

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

**FORM 10-Q**

(Mark one)

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: **0-28104**

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

**Delaware**  
(State or Other Jurisdiction of Incorporation or Organization)

**95-4527222**  
(I.R.S. Employer Identification No.)

**2951 28<sup>th</sup> Street**  
**Santa Monica, California**  
(Address of Principal Executive Offices)

**90405**  
(Zip Code)

Registrant's Telephone Number, Including Area Code: **(424) 268-9444**

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

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

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

Large accelerated filer  
☐

Accelerated filer  
☒

Non-accelerated filer  
☐

Smaller reporting company  
☐

(Do not check if a smaller reporting company)

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

The number of shares outstanding of the issuer's common stock is 20,002,003 as of November 9, 2016.

# JAKKS PACIFIC, INC. AND SUBSIDIARIES

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### DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

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

**PART I**  
**FINANCIAL INFORMATION**

**Item 1. Financial Statements**

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

Assets	December 31, 2015 (*)	September 30, 2016 (Unaudited)
<b>Current assets</b>		
Cash and cash equivalents	\$ 102,528	\$ 45,475
Restricted cash	—	2,687
Accounts receivable, net of allowance for uncollectible accounts of \$2,714 and \$2,447 in 2015 and 2016, respectively	163,387	272,257
Inventory, net	60,544	75,064
Income taxes receivable	24,008	23,435
Prepaid expenses and other assets	31,901	27,761
Total current assets	382,368	446,679
<b>Property and equipment</b>		
Office furniture and equipment	15,141	14,567
Molds and tooling	86,307	99,905
Leasehold improvements	10,640	10,950
Total	112,088	125,422
Less accumulated depreciation and amortization	93,653	102,724
Property and equipment, net	18,435	22,698
Intangibles, net	42,185	35,553
Other long term assets	3,125	2,423
Investment in DreamPlay, LLC	7,000	7,000
Goodwill, net	44,199	43,462
Trademarks, net	2,308	2,308
Total assets	\$ 499,620	\$ 560,123
<b>Liabilities and Stockholders' Equity</b>		
<b>Current liabilities</b>		
Accounts payable	\$ 34,986	\$ 102,577
Accrued expenses	54,081	57,358
Reserve for sales returns and allowances	17,267	16,379
Income taxes payable	21,067	22,791
Total current liabilities	127,401	199,105
Convertible senior notes, net of debt issuance costs of \$5,834 and \$4,372 in 2015 and 2016, respectively	209,166	207,933
Other liabilities	5,155	5,210
Income taxes payable	2,199	2,325
Deferred income taxes, net	2,293	2,265
Total liabilities	346,214	416,838
<b>Commitments and contingencies</b>		
<b>Stockholders' equity</b>		
Preferred stock, \$.001 par value; 5,000,000 shares authorized; nil outstanding	—	—
Common stock, \$.001 par value; 100,000,000 shares authorized; 21,701,239 and 19,999,540 shares issued and outstanding in 2015 and 2016, respectively	21	20
Treasury stock, at cost; 3,660,201 and 3,112,840 shares in 2015 and 2016, respectively	(28,322)	(24,000)
Additional paid-in capital	194,743	177,326
Retained earnings (accumulated deficit)	(3,391)	5,437
Accumulated other comprehensive loss	(10,051)	(16,077)
Total JAKKS Pacific, Inc. stockholders' equity	153,000	142,706
Non-controlling interests	406	579
Total stockholders' equity	153,406	143,285
Total liabilities and stockholders' equity	\$ 499,620	\$ 560,123

(\*) Derived from audited financial statements

See accompanying notes to condensed consolidated financial statements.

**JAKKS PACIFIC, INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME**  
(In thousands, except per share data)

	<b>Three Months Ended September 30, (Unaudited)</b>		<b>Nine Months Ended September 30, (Unaudited)</b>	
	<b>2015</b>	<b>2016</b>	<b>2015</b>	<b>2016</b>
Net sales	\$ 337,027	\$ 302,791	\$ 582,334	\$ 539,577
Cost of sales	232,698	207,858	403,340	368,661
Gross profit	104,329	94,933	178,994	170,916
Selling, general and administrative expenses	59,701	60,520	141,573	151,419
Income from operations	44,628	34,413	37,421	19,497
Income from joint ventures	60	—	1,744	861
Other income	5,642	207	5,642	282
Interest income	16	12	51	46
Interest expense	(3,107)	(3,020)	(9,187)	(9,466)
Income before provision for income taxes	47,239	31,612	35,671	11,220
Provision for income taxes	1,375	1,083	3,115	2,219
Net income	45,864	30,529	32,556	9,001
Net income (loss) attributable to non-controlling interests	19	(83)	(28)	173
Net income attributable to JAKKS Pacific, Inc.	\$ 45,845	\$ 30,612	\$ 32,584	\$ 8,828
Earnings per share – basic	\$ 2.47	\$ 1.91	\$ 1.72	\$ 0.53
Earnings per share –diluted	\$ 1.12	\$ 0.82	\$ 0.89	\$ 0.36
Comprehensive income	\$ 44,003	\$ 28,161	\$ 30,652	\$ 2,975
Comprehensive income attributable to JAKKS Pacific, Inc.	\$ 43,984	\$ 28,244	\$ 30,680	\$ 2,802

JAKKS PACIFIC, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In thousands)

	Nine Months Ended September 30, (Unaudited)	
	2015	2016
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 32,556	\$ 9,001
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	14,220	16,898
Write-off and amortization of debt issuance costs	1,464	1,877
Share-based compensation expense	1,452	1,254
Gain on disposal of property and equipment	(28)	—
Gain on extinguishment of convertible notes	—	(69)
Deferred income taxes	—	(29)
Changes in operating assets and liabilities:		
Accounts receivable	(58,345)	(108,870)
Inventory	(2,577)	(14,520)
Income taxes receivable	—	573
Prepaid expenses and other assets	(6,294)	4,428
Accounts payable	38,472	61,832
Accrued expenses	(17,264)	5,946
Reserve for sales returns and allowances	2,139	(888)
Income taxes payable	715	1,850
Other liabilities	2,358	55
Total adjustments	(23,688)	(29,663)
Net cash provided by (used in) operating activities	8,868	(20,662)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property and equipment	(14,354)	(11,239)
Sale of marketable securities	220	—
Distribution from joint venture	60	—
Change in other assets	(3,080)	(6,227)
Net cash used in investing activities	(17,154)	(17,466)
CASH FLOWS FROM FINANCING ACTIVITIES		
Repurchase of common stock for employee tax withholding	—	(844)
Repurchase of convertible senior notes	—	(2,626)
Proceeds from credit facility borrowings	25,000	—
Restricted cash	—	(2,687)
Credit facility costs	(188)	—
Repurchase of common stock	(6,988)	(13,505)
Net cash provided by (used in) financing activities	17,824	(19,662)
Effect of foreign currency translation	148	737
Net change in cash and cash equivalents	9,686	(57,053)
Cash and cash equivalents, beginning of period	71,525	102,528
Cash and cash equivalents, end of period	\$ 81,211	\$ 45,475
Cash paid during the period for:		
Income taxes	\$ 3,625	\$ 203
Interest	\$ 4,390	\$ 7,010

See Notes 5, 9 and 10 for additional supplemental information to the condensed consolidated statements of cash flows.

See accompanying notes to condensed consolidated financial statements.

# JAKKS PACIFIC, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

September 30, 2016

### Note 1 — Basis of Presentation

The accompanying unaudited interim condensed consolidated financial statements included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures are adequate to prevent the information presented from being misleading. These financial statements should be read in conjunction with Management’s Discussion and Analysis of Financial Condition and Results of Operations and the financial statements and the notes thereto included in the Company’s Annual Report on Form 10-K, which contains audited financial information for the three years in the period ended December 31, 2015.

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

The condensed consolidated financial statements include the accounts of JAKKS Pacific, Inc. and its wholly-owned subsidiaries (collectively, “the Company”). The condensed consolidated financial statements also include the accounts of DreamPlay Toys, LLC, a joint venture between JAKKS Pacific, Inc. and NantWorks LLC, and JAKKS Meisheng Trading (Shanghai) Limited, a joint venture between JAKKS Pacific, Inc. and Meisheng Culture & Creative Corp.

Certain prior period amounts have been reclassified for consistency with the current period presentation.

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (“ASU 2014-09”), which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP. The standard is effective for annual periods beginning after December 15, 2017, and interim periods therein, using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). The Company is currently evaluating the impact of the pending adoption of ASU 2014-09 on the consolidated financial statements and has not yet determined the method by which it will adopt the standard in 2018.

In August 2014, the FASB amended the FASB Accounting Standards Codification and amended Subtopic 205-40, “Presentation of Financial Statements — Going Concern.” This amendment prescribes that an entity’s management should evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity’s ability to continue as a going concern within one year after the date that the financial statements are issued. The amendments will become effective for the Company’s annual and interim reporting periods beginning January 1, 2017. Upon adoption, the Company will use this guidance to evaluate going concern.

In July 2015, the FASB issued Accounting Standards Update 2015-11, “Inventory (Topic 330): Simplifying the Measurement of Inventory” (“ASU 2015-11”). ASU 2015-11 requires inventory accounted for under the FIFO or average cost method to be measured using the lower of cost and net realizable value. The amendments are effective prospectively for fiscal years and for interim periods beginning after December 15, 2016. The Company is currently evaluating the impact of the pending adoption of ASU 2015-11 on the consolidated financial statements.

In February 2016, the FASB issued Accounting Standards Update 2016-02, “Leases” (“ASU 2016-02”). ASU 2016-02 establishes a right-of-use (“ROU”) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is currently evaluating the impact of the pending adoption of this new standard on its financial statements.

In March 2016, the FASB issued ASU No. 2016-09, “Improvements to Employee Share-Based Payment Accounting,” (“ASU 2016-09”) which simplifies several aspects of the accounting for share-based payments, including income tax consequences and classification on the statement of cash flows. Under the new standard, all excess tax benefits and tax deficiencies will be recognized as income tax expense or benefit in the income statement as discrete items in the reporting period in which they occur. Additionally, excess tax benefits will be classified as an operating activity on the statement of cash flows. In regards to forfeitures, the entity can make an accounting policy election to either recognize forfeitures as they occur or estimate the number of awards expected to be forfeited. The guidance in ASU 2016-09 is effective for the fiscal year, and interim periods within that fiscal year, beginning after December 15, 2016. The Company is currently evaluating the impact of the adoption of this standard on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. The new guidance is intended to reduce diversity in practice in how transactions are classified in the statement of cash flows. This ASU is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2017. The adoption of this standard is not expected to have a material impact on the Company’s financial statements.

In October 2016, the FASB issued ASU 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other than Inventory. The amendments in this ASU reduces the complexity in the accounting standards by allowing the recognition of current and deferred income taxes for an intra-entity asset transfer, other than inventory, when the transfer occurs. Historically, recognition of the income tax consequence was not recognized until the asset was sold to an outside party. This ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted. The Company is currently evaluating the impact of this ASU on its financial statements.



**JAKKS PACIFIC, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(Unaudited)

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

The Company is a worldwide producer and marketer of children's toys and other consumer products, principally engaged in the design, development, production, marketing and distribution of its diverse portfolio of products. The Company recently re-aligned its products into three new segments to better reflect the management and operation of the business. The Company's segments are (i) U.S. and Canada, (ii) International, and (iii) Halloween. Prior year's segment reporting units have been restated to reflect this change.

The U.S. and Canada segment includes action figures, vehicles, play sets, plush products, dolls, electronic products, construction toys, infant and pre-school toys, role play and everyday costume play, foot to floor ride-on vehicles, wagons, novelty toys, seasonal and outdoor products, kids' indoor and outdoor furniture, and pet treats and related products, primarily within the United States and Canada.

Within the International segment, the Company markets and sells its toy products in markets outside of the U.S. and Canada, primarily in the European, Asia Pacific, and Latin and South American regions.

Within the Halloween segment, the Company markets and sells Halloween costumes and accessories and everyday costume play products, primarily in the U.S. and Canada.

Segment performance is measured at the operating income level. All sales are made to external customers and general corporate expenses have been attributed to the various segments based upon relative sales volumes. Segment assets are primarily comprised of accounts receivable and inventories, net of applicable reserves and allowances, goodwill and other assets. Certain assets which are not tracked by operating segment and/or that benefit multiple operating segments have been allocated on the same basis.

Results are not necessarily those which would be achieved if each segment was an unaffiliated business enterprise. Information by segment and a reconciliation to reported amounts for the three and nine months ended September 30, 2015 and 2016 and as of December 31, 2015 and September 30, 2016 are as follows (in thousands):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2015</b>	<b>2016</b>	<b>2015</b>	<b>2016</b>
<b>Net Sales</b>				
U.S. and Canada	\$ 202,568	\$ 188,381	\$ 350,855	\$ 350,320
International	77,701	57,333	137,523	97,454
Halloween	56,758	57,077	93,956	91,803
	<u>\$ 337,027</u>	<u>\$ 302,791</u>	<u>\$ 582,334</u>	<u>\$ 539,577</u>
	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2015</b>	<b>2016</b>	<b>2015</b>	<b>2016</b>
<b>Income (Loss) from Operations</b>				
U.S. and Canada	\$ 28,126	\$ 24,865	\$ 21,808	\$ 16,966
International	12,724	6,876	15,530	4,371
Halloween	3,778	2,672	83	(1,840)
	<u>\$ 44,628</u>	<u>\$ 34,413</u>	<u>\$ 37,421</u>	<u>\$ 19,497</u>
	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2015</b>	<b>2016</b>	<b>2015</b>	<b>2016</b>
<b>Depreciation and Amortization Expense</b>				
U.S. and Canada	\$ 4,976	\$ 5,787	\$ 9,426	\$ 12,097
International	1,847	1,800	3,531	3,354
Halloween	556	619	1,263	1,447
	<u>\$ 7,379</u>	<u>\$ 8,206</u>	<u>\$ 14,220</u>	<u>\$ 16,898</u>
			<b>December 31, 2015</b>	<b>September 30, 2016</b>
<b>Assets</b>				
U.S. and Canada			\$ 320,528	\$ 339,212
International			157,493	175,232
Halloween			21,599	45,679
			<u>\$ 499,620</u>	<u>\$ 560,123</u>



**JAKKS PACIFIC, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(Unaudited)

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

The following tables present information about the Company by geographic area as of December 31, 2015 and September 30, 2016 and for the three and nine months ended September 30, 2015 and 2016 (in thousands):

	<b>December 31, 2015</b>	<b>September 30, 2016</b>
<b>Long-lived Assets</b>		
China	\$ 10,172	\$ 15,253
United States	7,702	6,914
Hong Kong	561	531
	<u>\$ 18,435</u>	<u>\$ 22,698</u>

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2015</b>	<b>2016</b>	<b>2015</b>	<b>2016</b>
<b>Net Sales by Customer Area</b>				
United States	\$ 242,467	\$ 229,850	\$ 416,690	\$ 416,034
Europe	55,389	43,446	92,948	67,611
Canada	16,441	12,709	27,255	22,412
Hong Kong	414	1,184	1,210	1,861
Other	22,316	15,602	44,231	31,659
	<u>\$ 337,027</u>	<u>\$ 302,791</u>	<u>\$ 582,334</u>	<u>\$ 539,577</u>

**Product Group**

Net sales by product group for the three and nine months ended September 30, 2015 and 2016 were as follows (in thousands):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2015</b>	<b>2016</b>	<b>2015</b>	<b>2016</b>
Traditional Toys and Electronics	\$ 204,332	\$ 163,528	\$ 332,737	\$ 268,194
Role Play, Novelty and Seasonal Toys	132,695	139,263	249,597	271,383
	<u>\$ 337,027</u>	<u>\$ 302,791</u>	<u>\$ 582,334</u>	<u>\$ 539,577</u>

**Major Customers**

Net sales to major customers for the three and nine months ended September 30, 2015 and 2016 were as follows (in thousands, except for percentages):

	<b>Three Months Ended September 30,</b>				<b>Nine Months Ended September 30,</b>			
	<b>2015</b>		<b>2016</b>		<b>2015</b>		<b>2016</b>	
	<b>Percentage of Amount Net Sales</b>		<b>Percentage of Amount Net Sales</b>		<b>Percentage of Amount Net Sales</b>		<b>Percentage of Amount Net Sales</b>	
Wal-Mart	\$ 77,240	22.9%	\$ 72,996	24.1%	\$ 126,743	21.7%	\$ 139,806	25.9%
Target	40,647	12.1	50,008	16.5	66,292	11.4	76,948	14.3
Toys 'R' Us	27,292	8.1	19,624	6.5	50,620	8.7	38,088	7.0
	<u>\$ 145,179</u>	<u>43.1%</u>	<u>\$ 142,628</u>	<u>47.1%</u>	<u>\$ 243,655</u>	<u>41.8%</u>	<u>\$ 254,842</u>	<u>47.2%</u>

At December 31, 2015 and September 30, 2016, the Company's three largest customers accounted for approximately 56.2% and 46.7%, respectively, of net accounts receivable. The concentration of the Company's business with a relatively small number of customers may expose the Company to material adverse effects if one or more of its large customers were to experience financial difficulty. The Company performs ongoing credit evaluations of its top customers and maintains an allowance for potential credit losses.

**JAKKS PACIFIC, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(Unaudited)

**Note 3 — Inventory**

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

	<b>December 31, 2015</b>	<b>September 30, 2016</b>
Raw materials	\$ 3,717	\$ 4,344
Finished goods	56,827	70,720
	<u>\$ 60,544</u>	<u>\$ 75,064</u>

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

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

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

The Company also participates in cooperative advertising arrangements with some customers, whereby it allows a discount from invoiced product amounts in exchange for customer purchased advertising that features the Company's products. Generally, these discounts range from 1% to 10% of gross sales, and are generally based upon product purchases or specific advertising campaigns. Such amounts are accrued when the related revenue is recognized or when the advertising campaign is initiated. These cooperative advertising arrangements are accounted for as direct selling expenses.

The Company's reserve for sales returns and allowances amounted to \$17.3 million as of December 31, 2015, compared to \$16.4 million as of September 30, 2016. This decrease is primarily due to certain customers taking their annual allowances related to 2015 sales as well as allowances related to 2016 during 2016.

**JAKKS PACIFIC, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**Note 5 — Credit Facility**

In March 2014, the Company and its domestic subsidiaries entered into a secured credit facility with General Electric Capital Corporation (“GECC”). The loan agreement, as amended and subsequently assigned to Wells Fargo Bank, N.A. pursuant to its acquisition of GECC, provides for a \$75.0 million revolving credit facility subject to availability based on prescribed advance rates on certain accounts receivable and inventory (the “WF Loan Agreement”). The amounts outstanding under the credit facility are payable in full upon maturity of the facility on March 27, 2019, and the credit facility is secured by a security interest in favor of the lender covering a substantial amount of the assets of the Company. As of December 31, 2015, the amount of outstanding borrowings was nil and outstanding stand-by letters of credit totaled \$23.2 million; the total excess borrowing capacity was \$55.5 million. As of September 30, 2016, the amount of outstanding borrowings was nil and outstanding stand-by letters of credit totaled \$28.2 million; the total excess borrowing capacity was \$24.7 million including \$2.7 million remaining of restricted funds on deposit in the process of being returned to the Company. Such funds became unrestricted when the excess borrowing capacity under the credit line became positive.

The Company’s ability to borrow under the WF Loan Agreement is also subject to its ongoing compliance with certain financial covenants, including the maintenance by the Company of a fixed charge coverage ratio of at least 1.2:1.0 based on the trailing four fiscal quarters. As of December 31, 2015 and September 30, 2016, the Company was in compliance with the financial covenants under the WF Loan Agreement.

The Company may borrow funds at LIBOR or at a base rate, plus applicable margins of 225 basis point spread over LIBOR and 125 basis point spread on base rate loans. In addition to standard fees, the facility has an unused credit line fee, which ranges from 25 to 50 basis points. As of December 31, 2015 and September 30, 2016, the interest rate on the credit facility was approximately 2.25%.

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

**JAKKS PACIFIC, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(Unaudited)

**Note 6 — Convertible Senior Notes**

In July 2013, the Company sold an aggregate of \$100.0 million principal amount of 4.25% Convertible Senior Notes due 2018 (the “2018 Notes”). The 2018 Notes are senior unsecured obligations of the Company paying interest semi-annually in arrears on August 1 and February 1 of each year at a rate of 4.25% per annum and will mature on August 1, 2018. The initial and still current conversion rate for the 2018 Notes is 114.3674 shares of JAKKS common stock per \$1,000 principal amount of notes, equivalent to an initial conversion price of approximately \$8.74 per share of common stock, subject to adjustment in certain events. Upon conversion, the 2018 Notes will be settled in shares of the Company’s common stock. Holders of the 2018 Notes may require that the Company repurchase for cash all or some of their notes upon the occurrence of a fundamental change (as defined in the 2018 Notes). During April and May of 2016 the Company repurchased and retired an aggregate of approximately \$0.7 million principal amount of the 2018 Notes.

In June 2014, the Company sold an aggregate of \$115.0 million principal amount of 4.875% Convertible Senior Notes due 2020 (the “2020 Notes”). The 2020 Notes are senior unsecured obligations of the Company paying interest semi-annually in arrears on June 1 and December 1 of each year at a rate of 4.875% per annum and will mature on June 1, 2020. The initial and still current conversion rate for the 2020 Notes is 103.7613 shares of JAKKS common stock per \$1,000 principal amount of notes, equivalent to an initial conversion price of approximately \$9.64 per share of common stock, subject to adjustment in certain events. Upon conversion, the 2020 Notes will be settled in shares of the Company’s common stock. Holders of the 2020 Notes may require that the Company repurchase for cash all or some of their notes upon the occurrence of a fundamental change (as defined in the 2020 Notes). In January 2016, the Company repurchased and retired an aggregate of \$2.0 million principal amount of the 2020 Notes.

On January 1, 2016, the Company adopted ASU 2015-03, “Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs,” which requires that debt issuance costs related to a recognized debt liability to be presented on the balance sheet as a direct deduction from the debt liability, similar to the presentation of debt premiums and discounts. ASU 2015-03 applies retrospectively and does not change the recognition and measurement requirements for debt issuance costs. As a result, the Company reclassified \$5.8 million of debt issuance costs previously included in other long term assets to convertible senior notes, net on its condensed consolidated financial statements as of December 31, 2015.

The fair value of the 2018 Notes as of December 31, 2015 and September 30, 2016 was approximately \$102.0 million and \$111.8 million, respectively, based upon the most recent quoted market price. The fair value of the 2020 Notes as of December 31, 2015 and September 30, 2016 was approximately \$112.3 million and \$120.0 million, respectively, based upon the most recent quoted market price. The fair value of the convertible senior notes is considered to be a Level 2 measurement on the fair value hierarchy.

Convertible senior notes, net of debt issuance costs consist of the following (in thousands):

	December 31, 2015			September 30, 2016		
	Principal Amount	Debt Issuance Costs	Net Amount	Principal Amount	Debt Issuance Costs	Net Amount
4.25% convertible senior notes (due 2018)	\$ 100,000	\$ 2,181	\$ 97,819	\$ 99,305	\$ 1,461	\$ 97,844
4.875% convertible senior notes (due 2020)	115,000	3,653	111,347	113,000	2,911	110,089
Total convertible senior notes, net of debt issuance costs	<u>\$ 215,000</u>	<u>\$ 5,834</u>	<u>\$ 209,166</u>	<u>\$ 212,305</u>	<u>\$ 4,372</u>	<u>\$ 207,933</u>

Amortization expense classified as interest expense related to debt issuance costs was \$0.4 million and \$0.4 million for the three months ended September 30, 2015 and 2016, respectively, and \$1.2 million and \$1.5 million for the nine months ended September 30, 2015 and 2016, respectively.

**JAKKS PACIFIC, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**Note 7 — Income Taxes**

The Company's income tax expense of \$1.4 million for the three months ended September 30, 2015 reflects an effective tax rate of 2.9%. The Company's income tax expense of \$1.1 million for the three months ended September 30, 2016 reflects an effective tax rate of 3.4%. The majority of the provision relates to foreign taxes.

The Company's income tax expense of \$3.1 million for the nine months ended September 30, 2015 reflects an effective tax rate of 8.7%. The Company's income tax expense of \$2.2 million for the nine months ended September 30, 2016 reflects an effective tax rate of 19.8%. The majority of the provision relates to foreign taxes.

In November 2015, the FASB issued ASU No. 2015-17, "Balance Sheet Classification of Deferred Taxes," which requires all deferred tax assets and liabilities to be classified as noncurrent on the balance sheet. The guidance in ASU 2015-17 is effective for the fiscal year, and interim periods within that fiscal year, beginning after December 15, 2016, with early adoption permitted. The Company early adopted this standard as of January 1, 2016 and applied the standard retrospectively. As a result of adopting this standard, current deferred tax liabilities of \$2.7 million and non-current deferred tax assets of \$0.4 million were reclassified to net non-current deferred tax liabilities as of December 31, 2015.

**JAKKS PACIFIC, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(Unaudited)

**Note 8 — Earnings Per Share**

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

	Three Months Ended September 30,					
	2015			2016		
	Income	Weighted Average Shares	Per-Share	Income	Weighted Average Shares	Per-Share
Earnings per share – basic						
Net income available to common stockholders	\$ 45,845	18,559	\$ 2.47	\$ 30,612	16,044	\$ 1.91
Effect of dilutive securities:						
Convertible senior notes	1,779	23,369		1,840	23,081	
Unvested performance stock grants	—	409		—	164	
Unvested restricted stock grants	—	225		—	215	
Earnings per share – diluted						
Net income available to common stockholders plus assumed exercises and conversion	\$ 47,624	42,562	\$ 1.12	\$ 32,452	39,504	\$ 0.82
	Nine Months Ended September 30,					
	2015			2016		
	Income	Weighted Average Shares	Per-Share	Income	Weighted Average Shares	Per-Share
Earnings per share – basic						
Net income available to common stockholders	\$ 32,584	18,929	\$ 1.72	\$ 8,828	16,561	\$ 0.53
Effect of dilutive securities:						
Convertible senior notes	5,516	23,369		5,557	23,123	
Unvested performance stock grants	—	284		—	115	
Unvested restricted stock grants	—	155		—	117	
Earnings per share – diluted						
Net income available to common stockholders plus assumed exercises and conversion	\$ 38,100	42,737	\$ 0.89	\$ 14,385	39,916	\$ 0.36

Basic earnings per share is calculated using the weighted average number of common shares outstanding during the period. Diluted earnings per share is calculated using the weighted average number of common shares and common share equivalents outstanding during the period (which consist of warrants, options and convertible debt to the extent they are dilutive). The weighted average number of common shares outstanding excludes shares repurchased pursuant to a prepaid forward share repurchase agreement (See Note 9). Common share equivalents that could potentially dilute basic earnings per share in the future, which were excluded from the computation of diluted earnings per share due to being anti-dilutive, totaled approximately 2,679,155 and 2,407,225 for the three months ended September 30, 2015 and 2016, respectively, and approximately 2,634,393 and 2,227,787 for the nine months ended September 30, 2015 and 2016, respectively.

**JAKKS PACIFIC, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**Note 9 — Common Stock and Preferred Stock**

In June 2014, the Company effectively repurchased 3,112,840 shares of its common stock at an average cost of \$7.71 per share for an aggregate amount of \$24.0 million pursuant to a prepaid forward share repurchase agreement entered into with Merrill Lynch International (“ML”). These repurchased shares are treated as retired for basic and diluted EPS purposes although they remain legally outstanding. The Company reflects the aggregate purchase price as a reduction to stockholders’ equity classified as Treasury Stock. No shares have been delivered to the Company by ML as of September 30, 2016.

In June 2015, the Board of Directors authorized the repurchase of up to an aggregate of \$30.0 million of the Company’s outstanding common stock and/or convertible notes (collectively, “securities”). The Company intends to retire any repurchased securities. As of September 30, 2016, the Company repurchased and retired 3,313,645 shares of its common stock at an aggregate cost of \$26.7 million and also repurchased and retired \$2.0 million principal amount of its 2020 Notes at a cost of \$1.94 million and \$695,000 principal amount of its 2018 Notes at a cost of \$685,887. As of September 30, 2016, the Company had \$0.7 million remaining under its current securities repurchase authorization.

In January 2016, the Company issued an aggregate of 449,120 shares of restricted stock at a value of approximately \$3.6 million to two executive officers, which vest, subject to certain company financial performance criteria and market conditions, over a three year period. In addition, an aggregate of 62,710 shares of restricted stock at an aggregate value of approximately \$0.5 million were issued to its five non-employee directors, which vest in January 2017.

In March 2016, the Company issued an aggregate of 134,058 shares of restricted stock at a value of approximately \$0.9 million to an executive officer, which vest, subject to certain company financial performance criteria and market conditions, over a three year period.

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

**JAKKS PACIFIC, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**Note 10 — Business Combinations**

In July 2012, the Company acquired all of the stock of Maui, Inc. and related entities (collectively, “Maui”). The total initial consideration of \$37.6 million consisted of \$36.2 million in cash and the assumption of liabilities in the amount of \$1.4 million. In addition, the Company agreed to pay an earn-out of up to an aggregate amount of \$18.0 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria. The fair value of the expected earn-out of \$16.0 million was accrued and recorded as goodwill as of the acquisition date. Maui did not achieve the prescribed minimum earn-out targets for each of the three years in the period ended December 31, 2015; therefore, changes of \$6.0 million, \$5.9 million and \$5.6 million in the earn-out liability were credited to other income in the fourth quarter of 2013 and third quarters of 2014 and 2015, respectively. Maui is a leading manufacturer and distributor of spring and summer activity toys and impulse toys, and was included in the Company’s results of operations from the date of acquisition.



JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
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**Note 11 — Joint Ventures**

The Company owns a fifty percent interest in a joint venture (“DreamPlay Toys”) with NantWorks LLC (“NantWorks”). Pursuant to the operating agreement of DreamPlay Toys, the Company paid to NantWorks cash in the amount of \$8.0 million and issued NantWorks a warrant to purchase 1.5 million shares of the Company’s common stock at a value of \$7.0 million in exchange for the exclusive right to utilize NantWorks’ recognition technology platform for toy products. The Company has classified these rights as an intangible asset and is amortizing the asset over the anticipated revenue stream from the exploitation of these rights. Pursuant to the amended Toy Services Agreement (the “TSA”) entered into with NantWorks, the joint venture may develop and produce toys utilizing recognition technologies owned by NantWorks, for which NantWorks is entitled to receive a preferred return based upon net sales of DreamPlay Toys product sales and third-party license fees. In exchange for cash payments in the aggregate amount of \$1.2 million payable to NantWorks over a two-year period, the TSA was extended to September 30, 2018, subject to the achievement of certain financial targets. The accrued preferred return for NantWorks was approximately \$295,457 and nil for the three months ended September 30, 2015 and 2016, respectively, and approximately \$359,452 and nil for the nine months ended September 30, 2015 and 2016, respectively. The Company retains the financial risk of the joint venture and is responsible for the day-to-day operations, including the development, sale and distribution of the toy products, for which it is entitled to receive any remaining profit or is responsible for any losses. The results of operations of the joint venture are consolidated with the Company’s results.

In addition, the Company purchased for \$7.0 million in cash a five percent economic interest in a related entity, DreamPlay, LLC, that will exploit the proprietary recognition technologies in non-toy consumer product categories. NantWorks has the right to repurchase all of the Company’s interest for \$7.0 million. The Company has classified this investment as a long term asset on its balance sheet and is accounting for it using the cost method. As of September 30, 2016 the Company determined that the value of this investment will be realized and that no impairment has occurred.

The Company owns a fifty-one percent interest in a joint venture with China-based Meisheng Culture & Creative Corp., which provides certain JAKKS licensed and non-licensed toys and consumer products to agreed-upon territories of the People’s Republic of China. The joint venture includes a subsidiary in the Shanghai Free Trade Zone that sells, distributes and markets these products. The results of operations of the joint venture are consolidated with the Company’s results. The non-controlling interest’s share of the income for the three months ended September 30, 2015 and of the loss for the nine months ended September 30, 2015 was immaterial. The net loss attributable to the non-controlling interest for the three months ended September 30, 2016 was \$0.1 million and the net income attributable to the non-controlling interest for the nine months ended September 30, 2016 was \$0.2 million.

The Company owns a fifty percent interest in a joint venture (“Pacific Animation Partners”) with the U.S. entertainment subsidiary of a leading Japanese advertising and animation production company. As of December 31, 2015 and September 30, 2016 the net investment in the joint venture was carried at nil. For the three and nine months ended September 30, 2015, the Company recognized \$0.1 million of income for funds received related to operations of the joint venture. For the three and nine months ended September 30, 2016, the Company recognized nil and \$0.7 million, respectively, of income for funds received related to operations of the joint venture. It is not known if any additional income will be generated by Pacific Animation Partners.

For the nine months ended September 30, 2015 and 2016, respectively, the Company recognized \$1.7 million and \$0.2 million of income for funds received related to a former video game joint venture in partial settlement of amounts owed to the Company when the joint venture partner was liquidated pursuant to their 2012 bankruptcy filing. It is not known if any additional funds will be received by the Company.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
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**Note 12 — Goodwill**

The changes to the carrying amount of goodwill as of September 30, 2016 are summarized as follows (in thousands):

	<b>Total</b>
Balance, December 31, 2015	\$ 44,199
Adjustments to goodwill for foreign currency translation	(737)
Balance, September 30, 2016	<u>\$ 43,462</u>

The Company applies a fair value-based impairment test to the carrying value of goodwill and indefinite-lived intangible assets on an annual basis and, if certain events or circumstances indicate that an impairment loss may have been incurred, on an interim basis. The analysis of potential impairment of goodwill requires a two-step process. The first step is the estimation of fair value. If the first step indicates that a potential impairment exists, the second step is performed to measure the amount of impairment, if any. Goodwill impairment exists when the estimated fair value of goodwill is less than its carrying value. No goodwill impairment was determined to have occurred during the nine months ended September 30, 2015 and 2016.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
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**Note 13 — Intangible Assets Other Than Goodwill and Other Assets**

Intangible assets other than goodwill and other assets consist primarily of licenses, product lines, customer relationships and trademarks. Amortized intangible assets are included in intangibles in the accompanying balance sheets. Trademarks are disclosed separately in the accompanying balance sheets. Intangible assets as of December 31, 2015 and September 30, 2016 include the following (in thousands, except for weighted useful lives):

	Weighted Useful Lives (Years)	December 31, 2015			September 30, 2016		
		Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
Amortized Intangible Assets:							
Licenses	5.81	\$ 24,930	\$ (20,436)	\$ 4,494	\$ 20,130	\$ (16,942)	\$ 3,188
Product lines	7.50	50,093	(14,376)	35,717	50,293	(18,993)	31,300
Customer relationships	4.90	3,152	(2,195)	957	3,152	(2,620)	532
Trade names	5.00	3,000	(2,050)	950	3,000	(2,500)	500
Non-compete agreements	5.00	200	(133)	67	200	(167)	33
Total amortized intangible assets		\$ 81,375	\$ (39,190)	\$ 42,185	\$ 76,775	\$ (41,222)	\$ 35,553
Deferred Costs:							
Debt issuance costs	3.07	\$ 1,865	\$ (1,048)	\$ 817	\$ 1,865	\$ (1,463)	\$ 402
Unamortized Intangible Assets:							
Trademarks		\$ 2,308	\$ —	\$ 2,308	\$ 2,308	\$ —	\$ 2,308

Amortization expense related to limited life intangible assets and debt issuance costs, pertaining to the Company's credit facility with Wells Fargo, formally GECC, was \$2.3 million and \$2.4 million for the three months ended September 30, 2015 and 2016, respectively, and \$6.4 million and \$7.2 million for the nine months ended September 30, 2015 and 2016, respectively.

# JAKKS PACIFIC, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

### Note 14 — Comprehensive Income

The table below presents the components of the Company's comprehensive income for the three and nine months ended September 30, 2015 and 2016 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2016	2015	2016
<b>Net Income</b>	\$ 45,864	\$ 30,529	\$ 32,556	\$ 9,001
Other comprehensive income (loss):				
Foreign currency translation adjustment	(1,861)	(2,368)	(1,904)	(6,026)
Comprehensive income	44,003	28,161	30,652	2,975
Less: Net income (loss) attributable to non-controlling interests	19	(83)	(28)	173
Comprehensive income attributable to JAKKS Pacific, Inc.	\$ 43,984	\$ 28,244	\$ 30,680	\$ 2,802

### Note 15 — Litigation

On July 25, 2013, a purported class action lawsuit was filed in the United States District Court for the Central District of California captioned Melot v. JAKKS Pacific, Inc. et al., Case No. CV13-05388 (JAK) against Stephen G. Berman, Joel M. Bennett (collectively the "Individual Defendants"), and the Company (collectively, "Defendants"). On July 30, 2013, a second purported class action lawsuit was filed containing similar allegations against Defendants captioned Dylewicz v. JAKKS Pacific, Inc. et al., Case No. CV13-5487 (OON). The two cases (collectively, the "Class Action") were consolidated on December 2, 2013 under Case No. CV13-05388 JAK (SSx) and lead plaintiff and lead counsel appointed. On January 17, 2014, Plaintiff filed a consolidated class action complaint (the "First Amended Complaint") against Defendants which alleged that the Company violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder by making false and/or misleading statements concerning Company financial projections and performance as part of its public filings and earnings calls from July 17, 2012 through July 17, 2013. Specifically, the First Amended Complaint alleged that the Company's forward looking statements, guidance and other public statements were false and misleading for allegedly failing to disclose (i) certain alleged internal forecasts, (ii) the Company's alleged quarterly practice of laying off and rehiring workers, (iii) the Company's alleged entry into license agreements with guaranteed minimums the Company allegedly knew it was unable to meet; and (iv) allegedly poor performance of the Monsuno and Winx lines of products after their launch. The First Amended Complaint also alleged violations of Section 20(a) of the Exchange Act by Messrs. Berman and Bennett. The First Amended Complaint sought compensatory and other damages in an undisclosed amount as well as attorneys' fees and pre-judgment and post-judgment interest. The Company filed a motion to dismiss the First Amended Complaint on February 17, 2014, and the motion was granted, with leave to replead. A Second Amended Complaint ("SAC") was filed on July 8, 2014 and it set forth similar allegations to those in the First Amended Complaint about discrepancies between internal projections and public forecasts and the other allegations except that the claim with respect to guaranteed minimums that the Company allegedly knew it was unable to meet was eliminated. The Company filed a motion to dismiss the SAC and that motion was granted with leave to replead. A Third Amended Complaint ("TAC") was filed on March 23, 2015 with similar allegations. The Company filed a motion to dismiss the TAC and that motion was argued on July 22, 2015; after argument it was taken on submission and a decision has not been issued. The foregoing is a summary of the pleadings and is subject to the text of the pleadings which are on file with the Court. The Company believes that the claims in the Class Action are without merit, and it intends to defend vigorously against them. However, because the Class Action is in a preliminary stage, the Company cannot assure you as to its outcome, or that an adverse decision in such action would not have a material adverse effect on our business, financial condition or results of operations.

On February 25, 2014, a shareholder derivative action was filed in the Central District of California by Advanced Advisors, G.P. against the Company, nominally, and against Messrs. Berman, Bennett, Miller, Skala, Glick, Ellin, Almagor, Poulsen and Reilly and Ms. Brodsky (Advanced Partners, G.P., v. Berman, et al., CV14-1420 (DSF)). On March 6, 2014, a second shareholder derivative action alleging largely the same claims against the same defendants was filed in the Central District of California by Louisiana Municipal Police Employees Retirement System (Louisiana Municipal Police Employees Retirement System v. Berman et al., CV14-1670 (GHF)). On April 17, 2014, the cases were consolidated under Case No. 2:14-01420-JAK (SSx) (the "Derivative Action"). On April 30, 2014, a consolidated amended complaint ("CAC") was filed, which alleged (i) a claim for contribution under Sections 10(b) and 21(D) of the Securities Exchange Act related to allegations made in the Class Action; (ii) derivative and direct claims for alleged violations of Section 14 of the Exchange Act and Rule 14a-9 promulgated thereunder related to allegedly misleading statements about Mr. Berman's compensation plan in the Company's October 25, 2013 proxy statement; (iii) derivative claims for breaches of fiduciary duty related to the Company's response to an unsolicited indication of interest from Oaktree Capital, stock repurchase, standstill agreement with the Clinton Group, and decisions related to the NantWorks joint venture; and (iv) claims against Messrs. Berman and Bennett for breach of fiduciary duty related to the Class Action. The CAC seeks compensatory damages, pre-judgment and post-judgment interest, and declaratory and equitable relief. The foregoing is a summary of the CAC and is subject to the text of the CAC, which is on file with the Court. A motion to dismiss the CAC or, in the alternative, to stay the CAC, was filed in May 2014. The Court granted the motion in part and denied the motion in part with leave for plaintiff to file an amended pleading. Plaintiff declined to do so. Accordingly, claims i, ii and iv have been dismissed and only the elements of claim iii not relating to the NantWorks joint venture remain. Thus, there are no surviving claims against Messrs. Poulsen, Reilly and Bennett and Ms. Brodsky and the Court approved the parties' stipulation to strike their names as defendants in the CAC. Pleadings in response to the CAC were filed on October 30, 2014, which are on file with the Court. The matter was referred to mediation by the Court and the parties, at the mediation, reached an agreement in principle to resolve the action. Thereafter the parties entered into a memorandum of such agreement, subject to Court approval. A motion was filed seeking preliminary approval of the settlement and establishment of the procedure for final approval of the settlement; preliminary approval of the settlement was granted and a hearing regarding final approval of the proposed settlement and attorneys' fees in connection therewith took place on November 2, 2015. At the hearing, the Judge indicated that he would approve the settlement with a formal order, and that he would take the attorneys' fee issue under advisement.

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



**JAKKS PACIFIC, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
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**Note 16 — Share-Based Payments**

The Company's 2002 *Stock Award and Incentive Plan* (the "Plan"), as amended, provides for the awarding of stock options and restricted stock to employees, officers and non-employee directors. Under the Plan, the Company grants directors, certain officers and other key employees restricted common stock, with vesting contingent upon completion of specified service periods ranging from one to five years. The Company also grants certain officers performance-based awards, with vesting contingent upon the Company's achievement of specified financial goals. The Plan is more fully described in Notes 15 and 17 to the Consolidated Financial Statements in the Company's 2015 Annual Report on Form 10-K.

The following table summarizes the total share-based compensation expense and related tax benefits recognized for the three and nine months ended September 30, 2015 and 2016 (in thousands):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2015</b>	<b>2016</b>	<b>2015</b>	<b>2016</b>
Restricted stock compensation expense	\$ 508	\$ 170	\$ 1,452	\$ 1,254
Tax benefit related to restricted stock compensation	—	—	—	—

No stock options were outstanding as of December 31, 2015 and there has been no stock option activity pursuant to the Plan for the nine months ended September 30, 2016.

Restricted stock award activity pursuant to the Plan for the nine months ended September 30, 2016 is summarized as follows:

	<b>Restricted Stock Awards</b>	
	<b>Number of Shares</b>	<b>Weighted Average Grant Price</b>
Outstanding, December 31, 2015	411,409	\$ 6.61
Awarded	645,884	7.00
Released	(125,246)	7.05
Forfeited	(24,822)	6.32
Outstanding, September 30, 2016	907,225	6.84

As of September 30, 2016, there was \$1.2 million of total unrecognized compensation cost related to non-vested restricted stock awards, which is expected to be recognized over a weighted-average period of 1.01 years.

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

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

### Critical Accounting Policies and Estimates

The accompanying consolidated financial statements and supplementary information were prepared in accordance with accounting principles generally accepted in the United States of America. Significant accounting policies are discussed in Note 2 to the Consolidated Financial Statements set forth in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015. Inherent in the application of many of these accounting policies is the need for management to make estimates and judgments in the determination of certain revenues, expenses, assets and liabilities. As such, materially different financial results can occur as circumstances change and additional information becomes known. The policies with the greatest potential effect on our results of operations and financial position include:

**Allowance for Doubtful Accounts.** Our allowance for doubtful accounts is based upon management's assessment of the business environment, customers' financial condition, historical collection experience, accounts receivable aging, customer disputes and the collectability of specific customer accounts. If there were a deterioration of a major customer's creditworthiness, or actual defaults higher than our historical experience, our estimates of the recoverability of amounts due to us could be overstated, which could have an adverse impact on our operating results. Our allowance for doubtful accounts is also affected by the time at which uncollectible accounts receivable balances are actually written off.

Major customers' accounts are monitored on an ongoing basis; more in-depth reviews are performed based upon changes in a customer's financial condition and/or the level of credit being extended. When a significant event occurs, such as a bankruptcy filing by a specific customer, and on a quarterly basis, the allowance is reviewed for adequacy and the balance or accrual rate is adjusted to reflect current risk prospects.

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

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

Factors we consider important that could trigger an impairment review include the following:

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

Due to the subjective nature of the impairment analysis, significant changes in the assumptions used to develop the estimate could materially affect the conclusion regarding the future cash flows necessary to support the valuation of long-lived assets, including goodwill. The valuation of goodwill involves a high degree of judgment. Based upon the assumptions underlying the valuation, impairment is determined by estimating the fair value of a reporting unit and comparing that value to the reporting unit's book value. If the implied fair value is more than the book value of the reporting unit, an impairment loss is not indicated. If impairment exists, the fair value of the reporting unit is allocated to all of its assets and liabilities excluding goodwill, with the excess amount representing the fair value of goodwill. An impairment loss is measured as the amount by which the book value of the reporting unit's goodwill exceeds the estimated fair value of that goodwill.

Goodwill, Trademarks (net) and Intangible assets amounted to \$81.3 million as of September 30, 2016 and \$88.7 million as of December 31, 2015.

***Reserve for Inventory Obsolescence.*** We value our inventory at the lower of cost or market. Based upon a consideration of quantities on hand, actual and projected sales volume, anticipated product selling prices and product lines planned to be discontinued, slow-moving and obsolete inventory is written down to its net realizable value.

Failure to accurately predict and respond to consumer demand could result in us under-producing popular items or over-producing less popular items. Furthermore, significant changes in demand for our products would impact management's estimates in establishing our inventory provision.

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

***Discrete Items for Income Taxes.*** During the three months ended September 30, 2016, a discrete tax benefit of \$127,000 was recognized for the reversal of a previously recognized tax assessment on the Hong Kong income tax audits for the tax year 2010/2011. During the nine months ended September 30, 2015, we recognized a discrete tax expense of \$606,000 related to the conclusion of the California income tax audits for the tax years 2008 to 2010, an adjustment in the overpayment account for Wisconsin, and a return to provision adjustment for state taxes.

***Income taxes and interest and penalties related to income tax payable.*** We do not file a consolidated return for our foreign subsidiaries. We file federal and state returns and our foreign subsidiaries each file returns as required. Deferred taxes are provided on an asset and liability method, whereby deferred tax assets are recognized as deductible temporary differences and operating loss and tax credit carry-forwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

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

We accrue a tax reserve for additional income taxes, which may become payable in future years as a result of audit adjustments by tax authorities. The reserve is based upon management's assessment of all relevant information and is periodically reviewed and adjusted as circumstances warrant. As of September 30, 2016 and December 31, 2015, our income tax reserves were approximately \$2.3 million and \$2.2 million, respectively. The \$2.3 million balance primarily relates to the potential tax settlement in Hong Kong and adjustments in the area of withholding taxes.



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

## **New Accounting Pronouncements**

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (ASU 2014-09), which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP. In April 2015, the FASB issued for public comment a proposed ASU to defer the effective date of ASU 2014-09 and in July 2015, affirmed its proposal to defer the effective date of the new revenue standard for all entities by one year. The mandatory adoption date of Accounting Standards Codification (“ASC”) ASC 606 is now January 1, 2018. There are two methods of adoption allowed, either: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). We are currently evaluating the impact of our pending adoption of ASU 2014-09 on our consolidated financial statements and have not yet determined the method by which we will adopt the standard in 2018.

In August 2014, the FASB amended the FASB Accounting Standards Codification and amended Subtopic 205-40, “Presentation of Financial Statements — Going Concern.” This amendment prescribes that an entity’s management should evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity’s ability to continue as a going concern within one year after the date that the financial statements are issued. The amendments will become effective for our annual and interim reporting periods beginning January 1, 2017. Upon adoption, we will use this guidance to evaluate going concern.

In July 2015, the FASB issued Accounting Standards Update 2015-11, “Inventory (Topic 330): Simplifying the Measurement of Inventory” (“ASU 2015-11”). ASU 2015-11 requires inventory accounted for under the FIFO or average cost method to be measured using the lower of cost and net realizable value. The amendments are effective prospectively for fiscal years and for interim periods beginning after December 15, 2016. We are currently evaluating the impact of the pending adoption of ASU 2015-11 on our consolidated financial statements.

In February 2016, the FASB issued Accounting Standards Update 2016-02, “Leases” (“ASU 2016-02”). ASU 2016-02 establishes a right-of-use (“ROU”) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. We are currently evaluating the impact of the pending adoption of this new standard on our financial statements.

In March 2016, the FASB issued ASU No. 2016-09, “Improvements to Employee Share-Based Payment Accounting,” (“ASU 2016-09”) which simplifies several aspects of the accounting for share-based payments, including income tax consequences and classification on the statement of cash flows. Under the new standard, all excess tax benefits and tax deficiencies will be recognized as income tax expense or benefit in the income statement as discrete items in the reporting period in which they occur. Additionally, excess tax benefits will be classified as an operating activity on the statement of cash flows. In regard to forfeitures, the entity can make an accounting policy election to either recognize forfeitures as they occur or estimate the number of awards expected to be forfeited. The guidance in ASU 2016-09 is effective for the fiscal year, and interim periods within that fiscal year, beginning after December 15, 2016. We are currently evaluating the impact of the adoption of this standard on our consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. The new guidance is intended to reduce diversity in practice in how transactions are classified in the statement of cash flows. This ASU is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2017. The adoption of this standard is not expected to have a material impact on our financial statements.

In October 2016, the FASB issued ASU 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other than Inventory. The amendments in this ASU reduces the complexity in the accounting standards by allowing the recognition of current and deferred income taxes for an intra-entity asset transfer, other than inventory, when the transfer occurs. Historically, recognition of the income tax consequence was not recognized until the asset was sold to an outside party. This ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted. We are currently evaluating the impact of this ASU on our financial statements.

## Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2016	2015	2016
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	69.0	68.6	69.3	68.3
Gross profit	31.0	31.4	30.7	31.7
Selling, general and administrative expenses	17.7	20.0	24.3	28.1
Income from operations	13.3	11.4	6.4	3.6
Income from joint ventures	—	—	0.3	0.1
Other income	1.6	—	1.0	0.1
Interest income	—	—	—	—
Interest expense	(0.9)	(1.0)	(1.6)	(1.8)
Income before provision for income taxes	14.0	10.4	6.1	2.0
Provision for income taxes	0.4	0.3	0.5	0.4
Net income	13.6	10.1	5.6	1.6
Net income (loss) attributable to non-controlling interests	—	—	—	—
Net income attributable to JAKKS Pacific, Inc.	13.6%	10.1%	5.6%	1.6%

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2016	2015	2016
<b>Net Sales</b>				
U.S. and Canada	\$ 202,568	\$ 188,381	\$ 350,855	\$ 350,320
International	77,701	57,333	137,523	97,454
Halloween	56,758	57,077	93,956	91,803
	337,027	302,791	582,334	539,577
<b>Cost of Sales</b>				
U.S. and Canada	138,949	125,480	244,279	232,740
International	51,559	38,688	89,876	66,242
Halloween	42,190	43,690	69,185	69,679
	232,698	207,858	403,340	368,661
<b>Gross Profit</b>				
U.S. and Canada	63,619	62,901	106,576	117,580
International	26,142	18,645	47,647	31,212
Halloween	14,568	13,387	24,771	22,124
	\$ 104,329	\$ 94,933	\$ 178,994	\$ 170,916

## Comparison of the Three Months Ended September 30, 2015 and 2016

### Net Sales

*U.S. and Canada.* Net sales of our U.S. and Canada segment were \$188.4 million for the three months ended September 30, 2016 compared to \$202.6 million for the prior year period, representing a decrease of \$14.2 million, or 7.0%. The decrease in net sales was primarily due to a decrease in unit sales of various products due to the suspension of shipments to a major U.S. customer and lower than expected unit sales of some movie licensed products.

*International.* Net sales of our International segment were \$57.3 million for the three months ended September 30, 2016 compared to \$77.7 million for the prior year period, representing a decrease of \$20.4 million, or 26.3%. The decrease in net sales was primarily driven by declines in unit sales of various products in the UK and Western Europe, due in part to the reduced buyer power of our customers due to the devaluation of the British Pound, and lower than expected unit sales of movie licensed product.

*Halloween.* Net sales of our Halloween segment were \$57.1 million for the three months ended September 30, 2016 compared to \$56.8 million for the prior year period, representing a modest increase of \$0.3 million, or 0.5%.

### Cost of Sales

*U.S. and Canada.* Cost of sales of our U.S. and Canada segment was \$125.5 million, or 66.6% of related net sales for the three months ended September 30, 2016 compared to \$138.9 million, or 68.6% of related net sales for the prior year period, representing a decrease of \$13.4 million, or 9.6%. The decrease in cost of sales is directly a function of lower overall unit sales, while the decrease as a percentage of net sales, year over year, is due to reduced costing of legacy products and product mix, partially offset by a higher average royalty rate. The increase in royalties is driven by a shift in the product mix to products with relatively higher royalty rates. Depreciation of molds and tools for the segment increased slightly in 2016 due to increased product tooling driven by new product introductions in 2016.

*International.* Cost of sales of our International segment was \$38.7 million, or 67.5% of related net sales for the three months ended September 30, 2016 compared to \$51.6 million, or 66.4% of related net sales for the prior year period, representing a decrease of \$12.9 million, or 25.0%. The decrease in cost of sales is directly a function of lower overall unit sales. The increase as a percentage of net sales, year-over-year, is due to the change in product mix to relatively higher cost product and an increase in the average royalty rate. The increase in royalties is driven by a shift in the product mix to products with relatively higher royalty rates and an increase in royalty rates on shipments made FOB China. Our depreciation of molds and tools for the segment showed a modest increase from 2015 due to increased product tooling driven by new product introductions in 2016.

*Halloween.* Cost of sales of our Halloween segment was \$43.7 million, or 76.5% of related net sales for the three months ended September 30, 2016 compared to \$42.2 million, or 74.3% of related net sales for the prior year period, representing a modest increase of \$1.5 million, or 3.6%. The increase in cost of sales is directly a function of higher overall unit sales. The increase as a percentage of net sales, year-over-year, is due to the shift in product mix to products with a relatively higher product cost.

### Selling, General and Administrative Expenses

Selling, general and administrative expenses were \$60.5 million for the three months ended September 30, 2016 compared to \$59.7 million for the prior year period constituting 20.0% and 17.7% of net sales, respectively. Selling, general and administrative expenses increased by \$0.8 million from the prior year period primarily driven by higher marketing expenses. Product development costs, in support of increased product launches, and general and administrative expenses were relatively flat year-over-year.

## Other Income

We recognized income of \$0.2 million for funds received in the three months ended September 30, 2016, related to the disgorgement of short swing trading profits from a shareholder, net of legal fees. It is not likely that any additional funds will be received by us.

## Interest Expense

Interest expense was \$3.0 million in the three months ended September 30, 2016, as compared to \$3.1 million in the prior period. In the three months ended September 30, 2016, we booked interest expense of \$2.8 million related to our convertible senior notes payable due in 2018 and 2020, and \$0.2 million related to our revolving credit facility. In the three months ended September 30, 2015, we booked interest expense of \$2.7 million related to our convertible senior notes payable due in 2018 and 2020, \$0.4 million related to our revolving credit facility.

## Provision for Income Taxes

Our income tax expense, which includes federal, state and foreign income taxes and discrete items, was \$1.1 million, or an effective tax rate of 3.4%, for the three months ended September 30, 2016. During the comparable period in 2015, our income tax expense was \$1.4 million, or an effective tax rate of 2.9%.

## **Comparison of the Nine Months Ended September 30, 2015 and 2016**

### Net Sales

*U.S. and Canada.* Net sales of our U.S. and Canada segment were \$350.3 million for the nine months ended September 30, 2016 compared to \$350.9 million for the prior year period, representing a slight decrease of \$0.6 million, or 0.2%. The slight decrease in net sales was primarily due to reduction in unit sales of various products due to the suspension of shipments to a major U.S. customer and lower than expected unit sales of some movie licensed products, partially offset by higher unit sales of our Disney Tsum Tsum line of collectibles, Disney Princess and Alice Through the Looking Glass dolls, kids furniture and accessories, and our Big Figs line.

*International.* Net sales of our International segment were \$97.5 million for the nine months ended September 30, 2016 compared to \$137.5 million for the prior year period, representing a decrease of \$40.0 million, or 29.1%. The decrease in net sales was primarily driven by declines in unit sales of various products in the UK and Western Europe due to the reduced buyer power of our customers resulting from the devaluation of the British Pound, and lower than expected unit sales of movie licensed product.

*Halloween.* Net sales of our Halloween segment were \$91.8 million for the nine months ended September 30, 2016 compared to \$94.0 million for the prior year period, representing a decrease of \$2.2 million, or 2.3%. The decrease in net sales was driven by a decrease in unit sales of a variety of products in the first three quarters of 2016.

### Cost of Sales

*U.S. and Canada.* Cost of sales of our U.S. and Canada segment was \$232.7 million, or 66.4% of related net sales for the nine months ended September 30, 2016 compared to \$244.3 million, or 69.6% of related net sales for the prior year period, representing a decrease of \$11.6 million, or 4.7%. The decrease in cost of sales as a percentage of net sales, year over year, is due to reduced costing of legacy products and product mix, partially offset by a higher average royalty rate. The increase in royalties is driven by a shift in the product mix to products with relatively higher royalty rates. Depreciation of molds and tools for the segment increased slightly in 2016 due to increased product tooling driven by new product introductions in 2016.

*International.* Cost of sales of our International segment was \$66.2 million, or 68.0% of related net sales for the nine months ended September 30, 2016 compared to \$89.9 million, or 65.4% of related net sales for the prior year period, representing a decrease of \$23.7 million, or 26.4%. The decrease in cost of sales is directly a function of lower overall unit sales. The increase as a percentage of net sales, year-over-year, is due to the change in product mix to relatively higher cost product and an increase in the average royalty rate. The increase in royalties is driven by a shift in the product mix to products with relatively higher royalty rates and an increase in royalty rates on shipments made FOB China. Our depreciation of molds and tools for the segment showed a modest increase from 2015 due to increased product tooling driven by new product introductions in 2016.

*Halloween.* Cost of sales of our Halloween segment was \$69.7 million, or 75.9% of related net sales for the nine months ended September 30, 2016 compared to \$69.2 million, or 73.6% of related net sales for the prior year period, representing an increase of \$0.5 million, or 0.7%. The increase as a percentage of net sales, year-over-year, is due to a higher average royalty rate.

### Selling, General and Administrative Expenses

Selling, general and administrative expenses were \$151.4 million for the nine months ended September 30, 2016 and \$141.6 million for the prior year period constituting 28.1% and 24.3% of net sales, respectively. Selling, general and administrative expenses increased by \$9.8 million from the prior year period driven by higher marketing expenses (\$5.1 million), higher product development costs in support of increased product launches (\$1.7 million), and increased general and administrative expenses (\$3.0 million).

#### Income from joint ventures

We recognized \$0.7 million for funds received in the nine months ended September 30, 2016, related to Pacific Animation Partners, compared to \$0.1 million received in the nine months ended September 30, 2015. We recognized \$0.2 million of income for funds received in 2016 related to our former video game joint venture in partial settlement of amounts owed to the Company when our joint venture partner was liquidated pursuant to their 2012 bankruptcy filing. In 2015, we received \$1.7 million of such funds. It is not known if any additional funds will be received by us.

#### Other Income

We recognized income of \$0.2 million for funds received in the nine months ended September 30, 2016, related to the disgorgement of short swing trading profits from a shareholder, net of legal fees. It is not likely that any additional funds will be received by us.

#### Interest Income

Interest income for the nine months ended September 30, 2016 was immaterial, compared to \$0.1 million for the nine months ended September 30, 2015.

#### Interest Expense

Interest expense was \$9.5 million in the nine months ended September 30, 2016, as compared to \$9.2 million in the prior period. In the nine months ended September 30, 2016, we booked interest expense of \$8.9 million related to our convertible senior notes payable due in 2018 and 2020, and \$0.6 million related to our revolving credit facility. In the nine months ended September 30, 2015, we booked interest expense of \$8.5 million related to our convertible senior notes payable due in 2018 and 2020, and \$0.7 million related to our revolving credit facility.

#### Provision for Income Taxes

Our income tax expense, which includes federal, state and foreign income taxes and discrete items, was \$2.2 million, or an effective tax rate of 19.8%, for the nine months ended September 30, 2016. During the comparable period in 2015, our income tax expense was \$3.1 million, or an effective tax rate of 8.7%.

## Seasonality and Backlog

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

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

## Liquidity and Capital Resources

As of September 30, 2016, we had working capital of \$247.6 million, compared to \$255.0 million as of December 31, 2015. The decrease was primarily attributable to the repurchase of our common stock and convertible senior notes and higher accounts payable, partially offset by a higher accounts receivable balance.

Operating activities used net cash of \$20.7 million in the nine months ended September 30, 2016, as compared to providing net cash of \$8.9 million in the prior year period. Net cash was primarily impacted by an increase in accounts receivable, partially offset by an increase in accounts payable. Our accounts receivable turnover as measured by days sales for the quarter outstanding in accounts receivable was 83 days as of September 30, 2016, compared to 80 days as of September 30, 2015. Other than open purchase orders issued in the normal course of business, we have no obligations to purchase finished goods from our manufacturers. As of September 30, 2016, we had cash and cash equivalents of \$45.5 million and restricted cash of \$2.7 million.

Our investing activities used net cash of \$17.5 million in the nine months ended September 30, 2016, as compared to using net cash of \$17.2 million in the prior year period, consisting primarily of cash paid for the purchase of molds and tooling used in the manufacture of our products of \$10.5 million. 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 20% payable on net sales of such products. As of September 30, 2016, these agreements required future aggregate minimum guarantees of \$91.0 million, exclusive of \$21.0 million in advances already paid. Of this \$91.0 million future minimum guarantee, \$47.0 million is due over the next twelve months.

Our financing activities used net cash of \$19.7 million in the nine months ended September 30, 2016, as compared to providing net cash of \$17.8 million in the prior year period, primarily consisting of the repurchase of our common stock of \$13.5 million and our 2020 convertible senior notes of \$1.9 million and our 2018 convertible senior notes of \$0.7 million. As of September 30, 2016, we had \$0.7 million remaining under our current securities repurchase authorization approved by the Board of Directors.

In March 2014, we, and our domestic subsidiaries, entered into a secured credit facility with General Electric Capital Corporation (“GECC”). The loan agreement, as amended and assigned to Wells Fargo Bank, N.A. pursuant to its acquisition of GECC (the “WF Loan Agreement”), provides for a \$75.0 million revolving credit facility subject to availability based on prescribed advance rates on certain accounts receivable and inventory. The amounts outstanding under the WF Loan Agreement are payable in full upon maturity of the credit facility on March 27, 2019, and the credit facility is secured by a security interest in favor of the lender covering a substantial amount of the assets of the Company. As of September 30, 2016, the amount of outstanding borrowings was nil and outstanding stand-by letters of credit totaled \$28.2 million; the total excess borrowing capacity was \$24.7 million including \$2.7 million remaining of restricted funds on deposit in the process of being returned to the Company. Such funds became unrestricted when the excess borrowing capacity under the credit line became positive.

In July 2013, we sold an aggregate of \$100.0 million principal amount of 4.25% Convertible Senior Notes due 2018 (the “2018 Notes”). The 2018 Notes, which are senior unsecured obligations, pay interest semi-annually in arrears on August 1 and February 1 of each year at a rate of 4.25% per annum and will mature on August 1, 2018. The initial conversion rate for the 2018 Notes will be 114.3674 shares of our common stock per \$1,000 principal amount of notes, equivalent to an initial conversion price of approximately \$8.74 per share of common stock, subject to adjustment in certain events. Upon conversion, the 2018 Notes will be settled in shares of the Company’s common stock. Holders of the 2018 Notes may require us to repurchase for cash all or some of their notes upon the occurrence of a fundamental change (as defined in the 2018 Notes). We used \$61.0 million of the approximate \$96.0 million in net proceeds from the offering to repurchase at par \$61.0 million principal amount of then outstanding. The remainder of the net proceeds has been used for general corporate purposes. In 2016, the Company repurchased and retired \$0.7 million principal amount of the 2018 Notes.

In June 2014, the Company sold an aggregate of \$115.0 million principal amount of 4.875% Convertible Senior Notes due 2020 (the “2020 Notes”). The 2020 Notes are senior unsecured obligations of the Company paying interest semi-annually in arrears on June 1 and December 1 of each year at a rate of 4.875% per annum and will mature on June 1, 2020. The initial conversion rate for the 2020 Notes is 103.7613 shares of our common stock per \$1,000 principal amount of notes, equivalent to an initial conversion price of approximately \$9.64 per share of common stock, subject to adjustment in certain events. Upon conversion, the 2020 Notes will be settled in shares of the Company’s common stock. Holders of the 2020 Notes may require us to repurchase for cash all or some of their notes upon the occurrence of a fundamental change (as defined in the 2020 Notes). The Company received net proceeds of approximately \$110.4 million from the offering of which \$24.0 million was used to repurchase 3.1 million shares of the Company’s common stock under a prepaid forward purchase contract and \$39.0 million was used to redeem the remaining principal amount of then outstanding notes. The remainder of the net proceeds has been used for general corporate purposes. In 2016, the Company repurchased and retired \$2.0 million principal amount of the 2020 Notes.

We believe that our cash flows from operations, cash and cash equivalents on hand and the availability under our credit facility 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 and due to the seasonality of our business, our operating and investing activities may use cash and, consequently, this growth may require us to obtain additional sources of financing. There can be no assurance that any necessary additional financing will be available to us on commercially reasonable terms, if at all. As of December 31, 2015 and September 30, 2016, we held cash and short term investments held by our foreign subsidiaries of \$91.7 million and \$40.4 million, respectively. Although a significant portion of our cash is held by our foreign subsidiaries off-shore, we intend to finance our long-term liquidity requirements out of net cash provided by operations and net cash and cash equivalents and availability under our credit facility. As of September 30, 2016, we do not have any off-balance sheet arrangements.



### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

#### **Interest Rate Risk**

We issued convertible senior notes in principal amount of \$100.0 million with a fixed interest rate of 4.25% per annum in July 2013 and \$115.0 million principal amount of senior notes with a fixed interest rate of 4.875% per annum in June 2014, of which \$99.3 million and \$113.0 million, respectively, remain outstanding as of September 30, 2016. Accordingly, we are not generally subject to any direct risk of loss arising from changes in interest rates on these issuances.

Our exposure to market risk includes interest rate fluctuations in connection with our revolving credit facility (see Note 5 - Credit Facility in the accompanying notes to the consolidated financial statements for additional information). Borrowings under the credit facility bear interest at a variable rate based on Prime Lending Rate or LIBOR Rate at the option of the Company. For Prime Lending Rate loans, the interest rate is equal to the highest of (i) the Federal Funds Rate plus a margin of 0.50%, (ii) the rate last quoted by The Wall Street Journal as the "Prime Rate," or (iii) the sum of a LIBOR rate plus 1.00%, plus a margin of 2.25%. For LIBOR rate loans, the interest rate is equal to a LIBOR rate plus a margin of 2.25%. Borrowings under the credit facility are therefore subject to risk based upon prevailing market interest rates. Interest rate risk may result from many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors that are beyond our control. During the nine months ended September 30, 2016, the maximum amount borrowed under the facility was \$10.0 million and the average amount of borrowings outstanding was \$1.9 million. As of September 30, 2016, the amount of total borrowings outstanding was nil and outstanding stand-by letters of credit totaled \$28.2 million. If the prevailing market interest rates relative to these borrowings increased by 10%, our interest expense during the period ended September 30, 2016 would have increased by less than \$0.1 million.

#### **Foreign Currency Risk**

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

### **Item 4. Controls and Procedures**

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

## PART II OTHER INFORMATION

### Item 1. Legal Proceedings

On July 25, 2013, a purported class action lawsuit was filed in the United States District Court for the Central District of California captioned *Melot v. JAKKS Pacific, Inc. et al.*, Case No. CV13-05388 (JAK) against Stephen G. Berman, Joel M. Bennett (collectively the “Individual Defendants”), and the Company (collectively, “Defendants”). On July 30, 2013, a second purported class action lawsuit was filed containing similar allegations against Defendants captioned *Dylewicz v. JAKKS Pacific, Inc. et al.*, Case No. CV13-5487 (OON). The two cases (collectively, the “Class Action”) were consolidated on December 2, 2013 under Case No. CV13-05388 JAK (SSx) and lead plaintiff and lead counsel appointed. On January 17, 2014, Plaintiff filed a consolidated class action complaint (the “First Amended Complaint”) against Defendants which alleged that the Company violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder by making false and/or misleading statements concerning Company financial projections and performance as part of its public filings and earnings calls from July 17, 2012 through July 17, 2013. Specifically, the First Amended Complaint alleged that the Company’s forward looking statements, guidance and other public statements were false and misleading for allegedly failing to disclose (i) certain alleged internal forecasts, (ii) the Company’s alleged quarterly practice of laying off and rehiring workers, (iii) the Company’s alleged entry into license agreements with guaranteed minimums the Company allegedly knew it was unable to meet; and (iv) allegedly poor performance of the Monsuno and Winx lines of products after their launch. The First Amended Complaint also alleged violations of Section 20(a) of the Exchange Act by Messrs. Berman and Bennett. The First Amended Complaint sought compensatory and other damages in an undisclosed amount as well as attorneys’ fees and pre-judgment and post-judgment interest. The Company filed a motion to dismiss the First Amended Complaint on February 17, 2014, and the motion was granted, with leave to replead. A Second Amended Complaint (“SAC”) was filed on July 8, 2014 and it set forth similar allegations to those in the First Amended Complaint about discrepancies between internal projections and public forecasts and the other allegations except that the claim with respect to guaranteed minimums that the Company allegedly knew it was unable to meet was eliminated. The Company filed a motion to dismiss the SAC and that motion was granted with leave to replead. A Third Amended Complaint (“TAC”) was filed on March 23, 2015 with similar allegations. The Company filed a motion to dismiss the TAC and that motion was argued on July 22, 2015; after argument it was taken on submission and a decision has not been issued. The foregoing is a summary of the pleadings and is subject to the text of the pleadings which are on file with the Court. We believe that the claims in the Class Action are without merit, and we intend to defend vigorously against them. However, because the Class Action is in a preliminary stage, we cannot assure you as to its outcome, or that an adverse decision in such action would not have a material adverse effect on our business, financial condition or results of operations.

On February 25, 2014, a shareholder derivative action was filed in the Central District of California by Advanced Advisors, G.P. against the Company, nominally, and against Messrs. Berman, Bennett, Miller, Skala, Glick, Ellin, Almagor, Poulsen and Reilly and Ms. Brodsky (Advanced Partners, G.P., v. Berman, et al., CV14-1420 (DSF)). On March 6, 2014, a second shareholder derivative action alleging largely the same claims against the same defendants was filed in the Central District of California by Louisiana Municipal Police Employees Retirement System (Louisiana Municipal Police Employees Retirement System v. Berman et al., CV14-1670 (GHF)). On April 17, 2014, the cases were consolidated under Case No. 2:14-01420-JAK (SSx) (the “Derivative Action”). On April 30, 2014, a consolidated amended complaint (“CAC”) was filed, which alleged (i) a claim for contribution under Sections 10(b) and 21(D) of the Securities Exchange Act related to allegations made in the Class Action; (ii) derivative and direct claims for alleged violations of Section 14 of the Exchange Act and Rule 14a-9 promulgated thereunder related to allegedly misleading statements about Mr. Berman’s compensation plan in the Company’s October 25, 2013 proxy statement; (iii) derivative claims for breaches of fiduciary duty related to the Company’s response to an unsolicited indication of interest from Oaktree Capital, stock repurchase, standstill agreement with the Clinton Group, and decisions related to the NantWorks joint venture; and (iv) claims against Messrs. Berman and Bennett for breach of fiduciary duty related to the Class Action. The CAC seeks compensatory damages, pre-judgment and post-judgment interest, and declaratory and equitable relief. The foregoing is a summary of the CAC and is subject to the text of the CAC, which is on file with the Court. A motion to dismiss the CAC or, in the alternative, to stay the CAC, was filed in May 2014. The Court granted the motion in part and denied the motion in part with leave for plaintiff to file an amended pleading. Plaintiff declined to do so. Accordingly, claims i, ii and iv have been dismissed and only the elements of claim iii not relating to the NantWorks joint venture remain. Thus, there are no surviving claims against Messrs. Poulsen, Reilly and Bennett and Ms. Brodsky and the Court approved the parties’ stipulation to strike their names as defendants in the CAC. Pleadings in response to the CAC were filed on October 30, 2014, which are on file with the Court. The matter was referred to mediation by the Court and the parties, at the mediation, reached an agreement in principle to resolve the action. Thereafter the parties entered into a memorandum of such agreement, subject to Court approval. A motion was filed seeking preliminary approval of the settlement and establishment of the procedure for final approval of the settlement; preliminary approval of the settlement was granted and a hearing regarding final approval of the proposed settlement and attorneys’ fees in connection therewith took place on November 2, 2015. At the hearing, the Judge indicated that he would approve the settlement with a formal order, and that he would take the attorneys’ fee issue under advisement.

We are a party to, and certain of our property is the subject of, various pending claims and legal proceedings that routinely arise in the ordinary course of our business, but we do not believe that any of these claims or proceedings will have a material effect on our business, financial condition or results of operations.

## Item 1A. Risk Factors

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

***Our inability to redesign, restyle and extend our existing core products and product lines as consumer preferences evolve, and to develop, introduce and gain customer acceptance of new products and product lines, may materially and adversely impact our business, financial condition and results of operations.***

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

- *age compression: the phenomenon of children outgrowing toys at younger ages, particularly in favor of interactive and high technology products;*
- *increasing use of technology;*
- *shorter life cycles for individual products; and*
- *higher consumer expectations for product quality, functionality and value.*

We cannot assure you that:

- *our current products will continue to be popular with consumers;*
- *the product lines or products that we introduce will achieve any significant degree of market acceptance;*
- *the life cycles of our products will be sufficient to permit us to recover licensing, design, manufacturing, marketing and other costs associated with those products; or*
- *our inclusion of new technology will result in higher sales or increased profits.*

Our failure to achieve any or all of the foregoing benchmarks may adversely affect our business, financial condition and results of operations.

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

The success of many of our character-related and theme-related products depends upon the popularity of characters in movies, television programs, auto racing events and other media. We cannot assure you that:

- *media associated with our character-related and theme-related product lines will be released at the times we expect or will be successful;*
- *the success of media associated with our existing character-related and theme-related product lines will result in substantial promotional value to our products;*
- *we will be successful in renewing licenses upon expiration on terms that are favorable to us; or*
- *we will be successful in obtaining licenses to produce new character-related and theme-related products in the future.*

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

***There are risks associated with our license agreements.***

- *Our current licenses require us to pay minimum royalties*

Sales of products under trademarks or trade or brand names licensed from others account for substantially all of our net sales. Product licenses allow us to capitalize on characters, designs, concepts and inventions owned by others or developed by toy inventors and designers. Our license agreements generally require us to make specified minimum royalty payments, even if we fail to sell a sufficient number of units to cover these amounts. In addition, under certain of our license agreements, if we fail to achieve certain prescribed sales targets, we may be unable to retain or renew these licenses.

- *Some of our licenses are restricted as to use*

Under the majority of our license agreements, the licensors have the right to review and approve our use of their licensed products, designs or materials before we may make any sales. If a licensor refuses to permit our use of any licensed property in the way we propose, or if their review process is delayed, our development or sale of new products could be impeded.

- *New licenses are difficult and expensive to obtain*

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

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

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

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

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

- *greater financial resources;*
- *larger sales, marketing and product development departments;*
- *stronger name recognition;*
- *longer operating histories; and*
- *greater economies of scale.*

In addition, the toy industry has no significant barriers to entry. Competition is based primarily upon the ability to design and develop new toys, procure licenses for popular characters and trademarks, and successfully market products. Many of our competitors offer similar products or alternatives to our products. Our competitors have obtained and are likely to continue to obtain licenses that overlap our licenses with respect to products, geographic areas and markets. We cannot assure you that we will be able to obtain adequate shelf space in retail stores to support our existing products, expand our products and product lines or continue to compete effectively against current and future competitors.

***We may not be able to sustain or manage our product line growth, which may prevent us from increasing our net revenues.***

Historically, we have experienced growth in our product lines through acquisitions of businesses, products and licenses. This growth in product lines has contributed significantly to our total revenues over the last few years. For example, revenues associated with companies we acquired since 2011 were approximately \$64.0 million and \$53.5 million for the year ended December 31, 2015 and the nine months ended September 30, 2016, respectively, representing 8.6% and 9.9% of our total revenues for those periods. As a result, comparing our period-to-period operating results may not be meaningful and results of operations from prior periods may not be indicative of future results. We cannot assure you that we will continue to experience growth in, or maintain our present level of, net sales.

Our growth strategy calls for us to continuously develop and diversify our toy business by acquiring other companies, entering into additional license agreements, refining our product lines and expanding into international markets, which will place additional demands on our management, operational capacity and financial resources and systems. The increased demand on management may necessitate our recruitment and retention of qualified management personnel. We cannot assure you that we will be able to recruit and retain qualified personnel or expand and manage our operations effectively and profitably. To effectively manage future growth, we must continue to expand our operational, financial and management information systems and train, motivate and manage our work force. There can be no assurance that our operational, financial and management information systems will be adequate to support our future operations. Failure to expand our operational, financial and management information systems or to train, motivate or manage employees could have a material adverse effect on our business, financial condition and results of operations.

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

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

Our growth strategy depends, in part, upon our ability to acquire companies and new product lines. Future acquisitions, if any, may succeed only if we can effectively assess characteristics of potential target companies and product lines, such as:

- *attractiveness of products;*
- *suitability of distribution channels;*
- *management ability;*
- *financial condition and results of operations; and*
- *the degree to which acquired operations can be integrated with our operations.*

We cannot assure you that we can identify attractive acquisition candidates or negotiate acceptable acquisition terms, and our failure to do so may adversely affect our results of operations and our ability to sustain growth. Our acquisition strategy involves a number of risks, each of which could adversely affect our operating results, including:

- *difficulties in integrating acquired businesses or product lines, assimilating new facilities and personnel and harmonizing diverse business strategies and methods of operation;*
- *diversion of management attention from operation of our existing business;*
- *loss of key personnel from acquired companies;*
- *failure of an acquired business to achieve projected financial results; and*
- *limited capital to finance acquisitions.*

***A limited number of customers account for a large portion of our net sales, so that if one or more of our major customers were to experience difficulties in fulfilling their obligations to us, cease doing business with us, significantly reduce the amount of their purchases from us or return substantial amounts of our products, it could have a material adverse effect on our business, financial condition and results of operations.***

Our three largest customers accounted for 44.4% and 47.2% of our net sales for the year ended December 31, 2015 and the nine months ended September 30, 2016, respectively. Except for outstanding purchase orders for specific products, we do not have written contracts with or commitments from any of our customers and pursuant to the terms of certain of our vendor agreements, even some purchase orders may be cancelled without penalty up until delivery. A substantial reduction in or termination of orders from any of our largest customers could adversely affect our business, financial condition and results of operations. In addition, pressure by large customers seeking price reductions, financial incentives, changes in other terms of sale, or for us to bear the risks and the cost of carrying inventory could also adversely affect our business, financial condition and results of operations. If one or more of our major customers were to experience difficulties in fulfilling their obligations to us, cease doing business with us, significantly reduce the amount of their purchases from us or return substantial amounts of our products, it could have a material adverse effect on our business, financial condition and results of operations. In addition, the bankruptcy or other lack of success of one or more of our significant retailers could negatively impact our revenues and bad debt expense.

***We depend upon our Chief Executive Officer and any loss or interruption of his services could adversely affect our business, financial condition and results of operations.***

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

***We depend upon third-party manufacturers, and if our relationship with any of them is harmed or if they independently encounter difficulties in their manufacturing processes, we could experience product defects, production delays, cost overruns or the inability to fulfill orders on a timely basis, any of which could adversely affect our business, financial condition and results of operations.***

We depend upon many third-party manufacturers who develop, provide and use the tools, dies and molds that we generally own to manufacture our products. However, we have limited control over the manufacturing processes themselves. As a result, any difficulties encountered by the third-party manufacturers that result in product defects, production delays, cost overruns or the inability to fulfill orders on a timely basis could adversely affect our business, financial condition and results of operations. Product defects could lead to recalls and personal injury claims which could be costly and harmful to our business reputation.

We do not have long-term contracts with our third-party manufacturers. Although we believe we could secure other third-party manufacturers to produce our products, our operations would be adversely affected if we lost our relationship with any of our current suppliers or if our current suppliers' operations or sea or air transportation with our overseas manufacturers were disrupted or terminated even for a relatively short period of time. Our tools, dies and molds are located at the facilities of our third-party manufacturers.

Although we do not purchase the raw materials used to manufacture our products, we are potentially subject to variations in the prices we pay our third-party manufacturers for products, depending upon what they pay for their raw materials.

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

We sell products and operate facilities in numerous countries outside the United States. For the year ended December 31, 2015 and nine months ended September 30, 2016, sales to our international customers comprised approximately 27.3% and 22.9%, respectively, of our net sales. We expect our sales to international customers to account for a greater portion of our revenues in future fiscal periods. Additionally, we utilize third-party manufacturers, located principally in China, and are subject to the risks normally associated with international operations, including:

- *currency conversion risks and currency fluctuations;*
- *limitations, including taxes, on the repatriation of earnings;*
- *political instability, civil unrest and economic instability;*
- *greater difficulty enforcing intellectual property rights and weaker laws protecting such rights;*
- *complications in complying with laws in varying jurisdictions and changes in governmental policies;*
- *greater difficulty and expenses associated with recovering from natural disasters, such as earthquakes, hurricanes and floods;*
- *transportation delays and interruptions;*
- *the potential imposition of tariffs; and*
- *the pricing of intercompany transactions may be challenged by taxing authorities in both Hong Kong and the United States, with potential increases in income taxes.*

Our reliance upon external sources of manufacturing can be shifted, over a period of time, to alternative sources of supply, should such changes be necessary. However, if we were prevented from obtaining products or components for a material portion of our product line due to medical, political, labor or other factors beyond our control, our operations would be disrupted while alternative sources of products were secured. Also, the imposition of trade sanctions by the United States against a class of products imported by us from, or the loss of “normal trade relations” status by, China could significantly increase our cost of products imported from that nation. Because of the importance of international sales and international sourcing of manufacturing to our business, our financial condition and results of operations could be significantly and adversely affected if any of the risks described above were to occur.

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

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

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

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

***We depend upon our proprietary rights, and our inability to safeguard and maintain the same, or claims of third parties that we have violated their intellectual property rights, could have a material adverse effect on our business, financial condition and results of operations.***

We rely upon trademark, copyright and trade secret protection, nondisclosure agreements and licensing arrangements to establish, protect and enforce our proprietary rights in our products. The laws of certain foreign countries may not protect intellectual property rights to the same extent or in the same manner as the laws of the United States. We cannot assure you that we or our licensors will be able to successfully safeguard and maintain our proprietary rights. Further, certain parties have commenced legal proceedings or made claims against us based upon our alleged patent infringement, misappropriation of trade secrets or other violations of their intellectual property rights. We cannot assure you that other parties will not assert intellectual property claims against us in the future. These claims could divert our attention from operating our business or result in unanticipated legal and other costs, which could adversely affect our business, financial condition and results of operations.

***Market conditions and other third-party conduct could negatively impact our margins and implementation of other business initiatives.***

Economic conditions, such as rising fuel prices, level of consumer debt, increased competition and decreased consumer confidence, may adversely impact our margins. Such a weakened economic and business climate could create uncertainty and adversely affect our sales and profitability. Other conditions, such as the unavailability of electronics components, may impede our ability to manufacture, source and ship new and continuing products on a timely basis. Significant and sustained increases in the price of oil could adversely impact the cost of the raw materials used in the manufacture of our products, such as plastic.

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

In June 2014, the Company sold an aggregate of \$115.0 million principal amount of 4.875% Convertible Senior Notes due on June 1, 2020 (the “2020 Notes”) of which \$113.0 million remain outstanding. Holders of the 2020 Notes may require us to repurchase for cash all or some of their notes upon the occurrence of a fundamental change (as defined in the 2020 Notes). Upon conversion, the 2020 Notes will be settled in shares of the Company’s common stock. In July 2013, the Company sold an aggregate of \$100.0 million principal amount of 4.25% Convertible Senior Notes due on August 1, 2018 (the “2018 Notes”) of which \$99.3 million remain outstanding. Holders of the 2018 Notes may require us to repurchase for cash all or some of their notes upon the occurrence of a fundamental change (as defined in the 2018 Notes). Upon conversion, the 2018 Notes will be settled in shares of the Company’s common stock. Restrictions on borrowings under or loss of the credit facility could have a material adverse effect on our financial condition including an adverse impact on our ability to pay the 2018 Notes and 2020 Notes when due.

***Restrictions under or the loss of availability under our credit facility could adversely impact our financial condition and our ability to pay our convertible notes when due.***

In March 2014, we obtained a \$75.0 million revolving line of credit. Any amounts borrowed under the revolving credit line are our senior secured obligations. All outstanding borrowings under the revolving credit line are accelerated and become immediately due and payable (and the revolving credit line terminates) in the event of a default which includes, among other things, failure to comply with financial ratio covenants or breach of representations contained in the credit line documents, defaults under other loans or obligations, involvement in bankruptcy proceedings, an occurrence of a change of control or an event constituting a material adverse effect on us (as such terms are defined in the credit line documents). We are also subject to negative covenants which, during the life of the credit line, prohibit and/or limit us from, among other things, incurring certain types of other debt, acquiring other companies, making certain expenditures or investments, changing the character of our business, and certain changes to our executive officers.



***We have a full valuation allowance on the entire balance of deferred taxes on our books since their future realization is uncertain.***

Deferred tax assets are realized by prior and future taxable income of appropriate character. Current accounting standards require that a valuation allowance be recorded if it is not likely that sufficient taxable income of appropriate character will be generated to realize the deferred tax assets. We currently believe that based on the available information, it is more likely than not that our deferred tax assets will not be realized, and accordingly we have recorded a valuation allowance against our US federal and state deferred tax assets. Our net operating losses and tax credit carry-forwards can expire if unused, and their utilization could be substantially limited in the event of an “ownership change” as defined in Section 382 of the Internal Revenue Code of 1986, as amended, or the Internal Revenue Code.

***Our inability to monetize recognition technology in non-toy segments could adversely affect our financial condition and results of operations.***

In September 2012, we invested \$7.0 million in cash in exchange for a five percent economic interest in DreamPlay, LLC which is expected to exploit recognition technologies in non-toy consumer product categories. In the event monetization is not viable, potential impairment of the investment could occur resulting in a non-cash charge to income of up to \$7.0 million.

***An adverse decision in litigation in which we have been named as a defendant could have a material adverse effect on our financial condition and results of operations.***

We are defendants in a class action described herein and under “Legal Proceedings” in our periodic reports filed pursuant to the Securities Exchange Act of 1934 (see “Legal Proceedings”). No assurances can be given that the results of these litigation matters will be favorable to us or that an adverse decision in such litigation would not have a material adverse impact on our financial condition and results of operations.

\* \* \* \* \*

The factors listed above are not exhaustive. Other sections of this Quarterly Report on Form 10-Q include additional factors that could materially and adversely impact JAKKS’s business, financial condition and results of operations. Moreover, JAKKS operates in a very competitive and rapidly changing environment. New factors emerge from time to time, and it is not possible for management to predict the impact of all of these factors on JAKKS’s business, financial condition or results of operations, or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds****Issuer Purchases of Equity Securities**

<b>Period</b>	<b>(a) Total number of shares purchased</b>	<b>(b) Average price paid per share</b>	<b>(c) Total number of shares purchased as part of publicly announced plans or programs</b>	<b>(d) Maximum dollar value of shares that may yet be purchased under the plans or programs</b>
July 1-31, 2016	102,751	\$ 8.52	102,751	\$ 1,301,148
August 1-31, 2016	30,000	9.23	30,000	1,024,182
September 1-30, 2016	40,000	8.72	40,000	675,410
Total	<u>172,751</u>	8.69	<u>172,751</u>	

In June 2015, the Board of Directors authorized a stock repurchase program, under which the Company could repurchase up to \$30.0 million of the Company's common stock and/or convertible senior notes payable from time to time. As of September 30, 2016, the Company had repurchased and retired 3,313,645 shares of its common stock at a total cost of \$26.7 million; \$2.0 million face amount of its 2020 Notes at a cost of \$1,940,000; and \$695,000 face amount of its 2018 Notes at a cost of \$685,887.

**Item 6. Exhibits**

<b>Number</b>	<b>Description</b>
3.1	Amended and Restated Certificate of Incorporation of the Company (1)
3.2	Amended and Restated By-Laws of the Company (2)
4.1	Indenture dated July 24, 2013 by and between the Registrant and Wells Fargo Bank, N.A (3)
4.2	Form of 4.25% Senior Convertible Note (3)
4.3	Credit Agreement dated as of March 27, 2014 by and among Registrant and its US wholly-owned subsidiaries and General Electric Capital Corporation (4)
4.4	Revolving Loan Note dated March 27, 2014 by Registrant and its US wholly-owned subsidiaries in favor of General Electric Capital Corporation (4)
4.5	Indenture dated June 9, 2014 by and between the Registrant and Wells Fargo Bank, N.A (5)
4.6	Form of 4.875% Senior Convertible Note (5)
4.7	Fourth Amendment to Credit Agreement dated as of June 5, 2015 among Registrant and its US wholly-owned subsidiaries and General Electric Capital Corporation (6)
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer (7)
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer (7)
32.1	Section 1350 Certification of Chief Executive Officer (7)
32.2	Section 1350 Certification of Chief Financial Officer (7)
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

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- (1) Filed previously as Appendix 2 to the Company's Schedule 14A Proxy Statement filed August 23, 2002 and incorporated herein by reference.
- (2) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed October 21, 2011 and incorporated herein by reference.
- (3) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed July 24, 2013 and incorporated herein by reference.
- (4) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed April 2, 2014 and incorporated herein by reference.
- (5) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed June 9, 2014 and incorporated herein by reference.
- (6) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed June 16, 2015 and incorporated herein by reference.
- (7) Filed herewith.
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## SIGNATURES

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

JAKKS PACIFIC, INC.

Date: November 9, 2016

By: /s/ JOEL M. BENNETT  
Joel M. Bennett  
Executive Vice President and Chief Financial Officer  
(Duly Authorized Officer and Principal Financial  
Officer)

**Item 6. Exhibits**

<b>Number</b>	<b>Description</b>
3.1	Amended and Restated Certificate of Incorporation of the Company (1)
3.2	Amended and Restated By-Laws of the Company (2)
4.1	Indenture dated July 24, 2013 by and between the Registrant and Wells Fargo Bank, N.A (3)
4.2	Form of 4.25% Senior Convertible Note (3)
4.3	Credit Agreement dated as of March 27, 2014 by and among Registrant and its US wholly-owned subsidiaries and General Electric Capital Corporation (4)
4.4	Revolving Loan Note dated March 27, 2014 by Registrant and its US wholly-owned subsidiaries in favor of General Electric Capital Corporation (4)
4.5	Indenture dated June 9, 2014 by and between the Registrant and Wells Fargo Bank, N.A (5)
4.6	Form of 4.875% Senior Convertible Note (5)
4.7	Fourth Amendment to Credit Agreement dated as of June 5, 2015 among Registrant and its US wholly-owned subsidiaries and General Electric Capital Corporation (6)
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer (7)
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer (7)
32.1	Section 1350 Certification of Chief Executive Officer (7)
32.2	Section 1350 Certification of Chief Financial Officer (7)
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

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- (1) Filed previously as Appendix 2 to the Company's Schedule 14A Proxy Statement filed August 23, 2002 and incorporated herein by reference.
- (2) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed October 21, 2011 and incorporated herein by reference.
- (3) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed July 24, 2013 and incorporated herein by reference.
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- (6) Filed previously as an exhibit to the Company's Current Report on Form 8-K filed June 16, 2015 and incorporated herein by reference.
- (7) Filed herewith.
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## CERTIFICATIONS

I, Stephen G. Berman, Chief Executive Officer, certify that:

I have reviewed this quarterly report on Form 10-Q of JAKKS Pacific, Inc. ("Company");

Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this quarterly report;

The Company's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Company and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

c) evaluated the effectiveness of the Company's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and

d) disclosed in this quarterly report any change in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter (the Company's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting; and

The Company's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Company's auditors and the Audit Committee of the Company's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Company's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal control over financial reporting.

By: /s/ Stephen G. Berman  
Stephen G. Berman  
Chief Executive Officer

Date: November 9, 2016

# CERTIFICATIONS

I, Joel M. Bennett, Chief Financial Officer, certify that:

I have reviewed this quarterly report on Form 10-Q of JAKKS Pacific, Inc. ("Company");

Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this quarterly report;

The Company's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Company and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

c) evaluated the effectiveness of the Company's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and

d) disclosed in this quarterly report any change in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter (the Company's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting; and

The Company's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Company's auditors and the Audit Committee of the Company's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Company's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal control over financial reporting.

By: /s/ Joel M. Bennett  
 Joel M. Bennett  
 Chief Financial Officer

Date: November 9, 2016

Written Statement of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350

Pursuant to 18 U.S.C. Section 1350, the undersigned officer of JAKKS Pacific, Inc. ("Registrant") hereby certifies that the Registrant's Quarterly Report on Form 10-Q for the three months ended September 30, 2016 (the "Report") fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934 and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ Stephen G. Berman

Stephen G. Berman  
*Chief Executive Officer*

Date: November 9, 2016



Written Statement of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

Pursuant to 18 U.S.C. Section 1350, the undersigned officer of JAKKS Pacific, Inc. ("Registrant") hereby certifies that the Registrant's Quarterly Report on Form 10-Q for the three months ended September 30, 2016 (the "Report") fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934 and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ Joel M. Bennett

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Joel M. Bennett  
*Chief Financial Officer*

Date: November 9, 2016

