



The
House that
JAKKS PacificTM
has Built





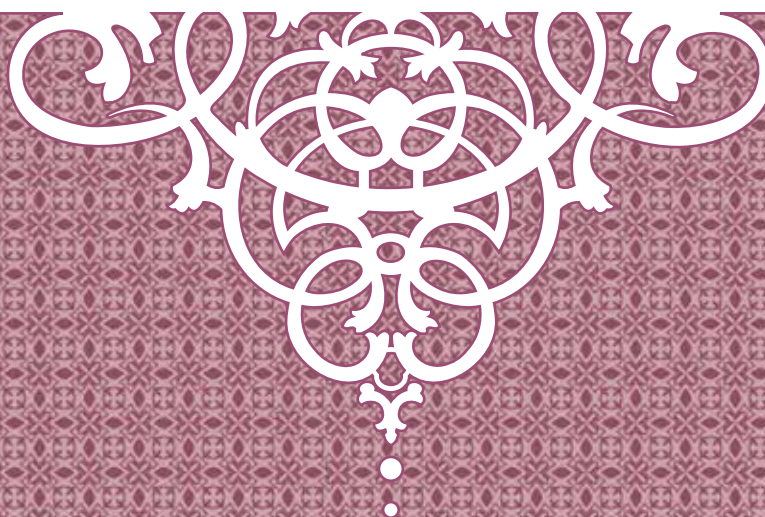
A little over ten years ago, a small group of creative thinkers, led by Stephen Berman and Jack Friedman, decided to shake up the toy world by creating a new house on the block. They established JAKKS Pacific, Inc. and knew they needed a solid foundation in order to build the business in a significant way. They were traditional toy guys who realized that they could take classic play patterns, add a little innovation and technology, and make them even more fun! They realized if they started with a prudent management team who used a strategic approach, worked to forge strong relationships within the industry, aligned themselves with proven brands and applied proven marketing expertise, they would have a solid infrastructure to support *The House that JAKKS Pacific™ has Built.*



Our Visionaries Build on the Foundation



In 1995, JAKKS Pacific began assembling and cultivating a team that could make things happen. Today, JAKKS Pacific boasts a seasoned talent pool that is among the best in the business. From designers, engineers and sales executives, to marketing, licensing and finance professionals, our team is driven to excel. The creativity, energy and dedication demonstrated by our employees worldwide enable us to thrive.





In addition to our strong foundation, JAKKS Pacific strategically approaches growth. Our teams collaborate on new concepts and winning products to expand our portfolio. We constantly seek to shape meaningful partnerships in our marketing ventures. We have structured our business to be able to adapt easily to an ever-changing retail landscape and seek out new areas for expansion through product development and acquisitions.



Our Strategy Creates the Framework



Our visionary leaders have designed and created products that have made JAKKS Pacific who we are today. We have chosen to align with some of today's most popular character licenses, pairing them with products and play patterns suitable for consumers of every age. Our licensing portfolio is filled with the powerhouses of children's entertainment, such as Nickelodeon®, Disney® and Marvel®, to name just a few.



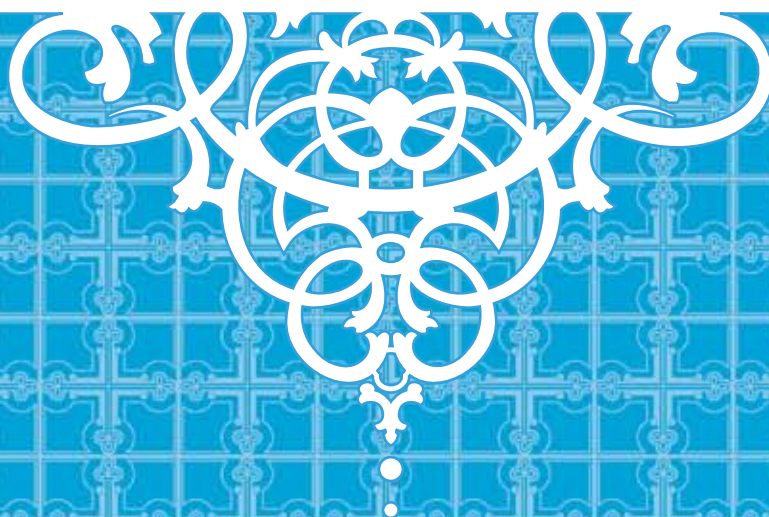


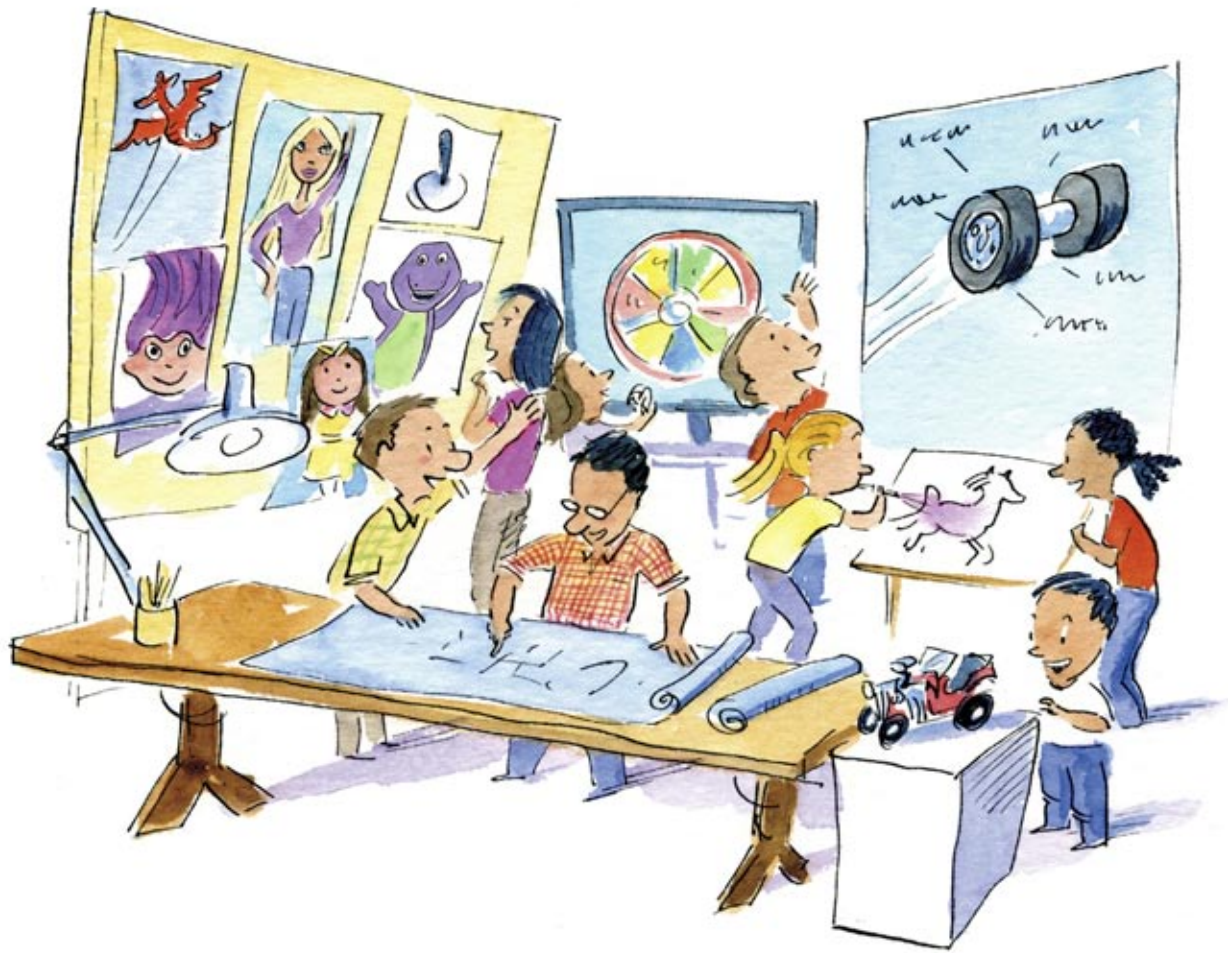
By expanding into new categories, JAKKS Pacific has become more than just a traditional toy company! We are fast becoming a diverse consumer products company, with entry into new retail channels, including office superstores, kite and hobby shops and, now, pet stores. With our mass-market toy retailers, we have added shelf space, and as a result, increased exposure for JAKKS Pacific. The nature of our diverse businesses and product lines has resulted in year-round sales for JAKKS™, but we haven't stopped there...



Plans for Success

We diligently examine each acquisition opportunity to see which part will make our “house” bigger and better for all of our affiliates. Our strategy of acquiring complementary companies led us to Toymax, from which we added Plug It In & Play TV Games™ and our Go Fly A Kite® outdoor products; Play Along, from which we added Cabbage Patch Kids® and Care Bears® plush to our roster; and Pet Pal, from which we added American Kennel Club (AKC®) pet products and developed White Bites™ oral care dog treats, as well as a full line of products for pets, large and small. Most recently, our acquisition of Creative Designs International brought to JAKKS beautiful Disney dress-up items, role-play toys, and more.





JAKKS takes existing products and continually looks for ways to make them better. For example, we saw the immense potential in our Plug It In & Play TV Games controllers. By making each controller thematic and toy-like down to the licensed property, we made simple, classic video games hugely appealing to today's consumers. Our in-house talents have many success stories with products such as high performing Fly Wheels™ toys, WWE® action figures, and UltraSharp® liquid graphite writing instruments that never need to be sharpened.



The House that JAKKS Pacific has Built

In ten short years, JAKKS Pacific has grown to over \$660 million in annual sales. We sell our diverse product portfolio to virtually every retail channel in more than 50 countries worldwide. Our seasoned and dedicated team of more than 600 employees around the globe works from concept inception to distribution of our stable of almost 4,000 different products.





JAKKS Pacific strives to constantly challenge ourselves to produce compelling products, the next big idea, or hot toys, while recognizing that we can also create just as much magic by taking regular day-to-day products and making them more attractive for today's consumers. Over the years, our products have brought joy to, and fulfilled the needs of, every member of the household...from children to grownups, and now even pets. The past ten years have been an amazing journey, and we are just beginning...



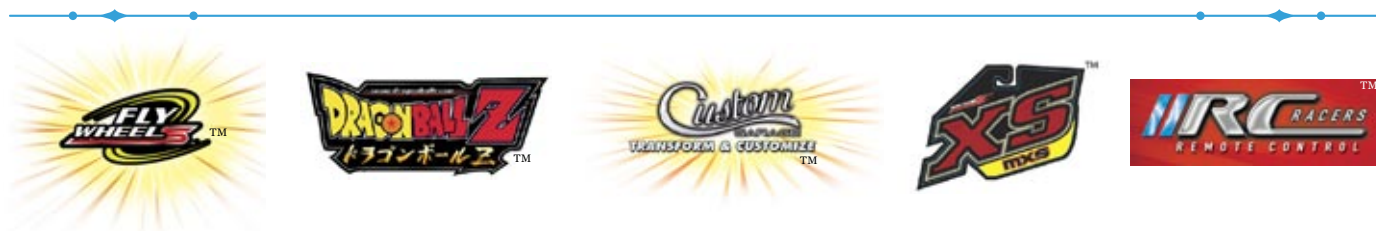
Boys' Action Toys



2005 was a great year for our Boys' Action product lines, highlighted by the exciting launch of our internally developed Fly Wheels toy vehicle line from our Road Champs® team. We also achieved growth in the category from multiple other product lines, including our WWE action figures, Dragon Ball Z® action figures, MXS® extreme sports bikes and riders, and Custom Garage™ vehicle activity kits.

The Fly Wheels toy vehicle line combines what boys crave—speed, performance and collectibility—and was a breakout hit in 2005. The basic line of licensed replica wheels, from several top auto, bike and skateboard companies, with rip cords and launchers, is a great example of JAKKS utilizing a hot market trend as a springboard to create an exciting new toy line.

The product proved profitable in several different retail channels, including mass merchant, toy and drug stores, and has enjoyed distribution to more than 30 countries. Our Fly Wheels toy also received multiple industry accolades in 2005. It was predicted to be a holiday “Hot Dozen” toy by *Toy Wishes Family and Entertainment* magazine. It was a finalist for Best Boy Toy of the Year by the Toy Industry Association. In addition, the Licensing Industry Merchandisers' Association nominated Fly Wheels



for Best Corporate Brand License, and Toys “R” Us bestowed our Male Action Toys team with a Vendor of the Year Award.

We saw nice momentum in 2005 on our MXS bikes and riders, RC Racers™ and Truck n’ Trailers™ toys, all of which have become staple products from our Road Champs portfolio. We also introduced Custom Garage, a fun new product that capitalizes on today’s popular trend of vehicle customization, allowing kids to turn a “junker” into a hot rod using a motorized buffer, new paint and deco.

On the action figure front, our WWE action figures have taken down the competition as the No. 2 or 3 action figure brand at most major accounts. Thanks to our Classic Superstars lineup, WWE action figure sell-through has been up considerably at our major customers nationwide.

In late 2006, we will introduce a line of collectible action figures based on the Rocky™ franchise to coincide with Rocky VI and the 30th Anniversary DVD box set slated for 2007. The pop culture phenomenon Pokémon® also joins JAKKS’ action figure lineup in 2007, as a whole new generation discovers the magic of this strong boys’ property.



Dolls, Plush & Role-Play



We bring generations together with play patterns that transcend time, while also generating profit for JAKKS.

Our Play Along® division is proving to be a tremendous resource in bringing to market beloved classics, such as Care Bears preschool and plush toys, Cabbage Patch Kids dolls, Sky Dancers® action dolls and Doodle Bear® plush. Both Sky Dancers dolls and Doodle Bears plush were well-loved in the 1990s and we were pleased with the results of their reintroductions in 2005, while Care Bears toys and Cabbage Patch Kids dolls, favored by children for decades, were also strong contributors.

Doodle Bear, a stuffed teddy bear that kids can color on, throw in the washing machine and color all over again, exceeded our expectations throughout the year. We also added Doodle Monster® for boys and a feature plush item, Magic Glow Doodle Bear, which was selected as a *Toy Wishes* magazine *All Star* for the 2005 Holiday Season, and a finalist for Best Activity Toy of the Year by the Toy Industry Association.

Little girls continue to love the Cabbage Patch Kids dolls, and Play Along has worked hard to manage the line as it was in its heyday. The first item launched was the classic yarn-haired Cabbage Patch Kids doll, to which we added Corn Silk Hair Kids, Cabbage Patch Ponies, and a new line of Cabbage Patch Babies, which



were also selected as a *Toy Wishes* magazine *All Star* for the 2005 Holiday Season. We look forward to making Cabbage Patch Kids dolls another evergreen brand for JAKKS Pacific.

Care Bears, which was awarded Property of the Year at the 2005 International Licensing Show, is now in Play Along's fourth selling year. We continue to offer an extensive assortment of collectible plush, preschool toys and feature plush, such as the Share-a-Story™ Care Bear that reads stories along with kids, and Smart Check-Up™ Care Bear. For 2006, the Play Along team has been busy bringing back the iconic original Good Luck DAM Trolls® figures, along with more Cabbage Patch Kids and Doodle Bears, plus a line of official merchandise for the fast-growing sport of cup stacking, called Speed Stacks®.

The newest gem in our portfolio of products is our Creative Designs International division, acquired in February 2006, which specializes in girls' dress-up and role-play items. The magical line encompasses beautiful princess and fairy dress-up sets, tea party sets, play mobile phones and other role-play staples. Licenses in the Creative Designs line include Disney, Build-A-Bear Workshop®, Barbie® and Black & Decker®. We are also striving to reinvigorate our Child Guidance division, having signed a number of top children's licenses for plush and master toy, including Barney®, Clifford the Big Red Dog® and Teletubbies®, which we expect to begin shipping in 2007.



Electronics



namco®

WHEEL OF FORTUNE®



Our Plug It In & Play TV Games line launched several years ago with retro video game and arcade titles from the pioneers of gaming, such as Namco®, Activision® and Atari®, with titles including Pac-Man®, Ms. Pac-Man®, Pong®, Pitfall!® and more. It has since evolved into a line of simple-to-use gaming systems for kids and adults.

The plug and play category is still fairly new, and in 2005, we gained valuable insight into what really sells best on this simple gaming platform. In the first half of the year, we released a mix of kid-driven titles (such as Batman®, Star Wars®, Fantastic Four®, Dragon Ball Z and Nicktoons®) and titles geared more towards serious gamers (including Mortal Kombat® and EA Sports®). After extensive research, which included market testing, focus groups, retailer feedback and more, we focused on titles appealing to our core consumers—children ages 4–9 years old and adult leisure gamers.

We now concentrate our energies towards younger-themed licenses, like Dora the Explorer®, SpongeBob SquarePants®, Disney, Sesame Street® and Winnie the Pooh®; movie-related properties such as Star Wars,



Spider-Man®, Batman, X-Men® and Superman®; retro titles including Super Pac-Man™; and leisure titles such as Wheel of Fortune®.

Determined to stay the leader of the plug and play market, in 2006, we have grown our electronics portfolio to maintain the coveted shelf space we have at many diverse retailers such as Game Stop, Foley's, Circuit City, Best Buy, Rite Aid, Walgreens, Radio Shack, Lord & Taylor and Meijer, as well as over 50 other retail outlets!

In late 2006, we expect to launch two new electronic items, TeleStory™ and VMIGO™ products, both of which utilize our plug and play technology. TeleStory is an interactive book system that connects directly into a standard TV and serves as a fun introductory reading guide for preschool-aged children. VMIGO toys are handheld virtual pets that, for the first time, combine virtual pets with plug and play gaming. We believe the features, price point and content for both lines will contribute to their success at retail.



Pets



With an entrepreneurial spirit and a seasoned, strategic approach, we constantly seek new avenues of growth for JAKKS Pacific. Throughout the past ten years, the cornerstone has been to add meaningful diversification to our product portfolio, consumer base and retailer base. We believe our recent acquisition in June 2005 of Pet Pal Corporation, a pet products company which we are now marketing under JPI™, is a great example of that strategy. With this small acquisition, we have enabled ourselves to enter the pet products market, a \$36 billion dollar industry, which has recently been growing faster than the traditional toy industry. In addition, between toys, grooming products, accessories and consumables, pet products have a year-round selling season.

Since the acquisition, we have been continuously working to develop pet toys, beds, treats, apparel and accessories that we believe will impact the industry. We secured several marquee character licenses, highlighted by Bratz™, the Marvel universe of superheroes and Disney's beloved portfolio of characters, and we are adding innovation and creativity to long-standing categories that have a great deal of potential. We are creating product lines full of kid-playable features that are meant to engage children with their pets.



**WHITE
BITES**

**Twisted
Whiskers**

max & lucy

MARVEL

Snoop Dogg

Woop Yox

The star of our line, the American Kennel Club (AKC), has been shining brightly and selling well at retail, with successful inline and endcap placement at some of our major accounts in 2005. In 2006, we expanded distribution of the AKC line into additional nationwide chains, with products based on the Cat Fanciers' Association (CFA™) expected late in the year. Similar to what AKC represents for dogs, CFA is the largest registry for pedigreed cats and epitomizes high end, top quality products for our feline friends. We have also been aggressively working to launch White Bites oral care treats for dogs, which hit Petco and Wal-Mart stores in June, with many other retailers expected to follow.

We work aggressively to place our diverse product lines at non-traditional toy sellers, and with JPI, we now have access to major pet retailers such as Petco and PetSmart, as well as more intimate "mom and pop" pet stores across the country. In addition, we are now in the pet aisles of our major retailers including Wal-Mart, Target, K-mart, Walgreens and Sam's Club. We are excited about the possibilities for JPI and look to the future with an eye on the world of pets!



Stationery & Activities

PENTECH

VividVelvet®

COLOR
WORKSHOP™

Flying
Colors®

Our Flying Colors® activity items feature many of today's top characters that kids adore! Dora the Explorer, SpongeBob SquarePants, My Little Pony® and Care Bears are just a few of the children's entertainment properties in our lineup.

2005 was a year of redevelopment for our Flying Colors division. We focused on revising many items to reflect the most successful play patterns for the category, and we made improvements on packaging to make it significant to the actual product where appropriate. This new activities packaging strategy should give consumers more value, as kids can re-use the packaging over and over as a bag or carry-on.

Dora the Explorer continues to be a top-selling licensed property for girls, and our activity items followed suit with strong sales. Our internally developed If You Say Sew!® line of do-it-yourself knitting activities



also did well in 2005 and was chosen as a *Toy Wishes* magazine *All Star*. Coming up in 2006, The Backyardigans™ and Go, Diego, Go!™, two of Nickelodeon's top-rated programs, join the lineup, as well as a relaunch of our Creepy Crawlers® Bug Maker Oven, and more.

The highlights in our writing instrument category are the UltraSharp Pencils and new Liquaphite™ Mechanical Pencils—liquid graphite pencils that are No. 2 equivalent and never need to be sharpened. Both are marketed under our Pentech® brand, as well as under private label by retailers nationwide. They are the latest examples of how JAKKS continually strives to add innovation and technology to traditional products. We have commitments from major retailers such as Office Max, Office Depot and Walgreens, and are working to expand our presence in the stationery aisles at retailers nationwide.



Seasonal



Our seasonal products, under the Go Fly A Kite, Air Creations®, Fun noodle® and The Storm® brands, make warm weather fun. New additions to the Go Fly A Kite product line target kids' imaginations by combining the best-flying kites with the hottest licenses, including Spider-Man and Friends™ and Care Bears. This year's lineup also includes an interactive Parachute Catch Kite® and a 2-in-1 kite combo for fun in the sky AND in the water!

We have strategically leveraged the strength of JAKKS' license portfolio to expand our placement of Go Fly A Kite at key mass market customers. In addition, we have further diversified and expanded our kite customers to include department store chains such as T.J. Maxx and Marshall's, as well as BMG Music, which is now offering kites in their millions of reply mailers every month.



With our Funnoodle water toys, we have added Spider-Man and Miss Spider's Sunny Patch Friends™ to the lineup as well as other new line extensions, including new sea animal-themed SeaFunnoodles™, and our Funnoodle line is available at mass, specialty, drug, grocery, club and pool stores.

We also relaunched The Storm brand of water guns into the specialty market with a very positive reception from our customers. One example is Dick's Sporting Goods, which now carries The Storm line in all 250 of its stores. Additional retailers include Linens 'n Things and Rite Aid. The Storm product line is now in over 200 accounts nationwide.

Our Laser Challenge® product line is also a staple of our seasonal line, with placement year-in and year-out at several of our major customers. JAKKS' outdoor lineup offers something for fun-in-the-sun seekers of all ages.



To Our Shareholders

Ten years ago we formed JAKKS Pacific, Inc. with the goal of building a great company with staying power. With a strong focus on innovation and strategic acquisitions, we have amassed an array of brands and products that appeal to a broad spectrum of consumers. A hard-working team of valued licensing and retail partners, loyal customers and dedicated employees around the world are all integral elements of *The House that JAKKS Pacific™ has Built.*





Not all companies have the talent, imagination and patience to build and expand as markets change. It also takes hard work, commitment and an eye for finding the right opportunity, which is the essence of JAKKS. We have a diverse portfolio of innovative new products incorporating today's top and evergreen licenses, all while still creating line extensions for existing products. Our new lines for stationery, professional office supplies, pet and seasonal products, as well as three distinct product lines in the JAKKS electronics portfolio, have made us into a much more diversified consumer products company than when we started ten years ago. We are growing our retail reach from primarily mass merchant and toy retailers to a broad variety of sales channels. We believe that these efforts are the cornerstone of our growth as we forge ahead to reach our goals of increasing annual sales and delivering higher long-term returns for our shareholders.

Our achievements demonstrate our ongoing success in building a great company. Net sales for the year ended December 31, 2005 increased 15.2% to \$661.5 million. Pro forma net income for 2005 was \$71.2 million, or \$2.30 per diluted share, excluding a charge of approximately \$7.7 million, or \$0.24 per diluted share, for income taxes on the repatriation of foreign subsidiary earnings. Reported net income for 2005 including the tax impact of the earnings repatriation was \$63.5 million, or \$2.06 per diluted share. We expanded our gross margins and reduced SG&A expense as a percentage of sales. We also strengthened our balance sheet, ending the year with approximately \$240 million in cash and equivalents and approximately \$300 million in working capital.

in·no·va·tion: (in'ə va'shən), *noun*, **1:** the introduction of something new; **2:** a new idea, method, or device.

The toy industry is seeing some interesting trends. Parents today are buying their young children hi-tech gadgets, such as MP3 players and computers. JAKKS Pacific has continued its growth because of our ability to develop products with play patterns that bridge multiple age groups, with classic and retro brands, as well as new electronic products.

In 2005, we introduced new kid-friendly Plug It In & Play TV Games, and saw our Doodle Bear® plush, Sky Dancers® dolls and Fly Wheels™ toy vehicles perform very well. The Doodle Bear line was a breakout item for us, and our Sky Dancers line of flying fashion dolls has been extended to a boys' version called Dragon Flyz™. Building upon our legacy of success for retro brand reintroductions, we are also bringing the classic DAM Trolls® back to the market.

pros·per: (pros'pər), *verb*, **1:** to succeed in an enterprise or activity; *especially:* to achieve economic success; **2:** to become strong and flourishing, *transitive verb:* to cause to succeed or thrive.

We have worked very hard to create and nurture our Plug It In & Play TV Games line which we have always viewed as a long-term business. Based on the strength of our classic and kid-driven titles, we have secured many wonderful licensed characters, including those from Sesame Street®, Bob the Builder®, Scooby-Doo®, Power Rangers®, Super Pac-Man®, along with a host of others. In addition, we have positioned ourselves for category expansion in 2006 with the development of two new electronic products: our TeleStory™ interactive reading system for preschoolers, and our exciting VMIGO™ virtual pets game line.

TeleStory was announced in late 2005, and we have obtained top licenses for the product line including: Dora the Explorer®, Winnie the Pooh®, Walt Disney's Cinderella®, Thomas the Tank Engine® and Power Rangers®, to name just a few.

Our video game line, produced by our joint venture with THQ, Inc., offers a magnitude of games across multiple platforms. Two of our most popular wrestling video games have been given "Superstar" treatment and honors. *WWE® Day of Reckoning* and *SmackDown! Vs. RAW 2006* sold 3 million units, and was also added to Nintendo's "Player's Choice" collection for Nintendo GameCube™ and to Sony's "Greatest Hits" collection for the PlayStation2® entertainment system.

Craft, activities and seasonal lines benefited from our continual search for opportunities to improve and grow. Several items in these areas gained promising traction in 2005, including our Dora the Explorer activities, and UltraSharp® and Pentech® writing instruments. Despite fierce competition, we have seen improvement thus far in 2006.

Our international business has strengthened significantly. In 2005, it grew 46% and accounted for 15% of our overall sales. This increase is a direct result of our dedication to continued expansion and distribution to over 60 countries outside North America.

During 2005, we purchased the Pet Pal™ line of pet products, including treats, apparel, toys and beds based on the American Kennel Club (AKC®) and other licensed brands. Since the acquisition, we have signed and secured additional licenses for well-known brands including Cat Fanciers' Association, Meow Mix®, Marvel®, Disney® and Bratz®. Our JPI™ pets division has marketed the pet line, which contributed \$9.3 million to total sales during 2005. We believe that licensed pet products complement our consumer products portfolio. The line will be expanded in 2006 with many new product introductions, such as our White Bites™ oral care treats for dogs, our Rip N Fetch™ toys and even two product lines dedicated to hamsters and hermit crabs.

Recently, JAKKS Pacific acquired Creative Designs International, a leading manufacturer of girls' dress-up and role-play toys with well-known licensed brands including Disney. We plan on expanding the CDI™ product line through JAKKS' extensive reach and distribution base.

pres·tige: (pre stēzh', -stēj'), *noun*, **1:** standing or estimation in the eyes of people: weight or credit in general opinion; **2:** commanding position in people's minds.

JAAKS Pacific is very proud of our industry-wide reputation. In 2005, we were honored to receive four prestigious Vendor of the Year awards from three of the nation's most important toy retailers: Toys R Us, Target and Wal-Mart. These awards were for consistently demonstrating excellence in multiple areas including on-time shipping, creating compelling exclusive retail programs and managing consistent inventory levels.

com·mit·ment: (kəmit'mənt), *noun*, **1:** an agreement or pledge to do something in the future; *especially:* an engagement to assume a financial obligation at a future date.

As we enter 2006, *The House that JAKKS Pacific has Built* has the elements in place to achieve our goals and make a positive impact in the leisure and toy industries. We have a top management team and continue to recruit seasoned executives. We have a diverse portfolio with strong brand identity. Our products are distributed nationwide throughout mass and specialty retailers, drug stores, grocery stores, stationery stores and super stores. We have honed our ability to develop products and identify strategic acquisition opportunities. Finally, we have built a strong balance sheet, giving us flexibility and ample cash flow that will continue to fuel our growth.

We thank our dedicated employees, our valued licensing and retail partners and consumers for their hard work and support in the past year. We also thank our shareholders for their continued confidence. It is a combination of all of you which has built this great company.



Jack Friedman
Chairman and Chief Executive Officer



Stephen G. Berman
President and Chief Operating Officer

Industry Awards & Honors 2005–2006



JAKKS Pacific, Inc. Wal-Mart names JAKKS Pacific Vendor Partner of the Year for 2004 and Wal-Mart Canada Vendor Partner of the Year for 2004

Toys “R” Us names JAKKS Vendor of the Year for 2004

Toys “R” Us names JAKKS Pacific Vendor of the Year for 2005

Toy Wishes magazine acknowledges Fly Wheels, Cabbage Patch Kids Babies and Magic Glow Doodle Bears toy lines as top holiday picks

Play Along Share-a-Story Care Bear makes eToys Hot Holiday Toys List and America Online’s Best Toys for the Holidays

Magic Glow Doodle Bear is a *Toy Wishes All Star* and Toy Industry Association finalist for Best Activity Toy of the Year

TIA nominates Cabbage Patch Kids for Best Girls’ Toy of the Year and Property of the Year

Cabbage Patch Kids Babies and Cabbage Patch Kids Cornsilk Kids receive a Canadian Toy Testing Council 3-star rating, lists as a *Toy Wishes All Star* and America Online’s Best Toys for the Holidays

Sky Dancers receives a Canadian Toy Testing Council 2-star rating

Road Champs Fly Wheels and its Rapid Fire Launcher is a *Toy Wishes All Star*, makes the Toys “R” Us Joy List and America Online’s Best Toys for the Holidays

Fly Wheels chosen as a finalist for Best Boys’ Toy of the Year by the Toy Industry Association

Custom Garage is a *Toy Wishes All Star* and receives Honorable Mention from Family Fun Toy of the Year

Flying Colors If You Say Sew! chosen as a *Toy Wishes All Star*

Dora Talking Poster chosen as Nick Jr. 50 Best Toys for the Holidays

TV Games TIA nominates TV Games for Best Electronic Entertainment Toy of the Year

Dora the Explorer TV Games featured as a top toy in the Great American Toy Test

TV Games makes the KB Toys Hot Holiday Toy List and Funosophy’s 15 Hottest Toys

Wheel of Fortune TV Games chosen as America Online’s Best Toys for the Holidays

Creative Designs

International Wal-Mart names Creative Designs International as Vendor of the Year 2005

Target gives Creative Designs International the Partner Award of Excellence of the Year 2005

Significant Events 2005–2006



2005

- January JAKKS Pacific ships Fly Wheels vehicle line and secures worldwide distribution
- February JAKKS Pacific rings the Closing Bell on NASDAQ
- March JAKKS Pacific signs license with Hasbro to produce art activities based on My Little Pony
- June JAKKS Pacific acquires Pet Pal product line
- JAKKS Pacific signs Miss Spider's Sunny Patch Friends license for stationery, activities and TV Games
- JAKKS Pacific signs Yu-Gi-Oh!™ license for TV Games
- JAKKS Pacific signs The Wiggles®, Barney™, Bob the Builder™ and Thomas & Friends™ for TV Games
- JAKKS Pacific signs Hi-5™ for soft dolls, youth electronics and instruments, art activity kits and TV Games
- July JAKKS Pacific launches UltraSharp Liquid Graphite Pencil
- October JAKKS Pacific announces the launch of TeleStory; announces licenses with Nelvana Limited, RJM, Scholastic Media, Universal Studios Consumer Products Group and Silver Lining Productions, Ltd.
- JAKKS Pacific signs Bratz license for pet products
- JAKKS Pacific signs Just Jimmy license for girls' craft and do-it-yourself activity toys
- JAKKS Pacific signs Shrek®, Shark Tale™, Over the Hedge™ and Madagascar™ for TV Games
- JAKKS Pacific signs Teletubbies™ license for plush and other toy products
- November JAKKS Pacific presents at The Lehman Brothers Second Annual Small Cap Conference
- JAKKS Pacific signs Cat Fanciers' Association and Meow Mix licenses for pets

2006

- March JAKKS Pacific signs licensing deal for It's Happy Bunny for girls' activities

Financial Highlights

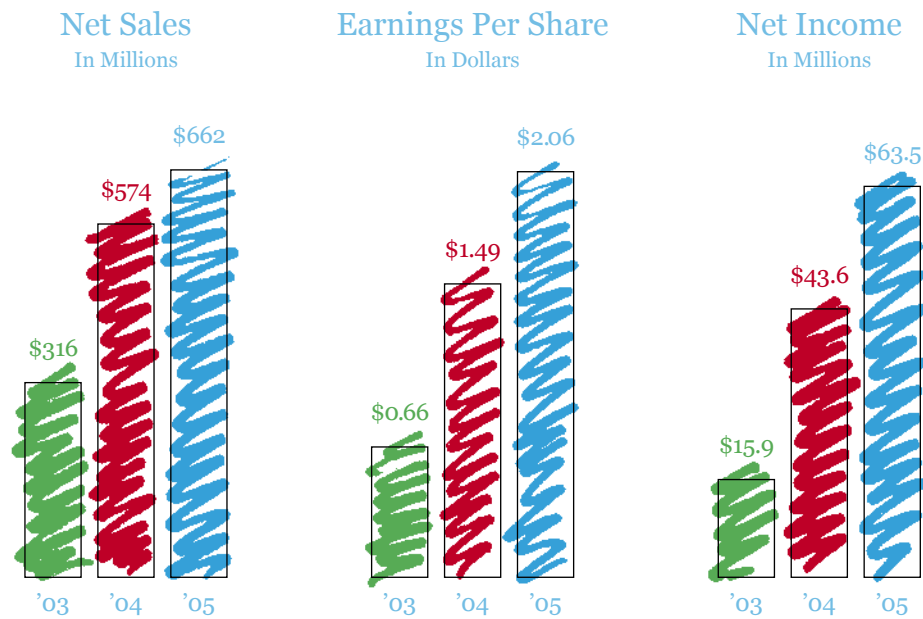


Table of Contents

29	Selected Financial Data
30	Management's Discussion and Analysis of Financial Condition and Results of Operations
39	Consolidated Balance Sheets
40	Consolidated Statements of Income
40	Consolidated Statements of Other Comprehensive Income
41	Consolidated Statements of Stockholders' Equity
42	Consolidated Statements of Cash Flows
43	Notes to Consolidated Financial Statements
59	Schedule II—Valuation and Qualifying Accounts
59	Management's Annual Report on Internal Control Over Financial Reporting
60	Report of Independent Registered Public Accounting Firm
62	Shareholder Information

Selected Financial Data

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

Year Ended December 31, (In thousands, except per share data)	2001	2002	2003	2004	2005
Consolidated Statement of Income Data:					
Net sales	\$284,309	\$310,016	\$315,776	\$574,266	\$661,536
Cost of sales	164,222	180,173	189,334	348,259	394,829
Gross profit	120,087	129,843	126,442	226,007	266,707
Selling, general and administrative expenses	89,575	98,111	113,053	172,282	178,722
Acquisition shut-down and product recall costs	1,214	6,718	2,000	—	—
Income from operations	29,298	25,014	11,389	53,725	87,985
Profit from video game joint venture	6,675	8,004	7,351	7,865	9,414
Other expense	—	—	—	—	(1,401)
Interest, net	2,057	1,141	(1,405)	(2,498)	639
Income before provision for income taxes and minority interest	38,030	34,159	17,335	59,092	96,637
Provision for income taxes	9,797	6,466	1,440	15,533	33,144
Income before minority interest	28,233	27,693	15,895	43,559	63,493
Minority interest	—	(237)	—	—	—
Net income	\$ 28,233	\$ 27,930	\$ 15,895	\$ 43,559	\$ 63,493
Basic earnings per share	\$ 1.55	\$ 1.27	\$ 0.66	\$ 1.69	\$ 2.37
Weighted average shares outstanding	18,199	21,963	24,262	25,797	26,738
Diluted earnings per share	\$ 1.45	\$ 1.23	\$ 0.66	\$ 1.49	\$ 2.06
Weighted average shares and equivalents outstanding	19,410	22,747	27,426	31,406	32,193
At December 31, (In thousands)	2001	2002	2003	2004	2005
Consolidated Balance Sheet Data:					
Cash and cash equivalents	\$ 25,036	\$ 68,413	\$118,182	\$176,544	\$240,238
Working capital	116,492	129,183	232,601	229,543	301,454
Total assets	284,041	408,916	529,997	696,762	753,955
Long-term debt, net of current portion	77	60	98,042	98,000	98,000
Total stockholders’ equity	244,404	357,236	377,900	451,485	524,651

Management's Discussion and Analysis of Financial Condition and Results of Operations

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

Critical Accounting Policies

The accompanying consolidated financial statements and supplementary information were prepared in accordance with accounting principles generally accepted in the United States of America. Significant accounting policies are discussed in Note 2 to the Consolidated Financial Statements. 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:

The allowance for doubtful accounts is based on our assessment of the collectibility of specific customer accounts and the aging of the accounts receivable. If there were a deterioration of a major customer's creditworthiness, or actual defaults were higher than our historical experience, our estimates of the recoverability of amounts due to us could be overstated, which could have an adverse impact on our operating results.

Our revenue recognition policy is significant because our revenue is a key component of our results of operations. In addition, our revenue recognition determines the timing of certain expenses, such as commissions and royalties. We follow very specific and detailed guidelines in measuring revenues; however, certain judgments affect the application of our revenue policy. Revenue results are difficult to predict, and any shortfall in revenue or delay in recognizing revenue could cause our operating results to vary significantly from quarter to quarter.

We assess the impairment of long-lived assets and goodwill at least annually or whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

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

When we determine that the carrying value of long-lived assets and goodwill may not be recoverable based upon the existence of one or more of the above indicators of impairment, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. Net long-lived assets, including goodwill, amounted to \$317.4 million as of December 31, 2005.

Recent Developments

On February 9, 2006, we acquired substantially all of the assets of Creative Designs International, Ltd. and a related Hong Kong company, Arbor Toys Company Limited (collectively "Creative Designs"). The total initial purchase price of \$107.7 million consisted of \$104.5 million in cash, 150,000 shares of our common stock at a value of approximately \$3.2 million and the assumption of liabilities in the amount of \$3.5 million. In addition, we agreed to pay an earn-out of up to an aggregate amount of \$20.0 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. Creative Designs is a leading designer and producer of dress-up and role-play toys and will be included in our results of operations beginning in the first quarter of 2006.

Results of Operations

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

Years Ended December 31,	2001	2002	2003	2004	2005
Net sales	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of sales	57.8	58.1	60.0	60.6	59.7
Gross profit	42.2	41.9	40.0	39.4	40.3
Selling, general and administrative expenses	31.5	31.6	35.8	30.0	27.0
Acquisition shut-down and product recall costs	0.4	2.2	0.6	—	—
Income from operations	10.3	8.1	3.6	9.4	13.3
Profit from video game joint venture	2.3	2.6	2.3	1.4	1.4
Other expense	—	—	—	—	(0.2)
Interest, net	0.7	0.4	(0.4)	(0.4)	0.1
Income before income taxes	13.3	11.1	5.5	10.4	14.6
Provision for income taxes	3.4	2.1	0.5	2.7	5.0
Net income	9.9%	9.0%	5.0%	7.7%	9.6%

Comparisons of the Years Ended December 31, 2005 and 2004

Net Sales. Net sales were \$661.5 million in 2005 compared to \$574.3 million in 2004, representing an increase of \$87.2 million, or 15.2%. The increase in net sales was primarily due to an increase in sales of our Traditional Toy products of \$71.9 million, which includes the addition of \$54.8 million in sales from product lines acquired in our Play Along acquisition, and increases in WWE action figures and accessories, wheels products, *Cabbage Patch Kids*, *Doodle Bear*® and *Sky Dancers*®, offset in part by decreases in *TV Games*, dolls, other action figures and *Care Bears* and *Teletubbies* products; and an increase in International sales of \$30.7 million, including increases in sales of *TV Games*, action figures and wheels products. The net increase in net sales was partially offset by decreases in sales of our Crafts and Activities and Writing instruments of \$19.1 million and our Seasonal products of \$5.5 million. Our *Funnoodle* line was adversely impacted by competition at retail in 2005. We have secured alternate sources of manufacturing for the *Funnoodle* products resulting in lower costs which we expect will enable us to expand distribution of this product line in 2006. Additionally, net sales in 2005 included approximately \$9.8 million of Pet Pal products.

With the addition of Creative Designs International, Ltd. in 2006, and our other ongoing initiatives in product development and marketing, we believe that the increased level of net sales of Traditional Toys should continue throughout 2006. (See “Forward-Looking Information.”)

Gross Profit. Gross profit increased \$40.7 million, or 18.0%, to \$266.7 million, or 40.3% of net sales, in 2005 from \$226.0 million, or 39.4% of net sales, in 2004. The overall increase in gross profit was attributable to the increase in net sales. The increase in gross profit margin of 0.9% of net sales was primarily due to lower product costs and tool and mold amortization, offset in part by an increase in royalty expense as a percentage of net sales due to changes in the product mix to more products with higher royalty rates from products with lower royalty rates or proprietary products with no royalties and the write-off of advances and guarantees related to expired or discontinued licenses in 2005.

Selling, General and Administrative Expenses. Selling, general and administrative expenses were \$178.7 million in 2005 and \$172.3 million in 2004, constituting 27.0% and 30.0% of net sales, respectively. The overall increase of \$6.4 million in such costs was primarily due to increases in direct selling expenses (\$17.3 million), product development costs (\$4.0 million) and general and administrative expenses (\$1.0 million), partially offset by a decrease in amortization expense related to intangible assets other than goodwill and trademarks (\$5.0 million) and stock-based compensation expense (\$10.2 million). Comparable grants of restricted stock awards and the increase in the price of our common stock in 2004 compared to a decrease in the price of our common stock in 2005 resulted in a stock-based compensation expense of \$3.4 million in 2005 compared to an expense of \$13.6 million in 2004. The increase in general and administrative expenses is primarily due to additional overhead related to the operations of Play Along and increases in bonus

Management's Discussion and Analysis of Financial Condition and Results of Operations (cont.)

expense (\$3.6 million) and donation expense (\$5.6 million), offset in part by decreases in legal costs (\$5.0 million), bad debt expense (\$2.0 million) and rent expense (\$1.3 million). The increase in direct selling expenses is primarily due to an increase in advertising and promotional expenses of \$12.1 million in 2005 in support of the sell-through of our various products at retail. We produce and air television commercials in support of several of our product lines. From time to time, we may increase or decrease our advertising efforts, if we deem it appropriate for particular products.

Profit from Video Game Joint Venture. Profit from our video game joint venture in 2005 was \$9.4 million, as compared to \$7.9 million in 2004, due to the release of four new games and stronger sales of existing titles in 2005, offset by the payment of \$0.8 million to THQ for their share of profit on our sales of WWE themed TV Games compared to 2004, in which period three new games were released and no payments were made by us to THQ. The amount of the preferred return we will receive after June 30, 2006 is subject to change.

Other Expense. Other expense in 2005 of \$1.4 million relates to the write-off of an investment in a Chinese joint venture. There were no such expenses in 2004.

Interest, Net. Interest income increased due to higher average cash balances and higher interest rates during 2005 compared to 2004. Interest expense of \$4.5 million for the convertible senior notes payable was comparable to 2004.

Provision for Income Taxes. Provision for income taxes included Federal, state and foreign income taxes at effective tax rates of 26.3% in 2004 and 34.3% in 2005, benefiting from a flat 17.5% Hong Kong Corporation Tax on our income arising in, or derived from, Hong Kong for each of 2004 and 2005. The increase in the effective tax rate in 2005 is due to a greater proportion of taxable income generated in the United States. As of December 31, 2005, we had net deferred tax assets of approximately \$7.2 million for which no allowance has been provided since, in the opinion of management, realization of the future benefit is probable. In October 2004, the American Jobs Creation Act of 2004 (the "Act") was signed into law. The Act created a one-time incentive for U.S. corporations to repatriate undistributed earnings from their international subsidiaries by providing an 85% dividends-received deduction for certain international earnings. The deduction was available to corporations during the tax year that includes October 2004, or in the immediately subsequent tax year. In the fourth quarter of 2005, our Board of Directors approved a plan to repatriate \$175.0 million in foreign earnings, which was completed in December 2005. The Federal and state income tax expense related to this repatriation was approximately \$8.0 million.

Comparisons of the Years Ended December 31, 2004 and 2003

Net Sales. Net sales were \$574.3 million in 2004 compared to \$315.8 million in 2003, representing an increase of 81.9%. This increase in net sales was primarily due to the addition of \$151.6 million in sales of Traditional Toys from our recent Play Along acquisition, as well as the addition of (i) \$147.5 million in sales of some of our other Traditional Toy products, including primarily *TV Games* (with 15 titles in release in 2004, as compared to 3 titles in release in 2003) and WWE action figures and accessories; and (ii) \$23.7 million in International sales (including \$13.9 million by Play Along). The increase in net sales was offset in part by decreases in sales of our Crafts and Activities and Writing instruments of \$48.2 million and our Seasonal products, including water guns and junior sports toys, of \$16.1 million.

Gross Profit. Gross profit increased \$99.6 million, or 78.8%, to \$226.0 million, or 39.4% of net sales, in 2004 from \$126.4 million, or 40.0% of net sales, in 2003. The overall increase in gross profit was attributable to the significant increase in net sales. The decrease in gross profit margin of 0.6% of net sales was primarily due to an increase in royalty expense as a percentage of net sales due to changes in the product mix to more products with higher royalty rates from products with lower royalty rates or proprietary products with no royalties.

Selling, General and Administrative Expenses. Selling, general and administrative expenses were \$172.3 million in 2004 and \$113.1 million in 2003, constituting 30.0% and 35.8% of net sales, respectively. The overall increase of

\$59.2 million in such costs was primarily due to the impact of stock-based compensation (\$5.2 million), an increase in legal fees and settlements (\$6.8 million) and bonus expense (\$4.5 million), an increase in amortization expense related to intangible assets other than goodwill acquired in the Play Along acquisition and the addition of overhead related to the operations of Play Along (\$27.2 million). Due to the increases in our grants of restricted stock awards and the price of our common stock in 2004, compared to a moderate increase in the price of our common stock in 2003, we had stock-based compensation charges of \$13.6 million compared to \$8.4 million in 2003. The increase in direct selling expenses (\$19.3 million) is primarily due to an increase in advertising and promotional expenses in 2004 in support of the sell-through of our various products at retail. We produced and aired television commercials in support of several of our products, including *World Wrestling Entertainment*, *Dragon Ball* and *Mucha Lucha*® action figures, *TV Games*, *Care Bears*, *Cabbage Patch Kids* and *Flying Colors* products in 2004, and *World Wrestling Entertainment* and *Dragon Ball* action figures and *Flying Colors* products in 2003. From time to time, we may increase our advertising efforts, if we deem it appropriate for particular products.

Product Recall Costs. There were no product recall costs in 2004. In the second quarter of 2003, we accrued a \$2.7 million charge for the recall of one of our products, and in the third quarter of 2003, we recorded a credit of \$0.7 million for the recovery of recall costs from one of our third-party factories.

The remaining component of the product recall costs is as follows (in thousands):

	Accrued Balance December 31, 2003	Accrual	Actual	Accrued Balance December 31, 2004
Product recall costs	\$490	\$ —	\$(490)	\$ —

Profit from Video Game Joint Venture. Profit from joint venture increased by \$0.5 million in 2004 due to the joint venture having lower unit sales at lower wholesale prices of its two vehicle combat games of the five games released in 2003 compared to releasing all new titles with higher unit sales at higher wholesale prices in addition to having higher sales of carryover titles in 2004. New releases typically generate higher unit sales resulting in higher overall sales as compared to carryover titles. Profit from the joint venture contributed significantly to our pre-tax profit, representing 22.2% of pre-tax income in 2003 and 12.7% in 2004. We expect to continue to receive a preferred return over the remaining term of the license agreement ending December 31, 2009, although we cannot predict with certainty what levels of return will be achieved and, in any case, we anticipate substantial fluctuations in the amount of the preferred return distributed to us from year to year.

Interest, Net. Interest income increased due to higher average cash balances during 2004 than in 2003, but was offset by interest expense of \$4.5 million related to the convertible notes issued in June 2003.

Provision for Income Taxes. Provision for income taxes included Federal, state and foreign income taxes in 2003 and 2004, at an effective tax rate of 8.3% and 26.3%, respectively, benefiting from a flat 17.5% Hong Kong Corporation Tax on our income arising in, or derived from, Hong Kong for 2003 and 2004. For 2004, the effective rate increased as a result of the recognition of U.S. taxes on a greater proportion of foreign earnings deemed to be subject to U.S. taxes. As of December 31, 2004, we had net deferred tax assets of approximately \$1.9 million. In making this determination, management believes it considered all available evidence, both positive and negative, as well as the weight and importance given to such evidence.

Quarterly Fluctuations and Seasonality

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

Management's Discussion and Analysis of Financial Condition and Results of Operations (cont.)

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

	2003			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
(In thousands, except per share data)				
Net sales	\$ 67,759	\$ 73,290	\$ 90,308	\$ 84,419
As a % of full year	21.5%	23.2%	28.6%	26.7%
Gross profit	\$ 27,442	\$ 27,906	\$ 36,226	\$ 34,868
As a % of full year	21.7%	22.1%	28.7%	27.6%
As a % of net sales	40.5%	38.1%	40.1%	41.3%
Income (loss) from operations	\$ 5,960	\$ 2,522	\$ 10,480	\$ (7,573)
As a % of full year	52.3%	22.1%	92.0%	(66.5)%
As a % of net sales	8.8%	3.4%	11.6%	(9.0)%
Income before income taxes and minority interest	\$ 6,299	\$ 2,679	\$ 10,495	\$ (2,138)
As a % of net sales	9.3%	3.7%	11.6%	(2.5)%
Net income	\$ 4,988	\$ 2,236	\$ 8,248	\$ 422
As a % of net sales	7.4%	3.1%	9.1%	0.5%
Diluted earnings per share	\$ 0.20	\$ 0.09	\$ 0.31	\$ 0.02
Weighted average shares and equivalents outstanding	24,917	24,982	29,529	29,542

	2004			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
(In thousands, except per share data)				
Net sales	\$ 73,986	\$109,395	\$206,083	\$184,802
As a % of full year	12.9%	19.0%	35.9%	32.2%
Gross profit	\$ 30,466	\$ 41,281	\$ 81,801	\$ 72,459
As a % of full year	13.5%	18.3%	36.2%	32.1%
As a % of net sales	41.2%	37.7%	39.7%	39.2%
Income (loss) from operations	\$ 4,885	\$ 8,321	\$ 29,915	\$ 10,604
As a % of full year	9.1%	15.5%	55.7%	19.7%
As a % of net sales	6.6%	7.6%	14.5%	5.7%
Income before income taxes and minority interest	\$ 4,764	\$ 7,637	\$ 30,042	\$ 16,649
As a % of net sales	6.4%	7.0%	14.6%	9.0%
Net income	\$ 3,791	\$ 6,004	\$ 23,255	\$ 10,508
As a % of net sales	5.1%	5.5%	11.3%	5.7%
Diluted earnings per share	\$ 0.15	\$ 0.22	\$ 0.76	\$ 0.36
Weighted average shares and equivalents outstanding	30,676	31,123	31,919	31,855

	2005			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
(In thousands, except per share data)				
Net sales	\$134,676	\$127,091	\$233,500	\$166,269
As a % of full year	20.4%	19.2%	35.3%	25.1%
Gross profit	\$ 54,212	\$ 48,073	\$ 93,452	\$ 70,970
As a % of full year	20.3%	18.0%	35.0%	26.6%
As a % of net sales	40.3%	37.8%	40.0%	42.7%
Income (loss) from operations	\$ 13,675	\$ 14,614	\$ 47,218	\$ 12,478
As a % of full year	15.5%	16.6%	53.7%	14.2%
As a % of net sales	10.2%	11.5%	20.2%	7.5%
Income before income taxes and minority interest	\$ 13,627	\$ 15,732	\$ 46,306	\$ 20,972
As a % of net sales	10.1%	12.4%	19.8%	12.6%
Net income	\$ 10,084	\$ 11,642	\$ 32,753	\$ 9,014
As a % of net sales	7.5%	9.2%	14.0%	5.4%
Diluted earnings per share	\$ 0.34	\$ 0.39	\$ 1.05	\$ 0.29
Weighted average shares and equivalents outstanding	32,256	32,229	32,088	32,197

Due to the restatement in 2003 relating to the accounting of the Toymax, Trendmasters and P&M acquisitions and to rounding, some of the figures above may differ from our previously filed Quarterly Reports on Form 10-Q.

During the second quarter of 2003, we recorded a charge which impacted operating income by approximately \$2.7 million relating to the recall of one of our products.

During the third quarter of 2003, we recovered \$0.7 million of the recall costs, recorded in the second quarter of 2003, from one of our factories.

During the fourth quarter of 2003, we recorded a non-cash charge of \$8.4 million which impacted operating income relating to the grant of restricted stock and a charge of \$2.1 million to provision for bad debt impacting operating income relating to the bankruptcy filing of several of our customers, including Kay Bee Toys.

During the fourth quarter of 2004, we recorded non-cash charges, which impacted operating income, of \$5.6 million relating to the grant of restricted stock and \$8.6 million relating to the amortization of short-lived intangible assets acquired in connection with the Play Along acquisition.

During the second quarter of 2005, we wrote off our \$1.4 million investment in a Chinese joint venture to Other Expense on our determination that none of the value would be realized.

During the fourth quarter of 2005, we recorded a non-cash charge, which impacted net income, of \$3.6 million for restricted stock, and we repatriated \$175.0 million from our Hong Kong subsidiaries which resulted in incremental income tax expense of \$8.0 million and reduced net income.

Recent Accounting Standards

We use the intrinsic-value method of accounting for stock options granted to employees. As required by our existing stock plans, stock options are granted at, or above, the fair value of our stock, and, accordingly, no compensation expense is recognized for these grants in the consolidated statement of operations. We record compensation expense related to other stock-based awards, such as restricted stock grants, over the period the award vests. Issued in December 2004, SFAS 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)"), amends SFAS 123, "Accounting for Stock-Based Compensation" and SFAS 95, "Statement of Cash Flows." SFAS 123(R) requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its consolidated financial statements, and requires additional accounting and disclosure related to the income tax and cash flow effects resulting from share-based payment arrangements. SFAS 123(R) is effective for us beginning as of January 1, 2006. The adoption of SFAS 123(R)'s fair value method will have an impact on our results of operations, although it will have no impact on our overall financial position. While we cannot estimate the level of share-based payments to be issued in the future, based on the stock options that are currently outstanding, we expect that the adoption of SFAS 123(R) will result in a charge to operations in 2006 of approximately \$2.7 million.

Liquidity and Capital Resources

As of December 31, 2005, we had working capital of \$301.5 million, as compared to \$229.5 million as of December 31, 2004. This increase was primarily attributable to our operating results.

Operating activities provided net cash of \$71.1 million in the year ended December 31, 2005, as compared to \$131.4 million in 2004. Net cash was provided primarily by net income of \$63.5 million, non-cash charges and changes in working capital. Our cash position was improved by accounts receivable turnover as measured by days sales outstanding in accounts receivable decreasing from approximately 50 days as of December 31, 2004 to approximately 47 days as

Management's Discussion and Analysis of Financial Condition and Results of Operations (cont.)

of December 31, 2005 primarily due to a shift in sales from domestic sales origin to FOB China, which carry shorter payment terms, a shift in domestic sales to customers with shorter payment terms and overall improved collection efforts and results. Other than open purchase orders, issued in the normal course of business, we have no obligations to purchase finished goods from our manufacturers. As of December 31, 2005, we had cash and cash equivalents of \$240.2 million.

Our investing activities used cash of \$9.5 million in the year ended December 31, 2005, as compared to \$73.3 million in 2004, consisting primarily of the purchase of office furniture and equipment and molds and tooling used in the manufacture of our products, and the goodwill and other intangible assets acquired in the acquisition of Pet Pal, plus the \$10.0 million in goodwill relating to the earn-out of Play Along, partially offset by the sale of marketable securities of \$19.0 million. In 2004, our investing activities consisted primarily of the purchase of molds and tooling used in the manufacture of our products, the purchase of other assets, the goodwill and other intangible assets acquired in the acquisition of Play Along, partially offset by the sale of marketable securities. 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 12% payable on net sales of such products. As of December 31, 2005, these agreements required future aggregate minimum guarantees of \$28.9 million, exclusive of \$14.9 million in advances already paid.

Our financing activities provided net cash of \$3.2 million in the year ended December 31, 2005, as compared to \$1.6 million in 2004. In 2005, cash was primarily provided from the exercise of stock options. In 2004, cash was primarily provided from the exercise of stock options, partially offset by the repayment of debt.

The following is a summary of our significant contractual cash obligations for the periods indicated that existed as of December 31, 2005 and is based on information appearing in the notes to the consolidated financial statements (in thousands):

	2006	2007	2008	2009	2010	Thereafter	Total
Long-term debt	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 98,000	\$ 98,000
Operating leases	6,912	6,463	4,184	3,810	3,401	8,809	33,579
Minimum guaranteed license/royalty payments	13,003	8,421	5,492	1,434	500	—	28,850
Employment contracts	5,591	5,419	3,166	2,244	2,280	—	18,700
Total contractual cash obligations	\$25,506	\$20,303	\$12,842	\$7,488	\$6,181	\$106,809	\$179,129

In February 2003, our Board of Directors approved a buyback of up to \$20.0 million of our common stock. During 2003, we repurchased and retired 554,500 shares of our common stock for a total of approximately \$6.1 million. Although there were no common stock repurchases during 2004 and 2005, we evaluate buyback opportunities on an ongoing basis and will buy back the approximately \$13.9 million of common stock still available under our buyback program if and when we deem such a repurchase to be in our best interests.

In October 2004, the American Jobs Creation Act of 2004 (the "Act") was signed into law. The Act created a one-time incentive for U.S. corporations to repatriate undistributed earnings from their international subsidiaries by providing an 85% dividends-received deduction for certain international earnings. The deduction was available to corporations during the tax year that includes October 2004, or in the immediately subsequent tax year. In the fourth quarter of 2005, our Board of Directors approved a plan to repatriate \$175.0 million in foreign earnings, which was completed in December 2005. The Federal and state income tax expense related to this repatriation was approximately \$8.0 million.

In June 2004, we purchased substantially all of the assets and assumed certain liabilities of Play Along, Inc., Play Along (Hong Kong) Limited and PA Distribution, Inc. (collectively "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 our common stock valued at \$14.9 million. In addition, we 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 years ended December 31, 2004 and 2005, \$10.0 million and \$6.7 million of the earn-out was earned and recorded as goodwill, respectively. 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. Our results of operations have included Play Along from the date of acquisition.

In October 2004, we were named as a defendant in a lawsuit commenced by WWE (the “WWE Action”). The complaint also named as defendants, among others, the joint venture with THQ Inc., certain of our foreign subsidiaries and our three executive officers. 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. Three shareholder derivative actions have also been filed against us, nominally, and against certain of our Board members (the “Derivative Actions”). The Derivative Actions seek to hold the individual defendants liable for damages allegedly caused to our Company by their actions, and, in one of the Derivative Actions, seeks restitution to our Company of profits, benefits and other compensation obtained by them. (See “Legal Proceedings.”)

On June 13, 2005, we purchased substantially all of the operating assets and assumed certain liabilities relating to the Pet Pal line of pet products, including toys, treats and related pet products. The total initial purchase price of \$10.6 million was paid in cash. In addition, we agreed to pay an earn-out of up to an aggregate amount of \$25.0 million in cash over the three fiscal years following the acquisition 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 liabilities assumed. This acquisition expands our product offerings and distribution channels. Our results of operations have included Pet Pal from the date of acquisition.

On February 9, 2006, we acquired substantially all of the assets of Creative Designs International, Ltd. and a related Hong Kong company, Arbor Toys Company Limited (collectively “Creative Designs”). The total initial purchase price of \$107.7 million consisted of \$104.5 million in cash, 150,000 shares of our common stock at a value of approximately \$3.2 million and the assumption of liabilities in the amount of \$3.5 million. In addition, we agreed to pay an earn-out of up to an aggregate amount of \$20.0 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. Creative Designs is a leading designer and producer of dress-up and role-play toys and will be included in our results of operations beginning in the first quarter of 2006.

In June 2003, we sold an aggregate of \$98.0 million of 4.625% Convertible Senior Notes due June 15, 2023. The notes may be converted into shares of our common stock at an initial conversion price of \$20.00 per share, subject to certain circumstances. Cash interest is payable at an annual rate of 4.625% of the principal amount at issuance, from the issue date to June 15, 2010, payable on June 15 and December 15 of each year, commencing on December 15, 2003. After June 15, 2010, interest will accrue on the outstanding notes until maturity. At maturity, we will redeem the notes at their accreted principal amount, which will be equal to \$1,811.95 (181.195%) per \$1,000 principal amount at issuance, unless redeemed or converted earlier.

We may redeem the notes at our option in whole or in part beginning on June 15, 2010, at 100% of their accreted principal amount plus accrued and unpaid interest, if any, payable in cash. Holders of the notes may also require us to repurchase all or part of their notes on June 15, 2010, for cash, at a repurchase price of 100% of the principal amount per note plus accrued and unpaid interest, if any. Holders of the notes may also require us to repurchase all or part of their notes on June 15, 2013 and June 15, 2018 at a repurchase price of 100% of the accreted principal amount per note plus accrued and unpaid interest, if any. Any repurchases at June 15, 2013 and June 15, 2018 may be paid in cash, in shares of common stock or a combination of cash and shares of common stock.

Management's Discussion and Analysis of Financial Condition and Results of Operations (cont.)

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

Exchange Rates

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

Consolidated Balance Sheets

December 31, (In thousands, except share data)	2004	2005
Assets		
Current assets		
Cash and cash equivalents	\$176,544	\$240,238
Marketable securities	19,047	—
Accounts receivable, net of allowance for uncollectible accounts of \$7,058 and \$2,336, respectively	102,266	87,199
Inventory	50,000	66,729
Deferred income taxes	6,161	13,618
Prepaid expenses and other	18,521	17,533
Total current assets	372,539	425,317
Property and equipment		
Office furniture and equipment	6,823	7,619
Molds and tooling	28,818	26,948
Leasehold improvements	2,572	3,522
Total	38,213	38,089
Less accumulated depreciation and amortization	27,273	25,394
Property and equipment, net	10,940	12,695
Intangibles and other, net	27,368	18,512
Investment in video game joint venture	9,816	10,365
Goodwill, net	258,331	269,298
Trademarks, net	17,768	17,768
Total assets	\$696,762	\$753,955
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	\$ 59,569	\$ 50,533
Accrued expenses	49,407	44,415
Reserve for sales returns and allowances	23,173	25,123
Income taxes payable	10,847	3,792
Total current liabilities	142,996	123,863
Convertible senior notes	98,000	98,000
Deferred rent liability	—	995
Deferred income taxes	4,281	6,446
Total liabilities	245,277	229,304
Commitments and contingencies		
Stockholders' equity		
Preferred shares, \$.001 par value; 5,000,000 shares authorized; nil outstanding	—	—
Common stock, \$.001 par value; 100,000,000 shares authorized; 26,234,016 and 26,944,559 shares issued and outstanding, respectively	26	27
Additional paid-in capital	276,642	287,356
Retained earnings	176,564	240,057
Accumulated other comprehensive loss	(1,747)	(2,789)
Total stockholders' equity	451,485	524,651
Total liabilities and stockholders' equity	\$696,762	\$753,955

See notes to consolidated financial statements.

Consolidated Statements of Income

Years Ended December 31, (In thousands, except per share amounts)	2003	2004	2005
Net sales	\$315,776	\$574,266	\$661,536
Cost of sales	189,334	348,259	394,829
Gross profit	126,442	226,007	266,707
Selling, general and administrative expenses	113,053	172,282	178,722
Product recall costs	2,000	—	—
Income from operations	11,389	53,725	87,985
Profit from video game joint venture	7,351	7,865	9,414
Other expense	—	—	(1,401)
Interest, net	(1,405)	(2,498)	639
Income before provision for income taxes	17,335	59,092	96,637
Provision for income taxes	1,440	15,533	33,144
Net income	\$ 15,895	\$ 43,559	\$ 63,493
Basic earnings per share	\$ 0.66	\$ 1.69	\$ 2.37
Basic weighted number of shares	24,262	25,797	26,738
Diluted earnings per share	\$ 0.66	\$ 1.49	\$ 2.06
Diluted weighted number of shares	27,426	31,406	32,193

See notes to consolidated financial statements.

Consolidated Statements of Other Comprehensive Income

Years Ended December 31, (In thousands)	2003	2004	2005
Other comprehensive income:			
Net income	\$ 15,895	\$ 43,559	\$ 63,493
Foreign currency translation adjustment	(349)	(1,398)	(1,042)
Other comprehensive income	\$ 15,546	\$ 42,161	\$ 62,451

See notes to consolidated financial statements.

Consolidated Statements of Stockholders' Equity

Years Ended December 31, 2003, 2004 and 2005 (In thousands)	Common Stock		Additional Paid-in Capital	Retained Earnings	Deferred Compensation from Restricted Stock Grants	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
	Number of Shares	Amount					
Balance, December 31, 2002	24,473	\$24	\$240,102	\$117,110	\$ —	\$ —	\$357,236
Exercise of options	312	—	1,777	—	—	—	1,777
Restricted stock grants	696	1	9,152	—	(789)	—	8,364
Issuance of warrants	—	—	1,057	—	—	—	1,057
Compensation for fully vested stock options	—	—	6	—	—	—	6
Repurchase and retirement of common stock	(554)	—	(6,086)	—	—	—	(6,086)
Net income	—	—	—	15,895	—	—	15,895
Foreign currency translation adjustment	—	—	—	—	—	(349)	(349)
Balance, December 31, 2003	24,927	25	246,008	133,005	(789)	(349)	377,900
Exercise of options	192	—	1,699	—	—	—	1,699
Stock option income tax benefit	—	—	739	—	—	—	739
Restricted stock grants	340	—	7,487	—	789	—	8,276
Compensation for fully vested stock options	—	—	5,365	—	—	—	5,365
Issuance of common stock for Play Along	749	1	14,850	—	—	—	14,851
Issuance of common stock for Kidz Biz earn-out	26	—	494	—	—	—	494
Net income	—	—	—	43,559	—	—	43,559
Foreign currency translation adjustment	—	—	—	—	—	(1,398)	(1,398)
Balance, December 31, 2004	26,234	26	276,642	176,564	—	(1,747)	451,485
Exercise of options	567	1	4,872	—	—	—	4,873
Stock option income tax benefit	—	—	4,119	—	—	—	4,119
Restricted stock grants	245	—	5,130	—	—	—	5,130
Compensation for fully vested stock options	—	—	(1,706)	—	—	—	(1,706)
Retirement of common stock	(101)	—	(1,701)	—	—	—	(1,701)
Net income	—	—	—	63,493	—	—	63,493
Foreign currency translation adjustment	—	—	—	—	—	(1,042)	(1,042)
Balance, December 31, 2005	26,945	\$27	\$287,356	\$240,057	\$ —	\$(2,789)	\$524,651

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

Years Ended December 31, (In thousands)	2003	2004	2005
Cash flows from operating activities			
Net income	\$ 15,895	\$ 43,559	\$ 63,493
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	16,029	21,518	15,527
Compensation for fully vested stock options	6	5,365	(1,706)
Acquisition earn-out	—	494	—
Investment in video game joint venture	79	(719)	(548)
Loss on disposal of property and equipment	—	1,096	104
Restricted stock compensation	8,364	8,276	5,130
Write-off of investment in Chinese joint venture	—	—	1,401
Changes in operating assets and liabilities			
Accounts receivable	(28,224)	(4,333)	16,697
Inventory	(2,654)	784	(13,272)
Prepaid expenses and other	(5,643)	(3,613)	1,088
Accounts payable	16,264	19,192	(9,437)
Accrued expenses	(3,259)	19,742	(1,915)
Income taxes payable	(1,397)	5,945	(2,936)
Reserve for sales returns and allowances	(5,827)	13,289	1,732
Deferred rent liability	—	—	995
Deferred income taxes	(2,240)	795	(5,292)
Total adjustments	(8,502)	87,831	7,568
Net cash provided by operating activities	7,393	131,390	71,061
Cash flows from investing activities			
Purchases of property and equipment	(4,472)	(5,917)	(8,270)
Purchases of other assets	(4,936)	(26,863)	118
Cash paid for net assets	(19,676)	(41,438)	(20,362)
Net (purchases) sales of marketable securities	(19,345)	967	19,047
Notes receivable—officers	1,113	—	—
Net cash used by investing activities	(47,316)	(73,251)	(9,467)
Cash flows from financing activities			
Repurchase of common stock	(6,086)	—	—
Proceeds from stock options exercised (net of cashless exercise of \$1.7 million in 2005)	1,777	1,682	3,173
Net proceeds from sale of convertible senior notes	94,366	—	—
Repayments of debt	(16)	(61)	—
Net cash provided by financing activities	90,041	1,621	3,173
Foreign currency translation adjustment	(349)	(1,398)	(1,073)
Net increase in cash and cash equivalents	49,769	58,362	63,694
Cash and cash equivalents, beginning of year	68,413	118,182	176,544
Cash and cash equivalents, end of year	\$118,182	\$176,544	\$240,238
Cash paid during the period for:			
Interest	\$ 2,375	\$ 4,534	\$ 4,533
Income taxes	\$ 9,694	\$ 2,688	\$ 41,284

See Note 18 for additional supplemental information to consolidated statements of cash flows.

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

December 31, 2005

Note 1—Principal Industry

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

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

Note 2—Summary of Significant Accounting Policies

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

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

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

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

Generally, the Company does not allow for product returns. The Company provides a negotiated allowance for breakage or defects to its customers, which is recorded when the related revenue is recognized. However, the Company does make occasional exceptions to this policy and consequently accrues a return allowance in gross sales based on historic return amounts and management estimates.

The Company also will occasionally grant credits to facilitate markdowns and sales of slow-moving merchandise. These credits are recorded as a reduction of gross sales at the time of occurrence. The Company’s reserve for sales returns and allowances increased by \$1.9 million from \$23.2 million as of December 31, 2004 to \$25.1 million as of December 31, 2005. This increase is due primarily to the increase in sales in 2005 and an increase in sales of electronic products which have higher defective rates, offset in part by the timing of customer deductions.

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

December 31,	2004	2005
Raw materials	\$ 1,557	\$ 2,679
Finished goods	48,443	64,050
	\$50,000	\$66,729

Marketable Securities. Marketable securities are categorized as available for sale and related unrealized holding gains or losses are included as a component of stockholders’ equity. At December 31, 2005, the Company had no marketable securities. At December 31, 2004, cost approximated fair market value.

Notes to Consolidated Financial Statements (cont.)

December 31, 2005

Fair Value of Financial Instruments. The Company's cash and cash equivalents, marketable securities and accounts receivable represent financial instruments. The carrying value of these financial instruments is a reasonable approximation of fair value. The fair value of the \$98.0 million of convertible senior notes payable at December 31, 2005 was approximately \$119.5 million based on the quoted market price.

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

Office equipment	5 years
Automobiles	5 years
Furniture and fixtures	5-7 years
Molds and tooling	2-4 years
Leasehold improvements	Shorter of length of lease or 10 years

Shipping and Handling Costs. The consolidated financial statements reflect the adoption of the classification or disclosure requirements pursuant to Emerging Issues Task Force ("EITF") 00-10, "Accounting for Shipping and Handling Fees and Costs," which was effective in the fourth quarter of fiscal 2000. Consistent with EITF 00-10, the Company has historically classified income from freight charges to customers in "Net sales." The Company classifies shipping and handling costs in "Selling, general and administrative expenses." Such costs amounted to approximately \$5.2 million in 2003, \$3.6 million in 2004 and \$3.1 million in 2005.

Advertising. Production costs of commercials and programming are charged to operations in the year during which the production is first aired. The costs of other advertising, promotion and marketing programs are charged to operations in the year incurred. Advertising expense for the years ended December 31, 2003, 2004 and 2005, was approximately \$12.4 million, \$26.4 million and \$38.8 million, respectively.

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

Income Taxes. The Company does not file a consolidated return with its foreign subsidiaries. The Company files Federal and state returns and its foreign subsidiaries each file Hong Kong returns and United Kingdom returns, as applicable. Deferred taxes are provided on a liability method whereby deferred tax assets are recognized as deductible temporary differences and operating loss and tax credit carryforwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

Translation of Foreign Currencies. Monetary assets and liabilities denominated in Hong Kong dollars or British pounds sterling are translated into United States dollars at the rate of exchange ruling at the balance sheet date. Transactions during the period are translated at the rates ruling at the dates of the transactions.

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

Accounting for the Impairment of Long-Lived Assets. Long-lived assets, which include property and equipment, goodwill and intangible assets other than goodwill, are evaluated at least annually for impairment when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable through the estimated

undiscounted future cash flows from the use of these assets. When any such impairment exists, the related assets will be written down to fair value.

Goodwill and Other Intangible Assets. In July 2001, Statement of Financial Accounting Standards (“SFAS”) No. 141, “Business Combinations” (“SFAS 141”) and SFAS 142, “Goodwill and Other Intangible Assets” (“SFAS 142”) were issued. SFAS 141 requires that all business combinations completed after its adoption in July 2001 be accounted for under the purchase method of accounting and establishes specific criteria for the recognition of intangible assets separately from goodwill. In accordance with the adoption of SFAS 142 on January 1, 2002, goodwill and certain other intangible assets are no longer amortized and are tested for impairment at least annually at the reporting unit level. Losses in value are recorded when and as material impairment has occurred in the underlying assets or when the benefits of the identified intangible assets are realized. As of December 31, 2005, there was no impairment to the underlying value of goodwill or intangible assets other than goodwill.

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

Intangible assets other than goodwill consist of product technology rights, trademarks, acquired backlog, customer relationships, product lines and license agreements. Intangible assets other than trademarks are amortized over the estimated economic lives of the related assets. Accumulated amortization as of December 31, 2004 and 2005 was \$28.2 million and \$32.0 million, respectively.

Stock Option Plans. At December 31, 2005, the Company had stock-based employee compensation plans, which are described more fully in Note 16. The Company accounts for those plans under the recognition and measurement principles of APB Opinion No. 25, “Accounting for Stock Issued to Employees” and related Interpretations, and the disclosure provisions provided by SFAS 123, “Accounting for Stock-Based Compensation.” No stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. However, certain options had been repriced resulting in compensation adjustments, which have been reflected in net income. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation.

In 2003, 2004 and 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%, 2.25% and 4.25%, respectively; dividend yield of 0%; with volatility of 82%, 136.9% and 130.2%, respectively; and expected lives of five years.

Year Ended December 31, (In thousands, except per share data)	2003	2004	2005
Net income, as reported	\$15,895	\$43,559	\$63,493
Add (Deduct): Stock-based employee compensation expense (income) included in reported net income net of related tax effects	5	3,970	(1,121)
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards net of related tax effects	(2,796)	(2,999)	(2,456)
Pro forma net income	\$13,104	\$44,530	\$59,916
Earnings per share:			
Basic—as reported	\$ 0.66	\$ 1.69	\$ 2.37
Basic—pro forma	\$ 0.54	\$ 1.73	\$ 2.24
Diluted—as reported	\$ 0.66	\$ 1.49	\$ 2.06
Diluted—pro forma	\$ 0.55	\$ 1.52	\$ 1.95

Notes to Consolidated Financial Statements (cont.)

December 31, 2005

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

2003			
	Income	Weighted Average Shares	Per Share
Basic EPS			
Income available to common stockholders	\$15,895	24,262	<u>\$0.66</u>
Effect of dilutive securities			
Assumed conversion of convertible senior notes	2,332	2,749	
Options and warrants	—	415	
Diluted EPS			
Income available to common stockholders plus assumed exercises	\$18,227	27,426	\$0.66
2004			
	Income	Weighted Average Shares	Per Share
Basic EPS			
Income available to common stockholders	\$43,559	25,797	<u>\$1.69</u>
Effect of dilutive securities			
Assumed conversion of convertible senior notes	3,354	4,900	
Options and warrants	—	709	
Diluted EPS			
Income available to common stockholders plus assumed exercises	\$46,913	31,406	\$1.49
2005			
	Income	Weighted Average Shares	Per Share
Basic EPS			
Income available to common stockholders	\$63,493	26,738	<u>\$2.37</u>
Effect of dilutive securities			
Assumed conversion of convertible senior notes	2,978	4,900	
Options and warrants	—	555	
Diluted EPS			
Income available to common stockholders plus assumed exercises	\$66,471	32,193	\$2.06

Recent Accounting Standards. The Company uses the intrinsic-value method of accounting for stock options granted to employees. As required by the Company's existing stock plans, stock options are granted at, or above, the fair value of the Company's stock, and, accordingly, no compensation expense is recognized for these grants in the consolidated statement of operations. The Company records compensation expense related to other stock-based awards, such as restricted stock grants, over the vesting period of the award. Issued in December 2004, SFAS 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)"), amends SFAS 123, "Accounting for Stock-Based Compensation" and SFAS 95, "Statement of Cash Flows." SFAS 123(R) requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its consolidated financial statements, and requires additional accounting and disclosure related to the income tax and cash flow effects resulting from share-based payment arrangements. SFAS 123(R) is effective for the Company beginning as of January 1, 2006. The adoption of SFAS 123(R)'s fair value method will have an impact on the Company's results of operations, although it will have no impact on its overall

financial position. While the Company cannot estimate the level of share-based payments to be issued in the future, based on the stock options that are currently outstanding, the Company expects that the adoption of SFAS 123(R) will result in a charge to operations in 2006 of approximately \$2.7 million.

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

Note 3—Business Segments, Geographic Data, Sales by Product Group, and Major Customers

The Company is a worldwide producer and marketer of children's toys and related products, principally engaged in the design, development, production and marketing of traditional toys, including boys action figures, vehicles and playsets, craft and activity products, writing instruments, compounds, girls' toys, plush, construction toys, and infant and pre-school 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 toy 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 accounts receivable and inventories, net of applicable reserves and allowances.

The accounting policies of the segments are described in Note 2.

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

Year Ended December 31, 2003	Traditional Toys	Craft/Activities/ Writing Products	Seasonal Products	Pet Products	Total
Net Sales					
North America Toys	\$109,175	\$125,947	\$41,053	\$ —	\$276,175
Pet Products (Note 5)	—	—	—	—	—
International	36,523	866	2,212	—	39,601
	\$145,698	\$126,813	\$43,265	\$ —	\$315,776
 Year Ended December 31, 2004	 Traditional Toys	 Craft/Activities/ Writing Products	 Seasonal Products	 Pet Products	 Total
North America Toys	\$419,061	\$ 77,405	\$24,995	\$ —	\$521,461
Pet Products (Note 5)	—	—	—	—	—
International	44,238	6,792	1,775	—	52,805
	\$463,299	\$ 84,197	\$26,770	\$ —	\$574,266
 Year Ended December 31, 2005	 Traditional Toys	 Craft/Activities/ Writing Products	 Seasonal Products	 Pet Products	 Total
North America Toys	\$495,490	\$ 58,114	\$19,665	\$ —	\$573,269
Pet Products (Note 5)	—	—	—	9,763	9,763
International	74,438	3,944	122	—	78,504
	\$569,928	\$ 62,058	\$19,787	\$9,763	\$661,536

Notes to Consolidated Financial Statements (cont.)

December 31, 2005

Year Ended December 31,	2003	2004	2005
Operating Income			
North America Toys	\$ 9,823	\$ 48,785	\$ 76,116
Pet Products (Note 5)	—	—	1,222
International	1,566	4,940	10,647
	\$ 11,389	\$ 53,725	\$ 87,985

December 31,	2004	2005
Assets		
North America Toys	\$632,693	\$677,420
Pet Products (Note 5)	—	23,432
International	64,069	53,103
	\$696,762	\$753,955

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

December 31,	2004	2005
Long-Lived Assets		
United States	\$278,734	\$283,350
Hong Kong	30,484	34,038
Europe	2,783	—
	\$312,001	\$317,388

Year Ended December 31,	2003	2004	2005
Net Sales by Geographic Area			
United States	\$271,051	\$505,803	\$562,396
Europe	35,547	37,700	38,620
Canada	5,125	15,658	20,589
Hong Kong	1,275	4,410	24,388
Other	2,778	10,695	15,543
	\$315,776	\$574,266	\$661,536

Year Ended December 31,	2003	2004	2005
Net Sales by Product Group			
Traditional Toys	\$147,813	\$463,300	\$569,928
Craft/Activities/Writing Products	124,698	84,197	62,058
Seasonal Products	43,265	26,769	19,788
Pet Products (Note 5)	—	—	9,762
	\$315,776	\$574,266	\$661,536

Major Customers. Net sales to major customers, which are part of our North America Toys segment, were approximately as follows (in thousands, except for percentages):

	2003		2004		2005	
	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales
Wal-Mart	\$ 91,378	28.9%	\$193,776	33.7%	\$212,620	32.1%
Target	30,371	9.6	74,429	13.0	95,716	14.5
Toys "R" Us	30,009	9.5	68,279	11.9	82,732	12.5
	\$151,758	48.0%	\$336,484	58.6%	\$391,068	59.1%

Wal-Mart has increased its percentage of the toy industry's sales at retail and the increase in the dollar amount of sales to Wal-Mart is consistent with this change. No other customer accounted for more than 10% of our total net sales.

At December 31, 2004 and 2005, the Company's three largest customers accounted for approximately 58.1% and 73.0%, respectively, of net accounts receivable. The concentration of the Company's business with a relatively small number of customers may expose the Company to material adverse effects if one or more of its large customers were to experience financial difficulty. The Company performs ongoing credit evaluations of its top customers and maintains an allowance for potential credit losses.

Note 4—Joint Ventures

The Company owns a 50% interest in a joint venture with a company that develops, publishes and distributes interactive entertainment software for the leading hardware game platforms in the home video game market. The joint venture has entered into a license agreement with an initial license period expiring December 31, 2009 under which it acquired the exclusive worldwide right to publish 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 will, in all likelihood, result in modifications to the amount of preferred return that the Company receives. 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 sale of WWE TV Games. During 2005, the Company paid THQ approximately \$0.8 million which is recorded as a reduction of profit from the joint venture. During 2003, 2004 and 2005, the Company earned \$7.4 million, \$7.9 million and \$9.4 million, respectively, in net profit from the joint venture.

During 2005, the Company wrote off its \$1.4 million investment in a Chinese joint venture to Other Expense on its determination that none of the value would be realized.

Note 5—Business Combinations

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

On June 13, 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 over the three fiscal years following the acquisition 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 operation have included Pet Pal from the date of acquisition. Pro forma results of operations are not provided since the amounts are not material to the consolidated results of operations.

In 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 three calendar years following the acquisition up to an aggregate amount of \$30.0 million based on the achievement of certain financial performance

Notes to Consolidated Financial Statements (cont.)

December 31, 2005

criteria which will be recorded as goodwill when and if earned. For the years ended December 31, 2004 and 2005, \$10.0 million and \$6.7 million of the earn-out was earned and recorded as goodwill, respectively. 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 new product development and marketing talent to the Company. This transaction has been accounted for by the Company under the purchase method of accounting, and the Company's results of operations have included Play Along from the date of acquisition.

In determining the purchase price allocation of the Play Along acquisition, the Company considered the acquired intangible assets that arise from contractual or other legal rights, including trademarks, copyrights, patents and license agreements, potential noncontractual intangible assets, including customer lists and customer-related relationships, as well as the value of synergies that will result from combining the operations of Play Along into the operations of the Company.

The total purchase price of the Play Along acquisition including the earn-outs earned through December 31, 2005 in the amount of \$16.7 million, which was allocated to goodwill, was allocated 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	\$ 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
	<hr/> \$102,353

Approximately \$44.8 million of the Play Along goodwill is expected to be deductible for Federal and state income tax purposes.

The following unaudited pro forma information represents the Company's consolidated results of operations as if the acquisition of Play Along had occurred on January 1, 2004 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 Play Along actually occurred on January 1, 2004 or on future operating results.

Year Ended December 31, 2004 (In thousands, except per share data)

Net sales	\$618,952
Net income	\$ 44,228
Basic earnings per share	\$ 1.69
Weighted average shares outstanding	26,127
Diluted earnings per share	\$ 1.50
Weighted average shares and equivalents outstanding	31,736

Note 6—Goodwill

The changes in the carrying amount of goodwill for the year ended December 31, 2005 are as follows (in thousands):

	North America Toys	Pet Products	International	Total
Balance at beginning of period	\$237,833	\$ —	\$20,498	\$258,331
Goodwill acquired during the period (See Note 5)	6,667	4,603	—	11,270
Adjustments to goodwill during the period	(154)	—	(149)	(303)
Balance at end of period	\$244,346	\$4,603	\$20,349	\$269,298

Note 7—Intangible Assets

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

		December 31, 2004			December 31, 2005		
	Weighted Useful Lives in Years	Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
Amortized Intangible Assets:							
Acquired order backlog	0.50	\$ 5,300	\$ (5,300)	\$ —	\$ —	\$ —	\$ —
Licenses	4.75	22,435	(5,169)	17,266	23,635	(12,082)	11,553
Product lines	3.50	17,700	(16,732)	968	17,700	(17,700)	—
Customer relationships	5.25	1,300	(389)	911	1,846	(700)	1,146
Non-compete/employment contracts	4.00	2,748	(344)	2,404	2,748	(1,049)	1,699
Debt offering costs	20.00	3,705	(292)	3,413	3,705	(477)	3,228
Total amortized intangible assets		53,188	(28,226)	24,962	49,634	(32,008)	17,626
Unamortized Intangible Assets:							
Trademarks	indefinite	17,768	N/A	17,768	17,768	N/A	17,768
		\$70,956	\$(28,226)	\$42,730	\$67,402	\$(32,008)	\$35,394

For the years ended December 31, 2003, 2004, and 2005, the Company's aggregate amortization expense related to intangible assets was \$8.3 million, \$14.0 million and \$9.1 million, respectively. The Company currently estimates continuing amortization expense for the next five years to be approximately (in thousands):

2006	\$7,193
2007	4,527
2008	2,741
2009	644
2010	222

Note 8—Concentration of Credit Risk

Financial instruments that subject the Company to concentration of credit risk are cash and cash equivalents and accounts receivable. Cash equivalents consist principally of short-term money market funds. These instruments are short-term in nature and bear minimal risk. To date, the Company has not experienced losses on these instruments.

The Company performs ongoing credit evaluations of its customers' financial condition, but does not require collateral to support domestic customer accounts receivables. Most goods shipped FOB Hong Kong or China are secured with irrevocable letters of credit.

Notes to Consolidated Financial Statements (cont.)

December 31, 2005

At December 31, 2004 and 2005, the Company's three largest customers accounted for approximately 58.1% and 73.0%, respectively, of net accounts receivable. The concentration of the Company's business with a relatively small number of customers may expose the Company to material adverse effects if one or more of its large customers were to experience financial difficulty. The Company performs ongoing credit evaluations of its top customers and maintains an allowance for potential credit losses.

Note 9—Accrued Expenses

Accrued expenses consist of the following (in thousands):

	2004	2005
Royalties	\$16,024	\$15,918
Bonuses	9,720	11,554
Acquisition earn-out	10,000	6,667
Employee salaries and benefits	1,865	1,781
Promotional commitment	1,066	1,066
Sales commissions	4,503	682
Other	6,229	6,747
	\$49,407	\$44,415

Note 10—Related Party Transactions

A director of the Company is a partner in the law firm that acts as counsel to the Company. The Company incurred legal fees and expenses to the law firm in the amount of approximately \$4.6 million in 2003, \$3.3 million in 2004 and \$3.2 million in 2005.

Note 11—Convertible Senior Notes

Convertible senior notes consist of the following (in thousands):

	2004	2005
Convertible senior notes	\$98,000	\$98,000

In June 2003, the Company sold an aggregate of \$98.0 million of 4.625% Convertible Senior Notes due June 15, 2023. The notes may be converted into shares of the Company's common stock at an initial conversion price of \$20.00 per share, subject to certain circumstances. Cash interest is payable at an annual rate of 4.625% of the principal amount at issuance, from the issue date to June 15, 2010, payable on June 15 and December 15 of each year, commencing on December 15, 2003. After June 15, 2010, interest will accrue on the outstanding notes. 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 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. Any repurchases at June 15, 2013 and June 15, 2018 may be paid in cash, in shares of common stock or a combination of cash and shares of common stock.

The following is a schedule of payments for the convertible senior notes (in thousands):

2006	\$ —
2007	—
2008	—
2009	—
2010	—
Thereafter	98,000
	<u>\$98,000</u>

Note 12—Income Taxes

The Company does not file a consolidated return with its foreign subsidiaries. The Company files Federal and state returns and its foreign subsidiaries file Hong Kong and United Kingdom returns. Income taxes reflected in the accompanying consolidated statements of operations are comprised of the following (in thousands):

	2003	2004	2005
Federal	\$ 608	\$ 696	\$20,821
State and local	55	1,088	4,326
Foreign	3,017	12,954	13,290
	<u>3,680</u>	<u>14,738</u>	<u>38,437</u>
Deferred	(2,240)	795	(5,293)
	<u>\$ 1,440</u>	<u>\$15,533</u>	<u>\$33,144</u>

The components of deferred tax assets/(liabilities) are as follows (in thousands):

	2004	2005
Net deferred tax assets/(liabilities):		
Current:		
Reserve for sales allowances and possible losses	\$ 1,940	\$ 3,305
Accrued expenses	1,044	1,895
Restricted stock grant	136	31
Foreign tax credit	2,166	(127)
Federal net operating loss carryforward	—	4,117
Deductible intangible assets	—	2,240
State income taxes	—	2,309
Other	875	(152)
	<u>6,161</u>	<u>13,618</u>
Long-Term:		
Undistributed earnings	(7,191)	(3,802)
Property and equipment	(983)	(2,419)
Original issue discount interest	(2,761)	(4,355)
Deductible goodwill and intangibles	(2,004)	1,103
Federal net operating loss carryforwards	8,416	—
Foreign tax credit	—	2,718
Other	242	309
	<u>(4,281)</u>	<u>(6,446)</u>
Total net deferred tax assets/(liabilities)	<u>\$ 1,880</u>	<u>\$ 7,172</u>

The current portion of deferred tax assets is included in prepaid expenses and other.

In October 2004, the American Jobs Creation Act of 2004 (the “Act”) was signed into law. The Act created a one-time incentive for U.S. corporations to repatriate undistributed earnings from their international subsidiaries by providing an 85% dividends-received deduction for certain international earnings. The deduction was available to corporations during the tax year that includes October 2004, or in the immediately subsequent tax year. In the fourth quarter of 2005, the Company’s Board of Directors approved a plan to repatriate \$175.0 million in foreign earnings, which was completed in December 2005. The Federal and state income tax expense related to this repatriation was approximately \$8.0 million.

Notes to Consolidated Financial Statements (cont.)

December 31, 2005

Income tax expense varies from the U.S. Federal statutory rate. The following reconciliation shows the significant differences in the tax at statutory and effective rates:

	2003	2004	2005
Federal income tax expense	35.0%	35.0%	35.0%
State income tax expense, net of federal tax effect	0.2	1.3	2.1
One time dividend from foreign subsidiaries	—	—	8.3
Effect of differences in U.S. and foreign statutory rates	(30.6)	(12.1)	(9.0)
Other	3.7	1.8	(2.1)
	8.3%	26.0%	34.3%

Deferred taxes result from temporary differences between tax bases of assets and liabilities and their reported amounts in the consolidated financial statements. The temporary differences result from costs required to be capitalized for tax purposes by the U.S. Internal Revenue Code ("IRC"), and certain items accrued for financial reporting purposes in the year incurred but not deductible for tax purposes until paid.

As of December 31, 2005, the Company has Federal and state net operating loss carryforwards of \$9.0 million and \$22.2 million, respectively, expiring through 2023. These carryforwards resulted from the acquisitions of Pentech and Toymax. The utilization of these losses to offset future income is limited under IRC§382. The Company's management concluded that a deferred tax asset valuation allowance was not necessary.

The components of income before provision for income taxes are as follows (in thousands):

	2003	2004	2005
Domestic	\$ (5,255)	\$(22,669)	\$24,953
Foreign	22,590	81,761	71,684
	\$17,335	\$ 59,092	\$96,637

Note 13—Leases

The Company leases office, warehouse and showroom facilities and certain equipment under operating leases. Rent expense for the three years ended December 31, 2005 totaled \$5.2 million, \$5.8 million and \$7.1 million, respectively. The following is a schedule of minimum annual lease payments (in thousands):

2006	\$ 6,912
2007	6,463
2008	4,184
2009	3,810
2010	3,401
Thereafter	8,809
	\$33,579

Note 14—Common Stock, Preferred Stock and Warrants

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 February 2003, the Company's Board of Directors approved a buyback of up to \$20.0 million of the Company's common stock. During 2003, the Company repurchased and retired 554,500 shares of its common stock at an aggregate cost of \$6.1 million. No shares were repurchased during 2004 and 2005.

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.

During 2004, the Company issued 749,005 shares of common stock at a value of \$14.9 million in connection with the Play Along acquisition and 25,749 shares of common stock at a value of \$0.5 million in connection with the 2001 Kidz Biz acquisition. In addition, 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. The Company also issued 192,129 shares of common stock on the exercise of options for a total of \$1.7 million.

During 2003, the Company awarded 2,760,000 shares of restricted stock to four executive officers of the Company pursuant to its 2002 Stock Award and Incentive Plan, 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. The Company also issued 312,491 shares of common stock on the exercise of options for a total of \$1.8 million.

During 2003, the Company issued 100,000 fully vested warrants, expiring in 2013, in connection with license costs relating to its video game joint venture. The fair value of these warrants was approximately \$1.1 million and has been included in the basis of the joint venture (Note 4). The Company also issued \$98.0 million of convertible senior notes payable that may be converted (at their initial conversion rate of \$20.00 per share) into an aggregate of 4.9 million shares of the Company's common stock (Note 11).

Warrant activity is summarized as follows:

	Number of Shares	Weighted Average Exercise Price
Outstanding, December 31, 2005	100,000	\$11.35

There has been no warrant activity since the issuance in 2003.

Note 15—Commitments

The Company has entered into various license agreements whereby the Company may use certain characters and properties in conjunction with its products. Generally, such license agreements call for royalties to be paid at 1% to 12% of net sales with minimum guarantees and advance payments. Additionally, under three separate licenses, the Company has committed to spend 12.5% of related net sales up to \$1.0 million, 8% of related net sales and 5% of related net sales, respectively, on advertising per year on such licenses. The Company estimates that its minimum commitment for advertising in fiscal 2006 will be approximately \$11.0 million.

Future annual minimum royalty guarantees as of December 31, 2005 are as follows (in thousands):

2006	\$13,003
2007	8,421
2008	5,492
2009	1,434
2010	500
	<u>\$28,850</u>

The Company has entered into employment agreements with certain executives expiring through December 31, 2010. The aggregate future annual minimum guaranteed amounts due under those agreements as of December 31, 2005 are as follows (in thousands):

2006	\$ 5,591
2007	5,419
2008	3,166
2009	2,244
2010	2,280
	<u>\$18,700</u>

Notes to Consolidated Financial Statements (cont.)

December 31, 2005

Note 16—Stock Award and Incentive Plan

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 (Note 14). 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 and restricted shares typically vest over one to two years.

As of December 31, 2005, 1,435,876 shares were available for future grant. Additional shares may become available to the extent that options or shares of restricted stock presently outstanding under the Plan terminate or expire. Stock option activity pursuant to the Plan is summarized as follows:

	Number of Shares	Weighted Average Exercise Price
Outstanding, December 31, 2002	2,607,887	\$11.35
Granted	184,500	13.31
Exercised	(312,491)	11.78
Canceled	(214,630)	12.71
Outstanding, December 31, 2003	2,265,266	12.15
Granted	287,644	19.49
Exercised	(192,129)	8.89
Canceled	(287,775)	13.76
Outstanding, December 31, 2004	2,073,006	13.22
Granted	360,000	21.74
Exercised	(566,546)	8.60
Canceled	(77,354)	15.74
Outstanding, December 31, 2005	1,789,106	\$16.32

The weighted average fair value of options granted to employees in 2003, 2004 and 2005 was \$13.28, \$19.48 and \$21.74 per share, respectively.

The following table summarizes information about stock options outstanding and exercisable at December 31, 2005:

	Outstanding			Exercisable	
	Number of Shares	Weighted Average Life in Years	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
\$ 7.875–\$13.47	603,416	3.37	\$11.17	427,866	\$10.31
\$13.48 –\$19.02	603,550	2.18	\$16.82	423,150	\$16.94
\$19.21 –\$22.11	582,140	5.83	\$21.13	148,144	\$20.55

Note 17—Employee Pension Plan

The Company sponsors, for its U.S. employees, a defined contribution plan under Section 401(k) of the Internal Revenue Code. The plan provides that employees may defer up to 15% of their annual compensation, and that the Company will make a matching contribution equal to 50% of each employee's deferral, up to 5% of the employee's annual compensation. Company matching contributions, which vest equally over a five-year period, totaled \$0.3 million, \$0.4 million and \$0.5 million for 2003, 2004 and 2005, respectively.

Note 18—Supplemental Information to Consolidated Statements of Cash Flows

In 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. Additionally, the Company recognized a \$4.1 million tax benefit from the exercise of stock options.

In 2004, 749,005 shares of common stock valued at approximately \$14.9 million were issued in connection with the acquisition of Play Along and 25,749 shares of common stock valued at approximately \$0.5 million were issued in connection with the 2001 Kidz Biz acquisition. Additionally, the Company recognized a \$0.7 million tax benefit from the exercise of stock options.

In 2003, the Company issued 100,000 warrants valued at approximately \$1.1 million in connection with license costs relating to its video game joint venture (Note 14).

Note 19—Selected Quarterly Financial Data (Unaudited)

Selected unaudited quarterly financial data for the years 2004 and 2005 are summarized below:

	2004				2005			
(In thousands, except per share data)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net sales	\$73,986	\$109,395	\$206,083	\$184,802	\$134,676	\$127,091	\$233,500	\$166,269
Gross profit	\$30,466	\$ 41,281	\$ 81,801	\$ 72,459	\$ 54,212	\$ 48,073	\$ 93,452	\$ 70,970
Income from operations	\$ 4,885	\$ 8,321	\$ 29,915	\$ 10,604	\$ 13,675	\$ 14,614	\$ 47,218	\$ 12,478
Income before income taxes	\$ 4,764	\$ 7,637	\$ 30,042	\$ 16,649	\$ 13,627	\$ 15,732	\$ 46,306	\$ 20,972
Net income	\$ 3,791	\$ 6,004	\$ 23,255	\$ 10,508	\$ 10,084	\$ 11,642	\$ 32,753	\$ 9,014
Basic earnings per share	\$ 0.15	\$ 0.24	\$ 0.89	\$ 0.40	\$ 0.38	\$ 0.44	\$ 1.22	\$ 0.33
Weighted average shares outstanding	25,276	25,502	26,167	26,232	26,560	26,678	26,778	26,930
Diluted earnings per share	\$ 0.15	\$ 0.22	\$ 0.76	\$ 0.36	\$ 0.34	\$ 0.39	\$ 1.05	\$ 0.29
Weighted average shares and equivalents outstanding	30,676	31,123	31,919	31,855	32,256	32,229	32,088	32,197

During the fourth quarter of 2004, the Company recorded non-cash charges, which impacted operating income, of \$5.6 million relating to the grant of restricted stock and \$8.6 million relating to the amortization of short-lived intangible assets acquired in connection with the Play Along acquisition.

During the second quarter of 2005, the Company wrote off its \$1.4 investment in a Chinese joint venture to other expense on its determination that none of the value would be realized.

During the fourth quarter of 2005, the Company recorded a non-cash charge, which impacted operating income, of \$3.6 million for restricted stock, and it repatriated \$175.0 million from its Hong Kong subsidiaries which resulted in incremental income for tax expense of \$8.0 million and reduced net income.

Notes to Consolidated Financial Statements (cont.)

December 31, 2005

Note 20—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 our foreign subsidiaries and the Company’s three executive officers. 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. Three shareholder derivative actions have also been filed against us, nominally, and against certain of the Company’s Board members (the “Derivative Actions”). The Derivative Actions seek to hold the individual defendants liable for damages allegedly caused to the Company by their actions, and, in one of the Derivative Actions, seeks restitution to the Company of profits, benefits and other compensation obtained by them.

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 effect on its business, financial condition or results of operations.

Note 21—Subsequent Event

On February 9, 2006, the Company acquired substantially all of the assets of Creative Designs International, Ltd. and a related Hong Kong company, Arbor Toys Company Limited (collectively “Creative Designs”). The total initial purchase price of \$107.7 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 \$3.2 million and the assumption of liabilities in the amount of \$3.5 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.

Schedule II—Valuation and Qualifying Accounts

Years Ended December 31, 2003, 2004 and 2005

Allowances are deducted from the assets to which they apply, except for sales returns and allowances.

(In thousands)	Balance at Beginning of Period	Charged to Costs and Expenses	Charged to Other Accounts	Deductions	Balance at End of Period
Year ended December 31, 2003:					
Allowance for:					
Uncollectible accounts	\$ 6,781	\$ 2,896	\$ —	\$ (1,800)	\$ 7,877
Reserve for potential product obsolescence	4,782	4,288	—	(4,045)	5,025
Reserve for sales returns and allowances	13,580	27,064	—	(32,891)	7,753
	\$25,143	\$34,248	\$ —	\$(38,736)	\$20,655
Year ended December 31, 2004:					
Allowance for:					
Uncollectible accounts	\$ 7,877	\$ 2,903	\$ —	\$ (3,722)	\$ 7,058
Reserve for potential product obsolescence	5,025	5,342	—	(2,325)	8,042
Reserve for sales returns and allowances	7,753	49,956	2,131 ^(a)	(36,667)	23,173
	\$20,655	\$58,201	\$ 2,131	\$(42,714)	\$38,273
Year ended December 31, 2005:					
Allowance for:					
Uncollectible accounts	\$ 7,058	\$ 902	\$(1,291) ^(b)	\$ (4,333)	\$ 2,336
Reserve for potential product obsolescence	8,042	6,981	—	(7,576)	7,447
Reserve for sales returns and allowances	23,173	54,767	218 ^(c)	(53,035)	25,123
	\$38,273	\$62,650	\$(1,073)	\$(64,944)	\$34,906

(a) *Play Along acquired reserve.*

(b) *Pet Pal acquired reserve, \$0.1 million; customer preference payments booked to Accrued Expenses, (\$1.4 million).*

(c) *Pet Pal acquired reserve.*

Management's Annual Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control system was designed to provide reasonable assurance to management and our board of directors regarding the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2005. In making this assessment, it used criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control—Integrated Framework*. We believe that, as of December 31, 2005, our internal control over financial reporting is effective based on those criteria.

Our independent auditors have issued an attestation report on management's assessment of our internal control over financial reporting. This report appears on page 60.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
JAKKS Pacific, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of JAKKS Pacific, Inc. and Subsidiaries (Company) as of December 31, 2004 and 2005, and the related consolidated statements of operations, other comprehensive income, stockholders' equity and cash flows and the financial statement schedule for each of the years in the three-year period ended December 31, 2005. We also have audited management's assessment, included in the accompanying Management's annual report on internal control over financial reporting, that the Company maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements and schedule referred to above present fairly, in all material respects, the financial position of JAKKS Pacific, Inc. and Subsidiaries as of December 31, 2004 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's assessment that JAKKS Pacific, Inc. and Subsidiaries maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Furthermore, in our opinion, JAKKS Pacific, Inc. and Subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

PKF

PKF
Certified Public Accountants
A Professional Corporation
Los Angeles, California
February 13, 2006

Shareholder Information

General Counsel

Feder, Kaszovitz, Isaacson, Weber, Skala,
Bass & Rhine LLP
750 Lexington Avenue, 23rd Floor
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Independent Auditors

BDO Seidman, LLP
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Investor Relations

Genna Rosenberg
Vice President, Corporate Communications
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John Mills
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Fax: 310-395-2217

Transfer Agent

U.S. Stock Transfer Corp.
1745 Gardena Avenue, 2nd Floor
Glendale, CA 91204

Stock Exchange Listing

Common stock trading on the Nasdaq National Market System under the symbol "JAKK." As of May 3, 2006, there were approximately 171 holders of record and approximately 13,469 beneficial owners of the Company's common stock. The Company has not paid cash dividends and does not anticipate paying cash dividends in the foreseeable future.

Annual Report

A copy of the Company's annual report on Form 10-K, as filed with the Securities and Exchange Commission, will be furnished to stockholders and interested investors free of charge upon written request to the Company, Attention: Corporate Secretary, 22619 Pacific Coast Highway, Malibu, CA 90265.

Common Stock Price Data

2004	High	Low
First Quarter	\$16.25	\$12.72
Second Quarter	\$21.00	\$14.48
Third Quarter	\$23.22	\$18.71
Fourth Quarter	\$25.55	\$12.75
2005		
First Quarter	\$23.96	\$17.25
Second Quarter	\$21.97	\$18.38
Third Quarter	\$20.20	\$15.54
Fourth Quarter	\$23.35	\$14.80
2006		
First Quarter	\$27.10	\$19.23
Second Quarter	\$28.50	\$17.06

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JAKKS Pacific®, Child Guidance®, Flying Colors®, Pentech®, Road Champs®, Go Fly A Kite®, Fly Wheels™, Fun noodle®, Color Workshop™, Play Along®, Laser Challenge®, BloPens®, Vivid Velvet®, Plug It In & Play TV Games™, The Storm®, Creepy Crawlers®, Air Creations®, If You Say Sew®, ROC Writer™, UltraSharp®, Toymax®, MXS®, SeaFun noodles™, TeleStory™, VMIGO™, Magic Glow™, Truck n' Trailers™, RC Racers™, Liguaphite™, JPI™, Creative Designs International™, CDI™, Pet Pal™, Custom Garage™, White Bites™ and XS Extreme Sports™ are trademarks of either JAKKS Pacific, Inc. or its subsidiaries.

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All other product names and associated designs mentioned or shown in this annual report are trademarks and copyrighted properties of their respective owners.

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Executive Management

Board of Directors

Jack Friedman
*Chairman
Chief Executive Officer
JAKKS Pacific, Inc.*

Stephen G. Berman
*President and Secretary
Chief Operating Officer
JAKKS Pacific, Inc.*

Dan Almagor
*Chairman
ACG Inc.*

David C. Blatte
*Managing Director
Centre Partners
Management LLP*

Robert E. Glick
*Apparel Manufacturing
Executive*

Michael G. Miller
Advertising Executive

Murray L. Skala
*Partner
Feder, Kaszovitz,
Isaacson, Weber, Skala,
Bass & Rhine LLP*

Corporate Officers

Jack Friedman
Chief Executive Officer

Stephen G. Berman
*President
Chief Operating Officer*

Joel M. Bennett
*Executive Vice President
Chief Financial Officer*

Senior Executive Team

Michael Bernstein
*Senior Vice President,
Marketing, Male Action,
Seasonal and Pets*

Jim Christianson
*Senior Vice President—
Go Fly A Kite*

Mike Dwyer
*Vice President,
Legal and Human
Resources—
JAKKS Pacific*

Charlie Emby
Co-President—Play Along

Jay Foreman
Co-President—Play Along

Lawrence Geller
*Senior Vice President,
General Counsel—
Play Along*

Geoffrey Greenberg
*President—Creative Designs
International*

Henry Ho
*Managing Director—
Arbor Toys*

Wills Hon
Managing Director—Asia

David Johnston
*Senior Vice President—
Funnoodle*

Tony Lawlor
Senior Vice President—JPI

Irene Li
*Managing Director—
Play Along Hong Kong*

Tamre Logan
*Senior Vice President,
Marketing, Girls Activities*

Jack McGrath
*Senior Vice President,
Operations*

Ken Price
Senior Vice President, Sales

Jennifer Richmond
*Senior Vice President,
Licensing and Media*

Carmine Russo
*Senior Vice President,
International Sales*

Merritt Schoch
Senior Vice President—JPI

J.R. Shatley
*Senior Vice President,
Sales—Play Along*

Kathleen Torrell
*Senior Vice President,
Marketing, Stationery*

Rick Watkins
*Senior Vice President,
Product Development—
Play Along*

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This annual report contains statements that may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on current expectations, estimates and projections about JAKKS' business based, in part, on assumptions made by its management. These statements are not guarantees of JAKKS' future performance and involve risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements due to numerous factors, including, but not limited to, those described above and the following: changes in demand for JAKKS' products, product mix, the timing of customer orders and deliveries, the impact of competitive products and pricing and difficulties encountered in the integration of acquired businesses. The forward-looking statements contained herein speak only as of the date on which they are made, and JAKKS does not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this annual report.



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