

JAKKS PACIFIC INC
Form 10-Q
November 08, 2013
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period from _____ to _____

Commission file number: 0-28104

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

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

JAKKS PACIFIC, INC. AND SUBSIDIARIES

INDEX TO QUARTERLY REPORT ON FORM 10-Q
Quarter Ended September 30, 2013

ITEMS IN FORM 10-Q

	Page
<u>Part I</u>	
<u>Item 1.</u>	
	<u>FINANCIAL INFORMATION</u>
	<u>Financial Statements</u>
	<u>Condensed Consolidated Balance Sheets - December 31, 2012 and September 30, 2013 (unaudited)</u> 3
	<u>Condensed Consolidated Statements of Operations for the Three Months and Nine Months Ended September 30, 2012 and 2013 (unaudited)</u> 4
	<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2012 and 2013 (unaudited)</u> 5
	<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u> 6
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> 20
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u> 30
<u>Item 4.</u>	<u>Controls and Procedures</u> 30
<u>Part II</u>	
<u>Item 1.</u>	
	<u>OTHER INFORMATION</u>
<u>Item 1A.</u>	<u>Legal Proceedings</u> 31
	<u>Risk Factors</u> 32
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds None
Item 3.	Defaults Upon Senior Securities None
Item 4.	Mine safety disclosures None
Item 5.	Other Information None
	<u>Exhibits</u> 39
<u>Signatures</u>	40
Exhibit 31.1	
Exhibit 31.2	
Exhibit 32.1	
Exhibit 32.2	

DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

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

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

JAKKS PACIFIC, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

Assets	December 31, 2012 (*)	September 30, 2013 (Unaudited)
Current assets		
Cash and cash equivalents	\$ 189,321	\$ 51,519
Marketable securities	218	220
Accounts receivable, net of allowance for uncollectible accounts of \$2,536 and \$4,236, respectively	105,455	257,965
Inventory	59,690	59,119
Income tax receivable	24,008	24,008
Deferred income taxes	7,058	7,058
Prepaid expenses and other	20,306	23,650
Total current assets	406,056	423,539
Property and equipment		
Office furniture and equipment	14,268	14,469
Molds and tooling	73,487	76,117
Leasehold improvements	7,044	7,057
Total	94,799	97,643
Less accumulated depreciation and amortization	78,973	85,549
Property and equipment, net	15,826	12,094
Intangibles	67,054	59,654
Other long term assets	4,584	6,335
Investment in DreamPlay LLC	7,000	7,000
Investment in joint venture	3,161	1,429
Goodwill, net	48,836	44,735
Trademarks, net	2,308	2,308
Total assets	\$ 554,825	\$ 557,094
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	\$ 37,793	\$ 89,780
Accrued expenses	63,677	85,235
Reserve for sales returns and allowances	34,373	35,307
Income taxes payable	12,922	17,972
Short term debt	70,710	—
Total current liabilities	219,475	228,294
Convertible senior notes, net	94,918	137,826
Other liabilities	18,345	13,182
Income taxes payable	4,687	3,259
Deferred income taxes	10,180	10,180
Total liabilities	347,605	392,741
Commitments and Contingencies		
Stockholders' equity		
Preferred shares, \$.001 par value; 5,000,000 shares authorized; nil outstanding	—	—

Edgar Filing: JAKKS PACIFIC INC - Form 10-Q

Common stock, \$.001 par value; 100,000,000 shares authorized; 21,969,355 and 22,303,706 shares issued and outstanding, respectively	22	22
Additional paid-in capital	202,577	200,305
Retained earnings (accumulated deficit)	8,836	(32,086)
Accumulated other comprehensive loss	(4,215)	(3,888)
Total stockholders' equity	207,220	164,353
Total liabilities and stockholders' equity	\$ 554,825	\$ 557,094

(*) Derived from audited financial statements

See accompanying notes to condensed consolidated financial statements.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	Three Months Ended		Nine Months Ended	
	September 30, (Unaudited)		September 30, (Unaudited)	
	2012	2013	2012	2013
Net sales	\$ 314,491	\$ 310,894	\$ 533,255	\$ 495,195
Cost of sales	217,779	219,499	366,084	378,183
Gross profit	96,712	91,395	167,171	117,012
Selling, general and administrative expenses	59,416	51,742	149,178	145,492
Income (loss) from operations	37,296	39,653	17,993	(28,480)
Profit from video game joint venture	1,000	—	3,000	—
Equity in net income (loss) of joint venture	48	(572)	4	(2,024)
Interest income	97	92	610	301
Interest expense, net of benefit	(2,015)	(2,298)	(6,085)	(7,202)
Income (loss) before provision for income taxes	36,426	36,875	15,522	(37,405)
Provision for income taxes	5,983	278	865	433
Net income (loss)	\$ 30,443	\$ 36,597	\$ 14,657	\$ (37,838)
Earnings (loss) per share – basic	\$ 1.38	\$ 1.67	\$ 0.59	\$ (1.73)
Earnings (loss) per share –diluted	\$ 1.10	\$ 1.11	\$ 0.59	\$ (1.73)
Comprehensive income (loss)	\$ 30,376	\$ 37,508	\$ 14,623	\$ (37,511)

JAKKS PACIFIC, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Nine Months Ended September 30, (Unaudited)	
	2012	2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	\$14,657	\$(37,838)
Adjustments to reconcile net income (loss) to net cash used by operating activities:		
Depreciation and amortization	21,751	19,572
Share-based compensation expense	1,189	563
Loss (gain) on disposal of property and equipment	19	2,202
Deferred income taxes	(5)	—
Equity in net loss of joint venture	119	2,024
Gain on extinguishment of convertible notes	—	(84)
Changes in operating assets and liabilities:		
Accounts receivable	(135,931)	(152,510)
Inventory	(24,206)	571
Prepaid expenses and other current assets	3,582	(2,344)
Income tax receivable	158	—
Accounts payable	80,292	52,369
Accrued expenses	18,378	25,660
Income taxes payable	12,497	3,622
Reserve for sales returns and allowances	(11,777)	934
Other liabilities	(2)	(5,163)
Total adjustments	(33,936)	(52,584)
Net cash used in operating activities	(19,279)	(90,422)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property and equipment	(11,811)	(7,971)
Change in other assets	(441)	240
Investment in DreamPlay LLC	(7,000)	—
Contribution to joint venture	(1,524)	(1,636)
Distribution from joint venture	374	962
Cash paid for intangible assets	(8,000)	—
Cash paid for net assets of business acquired	(34,367)	—
Net purchase of marketable securities	(4)	(2)
Net cash used in investing activities	(62,773)	(8,407)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from stock options exercised	101	—
Common stock surrendered	(103)	—
Common stock repurchased	(80,000)	—
Proceeds from (Repayment of) credit facility borrowings	53,410	(70,710)
Credit facility costs	(486)	—
Proceeds from issuance of senior convertible notes	—	100,000
Bank fees related to convertible notes	—	(4,179)
Retirement of senior convertible notes	—	(61,000)
Dividends paid	(7,373)	(3,084)

Edgar Filing: JAKKS PACIFIC INC - Form 10-Q

Net cash used in financing activities	(34,451)	(38,973)
Net decrease in cash and cash equivalents	(116,503)	(137,802)
Cash and cash equivalents, beginning of period	257,258	189,321
Cash and cash equivalents, end of period	\$140,755	\$51,519
Cash paid (received) during the period for:		
Income taxes	\$(13,697)	\$(4,721)
Interest	\$2,250	\$3,525

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)

September 30, 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”). The condensed consolidated financial statements also include the accounts of DreamPlay Toys, LLC, a joint venture between JAKKS Pacific, Inc. and NantWorks LLC.

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 and nine months ended September 30, 2012 and 2013 and as of December 31, 2012 and September 30, 2013 are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
Net Sales				
Traditional Toys and Electronics	\$ 171,156	\$ 156,874	\$ 285,197	\$ 243,881
Role Play, Novelty and Seasonal Toys	143,335	154,020	248,058	251,314
	\$ 314,491	\$ 310,894	\$ 533,255	\$ 495,195
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
Operating Income (loss)				
Traditional Toys and Electronics	\$ 19,019	\$ 19,506	\$ 5,913	\$ (22,162)
Role Play, Novelty and Seasonal Toys	18,277	20,147	12,080	(6,318)
	\$ 37,296	\$ 39,653	\$ 17,993	\$ (28,480)
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
Depreciation and Amortization Expense				
Traditional Toys and Electronics	\$ 7,108	\$ 4,954	\$ 11,994	\$ 9,951
Role Play, Novelty and Seasonal Toys	5,051	4,360	7,130	6,951
	\$ 12,159	\$ 9,314	\$ 19,124	\$ 16,902
			December 31, 2012	September 30, 2013
Assets				
Traditional Toys and Electronics			\$ 309,940	\$ 296,025
Role Play, Novelty and Seasonal Toys			244,885	261,069
			\$ 554,825	\$ 557,094

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 September 30, 2013 and for the three and nine months ended September 30, 2012 and 2013 (in thousands):

	December 31, 2012	September 30, 2013
Long-lived Assets		
China	\$ 10,793	\$ 8,323
United States	3,762	2,796
Hong Kong	1,271	975
	\$ 15,826	\$ 12,094

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
Net Sales by Customer Area				
United States	\$ 243,986	\$ 252,988	\$ 423,698	\$ 400,688
Europe	35,042	24,814	50,480	42,340
Canada	16,149	16,988	24,540	21,972
Hong Kong	385	2,799	1,490	5,456
Other	18,929	13,305	33,047	24,739
	\$ 314,491	\$ 310,894	\$ 533,255	\$ 495,195

Major Customers

Net sales to major customers for the three and nine months ended September 30, 2012 and 2013 were as follows (in thousands, except for percentages):

	Three Months Ended September 30,		Percentage		Nine Months Ended September 30,		Percentage	
	2012	2013	of	of	2012	2013	of	of
	Amount	Amount	Net	Net	Amount	Amount	Net	Net
			Sales	Sales			Sales	Sales
Wal-Mart	\$ 62,514	\$ 74,759	19.9 %	24.1 %	\$ 94,807	\$ 108,990	17.8 %	22.0 %
Target	45,857	42,162	14.6	13.6	79,105	65,676	14.8	13.3
Toys 'R' Us	36,765	29,475	11.7	9.5	58,072	46,958	10.9	9.5
	\$ 145,136	\$ 146,396	46.2 %	47.2 %	\$ 231,984	\$ 221,624	43.5 %	44.8 %

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

At December 31, 2012 and September 30, 2013, the Company's three largest customers accounted for approximately 42.1% and 44.1%, 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	September 30, 2013
Raw materials	\$ 3,296	\$ 3,445
Finished goods	56,394	55,674
	\$ 59,690	\$ 59,119

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 \$35.3 million as of September 30, 2013. This increase is primarily due to the Company granting additional allowances to certain customers in 2013 compared to 2012.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 5 — Credit Facility

In September 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 provided for a \$75.0 million working capital revolving credit facility. The amounts outstanding under the revolving credit facility were originally payable in full upon maturity of the credit facility on April 30, 2013.

By Amendment to the Loan Agreement dated March 28, 2013, the Company was granted an over advance of up to \$30.0 million over the borrowing capacity 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 the Company 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.

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 “2014 Notes”). The 2014 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 July 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 68.8564 shares of JAKKS common stock per \$1,000 principal amount of notes (or approximately \$14.52 per share). Prior to August 1, 2014, holders of the 2014 Notes may convert their notes only upon the occurrence of specified events. Upon conversion, the 2014 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 2014 Notes may require that the Company repurchase for cash all or some of their notes upon the occurrence of a fundamental change (as defined). On July 24, 2013, the Company repurchased an aggregate of \$61.0 million principal amount of these notes at par plus accrued interest with a portion of the net proceeds from the issuance of \$100.0 million principal amount of 4.25% convertible senior notes due 2018 resulting in a gain on extinguishment of \$0.1 million.

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 2014 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 September 30, 2012 and 2013 and \$2.0 million and \$2.5 million for each of the nine months ending September 30, 2012 and 2013. The Company repurchased \$61.0 million of the 2014 Notes during the quarter ended September 30, 2013 as discussed below, with \$2.8 million of the price allocated to the repurchase of the related equity component. In addition, approximately \$2.2 million of the unamortized debt discount and \$0.6 million of debt issuance costs were written off in connection with the repurchase of the 2014 Notes. The balance of the discount was \$5.1 million and \$1.2 million at December 31, 2012 and September 30, 2013, respectively.

On July 24, 2013, the Company sold an aggregate of \$100.0 million principal amount of 4.25% Convertible Senior Notes due 2018 (the “2018 Notes”). The 2018 Notes are senior unsecured obligations of the Company paying interest semi-annually in arrears on August 1 and February 1 of each year at a rate of 4.25% per annum and will mature on August 1, 2018. The initial conversion rate for the 2018 Notes will be 114.3674 shares of our common per \$1,000 principal amount of notes, equivalent to an initial conversion price of approximately \$8.74 per share of common stock, subject to adjustment in certain events. Holders of the 2018 Notes may convert their notes upon the occurrence of specified events. Upon conversion, the 2018 Notes will be settled in shares of the Company’s common stock. The Company used \$61.0 million of the approximate \$95.9 million in net proceeds from the offering to repurchase at par \$61.0 million principal amount of the 2014 Notes. The remainder of the net proceeds will be used for general corporate purposes.

The fair value of the 2014 Notes for the periods ending December 31, 2012 and September 30, 2013 was approximately \$107.9 million and \$36.5 million, respectively, based upon the most recent quoted market price. The fair value of the 2018 Notes for the period ending September 30, 2013 was approximately \$76.8 million, based upon the most recent quoted market price. The fair value of the convertible senior notes is considered to be a Level 1

measurement on the fair value hierarchy.

Note 7 — Income Taxes

The Company's income tax expense of \$0.3 million for the three months ended September 30, 2013 reflects an effective tax rate of 0.75%. The Company's income tax expense of \$6.0 million for the three months ended September 30, 2012 reflects an effective tax rate of 16.4%.

The Company's income tax expense of \$0.4 million for the nine months ended September 30, 2013 reflects an effective tax rate of (1.16%). Included in the tax expense of \$0.4 million is a discrete tax benefit of \$1.4 million related to a reduction in tax reserves resulting from closed statutes of limitation and a FIN48 reserve release for Moose Mountain HK mold depreciation. The Company's income tax expense of \$0.9 million for the nine months ended September 30, 2012 reflects an effective tax rate of 5.6%. Included in the tax expense of \$0.9 million is a discrete tax benefit of \$1 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 —Earnings/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 September 30,					
	Income	2012 Weighted Average Shares	Per-Share	Income	2013 Weighted Average Shares	Per- Share
Earnings per share – basic						
Net income available to common stockholders	\$ 30,443	22,110	\$ 1.38	\$ 36,597	21,920	\$ 1.67
Effect of dilutive securities:						
Convertible senior notes	1,289	6,707		1,354	12,294	
Options and warrants	-	5		—	—	
Unvested restricted stock grants	-	111		—	69	
Earnings per share – diluted						
Net income available to common stockholders plus assumed exercises and conversion	\$ 31,732	28,933	\$ 1.10	\$ 37,951	34,283	\$ 1.11
	Nine Months Ended September 30,					
	Income	2012 Weighted Average Shares	Per-Share	Loss	2013 Weighted Average Shares	Per- Share
Earnings (loss) per share – basic						
Net income (loss) available to common stockholders	\$ 14,657	24,656	\$ 0.59	\$ (37,838)	21,922	\$ (1.73)
Effect of dilutive securities:						
Convertible senior notes	3,867	6,520		—	—	
Options and warrants	-	6		—	—	
Unvested restricted stock grants	-	92		—	—	
Earnings (loss) per share – diluted						
Net income (loss) available to common stockholders plus assumed exercises and conversion	\$ 18,524	31,274	\$ 0.59	\$ (37,838)	21,922	\$ (1.73)

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 119,644 and 1,918,247 for the three months ended September 30, 2012 and 2013, respectively. 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 126,632 and 1,913,600 for the nine months ended September 30, 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.

In July 2012, the Company completed a self-tender to its shareholders and purchased 4 million shares of its common stock at a price of \$20.00 per share for a total of \$80.0 million, excluding offering costs of approximately \$0.6 million. The tendered shares were immediately retired.

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 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 charged 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 compensation 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 will be charged to expense when earned. JKID is the developer of augmented reality technology that enhances the play patterns of toys and consumer products.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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 was 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. 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 26 episodes of the 2nd season of the show, which began airing in April 2013. Production on an additional 13 episodes has commenced and is planned to be completed and delivered by late fall 2013. The Company is responsible for production costs in the aggregate amount of approximately \$5.7 million, of which \$1.4 million and \$1.6 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 September 30, 2012 and 2013, the Company recognized income from joint venture of \$48,116 and loss of \$571,730, respectively. For nine months ended September 30, 2012 and September 30, 2013 the Company recognized a loss from the joint venture of \$3,914 and \$2.0 million, respectively, which includes producer fees and royalty income from the joint venture in the amount of \$123,348 and \$382,909 for the nine months ended September 30, 2012 and 2013, respectively.

As of December 31, 2012 and September 30, 2013, the balance of the investment in the Pacific Animation Partners joint venture includes the following components (in thousands):

	December 31, 2012	September 30, 2013
Capital contributions, net of distributions	\$ 3,420	\$ 4,419
Equity in cumulative net loss	(259)	(2,990)

Investment in joint venture	\$	3,161	\$	1,429
-----------------------------	----	-------	----	-------

In September 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 have commenced 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 nine months ended September 30, 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	116	—	116
Acquisition earn out payment	175	—	175
Adjustment for final purchase price allocation	(4,392)	—	(4,392)
Balance, September 30, 2013	\$ 25,124	\$ 19,611	\$ 44,735

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 September 30, 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):

	Weighted Useful Lives (Years)	December 31, 2012			September 30, 2013		
		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	\$ (81,691)	\$ 9,797
Product lines	5.84	66,594	(19,561)	47,033	66,594	(21,496)	45,098
Customer relationships	5.21	9,347	(5,903)	3,444	9,347	(7,041)	2,306
Trade names	5.00	3,000	(250)	2,750	3,000	(700)	2,300
Non-compete/Employment contracts	3.90	3,333	(3,150)	183	3,333	(3,180)	153
Total amortized intangible assets		173,762	(106,708)	67,054	173,762	(114,108)	59,654
Deferred Costs:							
Debt issuance costs	5.05	4,224	(2,609)	1,615	8,402	(4,124)	4,278
Unamortized Intangible Assets:							
Trademarks		2,308		2,308	2,308		2,308
Total Intangible Assets:		\$ 180,294	\$ (109,317)	\$ 70,977	\$ 184,472	\$ (118,232)	\$ 66,240

Amortization expense related to limited life intangible assets and debt issuance costs was \$4.2 million and \$4.8 million for the three months ended September 30, 2012 and 2013, respectively, and \$6.6 million and \$8.4 million for the nine months ended September 30, 2012 and 2013, respectively. Debt issuance costs in the amount of \$0.6 million were written off in the third quarter of 2013 in connection with the repurchase of a portion of the convertible senior notes due in 2014.

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 (loss) for the three and nine months ended September 30, 2012 and 2013 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
Net income (loss)	\$ 30,443	\$ 36,597	\$ 14,657	\$ (37,838)
Other comprehensive income (loss):				
Foreign currency translation adjustment	(67)	911	(34)	327
Comprehensive income (loss)	\$ 30,376	\$ 37,508	\$ 14,623	\$ (37,511)

Note 15 — Litigation

In or around the end of July 2013, two purported class action lawsuits were filed in the United States District Court for the Central District of California (the "Class Actions"), alleging damages associated with the matters referenced in our July 17, 2013 Press Release. The Company is a party to, and certain of its property is the subject of, various other pending claims and legal proceedings that routinely arise in the ordinary course of its business. Other than with respect to the Class Actions, which are in a preliminary stage and with respect to which the Company cannot give assurance as to the outcome, the Company does not believe that any of these claims or proceedings will have a material adverse 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 and nine months ended September 30, 2012 and 2013 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
Restricted stock compensation expense	\$ 383	\$ 173	\$ 1,189	\$ 563
Tax benefit related to restricted stock compensation	\$ 144	\$ 65	\$ 448	\$ 213

Stock option activity pursuant to the Plan for the nine months ended September 30, 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	(7,500)	13.39
Outstanding, September 30, 2013	127,144	20.20

Restricted stock award activity pursuant to the Plan for the three months ended September 30, 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

Edgar Filing: JAKKS PACIFIC INC - Form 10-Q

Released	(41,706)	14.78
Forfeited	(10,122)	14.83
Outstanding, September 30, 2013	383,257	13.26

19

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 \$106.7 million as of September 30, 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.

Discrete Items for Income Taxes. A discrete tax benefit of \$1.4 million related to a reduction in tax reserves resulting from closed statutes of limitation was recognized during the nine months ended September 30, 2013. During this same period in 2012, we recognized a discrete tax benefit of \$1.0 million related to a reduction in tax reserves resulting from closed statutes of limitation.

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 September 30, 2013, our income tax reserves were approximately \$3.3 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.

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 \$4.0 million in ten equal 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 compensation 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 will be charged to expense when earned. 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.

Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	69.2	70.6	68.7	76.4
Gross profit	30.8	29.4	31.3	23.6
Selling, general and administrative expenses	18.9	16.6	28.0	29.4
Income (loss) from operations	11.9	12.8	3.3	(5.8)
Profit from video game joint venture	0.3		0.6	
Equity in net loss of joint venture		(0.2)		(0.4)
Interest income			0.1	0.1
Interest expense, net of benefit	(0.6)	(0.7)	(1.1)	(1.6)
Income (loss) before provision for income taxes	11.6	11.9	2.9	(7.7)
Provision for income taxes	1.9	0.1	0.2	0.1
Net Income (loss)	9.7%	11.8%	2.7%	(7.6)%

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
Net Sales				
Traditional Toys and Electronics	\$ 171,156	\$ 156,874	\$ 285,197	\$ 243,881
Role Play, Novelty and Seasonal Toys	143,335	154,020	248,058	251,314
	314,491	310,894	533,255	495,195
Cost of Sales				
Traditional Toys and Electronics	116,822	110,540	191,669	191,276
Role Play, Novelty and Seasonal Toys	100,957	108,959	174,415	186,907
	217,779	219,499	366,084	378,183
Gross Profit				
Traditional Toys and Electronics	54,334	46,335	93,528	52,605
Role Play, Novelty and Seasonal Toys	42,378	45,060	73,643	64,407
	\$ 96,712	\$ 91,395	\$ 167,171	\$ 117,012

Comparison of the Three Months Ended September 30, 2013 and 2012

Net Sales

Traditional Toys and Electronics. Net sales of our Traditional Toys and Electronics segment were \$156.9 million for the three months ended September 30, 2013, compared to \$171.2 million for the prior year period, representing a decrease of \$14.3 million, or 8.4%.

The decrease in net sales was due to a variety of factors, including decreased orders from several retailers, and the tapering off of sales of action figures based on the animation series Monsuno®, Winx Club® dolls, and unit sales of Spy Net® offset in part by an increase in unit sales of our 31 inch boys action figures.

Role Play, Novelty and Seasonal Toys. Net sales of our Role Play, Novelty and Seasonal Toys were \$154.0 million for the three months ended September 30, 2013, compared to \$143.3 million for the prior year period, representing an increase of \$10.7 million, or 7.5%. The increase in net sales was primarily due to an increase in units sales of our role play and dress up products and activity tables based on the Sofia the First® and Jake and the Neverland Pirates properties.

Cost of Sales

Traditional Toys and Electronics. Cost of sales of our Traditional Toys and Electronics segment was \$110.5 million, or 70.5% of related net sales, for the three months ended September 30, 2013, compared to \$116.8 million, or 68.3% of related net sales, for the prior year period, representing a decrease of \$6.3 million, or 5.4%. The dollar decrease in cost of sales is primarily due to lower unit sales year over year. The increase of cost as a percentage of sales is due to closeout sales. Our depreciation of molds and tools for the segment was comparable year over year. Royalties as a percentage of sales was also comparable year over year.

Role Play, Novelty and Seasonal Toys. Cost of sales of our Role Play, Novelty and Seasonal Toys segment was \$109.0 million, or 70.7% of related net sales, for the three months ended September 30, 2013, compared to \$101.0 million, or 70.4% of related net sales, for the prior year period, representing an increase of \$8.0 million, or 7.9%. The dollar increase in cost of sales is primarily due to the increase in sales year over year. Our depreciation of molds and tools for the segment was comparable year over year. Royalties as a percentage of sales was also comparable year over year.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were \$51.7 million for the three months ended September 30, 2013 and \$59.4 million for the prior year period, constituting 16.6% and 18.9% of net sales, respectively. Selling, general and administrative expenses decreased \$7.7 million from the prior year period, primarily due to decreases in legal and financial advising fees related to the unsolicited indication of interest to acquire the Company (\$1.0 million), employee salaries and benefits (\$1.3 million), travel and entertainment (\$0.9 million), cooperative advertising (\$2.2 million), media buys and other product marketing (\$3.6 million), restricted stock compensation (\$0.2 million), recovery of bad debt expenses (\$0.3 million), temporary help (\$0.1 million) and other direct selling expenses (\$0.5 million), offset in part by increases in foreign currency exchange losses (\$1.5 million), product development and testing (\$0.5 million) and acquisition amortization (\$0.4 million).

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 September 30, 2013, and nominal income for the prior year period.

Interest Income

Interest income for the three months ended September 30, 2013 was \$0.1 million, compared to \$0.1 million for the three months ended September 30, 2012.

Interest Expense

Interest expense was \$2.3 million in the three months ended September 30, 2013, as compared to \$2.0 million in the prior period. The increase is due to the additional interest expense related to our convertible senior notes payable due in 2018. In the three months ended September 30, 2013, we booked interest expense of \$2.1 million related to our convertible senior notes payable due in 2014 and 2018 and \$0.2 million related to the interest component of our Maui acquisition earn out payment. In the three months ended September 30, 2012, we booked interest expense of \$2.0 million related to our convertible senior notes payable due in 2014.

Provision 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 0.75%, for the three months ended September 30, 2013. During the comparable period in 2012, our income tax expense was \$6.0 million, or an effective tax rate of 16.4%.

Comparison of the Nine Months Ended September 30, 2013 and 2012

Net Sales

Traditional Toys and Electronics. Net sales of our Traditional Toys and Electronics segment were \$243.9 million for the nine months ended September 30, 2013, compared to \$285.2 million for the prior year period, representing a decrease of \$41.3 million, or 14.5%. The decrease in net sales was due to a variety of factors, including decreased orders from several retailers, and the tapering off of sales of action figures based on the animation series Monsuno®, Winx Club® dolls, and unit sales of Spy Net® offset in part by an increase in unit sales of our 31 inch boys action figures.

Role Play, Novelty and Seasonal Toys. Net sales of our Role Play, Novelty and Seasonal Toys were \$251.3 million for the nine months ended September 30, 2013, compared to \$248.1 million for the prior year period, representing an increase of \$3.2 million, or 1.3%. The increase in net sales was primarily due to the sales contribution of our recently acquired Maui Toys division and increase of unit sales of our role play and dress-up products and activity tables based on the Sofia the First® and Jake and the Neverland Pirates properties, offset in part by decreases in unit sales of our Disney Princess® dress up and role play items and unit sales of our Halloween costumes and accessories.

Cost of Sales

Traditional Toys and Electronics. Cost of sales of our Traditional Toys and Electronics segment was \$191.3 million, or 78.4% of related net sales, for the nine months ended September 30, 2013, compared to \$191.7 million, or 67.2% of related net sales, for the prior year period, representing a decrease of \$0.4 million, or 0.2%. The dollar decrease in cost of sales consisted of a royalty expense increase of \$3.7 million which is mainly due to the write down of minimum guarantees that are not expected to be earned in the future, offset in part by lower product costs due to lower unit sales. Our depreciation of molds and tools for the segment was comparable year over year. Product costs increased as a percentage of sales due to closeout sales and increased reserves on excess inventory.

Role Play, Novelty and Seasonal Toys. Cost of sales of our Role Play, Novelty and Seasonal Toys segment was \$186.9 million, or 74.4% of related net sales, for the nine months ended September 30, 2013, compared to \$174.4 million, or 70.3% of related net sales, for the prior year period, representing an increase of \$12.5 million, or 7.2%. The dollar increase in cost of sales is primarily due to increase unit sales but also consisted of a royalty expense increase of \$4.0 million which is mainly due to the write down of minimum guarantees that are not expected to be earned in the future. Our depreciation of molds and tools for the segment was comparable year over year. Product costs increased as a percentage of sales due to closeout sales and increased reserves on excess inventory.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were \$145.5 million for the nine months ended September 30, 2013 and \$149.2 million for the prior year period, constituting 29.4% and 28.0% of net sales, respectively. Selling, general and administrative expenses decreased \$3.7 million from the prior year period, primarily due to decreases in travel and entertainment (\$1.1 million), media buys and other product marketing (\$4.7 million), commissions (\$0.6 million), legal and financial advising fees related to the unsolicited indication of interest to acquire the Company (\$3.2 million), cooperative advertising (\$3.3 million), bank charges (\$0.2 million), office supplies (\$0.1 million), donations (\$0.2 million), restricted stock compensation (\$0.6 million), offset by increases in rent expense (\$1.6 million), other expenses which include the write down of molds and tools (\$2.1 million), foreign currency losses (\$1.4 million), bad debt expense (\$1.9 million), acquisition amortization (\$1.4 million), employee salaries and benefits (\$0.2 million), legal expense (\$0.3 million), temporary help (\$0.4 million), computer equipment (\$0.3 million), dues and memberships (\$0.1 million) and product development and testing expenses (\$0.5 million).

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 \$2.0 million for the nine months ended September 30, 2013, and nominal income for the prior year period.

Interest Income

Interest income for the nine months ended September 30, 2013 was \$0.3 million, compared to \$0.6 million for the nine months ended September 30, 2012.

Interest Expense

Interest expense was \$7.2 million in the nine months ended September 30, 2013, as compared to \$6.1 million in the prior period. The increase is due to the additional interest expense related to our convertible senior notes payable due in 2018. In the nine months ended September 30, 2013, we booked interest expense of \$6.0 million related to our convertible senior notes payable, \$0.9 million related to our credit facility and \$0.2 million related to the interest component of our Maui acquisition earn out payment. In the nine months ended September 30, 2012, we booked interest expense of \$2.0 million related to our convertible senior notes payable.

Provision for Income Taxes

Our income tax expense, which includes federal, state and foreign income taxes and discrete items, was \$0.4 million, or an effective tax rate of (1.16%), for the nine months ended September 30, 2013. During the comparable period in 2012, our income tax benefit was \$0.9 million, or an effective tax rate of 5.6%.

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

As of September 30, 2013 we had working capital of \$195.2 million, compared to \$186.6 million as of December 31, 2012. The increase was primarily attributable to seasonably high accounts receivable and inventory balances offset partially by higher accrued expenses and accounts payable balances.

Operating activities used net cash of \$90.4 million in the nine months ended September 30, 2013, as compared to using net cash of \$19.3 million in the prior year period. Net cash was impacted primarily by increases in accounts receivable and inventory and a decrease in reserves for sales returns and allowances, offset by an increase in accounts payable and accrued expenses. Our accounts receivable turnover as measured by days sales for the quarter outstanding in accounts receivable was 76 days as of September 30, 2013, comparable to 71 days as of September 30, 2012. Other than open purchase orders issued in the normal course of business, we have no obligations to purchase finished goods from our manufacturers. As of September 30, 2013, we had cash and cash equivalents of \$51.5 million.

Our investing activities used net cash of \$8.4 million in the nine months ended September 30, 2013, as compared to \$62.8 million in the prior year period, consisting primarily of cash paid for the purchase of office furniture and

equipment and molds and tooling of \$7.9 million used in the manufacture of our products. As part of our strategy to develop and market new products, we have entered into various character and product licenses with royalties generally ranging from 1% to 14% payable on net sales of such products. As of September 30, 2013, these agreements required future aggregate minimum guarantees of \$79.0 million, exclusive of \$21.3 million in advances already paid. Of this \$79.0 million future minimum guarantee, \$44.8 million is due over the next twelve months.

Our financing activities used net cash of \$39.0 million in the nine months ended September 30, 2013, as compared to \$34.5 million in the prior year period, consisting of net proceeds from the sale of convertible notes, offset in part by the partial retirement of previously existing convertible notes.

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.

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 initial cash consideration totaled \$36.2 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. All future changes to the earn-out liability will be charged to income. Maui is a leading manufacturer and distributor of spring and summer activity toys and impulse toys and was included in our results of operations from the date of acquisition.

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 semiannual payments of \$1.1 million each. In addition, we agreed to pay compensation 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 will be charged to expense when earned. JKID is the developer of augmented reality technology that enhances the play patterns of toys and consumer products.

During the first quarter of 2012, an aggregate of \$1.7 million of earn-out was paid in connection with the Tollytots acquisition, in addition to a working capital adjustment of \$0.7 million in connection with the Moose Mountain acquisition. During the first quarter of 2013, an aggregate amount of \$0.2 million of earn-out was paid in connection with the Moose Mountain acquisition.

In September 2012, we entered into a secured credit facility with Wells Fargo Bank, National Association (the "Loan Agreement"). The Loan Agreement provided for a \$75.0 million working capital revolving credit facility. The amounts outstanding under the revolving credit facility were originally payable in full upon maturity of the credit facility on April 30, 2013. By Amendment to the Loan Agreement dated March 28, 2013, the Bank granted an over advance of up to \$30.0 million of which \$29.0 million was advanced on March 29, 2013.

In addition, the maturity date was changed to April 2, 2013, on which we paid off the credit facility in full. We are in the process of obtaining a replacement credit facility or alternative financing. If we are unable to obtain a replacement line of credit or alternative financing, our operations and growth prospects may be adversely affected, and we 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 our ability to effectively operate and grow its business in the future.

In November 2009, we sold an aggregate principal amount of \$100.0 million of 4.50% Convertible Senior Notes (the "2014 Notes") due 2014. The 2014 Notes, which are senior unsecured obligations, pay interest semi-annually at a rate of 4.50% per annum and mature on November 1, 2014. The initial conversion rate was 63.2091 shares of our common stock per \$1,000 principal amount of notes (equivalent to an initial conversion price of approximately \$15.82 per share of common stock), subject to adjustment in certain circumstances. As a result of the cash dividend of \$0.10 per share declared by the Board of Directors and paid October 3, 2011, January 2, 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 July 1, 2013 and the above-market self-tender offer completed on July 5, 2012, the new conversion rate is 68.8564 shares of JAKKS common stock per \$1,000 principal amount of notes (or approximately \$14.52 per share). Prior to August 1, 2014, holders of the 2014 Notes may convert their notes only upon specified events. Upon conversion, the 2014 Notes may be settled, at our election, in cash, shares of our common stock or a combination of cash and shares of our common stock. Holders of the 2014 Notes may require us to repurchase for cash all or some of their notes upon the occurrence of a fundamental change (as defined in the 2014 Notes).

On July 24, 2013, we sold an aggregate of \$100.0 million principal amount of 4.25% Convertible Senior Notes due 2018 (the "2018 Notes"). The 2018 Notes, which are senior unsecured obligations, pay interest semi-annually in arrears on August 1 and February 1 of each year at a rate of 4.25% per annum and will mature on August 1, 2018. The initial conversion rate for the 2018 Notes will be 114.3674 shares of our common per \$1,000 principal amount of notes, equivalent to an initial conversion price of approximately \$8.74 per share of common stock, subject to adjustment in certain events. Holders of the 2018 Notes may convert their notes upon the occurrence of specified events. Upon conversion, the 2018 Notes will be settled in shares of the Company's common stock. We also granted the initial purchaser of the 2018 Notes a 30-day option to purchase up to an additional \$15.0 million in principal amount of additional notes to cover over-allotments if any. We used \$61.0 million of the approximate \$95.9 million in net proceeds from the offering to repurchase at par \$61.0 million principal amount of its 4.50% Convertible Senior Notes due 2014. The remainder of the net proceeds will be used for general corporate purposes.

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. As of September 30, 2013 and December 31, 2012, we held cash and short term investments held by our foreign subsidiaries was \$34.8 million and \$176.1 million, respectively. Although a significant portion of our cash is held off-shore and amounts repatriated in excess of approximately \$62.0 million are currently subject to a 25% repatriation tax, we intend to finance our long-term liquidity requirements out of net cash provided by operations and net cash and cash equivalents. As of September 30, 2013, we do not have any off-balance sheet arrangements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Risk

In November 2009, we issued convertible senior notes payable of \$100.0 million principal amount with a fixed interest rate of 4.50% per annum of which \$39.0 million remain outstanding as of September 30, 2013. In addition, on July 24, 2013, we issued convertible senior notes payable of \$100.0 million principal amount with a fixed interest rate of 4.25% per annum, which remain outstanding as of September 30, 2013. We have no other interest-bearing debt outstanding. Accordingly, we are not generally subject to any direct risk of loss arising from changes in interest rates on this issuance.

Foreign Currency Risk

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

Item 4. Controls and Procedures

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

PART II
OTHER INFORMATION

Item 1. Legal Proceedings

In or about the end of July 2013 two purported class action lawsuits were filed in the United States District Court for the Central District of California: (1) Melot v. JAKKS PACIFIC, INC. et al, Case No. CV13-05388 (JAK) (filed on July 25, 2013); and (2) Dylewicz v. JAKKS PACIFIC, INC. et al, Case No. CV13-5487 (OON) (filed on July 30, 2013) (collectively, the “Class Actions”). The complaints in the Class Actions allege that the Company made false and/or misleading statements concerning the extent of the negative impact that the shift in children’s preference for electronic devices was having on sales of the Company’s more traditional toys; the extent of the negative impact from poor sales of various of the Company’s licensed products and/or the Company’s financial statements were materially false and misleading. These allegations make reference to matters contained in the July 17, 2013 Press Release. The Melot complaint was amended such that the Class Period in such Class Action is from July 17, 2012 –July 17, 2013, the same period covered by the Dylewicz complaint. The Class Actions seek compensatory and other damages in an undisclosed amount, allege 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. Berman and Bennett), and violations of Section 20(a) of the Exchange Act by Messrs. Berman and Bennett. The Court has indicated that the Class Actions will proceed as one action and is in the process of selecting lead counsel and lead plaintiff. Thereafter an amended complaint will be filed and then the Company will respond to the complaint. We believe that the claims in the Class Actions are without merit and we intend to defend vigorously against them. However, because the Class Actions are in a preliminary stage, we cannot assure you as to their outcome, or that an adverse decision in such actions would not have a material adverse effect on our business, financial condition or results of operations.

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

Item 1A. Risk Factors

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, should such events occur, we would be able to find alternative sources of inventory at competitive prices, we cannot assure you that we would be able to do so. These exposures are directly related to our normal operating and funding activities. Historically, we have not used derivative instruments or engaged in hedging activities to minimize our market risk.

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

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 upon our ability to redesign, restyle and extend our existing core products and product lines as consumer preferences evolve, and to develop, introduce and gain customer acceptance of new products and product lines. Several trends in recent years have presented challenges for the toy industry, including:

Age Compression: the phenomenon of children outgrowing toys at younger ages, particularly in favor of interactive and high technology products;

increasing use of technology;

shorter life cycles for individual products; and

higher consumer expectations for product quality, functionality and value.

We cannot assure you that:

our current products will continue to be popular with consumers;

the product lines or products that we introduce will achieve any significant degree of market acceptance;
or

the life cycles of our products will be sufficient to permit us to recover licensing, design, manufacturing, marketing and other costs associated with those products.

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

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

The success of many of our character-related and theme-related products depends upon 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 substantially depend upon our ability to obtain additional licenses. Intense competition exists for desirable licenses in our industry. We cannot assure you that we will be able to secure or renew significant licenses on terms acceptable to us. In addition, as we add licenses, the need to fund additional royalty advances and guaranteed minimum royalty payments may strain our cash resources.

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

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

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

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

greater financial resources;

larger sales, marketing and product development departments;

stronger name recognition;

longer operating histories; and

greater economies of scale.

In addition, the toy industry has no significant barriers to entry. Competition is based primarily upon the ability to design and develop new toys, procure licenses for popular characters and trademarks and 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, expand our products and product lines or continue to compete effectively against current and future competitors.

We may not be able to sustain or manage our 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 ten years, which was achieved through acquisitions of businesses, products and licenses. For example, revenues associated with companies we acquired since 2008 were approximately \$282.6 million for the year ended December 31, 2012, and \$243.4 million for the nine months ended September 30, 2013, respectively, representing 42.4% and 49.2% 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 train, motivate and manage our work force. There can be no assurance that our operational, financial and management information systems will be adequate to support our future operations. Failure to expand our operational, financial and management information systems or to train, motivate or manage employees could have a material adverse effect on our business, financial condition and results of operations.

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

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

Our growth strategy depends, in part, upon our ability to acquire companies and new product lines. Revenues associated with our acquisitions since 2008 represented approximately 42.4% and 49.2% of our total revenues for the year ended December 31, 2012 and the nine months ended September 30, 2013, 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 42.1% and 44.8% of our net sales for the year ended December 31, 2012 and the nine months ended September 30, 2013, respectively. Except for outstanding purchase orders for specific products, we do not have written contracts with or commitments from any of our customers. A substantial reduction in or termination of orders from any of our largest customers could adversely affect our business, financial condition and results of operations. In addition, pressure by large customers seeking price reductions, financial incentives, changes in other terms of sale or for us to bear the risks and the cost of carrying inventory could also 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 upon our key Chief Executive Officer and any loss or interruption of his services could adversely affect our business, financial condition and results of operations.

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

We depend upon 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 upon 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 upon what they pay for their raw materials.

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

We sell products and operate facilities in numerous countries outside the United States. For the nine months ended September 30, 2013 and the year ended December 31, 2012, sales to our international customers comprised approximately 19.1% and 19.8%, respectively, of our net sales. We expect our sales to international customers to account for a greater portion of our revenues in future fiscal periods. Additionally, we utilize third-party manufacturers, located principally in China, and 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 upon 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 international sales and international sourcing of manufacturing to our business, our financial condition and results of operations could be significantly and adversely affected if any of the risks described above were to occur.

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

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

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

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

We depend upon 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 upon 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 upon 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, level of consumer debt, increased competition and decreased consumer confidence, may adversely impact our margins. Such a weakened economic and business climate could create uncertainty and adversely affect our sales and profitability. Other conditions, such as the unavailability of electronics components, may impede our ability to manufacture, source and ship new and continuing products on a

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

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

The remaining \$39.0 million outstanding of our \$100.0 million principal amount of 4.50% convertible senior notes mature on November 1, 2014. Holders of these notes may require us to purchase all or some of their notes for cash upon the occurrence of certain fundamental changes in our board composition or ownership structure, if we liquidate or dissolve under certain circumstances or if our common stock ceases being quoted on an established over-the-counter trading market in the United States. If we do not have, or have access to, sufficient funds to repurchase the notes, then we could be forced into bankruptcy. In fact, we expect that we would require third-party financing, but we cannot assure you that we would be able to obtain that financing on favorable terms, or at all.

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

Goodwill is the amount by which the cost of an acquisition exceeds the fair value of the net assets we acquire. Current accounting standards require that goodwill not be amortized but instead be periodically evaluated for impairment based upon the fair value of the reporting unit. Goodwill currently on our books and any goodwill associated with future acquisitions are subject to the same impairment risk.

Earthquakes or other catastrophic events out of our control may damage our facilities or those of our contractors and adversely affect our results of operations.

We have significant operations near major earthquake faults, including our corporate headquarters and distribution center in Southern California. A catastrophic event where we have important operations, such as an earthquake, tsunami, flood, typhoon, fire, or other natural or manmade disaster, could disrupt our operations or those of our contractors and impair production or distribution of our products, damage inventory, interrupt critical functions, or otherwise affect its business negatively, adversely affecting our results of operations.

Failure to successfully implement new initiatives could have a significant adverse effect on our business, financial condition and results of operations.

JAKKS has announced, and in the future may announce, initiatives to reduce its costs, increase its efficiency, improve the execution of its core business, globalize and extend its brands, catch new trends, create new brands, and offer new innovative products, enhance product safety, develop people, improve productivity, simplify processes, maintain customer service levels, as well as initiatives designed to drive sales growth, and improve its supply chain. These initiatives involve investment of capital and complex decision-making as well as extensive and intensive execution, and the success of these initiatives is not assured. Failure to successfully implement any of these initiatives, or the failure of any of these initiatives to produce the results anticipated by management, could have a significant adverse effect on our business, financial condition, and results of operations. Significant investments have been made in our DreamPlay initiative, which, if we are not successful, could result in the significant write-down of such investments and adversely affect our results of operations.

Issues with products may lead to product liability, personal injury or property damage claims, recalls, withdrawals, replacements of products, or regulatory actions by governmental authorities that could divert resources, affect business operations, decrease sales, increase costs, and put JAKKS at a competitive disadvantage, any of which could have a significant adverse effect on JAKKS's financial condition.

JAKKS has experienced, and may in the future experience, issues with products that may lead to product liability, personal injury or property damage claims, recalls, withdrawals, replacements of products, or regulatory actions by governmental authorities. Any of these activities could result in increased governmental scrutiny, harm to JAKKS's reputation, reduced demand by consumers for its products, decreased willingness by retailer customers to purchase or provide marketing support for those products, adverse impacts on JAKKS's ability to enter into licensing agreements for products on competitive terms, absence or increased cost of insurance, or additional safety and testing requirements. Such results could divert development and management resources, adversely affect JAKKS's business operations, decrease sales, increase legal fees and other costs, and put JAKKS at a competitive disadvantage compared to other manufacturers not affected by similar issues with products, any of which could have a significant adverse effect on JAKKS's financial condition.

We have been named as a defendant in Class Actions that are in a preliminary stage. The outcome of such litigation is unpredictable, and no assurances can be given that the result of the Class Actions will be favorable to us, or that an

adverse decision in such litigation would not have a material adverse effect on our business, financial condition or results of operations.

* * * * *

If any of the risks and uncertainties described in the cautionary factors listed above actually occurs, JAKKS's business, financial condition and results of operations could be significantly and adversely affected. The factors listed above are not exhaustive. Other sections of this Quarterly Report on Form 10-Q include additional factors that could materially and adversely impact JAKKS's business, financial condition and results of operations. For example, see Note 17 - Subsequent Events, to the Notes to Condensed Consolidated Financial Statements for disclosure with respect to recently filed Class Actions. Moreover, JAKKS operates in a very competitive and rapidly changing environment. New factors emerge from time to time, and it is not possible for management to predict the impact of all of these factors on JAKKS's business, financial condition or results of operations, or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these risks and uncertainties, investors should not rely on forward-looking statements as a prediction of actual results. Any or all of the forward-looking statements contained in this Annual Report on Form 10-K and any other public statement made by JAKKS or its representatives may turn out to be wrong. JAKKS expressly disclaims any obligation to update or revise any forward-looking statements, whether as a result of new developments or otherwise.

Item 6. Exhibits

Number	Description
3.1	Amended and Restated Certificate of Incorporation of the Company(1)
3.2	Amended and Restated By-Laws of the Company(2)
4.3	Indenture, dated November 10, 2009, by and between the Registrant and Wells Fargo Bank, N.A. (3)
4.4	Form of 4.50% Senior Convertible Note (3)
4.5	Credit Agreement dated as of September 27, 2012 among Registrant and its US wholly-owned subsidiaries and Wells Fargo Bank, National Association (4)
4.6	Secured Promissory Note dated September 27, 2012 in the amount of \$75,000,000 issued by Wells Fargo Bank, National Association to JAKKS Pacific, Inc., Creative Designs International, Ltd., Disguise, Inc., JAKKS Sales Corporation, Maui, Inc., an Ohio corporation, Kessler Services, Inc., Moose Mountain Marketing, Inc., and Kids Only, Inc. (4)
4.7	Form of 4.25% Senior Convertible Note (5)
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer(6)
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer(6)
32.1	Section 1350 Certification of Chief Executive Officer(6)
32.2	Section 1350 Certification of Chief Financial Officer(6)
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

-
- (1) Filed previously as Appendix 2 to the Company's Schedule 14A Proxy Statement filed August 23, 2002 and incorporated herein by reference.
- (2) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed October 21, 2011 and incorporated herein by reference.
- (3) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed November 10, 2009 and incorporated herein by reference.
- (4) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed October 4, 2012 and incorporated herein by reference.
- (5) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed July 18, 2013 and incorporated herein by reference.
- (6) Filed herewith.
-

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

JAKKS PACIFIC, INC.

Date: November 8, 2013

By: /s/ JOEL M. BENNETT

Joel M. Bennett
Executive Vice President and Chief Financial
Officer
(Duly Authorized Officer and Principal Financial
Officer)

EXHIBIT INDEX

Number	Description
3.1	Amended and Restated Certificate of Incorporation of the Company(1)
3.2	Amended and Restated By-Laws of the Company(2)
4.3	Indenture, dated November 10, 2009, by and between the Registrant and Wells Fargo Bank, N.A. (3)
4.4	Form of 4.50% Senior Convertible Note (3)
4.5	Credit Agreement dated as of September 27, 2012 among Registrant and its US wholly-owned subsidiaries and Wells Fargo Bank, National Association (4)
4.6	Secured Promissory Note dated September 27, 2012 in the amount of \$75,000,000 issued by Wells Fargo Bank, National Association to JAKKS Pacific, Inc., Creative Designs International, Ltd., Disguise, Inc., JAKKS Sales Corporation, Maui, Inc., an Ohio corporation, Kessler Services, Inc., Moose Mountain Marketing, Inc., and Kids Only, Inc. (4)
4.7	Form of 4.25% Senior Convertible Note (5)
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer(6)
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer(6)
32.1	Section 1350 Certification of Chief Executive Officer(6)
32.2	Section 1350 Certification of Chief Financial Officer(6)
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

-
- (1) Filed previously as Appendix 2 to the Company's Schedule 14A Proxy Statement filed August 23, 2002 and incorporated herein by reference.
- (2) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed October 21, 2011 and incorporated herein by reference.
- (3) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed November 10, 2009 and incorporated herein by reference.
- (4) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed October 4, 2012 and incorporated herein by reference.
- (5) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed July 18, 2013 and incorporated herein by reference.
- (6) Filed herewith.