

MATTEL INC /DE/

FORM 10-Q (Quarterly Report)

Filed 11/3/2005 For Period Ending 9/30/2005

Address	333 CONTINENTAL BLVD EL SEGUNDO, California 90245
Telephone	310-252-2000
CIK	0000063276
Industry	Recreational Products
Sector	Consumer Cyclical
Fiscal Year	12/31

Powered By **EDGAR**
Online

<http://www.edgar-online.com/>

© Copyright 2005. All Rights Reserved.

Distribution and use of this document restricted under EDGAR Online's Terms of Use.

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2005

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

Commission File Number 001-05647

MATTEL, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

95-1567322
(I.R.S. Employer Identification No.)

333 Continental Blvd.
El Segundo, CA 90245-5012
(Address of principal executive offices)

(310) 252-2000
(Registrant's telephone number)

(Former name, former address and former fiscal year, if changed since last report)

None

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 No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

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

Number of shares outstanding of registrant's common stock, \$1.00 par value, as of October 31, 2005:

403,816,283 shares

Table of Contents

MATTEL, INC. AND SUBSIDIARIES

	Page
PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements.	
Consolidated Balance Sheets	3
Consolidated Statements of Operations	4
Consolidated Statements of Cash Flows	5
Notes to Consolidated Financial Information	6
Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations .	17
Item 3. Quantitative and Qualitative Disclosures About Market Risk .	33
Item 4. Controls and Procedures .	33
PART II. OTHER INFORMATION	
Item 1. Legal Proceedings .	34
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds .	35
Item 6. Exhibits .	36
Signature	37

Table of Contents

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements.

MATTEL, INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)	September 30, 2005 (Unaudited)	September 30, 2004 (Unaudited)	December 31, 2004
ASSETS			
Current Assets			
Cash and equivalents	\$ 173,801	\$ 331,140	\$1,156,835
Accounts receivable, net	1,262,412	1,220,526	759,033
Inventories	725,868	666,515	418,633
Prepaid expenses and other current assets	264,715	287,407	302,649
Total current assets	2,426,796	2,505,588	2,637,150
Property, plant and equipment, net	538,224	596,904	586,526
Goodwill	721,444	723,860	735,680
Other noncurrent assets	715,057	686,468	797,136
Total Assets	\$4,401,521	\$4,512,820	\$4,756,492
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current Liabilities			
Short-term borrowings	\$ 89,271	\$ 89,236	\$ 28,995
Current portion of long-term debt	88,361	191,013	189,130
Accounts payable	447,626	394,828	349,159
Accrued liabilities	621,611	665,993	880,038
Income taxes payable	262,454	240,872	279,849
Total current liabilities	1,509,323	1,581,942	1,727,171
Noncurrent Liabilities			
Long-term debt	350,000	438,361	400,000
Other	259,372	244,489	243,509
Total noncurrent liabilities	609,372	682,850	643,509
Stockholders' Equity			
Common stock \$1.00 par value, 1.0 billion shares authorized; 441.4 million shares issued	441,369	441,369	441,369
Additional paid-in capital	1,589,420	1,598,460	1,594,332
Treasury stock at cost; 37.5 million shares, 26.6 million shares and 26.0 million shares, respectively	(685,702)	(485,091)	(473,349)
Retained earnings	1,231,147	995,805	1,093,288
Accumulated other comprehensive loss	(293,408)	(302,515)	(269,828)
Total stockholders' equity	2,282,826	2,248,028	2,385,812
Total Liabilities and Stockholders' Equity	\$4,401,521	\$4,512,820	\$4,756,492

The accompanying notes are an integral part of these financial statements.

Table of Contents

**MATTEL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS**

(Unaudited; in thousands, except per share amounts)	For the Three Months Ended		For the Nine Months Ended	
	September 30,	September 30,	September 30,	September 30,
	2005	2004	2005	2004
Net Sales	\$ 1,666,145	\$ 1,667,461	\$ 3,336,088	\$ 3,252,407
Cost of sales	904,888	870,807	1,843,954	1,737,728
Gross Profit	761,257	796,654	1,492,134	1,514,679
Advertising and promotion expenses	191,607	192,088	372,432	363,927
Other selling and administrative expenses	260,850	243,710	776,848	733,971
Operating Income	308,800	360,856	342,854	416,781
Interest expense	16,842	20,847	54,044	52,456
Interest (income)	(4,280)	(5,238)	(28,789)	(14,278)
Other non-operating (income), net	(15,101)	(5,872)	(28,694)	(17,410)
Income Before Income Taxes	311,339	351,119	346,293	396,013
Provision for income taxes	86,000	95,289	208,434	107,635
Net Income	\$ 225,339	\$ 255,830	\$ 137,859	\$ 288,378
Net Income Per Common Share – Basic	\$ 0.56	\$ 0.62	\$ 0.34	\$ 0.69
Weighted average number of common shares	403,743	414,592	409,824	420,624
Net Income Per Common Share – Diluted	\$ 0.55	\$ 0.61	\$ 0.33	\$ 0.68
Weighted average number of common and common equivalent shares	407,222	417,962	413,945	424,431

The accompanying notes are an integral part of these financial statements.

Table of Contents

MATTEL, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited; in thousands)	For the Nine Months Ended	
	September 30, 2005	September 30, 2004
Cash Flows From Operating Activities:		
Net income	\$ 137,859	\$ 288,378
Adjustments to reconcile net income to net cash flows used for operating activities:		
Gain on sale of investments	(31,935)	(21,750)
Net gain on sale of other property, plant and equipment	(2,712)	(532)
Depreciation	126,536	131,439
Amortization	3,273	4,527
Deferred income taxes	60,378	57,183
(Decrease) increase from changes in assets and liabilities:		
Accounts receivable, net	(514,173)	(671,766)
Inventories	(313,706)	(279,328)
Prepaid expenses and other current assets	37,687	20,527
Accounts payable, accrued liabilities and income taxes payable	(136,683)	(86,575)
Other, net	4,470	8,831
Net cash flows used for operating activities	(629,006)	(549,066)
Cash Flows From Investing Activities:		
Purchases of tools, dies and molds	(54,170)	(68,480)
Purchases of other property, plant and equipment	(38,853)	(40,910)
Payment for businesses acquired	(1,495)	(12,955)
Proceeds from sale of investments	48,361	31,695
Proceeds from sale of other property, plant and equipment	7,991	6,560
Net cash flows used for investing activities	(38,166)	(84,090)
Cash Flows From Financing Activities:		
Short-term borrowings, net	59,087	69,153
Purchase of treasury stock	(249,886)	(255,130)
Payment of long-term debt	(150,000)	(11,286)
Proceeds from exercise of stock options	32,372	12,625
Other, net	(2,871)	(771)
Net cash flows used for financing activities	(311,298)	(185,409)
Effect of Currency Exchange Rate Changes on Cash	(4,564)	(2,976)
Decrease in Cash and Equivalents	(983,034)	(821,541)
Cash and Equivalents at Beginning of Period	1,156,835	1,152,681
Cash and Equivalents at End of Period	\$ 173,801	\$ 331,140
Supplemental Cash Flow Information:		
Cash paid during the period for:		
Income taxes	\$ 159,816	\$ 63,894
Interest	52,208	48,243
Non-cash investing and financing activities:		
Liability for equipment acquired	\$ 443	\$ 2,369
Asset writedowns	(878)	(4,951)
Liability for businesses acquired	—	1,024

The accompanying notes are an integral part of these financial statements.

Table of Contents

MATTEL, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL INFORMATION (Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements and related disclosures have been prepared in accordance with accounting principles generally accepted in the United States of America applicable to interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. In the opinion of management, all adjustments, consisting of only those of a normal recurring nature, considered necessary for a fair presentation of the financial position and interim results of Mattel, Inc. and its subsidiaries ("Mattel") as of and for the periods presented have been included. Because Mattel's business is seasonal, results for interim periods are not necessarily indicative of those that may be expected for a full year.

The financial information included herein should be read in conjunction with Mattel's consolidated financial statements and related notes in its 2004 Annual Report on Form 10-K.

2. Accounts Receivable

Accounts receivable are shown net of allowances for doubtful accounts of \$27.0 million (September 30, 2005), \$29.8 million (September 30, 2004), and \$32.8 million (December 31, 2004).

3. Inventories

Inventories include the following:

(In thousands)	September 30, 2005	September 30, 2004	December 31, 2004
Raw materials and work in process	\$ 51,153	\$ 55,303	\$ 35,546
Finished goods	674,715	611,212	383,087
	<u>\$ 725,868</u>	<u>\$ 666,515</u>	<u>\$ 418,633</u>

4. Property, Plant and Equipment

Property, plant and equipment, net include the following:

(In thousands)	September 30, 2005	September 30, 2004	December 31, 2004
Land	\$ 28,974	\$ 35,272	\$ 29,282
Buildings	235,446	261,370	252,627
Machinery and equipment	720,599	692,162	710,122
Tools, dies and molds	607,140	561,607	585,181
Capitalized leases	23,271	23,271	23,271
Leasehold improvements	108,789	103,955	106,113
	<u>1,724,219</u>	<u>1,677,637</u>	<u>1,706,596</u>
Less: accumulated depreciation	<u>(1,185,995)</u>	<u>(1,080,733)</u>	<u>(1,120,070)</u>
	<u>\$ 538,224</u>	<u>\$ 596,904</u>	<u>\$ 586,526</u>

5. Goodwill

Goodwill is allocated to various reporting units, which are either at the operating segment level or one reporting level below the operating segment. Mattel's reporting units for purposes of applying the provisions of Statement of Financial Accounting Standards ("SFAS") No. 142, *Goodwill and Other Intangible Assets*, are: Mattel Brands US Girls division, Mattel Brands US Boys division, Fisher-Price Brands US, American Girl Brands and International.

Table of Contents

The change in the carrying amount of goodwill by reporting unit for the nine months ended September 30, 2005 is shown below. Brand-specific goodwill held by foreign subsidiaries is allocated to the US reporting units selling those brands, thereby causing foreign currency translation impact to the US reporting units.

(In thousands)	December 31, 2004	Impact of Currency Exchange Rate Changes	September 30, 2005
Mattel Brands US Girls division	\$ 37,566	\$ (2,814)	\$ 34,752
Mattel Brands US Boys division	54,411	(219)	54,192
Fisher-Price Brands US	217,152	(550)	216,602
American Girl Brands	207,571	—	207,571
International	218,980	(10,653)	208,327
	<u>\$ 735,680</u>	<u>\$ (14,236)</u>	<u>\$ 721,444</u>

In the third quarter of 2005, Mattel performed the annual impairment test required by SFAS No. 142 and determined that its goodwill was not impaired.

6. Other Noncurrent Assets

Other noncurrent assets include the following:

(In thousands)	September 30, 2005	September 30, 2004	December 31, 2004
Deferred income taxes	\$ 517,248	\$ 459,500	\$ 572,374
Identifiable intangible assets, net	21,003	23,808	22,926
Other	176,806	203,160	201,836
	<u>\$ 715,057</u>	<u>\$ 686,468</u>	<u>\$ 797,136</u>

7. Accrued Liabilities

Accrued liabilities include the following:

(In thousands)	September 30, 2005	September 30, 2004	December 31, 2004
Advertising and promotion	\$ 120,157	\$ 153,662	\$ 95,291
Other	501,454	512,331	784,747
	<u>\$ 621,611</u>	<u>\$ 665,993</u>	<u>\$ 880,038</u>

8. Long-term Debt

Long-term debt consists of the following:

(In thousands)	September 30, 2005	September 30, 2004	December 31, 2004
6 ¹ / ₈ % senior notes due July 2005	\$ —	\$ 150,000	\$ 150,000
Medium-term notes due 2006 to 2013	400,000	440,000	400,000
10.15% mortgage note due November 2005	38,361	39,374	39,130
	<u>438,361</u>	<u>629,374</u>	<u>589,130</u>
Less: current portion	(88,361)	(191,013)	(189,130)
	<u>\$ 350,000</u>	<u>\$ 438,361</u>	<u>\$ 400,000</u>

In the fourth quarter of 2004, Mattel repaid \$40.0 million of medium-term notes upon maturity. In July 2005, Mattel repaid \$150 million of 6 ¹/₈ % Senior Notes upon maturity.

Table of Contents

In October 2005, Mattel Asia Pacific Sourcing Limited (“MAPS”), a wholly-owned subsidiary of Mattel, entered into a commitment letter with Bank of America N.A. (“Bank of America”) and Banc of America Securities LLC, regarding the arrangement and syndication of senior credit facilities in the maximum aggregate principal amount of \$325.0 million (“MAPS senior credit facilities”). The MAPS senior credit facilities, which will be guaranteed by Mattel, will consist of a \$225.0 million term loan facility and a \$100.0 million revolving credit facility and will mature on the third anniversary of the closing date. The closing date for the establishment of the MAPS senior credit facilities is anticipated to occur on or before December 30, 2005.

9. Comprehensive Income (Loss)

The changes in the components of comprehensive income (loss), net of tax, are as follows:

(In thousands)	For the Three Months Ended		For the Nine Months Ended	
	September 30,	September 30,	September 30,	September 30,
	2005	2004	2005	2004
Net income	\$ 225,339	\$ 255,830	\$ 137,859	\$ 288,378
Currency translation adjustments	(753)	13,261	(36,090)	(10,463)
Minimum pension liability adjustments	1,163	—	1,814	—
Net unrealized gain (loss) on securities:				
Unrealized holding gains (losses)	1,289	(6,363)	(195)	(2,885)
Reclassification adjustment for realized (gains) included in net income	(7,238)	(5,548)	(16,247)	(11,539)
	(5,949)	(11,911)	(16,442)	(14,424)
Net unrealized gain (loss) on derivative instruments:				
Unrealized holding gains (losses)	770	(3,808)	19,529	(14,723)
Reclassification adjustment for realized losses included in net income	530	9,088	7,609	24,102
	1,300	5,280	27,138	9,379
	\$ 221,100	\$ 262,460	\$ 114,279	\$ 272,870

The components of accumulated other comprehensive loss are as follows:

(In thousands)	September 30, 2005	September 30, 2004	December 31, 2004
Currency translation adjustments	\$ (235,882)	\$ (246,635)	\$ (199,792)
Minimum pension liability adjustments	(59,658)	(60,042)	(61,472)
Net unrealized gain on securities	—	18,377	16,442
Net unrealized gain (loss) on derivative instruments	2,132	(14,215)	(25,006)
	\$ (293,408)	\$ (302,515)	\$ (269,828)

Currency Translation Adjustments

Mattel’s reporting currency is the US dollar. The translation of its net investment in subsidiaries with non-US dollar functional currencies subjects Mattel to currency exchange rate fluctuations in its results of operations and financial position. Assets and liabilities of subsidiaries with non-US dollar functional currencies are translated into US dollars at fiscal period-end exchange rates. Income, expense and cash flow items are translated at weighted average exchange rates prevailing during the fiscal period. The resulting currency translation adjustments are recorded as a component of accumulated other comprehensive loss within stockholders’ equity. Mattel’s primary currency translation exposures are on its net investment in subsidiaries having functional currencies denominated in the Euro, British pound sterling, Mexican peso and Indonesian rupiah. For the nine months ended September 30, 2005, currency translation adjustments resulted in a net loss of \$36.1 million, with losses from the weakening of the Euro and British pound sterling against the US dollar being partially offset by strengthening of the Mexican peso against the US dollar. For the nine months ended September 30, 2004, currency translation adjustments resulted in a net loss of \$10.5 million, with losses from the weakening of the Euro, Indonesian rupiah, and Mexican peso against the US dollar being

Table of Contents

partially offset by strengthening of the British pound sterling against the US dollar.

Marketable Securities

As of September 30, 2005, Mattel held no marketable securities. Unrealized pre-tax gains on marketable securities of \$29.2 million (\$18.4 million net of tax) and \$26.1 million (\$16.4 million net of tax) as of September 30, 2004 and December 31, 2004, respectively, were deferred in accumulated other comprehensive loss.

During the third quarter of 2005, Mattel sold marketable securities for proceeds totaling \$17.8 million. For the nine months ended September 30, 2005 and 2004, proceeds from the sale of marketable securities totaled \$42.0 million and \$28.2 million, respectively. Gains on sales of these securities totaling \$11.5 million and \$8.8 million, net of transaction costs, were recorded in other non-operating (income), net in the consolidated statement of operations for the three months ended September 30, 2005 and 2004. Gains totaling \$25.8 million and \$18.3 million, net of transaction costs, were recorded in other non-operating (income), net in the consolidated statements of operations for the nine months ended September 30, 2005 and 2004, respectively, from sales of marketable securities.

10. Income Taxes

On October 22, 2004, the American Jobs Creation Act (the “Jobs Act”) was signed into law. Among its various provisions, the Jobs Act creates a temporary incentive for US corporations to repatriate accumulated income earned abroad by providing an 85% dividends received deduction for certain qualifying dividends. On December 21, 2004, the Financial Accounting Standards Board (“FASB”) issued Staff Position 109-2 (“FSP 109-2”), *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004*. FSP 109-2 allows companies additional time beyond the financial reporting period in which the Jobs Act was enacted to evaluate the effect of the Jobs Act on a company’s plan for reinvestment or repatriation of unremitted foreign earnings for the purposes of applying SFAS No. 109, *Accounting For Income Taxes*.

Management’s plan for reinvestment and repatriation of foreign earnings under the Jobs Act was completed and approved by Robert A. Eckert, Mattel’s chief executive officer, on April 14, 2005. Mattel expects to repatriate up to approximately \$2.4 billion in foreign earnings. The statement of operations for the nine months ended September 30, 2005 includes a provision for income taxes of \$112.9 million for the total amount of earnings expected to be repatriated, which will occur throughout 2005. The tax provision may be further impacted by future law changes enacted by the US Congress or further guidance issued by the Internal Revenue Service (“IRS”). The impact of such future changes will be reflected in the financial reporting period in which any such change in law is enacted or becomes effective.

11. Foreign Currency Transaction Gains and Losses

Currency exchange rate fluctuations may impact Mattel’s results of operations and cash flows. Mattel’s currency transaction exposures include gains and losses realized on unhedged inventory purchases and unhedged receivable and payable balances that are denominated in a currency other than the applicable functional currency. Gains and losses on unhedged inventory purchases and other transactions associated with operating activities are recorded in the components of operating income in the consolidated statement of operations. Gains and losses on unhedged intercompany loans and advances are recorded as a component of other non-operating (income), net in the consolidated statement of operations in the period in which the currency exchange rate changes. Inventory purchase transactions denominated in the Euro, British pound sterling, Mexican peso, Hong Kong dollar and Indonesian rupiah are the primary transactions that cause foreign currency transaction exposure for Mattel.

Table of Contents

Currency transaction (gains)/losses included in the consolidated statements of operations are as follows:

(In thousands)	For the Three Months Ended		For the Nine Months Ended	
	September 30,	September 30,	September 30,	September 30,
	2005	2004	2005	2004
Operating (income)	\$ (11,936)	\$ (13,114)	\$ (38,201)	\$ (38,120)
Other non-operating (income), net	(130)	661	2,216	(483)
Net transaction (gains)	\$ (12,066)	\$ (12,453)	\$ (35,985)	\$ (38,603)

12. Other Selling and Administrative Expenses

Other selling and administrative expenses include the following:

(In thousands)	For the Three Months Ended		For the Nine Months Ended	
	September 30,	September 30,	September 30,	September 30,
	2005	2004	2005	2004
Research and development	\$ 46,707	\$ 43,320	\$ 132,831	\$ 126,347
Amortization of identifiable intangible assets	667	679	1,737	1,957

On October 10, 2005, Mattel announced the consolidation of its Mattel Brands and Fisher-Price Brands divisions into one division. The creation of the new "Mattel Brands" division will result in the consolidation of management and support functions. Severance and other costs associated with management changes made in the fourth quarter will impact the results of the fourth quarter of 2005.

13. Earnings Per Share

Basic income per common share is computed by dividing reported net income by the weighted average number of common shares outstanding during each period.

Diluted income per common share is computed by dividing reported net income by the weighted average number of common shares and other common equivalent shares outstanding during each period. The calculation of common equivalent shares assumes the exercise of dilutive stock options, net of assumed treasury share repurchases at average market prices, as applicable. Nonqualified stock options totaling 28.2 million and 26.4 million were excluded from the calculation of diluted earnings per share for the three and nine months ended September 30, 2005, respectively, because they were anti-dilutive. Nonqualified stock options totaling 23.5 million and 26.6 million were excluded from the calculation of diluted earnings per share for the three and nine months ended September 30, 2004, respectively, because they were anti-dilutive.

14. Employee Benefit Plans

Mattel and certain of its subsidiaries have qualified and nonqualified retirement plans covering substantially all employees of these companies, which are more fully described in Note 4 to the Consolidated Financial Statements in Mattel's 2004 Annual Report on Form 10-K.

Table of Contents

A summary of the components of net periodic benefit cost for Mattel's defined benefit pension plans is as follows:

(In thousands)	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2005	September 30, 2004	September 30, 2005	September 30, 2004
Service cost	\$ 2,422	\$ 1,868	\$ 7,291	\$ 5,556
Interest cost	5,735	5,089	17,287	15,503
Expected return on plan assets	(5,647)	(5,292)	(16,980)	(16,087)
Amortization of:				
Prior service cost	482	(129)	1,443	(390)
Net actuarial loss	2,469	1,958	7,307	5,809
Net periodic benefit cost	5,461	3,494	16,348	10,391
Settlement	(1,238)	—	(1,238)	—
Net benefit cost	\$ 4,223	\$ 3,494	\$ 15,110	\$ 10,391

A summary of the components of net periodic benefit cost for Mattel's postretirement benefit plans is as follows:

(In thousands)	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2005	September 30, 2004	September 30, 2005	September 30, 2004
Service cost	\$ 26	\$ (50)	\$ 90	\$ 91
Interest cost	827	781	2,433	2,553
Amortization of:				
Net actuarial loss	362	352	1,130	1,124
Net benefit cost	\$ 1,215	\$ 1,083	\$ 3,653	\$ 3,768

During the three and nine months ended September 30, 2005, Mattel made cash contributions totaling approximately \$3 million and \$11 million, respectively, to its defined benefit pension and postretirement benefit plans. Mattel expects to make cash contributions totaling approximately \$15 million to its defined benefit pension and postretirement benefit plans for the year ending December 31, 2005, including approximately \$12 million to cover benefit payments of its unfunded plans.

The Medicare Prescription Drug Improvement and Modernization Act of 2003 (the "Medicare Act") was signed into law on December 8, 2003. On May 19, 2004, the FASB issued Staff Position 106-2 ("FSP 106-2"), *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, which provides guidance as to how employers who sponsor post-65 prescription drug benefits should recognize the impact of the Medicare Act. Applying the guidance in FSP 106-2, Mattel, with the assistance of its outside actuaries, determined that the prescription drug benefits provided to certain retirees under one of its postretirement benefit plans are actuarially equivalent to the benefits provided under Medicare Part D, and that Mattel will be eligible to receive a federal subsidy beginning in 2006. On July 1, 2004, Mattel adopted the provisions of FSP 106-2 and reduced its accumulated postretirement benefit obligation by \$7.6 million in recognition of the actuarial impact of the subsidy on benefits attributed to prior service. Mattel's net periodic benefit cost for fiscal year 2004 was reduced by \$1.0 million in the areas of interest cost (\$0.5 million) and amortization of net actuarial loss (\$0.5 million). On January 21, 2005, the Centers for Medicare and Medicaid Services released final regulations implementing the Medicare Act, which did not result in a significant valuation change.

15. Stock-Based Compensation

Mattel has various stock compensation plans, which are more fully described in Note 7 to the Consolidated Financial Statements in its 2004 Annual Report on Form 10-K. In May 2005, Mattel's stockholders approved the Mattel, Inc. 2005 Equity Compensation Plan (the "2005 Plan"). Upon approval of the 2005 Plan, Mattel terminated the Mattel, Inc. 1996 Stock Option Plan (the "1996 Plan") and the Mattel 1999 Stock Option Plan (the "1999 Plan"), except with regard to grants then outstanding under the 1996 Plan and the 1999 Plan. All equity compensation grants are now being made under the 2005 Plan.

Table of Contents

Mattel applies the recognition and measurement principles of Accounting Principles Board (“APB”) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for its employee stock compensation plans. Accordingly, no compensation cost has been recognized in the results of operations for nonqualified stock options granted under Mattel’s plans, as such options are granted at not less than the quoted market price of Mattel’s common stock on the date of grant.

Mattel has adopted the disclosure-only provisions of SFAS No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*, which amended SFAS No. 123, *Accounting for Stock-Based Compensation*. Had compensation cost for nonqualified stock options been determined based on their fair value at the date of grant, consistent with the method of accounting prescribed by SFAS No. 123, Mattel’s net income and net income per common share would have been adjusted as follows:

(In millions, except per share amounts)	For the Three Months Ended		For the Nine Months Ended	
	September 30,	September 30,	September 30,	September 30,
	2005	2004	2005	2004
Net income				
As reported	\$ 225.3	\$ 255.8	\$ 137.9	\$ 288.4
Pro forma compensation cost, net of tax	(7.1)	(9.6)	(19.6)	(24.7)
Pro forma net income	\$ 218.2	\$ 246.2	\$ 118.3	\$ 263.7
Income per share				
Basic				
As reported	\$ 0.56	\$ 0.62	\$ 0.34	\$ 0.69
Pro forma compensation cost, net of tax	(0.02)	(0.02)	(0.05)	(0.06)
Pro forma net income per common share – basic	\$ 0.54	\$ 0.60	\$ 0.29	\$ 0.63
Diluted				
As reported	\$ 0.55	\$ 0.61	\$ 0.33	\$ 0.68
Pro forma compensation cost, net of tax	(0.01)	(0.02)	(0.04)	(0.06)
Pro forma net income per common share – diluted	\$ 0.54	\$ 0.59	\$ 0.29	\$ 0.62

The pro forma amounts shown above are not indicative of the pro forma effect in future periods primarily because of differences in grant date valuation assumptions, and the number and timing of options granted varies from period to period.

16. Contingencies

Litigation Related to The Learning Company, Inc. (“Learning Company”)

Following Mattel’s announcement in October 1999 of the expected results of its Learning Company division for the third quarter of 1999, various Mattel stockholders filed purported class action complaints naming Mattel and certain of its present and former officers and directors as defendants.

These shareholder complaints were consolidated into two lead cases, one under §10(b) of the Securities Exchange Act of 1934 (the “Exchange Act”), and the other under §14(a) of the Exchange Act. In November 2002, the United States District Court for the Central District of California permitted the actions to proceed as class actions.

Several stockholders filed related derivative complaints purportedly on behalf of Mattel. Some of the derivative suits were consolidated into one lawsuit in Los Angeles County Superior Court in California, which was dismissed for the plaintiff’s failure to make pre-suit demand on the board of directors. An appeal from that decision was dismissed in July 2003 by stipulation of the parties. Another derivative suit was filed in the Delaware Court of Chancery, and was dismissed without prejudice in August 2002 in deference to the then-ongoing California derivative case. A third derivative suit, filed in federal court in the Central District of California, was dismissed in July 2002, and re-filed in November 2002 as part of the settlement described below.

Table of Contents

In November 2002, the parties to the federal cases negotiated and thereafter memorialized in a final settlement agreement a settlement of all the federal lawsuits in exchange for payment of \$122.0 million and Mattel's agreement to adopt certain corporate governance procedures. The court granted final approval to the settlement in September 2003, and judgments were entered accordingly. On October 9, 2003, a group of persons purporting to be members of the §14(a) class filed a notice of appeal, challenging the manner in which the \$122.0 million was allocated between the §10(b) class and the §14(a) class. On July 29, 2005, the United States Court of Appeals for the Ninth Circuit affirmed the District Court's approval of the settlement. At the end of October 2005, the appellant filed a petition for writ of certiorari before the United States Supreme Court.

Litigation Related to LeapFrog Enterprises, Inc.

Fisher-Price, Inc. ("Fisher-Price"), a subsidiary of Mattel, was sued for patent infringement by LeapFrog Enterprises, Inc. in a lawsuit filed in October 2003 in the United States District Court for the District of Delaware, and in September 2004, Mattel was joined to the lawsuit as a defendant. The lawsuit alleges that Fisher-Price's PowerTouch™ system infringes a LeapFrog patent relating to an electronic learning device for teaching phonics. A 10-day trial commenced on May 16, 2005, which resulted in a deadlocked jury. As an alternative to retrying the case, the parties agreed to submit the case for decision, based on the current trial record, to the presiding judge. The parties have filed their post-trial briefs, and the Court has not yet rendered a decision. The plaintiff in this lawsuit asserted a total damages claim of up to approximately \$90 million, which has been reduced to approximately \$58 million pursuant to rulings by the Court, and seeks an injunction preventing the further sale of the PowerTouch™ system; the damages could possibly be trebled if the infringement is found to be willful. Mattel and its subsidiary Fisher-Price believe the action is without merit and intend to continue to vigorously defend themselves.

Litigation Related to Carter Bryant and MGA Entertainment, Inc.

In April 2004, Mattel filed a lawsuit in Los Angeles County Superior Court against Carter Bryant ("Bryant"), a former Mattel design employee. The suit alleges that Bryant aided and assisted a Mattel competitor, MGA Entertainment, Inc. ("MGA"), during the time he was employed by Mattel, in violation of his contractual and other duties to Mattel. In September 2004, Bryant asserted counterclaims against Mattel, including counterclaims in which Bryant seeks, as a putative class action representative, to invalidate Mattel's Confidential Information and Proprietary Inventions Agreements with its employees.

In December 2004, MGA intervened as a party-defendant in Mattel's action against Bryant, asserting that its rights to the "Bratz" property are at stake in the litigation. Mattel's suit has been removed to the United States District Court for the Central District of California, where it is currently pending.

Separately, in November 2004, Bryant filed an action against Mattel in the United States District Court for the Central District of California. The action seeks a judicial declaration that Bryant's purported conveyance of rights in "Bratz" was proper and that he did not misappropriate Mattel property in creating "Bratz."

In April 2005, MGA filed suit against Mattel in the United States District Court for the Central District of California. MGA's action alleges claims of trade dress infringement, trade dress dilution, false designation of origin, unfair competition and unjust enrichment. The suit alleges, among other things, that certain products, themes, packaging and/or television commercials in various Mattel product lines have infringed upon products, themes, packaging and/or television commercials for various MGA product lines, including "Bratz." The complaint also asserts that various alleged Mattel acts with respect to unidentified retailers, distributors and licensees have damaged MGA and that various alleged acts by industry organizations, purportedly induced by Mattel, have damaged MGA.

MGA's suit alleges that MGA has been damaged in an amount "believed to reach or exceed tens of millions of dollars" and further seeks punitive damages, disgorgement of Mattel's profits and injunctive relief. Mattel believes the claims by Bryant and MGA are without merit and intends to vigorously defend against them.

Litigation Related to Cunningham

This suit was filed in September 1999 in the Circuit Court of Madison County, Illinois. The two named plaintiffs, who purchased "limited edition" Barbie® dolls, contended that Mattel's use of the term "limited edition" on Barbie® dolls was deceptive and fraudulent to consumers (and that it constituted a breach of contract and breach of express warranty)

Table of Contents

on the grounds that the dolls were not “true” limited editions and thus are not as valuable as they would be otherwise. Originally, the plaintiffs claimed that use of the terms “special edition,” “collector’s edition” and “exclusive” on Barbie[®] dolls was also deceptive and fraudulent to consumers and constituted a breach of contract and breach of express warranty, but these claims were dismissed during motion practice.

In 2003, a nationwide class of “all persons who have purchased limited edition Barbie[®] dolls or Barbie[®] dolls which were described, promoted or packaged as available only in small, limited amounts” was certified based on California Business and Professions Code sections 17200 and 17500 et seq. Plaintiffs’ claims under the Illinois Consumer Fraud Act, as well as their breach of contract and breach of express warranty claims, were not certified for class action treatment. The plaintiffs claimed that the class suffered compensatory damages of at least between \$100 million and \$200 million, and sought punitive damages, attorneys’ fees and injunctive relief.

In January 2005, the Court issued an order decertifying the nationwide class in its entirety, without prejudice to the two named plaintiffs attempting to re-certify the class at a later date. On July 14, 2005, as a result of a settlement between Mattel and the two named plaintiffs, the Court dismissed the action with prejudice. The lawsuit was settled for an amount that was not material to Mattel’s consolidated financial information for the three and nine months ended September 30, 2005.

17. Segment Information

Mattel’s reportable segments are separately managed business units and are divided on a geographic basis between domestic and international. The Domestic segment is further divided into Mattel Brands US, Fisher-Price Brands US and American Girl Brands.

Mattel’s portfolio of brands and products are grouped in the following categories:

Mattel Brands – including Barbie[®] fashion dolls and accessories (“Barbie[®]”), Polly Pocket![™] and Disney Classics (collectively “Other Girls Brands”), Hot Wheels[®], Matchbox[®] and Tyco[®] R/C vehicles and playsets (collectively “Wheels”) and Harry Potter[™], Yu-Gi-Oh![™], Batman[™], Justice League[™], MegaMan[™] and games and puzzles (collectively “Entertainment”).

Fisher-Price Brands – including Fisher-Price[®], Little People[®], Rescue Heroes[®], BabyGear and View-Master[®] (collectively “Core Fisher-Price[®]”), Sesame Street[®], Barney[™], Dora the Explorer[™], Winnie the Pooh, InteracTV[™] and See ‘N Say[®] (collectively “Fisher-Price[®] Friends”) and Power Wheels[®].

American Girl Brands – including American Girl Today[®], The American Girls Collection[®] and Bitty Baby[®]. American Girl Brands products are sold directly to consumers and its children’s publications are also sold to certain retailers.

The International segment sells products in all toy categories, except American Girl Brands. Mattel does not currently expect that the recent consolidation of its Mattel Brands and Fisher-Price Brands divisions will change its reportable segments.

The tables below present information about revenues, income and assets by segment. Mattel does not include sales adjustments such as trade discounts and other allowances in the calculation of segment revenues (hereinafter referred to as “gross sales”). Mattel records these adjustments in its financial accounting systems at the time of sale to each customer, but the adjustments are not allocated to individual products. For this reason, Mattel’s chief operating decision maker (as defined in SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*) uses gross sales by segment as one of the metrics to measure segment performance. Such sales adjustments are included in the determination of segment income (loss) from operations based on the adjustments recorded in the financial accounting systems. Segment income (loss) from operations represents operating income, while consolidated income from operations represents income before income taxes as reported in the consolidated statements of operations. The corporate and other category includes costs not allocated to individual segments, including charges related to incentive compensation and corporate headquarters functions managed on a worldwide basis. Segment assets are comprised of accounts receivable and inventories, net of applicable reserves and allowances.

Table of Contents

(In thousands)	For the Three Months Ended		For the Nine Months Ended	
	September 30,	September 30,	September 30,	September 30,
	2005	2004	2005	2004
Revenues				
Domestic:				
Mattel Brands US	\$ 439,215	\$ 503,874	\$ 926,200	\$ 991,063
Fisher-Price Brands US	500,020	480,607	892,963	879,300
American Girl Brands	69,051	61,393	195,484	164,662
Total Domestic	1,008,286	1,045,874	2,014,647	2,035,025
International	796,735	759,687	1,605,292	1,503,452
Gross sales	1,805,021	1,805,561	3,619,939	3,538,477
Sales adjustments	(138,876)	(138,100)	(283,851)	(286,070)
Net sales	\$ 1,666,145	\$ 1,667,461	\$ 3,336,088	\$ 3,252,407
Segment Income (Loss)				
Domestic:				
Mattel Brands US	\$ 99,243	\$ 134,220	\$ 143,353	\$ 207,819
Fisher-Price Brands US	89,252	95,334	95,804	99,163
American Girl Brands	5,858	2,144	17,675	(764)
Total Domestic	194,353	231,698	256,832	306,218
International	133,695	137,592	156,768	159,852
Corporate and other expense	328,048	369,290	413,600	466,070
Operating income	19,248	8,434	70,746	49,289
Interest expense	308,800	360,856	342,854	416,781
Interest (income)	16,842	20,847	54,044	52,456
Other non-operating (income), net	(4,280)	(5,238)	(28,789)	(14,278)
Income before income taxes	(15,101)	(5,872)	(28,694)	(17,410)
	\$ 311,339	\$ 351,119	\$ 346,293	\$ 396,013
	September 30, 2005	September 30, 2004	December 31, 2004	
Assets				
Domestic:				
Mattel Brands US	\$ 429,764	\$ 478,561	\$ 319,351	
Fisher-Price Brands US	428,709	413,563	177,508	
American Girl Brands	94,771	85,791	48,128	
Total Domestic	953,244	977,915	544,987	
International	977,705	871,703	588,144	
Corporate and other	1,930,949	1,849,618	1,133,131	
Accounts receivable and inventories, net	57,331	37,423	44,535	
	\$ 1,988,280	\$ 1,887,041	\$ 1,177,666	

Table of Contents

Mattel sells a broad variety of toy products, which are grouped into three major categories: Mattel Brands, Fisher-Price Brands and American Girl Brands. The table below presents worldwide revenues by category:

(In thousands)	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2005	September 30, 2004	September 30, 2005	September 30, 2004
Worldwide Revenues				
Mattel Brands	\$ 1,005,007	\$ 1,060,945	\$ 2,083,192	\$ 2,106,345
Fisher-Price Brands	727,409	683,072	1,329,063	1,261,684
American Girl Brands	69,051	61,393	195,484	164,662
Other	3,554	151	12,200	5,786
Gross sales	1,805,021	1,805,561	3,619,939	3,538,477
Sales adjustments	(138,876)	(138,100)	(283,851)	(286,070)
Net sales	\$ 1,666,145	\$ 1,667,461	\$ 3,336,088	\$ 3,252,407

18. New Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123 (revised 2004) (“SFAS No. 123(R)”), *Share-Based Payment*, which replaced SFAS No. 123 and superseded APB Opinion No. 25. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS No. 123 will no longer be an alternative to financial statement recognition. Under SFAS No. 123(R), Mattel must determine the appropriate fair value method to be used for valuing share-based payments, the amortization method of compensation cost and the transition method to be used at the time of adoption. The transition methods include prospective and retroactive adoption options. The prospective method requires that compensation cost be recorded for all unvested stock options and nonvested stock at the beginning of the first quarter of adoption of SFAS No. 123(R), whereas the retroactive method requires recording compensation cost for all unvested stock options and nonvested stock beginning with the first period restated.

In April 2005, the Securities Exchange Commission amended Rule S-X to delay the effective date for compliance with SFAS No. 123 (R). Based on the amended rule, Mattel is required to adopt SFAS No. 123(R) on January 1, 2006. Mattel is evaluating the requirements of SFAS No. 123(R) and expects that the adoption of SFAS No. 123(R) will have a material adverse effect on its results of operations and earnings per share. Mattel has not yet determined whether the amounts recorded in the consolidated statements of operations in future periods will be similar to the current pro forma disclosures under SFAS No. 123.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs – An Amendment of ARB No. 43, Chapter 4*. SFAS No. 151 amends the guidance in Chapter 4, “Inventory Pricing,” of Accounting Research Bulletin (“ARB”) No. 43, *Restatement and Revision of Accounting Research Bulletins*, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (“spoilage”). Among other provisions, the statement requires that items such as idle facility expense, excessive spoilage, double freight, and rehandling costs be recognized as current-period charges regardless of whether they meet the criterion of “so abnormal” as stated in ARB No. 43. Additionally, SFAS No. 151 requires that the allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for fiscal years beginning after June 15, 2005. Mattel is currently evaluating the effect that the adoption of SFAS No. 151 will have on its results of operations and financial position, but does not expect it to have a material impact.

Table of Contents

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

MATTEL, INC. AND SUBSIDIARIES MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the consolidated financial information and related notes that appear in Part I of this Quarterly Report. Mattel's business is seasonal, and, therefore, results of operations are comparable only with corresponding periods.

Overview

Mattel designs, manufactures, and markets a broad variety of toy products worldwide through sales to retailers and wholesalers (i.e., "customers") and directly to consumers. Mattel's business is dependent in great part on its ability each year to redesign, restyle and extend existing core products and product lines, to design and develop innovative new products and product lines, and to successfully market those products and product lines. Mattel plans to continue to focus on its portfolio of traditional brands that have historically had worldwide appeal, to create new brands utilizing its knowledge of children's play patterns and to target customer and consumer preferences around the world.

Mattel's portfolio of brands and products are grouped in the following categories:

Mattel Brands – including Barbie[®] fashion dolls and accessories ("Barbie[®]"), Polly Pocket![™] and Disney Classics (collectively "Other Girls Brands"), Hot Wheels[®], Matchbox[®] and Tyco[®] R/C vehicles and playsets (collectively "Wheels") and Harry Potter[™], Yu-Gi-Oh![™], Batman[™], Justice League[™], MegaMan[™] and games and puzzles (collectively "Entertainment").

Fisher-Price Brands – including Fisher-Price[®], Little People[®], Rescue Heroes[®], BabyGear and View-Master[®] (collectively "Core Fisher-Price[®]"), Sesame Street[®], Barney[™], Dora the Explorer[™], Winnie the Pooh, InteracTV[™] and See 'N Say[®] (collectively "Fisher-Price[®] Friends") and Power Wheels[®].

American Girl Brands – including American Girl Today[®], The American Girls Collection[®] and Bitty Baby[®]. American Girl Brands products are sold directly to consumers and its children's publications are also sold to certain retailers.

On October 10, 2005, Mattel announced the consolidation of its Mattel Brands and Fisher-Price Brands divisions into one division. The creation of the new "Mattel Brands" division, which will result in the consolidation of management and support functions, is expected to more effectively and efficiently leverage Mattel's scale and will preserve the natural marketing and design groups that are empowered to create and market toys based on gender and age segments. These changes are consistent with Mattel's ongoing strategy to build brands, cut costs and develop people in a streamlined organization that is focused on scale, innovation and execution.

Management believes that the business environment for Mattel in 2005 will be similar to that of 2004. Mattel expects to continue facing challenges both domestically and internationally as retailers continue to rationalize stores and tightly manage inventory. In the first nine months of 2005, sales increases across much of Mattel's portfolio have been partially offset by declines in the Barbie[®] brand. Additionally, Mattel has experienced cost pressures in the areas of product costs, including oil-based resin, the impact of the recent strengthening of the Chinese yuan against the US dollar, transportation costs, and employee-related costs. Management believes that, for at least the remainder of 2005, Mattel will continue to encounter a challenging retail environment, along with cost pressures, and the possibility of continued sales declines in the Barbie[®] brand.

Mattel's objective is to continue to create long-term shareholder value by generating strong cash flow and deploying it in a disciplined and opportunistic manner as outlined in Mattel's capital and investment framework. To achieve this objective management has established two overarching goals. The first goal is to drive sales growth by reinvigorating the Barbie[®] brand, while maintaining growth in other core brands by continuing to develop innovative toys. Management's principal strategies for driving sales growth are as follows: (i) focusing on its core brands and core markets; (ii) aligning more effectively with growing retail customers by building closer partnerships with these customers around the world; and (iii) investing in developing markets, expanding its presence in categories in which Mattel does not currently have an extensive presence, and growing alternative sales channels.

Table of Contents

Additionally, Mattel plans to pursue additional licensing arrangements and strategic partnerships to extend its portfolio of brands into areas outside of traditional toys.

The second goal is to continue rationalizing manufacturing and vendor sourcing to reduce the cost of manufacturing, purchasing and distributing Mattel's products, and improve Mattel's cost structure by gaining further efficiencies in the supply chain through implementation of new spend management and e-procurement policies, procedures and information systems.

Results of Operations

Third Quarter

Consolidated Results

Sales increases across much of Mattel's portfolio, Hot Wheels[®], Fisher-Price[®], and American Girl[®], as well as key contributions from Entertainment properties such as Batman[™], Dora the Explorer[™] and the Disney Princesses line, were offset by declines in the Barbie[®] brand. Net sales for the third quarter of 2005 were flat at \$1.67 billion, as compared to 2004, including a benefit from changes in currency exchange rates of 1 percentage point. Net income for the third quarter of 2005 was \$225.3 million, or \$0.55 per diluted share, as compared to net income of \$255.8 million, or \$0.61 per diluted share, for the third quarter of 2004. Gross profit, as a percentage of net sales, declined from 47.8% in 2004 to 45.7% in 2005. External cost pressures were the primary cause of the decline in gross profit, including higher raw material, transportation, and royalty costs. Gross profit for the quarter was also negatively impacted by higher sales of lower margin products. These factors were partially offset by a modest price increase implemented in January 2005 and a benefit from changes in currency exchange rates.

The following table provides a summary of Mattel's consolidated results for the third quarter of 2005 and 2004:

(In millions, except percentage and basis point information)	For the Three Months Ended				Year/Year Change	
	September 30, 2005		September 30, 2004			
	Amount	% of Net	Amount	% of Net	%	Basis Points of Net Sales
		Sales		Sales		
Net sales	\$1,666.1	100.0%	\$1,667.5	100.0%	0%	
Gross profit	\$ 761.3	45.7%	\$ 796.7	47.8%	-4%	(210)
Advertising and promotion expenses	191.6	11.5	192.1	11.5	0%	
Other selling and administrative expenses	260.9	15.7	243.7	14.7	7%	100
Operating income	308.8	18.5	360.9	21.6	-14%	(310)
Interest expense	16.8	1.0	20.8	1.3	-19%	(30)
Interest (income)	(4.3)	(0.3)	(5.2)	(0.3)	-18%	—
Other non-operating (income), net	(15.0)		(5.8)			
Income before income taxes	\$ 311.3	18.7%	\$ 351.1	21.1%	-11%	(240)

Sales

Net sales for the third quarter of 2005 were flat at \$1.67 billion, as compared to 2004, including a benefit from changes in currency exchange rates of 1 percentage point. Gross sales within the US decreased 4% as compared to 2004 and accounted for 56% of consolidated gross sales in 2005 compared to 58% in 2004. In 2005, gross sales in international markets increased 5% compared to 2004, including a benefit from changes in currency exchange rates of 3 percentage points.

Worldwide gross sales of Mattel Brands decreased 5% in the third quarter of 2005 to \$1.01 billion, including a 2 percentage point benefit from changes in currency exchange rates. Domestic gross sales of Mattel Brands decreased 13%, and international gross sales of Mattel Brands increased 2%, including a 3 percentage point benefit from changes in currency exchange rates. Worldwide gross sales for Barbie[®] declined 18% from 2004, including a 1 percentage point benefit from changes in currency exchange rates. Domestic gross sales of Barbie[®] declined 30%, and international gross sales of Barbie[®] declined 8%, including a 2 percentage point benefit from changes in currency exchange rates. Worldwide gross sales of Other Girls Brands increased double-digits primarily driven by sales of Disney Princesses, Winx Club[™], Pound Puppies[®], and large dolls, including Little Mommy[™] and Teen Trends[™].

Table of Contents

Worldwide gross sales in the Wheels category increased 4%, including a 2 percentage point benefit from changes in currency exchange rates. Worldwide gross sales of the Hot Wheels[®] product line increased 8%, including a 3 percentage point benefit from changes in currency exchange rates. Worldwide gross sales in the Entertainment category decreased 7%, including a 2 percentage point benefit from changes in currency exchange rates. While worldwide sales of Batman[™] products continued to be strong during the third quarter, the Entertainment category was negatively impacted by sales declines in Yu-Gi-Oh![™] worldwide, and JuiceBox[™] in the US.

Worldwide gross sales of Fisher-Price Brands increased 6% in the third quarter of 2005 to \$727.4 million. Worldwide sales of Core Fisher-Price[®] were flat as compared to 2004, reflecting strong growth in international sales driven by continued success in the Infant and BabyGear product lines, offset by declines in domestic sales as shipments lagged strong performance at retail. Worldwide gross sales of Fisher-Price[®] Friends increased 21%, including a 1 percentage point benefit from changes in currency exchange rates, due to continued strength of the Dora the Explorer[™] property.

American Girl Brands gross sales increased 12% in the third quarter of 2005 to \$69.1 million, reflecting continued success of the new American Girl Today[®] doll, Marisol[™], which was launched in January 2005, and continued strong performance of the American Girl Place[®] retail stores.

Gross Profit

Gross profit, as a percentage of net sales, was 45.7% in the third quarter of 2005, compared to 47.8% in the third quarter of 2004. External cost pressures in transportation and raw material costs, sales of lower margin products, including shifts in sales volume from Barbie[®] products to other products, and higher royalty costs were the primary causes of the decline in gross profit. These factors were partially offset by a modest price increase implemented in January 2005 and a benefit from changes in currency exchange rates. Mattel expects the cost pressures to continue throughout the remainder of 2005, and this may adversely affect Mattel's gross profit. Management remains committed to at least partially offsetting the cost pressures through continuous improvement initiatives aimed at driving costs out of the sourcing and distribution networks.

Advertising and Promotion Expenses

Advertising and promotion expenses remained flat at 11.5% of net sales in the third quarter of 2005 compared to 2004. Mattel expects advertising spending levels for 2005, as a percentage of net sales, to be fairly consistent with 2004 to support its plan to invest in the business to drive long-term performance.

Other Selling and Administrative Expenses

Other selling and administrative expenses were \$260.9 million, or 15.7% of net sales, in the third quarter of 2005 compared to \$243.7 million, or 14.7% of net sales, in the third quarter of 2004. Other selling and administrative expenses was negatively impacted by higher employee-related costs, as well as continued investments in product design and development and emerging international markets.

Non-Operating Items

Interest expense decreased from \$20.8 million in the third quarter of 2004 to \$16.8 million in the third quarter of 2005, mainly due to lower short-term and long-term debt, resulting from the repayment of \$40.0 million of medium-term notes during the fourth quarter of 2004 and \$150.0 million of 6 1/8 senior notes in July 2005, and a reduction of commercial paper borrowings, partially offset by higher average short-term borrowing rates. Other non-operating (income), net was \$15.0 million in the third quarter of 2005, compared to \$5.8 million in the third quarter of 2004, and was mainly comprised of gains from the sale of marketable securities. As of September 30, 2005, Mattel held no marketable securities.

Business Segment Results

Mattel's reportable segments are separately managed business units and are divided on a geographic basis between domestic and international. The Domestic segment is further divided into Mattel Brands US, Fisher-Price Brands US and American Girl Brands.

Table of Contents

Domestic Segment

Mattel Brands US gross sales decreased 13% in the third quarter of 2005 compared to the third quarter of 2004. Within this segment, Barbie[®] gross sales declined 30% and sales of Other Girls Brands increased double-digits driven primarily by increased sales of Disney Princesses and large dolls including Little Mommy[™] and Teen Trends[™]. Gross sales in the Wheels category increased slightly. Gross sales in the Entertainment category decreased double digits driven by decreased sales of Yu-Gi-Oh![™] and JuiceBox[™], partially offset by strong sales of Batman[™] products. Mattel Brands US segment income decreased from \$134.2 million to \$99.2 million in the third quarter of 2005, primarily due to sales declines, lower gross profit caused by external cost pressures, sales of lower margin products and higher royalty costs, which were partially offset by the modest price increase implemented in January 2005, and higher employee-related costs.

Fisher-Price Brands US gross sales increased 4% in the third quarter of 2005 compared to the third quarter of 2004, mainly due to increased sales of Fisher-Price[®] Friends, driven by continued success of the Dora the Explorer[™] property. Fisher-Price Brands US segment income decreased to \$89.3 million in the third quarter of 2005, compared to \$95.3 million in the third quarter of 2004, primarily due to lower gross profit margins caused by external cost pressures, which were partially offset by the modest price increase implemented in January 2005 and increased sales volume.

American Girl Brands gross sales increased 12% in the third quarter of 2005 to \$69.1 million, reflecting continued success of the new American Girl Today[®] doll, Marisol[™], which was launched in January 2005, and continued strong performance of the American Girl Place[®] retail stores. American Girl Brands segment income increased from \$2.1 million in the third quarter of 2004 to \$5.9 million in the third quarter of 2005, primarily due to increased sales volume and improved gross profit margins.

International Segment

The following table provides a summary of percentage changes in gross sales within the International segment for the third quarter of 2005 versus 2004:

	% Change in Gross Sales	Impact of Change in Currency (in % pts)
Non-US Regions:		
Europe	(3)	—
Latin America	29	10
Canada	—	6
Asia Pacific	1	4
Total International	5	3

International gross sales increased 5% in the third quarter of 2005 compared to the third quarter of 2004, including a benefit from changes in currency exchange rates of 3 percentage points. Gross sales of Barbie[®] decreased 8%, including a 2 percentage point benefit from changes in currency exchange rates. Gross sales of Other Girls Brands increased double-digits primarily driven by increased sales of Disney Princesses, Winx Club[™], Pound Puppies[®], and large dolls including Little Mommy[™] and Teen Trends[™]. Gross sales increased in the Wheels category, reflecting growth in Hot Wheels[®] and Matchbox[®], partially offset by declines in sales of Tyco[®] R/C. Gross sales in the Entertainment category increased double digits, driven by strong sales of Batman[™] products due to the movie release in June 2005, partially offset by sales declines of the Yu-Gi-Oh![™] properties. Fisher-Price Brands gross sales increased 12%, including a benefit from changes in currency exchange rates of 2 percentage points, resulting from strong sales of Fisher-Price[®] Friends, mainly due to the Dora the Explorer[™] property, and Core Fisher-Price[®] products, including Infant and BabyGear product lines. International segment income decreased 3% to \$133.7 million in the third quarter of 2005 due to a decrease in gross profit margins and higher employee-related costs, partially offset by an increase in sales volume and benefits from changes in currency exchange rates.

Table of Contents

Results of Operations

First Nine Months

Consolidated Results

Sales increases across much of Mattel's portfolio for the first nine months of 2005 were partially offset by declines in the Barbie® brand. Net sales for the first nine months of 2005 were \$3.34 billion, a 3% increase compared to \$3.25 billion in the first nine months of 2004, including a benefit from changes in currency exchange rates of 2 percentage points. Net income for the first nine months of 2005 was \$137.9 million, or \$0.33 per diluted share, as compared to net income of \$288.4 million, or \$0.68 per diluted share, for the first nine months of 2004. The net income for the first nine months of 2005 included income tax expense of \$112.9 million related to the repatriation of unremitted foreign earnings under the Jobs Act. See "Income Taxes" for further discussion. Gross profit, as a percentage of net sales, declined from 46.6% in 2004 to 44.7% in 2005. External cost pressures in transportation and raw materials costs, sales of lower margin products, and higher obsolescence and royalty costs were the primary causes of the decline in gross profit. These factors were partially offset by a modest price increase implemented in January 2005 and a benefit from changes in currency exchange rates. For the first nine months of 2004, profitability was negatively impacted by a pre-tax charge of \$15.2 million, primarily related to the elimination of approximately 285 positions as a result of headcount reductions at certain domestic and international locations, and integration of the Matchbox® and Tyco® R/C business located in New Jersey into the Hot Wheels® business in California, partially offset by net favorable legal settlements.

The following table provides a summary of the consolidated results for the first nine months of 2005 and 2004:

(In millions, except percentage and basis point information)	For the Nine Months Ended					
	September 30, 2005		September 30, 2004		Year/Year Change	
	% of Net		% of Net		%	Basis Points of Net Sales
	Amount	Sales	Amount	Sales		
Net sales	\$3,336.1	100.0%	\$3,252.4	100.0%	3%	
Gross profit	\$1,492.1	44.7%	\$1,514.7	46.6%	-1%	(190)
Advertising and promotion expenses	372.4	11.2	363.9	11.2	2%	—
Other selling and administrative expenses	776.8	23.2	734.0	22.6	6%	60
Operating income	342.9	10.3	416.8	12.8	-18%	(250)
Interest expense	54.0	1.6	52.5	1.6	3%	—
Interest (income)	(28.7)	(0.9)	(14.3)	(0.4)	102%	50
Other non-operating (income), net	(28.7)		(17.4)			
Income before income taxes	\$ 346.3	10.4%	\$ 396.0	12.2%	-13%	(180)

Sales

Worldwide net sales for the first nine months of 2005 increased 3% to \$3.34 billion compared to the first nine months of 2004, including a 2 percentage point benefit from changes in currency exchange rates. Worldwide gross sales for the first nine months of 2005 increased 2% compared to the first nine months of 2004, including a 1 percentage point benefit from changes in currency exchange rates. Gross sales in the US decreased 1% and accounted for 56% of consolidated gross sales in 2005 compared to 58% in 2004. Gross sales for the first nine months of 2005 in international markets increased 7% compared to 2004, including a 4 percentage point benefit from changes in currency exchange rates.

Worldwide gross sales of Mattel Brands in the first nine months of 2005 decreased 1% to \$2.08 billion, including a 2 percentage point benefit from changes in currency exchange rates. Domestic gross sales of Mattel Brands decreased 7% and international gross sales of Mattel Brands increased 4%, including a benefit from changes in currency exchange rates of 4 percentage points. Worldwide gross sales of Barbie® declined 14% from 2004, including a 2 percentage point benefit from changes in currency exchange rates. Domestic gross sales of Barbie® decreased 23% and international gross sales of Barbie® decreased 7%, including a 2 percentage point benefit from changes in currency exchange rates. Worldwide gross sales of Other Girls Brands increased double-digits driven by strong sales as a result of new product introductions, including Disney Princesses, Winx Club™, Pound Puppies®, Doggie Daycare™ and Furryville™ and increased sales of large dolls including Little Mommy™ and Teen Trends™. Worldwide gross sales in the Wheels

Table of Contents

category increased 2% compared to 2004, including a 2 percentage point benefit from changes in currency exchange rates. Worldwide gross sales of the Hot Wheels[®] product line increased 4%, including a 2 percentage point benefit from changes in currency exchange rates. Worldwide gross sales in the Entertainment category increased 8%, including a 2 percentage point benefit from changes in currency exchange rates, compared to 2004, primarily driven by continued strength in male-action properties, including Batman[™] and Robots[™], partially offset by sales declines of the Yu-Gi-Oh![™] and Harry Potter[™] properties.

Worldwide gross sales of Fisher-Price Brands in the first nine months of 2005 compared to the first nine months of 2004 increased 5% to \$1.33 billion, including a benefit of 1 percentage point from changes in currency exchange rates. International gross sales of Fisher-Price Brands grew 14%, including a benefit of 3 percentage points from changes in currency exchange rates while domestic sales of Fisher-Price Brands increased 2% compared to the first nine months of 2004. The increase in international sales over 2004 was mainly attributable to sales growth in Infant and BabyGear lines and double-digit growth in Fisher-Price[®] Friends, due to continued strength of the Dora the Explorer[™] property.

American Girl Brands gross sales increased 19% in the first nine months of 2005 over the first nine months of 2004 to \$195.5 million, reflecting increased sales from the January 2005 launch of the new American Girl Today[®] doll, Marisol[™], and continued strong performance of the American Girl Place[®] retail stores.

Gross Profit

Gross profit, as a percentage of net sales, was 44.7% in the first nine months of 2005, compared to 46.6% in the first nine months of 2004. External cost pressures in transportation and raw materials costs, sales of lower margin products, including shifts in sales volume from Barbie[®] products to other products, and higher obsolescence and royalty costs were the primary causes of the decline in gross profit. These factors were partially offset by a modest price increase implemented in January 2005 and a benefit from changes in currency exchange rates.

Advertising and Promotion Expenses

Advertising and promotion expenses remained flat at 11.2% of net sales in the first nine months of 2005 compared to 2004. Mattel expects advertising spending levels for 2005, as a percentage of net sales, to be fairly consistent with 2004 to support its plan to invest in the business to drive long-term performance.

Other Selling and Administrative Expenses

Other selling and administrative expenses were \$776.8 million, or 23.2% of net sales, in the first nine months of 2005, compared to \$734.0 million, or 22.6% of net sales, in the first nine months of 2004. Other selling and administrative expenses benefited in the first nine months of 2005 from lower severance charges as compared to 2004. However, this benefit was offset by higher employee-related costs, the negative effect of changes in currency exchange rates on overhead costs, continued investment in product design and development and emerging international markets, and net favorable legal settlements in 2004, which were not repeated in 2005.

Non-Operating Items

Interest expense increased from \$52.5 million in the first nine months of 2004 to \$54.0 million in the first nine months of 2005, primarily due to higher average short-term borrowing rates, partially offset by lower long-term debt as a result of the repayment of \$40.0 million of medium-term notes during the fourth quarter of 2004 and \$150.0 million of 6 1/8 senior notes in July 2005, and a reduction of commercial paper borrowings. Interest (income) for the first nine months of 2005 totaled \$28.7 million, an increase of \$14.4 million over the first nine months of 2004, primarily due to higher returns earned on short-term investments. Other non-operating (income), net was \$28.7 million in the first nine months of 2005, compared to \$17.4 million in the first nine months of 2004, and was mainly comprised of gains from the sale of marketable securities. As of September 30, 2005, Mattel held no marketable securities.

Table of Contents

Business Segment Results

Domestic Segment

Mattel Brands US gross sales decreased 7% in the first nine months of 2005 compared to the first nine months of 2004. Within this segment, gross sales of Barbie[®] declined 23%, and sales of Other Girls Brands increased double-digits as a result of several new brand introductions, including Disney Princesses, Pound Puppies[®] and increased sales of large dolls including Little Mommy[™] and Teen Trends[™]. Gross sales in the Wheels category decreased. Gross sales in the Entertainment category decreased primarily related to declines in sales of Yu-Gi-Oh![™], Harry Potter[™] and JuiceBox[™], offset by strong sales of Batman[™] and Robots[™] products. Mattel Brands US segment income decreased 31% to \$143.4 million for the first nine months of 2005, primarily due to a decline in sales volume, lower gross profit margin (which was caused by external cost pressures, sales of lower margin products and higher royalty and obsolescence costs), and higher employee-related costs, partially offset by a modest price increase.

Fisher-Price Brands US gross sales increased 2% in the first nine months of 2005 compared to 2004 due to a double-digit growth in Fisher-Price[®] Friends, mainly attributable to Dora the Explorer[™] products, offset by a decrease in sales of Core Fisher-Price[®] products. Fisher-Price Brands US segment income decreased 3% to \$95.8 million for the first nine months of 2005, primarily due to higher employee-related costs and additional investment in product design and development, partially offset by increased sales volume and a modest price increase.

American Girl Brands gross sales increased 19% to \$195.5 million in the first nine months of 2005, reflecting increased sales from the January 2005 launch of the new American Girl Today[®] doll, Marisol[™], and continued strength of the American Girl Place[®] retail stores. American Girl Brands segment income improved from a loss of \$0.8 million in the first nine months of 2004 to income of \$17.7 million in the first nine months of 2005, driven by increased sales volume and improved gross profit.

International Segment

The following table provides a summary of percentage changes in gross sales within the International segment for the first nine months of 2005 versus the first nine months of 2004:

Non-US Regions:	% Change in Gross Sales	Impact of Change in Currency (in % pts)
Europe	1	2
Latin America	30	9
Canada	(3)	6
Asia Pacific	5	4
Total International	7	4

International segment gross sales increased 7% in the first nine months of 2005 compared to the first nine months of 2004, which included a benefit from changes in currency exchange rates of 4 percentage points. Gross sales of Barbie[®] decreased 7%, including a benefit from changes in currency exchange rates of 2 percentage points. Gross sales in the Other Girls Brands increased double-digits driven by new product introductions, including Disney Princesses, Winx Club[™], and Pound Puppies[®] and increased sales in large dolls including Little Mommy[™] and Teen Trends[™]. Gross sales increased single digits in the Wheels category in the first nine months of 2005 compared to the first nine months of 2004, mainly due to double-digit growth in Hot Wheels[®] products. Gross sales in the Entertainment category increased double digits in the first nine months of 2005 compared to the first nine months of 2004, primarily due to strong sales in male-action properties including Batman[™], Robots[™] and Megaman[™], partially offset by sales declines in the Harry Potter[™] and Yu-Gi-Oh![™] properties. Fisher-Price Brands gross sales increased 14%, including a benefit from changes in currency exchange rates of 3 percentage points, due to strong growth in Core Fisher-Price[®] products, including Infant and BabyGear, and Fisher-Price[®] Friends. International segment income decreased 2% in the first nine months of 2005 compared to the first nine months of 2004 as result of increased external cost pressures, higher employee-related costs and investments in emerging international markets, partially offset by an increase in sales volume, benefits from changes in currency exchange rates and a modest price increase.

Table of Contents

Income Taxes

On October 22, 2004, the Jobs Act was signed into law. Among its various provisions, the Jobs Act creates a temporary incentive for US corporations to repatriate accumulated income earned abroad by providing an 85% dividends received deduction for certain qualifying dividends. On December 21, 2004, the Financial Accounting Standards Board (“FASB”) issued Staff Position 109-2 (“FSP 109-2”), *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004*. FSP 109-2 allows companies additional time beyond the financial reporting period in which the Jobs Act was enacted to evaluate the effect of the Jobs Act on a company’s plan for reinvestment or repatriation of unremitted foreign earnings for the purposes of applying SFAS No. 109, *Accounting For Income Taxes*.

Management’s plan for reinvestment and repatriation of foreign earnings under the Jobs Act was completed and approved by Robert A. Eckert, Mattel’s chief executive officer, on April 14, 2005. Mattel expects to repatriate up to approximately \$2.4 billion in foreign earnings and has repatriated approximately \$1.2 billion during the nine months ended September 30, 2005, with the remaining half to be repatriated by the end of this year. Management has identified several qualified uses for reinvestment of the foreign earnings repatriated under the Jobs Act, including employee compensation, hiring and training, research and development costs, and advertising and promotion expenses. Management believes that Mattel’s aggregate spending in these areas will satisfy the reinvestment spending requirements outlined in the safe harbor provision of the Jobs Act.

The statements of operations for the nine months ended September 30, 2005, include a provision for income taxes of \$112.9 million for the total amount of earnings expected to be repatriated, which will occur throughout 2005. The tax provision may be further impacted by future law changes enacted by the US Congress or further guidance issued by the IRS. The impact of such future changes will be reflected in the financial reporting period in which any such change in law is enacted or becomes effective.

Liquidity and Capital Resources

Mattel’s primary sources of liquidity for the first nine months of 2005 were cash on hand at the beginning of the year and short-term borrowings. Cash flows from operations could be negatively impacted by decreased demand for Mattel’s products, which could result from factors such as adverse economic conditions and changes in public and consumer preferences, or by increased costs associated with manufacturing and distribution of products or shortages in raw materials or component parts. Additionally, Mattel’s ability to issue long-term debt and obtain seasonal financing could be adversely affected by factors such as an inability to meet its debt covenant requirements, which include maintaining consolidated debt-to-capital and interest coverage ratios, or a deterioration of Mattel’s credit ratings. Mattel’s ability to conduct its operations could be negatively impacted should these or other adverse conditions affect its primary sources of liquidity.

Capital and Investment Framework

To guide future capital deployment decisions, with a goal of maximizing shareholder value, Mattel’s board of directors, in 2003, established the following capital and investment framework:

- To maintain approximately \$800 million to \$1 billion in year-end cash available to fund a substantial portion of seasonal working capital;
- To maintain a year-end debt-to-total capital ratio of approximately 25%;
- To invest approximately \$180 million to \$200 million in capital expenditures annually to maintain and grow the business;
- To make strategic acquisitions consistent with Mattel’s vision of providing “the world’s premier toy brands - today and tomorrow”; and
- To return excess funds to shareholders through dividends and share repurchases.

Over the long term, assuming cash flows from operating activities remain strong, Mattel plans to use its free cash flows to invest in strategic acquisitions and to return funds to shareholders through cash dividends and, depending on market conditions, share repurchases. However, the ability to successfully implement the capital deployment plan is directly dependent on Mattel’s ability to generate strong cash flows from operating activities. There is no assurance that Mattel will continue to generate strong cash flows from operating activities or achieve its targeted goals from investing activities.

Table of Contents

The repatriation of foreign earnings under the Jobs Act does not change management's view of Mattel's capital and investment framework. The movement of cash into the US from offshore may allow Mattel to reduce its seasonal working capital borrowings in the US and will provide Mattel with greater flexibility to fund activities in other areas in accordance with its capital and investment framework.

Operating Activities

Cash flows used for operating activities was \$629.0 million in the first nine months of 2005, an increase of \$79.9 million compared to the first nine months of 2004. The increase in cash flows used for operating activities in 2005 was primarily driven by lower net income.

Investing Activities

Cash flows used for investing activities in the first nine months of 2005 was \$38.2 million compared to \$84.1 million in the first nine months of 2004. Cash flows used for investing activities was lower in 2005 primarily due to lower capital expenditures, increased proceeds from the sale of investments, and a reduced payment for businesses acquired in 2005 as compared to 2004.

Financing Activities

Cash flows used for financing activities in the first nine months of 2005 was \$311.3 million compared to \$185.4 million in the first nine months of 2004. The primary reason for the increase was Mattel's repayment of its \$150.0 million 6 ¹/₈ % senior notes in July 2005 upon maturity. Mattel intends to repay a \$38.4 million mortgage note in November 2005 upon maturity.

Seasonal Financing

Mattel's financing of seasonal working capital typically grows throughout the first half of the year and peaks in the third or fourth quarter, when inventories are at their highest levels in anticipation of expected second half sales volume and when accounts receivable are at their highest levels due to increased sales volume, consistent with the industry taken as a whole. Mattel maintains and periodically amends or replaces a domestic unsecured committed revolving credit facility with a commercial bank group that is used as the primary source of financing for the seasonal working capital requirements of its domestic subsidiaries. The agreement in effect was amended and restated in March 2005 and the expiration date of the facility was extended to March 23, 2010. All other terms and conditions of the amended facility are substantially similar to the previous facility, including the consolidated debt-to-capital and interest coverage ratios. Interest is charged at various rates selected by Mattel, ranging from market commercial paper rates to the bank reference rate. The domestic unsecured committed revolving credit facility contains a variety of covenants, including financial covenants that require Mattel to maintain certain consolidated debt-to-capital and interest coverage ratios. Specifically, Mattel is required to meet these financial covenant ratios at the end of each fiscal quarter and fiscal year, using the formulae specified in the credit agreement to calculate the ratios. Mattel was in compliance with such covenants at the end of the third quarter of 2005. As of September 30, 2005, Mattel's consolidated debt-to-capital ratio, as calculated per the terms of the credit agreement, was 0.24 to 1 (compared to a maximum allowed of 0.60 to 1) and Mattel's interest coverage ratio was 11.37 to 1 (compared to a minimum allowed of 3.50 to 1). The domestic unsecured committed revolving credit facility is a material agreement and failure to comply with the financial covenant ratios may result in an event of default under the terms of the facility. If Mattel defaulted under the terms of the domestic unsecured committed revolving credit facility, its ability to meet its seasonal financing requirements could be adversely affected.

To finance seasonal working capital requirements of certain foreign subsidiaries, Mattel utilizes individual short-term credit lines with a number of banks. Mattel expects to extend these credit lines throughout 2005.

Mattel believes its cash on hand at the beginning of 2005, amounts available under its domestic unsecured committed revolving credit facility, its uncommitted money market facility, and its foreign credit lines will be adequate to meet its seasonal financing requirements in 2005.

Table of Contents

In October 2005, two major credit rating agencies changed Mattel's long-term credit rating outlook to negative and one of the credit rating agencies reduced Mattel's short-term credit rating. Management does not expect these actions to have a significant impact on Mattel's ability to obtain financing or to have a significant negative impact on Mattel's liquidity or results of operations.

Mattel has a \$300.0 million domestic receivables sales facility that is a sub-facility of Mattel's domestic unsecured committed revolving credit facility. The outstanding amount of receivables sold under the domestic receivables facility may not exceed \$300.0 million at any given time, and the amount available to be borrowed under the credit facility is reduced to the extent of any such outstanding receivables sold. Under the domestic receivables facility, certain trade receivables are sold to a group of banks, which currently include, among others, Bank of America, N.A., as administrative agent, Citicorp USA, Inc. and Barclays Bank PLC, as co-syndication agents, and Societe Generale and BNP Paribas, as co-documentation agents. Pursuant to the domestic receivables facility, Mattel Sales Corp. and Fisher-Price, Inc. (which are wholly-owned subsidiaries of Mattel) can sell eligible trade receivables from Wal-Mart and Target to Mattel Factoring, Inc. ("Mattel Factoring"), a Delaware corporation and wholly-owned, consolidated subsidiary of Mattel. Mattel Factoring is a special purpose entity whose activities are limited to purchasing and selling receivables under this facility. Pursuant to the terms of the domestic receivables facility and simultaneous with each receivables purchase, Mattel Factoring sells those receivables to the bank group. Mattel records the transaction, reflecting cash proceeds and sale of accounts receivable on its consolidated balance sheet, at the time of the sale of the receivables to the bank group.

Mattel International Holdings B.V., a company incorporated in the Netherlands, Mattel France S.A.S., a company incorporated in France, and Mattel GmbH, a company incorporated in Germany, each of which is a subsidiary of Mattel, and Societe Generale Bank Nederland N.V. are parties to a Master Agreement for the Transfer of Receivables establishing a Euro 150 million European trade receivables facility, pursuant to which Mattel France S.A.S. and Mattel GmbH may sell trade receivables to Societe Generale Bank Nederland N.V. As with the domestic receivables facility, each sale of accounts receivable is recorded on Mattel's consolidated balance sheet at the time of such sale. No Mattel subsidiary is used as a special purpose entity in connection with these transactions. Under the European trade receivables facility, the outstanding amount of receivables sold may not exceed Euro 60 million from February 1 through July 31 of each year and may not exceed Euro 150 million at all other times. Pursuant to a letter agreement between Societe Generale Bank Nederland N.V. and Mattel International Holdings B.V., Mattel France S.A.S. and Mattel GmbH effective June 24, 2005, the commitment termination date for the European trade receivables facility was extended to June 23, 2006.

In October 2005, Mattel Asia Pacific Sourcing Limited ("MAPS"), a wholly-owned subsidiary of Mattel, entered into a commitment letter with Bank of America N.A. and Banc of America Securities LLC, regarding the arrangement and syndication of senior credit facilities in the maximum aggregate principal amount of \$325.0 million ("MAPS senior credit facilities"). The MAPS senior credit facilities, which will be guaranteed by Mattel, will consist of a \$225.0 million term loan facility and a \$100.0 million revolving credit facility and will mature on the third anniversary of the closing date. The closing date for the establishment of the MAPS senior credit facilities is anticipated to occur on or before December 30, 2005.

The outstanding amounts of accounts receivable that have been sold under these facilities and other factoring arrangements, net of collections from customers, have been excluded from Mattel's consolidated balance sheets and are summarized as follows:

(In millions)	September 30, 2005	September 30, 2004	December 31, 2004
Receivables sold pursuant to the:			
Domestic receivables facility	\$ 182.5	\$ 189.3	\$ 253.4
European receivables facility	115.4	138.4	93.8
Other factoring arrangements	38.3	40.2	99.1
	<u>\$ 336.2</u>	<u>\$ 367.9</u>	<u>\$ 446.3</u>

Financial Position

Mattel's cash and equivalents at September 30, 2005 decreased \$983.0 million to \$173.8 million compared to year end 2004, primarily due to cash flows used for operating, investing and financing activities, including the repurchase of shares of its common stock at a cost of \$249.9 million and the repayment of the \$150.0 million 6 1/8 % senior notes in July 2005 upon maturity. Accounts receivable, net increased \$503.4 million to \$1,262.4 million at September 30, 2005 compared to year end 2004 due to the seasonality of Mattel's business.

Table of Contents

Accounts payable and accrued liabilities decreased \$160.0 million to \$1,069.2 million at September 30, 2005 compared to year end 2004 due to payment of year end 2004 accounts payable and various accrued liability balances, including receivables collections due to bank related to the European trade receivables facility, incentive compensation and royalties. The current portion of long-term debt decreased \$100.8 million to \$88.4 million at September 30, 2005 compared to year end 2004, primarily due to repayment of the \$150.0 million 6 ¹/₈ % senior notes upon maturity in July 2005, partially offset by the reclassification of \$30.0 million of medium-term notes maturing in May 2006 and \$20.0 million of medium-term notes maturing in September 2006.

A summary of Mattel's capitalization is as follows:

(In millions, except percentage information)	September 30, 2005		September 30, 2004		December 31, 2004	
Medium-term notes	\$ 350.0	12%	\$ 400.0	14%	\$ 400.0	13%
Other long-term debt obligations	—	—	38.4	1	—	—
Long-term debt	350.0	12	438.4	15	400.0	13
Other noncurrent liabilities	259.4	9	244.5	8	243.5	8
Stockholders' equity	2,282.8	79	2,248.0	77	2,385.8	79
	<u>\$2,892.2</u>	<u>100%</u>	<u>\$2,930.9</u>	<u>100%</u>	<u>\$3,029.3</u>	<u>100%</u>

Long-term debt decreased \$88.4 million at September 30, 2005 compared to September 30, 2004 due to the reclassification of debt totaling \$50.0 million maturing in the next twelve months and the reclassification of a mortgage note payable of \$38.4 million, due in November 2005 from long-term to current. Mattel expects to satisfy its future long-term capital needs through the generation of corporate earnings and issuance of long-term debt instruments. Stockholders' equity increased \$34.8 million since September 30, 2004, primarily as a result of income from operations, partially offset by the purchase of \$249.9 million of treasury stock during 2005 and payment of the annual dividend on common stock in the fourth quarter of 2004. Stockholders' equity decreased \$103.0 million since December 31, 2004, primarily due to share repurchases and the impact of currency translation adjustments, partially offset by income from operations and cash received from the exercise of employee stock options.

Mattel's debt-to-total capital ratio, including short-term borrowings and current portion of long-term debt, decreased from 24.2% at September 30, 2004 to 18.8% at September 30, 2005, mainly due to the repayment of \$150.0 million 6 ¹/₈ % senior notes upon maturity in July 2005. Mattel's objective is to continue to maintain a year-end debt-to-total capital ratio of approximately 25%.

Litigation

See Part II, Item 1 "Legal Proceedings."

New Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123 (revised 2004) ("SFAS No. 123(R)"), *Share-Based Payment*, which replaced SFAS No. 123 and superseded APB Opinion No. 25. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS No. 123 will no longer be an alternative to financial statement recognition. Under SFAS No.

123(R), Mattel must determine the appropriate fair value method to be used for valuing share-based payments, the amortization method of compensation cost and the transition method to be used at the time of adoption. The transition methods include prospective and retroactive adoption options. The prospective method requires that compensation cost be recorded for all unvested stock options and nonvested stock at the beginning of the first quarter of adoption of SFAS No. 123(R), whereas the retroactive method requires recording compensation cost for all unvested stock options and nonvested stock beginning with the first period restated.

In April 2005, the Securities Exchange Commission amended Rule S-X to delay the effective date for compliance with SFAS No. 123(R). Based on the amended rule, Mattel is required to adopt SFAS No. 123(R) on January 1, 2006. Mattel is evaluating the requirements of SFAS No. 123(R) and expects that the adoption of SFAS No. 123(R) will have a material adverse effect on its

Table of Contents

results of operations and earnings per share. Mattel has not yet determined whether the amounts recorded in the consolidated statements of operations in future periods will be similar to the current pro forma disclosures under SFAS No. 123.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs – An Amendment of ARB No. 43, Chapter 4*. SFAS No. 151 amends the guidance in Chapter 4, “Inventory Pricing,” of Accounting Research Bulletin (“ARB”) No. 43, *Restatement and Revision of Accounting Research Bulletins*, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (“spoilage”). Among other provisions, the statement requires that items such as idle facility expense, excessive spoilage, double freight, and rehandling costs be recognized as current-period charges regardless of whether they meet the criterion of “so abnormal” as stated in ARB No. 43. Additionally, SFAS No. 151 requires that the allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for fiscal years beginning after June 15, 2005. Mattel is currently evaluating the effect that the adoption of SFAS No. 151 will have on its results of operations and financial position, but does not expect it to have a material impact.

Non-GAAP Financial Measure

In this Quarterly Report on Form 10-Q, Mattel includes a non-GAAP financial measure, gross sales, which it uses to analyze its continuing operations and to monitor, assess and identify meaningful trends in its operating and financial performance. Net sales, as reported in the consolidated statements of operations, include the impact of sales adjustments, such as trade discounts and other allowances. Gross sales represent sales to customers, excluding the impact of sales adjustments. Consistent with its segment reporting, Mattel presents changes in gross sales as a metric for comparing its aggregate, business unit, brand and geographic results to highlight significant trends in Mattel’s business. Changes in gross sales are discussed because, while Mattel records the detail of such sales adjustments in its financial accounting systems at the time of sale, such sales adjustments are generally not associated with individual products, making net sales less meaningful.

A reconciliation of gross sales to the most directly comparable GAAP financial measure, net sales, is as follows:

(In thousands)	For the Three Months Ended		For the Nine Months Ended	
	September 30,	September 30,	September 30,	September 30,
	2005	2004	2005	2004
Revenues				
Domestic:				
Mattel Brands US	\$ 439,215	\$ 503,874	\$ 926,200	\$ 991,063
Fisher-Price Brands US	500,020	480,607	892,963	879,300
American Girl Brands	69,051	61,393	195,484	164,662
Total Domestic	1,008,286	1,045,874	2,014,647	2,035,025
International	796,735	759,687	1,605,292	1,503,452
Gross sales	1,805,021	1,805,561	3,619,939	3,538,477
Sales adjustments	(138,876)	(138,100)	(283,851)	(286,070)
Net sales	\$ 1,666,145	\$ 1,667,461	\$ 3,336,088	\$ 3,252,407

Factors That May Affect Future Results

(Cautionary Statement Under the Private Securities Litigation Reform Act of 1995)

Certain written and oral statements made or incorporated by reference from time to time by Mattel or its representatives in this Quarterly Report on Form 10-Q, other filings or reports filed with the SEC, press releases, conferences, or otherwise, are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995 and may include, but are not limited to, statements about: sales and inventory levels; brand and customer management programs; increased competition; initiatives to promote revenue growth; globalization initiatives; restructuring and financial realignment plans; special charges and other non-recurring charges; initiatives aimed at anticipated cost savings; initiatives to invigorate the Barbie® brand, improve the execution of the core business, extend brands, catch new trends, create new brands and enter new categories, develop people, improve productivity, simplify processes, maintain customer service levels and improve supply chain; operating efficiencies; capital and investment framework (including statements about free cash flow, seasonal working capital, debt-to-total capital ratios, capital expenditures, strategic acquisitions, dividends and share repurchases); cost increases; advertising and promotion spending; profitability; the impact of recent organizational changes and the anticipated establishment of the MAPS senior credit facilities. Mattel is including this Cautionary Statement to make applicable and take advantage of the safe harbor provisions of the Private

Table of Contents

Securities Litigation Reform Act of 1995 for any such forward-looking statements. Forward-looking statements include any statement that may predict, forecast, indicate, or imply future results, performance, or achievements. Forward-looking statements can be identified by the use of terminology such as “believe,” “anticipate,” “expect,” “estimate,” “may,” “will,” “should,” “project,” “continue,” “plans,” “aims,” “intends,” “likely,” or other similar words or phrases. Except for historical matters, the matters discussed in this Quarterly Report on Form 10-Q and other statements or filings made by Mattel from time-to-time may be forward-looking statements. Management cautions you that forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from the forward-looking statements. In addition to the important factors detailed herein and from time-to-time in other reports filed by Mattel with the SEC, including Forms 8-K, 10-Q and 10-K, the following important factors could cause actual results to differ materially from past results or those suggested by any forward-looking statements.

Competition and New Product Introductions

Mattel’s business and operating results depend largely upon the appeal of its toy products. Consumer preferences, particularly among end users of Mattel’s products – children – are continuously changing. The toy industry experiences significant, sudden shifts in demand caused by “hit” toys and trends, which are often unpredictable. In recent years there have been trends towards shorter life cycles for individual toy products, the phenomenon of children outgrowing toys at younger ages and an increasing use of high technology in toys. In addition, Mattel competes with many other companies, both large and small, which means that Mattel’s market position is always at risk. Mattel’s ability to maintain its current category share, and increase its category share or establish category share in new product categories, will depend on Mattel’s ability to satisfy consumer preferences, enhance existing products, develop and introduce new products, and achieve market acceptance of such products. If Mattel does not successfully meet the challenges outlined above in a timely and cost-effective manner, demand for its products could decrease and Mattel’s results of operations may be adversely affected.

Seasonality, Managing Production and Predictability of Orders

Mattel’s business is subject to risks associated with the underproduction of popular toys and the overproduction of toys that do not match consumer demand. Sales of toy products at retail are seasonal, with a majority of retail sales occurring during the period from September through December. As a result, Mattel’s annual operating results will depend, in large part, on sales during the relatively brief traditional holiday season. Retailers are attempting to manage their inventories better, requiring Mattel to ship products closer to the time the retailers expect to sell the products to consumers. This in turn results in shorter lead times for production. Management believes that the increase in “last minute” shopping during the holiday season and the popularity of gift cards (which often result in purchases after the holiday season) may negatively impact customer re-orders during the holiday season. Shipping disruptions limiting the availability of ships or containers in Asia during peak demand times may affect Mattel’s ability to deliver its products in time to meet retailer demand. These factors may decrease sales or increase the risk that Mattel may not be able to meet demand for certain products at peak demand times, or that Mattel’s own inventory levels may be adversely impacted by the need to pre-build products before orders are placed.

Uncertain and Adverse General Economic Conditions

Current conditions in the domestic and global economies have a certain level of uncertainty. As a result, it is difficult to estimate the level of growth or contraction for the economy as a whole. It is even more difficult to estimate growth or contraction in various parts of the economy, including the markets in which Mattel participates. Because all components of Mattel’s budgeting and forecasting are dependent upon estimates of growth or contraction in the markets it serves and demand for its products, the prevailing economic uncertainties render estimates of future income and expenditures even more difficult than usual to make. Adverse changes may occur as a result of soft global economies, rising oil prices, wavering consumer confidence, or other factors affecting economic conditions generally. Such changes may negatively affect the sales of Mattel’s products, increase exposure to losses from bad debts, or increase costs associated with manufacturing and distributing these products.

Customer Concentration

A small number of customers account for a large share of Mattel’s net sales. In 2004, Mattel’s three largest customers, Wal-Mart, Toys “R” Us and Target, in the aggregate, accounted for approximately 46% of net sales, and its ten largest customers, in the aggregate, accounted for approximately 56% of net sales. The concentration of Mattel’s business with a relatively small number of customers may expose Mattel to a material adverse effect if one or more of Mattel’s large customers were to significantly reduce

Table of Contents

purchases for any reason. Customers make no binding long-term commitments to Mattel regarding purchase volumes and make all purchases by delivering one-time purchase orders. Any customer could reduce its overall purchases of Mattel's products, reduce the number and variety of Mattel's products that it carries and the shelf space allotted for Mattel's products, or otherwise seek to materially change the terms of the business relationship at any time. Any such change could significantly harm Mattel's business and operating results.

Competition from Private-Label Toys

In recent years, consumer goods companies generally, including those in the toy business, have experienced the phenomenon of retail customers developing their own private-label products that directly compete with the products of traditional manufacturers. Some retail chains that are customers of Mattel sell private-label toys designed, manufactured and branded by the retailers themselves. Such toys may be sold at prices lower than comparable toys sold by Mattel, and may result in lower purchases of Mattel-branded products by such retailers. In some cases, retailers who sell such private-label toys are larger than Mattel and may have substantially more resources than Mattel.

Rationalization of Mass-Market Retail Channel and Bankruptcy of Key Customers

Many of Mattel's key customers are mass-market retailers. The mass-market retail channel in the US has experienced significant shifts in market share among competitors in recent years, causing some large retailers to experience liquidity problems. From 2001 through early 2004, four large customers of Mattel filed for bankruptcy. In addition, Mattel's sales to customers are typically made on credit without collateral. There is a risk that customers will not pay, or that payment may be delayed, because of bankruptcy or other factors beyond the control of Mattel, which could increase Mattel's exposure to losses from bad debts. In addition, if these or other customers were to cease doing business as a result of bankruptcy, or significantly reduce the number of stores operated, it could have a material adverse effect on Mattel's business, financial condition and results of operations.

Adequate Supplies; Cost Increases

Mattel's ability to meet customer demand depends, in part, on its ability to obtain timely and adequate delivery of materials, parts and components from its suppliers and internal manufacturing capacity. Mattel has experienced shortages in the past, including raw materials and components. Although Mattel works closely with suppliers to avoid these types of shortages, there can be no assurance that Mattel will not encounter these problems in the future. A reduction or interruption in supplies or a significant increase in the price of one or more supplies, such as fuel and resin (which is an oil-based product) expenses, could have a material adverse effect on Mattel's business. Cost increases, whether resulting from shortages of materials or otherwise, including but not limited to rising costs of materials, transportation, services and labor (including but not limited to wages, expenses related to employee health plans and insurance policies) could impact the gross profit margins realized by Mattel on the sale of its products. Because of market conditions, timing of pricing decisions and other factors, there can be no assurance that Mattel will be able to offset any such increased costs by adjusting the prices of its products. Increases in prices of Mattel's products could result in lower sales.

Litigation and Disputes

Mattel is involved in a number of litigation matters. An unfavorable resolution of pending litigation could have a material adverse effect on Mattel's financial condition. Litigation may result in substantial costs and expenses and significantly divert the attention of Mattel's management regardless of the outcome. There can be no assurance that Mattel will be able to achieve a favorable settlement of pending litigation or obtain a favorable resolution of litigation if it is not settled. In addition, current and future litigation, governmental proceedings, labor disputes or environmental matters could lead to increased costs or interruption of the normal business operations of Mattel.

Recalls

Mattel is subject to regulation by the Consumer Product Safety Commission and similar state and international regulatory authorities, and its products could be subject to involuntary recalls and other actions by such authorities. Concerns about product safety may lead Mattel to voluntarily recall selected products. Mattel has experienced, and in the future may experience, defects or errors in products after their production and sale to customers. Such defects or errors could result in the rejection of Mattel's products by customers, damage to its reputation, lost sales, diverted development resources and increased customer service and support costs, any of which

Table of Contents

could harm Mattel's business. Individuals could sustain injuries from Mattel's products, and Mattel may be subject to claims or lawsuits resulting from such injuries. There is a risk that these claims or liabilities may exceed, or fall outside the scope of, Mattel's insurance coverage. Moreover, Mattel may be unable to obtain adequate liability insurance in the future. Recalls, post-manufacture repairs of Mattel products, absence or cost of insurance, and administrative costs associated with recalls could harm Mattel's reputation, increase costs or reduce sales.

Protection of Intellectual Property Rights

The value of Mattel's business depends to a large degree on its ability to protect its intellectual property, including its trademarks, trade names, copyrights, patents and trade secrets in the US and around the world. Any failure by Mattel to protect its proprietary intellectual property and information, including any successful challenge to Mattel's ownership of its intellectual property or material infringements of such property, could have a material adverse effect on Mattel's business, financial condition and results of operations.

Political Developments, including Trade Relations, and the Threat or Occurrence of War or Terrorist Activities

Mattel's business is worldwide in scope, including operations in 42 countries. The deterioration of the political situation in a country in which Mattel has significant sales or operations, or the breakdown of trade relations between the US and a foreign country in which Mattel has significant manufacturing facilities or other operations, could adversely affect Mattel's business, financial condition and results of operations. For example, a change in trade status for China could result in a substantial increase in the import duty of toys manufactured in China and imported into the US. In addition, the occurrence of war or hostilities between countries or threat of terrorist activities, and the responses to and results of such activities, could materially impact Mattel, its personnel and facilities, its customers and suppliers, retail and financial markets, and general economic conditions.

Manufacturing Risk; Severe Acute Respiratory Syndrome ("SARS"), Avian Flu or Other Diseases

Mattel owns and operates manufacturing facilities and utilizes third-party manufacturers throughout Asia, primarily in China, Indonesia, Malaysia and Thailand. The risk of political instability and civil unrest exists in certain of these countries, which could temporarily or permanently damage Mattel's manufacturing operations located there. In the past, outbreaks of SARS have been significantly concentrated in Asia, particularly in Hong Kong, and in the Guangdong province of China, where many of Mattel's manufacturing facilities and third-party manufacturers are located. The design, development and manufacture of Mattel's products could suffer if a significant number of Mattel's employees or the employees of its third-party manufacturers or their suppliers contract SARS, avian flu or other communicable diseases, or otherwise are unable to fulfill their responsibilities. Mattel has developed contingency plans designed to help mitigate the impact of disruptions in its manufacturing operations. Mattel's business, financial position and results of operations could be negatively impacted by a significant disruption to its manufacturing operations or suppliers.

Earthquakes or Other Catastrophic Events

Mattel has significant operations, including its corporate headquarters, near major earthquake faults in Southern California. Southern California has experienced earthquakes, wildfires and other natural disasters in recent years. A catastrophic event where Mattel has important operations, such as an earthquake, tsunami, flood, typhoon, fire or other natural or manmade disaster, could disrupt Mattel's operations or those of its contractors and impair production or distribution of its products, damage inventory, interrupt critical functions or otherwise affect business negatively, harming Mattel's results of operations.

Changes in Currency Exchange Rates

Mattel's net investment in its foreign subsidiaries and its results of operations and cash flows are subject to changes in currency exchange rates and regulations. Mattel seeks to mitigate the exposure of its results of operations to fluctuations in currency exchange rates by partially hedging such exposure using foreign currency forward exchange and option contracts. Such contracts are primarily used to hedge Mattel's purchase and sale of inventory, and other intercompany transactions denominated in foreign currencies. Government action may restrict Mattel's ability to transfer capital across borders and may also impact the fluctuation of currencies in the countries where Mattel conducts business or has invested capital. Significant changes in currency exchange rates, reductions in Mattel's ability to transfer its capital across borders, and changes in government-fixed currency exchange rates, including the Chinese yuan, could have a material adverse effect on Mattel's business and results of operations.

Table of Contents

Financing Matters

Increases in interest rates, both domestically and internationally, could negatively affect Mattel's cost of financing both its operations and investments. Any reduction in Mattel's credit ratings could increase the cost of obtaining financing. Additionally, Mattel's ability to issue long-term debt and obtain seasonal financing could be adversely affected by factors such as an inability to meet its debt covenant requirements, which include maintaining consolidated debt-to-capital and interest coverage ratios. Mattel's ability to conduct its operations could be negatively impacted should these or other adverse conditions affect its primary sources of liquidity.

Advertising and Promotion

Mattel's products are marketed worldwide through a diverse spectrum of advertising and promotional programs. Mattel's ability to sell products is dependent in part upon the success of such programs. If Mattel does not successfully market its products or if media or other advertising or promotional costs increase, these factors could have a material adverse effect on Mattel's business, financial condition and results of operations.

Success of New Initiatives

Mattel has announced initiatives to improve the execution of its core business, globalize and extend Mattel's brands, catch new trends, create new brands and enter new categories, develop people, and improve productivity, simplify processes and maintain customer service levels, as well as new initiatives designed to drive sales growth, manage costs and improve its supply chain. Such initiatives involve complex decision making as well as extensive and intensive execution, and the success of such initiatives is not assured. Failure to successfully implement any of these initiatives could have a material adverse effect on Mattel's business, financial condition and results of operations.

Changes in Laws and Regulations

Mattel operates in a highly regulated environment in the US and international markets. US federal, state and local governmental entities and foreign governments regulate many aspects of Mattel's business, including its products and the importation and exportation of its products. Such regulations may include accounting standards, taxation requirements (including changes in applicable income tax rates, new tax laws and revised tax law interpretations), trade restrictions, regulations regarding financial matters, environmental regulations, advertising directed toward children, safety and other administrative and regulatory restrictions. Changes in laws or regulations may lead to increased costs, changes in Mattel's effective tax rate, or the interruption of normal business operations that would negatively impact its financial condition and results of operations.

Acquisitions, Dispositions and Takeover Defenses

Mattel may engage in acquisitions, mergers or dispositions, which may affect the profit, revenues, profit margins, debt-to-capital ratio, capital expenditures, or other aspects of Mattel's business. There can be no assurance that Mattel will be able to identify suitable acquisition targets or merger partners or that, if identified, it will be able to acquire such targets on acceptable terms or agree to terms with merger partners. Additionally, there can be no assurance that Mattel will be successful in integrating any acquired company into its overall operations, or that any such acquired company will operate profitably or will not otherwise adversely impact Mattel's results of operations. In addition, Mattel has certain anti-takeover provisions in its by-laws that may make it more difficult for a third party to acquire Mattel without its consent, which may adversely affect Mattel's stock price.

If any of the risks and uncertainties described in the cautionary factors listed above actually occurs, Mattel's business, financial condition and results of operations could be materially and adversely affected. The factors listed above are not exhaustive. Other sections of this Quarterly Report on Form 10-Q include additional factors that could materially and adversely impact Mattel's business, financial condition and results of operations. Moreover, Mattel operates in a very competitive and rapidly changing environment. New factors emerge from time to time and it is not possible for management to predict the impact of all such factors on Mattel's business, financial condition or results of operations or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these risks and uncertainties, investors should not rely on forward-looking statements as a prediction of actual results. Any or all of the forward-looking

Table of Contents

statements contained in this Quarterly Report on Form 10-Q and any other public statement made by Mattel or its representatives may turn out to be wrong. Mattel expressly disclaims any obligation to update or revise any forward-looking statements, whether as a result of new developments or otherwise.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Foreign Currency Exchange Rate Risk

Currency exchange rate fluctuations may impact Mattel's results of operations and cash flows. Inventory purchase transactions denominated in the Euro, British pound sterling, Mexican peso, Hong Kong dollar and Indonesian rupiah are the primary transactions that cause currency transaction exposure for Mattel. Mattel seeks to mitigate its exposure to market risk by monitoring its currency transaction exposure for the year and partially hedging such exposure using foreign currency forward exchange and option contracts primarily to hedge its purchase and sale of inventory, and other intercompany transactions denominated in foreign currencies. These contracts generally have maturity dates of up to 18 months. For those intercompany receivables and payables that are not hedged, the transaction gains or losses are recorded in the consolidated statement of operations in the period in which the exchange rate changes as part of operating income or other non-operating (income) expense, net based on the nature of the underlying transaction. Transaction gains or losses on hedged intercompany inventory transactions are recorded in the consolidated statement of operations in the period in which the inventory is sold to customers. In addition, Mattel manages its exposure through the selection of currencies used for international borrowings. Mattel does not trade in financial instruments for speculative purposes.

Mattel's financial position is also impacted by currency exchange rate fluctuations on translation of its net investment in subsidiaries with non-US dollar functional currencies. Assets and liabilities of subsidiaries with non-US dollar functional currencies are translated into US dollars at fiscal year-end exchange rates. Income, expense and cash flow items are translated at weighted average exchange rates prevailing during the fiscal year. The resulting currency translation adjustments are recorded as a component of accumulated other comprehensive loss within stockholders' equity. Mattel's primary currency translation exposures are related to its net investment in subsidiaries having functional currencies denominated in the Euro, British pound sterling, Mexican peso and Indonesian rupiah.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

As of September 30, 2005, Mattel's disclosure controls and procedures were evaluated. Based on this evaluation, Robert A. Eckert, Mattel's principal executive officer, and Kevin M. Farr, Mattel's principal financial officer, concluded that these disclosure controls and procedures were effective, as of September 30, 2005, in timely alerting them to material information relating to Mattel required to be included in Mattel's periodic reports.

Changes in Internal Control Over Financial Reporting

Mattel made no change to its internal control over financial reporting or in other factors that materially affected, or were reasonably likely to have materially affected, its internal control over financial reporting during the quarter ended September 30, 2005.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings.

Litigation Related to The Learning Company, Inc. (“Learning Company”)

Following Mattel’s announcement in October 1999 of the expected results of its Learning Company division for the third quarter of 1999, various Mattel stockholders filed purported class action complaints naming Mattel and certain of its present and former officers and directors as defendants.

These shareholder complaints were consolidated into two lead cases, one under §10(b) of the Securities Exchange Act of 1934 (the “Exchange Act”), and the other under §14(a) of the Exchange Act. In November 2002, the United States District Court for the Central District of California permitted the actions to proceed as class actions.

Several stockholders filed related derivative complaints purportedly on behalf of Mattel. Some of the derivative suits were consolidated into one lawsuit in Los Angeles County Superior Court in California, which was dismissed for the plaintiff’s failure to make pre-suit demand on the board of directors. An appeal from that decision was dismissed in July 2003 by stipulation of the parties. Another derivative suit was filed in the Delaware Court of Chancery, and was dismissed without prejudice in August 2002 in deference to the then-ongoing California derivative case. A third derivative suit, filed in federal court in the Central District of California, was dismissed in July 2002, and re-filed in November 2002 as part of the settlement described below.

In November 2002, the parties to the federal cases negotiated and thereafter memorialized in a final settlement agreement a settlement of all the federal lawsuits in exchange for payment of \$122.0 million and Mattel’s agreement to adopt certain corporate governance procedures. The court granted final approval to the settlement in September 2003, and judgments were entered accordingly. On October 9, 2003, a group of persons purporting to be members of the §14(a) class filed a notice of appeal, challenging the manner in which the \$122.0 million was allocated between the §10(b) class and the §14(a) class. On July 29, 2005, the United States Court of Appeals for the Ninth Circuit affirmed the District Court’s approval of the settlement. At the end of October 2005, the appellant filed a petition for writ of certiorari before the United States Supreme Court.

Litigation Related to LeapFrog Enterprises, Inc.

Fisher-Price, Inc. (“Fisher-Price”), a subsidiary of Mattel, was sued for patent infringement by LeapFrog Enterprises, Inc. in a lawsuit filed in October 2003 in the United States District Court for the District of Delaware, and in September 2004, Mattel was joined to the lawsuit as a defendant. The lawsuit alleges that Fisher-Price’s PowerTouch™ system infringes a LeapFrog patent relating to an electronic learning device for teaching phonics. A 10-day trial commenced on May 16, 2005, which resulted in a deadlocked jury. As an alternative to retrying the case, the parties agreed to submit the case for decision, based on the current trial record, to the presiding judge. The parties have filed their post-trial briefs, and the Court has not yet rendered a decision. The plaintiff in this lawsuit asserted a total damages claim of up to approximately \$90 million, which has been reduced to approximately \$58 million pursuant to rulings by the Court, and seeks an injunction preventing the further sale of the PowerTouch™ system; the damages could possibly be trebled if the infringement is found to be willful. Mattel and its subsidiary Fisher-Price believe the action is without merit and intend to continue to vigorously defend themselves.

Litigation Related to Carter Bryant and MGA Entertainment, Inc.

In April 2004, Mattel filed a lawsuit in Los Angeles County Superior Court against Carter Bryant (“Bryant”), a former Mattel design employee. The suit alleges that Bryant aided and assisted a Mattel competitor, MGA Entertainment, Inc. (“MGA”), during the time he was employed by Mattel, in violation of his contractual and other duties to Mattel. In September 2004, Bryant asserted counterclaims against Mattel, including counterclaims in which Bryant seeks, as a putative class action representative, to invalidate Mattel’s Confidential Information and Propriety Inventions Agreements with its employees.

In December 2004, MGA intervened as a party-defendant in Mattel’s action against Bryant, asserting that its rights to the “Bratz” property are at stake in the litigation. Mattel’s suit has been removed to the United States District Court for the Central District of California, where it is currently pending.

Table of Contents

Separately, in November 2004, Bryant filed an action against Mattel in the United States District Court for the Central District of California. The action seeks a judicial declaration that Bryant's purported conveyance of rights in "Bratz" was proper and that he did not misappropriate Mattel property in creating "Bratz."

In April 2005, MGA filed suit against Mattel in the United States District Court for the Central District of California. MGA's action alleges claims of trade dress infringement, trade dress dilution, false designation of origin, unfair competition and unjust enrichment. The suit alleges, among other things, that certain products, themes, packaging and/or television commercials in various Mattel product lines have infringed upon products, themes, packaging and/or television commercials for various MGA product lines, including "Bratz." The complaint also asserts that various alleged Mattel acts with respect to unidentified retailers, distributors and licensees have damaged MGA and that various alleged acts by industry organizations, purportedly induced by Mattel, have damaged MGA.

MGA's suit alleges that MGA has been damaged in an amount "believed to reach or exceed tens of millions of dollars" and further seeks punitive damages, disgorgement of Mattel's profits and injunctive relief. Mattel believes the claims by Bryant and MGA are without merit and intends to vigorously defend against them.

Litigation Related to Cunningham

This suit was filed in September 1999 in the Circuit Court of Madison County, Illinois. The two named plaintiffs, who purchased "limited edition" Barbie® dolls, contended that Mattel's use of the term "limited edition" on Barbie® dolls was deceptive and fraudulent to consumers (and that it constituted a breach of contract and breach of express warranty) on the grounds that the dolls were not "true" limited editions and thus are not as valuable as they would be otherwise. Originally, the plaintiffs claimed that use of the terms "special edition," "collector's edition" and "exclusive" on Barbie® dolls was also deceptive and fraudulent to consumers and constituted a breach of contract and breach of express warranty, but these claims were dismissed during motion practice.

In 2003, a nationwide class of "all persons who have purchased limited edition Barbie® dolls or Barbie® dolls which were described, promoted or packaged as available only in small, limited amounts" was certified based on California Business and Professions Code sections 17200 and 17500 et seq. Plaintiffs' claims under the Illinois Consumer Fraud Act, as well as their breach of contract and breach of express warranty claims, were not certified for class action treatment. The plaintiffs claimed that the class suffered compensatory damages of at least between \$100 million and \$200 million, and sought punitive damages, attorneys' fees and injunctive relief.

In January 2005, the Court issued an order decertifying the nationwide class in its entirety, without prejudice to the two named plaintiffs attempting to re-certify the class at a later date. On July 14, 2005, as a result of a settlement between Mattel and the two named plaintiffs, the Court dismissed the action with prejudice. The lawsuit was settled for an amount that was not material to Mattel's consolidated financial information for the three and nine months ended September 30, 2005.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Recent Sales of Unregistered Securities

During the third quarter of 2005, Mattel did not sell any unregistered securities.

Issuer Purchases of Equity Securities

In 2003, Mattel's board of directors initiated a share repurchase program. The amount authorized for repurchase is approved by the board of directors based on the guidelines outlined in Mattel's capital and investment framework. From the inception of its share repurchase program through year end 2004, Mattel had repurchased 27.4 million shares of its common stock at a cost of \$499.5 million.

In March 2005, the board of directors approved the repurchase of an additional \$250.0 million of Mattel's common stock. During the second quarter of 2005, Mattel repurchased 12.9 million common shares at a cost of \$236.5 million. During the third quarter of 2005, Mattel repurchased 0.7 million common shares at a cost of \$13.4 million. As of September 30, 2005, \$0.5 million was available under the current authorization for share repurchase. Repurchases will take place from time to time, depending on market conditions. Mattel's share repurchase program has no expiration date.

Table of Contents

During the third quarter of 2005, Mattel repurchased its common stock in the open market as follows:

ISSUER PURCHASES OF EQUITY SECURITIES

<u>Period</u>	<u>Total Number of Shares (or Units) Purchased</u>	<u>Average Price Paid per Share (or Unit)</u>	<u>Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs</u>
July 1 – 31	720,400	\$ 18.54	720,400	\$ 13,845,350
August 1 – 31	—	—	—	\$ 488,992
September 1 – 30	—	—	—	\$ 488,992
Total	720,400	\$ 18.54	720,400	\$ 488,922

Item 6. Exhibits.

<u>Exhibit No.</u>	<u>Exhibit Description</u>
11.0*	Computation of Income per Common and Common Equivalent Share
31.0*	Certification of Principal Executive Officer dated November 3, 2005 pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.1*	Certification of Principal Financial Officer dated November 3, 2005 pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.0**	Certification of Principal Executive Officer and Principal Financial Officer dated November 3, 2005 pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 ¹

* *Filed herewith.*

** *Furnished herewith.*

¹ *This exhibit should not be deemed to be “filed” for purposes of Section 18 of the Securities Exchange Act of 1934.*

SIGNATURE

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

MATTEL, INC.
Registrant

Date: November 3, 2005

By: 
H. Scott Topham
Senior Vice President and Corporate Controller (Duly authorized officer and chief accounting officer)

**MATTEL, INC. AND SUBSIDIARIES
COMPUTATION OF INCOME PER COMMON AND COMMON EQUIVALENT SHARE**

(In thousands, except per share amounts)

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2005	September 30, 2004	September 30, 2005	September 30, 2004
	(Unaudited)		(Unaudited)	
BASIC				
Net income	\$ 225,339	\$ 255,830	\$ 137,859	\$ 288,378
Applicable Share of Computation of Income per Share:				
Weighted average common shares outstanding	403,743	414,592	409,824	420,624
Basic Income Per Common Share:				
Net income per common share	\$ 0.56	\$ 0.62	\$ 0.34	\$ 0.69
DILUTED				
Net income	\$ 225,339	\$ 255,830	\$ 137,859	\$ 288,378
Applicable Share of Computation of Income per Share:				
Weighted average common shares outstanding	403,743	414,592	409,824	420,624
Weighted average common equivalent shares arising from:				
Dilutive stock options	3,479	3,370	4,121	3,807
Weighted average number of common and common equivalent shares	407,222	417,962	413,945	424,431
Diluted Income Per Common Share:				
Net income per common share	\$ 0.55	\$ 0.61	\$ 0.33	\$ 0.68

CERTIFICATIONS

I, Robert A. Eckert, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Mattel, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to

the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 3, 2005

By: 

Robert A. Eckert
Chairman and Chief Executive Officer
(Principal executive officer)

EXHIBIT 31.1

CERTIFICATIONS

I, Kevin M. Farr, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Mattel, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

- a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 3, 2005

By: 

Kevin M. Farr
Chief Financial Officer
(Principal financial officer)

EXHIBIT 32.0

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

Each of the undersigned officers of Mattel, Inc., a Delaware corporation (the "Company"), does hereby certify, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2005 (the "Periodic Report"), which this statement accompanies, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)); and
- (2) Information contained in the Periodic Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

This certificate is being furnished solely for purposes of Section 906 and is not being filed as part of the Periodic Report.

Date: November 3, 2005

By: 

Robert A. Eckert
Chairman and Chief Executive Officer, Mattel, Inc.



Kevin M. Farr
Chief Financial Officer, Mattel, Inc.

End of Filing

Powered By 

© 2005 | EDGAR Online, Inc.