JAKKS PACIFIC INC
Form 10-K
March 16, 2007

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

FORM 10-K

(Mark One)

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

For the Fiscal Year Ended December 31, 2006

£ **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.
(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**95-4527222** **(I.R.S. Employer Identification No.)**
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**
Common Stock, $.001 par value per share	**Nasdaq Global Select**

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 if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes £ No T

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15 of the Act. Yes £ No T

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 T 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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (check one):

£ Large Accelerated Filer T Accelerated Filer £ Non-Accelerated Filer

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

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 14, 2007 of $23.27) is $629,213,540.

The number of shares outstanding of the registrant's Common Stock, $.001 par value (being the only class of its common stock), is 28,063,307 (as of March 14, 2007).

Documents Incorporated by Reference

None.

JAKKS PACIFIC, INC.

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For the Fiscal Year ended December 31, 2006

Items in Form 10-K

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," w 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.

PART I

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, produces and markets toys and related products, writing instruments and related products, pet toys, treats and related products and other consumer 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:

Traditional Toys

- Action figures and accessories, including licensed characters, principally based on *World Wrestling Entertainment*® ("WWE") and the *Dragon Ball*® and *Pokemon*® franchises, and toy vehicles, including *Road Champs*® die-cast collectibles, *Fly Wheels*™ and *RC Racers & MXS*™ toy vehicles and accessories;

- Electronics products, including *Plug It In & Play TV Games*™, *Vmigo*® virtual pet gaming system and *Laser Challenge*®;

- Role-play and dress-up products featuring entertainment and consumer products properties such as *Disney Princesse®s* and *Dora the Explorer* for girls and *Black & Decker*® and *Pirates of the Caribbean*® for boys;

- Infant and pre-school toys, TV activities and plush toys featuring *Care Bears*®, *Barney*® and *Doodle Bears*®and slumber bags; and

- Dolls including fashion and mini dolls and related accessories, includes *Disney Princess* dolls sold to Disney Stores and Disney Parks and Resorts and private label fashion dolls for other retailers, and soft body dolls featuring *Cabbage Patch Kids*®.

Craft, Activity and Writing Products

- Craft, activity and stationery products, including *Flying Colors*® activity sets, compounds, playsets and lunch boxes, and *Colorworkshop*® craft products such as *Blopens*®, *Vivid Velvet*®, and *Pentech*® writing instruments, stationery and activity products.

Seasonal/Outdoor Products

- Seasonal and outdoor toys and leisure products, including *Go Fly A Kite*®, *Air Creations*®, and other kites, *Funnoodle*® pool toys, *The Storm*® water guns and *Fly Wheels XPV* and *Flight*™ vehicles; and

- Junior sports, including *Gaksplat*™ and *The Storm*®.

Pet Products

- Pet products, including toys, treats, beds, clothing and accessories, with licenses used in conjunction with these products, including *American Kennel Club*® and *The Cat Fanciers' Association*™ brands, as well as entertainment properties, among others.

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;

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· 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 lines.

In addition to developing our proprietary brands and marks, we license brands such as *WWE*, *Nickelodeon*(R), *Dora the Explorer*, *Disney Princesses*, *Care Bears* and *Pokemon*. 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.

We have obtained an exclusive worldwide license for our joint venture with THQ Inc. (“THQ”), which develops, publishes and distributes video games based on WWE characters and themes. Since the joint venture’s first title release in 1999, it has released 29 new titles. We have recognized approximately $72.1 million in profit from the joint venture through December 31, 2006. We and the joint venture are named as defendants in lawsuits 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”).

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. Our three largest customers are Wal-Mart, Target and Toys ‘R’ Us, which account for approximately 27.5%, 17.6% and 13.6%, respectively, of our net sales in 2006. No other customer accounted for more than 10.0% of our net sales in 2006.

Our Growth Strategy

The execution of our growth strategy has resulted in increased revenues and earnings. In 2005 and 2006, we generated net sales of $661.5 million and $765.4 million, respectively, and net income of $63.5 million and $72.4 million, respectively. Approximately 10.1% and 24.3% of our increased net sales in 2005 and 2006, respectively, were attributable to our acquisitions since 2004. 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 feel of these action toys. These innovations produce higher quality and better likenesses of the representative characters.

· ***Enter New Product Categories.*** We use our extensive experience in the toy and other consumer product industries to evaluate products and licenses in new product categories and to develop additional product lines. We began marketing 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 with selected strategic acquisitions. Most recently, in June 2005, we acquired the assets of Pet Pal Corp. which expanded our offerings and distribution into pet toy, treats and related products, and in February 2006, we acquired the business of Creative Designs International, Ltd., a leading manufacturer of girls’ dress-up and role-play toys.. 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 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 2006, our sales generated outside the United States were approximately $99.1 million, or 12.9% 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. We expect these initiatives to continue to contribute to our international growth in 2007.

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

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," beginning on page 12). 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.

Recent Acquisitions

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

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

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

Industry Overview

According to Toy Industry Association, Inc., 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 $22.3 billion in 2006. 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 $12.5 billion in 2006.

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.

Products

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. Generally, our license agreements for products and concepts call for royalties ranging from 1% to 14% of net sales, and some may require minimum guarantees and advances. Our principal products include:

Traditional Toys

Electronics Products

Our electronic products category includes our *Plug it in & Play TV Games, Vmigo* virtual pet gaming system and *Laser Challenge* product line. Our current *TV Games*™ titles include licenses from Namco®, Disney, Marvel® and Nickelodeon, and feature such games as Dora the Explorer, Disney Princesses, Ms. Pac-Man® and Pac-Man®.

We regularly release new *TV Games* titles for the pre-school and leisure gamer segments including *Wheel of Fortune*®, *Deal or No Deal*®, *Sesame Street*® and *Thomas the Tank*®; and in 2006 we introduced *TeleStory*™ interactive electronic books featuring classic and other well-known stories including *Dora the Explorer*, *Lion King*®, *Cinderella*®, and *Winnie the Pooh*®, and *Vmigo* virtual pet gaming system, both of which use our plug-and-play TV technology.

Wheels Division Products

· *Toy and activity vehicles*

We internally developed a line of toy wheels and play sets called *Fly Wheels* that feature scale replicas of popular automobile tires and wheels and skateboard wheels. The wheels are launched from a handle with the pull of a zip cord. We continue to expand on the brand with new introductions.

Our *Remco*® toy line includes toy and activity vehicles and other toys. We also produce infrared radio controlled vehicles and *Mighty Mo's*® 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.

· *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. Through licenses, we produce replicas of well-known vehicles including those from *Ford*®, *Chevrolet*® and *Porsche*®. 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 offerings include our *MXS* line of motorcycles with riders, off-road vehicles, personal watercraft, surfboards and skateboards, which are sold individually and with playsets and accessories.

Action Figures and Accessories

We have an extensive toy license with the WWE pursuant to which we have the 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. 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. Our strategy has been to release new figures and accessories frequently to keep the line fresh and relevant to WWE's television programming, and to retain the interest of the consumers.

We also develop, manufacture and distribute other action figures and action figure accessories including those based on the animated series *Dragon Ball Z*® and *Pokemon*®.

Infant and pre-school toys

Our pre-school toys include *Care Bears* plush and electronic toys, *Doodle Bear* plush and *Cabbage Patch Kids* soft body dolls. These products generated a significant amount of net sales in 2006, and we expect that level of sales to continue in 2007.

· *Child Guidance*

Our line of pre-school *Child Guidance*® electronic toys features the character *Barney*. We also produce a line of licensed TV activity products featuring *HIT*, *Disney* and *Nickelodeon* characters, as well as non-licensed versions. In 2007, we expect to introduce new pre-school foam play products called *Gorilla Blocks*™.

· *Slumber bags*

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

Fashion Dolls

Fashion and mini dolls and related accessories, includes *Disney Princess* dolls sold to Disney Stores and Disney Parks and Resorts, and private label fashion dolls for our other retailers. We also expect to market fashion dolls for Disney characters *Hannah Montana*® and *The Cheetah Girls*® in 2007.

Craft, Activity and Writing Products

We market products into the toy activity category which contain a broad range of activities, such as make and paint your own characters, jewelry making, art studios, posters, puzzles and other projects. These activities, which feature popular characters, such as Nickelodeon's *Dora the Explorer*, among others, have immediate visual appeal and brand recognition. Our product lines also include stationery, back-to-school and office pens, pencils, markers, notebooks and craft products such as *Blopens* and *Vivid Velvet*® activities. These products are primarily marketed under our *Flying*

Colors and *Pentech* brands, in addition to various private label and other brands.

Seasonal/ Outdoor Products

Seasonal/ Outdoor Products

We have a wide range of seasonal toys and outdoor and leisure products. Our *Go Fly A Kite* product line includes youth and adult kites and a wide array of decorative flags, windsocks, and windwheels. Our *Funnoodle* pool toys include the basic funnoodle, pool floats and a variety of other pool toys. Our *The Storm* product line includes water guns, gliders and sport balls. Another outdoor product is our *Fly Wheels XPV* and *Flight*, extensions of our popular *Fly Wheels* vehicle line, incorporating our rip-cord design and patented connector with flying discs and flight-powered foam planes.

Junior Sports Products

Our junior sports products include *Gaksplat* and *Storm,* which include a variety of mini sport balls and activity products.

Pet Products

We entered the Pet Products category with our acquisition of Pet Pal, whose products include pet toys, treats, beds, clothes and related pet products. These products are marketed under JPI and licenses include *American Kennel Club*, *The Cat Fanciers' Association*, *Bratz*®, *Disney* and *Marvel*®, as well as numerous other entertainment and consumer product properties.

World Wrestling Entertainment Video Games

In June 1998, we formed a joint venture with THQ, a developer, publisher and distributor of interactive entertainment software for the leading hardware game platforms in the home video game market. The joint venture 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. We and the joint venture are named as defendants in lawsuits 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").

The games are designed, developed, manufactured and distributed by or through 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.

The joint venture agreement provides for us to have received guaranteed preferred returns through June 30, 2006 at varying rates of the joint venture's net sales depending on the cumulative unit sales and platform of each particular game. The preferred return was subject to change after June 30, 2006 and was to be set for the distribution period beginning July 1, 2006 and ending December 31, 2009 (the "Next Distribution Period"). The agreement provides that the parties will negotiate in good faith and agree to the preferred return not less than 180 days prior to the start of the Next Distribution Period. It further provides that if the parties are unable to agree on a preferred return, the preferred return will be determined by arbitration. The parties have not reached an agreement with respect to the preferred return for the Next Distribution Period and we anticipate that the reset, if any, of the preferred return will be determined through arbitration. The preferred return is accrued in the quarter in which the licensed games are sold and the preferred return is earned. Based on the same rates as set forth under the original joint venture agreement, an estimated receivable of $13.5 million has been accrued for the six months ended December 31, 2006, pending the resolution of this outstanding issue.

The joint venture currently publishes titles for the Sony, Nintendo and Microsoft consoles, Sony and Nintendo hand-held platforms, mobile/wireless and personal computers. 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 results with the joint venture since its inception:

	New Game Titles		Profit from video game 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
2005	3	1	9.4
2006	2	1	13.2

(1) Profit from the video game joint venture reflects our preferred return on joint venture revenue less certain costs incurred directly by us and payments made by us to THQ for their share of the profit on TV Games based on *WWE* content.

Wrestling video games have demonstrated consistent popularity. 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.

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 three largest customers are Wal-Mart, Target and Toys ‘R’ Us, which accounted for approximately 59.1% of our net sales in 2005 and 58.7% of our net sales in 2006. With the addition of the Pet Pal product line, we began to distribute pet products to key pet supply retailers Petco and Petsmart in addition to many other pet retailers and our existing customers. 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 and Amazon.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, many of whom 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,
- established direct relationships with retailers in certain territories, and
- expanded in-house resources dedicated to product development and marketing of our lines internally.

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 $99.1 million, or 12.9% of our net sales, in 2006 and approximately $99.1 million, or 15.0% of our net sales, in 2005. 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 and us.

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 may incur costs or other losses as a result of 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 occasionally test the consumer acceptance of new products in selected markets before committing resources to large-scale production.

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 print and television ads and in-store displays. We also produce and broadcast television commercials for several of our product lines, including our *WWE* action figure line, *Fly Wheels*, *Disney* large role playsets, *TV Games*, *Doodle Bears* and *Cabbage Patch Kids*. 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 to 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 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 2% 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.

Safety testing of our products is done at the manufacturers' facilities by quality control personnel employed by us or by independent third-party contractors engaged by us. Safety testing is designed to meet regulations imposed by federal and state, as well as applicable international, 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 and licensors 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. Substantially 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 subject to various factors beyond our control, and any delays in the future could adversely affect our sales. Currently, we have ongoing relationships with over eighty different manufacturers. We believe that alternative sources of supply are available to us, 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 are extensively involved 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 $7.5 million in 2005 and $12.6 million in 2006. Substantially all of these assets are located in China.

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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 (Mega Brands), Hasbro (Play-doh®) and Binney & Smith (Crayola®), and in our toy vehicle lines, with RC2. 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 and Activision.

Seasonality and Backlog

In 2006, approximately 70% of our net sales were made in the third and fourth quarters. Generally, the first 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 for orders shipped FOB China or Hong Kong and within three days on orders shipped domestically. 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 14, 2007, we employed 702 persons, all of whom are full-time employees, including three executive officers. We employed 393 people in the United States, 241 people in Hong Kong and 68 people in China. We believe that we have good relationships with our employees. None of our employees are 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.jakkspacific.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.

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.jakkspacific.com. The contents of our website are not incorporated in or deemed to be a part of this Annual Report or Form 10-K.

Item 1A. ***Risk Factors***

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*

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- *Higher consumer expectations for product quality, functionality and value.*

We cannot assure you that:

- *our current products will continue to be popular with consumers;*
- *the product lines or products that we introduce will achieve any significant degree of market acceptance; 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 the majority of our license agreements the licensors have the right to review and approve our use of their licensed products, designs or materials before we may make any sales. If a licensor refuses to permit our use of any licensed property in the way we propose, or if their review process is delayed, our development or sale of new products could be impeded.

· *New licenses are difficult and expensive to obtain*

Our continued success will 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 and results of operations.

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

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

In addition, the toy industry has no significant barriers to entry. Competition is based primarily 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 and against our video game joint venture with THQ by WWE, or a decline in the popularity of WWE, could adversely impact our interest in that joint venture.

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, or an adverse outcome against THQ or the joint venture in the lawsuit commenced by WWE against THQ and the joint venture (see the first Risk Factor, above, and “Legal Proceedings”), 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.

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.

The amount of preferred return that we now receive from the joint venture is subject to change, which could adversely affect our results of operations.

The joint venture agreement provides for us to have received guaranteed preferred returns through June 30, 2006 at varying rates of the joint venture's net sales depending on the cumulative unit sales and platform of each particular game. The preferred return was subject to change after June 30, 2006 and was to be set for the distribution period beginning July 1, 2006 and ending December 31, 2009 (the "Next Distribution Period"). The agreement provides that the parties will negotiate in good faith and agree to the preferred return not less than 180 days prior to the start of the Next Distribution Period. It further provides that if the parties are unable to agree on a preferred return, the preferred return will be determined by arbitration. The parties have not reached an agreement with respect to the preferred return for the Next Distribution Period and we anticipate that the reset, if any, of the preferred return will be determined through arbitration. The preferred return is accrued in the quarter in which the licensed games are sold and the preferred return is earned. Based on the same rates as set forth under the original joint venture agreement, an estimated receivable of $13.5 million has been accrued for the six months December 31, 2006, pending the resolution of this outstanding issue.

Any adverse change to the preferred return for the next distribution period as well as the ongoing performance of the joint venture may result in our experiencing reduced net income, which would adversely affect our results of operations.

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 companies we acquired since 2004 were approximately $185.6 million and $67.1 million, in 2006 and 2005, respectively, representing 24.3% and 10.1% 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 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 a significant component of our growth strategy.

Our growth strategy depends in part upon our ability to acquire companies and new product lines. Revenues associated with our acquisitions since 2004 represented approximately 24.3% and 10.1% of our total revenues in 2006 and 2005, 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 three largest customers accounted for 58.7% of our net sales in 2006. 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 and results of operations. In addition, the bankruptcy or other lack of success of one or more of our significant retailers could negatively impact our revenues and bad debt expense.

We depend 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 over eighty 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 common to international operations.

We sell products and operate facilities in numerous countries outside the United States. For the year ended December 31, 2006, sales to our international customers comprised approximately 12.9% 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 ("China") which 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;*
- *the potential imposition of tariffs; and*
- *the pricing of intercompany transactions may be challenged by taxing authorities in both Hong Kong and the United States, with potential increases in income taxes.*

Our reliance 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;*
- *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.

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, 2006, we have not had any impairment of Goodwill, which is reviewed on a quarterly basis and formally evaluated on an annual basis.

At December 31, 2006, approximately $338.0 million, or 38.2%, of our total assets represented goodwill. Declines in our profitability may impact the fair value of our reporting units, which could result in a write-down of our goodwill. Reductions in our net income caused by the write-down of goodwill would adversely affect our results of operations.

Item 2. ***Properties***

The following is a listing of the principal leased offices maintained by us as of March 14, 2007:

Property	Location	Approximate Square Feet	Lease Expiration Date
Domestic			
Corporate Office	Malibu, California	29,500	February 28, 2015
Design Center	Malibu, California	16,800	August, 31, 2008
Distribution Center	City of Industry, California	800,000	January 31, 2013
Go Fly A Kite	Clinton, Connecticut	10,300	September 30, 2007
Play Along U.S.	Deerfield Beach, Florida	24,600	December 31, 2007
Creative Designs	Trevose, Pennsylvania	14,700	June 30, 2009
Sales Office / Showroom	New York, New York	14,500	April 30, 2007 (1)
Sales Office / Showroom	New York, New York	11,500	December 30, 2009
Sales Offices	Bentonville, Arkansas	4,400	November 30, 2008
Palatine, Illinois		1,200	Month-to Month
International			
JAKKS Hong Kong	Kowloon, Hong Kong	22,900	October 31, 2007 (2)
Play Along Hong Kong	Kowloon, Hong Kong	18,300	May 23, 2007 (2)
JAKKS / Play Along Hong Kong	Kowloon, Hong Kong	36,600	March 31, 2009
Arbor Toys Hong Kong	Kowloon, Hong Kong	19,500	May 31, 2007 (3)
Production Inspection Office	Shanghai, China	1,700	March 31, 2007 (3)
Shenzhen Office	Shenzhen, China	2,900	June 30, 2008

(1) These premises will be vacated and all personnel and operations are expected to be relocated in April 2007 to new office space in New York which is currently under lease.

(2) These premises will be vacated and all personnel and operations will be relocated in April 2007 to new office space in Hong Kong which is currently under lease.

(3) These leases are expected to be renewed on terms comparable to those of the expiring leases.

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 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 filed an Amended Complaint seeking, among other things, to add the Chief Executive Officer of THQ as a defendant and to add a claim under the Sherman Act. The Court allowed the filing of the Amended Complaint and ordered a two-stage resolution of the viability of the Complaint, with motions to dismiss the federal claims based on certain threshold issues to proceed and all other matters to be deferred for consideration if the Complaint survived scrutiny with respect to the threshold issues. The Court also stayed discovery pending the determination of the motions to dismiss.

The motions to dismiss the Amended Complaint based on these threshold issues were fully briefed and argued and, on March 31, 2006, the Court granted the part of our motion seeking dismissal of the Robinson-Patman Act and Sherman Act claims and denied the part of our motion seeking to dismiss the RICO claims on the basis of the threshold issue that was briefed (the "March 31 Order").

On April 7, 2006, we sought certification to appeal from the portion of the March 31 Order denying our motion to dismiss the RICO claim on the one ground that was briefed. Shortly thereafter, WWE filed a motion for reargument with respect to the portion of the March 31 Order that dismissed the Sherman Act claim and, alternatively, sought judgment with respect to the Sherman Act claim so that it could pursue an immediate appeal. At a court conference on April 26, 2006 the Court deferred the requests for judgment and for certification and set up briefing schedules with respect to our motion to dismiss the RICO claim, which claim is presently the sole remaining basis for federal jurisdiction, on grounds that were not the subject of the first round of briefing, and our motion to dismiss the action based on the Release that WWE executed. The Court also established a briefing schedule for WWE's motion for reargument of the dismissal of the Sherman Act claim. These motions were argued and submitted in September 2006. Discovery remains stayed.

In November 2004, several purported class action lawsuits were filed in the United States District Court for the Southern District of New York: (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 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. On May 11, 2005, the Court appointed co-lead counsels and provided until July 11, 2005 for an amended complaint to be filed; and a briefing schedule thereafter with respect to a motion to dismiss. The motion to dismiss has been fully briefed and argument occurred on November 30, 2006. The motion is still pending.

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 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. Stays/and or extensions of time to answer are in place with respect to the derivative actions.

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.

On March 30, 2006, WWE's counsel wrote a letter alleging breaches by the joint venture of the video game agreement relating to the manner of distribution and the payment of royalties to WWE with respect to sales of the WWE video games in Japan. WWE has demanded that the alleged breaches be cured within the time periods provided in the video game license, while reserving all of its rights, including its alleged right of termination of the video game license.

On April 28, 2006 the joint venture responded, asserting, among other things, that WWE had acquiesced in the manner of distribution in Japan and the payment of royalties with respect to such sales and, in addition, had separately released the joint venture from any claims with respect to such matter, including the payment of royalties with respect to such sales, and that there is therefore no basis for an allegation of a breach of the license agreement.

While the joint venture does not believe that WWE has a valid claim, it tendered a protective "cure" of the alleged breaches with a full reservation of rights. WWE "rejected" that cure and reserved its rights. On October 12, 2006, WWE commenced a lawsuit in Connecticut state court against THQ and THQ/JAKKS Pacific LLC (the "LLC"), involving a claim set forth above concerning allegedly improper sales of WWE video games in Japan and other countries in Asia. The lawsuit seeks, among other things, a declaration that WWE is entitled to terminate the video game license and monetary damages. A motion to strike one claim was argued on March 12, 2007 and submitted to the Court. Additionally, a schedule has been set, with trial no earlier than October 2008. THQ and the LLC have stated that they believe the lawsuit is without merit and intend to defend themselves vigorously. However, because this action is in its preliminary stage, we cannot assure you as to the outcome, nor can we estimate the range of our potential losses, if any.

Our agreement with THQ provides for payment of a preferred return to us in connection with our joint venture (see Note 10, Joint Ventures). The preferred return is subject to change after June 30, 2006 and is to be set for the distribution period beginning July 1, 2006 and ending December 31, 2009 (the "Next Distribution Period"). The agreement provides that the parties will negotiate in good faith and agree to the preferred return not less than 180 days prior to the start of the Next Distribution Period. It further provides that if the parties are unable to agree on a preferred return, the preferred return will be determined by arbitration. The parties have not reached an agreement with respect to the preferred return for the Next Distribution Period and we anticipate that the reset, if any, of the preferred return will be determined through arbitration. With respect to the matter of the change in the preferred return, we cannot assure you of the outcome.

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.

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 Global Select exchange 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 this exchange.

	Price Range of Common Stock	
	High	**Low**
2005:		
First quarter	$ 23.96	$ 17.25
Second quarter	21.97	18.38
Third quarter	20.20	15.54
Fourth quarter	23.35	14.80
2006:		
First quarter	27.10	19.23
Second quarter	28.50	17.06
Third quarter	20.24	15.26
Fourth quarter	23.38	17.17

Performance Graph

The graph and tables below display the relative performance of our common stock, the Russell 2000 Price Index (the "Russell 2000") and a peer group index, by comparing the cumulative total stockholder return (which assumes reinvestment of dividends, if any) on an assumed $100 investment in our common stock, the Russell 2000 and the peer group index over the period from January 1, 2002 to December 31, 2006.

In accordance with recently enacted regulations implemented by the Securities and Exchange Commission, we retained the services of an expert compensation consultant. In the performance of its services, such consultant used a peer group index for its analysis of our compensation policies. Certain of the companies included in such peer group index were different from the companies included in the peer group index we used in our proxy statement for 2006. For the sake of consistency, we elected to utilize the new peer group index when preparing the below graph and tables. Our new peer group index (referred to below as "Peer Group II") includes the following companies: *Activision, Inc., Electronic Arts, Inc., EMak Worldwide, Inc., Hasbro, Inc., Leapfrog Enterprises, Inc., Marvel Enterprises, Inc., Mattel, Inc., Russ Berrie and Company, Inc., RC2 Corp., Take-Two Interactive, Inc. and THQ Inc.* We believe that these companies represent a cross-section of publicly-traded companies with product lines and businesses similar to our own throughout the comparison period.

The peer group index used by us in last year's proxy statement (referred to below as "Peer Group") includes the following companies: *Acclaim Entertainment, Inc., EMAK Worldwide, Inc., Mega Brands, Inc., Hasbro, Inc., Mattel, Inc., Russ Berrie and Company, Inc. and RC2 Corp.*

The historical performance data presented below may not be indicative of the future performance of our common stock, any reference index or any component company in a reference index.

Annual Return Percentage

	December 31, 2002	December 31, 2003	December 31, 2004	December 31, 2005	December 31, 2006
JAKKS Pacific	(28.92)%	(2.37)%	68.15%	(5.29)%	4.30%
Peer Group	1.30	16.81	1.98	(10.71)	42.28
Peer Group II	(19.83)	77.75	24.09	(10.15)	7.35
Russell 2000	(20.48)	47.25	18.33	4.56	18.35

Indexed Returns

	January 1, 2002	December 31, 2002	December 31, 2003	December 31, 2004	December 31, 2005	December 31, 2006
JAKKS Pacific	$ 100.00	71.08	69.40	116.69	110.52	115.28
Peer Group	$ 100.00	101.30	118.33	120.68	107.76	153.32
Peer Group II	$ 100.00	80.17	142.51	176.84	158.89	170.57
Russell 2000	$ 100.00	79.52	117.09	138.55	144.87	171.45

Security Holders

To the best of our knowledge, as of March 14, 2007, there were 194 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 year ended December 31, 2006 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.

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	1,462,378	$	17.05	1,224,876
Equity compensation plans not approved by security holders	100,000		11.35	—
Total	1,562,378	$	16.69	1,224,876

Equity compensation plans approved by our stockholders consists of the 2002 Stock Award and Incentive Plan. Equity compensation plans not approved by our security holders consist of a fully-vested warrant issued by us in 2003 (and expiring in 2013) in connection with license costs relating to our video game joint venture.

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).

	Years Ended December 31,									
		2002		2003		2004		2005		2006
	(In thousands, except per share data)									
Consolidated Statement of Income Data:										
Net sales	$	310,016	$	315,776	$	574,266	$	661,536	$	765,386
Cost of sales		180,173		189,334		348,259		394,829		470,592

Gross profit	129,843	126,442	226,007	266,707	294,794
Selling, general and administrative expenses	98,111	113,053	172,282	178,722	202,482
Acquisition shut-down and product recall costs	6,718	2,000	—	—	—
Income from operations	25,014	11,389	53,725	87,985	92,312
Profit from video game joint venture	8,004	7,351	7,865	9,414	13,226
Other expense	—	—	—	(1,401)	—
Interest income	1,258	1,131	2,052	5,183	4,930
Interest expense	(117)1	(2,536)	(4,550)	(4,544)	(4,533)
Income before provision for income taxes and minority interest	34,159	17,335	59,092	96,637	105,935
Provision for income taxes	6,466	1,440	15,533	33,144	33,560
Income before minority interest	27,693	15,895	43,559	63,493	72,375
Minority interest	(237)	—	—	—	—
Net income	$ 27,930	$ 15,895	$ 43,559	$ 63,493	$ 72,375
Basic earnings per share	$ 1.27	$ 0.66	$ 1.69	$ 2.37	$ 2.66
Basic weighted average shares outstanding	21,963	24,262	25,797	26,738	27,227
Diluted earnings per share	$ 1.23	$ 0.66	$ 1.49	$ 2.06	$ 2.30
Diluted weighted average shares and equivalents outstanding	22,747	27,426	31,406	32,193	32,714

In February 2006, we acquired Creative Designs. Also, effective January 1, 2006, we implemented SFAS 123R, which added required share-based compensation expense to be recorded.

In June 2005, we acquired the Pet Pal line of products.

In June 2004, we acquired Play Along.

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

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 Note 2 to the Consolidated Financial Statements, Item 8. Inherent in the application of many of these accounting policies is the need for management to make estimates and judgments in the determination of certain revenues, expenses, assets and liabilities. As such, materially different financial results can occur as circumstances change and additional information becomes known. The policies with the greatest potential effect on our results of operations and financial position include:

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

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

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

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

- significant changes in the manner of our use of the acquired assets or the strategy for our overall business; and
- significant negative industry or economic trends.

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

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

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

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

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

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

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

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

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

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

Recent Developments

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

Results of Operations

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

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

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

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

Comparison of the Years Ended December 31, 2006 and 2005

Net Sales

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

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

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

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

Cost of Sales

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

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

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

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

Selling, General and Administrative Expenses

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

Profit from Video Game Joint Venture

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

Other Expense

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

Interest Income

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

Interest Expense

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

Provision for Income Taxes

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

Comparison of the Years Ended December 31, 2005 and 2004

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

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

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

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

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

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

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

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

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

Quarterly Fluctuations and Seasonality

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

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

	2004				**2005**					
	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**	**First Quarter**	**Second Quarter**	**Third Quarter**	**Fourth Quarter**	**First Quarter**	**Seco Quar**
	(In thousands, except per share data)									
Net sales	73,986	109,395	206,083	184,802	134,676	127,091	233,500	166,269	107,244	124,
As a % of full year	12.9%	19.0%	35.9%	32.2%	20.4%	19.2%	35.3%	25.1%	14.0%	
Gross profit	30,466	41,281	81,801	72,459	54,212	48,073	93,452	70,970	44,163	49,
As a % of full year	13.5%	18.3%	36.2%	32.1%	20.3%	18.0%	35.0%	26.6%	15.0%	
As a % of net sales	41.2%	37.7%	39.7%	39.2%	40.3%	37.8%	40.0%	42.7%	41.2%	[illegible]
Income (loss) from operations	4,885	8,321	29,915	10,604	13,675	14,614	47,218	12,478	2,244	8,
As a % of full year	9.1%	15.5%	55.7%	19.7%	15.5%	16.6%	53.7%	14.2%	2.4%	
As a % of net sales	6.6%	7.6%	14.5%	5.7%	10.2%	11.5%	20.2%	7.5%	2.1%	
Income before income	4,764	7,637	30,042	16,649	13,627	15,732	46,306	20,972	3,283	9,

taxes and minority interest										
As a % of net sales	6.4%	7.0%	14.6%	9.0%	10.1%	12.4%	19.8%	12.6%	3.1%	
Net income	3,791	6,004	23,255	10,508	10,084	11,642	32,753	9,014	2,331	6,
As a % of net sales	5.1%	5.5%	11.3%	5.7%	7.5%	9.2%	14.0%	5.4%	2.2%	
Diluted earnings per share	$ 0.15	$ 0.22	$ 0.76	$ 0.36	$ 0.34	$ 0.39	$ 1.05	$ 0.29	$ 0.09	$ 0
Weighted average shares and equivalents outstanding	30,676	31,123	31,919	31,855	32,256	32,229	32,088	32,197	32,617	32,

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

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

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

Recent Accounting Standards

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

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

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

Liquidity and Capital Resources

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

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

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

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

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

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

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

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

In October 2004, we were named as a defendant in a lawsuit commenced by WWE (the “WWE Action”). The complaint also named as defendants, among others, the joint venture with THQ Inc., certain of our foreign subsidiaries and our three executive officers. In November 2004, several purported class action lawsuits were filed in the United States District Court for the Southern District of New York, alleging damages associated with the facts alleged in the WWE Action. Three shareholder derivative actions have also been filed against us, nominally, and against certain of our Board members (the “Derivative Actions”). The Derivative Actions seek to hold the individual defendants liable for damages allegedly caused to our Company by their actions, and, in one of the Derivative Actions, seeks restitution to our Company of profits, benefits and other compensation obtained by them. In October 2006, WWE commenced a lawsuit against THQ and the joint venture concerning allegedly improper sales of WWE video games in Japan and other countries in Asia, seeking among other things, a declaration that WWE is entitled to terminate its video games license with the joint venture and monetary damages. See “Legal Proceedings.”

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

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

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

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

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

Exchange Rates

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

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, 2006, 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, which remain outstanding as of December 31, 2006. 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 China. Sales are made by these operations on FOB China or Hong Kong terms and are denominated in U.S. dollars. However, purchases of inventory and Hong Kong operating expenses are typically denominated in Hong Kong dollars and local operating expenses in China are denominated in local currency, thereby creating exposure to changes in exchange rates. Changes in the Chinese Yuan or Hong Kong dollar/U.S. dollar exchange rates may positively or negatively affect our gross margins, operating income and retained earnings. A gain in Hong Kong dollars gave rise to the other comprehensive loss in the balance sheet at December 31, 2006. 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 Chinese Yuan.

Item 8. ***Consolidated Financial Statements and Supplementary Data***

Report of Independent Registered Public Accounting Firm

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

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

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

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

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

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

/s/ BDO Seidman, LLP

BDO Seidman, LLP

Los Angeles, California
March 15, 2007

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

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

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

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

/s/ PKF

PKF
Certified Public Accountants
A Professional Corporation

Los Angeles, California
February 13, 2006

JAKKS PACIFIC, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

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

Total liabilities and stockholders’ equity	$	753,955	$	881,894

See notes to consolidated financial statements.

JAKKS PACIFIC, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31,		
	2004	2005	2006
	(In thousands, except per share amounts)		
Net sales	$ 574,266	$ 661,536	$ 765,386
Cost of sales	348,259	394,829	470,592
Gross profit	226,007	266,707	294,794
Selling, general and administrative expenses	172,282	178,722	202,482
Income from operations	53,725	87,985	92,312
Profit from video game joint venture			