

# *Imagine*



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# Our Brands





## Our Licenses



AMERICAN  
KENNEL CLUB™



Barbie®



BLACK & DECKER  
JUNIOR

BRatz



CareBears™



The Cheetah  
Girls

DEAL OR NO DEAL

Dirt  
Devil®  
JUNIOR

Disney



HANNAH  
MONTANA

namco™

NICKELODEON

Pokémon

ROCKY

SCOOPY-DOO!

123  
SESAME STREET

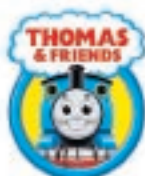
SHREK

Snoop Dogg



MARVEL  
SPIDER-MAN

STAR  
WARS



THE OFFICIAL SONG BOOK  
trolls



# *Imagine: Sharing the Vision*

What began as a big idea from two imaginative and ambitious men blossomed into JAKKS Pacific®, an unwavering ambassador to America's greatest brands. Today, our diverse portfolio features dozens of known licenses and more than 3,000 toys and consumer products, and we employ more than 700 people around the globe. One thing remains the same – our vision, imagination and drive have brought us here today, and we are just getting started!



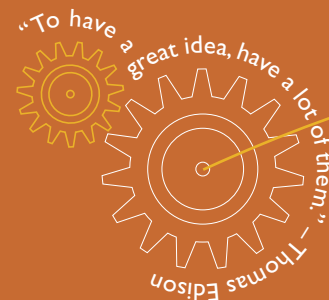
2006 Annual Report

[www.jakksacific.com](http://www.jakksacific.com)

## *Take these 3-D glasses!*

Some of the illustrations in this book are 3-D! Whenever you see this icon in the upper-right corner of the page, put them on!





## *The Big Picture*

**OUR BUSINESS APPROACH.** JAKKS applies innovation and imagination to its products AND to implement its business strategy. We start with a diverse product portfolio — classic toys such as action figures, vehicles, dress-up outfits, art activities, dolls and kites, alongside toys and other consumer products with cutting-edge technology.

We align ourselves with industry leaders and focus heavily on top licenses and evergreen brands. We then apply creative strategies to bring the most innovative products to market.

We seek strategic acquisitions that will add a meaningful and profitable presence to our business. Recent accretive acquisitions include Play Along®, Creative Designs International™ and Pet Pal,™ now our JAKKS Pets division.

JAKKS has customers in virtually every sales channel in the U.S., from mass retailers and club stores to drugstores and pet shops, along with a growing international presence. Today, children in more than 60 different countries, with many different cultures and languages, play with JAKKS' products.

Our approach has resulted in a strong financial performance since inception. JAKKS remains profitable year after year.







"Our success has really been based on partnerships from the very beginning." – Bill Gates

## *What a Character*

**LICENSING.** Whether it's little boys collecting and battling to become a Pokémon® master or little girls pretending they are Belle™ or Ariel™ in our Disney Princess™ dresses, our licensed toys bring children into a special world where they can let their imaginations run free.

JAKKS has had tremendous success with breathing new life into classic brands and creating new directions for properties, sometimes in ways their licensors had not even dreamed of. We believe licensing is one of our core strengths and our senior team was recognized in 2006 with *Variety Magazine's* Licensing Industry Excellence Award.

We partner with such giants as Disney®, Sony®, MGM®, 4Kids®, Marvel®, Warner Bros.®, Nickelodeon®, and more, holding licenses for many of today's top entertainment, children's and consumer brands, including Pokémon, Cabbage Patch Kids®, Care Bears®, Doodle Bear®, Shrek®, Spider-Man®, Barney®, Dora the Explorer®, Pac-Man®, Arm & Hammer® and Black & Decker®. Our peers also trust us to create products based on their brands, including MGA Entertainment's *Bratz*®, Hasbro's *Littlest Pet Shop*® and Mattel's *Barbie*® for various product categories.







"Everything you  
can imagine  
is real."  
— Pablo Picasso

## *The Magic Touch*

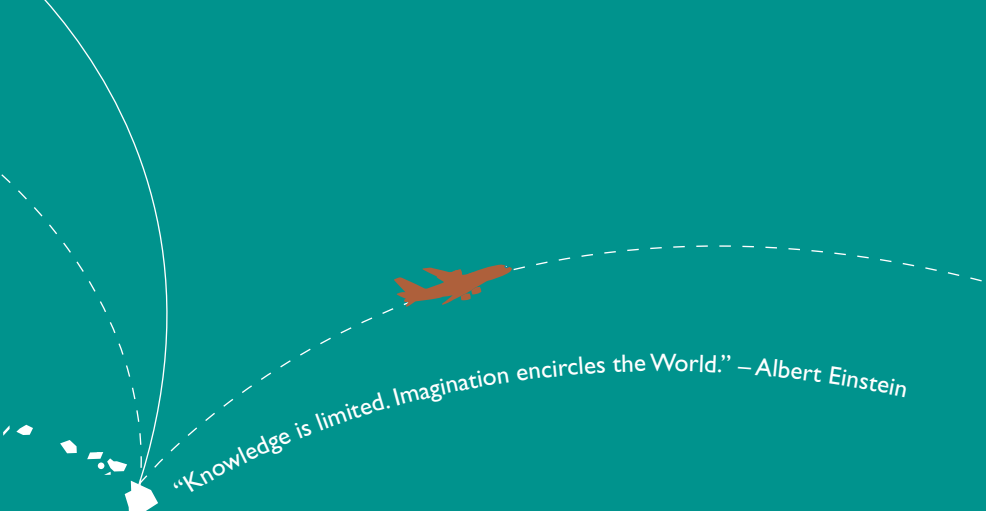
**PRODUCT DESIGN.** JAKKS has amassed a gifted team of designers, engineers, marketers and others to develop and maximize opportunities for our portfolio. We add simple innovation and strive to make our products appealing for 21st century children and all other consumers.

We created a whole new category for our industry with the simplistic yet innovative Plug It In & Play TV Games™ controllers platform in 2002 and expanded the technology into multiple product lines over the years. In 2007, we are launching a plug and play bionic eye called EyeClops™, which magnifies items up to 200 times their original size.

Our XPV Xtreme Performance Vehicle® toy received industry accolades for its ground-breaking performance and design in 2006. We created a hobby-grade RC vehicle for the mass market that retailed for well under \$100. In 2007, JAKKS is launching a whole arsenal of XPV®-branded RC vehicles to expand on the outstanding features of the original product.







"Knowledge is limited. Imagination encircles the World." – Albert Einstein

## *Expanding Our Horizons*

### **DOMESTIC & INTERNATIONAL EXPANSION.** JAKKS

distributes its diverse product portfolio to retailers across many channels both in the U.S. and to more than 60 countries around the world. Mass retail giants, including Wal-Mart, Target and Toys "R" Us, accounted for 58.7% of sales in 2006, with other channels growing steadily, including pet, drug, office and club store chains, on-line, clothing, novelty, automotive, convenience, department and supermarket channels.

Foreign markets offer us significant growth opportunities. In 2006, our international sales were approximately \$99.1 million, or 12.9% of total net sales. We will continue to expand our global reach by capitalizing on our experience and relationships with foreign distributors and retailers.

Our combination of FOB China and domestic shipping offers flexibility and profitability to our retail partners, and continuously refreshed and exclusive product assortments drive traffic to the stores. Our retail partners have recognized JAKKS as outstanding vendor partners for multiple years, including Wal-Mart's Vendor of the Year in 2004 and 2005, Target's Partner of the Year in 2005 and 2006, and Toys "R" Us' Vendor of the Year for the seventh time in Spring 2007.



"The only limit to  
your impact



is your  
imagination & commitment"

– Anthony Robbins

## *Dreaming the Dream*

**NEW DIRECTIONS.** Our dream is to make JAKKS Pacific a household name, with consumers using multiple JAKKS products as part of their lives. To this end, JAKKS actively seeks out new customers and unique new products to expand our portfolio. This results in increased shelf space at retail and opens windows of opportunity that might otherwise be unavailable.

Our Pet Pal pet products acquisition and subsequent expansion into oral care treats for dogs is another great example of thinking outside our toy box. Our White Bites™ treats help in the war against dog breath, giving consumers an important tool to combat their dog's poor oral hygiene. Plus, now JAKKS has a presence in a large fragmented category at mass and pet supply retailers nationwide, which translates into more opportunity for us.





# Boys Action Toys

To make and keep an action figure line fresh in the market, JAKKS couples imagination with an intimate knowledge of what makes both avid and budding collectors tick. In 2006, our WWE® action figure line experienced its third consecutive year of double-digit growth and was a top-five action figure brand at retail, as well as a big contributor to overall sales. For 2007, we again will expand the line with even more fun features and new WWE role-play items that allow kids to become their favorite Superstar wrestler.

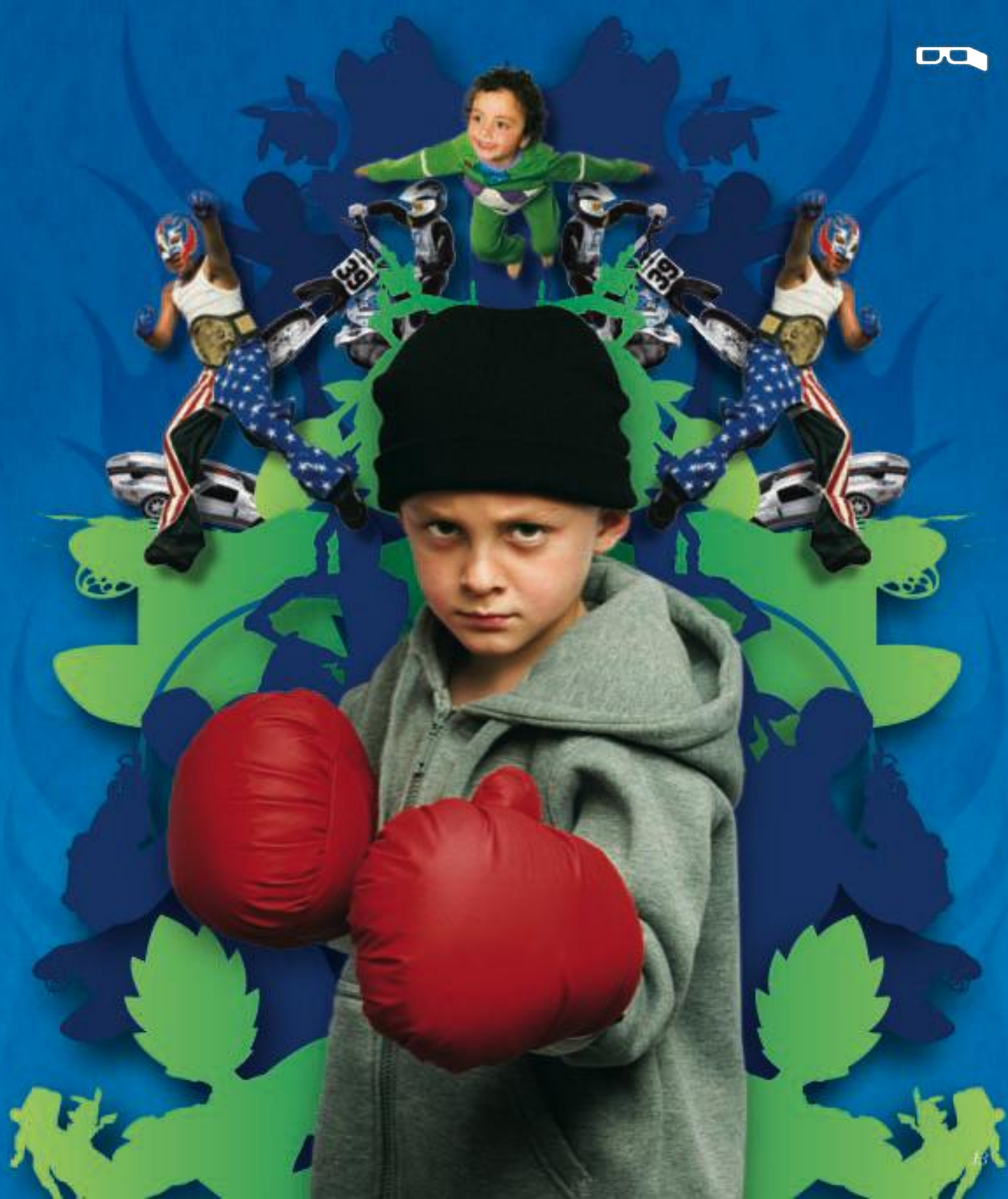
The Rocky™ boxing movie franchise has been around for 30 years and, to coincide with the anniversary and premiere of *Rocky Balboa™*, the sixth installment in the film series, JAKKS launched an action figure line featuring more than 40 high-quality, authentically detailed and collectible figures based on all of the iconic characters fans know and love, as well as electronic Boxing Gloves, Championship Belts and play sets.

In February 2006, JAKKS was awarded the Master Toy License for the global pop-culture phenomenon, Pokémon. We are excited to bring the vast universe of Pokémon characters to a new generation of kids today, and believe the line of collectible figures, interactive plush and electronic games will be another boys hit for JAKKS. Sales in the beginning of 2007 are strong with product available at every major retailer.

Fly Wheels™ toys, XS Extreme Sports™ vehicles and figures and other vehicles from our Road Champs® division drive boys into the heart of the action and give JAKKS footing in the vehicle aisles at retailers worldwide.









# Dolls, Plush, & Role-Play

With our dress-up and pretend products, imagination really is key. Our CDI and Play Along teams thrive in this area, with their expert execution of an extensive product portfolio based on classic brands such as Disney Princess, Care Bears and Cabbage Patch Kids.

CDI's 2006 Disney Princesses and Barbie® lines of pretend vanities, kitchens and beautiful dress-up and role-play accessories were excellent contributors to JAKKS' top and bottom lines. CDI also brought to market a line of Black & Decker pretend play tools and workshops for boys, as Play Along did with the introduction of Doodle Monsters® and pets, extending our Doodle Bear line significantly.

Our evergreen Cabbage Patch Kids dolls and Care Bears plush sold well in 2006 and included the Hide N' Seek Surprise Care Bear™ doll with interactive features, and the teeny tiny Cabbage Patch Kids Newborn™ dolls. New line extensions in 2007 include a whole new look for Care Bears, with the brand turning 25.

In Fall 2007, we are looking forward to launching fashion dolls and role-play products based on the two hit 'tween Disney pop acts, Hannah Montana™ and The Cheetah Girls™. Our Child Guidance® division will launch Gorilla Blocks™ toddler building blocks and KnotWüd™ foam construction and puzzle sets, along with new Barney® interactive musical toys that celebrate 20 years of Barney.



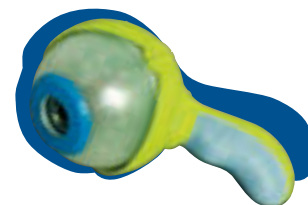


# Games & Electronics

JAKKS continues to introduce new Plug It In & Play TV Games controller titles based on today's top brands and the hottest gaming licenses. Preschool titles such as Go Diego Go!™, Scooby-Doo® and Dora the Explorer® were top sellers in 2006, along with Wheel of Fortune®. The hit TV shows Deal Or No Deal® and Jeopardy™ join our game show line-up in 2007, and other popular titles to look forward to include Hannah Montana, Spider-Man 3™ and Pirates of the Caribbean®.

We expanded upon our plug and play technology in 2006 to launch VMIGO™ interactive virtual pet toys that allow owners to nurture and develop their pet of choice via the handheld device, and then bring their pet to life on the TV screen in videogames and in-depth worlds. For 2007, JAKKS will also bring to market another plug and play product called EyeClops™ bionic eye, which lets kids magnify items up to 200 times and view them on the TV!

Speed Stacks® StackPack® games introduced the fast-action sport of sport stacking to the masses, and were the surprise hit of the 2006 toy season. Sport stacking is practiced in over 11,000 schools nationwide as part of physical education programs, and has been shown to improve children's hand-eye coordination, levels of concentration and overall athletic abilities. The game's popularity led to the creation of the World Sport Stacking Association (WSSA), which hosts the World Sport Stacking Championships and draws over 1,000 competitors from around the world. Play Along is the first ever to bring the official sport stacking equipment to retail. The official competition set and Glow-In-The-Dark Speed Stacks™ StackPack games are among the new additions to the award-winning product line slated for Fall 2007.







# Pets

More and more pet owners treat pets like their children, and no one has learned that fact like we have. Sales from our JAKKS Pets division, first acquired in late 2005, continue to grow as we expand our top-selling American Kennel Club® and The Cat Fanciers' Association™ product lines. The AKC® and CFA™-branded pet lines are created for canine and feline members of the family and feature premium quality treats, accessories and toys, such as our top-selling and realistic-looking CFA mouse toy and AKC squirrel, reflecting the prestige and quality long associated with these two premiere pet organizations.

White Bites safe and digestible dental chews for dogs, launched in 2006 and are growing in popularity. We are pleased to partner with Arm & Hammer, a trusted brand for over 150 years, to promote oral care for pets with our new White Bites Arm & Hammer Baking Soda oral care treats shipping in 2007. White Bites oral care dog treats were honored with *Pet Business Magazine's* 2006 Industry Recognition Award.

Pet products are a natural fit for JAKKS. We leverage our licensing power to launch pet products based on top children's brands, and sell them to both our mass customers and pet stores. Disney, Bratz, Snoop Dogg® and Spider-Man pet products are now appearing in the pet aisles and are engaging kids with their pets. Canine coats, tee-shirts, bathrobes and doggie disguises based on these licenses were sleeper hits for our pet division in 2006, and we expect to grow this area in 2007 and beyond.









# Stationery & Activities

Under our Flying Colors® art activity division, new play patterns and refreshers on key items keep our Dora the Explorer products moving at retail. On-the-go travel activities, along with large coloring pads and magnetic paper doll sets, were all well-placed at our customers. Vivid Velvet® and BloPens® activities were refreshed with fashion themes and evergreen licenses such as Care Bears and My Little Pony® in 2006. Our Creepy Crawlers® line based on the classic brand also did well in the year.

For 2007, activities based on younger-themed licenses, like Thomas the Tank Engine & Friends®, Bob the Builder®, Littlest Pet Shop and The Backyardigans™ will ship to retail for fall. Whether it's Bratz create-your-own fashions or Dora the Explorer adventure puzzles, JAKKS creates play patterns for licensed products that make sense for each property.

Our Pentech writing instruments and back-to-school division launched the next generation of our UltraSharp® Wooden Pencil called the Liquaphite® Mechanical Pencil. Both feature liquid graphite technology for writing instruments that last longer, never need to be sharpened and are equivalent to No. 2 lead. This patent pending advancement in pencils from JAKKS Pacific's stationery division is perfect for all standardized tests and pencil-writing students, as well as contractors, artists and architects of all ages.





# Seasonal

Our 2006 seasonal, outdoor products and water toys were highlighted by our Funnoodle® pool toys, kites from Go Fly A Kite® and our XPV Xtreme Performance Vehicle toy, which literally took radio control vehicles to new heights.

The XPV Xtreme Performance Vehicle product boosted sales in our seasonal category and topped many Hot Holiday Toy Lists. The XPV vehicle's intense level of speed and performance, typically associated only with hobby-grade RC vehicles, allowed RC fans to achieve speeds of up to 30 miles per hour on the ground, or fly over 20 stories high in the sky.

The XPV vehicle is a great example of how JAKKS takes a classic play pattern, enhances it with ground-breaking features and technology and makes it appealing to today's kids AND adults. In 2007 the XPV vehicle line will be extended into an entire XPV-branded arsenal of top performance vehicles for enthusiasts of every level.

Our Go Fly A Kite division introduced new top-quality kites that capture kids' imaginations by combining the best flying kites with the hottest kid's licenses, including Dora the Explorer, Spider-Man and Bratz. For the 2007 kite-flying season, the Go Fly A Kite team introduced the Power Flyer™ kite that does not even need the power of wind to fly! And the Hang Glider Kite allows kids to explore the skies through the eyes of their favorite action figure or doll.

Funnoodle pool floats continue to be the No. 1 selling foam pool floats. Fun fact: if you connected all of the Funnoodle pool floats that JAKKS has ever made, it would encircle the world!







# Dear Stockholders

2006 was another eventful year for JAKKS Pacific, Inc. as we continued to lay the groundwork for our future growth and success. Not only did we acquire our newest gem, Creative Designs International ("CDI"), and secure the master toy license for the pop culture phenomenon Pokémon, but we also grew 15.7% and realized record net sales of \$765.4 million, up from \$661.5 million in 2005. Net income for the year ended December 31, 2006 was \$72.4 million, or \$2.30 per diluted share, compared to \$63.5 million, or \$2.06 per diluted share, in 2005.

At JAKKS Pacific, we are committed to achieving our full potential. We think big and we dream big as we seek to inspire kids with truly imaginative and engaging products, and challenge our teams across the board to execute on our vision.

Our CDI division, which we acquired in February 2006, performed ahead of our expectations with classic Disney princess delivering sales of \$181.1 million. CDI's expansive range of dress-up and role play toys, large playsets and other licensed pretend play items is a terrific complement to JAKKS' portfolio. Their array of "magical" products such as last year's popular Ariel Interactive Vanity, which actually responds to young princesses, is simply enchanting for young children. We have already achieved significant operational efficiencies with our CDI division in shipping, sourcing and other areas.

As we continue to make strategic acquisitions, we remain focused on integrating our businesses and utilizing shared product publicity, licensing, packaging design, engineering and sourcing to achieve economies of scale.

Our goal is to bring additional synergies to each area of our business, often cross-categorizing a license amongst various product teams within their areas of expertise. One example of this licensing strategy is our new line based on two popular Disney 'tween properties, Hannah Montana and The Cheetah Girls. For these properties, we have our Play Along team executing on the fashion dolls and play sets, CDI working on role-play and dress-up items, and JAKKS' electronics team developing a line of Plug It In & Play TV Games controllers. We are optimistic about the success of the lines, which are expected to hit retail shelves late summer 2007.

**KIDS STILL LOVE TOYS!** Even though kids are more "wired" today than ever before, Traditional Toys still dominate kids' weekly entertainment activities and drive our sales. According to The NPD Group, 96% of kids age 2 to 4 and 81% of kids age 5 to 12 play with toys every week. Traditional Toys were the top drivers in our portfolio, with 86.1% of our 2006 sales coming from this category.

In Boys Action, our Pokémon toys based on the popular animé show, which now airs ten times per week on Cartoon Network, launched late in December 2006. With 52 new episodes of programming and 100 new Pokémon characters available to us, the product mix will be aggressive, and sales have already exceeded our expectations. This type of license is a perfect fit for JAKKS, with our expertise and long history of producing top-selling collectible action figures. We are embracing the world of Pokémon and enabling a whole new generation of kids and enthusiasts to collect, battle and win to become Pokémon masters.

**fact:** In 1996, JAKKS had sales of \$12 million. In 2006, JAKKS had sales of \$765.4 million.

*We think big and we dream big  
as we seek to inspire kids with truly  
imaginative and engaging products.*

**fact: JAKKS has sold more than 50 million Plug It In & Play TV Games controllers since creating the category in 2002.**

**fact: JAKKS acquired Creative Designs International in February 2006.**

Our Road Champs team introduced the XPV Xtreme Performance Vehicle toy, which topped Hot Toy Lists in 2006 and broke barriers for hobby-grade, high-performing radio control vehicles at mass market retail. For 2007, we are developing an entire line of XPV-branded top performance vehicles, including our XPV R.A.D.™ flying robot toy and an array of other flying toys for RC enthusiasts of all ages and skill levels.

Our Play Along division continued to expand several of our contemporary classic licenses in 2006, such as Cabbage Patch Kids and Care Bears, by adding innovative and modern features. For example, Magic Color Silk Cabbage Patch Kids™ dolls have fun and funky colored hair strands that magically change color when you touch their hair. New Cabbage Patch Kids for 2007 include our Newborns™ line, which are the newest, tiniest and youngest crop of kids from the Patch. Play Along introduced the Hide N' Seek Care Bear and our classic Care Bear with a video in 2006, and in 2007 will launch products to celebrate the brand's silver anniversary and new look.

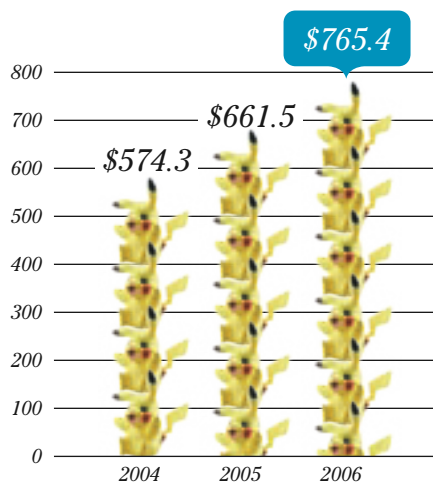
In our Child Guidance toy line, we are enthusiastic about our new Barney musical toys, KnotWüd foam construction sets and Gorilla

Blocks building blocks for preschoolers. We expect to see an upside in this category for 2007, with a Barney 20-City Birthday Tour and on-pack Sweepstakes on our Child Guidance Barney toys at retail.

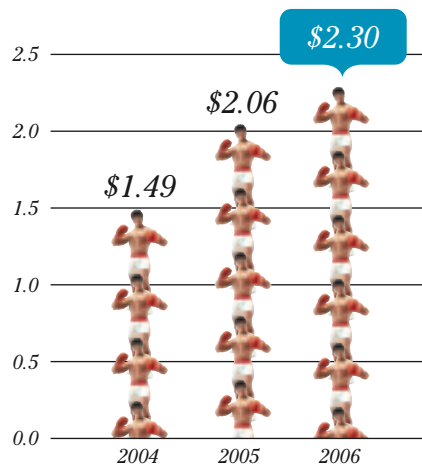
Other Funnoodle pool floats, Go Fly A Kite products and other outdoor products and pet product lines, nearly doubled in sales from 2005 to \$53.3 million in 2006.

2006 represented our first full year of pet products, which generated \$20.1 million in sales, up from \$9.7 million in the last eight months of 2005. The stars of JAKKS' Pets division continues to be our line of high-end, premium dog and cat products sold under the American Kennel Club and Cat Fanciers' Association brands. For 2007, we will premiere Green Planet Collection™, our "green" line of American Kennel Club environmentally friendly dog products. We have also partnered with household goods brand Arm & Hammer to launch a new version of our White Bites oral care treats infused with the power of Arm & Hammer Baking Soda.

**FORWARD MOMENTUM** We are growing globally as well. Our international sales were \$99.1 million, which represents 12.9%



**Net Sales**  
in millions



**Earnings Per Share**  
in dollars



**Net Income**  
in millions



*We want people to embrace our vision and truly realize the breadth of JAKKS Pacific.*

of overall JAKKS sales in 2006, which was driven by WWE action figures, Plug It In & Play TV Games, Road Champs vehicles and BloPens activities.

We strengthened our balance sheet and ended 2006 with \$184.5 million in cash and equivalents, \$280.4 million in net working capital and \$63.7 million in operating cash flow. Based on our current financial position, we are confident that we will be able to continue to invest for internal growth by creating new products and extensions of our current thriving lines, securing new licenses across our diverse product categories and pursuing complementary acquisitions.

We want people to embrace our vision and truly realize the breadth of JAKKS Pacific. A recent survey conducted by The NPD Group on Parents' Opinions on Toys found that 86% of parents surveyed believe that toys help their children learn, and the same amount believe that toys stimulate their children's imaginations. We wholeheartedly agree.

We began 2007 with great enthusiasm for these exciting times. As we move ahead, our agenda is focused on strategic growth, the continued development of innovative products, and new collaborations with determined execution and leadership. We realize the proud heritage on which we stand, yet we see the promise of the future yet to be fulfilled. As we continue to build on our solid foundation, we recognize the devotion, dedication, scholarship and outstanding contributions in our workforce. We are tremendously grateful for their efforts and for their continued allegiance to you, our stockholders.

To our loyal employees, valued licensing and retail partners, supportive consumers and all of our stockholders, we thank you.

Sincerely,



Jack Friedman  
Chairman and Chief Executive Officer



Stephen G. Berman  
President and Chief Operating Officer

***fact: JAKKS signs  
Master Toy License  
for Pokémon USA  
in June 2006.***



## *JAKKS Cares™*

*JAKKS Pacific believes in giving back to the community, that's why we created the JAKKS Cares program, which seeks to bring happiness and make a positive difference in the lives of children around the world who need it the most. The JAKKS Cares program provides toys and school supplies to special foundations and charitable organizations that have the ability to reach the greatest number of children in need through efficient and resourceful operations.*

The JAKKS Cares program partners with national and international organizations such as, Feed the Children®, Toys for Tots®, Operation Smile®, Gifts in Kind® through the Toy Industry Foundation, Camp Ronald McDonald for Good Times®, Boys & Girls' Clubs® of America, Children's Hospitals, The Today Show™ Toy Drive and many more. The JAKKS Cares program also works with foundations on a local level, including Boys & Girls Clubs of Southern California, Big Brothers Big Sisters® of Los Angeles and Ventura, Planet Hope™, Venice Family Clinic, Los Angeles Police Department, Los Angeles Unified School District, Malibu Sheriff and Police Department and others.

With the JAKKS Cares program, we also work to actively engage our employees to raise awareness for children's charities. In the end, the most important aspect of the JAKKS Cares program is helping children in need to smile, play and succeed!



***fact: JAKKS donated more than \$10 million in toys and school supplies during 2005 and 2006 to children in need around the world.***

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## Selected Financial Data

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

	Years Ended December 31,				
(In thousands, except per share data)	2002	2003	2004	2005	2006
<b>Consolidated Statement of Income Data:</b>					
Net sales	\$ 310,016	\$ 315,776	\$ 574,266	\$ 661,536	\$ 765,386
Cost of sales	180,173	189,334	348,259	394,829	470,592
Gross profit	129,843	126,442	226,007	266,707	294,794
Selling, general and administrative expenses	98,111	113,053	172,282	178,722	202,482
Acquisition shut-down and product recall costs	6,718	2,000	—	—	—
Income from operations	25,014	11,389	53,725	87,985	92,312
Profit from video game joint venture	8,004	7,351	7,865	9,414	13,226
Other expense	—	—	—	(1,401)	—
Interest income	1,258	1,131	2,052	5,183	4,930
Interest expense	(117)	(2,536)	(4,550)	(4,544)	(4,533)
Income before provision for income taxes and minority interest	34,159	17,335	59,092	96,637	105,935
Provision for income taxes	6,466	1,440	15,533	33,144	33,560
Income before minority interest	27,693	15,895	43,559	63,493	72,375
Minority interest	(237)	—	—	—	—
Net income	\$ 27,930	\$ 15,895	\$ 43,559	\$ 63,493	\$ 72,375
Basic earnings per share	\$ 1.27	\$ 0.66	\$ 1.69	\$ 2.37	\$ 2.66
Basic weighted average shares outstanding	21,963	24,262	25,797	26,738	27,227
Diluted earnings per share	\$ 1.23	\$ 0.66	\$ 1.49	\$ 2.06	\$ 2.30
Diluted weighted average shares and equivalents outstanding	22,747	27,426	31,406	32,193	32,714

	At December 31,				
(In thousands)	2002	2003	2004	2005	2006
<b>Consolidated Balance Sheet Data:</b>					
Cash and cash equivalents	\$ 68,413	\$ 118,182	\$ 176,544	\$ 240,238	\$ 184,489
Working capital	129,183	232,601	229,543	301,454	280,363
Total assets	408,916	529,997	696,762	753,955	881,894
Long-term debt, net of current portion	60	98,042	98,000	98,000	98,000
Total stockholders' equity	357,236	377,900	451,485	524,651	609,288

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

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

### Critical Accounting Policies

The accompanying consolidated financial statements and supplementary information were prepared in accordance with accounting principles generally accepted in the United States of America. Significant accounting policies are discussed in Note 2 to the Consolidated Financial Statements, Item 8. 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.** The allowance for doubtful accounts is based on our assessment of the collectibility of specific customer accounts and the aging of the accounts receivable. If there were a deterioration of a major customer's creditworthiness, or actual defaults were higher than our historical experience, our estimates of the recoverability of amounts due to us could be overstated, which could have an adverse impact on our operating results.

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

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

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

When we determine that the carrying value of long-lived assets and goodwill may not be recoverable based upon the existence of one or more of the above indicators of impairment, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. Net long-lived assets, including goodwill, amounted to \$413.8 million as of December 31, 2006.

**Reserve Inventory Obsolescence.** We value our inventory at the lower of cost or market. We accrue a reserve for obsolete, slow-moving inventory which is based on management's assessment of all relevant information. We periodically review and adjust our assumptions as circumstances warrant.

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

We accrue a tax reserve for additional income taxes and interest, which may become payable in future years as a result of audit adjustments by tax authorities. The reserve is based on management's assessment of all relevant information, and are periodically reviewed and adjusted as circumstances warrant. As of December 31, 2006, our income tax reserves are approximately \$10.3 million and relate to the potential income tax audit adjustments, primarily in the areas of income allocation and transfer pricing.

**Share-Based Payments.** We grant restricted stock and options to purchase our common stock to our employees (including officers) and non-employee directors under our 2002 Stock Award and Incentive Plan ("the Plan"), which incorporated our Third Amended and Restated 1995 Stock Option Plan. The benefits provided under the Plan are share-based payments subject to the provisions of revised Statement of Financial Accounting Standards No. 123 (Revised) (SFAS 123R), *Share-Based Payment*. Effective January 1, 2006, we began to use the fair value method to apply the provisions of SFAS 123R with a modified prospective application. The valuation provisions of SFAS 123R apply to new awards and to awards that were outstanding on the effective date and subsequently modified, cancelled or became vested. Under the modified prospective application, prior periods are not restated for comparative purposes. Share-based compensation expense recognized on a straight-line basis over the requisite service period under SFAS 123R for the year ended December 31, 2006 was \$1.9 million, relating to stock options, and \$4.6 million relating to restricted stock. At December 31, 2006, total unrecognized estimated compensation expense related to non-vested stock options granted prior to that date was \$2.5 million, which is expected to be recognized over a weighted average period of 3.51 years, and \$4.5 million related to non-vested restricted stock, which is expected to be recognized over a weighted average period of 2.7 years. Net stock options, after forfeitures and cancellations, granted during the year ended December 31, 2005 represented 1.13% of outstanding shares as of December 31, 2005. There were no stock options granted in 2006.

We estimate the value of share-based awards on the date of grant using the Black-Scholes option-pricing model. Prior to the adoption of SFAS 123R, the estimated value of each share-based award was used for the pro forma information required to be disclosed under SFAS 123. The determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of complex and subjective variables. These variables include our expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, cancellations, terminations, risk-free interest rate and expected dividends.

If factors change and we employ different assumptions in the application of SFAS 123R in future periods, the compensation expense that we record under SFAS 123R may differ from what we have recorded in the current period. Option-pricing models were developed for use in estimating the value of traded options that have no vesting or hedging restrictions, are fully transferable and do not cause dilution. Because our share-based payments have characteristics significantly different from those of freely traded options, and because changes in the subjective input assumptions can materially affect our estimates of fair values, in our opinion, existing valuation models, including the Black-Scholes and lattice binomial models, may not provide reliable measures of the fair values of our share-based compensation. Consequently, there is a risk that our estimates of the fair values of our share-based compensation awards on the grant dates may differ from the actual values realized upon the exercise, expiration, early termination or forfeiture of those share-based payments in the future. Certain share-based payments, such as employee stock options, may expire worthless or otherwise result in zero intrinsic value as compared to the fair values originally estimated on the grant date and reported in our financial statements. Alternatively, value may be realized from these instruments that is significantly in excess of the fair values originally estimated on the grant date and reported in our financial statements. There is currently no market-based mechanism or other practical application to verify the reliability and accuracy of the estimates stemming from these valuation models, nor is there a means to compare and adjust the estimates to actual values. Although the fair value of employee share-based awards is determined in accordance with SFAS 123R and the Securities and Exchange Commission's Staff Accounting Bulletin No. 107 (SAB 107) using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

Estimates of share-based compensation expenses do have an impact on our financial statements, but these expenses are based on the aforementioned option valuation model and will never result in the payment of cash by us. For this reason, and because we do not view share-based compensation as related to our operational performance, we exclude estimated share-based compensation expense when evaluating the business performance of our operating segments.

The guidance in SFAS 123R and SAB 107 is relatively new, and best practices are not well established. The application of these principles may be subject to further interpretation and refinement over time. There are significant differences among valuation models, and there is a possibility that we will adopt different valuation models in the future. This may result in a lack of consistency in future periods and materially affect the fair value estimate of share-based payments. It may also result in a lack of comparability with other companies that use different models, methods and assumptions.

Furthermore, theoretical valuation models and market-based methods are evolving and may result in lower or higher fair value estimates for share-based compensation. The timing, readiness, adoption, general acceptance, reliability and testing of these methods is uncertain. Sophisticated mathematical models may require voluminous historical information, modeling expertise, financial analyses, correlation analyses, integrated software and databases, consulting fees, customization and testing for adequacy of internal controls. Market-based methods are emerging that, if employed by us, may dilute our earnings per share and involve significant transaction fees and ongoing administrative expenses. The uncertainties and costs of these extensive valuation efforts may outweigh the benefits to investors.



## Recent Developments

On February 9, 2006, we acquired substantially all of the assets of Creative Designs International, Ltd. and a related Hong Kong company, Arbor Toys Company Limited (collectively, "Creative Designs"). The total initial purchase price of \$111.1 million consisted of \$101.7 million in cash, 150,000 shares of our common stock at a value of approximately \$3.3 million and the assumption of liabilities in the amount of \$6.1 million. In addition, we agreed to pay an earn-out of up to an aggregate amount of \$20.0 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. For the year ended December 31, 2006, \$6.9 million of the earn-out was earned and recorded as goodwill. Creative Designs is a leading designer and producer of dress-up and role-play toys and was included in our results of operations from the date of acquisition.

## Results of Operations

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

	Years Ended December 31,				
	2002	2003	2004	2005	2006
Net sales	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of sales	58.1	60.0	60.6	59.7	61.5
Gross profit	41.9	40.0	39.4	40.3	38.5
Selling, general and administrative expenses	31.6	35.8	30.0	27.0	26.5
Acquisition shut-down and product recall costs	2.2	0.6	—	—	—
Income from operations	8.1	3.6	9.4	13.3	12.0
Profit from video game joint venture	2.6	2.3	1.4	1.4	1.7
Other expense	—	—	—	(0.2)	—
Interest income	0.4	0.4	0.4	0.8	0.6
Interest expense	—	(0.8)	(0.8)	(0.7)	(0.6)
Income before income taxes	11.1	5.5	10.4	14.6	13.7
Provision for income taxes	2.1	0.5	2.7	5.0	4.4
Net income	9.0%	5.0%	7.7%	9.6%	9.3%

During 2006, we reorganized our business segments to conform to product groups that have become the focus of management review. The following unaudited table summarizes, for the periods indicated, certain income statement data by segment (in thousands).

	Years Ended December 31,	
	2005	2006
<b>Net Sales</b>		
Traditional Toys	\$ 568,737	\$ 658,804
Craft/Activity/Writing Products	62,058	52,834
Seasonal/Outdoor Products	20,978	33,694
Pet Products	9,763	20,054
	661,536	765,386
<b>Cost of Sales</b>		
Traditional Toys	334,669	410,339
Craft/Activity/Writing Products	39,928	29,044
Seasonal/Outdoor Products	13,957	19,072
Pet Products	6,275	12,137
	394,829	470,592
<b>Gross Margin</b>		
Traditional Toys	234,068	248,465
Craft/Activity/Writing Products	22,130	23,790
Seasonal/Outdoor Products	7,021	14,622
Pet Products	3,488	7,917
	\$ 266,707	\$ 294,794

## Comparison of the Years Ended December 31, 2006 and 2005

### Net Sales

**Traditional Toys.** Net sales of our Traditional Toys segment were \$658.8 million in 2006, compared to \$568.7 million in 2005, representing an increase of \$90.1 million or 15.8%. The increase in net sales was primarily due to the addition of the Creative Designs line of products, which we acquired in February 2006, with sales of \$181.1 million and increases in sales of WWE actions figures and accessories, Doodle Bear, Speed Stacks, Snugglers, Dragonflyz and Trolls, offset in part by decreases in sales of TV Games, wheels products, dolls, Sky Dancers, Care Bears and Cabbage Patch Kids.

**Craft/Activity/Writing Products.** Net Sales of our Craft/Activity/Writing Products were \$52.8 million in 2006, compared to \$62.0 million in 2005, representing a decrease of \$9.2 million or 14.8%. The decrease in net sales was primarily due to decreases in sales of our Flying Colors activities and our Pentech and Color Workshop writing instruments and related products, offset in part by an increase in sales of our Creepy Crawlers activity sets.

**Seasonal/Outdoor Products.** Net sales of our Seasonal/Outdoor Products were \$33.7 million in 2006, compared to \$21.0 million in 2005, representing an increase of \$12.7 million or 60.5%. The increase in net sales was primarily due to increases in sales of our Fly Wheels XPV and Flight toys and our Funnoodle pool toys, offset in part by decreases in sales of our Go Fly A Kite and junior sports products.

**Pet Products.** Net Sales of our Pet Pal line of products, which we acquired in June 2005, were \$20.1 million in 2006, compared to \$9.8 million in 2005, representing an increase of \$10.3 million or 105.1%. The increase is attributable to the growth in sales of this new line of products through our existing distribution channels and having sales for the entire year in 2006.

### Cost of Sales

**Traditional Toys.** Cost of sales of our Traditional Toys segment was \$410.3 million in 2006, compared to \$334.7 million in 2005, representing an increase of \$75.6 million or 22.6%. The increase primarily consisted of an increase in product costs of \$68.8 million, which is in line with the higher volume of sales. Furthermore, royalty expense for our Traditional Toys segment decreased by \$1.2 million and as a percentage of net sales due to changes in the product mix to more products with lower royalty rates or proprietary products with no royalty rates, from products with higher royalty rates. Product costs as a percentage of sales increased due to the mix of the product sold and sell-through of closeout product. Our depreciation of molds and tools increased by \$8.1 million due to new products being sold in this segment.

**Craft/Activity/Writing Products.** Cost of sales of our Craft/Activity/Writing Products was \$29.0 million in 2006, compared to \$39.9 million in 2005, representing a decrease of \$10.9 million or 27.3%. The decrease primarily consisted of decreases in product costs of \$8.6 million and royalty expense of \$2.2 million, which were in line with the lower volume of sales. Additionally, our depreciation of molds and tools was comparable year-over-year.

**Seasonal/Outdoor Products.** Cost of sales of our Seasonal/Outdoor Products segment was \$19.1 million in 2006, compared to \$14.0 million in 2005, representing an increase of \$5.1 million or 36.4%. The increase primarily consisted of increases in product costs of \$5.6 million which were in line with the higher volume of sales, partially offset by a decrease in royalty expense of \$0.3 million. Furthermore, royalty expense for the Seasonal/Outdoor segment decreased as a percentage of net sales due to changes in the product mix to more products with lower royalty rates or proprietary products with no royalty rates, from products with higher royalty rates. Product costs as a percentage of sales also decreased due to the mix of the product sold. Our depreciation of molds and tools decreased by \$0.2 million, which was comparable year-over-year.

**Pet Products.** Cost of sales of our Pet Pal line of products, which we acquired in June 2005, was \$12.1 million in 2006, compared to \$6.3 million in 2005, representing an increase of \$5.8 million or 92.1%. The increase primarily consisted of increases in product costs of \$4.8 million and royalty expense of \$0.8 million, which were in line with the higher volume of sales. Additionally, our depreciation of molds and tools increased by \$0.3 million.

### Selling, General and Administrative Expenses

Selling, general and administrative expenses were \$202.5 million in 2006 and \$178.7 million in 2005, constituting 26.5% and 27.0% of net sales, respectively. The overall increase of \$23.8 million in such costs was primarily due to the addition of overhead related to the operations of Creative Designs (\$20.3 million), increases in product development (\$2.7 million), amortization expense related to intangible assets other than goodwill (\$7.4 million) and stock-based compensation (\$3.1 million), offset in part by a decrease in other selling expenses (\$12.0 million). Increased grants of restricted stock awards to our non-employee directors and the increase in the price of our common stock in 2006 compared to 2005 resulted in stock-based compensation expense of \$6.5 million in 2006, compared to \$3.4 million in 2005. The decrease in direct selling expenses is primarily due to efficiencies gained by closing two third-party warehouses, and decreases in sales commission expense of \$1.9 million and advertising and promotional expenses of \$6.4 million in 2006 in support of several of our product lines. From time to time, we may increase or decrease our advertising efforts, if we deem it appropriate for particular products.

### Profit from Video Game Joint Venture

Profit from our video game joint venture in 2006 increased to \$13.2 million, as compared to \$9.4 million in 2005, due to the strong performance of the three new games released and stronger sales of existing titles in 2006, offset by the reduction of \$0.1 million to THQ for their share of profit on our sales of WWE themed TV Games compared to 2005, in which period four new games were released and \$0.8 million was earned by THQ for the WWE themed TV Games. The amount of the preferred return we will receive from the joint venture after June 30, 2006 is subject to change.

### Other Expense

Other expense in 2005 of \$1.4 million related to the write-off of an investment in a Chinese joint venture. There was no such expense in 2006.

### Interest Income

Interest income in 2006 was \$4.9 million, as compared to \$5.2 million in 2005. This decrease is due to lower average cash balances in 2006 as a result of our acquisition of Creative Designs, offset in part by higher interest rates during 2006 compared to 2005.

### Interest Expense

Interest expense in 2006 of \$4.5 million related to the convertible senior notes payable was comparable to 2005.

### Provision for Income Taxes

Provision for income taxes included Federal, state and foreign income taxes at effective tax rates of 34.3% in 2005 and 31.7% in 2006, benefiting from a flat 17.5% Hong Kong Corporation Tax on our income arising in, or derived from, Hong Kong for each of 2005 and 2006. The decrease in the effective tax rate in 2006 is due to the effect, in 2005, of a one-time repatriation of undistributed earnings from our international subsidiaries, which created additional taxes in 2005 on 15% of the dividends received. As of December 31, 2006, we had net deferred tax assets of approximately \$8.2 million for which an allowance of \$0.9 million has been provided since, in the opinion of management, realization of this portion of the future benefit is uncertain.

### Comparison of the Years Ended December 31, 2005 and 2004

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

With the addition of Creative Designs in 2006 and our other on-going initiatives in product development and marketing, we believe that the increased level of net sales of Traditional Toys should continue throughout 2006.

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



**Selling, General and Administrative Expenses.** Selling, general and administrative expenses were \$178.7 million in 2005 and \$172.3 million in 2004, constituting 27.0% and 30.0% of net sales, respectively. The overall increase of \$6.4 million in such costs was primarily due to increases in direct selling expenses (\$17.3 million), product development costs (\$4.0 million) and general and administrative expenses (\$1.0 million), partially offset by a decrease in amortization expense related to intangible assets other than goodwill and trademarks (\$5.0 million) and stock-based compensation expense (\$10.2 million). Comparable grants of restricted stock awards and the increase in the price of our common stock in 2004 compared to a decrease in the price of our common stock in 2005 resulted in a stock-based compensation expense of \$3.4 million in 2005 compared to an expense of \$13.6 million in 2004. The increase in general and administrative expenses is primarily due to additional overhead related to the operations of Play Along and increases in bonus expense (\$3.6 million) and donation expense (\$5.6 million), offset in part by decreases in legal costs (\$5.0 million), bad debt expense (\$2.0 million) and rent expense (\$1.3 million). The increase in direct selling expenses is primarily due to an increase in advertising and promotional expenses of \$12.1 million in 2005 in support of the sell-through of our various products at retail. We produce and air television commercials in support of several of our product lines. From time to time, we may increase or decrease our advertising efforts, if we deem it appropriate for particular products.

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

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

**Interest, Income.** Interest income increased due to higher average cash balances and higher interest rates during 2005 compared to 2004.

**Interest Expense.** Interest expense in 2005 of \$4.5 million related to the convertible senior notes payable was comparable to 2004.

**Provision for Income Taxes.** Provision for income taxes included Federal, state and foreign income taxes at effective tax rates of 26.3% in 2004 and 34.3% in 2005, benefiting from a flat 17.5% Hong Kong Corporation Tax on our income arising in, or derived from, Hong Kong for each of 2004 and 2005. The increase in the effective tax rate in 2005 is due to a greater proportion of taxable income generated in the United States. As of December 31, 2005, we had net deferred tax assets of approximately \$7.2 million for which no allowance has been provided since, in the opinion of management, realization of the future benefit is probable. In October 2004, the American Jobs Creation Act of 2004 (the "Act") was signed into law. The Act created a one-time incentive for U.S. corporations to repatriate undistributed earnings from their international subsidiaries by providing an 85% dividends-received deduction for certain international earnings. The deduction was available to corporations during the tax year that included October 2004, or in the immediately subsequent tax year. In the fourth quarter of 2005, our Board of Directors approved a plan to repatriate \$105.5 million in foreign earnings, which was completed in December 2005. The Federal and state income tax expense related to this repatriation was approximately \$5.4 million.

### Quarterly Fluctuations and Seasonality

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

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

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

	2005			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<i>(In thousands, except per share data)</i>				
Net sales	134,676	127,091	233,500	166,269
As a % of full year	20.4%	19.2%	35.3%	25.1%
Gross profit	54,212	48,073	93,452	70,970
As a % of full year	20.3%	18.0%	35.0%	26.6%
As a % of net sales	40.3%	37.8%	40.0%	42.7%
Income (loss) from operations	13,675	14,614	47,218	12,478
As a % of full year	15.5%	16.6%	53.7%	14.2%
As a % of net sales	10.2%	11.5%	20.2%	7.5%
Income before income taxes and minority interest	13,627	15,732	46,306	20,972
As a % of net sales	10.1%	12.4%	19.8%	12.6%
Net income	10,084	11,642	32,753	9,014
As a % of net sales	7.5%	9.2%	14.0%	5.4%
Diluted earnings per share	\$ 0.34	\$ 0.39	\$ 1.05	\$ .29
Weighted average shares and equivalents outstanding	32,256	32,229	32,088	32,197

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<i>(In thousands, except per share data)</i>				
Net sales	107,244	124,041	295,789	238,312
As a % of full year	14.0%	16.2%	38.6%	31.1%
Gross profit	44,163	49,280	112,883	88,468
As a % of full year	15.0%	16.7%	38.3%	30.0%
As a % of net sales	41.2%	39.7%	38.2%	37.1%
Income (loss) from operations	2,244	8,963	58,204	22,901
As a % of full year	2.4%	9.7%	63.1%	24.8%
As a % of net sales	2.1%	7.2%	19.7%	9.6%
Income before income taxes and minority interest	3,283	9,135	57,855	35,662
As a % of net sales	3.1%	7.4%	19.6%	15.0%
Net income	2,331	6,361	40,499	23,184
As a % of net sales	2.2%	5.1%	13.7%	9.7%
Diluted earnings per share	\$ 0.09	\$ 0.22	\$ 1.26	\$ 0.73
Weighted average shares and equivalents outstanding	32,617	32,790	32,736	32,803

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

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

During the fourth quarter of 2005, we recorded a non-cash charge, which impacted net income, of \$3.6 million for restricted stock, and we repatriated \$105.5 million from our Hong Kong subsidiaries which resulted in incremental income tax expense of \$5.4 million and reduced net income.

### Recent Accounting Standards

In July 2006, the FASB issued Final Interpretation No. ("FIN") 48, *Accounting for Uncertainty in Income Taxes*, an Interpretation of SFAS 109, which clarifies the accounting for income taxes by prescribing the minimum recognition threshold an uncertain tax position is required to meet before tax benefits associated with such uncertain tax position are recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. In addition, FIN 48 excludes income taxes from the scope of SFAS 5, *Accounting for Contingencies*. FIN 48 is effective for fiscal years beginning after December 15, 2006. Differences between the amounts recognized in the consolidated balance sheets prior to the adoption of FIN 48 and the amounts reported after adoption are accounted for as a cumulative-effect adjustment to the beginning balance of retained earnings upon adoption of FIN 48. FIN 48 also requires that amounts recognized in the balance sheet related to uncertain tax positions be classified as a current or non-current liability, based upon the timing of the ultimate payment to a taxing authority. We will adopt FIN 48 as of January 1, 2007 and are in the process of finalizing the effect FIN 48 will have on our financial statements. Under the guidance of FIN 48, management estimates that our income tax reserve may increase by approximately \$15.0 million to \$25.0 million, which is subject to revision when management completes an analysis of the impact of FIN 48. As required by FIN 48, upon adoption on January 1, 2007, this difference will be recorded in retained earnings as a cumulative effect adjustment.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*, which provides guidance for using fair value to measure assets and liabilities. Under SFAS 157, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction that fair value should be based on the assumptions market participants would use when pricing the asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data, for example, the reporting entity's own data. Fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We do not expect the adoption of SFAS 157 to have a material impact on our results of operations and financial position.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which provides companies with an option to report selected financial assets and liabilities at fair value. The objective of SFAS 159 is to reduce both the complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. SFAS 159 is effective for us as of January 1, 2008 and we do not expect the adoption of SFAS 159 to have a material effect on our operating results or financial position.



## Liquidity and Capital Resources

As of December 31, 2006, we had working capital of \$280.4 million, as compared to \$301.5 million as of December 31, 2005. This decrease was primarily attributable to cash used in connection with the acquisition of Creative Designs, partially offset by cash provided by our operating results.

Operating activities provided net cash of \$63.7 million in the year ended December 31, 2006, as compared to \$71.1 million in 2005. Net cash was provided primarily by net income of 72.4 million, non-cash charges and changes in working capital. Accounts receivable turnover as measured by days sales outstanding in accounts receivable increased from approximately 52 days as of December 31, 2005 to approximately 57 days as of December 31, 2006 primarily due to a shift in sales from FOB China to domestic sales origin, which carry longer payment terms, and the timing of sales where a greater percentage of the last quarter sales occurred at the end of the quarter. Other than open purchase orders, issued in the normal course of business, we have no obligations to purchase finished goods from our manufacturers. As of December 31, 2006, we had cash and cash equivalents of \$184.5 million.

Our investing activities used cash of \$121.9 million in the year ended December 31, 2006, as compared to \$9.5 million in 2005, consisting primarily of the purchase of office furniture and equipment and molds and tooling used in the manufacture of our products, and the goodwill and other intangible assets acquired in the acquisition of Creative Designs, plus the \$6.7 million in goodwill relating to the earn-out of Play Along, \$1.5 million in goodwill relating to the earn-out of Pet Pal and the purchase of marketable securities. In 2005, our investing activities consisted primarily of the purchase of molds and tooling used in the manufacture of our products and the goodwill and other intangible assets acquired in the acquisition of Pet Pal, plus the \$10.0 million in goodwill relating to the earn-out of Play Along, partially offset by the sale of marketable securities of \$19.0 million. As part of our strategy to develop and market new products, we have entered into various character and product licenses with royalties generally ranging from 1% to 14% payable on net sales of such products. As of December 31, 2006, these agreements required future aggregate minimum guarantees of \$47.4 million, exclusive of \$20.4 million in advances already paid. We do not have any significant capital expenditure commitments as of December 31, 2006.

Our financing activities provided net cash of \$3.1 million in the year ended December 31, 2006, as compared to \$3.2 million in 2005. In 2006, cash was primarily provided from the exercise of stock options and the tax benefit from stock options exercised. In 2005, cash was primarily provided from the exercise of stock options.

The following is a summary of our significant contractual cash obligations for the periods indicated that existed as of December 31, 2006 and is based on information appearing in the notes to the consolidated financial statements (in thousands):

	2007	2008	2009	2010	2011	Thereafter	Total
Long-term debt	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 98,000	\$ 98,000
Operating leases	8,146	6,964	5,383	4,633	4,548	7,729	37,403
Minimum guaranteed license/ royalty payments	20,722	15,760	6,366	3,358	—	1,145	47,351
Employment contracts	6,585	3,986	2,734	2,280	—	—	15,585
Total contractual cash obligations	\$ 35,453	\$ 26,710	\$ 14,483	\$ 10,271	\$ 4,548	\$ 106,874	\$ 198,339

In October 2004, the American Jobs Creation Act of 2004 (the "Act") was signed into law. The Act created a one-time incentive for U.S. corporations to repatriate undistributed earnings from their international subsidiaries by providing an 85% dividends-received deduction for certain international earnings. The deduction was available to corporations during the tax year that included October 2004, or in the immediately subsequent tax year. In the fourth quarter of 2005, our Board of Directors approved a plan to repatriate \$105.5 million in foreign earnings, which was completed in December 2005. The Federal and state income tax expense related to this repatriation was approximately \$5.4 million.

In June 2004, we purchased substantially all of the assets and assumed certain liabilities of Play Along. The total initial purchase price of \$85.7 million consisted of cash paid in the amount of \$70.8 million and the issuance of 749,005 shares of our common stock valued at \$14.9 million. In addition, we agreed to pay an earn-out of up to \$10.0 million per year for the four calendar years following the acquisition up to an aggregate amount of \$30.0 million based on the achievement of certain financial performance criteria which will be recorded as goodwill when and if earned. For the three years in the period ended December 31, 2006, \$10.0 million, \$6.7 million and \$6.7 million, respectively, of the earn-out was earned and recorded as goodwill. Accordingly, the maximum earn-out remaining for the year ending December 31, 2007 is approximately \$6.6 million. Our results of operations have included Play Along from the date of acquisition.

In October 2004, we were named as a defendant in a lawsuit commenced by WWE (the "WWE Action"). The complaint also named as defendants, among others, the joint venture with THQ Inc., certain of our foreign subsidiaries and our three executive officers. In November 2004, several purported class action lawsuits were filed in the United States District Court for the Southern District of New York, alleging damages associated with

the facts alleged in the WWE Action. Three shareholder derivative actions have also been filed against us, nominally, and against certain of our Board members (the "Derivative Actions"). The Derivative Actions seek to hold the individual defendants liable for damages allegedly caused to our Company by their actions, and, in one of the Derivative Actions, seeks restitution to our Company of profits, benefits and other compensation obtained by them. In October 2006, WWE commenced a lawsuit against THQ and the joint venture concerning allegedly improper sales of WWE video games in Japan and other countries in Asia, seeking among other things, a declaration that WWE is entitled to terminate its video games license with the joint venture and monetary damages.

In June 2005, we purchased substantially all of the operating assets and assumed certain liabilities relating to the Pet Pal line of pet products, including toys, treats and related pet products. The total initial purchase price of \$10.6 million was paid in cash. In addition, we agreed to pay an earn-out of up to an aggregate amount of \$25.0 million in cash over the three years ending June 30, 2008 following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. During the year ended December 31, 2006, \$1.5 million of the earn-out was earned and recorded as goodwill. Goodwill of \$4.6 million arose from this transaction, which represents the excess of the purchase price over the fair value of assets acquired less liabilities assumed. This acquisition expands our product offerings and distribution channels. Our results of operations have included Pet Pal from the date of acquisition.

On February 9, 2006, we acquired substantially all of the assets of Creative Designs. The total initial purchase price of \$111.1 million consisted of \$101.7 million in cash, 150,000 shares of our common stock at a value of approximately \$3.3 million and the assumption of liabilities in the amount of \$6.1 million. In addition, we agreed to pay an earn-out of up to an aggregate amount of \$20.0 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. For the year ended December 31, 2006, \$6.9 million of the earn-out was earned and recorded as goodwill. Creative Designs is a leading designer and producer of dress-up and role-play toys and is included in our results of operations from the date of acquisition.

In June 2003, we sold an aggregate of \$98.0 million of 4.625% Convertible Senior Notes due June 15, 2023. The notes may be converted into shares of our common stock at an initial conversion price of \$20.00 per share, or 50 shares per note, subject to certain circumstances. The notes may be converted in each quarter subsequent to any quarter in which the closing price of our common stock is at or above a prescribed price for at least 20 trading days in the last 30 trading day period of the quarter. The prescribed price for the conversion trigger is \$24.00 through June 30, 2010, and increases nominally each quarter thereafter. Cash interest is payable at an annual rate of 4.625% of the principal amount at issuance, from the issue date to June 15, 2010, payable on June 15 and December 15 of each year, commencing on December 15, 2003. After June 15, 2010, interest will accrue at the same rate on the outstanding notes until maturity. At maturity, we will redeem the notes at their accreted principal amount, which will be equal to \$1,811.95 (181.195%) per \$1,000 principal amount at issuance, unless redeemed or converted earlier. The notes were not convertible as of December 31, 2006.

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

We believe that our cash flows from operations and cash and cash equivalents will be sufficient to meet our working capital and capital expenditure requirements and provide us with adequate liquidity to meet our anticipated operating needs for at least the next 12 months. Although operating activities are expected to provide cash, to the extent we grow significantly in the future, our operating and investing activities may use cash and, consequently, this growth may require us to obtain additional sources of financing. There can be no assurance that any necessary additional financing will be available to us on commercially reasonable terms, if at all. We intend to finance our long-term liquidity requirements out of net cash provided by operations and cash and cash equivalents. As of December 31, 2006, we do not have any off-balance sheet arrangements.

## Exchange Rates

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

## *Report of Independent Registered Public Accounting Firm*

The Board of Directors and Stockholders  
JAKKS Pacific, Inc.  
Malibu, California

We have audited the accompanying consolidated balance sheet of JAKKS Pacific, Inc. (the "Company") as of December 31, 2006 and the related consolidated statements of income, other comprehensive income, stockholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of JAKKS Pacific, Inc. as of December 31, 2006, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

As more fully described in Note 2 to the consolidated financial statements, effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment."

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2006, based on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 15, 2007 expressed an unqualified opinion thereon.

*BDO Seidman, LLP*

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BDO Seidman, LLP

Los Angeles, California  
March 15, 2007



## *Report of Independent Registered Public Accounting Firm*

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

We have audited the accompanying consolidated balance sheets of JAKKS Pacific, Inc. and Subsidiaries (Company) as of December 31, 2005, and the related consolidated statements of operations, other comprehensive income, stockholders' equity, and cash flows and the financial statement schedule for each of the two years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements and schedule referred to above present fairly, in all material respects, the financial position of JAKKS Pacific, Inc. and Subsidiaries as of December 31, 2005, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America.



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PKF  
Certified Public Accountants  
A Professional Corporation

Los Angeles, California  
February 13, 2006

## JAKKS PACIFIC, INC. AND SUBSIDIARIES

### CONSOLIDATED BALANCE SHEETS

	December 31,	
(In thousands, except share data)	2005	2006
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 240,238	\$ 184,489
Marketable securities	—	210
Accounts receivable, net of allowance for uncollectible accounts of \$2,336 and \$1,206, respectively	87,199	153,116
Inventory	66,729	76,788
Deferred income taxes	13,618	10,592
Prepaid expenses and other	17,533	26,543
Total current assets	425,317	451,738
<b>Property and equipment</b>		
Office furniture and equipment	7,619	8,299
Molds and tooling	26,948	36,600
Leasehold improvements	3,522	4,882
Total	38,089	49,781
Less accumulated depreciation and amortization	25,394	32,898
Property and equipment, net	12,695	16,883
Intangibles and other, net	18,512	40,833
Investment in video game joint venture	10,365	14,873
Goodwill, net	269,298	337,999
Trademarks, net	17,768	19,568
Total assets	\$ 753,955	\$ 881,894
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current liabilities</b>		
Accounts payable	\$ 50,533	\$ 65,574
Accrued expenses	44,415	54,664
Reserve for sales returns and allowances	25,123	32,589
Income taxes payable	3,792	18,548
Total current liabilities	123,863	171,375
Convertible senior notes	98,000	98,000
Deferred rent liability	995	854
Deferred income taxes	6,446	2,377
Total liabilities	229,304	272,606
Commitments and contingencies		
<b>Stockholders' equity</b>		
Preferred shares, \$.001 par value; 5,000,000 shares authorized; nil outstanding	—	—
Common stock, \$.001 par value; 100,000,000 shares authorized; 26,944,559 and 27,776,947 shares issued and outstanding, respectively	27	28
Additional paid-in capital	287,356	300,255
Retained earnings	240,057	312,432
Accumulated other comprehensive loss	(2,789)	(3,427)
Total stockholders' equity	524,651	609,288
Total liabilities and stockholders' equity	\$ 753,955	\$ 881,894

See notes to consolidated financial statements.

## JAKKS PACIFIC, INC. AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31,		
(In thousands, except per share data)	2004	2005	2006
Net sales	\$ 574,266	\$ 661,536	\$ 765,386
Cost of sales	348,259	394,829	470,592
Gross profit	226,007	266,707	294,794
Selling, general and administrative expenses	172,282	178,722	202,482
Income from operations	53,725	87,985	92,312
Profit from video game joint venture	7,865	9,414	13,226
Other expense	—	(1,401)	—
Interest income	2,052	5,183	4,930
Interest expense	(4,550)	(4,544)	(4,533)
Income before provision for income taxes	59,092	96,637	105,935
Provision for income taxes	15,533	33,144	33,560
Net income	\$ 43,559	\$ 63,493	\$ 72,375
Basic earnings per share	\$ 1.69	\$ 2.37	\$ 2.66
Basic weighted number of shares	25,797	26,738	27,227
Diluted earnings per share	\$ 1.49	\$ 2.06	\$ 2.30
Diluted weighted number of shares	31,406	32,193	32,714

See notes to consolidated financial statements.



## JAKKS PACIFIC, INC. AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF OTHER COMPREHENSIVE INCOME

	Years Ended December 31,		
(In thousands)	2004	2005	2006
Other comprehensive income:			
Net income	\$ 43,559	\$ 63,493	\$ 72,375
Foreign currency translation adjustment	(1,398)	(1,042)	(638)
Other comprehensive income	\$ 42,161	\$ 62,451	\$ 71,737

See notes to consolidated financial statements.

## JAKKS PACIFIC, INC. AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Years Ended December 31, 2004, 2005 and 2006

(In thousands)

	Common Stock		Additional Paid-in Capital	Retained Earnings	Deferred Compensation From Restricted Stock Grants	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
	Number of Shares	Amount					
<b>Balance, December 31, 2003</b>	24,927	\$ 25	\$ 246,008	\$ 133,005	\$ (789)	\$ (349)	\$ 377,900
Exercise of options	192	—	1,699	—	—	—	1,699
Stock option income tax benefit	—	—	739	—	—	—	739
Restricted stock grants	340	—	7,487	—	789	—	8,276
Compensation for fully vested stock options	—	—	5,365	—	—	—	5,365
Issuance of common stock for Play Along	749	1	14,850	—	—	—	14,851
Issuance of common stock for Kidz Biz earn-out	26	—	494	—	—	—	494
Net income	—	—	—	43,559	—	—	43,559
Foreign currency translation adjustment	—	—	—	—	—	(1,398)	(1,398)
<b>Balance, December 31, 2004</b>	26,234	26	276,642	176,564	—	(1,747)	451,485
Exercise of options	567	1	4,872	—	—	—	4,873
Stock option income tax benefit	—	—	4,119	—	—	—	4,119
Restricted stock grants	245	—	5,130	—	—	—	5,130
Compensation for fully vested stock options	—	—	(1,706)	—	—	—	(1,706)
Retirement of common stock	(101)	—	(1,701)	—	—	—	(1,701)
Net income	—	—	—	63,493	—	—	63,493
Foreign currency translation adjustment	—	—	—	—	—	(1,042)	(1,042)
<b>Balance, December 31, 2005</b>	26,945	27	287,356	240,057	—	(2,789)	524,651
Exercise of options	333	—	4,382	—	—	—	4,382
Stock option income tax benefit	—	—	1,509	—	—	—	1,509
Restricted stock grants	473	1	4,579	—	—	—	4,580
Compensation for fully vested stock options	—	—	1,902	—	—	—	1,902
Retirement of common stock	(124)	—	(2,798)	—	—	—	(2,798)
Issuance of common stock for Creative Designs	150	—	3,325	—	—	—	3,325
Net income	—	—	—	72,375	—	—	72,375
Foreign currency translation adjustment	—	—	—	—	—	(638)	(638)
<b>Balance, December 31, 2006</b>	27,777	\$ 28	\$ 300,255	\$ 312,432	\$ —	\$ (3,427)	\$ 609,288

See notes to consolidated financial statements.

# JAKKS PACIFIC, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
(In thousands)	2004	2005	2006
<b>Cash flows from operating activities</b>			
Net income	\$ 43,559	\$ 63,493	\$ 72,375
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	21,518	15,527	26,166
Share-based compensation expense	13,641	3,424	6,482
Acquisition earn-out	494	—	—
Investment in video game joint venture	(719)	(548)	(5,147)
Loss on disposal of property and equipment	1,096	104	48
Write-off of investment in Chinese Joint Venture	—	1,401	—
Changes in operating assets and liabilities			
Accounts receivable	(4,333)	16,697	(52,885)
Inventory	784	(13,272)	(8,352)
Prepaid expenses and other	(3,613)	1,088	(8,293)
Accounts payable	19,192	(9,437)	12,608
Accrued expenses	19,742	(1,915)	1,882
Income taxes payable	5,945	(2,936)	14,756
Reserve for sales returns and allowances	13,289	1,732	5,253
Deferred rent liability	—	995	(140)
Deferred income taxes	795	(5,292)	(1,043)
Total adjustments	87,831	7,568	(8,665)
Net cash provided by operating activities	131,390	71,061	63,710
<b>Cash flows from investing activities</b>			
Purchases of property and equipment	(5,917)	(8,270)	(11,204)
Purchases of other assets	(26,863)	118	(655)
Cash paid for net assets	(41,438)	(20,362)	(109,845)
Net (purchases) sales of marketable securities	967	19,047	(210)
Net cash used by investing activities	(73,251)	(9,467)	(121,914)
<b>Cash flows from financing activities</b>			
Proceeds from stock options exercised (net of cash-less exercises of \$1.7 million and \$2.8 million in 2005 and 2006, respectively)	1,682	3,173	1,584
Tax benefit from stock options exercised	—	—	1,509
Repayments of debt	(61)	—	—
Net cash provided by financing activities	1,621	3,173	3,093
Foreign currency translation adjustment	(1,398)	(1,073)	(638)
Net increase (decrease) in cash and cash equivalents	58,362	63,694	(55,749)
Cash and cash equivalents, beginning of year	118,182	176,544	240,238
Cash and cash equivalents, end of year	\$ 176,544	\$ 240,238	\$ 184,489
Cash paid during the period for:			
Interest	\$ 4,534	\$ 4,533	\$ 4,533
Income taxes	\$ 2,688	\$ 41,284	\$ 19,496

See Notes 5 and 18 for additional supplemental information to consolidated statements of cash flows.

See notes to consolidated financial statements.



## JAKKS PACIFIC, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006

#### Note 1—Principal Industry

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

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

#### Note 2—Summary of Significant Accounting Policies

##### **Principles of consolidation**

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

##### **Cash and cash equivalents**

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

##### **Use of estimates**

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

##### **Revenue recognition**

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

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

The Company also will occasionally grant credits to facilitate markdowns and sales of slow moving merchandise. These credits are recorded as a reduction of gross sales at the time of occurrence. The Company's reserve for sales returns and allowances increased by \$7.5 million from \$25.1 million as of December 31, 2005 to \$32.6 million as of December 31, 2006.

##### **Inventory**

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

	December 31,	
	2005	2006
Raw materials	\$ 2,679	\$ 3,845
Finished goods	64,050	72,943
	\$ 66,729	\$ 76,788

**Fair value of financial instruments**

The Company's cash and cash equivalents, marketable securities and accounts receivable represent financial instruments. The carrying value of these financial instruments is a reasonable approximation of fair value. The fair value of the \$98.0 million of convertible senior notes payable at December 31, 2006 was approximately \$127.4 million based on the quoted market price.

**Property and equipment**

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

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

**Advertising**

Production costs of commercials and programming are charged to operations in the year during which the production is first aired. The costs of other advertising, promotion and marketing programs are charged to operations in the year incurred. Advertising expense for the three years in the period ended December 31, 2006, was approximately \$26.4 million, \$38.8 million and \$36.7 million, respectively.

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

**Income taxes**

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

**Translation of foreign currencies**

Assets and liabilities denominated in Hong Kong dollars are translated into United States dollars at the rate of exchange ruling at the balance sheet date. Transactions during the period are translated at the rates ruling at the dates of the transactions.

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

**Accounting for the impairment of long-lived assets**

Long-lived assets with finite lives, which include property and equipment, intangible assets other than goodwill, are evaluated at least annually for impairment when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable through the estimated undiscounted future cash flows from the use of these assets. When any such impairment exists, the related assets will be written down to fair value. Finite-lived intangible assets consist primarily of product technology rights, acquired backlog, customer relationships, product lines and license agreements. These intangible assets are amortized over the estimated economic lives of the related assets. Accumulated amortization as of December 31, 2005 and 2006 was \$32.0 million and \$48.5 million, respectively.

**Goodwill and other indefinite-lived intangible assets**

In accordance with the adoption of Statement of Financial Accounting Standards ("SFAS") 142, *Goodwill and Other Intangible Assets*, on January 1, 2002, goodwill and indefinite-lived intangible assets are not amortized, but are tested for impairment at least annually at the reporting unit level. Losses in value are recorded when and as material impairment has occurred in the underlying assets or when the benefits of the identified intangible assets are realized. As of December 31, 2006, there was no impairment to the underlying value of goodwill or indefinite-lived intangible assets other than goodwill. Indefinite-lived intangible assets other than goodwill consists of trademarks.

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

#### **Share-based payments**

In December 2004, the FASB issued SFAS 123 (Revised), *Share-Based Payment*, (SFAS 123R) which amends SFAS 123, *Accounting for Stock Based Compensation*, and SFAS 95, *Statement of Cash Flows*. SFAS 123R requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its consolidated financial statements, and requires additional accounting and disclosure related to the income tax and cash flow effects resulting from share-based payment arrangements. SFAS 123R was effective for the Company beginning as of January 1, 2006, and it recorded \$1.9 million of share-based compensation expense in 2006 as further detailed in Note 16.

#### **Earnings per share**

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

2004			
	Income	Weighted Average Shares	Per Share
Basic EPS			
Income available to common stockholders	\$ 43,559	25,797	<u>\$ 1.69</u>
Effect of dilutive securities			
Assumed conversion of convertible senior notes	3,354	4,900	
Options and warrants	—	709	
Diluted EPS			
Income available to common stockholders plus assumed exercises	\$ 46,913	31,406	<u>\$ 1.49</u>
2005			
	Income	Weighted Average Shares	Per Share
Basic EPS			
Income available to common stockholders	\$ 63,493	26,738	<u>\$ 2.37</u>
Effect of dilutive securities			
Assumed conversion of convertible senior notes	2,978	4,900	
Options and warrants	—	555	
Diluted EPS			
Income available to common stockholders plus assumed exercises	\$ 66,471	32,193	<u>\$ 2.06</u>
2006			
	Income	Weighted Average Shares	Per Share
Basic EPS			
Income available to common stockholders	\$ 72,375	27,227	<u>\$ 2.66</u>
Effect of dilutive securities			
Assumed conversion of convertible senior notes	2,946	4,900	
Options and warrants	—	362	
Unvested restricted stock grants	—	225	
Diluted EPS			
Income available to common stockholders plus assumed exercises	\$ 75,321	32,714	<u>\$ 2.30</u>

Basic earnings per share has been computed using the weighted average number of common shares outstanding. Diluted earnings per share has been computed using the weighted average number of common shares and common share equivalents outstanding (which consist of warrants, options and convertible debt to the extent they are dilutive). Potentially dilutive stock options of 279,275, 487,506 and 406,612 for the years ended December 31, 2004, 2005 and 2006, respectively, were not included in the computation of diluted earnings per share as the average market price of the Company's common stock did not exceed the weighted average exercise price of such options and to have included them would have been anti-dilutive.

#### **Recent Accounting Standards**

In July 2006, the FASB issued Interpretation No. ("FIN") 48, *Accounting for Uncertainty in Income Taxes*, an Interpretation of SFAS 109, which clarifies the accounting for income taxes by prescribing the minimum recognition threshold an uncertain tax position is required to meet before tax benefits associated with such uncertain tax position are recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. In addition, FIN 48 excludes income taxes from the scope of SFAS 5, *Accounting for Contingencies*. FIN 48 is effective for fiscal years beginning after December 15, 2006. Differences between the amounts recognized in the consolidated balance sheets prior to the adoption of FIN 48 and the amounts reported after adoption are accounted for as a cumulative-effect adjustment to the beginning balance of retained earnings upon adoption of FIN 48. FIN 48 also requires that amounts recognized in the balance sheet related to uncertain tax positions be classified as a current or noncurrent liability, based upon the timing of the ultimate payment to a taxing authority. The Company will adopt FIN 48 as of January 1, 2007 and is in the process of finalizing the effect FIN 48 will have on its financial statements. Under the guidance of FIN 48, management estimates that its income tax reserve may increase by approximately \$15.0 million to \$25.0 million, which is subject to revision when management completes an analysis of the impact of FIN 48. As required by FIN 48, upon adoption on January 1, 2007, this difference will be recorded in retained earnings as a cumulative effect adjustment.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*, which provides guidance for using fair value to measure assets and liabilities. Under SFAS 157, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction that fair value should be based on the assumptions market participants would use when pricing the asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data, for example, the reporting entity's own data. Fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company does not expect the adoption of SFAS 157 to have a material impact on its results of operations and financial position.

In February 2007, the FASB issued SFAS 159, *Fair Value Option for Financial Assets and Financial Liabilities*, which provides companies with an option to report selected financial assets and liabilities at fair value. The objective of SFAS 159 is to reduce both the complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. SFAS 159 is effective for the Company as of January 1, 2008 and it does not expect the adoption of SFAS 159 to have a material effect on its operating results or financial position.

#### **Reclassifications**

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

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

The Company is a worldwide producer and marketer of children's toys and related products, principally engaged in the design, development, production and marketing of traditional toys, including boys' action figures, vehicles and playsets, craft and activity products, writing instruments, compounds, girls' toys, plush, construction toys, and infant and preschool toys, as well as pet treats, toys and related pet products. Prior to 2006, the Company's reportable segments were North America Toys, Pet Products and International. During 2006, the Company reorganized its business segments to conform to product groups that have become the focus of management review. The Company's reportable segments are Traditional Toys, Craft/Activity/Writing Products, Seasonal/Outdoor Products, and Pet Products.

All segments included worldwide sales. Traditional Toys include boys' action figures, vehicles and playsets, plush products, role-play and electronic toys. Craft/Activity/Writing Products include pens, pencils, stationery and drawing, painting and other craft related products. Seasonal/Outdoor Products include swimming pool toys, kites, remote control flying vehicles, squirt guns, and related products. Pet Products include pet treats, toys and related products.

Segment performance is measured at the operating income level. All sales are made to external customers, and general corporate expenses have been attributed to the various segments based on sales volumes. Segment assets are comprised of accounts receivable and inventories, net of applicable reserves and allowances, goodwill and other assets.



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

	Years Ended December 31,		
	2004	2005	2006
<b>Net Sales</b>			
Traditional Toys	\$ 463,299	\$ 568,737	\$ 658,804
Craft/Activity/Writing Products	84,197	62,058	52,834
Seasonal/Outdoor Products	26,770	20,978	33,694
Pet Products	—	9,763	20,054
	<u>\$ 574,266</u>	<u>\$ 661,536</u>	<u>\$ 765,386</u>

	Years Ended December 31,		
	2004	2005	2006
<b>Operating Income</b>			
Traditional Toys	\$ 43,344	\$ 75,643	\$ 79,457
Craft/Activity/Writing Products	7,877	8,254	6,372
Seasonal/Outdoor Products	2,504	2,790	4,064
Pet Products	—	1,298	2,419
	<u>\$ 53,725</u>	<u>\$ 87,985</u>	<u>\$ 92,312</u>

	December 31,	
	2005	2006
<b>Assets</b>		
Traditional Toys	\$ 526,984	\$ 687,162
Craft/Activity/Writing Products	153,646	119,883
Seasonal/Outdoor Products	56,241	56,784
Pet Products	17,084	18,065
	<u>\$ 753,955</u>	<u>\$ 881,894</u>

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

	December 31,	
	2005	2006
Long-lived Assets		
United States	\$ 283,350	\$ 352,959
Hong Kong	34,038	60,814
	<u>\$ 317,388</u>	<u>\$ 413,773</u>

	Years Ended December 31,		
	2004	2005	2006
<b>Net Sales by Geographic Area</b>			
United States	\$ 505,803	\$ 562,396	\$ 666,294
Europe	37,700	38,620	30,169
Canada	15,658	20,589	27,067
Hong Kong	4,410	24,388	17,500
Other	10,695	15,543	24,356
	<u>\$ 574,266</u>	<u>\$ 661,536</u>	<u>\$ 765,386</u>

## Major Customers

Net sales to major customers were approximately as follows (in thousands, except for percentages):

	2004		2005		2006	
	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales
Wal-Mart	\$ 193,776	33.7%	\$ 212,620	32.1%	\$ 210,758	27.5%
Target	74,429	13.0	95,716	14.5	134,347	17.6
Toys 'R' Us	68,279	11.9	82,732	12.5	104,392	13.6
	\$ 336,484	58.6%	\$ 391,068	59.1%	\$ 449,497	58.7%

No other customer accounted for more than 10% of our total net sales.

At December 31, 2005 and 2006, the Company's three largest customers accounted for approximately 73.0% and 78.1%, respectively, of net accounts receivable. The concentration of the Company's business with a relatively small number of customers may expose the Company to material adverse effects if one or more of its large customers were to experience financial difficulty. The Company performs ongoing credit evaluations of its top customers and maintains an allowance for potential credit losses.

## Note 4—Joint Ventures

The Company owns a fifty percent interest in a joint venture with THQ Inc. ("THQ") which develops, publishes and distributes interactive entertainment software for the leading hardware game platforms in the home video game market. The joint venture has entered into a license agreement with an initial license period expiring December 31, 2009 and a renewal period at the option of the joint venture expiring December 31, 2014 under which it acquired the exclusive worldwide right to publish video games on all hardware platforms. The Company's investment is accounted for using the cost method due to the financial and operating structure of the venture and its lack of significant influence over the joint venture. The Company's basis consists primarily of organizational costs, license costs and recoupable advances and is being amortized over the term of the initial license period. The joint venture agreement provides for the Company to receive guaranteed preferred returns through June 30, 2006 at varying rates of the joint venture's net sales depending on the cumulative unit sales and platform of each particular game. The preferred return was subject to change after June 30, 2006 and was to be set for the distribution period beginning July 1, 2006 and ending December 31, 2009 (the "Next Distribution Period"). The agreement provides that the parties will negotiate in good faith and agree to the preferred return not less than 180 days prior to the start of the Next Distribution Period. It further provides that if the parties are unable to agree on a preferred return, the preferred return will be determined by arbitration. The parties have not reached an agreement with respect to the preferred return for the Next Distribution Period and the Company anticipates that the reset, if any, of the preferred return will be determined through arbitration. The preferred return is accrued in the quarter in which the licensed games are sold and the preferred return is earned. Based on the same rates as set forth under the original joint venture agreement, an estimated receivable of \$13.5 million has been accrued for the six months ended December 31, 2006, pending the resolution of this outstanding issue. As of December 31, 2005 and 2006, the balance of the investment in the video game joint venture includes the following components (in thousands):

	December 31,	
	2005	2006
Preferred return receivable	\$ 8,334	\$ 13,482
Investment costs, net	2,031	1,391
	\$ 10,365	\$ 14,873

The Company's joint venture partner retains the financial risk of the joint venture and is responsible for the day-to-day operations, including development, sales and distribution, for which they are entitled to any remaining profits. In addition, THQ is entitled to receive a preferred return based on the sale by the Company of its WWE-themed TV Games. During 2005 and 2006, the Company incurred a liability of approximately \$0.8 million and \$0.1 million, respectively, which is recorded as a reduction of profit from the joint venture. During 2004, 2005 and 2006, the Company earned \$7.9 million, \$9.4 million and \$13.2 million, respectively, in net profit from the joint venture.

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

## Note 5—Business Combinations

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

On February 9, 2006, the Company acquired substantially all of the assets of Creative Designs International, Ltd. and a related Hong Kong company, Arbor Toys Company Limited (collectively, "Creative Designs"). The total initial consideration of \$111.1 million consisted of cash paid at closing in the amount of \$101.7 million, the issuance of 150,000 shares of the Company's common stock valued at approximately \$3.3 million and the assumption of liabilities in the amount of \$6.1 million, and resulted in the recording of goodwill in the amount of \$53.6 million. Goodwill represents anticipated synergies to be gained via the combination of Creative Designs with the Company. In addition, the Company agreed to pay an earn-out of up to an aggregate of \$20.0 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. For the year ended December 31, 2006, \$6.9 million of the earn-out was earned and recorded as goodwill. Creative Designs is a leading designer and producer of dress-up and role-play toys. This acquisition expands the Company's product offerings in the girls role-play and dress-up area and brings it new product development and marketing talent. The Company's results of operations have included Creative Designs from the date of acquisition.

The amount of goodwill from the Creative Designs acquisition that is expected to be deductible for Federal and state income tax purposes is approximately \$51.4 million. The total purchase price was allocated based on studies and valuations performed to the estimated fair value of assets acquired and liabilities assumed. The purchase price allocation including an earn-out of \$6.9 million earned through December 31, 2006 is set forth in the following table (in thousands):

### Estimated fair value of net assets:

Current assets acquired	\$ 15,655
Property and equipment, net	1,235
Other assets	103
Liabilities assumed	(6,081)
Intangible assets other than goodwill	40,488
Goodwill	60,519
	<u>\$ 111,919</u>

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

(In thousands, except per share data)	Year Ended December 31,	
	2005	2006
Net sales	\$ 829,622	\$ 778,269
Net income	\$ 81,702	\$ 75,221
Basic earnings per share	\$ 3.02	\$ 2.73
Weighted average shares outstanding	27,049	27,512
Diluted earnings per share	\$ 2.62	\$ 2.38
Weighted average shares and equivalents outstanding	32,342	32,777

In June 2005, the Company purchased substantially all of the operating assets and assumed certain liabilities relating to the Pet Pal line of pet products, including toys, treats and related pet products. The total initial purchase price of \$10.6 million was paid in cash. In addition, the Company agreed to pay an earn-out of up to an aggregate amount of \$25.0 million in cash over the three years ending June 30, 2008 following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. During the year-ended December 31, 2006, \$1.5 million of the earn-out was earned and recorded as goodwill. Goodwill of \$4.6 million arose from this transaction, which represents the excess of the purchase price over the fair value of assets acquired less the liabilities assumed. This acquisition expands the Company's product offerings and distribution channels. The Company's results of operation have included Pet Pal from the date of acquisition. Proforma results of operations are not provided since the amounts are not material to the consolidated results of operations.

In June 2004, the Company purchased substantially all of the assets and assumed certain liabilities of Play Along, Inc. and related companies (collectively, "Play Along"). The total initial purchase price of \$85.7 million consisted of cash paid in the amount of \$70.8 million and the issuance of 749,005 shares of the Company common stock valued at \$14.9 million and resulted in goodwill of \$67.8 million. In addition, the Company agreed to pay an earn-out of up to \$10.0 million per year for the three calendar years following the acquisition up to an aggregate amount of \$30.0 million based on the achievement of certain financial performance criteria which will be recorded as goodwill when and if earned. For the three years ended December 31, 2006, \$10.0 million, \$6.7 million and \$6.7 million, respectively, of the earn-out was earned and recorded as goodwill. Accordingly, the maximum earn-out remaining for the year ending December 31, 2007 is approximately \$6.6 million. Play Along designs and produces traditional toys, which it distributes domestically and internationally. This acquisition expands the Company's product offerings in the pre-school area and brings new product development and marketing talent to the Company. This transaction has been accounted for by the Company under the purchase method of accounting, and the Company's results of operations have included Play Along from the date of acquisition.

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

The total purchase price of Play Along, including the earn-outs earned through December 31, 2006 in the aggregate amount of \$23.4 million, which was allocated to goodwill, was allocated to the estimated fair value of assets acquired and liabilities assumed as set forth in the following table (in thousands):

**Estimated fair value:**

Current assets	\$ 24,063
Property and equipment, net	546
Other assets	3,184
Liabilities assumed	(22,263)
Intangible assets other than goodwill	22,100
Goodwill	81,390
	<u>\$ 109,020</u>

Approximately \$46.4 million of the Play Along goodwill is expected to be deductible for Federal and state income tax purposes.

**Note 6—Goodwill**

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

	Traditional Toys	Craft/Activity/ Writing Products	Seasonal/ Outdoor Products	Pet Products	Total
Balance at beginning of the year	\$ 142,962	\$ 82,826	\$ 38,906	\$ 4,604	\$ 269,298
Goodwill acquired during the year (See Note 5)	60,519	—	—	—	60,519
Adjustments to goodwill during the year	6,662	—	—	1,520	8,182
Balance at end of the year	<u>\$ 210,143</u>	<u>\$ 82,826</u>	<u>\$ 38,906</u>	<u>\$ 6,124</u>	<u>\$ 337,999</u>

Adjustments to goodwill during the year represents earn-outs earned during the year on acquisitions made in prior years (see Note 5).

**Note 7—Intangible Assets Other Than Goodwill**

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



	December 31, 2005				December 31, 2006			
	Weighted Useful Lives	Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount	
<b>Amortized Intangible Assets:</b>								
Acquired order backlog	0.50	\$ —	\$ —	\$ —	\$ 1,298	\$ (1,298)	\$ —	
Licenses	4.75	23,635	(12,082)	11,553	58,699	(25,821)	32,878	
Product lines	3.50	17,700	(17,700)	—	17,700	(17,700)	—	
Customer relationships	6.25	1,846	(700)	1,146	3,646	(1,239)	2,407	
Non-compete/ Employment contracts	4.00	2,748	(1,049)	1,699	2,748	(1,753)	995	
Debt offering costs	20 Years	3,705	(477)	3,228	3,705	(662)	3,043	
Total amortized intangible assets		49,634	(32,008)	17,626	87,796	(48,473)	39,323	
Unamortized Intangible Assets:								
Trademarks	indefinite	17,768	N/A	17,768	19,568	N/A	19,568	
		\$ 67,402	\$ (32,008)	\$35,394	\$ 107,364	\$ (48,473)	\$ 58,891	

For the years ended December 31, 2004, 2005, and 2006, the Company's aggregate amortization expense related to intangible assets was \$14.0 million, \$9.1 million and \$16.5 million, respectively. The Company currently estimates continuing amortization expense for the next five years to be approximately (in thousands):

2007	\$ 14,043
2008	9,108
2009	5,249
2010	3,048
2011	2,011

### Note 8—Concentration of Credit Risk

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

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

At December 31, 2005 and 2006, the Company's three largest customers accounted for approximately 73.0% and 78.1%, respectively, of net accounts receivable. The concentration of the Company's business with a relatively small number of customers may expose the Company to material adverse effects if one or more of its large customers were to experience financial difficulty. The Company performs ongoing credit evaluations of its top customers and maintains an allowance for potential credit losses.

### Note 9—Accrued Expenses

Accrued expenses consist of the following (in thousands):

	2005	2006
Royalties	\$ 15,918	\$ 17,829
Bonuses	11,554	7,172
Acquisition earn-out	6,667	13,598
Employee salaries and benefits	1,781	1,616
Promotional commitment	1,066	1,341
Sales commissions	682	1,764
Molds and tools	868	1,489
Other	5,879	9,855
	\$ 44,415	\$ 54,664

## Note 10—Related Party Transactions

A director of the Company is a partner in the law firm that acts as counsel to the Company. The Company incurred legal fees and expenses to the law firm in the amount of approximately \$3.3 million in 2004, \$3.2 million in 2005 and \$2.7 in 2006.

## Note 11—Convertible Senior Notes

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

	2005	2006
4.625% Convertible senior notes	\$ 98,000	\$ 98,000

In June 2003, the Company sold an aggregate of \$98.0 million of 4.625% Convertible Senior Notes due June 15, 2023. The notes may be converted into shares of the Company's common stock at an initial conversion price of \$20.00 per share, or 50 shares per note, subject to certain circumstances. The notes may be converted in each quarter subsequent to any quarter in which the closing price of the Company's common stock is at or above a prescribed price for at least 20 trading days in the last 30 trading day period of the quarter. The prescribed price for the conversion trigger is \$24.00 through June 30, 2010, and increases nominally each quarter thereafter. Cash interest is payable at an annual rate of 4.625% of the principal amount at issuance, from the issue date to June 15, 2010, payable on June 15 and December 15 of each year, commencing on December 15, 2003. After June 15, 2010, interest will accrue at the same rate on the outstanding notes. At maturity, the Company will redeem the notes at their accreted principal amount, which will be equal to \$1,811.95 (181.195%) per \$1,000 principal amount at issuance, unless redeemed or converted earlier. The notes were not convertible as of December 31, 2006.

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

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

2007	\$ —
2008	—
2009	—
2010	—
2011	—
Thereafter	98,000
	<u>\$ 98,000</u>

## Note 12—Income Taxes

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

	2004	2005	2006
Federal	\$ 696	\$ 20,821	\$ 22,031
State and local	1,088	4,326	4,310
Foreign	12,954	13,290	8,204
	14,738	38,437	34,545
APIC	—	—	58
Deferred	795	(5,293)	(1,043)
	<u>\$ 15,533</u>	<u>\$ 33,144</u>	<u>\$ 33,560</u>

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

	2005	2006
<b>Net deferred tax assets/(liabilities):</b>		
Current:		
Reserve for sales allowances and possible losses	\$ 3,305	\$ 881
Accrued expenses	1,895	2,404
Restricted stock grant	31	1,882
Foreign tax credit	(127)	—
Federal and state net operating loss carryforwards	4,117	2,993
Deductible intangible assets	2,240	2,079
State income taxes	2,309	1,302
Other	(152)	(29)
	13,618	11,512
<b>Long Term:</b>		
Undistributed earnings	(3,802)	—
Property and equipment	(2,419)	(608)
Original issue discount interest	(4,355)	(8,816)
Deductible goodwill and intangibles	1,103	1,873
Foreign tax credit	2,718	2,718
Stock options	—	686
Income from joint venture	—	1,770
Other	309	—
	(6,446)	(2,377)
Valuation allowance related to federal and state net operating loss carryforwards	—	(920)
<b>Total net deferred tax assets/(liabilities)</b>	<b>\$ 7,172</b>	<b>\$ 8,215</b>

In October 2004, the American Jobs Creation Act of 2004 (the "Act") was signed into law. The Act created a one-time incentive for U.S. corporations to repatriate undistributed earnings from their international subsidiaries by providing an 85% dividends-received deduction for certain international earnings. The deduction was available to corporations during the tax year that included October 2004, or in the immediately subsequent tax year. In the fourth quarter of 2005, the Company's Board of Directors approved a plan to repatriate \$105.5 million in foreign earnings, which was completed in December 2005. The Federal and State income tax expense related to this repatriation was approximately \$5.4 million.

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

	2004	2005	2006
Federal income tax expense	35.0%	35.0%	35.0%
State income tax expense, net of federal tax effect	1.3	2.1	2.6
One time dividend from foreign subsidiaries	—	8.3	—
Effect of differences in U.S. and Foreign statutory rates	(12.1)	(9.0)	(5.4)
Other	1.8	(2.1)	(0.5)
	26.0%	34.3%	31.7%

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

As of December 31, 2006, the Company has federal and state net operating loss carryforwards of \$5.9 million and \$12.5 million, respectively, expiring through 2023 and 2024. These carryforwards resulted from the acquisitions of Pentech and Toymax. The utilization of these losses to offset future income is limited under IRC§382. As of December 31, 2006, the Company's management concluded that a deferred tax asset valuation allowance was necessary for \$0.9 million of the state net operating loss carryforwards due to uncertainty about the ability to utilize these losses prior to expiration.

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

	2004	2005	2006
Domestic	\$ (22,669)	\$ 24,953	\$ 58,227
Foreign	81,761	71,684	47,708
	<u>\$ 59,092</u>	<u>\$ 96,637</u>	<u>\$ 105,935</u>

### Note 13—Leases

The Company leases office, warehouse and showroom facilities and certain equipment under operating leases. Rent expense for the years ended December 31, 2004, 2005 and 2006 totaled \$5.8 million, \$7.1 million and \$9.1 million, respectively. The following is a schedule of minimum annual lease payments (in thousands):

2007	\$ 8,146
2008	6,964
2009	5,383
2010	4,633
2011	4,548
Thereafter	7,729
	<u>\$ 37,403</u>

### Note 14—Common Stock, Preferred Stock and Warrants

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

During 2006, the Company issued 150,000 shares of common stock at a value of \$3.3 million in connection with the Creative Designs acquisition. The Company issued 473,160 shares of restricted stock to two executive officers, five non-employee directors of the Company and certain of the Company's management at a value of approximately \$9.0 million. The Company also issued 333,228 shares of common stock on the exercise of options for a total value of \$4.4 million, including 37,910 shares of common stock acquired by two executive officers in a cashless exercise of options through the surrender of an aggregate of 13,264 shares of restricted stock as payment of the exercise prices therefor at a value of \$0.3 million. In addition, the two executive officers surrendered an aggregate of 110,736 shares of restricted stock at a value of \$2.5 million as payment for income taxes due on the vesting of such stock. This restricted stock was subsequently retired by the Company.

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

During 2004, the Company issued 749,005 shares of common stock at a value of \$14.9 million in connection with the Play Along acquisition and 25,749 shares of common stock at a value of \$0.5 million in connection with the 2001 Kidz Biz acquisition. In addition, the Company issued 340,310 shares of restricted stock to three executive officers and five non-employee directors of the Company at a value of approximately \$4.5 million. The Company also issued 192,129 shares of common stock on the exercise of options for a total of \$1.7 million.



During 2003, the Company awarded 2,760,000 shares of restricted stock to four executive officers of the Company pursuant to its 2002 Stock Award and Incentive Plan ("the Award"), of which 636,000 were earned during 2003, 396,000 were earned during 2004, 288,000 were canceled upon the termination of employment of one of our executive officers in October 2004, and the balance may be earned through 2010 based upon the achievement of certain financial criteria and continuing employment (see Note 16.)

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

Warrant activity is summarized as follows:

	Number of Shares	Weighted Average Exercise Price
Outstanding, December 31, 2006	100,000	\$ 11.35

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

### Note 15—Commitments

The Company has entered into various license agreements whereby the Company may use certain characters and intellectual properties in conjunction with its products. Generally, such license agreements provide for royalties to be paid at 1% to 14% of net sales with minimum guarantees and advance payments. Additionally, under three separate licenses, the Company has committed to spend 2% to 10% of related net sales on advertising per year on such licenses. The Company estimates that its minimum commitment for advertising in fiscal 2007 will be approximately \$4.4 million.

Future annual minimum royalty guarantees as of December 31, 2006 are as follows (in thousands):

2007	\$ 20,722
2008	15,760
2009	6,366
2010	3,358
2011	—
Thereafter	1,145
	<u>\$ 47,351</u>

The Company has entered into employment and consulting agreements with certain executives expiring through December 31, 2010. The aggregate future annual minimum guaranteed amounts due under those agreements as of December 31, 2006 are as follows (in thousands):

2007	\$ 6,585
2008	3,986
2009	2,734
2010	2,280
	<u>\$ 15,585</u>

## Note 16—Share-Based Payments

Under its 2002 Stock Award and Incentive Plan ("the Plan"), which incorporated its Third Amended and Restated 1995 Stock Option Plan, the Company has reserved 6,025,000 shares of its common stock for issuance upon the exercise of options granted under the Plan, as well as for the awarding of other securities. Under the Plan, employees (including officers), non-employee directors and independent consultants may be granted options to purchase shares of common stock and other securities (Note 14). The vesting of these options and other securities may vary, but typically vest on a step-up basis over a maximum period of 5 years and restricted shares typically vest over one to two years. Share-based compensation expense is recognized on a straight-line basis over the requisite service period.

Under the Plan, share-based compensation payments may include the issuance of shares of restricted stock. Two executive officers are each entitled to be awarded 120,000 shares of restricted stock annually on each January 1 (through and including January 1, 2010). Such awards vest 50% each on the first and second anniversaries of issuance, subject to acceleration. Beginning in January 2006, the Company's five non-employee directors each receive annual grants of restricted stock at a value of \$120,000 (or, for 2006, 5,732 shares per director) which vest after one year. In March 2003, two executive officers of the Company were each granted 240,000 shares of restricted stock which, based on the achievement of certain financial performance criteria, vested on January 1, 2004. In January 2004, the Company issued 240,000 shares of restricted stock which, based on the achievement of certain financial performance criteria, vested on January 1, 2005. In January 2005 and 2006, respectively, the Company issued 245,000 shares of restricted stock at a value of \$5.1 million and 268,660 shares of restricted stock at a value of \$5.6 million to two executive officers and five non-employee directors of the Company. During 2006, the Company granted and issued an aggregate of 204,500 shares of restricted stock to its employees, which vest over a five-year period, at an aggregate value of approximately \$3.4 million, which represents the fair market value at the grant date. No shares of restricted stock were forfeited in 2006.

Under SFAS 123R, share-based compensation cost is measured at the grant date, based on the estimated fair value of the award, and is recognized as expense over the employee's requisite service period. The Company adopted the provisions of SFAS 123R using a modified prospective application. The valuation provisions of SFAS 123R apply to new awards and to awards that are outstanding on the effective date and subsequently vest or are modified or cancelled. Estimated compensation expense for awards outstanding at the effective date will be recognized over the remaining service period using the compensation cost calculated for pro forma disclosure purposes under SFAS 123, *Accounting for Stock-Based Compensation*.

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

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

The amount of share-based compensation expense recognized in the year ended December 31, 2006 is based on options granted prior to January 1, 2006 and restricted stock issued during the year ended December 31, 2006, and ultimately expected to vest, and it has been reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Total share-based compensation expense and related tax benefits recognized for the year ended December 31, 2006 was \$1.9 million and \$0.6 million, respectively, relating to options and \$4.6 million and \$1.4 million, respectively, relating to restricted stock. As of December 31, 2006, 1,224,876 shares were available for future grant. Additional shares may become available to the extent that options or shares of restricted stock presently outstanding under the Plan terminate or expire. Stock option activity pursuant to the Plan is summarized as follows:

	Number of Shares	Weighted Average Exercise Price
<b>Outstanding, December 31, 2003</b>	2,265,266	\$ 12.15
Granted	302,644	9.48
Exercised	(192,129)	8.91
Canceled	(287,775)	13.76
<b>Outstanding, December 31, 2004</b>	2,088,006	13.28
Granted	360,000	21.74
Exercised	(566,546)	8.60
Canceled	(77,354)	15.74
<b>Outstanding, December 31, 2005</b>	1,804,106	16.33
Granted	—	—
Exercised	(333,228)	13.15
Canceled	(8,500)	17.23
<b>Outstanding, December 31, 2006</b>	1,462,378	\$ 17.05

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

In 2004 and 2005, the fair value of each employee option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions used: risk-free rate of interest of 2.25% and 4.25%, respectively; dividend yield of 0%; with volatility of 136.9% and 130.2%, respectively; and expected lives of five years. There were no option grants in 2006.

The following table summarizes information about stock options outstanding and exercisable at December 31, 2006:

Option Price Range	Number of Shares	Outstanding		Exercisable	
		Weighted Average Life in Years	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
\$7.875 — \$13.48	411,338	4.77	\$ 11.87	304,038	\$ 11.39
\$13.49 — \$19.27	540,825	1.80	\$ 16.92	506,925	\$ 16.81
\$19.28 — \$22.11	510,219	4.64	\$ 21.35	156,094	\$ 21.25

As of December 31, 2005, the Company had 245,000 shares of restricted stock outstanding, all of which vested during the first quarter of 2006. In January 2006, the Company issued 268,660 shares of restricted stock, 240,000 of which vest over a two-year period subject to acceleration and 28,660 of which vest over a one-year period. In August and October 2006, the Company issued 200,000 shares and 4,500 shares of restricted stock, respectively, to certain of its employees, which vest over a five-year period. All restricted shares granted during 2006 remain unvested as of December 31, 2006. Restricted stock issued is valued at the fair market value of the traded common stock at the date of issuance.

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

Number of options outstanding	1,462,378
Weighted-average exercise price	\$ 17.05
Aggregate intrinsic value of options outstanding	\$ 7,068,762
Weighted-average contractual term of options outstanding	3.6 years
Number of options currently exercisable	967,057
Weighted-average exercise price of options currently exercisable	\$ 15.82
Aggregate intrinsic value of options currently exercisable	\$ 5,838,931
Weighted-average contractual term of currently exercisable	3.36 years

At and for the two years in the period ended December 31, 2005, the Company accounted for options granted under the Plan using the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. Prior to the implementation of SFAS 123R, stock-based employee compensation expense was not generally reflected in net income, as all options granted under the Plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123R to stock-based employee compensation for the years ended December 31, 2004 and 2005:

(In thousands, except per share data)	Years Ended December 31,	
	2004	2005
Net income, as reported	\$ 43,559	\$ 63,493
Add (Deduct): Stock-based employee compensation expense (income) included in reported net income net of related tax effects	3,954	(1,121)
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards net of related tax effects	(1,694)	(2,343)
Pro forma net income	\$ 45,819	\$ 60,029
Earnings per share:		
Basic — as reported	\$ 1.69	\$ 2.37
Basic — pro forma	\$ 1.78	\$ 2.25
Diluted — as reported	\$ 1.49	\$ 2.06
Diluted — pro forma	\$ 1.57	\$ 1.96

#### Note 17—Employee Pension Plan

The Company sponsors for its U.S. employees, a defined contribution plan under Section 401(k) of the Internal Revenue Code. The plan provides that employees may defer up to 50% of their annual compensation subject to annual dollar limitations, and that the Company will make a matching contribution equal to 100% of each employee's deferral, up to 5% of the employee's annual compensation. Company matching contributions, which vest immediately, totaled \$0.4 million, \$0.5 million and \$0.7 million for 2004, 2005 and 2006, respectively.

#### Note 18—Supplemental Information to Consolidated Statements of Cash Flows

In 2006, two executive officers acquired 37,910 shares of common stock in a cashless exercise of options through the surrender of an aggregate of 13,264 shares of restricted stock as payment of the exercise prices therefor at a value of \$0.3 million. In addition, the two executive officers surrendered an aggregate of 110,736 shares of restricted stock at a value of \$2.5 million as payment for income taxes due on the vesting of such stock. This restricted stock was subsequently retired by the Company. Additionally, the Company recognized a \$1.5 million tax benefit from the exercise of stock options. During 2006, the Company issued 150,000 shares of common stock at a value of \$3.3 million in connection with the Creative Designs acquisition.

In 2005, two executive officers acquired 215,982 shares of common stock in a cashless exercise of options through the surrender of an aggregate of 101,002 shares of restricted stock as payment of the exercise prices therefor at a value of \$1.7 million. This restricted stock was subsequently retired by the Company. Additionally, the Company recognized a \$4.1 million tax benefit from the exercise of stock options.

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



## Note 19—Selected Quarterly Financial Data (Unaudited)

Selected unaudited quarterly financial data for the years 2005 and 2006 are summarized below:

	2005			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<i>(In thousands, except per share data)</i>				
Net sales	\$ 134,676	\$ 127,091	\$ 233,500	\$ 166,269
Gross profit	\$ 54,212	\$ 48,073	\$ 93,452	\$ 70,970
Income from operations	\$ 13,675	\$ 14,614	\$ 47,218	\$ 12,478
Income before income taxes	\$ 13,627	\$ 15,732	\$ 46,306	\$ 20,972
Net income	\$ 10,084	\$ 11,642	\$ 32,753	\$ 9,014
Basic earnings per share	\$ 0.38	\$ 0.44	\$ 1.22	\$ 0.33
Weighted average shares outstanding	26,560	26,678	26,778	26,930
Diluted earnings per share	\$ 0.34	\$ 0.39	\$ 1.05	\$ 0.29
Weighted average shares and equivalents outstanding	32,256	32,229	32,088	32,197

	2006			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<i>(In thousands, except per share data)</i>				
Net sales	\$ 107,244	\$ 124,041	\$ 295,789	\$ 238,312
Gross profit	\$ 44,163	\$ 49,280	\$ 112,883	\$ 88,468
Income from operations	\$ 2,244	\$ 8,963	\$ 58,204	\$ 22,901
Income before income taxes	\$ 3,283	\$ 9,135	\$ 57,855	\$ 35,662
Net income	\$ 2,331	\$ 6,361	\$ 40,499	\$ 23,184
Basic earnings per share	\$ 0.09	\$ 0.23	\$ 1.46	\$ 0.85
Weighted average shares outstanding	27,310	27,536	27,694	27,298
Diluted earnings per share	\$ 0.09	\$ 0.22	\$ 1.26	\$ 0.73
Weighted average shares and equivalents outstanding	32,617	32,790	32,736	32,803

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

During the fourth quarter of 2005, the Company recorded a non-cash charge, which impacted operating income, of \$3.6 million for restricted stock, and it repatriated \$105.5 million from its Hong Kong subsidiaries which resulted in incremental income for tax expense of \$5.4 million and reduced net income.

## Note 20—Litigation

In October 2004, the Company was named as a defendant in a lawsuit commenced by World Wrestling Entertainment, Inc. ("WWE") (the "WWE Action"). The complaint also named as defendants, among others, the joint venture with THQ Inc., certain of the Company's foreign subsidiaries and the Company's three executive officers. The Complaint was amended, the antitrust claims were dismissed and, on grounds not previously considered by the Court, a motion to dismiss the RICO claim, the only remaining basis for jurisdiction, was argued and submitted in September 2006. Discovery remains stayed. In November 2004, several purported class action lawsuits were filed in the United States District Court for the Southern District of New York, alleging damages associated with the facts alleged in the WWE Action (the "Class Action"). They are the subject of a motion to dismiss that has been fully briefed and argument occurred on November 30, 2006. The motion is still pending. Three shareholder derivative actions have also been filed against the Company, nominally, and against certain of the Company's Board members (the "Derivative Actions"). The Derivative Actions seek to hold the individual defendants liable for damages allegedly caused to the Company by their actions, and, in one of the Derivative Actions, seeks restitution to the Company of profits, benefits and other compensation obtained by them. These actions are currently stayed or the time to answer has been extended.

The Company received notice from WWE alleging breaches of the video game license in connection with sales of WWE video games in Japan and other countries in Asia. The joint venture responded that WWE acquiesced in the arrangements, and separately released any claim against the joint venture in connection therewith and accordingly there is no breach of the joint venture's video game license. While the joint venture does not believe that WWE has a valid claim, it tendered a protective "cure" of the alleged breaches with a full reservation of rights. WWE "rejected" that cure and reserved its rights. On October 12, 2006, WWE commenced a lawsuit in Connecticut state court against THQ and the joint venture, involving the claim set forth above concerning allegedly improper sales of WWE video games in Japan and other countries in Asia (the "JV Action"). The lawsuit seeks, among other things, a declaration that WWE is entitled to terminate the video game license and monetary damages. A motion to strike one claim was argued on March 12, 2007 and submitted to the Court. Additionally, a schedule has been set, with trial no earlier than October 2008.

In connection with the joint venture with THQ (see Note 4), the Company receives its profit through a preferred return based on net sales of the joint venture, which was to be reset as of July 1, 2006. The agreement with THQ provides for the parties to agree on the reset of the preferred return or, if no agreement is reached, for arbitration of the issue. No agreement has been reached and the Company anticipates that the reset, if any, of the preferred return will be determined through arbitration. The preferred return is accrued in the quarter in which the licensed games are sold and the preferred return is earned. Based on the same rates as set forth under the original joint venture agreement, an estimated receivable of \$13.5 million has been accrued for the six months ended December 31, 2006, pending the resolution of this outstanding issue.

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

### *Report of Independent Registered Public Accounting Firm*

The Board of Directors and Stockholders  
JAKKS Pacific, Inc.  
Malibu, California

The audit referred to in our report dated March 15, 2007 relating to the 2006 consolidated financial statements of JAKKS Pacific, Inc., which is contained in Item 8 of this Form 10-K included the audit of the 2006 amounts in the accompanying financial statement schedule. This financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement schedule based upon our audit.

In our opinion such financial statement schedule presents fairly, in all material respects, the information for 2006 set forth therein.

*BDO Seidman, LLP*  
\_\_\_\_\_  
BDO Seidman, LLP

Los Angeles, California  
March 15, 2007

## JAKKS PACIFIC, INC. AND SUBSIDIARIES

### SCHEDULE II—VALUATION AND QUALIFYING ACCOUNTS

Years Ended December 31, 2004, 2005 and 2006

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

<i>(In thousands)</i>	Balance at Beginning of Period	Charged to Costs and Expenses	Charged to Other Accounts	Deductions	Balance at End of Period
<b>Year ended December 31, 2004:</b>					
Allowance for:					
Uncollectible accounts	\$ 7,877	\$ 2,903	\$ —	\$ (3,722)	\$ 7,058
Reserve for potential product obsolescence	5,025	5,342	—	(2,325)	8,042
Reserve for sales returns and allowances	7,753	49,956	2,131(a)	(36,667)	23,173
	<u>\$ 20,655</u>	<u>\$ 58,201</u>	<u>\$ 2,131</u>	<u>\$ (42,714)</u>	<u>\$ 38,273</u>
<b>Year ended December 31, 2005:</b>					
Allowance for:					
Uncollectible accounts	\$ 7,058	\$ 902	\$ (1,291)(b)	\$ (4,333)	\$ 2,336
Reserve for potential product obsolescence	8,042	6,981	—	(7,576)	7,447
Reserve for sales returns and allowances	23,173	54,767	218(c)	(53,035)	25,123
	<u>\$ 38,273</u>	<u>\$ 62,650</u>	<u>\$ (1,073)</u>	<u>\$ (64,944)</u>	<u>\$ 34,906</u>
<b>Year ended December 31, 2006:</b>					
Allowance for:					
Uncollectible accounts	\$ 2,336	\$ 37	\$ —	\$ (1,167)	\$ 1,206
Reserve for potential product obsolescence	7,447	3,412	—	(3,504)	7,355
Reserve for sales returns and allowances	25,123	49,951	2,213(d)	(44,698)	32,589
	<u>\$ 34,906</u>	<u>\$ 53,400</u>	<u>\$ 2,213</u>	<u>\$ (49,369)</u>	<u>\$ 41,150</u>

(a) Play Along acquired reserve.

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

(c) Pet Pal acquired reserve.

(d) Creative Designs acquired reserve.

**Management's Annual Report on Internal Control over Financial Reporting.**

We, as management, are responsible for establishing and maintaining adequate "internal control over financial reporting" (as defined in Exchange Act Rule 13a-15(f)). Our internal control system was designed by or is under the supervision of management and our board of directors to provide reasonable assurance regarding the reliability of financial reporting and the preparation of published financial statements.

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

Our management, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our internal control over financial reporting as of December 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control — Integrated Framework*. We believe that, as of December 31, 2006, our internal control over financial reporting is effective based on those criteria.

On February 9, 2006, the Company acquired substantially all of the assets of Creative Designs International, Ltd. and a related Hong Kong company, Arbor Toys Limited (collectively, "Creative Designs"). Management's assessments did not include the internal controls of Creative Designs for the year of acquisition. Creative Designs contributed \$181.1 million in net sales and \$34.9 million in operating income to our consolidated operations during 2006.

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



## Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders  
JAKKS Pacific, Inc.  
Malibu, California

We have audited management's assessment, included in the accompanying *Management's Annual Report on Internal Control over Financial Reporting*, that JAKKS Pacific, Inc. (the "Company") maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). JAKKS Pacific Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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

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

As indicated in the accompanying *Management's Annual Report on Internal Control over Financial Reporting*, management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of Creative Designs International, Ltd. and Arbor Toys Limited (Collectively "Creative Designs"), which were acquired on February 9, 2006, and which are included in the consolidated balance sheet of JAKKS Pacific, Inc. as of December 31, 2006, and the related consolidated statements of income, other comprehensive income, stockholders' equity, and cash flows for the year then ended. Creative Designs constituted 6.6% and 6.7% of total assets and net assets, respectively, as of December 31, 2006, and 23.7% and 45.8% of revenues and net income, respectively, for the year then ended. Management did not assess the effectiveness of internal control over financial reporting of Creative Designs because of the timing of the acquisition which was completed on February 9, 2006. Our audit of internal control over financial reporting of JAKKS Pacific, Inc. also did not include an evaluation of the internal control over financial reporting of Creative Designs.

In our opinion, management's assessment that JAKKS Pacific, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also in our opinion, JAKKS Pacific, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of JAKKS Pacific, Inc. as of December 31, 2006, and the related consolidated statements of income, other comprehensive income, stockholders' equity, and cash flows for the year then ended and our report dated March 15, 2007 expressed an unqualified opinion thereon.



BDO Seidman, LLP

Los Angeles, California  
March 15, 2007

## Executive Management

### Board of Directors

Jack Friedman  
Chairman  
Chief Executive Officer  
JAKKS Pacific, Inc.

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

Dan Almagor  
Chairman  
ACG Inc.

David C. Blatte  
Managing Director  
Centre Partners Management LLP

Robert E. Glick  
Apparel Manufacturing Executive

Michael G. Miller  
Advertising Executive

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

### Corporate Officers

Jack Friedman  
Chief Executive Officer

Stephen G. Berman  
President  
Chief Operating Officer

Joel M. Bennett  
Executive Vice President  
Chief Financial Officer

### Senior Executive Team

John Ardell  
Senior Vice President,  
Marketing – Interactive Products

Michael Bernstein  
Senior Vice President,  
Marketing – Boys Action

James Christianson  
Senior Vice President,  
Sales – Go Fly A Kite

Michael Dwyer  
Vice President,  
Legal & Human Resources

Charles Emby  
Co-President – Play Along

Jay Foreman  
Co-President – Play Along

Lawrence Geller  
Senior Vice President &  
General Counsel – Play Along

Geoffrey Greenberg  
President – Creative Designs  
International

Henry Ho  
Managing Director – Arbor Toys

Wills Hon  
Managing Director – Asia

David Johnston  
Senior Vice President –  
National Accounts

Tony Lawlor  
Senior Vice President –  
JAKKS Pets division

Irene Li  
Managing Director – Play Along  
Hong Kong

Tamre Logan  
Senior Vice President,  
Marketing and Sales –  
Girls Toys and Activities

Jack McGrath  
Senior Vice President, Operations

Ken Price  
Senior Vice President, Sales

Jennifer Richmond  
Senior Vice President,  
Licensing and Media

Genna Rosenberg  
Senior Vice President,  
Corporate Communications  
and Investor Relations

Carmine Russo  
Senior Vice President,  
International Sales

Merritt Schoch  
Senior Vice President –  
JAKKS Pets division

J.R. Shatley  
Senior Vice President, Sales – Play Along

Rick Watkins  
Senior Vice President,  
Product Development – Play Along

### Corporate Offices

Corporate Headquarters  
22619 Pacific Coast Highway  
Malibu, CA 90265  
Tel: 310-456-7799  
Fax: 310-317-8527

Sales Offices and Showrooms:  
11 East 26th Street, 4th Floor  
New York, NY 10010  
Tel: 212-929-9222  
Fax: 212-929-9278

809 Southwest I Street, Suite 5  
Bentonville, AK 72712  
Tel: 479-254-8888  
Fax: 479-366-3072

Distribution Center  
21749 Baker Parkway  
Industry, CA 91789  
Tel: 909-594-1379  
Fax: 909-594-2179

Asia Headquarters  
12/F  
Wharf T&T Centre,  
7 Canton Road, Room 718  
TST, Hong Kong  
Tel: 852-2311-1386  
Fax: 852-2265-4587

Play Along  
800 Fairway Drive, Suite 295  
Deerfield Beach, FL 33441  
Tel: 954-596-2210  
Fax: 954-596-8710

Creative Designs International  
2540 Metropolitan Drive  
Trevose, PA 19053  
Tel: 215-953-2800  
Fax: 215-953-2806

Arbor Toys/ Creative Designs  
International Hong Kong  
Suite 816, Chinachem  
Golden Plaza,  
77 Mody Road,  
Tsimshatsui East, Kowloon  
Hong Kong  
Tel: 852-2366-1363  
Fax: 852-2366-1689

### Shareholder Information

#### Legal Counsel

Feder, Kaszovitz, Isaacson, Weber,  
Skala, Bass & Rhine LLP  
750 Lexington Avenue,  
23rd Floor  
New York, NY 10022

#### Independent Auditors

BDO Seidman  
1900 Avenue of the Stars, 11th Floor  
Los Angeles, CA 90067

### Investor Relations

Genna Rosenberg  
JAKKS Pacific, Inc.  
22619 Pacific Coast Highway  
Malibu, CA 90265  
Tel: 310-455-6235 Fax: 310-317-8527

John Mills  
Integrated Corporate Relations, Inc.  
12121 Wilshire Blvd., Suite 300  
Los Angeles, CA 90025  
Tel: 310-395-2215 Fax: 310-395-2217

### Transfer Agent

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

### Stock Exchange Listing

Common stock trading on the  
Nasdaq National Market System  
under the symbol "JAKK." As of  
May 8, 2007, there were approxi-  
mately 183 shareholders of record  
and approximately 13,097 beneficial  
owners of the Company's com-  
mon stock. The Company has not  
paid cash dividends and does not  
anticipate paying cash dividends in  
the foreseeable future.

### Annual Report

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

### Common Stock Price Data

	High	Low
<b>2005:</b>		
First Quarter	\$23.96	\$17.25
Second Quarter	\$21.97	\$18.83
Third Quarter	\$20.20	\$15.54
Fourth Quarter	\$23.35	\$14.80
<b>2006:</b>		
First Quarter	\$27.10	\$19.23
Second Quarter	\$28.50	\$17.06
Third Quarter	\$20.24	\$15.26
Fourth Quarter	\$23.38	\$17.17
<b>2007:</b>		
First Quarter	\$25.96	\$19.31

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



[www.jakkspacific.com](http://www.jakkspacific.com)

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