Selected Financial Data

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

Year Ended December 31, (In thousands, except per share data and ratios)	1999	2000	2001	2002	2003
Consolidated Statement of Operations Data:					
Net sales	$183,685	$252,288	$284,309	$310,016	$315,776
Cost of sales	107,602	149,881	164,222	179,465	189,142
Gross profit	76,083	102,407	120,087	130,551	126,634
Selling, general and administrative expenses	51,154	80,435	89,575	91,849	105,771
Acquisition shut-down and product recall costs	—	1,469	1,214	6,718	2,000
Income from operations	24,929	20,503	29,298	31,984	18,863
Profit from joint venture	(3,605)	(15,906)	(6,675)	(8,004)	(7,351)
Interest, net	(1,588)	(3,833)	(2,057)	(1,141)	1,405
Other income	(182)	(92)	—	—	—
Income before provision for income taxes and minority interest	30,304	40,334	38,030	41,129	24,809
Provision for income taxes	8,334	11,697	9,797	9,048	4,205
Income before minority interest	21,970	28,637	28,233	32,081	20,604
Minority interest	—	—	—	810	—
Net income	$ 21,970	$ 28,637	$ 28,233	$ 31,271	$ 20,604
Basic earnings per share	$ 1.58	$ 1.50	$ 1.55	$ 1.42	$ 0.85
Weighted average shares outstanding	13,879	19,060	18,199	21,963	24,262
Diluted earnings per share	$ 1.39	$ 1.41	$ 1.45	$ 1.37	$ 0.83
Weighted average shares and equivalents outstanding	15,840	20,281	19,410	22,747	24,677
Ratio of earnings to fixed charges(1)	72.64x	89.84x	38.80x	25.42x	6.39x

At December 31, (In thousands)	1999	2000	2001	2002	2003
Consolidated Balance Sheet Data:					
Cash and cash equivalents	$ 57,546	$ 29,275	$ 25,036	$ 68,413	$118,182
Working capital	$113,170	$ 86,897	$116,492	$129,183	$232,600
Total assets	$232,878	$248,722	$284,041	$408,810	$537,364
Long-term debt, net of current portion	$ 9	$ 1,000	$ 77	$ 60	$ 98,042
Total stockholders' equity	$187,501	$204,530	$244,404	$360,577	$385,950

(1) For the purpose of computing the ratio of fixed charges, earnings consist of income before provision for income taxes plus fixed charges. Fixed charges consist of interest charges, amortization of debt expenses and that portion of rental expense we believe to be representative of interest.

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

Critical Accounting Policies

The accompanying consolidated financial statements and supplementary information were prepared in accordance with accounting principles generally accepted in the United States of America. Significant accounting policies are discussed in Footnote 2 to the Consolidated Financial Statements. Inherent in the application of many of these accounting policies is the need for management to make estimates and judgments in the determination of certain revenues, expenses, assets and liabilities. As such, materially different financial results can occur as circumstances change and additional information becomes known. The policies with the greatest potential effect on our results of operation and financial position include:

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

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

We assess the impairment of long-lived assets and goodwill 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 $241.5 million as of December 31, 2003.

Recent Developments

On May 31, 2003, we purchased certain product lines, including *ColorWorkshop* and *Blopens*, assets and assumed certain liabilities of P&M Products USA, Inc. and an affiliated United Kingdom company, P&M Products Limited (collectively "P&M"). The total purchase price of approximately $22.0 million consisted of all cash and the assumption of certain liabilities and resulted in goodwill of $16.8 million. Our results of operations have included P&M from the date of acquisition.

Results of Operation

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

Years Ended December 31,	1999	2000	2001	2002	2003
Net sales	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of sales	58.6	59.4	57.8	57.9	59.9
Gross profit	41.4	40.6	42.2	42.1	40.1
Selling, general and administrative expenses	27.8	31.9	31.5	29.6	33.5
Acquisition shut-down and product recall costs	—	0.5	0.4	2.2	0.6
Income from operations	13.6	8.2	10.3	10.3	6.0
Profit from Joint Venture	(2.0)	(6.3)	(2.3)	(2.6)	(2.3)
Interest, net	(0.9)	(1.5)	(0.7)	(0.4)	0.4
Income before income taxes and minority interest	16.5	16.0	13.3	13.3	7.9
Provision for income taxes	4.5	4.6	3.4	2.9	1.3
Income before minority interest	12.0	11.4	9.9	10.4	6.6
Minority interest	—	—	—	0.3	—
Net income	12.0%	11.4%	9.9%	10.1%	6.6%

Years Ended December 31, 2003 and 2002

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

Gross Profit. Gross profit decreased $3.9 million, or 3.0%, to $126.6 million, or 40.1% of net sales, in 2003 from $130.6 million, or 42.1% of net sales, in 2002. The overall decrease in gross profit was attributable to a decrease in gross profit margin. The decrease in gross profit margin of 2.0% of net sales was due to higher sales of seasonal products with lower margins and an increase in royalty expense as a percentage of net sales due to changes in the product mix resulting from the sale of more products with higher royalty rates, though offset in part by a decrease in amortization expense of molds and tools used in the manufacture of our products.

Selling, General and Administrative Expenses. Selling, general and administrative expenses were $105.8 million in 2003 and $91.8 million in 2002, constituting 33.5% and 29.6% of net sales, respectively. The overall increase of $14.0 million in such costs was primarily due to a charge for the grant of restricted stock of $8.4 million, a charge of $2.1 million to bad debt relating to the bankruptcy of several of our customers, including Kay Bee Toys, and an increase in direct selling expenses, product development costs, option compensation expense resulting from the price reset of options in 2000 and operating expenses incurred in connection with the P&M asset acquisition. We produced and aired television commercials in support of several of our products, including *WWE* and *Dragon Ball Z* action figures and *Flying Colors* products in 2003 and *WWE* action figures and *Flying Colors* products in 2002. From time to time, we may increase our advertising efforts, if we deem it appropriate for particular products.

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

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

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

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

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

Provision for Income Taxes. Provision for income taxes included Federal, state and foreign income taxes in 2002 and 2003, at an effective tax rate of 22.0% and 17% in 2002 and 2003, respectively, benefiting from a flat 16.5% and 17.0% Hong Kong Corporation Tax on our income arising in, or derived from, Hong Kong for 2002 and 2003, respectively. For 2003, the effective rate decreased as a result of a higher proportionate share of income arising in Hong Kong as opposed to income arising in the higher statutory jurisdictions. As of December 31, 2003, we had deferred tax assets of approximately $4.0 million for which no allowance has been provided since, in the opinion of management, realization of the future benefit is probable. In making this determination, management believes it considered all available evidence, both positive and negative, as well as the weight and importance given to such evidence.

Years Ended December 31, 2002 and 2001

Net Sales. Net sales increased $25.7 million, or 9.0%, to $310.0 million in 2002 from $284.3 million in 2001. The growth in net sales was due primarily to the addition of the Toymax products and continuing growth in sales of our *Flying Colors* and doll products which was offset in part by a decrease in sales of our Wheels division, consisting primarily of our *Road Champs* die-cast toy and collectible vehicles with its extreme sports products.

Gross Profit. Gross profit increased $10.5 million, or 8.7%, to $130.6 million in 2002, or 42.1% of net sales, from $120.1 million, or 42.2% of net sales, in 2001. The overall increase in gross profit was attributable to the increase in net sales. Gross profit margin was comparable to last year as lower margins for Toymax products were offset by the decrease in royalty expense as a percentage of net sales due to changes in the product mix resulting from the sale of more products with lower royalty rates or proprietary products with no royalties.

Selling, General and Administrative Expenses. Selling, general and administrative expenses were $91.8 million in 2002 and $89.6 million in 2001, constituting 29.6% and 31.5% of net sales, respectively. The overall increase of $2.2 million in such costs was due to costs incurred in support of our Kidz Biz and Toymax acquisitions and increased media buys, offset in part by a decrease in goodwill amortization expense based on the implementation of SFAS 142. The decrease as a percentage of net sales is primarily attributable to the relative fixed nature of certain expenses with a concurrent increase in net sales. We produced and aired television commercials in support of several of our products, including *WWE* action figures and *Flying Colors* products, in 2001 and 2002. From time to time, we may increase our advertising efforts, if we deem it appropriate for particular products.

Acquisition Shut-down and Recall Costs. Acquisition shut-down costs in 2002 relate to shut-down costs, including lease termination, fixed asset abandonment and other costs, of certain operations of Toymax and Kidz Biz. Such costs in 2001 relate to shut-down costs of certain operations of Pentech, acquired in 2000. Operations impacted by these shut-downs were sales, design, distribution and administration. The integration of Pentech was completed in 2001 and the integration of Toymax and Kidz Biz was completed in 2002. In 2002, we accrued $2.2 million for the recall of one of our products.

The components of the acquisition shut-down and recall costs are as follows (in thousands):

	Accrued Balance December 31, 2001	Accrual	Actual	Accrued Balance December 31, 2002
Lease abandonment costs	$—	$3,724	$(1,414)	$2,310
Fixed asset write-off	—	260	(260)	—
Other	—	559	(559)	—
Recall	—	2,175	(2,175)	—
Total acquisition shut-down and recall costs	$—	$6,718	$(4,408)	$2,310

Profit from Joint Venture. Profit from joint venture increased by $1.3 million in 2002 due to the joint venture having sales of only carryover titles in 2001 compared to releasing a new Microsoft *Xbox* title in addition to having sales of carryover titles in 2002. New releases typically generate higher unit sales resulting in higher overall sales as compared to carryover titles. Profit from the joint venture contributed significantly to our pre-tax profit, representing 17.6% of pre-tax income in 2001 and 19.5% in 2002.

Interest, Net. Interest income decreased in 2002 compared to 2001 in spite of higher average cash balances due to lower interest rates.

Provision for Income Taxes. Provision for income taxes included Federal, state and foreign income taxes in 2001 and 2002, at effective tax rates of 26% in 2001 and 22% in 2002, benefiting from a flat 16.5% Hong Kong Corporation Tax on our income arising in, or derived from, Hong Kong. The decrease in the current year effective rate results primarily from certain permanently non-taxable items in addition to a continued shift in profits to more favorable tax jurisdictions.

Quarterly Fluctuations and Seasonality

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

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

	2001			
(In thousands, except per share data)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net sales	$59,962	$70,141	$ 92,768	$61,438
As a % of full year	21.1%	24.7%	32.6%	21.6%
Gross profit	$24,468	$32,609	$ 39,056	$23,954
As a % of full year	20.4%	27.2%	32.5%	19.9%
As a % of net sales	40.8%	46.5%	42.1%	39.0%
Income (loss) from operations	$ 7,267	$ 8,879	$ 14,562	$ (1,410)
As a % of full year	24.8%	30.3%	49.7%	(4.8)%
As a % of net sales	12.7%	12.1%	15.7%	(2.3)%
Income before income taxes and minority interest	$ 8,480	$ 9,478	$ 15,250	$ 4,822
As a % of net sales	14.1%	13.5%	16.4%	7.8%
Net income	$ 6,021	$ 6,873	$ 10,949	$ 4,390
As a % of net sales	10.0%	9.8%	11.8%	7.1%
Diluted earnings per share	$ 0.32	$ 0.36	$ 0.56	$ 0.22
Weighted average shares and equivalents outstanding	18,920	19,259	19,586	19,763

	2002			
(In thousands, except per share data)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net sales	$59,895	$78,992	$102,640	$68,489
As a % of full year	19.3%	25.5%	33.1%	22.1%
Gross profit	$26,470	$35,192	$ 41,812	$27,077
As a % of full year	20.3%	27.0%	32.0%	20.7%
As a % of net sales	44.2%	44.6%	40.7%	39.5%
Income from operations	$ 1,420	$ 9,912	$ 18,895	$ 1,757
As a % of full year	4.4%	31.0%	59.1%	5.5%
As a % of net sales	2.4%	12.5%	18.4%	2.6%
Income before income taxes and minority interest	$ 2,985	$10,849	$ 19,944	$ 7,351
As a % of net sales	5.0%	13.7%	19.4%	10.7%
Net income	$ 2,156	$ 7,832	$ 13,954	$ 7,329
As a % of net sales	3.6%	9.9%	13.6%	10.7%
Diluted earnings per share	$ 0.11	$ 0.36	$ 0.58	$ 0.30
Weighted average shares and equivalents outstanding	20,236	21,953	24,059	24,800

	2003			
(In thousands, except per share data)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net sales	$67,759	$73,290	$90,308	$84,419
As a % of full year	21.5%	23.2%	28.6%	26.7%
Gross profit	$27,442	$27,906	$36,226	$35,060
As a % of full year	21.7%	22.0%	28.6%	27.7%
As a % of net sales	40.5%	38.1%	40.1%	41.5%
Income (loss) from operations	$ 7,504	$ 4,065	$12,578	$ (5,284)
As a % of full year	39.8%	21.6%	66.7%	(28.0)%
As a % of net sales	11.1%	5.5%	13.9%	(6.3)%
Income before income taxes and minority interest	$ 7,842	$ 4,222	$12,593	$ 152
As a % of net sales	11.6%	5.8%	13.9%	0.2%
Net income	$ 5,960	$ 3,208	$ 9,570	$ 1,866
As a % of net sales	8.8%	4.4%	10.6%	2.2%
Diluted earnings per share	$ 0.24	$ 0.13	$ 0.39	$ 0.08
Weighted average shares and equivalents outstanding	24,917	24,683	24,629	24,642

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

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

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

During the fourth quarter of 2002, we reversed $2.1 million of the restructuring charge recorded in the first quarter of 2002 and recorded an additional charge of approximately $0.7 million relating to the recall of one of our products, the net of which favorably impacted operating income by approximately $1.4 million. In addition, our effective tax rate for the year 2002 was reduced from 26% to 22%.

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

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

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

Recent Accounting Standards

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards 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 was adopted effective January 1, 2003 and the adoption of this statement had no material impact on the consolidated financial statements.

In April 2002, the FASB issued Statement of Financial Accounting Standards No. 145, "Rescission of Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections" ("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. SFAS 145 was adopted effective January 1, 2003 and the adoption of this statement had no material impact on the consolidated financial statements.

In June 2002, the FASB issued Statement of Financial Accounting Standards 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 adoption of SFAS 146 had no material effect on the Company's financial position or results of operations.

In November 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("Interpretation 45"), which addresses the accounting for and disclosure of guarantees. Interpretation 45 requires a guarantor to recognize a liability for the fair value of a guarantee at inception. The recognition of the liability is required even if it is not probable that payments will be required under the guarantee. The disclosure requirements are effective for interim and annual financial statements ending after December 15, 2002. The initial recognition and measurement provisions are effective for all guarantees within the scope of Interpretation 45 issued or modified after December 31, 2002. The application of Interpretation 45 did not have a material effect on the Company's financial position or results of operations.

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

In January 2003 and as revised in December 2003, FASB issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("Interpretation 46") and FASB Interpretation No. 46R. Interpretations 46 and 46R require companies with a variable interest in a variable interest entity to apply this guidance as of the beginning of the first reporting period after December 15, 2003. The application of the guidance could result in the consolidation of a variable interest entity. The Company anticipates that the adoption of Interpretations 46 and 46R will not have a material effect on the Company's financial position or results of operations.

Liquidity and Capital Resources

As of December 31, 2003, we had working capital of $232.6 million, as compared to $129.2 million as of December 31, 2002. This increase was primarily attributable to the receipt of net proceeds from the issuance of our convertible notes payable and from operating activities offset in part by disbursements relating to the acquisition of certain assets of P&M.

Operating activities provided net cash of $7.2 million in the year ended December 31, 2003 as compared to $66.2 million, including cash provided from the sale of marketable securities of $37.1 million, in 2002. Net cash was provided primarily by net income and non-cash charges, such as the grant of restricted stock and depreciation and amortization, as well as increases in accounts payable and deferred income taxes, which were offset in part by an increase in accounts receivable, inventory, prepaid expenses and other and decreases in accrued expenses, income taxes payable, and reserve for sales returns and allowances. As of December 31, 2003, we had cash

and cash equivalents of $118.2 million and marketable securities of $19.3 million.

Our investing activities used cash of $47.5 million in the year ended December 31, 2003, as compared to $87.8 million in 2002, consisting primarily of the purchase of office furniture and equipment and molds and tooling used in the manufacture of our products, the purchase of other assets, the goodwill acquired in the acquisition of P&M and the purchase of marketable securities, partially offset by the repayment of notes receivable from officers. In 2002, our investing activities consisted primarily of the purchase of molds and tooling used in the manufacture of our products, the goodwill acquired in the acquisitions of Toymax and Trendmasters, plus the $4.5 million in goodwill relating to the final earn-out for Flying Colors, partially offset by the repayment of notes receivable from officers. As part of our strategy to develop and market new products, we have entered into various character and product licenses with royalties ranging from 1% to 18% payable on net sales of such products. As of December 31, 2003, these agreements required future aggregate minimum guarantees of $21.9 million, exclusive of $4.8 million in advances already paid.

Our financing activities provided net cash of $90.0 million in the year ended December 31, 2003, as compared to $64.9 million in 2002. In 2003, cash was primarily provided from the sale of our convertible senior notes and from the exercise of stock options, partially offset by the repurchase of our common stock and the repayment of long-term debt. In 2002, cash was primarily provided from the sale of our common stock and from the exercise of stock options and warrants, partially offset by the repayment of debt.

The following is a summary of our significant contractual cash obligations for the periods indicated that existed as of December 31, 2003 and is based on information appearing in the notes to the consolidated financial statements (in thousands):

	2004	2005	2006	2007	2008	Thereafter	Total
Long-term debt	$ 19	$ 21	$ 21	$ —	$ —	$ 98,000	$ 98,061
Operating leases	4,757	4,285	4,022	3,531	444	481	17,520
Minimum guaranteed license/royalty payments	6,593	7,682	3,571	1,198	1,427	1,435	21,906
Employment contracts	4,675	4,473	3,215	2,930	2,180	4,510	21,983
Total contractual cash obligations	$16,044	$16,461	$10,829	$7,659	$4,051	$104,426	$159,470

In December 2001, we acquired all of the outstanding capital stock of Kidz Biz Limited, a United Kingdom company, and an affiliated Hong Kong company, Kidz Biz Far East Limited, for an aggregate purchase price of approximately $12.4 million. Total consideration was paid on the closing of the transaction in cash in the amount of $6.4 million and the issuance of 308,992 shares of our common stock at a value of $6.0 million. In addition, we agreed to pay an earn-out for each of 2002, 2003, 2004 and 2005, based on the year over year increase in Kidz Biz sales, payable by delivery of up to 25,749 shares of our common stock per year. In 2002 and 2003, no earn-outs were earned.

In October 2001, we and all of our domestic subsidiaries jointly and severally secured a syndicated line of credit totaling $50.0 million with a consortium of banks led by Bank of America, N.A. ("Line of Credit"). On June 3, 2003, we and the banks amended the loan agreements governing the Line of Credit (the "Loan Agreements"), pursuant to which amendment (i) the banks suspended certain of our covenants under the Loan Agreements, including those that prohibited us from consummating the Convertible Senior Notes offering (note 8) without the banks' consent, and (ii) the banks' obligations to extend credit under the Line of Credit were simultaneously suspended. The amendment contemplates that we and the banks will attempt to negotiate revised terms for the Line of Credit, to be reflected in a further amendment to the Loan Agreements, while waiving the requirement for obtaining consent for

this offering. Neither we nor the banks, however, have any obligation to enter into such further amendment to the Loan Agreements. The amendment did not otherwise affect our right under the Loan Agreements to voluntarily reduce or terminate the Line of Credit. There have never been any outstanding borrowings under the Line of Credit since its inception.

In February 2003, our Board of Directors approved a buyback of up to $20 million of our common stock. As of December 31, 2003, we repurchased and retired 554,500 shares of our common stock for a total of approximately $6.1 million.

On May 31, 2003, we purchased certain product lines, related assets and assumed certain liabilities of P&M. The total purchase price of approximately $22.0 million consisted of cash paid in the amount of $20.7 million and liabilities of $1.3 million and resulted in goodwill of $16.8 million. Results of operations have included P&M from the date of acquisition.

Pursuant to the terms of a Purchase Agreement, dated June 9, 2003, we sold an aggregate of $98 million of 4.625% Convertible Senior Notes due June 15, 2023. The holders of the notes may convert the notes into shares of our common stock at any time at an initial conversion price of $20.00 per share, subject to certain circumstances described in the notes. We will pay cash interest on the notes at an annual rate of 4.625% of the principal amount at issuance, from the issue date to June 15, 2010, payable on June 15 and December 15 of each year, commencing on December 15, 2003. After June 15, 2010, we will not pay cash interest on the notes. At maturity, on June 15, 2023, we will redeem the notes at their accreted principal amount, which will be equal to $1,811.95 (181.195%) per $1,000 principal amount at issuance.

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

We believe that our cash flows from operations, cash and cash equivalents on hand and marketable securities will be sufficient to meet our working capital and capital expenditure requirements and provide us with adequate liquidity to meet our anticipated operating needs for at least the next 12 months. Although operating activities are expected to provide cash, to the extent we grow significantly in the future, our operating and investing activities may use cash and, consequently, this growth may require us to obtain additional sources of financing. There can be no assurance that any necessary additional financing will be available to us on commercially reasonable terms, if at all.

Exchange Rates

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

Consolidated Balance Sheets

December 31, (In thousands, except share data)	2002	2003
Assets		
Current assets		
Cash and cash equivalents	$ 68,413	$118,182
Marketable securities	—	19,345
Accounts receivable, net of allowance for uncollectible accounts of $6,781 and $7,877, respectively	56,195	86,119
Inventory, net of reserves of $4,782 and $5,025, respectively	38,010	44,400
Prepaid and other	13,062	16,762
Notes receivable—officers	1,113	—
Total current assets	176,793	284,808
Property and equipment		
Office furniture and equipment	5,932	6,563
Molds and tooling	31,069	34,481
Leasehold improvements	2,464	2,429
Total	39,465	43,473
Less accumulated depreciation and amortization	24,640	31,751
Property and equipment, net	14,825	11,722
Intangibles and other, net	8,169	13,217
Investment in joint venture	8,119	9,097
Goodwill, net	189,336	206,952
Trademarks, net	11,568	11,568
Total assets	$408,810	$537,364
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$ 8,994	$ 25,064
Accrued expenses	19,394	17,351
Reserve for sales returns and allowances	13,579	7,753
Current portion of long-term debt	18	19
Income taxes payable	5,625	2,021
Total current liabilities	47,610	52,208
Long-term debt, net of current portion	60	98,042
Deferred income taxes	563	1,164
Total liabilities	48,233	151,414
Commitments and contingencies		
Stockholders' equity		
Preferred shares, $.001 par value; 5,000,000 shares authorized; nil outstanding	—	—
Common stock, $.001 par value; 100,000,000 shares authorized; 24,472,884 and 24,866,940 shares issued and outstanding, respectively	24	25
Additional paid-in capital	240,102	245,219
Retained earnings	120,451	141,055
Accumulated other comprehensive loss	—	(349)
Total stockholders' equity	360,577	385,950
Total liabilities and stockholders' equity	$408,810	$537,364

See notes to consolidated financial statements.

Consolidated Statements of Operations

Years Ended December 31, (In thousands, except per share amounts)	2001	2002	2003
Net sales	$284,309	$310,016	$315,776
Cost of sales	164,222	179,465	189,142
Gross profit	120,087	130,551	126,634
Selling, general and administrative expenses	89,575	91,849	105,771
Acquisition shut-down and product recall costs	1,214	6,718	2,000
Income from operations	29,298	31,984	18,863
Profit from joint venture	(6,675)	(8,004)	(7,351)
Interest, net	(2,057)	(1,141)	1,405
Income before provision for income taxes and minority interest	38,030	41,129	24,809
Provision for income taxes	9,797	9,048	4,205
Income before minority interest	28,233	32,081	20,604
Minority interest	—	810	—
Net income	$ 28,233	$ 31,271	$ 20,604
Basic earnings per share	$ 1.55	$ 1.42	$ 0.85
Diluted earnings per share	$ 1.45	$ 1.37	$ 0.83

See notes to consolidated financial statements.

Consolidated Statements of Other Comprehensive Income

Years Ended December 31, (In thousands)	2001	2002	2003
Other comprehensive income:			
Net income	$28,233	$31,271	$20,604
Foreign currency translation adjustment	—	—	(349)
Other comprehensive income	$28,233	$31,271	$20,255

See notes to consolidated financial statements.

Consolidated Statements of Stockholders' Equity

December 31, 2001, 2002 and 2003 (In thousands)	Common Stock Number of Shares	Common Stock Amount	Additional Paid-in Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
Balance, December 31, 2000	17,992	$19	$156,475	$(12,911)	$ 60,947	$ —	$204,530
Exercise of options and warrants	526	1	3,069	—	—	—	3,070
Earned compensation for fully vested stock options	—	—	2,571	—	—	—	2,571
Issuances of common shares for Kidz Biz	309	—	6,000	—	—	—	6,000
Net income	—	—	—	—	28,233	—	28,233
Balance, December 31, 2001	18,827	20	168,115	(12,911)	89,180	—	244,404
Exercise of options and warrants	955	1	5,883	—	—	—	5,884
Earned compensation for fully vested stock options	—	—	(1,308)	—	—	—	(1,308)
Retirement of treasury stock	—	(1)	(12,910)	12,911	—	—	—
Fair value of outstanding stock options in acquisition	—	—	3,151	—	—	—	3,151
Issuance of common stock for cash	3,525	3	59,091	—	—	—	59,094
Issuance of common stock for Toymax	1,166	1	18,080	—	—	—	18,081
Net income	—	—	—	—	31,271	—	31,271
Balance, December 31, 2002	24,473	24	240,102	—	120,451	—	360,577
Exercise of options	312	—	1,777	—	—	—	1,777
Restricted stock grants	636	1	8,363	—	—	—	8,364
Issuance of warrants	—	—	1,057	—	—	—	1,057
Earned compensation for fully vested stock options	—	—	6	—	—	—	6
Repurchase and retirement of common stock	(555)	—	(6,086)	—	—	—	(6,086)
Net income	—	—	—	—	20,604	—	20,604
Foreign currency translation adjustment	—	—	—	—	—	(349)	(349)
Balance, December 31, 2003	24,866	$25	$245,219	$ —	$141,055	$(349)	$385,950

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

Years Ended December 31, (In thousands)	2001	2002	2003
Cash flows from operating activities			
Net income	$ 28,233	$ 31,271	$ 20,604
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	12,220	9,193	8,747
Foreign currency translation adjustment	—	—	(349)
Earned compensation for fully vested stock options	2,571	(1,308)	6
Investment in joint venture	2,977	(225)	79
Loss on disposal of property and equipment	16	—	—
Forgiveness of officer note receivable	—	285	—
Restricted stock grants	—	—	8,364
Minority interest	—	810	—
Changes in operating assets and liabilities			
Net sale (purchase) of marketable securities	(23,501)	37,119	—
Accounts receivable	(5,835)	(3,307)	(28,224)
Inventory	(1,489)	(10,996)	(2,654)
Prepaid expenses and other	1,423	507	(5,643)
Accounts payable	(1,927)	(3,698)	16,070
Accrued expenses	5,529	(9,535)	(3,115)
Income taxes payable	(6,052)	7,056	(1,397)
Reserve for sales returns and allowances	(1,600)	8,626	(5,827)
Deferred income taxes	800	432	525
Total adjustments	(14,868)	34,959	(13,418)
Net cash provided by operating activities	13,365	66,230	7,186
Cash flows from investing activities			
Purchases of property and equipment	(4,971)	(6,594)	(4,471)
Purchases of other assets	(1,231)	(1,659)	(2,434)
Investment in joint venture	(1,112)	—	—
Cash paid for net assets	(12,281)	(80,410)	(22,320)
Net purchases of marketable securities	—	—	(19,345)
Notes receivable—officers	226	861	1,113
Net cash used by investing activities	(19,369)	(87,802)	(47,457)
Cash flows from financing activities			
Proceeds from sale of common stock	—	59,095	—
Repurchase of common stock	—	—	(6,087)
Proceeds from debt	95	—	—
Proceeds from stock options and warrants exercised	3,070	5,884	1,777
Net proceeds from sale of convertible notes	—	—	94,366
Repayments of debt	(1,400)	(30)	(16)
Net cash provided by financing activities	1,765	64,949	90,040
Net increase (decrease) in cash and cash equivalents	(4,239)	43,377	49,769
Cash and cash equivalents, beginning of year	29,275	25,036	68,413
Cash and cash equivalents, end of year	$ 25,036	$ 68,413	$118,182
Cash paid during the period for:			
Interest	$ 118	$ 80	$ 2,375
Income taxes	$ 14,008	$ 3,235	$ 9,694

See note 17 for additional supplemental information to consolidated statements of cash flows.

See notes to consolidated financial statements.

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 intercompany 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 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, (In thousands)	2002	2003
Deposits	$ 20	$ —
Raw materials	586	1,033
Finished goods	37,404	43,367
	$38,010	$44,400

Marketable securities. Marketable securities categorized as trading securities were liquidated at December 31, 2002 and related unrealized holding gains or losses are included in earnings. New investments made in 2003 are categorized as available for sale and related unrealized holding gains or losses are included as a component of stockholders' equity. At December 31, 2002 and 2003, cost approximated fair market value.

Fair value of financial instruments. The Company's cash and cash equivalents, accounts receivable and loan payable represent financial instruments. The carrying value of these financial instruments is a reasonable approximation of fair value. The fair value of the convertible senior notes at December 31, 2003 was approximately $99.0 million. The fair value of the Company's convertible senior notes approximates the carrying value based on quoted trading prices for the notes.

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 $11.9 million in 2001, $8.1 million in 2002 and $5.2 million in 2003.

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, 2001, 2002 and 2003, was approximately $11.0 million, $12.7 million and 12.4 million, 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 and United Kingdom 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 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 and statements of other comprehensive income.

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 Financial Accounting Standards Board ("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, 2003, 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, (In thousands, except per share amounts)	2001	2002	2003
Reported net income	$28,233	$31,271	$20,604
Add back: Amortization of goodwill and other intangibles, net of tax effect	2,579	—	—
Net income, as adjusted	$30,812	$31,271	$20,604
Earnings per share—basic:			
Reported net income	$ 1.55	$ 1.42	$ 0.85
Add back: Amortization of goodwill and other intangibles, net of tax effect	0.14	—	—
Earnings per share—basic, as adjusted	$ 1.69	$ 1.42	$ 0.85
Earnings per share—diluted:			
Reported net income	$ 1.45	$ 1.37	$ 0.83
Add back: Amortization of goodwill and other intangibles, net of tax effect	0.13	—	—
Earnings per share—diluted, as adjusted	$ 1.58	$ 1.37	$ 0.83

Goodwill represents the excess purchase price paid over the fair market value of the assets of acquired 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, 2002 and 2003 totaled $6.6 million.

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, 2002 and 2003 was $2.9 million and $3.0 million, 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, 2003, 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 2001, 2002 and 2003, 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%, 4% and 4%, respectively; dividend yield of 0%; volatility of 91%, 87% and 82% respectively; and expected lives of five years.

Year Ended December 31, (In thousands, except per share data)	2001	2002	2003
Net income, as reported	$28,233	$31,271	$20,604
Add (Deduct): Stock-based employee compensation expense (income) included in reported net income	2,571	(1,308)	6
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards net of related tax effects	(1,499)	(2,034)	(2,796)
Pro forma net income	$29,305	$27,929	$17,814
Earnings per share:			
Basic—as reported	$ 1.55	$ 1.42	$ 0.85
Basic—pro forma	$ 1.61	$ 1.27	$ 0.73
Diluted—as reported	$ 1.45	$ 1.37	$ 0.83
Diluted—pro forma	$ 1.51	$ 1.23	$ 0.72

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):

2001	Income	Weighted Average Shares	Per Share
Basic EPS			
Income available to common stockholders	$28,233	18,199	$1.55
Effect of dilutive securities			
Options and warrants	—	1,211	
Diluted EPS			
Income available to common stockholders plus assumed exercises	$28,233	19,410	$1.45

2002	Income	Weighted Average Shares	Per Share
Basic EPS			
Income available to common stockholders	$31,271	21,963	$1.42
Effect of dilutive securities			
Options and warrants	—	784	
Diluted EPS			
Income available to common stockholders plus assumed exercises	$31,271	22,747	$1.37

2003	Income	Weighted Average Shares	Per Share
Basic EPS			
Income available to common stockholders	$20,604	24,262	$0.85
Effect of dilutive securities			
Options and warrants	—	415	
Diluted EPS			
Income available to common stockholders plus assumed exercises	$20,604	24,677	$0.83

Recent Accounting Standards. In June 2001, the FASB issued Statement of Financial Accounting Standards 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 was adopted effective January 1, 2003 and the adoption of this statement had no material impact on the consolidated financial statements.

In April 2002, the FASB issued Statement of Financial Accounting Standards No. 145, "Rescission of Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections" ("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. SFAS 145 was adopted effective January 1, 2003 and the adoption of this statement had no material impact on the consolidated financial statements.

In June 2002, the FASB issued Statement of Financial Accounting Standards 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 adoption of SFAS 146 had no material effect on the Company's financial position or results of operations.

In November 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("Interpretation 45"), which addresses the accounting for and disclosure of guarantees. Interpretation 45 requires a guarantor to recognize a liability for the fair value of a guarantee at inception. The recognition of the liability is required even if it is not probable that payments will be required under the guarantee. The disclosure requirements are effective for interim and annual financial statements ending after December 15, 2002. The initial recognition and measurement provisions are effective for all guarantees within the scope of Interpretation 45 issued or modified after December 31, 2002. The application of Interpretation 45 did not have a material effect on the Company's financial position or results of operations.

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

In January 2003 and as revised in December 2003, FASB issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("Interpretation 46") and FASB Interpretation No. 46R. Interpretations 46 and 46R require companies with a variable interest in a variable interest entity to apply this guidance as of the beginning of the first reporting period after December 15, 2003. The application of the guidance could result in the consolidation of a variable interest entity. The Company anticipates that the adoption of Interpretations 46 and 46R 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, Inc. 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, 2003 are as follows (in thousands):

Year Ended December 31,	2001	2002	2003
Net Sales			
North America Toys	$250,627	$263,314	$272,317
International	32,871	46,251	43,424
Other	811	451	35
	$284,309	$310,016	$315,776

Year Ended December 31,	2001	2002	2003
Operating Income			
North America Toys	$ 25,827	$ 27,166	$ 16,267
International	3,387	4,772	2,594
Other	84	46	2
	$ 29,298	$ 31,984	$ 18,863

December 31,	2002	2003
Assets		
North America Toys	$347,488	$463,409
International	60,913	73,897
Other	409	58
	$408,810	$537,364

The following tables present information about the Company by geographic area as of and for the three years ended December 31, 2003 (in thousands):

December 31,	2001	2002	2003
Long-lived Assets			
United States	$ 93,155	$161,597	$184,949
Hong Kong	24,557	59,745	52,550
Europe	497	613	4,012
	$118,209	$221,955	$241,511

Year Ended December 31,	2001	2002	2003
Net Sales by Geographic Area			
United States	$244,317	$256,799	$271,051
Europe	29,030	39,414	35,547
Canada	7,121	6,966	5,125
Hong Kong	—	324	1,275
Other	3,841	6,513	2,778
	$284,309	$310,016	$315,776

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 with an initial license period expiring December 31, 2009 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, license costs and recoupable advances and is being amortized over the term of the initial license period. The joint venture agreement provides for the Company to receive guaranteed preferred returns through June 30, 2006 at varying rates of the joint venture's net sales depending on the cumulative unit sales and platform of each particular game. 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 2001, 2002 and 2003, the Company earned $6.7 million, $8.0 million and $7.4 million, respectively, in profit from the joint venture.

In December 2001, the Company acquired all the outstanding stock of Kidz Biz Ltd., a United Kingdom company, and Kidz Biz Far East Limited, an affiliated 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. In addition, we agreed to pay an earn-out for each of 2002, 2003, 2004 and 2005, based on the year over year increase in Kidz Biz sales, payable by delivery of up to 25,749 shares of our common stock per year. In 2002 and 2003, no earn-outs were earned. 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 businesses.

In March 2002, the Company purchased a controlling interest in Toymax International, Inc. ("Toymax") and on October 25, 2002, the Company completed that acquisition by acquiring the remaining outstanding common shares in a merger transaction. The total purchase price of approximately $62.8 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.

In November 2002, the Company purchased certain product lines, assets and assumed certain specific liabilities from Trendmasters, Inc. ("Trendmasters"). The total purchase price of approximately $19.2 million consisted of all cash. Results of operations have included Trendmasters from the date of acquisition.

On May 31, 2003, the Company purchased certain product lines, assets and assumed certain liabilities of P&M Products USA, Inc. and an affiliated United Kingdom company, P&M Products Limited (collectively "P&M"). The total purchase price of approximately $22.0 million consisted of $20.7 million in cash and $1.3 million in liabilities. Results of operations have included P&M 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:

(In thousands)	Toymax	Trendmasters	P&M	Total
Condensed balance sheet:				
Current assets	$ 26,857	$ 20	$ 5,121	$ 31,998
Property and equipment, net	1,673	1,488	17	3,178
Other assets	11,751	—	11	11,762
Current liabilities	(43,000)	(8,713)	(1,267)	(52,980)
Goodwill	65,493	26,447	16,825	108,765
Total	$ 62,774	$19,242	$20,707	$102,723

Goodwill related to Trendmasters is not expected to be deductible for tax purposes; however, approximately $12.7 million of the Toymax goodwill and $13.6 million of the P&M 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 Toymax, Trendmasters and P&M had occurred on January 1, 2002 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 Toymax, Trendmasters and P&M actually occurred on January 1, 2002 or on future operating results.

Year Ended December 31, (In thousands, except per share data)	2002	2003
Net sales	$409,143	$326,105
Net income	$ 25,981	$ 18,737
Basic earnings per share	$ 1.16	$ 0.77
Weighted average shares outstanding	22,363	24,262
Diluted earnings per share	$ 1.11	$ 0.76
Weighted average shares and equivalents outstanding	23,483	24,677

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 backed by irrevocable letters of credit.

Note 6—Accrued expenses

Accrued expenses consist of the following (in thousands):

	2002	2003
Royalties and sales commissions	$ 3,973	$ 4,738
Other	15,421	12,613
	$19,394	$17,351

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 $1.1 million in 2001, $2.7 million in 2002 and $4.6 million in 2003. On March 27, 2003, the balance of the notes receivable from two officers of the Company totaling $1.1 million plus accrued interest at interest rates of 6.5% per annum each, were paid in full.

Note 8—Long-term debt

Long-term debt consists of the following (in thousands):

	2002	2003
Convertible senior notes[1]	$ —	$98,000
Loan payable, due in sixty monthly payments with the final payment due December 4, 2006, with interest at 6.7% per annum	78	61
	78	98,061
Less current portion of long-term debt	(18)	(19)
Long-term debt, net of current portion	$ 60	$98,042

(1) Pursuant to the terms of a Purchase Agreement, dated June 9, 2003, the Company sold an aggregate of $98.0 million of 4.625% Convertible Senior Notes due June 15, 2023. The holders of the notes may convert the notes into shares of our common stock at any time at an initial conversion price of $20.00 per share, subject to certain circumstances described in the notes. The Company will pay cash interest on the notes at an annual rate of 4.625% of the principal amount at issuance, from the issue date to June 15, 2010, payable on June 15 and December 15 of each year, commencing on December 15, 2003. After June 15, 2010, the Company will not pay cash interest on the notes. At maturity, on June 15, 2023, 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.

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 (including contingent interest and additional amounts), 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 (including contingent interest and additional amounts), 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 (including contingent interest and additional amounts), if any. Any repurchases at June 15, 2013 and June 15, 2018 may be paid in cash, in shares of common stock or a combination of cash and shares of common stock.

The following is a schedule of payments for the long-term debt (in thousands):

2004	*$ 19*
2005	*21*
2006	*21*
2007	*—*
2008	*—*
Thereafter	*98,000*
	$98,061

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:

(In thousands)	2001	2002	2003
Federal	$2,596	$2,241	$ 608
State and local	1,065	270	55
Foreign	5,336	6,105	3,017
	8,997	8,616	3,680
Deferred	800	432	525
	$9,797	$9,048	$4,205

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

(In thousands)	2002	2003
Net deferred tax assets/(liabilities):		
Current:		
Reserve for sales allowances and possible losses	$ 2,013	$ 1,114
Accrued expenses	1,849	182
Restricted stock grant	—	3,094
Other	584	132
	4,446	4,522
Long-Term:		
Undistributed earnings	(11,024)	(7,191)
Property and equipment	(1,564)	(1,088)
Original issue discount interest	—	(925)
Deductible goodwill	(1,223)	(2,100)
Other	2,793	2,152
Federal net operating loss carryforwards	9,666	7,321
State net operating loss carryforwards	789	667
	(563)	(1,164)
Total net deferred tax assets/(liabilities)	$ 3,883	$ 3,358

The current portion of deferred tax assets is included in prepaid expenses and other.

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:

	2001	2002	2003
Federal income tax expense	35%	35%	35%
State income tax expense, net of federal tax effect	1.8	0.4	0.1
Effect of differences in U.S. and foreign statutory rates	(16.7)	(15.3)	(20.7)
Other	5.9	1.9	2.6
	26%	22%	17%

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, 2003, the Company has federal and state net operating loss carryforwards of $20.4 million and $38.9 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 (in thousands):

	2001	2002	2003
Domestic	$ 4,678	$ 3,537	$ 2,219
Foreign	33,352	37,592	22,590
	$38,030	$41,129	$24,809

Note 10—Credit facility

In October 2001, the Company and all of its subsidiaries jointly and severally secured a syndicated line of credit totaling $50.0 million with a consortium of banks led by Bank of America, N.A. ("Line of Credit"). On June 3, 2003, the Company and the banks amended the loan agreements governing the Line of Credit (the "Loan Agreements"), pursuant to which amendment (i) the banks suspended certain of our covenants under the Loan Agreements, including those that prohibited the Company from consummating the Convertible Senior Notes offering (note 8) without the banks' consent, and (ii) the banks' obligations to extend credit under the Line of Credit were simultaneously suspended. The amendment contemplates that the Company and the banks will attempt to negotiate revised terms for the Line of Credit, to be reflected in a further amendment to the Loan Agreements, while waiving the requirement for obtaining consent for this offering. Neither the Company nor the banks, however, have any obligation to enter into such further amendment to the Loan Agreements. The amendment did not otherwise affect the Company's right under the Loan Agreements to voluntarily reduce or terminate the Line of Credit. There have never been any outstanding borrowings under the Line of Credit since its inception.

Note 11—Leases

The Company leases office, warehouse and showroom facilities and certain equipment under operating leases. Rent expense for the three years ended December 31, 2003 totaled $2.5 million, $4.0 million and $5.2 million, respectively. The following is a schedule of minimum annual lease payments (in thousands):

2004	$ 4,757
2005	4,285
2006	4,022
2007	3,531
2008	444
Thereafter	481
	$17,520

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. During 2003, the Company repurchased and retired 554,500 shares of its common stock at an aggregate cost of $6.1 million.

During 2003, the Company awarded 2,760,000 shares of restricted stock to four executive officers of the Company pursuant to its 2002 Stock Award and Incentive Plan, of which 636,000 were earned on December 31, 2003 and the balance may be earned through 2010 based upon the achievement of certain financial criteria and continuing employment. A charge of $8.4 million was recorded as of December 31, 2003 relating to this award. The Company also issued 312,492 shares of common stock on the exercise of options for a total of $1.8 million.

During 2002, the Company issued 954,770 shares of common stock on the exercise of options and warrants for a total of $5.9 million, 1,166,360 shares of common stock at a value of $18.1 million 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.

During 2001, the Company issued 525,780 shares of common stock on exercise of options and warrants for a total of $3.1 million and 308,992 shares of common stock at a value of $6.0 million in connection with the Kidz Biz acquisition.

During 2003, the Company issued 100,000 fully vested warrants, expiring in 2013, in connection with license costs relating to its investment in the joint venture. The fair market value of these warrants was approximately $1.1 million and has been included in the basis of the joint venture (note 4).

Warrant activity is summarized as follows:

	Number of Shares	Weighted Average Exercise Price
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	—	—
Granted	100,000	11.35
Exercised	—	—
Outstanding, December 31, 2003	**100,000**	**$11.35**

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% to 18% 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 $1.0 million and 5% of related net sales on advertising per year on such licenses.

Future annual minimum royalty guarantees as of December 31, 2003 are as follows (in thousands):

2004	$ 6,593
2005	7,682
2006	3,571
2007	1,198
2008	1,427
Thereafter	1,435
	$21,906

The Company has entered into various employment agreements with certain executives expiring through December 31, 2010. At December 31, 2003, the aggregate minimum guaranteed amounts under those agreements amount to approximately $22.0 million.

Note 14—Stock option plans

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 exercise of options granted under the Plan. Under the Plan, employees (including officers), non-employee directors and independent consultants may be granted options to purchase shares of common stock.

As of December 31, 2003, 1,718,392 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 Plan is summarized as follows:

	Number of Shares	Weighted Average Exercise Price
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
Granted	184,500	13.31
Exercised	(309,296)	11.78
Canceled	(214,630)	12.71
Outstanding, December 31, 2003	**2,268,461**	**$12.15**

Stock option activity outside of the Plan is summarized as follows:

	Number of Shares	Weighted Average Exercise Price
Outstanding, December 31, 2000	16,126	$2.24
Exercised	(16,126)	2.24
Outstanding, December 31, 2001, 2002 and 2003	—	$ —

The weighted average fair value of options granted to employees in 2001, 2002 and 2003 was $16.24, $10.65 and $13.28 per share, respectively.

The following table summarizes information about stock options outstanding and exercisable at December 31, 2003:

	Outstanding			Exercisable	
Option Price Range	Number of Shares	Weighted Average Life	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
$3.00–$19.02	2,268,461	3.62 years	$12.15	984,596	$11.07

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% of annual compensation, and that the Company will make a matching contribution equal to 50% of each employee's deferral, up to 5% of compensation. Company matching contributions, which vest equally over a five-year period, totaled $0.2 million, $0.3 million and $0.3 million for 2001, 2002 and 2003, respectively.

Note 16—Major customers

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

2001		2002		2003	
Amount	Percentage	Amount	Percentage	Amount	Percentage
$ 44,646	15.7%	$ 46,396	15.0%	$ 91,378	28.9%
36,024	12.7	41,506	13.4	30,371	9.6
34,319	12.1	34,773	11.2	30,009	9.5
20,972	7.4	34,018	11.0	17,996	5.7
19,425	6.8	16,077	5.1	12,670	4.0
$155,386	54.7%	$172,770	55.7%	$182,424	57.7%

Note 17—Supplemental information to consolidated statements of cash flows

In 2003, the Company issued 100,000 warrants valued at approximately $1.1 million in connection with license costs relating to its investment in the joint venture (note 12).

In 2002, 1,166,360 shares of common stock valued at approximately $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 approximately $6.0 million 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 2002 and 2003 are summarized below:

	2002				2003			
(In thousands, except per share data)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net sales	$59,895	$78,992	$102,640	$68,489	$67,759	$73,290	$90,308	$84,419
Gross profit	$26,470	$35,192	$ 41,812	$27,077	$27,442	$27,906	$36,226	$35,060
Income (loss) from operations	$ 1,420	$ 9,912	$ 18,895	$ 1,757	$ 7,504	$ 4,065	$12,578	$ (5,284)
Income before income taxes and minority interest	$ 2,985	$10,849	$ 19,944	$ 7,351	$ 7,842	$ 4,222	$12,593	$ 152
Net income	$ 2,156	$ 7,832	$ 13,954	$ 7,329	$ 5,960	$ 3,208	$ 9,570	$ 1,866
Basic earnings per share	$ 0.11	$ 0.37	$ 0.59	$ 0.30	$ 0.24	$ 0.13	$ 0.40	$ 0.08
Weighted average shares outstanding	19,017	20,985	23,586	24,178	24,430	24,175	24,177	24,304
Diluted earnings per share	$ 0.11	$ 0.36	$ 0.58	$ 0.30	$ 0.24	$ 0.13	$ 0.39	$ 0.08
Weighted average shares and equivalents outstanding	20,236	21,953	24,059	24,800	24,917	24,683	24,629	24,642

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 $1.5 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% to 22%.

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

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

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

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.

Schedule II—Valuation and Qualifying Accounts

Years Ended December 31, 2001, 2002 and 2003

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

(In thousands)	Balance at Beginning of Period	Charged to Costs and Expenses	Charged to Other Accounts	Deductions	Balance at End of Period
Year ended December 31, 2001:					
Allowance for:					
Uncollectible accounts	$ 3,012	$ 6,321	$ —	$ 2,059	$ 7,274
Reserve for potential product obsolescence	7,322	1,039	—	5,770	2,591
Reserve for sales returns and allowances	6,553	25,190	—	26,791	4,952
	$16,887	$32,550	$ —	$34,620	$14,817
Year ended December 31, 2002:					
Allowance for:					
Uncollectible accounts	$ 7,273	$ 2,373	$ —	$ 2,865	$ 6,781
Reserve for potential product obsolescence	2,590	4,085	—	1,893	4,782
Reserve for sales returns and allowances	4,953	31,917	7,500[a]	30,790	13,580
	$14,816	$38,375	$7,500	$35,548	$25,143
Year ended December 31, 2003:					
Allowance for:					
Uncollectible accounts	$ 6,781	$ 2,896	$ —	$ 1,800	$ 7,877
Reserve for potential product obsolescence	4,782	4,288	—	4,045	5,025
Reserve for sales returns and allowances	13,580	27,064	—	32,891	7,753
	$25,143	$34,248	$ 0	$38,736	$20,655

(a) Obligations assumed in conjunction with the asset acquisitions of Trendmasters and Dragon Ball Franchise.

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Independent Auditors' Report

The Stockholders
JAKKS Pacific, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of JAKKS Pacific, Inc. and Subsidiaries as of December 31, 2002 and 2003, and the related consolidated statements of operations, other comprehensive income, stockholders' equity and cash flows and the financial statement schedule for each of the three years in the period ended December 31, 2003. These financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and the financial statement schedule based on our audits.

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

In our opinion, the consolidated financial statements and schedule referred to above present fairly, in all material respects, the financial position of JAKKS Pacific, Inc. and Subsidiaries as of December 31, 2002 and 2003, and the results of their operations and cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

PKF
Certified Public Accountants
A Professional Corporation
Los Angeles, California
February 16, 2004

Shareholder Information

Legal Counsel
Feder, Kaszovitz, Isaacson, Weber,
Skala, Bass & Rhine LLP
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Independent Auditors
PKF, Certified Public Accountants
400 South Hope Street, Suite 710
Los Angeles, CA 90017

Investor Relations
Integrated Corporate Relations, Inc.
525 Broadway, Suite 210
Santa Monica, CA 90401
Tel: 310-395-2215
Fax: 310-395-2217

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

Stock Exchange Listing
JAKKS Pacific common stock trades on the Nasdaq National Market System under the symbol "JAKK." As of July 19, 2004, there were approximately 147 holders of record and approximately 7,035 beneficial owners of the Company's common stock. The Company has not paid cash dividends, but may consider paying cash dividends in the foreseeable future.

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

Common Stock Price Data

2002:	High	Low
First Quarter	$23.70	$15.85
Second Quarter	$23.49	$15.91
Third Quarter	$17.76	$ 9.57
Fourth Quarter	$16.63	$ 9.30
2003:		
First Quarter	$14.49	$ 9.50
Second Quarter	$14.49	$10.22
Third Quarter	$14.04	$10.06
Fourth Quarter	$13.75	$11.74
2004:		
First Quarter	$16.25	$12.72
Second Quarter	$21.00	$14.48

Forward-Looking Statements
This annual report contains forward-looking statements that are subject to the safe harbor created by Section 27a of the federal securities law, including, among others, statements relating to sales growth, political support for education, acceptance of our products and new product introductions. Such statements are subject to substantial risks and uncertainties. Actual events or results may differ materially as a result of many factors, including but not limited to: the extent of acceptance and purchase of the Company's products by target customers; the extent of educators' acceptance of technology, accountability and standardized testing; political trends; seasonality and sales cycles in the Company's markets; competition; availability of funding available to schools; the Company's ability to continue to demonstrate the efficacy of its products, which depends on how the programs are administered, the demography of participants and other factors; the Company's ability to retain key personnel; pricing pressures; obstacles or delays in product development; and other risks detailed in the Company's SEC reports, including the Company's reports on Form 10-K and 10-Q.