JAKKS PACIFIC INC
Form 10-Q
November 10, 2014

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

FORM 10-Q

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

For the quarterly period ended September 30, 2014

OR

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

For the transition period from ______ to ______

Commission file number: 0-28104

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

Delaware	95-4527222
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

22619 Pacific Coast Highway Malibu, California	90265
(Address of Principal Executive Offices)	(Zip Code)

Registrant’s Telephone Number, Including Area Code: (310) 456-7799

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	Accelerated filer	Non-accelerated filer	Smaller reporting company
o	x	o	o
		(Do not check if a smaller reporting company)	

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

The number of shares outstanding of the issuer’s common stock is 23,264,905 as of November 10, 2014.

1

JAKKS PACIFIC, INC. AND SUBSIDIARIES

INDEX TO QUARTERLY REPORT ON FORM 10-Q
Quarter Ended September 30, 2014
ITEMS IN FORM 10-Q

DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

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

JAKKS PACIFIC, INC. AND SUBSIDIARIES

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

Assets	December 31, 2013 (*)	September 30, 2014 (Unaudited)
Current assets		
Cash and cash equivalents	$ 117,071	$ 88,617
Marketable securities	220	220
Accounts receivable, net of allowance for uncollectible accounts of $2,928 and $3,100, respectively	101,223	304,338
Inventory	46,784	88,776
Income tax receivable	24,008	24,008
Deferred income taxes	3,953	3,953
Prepaid expenses and other	27,673	29,691
Total current assets	320,932	539,603
Property and equipment		
Office furniture and equipment	14,312	14,368
Molds and tooling	78,096	86,165
Leasehold improvements	4,917	4,839
Total	97,325	105,372
Less accumulated depreciation and amortization	86,229	94,820
Property and equipment, net	11,096	10,552
Intangibles	57,439	50,545
Other long term assets	6,175	10,972
Investment in DreamPlay, LLC	7,000	7,000
Investment in joint venture	18	—
Goodwill, net	44,876	44,776
Trademarks, net	2,308	2,308
Total assets	$ 449,844	$ 665,756
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$ 25,275	$ 115,623
Accrued expenses	69,086	80,366
Reserve for sales returns and allowances	31,374	28,878
Income taxes payable	20,762	25,430
Current portion of long term debt	38,098	38,905
Total current liabilities	184,595	289,202
Long term debt, net of current portion	100,000	215,000
Other liabilities	7,021	7,249
Income taxes payable	2,597	2,725
Deferred income taxes	6,946	6,946
Total liabilities	301,159	521,122
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; 22,668,680 and 23,264,905 shares issued and outstanding, respectively	23	23
Additional paid-in capital	200,665	177,662
Accumulated deficit	(48,154)	(29,443)
Accumulated other comprehensive loss	(3,849)	(3,608)
Total stockholders’ equity	148,685	144,634
Total liabilities and stockholders’ equity	$ 449,844	$ 665,756

(*) Derived from audited financial statements

See accompanying notes to condensed consolidated financial statements.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

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

	Three Months Ended September 30, (Unaudited)		Nine Months Ended September 30, (Unaudited)	
	2013	2014	2013	2014
Net sales	$ 310,894	$ 349,362	$ 495,195	$ 556,044
Cost of sales	219,499	254,625	378,183	399,934
Gross profit	91,395	94,737	117,012	156,110
Selling, general and administrative expenses	51,742	50,925	145,492	132,041
Income (loss) from operations	39,653	43,812	(28,480)	24,069
Equity in net (loss) income of joint venture	(572)	—	(2,024)	314
Other income	—	5,932	—	5,932
Interest income	92	32	301	89
Interest expense	(2,298)	(3,969)	(7,202)	(9,158)
Income (loss) before provision for income taxes	36,875	45,807	(37,405)	21,246
Provision for income taxes	278	1,738	433	2,535
Net income (loss)	$ 36,597	$ 44,069	$ (37,838)	$ 18,711
Earnings (loss) per share – basic	$ 1.67	$ 2.33	$ (1.73)	$ 0.90
Earnings (loss) per share – diluted	$ 1.11	$ 1.03	$ (1.73)	$ 0.61
Comprehensive income (loss)	$ 37,508	$ 43,821	$ (37,511)	$ 18,952

JAKKS PACIFIC, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Nine Months Ended September 30, (Unaudited) 2013	2014
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	$ (37,838)	$ 18,711
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	16,902	16,134
Amortization of debt discount and issuance costs	2,670	2,243
Share-based compensation expense	563	997
Loss on disposal of property and equipment	2,202	18
Equity in net income (loss) of joint venture	2,024	(314)
Gain on extinguishment of convertible notes	(84)	—
Changes in operating assets and liabilities:		
Accounts receivable	(152,510)	(203,115)
Inventory	571	(41,992)
Prepaid expenses and other current assets	(2,344)	(2,018)
Accounts payable	52,369	90,348
Accrued expenses	25,660	11,280
Income taxes payable	3,622	4,796
Reserve for sales returns and allowances	934	(2,496)
Other liabilities	(5,163)	228
Total adjustments	(52,584)	(123,891)
Net cash used in operating activities	(90,422)	(105,180)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property and equipment	(7,971)	(8,714)
Change in other assets	240	453
Contribution to joint venture	(1,636)	—
Distribution from joint venture	962	332
Net purchase of marketable securities	(2)	—
Net cash used in investing activities	(8,407)	(7,929)
CASH FLOWS FROM FINANCING ACTIVITIES		
Common stock repurchased	—	(24,000)
Proceeds from credit facility borrowings	—	10,000
Repayment of credit facility borrowings	(70,710)	(10,000)
Proceeds from issuance of senior convertible notes	100,000	115,000
Issuance costs related to senior convertible notes	(4,179)	(4,594)
Retirement of senior convertible notes	(61,000)	—
Credit facility costs	—	(1,851)
Dividends paid	(3,084)	—
Net cash (used in) provided by financing activities	(38,973)	84,555
Effect of foreign currency translation	—	100
Net change in cash and cash equivalents	(137,802)	(28,454)
Cash and cash equivalents, beginning of period	189,321	117,071
Cash and cash equivalents, end of period	$ 51,519	$ 88,617

Cash paid (received) during the period for:				
Income taxes	$	(4,721)	$	(2,331)
Interest	$	3,525	$	5,408

See Notes 9 and 10 for additional supplemental information to the condensed consolidated statements of cash flows.

See accompanying notes to condensed consolidated financial statements.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
September 30, 2014

Note 1 — Basis of Presentation

The accompanying unaudited interim condensed consolidated financial statements included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures are adequate to prevent the information presented from being misleading. These financial statements should be read in conjunction with Management’s Discussion and Analysis of Financial Condition and Results of Operations and the financial statements and the notes thereto included in the Company’s Annual Report on Form 10-K, which contains audited financial information for the three years in the period ended December 31, 2013.

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

The condensed consolidated financial statements include the accounts of JAKKS Pacific, Inc. and its wholly-owned subsidiaries (collectively, “the Company”). The condensed consolidated financial statements also include the accounts of DreamPlay Toys, LLC, a joint venture between JAKKS Pacific, Inc. and NantWorks LLC.

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

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (ASU 2014-09), which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP.

The standard is effective for annual periods beginning after December 15, 2016, and interim periods therein, using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). The Company is currently evaluating the impact of our pending adoption of ASU 2014-09 on our consolidated financial statements and have not yet determined the method by which we will adopt the standard in 2017.

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

The Company is a worldwide producer and marketer of children’s toys and other consumer products, principally engaged in the design, development, production, marketing and distribution of its diverse portfolio of products. The Company’s reportable segments are Traditional Toys and Electronics and Role Play, Novelty and Seasonal Toys, each of which includes worldwide sales.

The Traditional Toys and Electronics segment includes action figures, vehicles, playsets, plush products, dolls, accessories, electronic products, construction toys, infant and pre-school toys, foot to floor ride-on vehicles, wagons and pet treats and related products.

The Role Play, Novelty and Seasonal Toys segment includes role play and dress-up products, Halloween and everyday costume play, novelty toys, seasonal and outdoor products and indoor and outdoor kids’ furniture.

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

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

Results are not necessarily those that would be achieved were each segment an unaffiliated business enterprise. Information by segment and a reconciliation to reported amounts for the three and nine months ended September 30, 2013 and 2014 and as of December 31, 2013 and September 30, 2014 are as follows (in thousands):

	Three Months Ended September 30, 2013	Three Months Ended September 30, 2014	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2014
Net Sales				
Traditional Toys and Electronics	$ 156,874	$ 173,785	$ 243,881	$ 258,872
Role Play, Novelty and Seasonal Toys	154,020	175,577	251,314	297,172
	$ 310,894	$ 349,362	$ 495,195	$ 556,044

	Three Months Ended September 30, 2013	Three Months Ended September 30, 2014	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2014
Operating Income (Loss)				
Traditional Toys and Electronics	$ 19,420	$ 21,322	$ (22,250)	$ 6,208
Role Play, Novelty and Seasonal Toys	20,233	22,490	(6,230)	17,861
	$ 39,653	$ 43,812	$ (28,480)	$ 24,069

	Three Months Ended September 30, 2013	Three Months Ended September 30, 2014	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2014
Depreciation and Amortization Expense				
Traditional Toys and Electronics	$ 4,954	$ 4,773	$ 9,951	$ 9,062
Role Play, Novelty and Seasonal Toys	4,360	3,859	6,951	7,072
	$ 9,314	$ 8,632	$ 16,902	$ 16,134

	December 31, 2013	September 30, 2014
Assets		
Traditional Toys and Electronics	$ 280,217	$ 342,973
Role Play, Novelty and Seasonal Toys	169,627	322,783
	$ 449,844	$ 665,756

7

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

The following tables present information about the Company by geographic area as of December 31, 2013 and September 30, 2014 and for the three and nine months ended September 30, 2013 and 2014 (in thousands):

	December 31, 2013	September 30, 2014
Long-lived Assets		
China	$ 8,488	$ 8,505
United States	1,768	1,406
Hong Kong	840	641
	$ 11,096	$ 10,552

	Three Months Ended September 30, 2013	Three Months Ended September 30, 2014	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2014
Net Sales by Customer Area				
United States	$ 252,988	$ 281,989	$ 400,688	$ 448,842
Europe	24,814	28,018	42,340	41,410
Canada	16,988	14,434	21,972	22,948
Hong Kong	2,799	1,354	5,456	2,095
Other	13,305	23,567	24,739	40,749
	$ 310,894	$ 349,362	$ 495,195	$ 556,044

Major Customers

Net sales to major customers for the three and nine months ended September 30, 2013 and 2014 were as follows (in thousands, except for percentages):

	Three Months Ended September 30, 2013		2014		Nine Months Ended September 30, 2013		2014	
	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales
Wal-Mart	$ 74,759	24.1%	$ 81,731	23.4%	$ 108,990	22.0%	$ 115,295	20.7%
Target	42,162	13.6	55,849	16.0	65,676	13.3	79,954	14.4
Toys ‘R’ Us	29,475	9.5	33,770	9.7	46,958	9.5	61,063	11.0
	$ 146,396	47.2%	$ 171,350	49.1%	$ 221,624	44.8%	$ 256,312	46.1%

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

At December 31, 2013 and September 30, 2014, the Company's three largest customers accounted for approximately 39.5% and 27.2% respectively, of net accounts receivable. The concentration of the Company's business with a relatively small number of customers may expose the Company to material adverse effects if one or more of its large customers were to experience financial difficulty. The Company performs ongoing credit evaluations of its top customers and maintains an allowance for potential credit losses.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 3 — Inventory

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

	December 31, 2013	September 30, 2014
Raw materials	$ 1,784	$ 1,464
Finished goods	45,000	87,312
	$ 46,784	$ 88,776

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

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

Generally, the Company does not allow product returns. It provides its customers a negotiated allowance for breakage or defects, which is recorded when the related revenue is recognized. However, the Company does make occasional exceptions to this policy and consequently accrues a return allowance based upon historic return amounts and management estimates. The Company occasionally grants credits to facilitate markdowns and sales of slow moving merchandise. These credits are recorded as a reduction of gross sales at the time of occurrence.

The Company also participates in cooperative advertising arrangements with some customers, whereby it allows a discount from invoiced product amounts in exchange for customer purchased advertising that features the Company's products. Typically, these discounts range from 1% to 6% of gross sales, and are generally based upon product purchases or specific advertising campaigns. Such amounts are accrued when the related revenue is recognized or when the advertising campaign is initiated. These cooperative advertising arrangements are accounted for as direct selling expenses.

The Company's reserve for sales returns and allowances amounted to $31.4 million as of December 31, 2013, compared to $28.9 million as of September 30, 2014. This decrease is primarily due to certain customers taking their year-end allowances related to 2013 sales during 2014.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 5 — Credit Facility

In September 2012, the Company and its domestic subsidiaries entered into a secured credit facility with Wells Fargo Bank, National Association (the “WF Loan Agreement”). The WF Loan Agreement provided for a $75.0 million revolving credit facility. The amounts outstanding under the revolving credit facility were originally payable in full upon maturity of the revolving credit facility on April 30, 2013. By amendment to the WF Loan Agreement dated March 28, 2013, the Company was granted an over advance of up to $30.0 million in excess of the borrowing capacity of which $29.0 million was advanced to the Company on March 29, 2013. In addition, the maturity date was changed to April 2, 2013, on which date the Company paid off the revolving credit facility in full.

On March 27, 2014, the Company and its domestic subsidiaries entered into a secured credit facility with General Electric Capital Corporation (the “GE Loan Agreement”). The GE Loan Agreement provides for a $75.0 million revolving credit facility subject to availability based on prescribed advance rates on certain accounts receivable and inventory. The amounts outstanding under the revolving credit facility are payable in full upon maturity of the revolving credit facility on March 27, 2017. The revolving credit facility is secured by a security interest in favor of the lender covering a substantial amount of the assets of the Company. The amount outstanding on the revolving credit facility as of September 30, 2014 is nil; the total borrowing capacity was approximately $67.5 million.

The Company’s ability to borrow under the GE Loan Agreement is also subject to its ongoing compliance with certain financial covenants, including that the Company and its domestic subsidiaries (a) for the year-to-date periods ending on March 31, 2014 and June 30, 2014 maintain and earn on a year-to-date consolidated basis consolidated EBITDA equal to or greater than negative $12.5 million and negative $10.8 million, respectively, and (b) maintain a fixed charge coverage ratio of at least 1.2:1.0 based on (i) the trailing three quarters as of September 30, 2014; and (ii) the trailing four quarters as of December 31, 2014 and thereafter.

The GE Loan Agreement allows the Company to borrow under the revolving credit facility at LIBOR or at a base rate, plus applicable margins of 325 basis point spread over LIBOR and 225 basis point spread on base rate loans. In addition to standard fees, the revolving credit facility has an unused line fee based on the unused amount of the credit facility, ranging from 38.5 to 62.5 basis points. As of September 30, 2014, the rate on the revolving credit facility was 0.625%.

The GE Loan Agreement also contains customary events of default, including a cross default provision and a change of control provision. In the event of a default, all of the obligations of the Company and its subsidiaries under the GE Loan Agreement may be declared immediately due and payable. For certain events of default relating to insolvency and receivership, all outstanding obligations become due and payable.

As of September 30, 2014, the Company was in compliance with the financial covenants under the GE Loan Agreement. In the event the Company fails to meet any of the financial covenants or any other of the original or additional covenants under the GE Loan Agreement in the future, the lender could declare an event of default, which could have a material adverse effect on the Company’s financial condition and results of operations. The Company would be required to obtain amendments and/or waivers or renegotiate the GE Loan Agreement with its lender. However there is no assurance that the lender will grant any waiver or agree to an amendment or renegotiation of the GE Loan Agreement. Any such amendment or waiver will likely require payment of a fee, result in higher interest rates on outstanding loan amounts and/or impose other restrictions. If the lender does not agree to a waiver and/or amendment and determine an event of default has occurred, the lender may accelerate all obligations of the Company under the GE Loan Agreement, demand immediate repayment of all obligations, and/or terminate all commitments to extend further credit under the GE Loan Agreement. If access to our credit facility is limited or terminated, liquidity could be constrained, which might affect the Company’s operations and growth prospects, and the Company might need to seek additional equity or debt financing. There is no assurance that such alternative financing would be available on acceptable terms or at all. Furthermore, any equity financing could result in dilution to existing stockholders and any debt financing might include restrictive covenants that could impede the Company’s ability to effectively operate and grow its business in the future.

Note 6 — Convertible Senior Notes

In November 2009, the Company sold an aggregate of $100.0 million principal amount of 4.50% Convertible Senior Notes due 2014 (the “2014 Notes”). The 2014 Notes, which are senior unsecured obligations of the Company, pay cash interest semi-annually at a rate of 4.50% per annum and will mature on November 1, 2014. The initial conversion rate was 63.2091 shares of JAKKS common stock per $1,000 principal amount of notes (equivalent to an initial conversion price of approximately $15.82 per share of common stock), subject to adjustment under certain circumstances. As a result of the cash dividends of $0.10 per share paid in 2011, $0.40 per share paid in 2012 and $0.14 per share paid in 2013 and the above-market self-tender offer in July 2012, the current conversion rate is 68.8564 shares of JAKKS common stock per $1,000 principal amount of notes (or approximately $14.52 per share). Prior to August 1, 2014, holders of the 2014 Notes could only have converted their notes upon the occurrence of specified events. Upon conversion, the 2014 Notes may be settled, at the Company’s election, in cash, shares of its common stock or a combination of cash and shares of its common stock. Holders of the 2014 Notes may require that the Company repurchase for cash all or some of their notes upon the occurrence of a fundamental change (as defined in the 2014 Notes). In July 2013, the Company repurchased an aggregate of $61.0 million principal amount of the 2014 Notes at par plus accrued interest with a portion of the net proceeds from the issuance of $100.0 million principal amount of 4.25% convertible senior notes due 2018 resulting in a gain on extinguishment of $0.1 million.

Accounting Standards Codification ("ASC") 470-20, “Debt with Conversion and Other Options,” requires the issuer of certain convertible debt instruments that may be settled in cash (or other assets) upon conversion to separately account for the liability (debt) and equity (conversion option) components of the instrument in a manner that reflects the issuer's non-convertible debt borrowing rate. In accordance with ASC 470-20, the Company allocated $13.7 million of the $100.0 million principal amount of the 2014 Notes to the equity component, which represents a discount to the debt that is being amortized to interest expense through November 1, 2014. Interest expense associated with the amortization of the discount was $2.5 million and $0.8 million for the nine months ended September 30, 2013 and 2014, respectively. The Company repurchased $61.0 million of the 2014 Notes during the quarter ended September 30, 2013 as discussed below, with $2.8 million of the price allocated to the repurchase of the related equity component. In addition, approximately $2.2 million of the unamortized debt discount and $0.6 million of debt issuance costs were written off in connection with the repurchase of the 2014 Notes. The balance of the discount was $0.9 million and $0.1 million at December 31, 2013 and September 30, 2014, respectively. As of November 1, 2014, the Company paid the outstanding balance of $39.0 million related to the 2014 Notes.

In July 2013, the Company sold an aggregate of $100.0 million principal amount of 4.25% Convertible Senior Notes due 2018 (the “2018 Notes”). The 2018 Notes are senior unsecured obligations of the Company paying interest semi-annually in arrears on August 1 and February 1 of each year at a rate of 4.25% per annum and will mature on August 1, 2018. The initial conversion rate for the 2018 Notes is 114.3674 shares of JAKKS common stock per $1,000 principal amount of notes, equivalent to an initial conversion price of approximately $8.74 per share of common stock, subject to adjustment in certain events. Upon conversion, the 2018 Notes will be settled in shares of the Company’s common stock. Holders of the 2018 Notes may require that the Company repurchase for cash all or some of their notes upon the occurrence of a fundamental change (as defined in the 2018 Notes). The Company used $61.0 million of the approximately $96.0 million in net proceeds from the offering to repurchase at par $61.0 million principal amount of the 2014 Notes. The remainder of the net proceeds has been, and will be, used for general corporate purposes.

On June 9, 2014 and June 12, 2014, the Company sold an aggregate of $100.0 million and $15.0 million, respectively, principal amount of 4.875% Convertible Senior Notes due 2020 (the “2020 Notes”). The 2020 Notes are senior unsecured obligations of the Company paying interest semi-annually in arrears on June 1 and December 1 of each year at a rate of 4.875% per annum and will mature on June 1, 2020. The initial conversion rate for the 2020 Notes is 103.7613 shares of our common stock per $1,000 principal amount of notes, equivalent to an initial conversion price of approximately $9.64 per share of common stock, subject to adjustment in certain events. Upon conversion, the 2020 Notes will be settled in shares of the Company's common stock. Holders of the 2020 Notes may require that the Company repurchase for cash all or some of their notes upon the occurrence of a fundamental change (as defined in the 2020 Notes). The Company received net proceeds of approximately $110.4 million from the offering of which $24.0 million was used to repurchase 3.1 million shares of the Company's common stock under a prepaid forward purchase contract and $39.0 million will be used to redeem the remaining outstanding principal amount of the 2014 Notes at maturity. The remainder of the net proceeds will be used for general corporate purposes.

The fair value of the 2014 Notes as of December 31, 2013 and September 30, 2014 was approximately $37.7 million and $39.2 million, respectively, based upon the most recent quoted market price. The fair value of the 2018 Notes as of December 31, 2013 and September 30, 2014 was approximately $97.4 million and $101.4 million, respectively, based upon the most recent quoted market price. The fair value of the 2020 Notes as of September 30, 2014 was approximately $102.6 million based upon the most recent quoted market price. The fair value of the convertible senior notes is considered to be a Level 2 measurement on the fair value hierarchy.

Note 7 — Income Taxes

The Company’s income tax expense of $1.7 million for the three months ended September 30, 2014 reflects an effective tax rate of 3.79%. The Company’s income tax expense of $0.3 million for the three months ended September 30, 2013 reflects an effective tax rate of 0.75%. The majority of the provision relates to foreign taxes in Hong Kong.

The Company’s income tax expense of $2.5 million for the nine months ended September 30, 2014 reflects an effective tax rate of 11.93%. Included in the tax expense of $2.6 million is a discrete tax benefit of $44,000 related to a reduction in tax reserves resulting from a closed Federal tax audit and a discrete tax expense of $15,000 related to an increase in tax resulting from a state tax audit. The Company’s income tax expense of $0.4 million for the nine months ended September 30, 2013 reflects an effective tax rate of (1.16%). Included in the tax expense of $0.4 million is a discrete tax benefit of $1.4 million related to a reduction in tax reserves resulting from closed statutes of limitation and an uncertain tax positions reserve release for Moose Mountain HK mold depreciation. Majority of the provision relate to foreign taxes in Hong Kong.

In July 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (ASU 2013-11), which requires entities to present an unrecognized tax benefit as a reduction of a deferred tax asset for a net operating loss (NOL) or tax credit carryforward whenever the NOL or tax credit carryforward would be available to reduce the additional taxable income or tax due if the tax position is disallowed. This accounting standard update requires entities to assess whether to net the unrecognized tax benefit with a deferred tax asset as of the reporting date. The adoption of this update did not have a material impact on the financial statements of the Company.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 8 — Income (Loss) Per Share

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

	Three Months Ended September 30,					
	2013			2014		
	Income	Weighted Average Shares	Per-Share	Income	Weighted Average Shares	Per-Share
Earnings per share – basic						
Net income available to common stockholders	$ 36,597	21,920	$ 1.67	$ 44,069	18,897	$ 2.33
Effect of dilutive securities:						
Convertible senior notes	1,354	12,294		2,442	26,055	
Options and warrants	—	—		—	—	
Unvested restricted stock grants	—	69		—	200	
Earnings per share – diluted						
Net income available to common stockholders plus assumed exercises and conversion	$ 37,951	34,283	$ 1.11	$ 46,511	45,152	$ 1.03

	Nine Months Ended September 30,					
	2013			2014		
	Income	Weighted Average Shares	Per-Share	Loss	Weighted Average Shares	Per-Share
Earnings (loss) per share – basic						
Net income (loss) available to common stockholders	$ (37,838)	21,922	$ (1.73)	$ 18,711	20,721	$ 0.90
Effect of dilutive securities:						
Convertible senior notes	—	—		5,456	19,063	
Options and warrants	—	—		—	—	
Unvested restricted stock grants	—	—		—	167	
Earnings (loss) per share – diluted						
Net income (loss) available to common stockholders plus assumed exercises and conversion	$ (37,838)	21,922	$ (1.73)	$ 24,167	39,951	$ 0.61

Basic earnings per share is calculated using the weighted average number of common shares outstanding during the period. Diluted earnings per share is calculated using the weighted average number of common shares and common share equivalents outstanding during the period (which consist of warrants, options and convertible debt to the extent they are dilutive). The weighted average number of common shares outstanding excludes shares repurchased pursuant to a prepaid forward share repurchase agreement (See Note 9). Common share equivalents that could potentially dilute basic earnings per share in the future, which were excluded from the computation of diluted loss per share, totaled approximately 2,302,404 and 2,849,726 for the three months ended September 30, 2013 and 2014, respectively, and approximately 2,297,757 and 2,871,129 for the nine months ended September 30, 2013 and 2014, respectively. Convertible notes interest and related common share equivalents excluded from the diluted earnings per share calculation due to being anti-dilutive were approximately 12,293,902 shares and nil shares for the three months ended September 30, 2013 and 2014, respectively, and approximately 8,655,776 share and nil shares for the nine months ended September 30, 2013 and 2014, respectively.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 9 — 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.

On June 9, 2014, the Company effectively repurchased 3,112,840 shares of its common stock at an average cost of $7.71 per share for an aggregate amount of $24.0 million pursuant to a prepaid forward share repurchase agreement entered into with Merrill Lynch International ("ML"). These repurchased shares are treated as retired for basic and diluted EPS purposes although they remain legally outstanding. The Company reflects the aggregate purchase price of its common shares repurchased as a reduction to stockholders' equity allocated to common stock and additional paid-in capital. No shares have been delivered to the Company by ML as of September 30, 2014.

In January 2014, the Company issued an aggregate of 531,993 shares of restricted stock at a value of approximately $3.6 million to two executive officers, which vest, subject to certain company financial performance criteria, over a one to three year period. In addition, an aggregate of 78,150 shares of restricted stock were issued to its five non-employee directors, which vest in January 2015, at an aggregate value of approximately $0.5 million.

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

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 10 — Business Combinations

In July 2012, the Company acquired all of the stock of Maui, Inc., an Ohio corporation, Kessler Services, Inc., a Nevada corporation, and A.S. Design Limited, a Hong Kong corporation (collectively, “Maui”). The total initial consideration of $37.6 million consisted of $36.2 million in cash and the assumption of liabilities in the amount of $1.4 million. In addition, the Company agreed to pay an earn-out of up to an aggregate amount of $18.0 million in cash over the three calendar years following the acquisition based on the achievement of certain financial performance criteria. The fair value of the expected earn-out of $16.0 million was accrued and recorded as goodwill as of the acquisition date. All future changes to the earn-out liability will be credited to income. Maui did not achieve the prescribed earn-out targets for 2013, therefore, $6.0 million was credited to other income in the fourth quarter of 2013. In addition, as of September 30, 2014 it was determined that Maui will not achieve the prescribed earnout targets for 2014; accordingly, $5.9 million was credited to income in the third quarter of 2014. Maui is a leading manufacturer and distributor of spring and summer activity toys and impulse toys and was included in the Company’s results of operations from the date of acquisition.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 11 — Joint Ventures

The Company owns a fifty percent interest in a joint venture (“Pacific Animation Partners”) with the U.S. entertainment subsidiary of a leading Japanese advertising and animation production company. The joint venture was created to develop and produce a boys’ animated television show, which it licenses worldwide for television broadcast as well as consumer products. The Company is producing and marketing toys based upon the television program under a license from the joint venture. The joint venture has also licensed certain other merchandising rights to third parties. The Company is responsible for fifty percent of the operating expenses of the joint venture and thirty-one percent of the production costs of the television show. The joint venture completed and delivered 52 episodes of the show, which began airing in February 2012, and completed an additional 13 episodes of the show. As of December 31, 2013, the joint venture has chosen to cease production of the television show. The Company’s investment is being accounted for using the equity method. For the three months ended September 30, 2013 and 2014, the Company recognized a loss of $0.6 million and nil from the joint venture, respectively. For the nine months ended September 30, 2013 and 2014, the Company recognized a loss of $2.0 million and income of $0.3 million from the joint venture, respectively, including producer fees and royalty income from the joint venture in the amount of nil for each of the respective quarters.

As of December 31, 2013 and September 30, 2014, the balance of the investment in the Pacific Animation Partners joint venture includes the following components (in thousands):

	December 31, 2013	September 30, 2014
Capital contributions, net of distributions	$ 4,188	$ 3,509
Equity in cumulative net loss	(4,170)	(3,509)
Investment in joint venture	$ 18	$ —

In September 2012, the Company entered into a joint venture (“DreamPlay Toys”) with NantWorks LLC (“NantWorks”) in which it owns a fifty percent interest. Pursuant to the operating agreement of DreamPlay Toys, the Company paid to NantWorks cash in the amount of $8.0 million and issued NantWorks a warrant to purchase 1.5 million shares of the Company’s common stock at a value of $7.0 million in exchange for the exclusive right to arrange for the provision of the NantWorks recognition technology platform for toy products. The Company has classified these rights as an intangible asset and is amortizing the asset over the anticipated revenue stream from the exploitation of these rights. The joint venture entered into a Toy Services Agreement with an initial term of three years expiring on October 1, 2015 and a renewal period at the option of the Company expiring October 1, 2018, subject to the achievement of certain financial targets, to develop and produce toys utilizing recognition technologies owned by NantWorks. Pursuant to the terms of the Toy Services Agreement, NantWorks is entitled to receive a preferred return based upon net sales of DreamPlay Toys product sales and third-party license fees. The preferred return for NantWorks was nil and $530,789 for the three months ended September 30, 2013 and September 30, 2014, respectively, and nil and $614,753 for the nine months ended September 30, 2013 and September 30, 2014, respectively. The Company retains the financial risk of the joint venture and is responsible for the day-to-day operations, including development, sales and distribution, for which it is entitled to receive any remaining profit or is responsible for any losses, and the results of operations of the joint venture are consolidated with the Company’s results. Sales of DreamPlay Toys products commenced in the third quarter of 2013.

In addition, the Company purchased for $7.0 million in cash a five percent economic interest in a related entity, DreamPlay, LLC, that will exploit the proprietary recognition technologies in non-toy consumer product categories. NantWorks has the right to repurchase the Company’s interest for $7.0 million. The Company has classified this investment as a long term asset on its balance sheet and is accounting for it using the cost method. As of September 30, 2014 the Company determined that the value of this investment will be realized and that no impairment has occurred.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 12 — Goodwill

The changes to the carrying amount of goodwill as of December 31, 2013 and September 30, 2014 are as follows (in thousands):

	Traditional Toys and Electronics	Role Play, Novelty and Seasonal Toys	Total
Balance at December 31, 2013	$ 25,265	$ 19,611	$ 44,876
Adjustments to goodwill for foreign currency translation	(100)	—	(100)
Balance, September 30, 2014	$ 25,165	$ 19,611	$ 44,776

The Company applies a fair value-based impairment test to the carrying value of goodwill and indefinite-lived intangible assets on an annual basis and, if certain events or circumstances indicate that an impairment loss may have been incurred, on an interim basis. The analysis of potential impairment of goodwill requires a two-step process. The first step is the estimation of fair value. If step one indicates that an impairment potentially exists, the second step is performed to measure the amount of impairment, if any. Goodwill impairment exists when the estimated fair value of goodwill is less than its carrying value. There was no goodwill impairment during the nine months ended September 30, 2013 and 2014.

JAKKS PACIFIC, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 13 — Intangible Assets Other Than Goodwill and Other Assets

Intangible assets other than goodwill and other assets consist primarily of licenses, product lines, customer relationships and trademarks. Amortized intangible assets are included in Intangibles in the accompanying balance sheets. Trademarks are disclosed separately in the accompanying balance sheets. Debt offering costs from the issuance of the Company's convertible senior notes are included in Other Long Term Assets in the accompanying balance sheets. Intangible assets and debt issuance costs as of December 31, 2013 and September 30, 2014 are as follows (in thousands, except for weighted useful lives):

		December 31, 2013			September 30, 2014		
	Weighted Useful Lives (Years)	Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
Amortized Intangible Assets:							
Licenses	4.96	$ 91,488	$ (82,410)	$ 9,078	$ 91,488	$ (84,919)	$ 6,569
Product lines	5.84	66,594	(22,623)	43,971	66,594	(26,093)	40,501
Customer relationships	5.21	9,348	(7,251)	2,097	9,348	(7,686)	1,662
Trade names	5.00	3,000	(850)	2,150	3,000	(1,300)	1,700
Non-compete/Employment contracts	3.90	3,333	(3,190)	143	3,333	(3,220)	113
Total amortized intangible assets		173,763	(116,324)	57,439	173,763	(123,218)	50,545
Deferred Costs:							
Debt issuance costs	6.35	8,478	(4,407)	4,071	14,923		