JAKKS PACIFIC INC
Form 10-Q
May 10, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2013

OR

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

For the transition period from ______ to ______

Commission file number: 0-28104

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

Delaware	95-4527222
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

22619 Pacific Coast Highway Malibu, California	90265
(Address of Principal Executive Offices)	(Zip Code)

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

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 x No o

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

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

Large accelerated filer	Accelerated filer	Non-accelerated filer	Smaller reporting company
o	x	o (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 o No x

The number of shares outstanding of the issuer’s common stock is 22,306,338 as of May 9, 2013.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

INDEX TO QUARTERLY REPORT ON FORM 10-Q
Quarter Ended March 31, 2013

ITEMS IN FORM 10-Q

DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

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

JAKKS PACIFIC, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share amounts)

Assets	December 31, 2012 (*)	March 31, 2013 (Unaudited)
Current assets		
Cash and cash equivalents	$ 189,321	$ 165,361
Marketable securities	218	218
Accounts receivable, net of allowance for uncollectible accounts of $2,536 and $2,824, respectively	105,455	64,985
Inventory	59,690	52,052
Income tax receivable	24,008	24,008
Deferred income taxes	7,058	7,058
Prepaid expenses and other	20,306	31,916
Total current assets	406,056	345,598
Property and equipment		
Office furniture and equipment	14,268	14,345
Molds and tooling	73,487	75,388
Leasehold improvements	7,044	7,046
Total	94,799	96,779
Less accumulated depreciation and amortization	78,973	80,543
Property and equipment, net	15,826	16,236
Deferred income taxes	—	—
Intangibles	67,054	66,031
Other long term assets	4,584	4,132
Investment in DreamPlay LLC	7,000	7,000
Investment in joint venture	3,161	4,062
Goodwill, net	48,836	48,489
Trademarks, net	2,308	2,308
Total assets	$ 554,825	$ 493,856
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$ 37,793	$ 30,402
Accrued expenses	63,677	49,974
Reserve for sales returns and allowances	34,373	30,725
Income taxes payable	12,922	18,251
Short term debt	70,710	57,910
Total current liabilities	219,475	187,262
Convertible senior notes, net	94,918	95,600
Other liabilities	18,345	18,449
Income taxes payable	4,687	4,614
Deferred income taxes	10,180	10,180
Total liabilities	347,605	316,105
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; 21,969,355 and 22,306,338 shares issued and outstanding, respectively		22		22
Additional paid-in capital		202,577		202,784
Retained earnings		8,836		(20,273)
Accumulated other comprehensive loss		(4,215)		(4,782)
Total stockholders' equity		207,220		177,751
Total liabilities and stockholders' equity	$	554,825	$	493,856

(*) Derived from audited financial statements
See accompanying notes to condensed consolidated financial statements.

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JAKKS PACIFIC, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

	Three Months Ended March 31, (Unaudited)	
	2012	2013
Net sales	$ 73,405	$ 78,069
Cost of sales	49,839	54,690
Gross profit	23,566	23,379
Selling, general and administrative expenses	42,976	47,224
Loss from operations	(19,410)	(23,845)
Equity in net income (loss) of joint venture	54	(646)
Interest income	199	75
Interest expense, net of benefit	(2,035)	(2,846)
Loss before provision (benefit) for income taxes	(21,192)	(27,262)
Provision (benefit) for income taxes	(5,192)	300
Net loss	$ (16,000)	$ (27,562)
Loss per share – basic and diluted	$ (0.62)	$ (1.26)
Comprehensive income (loss)	$ (16,052)	$ (28,129)

See accompanying notes to condensed consolidated financial statements.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Three Months Ended March 31, (Unaudited)	
	2012	2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$ (16,000)	$ (27,562)
Adjustments to reconcile net loss to net cash provided (used) by operating activities:		
Depreciation and amortization	3,171	3,728
Share-based compensation expense	338	207
Loss on disposal of property and equipment	17	
Deferred income taxes	(238)	
Equity in net loss of joint venture	(54)	834
Changes in operating assets and liabilities:		
Accounts receivable	45,234	40,470
Inventory	2,021	7,638
Prepaid expenses and other current assets	(3,718)	(11,610)
Income tax receivable	158	
Accounts payable	(4,700)	(7,391)
Accrued expenses	(11,565)	(13,703)
Income taxes payable	5,142	5,256
Reserve for sales returns and allowances	(13,893)	(3,648)
Other liabilities	228	104
Total adjustments	22,141	21,885
Net cash provided (used) by operating activities	6,141	(5,677)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property and equipment	(3,216)	(1,982)
Change in other assets	(39)	(566)
Contribution to joint venture	(610)	(2,237)
Distribution from joint venture		502
Cash (paid) refunded for net assets of business acquired	(2,377)	347
Net cash used in investing activities	(6,242)	(3,936)
CASH FLOWS FROM FINANCING ACTIVITIES		
Common stock surrendered	(15)	
Proceeds from credit facility borrowings		(12,800)
Dividends paid	(2,587)	(1,547)
Net cash used in financing activities	(2,602)	(14,347)
Net decrease in cash and cash equivalents	(2,703)	(23,960)
Cash and cash equivalents, beginning of period	257,258	189,321
Cash and cash equivalents, end of period	$ 254,555	$ 165,361
Cash paid (received) during the period for:		
Income taxes	$ (12,083)	$ (4,788)
Interest	$	$ 524

See Notes 9 and 10 for additional supplemental information to the condensed consolidated statements of cash flows.

See accompanying notes to condensed consolidated financial statements.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
March 31, 2013

Note 1 — Basis of Presentation

The accompanying unaudited interim condensed consolidated financial statements included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures are adequate to prevent the information presented from being misleading. These financial statements should be read in conjunction with Management’s Discussion and Analysis of Financial Condition and Results of Operations and the financial statements and the notes thereto included in the Company’s Annual Report on Form 10-K, which contains audited financial information for the three years in the period ended December 31, 2012.

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

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

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

The Company is a worldwide producer and marketer of children’s toys and other consumer products, principally engaged in the design, development, production, marketing and distribution of its diverse portfolio of products. The Company’s reportable segments are Traditional Toys and Electronics and Role Play, Novelty and Seasonal Toys, each of which includes worldwide sales.

The Traditional Toys and Electronics segment includes action figures, vehicles, playsets, plush products, dolls, accessories, electronic products, construction toys, infant and pre-school toys, foot to floor ride-on vehicles, wagons and pet treats and related products.

Role Play, Novelty and Seasonal Toys include role play and dress-up products, Halloween and everyday costume play, novelty toys, seasonal and outdoor products and indoor and outdoor kids’ furniture.

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 upon sales volumes. Segment assets are comprised of accounts receivable and inventories, net of applicable reserves and allowances, goodwill and other assets.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

Results are not necessarily those that would be achieved were each segment an unaffiliated business enterprise. Information by segment and a reconciliation to reported amounts for the three months ended March 31, 2012 and 2013 and as of December 31, 2012 and March 31, 2013 are as follows (in thousands):

	Three Months Ended March 31,	
	2012	2013
Net Sales		
Traditional Toys and Electronics	$ 41,578	$ 38,117
Role Play, Novelty and Seasonal Toys	31,827	39,952
	$ 73,405	$ 78,069

	Three Months Ended March 31,	
	2012	2013
Loss from Operations		
Traditional Toys and Electronics	$ (10,856)	$ (13,122)
Role Play, Novelty and Seasonal Toys	(8,554)	(10,723)
	$ (19,410)	$ (23,845)

	Three Months Ended March 31,	
	2012	2013
Depreciation and Amortization Expense		
Traditional Toys and Electronics	$ 1,745	$ 1,793
Role Play, Novelty and Seasonal Toys	559	865
	$ 2,304	$ 2,658

	December 31, 2012	March 31, 2013
Assets		
Traditional Toys and Electronics	$ 309,940	$ 230,158
Role Play, Novelty and Seasonal Toys	244,885	263,698
	$ 554,825	$ 493,856

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JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

The following tables present information about the Company by geographic area as of December 31, 2012 and March 31, 2013 and for the three months ended March 31, 2012 and 2013 (in thousands):

	December 31, 2012	March 31, 2013
Long-lived Assets		
China	$ 10,793	$ 11,643
United States	3,762	3,425
Hong Kong	1,271	1,168
	$ 15,826	$ 16,236

	Three Months Ended March 31, 2012	2013
Net Sales by Customer Location		
United States	$ 63,871	$ 61,383
Europe	3,209	9,068
Canada	2,779	2,090
Hong Kong	229	1,210
Other	3,317	4,318
	$ 73,405	$ 78,069

Major Customers

Net sales to major customers for the three months ended March 31, 2012 and 2013 were as follows (in thousands, except for percentages):

	Three Months Ended March 31, 2012		2013	
	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales
Target	$ 6,651	9.1%	$ 9,493	12.2%
Wal-Mart	16,126	22.0	18,182	23.3
Toys ‘R’ Us	10,575	14.4%	7,052	9.0
	$ 33,352	45.5%	$ 34,727	44.5%

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

At December 31, 2012 and March 31, 2013, the Company’s three largest customers accounted for approximately 42.1% and 46.2%, 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.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 3 — Inventory

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

	December 31, 2012	March 31, 2013
Raw materials	$ 3,296	$ 3,716
Finished goods	56,394	48,336
	$ 59,690	$ 52,052

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

Revenue is recognized upon the shipment of goods to customers or their agents, depending upon terms, provided 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 product returns. It provides its customers a negotiated allowance for breakage or defects, 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 based upon historic return amounts and management estimates. The Company occasionally grants credits to facilitate markdowns and sales of slow moving merchandise. These credits are recorded as a reduction of gross sales at the time of occurrence.

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

The Company's reserve for sales returns and allowances amounted to $34.4 million as of December 31, 2012, compared to $30.7 million as of March 31, 2013. This decrease was primarily due to certain customers taking their year-end allowances related to 2012 sales during 2013.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 5 — Credit Facility

On September 27, 2012, the Company and its domestic subsidiaries entered into a secured credit facility with Wells Fargo Bank, National Association (the “Loan Agreement”). The Loan Agreement provides for a $75.0 million working capital revolving credit facility. The amounts outstanding under the revolving credit facility are payable in full upon maturity of the credit facility on April 30, 2013. The credit facility is secured by a substantial amount of the assets of the Company. The amount outstanding on the credit facility at March 31, 2013 was $57.9 million; the total borrowing capacity was approximately $60.0 million which includes an over advance of up to $30.0 million based on the amendment to the Loan Agreement.

The Company’s ability to borrow under the Loan Agreement is subject to its ongoing compliance with certain financial covenants, including that the Company and its subsidiaries (a) maintain and earn on a consolidated basis as of the last day of each fiscal quarter, for the rolling four quarter period ending on such date, consolidated Net Profit (as defined in the Loan Agreement) equal to or greater than $1 (one dollar); (b) maintain a ratio of consolidated total funded debt to consolidated EBITDA (the “consolidated leverage ratio”) of not greater than 3.00:1.0; and (c) maintain Liquidity (as defined in the Loan Agreement) of at least $100.0 million.

The Loan Agreement allows the Company to borrow under the credit facility at LIBOR or at a base rate, plus applicable margins based on the funded debt to EBITDA leverage ratio for the most recent twelve month rolling quarter end. Applicable margins vary between a 150 to 200 basis point spread over LIBOR and between a negative 50 to zero basis point spread on base rate loans. As of March 31, 2013, the rate on the credit facility was 3.25%. In addition, the credit facility has an unused line fee based on the unused amount of the credit facility, ranging from 12.5 to 25 basis points.

The Loan Agreement also contains customary events of default, including a cross default provision and a change of control provision. In the event of a default, all of the obligations of the Company and its subsidiaries under the Loan Agreement may be declared immediately due and payable. For certain events of default relating to insolvency and receivership, all outstanding obligations become due and payable.

As of March 31 2013, the Company was not in compliance with two of the three financial covenants under the Loan Agreement but was in compliance with all of the remaining covenants. At March 31, 2013, the Company had consolidated Net Profit of negative $34.4 million when it was required to have at least $1 and it had a consolidated leverage ratio of 35.02 when it was required to be not greater than 3.00. The Company met the third covenant of having at least $100.0 million of Liquidity by having $165.6 million of Liquidity. By Amendment to the Loan Agreement dated March 28, 2013, the Bank granted the Company an over advance of up to $30.0 over the borrowing capacity million of which $29.0 million was advanced to the Company on March 29, 2013.

In addition, the maturity date was changed to April 2, 2013, on which date the Company paid off the credit facility in full. The Company is in the process of obtaining a replacement credit facility. If the Company is unable to obtain a replacement line of credit, the Company's operations and growth prospects may be adversely affected, and they might need to seek additional equity or debt financing. There is no assurance that such alternative financing would be available on acceptable terms or at all. Furthermore, any equity financing could result in dilution to existing stockholders and any debt financing might include restrictive covenants that could impede the Company’s ability to effectively operate and grow its business in the future.

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Note 6 — Convertible Senior Notes

In November 2009, the Company sold an aggregate of $100.0 million principal amount of 4.50% Convertible Senior Notes due 2014 (the “Notes”). The Notes, which are senior unsecured obligations of the Company, pay cash interest semi-annually at a rate of 4.50% per annum and will mature on November 1, 2014. The initial conversion rate was 63.2091 shares of JAKKS common stock per $1,000 principal amount of notes (equivalent to an initial conversion price of approximately $15.82 per share of common stock), subject to adjustment under certain circumstances. As a result of the cash dividend of $0.10 per share declared by the Board of Directors paid October 3, 2011, January 3, 2012, April 2, 2012, July 2, 2012, October 1, 2012 and January 2, 2013 and of $0.07 per share declared by the Board paid April 1, 2013 and the above-market self-tender offer in July 2012 (see Note 9 – Common Stock and Preferred Stock), the new conversion rate is 68.3831 shares of JAKKS common stock per $1,000 principal amount of notes (or approximately $14.62 per share). Prior to August 1, 2014, holders of the Notes may convert their Notes only upon the occurrence of specified events. Upon conversion, the Notes may be settled, at the Company’s election, in cash, shares of its common stock or a combination of cash and shares of its common stock. Holders of the Notes may require that the Company repurchase for cash all or some of their Notes upon the occurrence of a fundamental change (as defined).

Accounting Standards Codification ("ASC") 470-20, “Debt with Conversion and Other Options,” requires the issuer of certain convertible debt instruments that may be settled in cash (or other assets) upon conversion to separately account for the liability (debt) and equity (conversion option) components of the instrument in a manner that reflects the issuer's non-convertible debt borrowing rate. In accordance with ASC 470-20, the Company allocated $13.7 million of the $100.0 million principal amount of the Notes to the equity component, which represents a discount to the debt that is being amortized to interest expense through November 1, 2014. Interest expense associated with the amortization of the discount was $0.7 million for each of the three months ended March 31, 2012 and 2013. The balance of the discount was $4.4 million and $5.1 million at March 31, 2013 and December 31, 2012, respectively.

Note 7 — Income Taxes

The Company’s income tax expense of $0.3 million for the three months ended March 31, 2013 reflects an effective tax rate of (1.10%). Included in the tax expense of $0.3 million is a discrete tax benefit of $73,000 related to a reduction in tax reserves resulting from closed statutes of limitation. The Company’s income tax benefit of $5.2 million for the three months ended March 31, 2012 reflects an effective tax rate of 24.5%. Included in the tax benefit of $5.2 million is a discrete tax benefit of $0.4 million related to a reduction in tax reserves resulting from closed statutes of limitation.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 8 —Loss Per Share

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

	Three Months Ended March 31,					
	2012			2013		
	Loss	Weighted Average Shares	Per-Share	Loss	Weighted Average Shares	Per-Share
Loss per share – basic						
Net loss available to common stockholders	$ (16,000)	25,831	$ (0.62)	$ (27,562)	21,873	$ (1.26)
Effect of dilutive securities:						
Convertible senior notes	–			–		
Options and warrants	–			–		
Unvested restricted stock grants	–			–		
Loss per share – diluted						
Loss available to common stockholders plus assumed exercises and conversion	$ (16,000)	25,831	$ (0.62)	$ (27,562)	21,873	$ (1.26)

Basic earnings per share is calculated using the weighted average number of common shares outstanding during the period. Diluted earnings per share is calculated using the weighted average number of common shares and common share equivalents outstanding during the period (which consist of warrants, options and convertible debt to the extent they are dilutive). Common share equivalents that could potentially dilute basic earnings per share in the future, which were excluded from the computation of diluted loss per share, totaled approximately 240,265 and 417,207 for the three months ended March 31, 2012 and 2013, respectively.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 9 — Common Stock and Preferred Stock

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

In January 2013, the Company issued an aggregate of 285,543 shares of restricted stock at a value of $3.6 million to two executive officers, which vest, subject to certain company financial performance criteria, over a one to three year period. In addition, an aggregate of 54,227 shares of restricted stock were issued to its seven non-employee directors, which vest in January 2014, at an aggregate value of approximately $0.7 million.

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

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 10 — Business Combinations

In October 2011, the Company acquired all of the stock of Moose Mountain Toymakers Limited, a Hong Kong company, and a related New Jersey company, Moose Mountain Marketing, Inc. (collectively, “Moose Mountain”). The total initial consideration of $32.2 million consisted of $16.7 million in cash and the assumption of liabilities in the amount of $15.5 million, and resulted in goodwill of $14.2 million. In addition, the Company agreed to pay an earn-out of up to an aggregate amount of $5.3 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria. The fair value of the expected earn-out of $4.6 million was included in goodwill and assumed liabilities as of the acquisition date. All future changes to the earn-out liability will be charged to income. Moose Mountain is a leading designer and producer of foot to floor ride-ons, inflatable environments, wagons, pinball machines and tents and was included in the Company’s results of operations from the date of acquisition.

In July 2012, the Company acquired all of the stock of Maui, Inc., an Ohio corporation, Kessler Services, Inc., a Nevada corporation, and A.S. Design Limited, a Hong Kong corporation (collectively, “Maui”). The total initial consideration of $37.6 million consisted of $36.2 million in cash and the assumption of liabilities in the amount of $1.4 million. In addition, the Company agreed to pay an earn-out of up to an aggregate amount of $18.0 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria. The fair value of the expected earn-out of $16.0 million was accrued and recorded as goodwill as of the acquisition date. All future changes to the earn-out liability will be changed to income. Maui is a leading manufacturer and distributor of spring and summer activity toys and impulse toys and was included in the Company’s results of operations from the date of acquisition.

In September 2012, the Company acquired all of the stock of JKID, LTD., a United Kingdom corporation for an initial cash consideration of $1.1 million and deferred cash payments of $5.5 million payable in five semiannual payments of $1.1 million each. In addition, the Company agreed to pay an earn-out of up to an aggregate amount of $4.4 million in cash over the two year period of 2015 through 2016, based upon the achievement of certain financial performance criteria, which has been accrued and recorded as goodwill as of the acquisition date. The Company has not finalized its purchase price allocation for JKID and is in the process of performing studies and valuations of the estimated fair value of assets and liabilities assumed. JKID is the developer of augmented reality technology that enhances the play patterns of toys and consumer products.

Note 11 — Joint Ventures

The Company owned a fifty percent interest in a joint venture with THQ Inc. ("THQ"), which developed, published and distributed interactive entertainment software for the leading hardware game platforms in the home video game market. Pursuant to a Settlement Agreement and Mutual Release (the "Agreement") dated December 22, 2009, the joint venture was terminated on December 31, 2009 and THQ is obligated to pay the Company fixed payments in the aggregate amount of $20.0 million, to be paid in installments of $6.0 million on each of June 30, 2010 (payment received in June 2010) and 2011 (payment received in June 2011) and $4.0 million on each of June 30, 2012 and 2013 which the Company will record as income on a cash basis when received, as the Company cannot reasonably assure its collectability. Pursuant to an amendment to the Agreement, the 2012 installment is to be paid $2.0 million on June 20, 2012 (payment received in June 2012) and $1.0 million plus accrued interest of 5% per annum on each of August 30, 2012 (payment received in August 2012) and October 30, 2012 (payment received in October 2012) and the 2013 installment was to be paid in ten equal monthly non-interest bearing installments of $0.4 million commencing on February 28, 2013. On December 19, 2012, THQ filed voluntary petitions under Chapter 11 of the U.S. Bankruptcy Court, and on January 24, 2013 the US Bankruptcy Court approved the sale of most of THQ's assets to multiple buyers. Given that the final payment received from THQ (in October 2012) was within 90 days of their filing for bankruptcy, the Company has not recognized this payment as revenue and has reserved the amount received pending the final settlement of THQ's assets in accordance with bankruptcy law.

The Company owns a fifty percent interest in a joint venture ("Pacific Animation Partners") with the U.S. entertainment subsidiary of a leading Japanese advertising and animation production company. The joint venture was created to develop and produce a boys' animated television show, which it licenses worldwide for television broadcast as well as consumer products. The Company is producing and marketing toys based upon the television program under a license from the joint venture. The joint venture has also licensed certain other merchandising rights to third parties. The Company is responsible for fifty percent of the operating expenses of the joint venture and thirty-one percent of the production costs of the television show. The joint venture completed and delivered 26 episodes of the first season of the show, which began airing in February 2012. The joint venture has also delivered 18 episodes of the second season of the show, which began airing in April 2013, with 8 more episodes to be delivered in the coming 3 months. Production on an additional 13 episodes has commenced and is planned to be completed by Fall 2014. The Company is responsible for production costs in the aggregate amount of approximately $6.3 million, of which $1.4 million and $2.2 million were paid in 2012 and 2013, respectively. The Company's investment is being accounted for using the equity method. For the three months ended March 31, 2012 and 2013, the Company recognized income from the joint venture of $53,739 and a loss of $646,355, respectively, including producer fees and royalty income from the joint venture in the amount of $77,638 and $186,770.

As of December 31, 2012 and March 31, 2013, the balance of the investment in the Pacific Animation Partners joint venture includes the following components (in thousands):

	December 31, 2012	March 31, 2013
Capital Contributions, net of distributions	$ 3,420	$ 5,155
Equity in cumulative net loss	(259)	(1,093)
Investment in joint venture	$ 3,161	$ 4,062

On September 12, 2012, the Company entered into a joint venture ("DreamPlay Toys") with NantWorks LLC ("NantWorks") in which it owns a fifty percent interest. Pursuant to the operating agreement of DreamPlay Toys, the Company paid to NantWorks cash in the amount of $8.0 million and issued NantWorks a warrant to purchase 1.5 million shares of the Company's common stock at a value of $7.0 million in exchange for the exclusive right to arrange for the provision of the NantWorks recognition technology platform for toy products. The Company has classified these rights as an intangible asset and will amortize the asset over the anticipated revenue stream from the exploitation of these rights. The joint venture entered into a Toy Services Agreement with an initial term of three years expiring on October 1, 2015 and a renewal period at the option of the Company expiring October 1, 2018, subject to the achievement of certain financial targets, to develop and produce toys utilizing recognition technologies owned by NantWorks. Pursuant to the terms of the Toy Services Agreement, NantWorks is entitled to receive a preferred return based upon net sales of DreamPlay Toys product sales and third-party license fees. The Company retains the financial risk of the joint venture and is responsible for the day-to-day operations, including development, sales and distribution, for which it is entitled to receive any remaining profit or is responsible for any losses, and the results of operations of the joint venture will be consolidated with the Company's results. Sales of DreamPlay Toys products is expected to commence in the third quarter of 2013.

In addition, the Company invested $7.0 million in cash in exchange for a five percent economic interest in a related entity, DreamPlay LLC, that will exploit the recognition technologies in non-toy consumer product categories. NantWorks has the right to repurchase the Company's interest for $7.0 million. The Company has classified this investment as a long term asset on its balance sheet.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 12 — Goodwill

The changes to the carrying amount of goodwill for the three months ended March 31, 2013 are as follows (in thousands):

	Traditional Toys and Electronics	Role Play, Novelty and Seasonal Toys	Total
Balance at beginning of the period	$ 29,225	$ 19,611	$ 48,836
Adjustments to goodwill for foreign currency translation	(347)	—	(347)
Balance, March 31, 2013	$ 28,878	$ 19,611	$ 48,489

The Company applies a fair value-based impairment test to the carrying value of goodwill and indefinite-lived intangible assets on an annual basis and, if certain events or circumstances indicate that an impairment loss may have been incurred, on an interim basis. The analysis of potential impairment of goodwill requires a two-step process. The first step is the estimation of fair value. If step one indicates that an impairment potentially exists, the second step is performed to measure the amount of impairment, if any. Goodwill impairment exists when the estimated fair value of goodwill is less than its carrying value. There was no goodwill impairment during the periods ended March 31, 2012 and 2013.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 13 — Intangible Assets Other Than Goodwill

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

		December 31, 2012			March 31, 2013		
	Weighted Useful Lives (Years)	Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
Amortized Intangible Assets:							
Licenses	4.96	$ 91,488	$ (77,844)	$ 13,644	$ 91,488	$ (78,164)	$ 13,324
Product lines	5.84	66,594	(19,561)	47,033	66,594	(19,923)	46,671
Customer relationships	5.21	9,347	(5,903)	3,444	9,347	(6,084)	3,263
Trade names	5.00	3,000	(250)	2,750	3,000	(400)	2,600
Non-compete/Employment contracts	3.90	3,333	(3,150)	183	3,333	(3,160)	173
Total amortized intangible assets		173,762	(106,708)	67,054	173,762	(107,731)	66,031
Deferred Costs:							
Debt issuance costs	2.79	4,224	(2,609)	1,615	4,224	(3,059)	1,165
Unamortized Intangible Assets:							
Trademarks		2,308		2,308	2,308		2,308
Total Intangible Assets:		$ 180,294	$ (109,317)	$ 70,977	$ 180,294	$ (110,790)	$ 69,504

Amortization expense related to limited life intangible assets and debt offering costs was $0.7 million and $1.5 million for the three months ended March 31, 2012 and 2013, respectively.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 14 — Comprehensive Income (Loss)

The table below presents the components of the Company’s comprehensive income for the three months ended March 31, 2012 and 2013 (in thousands):

	Three Months Ended March 31,	
	2012	2013
Net Loss	$ (16,000)	$ (27,562)
Other comprehensive (loss):		
Foreign currency translation adjustment	(52)	(567)
Comprehensive (loss)	$ (16,052)	$ (28,129)

Note 15 — Litigation

The Company is a party to, and certain of its property is the subject of, various pending claims and legal proceedings that routinely arise in the ordinary course of its business. The Company does not believe that any of these claims or proceedings will have a material effect on its business, financial condition or results of operations.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 16 — Share-Based Payments

The Company's 2002 Stock Award and Incentive Plan (the "Plan") provides for the awarding of stock options and restricted stock to employees, officers and non-employee directors. Under the Plan, the Company grants directors, certain executives and other key employees restricted common stock, with vesting contingent upon completion of specified service periods ranging from one to five years. The Company also grants certain executives performance-based awards, with vesting contingent upon the Company's achievement of specified financial goals. The Plan is more fully described in Notes 14 and 17 to the Consolidated Financial Statements in the Company's 2012 Annual Report on Form 10-K.

The following table summarizes the total share-based compensation expense and related tax benefits recognized for the three months ended March 31, 2012 and 2013 (in thousands):

	Three Months Ended March 31,	
	2012	2013
Restricted stock compensation expense	$ 338	$ 207
Tax benefit related to restricted stock compensation	$ 127	$ 79

Stock option activity pursuant to the Plan for the three months ended March 31, 2013 is summarized as follows:

	Plan Stock Options	
	Number of Shares	Weighted Average Exercise Price
Outstanding, December 31, 2012	134,644	$ 19.82
Granted		
Exercised		
Cancelled		
Outstanding, March 31, 2013	134,644	19.82

Restricted stock award activity pursuant to the Plan for the three months ended March 31, 2013 is summarized as follows:

	Restricted Stock Awards	
	Number of Shares	Weighted Average Grant Price
Outstanding, December 31, 2012	95,315	$ 16.75
Awarded	339,770	12.52
Released	(41,706)	14.78

Forfeited	(1,500)	18.24
Outstanding, March 31, 2013	391,879	13.29

Non-Employee Stock Warrants

In September 2012, we granted 1,500,000 stock warrants with an exercise price of $16.28 per share and a five year term to a third party as partial consideration for the exclusive right to use certain recognition technology in connection with our toy products. The exercise price of the 2012 stock warrants is equal to the volume-weighted average price of our common stock over the five trading days preceding the date of grant. All warrants vest upon grant and are exercisable over the terms of the warrants.

At December 31, 2012 and March 31, 2013, we had 1,500,000 stock warrants outstanding with an exercise price of $16.28 per share and an expiration date of September 12, 2017.

We measure the fair value of our warrants granted on the measurement date. The fair value of the 2012 stock warrant is capitalized as an intangible asset and will be amortized to expense in our consolidated statements of operations when the related product is released and the related net sales are recognized, which is expected to be in the third quarter of 2013. For the three months ended March 31, 2012 and 2013 there was no amortization expense related to the warrants.

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

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

Critical Accounting Policies and Estimates

The accompanying consolidated financial statements and supplementary information were prepared in accordance with accounting principles generally accepted in the United States of America. Significant accounting policies are discussed in Note 2 to the Consolidated Financial Statements set forth in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012. 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 upon 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 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. Our 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 upon changes in a customer’s financial condition and/or the level of credit being extended. When a significant event occurs, such as a bankruptcy filing by a specific customer, and on a quarterly basis, the allowance is reviewed for adequacy and the balance or accrual rate is adjusted to reflect current risk prospects.

Revenue Recognition. Our revenue recognition policy is to recognize revenue when persuasive evidence of an arrangement exists, title transfer has occurred (product shipment), the price is fixed or readily determinable and collectability is probable. Sales are recorded net of sales returns and discounts, which are estimated at the time of shipment based upon historical data. We routinely enter into arrangements with our customers to provide sales incentives and support customer promotions and we provide allowances for returns and defective merchandise. Such programs are primarily based upon 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 in which the related revenue is recognized.

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

Factors we consider important that 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. Based upon 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.

Goodwill, Trademarks (net) and Intangible assets amounted to $116.8 million as of March 31, 2013 and $118.2 million as of December 31, 2012.

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 us under-producing popular items or over-producing less popular items. Furthermore, significant changes in demand for our products would impact management's estimates in establishing our inventory provision.

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

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

Discrete Items for Income Taxes. A discrete tax benefit of $0.1 million related to a reduction in tax reserves resulting from closed statutes of limitation was recognized during the three months ended March 31, 2013. During this same period in 2012, we recognized a discrete tax benefit of $0.4 million related to a reduction in tax reserves resulting from closed statutes and an adjustment to record various outstanding state tax refunds.

Income taxes and interest and penalties related to income tax payable. We do not file a consolidated return for our foreign subsidiaries. We file federal and state returns and our foreign subsidiaries each file returns as required. 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 bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some 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.

Management employs a threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Tax benefits that are subject to challenge by tax authorities are analyzed and accounted for in the income tax provision.

We accrue a tax reserve for additional income taxes, which may become payable in future years as a result of audit adjustments by tax authorities. The reserve is based upon management's assessment of all relevant information and is periodically reviewed and adjusted as circumstances warrant. As of March 31, 2013, our income tax reserves were approximately $4.6 million and relate to the potential income tax audit adjustments, primarily in the areas of fixed asset depreciation in Hong Kong and ongoing state audits. As of December 31, 2012, our income tax reserves were approximately $4.7 million and related to the potential income tax audit adjustments, primarily in the areas of income allocation, foreign depreciation allowances and state taxes.

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Share-Based Compensation. We grant restricted stock awards to our employees (including officers) and to non-employee directors under our 2002 Stock Award and Incentive Plan (the “Plan”), which incorporated the shares remaining under our Third Amended and Restated 1995 Stock Option Plan. The benefits provided under the Plan are share-based payments. We amortize over a requisite service period, the net total deferred restricted stock expense based upon the fair value of the stock on the date of the grants. In certain instances, the service period may differ from the period in which each award will vest. Additionally, certain groups of grants are subject to an expected forfeiture rate calculation.

Recent Developments

During the second quarter of 2012, we amended the Settlement Agreement pursuant to which our joint venture with THQ was terminated as of December 31, 2009. In accordance with the original settlement agreement, we received and recorded as income $6.0 million in each of June 2010 and 2011. Although the amended settlement agreement called for the payment of an additional $1.0 million on October 30, 2012 (which we received) and $0.4 million each in ten consecutive monthly payments beginning February 28, 2013, on December 19, 2012, THQ filed voluntary petitions under Chapter 11 of the U.S. Bankruptcy Court, and on January 24, 2013 the US Bankruptcy Court approved the sale of most of THQ’s assets to multiple buyers. Given that the final payment received from THQ (in October 2012) was within 90 days of their filing for bankruptcy, we have not recognized this payment as revenue and have reserved the amount received pending the final settlement of THQ’s assets in accordance with bankruptcy law.

Acquisitions

In September 2012, we acquired all of the stock of JKID, LTD., a United Kingdom corporation, for an initial cash consideration of $1.1 million and deferred cash payments of $5.5 million payable in five semi-annual payments of $1.1 million each. In addition, we agreed to pay an earn-out of up to an aggregate amount of $4.4. million in cash over the two year period of 2015 through 2016, based upon the achievement of certain financial performance criteria, which has been accrued and recorded as goodwill as of the acquisition date. We have not finalized our purchase price allocation for JKID. JKID is the developer of augmented reality technology that enhances the play patterns of toys and consumer products.

In July 2012, we acquired all of the stock of Maui, Inc., an Ohio corporation, Kessler Services, Inc., a Nevada corporation, and A.S. Design Limited, a Hong Kong corporation (collectively, "Maui"). The total initial consideration of $37.6 million consisted of $36.2 million in cash and the assumption of liabilities in the amount of $1.4 million. In addition, we agreed to pay an earn-out of up to an aggregate amount of $18.0 million in cash over the three calendar years following the acquisition based upon the achievement of certain financial performance criteria, which has been accrued and recorded as goodwill as of the acquisition date.

In October 2011, we acquired all of the stock of Moose Mountain Toymakers Limited, a Hong Kong company, and a related New Jersey company, Moose Mountain Marketing, Inc. (collectively, “Moose Mountain”). The total initial consideration of $31.5 million consisted of $16.0 million in cash and the assumption of liabilities in the amount of $15.5 million, and resulted in goodwill of $13.5 million. In addition, we agreed to pay an earn-out of up to an aggregate amount of $5.3 million in cash over the three calendar years following the acquisition based upon the achievement of certain financial performance criteria. The fair value of the expected earn-out was included in goodwill and assumed liabilities as of the acquisition date. Moose Mountain is a leading designer and producer of foot to floor ride-ons, inflatable environments, wagons, pinball machines and tents and was included in our results of operations from the date of acquisition.

Results of Operations

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

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2013
Net sales	100.0%	100.0%
Cost of sales	67.9	70.1
Gross profit	32.1	29.9
Selling, general and administrative expenses	58.5	60.5
Loss from operations	(26.4)	(30.6)
Equity in net income (loss) of joint venture	0.1	(0.8)
Interest income	0.2	0.1
Interest expense, net of benefit	(2.8)	(3.6)
Loss before provision (benefit) for income taxes	(28.9)	(34.9)
Provision (benefit) for income taxes	(7.1)	0.4
Net Loss	(21.8)%	(35.3)%

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

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2013
Net Sales		
Traditional Toys and Electronics	$ 41,578	$ 38,117
Role Play, Novelty and Seasonal Toys	31,827	39,952
	73,405	78,069
Cost of Sales		
Traditional Toys and Electronics	27,305	26,866
Role Play, Novelty and Seasonal Toys	22,534	27,824
	49,839	54,690
Gross Profit		
Traditional Toys and Electronics	14,273	11,251
Role Play, Novelty and Seasonal Toys	9,293	12,128
	$ 23,566	$ 23,379

Comparison of the Three Months Ended March 31, 2013 and 2012

Net Sales

Traditional Toys and Electronics. Net sales of our Traditional Toys and Electronics segment were $38.1 million for the three months ended March 31, 2013, compared to $41.6 million for the prior year period, representing a decrease of $3.5 million, or 8.3%. The decrease in net sales was primarily due to the tapering off of sales of action figures based on the animation series Monsuno and Winx Club® dolls. This was offset in part by an increase of sales due to the re-launch of our Fly Wheels® line.

Role Play, Novelty and Seasonal Toys. Net sales of our Role Play, Novelty and Seasonal Toys were $40.0 million for the three months ended March 31, 2013, compared to $31.8 million for the prior year period, representing an increase of $8.2 million, or 25.5%. The increase in net sales was primarily due to sales contribution of our recently acquired Maui Toys division and increases in unit sales of Halloween costumes and accessories. This was offset in part by decreases in unit sales of our Disney Princess® dress up and role play items, and our kids outdoor furniture and activity tables.

Cost of Sales

Traditional Toys and Electronics. Cost of sales of our Traditional Toys and Electronics segment was $26.9 million, or 70.5% of related net sales, for the three months ended March 31, 2013, compared to $27.3 million, or 65.7% of related net sales, for the prior year period, representing a decrease of $0.4 million, or 1.6%. The dollar decrease in cost of sales consisted of an $0.7 million decrease of product cost, which is mostly due to a lower volume of sales and offset by a higher volume of lower margin sales. Royalty expense decreased by $1.0 million and is consistent with the lower volume of sales and also due to royalty expense as a percentage of sales decreased 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 for the segment was comparable year over year.

Role Play, Novelty and Seasonal Toys. Cost of sales of our Role Play, Novelty and Seasonal Toys segment was $27.8 million, or 69.6% of related net sales, for the three months ended March 31, 2013, compared to $22.5 million, or 70.8% of related net sales, for the prior year period, representing a decrease of $5.3 million, or 23.5%. Product costs increased by $5.3 million, which is in line with the higher volume of sales and is comparable as a percentage of net sales year over year. Royalty expense and our depreciation of molds and tools for the segment was comparable year over year.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were $47.2 million for the three months ended March 31, 2013 and $43.0 million for the prior year period, constituting 60.5% and 58.5% of net sales, respectively. Selling, general and administrative expenses increased $4.2 million from the prior year period, primarily due to increases in legal expense ($0.5 million), bad debt expenses ($1.2 million), product development ($0.5 million) intangible amortization expense ($0.6 million), direct selling expenses ($1.0 million), and temporary employee expense ($0.4 million). Selling, general and administrative expenses increased as a percentage of sales due to the incremental overhead addition from our recent acquisition of Maui Toys.

Equity in Net Income (Loss) of Joint Venture

Operations of the animated television show joint venture commenced in the fourth quarter of 2010. We recognized a loss of $0.6 million for the three months ended March 31, 2013, and nominal income for the prior year period.

Interest Income

Interest income for the three months ended March 31, 2013 was $0.1 million, compared to $0.2 million for the three months ended March 31, 2012.

Interest Expense

Interest expense was $2.8 million in the three months ended March 31, 2013, as compared to $2.0 million in the prior period. In the three months ended March 31, 2013, we booked interest expense of $1.9 million related to our convertible senior notes payable, $0.8 million related to our credit facility and $0.1 million related to the interest component of our Maui acquisition earn out payment. In the three months ended March 31, 2012, we booked interest expense of $2.0 million related to our convertible senior notes payable.

Provision (Benefit) for Income Taxes

Our income tax expense, which includes federal, state and foreign income taxes and discrete items, was $0.3 million, or an effective tax rate of (1.10%), for the three months ended March 31, 2013. During the comparable period in 2012, our income tax benefit was $5.2 million, or an effective tax rate of 24.5%.

Seasonality and Backlog

The retail toy industry is inherently seasonal. Generally, our sales have been highest during the third and fourth quarters, and collections for those sales have been highest during the succeeding fourth and first quarters. Our working capital needs have been highest during the third and fourth quarters.

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

Liquidity and Capital Resources