MATTEL INC /DE/
Form 10-Q
October 26, 2007
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2007

¨ **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	**95-1567322**
(State or other jurisdiction of incorporation or organization)	**(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 x   No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer x   Accelerated filer ¨   Non-accelerated filer ¨

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

Number of shares outstanding of registrant s common stock, $1.00 par value, as of October 25, 2007:

366,844,690 shares

Table of Contents

MATTEL, INC. AND SUBSIDIARIES

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

MATTEL, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	September 30, 2007	September 30, 2006	December 31, 2006
		(Unaudited; in thousands, except share data)	
ASSETS			
Current Assets			
Cash and equivalents	$ 276,824	$ 552,425	$ 1,205,552
Accounts receivable, net	1,640,305	1,387,934	943,813
Inventories	732,257	672,232	383,149
Prepaid expenses and other current assets	219,956	272,909	317,624
Total current assets	2,869,342	2,885,500	2,850,138
Noncurrent Assets			
Property, plant and equipment, net	515,425	525,423	536,749
Goodwill	857,217	730,292	845,324
Other noncurrent assets	886,569	729,016	723,673
Total Assets	$ 5,128,553	$ 4,870,231	$ 4,955,884
LIABILITIES AND STOCKHOLDERS EQUITY			
Current Liabilities			
Short-term borrowings	$ 363,896	$ 57,396	$
Current portion of long-term debt	40,000	100,000	64,286
Accounts payable	494,358	455,308	375,882
Accrued liabilities	807,391	750,774	980,435
Income taxes payable	45,115	134,626	161,917
Total current liabilities	1,750,760	1,498,104	1,582,520
Noncurrent Liabilities			
Long-term debt	560,000	775,000	635,714
Other noncurrent liabilities	454,757	297,372	304,676
Total noncurrent liabilities	1,014,757	1,072,372	940,390
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	1,633,132	1,606,613	1,613,307
Treasury stock at cost; 72.5 million shares, 62.4 million shares and 57.1 million shares, respectively	(1,409,372)	(1,090,695)	(996,981)

Retained earnings	1,923,657	1,616,397	1,652,140
Accumulated other comprehensive loss	(225,750)	(273,929)	(276,861)
Total stockholders equity	2,363,036	2,299,755	2,432,974
Total Liabilities and Stockholders Equity	$ 5,128,553	$ 4,870,231	$ 4,955,884

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

3

Table of Contents

MATTEL, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
	(Unaudited; in thousands, except per share amounts)			
Net Sales	$ 1,838,574	$ 1,790,312	$ 3,781,464	$ 3,541,314
Cost of sales	973,862	938,943	2,054,904	1,941,867
Gross Profit	864,712	851,369	1,726,560	1,599,447
Advertising and promotion expenses	211,436	205,886	423,852	395,293
Other selling and administrative expenses	342,748	323,248	934,700	863,999
Operating Income	310,528	322,235	368,008	340,155
Interest expense	16,354	22,559	44,969	53,840
Interest (income)	(6,202)	(6,722)	(28,644)	(21,983)
Other non-operating (income) expense, net	(7,312)	1,845	(8,108)	(2,114)
Income Before Income Taxes	307,688	304,553	359,791	310,412
Provision for income taxes	70,938	65,528	88,274	3,837
Net Income	$ 236,750	$ 239,025	$ 271,517	$ 306,575
Net Income Per Common Share Basic	$ 0.61	$ 0.63	$ 0.69	$ 0.80
Weighted average number of common shares	386,346	378,628	390,796	384,491
Net Income Per Common Share Diluted	$ 0.61	$ 0.62	$ 0.68	$ 0.79
Weighted average number of common and common equivalent shares	391,294	382,664	397,245	387,171

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

Table of Contents

MATTEL, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Nine Months Ended September 30, 2007	September 30, 2006
	(Unaudited; in thousands)	
Cash Flows From Operating Activities:		
Net income	$ 271,517	$ 306,575
Adjustments to reconcile net income to net cash flows used for operating activities:		
(Gain) loss on disposal of other property, plant and equipment	(4)	1,552
Depreciation	119,459	124,919
Amortization	8,385	3,042
Deferred income taxes	(11,130)	(16,944)
Share-based compensation	13,853	24,880
Changes in assets and liabilities:		
Accounts receivable	(651,061)	(610,694)
Inventories	(329,182)	(291,162)
Prepaid expenses and other current assets	104,160	7,708
Accounts payable, accrued liabilities and income taxes payable	(116,927)	70,948
Other, net	(20,072)	11,519
Net cash flows used for operating activities	(611,002)	(367,657)
Cash Flows From Investing Activities:		
Purchases of tools, dies and molds	(46,741)	(50,609)
Purchases of other property, plant and equipment	(51,192)	(49,289)
Payments for businesses acquired	(104,753)	(1,345)
Purchases of long-term investments	(35,000)	
Proceeds from disposal of other property, plant and equipment	429	718
Net cash flows used for investing activities	(237,257)	(100,525)
Cash Flows From Financing Activities:		
Proceeds from short-term borrowings	362,028	179,874
Repayments of short-term borrowings		(240,377)
Proceeds from long-term borrowings		298,356
Repayments of long-term borrowings	(100,000)	(50,000)
Share repurchases	(603,773)	(205,947)
Proceeds from exercises of stock options	221,437	29,248
Other, net	32,439	5,685
Net cash flows (used for) from financing activities	(87,869)	16,839
Effect of Currency Exchange Rate Changes on Cash	7,400	6,034
Decrease in Cash and Equivalents	(928,728)	(445,309)
Cash and Equivalents at Beginning of Period	1,205,552	997,734
Cash and Equivalents at End of Period	$ 276,824	$ 552,425
Supplemental Cash Flow Information:		
Cash paid during the period for:		

Income taxes, gross	$ 65,250	$ 137,375
Interest	36,287	45,123
Non-cash investing and financing activities:		
Asset write-downs	1,400	950

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

Table of Contents

MATTEL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(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.

Certain amounts in the consolidated financial statements for prior years have been reclassified to conform to the current year presentation.

The year-end balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

The financial information included herein should be read in conjunction with Mattel s consolidated financial statements and related notes in its 2006 Annual Report on Form 10-K.

2. Change in Accounting Principle

Effective January 1, 2007, Mattel adopted Financial Accounting Standards Board (FASB) Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of SFAS No. 109. FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold an uncertain tax position is required to meet before tax benefits associated with such uncertain tax positions are recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 excludes income taxes from the scope of Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*. FIN 48 also requires that amounts recognized in the balance sheet related to uncertain tax positions be classified as a current or noncurrent liability, based upon the expected timing of the payment to a taxing authority.

Prior to January 1, 2007, Mattel recorded reserves related to uncertain tax positions as a current liability, whereas upon adoption of FIN 48, Mattel reclassified tax reserves related to uncertain tax positions for which a cash tax payment is not expected within the next twelve months to noncurrent liabilities. Mattel s adoption of FIN 48 did not require a cumulative effect adjustment to the opening balance of its retained earnings. Mattel classifies interest and penalties related to unrecognized tax benefits as a component of income tax expense.

3. Accounts Receivable

Accounts receivable are net of allowances for doubtful accounts of $20.3 million, $20.4 million and $19.4 million as of September 30, 2007, September 30, 2006, and December 31, 2006, respectively.

4. Inventories

Inventories include the following:

	September 30, 2007	September 30, 2006	December 31, 2006

		(In thousands)	
Raw materials and work in process	$ 68,089	$ 53,285	$ 45,470
Finished goods	664,168	618,947	337,679
	$ 732,257	$ 672,232	$ 383,149

Table of Contents

5. Property, Plant and Equipment

Property, plant and equipment, net include the following:

	September 30, 2007	September 30, 2006 (In thousands)	December 31, 2006
Land	$ 29,558	$ 29,066	$ 39,445
Buildings	239,192	235,861	227,935
Machinery and equipment	789,465	760,740	759,467
Tools, dies and molds	576,635	566,713	537,463
Capital leases	23,271	23,271	23,271
Leasehold improvements	142,382	125,153	128,668
	1,800,503	1,740,804	1,716,249
Less: accumulated depreciation	(1,285,078)	(1,215,381)	(1,179,500)
	$ 515,425	$ 525,423	$ 536,749

6. Goodwill

Goodwill is allocated to various reporting units, which are either at the operating segment level or one reporting level below the operating segment level, for purposes of evaluating whether goodwill is impaired. Mattel s reporting units are: Mattel Girls Brands US, Mattel Boys Brands US, Fisher-Price Brands US, American Girl Brands and International. Mattel tests its goodwill for impairment annually in the third quarter, or whenever events or changes in circumstances indicate that the carrying value may not be recoverable, based on the fair value of the cash flows that the reporting units can be expected to generate in the future. In the third quarter of 2007, Mattel performed the annual impairment test required by SFAS No. 142, *Goodwill and Other Intangible Assets*, and determined that its goodwill was not impaired.

The change in the carrying amount of goodwill by reporting unit for the nine months ended September 30, 2007 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.

	December 31, 2006	Additions	Impact of Currency Exchange Rate Changes (In thousands)	September 30, 2007
Mattel Girls Brands US	$ 38,278	$	$ 1,600	$ 39,878
Mattel Boys Brands US	126,193	2,714	124	129,031
Fisher-Price Brands US	217,291		315	217,606
American Girl Brands	207,571			207,571
International	255,991	1,357	5,783	263,131
	$ 845,324	$ 4,071	$ 7,822	$ 857,217

7. Other Noncurrent Assets

Other noncurrent assets include the following:

	September 30, 2007	September 30, 2006 (In thousands)	December 31, 2006
Deferred income taxes	$ 505,393	$ 508,362	$ 503,168
Identifiable intangibles (net of amortization of $49.5 million, $40.5 million and $42.7 million, respectively)	72,993	18,622	55,193
Nonamortizable identifiable intangibles	128,858		15,400
Other	179,325	202,032	149,912
	$ 886,569	$ 729,016	$ 723,673

Table of Contents

On May 23, 2007, Mattel acquired Origin Products Limited (Origin), which owns the Polly Pocket! trademark and tradename rights, for $79.6 million in cash, including acquisition costs. Prior to the acquisition, Mattel had exclusive rights to manufacture, design and distribute Polly Pocket! products. In connection with the acquisition of Origin, Mattel recorded indefinite-lived identifiable intangible assets totaling $113.5 million, including the $79.6 million for the purchase price and acquisition costs, along with related deferred tax liabilities.

On August 16, 2007, Mattel acquired the rights to manufacture, distribute and market several game properties, including Apples to Apples®, Snorta!®, and Blink®, from Out of the Box Publishing, Inc. for $25.1 million, including acquisition costs.

8. Accrued Liabilities

Accrued liabilities include the following:

	September 30, 2007	September 30, 2006 (In thousands)	December 31, 2006
Royalties	$ 98,128	$ 112,202	$ 125,581
Advertising and promotion	147,786	147,202	76,799
Receivable collections due bank	24,676	64,897	245,545
Other	536,801	426,473	532,510
	$ 807,391	$ 750,774	$ 980,435

9. Long-term Debt

Long-term debt includes the following:

	September 30, 2007	September 30, 2006 (In thousands)	December 31, 2006
Medium-term notes due March 2008 to November 2013	$ 300,000	$ 350,000	$ 350,000
Senior Notes due June 2009 to June 2011	300,000	300,000	300,000
MAPS term loan facility		225,000	50,000
	600,000	875,000	700,000
Less: current portion	(40,000)	(100,000)	(64,286)
	$ 560,000	$ 775,000	$ 635,714

In January 2007, Mattel repaid the remaining $50.0 million of the MAPS term loan facility and, as a result of the repayment, the MAPS term loan facility terminated. In May and July 2007, Mattel repaid Medium-term notes which totaled $30.0 million and $20.0 million, respectively.

10. Other Noncurrent Liabilities

Other noncurrent liabilities include the following:

	September 30, 2007	September 30, 2006 (In thousands)	December 31, 2006

Noncurrent tax liabilities	$ 163,434	$ 18,970	$ 8,735
Benefit plan liabilities	188,905	179,031	176,584
Other	102,418	99,371	119,357
	$ 454,757	$ 297,372	$ 304,676

In connection with the January 1, 2007 adoption of FIN 48, tax reserves for which a cash tax payment is not expected in the next twelve months were reclassified from current income taxes payable to other noncurrent liabilities.

Table of Contents

11. Comprehensive Income (Loss)

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

	For the Three Months Ended September 30, 2007	For the Three Months Ended September 30, 2006	For the Nine Months Ended September 30, 2007	For the Nine Months Ended September 30, 2006
	(In thousands)			
Net income	$ 236,750	$ 239,025	$ 271,517	$ 306,575
Currency translation adjustments	40,060	4,577	73,086	36,566
Amortization of prior service cost	491		1,469	
Net unrealized (losses) gains on derivative instruments:				
Unrealized holding (losses) gains	(27,390)	3,917	(31,926)	(7,971)
Reclassification adjustment for realized losses (gains) included in net income	10,281	(762)	8,482	504
	(17,109)	3,155	(23,444)	(7,467)
	$ 260,192	$ 246,757	$ 322,628	$ 335,674

The components of accumulated other comprehensive loss are as follows:

	September 30, 2007	September 30, 2006	December 31, 2006
	(In thousands)		
Currency translation adjustments	$ (95,841)	$ (201,993)	$ (168,927)
Minimum pension liability adjustments, net of tax		(68,715)	
Net unrealized losses on derivative instruments, net of tax	(29,985)	(3,221)	(6,541)
Defined benefit plan adjustments, net of tax	(99,924)		(101,393)
	$ (225,750)	$ (273,929)	$ (276,861)

Currency Translation Adjustments

Mattel s reporting currency is the US dollar. The translation of its results of operations and financial position of 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 were related to entities having functional currencies denominated in the Euro, British pound sterling, Mexican peso, and Brazilian real. For the nine months ended September 30, 2007, currency translation adjustments resulted in a net gain of $73.1 million, with gains from the strengthening of the Euro, British pound sterling and Brazilian real against the US dollar. For the nine months ended September 30, 2006, currency translation adjustments resulted in a net gain of $36.6 million, with gains from the strengthening of the Euro and British pound sterling against the US dollar, partially offset by the weakening of the Mexican peso against the US dollar.

12. Income Taxes

As of January 1, 2007, Mattel had $122.0 million of liabilities for unrecognized tax benefits, of which $101.1 million would, if recognized, affect the effective tax rate. As of January 1, 2007, Mattel had $12.2 million of accrued liabilities for interest and penalties recognized in its consolidated balance sheet related to unrecognized tax benefits, of which $4.2 million would, if recognized, affect the effective tax rate.

9

In the normal course of business, Mattel is regularly audited by federal, state and foreign tax authorities. The Internal Revenue Service (IRS) has completed audits through the 2003 tax year and is currently auditing Mattel s 2004 and 2005 federal income tax returns. The IRS audit plan calls for the completion of the current examination in the first quarter of 2008. At this time, there is insufficient information related to current IRS, state, and foreign audits to quantify any possible changes in the unrecognized tax benefits that may occur during the next twelve months.

Mattel s federal income tax returns remain subject to examination for the 2004 through 2007 tax years. Mattel files multiple state income tax returns and remains subject to examination in major state jurisdictions, including California for the 2003 through 2007 tax years, New York for the 1998 through 2007 tax years, and Wisconsin for the 2004 through 2007 tax years. Mattel files multiple foreign income tax returns and remains subject to examination in major foreign jurisdictions, including Hong Kong and the Netherlands for the 2002 through 2007 tax years and in Mexico for the 2001 through 2007 tax years.

During the three months ended June 30, 2007, the state of New York enacted corporate tax law changes, effective retroactive to January 1, 2007, reducing its corporate tax rate from 7.5% to 7.1% and modifying its method of apportioning income to a single weighted sales factor. As a result of the law changes, Mattel s effective New York state tax rate decreased, resulting in a reduction of $5.3 million to previously recorded deferred tax assets during the three months ended June 30, 2007.

During the nine months ended September 30, 2006, Mattel recognized income tax benefits of $63.0 million related to settlements with taxing authorities, including $56.8 million as a result of settlements with foreign tax authorities and $6.2 million primarily due to a settlement with a state tax authority for tax years 1997 and 1998, and income tax benefits of $6.0 million related to a pre-tax charge of $19.3 million for prior period unintentional stock option accounting errors.

13. 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 receivables and payables 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 statements of operations. Gains and losses on unhedged intercompany loans and advances are recorded as a component of other non-operating (income) expense, net in the consolidated statements of operations in the period in which the currency exchange rate changes. Inventory purchase transactions denominated in the Euro, British pound sterling, Mexican peso, and Hong Kong dollar are the primary transactions that cause foreign currency transaction exposure for Mattel.

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

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
	(In thousands)			
Operating (income)	$ (25,250)	$ (12,817)	$ (52,982)	$ (17,789)
Other non-operating (income) expense, net	(7,398)	1,122	(9,579)	(309)
Net transaction (gains)	$ (32,648)	$ (11,695)	$ (62,561)	$ (18,098)

Table of Contents

14. Other Selling and Administrative Expenses

Other selling and administrative expenses include the following:

	For the Three Months Ended September 30, 2007	September 30, 2006	For the Nine Months Ended September 30, 2007	September 30, 2006
	(In thousands)			
Design and development	$ 45,237	$ 43,404	$ 136,043	$ 123,175
Identifiable intangible asset amortization	2,384	558	6,844	1,682

15. Earnings Per Share

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

Diluted net 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. Nonqualified stock options totaling 3.3 million shares were excluded from the calculation of diluted net income per common share for the three and nine months ended September 30, 2007, because they were anti-dilutive. Nonqualified stock options totaling 23.5 million and 24.3 million were excluded from the calculation of diluted net income per common share for the three and nine months ended September 30, 2006, respectively, because they were anti-dilutive.

16. 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 2006 Annual Report on Form 10-K.

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

	For the Three Months Ended September 30, 2007	September 30, 2006	For the Nine Months Ended September 30, 2007	September 30, 2006
	(In thousands)			
Service cost	$ 2,877	$ 2,938	$ 8,798	$ 8,541
Interest cost	5,446	5,743	16,677	17,082
Expected return on plan assets	(5,562)	(6,913)	(16,959)	(18,389)
Amortization of prior service cost	490	82	1,468	1,448
Recognized actuarial loss	2,119	2,661	6,398	7,164
	$ 5,370	$ 4,511	$ 16,382	$ 15,846

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

	For the Three Months Ended September 30,	September 30, 2006	For the Nine Months Ended September 30, 2007	September 30, 2006

	2007			
		(In thousands)		
Service cost	$ 20	$ 26	$ 74	$ 79
Interest cost	748	673	2,124	2,018
Recognized actuarial loss	265	229	635	688
	$ 1,033	$ 928	$ 2,833	$ 2,785

11

Table of Contents

During the three and nine months ended September 30, 2007, Mattel made cash contributions totaling approximately $5 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 during 2007, including approximately $10 million to cover benefit payments for its unfunded plans.

17. Share-Based Payments

Mattel has various stock compensation plans, which are more fully described in Note 7 to the Consolidated Financial Statements in its 2006 Annual Report on Form 10-K. Under the Mattel, Inc. 2005 Equity Compensation Plan (the 2005 Plan), Mattel has the ability to grant nonqualified stock options, incentive stock options, stock appreciation rights, restricted stock, restricted stock units (RSUs), dividend equivalent rights and shares of common stock to officers, employees, and other persons providing services to Mattel. Stock options expire no later than ten years from the date of grant and generally provide for vesting over a period of three years from the date of grant. Such stock options under the 2005 Plan were granted with exercise prices at or above the fair market value of Mattel s common stock on the applicable measurement dates.

Compensation expense, included within other selling and administrative expense, related to stock options and RSUs is as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended	
	2007	September 30, 2006	September 30, 2007	September 30, 2006
	(In thousands)			
Stock option compensation expense	$ 2,427	$ 1,563	$ 4,494	$ 2,700
RSU compensation expense	4,549	2,576	9,359	2,869
	$ 6,976	$ 4,139	$ 13,853	$ 5,569

For the three and nine months ended September 30, 2006, Mattel also recognized non-cash compensation expense of $19.3 million ($13.3 million net of income tax) related to prior period unintentional stock option accounting errors associated with the use of incorrect measurement dates for certain grants. The correcting adjustment also increased noncurrent deferred tax assets by $3.5 million and additional paid in capital by $16.8 million as of September 30, 2006.

As of September 30, 2007, total unrecognized compensation cost related to unvested share-based payments totaled $62.1 million and is expected to be recognized over a weighted-average period of 2.4 years.

Mattel uses treasury shares purchased under its share repurchase program to satisfy stock option exercises. Cash received for stock options exercises during the nine months ended September 30, 2007 and 2006 was $221.4 million and $29.2 million, respectively, and the tax benefit recognized as additional paid-in capital during the nine months ended September 30, 2007 and 2006 was $14.0 million and $3.0 million, respectively.

18. Product Recalls

In August 2007, Mattel recalled products with high-powered magnets that may become dislodged and other products that were produced using non-approved paint containing lead in excess of applicable regulatory and Mattel standards. During the three months ended June 30, 2007, Mattel reversed sales associated with the products that were recalled in August 2007, recorded an impairment of the affected inventory, and accrued other recall-related costs. These recall charges resulted in a total reduction to operating income of $28.8 million for the three months ended June 30, 2007, and were based on estimates associated with the expected levels of affected product at retail and historical consumer return rates.

Table of Contents

Mattel s actual returns experience associated with the August 2007 recalls has been higher than expected, particularly in international markets. Consequently, incremental charges related to the August 2007 recalls were recorded during the three months ended September 30, 2007 which reduced operating income by $13.3 million. Also, during the three months ended September 30, 2007, additional charges reducing operating income by $9.1 million were recorded for subsequent product recalls (collectively, along with the August 2007 recalls, the Product Recalls). Mattel has also incurred incremental costs for legal fees, recall advertisements, and recall administration around the world. Mattel estimates that it incurred incremental recall-related costs totaling approximately $17 million during the three months ended September 30, 2007.

Although management is not aware of any additional significant issues associated with lead in paints used on its products, there can be no assurance that additional issues will not be identified in the future. Mattel believes that it has some of the most rigorous quality and safety testing procedures in the toy industry.

Management also believes that Mattel s history of acting responsibly and quickly will maintain the trust of its customers and consumers. However, these recalls may have a negative impact on both customer and consumer demand for Mattel s products in the future.

19. Contingencies

With regard to the claims against Mattel described below, Mattel intends to defend itself vigorously. Management cannot reasonably determine the scope or amount of possible liabilities that could result from unfavorable settlement or resolution of these claims, and no reserves for these claims have been established as of September 30, 2007. However, it is possible that an unfavorable resolution of the claims could have a material adverse effect on Mattel s financial condition and results of operations, and there can be no assurance that Mattel will be able to achieve a favorable settlement or resolution of these claims.

Litigation Related to Product Recalls

Product Liability Litigation in the United States

Since August 7, 2007, seventeen lawsuits have been filed in the United States asserting claims allegedly arising out of the August 2, August 14, and/or September 4, 2007 voluntary product recalls by Mattel and Fisher-Price.

Twelve of those cases have been commenced in the following United States District Courts: seven in the Central District of California (*Mayhew v. Mattel*, filed August 7, 2007; *White v. Mattel*, filed August 16, 2007; *Luttenberger v. Mattel*, filed August 23, 2007; *Puerzer v. Mattel*, filed August 29,2007; *Shah v. Fisher-Price*, filed September 13, 2007; *Rusterholtz v. Mattel*, filed September 27, 2007; and *Jimenez v. Mattel*, filed October 12, 2007); two in the Southern District of New York (*Shoukry v. Fisher-Price*, filed August 10, 2007, and *Goldman v. Fisher-Price*, filed August 31, 2007), two in the Eastern District of Pennsylvania (*Monroe v. Mattel*, filed August 17, 2007, and *Chow v. Mattel*, filed September 7, 2007), one in the Southern District of Indiana (*Sarjent v. Fisher-Price*, filed August 16, 2007), and one in the District of South Carolina (*Hughey v. Fisher-Price*, filed August 24, 2007). Two other actions originally filed in Los Angeles County Superior Court have since been removed to federal court in the Central District of California (*Healy v. Mattel*, filed August 21, 2007, and *Powell v. Mattel*, filed August 20, 2007). Another lawsuit commenced in San Francisco County Superior Court has been removed to the federal court in the Northern District of California (*Harrington v. Mattel*, filed August 20, 2007). One other action was commenced in District of Columbia Superior Court, and it has since been removed to the United States District Court for the District of Columbia (*DiGiacinto v. Mattel*, filed August 29, 2007). As a result, all seventeen lawsuits in the United States are now pending in federal court. Mattel is a defendant in all of the actions, while Fisher-Price is named as a defendant in thirteen of the cases. Mattel Overseas, Inc., Mattel Sales Corp., Mattel Direct Import, Inc., and Mattel Operations, Inc., are named as

Table of Contents

defendants in two of the cases (*Powell* and *Chow*). Target Corporation, named as a defendant in the *Mayhew* case, has tendered the defense of the action to Mattel and requested indemnification for the specific claims in the complaint, which tender and request for indemnification have been accepted. Target Corporation is also a named defendant in the *Jimenez* action.

All but one of the cases seek to bring claims as a class action. Twelve of the lawsuits seek certification of a nationwide class, while four (*Monroe, Chow, Hughey* and *Harrington*) seek certification of statewide classes only. While the specific scope of each proposed plaintiff class varies, they generally seek to certify classes that would include either or both of (i) all purchasers in the United States of the toys recalled by Mattel and Fisher-Price in August and September 2007, and/or (ii) all children who used or were exposed to the toys recalled in August and September 2007 and/or their parents. In the *Harrington* and *Healy* actions, the claims are on their face tied to the August and September 2007 recalls, yet each seeks to certify a class that includes purchasers of toys from January 1, 2003, and August 14, 2003, respectively, to the present. Two of the actions (*Shoukry* and *Goldman*) also seek certification of a defendant class of other entities that purchased toys containing lead paint for resale from the manufacturer involved in the Company s August 2, 2007 recall. The *DiGiacinto* action is not a class action; rather, the plaintiff purports to represent the General Public of the District of Columbia under the District s consumer protection statute.

With some variation in how the claims are stated among the cases, they generally allege that defendants failed to prevent products manufactured in China from containing lead paint and misled the public with its branding and advertising suggesting that the products were safe. In the *Healy* and *Rusterholtz* cases, plaintiffs allege that the toys with magnets recalled on August 14, 2007, were defective. The cases present a range of legal theories, but they generally fall into four categories: (i) breach of express or implied warranty; (ii) consumer fraud and unfair practices under state statutes; (iii) traditional negligence and strict liability claims; and (iv) unjust enrichment. Plaintiffs make two fundamental claims with respect to the remedies sought: (i) the vouchers provided in connection with the recalls are inadequate and plaintiffs should receive cash compensation, usually in the form of reimbursement, restitution or disgorgement, and (ii) exposure to the toys has increased the risk of injury from lead so that defendants should be required to fund a medical monitoring program to test and/or treat children exposed to the recalled toys. Claims for statutory penalties, punitive damages, treble damages, pre-judgment and post-judgment interest and attorneys fees are also included in many of the cases. None of the actions filed in the United States specifies the amount of damages claimed. A number of the cases also seek injunctive relief, including orders requiring defendants to stop their allegedly deceptive consumer practices, institute additional testing of products from China, or certify that their products are lead-free.

All of the actions in the United States are at a preliminary stage.

Multidistrict Litigation

On September 5, 2007, Mattel and Fisher-Price filed a motion before the Judicial Panel on Multidistrict Litigation asking that all federal actions related to the recalls be coordinated and transferred to the Central District of California (*In re Mattel Inc. Toy Lead Paint Products Liability Litigation*). Some plaintiffs in the federal actions have supported coordination and transfer to the Central District of California, while others have opposed either coordination or the proposed location of any MDL proceedings. The MDL Panel has scheduled oral argument on the motion to coordinate the Mattel/Fisher-Price litigation for November 29, 2007.

California Proposition 65 Claims

On September 24 and September 26, 2007, respectively, the Environmental Law Foundation and the Center for Environmental Health (together, the Noticing Parties), each of which is a non-profit environmental group, issued pre-litigation notices of intent to sue (the Notices) against Mattel for allegedly failing to issue clear and reasonable warnings in accordance with California Health and Safety Code Section 25249.6 (Proposition 65) with regard to potential exposures to lead and lead compounds from certain toys distributed for sale in California.

Table of Contents

Pursuant to Proposition 65, the pre-litigation Notices must be served on the California Attorney General, the district attorneys in California, and certain city attorneys, at least sixty days before the Noticing Parties can proceed with a formal lawsuit. Prior to the expiration of the sixty-day period, the governmental authorities may file a Proposition 65 civil enforcement action in California Superior Court, which would preclude the Noticing Parties from proceeding with a lawsuit of their own. Proposition 65 provides for injunctive relief and civil monetary penalties in amounts up to $2,500 per day per violation; enforcement of Proposition 65 by governmental authorities may also involve claims under Section 17200 *et seq.* of the California Business & Professions Code, which provides for an additional civil penalty of up to $2,500 per day per violation as well as injunctive relief and restitutionary remedies. Mattel has not been advised to date as to whether the California Attorney General or any other governmental authority will proceed with a Proposition 65 enforcement action.

Product Liability Litigation in Canada

Since September 26, 2007, eight proposed class actions have been filed in the provincial superior courts of the following Canadian provinces: British Columbia (*Trainor v. Fisher-Price*, filed September 26, 2007); Alberta (*Cairns v. Fisher-Price*, filed September 26, 2007); Saskatchewan (*Sharp v. Mattel Canada*, filed September 26, 2007); Quebec (*El-Mousfi v. Mattel Canada*, filed September 27, 2007, and *Fortier v. Mattel Canada*, filed October 10, 2007); Ontario (*Wiggins v. Mattel Canada*, filed September 28, 2007); New Brusnwick (*Travis v. Fisher-Price*, filed September 28, 2007); and Manitoba (*Close v. Fisher-Price*, filed October 3, 2007). Mattel, Fisher-Price and Mattel Canada are defendants in all of the actions, and Fisher-Price Canada is a defendant in two of the actions (*El-Mousfi* and *Wiggins*). All but one of the cases seek certification of both a class of residents of that province and a class of all other residents of Canada outside the province where the action was filed. The most recent action filed in Quebec (*Fortier*), apparently filed without legal counsel, seeks certification of a class of residents of Quebec only. The classes are generally defined similarly in all of the actions to include both purchasers of the toys recalled by Mattel and Fisher-Price in August and September 2007 and children, either directly or through their parents as next friends, who have had contact with those toys (either directly or through their parents as next friends).

The actions in Canada generally allege that defendants were negligent in allowing their products to be manufactured and sold with lead paint on the toys and negligent in the design of the toys with the small magnets, which led to the sale of defective products. The cases typically state claims in four categories: (i) production of a defective product; (ii) misrepresentations; (iii) negligence; and (iv) violations of consumer protection statutes. Plaintiffs generally seek general and special damages, damages in the amount of monies paid for testing of children based on alleged exposure to lead, restitution of any amount of monies paid for replacing recalled toys, disgorgement of benefits resulting from recalled toys, aggravated and punitive damages, pre-judgment and post-judgment interest, and an award of litigation costs and attorneys fees. Plaintiffs in all of the actions except one do not specify the amount of damages sought. In the Ontario action (*Wiggins*), plaintiff demands general damages of CDN$75 million and special damages of CDN$150 million, in addition to the other remedies.

All of the actions in Canada are at a preliminary stage.

Product Liability and Related Claims in Brazil

Three consumer protection associations and agencies have filed claims against Mattel s subsidiary Mattel do Brasil Ltda. in the following courts in Brazil: (a) the Public Treasury Court in the State of Santa Catarina (*Associacao Catarinense de Defensa dos Cidadaos, dos Consumidores e dos Contribuintes ACC/*SC v. *Mattel do Brasil Ltda*., filed February 2, 2007); (b) the Second Circuit Commercial Court in the State of Rio de Janeiro (*Consumer Protection Committee from the State Legislative Body from Rio de Janeiro CPLeg/RJ v. Mattel do Brasil Ltda.*, filed August 17, 2007); and (c) the Sixth Circuit Civil Court in the Federal District (*Brazilian Institute for the Study and Defense of Consumer Relationships - IBEDEC v. Mattel do Brasil Ltda.*, filed September 13, 2007). The *ACC/SC* case relates to the recall of magnetic products in November 2006; the *CPLeg/RJ* case relates to the August 2007 recall of magnetic products; and the *IBEDEC* case relates to the August and September 2007 recalls of magnetic products and products with non-approved paint containing lead

Table of Contents

in excess of applicable regulatory and Mattel standards. The cases generally state claims in four categories: (i) production of a defective product; (ii) misrepresentations; (iii) negligence; and (iv) violations of consumer protection statutes. Plaintiffs generally seek general and special damages; restitution of monies paid by consumers to replace recalled toys; disgorgement of benefits resulting from recalled toys; aggravated and punitive damages; pre-judgment and post-judgment interest; injunctive relief; and litigation costs and attorneys fees. The amount of damages sought by plaintiffs is not generally specified, except that in the Public Treasury Court in the State of Santa Catarina action (*ACC/SC*), plaintiff demands general damages of approximately US$1 million, in addition to other remedies, and in the Sixth Circuit Civil Court in the Federal District action (*IBEDEC*), plaintiff demands general damages of approximately $25 million, in addition to other remedies.

Since August 20, 2007, the Department of Consumer Protection and Defense (DPDC), the Executive Group for Consumer Protection (PROCON) from São Paulo, Mato Grosso and Rio Grande do Norte, and public prosecutors from the States of Pernambuco and Rio de Janeiro have initiated seven administrative proceedings against Mattel do Brasil for offering products that Mattel allegedly should have known to present a risk for the consumers health and safety. The proceedings have been filed in the following administrative tribunals: (a) DPDC (*DPDC v. Mattel do Brasil Ltda.,* filed August 20, 2007, and *DPDC v. Mattel do Brasil Ltda.,* filed September 14, 2007); (b) PROCON (*PROCON/MT v. Mattel do Brasil,* filed August 29, 2007, *PROCON/SP v. Mattel do Brasil,* filed September 4, 2007, and *PROCON/RN v. Mattel do Brasil,* filed October 10, 2007); and (c) the Public Prosecutor s Office (*MP/RJ v. Mattel do Brasil,* filed September 27, 2007, and *MP/PE v. Mattel do Brasil,* filed September 28, 2007). The administrative proceedings generally state claims based on the alleged negligence of Mattel do Brasil regarding recalled products. In the *PROCON/SP* proceeding plaintiff estimates a fine equivalent to approximately $0.4 million. None of the other administrative proceedings listed above specify the amount of the penalties that could be applied if the claims against Mattel do Brasil are successful.

All of the actions in Brazil are at a preliminary stage.

Product Liability Litigation in Colombia

On August 22, 2007, plaintiff, a resident of Colombia, filed an action (*Matiz v. Ministry of Health, et al.*) in the Administrative Court for the Bogata Circuit in the Republic of Colombia against Mattel and the Colombian Ministry of Health. Plaintiff alleges the following claims: (a) violation of the collective right to free economic competition, (b) violation of the collective right to public health, (c) violation of the prohibition against the introduction of toxic waste into the national territory, and (d) violation of the collective right of consumers to be free from unsafe products. Plaintiff seeks the following relief: an affirmative injunction for additional recalls; a declaration of liability for violation of consumers collective rights to public health, free economic competition and the prohibition against the introduction of toxic waste into the national territory; economic incentives of between 10 and 150 times the minimum monthly legal wage; and an award of litigation costs and attorneys fees. The action in Colombia is in a preliminary stage.

20. Segment Information

Mattel s operating segments are separately managed business units and are divided on a geographic basis between domestic and international. On October 10, 2005, Mattel announced the consolidation of its domestic Mattel Girls & Boys Brands and Fisher-Price Brands divisions into one division. The creation of the Mattel Brands division, which resulted in the consolidation of some management and support functions, preserved the natural marketing and design groups that are empowered to create and market toys based on gender and age groups and is expected to more effectively and efficiently leverage Mattel s scale. These changes are consistent with Mattel s ongoing strategy to enhance innovation and improve execution. In connection with this consolidation, Mattel executed an initiative in 2006 to streamline its workforce, primarily in El Segundo, California. The consolidation of these divisions did not change Mattel s operating segments.

Table of Contents

Mattel s domestic operating segments include:

Mattel Girls & Boys Brands including Barbie® fashion dolls and accessories (Barbie®), Polly Pocket!, Pixel Chix, Winx Club and Disney Classics (collectively Other Girls Brands), Hot Wheels®, Matchbox® and Tyco® R/C vehicles and playsets (collectively Wheels) and Batman, CARS, Superman, Radica®, and games and puzzles (collectively Entertainment).

Fisher-Price Brands including Fisher-Price®, Little People®, BabyGear and View-Master® (collectively Core Fisher-Price®), Sesame Street®, Dora the Explorer, Go-Diego-Go!, Winnie the Pooh, InteracTV and See N Say® (collectively Fisher-Price® Friends) and Power Wheels®.

American Girl Brands including Just Like You®, the historical collection and Bitty Baby®. American Girl Brands products are sold directly to consumers and its children s publications are also sold to certain retailers.

Additionally, the International segment sells products in all toy categories, except American Girl Brands.

The following tables 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 (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 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 from operations based on the adjustments recorded in the financial accounting systems. Segment income from operations represents operating income, while consolidated income from operations represents income from operations 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, share-based payments, and corporate headquarters functions managed on a worldwide basis and the impact of changes in foreign currency rates on intercompany transactions.

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
	(In thousands)			
Revenues				
Domestic:				
Mattel Girls & Boys Brands US	$ 448,842	$ 467,342	$ 921,037	$ 961,219
Fisher-Price Brands US	514,064	518,551	1,005,781	949,805
American Girl Brands	71,091	71,226	189,777	194,733
Total Domestic	1,033,997	1,057,119	2,116,595	2,105,757
International	984,785	892,598	2,035,716	1,750,732
Gross sales	2,018,782	1,949,717	4,152,311	3,856,489
Sales adjustments	(180,208)	(159,405)	(370,847)	(315,175)
	$ 1,838,574	$ 1,790,312	$ 3,781,464	$ 3,541,314

	For the Three Months Ended September 30, 2007	September 30, 2006	For the Nine Months Ended September 30, 2007	September 30, 2006
		(In thousands)		
Segment Income				
Domestic:				
Mattel Girls & Boys Brands US	$ 83,838	$ 105,231	$ 112,184	$ 153,018
Fisher-Price Brands US	112,199	99,129	142,310	118,039
American Girl Brands	3,325	6,789	592	7,353
Total Domestic	199,362	211,149	255,086	278,410
International	165,047	176,097	240,745	216,301
	364,409	387,246	495,831	494,711
Corporate and other expense (a)	53,881	65,011	127,823	154,556
Operating income	310,528	322,235	368,008	340,155
Interest expense	16,354	22,559	44,969	53,840
Interest (income)	(6,202)	(6,722)	(28,644)	(21,983)
Other non-operating (income) expense, net	(7,312)	1,845	(8,108)	(2,114)
Income before income taxes	$ 307,688	$ 304,553	$ 359,791	$ 310,412

(a) Corporate and other expense includes (i) charges related to severance of $0.9 million and $2.3 million for the three and nine months ended September 30, 2007, respectively, and $0.5 million and $15.8 million for the three and nine months ended September 30, 2006, respectively, (ii) stock compensation expense of $7.0 million and $13.9 million for the three and nine months ended September 30, 2007, respectively, and $23.6 million and $24.9 million for the three and nine months ended September 30, 2006, respectively, and (iii) recall-related expenses estimated to total approximately $9 million for the three and nine months ended September 30, 2007. Stock compensation expense for the three and nine months ended September 30, 2006 included $19.3 million related to the correction of a prior period unintentional stock option accounting error. The 2006 severance charge was related to the January 2006 reduction of over 200 positions, primarily in connection with the streamlining of the Mattel Brands organization.

	September 30, 2007	September 30, 2006	December 31, 2006
		(In thousands)	
Assets			
Domestic:			
Mattel Girls & Boys Brands US	$ 380,500	$ 390,658	$ 296,533
Fisher-Price Brands US	432,102	429,384	217,124
American Girl Brands	99,092	99,628	61,014
Total Domestic	911,694	919,670	574,671
International	1,416,996	1,065,152	663,393
	2,328,690	1,984,822	1,238,064
Corporate and other	43,872	75,344	88,898
Accounts receivable and inventories	$ 2,372,562	$ 2,060,166	$ 1,326,962

Table of Contents

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

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
	(In thousands)			
Worldwide Revenues				
Mattel Girls & Boys Brands	$ 1,143,129	$ 1,082,062	$ 2,348,538	$ 2,184,896
Fisher-Price Brands	799,788	790,524	1,601,421	1,463,479
American Girl Brands	71,031	71,226	189,717	194,733
Other	4,834	5,905	12,635	13,381
Gross sales	2,018,782	1,949,717	4,152,311	3,856,489
Sales adjustments	(180,208)	(159,405)	(370,847)	(315,175)
Net sales	$ 1,838,574	$ 1,790,312	$ 3,781,464	$ 3,541,314

21. New Accounting Pronouncements

SFAS No. 157

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which provides guidance for using fair value to measure assets and liabilities. The standard also responds to investors requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. Under SFAS No. 157, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. SFAS No. 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data, for example, the reporting entity s own data. Fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS No. 157 is effective for Mattel as of January 1, 2008. Mattel does not expect the adoption of SFAS No. 157 to have a material impact on its results of operations and financial position.

SFAS No. 159

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which provides companies with an option to report selected financial assets and liabilities at fair value. The objective of SFAS No. 159 is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. SFAS No. 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective for Mattel as of January 1, 2008. Mattel does not expect the adoption of SFAS No. 159 to have a material impact on its results of operations or financial position.

Table of Contents

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Op erations.

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 its 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 Girls & Boys Brands including Barbie® fashion dolls and accessories (Barbie®), Polly Pocket!, Pixel Chix, Winx Club and Disney Classics (collectively Other Girls Brands), Hot Wheels®, Matchbox® and Tyco® R/C vehicles and playsets (collectively Wheels) and Batman, CARS, Superman, Radica®, and games and puzzles (collectively Entertainment).

Fisher-Price Brands including Fisher-Price®, Little People®, BabyGear and View-Master® (collectively Core Fisher-Price®), Sesame Street®, Dora the Explorer, Go-Diego-Go!, Winnie the Pooh, InteracTV and See N Say® (collectively Fisher-Price® Friends) and Power Wheels®.

American Girl Brands including Just Like You, the historical 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 domestic Mattel Girls & Boys Brands and Fisher-Price Brands divisions into one division. The creation of the Mattel Brands division, which resulted in the consolidation of some management and support functions, preserved the natural marketing and design groups that are empowered to create and market toys based on gender and age groups and is expected to more effectively and efficiently leverage Mattel s scale. These changes are consistent with Mattel s ongoing goals to enhance innovation and improve execution. In connection with this consolidation, Mattel executed an initiative in 2006 to streamline its workforce, primarily in El Segundo, California. The consolidation of these divisions did not change Mattel s operating segments.

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 three overarching goals.

The first goal is to enhance innovation in order to reinvigorate the Barbie® brand, while maintaining growth in other core brands by continuing to develop popular toys. 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 improve execution in areas including manufacturing, distribution and selling. In 2007, Mattel is continuing to focus on improving the efficiency of its supply chain using lean supply chain initiatives. The objective of the lean program is to improve the flow of processes, do more with less, and focus on the value chain from beginning to end.

Table of Contents

The third goal is to further capitalize on Mattel s scale advantage. For example, as the world s largest toy company, Mattel believes it can realize cost savings when making purchasing decisions based on a One Mattel philosophy.

Management believes that the business environment for Mattel for the remainder of 2007 will be similar to that of 2006. Mattel expects to continue facing challenges both domestically and internationally as retailers continue to tightly manage inventory. Additionally, Mattel has experienced continued cost pressures in the areas of product costs, including oil-based resin and zinc, and employee-related costs. Management believes that Mattel will continue to encounter a challenging retail environment, along with cost pressures.

Product Recalls

During the third quarter of 2007, Mattel recalled products with high-powered magnets that may become dislodged and other products that were produced using non-approved paint containing lead in excess of applicable regulatory and Mattel standards. As a result of these recalls, Mattel intentionally slowed down its shipments out of Asia while it conducted extensive product testing. Also, export licenses at several manufacturing facilities in China were temporarily suspended in September 2007 while safety procedures were reviewed. While nearly all the licenses are now back in place, delays of one to two weeks in shipments from some facilities reduced Mattel s net sales for the third quarter of 2007, particularly affecting the Barbie® and Fisher-Price® Friends brands. Mattel s ability to import products into certain countries was also impacted by product recalls as certain countries and regulatory authorities reviewed Mattel s safety procedures. These issues have since been resolved in most countries and did not have a significant financial impact on Mattel s third quarter results. In Brazil, Mattel has been allowed to resume shipping some toys, and is working with authorities to gain approval for the remaining containers. In the third quarter of 2007, Mattel had sufficient inventory on hand in Brazil to fill most orders.

The August 2007 recall of products with high-powered magnets was a recall of older toys with magnets that do not meet Mattel s current retention system requirements. Since November 2006, when Mattel conducted its first voluntary recall for magnetic toys, Mattel has implemented enhanced magnet retention systems across all of its brands. Beginning in January 2007, all magnets must be locked into the toy with sturdy material holding in the edges around the exposed face of the magnet or completely covering or encapsulating the magnet. Mattel also conducted an extensive review of technical data and consumer information on all magnetic toys and is confident in the new requirements, based on its continued testing and consumer experience.

In July 2007, Mattel determined that certain products, manufactured by a third-party contract manufacturer in China, were produced using non-approved paint containing lead in excess of applicable regulatory and Mattel standards. As a result, and also in July 2007, Mattel launched a thorough investigation and expanded its testing programs to ensure that painted finished goods, at third-party contract manufacturers as well as facilities operated by Mattel, are systematically tested prior to being shipped to customers. In addition, Mattel implemented a strengthened three-point check system to enforce compliance with all regulations and standards applicable to lead paint, as follows:

Every batch of paint must not only be purchased from a certified paint supplier but also be re-tested before it is used, to ensure compliance with lead standards.

To further ensure that Mattel toys are safe before they reach store shelves, paint on samples of finished products from every production run must be tested for lead either by Mattel s own laboratories or by laboratories certified by Mattel.

Mattel has increased the frequency of random, unannounced inspections of vendors and subcontractors for compliance with Mattel s quality and safety procedures, including the applicable lead paint standard.

21

Table of Contents

Mattel has also implemented additional protections. Vendors and subcontractors must segregate all production for Mattel and they must have dedicated storage for paint used on Mattel products. No subcontractor may further subcontract out any part of a job to other locations. Before using a subcontractor s components in Mattel products, a vendor must test samples of such components for lead paint. Finally, the vendor as well as the subcontractor are both subject to unannounced audits and are held accountable for Mattel s rules and requirements. More generally, Mattel has also created a new Corporate Responsibility organization, which has an even greater level of accountability internally and externally for adherence to the company s safety and compliance protocols.

Although management is not aware of any additional significant issues associated with lead in paints used on its products, there can be no assurance that additional issues will not be identified in the future. Mattel believes that it has some of the most rigorous quality and safety testing procedures in the toy industry. Management also believes that Mattel s history of acting responsibly and quickly will maintain the trust of its customers and consumers. However, these recalls may have a negative impact on both customer and consumer demand for Mattel s products in the future.

Results of Operations Third Quarter

Consolidated Results

Net sales for the third quarter of 2007 were $1.84 billion, up 3% as compared to $1.79 billion in 2006, including favorable changes in currency exchange rates of 3 percentage points. Net income for the third quarter of 2007 was $236.8 million, or $0.61 per diluted share, as compared to $239.0 million in the third quarter of 2006, or $0.62 per diluted share.

Operating income for the third quarter of 2007 of $310.5 million included charges and incremental costs of approximately $40 million related to product recalls during 2007. Of this total, $13.3 million related to an increase in the reserves recorded in the second quarter of 2007, due primarily to higher than anticipated product return rates, $9.1 million related to additional reserves for subsequent product recalls, and approximately $17 million related to incremental recall-related legal, advertising and administration costs incurred in the third quarter of 2007.

Operating income for the third quarter of 2006 was negatively impacted by $19.3 million of non-cash compensation expense related to prior period unintentional stock option accounting errors.

The following table provides a summary of Mattel s consolidated results for the third quarter of 2007 and 2006 (in millions, except percentage and basis point information):

	For the Three Months Ended September 30,					
	2007		2006		Year/Year Change	
	Amount	% of Net Sales	Amount	% of Net Sales	%	Basis Points of Net Sales
Net sales	$ 1,838.6	100.0%	$ 1,790.3	100.0%	3%	
Gross profit	$ 864.7	47.0%	$ 851.4	47.6%	2%	(60)
Advertising and promotion expenses	211.4	11.5	205.9	11.5	3%	
Other selling and administrative expenses	342.8	18.6	323.3	18.1	6%	50
Operating income	310.5	16.9	322.2	18.0	4%	(110)
Interest expense	16.4	0.9	22.6	1.3	28%	(40)
Interest (income)	(6.2)	0.3	(6.7)	0.4	8%	10
Other non-operating (income) expense, net	(7.4)		1.7			
Income before income taxes	$ 307.7	16.7%	$ 304.6	17.0%		(30)

Table of Contents

Sales

Net sales for the third quarter of 2007 were $1.84 billion, up 3% as compared to $1.79 billion in 2006, including favorable changes in currency exchange rates of 3 percentage points. In the third quarter of 2007, the Product Recalls reduced net sales by approximately $19 million for sales returns and reserves recorded. Gross sales within the US decreased 2%, as compared to 2006, and accounted for 51.2% of consolidated gross sales in 2007, as compared to 54.2% in 2006. Gross sales in international markets increased 10% during the third quarter of 2007, as compared to 2006, including favorable changes in currency exchange rates of 6 percentage points.

Worldwide gross sales of Mattel Girls & Boys Brands increased 6% in the third quarter of 2007 to $1.14 billion, with favorable changes in currency exchange rates of 4 percentage points. Domestic gross sales of Mattel Girls & Boys Brands decreased 4% as compared to the third quarter of 2006 and international gross sales increased 13%, with favorable changes in currency exchange rates of 7 percentage points. Worldwide gross sales of Barbie® decreased 4% from the third quarter of 2006, with favorable changes in currency exchange rates of 4 percentage points. The decline was primarily due to ongoing softness in Barbie® Fantasy products as well as shipping delays caused by short-term supply chain disruptions resulting from the Product Recalls. International gross sales of Barbie® increased 6%, including favorable changes in currency exchange rates of 6 percentage points, while domestic gross sales of Barbie® decreased 19% in the third quarter of 2007. Worldwide gross sales of Other Girls products decreased 10%, including favorable changes in currency exchange rates of 3 percentage points, primarily due to sales declines in Polly Pocket! domestically and Pixel Chix and Winx Club internationally. Worldwide gross sales of Wheels products increased 9%, including favorable changes in currency exchange rates of 3 percentage points, primarily as a result of strong sales growth in Hot Wheels® internationally and Matchbox® worldwide, which more than offset sales declines in Hot Wheels® and Tyco® R/C domestically. Worldwide gross sales of Entertainment products increased 29%, including favorable changes in currency exchange rates of 4 percentage points, primarily driven by continued strong worldwide sales of CARS products and the inclusion of approximately $58 million of Radica® sales.

Worldwide gross sales of Fisher-Price Brands increased 1% in the third quarter of 2007 to $799.8 million, including favorable changes in currency exchange rates of 2 percentage points. International gross sales of Fisher-Price Brands increased 5%, including favorable changes in currency exchange rates of 5 percentage points, while domestic gross sales decreased 1%. Worldwide gross sales of Core Fisher-Price® increased 19%, including favorable changes in currency exchange rates of 2 percentage points, primarily driven by continued strength in infant, preschool, BabyGear, learning, and newborn products. Worldwide gross sales of Fisher-Price® Friends decreased 30%, including a 1 percentage point benefit from changes in currency exchange rates. The decrease in Fisher-Price® Friends was primarily driven by sales declines in Dora the Explorer, Winnie the Pooh, and Sesame Street and supply chain delays caused by the Product Recalls.

American Girl Brands gross sales were flat in the third quarter of 2007 at $71.0 million as compared to $71.2 million in the third quarter of 2006, driven by softness in the catalog business, partially offset by contributions from the August 2007 opening of the Atlanta American Girl® Boutique & Bistro and the September 2007 launch of the newest historical character, Julie.

Cost of Sales

Cost of sales increased by $35.0 million, or 4%, from $938.9 million in the third quarter of 2006 to $973.9 million in the third quarter of 2007, as compared to a 3% increase in net sales. On an overall basis, cost of sales increased primarily due to increased sales volume and the impact of the Product Recalls, which increased cost of sales by approximately $3 million in the third quarter of 2007. Within cost of sales, product costs increased by $44.2 million, or 6%, from $753.5 million in the third quarter of 2006 to $797.7 million in the third quarter of 2007, which was primarily driven by increased sales volume and the impact of the Product Recalls. Royalty expense decreased by $9.0 million, or 10%, from $86.6 million in the third quarter of 2006 to $77.6 million in third quarter of 2007, and is primarily reflective of product mix. Freight and logistics expenses in the third quarter of 2007 of $98.6 million were flat with the third quarter of 2006.

Gross Profit

Gross profit, as a percentage of net sales, was 47.0% in the third quarter of 2007, as compared to 47.6% in the third quarter of 2006. The decrease in gross profit was primarily driven by a 70 basis point negative impact from Product Recall costs. Alignment of prices with increased input costs and favorable exchange rates largely offset external cost pressures.

Advertising and Promotion Expenses

Advertising and promotion expenses in the third quarter of 2007 were flat with the third quarter of 2006 at 11.5% of net sales. Product recall-related advertising and promotion expenditures were approximately $4 million in the third quarter of 2007.

Other Selling and Administrative Expenses

Other selling and administrative expenses were $342.8 million, or 18.6% of net sales, in the third quarter of 2007, as compared to $323.3 million, or 18.1% of net sales, in the third quarter of 2006. The Product Recalls increased other selling and administrative expenses by approximately $14 million in the third quarter of 2007. Compensation expense related to stock options and RSUs totaled $7.0 million in the third quarter of 2007 as compared to $23.6 million in the third quarter of 2006. Compensation expense related to stock options for the third quarter of 2006 included $19.3 million for the correction of prior period unintentional stock option accounting errors. Higher employee-related costs, increased investments in the business, the negative impact of foreign currency exchange rates and the inclusion of Radica® costs also contributed to the increase in other selling and administrative expenses during the third quarter of 2007, which was partially offset by lower incentive compensation costs.

Non-Operating Items

Interest expense decreased from $22.6 million in the third quarter of 2006 to $16.4 million in the third quarter of 2007, primarily due to lower average borrowings. Interest income decreased from $6.7 million in the third quarter of 2006 to $6.2 million in the third quarter of 2007, primarily due to lower average invested cash balances. Other non-operating income increased from a loss of $1.8 million in the third quarter of 2006 to income of $7.3 million in the third quarter of 2007, due primarily to foreign currency exchange gains.

Provision for Income Taxes

Provision for income taxes increased from $65.5 million in the third quarter of 2006 to $70.9 million in the third quarter of 2007. During the second quarter of 2007, Mattel recognized tax expense of $5.3 million related to enacted New York corporate tax law changes. During the third quarter of 2006, Mattel recognized income tax benefits of $6.0 million related to a pre-tax charge of $19.3 million for prior period unintentional stock option accounting errors.

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 Girls & Boys Brands US, Fisher-Price Brands US and American Girl Brands.

Domestic Segment

Mattel Girls & Boys Brands US gross sales decreased to $448.8 million in the third quarter of 2007 as compared to $467.3 million in the third quarter of 2006. Within this segment, gross sales of Barbie® products

Table of Contents

decreased 19%, primarily driven by short-term supply chain disruptions resulting from the Product Recalls and sales declines in Barbie® Fantasy. Gross sales of Other Girls products decreased 13%, primarily driven by lower sales of Polly Pocket! products. Gross sales of Wheels products decreased 5%, primarily driven by lower sales of Tyco® R/C and Hot Wheels® products, partially offset by higher sales of Matchbox® products. Gross sales of Entertainment products increased 25%, primarily driven by continued strong sales of CARS products and the inclusion of Radica® sales. Mattel Girls & Boys Brands US segment operating income decreased $21.4 million to $83.8 million in the third quarter of 2007, largely driven by lower sales volume, the impact of the Product Recalls, which lowered Mattel Girls & Boys Brands US segment income by approximately $4 million, and higher other selling and administrative expenses.

Fisher-Price Brands US gross sales decreased 1% in the third quarter of 2007 as compared to the third quarter of 2006, reflecting a decrease in Fisher-Price® Friends sales, partially offset by increased sales of Core Fisher-Price® products. Sales increases in Core Fisher-Price® products reflected strong sales of learning, preschool, infant, and BabyGear products. Lower sales of Fisher-Price® Friends products were driven primarily by sales declines in Dora the Explorer, Winnie the Pooh, and the impact of the Product Recalls. Fisher-Price Brands US segment income increased $13.1 million to $112.2 million in the third quarter of 2007 from $99.1 million in the third quarter of 2006, primarily due to higher gross margins, partially offset by the impact of the Product Recalls, which lowered segment income by approximately $6 million.

American Girl Brands gross sales were flat in the third quarter of 2007 at $71.1 million, as compared to $71.2 million in the third quarter of 2006, driven by softness in the catalog business, partially offset by contributions from the August 2007 opening of the Atlanta American Girl® Boutique & Bistro and the September 2007 launch of the newest historical character, Julie. American Girl Brands segment operating income declined from $6.8 million in the third quarter of 2006 to $3.3 million in the third quarter of 2007, primarily due to higher other selling and administrative expenses and opening costs for the Atlanta American Girl® Boutique & Bistro.

International Segment

The following table provides a summary of percentage changes in gross sales within the International segment for the third quarter of 2007 versus 2006:

Non-US Regions:	**% Change in Gross Sales**	**Impact of Change in Currency Rates (in % pts)**
Total International	10	6
Europe	9	6
Latin America	17	6
Asia Pacific	16	6
Other	(6)	4

International gross sales increased by 10% in the third quarter of 2007, as compared to the third quarter of 2006, including favorable changes in currency exchange rates of 6 percentage points. Gross sales of Barbie® increased 6% in the third quarter of 2007, including favorable changes in currency exchange rates of 6 percentage points. Gross sales of Other Girls products decreased 8% in the third quarter of 2007, including favorable changes in currency exchange rates of 5 percentage points, primarily driven by sales declines in Pixel Chix and Winx Club. Gross sales of Wheels products increased 23%, including favorable changes in currency exchange rates of 7 percentage points, reflecting growth in Hot Wheels® and Matchbox®. Gross sales of Entertainment products increased 32%, including favorable changes in currency exchange rates of 8 percentage points, primarily driven by strong sales of CARS products, growth in the games business, and the inclusion of Radica® sales. Gross sales of Fisher-Price Brands increased 5%, including favorable changes in currency exchange rates of 5 percentage points, driven by strong sales of Core Fisher-Price® products, offset by sales declines in Fisher-Price® Friends. International segment income decreased from $176.1 million in the third

Table of Contents

quarter of 2006 to $165.0 million in the third quarter of 2007, primarily due to the impact of the Product Recalls, which lowered International segment income by approximately $21 million, and higher other selling and administrative expenses, partially offset by increased sales volume.

Results of Operations First Nine Months

Consolidated Results

Net sales for the first nine of 2007 were $3.78 billion, up 7% as compared to $3.54 billion in 2006, including favorable changes in currency exchange rates of 3 percentage points. Net income for the first nine months of 2007 was $271.5 million, or $0.68 per diluted share, as compared to net income of $306.6 million, or $0.79 per diluted share for the first nine months of 2006. Operating income for the first nine months of 2007 of $368.0 million included charges and incremental costs of approximately $69 million related to the Product Recalls. Of this total, $28.8 million related to reserves recorded in the second quarter of 2007, $13.3 million related to an increase to the reserves that were recorded in the second quarter of 2007, due primarily to higher than anticipated product return rates, $9.1 million related to additional reserves for subsequent product recalls, and approximately $17 million related to incremental recall-related legal, advertising and administration costs incurred in the third quarter of 2007. Operating income for the first nine months of 2006 was negatively impacted by $19.3 million of non-cash compensation expense related to prior period unintentional stock option accounting errors, and $15.8 million of severance primarily related to the streamlining of the Mattel Brands organization. Net income for the first nine months of 2006 was positively impacted by $63.0 million of income tax benefits, primarily related to audit settlements with foreign and state tax authorities.

The following table provides a summary of Mattel s consolidated results for the first nine months of 2007 and 2006 (in millions, except percentage and basis point information):

	For the Nine Months Ended September 30,					
	2007		2006		Year/Year Change	
	Amount	% of Net Sales	Amount	% of Net Sales	%	Basis Points of Net Sales
Net sales	$ 3,781.5	100.0%	$ 3,541.3	100.0%	7%	
Gross profit	$ 1,726.6	45.7%	$ 1,599.4	45.2%	8%	50
Advertising and promotion expenses	423.9	11.2	395.3	11.2	7%	
Other selling and administrative expenses	934.7	24.7	863.9	24.4	8%	30
Operating income	368.0	9.7	340.2	9.6	8%	10
Interest expense	45.0	1.2	53.8	1.5	16%	(30)
Interest (income)	(28.6)	0.8	(22.0)	0.6	30%	(20)
Other non-operating (income), net	(8.2)		(2.0)			
Income before income taxes	$ 359.8	9.5%	$ 310.4	8.8%		70

Sales

Net sales for the first nine months of 2007 were $3.78 billion, up 7% as compared to $3.54 billion in 2006, including favorable changes in currency exchange rates of 3 percentage points. The Product Recalls reduced net sales by approximately $36 million for sales returns and reserves recorded for the first nine months of 2007. Gross sales within the US increased 1% in the first nine months of 2007, as compared to 2006, and accounted for 51.0% of consolidated gross sales in the first nine months of 2007, as compared to 54.6% in 2006. Gross sales in international markets increased 16% in the first nine months of 2007, as compared to 2006, including favorable changes in currency exchange rates of 6 percentage points.

Worldwide gross sales of Mattel Girls & Boys Brands increased 7% in the first nine months of 2007 to $2.35 billion, with favorable changes in currency exchange rates of 3 percentage points. Domestic gross sales of

Table of Contents

Mattel Girls & Boys Brands decreased 4% as compared to the first nine months of 2006 and international gross sales increased 17%, with favorable changes in currency exchange rates of 7 percentage points. Worldwide gross sales of Barbie® remained flat with 2006, with a 4 percentage point benefit from currency exchange rates. During the first nine months of 2007, domestic gross sales of Barbie® decreased 16%, and international gross sales increased 11%, including favorable changes in currency exchange rates of 6 percentage points. Worldwide gross sales of Other Girls products declined 8%, including favorable changes in currency exchange rates of 3 percentage points, due to sales declines in Polly Pocket! domestically and Pixel Chix and Winx Club worldwide. Worldwide gross sales of Wheels products increased 13%, including favorable changes in currency exchange rates of 3 percentage points, primarily as a result of strong sales growth in Hot Wheels® internationally and Matchbox® worldwide, which more than offset sales declines in Hot Wheels® and Tyco® R/C domestically. Worldwide gross sales of Entertainment products increased 23%, including favorable changes in currency exchange rates of 4 percentage points, primarily driven by continued strong worldwide sales of CARS products, the inclusion of Radica® sales, and growth in the games business, partially offset by sales declines in Superman products.

Worldwide gross sales of Fisher-Price Brands were $1.60 billion, up 9% in the first nine months of 2007, including a 1 percentage point benefit from currency exchange rates. Worldwide gross sales of Core Fisher-Price® increased 22%, including favorable changes in currency exchange rates of 3 percentage points, primarily driven by continued strength in preschool, BabyGear, infant, learning and newborn products. Worldwide gross sales of Fisher-Price® Friends decreased by 13%, including favorable changes in currency exchange rates of 2 percentage points, primarily due to sales declines of Dora the Explorer and Winnie the Pooh products, partially offset by higher sales of Sesame Street products.

American Girl Brands gross sales were $189.7 million, down 3% in the first nine months of 2007, as compared to $194.7 million in the first nine months of 2006, primarily due to softness in the catalog business and lower sales of historical characters, partially offset by sales from the Los Angeles American Girl Place® store, which opened in April 2006 and the Atlanta American Girl® Boutique and Bistro, which opened in August 2007.

Cost of Sales

Cost of sales in the first nine months of 2007 were $2.05 billion, up $113.0 million or 6%, from $1.94 billion in 2006, as compared to a 7% increase in net sales. On an overall basis, cost of sales increased primarily due to increased sales volume and the impact of the Product Recalls, which increased costs of sales by $12.7 million during the first nine months of 2007. Within cost of sales, product costs increased by $119.6 million, or 8%, from $1.54 billion in the first nine months of 2006 to $1.66 billion in the first nine months of 2007, which was primarily driven by increased sales volume and the impact of the Product Recalls. Royalty expense decreased $11.3 million, or 7%, from $168.7 million in the first nine months of 2006 to $157.4 million in first nine months of 2007, and is reflective of product mix. Freight and logistics expenses increased by $4.7 million, or 2%, from $230.4 million in the first nine months of 2006 to $235.1 million in the first nine months of 2007.

Gross Profit

Gross profit, as a percentage of net sales, was 45.7% in the first nine months of 2007 as compared to 45.2% in the first nine months of 2006. The improvement in gross profit was primarily driven by the alignment of prices with increased output costs and favorable exchange rates, partially offset by external cost pressures and an 80 basis point negative impact from the Product Recalls.

Advertising and Promotion Expenses

Advertising and promotion expenses remained flat at 11.2% of net sales in the first nine months of 2007, as compared to 2006. Product recall-related advertising and promotion expenditures were approximately $4 million during the first nine months of 2007.

Other Selling and Administrative Expenses

Other selling and administrative expenses were $934.7 million, or 24.7% of net sales, in the first nine months of 2007 as compared to $864.0 million, or 24.4% of net sales, in the first nine months of 2006. The Product Recalls increased other selling and administrative expenses by approximately $16 million during the first nine months of 2007. Compensation expense related to stock options and RSUs totaled $13.9 million in the first nine months of 2007 as compared to $24.9 million in the first nine months of 2006. Compensation expense related to stock options for the first nine months of 2006 included $19.3 million of compensation expense for the correction of prior period unintentional stock option accounting errors. The first nine months of 2006 also included a $15.8 million severance charge related to the streamlining of the Mattel Brands organization. Higher investments in the business, including design and development costs and expansion in international markets, the impact of foreign exchange rates, increases in employee-related costs, and the inclusion of Radica® costs also contributed to the increase.

Non-Operating Items

Interest expense decreased from $53.8 million in the first nine months of 2006 to $45.0 million in the first nine months of 2007, due to lower average borrowings. Interest income increased from $22.0 million in the first nine months of 2006 to $28.6 million in the first nine months of 2007, due to higher average invested cash balances and higher average interest rates. Other non-operating income, net increased from $2.1 million to $8.1 million in the first nine months of 2007, primarily due to foreign currency exchange gains.

Provision for Income Taxes

Mattel s provision for income taxes for the first nine months of 2007 includes income tax expense of $5.3 million relating to a change in a New York state tax law. During the first nine months of 2006, Mattel recognized income tax benefits of $63.0 million related to settlements with foreign and state tax authorities, and income tax benefits of $6.0 million related to a pre-tax charge of $19.3 million for prior period unintentional stock option accounting errors.

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 Girls & Boys Brands US, Fisher-Price Brands US and American Girl Brands.

Domestic Segment

Mattel Girls & Boys Brands US gross sales were $921.0 million in the first nine months of 2007, down $40.2 million or 4%, as compared to $961.2 million in the first nine months of 2006. Within this segment, gross sales of Barbie® products decreased 16%, primarily driven by sales declines in Barbie® Fantasy products. Gross sales of Other Girls products decreased 17%, primarily driven by sales declines of Polly Pocket! and Pixel Chix products. Gross sales of Wheels products decreased 2%, primarily due to sales declines in Hot Wheels® and Tyco® R/C, partially offset by higher sales of Matchbox® products. Gross sales of Entertainment products increased 16%, primarily driven by continued strong sales of CARS products and the inclusion of Radica® sales, partially offset by lower sales of Superman products. Mattel Girls & Boys Brands US segment income decreased $40.8 million, to $112.2 million in the first nine months of 2007, driven by lower sales volume, higher other selling and administrative expenses, and the impact of the Product Recalls, which lowered Mattel Girls & Boys Brands US segment income by approximately $8 million.

Fisher-Price Brands US gross sales increased 6% in the first nine months of 2007 as compared to the first nine months of 2006, reflecting an increase in sales of Core Fisher-Price® products, partially offset by sales declines of Fisher-Price® Friends products. Sales increases in Core Fisher-Price® products reflected strong sales of preschool, BabyGear, learning, and infant products. Sales decreases in Fisher-Price® Friends products were driven by sales declines of Dora the Explorer and Winnie the Pooh products, during the first nine months of 2007, partially offset by higher Sesame Street sales. Fisher-Price Brands US segment income increased $24.3 million to $142.3 million in the first nine months of 2007 from $118.0 million in the first nine months of 2006, primarily due to higher sales volume and improved gross profit, partially offset by higher other selling and administrative expenses and the impact of the Product Recalls, which decreased Fisher-Price Brands US segment operating income by approximately $21 million during the first nine months of 2007.

American Girl Brands gross sales declined 3% in the first nine months of 2007, as compared to the first nine months of 2006, primarily due to softness in the catalog business and lower sales of historical characters, partially offset by sales from the Los Angeles American Girl Place® store, which opened in April 2006 and American Girl® Boutique and Bistro retail store in Atlanta, Georgia, which opened in August 2007. American Girl Brands segment operating income declined from income of $7.4 million in the first nine months of 2006 to $0.6 million in the first nine months of 2007, primarily due to lower sales volume and higher other selling and administrative expenses.

International Segment

The following table provides a summary of percentage changes in gross sales within the International segment for the first nine months of 2007 versus 2006:

Non-US Regions:	% Change in Gross Sales	Impact of Change in Currency (in % pts)
Total International	16	6
Europe	16	6
Latin America	24	5
Asia Pacific	13	6
Other	(7)	2

International gross sales increased by 16% in the first nine months of 2007, as compared to the first nine months of 2006, including favorable changes in currency exchange rates of 6 percentage points. Gross sales of Barbie® increased 11% in the first nine months of 2007, including favorable changes in currency exchange rates of 6 percentage points, primarily due to higher sales of Barbie® Reality products. Gross sales of Other Girls products decreased 1% in the first nine months of 2007, including favorable changes in currency exchange rates of 6 percentage points. Gross sales of Wheels products increased 27%, including favorable changes in currency exchange rates of 6 percentage points, reflecting growth in Hot Wheels® and Matchbox®. Gross sales of Entertainment products increased 29%, including favorable changes in currency exchange rates of 7 percentage points, primarily driven by strong sales of CARS products, growth in the games business, and the inclusion of Radica® sales, partially offset by sales declines of Superman products. Gross sales of Fisher-Price Brands increased 16%, including favorable changes in currency exchange rates of 5 percentage points, driven by strong sales in Core Fisher-Price®, partially offset by sales declines of Fisher-Price® Friends products. International segment income was $240.7 million in the first nine months of 2007, up $24.4 million from $216.3 million in the first nine months of 2006, primarily due to increased sales volume, partially offset by higher other selling and administrative expenses and the impact of the Product Recalls, which decreased International segment operating income by approximately $31 million during the first nine months of 2007.

Income Taxes

During the first nine months of 2007, Mattel recognized tax expense of $5.3 million related to enacted New York corporate tax law changes. During the first nine months of 2006, Mattel recognized income tax benefits of $63.0 million as a result of settlements with foreign and state tax authorities and income tax benefits of $6.0 million related to a pre-tax charge of $19.3 million for prior period unintentional stock option accounting

Table of Contents

errors. Mattel s provision for income taxes could be positively or negatively impacted by the results of routine audits by federal, state, and foreign tax authorities and enacted income tax legislation by federal, state, and foreign governments.

Liquidity and Capital Resources

Mattel s primary sources of liquidity are its cash balances and access to short-term borrowing facilities. 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-capital ratio of about 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 implement successfully 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.

Operating Activities

Cash flows used for operating activities were $611.0 million in the first nine months of 2007, as compared to $367.7 million used in the first nine months of 2006. The increase in cash flows used for operating activities was primarily due to changes in the amount and timing of accrued liabilities and accounts payables, lower sales of receivables, lower net income and increased inventory.

Investing Activities

Cash flows used for investing activities in the first nine months of 2007 increased $136.8 million to $237.3 million, as compared to $100.5 million used in the first nine months of 2006, mainly due to the May 2007 acquisition of Origin Products Limited for $79.6 million, the August 2007 purchase of rights to manufacture, distribute and market several game properties from Out of the Box Publishing, Inc. for $25.1 million, and a $35.0 million long-term investment security. Mattel s spending level for 2007 is expected to be below the long-term targets of $180-$200 million, as set forth in the capital and investment framework.

Table of Contents

Financing Activities

Cash flows used for financing activities in the first nine months of 2007 were $87.9 million, as compared to cash flow provided from financing activities of $16.8 million in the first nine months of 2006. The decrease in net cash flows from financing activities was primarily due to higher share repurchases in the first nine months of 2007, which were partially offset by higher proceeds from the exercise of stock options and higher net borrowings.

Seasonal Financing

Mattel maintains and periodically amends or replaces a $1.3 billion 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 expires on March 23, 2010 and interest is charged at various rates selected by Mattel, ranging from market commercial paper rates to the bank reference rate. The 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 2007. As of September 30, 2007, Mattel s consolidated debt-to-capital ratio, as calculated per the terms of the credit agreement, was 0.32 to 1 (compared to a maximum allowed of 0.60 to 1) and Mattel s interest coverage ratio was 13.73 to 1 (compared to a minimum required 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.

On December 9, 2005, Mattel, Mattel Asia Pacific Sourcing Limited (MAPS), a wholly-owned subsidiary of Mattel, Bank of America, N.A., as a lender and administrative agent, and other financial institutions executed a credit agreement (the MAPS facility) which provided for (i) a term loan facility of $225.0 million consisting of a term loan advanced to MAPS in the original principal amount of $225.0 million, with $50.0 million of such amount to be repaid on each of December 15, 2006 and December 15, 2007, and the remaining aggregate principal amount of $125.0 million to be repaid on December 9, 2008, and (ii) a revolving loan facility consisting of revolving loans advanced to MAPS in the maximum aggregate principal amount at any time outstanding of $100.0 million, with a maturity date of December 9, 2008. Interest was charged at various rates selected by Mattel based on Eurodollar rates or bank reference rates. On December 15, 2006, in addition to the required payment of $50.0 million, MAPS prepaid an incremental $125.0 million of the MAPS term loan facility. The remaining $50.0 million principal amount, consisting of $14.3 million due on December 15, 2007 and $35.7 million due on December 9, 2008, was prepaid on January 16, 2007. As a result of such pre-payments, the MAPS term loan facility terminated in accordance with its terms, but the MAPS revolving loan facility remained in effect. On March 26, 2007, Mattel terminated the MAPS revolving loan facility. Mattel did not incur any early termination penalties in connection with the termination of the MAPS revolving loan facility.

To finance seasonal working capital requirements of certain foreign subsidiaries, Mattel avails itself of individual short-term credit lines with a number of banks. Mattel expects to extend the majority of these credit lines throughout 2007.

In June 2006, Mattel issued $100.0 million of unsecured floating rate senior notes (Floating Rate Senior Notes) due June 15, 2009 and $200.0 million of unsecured 6.125% senior notes (6.125% Senior Notes) due June 15, 2011 (collectively Senior Notes). Interest on the Floating Rate Senior Notes is based on the three-month US Dollar London Interbank Offered Rate (LIBOR) plus 40 basis points with interest payable quarterly beginning September 15, 2006. Interest on the 6.125% Senior Notes is payable semi-annually beginning

Table of Contents

December 15, 2006. The 6.125% Senior Notes may be redeemed at any time at the option of Mattel at a redemption price equal to the greater of (i) the principal amount of the notes being redeemed plus accrued interest to the redemption date, or (ii) a make whole amount based on the yield of a comparable US Treasury security plus 20 basis points.

In June 2006, Mattel entered into two interest rate swap agreements on the $100.0 million Floating Rate Senior Notes, each in a notional amount of $50.0 million, for the purpose of hedging the variability of cash flows in the interest payments due to fluctuations of the LIBOR benchmark interest rate. These cash flow hedges are accounted for under Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities,* whereby the hedges are reported in Mattel s consolidated balance sheets at fair value, with changes in the fair value of the hedges reflected in accumulated other comprehensive loss. Under the terms of the agreements, Mattel receives quarterly interest payments from the swap counterparties based on the three-month LIBOR plus 40 basis points and makes semi-annual interest payments to the swap counterparties based on a fixed rate of 5.87125%. The three-month LIBOR rate used to determine interest payments under the interest rate swap agreements resets every three months, matching the variable interest on the Floating Rate Senior Notes. The agreements expire in June 2009, which corresponds with the maturity of the Floating Rate Senior Notes.

In September 2007, a major credit rating agency reaffirmed Mattel s long-term credit rating at BBB-, but changed the outlook from positive to stable. In August 2007, another major credit rating agency changed its outlook to positive, but maintained its long-term credit rating at BBB. In May 2007, another major credit rating agency maintained its long-term rating for Mattel at Baa2, but changed its long-term outlook from negative to stable. 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 believes its cash on hand, amounts available under its domestic unsecured committed revolving credit facility, and its foreign credit lines will be adequate to meet its seasonal financing requirements in 2007.

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 in its consolidated balance sheet, at the time of the sale of the receivables to the bank group.

Sales of receivables pursuant to the domestic receivables sale facility occur periodically, generally quarterly. The receivables are sold by Mattel Sales Corp. and Fisher-Price, Inc. to Mattel Factoring for a purchase price equal to the nominal amount of the receivables sold. Mattel Factoring then sells such receivables to the bank group at a slight discount, and Mattel acts as a servicer for such receivables. Mattel has designated Mattel Sales Corp. and Fisher-Price, Inc. as sub-servicers, as permitted by the facility. Mattel s appointment as a servicer is subject to termination events that are customary for such transactions. The domestic receivables sales facility is also