JAKKS PACIFIC INC
Form 10-Q
May 10, 2007

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

FORM 10-Q

(Mark one)

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

For the quarterly period ended March 31, 2007

-OR

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

For the transition period from ______ to ______

Commission file number: **0-28104**

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

Delaware	**95-4527222**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
22619 Pacific Coast Highway Malibu, California	**90265**
(Address of Principal Executive Offices)	(Zip Code)

Registrant’s telephone number, including area code: **(310) 456-7799**

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 ý No ¨

Indicate by 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 ¨ Accelerated Filer ý 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 ý

The number of shares outstanding of the issuer's common stock is 28,143,968 (as of May 10, 2007).

JAKKS PACIFIC, INC. AND SUBSIDIARIES

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Quarter Ended March 31, 2007

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DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

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

we may presently be planning. We 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.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share amounts)

	December 31, 2006 (*)	March 31, 2007 (Unaudited)
ASSETS		
Current assets		
Cash and cash equivalents	$ 184,489	$ 192,033
Marketable securities	210	211
Accounts receivable, net of allowances for uncollectible accounts of $1,206 and $1,165, respectively	153,116	75,111
Inventory	76,788	69,001
Prepaid expenses and other current assets	26,543	21,726
Deferred income taxes	10,592	10,945
Total current assets	451,738	369,027
Property and equipment		
Office furniture and equipment	8,299	8,671
Molds and tooling	36,600	37,956
Leasehold improvements	4,882	5,376
Total	49,781	52,003
Less accumulated depreciation and amortization	32,898	35,745
Property and equipment, net	16,883	16,258
Deferred income taxes	—	1,471
Investment in video game joint venture	14,873	16,394
Goodwill, net	337,999	338,007
Trademarks, net	19,568	19,568
Intangibles and other, net	40,833	37,415
Total assets	$ 881,894	$ 798,140
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 65,574	$ 31,047
Accrued expenses	54,664	28,077
Reserve for sales returns and allowances	32,589	18,098
Income taxes payable	18,548	7,713
Total current liabilities	171,375	84,935
Deferred income taxes	2,377	2,379
Income tax payable	—	8,093
Other liabilities	854	5,313
Convertible senior notes	98,000	98,000
Total liabilities	272,606	198,720
Stockholders' equity		
Preferred stock, $.001 par value; 5,000,000 shares authorized; nil outstanding	—	—
Common stock, $.001 par value; 100,000,000 shares authorized; 27,776,947 and 28,120,418 shares issued and outstanding, respectively	28	28
Additional paid-in capital	300,255	303,167
Retained earnings	312,432	299,668

Accumulated comprehensive loss		(3,427)		(3,443)
Total stockholders’ equity		609,288		599,420
Total liabilities and stockholders’ equity	$	881,894	$	798,140

(*) Derived from audited financial statements

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JAKKS PACIFIC, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)

	Three Months Ended March 31, (Unaudited)	
	2006	**2007**
Net sales	$ 107,244	$ 124,062
Cost of sales	63,081	78,554
Gross profit	44,163	45,508
Selling, general and administrative expenses	41,919	42,184
Income from operations	2,244	3,324
Profit from video game joint venture	757	1,495
Interest Income	1,415	1,514
Interest Expense	(1,133)	(1,571)
Income before provision for income taxes	3,283	4,762
Provision for income taxes	952	1,524
Net income	$ 2,331	$ 3,238
Earnings per share - basic	$ 0.09	$ 0.12
Earnings per share - diluted	$ 0.09	$ 0.12

JAKKS PACIFIC, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Three Months Ended March 31, (Unaudited)	
	2006	**2007**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 2,331	$ 3,238
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Depreciation and amortization	6,021	6,427
Share-based compensation expense	2,367	2,117
Loss on disposal of property and equipment	—	92
Deferred income taxes	546	(9)
Change in operating assets and liabilities:		
Accounts receivable	31,791	78,006
Inventory	5,925	7,814
Prepaid expenses and other current assets	(12,278)	4,824
Income tax receivable	(5,034)	—
Investment in video game joint venture	7,164	(1,680)
Accounts payable	(25,776)	(34,300)
Accrued expenses	(12,327)	(14,823)
Reserve for sales returns and allowances	(5,141)	(14,427)
Income taxes payable	(3,181)	(15,243)
Other liabilities	(35)	400
Total adjustments	(9,958)	19,198
Net cash provided (used) by operating activities	(7,627)	22,436
CASH FLOWS FROM INVESTING ACTIVITIES		
Cash paid for net assets acquired, net of cash acquired	(107,755)	(13,605)
Purchase of property and equipment	(1,781)	(2,310)
Purchase of other assets	(194)	(411)
Net purchase of marketable securities	—	(2)
Net cash used by investing activities	(109,730)	(16,328)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from stock options exercised	865	1,436
Net cash provided by financing activities	865	1,436
Foreign currency translation adjustment	(9)	—
Net increase (decrease) in cash and cash equivalents	(116,501)	7,544
Cash and cash equivalents, beginning of period	240,238	184,489
Cash and cash equivalents, end of period	$ 123,737	$ 192,033
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Income taxes	$ 8,641	$ 16,855
Interest	$ —	$ —

Non cash investing and financing activity:

In February 2006, the Company issued 150,000 shares of its common stock valued at approximately $3.4 million in connection with an acquisition (see Note 9).

During the three months ended March 31, 2006, two executive officers surrendered 110,736 shares of restricted stock at a value of $2.5 million to cover their income taxes due on the 2006 vesting of the restricted shares granted them in 2005. This restricted stock was subsequently retired by the Company.

During the three months ended March 31, 2007, two executive officers surrendered 83,644 shares of restricted stock at a value of $1.8 million to cover their income taxes due on the 2007 vesting of the restricted shares granted them in 2006. This restricted stock was subsequently retired by the Company

See Notes 8 and 9 for additional supplemental information to the consolidated statements of cash flows.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
March 31, 2007

Note 1 — Basis of Presentation

The accompanying unaudited interim condensed consolidated financial statements included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures are adequate to prevent the information presented from being misleading. These financial statements should be read in conjunction with Management's Discussion and Analysis of financial condition and results of operations and the financial statements and the notes thereto included in the Company's Form 10-K, which contains financial information for the three years in the period ended December 31, 2006.

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

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

The condensed consolidated financial statements include the accounts of JAKKS Pacific, Inc. and its wholly-owned subsidiaries.

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

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

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

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

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

Results are not necessarily those that would be achieved were each segment an unaffiliated business enterprise. Information by segment and a reconciliation to reported amounts as of December 31, 2006 and March 31, 2007 and for the three months ended March 31, 2006 and 2007 are as follows (in thousands):

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2007
Net Sales		
Traditional Toys	$ 83,347	$ 102,515
Craft/Activity/Writing Products	13,063	9,167
Seasonal/Outdoor Products	8,464	8,209
Pet Products	2,370	4,171
	$ 107,244	$ 124,062

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2007
Operating Income		
Traditional Toys	$ 1,744	$ 2,746
Craft/Activity/Writing Products	273	246
Seasonal/Outdoor Products	177	220
Pet Products	50	112
	$ 2,244	$ 3,324

	December 31, 2006	March 31, 2007
Assets		
Traditional Toys	$ 687,162	$ 621,292
Craft/Activity/Writing Products	119,883	113,042
Seasonal/Outdoor Products	56,784	48,253
Pet Products	18,065	15,553
	$ 881,894	$ 798,140

The following tables present information about the Company by geographic area as of December 31, 2006 and March 31, 2007 and for the three months ended March 31, 2006 and 2007 (in thousands):

	December 31, 2006	March 31, 2007
Long-lived Assets		
United States	$ 352,959	$ 349,484
Hong Kong	60,814	59,878
	$ 413,773	$ 409,362

Three Months Ended March 31,

	2006	2007
Net Sales by Geographic Area		
United States	$ 92,499	$ 107,364
Europe	4,949	5,244
Canada	2,796	3,362
Hong Kong	3,122	4,682
Other	3,878	3,410
	$ 107,244	$ 124,062

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JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

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

Major Customers

Net sales to major customers for the three months ended March 31, 2006 and 2007 were as follows (in thousands, except for percentages):

	Three Months Ended March 31,			
	2006		2007	
	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales
Wal-Mart	$ 26,956	25.1%	$ 38,290	30.9%
Toys ‘R’ Us	15,172	14.2%	14,200	11.5
Target	18,906	17.6%	18,859	15.2
	$ 61,034	56.9%	$ 71,349	57.6%

No other customer accounted for more than 10% of the Company’s total net sales.

At December 31, 2006 and March 31, 2007, the Company’s three largest customers accounted for approximately 78.1% and 77.9%, respectively, of net accounts receivable. The concentration of the Company’s business with a relatively small number of customers may expose the Company to material adverse effects if one or more of its large customers were to experience financial difficulty. The Company performs ongoing credit evaluations of its top customers and maintains an allowance for potential credit losses.

Note 3 — Inventory

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

	December 31, 2006	March 31, 2007
Raw materials	$ 3,845	$ 2,497
Finished goods	72,943	66,504
	$ 76,788	$ 69,001

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

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

Generally, the Company does not allow for product returns. It provides a negotiated allowance for breakage or defects to its customers, which is recorded when the related revenue is recognized. However, the Company does make

occasional exceptions to this policy and consequently accrues a return allowance in gross sales based on historic return amounts and management estimates. The Company also will occasionally grant credits to facilitate markdowns and sales of slow moving merchandise. These credits are recorded as a reduction of gross sales at the time of occurrence.

The Company also participates in cooperative advertising arrangements with some customers, whereby it allows a discount from invoiced product amounts in exchange for customer purchased advertising that features the Company's products. Typically, these discounts range from 1% to 6% of gross sales, and are generally based on

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 4 — Revenue Recognition and Reserve for Sales Returns and Allowances (continued)

product purchases or on specific advertising campaigns. Such amounts are accrued when the related revenue is recognized or when the advertising campaign is initiated. These cooperative advertising arrangements are accounted for as direct selling expenses.

The Company's reserve for sales returns and allowances amounted to $18.1 million as of March 31, 2007, compared to $32.6 million as of December 31, 2006. This decrease was due primarily to certain customers taking their allowances related to 2006 during the three months ended March 31, 2007. Additionally, sales for the first quarter 2007 were lower than sales for the fourth quarter 2006, which contributed to a lower sales return and allowances reserve balance as of March 31, 2007.

Note 5 — Convertible Senior Notes

In June 2003, the Company sold an aggregate of $98.0 million of 4.625% Convertible Senior Notes due June 15, 2023 and received net proceeds of approximately $94.4 million. The notes are convertible into shares of the Company's common stock at an initial conversion price of $20.00 per share, or 50 shares per note, subject to certain circumstances. The notes may be converted in each quarter subsequent to any quarter in which the closing price of the Company's common stock is at or above a prescribed price for at least 20 trading days in the last 30 trading day period of the quarter. The prescribed price for the conversion trigger is $24.00 through June 30, 2010, and increases nominally each quarter thereafter. Cash interest is payable at an annual rate of 4.625% of the principal amount at issuance, from the issue date to June 15, 2010, payable on June 15 and December 15 of each year. After June 15, 2010, interest will accrue on the outstanding notes until maturity. At maturity, the Company will redeem the notes at their accreted principal amount, which will be equal to $1,811.95 (181.195%) per $1,000 principal amount at issuance, unless redeemed or converted earlier. The notes were not convertible as of March 31, 2007 and are not convertible during the second quarter of 2007.

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

Note 6 — Income Taxes

Provision for income taxes includes Federal, state and foreign income taxes at effective tax rates of 29% in 2006, and 32% in 2007, benefiting from a flat 17.5% tax rate on the Company's income arising in, or derived from, Hong Kong for each of 2006 and 2007. The increase in the effective rate in 2007 is primarily due to a greater portion of income being derived from the United States. As of March 31, 2007, the Company had net deferred tax assets of approximately $10.0 million for which an allowance of $0.9 million has been provided since, in the opinion of management, realization of the future benefit is uncertain.

As of January 1, 2007, the Company adopted the provisions of FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, which prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Until adoption of FIN 48, the Company's policy has been to account for uncertainty in income taxes in accordance with the provisions of Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, which considered whether the tax benefit from an uncertain tax position was probable of being sustained. Under FIN 48, the tax benefit from uncertain tax positions may only be recognized if it is more likely than not that the tax position

Note 6 – Income Taxes (continued)

will be sustained, based solely on its technical merits, with the taxing authority having full knowledge of all relevant information.

The Company’s total unrecognized tax position (UTP) liabilities at FIN 48 adoption were $22.8 million, including $10.3 million of UTPs that were previously recognized as income tax expense and an increase in the liability for UTPs of $12.5 million, which was accounted for as a reduction to the January 1, 2007 balance of retained earnings. These unrecognized tax benefits are primarily due to income allocation issues between the United States and Hong Kong, and fixed asset depreciation in Hong Kong. The Company has also recognized an additional liability of $2.5 million for penalties and $2.8 million for interest on the potential tax liability. These amounts were also accounted for as a reduction in the January 1, 2007 balance of retained earnings, net of associated income tax benefit. Current interest on income tax liabilities is recognized as interest expense and penalties on income tax liabilities are recognized as other expense in the consolidated statement of operations.

Approximately $2.9 million of United States based, and $1.5 million of Hong Kong based unrecognized tax benefits will potentially become recognized during 2007 if the periods for which certain tax years are subject to examination were to expire. Under these circumstances, these amounts would be recognized in the 2007 income tax provision. The tax years 2001 through 2006 are still subject to examination in Hong Kong. The tax years 2003 through 2006 are still subject to examination in the United States and the tax years 2002 through 2006 are still subject to examination in California.

Note 7 – Earnings Per Share

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

	Three Months Ended March 31,					
	2006			2007		
	Income	Weighted Average Shares	Per-Share	Income	Weighted Average Shares	Per-Share
Earnings per share - basic						
Income available to common stockholders	$ 2,331	27,310	$ 0.09	$ 3,238	27,498	$ 0.12
Effect of dilutive securities:						
Convertible senior notes	737	4,900		—	—	
Options and warrants	—	407		—	362	
Unvested restricted stock grants	—	—		—	124	
Earnings per share - diluted						
Income available to common stockholders plus assumed exercises and conversion	$ 3,068	32,617	$ 0.09	$ 3,238	27,984	$ 0.12

Basic earnings per share has been computed using the weighted average number of common shares outstanding excluding unvested restricted shares. Diluted earnings per share has been computed using the weighted average number of common shares and common share equivalents outstanding (which consist of warrants, options and convertible debt to the extent they are dilutive). For the three months ended March 31, 2007, the convertible senior notes interest and related common share equivalents of 4,900,000 were excluded from the diluted earnings per share calculation because they were anti-dilutive. Potentially dilutive stock options of 460,931 and 315,219 for the three months ended March 31, 2006 and 2007, respectively, were not included in the computation of diluted earning per share as the average market price of the Company’s common stock did not exceed the weighted average exercise price of such options and to have included them would have been anti-dilutive.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 8 — Common Stock and Preferred Stock

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

In January 2007, the Company issued an aggregate of 240,000 shares of restricted stock to two of its executive officers, which vest 50% in each of January 2008 and 2009 subject to acceleration based on the Company achieving certain financial performance criteria, and an aggregate of 27,340 shares of restricted stock to its five non-employee directors, which vest in January 2008, at an aggregate value of approximately $5.8 million. During the three months ended March 31, 2007, the Company also issued 161,775 shares of common stock on the exercise of options for a total of $2.6 million, and 83,644 shares of restricted stock previously received by two executive officers were surrendered at a value of $1.8 million to cover their income taxes due on the 2007 vesting of the restricted shares granted them in 2006. This surrendered restricted stock was subsequently retired by the Company.

In January 2006, the Company issued an aggregate of 240,000 shares of restricted stock to two of its executive officers, 75% of which vested in January 2007 and the remaining 25% of which vests in January 2008, and an aggregate of 28,660 shares of restricted stock to its five non-employee directors, which vested in January 2007, at an aggregate value of approximately $5.6 million. During the three months ended March 31, 2006, the Company also issued 219,098 shares of common stock on the exercise of options for a total of $3.4 million, and 110,736 shares of restricted stock previously received by two executive officers were surrendered at a value of $2.5 million to cover their income taxes due on the 2006 vesting of the restricted shares granted them in 2005. This surrendered restricted stock was subsequently retired by the Company. In February 2006, the Company issued 150,000 shares of its common stock valued at approximately $3.3 million in connection with the acquisition of Creative Designs International, Ltd. and a related Hong Kong company, Arbor Toys Company Limited (collectively “Creative Designs”) (see Note 9). In 2006, the Company granted and issued an aggregate of 204,500 shares of restricted stock to its employees, which vest over a five-year period, at an aggregate value of approximately $3.4 million, which represents the fair market value at the grant date. In the three months ended March 31, 2007, 2,000 shares of the restricted stock granted to its employees were cancelled.

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

Note 9 — Business Combinations

The Company acquired the following entities to further enhance its existing product lines, continue diversification into other toy categories and counter-seasonal businesses and expand distribution of its products.

In February 2006, the Company acquired substantially all of the assets of Creative Designs. The total initial consideration of $111.1 million consisted of cash paid at closing in the amount of $101.7 million, the issuance of 150,000 shares of the Company’s common stock valued at approximately $3.3 million and the assumption of liabilities in the amount of $6.1 million, and resulted in the recording of goodwill in the amount of $53.6 million. Goodwill represents anticipated synergies to be gained via the combination of Creative Designs with the Company. In addition, the Company agreed to pay an earn-out of up to an aggregate of $20.0 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. For the year ended December 31, 2006, $6.9 million of the earn-out was earned and

recorded as goodwill. Creative Designs is a leading designer and producer of dress-up and role-play toys. This acquisition expands our product offerings in the girls role-play and dress-up area and brings new product development and marketing talent to the Company. The Company's results of operations have included Creative Designs from the date of acquisition.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 9 –Business Combinations (continued)

The amount of goodwill from the Creative Designs acquisition that is expected to be deductible for Federal and state income tax purposes is approximately $51.4 million. The total purchase price was allocated based on studies and valuations performed to the estimated fair value of assets acquired and liabilities assumed as set forth in the following table (in thousands):

Estimated fair value of net assets:		
Current assets acquired	$	15,655
Property and equipment, net		1,235
Other assets		103
Liabilities assumed		(6,081)
Intangible assets other than goodwill		40,488
Goodwill		60,519
	$	111,919

The following unaudited pro forma information represents the Company’s consolidated results of operations as if the acquisition of Creative Designs had occurred on January 1, 2006 and after giving effect to certain adjustments including the elimination of certain general and administrative expenses and other income and expense items not attributable to ongoing operations, interest expense, and related tax effects. Such pro forma information does not purport to be indicative of operating results that would have been reported had the acquisition of Creative Designs actually occurred on January 1, 2006 or future operating results (in thousands, except per share data).

		Three Months Ended March 31, 2006
Net sales	$	120,127
Net income	$	3,998
Earnings per share - basic	$	0.15
Weighted average shares outstanding - basic		27,462
Earnings per share - diluted	$	0.14
Weighted average shares and equivalents outstanding - diluted		32,767

In June 2005, the Company purchased substantially all of the operating assets and assumed certain liabilities relating to the Pet Pal line of pet products, including toys, treats and related pet products. The total initial consideration of $11.2 million consisted of cash paid at closing in the amount of $10.6 million and the assumption of liabilities in the amount of $0.6 million. 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. In addition, the Company agreed to pay an earn-out of up to an aggregate amount of $25.0 million in cash based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. For the fiscal year ended May 31, 2006, $1.5 million of the earn-out was earned and recorded as goodwill. This acquisition expands the Company’s product offerings and distribution channels. The Company’s results of operations have included Pet Pal from the date of acquisition.

In June 2004, the Company purchased substantially all of the assets and assumed certain liabilities of Play Along. The total initial consideration of $108.0 million consisted of cash paid at closing in the amount of $70.8 million, the issuance of 749,005 shares of the Company's common stock valued at $14.9 million and the assumption of liabilities in the amount of $22.3 million, and resulted in the recording of goodwill in the amount of $58.0 million. In addition, the Company agreed to pay an earn-out of up to $10.0 million per year for the four

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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Note 9 — Business Combinations (continued)

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. Play Along designs and produces traditional toys, which it distributes domestically and internationally. This acquisition expands the Company's product offerings in the pre-school area and brings new product development and marketing talent to the Company. The Company's results of operations have included Play Along from the date of acquisition.

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

Estimated fair value of net assets:		
Current assets acquired	$	24,063
Property and equipment, net		546
Other assets		3,184
Liabilities assumed		(22,263)
Intangible assets other than goodwill		22,100
Goodwill		81,390
	$	109,020

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

Note 10 — Joint Ventures

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

arbitration. On April 30, 2007, THQ filed an action in the Superior Court, Los Angeles County, to compel arbitration and to appoint an arbitrator pursuant to the relevant provisions of the agreement. 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 $15.2 million for the cumulative preferred return for the period from July 1, 2006 to March 31, 2007 has been accrued as of March 31, 2007, pending the resolution of this outstanding issue. As of December 31, 2006 and March 31, 2007, the balance of the investment in the video game joint venture includes the following

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JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 10 — Joint Ventures (continued)

components (in thousands):

	December 31, 2006	March 31, 2007
Preferred return receivable	$ 13,482	$ 15,162
Investment costs, net	1,391	1,232
	$ 14,873	$ 16,394

The Company's joint venture partner retains the financial risk of the joint venture and is responsible for the day-to-day operations, including development, sales and distribution, for which they are entitled to any remaining profits. During three months ended March 31, 2006 and 2007, the Company earned $0.8 million and $1.5 million, respectively, in net profit from the joint venture.

Note 11 — Goodwill

The changes in the carrying amount of goodwill for the three months ended March 31, 2007 are as follows (in thousands):

	Traditional Toys	Craft/Activity/Writing Products	Seasonal/ Outdoor Products	Pet Products	Total
Balance at beginning of the period	$ 210,143	$ 82,826	$ 38,906	$ 6,124	$ 337,999
Adjustments to goodwill during the period	8	—	—	—	8
Balance at end of the period	$ 210,151	$ 82,826	$ 38,906	$ 6,124	$ 338,007

Note 12 — Intangible Assets

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

		December 31, 2006			March 31, 2007		
	Weighted Useful Lives (Years)	Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
Amortized Intangible Assets:							
Acquired order backlog	0.50	$ 1,298	$ (1,298)	$ —	$ 1,298	$ (1,298)	$ —
Licenses	4.75	58,699	(25,821)	32,878	58,699	(29,251)	29,448
Product lines	3.50	17,700	(17,700)	—	17,700	(17,700)	—

Customer relationships	6.25	3,646	(1,239)	2,407	3,646	(1,382)	2,264
Non-compete/Employment contracts	4.00	2,748	(1,753)	995	2,748	(1,927)	821
Debt offering costs	20.00	3,705	(662)	3,043	3,705	(708)	2,997
Total amortized intangible assets		87,796	(48,473)	39,323	87,796	(52,266)	35,530
Unamortized Intangible Assets:							
Trademarks	indefinite	19,568	N/A	19,568	19,568	N/A	19,568
		$ 107,364	$ (48,473)	$ 58,891	$ 107,364	$ (52,266)	$ 55,098

Amortization expense related to limited life intangible assets was $4.2 million and $3.8 million, for the three months ended March 31, 2006 and 2007, respectively.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 13 – Share-Based Payments

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

Under the Plan, share-based compensation payments may include the issuance of shares of restricted stock. In January 2007, the Company's five non-employee directors each received annual grants of restricted stock at a value of $119,421 (or, for 2007, 5,468 shares per director) which vest after one year. In March 2003, two executive officers of the Company entered into employment agreements which provided, *inter alia*, for the issuance of (i) 240,000 shares of restricted stock (or 480,000 shares in the aggregate) upon the execution of such agreements; and (ii) 120,000 shares of restricted stock (or 240,000 shares in the aggregate) on January 1, 2004 and on each January 1 thereafter through and including January 1, 2010 (subject in each instance to the achievement by the Company of certain financial performance criteria and continuing employment by the respective executive). The employment agreements further provided that one-half of the issued shares of restricted stock vest on each of the one and two year anniversaries of issuance, subject to acceleration based on the achievement of certain financial performance criteria. To date, all restricted stock scheduled to have been issued through January 1, 2007 has been issued and, of such issued shares, 1,140,000 shares have vested; 180,000 shares are scheduled to vest on January 1, 2008; and (subject to acceleration based on the achievement of certain financial performance criteria) the remaining 120,000 shares are scheduled to vest on January 1, 2009. Included in the foregoing were issuances made in January 2006 and 2007, respectively, whereby the Company issued 268,660 shares of restricted stock at a value of $5.6 million and 267,340 shares of restricted stock at a value of $5.8 million to two executive officers and five non-employee directors of the Company. In 2006, the Company granted and issued an aggregate of 204,500 shares of restricted stock to its employees, which vest over a five-year period, at an aggregate value of approximately $3.4 million, which represents the fair market value at the grant date.

The Company accounts for grants of stock options and restricted stock in accordance with the revised Statement of Financial Accounting Standards No. 123 ("FAS 123R"), *Share-Based Payment*.

The Company issued no stock options during the three months ended March 31, 2007. The amount of share-based compensation expense recognized in the three months ended March 31, 2007 is based on options issued prior to January 1, 2006 and restricted stock issued during 2006 and the three months ended March 31, 2007, and ultimately expected to vest, and it has been reduced for estimated forfeitures. FAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The following table summarizes the total share-based compensation expense and related tax benefits recognized for the three months ended March 31, 2006 and 2007 (in thousands):

	March 31,	
	2006	2007

Stock option compensation expense	$	571	$	265
Tax benefit related to stock option compensation	$	223	$	103
Restricted stock compensation expense	$	1,796	$	1,852
Tax benefit related to restricted stock compensation	$	700	$	722

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 13 — Share-Based Payments (continued)

Stock option activity pursuant to the Plan for the three months ended March 31, 2007 is summarized as follows:

	Plan Stock Options		
	Number of Shares		Weighted Average Exercise Price
Outstanding, December 31, 2006	1,462,378	$	17.05
Granted	—		—
Exercised	(161,775)	$	16.24
Forfeited	(19,575)	$	19.60
Outstanding, March 31, 2007	1,281,028	$	17.11

As of December 31, 2006, the Company had 268,660 shares of restricted stock outstanding, of which 208,660 vested during the first quarter of 2007 and the remaining 60,000 shares are scheduled to vest January 1, 2008. In January 2007, the Company issued 267,340 shares of restricted stock, 240,000 of which vest over a two-year period subject to acceleration and 27,340 of which vest over a one-year period. In 2006, the Company also issued an aggregate of 204,500 shares of restricted stock to certain of its non-officer employees, which vest over a five-year period beginning August 2007 and which remain unvested as of March 31, 2007.

Note 14 — Comprehensive Income

The table below presents the components of the Company's comprehensive income for the three months ended March 31, 2006 and 2007 (in thousands):

	Three Months Ended March 31,			
		2006		2007
Net income	$	2,331	$	3,238
Other comprehensive income (loss):				
Foreign currency translation adjustment		(46)		(17)
Comprehensive income	$	2,285	$	3,221

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JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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Note 15 — Recent Accounting Pronouncement

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes,* which prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Under FIN 48, the tax benefit of uncertain tax positions may be recognized only if it is more likely than not that the tax position will be sustained, based solely on its technical merits presuming the tax authority has full knowledge of all relevant information. Additionally, FIN 48 provided guidance on the de-recognition, classification, and accounting in interim periods and disclosure requirements for uncertain tax positions. In the first quarter of 2007, the Company adopted FIN 48 which resulted in the recognition of an increased current and non-current income tax payable for unrecognized tax benefits of $12.5 million. The Company has also recognized an additional liability of $2.5 million for penalties and $2.8 million for interest on the income tax liability. These increases to the liabilities resulted in a reduction of $16.0 million to the January 1, 2007 balance of retained earnings, net of related tax benefits.

Note 16 — Litigation

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

The Company received notice from WWE alleging breaches of the video game license in connection with sales of WWE video games in Japan and other countries in Asia. The joint venture has responded that WWE acquiesced in the arrangements, and separately released any claim against the joint venture in connection therewith and accordingly there is no breach of the joint venture’s video game license.

While the joint venture does not believe that WWE has a valid claim, it tendered a protective “cure” of the alleged breaches with a full reservation of rights. WWE “rejected” that cure and reserved its rights.

On October 12, 2006, WWE commenced a lawsuit in Connecticut state court against THQ and 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 “Connecticut Action”). The lawsuit seeks, among other things, a declaration that WWE is entitled to terminate the video game license and monetary damages and raised Connecticut Unfair Trade Practices Act (“CUTPA”) and contract claims against THQ and the LLC. A motion to strike the CUTPA claim was recently denied.

In March 2007, WWE filed a motion seeking leave to amend its complaint in the Connecticut Action to add the principal part of the state law claims present in the WWE Action to the Connecticut Action. That motion further sought, *inter alia*, to add the Company and Messrs. Friedman, Berman and Bennett as defendants in the Connecticut Action. The motion was argued on May 8, 2007 and was granted from the bench, subject to a decision that the schedule was suspended and no discovery matters would be addressed until pleading motions were resolved.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 16 — Litigation (continued)

In connection with the joint venture with THQ (see Note 10), the Company receives its profit through a preferred return based on net sales of the joint venture, which was to be reset as of July 1, 2006. The agreement with THQ provides for the parties to agree on the reset of the preferred return or, if no agreement is reached, for arbitration of the issue. No agreement has been reached and the Company anticipates that the reset of the preferred return will be determined through arbitration. On April 30, 2007, THQ filed an action in the Superior Court, Los Angeles County, to compel arbitration and to appoint an arbitrator pursuant to the relevant provisions of the agreement. 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 $15.2 million for the cumulative preferred return for the period from July 1, 2006 to March 31, 2007 has been accrued as of March 31, 2007, pending the resolution of this outstanding issue.

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

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

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

Critical Accounting Policies and Estimates

The accompanying consolidated financial statements and supplementary information were prepared in accordance with accounting principles generally accepted in the United States of America. Significant accounting policies are discussed in Note 2 to the Consolidated Financial Statements, 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 $409.4 million as of March 31, 2007.

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 is periodically reviewed and adjusted as circumstances warrant. As of March 31, 2007, our income tax reserves are approximately $22.8 million and relate to the potential income tax audit adjustments, primarily in the areas of income allocation and transfer pricing.

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

As of January 1, 2007, we adopted the provisions of FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, which prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be take in a tax return. As of the date of adoption, tax benefits that are subject to challenge by tax authorities are analyzed and accounted for in the income tax provision. The cumulative effect of the potential liability for unrecognized tax benefits prior to the adoption of FIN 48, along with the associated interest and penalties, are recognized as a reduction in the January 1, 2007 balance of retained earnings.

We recognize current period interest expense on the income tax liability for unrecognized tax benefits as interest expense, and penalties related to the income taxes payable as other expense in our consolidated statements of operations.

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. We estimate the value of share-based awards on the date of grant using the Black-Scholes option-pricing model. 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.

Recent Developments

In February 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 at a value of 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 our Company. 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 category and brings new product development and marketing talent to us. Our results of operations have included Creative Designs from the date of acquisition.

Results of Operations

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

	Three Months Ended March 31,	
	2006	**2007**
Net sales	100.0%	100.0%
Cost of sales	58.8	63.3
Gross profit	41.2	36.7
Selling, general and administrative expenses	39.1	34.0
Income from operations	2.1	2.7
Profit from video game joint venture	0.7	1.2
Interest income	1.4	1.2
Interest expense	(1.1)	(1.3)
Income before provision for income taxes	3.1	3.8
Provision for income taxes	0.9	1.2
Net income	2.2%	2.6%

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).

	Three Months Ended March 31,			
	2006		**2007**	
Net Sales				
Traditional Toys	$	83,347	$	102,515
Craft/Activity/Writing Products		13,063		9,167
Seasonal/Outdoor Products		8,464		8,209
Pet Products		2,370		4,171
		107,244		124,062
Cost of Sales				
Traditional Toys		50,071		64,988
Craft/Activity/Writing Products		5,786		5,843
Seasonal/Outdoor Products		5,477		5,332
Pet Products		1,747		2,391
		63,081		78,554
Gross Margin				
Traditional Toys		33,276		37,527
Craft/Activity/Writing Products		7,277		3,324
Seasonal/Outdoor Products		2,987		2,877
Pet Products		623		1,780
	$	44,163	$	45,508

***Comparison of the Three Months Ended* March 31, 2007 and 2006**

Net Sales

Traditional Toys. Net sales of our Traditional Toys segment were $102.5 million in 2007, compared to $83.3 million in 2006, representing an increase of $19.2 million, or 23.1%. The increase in net sales was primarily due to the full quarter impact of sales related to our Creative Designs line of products, which had incremental sales of $17.4 million and increases in sales of WWE actions figures and accessories, TV Games, Pokemon, In My Pocket toys, Speed Stacks and Snugglers, offset in part by decreases in sales of Dragonball Z action figures, wheels products, Sky Dancers, Doodle Bears, Dragon Flyz, Care Bears and Cabbage Patch Kids.

Craft/Activity/Writing Products. Net Sales of our Craft/Activity/Writing Products were $9.2 million in 2007, compared to $13.1 million in 2006, representing a decrease of $3.9 million, or 29.8%. The decrease in net sales was primarily due to decreases in sales of our Flying Colors activities products and our Pentech and Color Workshop writing instruments and related products.

Seasonal/Outdoor Products. Net sales of our Seasonal/Outdoor Products were $8.2 million in 2007, compared to $8.5 million in 2006, representing a decrease of $0.3 million, or 3.5%. The decrease in net sales was primarily due to decreases in sales of our Funnoodle pool toys and our Go Fly A Kite and junior sports products, offset in part by an increase in sales of our Fly Wheels XPV toys.

Pet Products. Net Sales of our Pet Pal line of products were $4.2 million in 2007, compared to $2.4 million in 2006, representing an increase of $1.8 million, or 75.0%. The increase is attributable to the expanding line of product and expanding distribution.

Cost of Sales

Traditional Toys. Cost of sales of our Traditional Toys segment was $65.0 million in 2007, compared to $50.1 million in 2006, representing an increase of $14.9 million or 29.7%. The increase primarily consisted of an increase in product costs of $11.9 million, which is in line with the higher volume of sales. Furthermore, royalty expense for our Traditional Toys segment increased by $2.5 million and 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 royalty rates. Additionally, certain royalty advances and guarantees were written off for licensed product whose sell-off period had expired. Product costs as a percentage of sales increased due to the mix of the product sold and the sell-off of closeout product. Our depreciation of molds and tools increased by $0.5 million due to new products being sold in this segment.

Craft/Activity/Writing Products. Cost of sales of our Craft/Activity/Writing Products remained comparable at $5.8 million in 2007 with the $5.8 million in 2006. Although product costs remained comparable, product costs as a percentage of net sales increased primarily due to the mix of the product sold and sell-off of closeout product. Royalty expense also remained comparable year-over-year, but increased 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 royalty rates. 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 $5.3 million in 2007, compared to $5.5 million in 2006, representing a decrease of $0.2 million, or 3.6%. The decrease primarily consisted of decreases in product costs of $0.2 million which were in line with the lower volume of sales, and royalty expense of $0.1 million. Our depreciation of molds and tools increased by $0.1 million, which was comparable year-over-year.

Pet Products. Cost of sales of our Pet Pal line of products was $2.4 million in 2007, compared to $1.7 million in 2006, representing an increase of $0.7 million, or 41.2%. The increase primarily consisted of increases in product costs of $0.4 million and royalty expense of $0.2 million, which were in line with the higher volume of sales. Additionally, our depreciation of molds and tools increased by $0.1 million.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were $42.2 million in 2007 and $41.9 million in 2006, constituting 34.0% and 39.1% of net sales, respectively. The overall increase of $0.3 million in such costs was primarily due to the incremental overhead related to a full quarter operations of Creative Designs ($1.5 million) in 2007 (as compared to a partial quarter of operations in 2006 as a result of the February 2006 acquisition thereof), offset in part by decreases in amortization expense related to intangible assets other than goodwill ($0.4 million), stock-based compensation ($0.3

million) and other selling expenses ($1.8 million). Stock-based compensation expense decreased by $0.3 million from $2.4 million in 2006, compared to $2.1 million in 2007 mainly due to fewer unexercised stock options and comparable restricted stock expense year-over-year. The decrease in direct selling expenses is primarily due to efficiencies gained by closing two third-party warehouses by the end of the second quarter in 2006 and decreases in advertising and promotional expenses of $2.3 million in 2007 in support of several of our product lines, offset in part by a decrease in sales commission expense of $0.5 million. 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 2007 increased to $1.5 million, as compared to $0.8 million in 2006, due to the strong performance of the new games released and stronger sales of existing titles in 2007 compared to 2006, where fewer new games were released. Furthermore, we devoted and allocated $0.4 million less of JAKKS' overhead to the video joint venture. The amount of the preferred return we receive from the joint venture after June 30, 2006 became subject to change (see "Risk Factors", *infra*, and Note 10 to the Notes to Condensed Consolidated Financial Statements (Unaudited), *supra*).

Interest Income.

Interest income in 2007 was $1.5 million, as compared to $1.4 million in 2006. The increase is due to higher average cash balances and higher interest rates during 2007 compared to 2006.

Interest Expense

Interest expense was $1.6 million and $1.1 million for 2007 and 2006, respectively. The increase is due to interest accrued pursuant to our January 1, 2007 adoption of the provisions of FIN 48. The amounts related to our convertible senior notes payable are comparable in 2007 and 2006.

Provision for Income Taxes

Provision for income taxes includes Federal, state and foreign income taxes at effective tax rates of 29% in 2006, and 32% in 2007, benefiting from a flat 17.5% tax rate on our income arising in, or derived from, Hong Kong for each of 2006 and 2007. The increase in the effective rate in 2007 is primarily due to a greater portion of income being derived from the United States. As of March 31, 2007, we had net deferred tax assets of approximately $10.0 million for which an allowance of $0.9 million has been provided since, in the opinion of management, realization of the future benefit is uncertain.

Seasonality and Backlog

The retail toy industry is inherently seasonal. Generally, our sales have been highest during the third and fourth quarters, and collections for those sales have been highest during the succeeding fourth and first fiscal quarters. Sales of writing instrument products are likewise seasonal, with sales highest during the second and third quarters, as are our Go Fly a Kite, Funnoodle and Storm outdoor products, which are largely sold in the first and second quarters. Our working capital needs have been highest during the third and fourth quarters.

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

Recent Accounting Pronouncement

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, which prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Under FIN 48, the tax benefit of uncertain tax positions may be recognized only if it is more likely than not that the tax position will be sustained,

based solely on its technical merits presuming the tax authority has full knowledge of all relevant information. Additionally, FIN 48 provided guidance on the de-recognition, classification, and accounting in interim periods and disclosure requirements for uncertain tax positions. In the first quarter of 2007, we adopted FIN 48 which resulted in the recognition of an increased current and non-current income tax payable for unrecognized tax benefits of $12.5 million. We have also recognized an additional liability of $2.5 million for penalties and $2.8 million for interest on the income tax liability. These increases to the liabilities resulted in a reduction of $16.0 million to the January 1, 2007 balance of retained earnings, net of related tax benefits.

Liquidity and Capital Resources

As of March 31, 2007, we had working capital of $284.1 million, compared to $280.4 million as of December 31, 2006. This increase was primarily attributable to our operating activities, offset in part by earn-out payments related to our Play Along and Creative Designs acquisitions.

Operating activities provided net cash of $22.4 million in 2007, as compared to having used cash of $7.6 million in 2006. Net cash was provided primarily by net income, non-cash charges and changes in working capital. Our accounts receivable turnover as measured by days sales for the quarter outstanding in accounts receivable was 55 days as of March 31, 2007 which is comparable to the 57 days as of March 31, 2006. 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 March 31, 2007, we had cash and cash equivalents of $192.0 million.

Our investing activities used net cash of $16.3 million in 2007, as compared to $109.7 million in 2006, consisting primarily of cash paid for the Creative Designs earn-out of $6.9, the Play Along earn-out of $6.7 million, and the purchase of office furniture and equipment and molds and tooling of $2.3 million used in the manufacture of our products and other assets. In 2006, our investing activities consisted primarily of cash paid for the purchase of net assets in the Creative Designs acquisition of $101.7 million, the Play Along earn-out of $6.7 million and the purchase of office furniture and equipment and molds and tooling used in the manufacture of our products and other assets. As part of our strategy to develop and market new products, we have entered into various character and product licenses with royalties generally ranging from 1% to 12% payable on net sales of such products. As of March 31, 2007, these agreements required future aggregate minimum guarantees of $46.0 million, exclusive of $21.7 million in advances already paid. Of this $46.0 million future minimum guarantee, $21.5 million is due over the next twelve months.

Our financing activities provided net cash of $1.4 million in 2007, consisting of proceeds from the exercise of stock options. In 2006, financing activities provided net cash of $0.9 million, consisting of proceeds from the exercise of stock options.

In June 2003, we sold an aggregate of $98.0 million of 4.625% Convertible Senior Notes due June 15, 2023 and received net proceeds of approximately $94.4 million. The notes are convertible 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. After June 15, 2010, interest will accrue on the outstanding notes until maturity. At maturity, we will redeem the notes at their accreted principal amount, which will be equal to $1,811.95 (181.195%) per $1,000 principal amount at issuance, unless redeemed or converted earlier. The notes were not convertible as of March 31, 2007 and are not convertible during the second quarter of 2007.

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, and may be paid in cash, in shares of common stock or a combination of cash and shares of common stock.

In February 2006, we acquired substantially all of the assets of Creative Designs. The total initial consideration of $111.1 million consisted of $101.7 million in cash paid at closing, the issuance 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 our Company. 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. 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 consideration of $11.2 million consisted of cash paid at closing in the amount of $10.6 million and the assumption of liabilities in the amount of $0.6 million. Goodwill of $4.6 million arose from this transaction, which represents the excess of the purchase price over the fair value of the net assets acquired. In addition, we agreed to pay an earn-out of up to an aggregate amount of $25.0 million in cash based on the achievement of certain financial performance criteria, which will be recorded as goodwill when and if earned. For the fiscal year ended May 31, 2006, $1.5 million of the earn-out was earned and recorded as goodwill. This acquisition expands our product offerings and distribution channels. Our results of operations have included Pet Pal from the date of acquisition.

In June 2004, we purchased substantially all of the assets and assumed certain liabilities from Play Along. The total initial consideration of $108.0 million consisted of cash paid at closing in the amount of $70.8 million, the issuance of 749,005 shares of our common stock valued at $14.9 million, and the assumption of liabilities in the amount of $22.3 million, and resulted in the recording of goodwill of $58.0 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, $23.4 million of the earn-out was earned and recorded as goodwill. The maximum earn-out for the remaining year through 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.

We believe that our cash flow from operations and cash and cash equivalents on hand 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 on hand.

Item 3. 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, 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 March 31, 2007. 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 made by the Hong Kong subsidiaries are denominated in U.S. dollars. However, purchases of inventory are typically denominated in Hong Kong dollars and local operating expenses are denominated in the local currency of the subsidiary, thereby creating exposure to changes in exchange rates. Changes in the local currency/U.S. dollar exchange rates may positively or negatively affect our operating results. We do not believe that near-term changes in these exchange rates, if any, will result in a material effect on our future earnings, fair values or cash flows, and therefore, we have chosen not to enter into foreign currency hedging transactions. We cannot assure you that this approach will be successful, especially in the event of a significant and sudden change in the value of the Hong Kong dollar or Chinese Yuan relative to the U.S. dollar.

Item 4. Controls and Procedures

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

PART II
OTHER INFORMATION

Item 1. Legal Proceedings

On 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 jurisdiction 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 "Connecticut Action"). The lawsuit seeks, among other things, a declaration that WWE is entitled to terminate the video game license and monetary damages and raised Connecticut Unfair Trade Practices Act ("CUTPA") and contract claims against THQ and the LLC. A motion to strike the CUTPA claim was recently denied.

In March 2007, WWE filed a motion seeking leave to amend its complaint in the Connecticut Action to add the principal part of the state law claims present in the WWE Action to the Connecticut Action. That motion further sought, *inter alia*, to add our Company and Messrs. Friedman, Berman and Bennett as defendants in the Connecticut Action. The motion was argued on May 8, 2007 and was granted from the bench, subject to a decision that the schedule was suspended and no discovery matters would be addressed until pleading motions were resolved.

THQ and the LLC have stated that they believe the Connecticut Action 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 of the preferred return will be determined through arbitration. On April 30, 2007, THQ filed an action in the Superior Court, Los Angeles County, to compel arbitration and to appoint an arbitrator pursuant to the relevant provisions of the agreement. 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.

Item 1A. Risk Factors

From time to time, including in this Quarterly Report on Form 10-Q, we publish forward-looking statements, as disclosed in our Disclosure Regarding Forward-Looking Statements beginning immediately following the Table of Contents of this Report. We note that a variety of factors could cause our actual results and experience to differ materially from the anticipated results or other expectations expressed or anticipated in our forward-looking statements. The factors listed below are 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 Report to reflect events or circumstances occurring after the date of the filing of this report.

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

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

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

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

- Increasing use of technology;
- Shorter life cycles for individual products; and
- Higher consumer expectations for product quality, functionality and value.

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 many of our license agreements, including WWE and Nickelodeon, 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 **receive from the joint venture is in dispute and a materially adverse determination of the amount thereof 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 of the preferred return will be determined through arbitration. On April 30, 2007, THQ filed an action in the Superior Court, Los Angeles County, to compel arbitration and to appoint an arbitrator pursuant to the relevant provisions of the agreement. 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 $15.2 million for the cumulative preferred return for the period from July 1, 2006 to March 31, 2007 has been accrued as of March 31, 2007, 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 $11.8 million, $185.6 million and $67.1 million, for the three months ended March 31, 2007 and for the years ended December 31, 2006 and 2005, respectively, representing 9.5%, 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 9.5%, 24.3% and 10.1% of our total revenues for the three months ended March 31, 2007 and the years ended December 31, 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 57.6% and 58.7% of our net sales for the three months ended March 31, 2007 and the year ended December 31, 2006, respectively. 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 forty 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 three months ended March 31, 2007 and the year ended December 31, 2006, sales to our international customers comprised approximately 13.5% and 12.9%, respectively, of our net sales. We expect our sales to international customers to account for a greater portion of our revenues in future fiscal periods. Additionally, we utilize third-party manufacturers located principally in 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 and 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. 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 March 31, 2007, we have not had any impairment of Goodwill, which is reviewed on a quarterly basis and formally evaluated on an annual basis.

At March 31, 2007, approximately $338.0 million, or 42.3%, of our total assets represented goodwill. Declines in our profitability may impact the fair value of our reporting units, which could result in a further write-down of our goodwill. Reductions in our net income caused by the write-down of goodwill would adversely affect our results of operations.

Item 6. Exhibits

Number	Description
3.1.1	Restated Certificate of Incorporation of the Company(1)
3.1.2	Certificate of Amendment of Restated Certificate of Incorporation of the Company(2)
3.2.1	By-Laws of the Company(1)
3.2.2	Amendment to By-Laws of the Company(3)
4.1	Indenture, dated as of June 9, 2003, by and between the Registrant and Wells Fargo Bank, N.A.(4)
4.2	Form of 4.625% Convertible Senior Note(4)
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer(5)
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer(5)
32.1	Section 1350 Certification of Chief Executive Officer(5)
32.2	Section 1350 Certification of Chief Financial Officer(5)

(1) Filed previously as an exhibit to the Company’s Registration Statement on Form SB-2 (Reg. No. 333-2048-LA), effective May 1, 1996, and incorporated herein by reference.

(2) Filed previously as exhibit 4.1.2 of the Company’s Registration Statement on Form S-3 (Reg. No. 333-74717), filed on March 9, 1999, and incorporated herein by reference.

(3) Filed previously as an exhibit to the Company’s Registration Statement on Form SB-2 (Reg. No. 333-22583), effective May 1, 1997, and incorporated herein by reference.

(4) Filed previously as an exhibit to the Company’s Quarterly Report on Form 10-Q for the quarter ended June 30, 2003, filed on August 14, 2003, and incorporated herein by reference.

(5) Filed herewith.

SIGNATURES

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

		JAKKS PACIFIC, INC.	
Date: May 10, 2007	By:		/s/ JOEL M. BENNETT Joel M. Bennett Executive Vice President and Chief Financial Officer (Duly Authorized Officer and Principal Financial Officer)

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