NOTE 1—PRINCIPAL INDUSTRY

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

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

NOTE 2—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

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

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

Revenue recognition. Revenue is recognized upon the shipment of goods to customers. Provisions for estimated returns, defective products, markdowns and other allowances are made at the time of sale.

Inventory. Inventory, which includes the ex-factory cost of goods and in-bound freight, is valued at the lower of cost (first-in, first-out) or market and consists of the following:

December 31,	2001	2002
Deposits	$ 82,793	$ 20,185
Raw materials	236,206	586,244
Finished goods	31,704,961	37,403,318
	$32,023,960	$38,009,747

Marketable securities. Marketable securities have been categorized as trading and as a result are stated at fair value, with unrealized holding gains and losses included in earnings. At December 31, 2001 and 2002, such gains and losses were not material.

Fair value of financial instruments. The Company's cash and cash equivalents, accounts receivable and notes payable represent financial instruments. The carrying value of these financial instruments is a reasonable approximation of fair value.

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

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

Shipping and handling costs. The consolidated financial statements reflect, for all periods presented, the adoption of the classification or disclosure requirements pursuant to Emerging Issues Task Force ("EITF") 00-10, "Accounting for Shipping and Handling Fees and Costs," which was effective in the fourth quarter of fiscal 2000. Consistent with EITF 00-10, the Company has historically classified income from freight charges to customers in "Net sales." The Company classifies shipping and handling costs in "Selling, general and administrative expenses." Such costs amounted to approximately $8,127,000 in 2000, $11,940,000 in 2001 and $8,135,000 in 2002.

Advertising. Production costs of commercials and programming are charged to operations in the year during which the production is first aired. The costs of other advertising, promotion and marketing programs are charged to operations in the year incurred. Advertising expense for the years ended December 31, 2000, 2001 and 2002, was approximately $14,416,000, $11,026,000 and $12,697,000, respectively.

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

Translation of foreign currencies. Monetary assets and liabilities denominated in Hong Kong dollars or British pounds sterling are translated into United States dollars at the rate of exchange ruling at the balance sheet date. Transactions during the period are translated at the rates ruling at the dates of the transactions.

Profits and losses resulting from the above translation policy are recognized in the consolidated statements of operations.

Accounting for the impairment of long-lived assets. Long-lived assets, which include property and equipment, goodwill and intangible assets other than goodwill, are evaluated for impairment when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable through the estimated undiscounted future cash flows from the use of these assets. When any such impairment exists, the related assets will be written down to fair value.

Goodwill and other intangible assets. In July 2001, the FASB issued Statement of Financial Accounting Standards No. 141, "Business Combinations" (SFAS 141) and Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" (SFAS 142). SFAS 141 is effective for business combinations initiated after June 30, 2001. SFAS 141 requires that all business combinations completed after its adoption be accounted for under the purchase method of accounting and establishes specific criteria for the recognition of intangible assets separately from goodwill. SFAS 142 was effective for the Company on January 1, 2002 and primarily addresses the accounting for goodwill and intangible assets subsequent to their acquisition. With the adoption of SFAS 142, goodwill and other intangible assets are no longer amortized and are tested for impairment at least annually at the reporting unit level. As of December 31, 2002, there was no impairment to the underlying value of goodwill or intangible assets other than goodwill.

The effect of adoption of SFAS 142 on the reported net income for the current and comparative prior period is as follows:

For the Year Ended December 31,	2000	2001	2002
Reported net income	$28,637,395	$28,232,901	$31,271,462
Add back: Amortization of goodwill and other intangibles, net of tax effect	1,591,578	2,578,676	—
Net income, as adjusted	$30,228,973	$30,811,577	$31,271,462
Earnings per share—basic:			
Reported net income	$ 1.50	$ 1.55	$ 1.42
Add back: Amortization of goodwill and other intangibles, net of tax effect	0.08	0.14	—
	$ 1.58	$ 1.69	$ 1.42
Earnings per share—diluted:			
Reported net income	$ 1.41	$ 1.45	$ 1.37
Add back: Amortization of goodwill and other intangibles, net of tax effect	0.08	0.13	—
Net income, as adjusted	$ 1.49	$ 1.58	$ 1.37

Goodwill represents the excess purchase price paid over the fair market value of the assets of acquired toy companies. In fiscal 2002, the Company began to write off goodwill and certain intangible assets on an impairment basis where losses in value are recorded when and as material impairment has occurred in the underlying assets. Accumulated amortization of goodwill at December 31, 2001 and 2002 totaled $6,577,121.

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

Intangible assets other than goodwill consist of product technology rights and trademarks. Intangible assets are amortized on a straight-line basis, over five to thirty years, the estimated economic lives of the related assets. Accumulated amortization as of December 31, 2001 and 2002 was $1,961,113 and $2,910,386, respectively.

Stock option plans. In December 2002, the FASB issued Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure an Amendment of FASB Statement No. 123" (SFAS 148). SFAS 148 Statement amends Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS 123), to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation. It also amends the disclosure provisions of that Statement to require prominent disclosure about the effects on reported net income of an entity's accounting policy decisions with respect to stock-based employee compensation. Finally, SFAS 148 amends APB Opinion No. 28, "Interim Financial Reporting," to require disclosure about those effects in interim financial information.

At December 31, 2002, the Company has stock-based employee compensation plans, which are described more fully in Note 14. The Company accounts for those plans under the recognition and measurement principles of APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. However, certain options had been repriced resulting in compensation adjustments, which have been reflected in net income. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123, to stock-based employee compensation.

In 2000, 2001 and 2002 the fair value of each employee option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions used: risk-free rate of interest of 6%, 6% and 4%, respectively; dividend yield of 0%; with volatility of 94%, 91% and 87% respectively; and expected lives of five years.

Year Ended December 31,	2000	2001	2002
Net Income, as reported	$28,637,395	$28,232,901	$31,271,462
Add (Deduct): Stock-based employee compensation expense (income) included in reported net income	131,531	2,570,566	(1,308,365)
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards net of related tax effects	(1,806,108)	(1,498,495)	(2,034,284)
Pro forma net income	$26,962,818	$29,304,972	$27,928,813
Earnings per share:			
Basic—as reported	$ 1.50	$ 1.55	$ 1.42
Basic—pro forma	$ 1.41	$ 1.61	$ 1.27
Diluted—as reported	$ 1.41	$ 1.45	$ 1.37
Diluted—pro forma	$ 1.33	$ 1.51	$ 1.23

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:

2000	Income	Weighted Average Shares	Per Share
Basic EPS			
Income available to common stockholders	$28,637,395	19,059,544	$1.50
Effect of dilutive securities			
Options and warrants	—	1,221,931	
Diluted EPS			
Income available to common stockholders plus assumed exercises	$28,637,395	20,281,475	$1.41

2001	Income	Weighted Average Shares	Per Share
Basic EPS			
Income available to common stockholders	$28,232,901	18,199,108	$1.55
Effect of dilutive securities			
Options and warrants	—	1,210,817	
Diluted EPS			
Income available to common stockholders plus assumed exercises	$28,232,901	19,409,925	$1.45

2002	Income	Weighted Average Shares	Per Share
Basic EPS			
Income available to common stockholders	$31,271,462	21,962,807	$1.42
Effect of dilutive securities			
Options and warrants	—	783,700	
Diluted EPS			
Income available to common stockholders plus assumed exercises	$31,271,462	22,746,507	$1.37

Recent accounting standards. In June 2001, the FASB issued Statement No. 143, "Accounting for Asset Retirement Obligations" (SFAS 143). The objective of SFAS 143 is to establish an accounting standard for the recognition and measurement of an asset retirement obligation on certain long-lived assets. The retirement obligation must be one that results from the acquisition, construction or normal operation of a long-lived asset. SFAS 143 requires the legal obligation associated with the retirement of a tangible long-lived asset to be recognized at fair value as a liability when incurred, and the cost to be capitalized by increasing the carrying amount of the related long-lived asset. SFAS 143 will be effective for the Company's fiscal year beginning January 1, 2003. The adoption of this statement will have no material impact on the consolidated financial statements.

In October 2001, the FASB issued Statement of Financial Accounting Standards No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets” (SFAS 144). SFAS 144 supersedes SFAS No. 121, “Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of” (“Statement 121”) and retains the basic requirements of SFAS 121 regarding when and how to measure an impairment loss. SFAS 144 provides additional implementation guidance on accounting for an impairment loss. SFAS 144 is effective for all fiscal years beginning after December 15, 2001. The Company adopted SFAS 144 beginning in fiscal 2002, the adoption of which did not have a material effect on the Company’s financial position or results of operations.

In April 2002, the FASB issued Statement No. 145, “Rescission of Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Correction” (SFAS 145). SFAS 145 eliminates extraordinary accounting treatment for reporting gains or losses on debt extinguishments, and amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. The provisions of this SFAS are effective for fiscal years beginning after May 15, 2002; however, early application of SFAS 145 is encouraged. Debt extinguishments reported as extraordinary items prior to scheduled or early adoption of this SFAS would be reclassified to other income in most cases following adoption.

The Company is currently evaluating the impact the adoption of SFAS 145 would have on its consolidated results of operations subject to the evaluation in accordance with APB 30, “Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business and Extraordinary, Unusual and Infrequently Occurring Events and Transactions.”

In June 2002, the FASB issued Statement No. 146, “Accounting for Costs Associated with Exit or Disposal Activities” (SFAS 146), which changes the accounting for costs such as lease termination costs and certain employee severance costs that are associated with a restructuring, discontinued operation, plant closing, or other exit or disposal activity initiated after December 31, 2002. The standard requires companies to recognize the fair value of costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan.

The Company anticipates that the adoption of SFAS 146 will not have a material effect on the Company’s financial position or results of operations.

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

NOTE 3—BUSINESS SEGMENTS AND GEOGRAPHIC DATA

JAKKS Pacific is a worldwide producer and marketer of children’s toys and related products, principally engaged in the design, development, production and marketing of traditional toys, including boys action figures, vehicles and playsets, craft and activity products, writing instruments, compounds, girls toys, and infant and preschool toys. The Company’s reportable segments are North America Toys, International and Other.

The North America Toys segment, which includes the United States and Canada, and the International toy segment, which includes sales to non-North American markets, include the design, development, production and marketing of children’s toys and related products. The Company also has an additional segment classified as Other, which sells various products to the specialty markets in the United States.

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 North America Toy segment, which is a dominant segment. Segment assets are comprised of accounts receivable and inventories, net of applicable reserves and allowances.

The accounting policies of the segments are described in Note 2.

Results are not necessarily those that would be achieved were each segment an unaffiliated business enterprise. Information by segment and a reconciliation to reported amounts for the three years ended December 31, 2000, 2001 and 2002 are as follows:

Year Ended December 31,	2000	2001	2002
Net Sales			
North America Toys	$235,136,139	$250,627,160	$263,313,848
International	15,567,118	32,870,718	46,250,930
Other	1,584,686	811,143	451,430
	$252,287,943	$284,309,021	$310,016,208

Year Ended December 31,	2000	2001	2002
Operating Income			
North America Toys	$ 19,109,540	$ 25,827,227	$ 27,166,108
International	1,265,141	3,387,340	4,771,919
Other	128,788	83,589	46,575
	$ 20,503,469	$ 29,298,156	$ 31,984,602

December 31,	2001	2002
Assets		
North America Toys	$250,523,882	$347,488,457
International	33,119,144	60,912,682
Other	397,657	408,810
	$284,040,683	$408,809,949

The following tables present information about the Company by geographic area as of and for the three years ended December 31, 2002:

December 31,	2000	2001	2002
Long-lived Assets			
United States	$ 92,737,874	$ 93,154,559	$161,596,858
Hong Kong	13,705,700	24,556,935	612,710
Europe	—	497,381	59,745,654
	$106,443,574	$118,208,875	$221,955,222

Year Ended December 31,	2000	2001	2002
Net Sales by Geographic Area			
United States	$229,792,943	$244,317,186	$256,798,941
Europe	8,323,132	29,029,659	39,414,011
Canada	6,133,948	7,121,117	6,966,338
Hong Kong	5,397,135	—	323,527
Other	2,640,785	3,841,239	6,513,391
	$252,287,943	$284,309,021	$310,016,208

NOTE 4—ACQUISITIONS AND JOINT VENTURE

The Company owns a fifty percent interest in a joint venture with a company that 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 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 our lack of control over the joint venture. The Company's basis consists primarily of organizational costs and recoupable advances. The joint venture agreement provides for the Company to receive guaranteed preferred returns through June 30, 2006, subject to annual minimum payments of $2,600,000 through December 31, 2003, at varying rates of the joint venture's net sales depending on the cumulative unit sales and platform of each particular game. For periods after June 30, 2006, the amount of the preferred return will be subject to renegotiation between the parties. The preferred return is accrued in the quarter in which the licensed games are sold and the preferred return is earned. 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 2000, 2001 and 2002, the Company earned $15,905,860, $6,675,428 and $8,003,925, respectively, in profit from the joint venture.

In October 1999, the Company acquired all of the stock of Flying Colors Toys, Inc. ("Flying Colors") for $52,879,182 in cash paid at closing. Contingent consideration paid included an earn-out of $4,500,000 in each of the three 12-month periods following the closing, because gross profit of Flying Colors branded products achieved certain prescribed levels in each of such periods. Of the $4,500,000 earned in 2000, the amount of $464,938 was deemed to be compensation and has been expensed in 2000. The remaining balance of $4,035,062 and the 2001 and 2002 earn-outs have been recorded as goodwill.

In December 2001, the Company acquired all the outstanding stock of Kidz Biz Ltd., a United Kingdom company, and Kidz Biz Far East Limited, a Hong Kong corporation, collectively ("Kidz Biz"), for an aggregate purchase price of approximately $12.4 million, which was paid by the issuance of 308,992 shares of the Company's common stock at a value of $6.0 million and cash of $6.4 million. Both the United Kingdom and Hong Kong based companies are distributors of toys and related products in the United Kingdom, Ireland and the Channel Islands.

The Company acquired the following entities to further enhance its existing product lines and to continue diversification into other seasonal business.

On March 11, 2002, the Company purchased a controlling interest in Toymax International, Inc. ("Toymax"). On October 25, 2002, we completed that acquisition by acquiring the remaining outstanding common shares in a merger transaction. The total purchase price of approximately $62.2 million consisted of 1,166,360 shares of the Company's common stock, 598,697 options and approximately $41.0 million in cash. Results of operations have included Toymax from March 12, 2002; however, for the period from March 12, 2002 through October 25, 2002, the minority interest's share of Toymax's earnings were excluded.

On November 27, 2002, the Company purchased certain product lines, assets and assumed certain specific liabilities from Trendmasters, Inc. ("Trendmasters"). The total purchase price of approximately $19.0 million consisted of all cash. Results of operations have included Trendmasters from the date of acquisition.

The total purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed as set forth in the following table:

	Kidz Biz	Toymax	Trendmasters	Total
Condensed balance sheet:				
Current assets	$ 8,254,974	$ 26,856,685	$ 20,158	$ 35,131,817
Property and equipment, net	503,294	1,672,614	1,488,318	3,664,226
Other assets	—	11,751,594	—	11,751,594
Current liabilities	(15,042,928)	(42,999,773)	(8,713,143)	(66,755,844)
Goodwill	18,684,660	64,923,989	26,230,167	109,838,816
Total	$ 12,400,000	$ 62,205,109	$19,025,500	$ 93,630,609

Goodwill related to Kidz Biz and Trendmasters is not expected to be deductible for tax purposes, however, approximately $12.7 million of the Toymax goodwill is expected to be deductible for tax purposes.

The following unaudited pro forma information represents the Company's consolidated results of operations as if the acquisitions of Kidz Biz, Toymax and Trendmasters had occurred on January 1, 2001 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 acquisitions of Kids Biz, Toymax and Trendmasters occurred on January 1, 2001 or future operating results.

Year Ended December 31,	2001	2002
Net Sales	$483,941,432	$375,008,126
Net income	$ 23,529,672	$ 25,457,352
Basic earnings per share	$ 1.16	$ 1.11
Weighted average shares outstanding	20,273,181	22,998,347
Diluted earnings per share	$ 1.10	$ 1.07
Weighted average shares and equivalents outstanding	21,483,998	23,782,047

NOTE 5—CONCENTRATION OF CREDIT RISK

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

The Company performs ongoing credit evaluations of its customers' financial condition, but does not require collateral to support domestic customer accounts receivables. Most goods shipped FOB Hong Kong or China are sold on irrevocable letter of credit basis.

NOTE 6—ACCRUED EXPENSES

Accrued expenses consist of the following:

	2001	2002
Bonuses	$ 2,381,698	$ 2,124,000
Royalties and sales commissions	4,787,099	3,972,753
Hong Kong subsidiaries accruals	6,193,354	2,900,611
Other	4,706,574	10,396,650
	$18,068,725	$19,394,014

NOTE 7—RELATED PARTY TRANSACTIONS

A director of the Company is a partner in the law firm that acts as counsel to the Company. The Company incurred legal fees and expenses to the law firm in the amount of approximately $975,000 in 2000, $1,129,000 in 2001 and $2,653,000 in 2002.

As of December 31, 2002, there were two notes receivable from officers totaling $1,113,000 issued at interest rates of 6.5% each, with interest payable on each April 28 and October 28 of each year, and principal payable at a maturity date of April 28, 2003. Additionally, there was a third note receivable from an officer for $250,000 issued at an interest rate of 7.0%, with interest and principal payable at a maturity date of May 12, 2002, except that all indebtedness under the loan was forgiven on May 12, 2002, pursuant to this officer's employment agreement because employment continued through such date.

NOTE 8—LONG-TERM DEBT

Long-term debt consists of the following:

	2001	2002
Loan payable, due in 60 monthly payments with the final payment due December 4, 2006, with interest at 6.7% per annum	$95,070	$77,488
Less current portion of long-term debt	17,582	17,805
Long-term debt, net of current portion	$77,488	$59,683

The following is a schedule of payments for the loan payable:

2003	$17,805
2004	19,036
2005	20,350
2006	20,297
	$77,488

NOTE 9—INCOME TAXES

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

Year Ended December 31,	2000	2001	2002
Federal	$ 4,979,188	$2,595,989	$2,241,028
State and local	1,112,798	1,064,843	270,465
Foreign	5,161,994	5,336,377	6,105,378
	11,253,980	8,997,209	8,616,871
Deferred	442,983	800,000	431,667
	$11,696,963	$9,797,209	$9,048,538

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

	2001	2002
Net deferred tax assets/(liabilities):		
Current:		
Reserve for sales allowances and possible losses	$ 495,787	$ 2,012,524
Accrued expenses	(495,787)	1,848,700
Other	—	584,434
	—	4,445,658
Long-Term:		
Undistributed earnings	(5,084,165)	(11,024,165)
Property and equipment	(2,441,471)	(1,564,268)
Other	801,945	1,570,124
Federal net operating loss carryforwards	4,466,874	9,666,608
State net operating loss carryforwards	—	788,753
	(2,256,817)	(562,948)
Total net deferred tax assets/(liabilities)	$(2,256,817)	$ 3,882,710

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

	2000	2001	2002
Federal income tax expense	35%	35%	35%
State income tax expense, net of Federal tax effect	1.8	1.8	0.4
Effect of differences in U.S. and foreign statutory rates	(14.8)	(16.7)	(15.3)
Other	7.0	5.9	1.9
	29%	26%	22%

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

As of December 31, 2002, the Company has Federal and state net operating loss carryforwards of $27.6 million and $43 million, respectively, expiring through 2023. These carryforwards resulted from the acquisitions of Pentech and Toymax; the utilization of these losses to offset future income is limited under IRC§382. The Company's management concluded that a deferred tax asset valuation allowance was not necessary.

The components of income before provision for income taxes and minority interest are as follows:

	2000	2001	2002
Domestic	$ 8,480,038	$ 4,677,721	$ 3,537,593
Foreign	31,854,320	33,352,389	37,592,125
	$40,334,358	$38,030,110	$41,129,718

NOTE 10—CREDIT FACILITY

On October 12, 2001, the Company entered into a Loan Agreement with a consortium of banks led by Bank of America, N.A. This agreement expires on October 12, 2004 and permits the Company to borrow (and maintain obligations under outstanding letters of credit) up to an aggregate of $50,000,000. Available borrowings under the facility are determined by applying specified advance rates to eligible domestic accounts receivable and inventory.

The Company is required to not have any outstanding borrowings in excess of $30,000,000 for a period of at least 30 consecutive days during the first fiscal quarter of each year of the agreement.

This Credit facility is secured by a lien on substantially all of the Company's assets and contains customary financial and non-financial covenants which limit the ability to incur additional indebtedness, pay dividends or make other distributions, sell assets and enter into certain mergers or acquisitions. Amounts outstanding under this credit facility bears interest at 0.25% plus the greater of the Prime Rate or Federal Funds Rate plus 0.5%, and is subject to change based on certain financial ratios. As of December 31, 2002, the Company has no outstanding borrowings.

NOTE 11—LEASES

The Company leases office, warehouse and showroom facilities and certain equipment under operating leases. Rent expense for the years ended December 31, 2000, 2001 and 2002 totaled $769,070, $2,495,390 and $3,957,712, respectively. The following is a schedule of minimum annual lease payments.

2003	$ 4,707,091
2004	4,601,158
2005	3,967,662
2006	3,905,415
2007	3,490,756
Thereafter	1,292,900
	$21,964,982

NOTE 12—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. At the Company's annual meeting on September 27, 2002, its Stockholders approved increases in our authorized shares from 25,000,000 shares of common stock and 1,000,000 shares of preferred stock.

During 2002, the Company issued 954,770 shares of common stock on the exercise of options and warrants for a total of $5,883,931, 1,166,360 shares of common stock at a value of $18,081,243 in connection with the Toymax acquisition and 3,525,000 shares of common stock in connection with an underwritten public offering for net proceeds of approximately $59.1 million.

Warrant activity is summarized as follows:

	Number of Shares	Weighted Average Exercise Price
Outstanding, December 31, 1999	293,132	$5.92
Exercised	(36,777)	5.79
Outstanding, December 31, 2000	256,355	5.94
Exercised	(82,118)	4.48
Canceled	(7,362)	5.63
Outstanding, December 31, 2001	166,875	6.67
Exercised	(166,875)	6.67
Outstanding, December 31, 2002	—	$ —

During 2001, the Company issued 525,780 shares of common stock on exercise of options and warrants for a total of $3,069,745 and 308,992 shares of common stock at a value of $6,000,000 in connection with the Kidz Biz acquisition.

During 2000, the Company issued 212,890 shares of common stock on exercise of options and warrants for a total of $1,171,243. The Company repurchased 1,493,600 shares of common stock for a total of $12,911,483 and retired such stock in 2002.

NOTE 13—COMMITMENTS

The Company has entered into various license agreements whereby the Company may use certain characters and properties in conjunction with its products. Such license agreements call for royalties to be paid at 1.0% to 14.0% of net sales with minimum guarantees and advance payments. Additionally, under two separate licenses, the Company has committed to spend 12.5% of related net sales up to $1,000,000 and 5.0% of related net sales on advertising per year on such licenses.

Future annual minimum royalty guarantees as of December 31, 2002 are as follows:

2003	$ 4,202,692
2004	1,829,063
2005	4,538,335
2006	1,040,000
2007	1,040,000
Thereafter	6,731,000
	$19,381,090

The Company has entered into various employment agreements with certain executives expiring through June 2009. At December 31, 2002, the aggregate minimum guaranteed amounts under those agreements amount to $22.4 million.

NOTE 14—STOCK OPTION PLANS

Under its Third Amended and Restated 1995 Stock Option Plan ("the Plan"), the Company has reserved 3,725,000 shares of its common stock for issuance upon exercise of options granted under the Plan. And, under the 2002 Stock Award and Incentive Plan (the "2002 Plan"), the Company has reserved 2,300,000 shares of its common stock. Under the plans, employees (including officers), non-employee directors and independent consultants may be granted options to purchase shares of common stock.

As of December 31, 2002, 1,688,262 shares were available for future grant. Additional shares may become available to the extent that options presently outstanding under the Plan terminate or expire unexercised. Stock option activity pursuant to the Plans is summarized as follows:

	Number of Shares	Weighted Average Exercise Price
Outstanding, December 31, 1999	2,138,318	$11.70
Granted	2,036,497	10.49
Exercised	(91,177)	6.88
Canceled	(1,880,898)	15.82
Outstanding, December 31, 2000	2,202,740	7.15
Granted	724,125	15.73
Exercised	(427,536)	6.21
Canceled	(185,773)	7.98
Outstanding, December 31, 2001	2,313,556	9.97
Granted	1,124,197	11.06
Exercised	(787,836)	6.71
Canceled	(42,030)	15.00
Outstanding, December 31, 2002	2,607,887	$11.35

During 2002, the Company issued 598,697 options in connection with the Toymax acquisition. Stock option activity outside of the Plans is summarized as follows:

	Number of Shares	Weighted Average Exercise Price
Outstanding, December 31, 1999	101,062	$3.69
Exercised	(84,936)	3.96
Outstanding, December 31, 2000	16,126	2.24
Exercised	(16,126)	2.24
Outstanding, December 31, 2001 and 2002	—	$ —

The weighted average fair value of options granted to employees in 2000, 2001 and 2002 was $7.23, $16.24 and $10.65 per share, respectively.

The following table summarizes information about stock options outstanding and exercisable at December 31, 2002:

	Outstanding			Exercisable	
Option Price Range	Number of Shares	Weighted Average Life	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
$2.24–$20.57	2,607,887	4.28 years	$11.35	974,007	$9.34

NOTE 15—EMPLOYEE PENSION PLAN

The Company sponsors for its U.S. employees, a defined contribution plan under Section 401(k) of the Internal Revenue Code. The plan provides that employees may defer up to 15.0% of annual compensation, and that the Company will make a matching contribution equal to 50.0% of each employee's deferral, up to 5.0% of compensation. Company matching contributions, which vest equally over a five-year period, totaled $212,212, $216,038 and $268,086 for 2000, 2001 and 2002, respectively.

NOTE 16—MAJOR CUSTOMERS

Net sales to major customers, which are part of our North America Toys segment, were approximately as follows:

2000		2001		2002	
Amount	Percentage	Amount	Percentage	Amount	Percentage
$ 43,505,000	17.2%	$ 44,646,000	15.7%	$ 46,396,000	15.0%
36,321,000	14.4	36,024,000	12.7	41,506,000	13.4
30,481,000	12.1	34,319,000	12.1	34,773,000	11.2
27,338,000	10.8	20,972,000	7.4	34,018,000	11.0
21,875,000	8.7	19,425,000	6.8	16,077,000	5.1
$159,520,000	63.2%	$155,386,000	54.7%	$172,770,000	55.7%

NOTE 17—SUPPLEMENTAL INFORMATION TO CONSOLIDATED STATEMENTS OF CASH FLOWS

In 2002, 1,166,360 shares of common stock valued at $18.1 million and 598,697 options valued at $3.2 million were issued in connection with the acquisition of Toymax (Note 4).

In 2001, 308,992 shares of common stock valued at $6,000,000 were issued in connection with the acquisition of Kidz Biz (Note 4).

NOTE 18—SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

Selected unaudited quarterly financial data for the years 2001 and 2002 are summarized below:

	2001				2002			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
(in thousands, except per share data)								
Net sales	$59,962	$70,141	$92,768	$61,438	$59,895	$78,992	$102,640	$68,489
Gross profit	$24,468	$32,609	$39,056	$23,953	$26,470	$35,192	$ 41,812	$27,077
Income (loss) from operations	$ 7,267	$ 8,879	$14,562	$ (1,410)	$ 1,420	$ 9,912	$ 18,895	$ 1,758
Income before income taxes and minority interest	$ 8,480	$ 9,478	$15,250	$ 4,822	$ 2,985	$10,849	$ 19,944	$ 7,352
Net income	$ 6,021	$ 6,873	$10,949	$ 4,390	$ 2,156	$ 7,832	$ 13,954	$ 7,329
Basic earnings per share	$ 0.33	$ 0.38	$ 0.60	$ 0.24	$ 0.11	$ 0.37	$ 0.59	$ 0.30
Weighted average shares outstanding	18,008	18,048	18,273	18,463	19,017	20,985	23,586	24,178
Diluted earnings per share	$ 0.32	$ 0.36	$ 0.56	$ 0.22	$ 0.11	$ 0.36	$ 0.58	$ 0.30
Weighted average shares and equivalents outstanding	18,920	19,259	19,586	19,763	20,236	21,953	24,059	24,800

During the second quarter of 2000, the Company recorded a charge which impacted operating income by approximately $1.4 million relating to the recall of one of our products.

During the fourth quarter of 2001, the Company recorded a charge of $5.0 million to bad debt impacting operating income relating to the bankruptcy filing of one of its customers, Kmart.

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

During the second quarter of 2002, the Company recorded a charge which impacted operating income by approximately $1.4 million relating to the recall of one of its products.

During the fourth quarter of 2002, the Company reversed $2.1 million of the restructuring charge recorded in the first quarter of 2002 and recorded an additional charge of approximately $0.7 million relating to the recall of one of its products, the net of which favorably impacted operating income by approximately $1.5 million. In addition, the Company's effective tax rate for the year 2002 was reduced from 26.0% to 22.0%.

NOTE 19—LITIGATION

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

NOTE 20—SUBSEQUENT EVENTS

In February 2003, the Company's Board of Directors approved a buyback of up to $20.0 million of the Company's common stock. As of March 27, 2003, the Company repurchased 330,000 shares of its common stock for a total of approximately $3.4 million.