

JAKKS PACIFIC INC
Form 10-K/A
May 12, 2005

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

**FORM 10-K/A
Amendment No. 1**

(Mark One)

x

**ANNUAL REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Fiscal Year Ended December 31, 2004

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

For the transition period from _____ to _____

Commission File Number 0-28104

JAKKS PACIFIC, INC.

(Name of registrant as specified in its charter)

**Delaware
(State or other jurisdiction of
incorporation or organization)**

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

**22619 Pacific Coast Highway
Malibu, California
(Address of principal executive offices)**

**90265
(Zip Code)**

**Registrant's telephone number, including area code: (310) 456-7799
Securities registered pursuant to Section 12(b) of the Exchange Act:**

Title of each class **Name of each exchange
on which registered**

None

Securities registered pursuant to Section 12(g) of the Exchange Act:

Title of Class

Common Stock, \$.001 par value per share

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by a check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

The aggregate market value of the voting and non-voting common equity (the only such common equity being Common Stock, \$.001 par value per share) held by non-affiliates of the registrant (computed by reference to the closing sale price of the Common Stock on March 28, 2005) is \$557,486,684.

The number of shares outstanding of the registrant's Common Stock, \$.001 par value (being the only class of its common stock) is 26,665,703 (as of March 28, 2005).

Documents Incorporated by Reference

None.

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On May 9, 2005, the Company was notified by Nasdaq that the wording used in Exhibits 31.1 and 31.2 (the 302 Certifications) to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2004 (the 2004 10-K) was inaccurate. As such, the Company is hereby amending the 2004 10-K to revise the introductory sentence of Section 4 of each of the 302 Certifications, so that such Section 4 now accurately reflects that the Company's certifying officers are responsible for establishing and maintaining not only disclosure controls and procedures, but also internal control over financial reporting.

The balance of the 2004 10-K remains unchanged.

In its notice, Nasdaq did not state that the Company had failed to satisfy any specific rule or standard for continued listing, yet did state that the Company was obligated to file this Amendment No. 1.

Except for disclosures affected by the revisions to Exhibits 31.1 and 31.2, this Amendment No. 1 speaks as of the original filing date of the 2004 10-K on March 31, 2005, and does not modify or update disclosures in the 2004 10-K to reflect events occurring or items discovered after March 31, 2005. Accordingly, this Amendment No. 1 should be read in conjunction with the Company's filings made with the Securities and Exchange Commission subsequent to March 31, 2005.

JAKKS PACIFIC, INC.
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For the Fiscal Year ended December 31, 2004
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DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

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

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Item 1. Business

In this report, JAKKS, the Company, we, us and our refer to JAKKS Pacific, Inc. and its subsidiaries.

Company Overview

We are a leading multi-line, multi-brand toy company that designs, develops, produces and markets toys and related products. We focus our business on acquiring or licensing well-recognized trademarks and brand names with long product histories (evergreen brands). We seek to acquire these evergreen brands because we believe they are less subject to market fads or trends. Our products are typically lower-priced toys and accessories and include:

Action figures and accessories including licensed characters, principally based on *World Wrestling Entertainment*[™] (WWE) and the *Dragon Ball*[®] franchise, and toy vehicles, including *Road Champs*[®] die-cast collectibles and *Remco*[®] toy vehicles and role-play toys and accessories;

Craft, activity and stationery products, including *Flying Colors Toys*[®] activity sets, compounds, playsets and lunch boxes, and *Colorworkshop*[®] craft products such as the *Bloppen*[®] and *Pentech*[®] writing instruments, stationery and activity products;

Infant and pre-school electronic toys, TV activities, toy foam puzzle mats and blocks, activity sets, outdoor products, plush toys featuring *Care Bears* and *Teletubbies*, soft body dolls featuring *Cabbage Patch Kids* and slumber bags;

Seasonal toys and leisure products, including kites, *Funnoodle*[®] pool toys, and *Storm*[™] water guns;

Electronics products, including *Plug it in & Play TV Games*[™] and *Laser Challenge*[™];

Junior sports, including Disney products, *Gaksplat*[™] and *Storm*[™]; and

Fashion and mini dolls and related accessories, including *Disney Princesses* sold in The Disney Store chain. We continually review the marketplace to identify and evaluate evergreen brands that we believe have the potential for significant growth. We endeavor to generate growth within these brands by:

- creating innovative products under established brand names;

- focusing our marketing efforts to enhance consumer recognition and retailer interest;

- linking them with our evergreen portfolio of brands;

- adding new items to the branded product lines that we expect will enjoy greater popularity; and

- adding new features and improving the functionality of products in the line.

In addition to developing our proprietary brands and marks, we license brands such as *WWE*[™], *Nickelodeon*[®], *Rugrats*[®], *Dora the Explorer*[®], *Blue s Clues*[®], *SpongeBob SquarePants*[®], *Mickey Mouse*, *Winnie the Pooh*, *Hello Kitty*[®] and *NASCAR*[®]. Licensing enables us to use these high-profile marks at a lower cost than we would incur if we purchased these marks or developed comparable marks on our own. By licensing marks, we have access to a far greater range of marks than would be available for purchase. We also license technology produced by unaffiliated inventors and product developers to improve the design and functionality of our products.

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We have obtained an exclusive worldwide license for our joint venture with THQ Inc. (THQ), which develops, produces, manufactures and markets video games based on WWE characters and themes. Since the joint venture's first title release in 1999, it has released 23 new titles. We have recognized approximately \$49.5 million in profit from the joint venture through December 31, 2004. On October 19, 2004, we were named as defendants in a lawsuit commenced by WWE, pursuant to which WWE is seeking treble, punitive and other damages (including disgorgement of profits) in an undisclosed amount and a declaration that the video game license with the joint venture and an amendment to our toy licenses with WWE are void and unenforceable (see Legal Proceedings).

Through the Toymax International, Inc. (Toymax) acquisition, we added toy brand names such as *Laser Challenge* and *Creepy Crawlers*® to our brand portfolio. In addition, pool-related products branded under the name *Funnoodle* and kites branded under the name *Go Fly a Kite*® further diversified our portfolio with products popular in the spring and summer seasons.

Through the assets acquired from Trendmasters®, Inc. (Trendmasters), we added to our portfolio the *The Storm* brand of water guns, gliders and junior sports toys, seasonal products for Halloween, Christmas and Easter, and vehicles, action figures, dolls and playsets under multiple brands.

In May 2003, we acquired from P&M Products USA, Inc. and an affiliated United Kingdom company, P&M Products Limited, (collectively P&M) the *Bloper*, *Blitz*, *Vivid Velvet*® and *Paints*® line of products.

In June 2004, we acquired from Play Along, Inc., Play Along (Hong Kong) Limited and PA Distribution, Inc. (collectively Play Along) pre-school toys including plush toys featuring *Care Bears* and *Teletubbies*, soft body dolls featuring *Cabbage Patch Kids*, and others.

Most of our current products are relatively inexpensive. In 2004, approximately 70% of our revenue came from products priced at twenty dollars or less at retail. We believe that these products have enduring appeal and are less subject to general economic conditions, toy product fads and trends, and changes in retail distribution channels. As of December 31, 2004, we had over 4,775 products in over 21 product categories. In addition, the simplicity of these products enables us to choose among a wider range of manufacturers and affords us greater flexibility in product design, pricing and marketing. Our product development process typically takes from three to nine months from concept to production and shipment to our customers. We believe that many licensors and retailers recognize and reward our ability to bring product to market faster and more efficiently than many of our competitors.

We sell our products through our in-house sales staff and independent sales representatives to toy and mass-market retail chain stores, department stores, office supply stores, drug and grocery store chains, club stores, toy specialty stores and wholesalers. The *Road Champs*, *Flying Colors* and *Pentech* products also are sold to smaller hobby shops, specialty retailers and corporate accounts, among others. Our five largest customers are Target, Kmart, Toys R Us, Wal-Mart, and Kay Bee Toys, which collectively accounted for approximately 65.6% of our net sales in 2004. No other customer accounted for more than 2.0% of our net sales in 2004. Kay Bee Toys filed for Chapter 11 bankruptcy protection in January 2004. As a result, we have reserved \$2.1 million for potential bad debt, which represents 84% of Kay Bee Toys' \$2.5 million pre-petition accounts receivable balance with us. If Kay Bee Toys is unable to extricate itself from bankruptcy and we are unable to replace the revenues previously earned by us from Kay Bee Toys with other retailers, our business, financial condition and results of operations could be materially adversely affected (see Risk Factors).

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Our Growth Strategy

The execution of our growth strategy has resulted in increased revenues and earnings. In 2003 and 2004, we generated net sales of \$315.8 million and \$574.3 million, respectively, and net income of \$15.9 million and \$43.6 million, respectively. We believe approximately 12.7% and 29.4% of our increase in net sales in 2003 and 2004 were respectively attributable to our acquisitions. Key elements of our growth strategy include:

Expand Core Products. We manage our existing and new brands through strong product development initiatives, including introducing new products, modifying existing products and extending existing product lines. Our product designers strive to develop new products or product lines to offer added technological, aesthetic and functional improvements to our product lines. We use real-scan technology in our action toys, and we incorporate articulated joints and a flexible rubberized coating to enhance the life-like and feel of these action toys. These innovations produce higher quality and better likenesses of the representative characters.

Enter New Product Categories. We will continue to use our extensive experience in the toy and other industries to evaluate products and licenses in new product categories and to develop additional product lines. We have entered the toy candy category through our internal creation of *Tongue Tape*, commenced marketing of licensed classic video games for simple plug-in use with television sets and expanded into slumber bags through the licensing of this category from our current licensors, such as Nickelodeon.

Pursue Strategic Acquisitions. We intend to supplement our internal growth rate with selected strategic acquisitions. Since our inception in 1995, we have successfully completed and integrated twelve acquisitions of companies and trademarks. Most recently, in June 2004, we acquired the assets of Play Along which expanded our pre-school offerings. We will continue focusing our acquisition strategy on businesses or brands that have compatible product lines and offer valuable trademarks or brands.

Acquire Additional Character and Product Licenses. We have acquired the rights to use many familiar corporate, trade and brand names and logos from third parties that we use with our primary trademarks and brands. Currently, we have license agreements with the WWE, Nickelodeon, Disney, and Warner Bros.®, as well as with the licensors of the many popular licensed children's characters previously mentioned, among others. We intend to continue to pursue new licenses from these entertainment and media companies and other licensors. We also intend to continue to purchase additional inventions and product concepts through our existing network of product developers.

Expand International Sales. We believe that foreign markets, especially Europe, Australia, Canada, Latin America and Asia, offer us significant growth opportunities. In 2004, our sales generated outside the United States were approximately \$68.5 million, or 11.9% of total net sales. We intend to continue to expand our international sales by capitalizing on our experience and our relationships with foreign distributors and retailers. Our recent expansion efforts included expanding internal resources and entering into a distribution agreement with Vivid Imaginations Ltd., a United Kingdom based toy distributor. We expect these initiatives to continue to contribute to our international growth in 2005 along with the addition of the Play Along product.

Capitalize On Our Operating Efficiencies. We believe that our current infrastructure and low-overhead operating model can accommodate significant growth without a proportionate increase in our operating and administrative expenses, thereby increasing our operating margins.

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The execution of our growth strategy, however, is subject to several risks and uncertainties and we cannot assure you that we will continue to experience growth in, or maintain our present level of, net sales (see Risk Factors That May Affect Future Results, beginning on page 14). For example, our growth strategy will place additional demands on our management, operational capacity and financial resources and systems. The increased demand on management may necessitate our recruitment and retention of qualified management personnel. We cannot assure you that we will be able to recruit and retain qualified personnel or expand and manage our operations effectively and profitably. To effectively manage future growth, we must continue to expand our operational, financial and management information systems and to train, motivate and manage our work force. There can be no assurance that our operational, financial and management information systems will be adequate to support our future operations. Failure to expand our operational, financial and management information systems or to train, motivate or manage employees could have a material adverse effect on our business, financial condition and results of operations.

Moreover, implementation of our growth strategy is subject to risks beyond our control, including competition, market acceptance of new products, changes in economic conditions, our ability to obtain or renew licenses on commercially reasonable terms and our ability to finance increased levels of accounts receivable and inventory necessary to support our sales growth, if any.

Furthermore, we cannot assure you that we can identify attractive acquisition candidates or negotiate acceptable acquisition terms, and our failure to do so may adversely affect our results of operations and our ability to sustain growth.

Finally, our acquisition strategy involves a number of risks, each of which could adversely affect our operating results, including difficulties in integrating acquired businesses or product lines, assimilating new facilities and personnel and harmonizing diverse business strategies and methods of operation; diversion of management attention from operation of our existing business; loss of key personnel from acquired companies; and failure of an acquired business to achieve targeted financial results.

Industry Overview

According to Toy Industry Association, Inc. (TIA), the leading toy industry trade group, the United States is the world's largest toy market, followed by Japan and Western Europe. Total retail sales of toys, excluding video games, in the United States, were approximately \$20.1 billion in 2004. Sales by domestic toy manufacturers to foreign customers exceeded \$6.0 billion in 2002. We believe the two largest United States toy companies, Mattel and Hasbro, collectively hold a dominant share of the domestic non-video toy market. In addition, hundreds of smaller companies compete in the design and development of new toys, the procurement of character and product licenses, and the improvement and expansion of previously introduced products and product lines. In the United States video game segment, total retail sales of video game software were approximately \$9.9 billion in 2004.

Over the past few years, the toy industry has experienced substantial consolidation among both toy companies and toy retailers. We believe that the ongoing consolidation of toy companies provides us with increased growth opportunities due to retailers' desire to not be entirely dependent on a few dominant toy companies. Retailer concentration also enables us to ship products, manage account relationships and track retail sales more effectively and efficiently.

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We focus our business on acquiring or licensing well-recognized trademarks or brand names, and we seek to acquire evergreen brands which are less subject to market fads or trends. Some of our license agreements for products and concepts call for royalties ranging from 1% to 18% of net sales, and some may require minimum guarantees and advances. Our principal products include:

Action Figures and Accessories

We have an extensive toy license with the WWE pursuant to which we have the exclusive worldwide right, until December 31, 2009, to develop and market a full line of toy products based on the popular *WWE* professional wrestlers. These wrestlers perform throughout the year at live events that attract large crowds, many of which are broadcast on free and cable television, including pay-per-view specials. We launched this product line in 1996 with various series of 6 inch articulated action figures that have movable body parts and feature real-life action sounds from our patented bone-crunching mechanism that allows the figures' bones to crack when they are bent. We continually expand and enhance this product line by using technology in the development and in the products themselves. The 6 inch figures currently make up a substantial portion of our overall *WWE* line, which has since grown to include many other new products including playsets using interactive technology. Our strategy has been to release new figures and accessories frequently to keep the line fresh and to retain the interest of the consumers.

In 2003, we began to develop, manufacture and distribute action figures and action figure accessories based on the animated series *Dragon Ball*, *Dragon Ball Z* and *Dragon Ball GT*. We also introduced action figures based on Universal Studios' Classic Monsters and Van Helsing feature film and another animated series, *Mucha Lucha*. In 2005, we will introduce action figures and accessories based on the animated series *Dragon Boosters*.

Flying Colors/Pentech Activity Sets, Compounds, Playsets, Writing Instruments and Lunch Boxes

Through our acquisition of Flying Colors Toys we entered into the toy activity category with compounds and plastic molded activity cases containing a broad range of activities, such as make and paint your own characters, jewelry making, art studios, posters, puzzles and other projects. The activity cases, with molded and painted likenesses of popular characters, such as Nickelodeon's *Blue's Clues* and *SpongeBob SquarePants*, and *Hello Kitty*, have immediate visual appeal. Using a related production technology, our lunch boxes complement this line with similarly-styled molded and painted likenesses featuring these and other popular characters. Our product lines also include stationery, back-to-school pens, pencils, markers, notebooks and P&M craft products such as *Blopens*® and *Vivid Velvet*.

Our compounds represent another significant area of emphasis for Flying Colors. Launched under the *Blue's Clues* license, this line has expanded from play clay in a bucket to an entire *Blue's Clues* playset featuring book molds, extrusion and other devices. We are continuing to expand the compound area and have introduced a full line of innovative compounds under the *Nickelodeon* brand, including *Splish Splat*™, among others.

Electronics Products

Through our acquisition of Toymax we entered into the electronic products category with our *Plug it in & Play TV Games* and *Laser Challenge* product line. Our *Laser Challenge* product line includes laser games and NRG paintball™. Our current TV Games include licenses from Activision, Atari, Namco and Nickelodeon, and feature such games as Centipede® and Pac-Man®.

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In 2004, we released twelve new TV Games including Ms. Pac-Man®, Spider-Man®, Disney and several licensed and non-licensed preschool titles, and we expect to release approximately 20 new TV Games in 2005, including Batman, Star Wars and a wireless version of Ms. Pac-Man. TV Games generated a significant amount of net sales in 2004 and we expect that level of sales to continue in 2005.

Seasonal Products

We have a wide range of seasonal toys and leisure products. Our *Go Fly A Kite* product line includes youth and adult kites and a wide array of decorative flags, windstocks, and windwheels. Our *Funnoodle* pool toys include the basic funnoodle, pool floats and a variety of other pool toys. Our *Storm* product line includes water guns, gliders and sport balls. In addition, we added a holiday product line for Easter, Halloween and Christmas.

Junior Sports Products

Our junior sports products include Disney licensed products, *Gaksplat* and *Storm*. Our Disney sports include such activities as basketball, bowling and golf. Our *Gaksplat* and *Storm* junior sports include a variety of mini sport balls and activity products.

Wheels Division Products

Road Champs die-cast collectible and toy vehicles

The *Road Champs* product line consists of highly detailed, die-cast replicas of new and classic cars, trucks, motorcycles, emergency vehicles and service vehicles, primarily in 1/43 scale (including police cars, fire trucks and ambulances), buses and aircraft (including propeller planes, jets and helicopters). Through licenses, we produce replicas of well-known vehicles including those from *Ford*®, *Chevrolet*® and *Porsche*®. Additionally, through our *NASCAR* license, we produce radio-controlled vehicles in a variety of scales. We believe that these licenses, increase the perceived value of the products and enhance their marketability.

Extreme sports die-cast collectibles and toy vehicles and action figures

Our extreme sports offering includes our *MXS*® line of motorcycles with riders featuring click n grip functionality which allows the user to release the rider from the motorcycle seat and perform the signature moves of the sport's top riders. Other products include off-road vehicles, personal watercraft, surfboards and skateboards, all sold individually and with playsets and accessories.

Toy and activity vehicles

Our *Remco* toy line includes toy and activity vehicles and other toys. In 2002, we also added infrared radio controlled vehicles and *Mighty Mops*® toy vehicles. Our toy vehicle line is comprised of a large assortment of rugged die-cast and plastic vehicles that range in size from four and three-quarter inch to big-wheeled seventeen inch vehicles. The breadth of the line is extensive, with themes ranging from emergency, fire, farm and construction, to racing and jungle adventure.

In 2004, we introduced an internally developed line of toy wheels and play sets called *Fly Wheels* that feature scale replicas of popular automobile tires and wheels. The wheels are launched from a handle with the pull of a zip cord.

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Infant and pre-school toys

Through our acquisition of Play Along we added to our pre-school toys with *Care Bears* plush and electronic toys, *Teletubbies* plush and *Cabbage Patch Kids* soft body dolls. These products generated a significant amount of net sales in 2004, and we expect that level of sales to continue in 2005.

Child Guidance

Our line of pre-school Child Guidance electronic toys features products that enhance sensory stimulation and learning through play, while offering value to the trade as well as to the consumer. Our products are designed for children ages two and under. We have combined the fun of music, lights, motion and sound with the early introduction of numbers, letters, shape and color recognition, all at a value price. In 2004, we introduced a line of licensed TV activity products featuring Disney and Nickelodeon characters as well as non-licensed versions.

Foam puzzle mats and playsets

The foam toy products include puzzle mats featuring licensed characters, such as *Winnie the Pooh* and *Blue's Clues*, among others, as well as letters of the alphabet and numbers. The inter-locking puzzle pieces can also be used to build houses and other play areas. Other products include foam puzzles of the United States, foam vehicles and outdoor foam products.

Slumber bags

Our line of children's indoor slumber bags features *Dora the Explorer*, *SpongeBob SquarePants* and *Blue's Clues* in addition to proprietary designs.

Fashion and Mini Dolls and Related Accessories

We produce various proprietary and licensed fashion and mini dolls and accessories for children between the ages of three and ten. The proprietary product lines include 11¹/₂ inch fashion dolls customized with high-fashion designs that correspond with particular holidays, events or themes, and fashion dolls based on children's classic fairy tales and holidays. We also have an agreement to manufacture for The Disney Store chain a full line of dolls under a private label which features *Disney Princesses* and classic Disney characters.

Our in-house product developers originate the design and functionality of most of our fashion dolls. In many cases, they work with retailers and incorporate their input on doll characteristics, packaging and other design elements to create exclusive product lines for them.

World Wrestling Entertainment Video Games

In June 1998, we formed a joint venture with THQ, Inc., a developer, publisher and distributor of interactive entertainment software for the leading hardware game platforms in the home video game market. The joint venture entered into a license agreement with the WWE under which it acquired the exclusive worldwide right to publish *WWE* video games on all hardware platforms. The term of the license agreement expires on December 31, 2009, and the joint venture has a right to renew the license for an additional five years under various conditions. On October 19, 2004, we were named as defendants in a lawsuit commenced by WWE, pursuant to which WWE is seeking treble, punitive and other damages (including disgorgement of profits) in an undisclosed amount and a declaration that the video game license with the joint venture and an amendment to our toy licenses with WWE are void and unenforceable (see Legal Proceedings).

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The games are designed, developed, manufactured and distributed by THQ. THQ arranges for the manufacture of the CD-ROMs and game cartridges used in the various video game platforms under non-exclusive licenses with Sony, Nintendo and Microsoft. No other licenses are required for the manufacture of the personal computer titles.

Through June 30, 2006, we are entitled to receive a guaranteed percentage preferred return from the joint venture at varying rates of net sales of the video games depending on the cumulative unit sales and platform of each particular game, as well as on the royalties earned by the joint venture from the publishing of game guides by third parties. After June 30, 2006, the amount of our preferred return from the joint venture will be subject to renegotiation between THQ and us. THQ is entitled to receive the balance of the profits.

The joint venture currently publishes titles for the Sony *PlayStation*® and *PlayStation 2*®, *Nintendo 64*® and *GameCube*® and Microsoft *Xbox*® consoles, *Nintendo Game Boy Color*® and *Game Boy Advance*® hand-held platforms, mobile/wireless and personal computers. The joint venture launched its first products in November 1999. It will also publish titles for new hardware platforms when, and as they are introduced to the market and have established a sufficient installed base to support new software. These titles are marketed to our existing customers as well as to game, electronics and other specialty stores, such as Electronics Boutique and Best Buy.

The following table presents our past results with the joint venture:

	New Game Titles		Profit from Joint Venture⁽¹⁾
	Console Platforms	Hand-held Platforms	(In millions)
1999	1	1	\$ 3.6
2000	4	1	15.9
2001	1	2	6.7
2002	3	1	8.0
2003	5		7.4
2004	2	1	7.9

(1) Profit from the joint venture reflects our preferred return on joint venture revenue less certain costs incurred directly by us.

Wrestling video games have demonstrated consistent popularity, with six of our wrestling-themed video games each having sold in excess of 1 million units since 1999, at retail prices ranging from approximately \$42 to \$60 per game. We believe that the success of *WWE* titles is dependent on the graphic look and feel of the software, the depth and variation of game play and the popularity of *WWE*. We believe that as a franchise property, *WWE* titles have brand recognition and sustainable consumer appeal, which may allow the joint venture to use titles over an extended period of time through the release of sequels and extensions and to re-release such products at different price points in the future.

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Sales, Marketing and Distribution

We sell all of our products through our own in-house sales staff and independent sales representatives to toy and mass-market retail chain stores, department stores, office supply stores, drug and grocery store chains, club stores, toy specialty stores and wholesalers. Our five largest customers are Target, Kmart, Toys R Us, Wal-Mart, and Kay Bee Toys, which accounted for approximately 57.7% of our net sales in 2003 and 65.6% of our net sales in 2004. Kay Bee Toys filed for bankruptcy protection under Chapter 11 in January 2004. Except for purchase orders relating to products on order, we do not have written agreements with our customers. Instead, we generally sell products to our customers pursuant to letters of credit or, in some cases, on open account with payment terms typically varying from 30 to 90 days. From time to time, we allow our customers credits against future purchases from us in order to facilitate their retail markdown and sales of slow-moving inventory. We also sell our products through e-commerce sites, including Toysrus.com.

We contract the manufacture of most of our products to unaffiliated manufacturers located in China. We sell the finished products on a letter of credit basis or on open account to our customers, who take title to the goods in Hong Kong or China. These methods allow us to reduce certain operating costs and working capital requirements. A portion of our sales originate in the United States, so we hold certain inventory in our warehouse and fulfillment facilities. To date, a significant portion of all of our sales has been to domestic customers. We intend to continue expanding distribution of our products into foreign territories and, accordingly, we have:

engaged representatives to oversee sales in certain territories,

engaged distributors in certain territories, such as Vivid Imaginations Ltd. in England,

established direct relationships with retailers in certain territories, and

expanded in-house resources.

Outside of the United States, we currently sell our products primarily in Europe, Australia, Canada, Latin America and Asia. Sales of our products abroad accounted for approximately \$44.7 million, or 14.2% of our net sales, in 2003 and approximately \$68.5 million, or 11.9% of our net sales, in 2004. We believe that foreign markets present an attractive opportunity, and we plan to intensify our marketing efforts and further expand our distribution channels abroad.

We establish reserves for sales allowances, including promotional allowances and allowances for anticipated defective product returns, at the time of shipment. The reserves are determined as a percentage of net sales based upon either historical experience or on estimates or programs agreed upon by our customers.

We obtain, directly, or through our sales representatives, orders for our products from our customers and arrange for the manufacture of these products as discussed below. Cancellations generally are made in writing, and we take appropriate steps to notify our manufacturers of these cancellations.

We maintain a full-time sales and marketing staff, many of whom make on-site visits to customers for the purpose of showing product and soliciting orders for products. We also retain a number of independent sales representatives to sell and promote our products, both domestically and internationally. Together with retailers, we sometimes test the consumer acceptance of new products in selected markets before committing resources to large-scale production.

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We advertise our products in trade and consumer magazines and other publications, market our products at international, national and regional toy, stationery and other specialty trade shows, conventions and exhibitions and carry on cooperative advertising programs with toy and mass market retailers and other customers which include the use of in-store displays. We also produce and broadcast television commercials for several of product lines including our *WWE* action figure line, *TV Games*, *Care Bears* and *Cabbage Patch Kids*, as well as for some of our *Flying Colors* and *Electronics* products. We may also advertise some of our other products on television, if we expect that the resulting increase in our net sales will justify the relatively high cost of television advertising.

Product Development

Each of our product lines has an in-house manager responsible for product development. The in-house manager identifies and evaluates inventor products and concepts and other opportunities to enhance or expand existing product lines or to enter new product categories. In addition, we create proprietary products, the principal source of products for our fashion doll line, and products to more fully exploit our concept and character licenses. Although we do have the capability to create and develop products from inception to production, we generally use third-parties to provide a substantial portion of the sculpting, sample making, illustration and package design required for our products in order to accommodate our increasing product innovations and introductions. Typically, the development process takes from three to nine months from concept to production and shipment to our customers.

We employ a staff of designers for all of our product lines. We occasionally acquire our other product concepts from unaffiliated third parties. If we accept and develop a third party's concept for new toys, we generally pay a royalty on the toys developed from this concept that are sold, and may, on an individual basis, guarantee a minimum royalty. In addition, we engage third party developers to program our line of *Plug it in & Play TV Games*. Royalties payable to inventors and developers generally range from 1% to 8% of the wholesale sales price for each unit of a product sold by us. We believe that utilizing experienced third-party inventors gives us access to a wide range of development talent. We currently work with numerous toy inventors and designers for the development of new products and the enhancement of existing products. We believe that toy inventors and designers have come to appreciate our practice of acting quickly and decisively to acquire and market licensed products. In addition, we believe that all of these factors, as well as our recent success in developing and marketing products, make us more attractive to toy inventors and developers than some of our competitors.

Safety testing of our products is done at the manufacturers' facilities by an engineer employed by us or by independent third-party contractors engaged by us. Safety testing is designed to meet regulations imposed by federal and state governmental authorities. We also monitor quality assurance procedures for our products for safety purposes. In addition, independent laboratories engaged by some of our larger customers test certain of our products.

Manufacturing and Supplies

Most of our products are currently produced by overseas third-party manufacturers, which we choose on the basis of quality, reliability and price. Consistent with industry practice, the use of third-party manufacturers enables us to avoid incurring fixed manufacturing costs, while maximizing flexibility, capacity and production technology. All of the manufacturing services performed overseas for us are paid for on open account with the manufacturers. To date, we have not experienced any material delays in the delivery of our products; however, delivery schedules are

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subject to various factors beyond our control, and any delays in the future could adversely affect our sales. Currently, we have ongoing relationships with approximately twenty-five different manufacturers. We believe that alternative sources of supply are available, although we cannot be assured that we can obtain adequate supplies of manufactured products.

Although we do not conduct the day-to-day manufacturing of our products, we participate in the design of the product prototype and production tools, dies and molds for our products and we seek to ensure quality control by actively reviewing the production process and testing the products produced by our manufacturers. We employ quality control inspectors who rotate among our manufacturers' factories to monitor the production of substantially all of our products.

The principal raw materials used in the production and sale of our toy products are plastics, zinc alloy, plush, printed fabrics, paper products and electronic components, all of which are currently available at reasonable prices from a variety of sources. Although we do not manufacture our products, we own the tools, dies and molds used in the manufacturing process, and these are transferable among manufacturers if we choose to employ alternative manufacturers. Tools, dies and molds represent a substantial portion of our property and equipment with a net book value of \$7.1 million in 2003 and \$6.8 million in 2004. Substantially all of these assets are located in China.

Trademarks and Copyrights

Most of our products are produced and sold under trademarks owned by or licensed to us. We typically register our properties, and seek protection under the trademark, copyright and patent laws of the United States and other countries where our products are produced or sold. These intellectual property rights can be significant assets. Accordingly, while we believe we are sufficiently protected, the loss of some of these rights could have an adverse effect on our business, financial condition and results of operations.

Competition

Competition in the toy industry is intense. Globally, certain of our competitors have greater financial resources, larger sales and marketing and product development departments, stronger name recognition, longer operating histories and benefit from greater economies of scale. These factors, among others, may enable our competitors to market their products at lower prices or on terms more advantageous to customers than those we could offer for our competitive products. Competition often extends to the procurement of entertainment and product licenses, as well as to the marketing and distribution of products and the obtaining of adequate shelf space. Competition may result in price reductions, reduced gross margins and loss of market share, any of which could have a material adverse effect on our business, financial condition and results of operations. In each of our product lines we compete against one or both of the toy industry's two dominant companies, Mattel and Hasbro. In addition, we compete, in our *Flying Colors* and *Pentech* product categories, with Rose Art Industries, Hasbro (Play-doh) and Binney & Smith (Crayola), and, in our toy vehicle lines, with RC2 (formerly Racing Champions). We also compete with numerous smaller domestic and foreign toy manufacturers, importers and marketers in each of our product categories. Our joint venture's principal competitors in the video game market are Electronic Arts, Activision and Acclaim Entertainment.

Seasonality and Backlog

In 2004, approximately 63% of our pro forma net sales (which includes sales of Play Along products from January 1, 2004) were made in the third and fourth quarters. Generally, the first

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quarter is the period of lowest shipments and sales in our business and the toy industry generally and therefore the least profitable due to various fixed costs. Seasonality factors may cause our operating results to fluctuate significantly from quarter to quarter. However, our writing instrument and activity products generally are counter-seasonal to the traditional toy industry seasonality due to the higher volume generally shipped for back-to-school beginning in the second quarter. In addition, our seasonal products are primarily sold in the spring and summer seasons. Our results of operations may also fluctuate as a result of factors such as the timing of new products (and related expenses) introduced by us or our competitors, the advertising activities of our competitors, delivery schedules set by our customers and the emergence of new market entrants. We believe, however, that the low retail price of most of our products may be less subject to seasonal fluctuations than higher priced toy products.

We ship products in accordance with delivery schedules specified by our customers, which usually request delivery of their products within three to six months of the date of their orders. Because customer orders may be canceled at any time without penalty, our backlog may not accurately indicate sales for any future period.

Government and Industry Regulation

Our products are subject to the provisions of the Consumer Product Safety Act (CPSA), the Federal Hazardous Substances Act (FHSA), the Flammable Fabrics Act (FFA) and the regulations promulgated thereunder. The CPSA and the FHSA enable the Consumer Products Safety Commission (CPSC) to exclude from the market consumer products that fail to comply with applicable product safety regulations or otherwise create a substantial risk of injury, and articles that contain excessive amounts of a banned hazardous substance. The FFA enables the CPSC to regulate and enforce flammability standards for fabrics used in consumer products. The CPSC may also require the repurchase by the manufacturer of articles. Similar laws exist in some states and cities and in various international markets. We maintain a quality control program designed to ensure compliance with all applicable laws.

Employees

As of March 29, 2005, we employed 419 persons, all of whom are full-time employees, including four executive officers. We employed 267 in the United States, 3 in the United Kingdom, 124 in Hong Kong and 25 in China. We believe that we have good relationships with our employees. None of our employees is represented by a union.

Environmental Issues

We are subject to legal and financial obligations under environmental, health and safety laws in the United States and in other jurisdictions where we operate. We are not currently aware of any material environmental liabilities associated with any of our operations.

Available Information

We make available free of charge on or through our Internet website, www.jakkspace.com, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to these reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

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Our Corporate Information

We were formed as a Delaware corporation in 1995. Our principal executive offices are located at 22619 Pacific Coast Highway, Malibu, California 90265. Our telephone number is (310) 456-7799 and our Internet Website address is www.jakkspace.com.

Risk Factors That May Affect Future Results

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

The outcome of litigation in which we have been named as a defendant is unpredictable and a materially adverse decision in any such matter could have a material adverse affect on our financial position and results of operations.

We are defendants in litigation matters, as described under **Legal Proceedings** in our periodic reports filed pursuant to the Securities Exchange Act of 1934, including the lawsuit commenced by WWE and the purported securities class action and derivative action claims stemming from the WWE lawsuit (see **Legal Proceedings**). These claims may divert financial and management resources that would otherwise be used to benefit our operations. Although we believe that we have meritorious defenses to the claims made in each and all of the litigation matters to which we have been named a party, and intend to contest each lawsuit vigorously, no assurances can be given that the results of these matters will be favorable to us. A materially adverse resolution of any of these lawsuits could have a material adverse affect on our financial position and results of operations.

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

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

The phenomenon of children outgrowing toys at younger ages, particularly in favor of interactive and high technology products;

Increasing use of technology;

Shorter life cycles for individual products; and

Higher consumer expectations for product quality, functionality and value.

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We cannot assure you that:

our current products will continue to be popular with consumers;

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

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

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

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

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

media associated with our character-related and theme-related product lines will be released at the times we expect or will be successful;

the success of media associated with our existing character-related and theme-related product lines will result in substantial promotional value to our products;

we will be successful in renewing licenses upon expiration on terms that are favorable to us; or

we will be successful in obtaining licenses to produce new character-related and theme-related products in the future.

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

There are risks associated with our license agreements.

Our current licenses require us to pay minimum royalties

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

Some of our licenses are restricted as to use

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

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New licenses are difficult and expensive to obtain

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

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

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

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

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

greater financial resources;

larger sales, marketing and product development departments;

stronger name recognition;

longer operating histories; and

greater economies of scale.

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

An adverse outcome in the litigation commenced against us by WWE or a decline in the popularity of WWE could adversely impact our video game joint venture with THQ.

The joint venture with THQ depends entirely on a single license, which gives the venture exclusive worldwide rights to produce and market video games based on World Wrestling Entertainment characters and themes. An adverse outcome against us, THQ or the joint venture in the lawsuit commenced by WWE (see the first Risk Factor, above) would adversely impact our rights under the joint venture's single license, which would adversely effect the joint venture's and our business, financial condition and results of operation.

Furthermore, the popularity of professional wrestling, in general, and World Wrestling Entertainment, in particular, is subject to changing consumer tastes and demands. The relative popularity of professional wrestling has fluctuated significantly in recent years. A decline in the popularity of World Wrestling Entertainment could adversely affect the joint venture's and our business, financial condition and results of operations.

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The termination of THQ's manufacturing licenses and the inability of the joint venture to otherwise obtain these licenses from other manufacturers would materially adversely affect the joint venture's and our business, financial condition and results of operations.

The joint venture relies on hardware manufacturers and THQ's non-exclusive licenses with them for the right to publish titles for their platforms and for the manufacture of the joint venture's titles. If THQ's manufacturing licenses were to terminate and the joint venture could not otherwise obtain these licenses from other manufacturers, the joint venture would be unable to publish additional titles for these manufacturers' platforms, which would materially adversely affect the joint venture's and our business, financial condition and results of operations.

The failure of the joint venture or THQ to perform as anticipated could have a material adverse affect on our financial position and results of operations.

The joint venture's failure to timely develop titles for new platforms that achieve significant market acceptance, to maintain net sales that are commensurate with product development costs or to maintain compatibility between its personal computer CD-ROM titles and the related hardware and operating systems would adversely affect the joint venture's and our business, financial condition and results of operations.

Furthermore, THQ controls the day-to-day operations of the joint venture and all of its product development and production operations. Accordingly, the joint venture relies exclusively on THQ to manage these operations effectively. THQ's failure to effectively manage the joint venture would have a material adverse effect on the joint venture's and our business and results of operations. We are also dependent upon THQ's ability to manage cash flows of the joint venture. If THQ is required to retain cash for operations, or because of statutory or contractual restrictions, we may not receive cash payments for our share of profits, on a timely basis, or at all.

We may not be able to sustain or manage our rapid growth, which may prevent us from continuing to increase our net revenues.

We have experienced rapid growth in our product lines resulting in higher net sales over the last six years, which was achieved through acquisitions of businesses, products and licenses. For example, revenues associated with our acquired companies in 2004 and 2003 were approximately \$168.9 million and \$40.1 million, respectively, representing 29.4% and 12.7% of our total revenues for those periods. As a result, comparing our period-to-period operating results may not be meaningful and results of operations from prior periods may not be indicative of future results. We cannot assure you that we will continue to experience growth in, or maintain our present level of, net sales.

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

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employees could have a material adverse effect on our business, financial condition and results of operations.

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

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

Our growth strategy depends in part upon our ability to acquire companies and new product lines. Revenues associated with our acquisitions represented approximately 29.4% and 12.7% of our total revenues in 2004 and 2003, respectively. Future acquisitions will succeed only if we can effectively assess characteristics of potential target companies and product lines, such as:

attractiveness of products;

suitability of distribution channels;

management ability;

financial condition and results of operations; and

the degree to which acquired operations can be integrated with our operations.

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

difficulties in integrating acquired businesses or product lines, assimilating new facilities and personnel and harmonizing diverse business strategies and methods of operation;

diversion of management attention from operation of our existing business;

loss of key personnel from acquired companies; and

failure of an acquired business to achieve targeted financial results.

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

Our five largest customers accounted for 65.6% of our net sales in 2004. Except for outstanding purchase orders for specific products, we do not have written contracts with or commitments from any of our customers. A substantial reduction in or termination of orders from any of our largest customers could adversely affect our business, financial condition and results of operations. In addition, pressure by large customers seeking price reductions, financial incentives, changes in other terms of sale or for us to bear the risks and the cost of carrying inventory also could adversely affect our business, financial condition and results of operations. If one or more of our major customers were to experience difficulties in fulfilling their obligations to us, cease doing business with us, significantly reduce the amount of their purchases from us or return substantial amounts of our products, it could have a material adverse effect on our business, financial condition

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and results of operations. In addition, the bankruptcy or other lack of success of one or more of our significant retailers could negatively impact our revenues and bad debt expense. For example, one of our five largest customers in 2004, Kay Bee Toys, filed for Chapter 11 bankruptcy protection in January 2004. As a result, we have reserved \$2.1 million for potential bad debt, which represents 84% of Kay Bee Toys' \$2.5 million pre-petition accounts receivable balance with us. If Kay Bee Toys is unable to extricate itself from bankruptcy and we are unable to replace the revenues previously earned by us from Kay Bee Toys, our business, financial condition and results of operations could be materially adversely affected.

We depend on our key personnel and any loss or interruption of either of their services could adversely affect our business, financial condition and results of operations.

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

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

We depend on approximately twenty-five third-party manufacturers who develop, provide and use the tools, dies and molds that we own to manufacture our products. However, we have limited control over the manufacturing processes themselves. As a result, any difficulties encountered by the third-party manufacturers that result in product defects, production delays, cost overruns or the inability to fulfill orders on a timely basis could adversely affect our business, financial condition and results of operations.

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

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

We have substantial sales and manufacturing operations outside of the United States subjecting us to risks associated with the outbreak of SARS, as well as risks common to international operations.

We sell products and operate facilities in numerous countries outside the United States. For the fiscal year ended December 31, 2004, sales to our international customers comprised approximately 11.9% of our net sales. We expect our sales to international customers to account for a greater portion of our revenues in future fiscal periods. Additionally, we utilize third-party manufacturers located principally in The People's Republic of China ("PRC"), which has been significantly

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impacted by the outbreak of Severe Acute Respiratory Syndrome (SARS). The inability of the PRC to effectively control the spread of SARS within its borders or the failure of the medical community to develop a cure for this illness may deplete the workforce of the PRC available to manufacture our products, create barriers to entry into commercial markets for our products manufactured in the PRC and prevent us from sending the requisite monitors and inspectors to the PRC to ensure that our products are being manufactured in accordance with our requirements and specifications. Any of the foregoing may cause the infrastructure of our PRC operations to fail, thereby adversely affecting our business, financial condition and results of operations.

Furthermore, our PRC sales and manufacturing operations are subject to the risks normally associated with international operations, including:

currency conversion risks and currency fluctuations;

limitations, including taxes, on the repatriation of earnings;

political instability, civil unrest and economic instability;

greater difficulty enforcing intellectual property rights and weaker laws protecting such rights;

complications in complying with laws in varying jurisdictions and changes in governmental policies;

greater difficulty and expenses associated with recovering from natural disasters;

transportation delays and interruptions; and

the potential imposition of tariffs.

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

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

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

product liability claims;

loss of sales;

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diversion of resources;

damage to our reputation;

increased warranty costs; and

removal of our products from the market.

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

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

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

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

Economic conditions, such as rising fuel prices and decreased consumer confidence, may adversely impact our margins. In addition, general economic conditions were significantly and negatively affected by the September 11th terrorist attacks and could be similarly affected by any future attacks. Such a weakened economic and business climate, as well as consumer uncertainty created by such a climate, could adversely affect our sales and profitability. Other conditions, such as the unavailability of electronics components, may impede our ability to manufacture, source and ship new and continuing products on a timely basis. Significant and sustained increases in the price of oil could adversely impact the cost of the raw materials used in the manufacture of our products, such as plastic.

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

On June 15, 2010, June 15, 2013 and June 15, 2018, holders of our convertible senior notes may require us to purchase their notes, which repurchase may be made for cash. In addition, holders may also require us to purchase their notes for cash upon the occurrence of certain fundamental changes in our board composition or ownership structure, if we liquidate or dissolve under certain circumstances or if our common stock ceases being quoted on an established over-the-counter trading market in the United States. If we do not have, or have access to, sufficient funds to repurchase the notes, then we could be forced into bankruptcy. In fact, we expect that we would require third-party financing, but we cannot assure you that we would be able to obtain that financing on favorable terms or at all.

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We have a material amount of goodwill which, if it becomes impaired, would result in a reduction in our net income.

Goodwill is the amount by which the cost of an acquisition accounted for using the purchase method exceeds the fair value of the net assets we acquire. Current accounting standards require that goodwill no longer be amortized but instead be periodically evaluated for impairment based on the fair value of the reporting unit. As at December 31, 2004, we have not had any impairment of Goodwill, which is evaluated on an annual basis.

At December 31, 2004, approximately \$258.3 million, or 37.3%, of our total assets represented goodwill. Declines in our profitability may impact the fair value of our reporting units, which could result in a further write-down of our goodwill. Reductions in our net income caused by the write-down of goodwill could harm our results of operations.

Item 2. Properties

Our principal executive offices occupy approximately 19,000 square feet of space in Malibu, California under a lease expiring on February 28, 2008. We have a lease, expiring August 31, 2007, for approximately 11,000 square feet of additional office space in Malibu, California, which contains our design offices. We have a lease, expiring December 31, 2007, for approximately 17,000 square feet of office space in Deerfield Beach, Florida. We have two leases for showroom and office space at the International Toy Center in New York City, one for approximately 14,500 square feet, which expires April 30, 2010, and an additional one for 4,500 square feet, which expires April 30, 2007. We also have leased office and showroom space of approximately 20,000 square feet in Hong Kong from which we oversee our China-based third-party manufacturing operations, 318,000 square feet of warehouse space in City of Industry, California, and 10,000 square feet of office space in Surrey, England. We entered into a lease for approximately 600,000 square feet of warehouse space in City of Industry, California that is expected to commence in July 2005. We also occupy approximately 25,000 square feet of office and warehouse space in Clinton, Connecticut under a lease expiring September 30, 2007 from which the operations of our Go Fly a Kite and Funnoodle divisions are carried out. We believe that our facilities in the United States, Hong Kong and England are adequate for our reasonably foreseeable future needs.

Item 3. Legal Proceedings

On October 19, 2004, we were named as defendants in a lawsuit commenced by WWE in the U.S. District Court for the Southern District of New York concerning our toy licenses with WWE and the video game license between WWE and the joint venture company operated by THQ and us, encaptioned World Wrestling Entertainment, Inc. v. JAKKS Pacific, Inc., et al., 1:04-CV-08223-KMK (the WWE Action). The complaint also named as defendants THQ, the joint venture, certain of our foreign subsidiaries, Jack Friedman (our Chairman and Chief Executive Officer), Stephen Berman (our Chief Operating Officer, President and Secretary and a member of our Board of Directors), Joel Bennett (our Chief Financial Officer), Stanley Shenker and Associates, Inc., Bell Licensing, LLC, Stanley Shenker and James Bell.

WWE sought treble, punitive and other damages (including disgorgement of profits) in an undisclosed amount and a declaration that the video game license with the joint venture, which is scheduled to expire in 2009 (subject to joint venture's right to extend that license for an additional five years), and an amendment to our toy licenses with WWE, which are scheduled to expire in 2009, are void and unenforceable. This action alleged violations by the defendants of the Racketeer

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Influenced and Corrupt Organization Act (RICO) and the anti-bribery provisions of the Robinson-Patman Act, and various claims under state law.

On February 16, 2005, we filed a motion to dismiss the WWE Action. On March 30, 2005, the day before WWE s opposition to our motion was due, WWE amended its complaint to, among other things, add the Chief Executive Officer of THQ as a defendant and to add a claim under the Sherman Act. On March 31, 2005, the WWE sent a letter to the Court proposing, *inter alia*, a briefing schedule for defendants motions to dismiss the amended complaint.

In November 2004, several purported class action lawsuits were filed in the United States District Court for the Southern District of New York; (1) Garcia v. Jakks Pacific, Inc. et al., Civil Action No. 04-8807 (filed on November 5, 2004), (2) Jonco Investors, LLC v. Jakks Pacific, Inc. et al., Civil Action No. 04-9021 (filed on November 16, 2004), (3) Kahn v. Jakks Pacific, Inc. et al., Civil Action No. 04-8910 (filed on November 10, 2004), (4) Quantum Equities L.L.C. v. Jakks Pacific, Inc. et al., Civil Action No. 04-8877 (filed on November 9, 2004), and (5) Irvine v. Jakks Pacific, Inc. et al., Civil Action No. 04-9078 (filed on November 16, 2004) (the Class Action). The complaints in the Class Actions allege that defendants issued positive statements concerning increasing sales of our WWE licensed products which were false and misleading because the WWE licenses had allegedly been obtained through a pattern of commercial bribery, our relationship with the WWE was being negatively impacted by the WWE s contentions and there was an increased risk that the WWE would either seek modification or nullification of the licensing agreements with us. Plaintiffs also allege that we misleadingly failed to disclose the alleged fact that the WWE licenses were obtained through an unlawful bribery scheme. The plaintiffs in the Class Actions are described as purchasers of our common stock, who purchased from as early as October 26, 1999 to as late as October 19, 2004. The Class Actions seek compensatory and other damages in an undisclosed amount, alleging violations of Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act) and Rule 10b-5 promulgated thereunder by each of the defendants (namely the Company and Messrs. Friedman, Berman and Bennett), and violations of Section 20(a) of the Exchange Act by Messrs. Friedman, Berman and Bennett. On January 25, 2005, the Court consolidated the Class Actions under the caption In re JAKKS Pacific, Inc. Shareholders Class Action Litigation, Civil Action No. 04-8807.

We believe that the claims in the WWE Action and the Class Actions are without merit and we intend to defend vigorously against them. However, because these Actions are in their preliminary stages, we cannot assure you as to the outcome of the Actions, nor can we estimate the range of our potential losses.

On February 16, 2005, we filed a motion to dismiss WWE s Complaint in the WWE Action. The motion is currently scheduled to be fully briefed on April 14, 2005, with oral argument to be scheduled thereafter.

On December 2, 2004, a shareholder derivative action was filed in the Southern District of New York by Freeport Partner, LLC against us, nominally, and against Messrs. Friedman, Berman and Bennett, Freeport Partners v. Friedman, et al., Civil Action No. 04-9441 (the Derivative Action). The Derivative Action seeks to hold the individual defendants liable for damages allegedly caused to us by their actions and in particular to hold them liable on a contribution theory with respect to any liability we incur in connection with the Class Actions. On or about February 10, 2005, a second shareholder derivative action was filed in the Southern District of New York by David Oppenheim against us, nominally, and against Messrs. Friedman, Berman, Bennett, Blatte, Glick, Miller and Skala, Civil Action 05-2046 (the Second Derivative Action). The Second Derivative Action seeks to hold the individual defendants liable for damages allegedly caused to us by their actions as a result

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of alleged breaches of their fiduciary duties. On or about March 16, 2005, a third shareholder derivative action was filed. It is captioned Warr v. Friedman, Berman, Bennett, Blatte, Glick, Miller, Skala, and Jakks (as a nominal defendant), and it was filed in the Superior Court of California, Los Angeles County (the Third Derivative Action). The Third Derivative Action seeks to hold the individual defendants liable for (1) damages allegedly caused to us by their alleged breaches of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment; and (2) restitution to us of profits, benefits and other compensation obtained by them.

On March 1, 2005, we delivered a Notice of Breach of Settlement Agreement and Demand for Indemnification to WWE (the Notification). The Notification asserted that WWE s filing of the WWE Action violated A Covenant Not to Sue contained in a January 15, 2004 Settlement Agreement and General Release (General Release) entered into between WWE and us and, therefore, that we were demanding indemnification, pursuant to the Indemnification provision contained in the General Release, for all losses that the WWE s actions have caused or will cause to us and our officers, including but not limited to any losses sustained by us in connection with the Class Actions. On March 4, 2005, in a letter from its outside counsel, WWE asserted that the General Release does not cover the claims in the WWE Action.

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

Table of Contents**PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities****Market Information**

Our common stock is traded on the Nasdaq National Market under the symbol JAKK. The following table sets forth, for the periods indicated, the range of high and low sales prices for our common stock on the Nasdaq National Market.

	Price Range of Common Stock	
	High	Low
2003:		
First quarter	\$ 14.49	\$ 9.50
Second quarter	14.49	10.22
Third quarter	14.04	10.05
Fourth quarter	13.77	11.74
2004:		
First quarter	16.25	12.72
Second quarter	21.00	14.48
Third quarter	23.22	18.71
Fourth quarter	25.55	12.75

Security Holders

To the best of our knowledge, as of March 25, 2005, there were 149 holders of record of our common stock. We believe there are numerous beneficial owners of our common stock whose shares are held in street name.

Dividends

We have never paid any cash dividends on our common stock. We currently intend to retain our future earnings, if any, to finance the growth and development of our business, but may consider implementing a plan to pay cash dividends on our common stock in the future.

Equity Compensation Plan Information

The table below sets forth the following information as of the fiscal year ended December 31, 2004 for (i) all compensation plans previously approved by our stockholders and (ii) all compensation plans not previously approved by our stockholders, if any:

(a) the number of securities to be issued upon the exercise of outstanding options, warrants and rights;

(b) the weighted-average exercise price of such outstanding options, warrants and rights;

(c) other than securities to be issued upon the exercise of such outstanding options, warrants and rights, the number of securities remaining available for future issuance under the plans.

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Plan Category	Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights (a)	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c)
Equity compensation plans approved by security holders	2,073,006	\$ 13.22	1,728,523
Equity compensation plans not approved by security holders			
Total	2,073,006	\$ 13.22	1,728,523

Equity compensation plans approved by our stockholders consists of the 2002 Stock Award and Incentive Plan.

Item 6. 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 (included in Item 8).

Year Ended December 31,

	2000	2001	2002	2003	2004
	(In thousands, except per share data)				
Consolidated Statement of Operations Data:					
Net sales	\$ 252,288	\$ 284,309	\$ 310,016	\$ 315,776	\$ 574,266
Cost of sales	149,881	164,222	180,173	189,334	348,259
Gross profit	102,407	120,087	129,843	126,442	226,007
Selling, general and administrative expenses	80,435	89,575	98,111	113,053	172,282
Acquisition shut-down and product recall costs	1,469	1,214	6,718	2,000	
Income from operations	20,503	29,298	25,014	11,389	53,725
Profit from Joint Venture	(15,906)	(6,675)	(8,004)	(7,351)	(7,865)
Interest, net	(3,833)	(2,057)	(1,141)	1,405	2,498

Other (income) expense, net (92)

Income before provision for income taxes and minority interest	40,334	38,030	34,159	17,335	59,092
Provision for income taxes	11,697	9,797	6,466	1,440	15,533
Income before minority interest	28,637	28,233	27,693	15,895	43,559
Minority interest			(237)		
Net income	\$ 28,637	\$ 28,233	\$ 27,930	\$ 15,895	\$ 43,559
Basic earnings per share	\$ 1.50	\$ 1.55	\$ 1.27	\$ 0.66	\$ 1.69
Weighted average shares outstanding	19,060	18,199	21,963	24,262	25,797
Diluted earnings per share	\$ 1.41	\$ 1.45	\$ 1.23	\$ 0.66	\$ 1.49
Weighted average shares and equivalents outstanding	20,281	19,410	22,747	27,437	31,406

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	At December 31,				
	2000	2001	2002	2003	2004
	(In thousands)				
Consolidated Balance Sheet Data:					
Cash and cash equivalents	\$ 29,275	\$ 25,036	\$ 68,413	\$ 118,182	\$ 176,544
Working capital	86,897	116,492	129,183	232,601	229,543
Total assets	248,722	284,041	408,916	529,997	696,762
Long-term debt, net of current portion	1,000	77	60	98,042	98,000
Total stockholders' equity	204,530	244,404	357,236	377,900	451,485

Item 7. 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 (included in Item 8).

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 Footnote 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 operation and financial position include:

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

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

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

significant underperformance relative to expected historical or projected future operating results;

significant changes in the manner of our use of the acquired assets or the strategy for our overall business; and

significant negative industry or economic trends.

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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 \$312.0 million as of December 31, 2004.

Recent Developments

On June 10, 2004, we purchased substantially all of the assets and assumed certain liabilities of Play Along, Inc., Play Along (Hong Kong) Limited and PA Distribution, Inc. (collectively Play Along). The total purchase price of approximately \$85.7 million consisted of cash in the amount of \$70.8 million, 749,005 shares of our common stock at a value of \$14.9 million and the assumption of certain liabilities and resulted in goodwill of \$67.8 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. Our results of operations have included Play Along from the date of acquisition.

On October 19, 2004, we were named as defendants in a lawsuit commenced by WWE in the U.S. District Court for the Southern District of New York concerning our toy licenses with WWE and the video game license between WWE and the joint venture company operated by THQ and us, encaptioned World Wrestling Entertainment, Inc. v. JAKKS Pacific, Inc., et al., 1:04-CV-08223-KMK (the WWE Action). The complaint also named as defendants THQ, the joint venture, certain of our foreign subsidiaries, Jack Friedman (our Chairman and Chief Executive Officer), Stephen Berman (our Chief Operating Officer, President and Secretary and a member of our Board of Directors), Joel Bennett (our Chief Financial Officer), Stanley Shenker and Associates, Inc., Bell Licensing, LLC, Stanley Shenker and James Bell.

WWE sought treble, punitive and other damages (including disgorgement of profits) in an undisclosed amount and a declaration that the video game license with the joint venture, which is scheduled to expire in 2009 (subject to joint venture's right to extend that license for an additional five years), and an amendment to our toy licenses with WWE, which are scheduled to expire in 2009, are void and unenforceable. This action alleged violations by the defendants of the Racketeer Influenced and Corrupt Organization Act (RICO) and the anti-bribery provisions of the Robinson-Patman Act, and various claims under state law.

On February 16, 2005, we filed a motion to dismiss the WWE Action. On March 30, 2005, the day before WWE's opposition to our motion was due, WWE amended its complaint to, among other things, add the Chief Executive Officer of THQ as a defendant and to add a claim under the Sherman Act. On March 31, 2005, the WWE sent a letter to the Court proposing, *inter alia*, a briefing schedule for defendants' motions to dismiss the amended complaint.

In November 2004, several purported class action lawsuits were filed in the United States District Court for the Southern District of New York; (1) Garcia v. Jakks Pacific, Inc. et al., Civil Action No. 04-8807 (filed on November 5, 2004), (2) Jonco Investors, LLC v. Jakks Pacific, Inc. et al., Civil Action No. 04-9021 (filed on November 16, 2004), (3) Kahn v. Jakks Pacific, Inc. et al., Civil Action No. 04-8910 (filed on November 10, 2004), (4) Quantum Equities L.L.C. v. Jakks Pacific, Inc. et al., Civil Action No. 04-8877 (filed on November 9, 2004), and (5) Irvine v. Jakks Pacific, Inc. et al., Civil Action No. 04-9078 (filed on November 16, 2004) (the Class Action). The complaints in the Class Actions allege that defendants issued positive statements concerning

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increasing sales of our WWE licensed products which were false and misleading because the WWE licenses had allegedly been obtained through a pattern of commercial bribery, our relationship with the WWE was being negatively impacted by the WWE's contentions and there was an increased risk that the WWE would either seek modification or nullification of the licensing agreements with us. Plaintiffs also allege that we misleadingly failed to disclose the alleged fact that the WWE licenses were obtained through an unlawful bribery scheme. The plaintiffs in the Class Actions are described as purchasers of our common stock, who purchased from as early as October 26, 1999 to as late as October 19, 2004. The Class Actions seek compensatory and other damages in an undisclosed amount, alleging violations of Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act) and Rule 10b-5 promulgated thereunder by each of the defendants (namely the Company and Messrs. Friedman, Berman and Bennett), and violations of Section 20(a) of the Exchange Act by Messrs. Friedman, Berman and Bennett. On January 25, 2005, the Court consolidated the Class Actions under the caption In re JAKKS Pacific, Inc. Shareholders Class Action Litigation, Civil Action No. 04-8807.

We believe that the claims in the WWE Action and the Class Actions are without merit and we intend to defend vigorously against them. However, because these Actions are in their preliminary stages, we cannot assure you as to the outcome of the Actions, nor can we estimate the range of our potential losses.

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On December 2, 2004, a shareholder derivative action was filed in the Southern District of New York by Freeport Partner, LLC against us, nominally, and against Messrs. Friedman, Berman and Bennett, Freeport Partners v. Friedman, et al., Civil Action No. 04-9441 (the Derivative Action). The Derivative Action seeks to hold the individual defendants liable for damages allegedly caused to us by their actions and in particular to hold them liable on a contribution theory with respect to any liability we incur in connection with the Class Actions. On or about February 10, 2005, a second shareholder derivative action was filed in the Southern District of New York by David Oppenheim against us, nominally, and against Messrs. Friedman, Berman, Bennett, Blatte, Glick, Miller and Skala, Civil Action 05-2046 (the Second Derivative Action). The Second Derivative Action seeks to hold the individual defendants liable for damages allegedly caused to us by their actions as a result of alleged breaches of their fiduciary duties. On or about March 16, 2005, a third shareholder derivative action was filed. It is captioned Warr v. Friedman, Berman, Bennett, Blatte, Glick, Miller, Skala, and Jakks (as a nominal defendant), and it was filed in the Superior Court of California, Los Angeles County (the Third Derivative Action). The Third Derivative Action seeks to hold the individual defendants liable for (1) damages allegedly caused to us by their alleged breaches of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment; and (2) restitution to us of profits, benefits and other compensation obtained by them.

On March 1, 2005, we delivered a Notice of Breach of Settlement Agreement and Demand for Indemnification to WWE (the Notification). The Notification asserted that WWE's filing of the WWE Action violated A Covenant Not to Sue contained in a January 15, 2004 Settlement Agreement and General Release (General Release) entered into between WWE and us and, therefore, that we were demanding indemnification, pursuant to the Indemnification provision contained in the General Release, for all losses that the WWE's actions have caused or will cause to us and our officers, including but not limited to any losses sustained by us in connection with

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the Class Actions. On March 4, 2005, in a letter from its outside counsel, WWE asserted that the General Release does not cover the claims in the WWE Action.

On March 31, 2004, our consolidated financial statements as of December 31, 2002 and 2003 and for the two years in the period ended December 31, 2003 were restated from those originally issued to reflect certain adjustments related to the accounting for the acquisitions of Toymax, Trendmasters and P&M in accordance with Statement of Financial Accounting Standards No. 141. Specifically, the purchase price of these acquisitions was originally allocated substantially to goodwill, and, based on studies and valuations completed in 2005 by a third-party valuation consultant, the purchase price of these acquisitions was reallocated in part to intangible assets other than goodwill, including those with limited lives. The resulting adjustment to amortization expense related to the limited life intangible assets of \$6.3 million in 2002 and \$7.3 million in 2003 and the resulting charge to cost of sales related to the mark-up of acquired inventory of \$0.7 million in 2002 and \$0.2 million in 2003, which led to a reduction of operating income in 2002 and 2003.

These adjustments impacted the consolidated balance sheets as of December 31, 2002 and 2003, and the consolidated statements of operations, other comprehensive income, stockholders' equity and cash flows for each of the two years ended December 31, 2002 and 2003.

Results of Operation

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

	Years Ended December 31,				
	2000	2001	2002	2003	2004
Net sales	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of sales	59.4	57.8	58.1	60.0	60.6
Gross profit	40.6	42.2	41.9	40.0	39.4
Selling, general and administrative expenses	31.9	31.5	31.6	35.8	30.0
Acquisition shut-down and product recall costs	0.5	0.4	2.2	0.6	
Income from operations	8.2	10.3	8.1	3.6	9.4
Profit from Joint Venture	(6.3)	(2.3)	(2.6)	(2.3)	(1.4)
Interest, net	(1.5)	(0.7)	(0.4)	0.4	0.4
Income before income taxes and minority interest	16.0	13.3	11.1	5.5	10.4
Provision for income taxes	4.6	3.4	2.1	0.5	2.7
Income before minority interest	11.4	9.9	9.0	5.0	7.7
Minority interest					
Net income	11.4%	9.9%	9.0%	5.0%	7.7%

Comparisons of the Years Ended December 31, 2004 and 2003

Net Sales. Net sales were \$574.3 million in 2004 compared to \$315.8 million in 2003, representing an increase of 81.9%. This increase in net sales was primarily due to the addition of \$151.6 million in sales of traditional toys from our recent Play Along acquisition, as well as the addition of (i) \$147.5 million in sales of some of our other traditional toy products, including primarily TV Games (with 15 titles in release in 2004, as compared to 3 titles in release in 2003) and WWE action figures and accessories; and (ii) \$23.7 million in international sales (including \$13.9 million by Play Along). The increase in net sales was offset in part by decreases in sales of

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our crafts and activities and writing instruments of \$48.2 million and our seasonal products, including water guns and junior sports toys, of \$16.1 million.

With the addition of Play Along, in addition to our other initiatives, we believe that the increased level of net sales should continue into 2005 (see Forward Looking Information).

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

Selling, General and Administrative Expenses. Selling, general and administrative expenses were \$172.3 million in 2004 and \$113.1 million in 2003, constituting 30.0% and 35.8% of net sales, respectively. The overall increase of \$59.2 million in such costs was primarily due to the impact of stock-based compensation (\$5.2 million), an increase in legal fees and settlements (\$6.8 million) and bonus expense (\$4.5 million), an increase in amortization expense related to intangible assets other than goodwill acquired in the Play Along acquisition and the addition of overhead related to the operations of Play Along (\$27.2 million). Due to the increases in our grants of restricted stock awards and the price of our common stock in 2004, compared to a moderate increase in the price of our common stock in 2003, we had stock-based compensation charges of \$13.6 million compared to \$8.4 million in 2003. The increase in direct selling expenses (\$19.3 million) is primarily due to an increase in advertising and promotional expenses in 2004 in support of the sell-through of our various products at retail. We produced and aired television commercials in support of several of our products, including World Wrestling Entertainment, Dragon Ball and Mucha Lucha action figures, TV Games, Care Bears, Cabbage Patch Kids and Flying Colors products in 2004, and World Wrestling Entertainment and Dragon Ball action figures and Flying Colors products in 2003. From time to time, we may increase our advertising efforts, if we deem it appropriate for particular products.

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

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

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

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

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

Provision for Income Taxes. Provision for income taxes included Federal, state and foreign income taxes in 2003 and 2004, at an effective tax rate of 8.3% and 26.0%, respectively, benefiting from a flat 17.0% Hong Kong Corporation Tax on our income arising in, or derived from, Hong Kong for 2003 and 2004. For 2004, the effective rate increased as a result of the recognition of U.S. taxes on a greater proportion of foreign earnings deemed to be subject to U.S. taxes. As of December 31, 2004, we had net deferred tax assets of approximately \$1.9 million. In making this determination, management believes it considered all available evidence, both positive and negative, as well as the weight and importance given to such evidence.

Comparisons of the Years Ended December 31, 2003 and 2002

Net Sales. Net sales were \$315.8 million in 2003 compared to \$310.0 million in 2002, representing an increase of 1.9%. The increase in net sales of \$17.6 million by our seasonal products, including *Trendmasters*, *Go Fly a Kite*, *Funnoodle* and sports toys, and new product introductions, including *Dragon Ball* and *NASCAR* action toys, TV games and *ColorWorkshop* craft products, were offset by a decrease of \$20.6 million in sales of our other traditional products, and \$8.5 million in international sales, which included a reduction in sales of our karaoke machines and Equalizer radio control vehicle in 2003, both higher priced items.

Gross Profit. Gross profit decreased \$3.4 million, or 2.7%, to \$126.4 million, or 40.0% of net sales, in 2003 from \$129.8 million, or 41.9% of net sales, in 2002. The overall decrease in gross profit was attributable to a decrease in gross profit margin. The decrease in gross profit margin of 1.9% of net sales was due to higher sales of seasonal products with lower margins and an increase in royalty expense as a percentage of net sales due to changes in the product mix resulting from the sale of more products with higher royalty rates, though offset in part by a decrease in amortization expense of molds and tools used in the manufacture of our products.

Selling, General and Administrative Expenses. Selling, general and administrative expenses were \$113.1 million in 2003 and \$98.1 million in 2002, constituting 35.8% and 31.6% of net sales, respectively. The overall increase of \$15.0 million in such costs was primarily due to a charge for the grant of restricted stock of \$8.4 million, a charge of \$2.1 million to bad debt relating to the bankruptcy of several of our customers, including Kay Bee Toys, and an increase in direct selling expenses, product development costs, option compensation expense resulting from the price reset of options in 2000 and operating expenses incurred in connection with the P&M asset acquisition. We produced and aired television commercials in support of several of our products, including *WWE* and *Dragon Ball Z* action figures and *Flying Colors* products in 2003 and *WWE* action figures and *Flying Colors* products in 2002. From time to time, we may increase our advertising efforts, if we deem it appropriate for particular products.

Acquisition Shut-down and Product Recall Costs. Acquisition shut-down costs in 2002 relate to shut-down costs, including lease termination, fixed asset abandonment and other costs, of certain operations of Toymax and Kidz Biz. There were no such costs in 2003. Operations impacted by these shut-downs were sales, design, distribution, and administration. The integrations of Toymax and Kidz Biz were completed in 2002. In 2003, we accrued a net amount of \$2.0 million for the recall of one of our products, compared to having accrued \$2.2 million in 2002 for the recall of the same product.

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The remaining component of the acquisition shut-down and product recall costs is as follows (in thousands):

	Accrued Balance December 31, 2002	Accrual	Actual	Accrued Balance December 31, 2003
Lease abandonment costs	\$ 2,310	\$	\$ (2,310)	\$
Product recall costs		2,000	(1,510)	490
Total	\$ 2,310	\$ 2,000	\$ (3,820)	\$ 490

Profit from Joint Venture. Profit from joint venture decreased by \$0.7 million in 2003 due to the joint venture having lower unit sales at lower wholesale prices of its two vehicle combat games of the five games released in 2003 compared to releasing all new titles with higher unit sales at higher wholesale prices in addition to having higher sales of carryover titles in 2002. New releases typically generate higher unit sales resulting in higher overall sales as compared to carryover titles. Profit from the joint venture contributed significantly to our pre-tax profit, representing 19.5% of pre-tax income in 2002 and 22.2% in 2003. We expect to continue to receive a preferred return over the remaining term of the license agreement ending December 31, 2009, although we cannot predict with certainty what levels of return will be achieved and, in any case, we anticipate substantial fluctuations in the amount of the preferred return distributed to us from year to year.

Interest Net. Interest income increased due to higher average cash balances during 2003 than in 2002, but was offset by interest expense of \$2.5 million related to the convertible notes issued in June 2003.

Provision for Income Taxes. Provision for income taxes included Federal, state and foreign income taxes in 2002 and 2003, at an effective tax rate of 18.9% and 8.3%, respectively, benefiting from a flat 16.5% and 17.0%, Hong Kong Corporation Tax on our income arising in, or derived from, Hong Kong for 2002 and 2003, respectively. For 2003, the effective rate decreased as a result of a higher proportionate share of income arising in Hong Kong as opposed to losses arising in the higher statutory jurisdictions. As of December 31, 2003, we had deferred tax assets of approximately \$4.5 million for which no allowance has been provided since, in the opinion of management, realization of the future benefit is probable. In making this determination, management believes it considered all available evidence, both positive and negative, as well as the weight and importance given to such evidence.

Table of Contents**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.

	2002				2003				2004			
First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	
(In thousands, except per share data)												
59,895	78,992	102,640	68,489	67,759	73,290	90,308	84,419	73,986	109,395	206,083	180,000	
19.3%	25.5%	33.1%	22.1%	21.5%	23.2%	28.6%	26.7%	12.9%	19.0%	35.9%	31.1%	
26,470	35,192	41,812	26,369	27,442	27,906	36,226	34,868	30,466	41,281	81,801	70,000	
20.4%	27.1%	32.2%	20.3%	21.7%	22.1%	28.7%	27.6%	13.5%	18.3%	36.2%	31.1%	
44.2%	44.6%	40.7%	38.5%	40.5%	38.1%	40.1%	41.3%	41.2%	37.7%	39.7%	39.7%	
ns1,420	7,863	16,835	(1,104)	5,960	2,522	10,480	(7,573)	4,885	8,321	29,915	10,000	
5.7%	31.4%	67.3%	-4.4%	52.3%	22.1%	92.0%	-66.5%	9.1%	15.5%	55.7%	31.1%	
2.4%	10.0%	16.4%	-1.6%	8.8%	3.4%	11.6%	-9.0%	6.6%	7.6%	14.5%	14.5%	
2,985	8,800	17,884	4,490	6,299	2,679	10,495	(2,138)	4,764	7,637	30,042	10,000	
5.0%	11.1%	17.4%	6.6%	9.3%	3.7%	11.6%	-2.5%	6.4%	7.0%	14.6%	31.1%	

2,156	6,973	13,085	5,717	4,988	2,236	8,248	422	3,791	6,004	23,255
3.6%	8.8%	12.7%	8.3%	7.4%	3.1%	9.1%	0.5%	5.1%	5.5%	11.3%
0.11	\$ 0.32	\$ 0.54	\$ 0.23	\$ 0.20	\$ 0.09	\$ 0.33	\$ 0.02	\$ 0.15	\$ 0.22	\$ 0.75

2,236	21,953	24,059	24,800	24,917	24,683	24,629	24,642	30,676	31,123	31,919
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Due to the restatement in 2003 relating to the accounting of the Toymax, Trendmasters and P&M acquisition and to rounding, some of the figures above may differ from our previously filed Quarterly Reports on Form 10-Q.

During the first quarter of 2002, we recorded a charge which impacted operating income by approximately \$6.6 million relating to the restructuring of Toymax and Kidz Biz.

During the second quarter of 2002, we recorded a charge which impacted operating income by approximately \$1.5 million relating to the recall of one of our products.

During the fourth quarter of 2002, we reversed \$2.1 million of the restructuring charge recorded in the first quarter of 2002 and recorded an additional charge of approximately \$0.7 million relating to the recall of one of our products, the net of which favorably impacted operating income by approximately \$1.4 million. In addition, our effective tax rate for the year 2002 was reduced from 26% to 19%.

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

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

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

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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.

Recent Accounting Standards

In January 2003 and as revised in December 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities (Interpretation 46) and FASB Interpretation No. 46R (Interpretation 46R). Interpretations 46 and 46R require companies with a variable interest in a variable interest entity to apply the guidance contained in such Interpretations as of the beginning of the first reporting period after December 15, 2003. If applicable, the application of the guidance could result in the consolidation of a variable interest entity. Interpretations 46 and 46R are not applicable to us, as we are not the beneficiary of any variable interest entities.

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity (SFAS 150). SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. The provisions of SFAS 150 were adopted effective June 9, 2003. The adoption of SFAS 150 did not have a material effect on our financial position or results of operations.

We use the intrinsic-value method of accounting for stock options granted to employees. As required by our existing stock plans, stock options are granted at, or above, the fair market value of our stock, and, accordingly, no compensation expense is recognized for these grants in the consolidated statement of operations. We record compensation expense related to other stock-based awards, such as restricted stock grants, over the period the award vests. On December 16, 2004, the FASB issued SFAS 123 (revised 2004), Share-Based Payment (SFAS 123(R)), which amends SFAS 123, Accounting for Stock-Based Compensation and SFAS 95 Statement of Cash Flows . SFAS 123(R) requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its consolidated financial statements. In addition, the adoption of SFAS 123(R) requires additional accounting and disclosure related to the income tax and cash flow effects resulting from share-based payment arrangements. SFAS 123(R) is effective for us as of July 1, 2005. The adoption of SFAS 123(R) s fair value method will have an impact on our results of operations, although it will have no impact on our overall financial position. While we cannot estimate the level of share-based payments to be issued in the future, based on the stock options that are currently outstanding, we expect that the adoption of SFAS 123(R) will result in a charge to operations in the second half of 2005 of approximately \$1.5 million.

In accordance with Emerging Issues Task Force (EITF) Issue 04-8, The Effect of Contingently Convertible Instruments on Diluted Earnings per Share , which we adopted in December 2004, diluted earnings per share for 2003 was restated to reflect the dilutive effect of the assumed conversion of our convertible senior notes due in 2023. The diluted earnings per share calculations for the two fiscal years ended December 31, 2004 include adjustments to add back to earnings the interest expense, net of tax, incurred on the convertible senior notes, and to include in diluted weighted average shares the shares potentially issuable as if the contingent conversion features were met. There was no effect on 2003 diluted earnings per share.

Liquidity and Capital Resources

As of December 31, 2004, we had working capital of \$225.9 million, as compared to \$232.6 million as of December 31, 2003. This decrease was primarily attributable to disbursements relating to the acquisition of certain assets of Play Along offset in part by operating activities.

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Operating activities provided net cash of \$131.4 million in the year ended December 31, 2004, as compared to \$7.4 million in 2003. Net cash was provided primarily by net income and non-cash charges, including compensation from stock option grants and restricted stock grants, acquisition earnout expense, depreciation and amortization and loss on disposal of property and equipment, as well as increases in accounts payable, accrued expenses, reserve for sales returns and allowances, income taxes payable and deferred income taxes and a decrease in inventory, which were offset in part by an increase in accounts receivable, prepaid expenses and other and an increase in the cash received from the preferred return from our joint venture. Our accounts receivable turnover as measured by days sales outstanding in accounts receivable decreased from approximately 92 days as of December 31, 2003 to approximately 50 days as of December 31, 2004 primarily due to a shift in sales from domestic sales origin to FOB China, which carry shorter payment terms, a shift in domestic sales to customers with shorter payment terms and overall improved collection efforts and results. Other than open purchase orders, issued in the normal course of business, we have no obligations to purchase finished goods from our manufacturers. As of December 31, 2004, we had cash and cash equivalents of \$176.5 million and marketable securities of \$19.0 million.

Our investing activities used cash of \$73.3 million in the year ended December 31, 2004, as compared to \$47.3 million in 2003, consisting primarily of the purchase of office furniture and equipment and molds and tooling used in the manufacture of our products, the purchase of other assets and the goodwill and other intangible assets acquired in the acquisition of Play Along, partially offset by the sale of marketable securities. In 2003, our investing activities consisted primarily of the purchase of molds and tooling used in the manufacture of our products, the purchase of other assets, the goodwill and other intangible assets acquired in the acquisition of P&M, the purchase of marketable securities, partially offset by the repayment of notes receivable from officers. As part of our strategy to develop and market new products, we have entered into various character and product licenses with royalties ranging from 1% to 18% payable on net sales of such products. As of December 31, 2004, these agreements required future aggregate minimum guarantees of \$27.2 million, exclusive of \$9.1 million in advances already paid.

Our financing activities provided net cash of \$1.6 million in the year ended December 31, 2004, as compared to \$90.0 million in 2003. In 2004, cash was primarily provided from the exercise of stock options, partially offset by the repayment of long-term debt. In 2003, cash was primarily provided from the sale of our convertible senior notes and from the exercise of stock options, partially offset by the repurchase of \$6.1 million of our common stock and the repayment of debt.

The following is a summary of our significant contractual cash obligations for the periods indicated that existed as of December 31, 2004 and is based on information appearing in the notes to the consolidated financial statements (in thousands):

	2005	2006	2007	2008	2009	Thereafter	Total
Long-term debt	\$	\$	\$	\$	\$	\$ 98,000	\$ 98,000
Operating leases	6,543	5,714	4,723	2,819	2,804	6,603	29,206
Minimum guaranteed license/royalty payments	13,635	8,868	1,795	1,427	1,435		27,160
Employment contracts	5,069	4,557	4,248	2,180	2,230	2,280	20,564
Total contractual cash obligations	\$ 25,247	\$ 19,139	\$ 10,766	\$ 6,426	\$ 6,469	\$ 106,883	\$ 174,930

In December 2001, we acquired all of the outstanding capital stock of Kidz Biz Limited, a United Kingdom company, and an affiliated Hong Kong company, Kidz Biz Far East Limited, for an aggregate purchase price of approximately \$12.4 million. Total consideration was paid on the closing of the transaction in cash in the amount of \$6.4 million and the issuance of 308,992 shares of our common stock at a value of \$6.0 million. In addition, we agreed to pay an earn-out for each of 2002, 2003, 2004 and 2005, based on the achievement of certain financial

performance criteria,

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payable by delivery of up to 25,749 shares of our common stock per year. In 2002, 2003 and 2004, no earn-outs were earned because the criteria were not met. However, we paid the 2005 earn-out at a value of \$0.5 million during 2004 upon the termination of employment of a principal of the seller, which was charged to expense in 2004.

In October 2001, we and all of our domestic subsidiaries jointly and severally secured a syndicated line of credit totaling \$50.0 million with a consortium of banks (Line of Credit). On August 6, 2004, we and all of our domestic subsidiaries notified the banks that we were terminating the Line Credit effective August 13, 2004. There have never been any outstanding borrowings under the Line of Credit since its inception.

In February 2003, our Board of Directors approved a buyback of up to \$20.0 million of our common stock. During 2003, we repurchased and retired 554,500 shares of our common stock for a total of approximately \$6.1 million. No shares were repurchased in 2004.

In May 2003, we purchased certain product lines, related assets and assumed certain liabilities of P&M. The total purchase price of approximately \$22.0 million consisted of cash paid in the amount of \$20.7 million and liabilities assumed of \$1.3 million and resulted in goodwill of \$13.5 million. Results of operations have included P&M from the date of acquisition.

On June 10, 2004, we purchased substantially all of the assets and assumed certain liabilities of Play Along, Inc., Play Along (Hong Kong) Limited and PA Distribution, Inc. (collectively Play Along). The total 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 year ended December 31, 2004, \$10.0 million of the earn-out was earned and recorded as goodwill as of December 31, 2004. Accordingly, the annual maximum earn-out for the remaining three years through December 31, 2007 is approximately \$6.7 million, or an aggregate of \$20.0 million. Results of operations have included Play Along from the date of acquisition.

On October 19, 2004, we were named as defendants in a lawsuit commenced by WWE in the U.S. District Court for the Southern District of New York concerning our toy licenses with WWE and the video game license between WWE and the joint venture company operated by THQ and us, encaptioned World Wrestling Entertainment, Inc. v. JAKKS Pacific, Inc., et al., 1:04-CV-08223-KMK (the WWE Action). The complaint also named as defendants THQ, the joint venture, certain of our foreign subsidiaries, Jack Friedman (our Chairman and Chief Executive Officer), Stephen Berman (our Chief Operating Officer, President and Secretary and a member of our Board of Directors), Joel Bennett (our Chief Financial Officer), Stanley Shenker and Associates, Inc., Bell Licensing, LLC, Stanley Shenker and James Bell.

WWE sought treble, punitive and other damages (including disgorgement of profits) in an undisclosed amount and a declaration that the video game license with the joint venture, which is scheduled to expire in 2009 (subject to joint venture s right to extend that license for an additional five years), and an amendment to our toy licenses with WWE, which are scheduled to expire in 2009, are void and unenforceable. This action alleged violations by the defendants of the Racketeer Influenced and Corrupt Organization Act (RICO) and the anti-bribery provisions of the Robinson-Patman Act, and various claims under state law.

On February 16, 2005, we filed a motion to dismiss the WWE Action. On March 30, 2005, the day before WWE s opposition to our motion was due, WWE amended its complaint to, among other things, add the Chief Executive Officer of THQ as a defendant and to add a claim under the

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Sherman Act. On March 31, 2005, the WWE sent a letter to the Court proposing, *inter alia*, a briefing schedule for defendants' motions to dismiss the amended complaint.

In November 2004, several purported class action lawsuits were filed in the United States District Court for the Southern District of New York: (1) Garcia v. Jakks Pacific, Inc. et al, Civil Action No. 04-8807 (filed on November 5, 2004), (2) Jonco Investors, LLC v. Jakks Pacific, Inc. et al, Civil Action No. 04-9021 (filed on November 16, 2004), (3) Kahn v. Jakks Pacific, Inc. et al, Civil Action No. 04-8910 (filed on November 10, 2004), (4) Quantum Equities L.L.C. v. Jakks Pacific, Inc. et al, Civil Action No. 04-8877 (filed on November 9, 2004), and (5) Irvine v. Jakks Pacific, Inc. et al, Civil Action No. 04-9078 (filed on November 16, 2004) (the Class Actions). The complaints in the Class Actions allege that defendants issued positive statements concerning increasing sales of our WWE licensed products which were false and misleading because the WWE licenses had allegedly been obtained through a pattern of commercial bribery, our relationship with the WWE was being negatively impacted by the WWE's contentions and there was an increase risk that the WWE would either seek modification or nullification of the licensing agreements with us. Plaintiffs also allege that we misleadingly failed to disclose the alleged fact that the WWE licenses were obtained through an unlawful bribery scheme. The plaintiffs in the Class Actions are described as purchasers of our common stock, who purchased from as early as October 26, 1999 to as late as October 19, 2004. The Class Actions seek compensatory and other damages in an undisclosed amount, alleging violations of Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act) and Rule 10b-5 promulgated thereunder by each of the defendants (namely the Company and Messrs. Friedman, Berman and Bennett), and violations of Section 20(a) of the Exchange Act by Messrs. Friedman, Berman and Bennett. On January 25, 2005, the Court consolidated the Class Actions under the caption In re JAKKS Pacific, Inc. Shareholders Class Action Litigation, Civil Action No. 04-8807.

We believe that the claims in the WWE Action and the Class Actions are without merit and we intend to defend vigorously against them. However, because these Actions are in their preliminary stages, we cannot assure you as to the outcome of the Actions, nor can we estimate the range of our potential losses.

On February 16, 2005, we filed a motion to dismiss WWE's Complaint in the WWE Action. The motion is currently scheduled to be fully briefed on April 14, 2005, with oral argument to be scheduled thereafter.

On December 2, 2004, a shareholder derivative action was filed in the Southern District of New York by Freeport Partner, LLC against us, nominally, and against Messrs. Friedman, Berman and Bennett, Freeport Partners v. Friedman, et al., Civil Action No. 04-9441 (the Derivative Action). The Derivative Action seeks to hold the individual defendants liable for damages allegedly caused to us by their actions and in particular to hold them liable on a contribution theory with respect to any liability we incur in connection with the Class Actions. On or about February 10, 2005, a second shareholder derivative action was filed in the Southern District of New York by David Oppenheim against us, nominally, and against Messrs. Friedman, Berman, Bennett, Blatte, Glick, Miller and Skala, Civil Action 05-2046 (the Second Derivative Action). The Second Derivative Action seeks to hold the individual defendants liable for damages allegedly caused to us by their actions as a result of alleged breaches of their fiduciary duties. On or about March 16, 2005, a third shareholder derivative action was filed. It is captioned Warr v. Friedman, Berman, Bennett, Blatte, Glick, Miller, Skala, and Jakks (as a nominal defendant), and it was filed in the Superior Court of California, Los Angeles County (the Third Derivative Action). The Third Derivative Action seeks to hold the individual defendants liable for (1) damages allegedly caused to us by their alleged breaches of fiduciary duty, abuse of control, gross mismanagement,

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waste of corporate assets and unjust enrichment; and (2) restitution to us of profits, benefits and other compensation obtained by them.

On March 1, 2005, we delivered a Notice of Breach of Settlement Agreement and Demand for Indemnification to WWE (the Notification). The Notification asserted that WWE's filing of the WWE Action violated A Covenant Not to Sue contained in a January 15, 2004 Settlement Agreement and General Release (General Release) entered into between WWE and us and, therefore, that we were demanding indemnification, pursuant to the Indemnification provision contained in the General Release, for all losses that the WWE's actions have caused or will cause to us and our officers, including but not limited to any losses sustained by us in connection with the Class Actions. On March 4, 2005, in a letter from its outside counsel, WWE asserted that the General Release does not cover the claims in the WWE Action.

Pursuant to the terms of a Purchase Agreement, dated June 9, 2003, we sold an aggregate of \$98 million of 4.625% Convertible Senior Notes due June 15, 2023. The holders of the notes may convert the notes into shares of our common stock at any time at an initial conversion price of \$20.00 per share, subject to certain circumstances described in the notes. We will pay cash interest on the notes 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, we will not pay cash interest on the notes. At maturity, on June 15, 2023, 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.

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 (including contingent interest and additional amounts), 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 (including contingent interest and additional amounts), 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 (including contingent interest and additional amounts), 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, cash and cash equivalents on hand and marketable securities 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, marketable securities and cash on hand.

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. Domestic sales from our United Kingdom 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 gross margins, operating income and retained earnings. The exchange rate of the Hong Kong dollar to the

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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.

Item 7A. *Quantitative and Qualitative Disclosures About Market Risk*

Market risk represents the risk of loss that may impact our financial position, results of operations or cash flows due to adverse changes in financial and commodity market prices and rates. We are exposed to market risk in the areas of changes in United States and international borrowing rates and changes in foreign currency exchange rates. In addition, we are exposed to market risk in certain geographic areas that have experienced or remain vulnerable to an economic downturn, such as China. We purchase substantially all of our inventory from companies in China, and, therefore, we are subject to the risk that such suppliers will be unable to provide inventory at competitive prices. While we believe that, if such an event were to occur we would be able to find alternative sources of inventory at competitive prices, we cannot assure you that we would be able to do so. These exposures are directly related to our normal operating and funding activities. Historically and as of December 31, 2004, we have not used derivative instruments or engaged in hedging activities to minimize our market risk.

Interest Rate Risk

In June 2003, we issued convertible senior notes payable of \$98.0 million with a fixed interest rate of 4.625% per annum. These notes payable were outstanding as of December 31, 2004. Accordingly, we are not generally subject to any direct risk of loss arising from changes in interest rates.

Foreign Currency Risk

We have wholly-owned subsidiaries in Hong Kong and in the United Kingdom. Sales by these operations made on a FOB China or Hong Kong basis are denominated in U.S. dollars. However, purchases of inventory and Hong Kong operating expenses are typically denominated in Hong Kong dollars and domestic sales and operating expenses made in the United Kingdom are typically denominated in British Pounds, thereby creating exposure to changes in exchange rates. Changes in the British Pound or Hong Kong dollar/ U.S. dollar exchange rates may positively or negatively affect our gross margins, operating income and retained earnings. The British Pound gave rise to the other comprehensive loss in the balance sheet at December 31, 2004. 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 do not believe that near-term changes in these exchange rates, if any, will result in a material effect on our future earnings, fair values or cash flows, and therefore, we have chosen not to enter into foreign currency hedging transactions. We cannot assure you that this approach will be successful, especially in the event of a significant and sudden change in the value of the Hong Kong dollar or British Pound.

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Item 8. Consolidated Financial Statements and Supplementary Data

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, 2003 and 2004, and the related consolidated statements of operations, other comprehensive income, stockholders' equity and cash flows and the financial statement schedule for each of the years in the three-year period ended December 31, 2004. We also have audited management's assessment, included in the accompanying Management's annual report on internal control over financial reporting, that the Company maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audits.

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

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

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

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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, 2003 and 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's assessment that JAKKS Pacific, Inc. and Subsidiaries maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Furthermore, in our opinion, JAKKS Pacific, Inc. and Subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In conducting their evaluation of the effectiveness of internal control over financial reporting, management of the Company did not include the internal controls of Play Along, Inc., PA Distribution, Inc. and Play Along (Hong Kong) Limited (collectively - Play Along) which the Company acquired on June 11, 2004. The acquired entities constituted approximately 26% of total consolidated assets of the Company as of December 31, 2004 and approximately 29% of consolidated net sales and approximately 75% of consolidated net income for the year ended December 31, 2004. Refer to Note 4 to the consolidated financial statements for a further discussion of the acquisitions and their impact on the Company's consolidated financial statements. Our audit of internal control over financial reporting of the Company also excluded an evaluation of the internal control over financial reporting of Play Along.

/s/ PKF

PKF
Certified Public Accountants
A Professional Corporation

Los Angeles, California

February 21, 2005, except Notes 2, 4 and 18 for which the date is March 29, 2005

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**JAKKS PACIFIC, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS**

December 31,

2003

2004

**(In thousands, except
share data)**

Assets			
Current assets			
Cash and cash equivalents	\$	118,182	\$ 176,544
Marketable securities		19,345	19,047
Accounts receivable, net of allowance for uncollectible accounts of \$7,877 and \$7,058, respectively			