ (1,298)	\$ —	\$ 2,393	\$ (2,165)	\$ 228
Licenses	4.41	58,699	(39,091)	19,608	67,088	(46,638)	20,450
Product lines	3.45	17,700	(17,700)	—	17,700	(17,700)	—
Customer relationships	5.57	3,646	(1,805)	1,841			