JAKKS PACIFIC INC
Form 10-Q
May 02, 2006

Table of Contents

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

Form 10-Q

(Mark one)

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

For the quarterly period ended March 31, 2006

or

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

For the transition period from to

Commission file number: 0-28104
JAKKS Pacific, Inc.
(Exact name of registrant as specified in its charter)

Delaware	**95-4527222**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
22619 Pacific Coast Highway Malibu, California	**90265**
(Address of principal executive offices)	*(Zip Code)*

Registrant s telephone number, including area code:
(310) 456-7799

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

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

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

The number of shares outstanding of the issuer s common stock is 27,536,451 (as of May 1, 2006).

JAKKS PACIFIC, INC. AND SUBSIDIARIES
INDEX TO QUARTERLY REPORT ON FORM 10-Q
Quarter Ended March 31, 2006
ITEMS IN FORM 10-Q

DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

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

Table of Contents

JAKKS PACIFIC, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share amounts)

	December 31, 2005	March 31, 2006
	(*)	(Unaudited)
ASSETS		
Current assets		
Cash and cash equivalents	$ 240,238	$ 123,737
Accounts receivable, net of allowances for uncollectible accounts of $2,336 and $1,794, respectively	87,199	67,795
Inventory	66,729	62,198
Prepaid expenses and other current assets	17,533	35,653
Deferred income taxes	13,618	13,638
Total current assets	425,317	303,021
Property and equipment		
Office furniture and equipment	7,619	8,267
Molds and tooling	26,948	29,383
Leasehold improvements	3,522	3,803
Total	38,089	41,453
Less accumulated depreciation and amortization	25,394	27,234
Property and equipment, net	12,695	14,219
Investment in video game joint venture	10,365	3,201
Goodwill, net	269,298	345,051
Trademarks, net	17,768	19,168
Intangibles and other, net	18,512	31,612
Total assets	$ 753,955	$ 716,272
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 50,533	$ 27,190
Accrued expenses	44,415	26,856
Reserve for sales returns and allowances	25,123	22,033
Income taxes payable	3,792	
Total current liabilities	123,863	76,079
Deferred income taxes	6,446	7,013
Deferred rent liability	995	959
Convertible senior notes	98,000	98,000
Total liabilities	229,304	182,051

Stockholders equity				
Preferred stock, $.001 par value; 5,000,000 shares authorized; nil outstanding				
Common stock, $.001 par value; 100,000,000 shares authorized; 26,944,559 and 27,471,581 shares issued and outstanding, respectively		27		27
Additional paid-in capital		287,356		300,029
Retained earnings		240,057		242,388
Deferred compensation from restricted stock				(5,388)
Accumulated comprehensive loss		(2,789)		(2,835)
Total stockholders equity		524,651		534,221
Total liabilities and stockholders equity	$	753,955	$	716,272

(*) Derived from audited financial statements

See accompanying notes to condensed consolidated financial statements.

Table of Contents

JAKKS PACIFIC, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)

	Three Months Ended March 31, (Unaudited)	
	2005	**2006**
Net sales	$ 134,676	$ 107,244
Cost of sales	80,464	63,081
Gross profit	54,212	44,163
Selling, general and administrative expenses	40,537	41,919
Income from operations	13,675	2,244
Profit from video game joint venture	150	757
Interest, net	(198)	282
Income before provision for income taxes	13,627	3,283
Provision for income taxes	3,543	952
Net income	$ 10,084	$ 2,331
Earnings per share basic	$ 0.38	$ 0.09
Earnings per share diluted	$ 0.34	$ 0.09

See accompanying notes to condensed consolidated financial statements.

3

Table of Contents

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

	Three Months Ended March 31, (Unaudited)	
	2005	**2006**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 10,084	$ 2,331
Adjustments to reconcile net income to net cash used by operating activities:		
Depreciation and amortization	3,676	6,021
Share-based compensation expense	438	2,367
Change in operating assets and liabilities		
Accounts receivable	24,890	31,791
Inventory	(12,828)	5,925
Prepaid expenses and other current assets	1,444	(12,278)
Income taxes receivable		(5,034)
Investment in video game joint venture	6,631	7,164
Accounts payable	(26,876)	(25,776)
Accrued expenses	42	(12,327)
Reserve for sales returns and allowances	(2,175)	(5,141)
Income taxes payable	1,522	(3,181)
Deferred rent liability		(35)
Deferred income taxes	4	546
Total adjustments	(3,232)	(9,958)
Net cash provided (used) by operating activities	6,852	(7,627)
CASH FLOWS FROM INVESTING ACTIVITIES		
Cash paid for net assets acquired, net of cash acquired	(9,262)	(107,755)
Purchase of property and equipment	(902)	(1,781)
Purchase of other assets	(25)	(194)
Net purchase of marketable securities	(4,085)	
Net cash used by investing activities	(14,274)	(109,730)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from stock options exercised	1,768	865
Net cash provided by financing activities	1,768	865
Foreign currency translation adjustment	(42)	(9)
Net increase (decrease) in cash and cash equivalents	(5,696)	(116,501)

Cash and cash equivalents, beginning of period	176,544	240,238
Cash and cash equivalents, end of period	$ 170,848	$ 123,737
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Income taxes	$ 2,028	$ 8,641
Interest	$	$

Non cash investing and financing activity:

In February 2006, the Company issued 150,000 shares of its common stock valued at approximately $3.4 million in connection with the acquisition of Creative Designs (see Note 9).

During the three months ended March 31, 2006, two executive officers surrendered 110,736 shares of restricted stock at a value of $2.5 million to cover their income taxes due on the 2006 vesting of the 2005 restricted share grant. This restricted stock was subsequently retired by the Company.

In September 2005, two executive officers acquired 215,982 shares of common stock in a cashless exercise through their surrender of an aggregate of 101,002 shares of restricted stock at a value of $1.7 million. This restricted stock was subsequently retired by the Company.

See accompanying notes to condensed consolidated financial statements.

4

JAKKS PACIFIC, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
March 31, 2006

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 and the financial statements and the notes thereto included in the Company s Form 10-K, which contains financial information for the three years in the period ended December 31, 2005.

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.

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 related products, principally engaged in the design, development, production and marketing of traditional toys, including boys action figures, vehicles and playsets, role-play, dress-up, craft and activity products, writing instruments, compounds, girls toys, plush, construction toys, and infant and preschool toys, as well as pet treats, toys and related pet products. The Company s reportable segments are North America Toys, Pet Products and International.

The North America Toys segment, which includes the United States and Canada, and the International segment, which includes sales to non-North American markets, include the design, development, production and marketing of children s toys and related products, and Pet Products includes the design, development, production and marketing of pet treats, toys and related pet products.

Segment performance is measured at the operating income level. All sales are made to external customers, and general corporate expenses have been attributed to the North America Toy segment, which is a dominant segment. Segment assets are comprised of all assets, net of applicable reserves and allowances.

Results are not necessarily those that would be achieved were each segment an unaffiliated business enterprise. Information by segment and a reconciliation to reported amounts for the three months ended March 31, 2005 and 2006 and as of December 31, 2005 and March 31, 2006 are as follows (in thousands):

	Three Months Ended March 31, 2005				
	Traditional Toys	**Craft/Activities/ Writing Products**	**Seasonal Products**	**Pet Products**	**Total**
Net Sales					
North America Toys	$ 100,668	$ 10,723	$ 9,392	$	$ 120,783
Pet Products (see Note 9)					
International	12,318	577	998		13,893
	$ 112,986	$ 11,300	$ 10,390	$	$ 134,676

Table of Contents

JAKKS PACIFIC, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

	Three Months Ended March 31, 2006				
	Traditional Toys	Craft/Activities/ Writing Products	Seasonal Products	Pet Products	Total
North America Toys	$ 72,653	$ 12,127	$ 8,145	$	$ 92,925
Pet Products				2,370	2,370
International	10,694	936	319		11,949
	$ 83,347	$ 13,063	$ 8,464	$ 2,370	$ 107,244

	Three Months Ended March 31,	
	2005	2006
Operating Income		
North America Toys	$ 12,255	$ 1,895
Pet Products		99
International	1,420	250
	$ 13,675	$ 2,244

	December 31, 2005	March 31, 2006
Assets		
North America Toys	$ 677,420	$ 604,884
Pet Products	23,432	31,581
International	53,103	79,807
	$ 753,955	$ 716,272

The following tables present information about the Company by geographic area as of December 31, 2005 and March 31, 2006 and for the three months ended March 31, 2005 and 2006 (in thousands):

	December 31, 2005	March 31, 2006

Long-lived Assets				
United States	$	283,350	$	344,950
Hong Kong		34,038		64,068
	$	317,388	$	409,018

JAKKS PACIFIC, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

	Three Months Ended March 31,	
	2005	**2006**
Net Sales by Geographic Area		
United States	$ 117,067	$ 92,499
Europe	6,749	4,949
Canada	3,626	2,796
Hong Kong	4,787	3,122
Other	2,447	3,878
	$ 134,676	$ 107,244

	Three Months Ended March 31,	
	2005	**2006**
Net Sales by Product Group		
Traditional Toys	$ 112,986	$ 83,347
Craft/Activities/Writing Products	11,300	13,063
Seasonal Products	10,390	8,464
Pet Products		2,370
	$ 134,676	$ 107,244

Major Customers

Net sales to major customers for the three months ended March 31, 2005 and 2006 were approximately as follows (in thousands, except for percentages):

	Three Months Ended March 31,			
	2005		**2006**	
	Amount	**Percentage of Net Sales**	**Amount**	**Percentage of Net Sales**
Wal-Mart	$ 51,775	38.4%	$ 26,956	25.1%
Toys R Us	18,126	13.5	15,172	14.2
Target	17,575	13.1	18,906	17.6

	$ 87,476	65.0%	$ 61,034	56.9%

Wal-Mart accounts for a large percentage of the toy industry s sales at retail and the proportion of the Company s sales to Wal-Mart is consistent with this. No other customer accounted for more than 10% of the Company s total net sales.

At December 31, 2005 and March 31, 2006, the Company s three largest customers accounted for approximately 73.0% and 66.4%, 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 (Continued)
(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, 2005	March 31, 2006
Raw materials	$ 2,679	$ 3,146
Finished goods	64,050	59,052
	$ 66,729	$ 62,198

Note 4 Revenue Recognition and Reserve for Sales Returns and Allowances

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

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

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

The Company s reserve for sales returns and allowances amounted to $22.0 million as of March 31, 2006, compared to $25.1 million as of December 31, 2005. The decrease was due primarily to the overall decrease in net sales, including a decrease in sales of electronic products which have higher defective rates than the Company s other products.

Note 5 Convertible Senior Notes

In June 2003, the Company sold an aggregate of $98.0 million of 4.625% Convertible Senior Notes due June 15, 2023 and received net proceeds of approximately $94.4 million. Beginning April 1, 2006, the notes became convertible into shares of the Company s common stock at an initial conversion price of $20.00 per share. The notes provide for the cash payment of interest at an annual rate of 4.625% of the principal amount at issuance, from the issue date to June 15, 2010, payable on June 15 and December 15 of each year. After June 15, 2010, interest will accrue on the outstanding notes until maturity. At maturity, the Company will redeem the notes at their accreted principal amount, which will be equal to $1,811.95 (181.195%) per $1,000 principal amount at issuance, unless redeemed or converted earlier.

The Company may redeem the notes at its option in whole or in part beginning on June 15, 2010, at 100% of their accreted principal amount plus accrued and unpaid interest, if any, payable in cash. Holders of the notes may also require the Company to repurchase all or part of their notes on June 15, 2010, for cash, at a repurchase price of 100%

of the principal amount per note plus accrued and unpaid interest, if any. Holders of

JAKKS PACIFIC, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

the notes may also require the Company to repurchase all or part of their notes on June 15, 2013 and June 15, 2018 at a repurchase price of 100% of the accreted principal amount per note plus accrued and unpaid interest, if any, and may be paid in cash, in shares of common stock or a combination of cash and shares of common stock.

Note 6 Income Taxes

Provision for income taxes included Federal, state and foreign income taxes at effective tax rates of 26.0% in 2005 and 29.0% in 2006, benefiting from a flat 17.5% tax rate on the Company s income arising in, or derived from, Hong Kong for each of 2005 and 2006. The increase in the effective tax rate in 2006 is due to a greater proportion of taxable income generated in the United States. As of March 31, 2006, the Company had net deferred tax assets of approximately $6.6 million for which no allowance has been provided since, in the opinion of management, realization of the future benefit is probable.

Note 7 Earnings Per Share

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

	Three Months Ended March 31,					
	2005			2006		
	Income	Weighted Average Shares	Per-Share	Income	Weighted Average Shares	Per-Share
Earnings per share basic						
Income available to common stockholders	$ 10,084	26,560	$ 0.38	$ 2,331	27,310	$ 0.09
Effect of dilutive securities						
Convertible senior notes	737	4,900		737	4,900	
Options and warrants		796			407	
Earnings per share diluted						
Income available to common stockholders plus assumed exercises and conversion	$ 10,821	32,256	$ 0.34	$ 3,068	32,617	$ 0.09

Basic earnings per share has been computed using the weighted average number of common shares outstanding. Diluted earnings per share has been computed using the weighted average number of common shares and common share equivalents outstanding (which consist of warrants, options and convertible debt to the extent they are dilutive).

Note 8 Common Stock and Preferred Stock

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

During the three months ended March 31, 2006, the Company issued 268,660 shares of restricted stock to two executive officers and five non-employee directors of the Company at a value of approximately $5.6 million. The Company also issued 219,098 shares of common stock on the exercise of options for a total of $3.4 million, and

110,736 shares of restricted stock previously received by two executive officers were surrendered at a value of $2.5 million to cover their income taxes due on the 2006 vesting of the 2005 restricted share grant. This restricted stock was subsequently retired by the Company. In February 2006,

JAKKS PACIFIC, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

the Company issued 150,000 shares of its common stock valued at approximately $3.4 million in connection with the acquisition of Creative Designs International, Ltd. and a related Hong Kong company, Arbor Toys Company Limited (collectively Creative Designs) (see Note 9).

During 2005, the Company issued 245,000 shares of restricted stock to two executive officers and five non-employee directors of the Company at a value of approximately $5.1 million. The Company also issued 566,546 shares of common stock on the exercise of options for a total of $4.9 million, including 215,982 shares of common stock acquired by two executive officers in a cashless exercise through their surrender of an aggregate of 101,002 shares of restricted stock at a value of $1.7 million. This restricted stock was subsequently retired by the Company.

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.

Note 9 Business Combinations

The Company acquired the following entities to further enhance its existing product lines, continue diversification into other toy categories and counter-seasonal businesses and expand distribution of its products.

On February 9, 2006, the Company acquired substantially all of the assets of Creative Designs. The total initial purchase price of $107.9 million consisted of cash in the amount of $104.5 million, 150,000 shares of the Company s common stock at a value of approximately $3.4 million and the assumption of liabilities in the amount of $5.9 million. In addition, the Company agreed to pay an earn-out of up to an aggregate of $20.0 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. Creative Designs is a leading designer and producer of dress-up and role-play toys. This acquisition expands our product offerings in the girls role-play and dress-up area and brings new product development and marketing talent to us. The Company s results of operations have included Creative Designs from the date of acquisition.

The amount of goodwill from the Creative Designs acquisition that is expected to be deductible for income tax purposes is approximately $45.5 million. The total purchase price was allocated based on preliminary studies and valuations (which are expected to be completed in the second quarter of 2006) to the estimated fair value of assets acquired and liabilities assumed, as set forth in the following table (in thousands):

Estimated fair value:		
Current assets acquired	$	14,787
Property and equipment, net		1,235
Other assets		103
Liabilities assumed		(5,919)
Intangible assets other than goodwill		18,570
Goodwill		75,750
	$	104,526

Table of Contents

JAKKS PACIFIC, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

The following unaudited pro forma information represents the Company s consolidated results of operations as if the acquisition of Creative Designs had occurred on January 1, 2005 and after giving effect to certain adjustments including the elimination of certain general and administrative expenses and other income and expense items not attributable to ongoing operations, interest expense, and related tax effects. Such pro forma information does not purport to be indicative of operating results that would have been reported had the acquisition of Creative Designs occurred on January 1, 2005 or future operating results (in thousands, except per share data).

	Three Months Ended March 31,	
	2005	**2006**
Net Sales	$ 146,895	$ 120,127
Net income	$ 10,784	$ 3,998
Earnings per share basic	$ 0.40	$ 0.15
Weighted average shares outstanding basic	26,710	27,462
Earnings per share diluted	$ 0.36	$ 0.14
Weighted average shares and equivalents outstanding diluted	32,406	32,767

In June 2005, the Company purchased substantially all of the operating assets and assumed certain liabilities relating to the Pet Pal line of pet products, including toys, treats and related pet products. The total initial purchase price of $10.6 million was paid in cash. In addition, the Company agreed to pay an earn-out of up to an aggregate amount of $25.0 million in cash based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. Goodwill of $4.6 million arose from this transaction, which represents the excess of the purchase price over the fair value of assets acquired less the liabilities assumed. This acquisition expands the Company s product offerings and distribution channels. The Company s results of operations have included Pet Pal from the date of acquisition. Proforma results of operations are not provided since the amounts are not material to the consolidated results of operations.

In June 2004, the Company purchased substantially all of the assets and assumed certain liabilities of Play Along. The total initial purchase price of $85.7 million consisted of cash paid in the amount of $70.8 million and the issuance of 749,005 shares of the Company common stock valued at $14.9 million and resulted in goodwill of $67.8 million. In addition, the Company agreed to pay an earn-out of up to $10.0 million per year for the four calendar years following the acquisition up to an aggregate amount of $30.0 million based on the achievement of certain financial performance criteria which will be recorded as goodwill when and if earned. For the two years in the period ended December 31, 2005, $16.7 million of the earn-out was earned and recorded as goodwill. Accordingly, the annual maximum earn-out for the remaining two years through December 31, 2007 is approximately $6.7 million, or an aggregate of $13.3 million. Play Along designs and produces traditional toys, which it distributes domestically and internationally. This acquisition expands the Company s product offerings in the pre-school area and brings it new product development and marketing talent. The Company s results of operations have included Play Along from the date of acquisition.

Approximately $44.8 million of goodwill from the Play Along acquisition is expected to be deductible for Federal and state income tax purposes. The total purchase price, including the earn-out of $16.7 million

JAKKS PACIFIC, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

earned in 2004 and 2005, was allocated based on studies and valuations performed to the estimated fair value of assets acquired and liabilities assumed, as set forth in the following table:

Estimated fair value (in thousands):	
Current assets acquired	$ 24,063
Property and equipment, net	546
Other assets	3,184
Liabilities assumed	(22,263)
Intangible assets other than goodwill	22,100
Goodwill	74,723
	$ 102,353

Note 10 Joint Ventures

The Company owns a fifty percent interest in a joint venture with THQ Inc. (THQ), a developer, publisher and distributor of interactive entertainment software for the leading hardware game platforms in the home video game market. The joint venture has entered into a license agreement with an initial license period expiring December 31, 2009, and a renewal for five years at the option of the joint venture, under which it acquired the exclusive worldwide right to publish WWE themed wrestling video games on all hardware platforms. The Company s investment is accounted for using the cost method due to the financial and operating structure of the venture and its lack of control over the joint venture. The Company s basis consists primarily of organizational costs, license costs and recoupable advances and is being amortized over the term of the initial license period. The joint venture agreement provides for the Company to receive guaranteed preferred returns through June 30, 2006 at varying rates of the joint venture s net sales depending on the cumulative unit sales and platform of each particular game. For periods after June 30, 2006, the amount of the preferred return will be subject to change between the parties. This change is to be negotiated between the parties and, in the absence of an agreement, is to be resolved by arbitration. No agreement has been reached and we anticipate that the reset of the preferred return will be determined through arbitration. The preferred return is accrued in the quarter in which the licensed games are sold and the preferred return is earned. The Company s joint venture partner retains the financial risk of the joint venture and is responsible for the day-to-day operations, including development, sales and distribution, for which they are entitled to any remaining profits. In addition, THQ is entitled to receive a preferred return based on the Company s sale of WWE themed TV Games. No preferred return was paid to THQ in the three months ended March 31, 2005 and 2006.

Note 11 Goodwill

The changes in the carrying amount of goodwill for the three months ended March 31, 2006 are as follows (in thousands):

Balance at beginning of period	$ 269,298
Goodwill acquired during the period (see Note 9)	75,750
Adjustments to goodwill during the period	3
Balance at end of period	$ 345,051

Table of Contents

JAKKS PACIFIC, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Note 12 Intangible Assets

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

		December 31, 2005			March 31, 2006		
	Weighted Useful Lives (Years)	Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
Amortized Intangible Assets:							
Acquired order backlog	0.5				$ 2,630	$ (1,854)	776
Licenses	4.25	$ 23,635	$ (12,082)	$ 11,553	37,935	(14,132)	23,803
Product lines	3.5	17,700	(17,700)		17,700	(17,700)	
Customer relationships	5.0	1,846	(700)	1,146	2,086	(793)	1,293
Non-compete/ Employment contracts	4.0	2,748	(1,049)	1,699	2,748	(1,222)	1,526
Debt offering costs	20.0	3,705	(477)	3,228	3,705	(523)	3,182
Total amortized intangible assets		49,634	(32,008)	17,626	66,804	(36,224)	30,580
Unamortized Intangible Assets:							
Trademarks	indefinite	17,768	N/A	17,768	19,168	N/A	19,168
		$ 67,402	$ (32,008)	$ 35,394	$ 85,972	$ (36,224)	$ 49,748

For the three months ended March 31, 2005 and 2006, the Company s aggregate amortization expense related to intangible assets was $2.2 million and $4.2 million, respectively.

13

Table of Contents

JAKKS PACIFIC, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Note 13 Share-Based Payments

Under its 2002 Stock Award and Incentive Plan (the Plan), which incorporated its Third Amended and Restated 1995 Stock Option Plan, the Company has reserved 6,025,000 shares of its common stock for issuance upon the exercise of options granted under the Plan, as well as for the awarding of other securities. Under the Plan, employees (including officers), non-employee directors and independent consultants may be granted options to purchase shares of common stock and other securities. The vesting of these options and other securities may vary, but typically vest on a step-up basis over a maximum period of five years. Share-based compensation expense is recognized on a straight-line basis over the requisite service period.

Under the Plan, share-based compensation payments include the issuance of restricted stock. Beginning in January 2006, the Company s five non-employee directors are each issued annually restricted stock at a value of $120,000 (or, for 2006, 5,732 shares per director). During 2006, the Company issued 268,660 shares of restricted stock to two executive officers and five non-employee directors of the Company at a value of approximately $5.6 million. During 2005, the Company issued 245,000 shares of restricted stock to two executive officers and five non-employee directors of the Company at a value of approximately $5.1 million. In 2004, the Company issued 340,310 shares of restricted stock to three executive officers and five non-employee directors of the Company at a value of approximately $4.5 million. During 2003, the Company granted 2,760,000 shares of restricted stock to four executive officers of the Company, of which 636,000 were earned during 2003, 396,000 were earned during 2004, 288,000 were canceled upon the termination of employment of one of our executive officers in October 2004, and the balance may be earned through 2010 based upon the achievement of certain financial criteria and continuing employment.

In December 2004, the Financial Accounting Standards Board (FASB) revised Statement of Financial Accounting Standards No. 123 (FAS 123R), Share-Based Payment, which establishes accounting for share-based awards exchanged for employee services and requires companies to expense the estimated fair value of these awards over the requisite employee service period. The accounting provisions of FAS 123R became effective for the Company beginning on January 1, 2006.

Under FAS 123R, share-based compensation cost is measured at the grant date, based on the estimated fair value of the award, and is recognized as expense over the employee s requisite service period. The Company adopted the provisions of FAS 123R using a modified prospective application. The valuation provisions of FAS 123R apply to new awards and to awards that are outstanding on the effective date and subsequently modified or cancelled. Estimated compensation expense for awards outstanding at the effective date will be recognized over the remaining service period using the compensation cost calculated for pro forma disclosure purposes under FASB Statement No. 123, Accounting for Stock-Based Compensation (FAS 123).

In November 2005, the FASB issued FASB Staff Position No. FAS 123(R)-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards. The Company has elected to adopt the alternative transition method provided in this FASB Staff Position for calculating the tax effects of share-based compensation pursuant to FAS 123R. The alternative transition method includes a simplified method to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee share-based compensation, which is available to absorb tax deficiencies recognized subsequent to the adoption of FAS 123R.

The Company uses the Black-Scholes method of valuation for share-based option awards. In valuing the stock options, the Black-Scholes model incorporates assumption about stock volatility, expected term of stock options, and risk free interest rate. The valuation is reduced by an estimate of stock option forfeitures.

The Company issued no stock options during the first quarter of 2006. The amount of share-based compensation expense recognized in the three months ended March 31, 2006 is based on options and restricted stock issued prior to January 1, 2006 and restricted stock issued during the first quarter of 2006, and

JAKKS PACIFIC, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

ultimately expected to vest, and it has been reduced for estimated forfeitures. FAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Total share-based compensation expense and related tax benefits recognized for the three months ended March 31, 2006 were $0.6 million and $0.2 million, respectively, relating to stock options and $1.8 million and $0.7 million, respectively, relating to restricted stock. Stock option activity pursuant to the Plan for the three months ended March 31, 2006 is summarized as follows:

	Plan Stock Options	
	Number of Shares	Weighted Average Exercise Price
Outstanding, December 31, 2005	1,789,106	$ 16.32
Granted		
Exercised	219,098	$ 15.36
Forfeited		
Outstanding, March 31, 2006	1,570,008	$ 16.45

As of December 31, 2005, the Company had 245,000 shares of restricted stock outstanding, all of which vested during the three months ended March 31, 2006. During the three months ended March 31, 2006, the Company granted 268,660 additional shares of restricted stock, which remain unvested as of March 31, 2006.

The following characteristics apply to the Plan stock options that are fully vested, or expected to vest, as of March 31, 2006:

Number of options outstanding	1,570,008
Weighted-average exercise price	$ 16.45
Aggregate intrinsic value	$ 11,365,731
Weighted-average contractual term of options outstanding	3.7 years
Number of options currently exercisable	800,312
Weighted-average exercise of options currently exercisable	$ 14.53
Aggregate intrinsic value of options currently exercisable	$ 7,553,188
Weighted-average contractual term of currently exercisable	3.5 years

At March 31, 2005, the Company accounted for the Plan under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. Prior to the implementation of FAS 123R, stock-based employee compensation expense was not generally reflected in net income, as all options granted under the Plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FAS 123R to stock-

Table of Contents

JAKKS PACIFIC, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

based employee compensation for the three months ended March 31, 2005, (in thousands, except per share data):

	Three Months Ended March 31, 2005
Net income, as reported	$ 10,084
Add (deduct): Stock-based employee compensation expense included in reported net income, net of related tax effects	(230)
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(580)
Pro forma net income	$ 9,274
Earnings per share:	
Basic as reported	$ 0.38
Basic pro forma	$ 0.35
Diluted as reported	$ 0.34
Diluted pro forma	$ 0.31

In 2005, the fair value of each employee option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions used: risk-free rate of interest of 4.25%; dividend yield of 0%, with volatility of 55.3%; and expected lives of five years.

Note 14 Comprehensive Income

The table below presents the components of the Company s comprehensive income for the three months ended March 31, 2005 and 2006 (in thousands):

	Three Months Ended March 31, 2005	2006
Net income	$ 10,084	$ 2,331
Other comprehensive income (loss):		
Foreign currency translation adjustment	(11)	(46)
Other comprehensive income (loss)	(11)	(46)
Comprehensive income	$ 10,073	$ 2,285

Note 15 Litigation

In October 2004, the Company was named as a defendant in a lawsuit commenced by WWE (the WWE Action). The complaint also named as defendants, among others, the joint venture with THQ Inc., certain of the Company s foreign subsidiaries and the Company s three executive officers. The Complaint was amended, the antitrust claims were dismissed and, on grounds not previously considered by the Court, a motion to dismiss the RICO claim, the only remaining basis for federal jurisdiction, will be briefed pursuant to a scheduling order and is scheduled to be argued in September 2006. In November 2004, several purported class action lawsuits were filed in the United States District Court for the Southern District of New York, alleging damages associated with the facts alleged in the WWE Action (the Class Action). They are the subject of a motion to dismiss that has been fully briefed. Three shareholder derivative actions have also been filed against the Company, nominally, and against certain of the Company s Board members (the Derivative

JAKKS PACIFIC, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Actions). The Derivative Actions seek to hold the individual defendants liable for damages allegedly caused to the Company by their actions, and, in one of the Derivative Actions, seeks restitution to the Company of profits, benefits and other compensation obtained by them. These actions are currently stayed or the time to answer has been extended.

The Company received notice from WWE alleging breaches of the video game license in connection with Japanese sales of WWE video games. The joint venture has responded that WWE acquiesced in the arrangements, and separately released any claim against the joint venture in connection therewith and accordingly there is no breach of the joint venture s video game license.

In connection with the joint venture with THQ (see Note 10, Joint Ventures), we receive a preferred return. The preferred return is to be reset as of July 1, 2006. The agreement with THQ provides for the parties to agree on the reset of the preferred return and, if no agreement is reached, for arbitration of the issue. No agreement has been reached and we anticipate that the reset of the preferred return will be determined through arbitration.

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

Table of Contents

JAKKS PACIFIC, INC. AND SUBSIDIARIES

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

Share-Based Payments. We grant restricted stock and options to purchase our common stock to our employees (including officers) and non-employee directors under our 2002 Stock Award and Incentive Plan (the Plan), which incorporated our Third Amended and Restated 1995 Stock Option Plan. The benefits provided under the Plan are share-based payments subject to the provisions of revised Statement of Financial Accounting Standards No. 123 (FAS 123R), Share-Based Payment. Effective January 1, 2006, we began to use the fair value method to apply the provisions of FAS 123R with a modified prospective application. The valuation provisions of FAS 123R apply to new awards and to awards that were outstanding on the effective date and subsequently modified or cancelled. Under the modified prospective application, prior periods are not revised for comparative purposes. Share-based compensation expense recognized on a straight-line basis over the requisite service period under FAS 123R for the three months ended March 31, 2006 was $0.6 million relating to stock options and $1.8 million relating to restricted stock. At March 31, 2006, total unrecognized estimated compensation expense related to non-vested stock options granted prior to that date was $3.8 million, which is expected to be recognized over a weighted average period of 3.7 years, and $5.4 million related to non-vested restricted stock, w