

# MEGA Brands Inc.

## Management's Discussion and Analysis of Results of Operations and Financial Position

For the first quarter ended March 31, 2007

### Financial Highlights

Three-month periods  
ended March 31,

(U.S. \$ millions, except per share data)

	2007 (Unaudited) \$	2006 (Unaudited) \$
Net sales	90.1	78.6
Earnings (loss) from operations	(35.3)	4.1
Net earnings (loss)	(23.9)	0.6
Earnings (loss) per share		
Basic	(0.73)	0.02
Diluted	(0.73)	0.02

### Stock Exchange

Toronto Stock Exchange: MB

### Shares Outstanding

(as at March 31, 2007)  
32,711,213 Common Shares

### Trading History

TSX	(CA\$)
	Q1 2007
High:	\$27.20
Low:	\$24.56
Close:	\$25.36
Average volume:	141,390

### Transfer Agent

CIBC Mellon Trust Company  
1.800.387.0825

### Investor Relations

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## Management's Discussion and Analysis For the first quarter ended March 31, 2007

The following Management's Discussion and Analysis of Financial Position and Results of Operations ("MD&A") for MEGA Brands Inc. (formerly Mega Bloks Inc.) and its subsidiaries (referred to hereunder as "MEGA Brands", the "Corporation", "we", "our" and "us"), should be read in conjunction with the unaudited Consolidated Financial Statements and Notes thereto for the interim periods ended March 31, 2007 and 2006 as well as the audited consolidated financial statements and the MD&A for the year ended December 31, 2006. The financial information in this MD&A and in our financial statements has been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") of the Canadian Institute of Chartered Accountants ("CICA"). We also present certain non-GAAP financial measures, which we believe are useful to investors for comparing our performance from period to period. Please refer to the "Non-GAAP Financial Measures" section of this MD&A. This MD&A is current as of May 17, 2007.

All figures in this MD&A are expressed in U.S. dollars, (reporting and functional currency) unless otherwise indicated. Throughout this MD&A, the name "MEGA Brands America" refers to Rose Art Industries, Inc., Warren Industries, Inc. and their respective subsidiaries, as they were at the time of their acquisition.

### Forward-Looking Statements

*All statements in this MD&A that do not directly and exclusively relate to historical facts constitute "forward-looking statements". These statements represent the Corporation's intentions, plans, expectations and beliefs. In certain instances, these statements require us to make assumptions and there is significant risk that these assumptions may not be correct. Furthermore, these statements are subject to risks, uncertainties and other factors, many of which are beyond the Corporation's control. These factors include and are not restricted to: realization of synergies, litigation and its inherent uncertainty, including the recovery of the full product liability settlement amount and risks associated with product recalls, international operations, insurance coverage, difficulty in predicting consumer preferences and development and acceptance of new products, rate of growth or profitability, dependence on a few large customers, fluctuations in the price of plastic resins and other raw materials as well as currency rates, seasonality of toy and stationery industries, risks related to licensed products, retail environment, construction toy litigation and financing and interest rate matters. The words "believe", "estimate", "expect", "intend", "anticipate", "foresee", "plan", and similar expressions and variations thereof, identify certain of such forward-looking statements, which speak only as of the date on which they are made. The Corporation disclaims any intention or obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, other than as required by applicable legislation. Readers are cautioned not to place undue reliance on these forward-looking statements. More information about the risks that could cause our actual results to significantly differ from our current expectations can be found in the "Risks and Uncertainties" section of the Corporation's 2006 annual MD&A and this MD&A. When we state that we believe that the Corporation is well positioned for continued international growth in construction toys, that we believe there is strong growth potential for our Stationery and Activities product lines in international markets, that we expect to realize operational efficiencies in 2007, that we expect continued expansion and to accelerate our market share growth, that we expect to recover from insurers and through other recourses substantially the full amount paid to settle the lawsuits relating to injuries to children resulting from the ingestion of magnets and that we expect to reduce inventory levels by the end of the year, we have assumed that we will succeed in realizing the cost and revenue synergies from the integration of MEGA Brands America including without limitation the synergies resulting from the downsizing and closing of manufacturing plants in North America and the concentration of distribution in one facility, that we will maintain or increase the quality of products manufactured in new locations, that we will be successful in reducing inventory levels, that we will maintain service levels in our new distribution facility, that we will be able to attract and retain key personnel in key positions, that international markets that we service through our sales and marketing organization will have an interest in ROSE ART and MAGNETIX brands and in other products that we will offer, that the retail markets into which we sell will continue to demonstrate strong demand for the Corporation's product lines, that product recalls do not materially affect sales, that our insurers will not successfully deny any material portion of the claims, and that any such portion which may be denied will be recoverable against former shareholders of MEGA Brands America and that the number and quantum of self-insured product liability claims will not be material. As described in the "Risks and Uncertainties" section of the Corporation's 2006 annual MD&A and of this MD&A, there are risks and uncertainties that could mean that one or more of these assumptions ultimately turn out to be incorrect and that we do not therefore experience the growth that we anticipate.*



## Corporate Overview

MEGA Brands designs, manufactures and markets high quality toys and stationery products. Headquartered in Montreal, the Corporation has over 6,000 employees with offices, manufacturing facilities or distribution centers in 14 countries. The Corporation's products are sold in over 100 countries.

The Corporation operates under two geographical segments, North America and International, with sales and marketing conducted through two product lines.

- Toys product line is comprised of MEGA BLOKS<sup>®</sup> construction toys in the preschool and boys 5-plus categories, MAGNETIX<sup>®</sup> building sets for children 6-plus and MEGA<sup>™</sup> games and puzzles for families.
- Stationery and Activities product line is comprised of art materials (crayons, colored pencils, highlighters and markers) sold mainly under the ROSE ART<sup>®</sup> brand; writing instruments (pens, mechanical pencils and woodcase pencils) sold mainly under the ROSE ART, SRX<sup>®</sup> and USA GOLD<sup>®</sup> brands; dry-erase and cork presentation boards, organizers and accessories sold mainly under the BOARD DUDES<sup>®</sup> brand, and ROSE ART and MEGA craft and activity sets.

## Strategy and Objectives

Product innovation is the key success factor in the toy industry and the main driver of our sales growth. We annually renew approximately 40% of the previous year's toy sales with new product lines and extensions, enhancements and replacements of existing lines. We meet this competitive necessity by investing 3-4% of sales on new product design, engineering, prototyping and development.

Licensed products, which accounted for approximately 19% of sales in 2006, complement our internal product development initiatives. In recent years, we have entered into licensing agreements with affiliates of The Walt Disney Corporation, Marvel Enterprises Inc., MTV Networks (Nickelodeon), NASCAR and others. Our focus is on evergreen brands with enduring popularity that have the potential to expand our product lines and drive incremental sales growth. The percentage of our annual sales based on licenses is lower than the 30-35% average for the North American toy industry.

Penetration of international markets is an important driver of our long-term growth. We have established a strong sales, marketing and logistics organization in Europe and Mexico, a marketing partnership with Bandai in Japan, as well as distributorships covering another 60 global markets. We expect continued international growth in construction toys with the continued penetration of the MEGA BLOKS brand in key European markets and penetration of new markets in Europe, Asia and Australia, as well as through the introduction of the MAGNETIX brand in new markets.

We believe there is strong growth potential for our Stationery and Activities product lines in international markets. We have selected a portfolio of ROSE ART craft and activity sets and adapted these products for introduction into our key European markets for 2007, complemented by a broad assortment of Disney licensed products. In stationery, we have a dedicated sales force in five markets - United Kingdom, France, Italy, Mexico and Australia - and our products will be available at retail for the 2007 back-to-school season.

We plan to supplement our internal growth with selected strategic acquisitions that will reinforce our product range and consumer reach. In identifying attractive acquisition candidates, we are looking to: expand into basic and growing categories, strengthen our position in current core competencies, expand shelf space into multiple aisles, strengthen relationships with key retailers, expand global distribution and enter into new retail channels. Furthermore, we are looking for acquisitions that will offer significant synergies. Our priority in 2007 is to fully realize the benefits of the integration of MEGA Brands America.

With the integration of MEGA Brands America essentially completed, we expect to realize between \$7-10 million of operational efficiencies on an annualized basis, from which the Corporation expects to benefit commencing in the second half of 2007.



## Recent Developments

The Corporation announced the appointments of Al Hunyadi as President of Stationery & Activities and of Kathleen Campisano as Executive Vice-President and Chief Marketing Officer. These nominations are expected to help drive our continued expansion, accelerate our market share growth and brand elevation plans and strengthen our relationships with both customers and consumers.

On April 19, 2007, the Corporation announced an expanded voluntary recall and replacement program for MAGNETIX products jointly with the U.S. Consumer Product Safety Commission ("CPSC"). Approximately 5,700 consumer calls were received between April 19 and May 14, 2007, bringing the total to approximately 20,000 since the initial recall and replacement program was announced on March 31, 2006. This action was taken in response to additional injuries to children reported to the CPSC following the initial March 31, 2006 recall announcement.

On April 24, 2007 the Corporation learned that a lawsuit had been filed in the U.S. District Court of Indiana by the family of a child who is alleged to have sustained injuries related to magnet ingestion. The lawsuit is being handled by our insurers. Including this latest case, a total of four product liability lawsuits are outstanding against the Corporation for magnet related injuries. Insurers have confirmed coverage in all but one of these lawsuits. The Corporation is also aware of at least eleven other incidents in which children are alleged to have required surgery following the ingestion of multiple magnets. Of these incidents, at least four involved the ingestion of non-magnetized spheres and/or entire pieces. The Corporation is not able to assess with any certainty the outcome of the above lawsuits and claims or impact, if any. As such, no amounts have been reserved in our financial statements.

In 2006, the Corporation announced that it had settled four lawsuits and ten claims related to injuries to children resulting from the ingestion of magnets. The aggregate amount paid to settle the lawsuits and claims was \$13.5 million and was recorded as a product liability settlement expense in the 2006 consolidated statement of earnings. The Corporation expects to recover substantially the full amount from its insurers and through other recourses, although there can be no assurance that a favorable outcome will be achieved. Discussions with our insurers in this regard are underway and the Corporation received, in April 2007, a first payment of \$1 million from its primary insurer. This amount will be recorded in the consolidated statement of earnings for the three-month period ending June 30, 2007.

## Voluntary Product Recall and Other Charges

On April 19, 2007, we jointly announced with the CPSC an expanded recall campaign for MAGNETIX building sets. The CPSC recall does not involve sets sold by MEGA Brands after March 31, 2006 that are age-labeled 6+ and sets that have a pre-printed magnet ingestion warning label. Moreover, in order to eliminate confusion in light of media reports, the Corporation has decided to take the additional step of removing from retail shelves, in the U.S. market and in all international markets, all MAGNETIX products that do not contain the pre-printed magnet ingestion warning label that was developed by the Corporation on its own initiative in the wake of the initial product recall and replacement program.

The Corporation recorded charges totaling \$35.2 million for the first quarter of 2007 (\$757,000 for the corresponding 2006 period) related to the expanded MAGNETIX product recall and other charges. These charges reflect the Corporation's best estimate based on information available as at May 17, 2007. This includes:

- Estimated charges totaling \$30.5 million impacting gross margin which consist of returned goods, associated charges, freight handling costs and inventory write-offs.



- Estimated voluntary product recall and replacement expenses of \$4.7 million consisting of merchandising and handling expenses to sort goods at retail and costs related to the replacement program for consumers pursuant to the expanded recall campaign for MAGNETIX products.

Litigation expenses of \$0.8 million are mainly related to the Rosen Litigation. As disclosed in the “Risks and Uncertainties – Litigation” section of the 2006 annual MD&A, the former shareholders of MEGA Brands America, Inc. filed a complaint against the Corporation seeking payment of certain amounts due under the Share Purchase Agreement and the two former shareholders who held executive positions filed arbitration proceedings seeking unspecified damages for the Corporation's alleged breach of their employment agreements. These expenses are recorded as a separate line item in operating expenses in 2007.

The following table summarizes the financial impact of the MAGNETIX product recalls and other charges:

(U.S. \$ thousands, except per share data) (unaudited)	Three-month periods ended March 31,	
	2007	2006
	\$	\$
Gross profit	30,500 <sup>(1)</sup>	78
Litigation expenses	812	-
Voluntary product recall and replacement	4,700 <sup>(1)</sup>	679
Impact on earnings from operations	36,012	757
Income taxes	(13,505)	284
Impact on net earnings	22,507	473
Impact on earnings per share– basic and diluted <sup>(2)</sup>	0.69	0.01

<sup>(1)</sup> Reflects the Corporation's best estimate based on information available as of May 17, 2007.

<sup>(2)</sup> Basic and diluted earnings per share calculation is the same for the three-month period ended March 31, 2007 since the dilutive effect of outstanding options under the treasury stock method is nil as it was anti-dilutive.



## Results of Operations

(U.S. \$ thousands, except per share data) (unaudited)	Three-month periods ended March 31,			
	2007		2006	
	\$	% of Net Sales	\$	% of Net Sales
<b>Net sales</b>	<b>90,106</b>	<b>100.0%</b>	78,564	100.0%
Cost of sales	80,755	89.6%	44,365	56.5%
Gross profit	9,351	10.4%	34,199	43.5%
Marketing and advertising expenses	6,307	7.0%	4,224	5.4%
Research and development expenses	5,257	5.8%	3,229	4.1%
Other selling, distribution and administrative expenses	28,052	31.1%	23,279	29.6%
Voluntary product recall and replacement	4,700	5.2%	679	0.9%
Litigation expenses	812	0.9%	-	0.0%
Gain on foreign currency translation	(431)	(0.5)%	(1,289)	(1.6)%
Earnings (loss) from operations	(35,346)	(39.2)%	4,077	5.2%
Interest and other expenses	6,123	6.8%	5,113	6.5%
Loss before income taxes	(41,469)	(46.0)%	(1,036)	(1.3)%
Income taxes	(17,559)	(19.5)%	(1,614)	(2.1)%
<b>Net earnings (loss)</b>	<b>(23,910)</b>	<b>(26.5)%</b>	578	0.7%
Earnings (loss) per share- basic and diluted <sup>(1)</sup>	(0.73)		0.02	

## Canadian Dollar Data<sup>(2)</sup>

(Canadian \$ thousands, except per share data) (unaudited)	Three-month periods ended March 31,	
	2007	2006
	\$	\$
Net sales	103,883	90,576
Earnings (loss) from operations	(40,750)	4,700
Net earnings (loss)	(27,566)	666
Earnings (loss) per share – basic and diluted <sup>(1)</sup>	(0.84)	0.02

<sup>(1)</sup> Basic and diluted earnings (loss) per share calculation for the three-month period ended March 31, 2007 is the same since the dilutive effect of outstanding options under the treasury stock method is nil as it was anti-dilutive.

<sup>(2)</sup> U.S. dollar financial data is converted into Canadian dollars at the March 31, 2007 period end exchange rate of CA\$1.1529 per US\$1.00, using the translation of convenience method.



### **Net Sales**

Net sales in the first quarter of 2007 increased 14.7% to \$90.1 million compared to \$78.6 million in the corresponding period last year. Higher net sales are mainly related to strong demand from retailers for our Toys product lines.

Net sales of our Toys product lines in the first quarter of 2007 increased 27.4% to \$54.1 million compared to \$42.5 million in the first quarter of 2006. This increase was mainly driven by the launch of construction toys based on Dora the Explorer and Go Diego Go! character brands in the preschool category and on theme toys based on two major theatrical releases, Disney's "Pirates of the Caribbean: At World's End" and Marvel's "Spider-Man 3" in the boys 5-plus category. Sales of MAGNETIX and Games & Puzzles declined slightly compared to the first quarter of last year.

Net sales of Stationery and Activities product lines in the first quarter of 2007 were stable at \$36.0 million compared to \$36.1 million in the corresponding period last year. Higher Stationery sales and an additional month of Board Dudes' contribution were offset by lower sales in Activities.

Net sales in North America in the first quarter of 2007 increased 10.8% to \$66.2 million compared to \$59.7 million in the first quarter of 2006. International net sales in the first quarter of 2007 were up 26.9% to \$23.9 million compared to \$18.8 million in the corresponding period of last year. Growth in both geographic segments was driven by construction toy sales in the preschool and boys 5-plus categories. International net sales accounted for 26.5% of consolidated net sales in the first quarter of 2007 compared to 24.0% in the first quarter of 2006.

### **Cost of Sales**

Cost of sales increased to \$80.8 million in the first quarter of 2007 compared to \$44.4 million in the corresponding period of 2006. For the purpose of financial statement presentation, expanded MAGNETIX product recall and other charges of \$30.5 million are included in cost of sales.

### **Gross Profit**

Gross profit in the first quarter of 2007 decreased to \$9.4 million compared to \$34.2 million in the first quarter of 2006. Excluding estimated expanded MAGNETIX product recall and other charges of \$30.5 million, gross profit was up 16.5% and gross margin improved to 44.2% compared to 43.5% in the first quarter of last year as a result of higher margins on boys 5-plus products. Plastic resin prices in the first quarter of 2007 were in line with the corresponding period last year and magnet costs were higher due to commodity prices.

### **Operating Expenses**

Marketing and advertising expenses increased to \$6.3 million in the first quarter of 2007 compared to \$4.2 million in the first quarter of 2006. This increased investment in our brands reflects the timing of new product launches in 2007 compared to the first quarter of 2006.

Research and development expenses increased to \$5.3 million in the first quarter of 2007 compared to \$3.2 million in the corresponding period last year. This increase is mainly related to the launch of new construction toys based on "Pirates of the Caribbean: At World's End", "Spider-Man 3" and Dora and Diego in the first quarter of 2007.

Other selling, distribution and administrative expenses were \$28.1 million in the first quarter of 2007 compared to \$23.3 million in the first quarter of 2006. This increase mainly reflects higher distribution expenses resulting from sales growth in international markets.

### **Earnings (Loss) from Operations**

As a result of the above, loss from operations was \$35.3 million for the first quarter of 2007 compared to earnings from operations of \$4.1 million in the corresponding 2006 period. In North America, the loss from operations for the first quarter of 2007 was \$36.1 million compared to earnings from operations of



\$4.9 million last year. International earnings from operations were \$0.8 million compared to a loss from operations of \$0.8 million in the first quarter of 2006.

### **Non-Operating Expenses**

Interest expenses in the first quarter of 2007 were \$6.1 million compared to \$5.1 million in the same 2006 period, reflecting mainly an increase in average long-term debt and to a lesser extent higher interest rates.

### **Income Taxes**

Reflecting MAGNETIX product recall and other charges in both periods, income tax recovery was \$17.6 million compared to \$1.6 million in the first quarter of 2006. The tax rate used to establish the income tax expense for the quarterly results is the applicable estimated effective rate of each entity of the group. The effective tax rate reflects the Corporation's structure for tax purposes as well as the financing structure put in place following the acquisition of MEGA Brands America.

### **Net Earnings (Loss)**

The net loss was \$23.9 million or \$0.73 diluted loss per share in the first quarter of 2007 compared to net earnings of \$0.6 million or \$0.02 diluted earnings per share for the corresponding period last year.

Excluding the impact of MAGNETIX product recall and other charges totaling \$22.5 million after tax or \$0.69 diluted earnings per share, the net loss in the first quarter of 2007 was \$1.4 million or \$0.04 diluted loss per share. This compares to net earnings of \$1.1 million or \$0.03 diluted earnings per share excluding the impact of MAGNETIX product recall and other charges in the corresponding period last year. Please refer to the "Non-GAAP Financial Measures" section on page 15 of this MD&A.

### **Shares Outstanding**

As at May 17, 2007, there was a total of 32,712,663 common shares outstanding for a principal amount of \$237.0 million and 2,615,856 stock options outstanding, of which 2,575,856 were exercisable.

### **Seasonality and Quarterly Financial Information**

We have historically experienced significant quarterly fluctuations in operating results and anticipate these fluctuations in the future. This seasonality is increasing as large retailers become more efficient in their control of inventory levels through just-in-time inventory management systems. Retailers require the Corporation to ship products closer to the time they expect to sell the products to consumers creating shorter lead times for production and increased pressure to fill orders promptly.

Operating results for any quarter are not necessarily indicative of results for any future period and are comparable only with corresponding periods of prior years. Our profitability is typically lower for the first two quarters as a result of fairly constant fixed operating expenses while net sales are at their lowest levels of the year. Working capital needs typically grow through the first three quarters as inventories are built-up for the peak sales season. This seasonality is consistent with the results of other companies in our business. As a result of the seasonal nature of our business, our statements of cash flows for any quarter are generally not indicative of cash flows for a full year. Therefore, year-over-year comparisons between statements of cash flows are generally more meaningful than with the previous year-end.



The following table presents selected quarterly financial information for each of the eight most recently completed quarters:

(U.S. \$ thousands, except per share data) (unaudited)	Q1		Q4		Q3		Q2	
	2007	2006	2006	2005	2006	2005	2006	2005
Net sales	90,106	78,564	164,805	166,234	201,778	154,203	102,200	36,103
As a % of full year	-	14.3%	30.1%	43.2%	36.9%	40.1%	18.7%	9.4%
Gross profit	9,351	34,199	51,533	77,675	90,547	67,284	42,246	13,849
Earnings (loss) from operations	(35,346)	4,077	(1,278)	31,703	26,200	32,567	10,162	(485)
Net earnings (loss)	(23,910)	578	2,761	20,911	17,959	20,415	4,050	(540)
Earnings (loss) per share – basic	(0.73)	0.02	0.09	0.66	0.56	0.67	0.13	(0.02)
Earnings (loss) per share – diluted	(0.73)	0.02	0.08	0.61	0.53	0.62	0.12	(0.02)
Cash flows from operating activities	(23,351)	32,973	28,038	11,036	(26,225)	(9,871)	(19,470)	(2,067)

### Comprehensive Income and Accumulated Comprehensive Income

On January 1, 2007, the Corporation prospectively adopted new accounting standards on comprehensive income. The consolidated financial statements include a consolidated statement of comprehensive income, and accumulated other comprehensive income, which is presented separately under shareholders' equity in the consolidated balance sheet. The consolidated statement of comprehensive income presents net income, as well as "other comprehensive income items" which reflects the change in fair value of the interest rate swaps designated as cash flow hedging instruments, net of related income taxes. The accumulated other comprehensive income reflects the fair value of the interest rate swaps, net of related income taxes. Please refer to the "Changes in Significant Accounting Policies and Use of Estimates" section starting on page 11 of this MD&A.

### Liquidity and Capital Resources

Historically, our primary sources of liquidity have been cash flows from operations and short-term borrowings under a revolving credit facility. Cash flows from operations could be negatively impacted by decreased demand for our 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. Our primary capital needs are related to inventory financing, accounts receivable funding, debt servicing and capital expenditures for new product line initiatives. As a result of the seasonal nature of the toy and stationery industries, working capital requirements are variable throughout the year. Working capital needs typically grow through the first three quarters as inventories are built-up for the peak sales period.

#### Operating Activities

During the first quarter of 2007, cash flows used for operating activities were \$23.4 million due primarily to a net loss of \$23.9 million. In the corresponding period last year, \$33.0 million of cash flows were generated from operations as a result of a \$27.9 million decline in non-cash operating working capital items (resulting mainly from a significant decline in accounts receivable) and cash flows from operations before changes in non-cash working capital items of \$5.1 million.

#### Financing Activities

Cash flows from financing activities in the first quarter of 2007 were \$21.5 million, reflecting mainly a draw-down of \$23.2 million of the Corporation's revolving credit facility and the repayment of \$2.4 million of long-term debt. The draw-down is mainly related to supporting working capital requirements. In the first quarter of 2006, cash flows used for financing activities were \$1.0 million.



## Investing Activities

Cash flows used for investing activities in the first quarter of 2007 were \$5.8 million compared to \$21.2 million in the corresponding period of last year. The decline is mainly related to the acquisition of Board Dudes for \$17.5 million in the first quarter of 2006.

## Financial Position

(U.S. \$ thousands) (unaudited)	March 31, 2007	December 31, 2006	March 31, 2006
	\$	\$	\$
Working capital <sup>(1)</sup>	102,923	125,330	92,209
Property, plant and equipment	46,053	43,213	40,221
Total assets	748,464	797,452	696,234
Total debt	329,548	308,567	295,406

<sup>(1)</sup> Working capital is defined as current assets minus current liabilities.

Since December 31, 2006, there have been major changes to accounts receivable, inventories, future income taxes, accounts payable and accrued liabilities and long-term debt.

The \$70.4 million decline in accounts receivable is mainly due to timing of shipments and customer payments. Inventories increased to \$149.9 million as at March 31, 2007 compared to \$140.6 million at the end of 2006. During the first quarter, the Corporation built up inventories of basic products related to playsets based on two major theatrical releases scheduled for the month of May: Disney's "Pirates of the Caribbean: At World's End" and Marvel's "Spider-Man 3". In addition, production levels were higher than usual due to the launch of preschool construction toys based on Dora the Explorer and Go Diego Go!. The Corporation's objective is to reduce inventory levels to a range of approximately \$110.0 million to \$120.0 million by the end of 2007. The \$16.3 million increase in future income tax asset is mainly related to the future income tax recovery related to MAGNETIX product recall and other charges.

Accounts payable and accrued liabilities decreased by \$47.7 million due to timing of purchases and payments to suppliers. Long-term debt at the end of the first quarter was \$329.5 million compared to \$308.6 million at the end of 2006. The \$21.0 million increase in long-term debt is mainly related to negative cash flows from operations before changes in non-cash working capital items of \$36.9 million offset by a \$13.5 million decrease in non-cash operating working capital items.

As at March 31, 2007, the Corporation's debt was comprised mainly of \$12.8 million under its Term A facility maturing in 2009, \$256.1 million under its Term B facility maturing in 2012 and \$63.2 million drawn against its \$120.0 million revolving credit facility, offset partially by amortized deferred financing cost of \$3.2 million.

Under the terms of its \$400 million Credit Facility, the Corporation must satisfy certain restrictive covenants as to financial ratios. As a result of the MAGNETIX product recall and other charges, the Corporation has obtained confirmation from its lender that these charges are to be excluded from its financial ratio calculations as at March 31, 2007. The Corporation was in compliance with all covenants of its credit facility as at March 31, 2007.

## Foreign Exchange and Interest Rate Risk Management

The Corporation uses various derivative financial instruments to manage interest rate risk and foreign currency exposure and formally documents when required all relationships between derivatives and the items they hedge, and its risk management objective and strategy for using various hedges. Derivatives that are economic hedges but do not qualify for hedge accounting are recognized at fair value with the changes in fair value recorded in earnings. The Corporation does not use derivative financial instruments for speculative or trading purposes.



As at March 31, 2007, the Corporation had entered into foreign currency forward contracts to sell 4.5 million Euro and GBP2.3 million at rates of 1.3021 and 1.8746 respectively, all maturing in December 2007. The fair value of these forward contracts as at March 31, 2007 is \$0.4 million in favour of third parties. These derivative instruments have not been designated as hedges for accounting purposes as the Corporation has terminated its designation of all hedging relationships for foreign currency forward contracts. The associated liability is recorded in accrued liabilities and the unrealized loss has been recorded in the foreign currency translation account.

As at March 31, 2007, the interest swap agreements are with third parties for a notional value of \$150 million at a fixed rate of 4.66325%, maturing in July 2012. The Corporation is applying hedge accounting to these financial instruments and as a result the difference between the swap rate and the actual rate is reflected against the related expense. As at March 31, 2007 the fair value of these swaps was \$2.0 million in favour of the Corporation and was recorded in the balance sheet as an asset under derivative financial instruments. The change in fair value of these swaps was recorded in the statement of other comprehensive income and resulted in a \$0.5 million loss. Please refer to "Section 1530, Comprehensive Income" on page 13 for further information.

### **Financial Outlook for 2007**

We believe we have a strong product line-up in all of our categories for 2007, with the introduction of many new products, an exceptional licensed products offering and the launch of arts and crafts and stationery products in new geographic markets. We expect net sales growth in North America and in International markets. With the integration of MEGA Brands America essentially completed, we expect to realize \$7-10 million of operating efficiencies on an annualized basis, from which the Corporation should benefit commencing in the second half of 2007. The Corporation's objective is to reduce inventory levels to a range of approximately \$110.0 million to \$120.0 million by the end of 2007 and maintain capital expenditure proportionally in line with sales growth.

### **Changes in Significant Accounting Policies and Use of Estimates**

#### **Accounting Policies Implemented in 2006**

EIC-156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Product)", was issued and provides guidance to companies that give incentives to customers or resellers in the form of cash, equity, free gifts, coupons and other. The adoption of EIC-156 is effective for fiscal years beginning on or after January 1, 2006. Since the adjustments were not material in the first half of 2006, the new guideline was implemented beginning in the third quarter of 2006 with an adjustment made in the nine-month period ended September 30, 2006. As a result, for comparative purposes, the Corporation has reclassified such allowances for the first quarter of 2006. The adoption of EIC-156 reduced net sales by \$3.0 million in the first quarter of 2006.

Handbook Section 3831, "Non-Monetary Transactions", effective for transactions initiated in periods beginning on or after January 1, 2006, requires non-monetary transactions to be recorded at fair value unless the transaction has no commercial substance, it is an exchange of product or property, it is a non-monetary non-reciprocal transfer to owners or it is not reliably measurable. The adoption of this new Handbook Section did not have a material impact on the Corporation's consolidated financial statements.

#### **Accounting Policies Implemented in 2007**

#### **Financial Instruments**

On April 1, 2005, the CICA issued three accounting standards: Financial Instruments – Recognition and Measurement, Hedges and Comprehensive Income. The standard requires the Corporation to make certain elections, upon initial adoption of the new rules, regarding the accounting policy to be used to account for each financial instrument. This new section also requires that transaction costs incurred in connection with the issuance of financial instruments either be capitalized and presented as a reduction of the carrying



value of the related financial instrument or expensed as incurred. If capitalized, transaction costs must be amortized to income using the effective interest method.

The Corporation adopted these standards on January 1, 2007 and the accounting consequences of these new standards on the financial statements of the Corporation are presented below.

#### *Section 3855, Financial Instruments – Recognition and Measurement*

Under Section 3855, all financial assets and liabilities are carried at fair value in the consolidated balance sheet, except for loans and receivables, and non-trading liabilities, which are recognized at amortized cost using the effective interest method. Changes in the fair value of financial instruments carried at fair value are charged or credited to the statement of earnings for the relevant period, except for changes in the fair value of financial instruments designated as cash flow hedges which are charged or credited to other comprehensive income until realized after which these amounts will be recognized in the consolidated statement of earnings.

All derivative financial instruments will be carried at fair value in the consolidated balance sheet, including those derivatives that are embedded in other contracts but are not considered to be closely related to the host contract.

#### *Section 3865, Hedges*

When the Corporation uses derivative financial instruments to manage its own exposures, the Corporation determines for each derivative financial instrument whether hedge accounting is appropriate. When appropriate, the Corporation formally documents the hedging relationship detailing, among other things, the type of hedge (either fair value or cash flow), the item being hedged, the risk management objective, the hedging strategy and the method to be used to measure its effectiveness. The derivative financial instrument must be highly effective in accomplishing the objective of offsetting the changes in the hedged item's fair value attributable to the risk being hedged both at inception and over the life of the hedge. Effectiveness is generally reviewed on a monthly basis using the critical terms method.

#### *Cash flow hedge*

Interest rate swaps designated as cash flow hedge transactions are predominantly used to hedge the variability in cash flows related to a variable rate asset or liability.

Effective derivative financial instruments, held for cash flow hedging purposes, are recognized at fair value and the changes in fair value related to the effective portion of the hedge are recognized in other comprehensive income. The changes in fair value related to the ineffective portion of the hedge are immediately recorded in the consolidated statement of income. The changes in fair value recognized in other comprehensive income are reclassified in the consolidated statement of income under interest on long-term debt in the periods during which the cash flows constituting the hedged item affect income.

When the derivative instrument no longer qualifies as an effective hedge, or when the hedging instrument is sold or terminated prior to maturity, if applicable, hedge accounting is discontinued prospectively. Accumulated other comprehensive income related to a cash flow hedging relationship that ceases to be effective is reclassified in the consolidated statement of income under interest on long-term debt in the periods during which the cash flows constituting the hedged item affect income. Furthermore, if the hedged item is sold or terminated prior to maturity, hedge accounting is discontinued, and the related accumulated other comprehensive income is then immediately reclassified in the consolidated statement of income.

#### *Section 1530, Comprehensive Income*

The consolidated financial statements include a consolidated statement of comprehensive income, and the cumulative amount, i.e. accumulated other comprehensive income, is presented separately under shareholders' equity in the consolidated balance sheet. The consolidated statement of comprehensive income presents net income, as well as "other comprehensive income items": the effective portion of the changes in value of the derivative instruments designated as cash flow hedging instruments and the



balance to be reclassified in the consolidated statement of earnings from terminated cash flow hedges, if any.

The following is a summary of the accounting policy that the Corporation has elected to apply to each of its categories of financial instruments outstanding as of January 1, 2007:

<b>Assets / Liabilities</b>	<b>Category</b>	<b>Measurement</b>
Cash and cash equivalents	Held for trading	Fair value
Trade accounts receivable	Loans and receivables	Amortized cost
Other accounts receivable	Loans and receivables	Amortized cost
Accounts payable and accrued liabilities	Other liabilities	Amortized cost
Long-term debt	Other liabilities	Amortized cost

*Other information:*

- The Corporation has elected to account for transaction costs related to the issuance of financial instruments as a reduction of the carrying value of the related financial instruments.
- The Corporation does not have any outstanding contracts with embedded derivatives.

*Impact of adopting Sections 3855, 3865 and 1530*

The adoption of Sections 3855, 3865 and 1530 as at January 1, 2007 had an impact on certain items of the Corporation's consolidated balance sheet, which are as follows:

a) Reclassification of transaction costs

<i>(U.S. \$ thousands)</i> (unaudited)	<b>March 31, 2007</b>	December 31, 2006	March 31 2006
	\$	\$	\$
<b>Credit facility</b>			
Term A loan	12,800	14,400	39,200
Term B loan	256,100	256,750	258,700
Revolving term facility	63,200	40,000	-
<b>Other debt</b>			
Obligation under capital leases	665	804	1,187
Mortgage	-	-	254
	<b>332,765</b>	311,954	299,341
Less: Current portion of long-term debt	9,503	9,609	9,565
Amortization of deferred financing costs	(711)	(711)	(712)
	<b>8,792</b>	8,898	8,853
	<b>323,262</b>	302,345	289,776
Amortization of deferred financing costs	(2,506)	(2,676)	(3,223)
	<b>320,756</b>	299,669	286,553



b) New accounting standards regarding hedge accounting for effective cash flow hedges

Reconciliation of opening and ending accumulated other comprehensive income

<i>(U.S. \$ thousands)</i>	<b>\$</b>
(unaudited)	
Accumulated other comprehensive income as at December 31, 2006, as reported	-
Adjustment for effective cash flow hedge, net of income taxes	1,751
Accumulated other comprehensive income as at January 1, 2007, as restated	1,751
Other comprehensive loss for the period ended March 31, 2007	(516)
Accumulated other comprehensive income as at March 31, 2007	<b>1,235</b>
Statement of other comprehensive income	<b>\$</b>
Net loss	(23,910)
Losses on derivatives designated as cash flow hedges	(516)
Other comprehensive loss for the period ended March 31, 2007	<b>(24,426)</b>

### Accounting Changes

Handbook Section 1506, "Accounting Changes" established criteria for changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies and estimates, and correction of errors.

### Other

There has been no other significant change in the Corporation's accounting policies and estimates and future accounting pronouncements since December 31, 2006. A description of these policies and estimates can be found in the Corporation's 2006 annual MD&A.

### Risks and Uncertainties

The Corporation is subject to a variety of business risks and uncertainties. Risks and uncertainties that could materially affect our business, financial condition and results of operations are disclosed in the "Risks and Uncertainties" section of the 2006 annual MD&A filed by the Corporation, which are hereby incorporated by reference. Changes to risks and uncertainties described in the 2006 annual MD&A are described below.

### Litigation Related to MAGNETIX

We are subject to regulation by the CPSC and similar state, provincial and international regulatory authorities and our products could be subject to involuntary recalls and other actions by such authorities. We may also voluntarily recall selected products out of concern for product safety. On April 19, 2007, we jointly announced with the CPSC an expanded recall of MAGNETIX building sets in response to additional injuries to children being reported to the CPSC following the March 31, 2006 initial recall announcement.

We may experience defects in products after their production and sale to consumers. Recalls or defects could result in the rejection of our products by consumers, damage to our reputation, lost sales, negative publicity, fines or penalties, diverted development resources and increased customer service and support costs, any of which could have a material adverse effect on our financial condition, business operations and/or business prospects. Individuals may sustain injuries from our products and we may be subject to claims and lawsuits resulting from such injuries.

In 2006, the Corporation announced that it had settled four lawsuits and ten claims related to injuries to children resulting from the ingestion of magnets. The aggregate amount paid to settle the lawsuits and



claims was \$13.5 million and was recorded as a product liability settlement expense in the 2006 consolidated statement of earnings. The Corporation expects to recover substantially the full amount from its insurers and through other recourses, although there can be no assurance that a favorable outcome will be achieved. Discussions with our insurers in this regard are underway and the Corporation received, in April 2007, a first payment of \$1 million from its primary insurer.

On September 14, 2006 and on December 5, 2006, two lawsuits related to magnet ingestion requiring surgical removal were served on the Corporation and remain outstanding. They are being handled by the Corporation's insurers. On March 29, 2007 and on April 24, 2007, the Corporation learned that two other lawsuits had been filed in U.S. District Court by families of children who are alleged to have sustained similar injuries. The lawsuits have been reported to our insurers. To date, our insurers have confirmed coverage in all but one lawsuit. The Corporation is also aware of at least eleven other incidents in which children are alleged to have required surgery following the ingestion of multiple magnets. Lawsuits have not been filed in these matters as of May 17, 2007. The Corporation is not able to assess with any certainty the outcome of these lawsuits and claims or impact, if any. As such, no amounts have been reserved in our financial statements. There can be no assurance that additional incidents, lawsuits or claims will not arise, or that additional enquiries by the CPSC or other regulatory authorities in respect of MAGNETIX or other products will not be brought in the future, or result in additional product recalls or negative publicity.

### **Construction Toy Litigation**

As disclosed in the Corporation's 2006 annual MD&A under the "Risks and Uncertainties – Construction Toy Litigation" section, MEGA Brands is involved in various legal proceedings with companies in the LEGO Group ("LEGO"). On May 2, 2007, the German Federal Patent Court of Appeal issued a pair of decisions the upshot of which was to support the holding of the German Patent and Trademark Office in February 2005 invalidating LEGO's German trademark registration for a 2 x 4 stud brick design with respect to wares described as "construction toys". In these decisions, the German Federal Patent Court of Appeal aligns itself with the reasoning of the Grand Board of Appeal of the Office for Harmonization of the Internal Market of the European Union ("OHIM") in the matter of MEGA Brands Inc. vs. LEGO Juris A/S. The latter case, which was decided in July 2006, dismissed LEGO's appeal from the July 2004 decision of the OHIM Cancellation Division, which had invalidated Lego's three-dimensional Community Trademark registration for an identical trademark. MEGA Brands believes that these decisions, which are subject to further appeal, are consistent with the clear trend of the trademark jurisprudence favouring competitive access to useful product features, like the basic LEGO block, which are no longer protected by patents.

### **Non-GAAP Financial Measures**

The terms "net earnings (loss) before MAGNETIX product recall and other charges" and "diluted earnings (loss) per share before MAGNETIX product recall and other charges" do not have any standardized meaning under GAAP and are therefore unlikely to be comparable to similar measures presented by other companies. We present them as a measure of operating performance of our ongoing business without the effects of unusual items. We exclude such items because they affect the comparability of our financial results between periods and could potentially distort the analysis of trends in business performance.

### **Additional Information**

This MD&A is dated May 17, 2007. Additional information about MEGA Brands, including our Annual Information Form, is available on SEDAR at [www.sedar.com](http://www.sedar.com).



## Consolidated statements of earnings

(in thousands of U.S. dollars, except per share data)  
(Unaudited)

	Three-month periods ended March 31,	
	2007	2006
	\$	\$
<b>Net Sales</b>	<b>90,106</b>	78,564
Cost of sales (Note 8)	<b>80,755</b>	44,365
Gross profit	<b>9,351</b>	34,199
Marketing and advertising expenses	<b>6,307</b>	4,224
Research and development expenses	<b>5,257</b>	3,229
Other selling, distribution and administrative expenses	<b>28,052</b>	23,279
Voluntary product recall and replacement (Note 8)	<b>4,700</b>	679
Litigation expenses (Note 13)	<b>812</b>	-
Gain on foreign currency translation	<b>(431)</b>	(1,289)
Earnings (loss) from operations	<b>(35,346)</b>	4,077
Interest and other expenses		
Interest on long-term debt	<b>6,047</b>	5,001
Amortization of deferred financing costs	<b>170</b>	191
Other interest	<b>(94)</b>	(79)
	<b>6,123</b>	5,113
Loss before income taxes	<b>(41,469)</b>	(1,036)
Income taxes (Note 5)		
Current	<b>(1,426)</b>	(4,050)
Future	<b>(16,133)</b>	2,436
	<b>(17,559)</b>	(1,614)
<b>Net earnings (loss)</b>	<b>(23,910)</b>	578
Earnings (loss) per share (Note 9)		
Basic	<b>(0.73)</b>	0.02
Diluted <sup>(1)</sup>	<b>(0.73)</b>	0.02

<sup>(1)</sup> The dilutive effect of outstanding options under the treasury stock method for the three-month period ended March 31, 2007 is nil as it was anti-dilutive.



## Consolidated statements of retained earnings (deficit)

(in thousands of U.S. dollars)  
(Unaudited)

	Three-month periods ended March 31,	
	2007	2006
	\$	\$
<b>Balance, beginning of period</b>	<b>12,636</b>	(12,712)
Net earnings (loss)	(23,910)	578
<b>Balance, end of period</b>	<b>(11,274)</b>	(12,134)

## Consolidated statements of comprehensive income and Accumulated other comprehensive income

(in thousands of U.S. dollars)  
(Unaudited)

	Three-month periods ended March 31,	
	2007	2006
	\$	\$
<b>Net loss for the period</b>	<b>(23,910)</b>	-
<b>Other comprehensive loss, net of income taxes</b>		
Loss on derivatives designated as cash flow hedges	(516)	-
<b>Comprehensive loss for the period</b>	<b>(24,426)</b>	-
<b>Accumulated other comprehensive income</b>		
Balance, beginning of period	-	-
Impact of adopting the new accounting policy regarding financial instruments, net of income taxes	1,751	-
Other comprehensive loss, net of income taxes	(516)	-
<b>Balance, end of period</b>	<b>1,235</b>	-



## Consolidated balance sheet

(in thousands of U.S. dollars)

	March 31, 2007 (Unaudited)	December 31, 2006 (Audited)	March 31 2006 (Unaudited)
	\$	\$	\$
<b>Assets</b>			
Current assets			
Cash and cash equivalents	6,040	13,658	30,369
Accounts receivable	91,212	161,612	89,310
Inventories	149,855	140,630	104,566
Income taxes	6,730	9,317	10,728
Future income taxes	7,940	8,354	16,790
Prepaid expenses	13,385	12,316	10,448
	<b>275,162</b>	<b>345,887</b>	<b>262,211</b>
Property, plant and equipment	46,053	43,213	40,221
Intangible assets	79,332	79,517	72,149
Goodwill	301,171	300,829	321,653
Derivative financial instruments (Note 3)	1,994	-	-
Future income taxes	44,752	28,006	-
	<b>748,464</b>	<b>797,452</b>	<b>696,234</b>
<b>Liabilities</b>			
Current liabilities			
Accounts payable and accrued liabilities	105,750	153,437	92,865
Additional consideration accrued on business combination (Note 10)	57,316	57,825	68,284
Derivative financial instruments (Note 3)	381	397	-
Current portion of long-term debt	8,792	8,898	8,853
	<b>172,239</b>	<b>220,557</b>	<b>170,002</b>
Long-term debt (Note 3)	320,756	299,669	286,553
Future income taxes	27,981	27,782	18,303
	<b>520,976</b>	<b>548,008</b>	<b>474,858</b>
<b>Shareholders' equity</b>			
Capital stock (Note 4)	236,972	236,088	232,302
Contributed surplus	555	720	1,208
Retained earnings (deficit)	(11,274)	12,636	(12,134)
Accumulated other comprehensive income (Note 3)	1,235	-	-
	<b>227,488</b>	<b>249,444</b>	<b>221,376</b>
	<b>748,464</b>	<b>797,452</b>	<b>696,234</b>



## Consolidated statements of cash flows

(in thousands of U.S. dollars)  
(Unaudited)

	Three-month periods ended March 31,	
	2007	2006
	\$	\$
<b>Cash flows from operating activities</b>		
Net earnings (loss)	(23,910)	578
Items not affecting cash and cash equivalents		
Amortization of property, plant and equipment	3,020	2,982
Amortization of deferred financing costs	170	191
Amortization of intangible assets	185	81
Stock-based compensation plans	(125)	71
Future income taxes	(16,133)	2,436
Gain on disposal of property, plant and equipment	(220)	-
Loss (gain) on foreign currency	137	(1,289)
	<b>(36,876)</b>	5,050
Changes in non-cash operating working capital items (Note 11)	<b>13,525</b>	27,923
	<b>(23,351)</b>	32,973
<b>Cash flows from financing activities</b>		
Repayment of long-term debt	(2,389)	(1,682)
Change in revolving credit facility	23,200	-
Issuance of capital stock	702	710
	<b>21,513</b>	(972)
<b>Cash flows from investing activities</b>		
Acquisition of property, plant and equipment	(6,236)	(3,699)
Proceeds from disposal of property, plant and equipment	798	-
Business combinations	(342)	(17,500)
	<b>(5,780)</b>	(21,199)
Increase (decrease) in cash and cash equivalents	<b>(7,618)</b>	10,802
Cash and cash equivalents, beginning of period	<b>13,658</b>	19,567
<b>Cash and cash equivalents, end of period</b>	<b>6,040</b>	30,369
Supplementary disclosure of cash flow information		
Interest paid	<b>6,388</b>	4,856
Income taxes paid (recovery)	<b>(4,002)</b>	11,422



## Notes to interim consolidated financial statements

For the three-month periods ended March 31, 2007 and 2006  
(Column figures are expressed in thousands of U.S. dollars, except per share data.)  
(Unaudited)

### 1. Nature of business

On June 15, 2006, the shareholders adopted a special resolution authorizing the Corporation to change its legal name to MEGA Brands Inc. (formerly Mega Bloks Inc.). On June 22, 2006, the Corporation filed the amendment to its articles of incorporation under the Canada Business Corporations Act to change its name. The legal names of the Corporation's principal subsidiaries have been changed to MEGA Brands America, Inc. (formerly Rose Art Industries, Inc.), MEGA Brands Europe NV (formerly Mega Bloks Europe NV) and MEGA Brands International (formerly Mega Bloks International Sàrl).

The Corporation designs, manufactures and markets a broad line of toys and stationery and activities products. The Corporation sells and distributes its products in over 100 countries under the MEGA BLOKS, ROSE ART, MAGNETIX and BOARD DUDES brands.

### 2. Basis of presentation and significant accounting policies

The consolidated financial statements are expressed in U.S. dollars as it is the Corporation's functional currency and have been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"), which requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results may differ from those estimates.

The unaudited interim consolidated financial statements have been prepared in accordance with GAAP on a basis consistent with those followed in the consolidated financial statements dated December 31, 2006 except for new accounting policies noted below. However, they do not include all disclosures required under GAAP for annual financial statements and should be read in conjunction with the Corporation's audited year-end consolidated financial statements and notes.

#### *Use of estimates*

Preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. The most significant areas requiring the use of management estimates relates to: provision for MAGNETIX product recall and other charges, inventory valuation, valuation of year-end provision on accounts receivable, future income taxes, intangible assets, goodwill, reserves and allowances, specifically those related to the integration costs, general liability and income taxes.

#### *Self-insurance*

The Corporation is primarily self-insured for MAGNETIX products manufactured before May 1, 2006. Required accruals for self-insurance liabilities are determined by management based on claims filed and an estimate of claims incurred but not yet reported, and are not discounted.

### 3. New accounting policies

#### **Financial instruments**

On April 1, 2005, the CICA issued three accounting standards: Financial Instruments – Recognition and Measurement, Hedges and Comprehensive Income. The standard requires the Corporation to make certain elections, upon initial adoption of the new rules, regarding the accounting policy to be used to account for each financial instrument. This new section also requires that transaction costs incurred in connection with the issuance of financial instruments either be capitalized and presented as a reduction of the carrying



value of the related financial instrument or expensed as incurred. If capitalized, transaction costs must be amortized to income using the effective interest method.

The Corporation adopted these standards on January 1, 2007 and the accounting consequences of these new standards on the financial statements of the Corporation are presented below.

#### *Section 3855, Financial Instruments – Recognition and Measurement*

Under Section 3855, all financial assets and liabilities are carried at fair value in the consolidated balance sheet, except for loans and receivables, and non-trading liabilities, which are recognized at amortized cost using the effective interest method. Changes in the fair value of financial instruments carried at fair value are charged or credited to the statement of earnings for the relevant period, except for changes in the fair value of financial instruments designated as cash flow hedges which are charged or credited to other comprehensive income until realized after which these amounts will be recognized in the consolidated statement of earnings.

All derivative financial instruments will be carried at fair value in the consolidated balance sheet, including those derivatives that are embedded in other contracts but are not considered to be closely related to the host contract.

#### *Section 3865, Hedges*

When the Corporation uses derivative financial instruments to manage its own exposures, the Corporation determines for each derivative financial instrument whether hedge accounting is appropriate. When appropriate, the Corporation formally documents the hedging relationship detailing, among other things, the type of hedge (either fair value or cash flow), the item being hedged, the risk management objective, the hedging strategy and the method to be used to measure its effectiveness. The derivative financial instrument must be highly effective in accomplishing the objective of offsetting the changes in the hedged item's fair value attributable to the risk being hedged both at inception and over the life of the hedge. Effectiveness is generally reviewed on a monthly basis using the critical terms method.

#### *Cash flow hedge*

Interest rate swaps designated as cash flow hedge transactions are predominantly used to hedge the variability in cash flows related to a variable rate asset or liability.

Effective derivative financial instruments, held for cash flow hedging purposes, are recognized at fair value and the changes in fair value related to the effective portion of the hedge are recognized in other comprehensive income. The changes in fair value related to the ineffective portion of the hedge are immediately recorded in the consolidated statement of income. The changes in fair value recognized in other comprehensive income are reclassified in the consolidated statement of income under interest on long-term debt in the periods during which the cash flows constituting the hedged item affect income.

When the derivative instrument no longer qualifies as an effective hedge, or when the hedging instrument is sold or terminated prior to maturity, if applicable, hedge accounting is discontinued prospectively. Accumulated other comprehensive income related to a cash flow hedging relationship that ceases to be effective is reclassified in the consolidated statement of income under interest on long-term debt in the periods during which the cash flows constituting the hedged item affect income. Furthermore, if the hedged item is sold or terminated prior to maturity, hedge accounting is discontinued, and the related accumulated other comprehensive income is then immediately reclassified in the consolidated statement of income.



### Section 1530, Comprehensive Income

The consolidated financial statements include a consolidated statement of comprehensive income, and the cumulative amount, i.e. accumulated other comprehensive income, is presented separately under shareholders' equity in the consolidated balance sheet. The consolidated statement of comprehensive income presents net income, as well as "other comprehensive income items": the effective portion of the changes in value of the derivative instruments designated as cash flow hedging instruments and the balance to be reclassified in the consolidated statement of earnings from terminated cash flow hedges, if any.

Following is a summary of the accounting policy the Corporation has elected to apply to each of its categories of financial instruments outstanding as of January 1, 2007:

Assets / Liabilities	Category	Measurement
Cash and cash equivalents	Held for trading	Fair value
Trade accounts receivable	Loans and receivables	Amortized cost
Other accounts receivable	Loans and receivables	Amortized cost
Accounts payable and accrued liabilities	Other liabilities	Amortized cost
Long-term debt	Other liabilities	Amortized cost

#### Other information:

- The Corporation has elected to account for transaction costs related to the issuance of financial instruments as a reduction of the carrying value of the related financial instruments.
- The Corporation does not have any outstanding contracts with embedded derivatives.

#### Impact of adopting Sections 3855, 3865 and 1530

The adoption of Sections 3855, 3865 and 1530 as at January 1, 2007 had an impact on certain items of the Corporation's consolidated balance sheet, which are as follows:

#### a) Reclassification of transaction costs.

	March 31, 2007	December 31, 2006	March 31 2006
	\$	\$	\$
<b>Credit facility</b>			
Term A loan	12,800	14,400	39,200
Term B loan	256,100	256,750	258,700
Revolving term facility	63,200	40,000	-
<b>Other debt</b>			
Obligation under capital leases	665	804	1,187
Mortgage	-	-	254
	<b>332,765</b>	311,954	299,341
Less: Current portion of long-term debt	9,503	9,609	9,565
Amortization of deferred financing costs	(711)	(711)	(712)
	<b>8,792</b>	8,898	8,853
	<b>323,262</b>	302,345	289,776
Amortization of deferred financing costs	(2,506)	(2,676)	(3,223)
	<b>320,756</b>	299,669	286,553



b) New accounting standards regarding hedge accounting for effective cash flow hedges.

Reconciliation of opening and ending accumulated other comprehensive income:

	\$
Accumulated other comprehensive income as at December 31, 2006, as reported	-
Adjustment for effective cash flow hedge, net of income taxes	1,751
Accumulated other comprehensive income as at January 1, 2007, as restated	1,751
Other comprehensive loss for the period ended March 31, 2007	(516)
Accumulated other comprehensive income as at March 31, 2007	1,235

Statement of other comprehensive income:

	\$
Net loss	(23,910)
Loss on derivatives designated as cash flow hedges	(516)
Other comprehensive loss for the period ended March 31, 2007	(24,426)

### Accounting Changes

On January 1, 2007, the Corporation adopted Handbook Section 1506, "Accounting Changes": This Section established criteria for changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies and estimates, and correction of errors.

### 4. Capital stock

#### *Outstanding share data*

As at March 31, 2007, there were 32,711,213 Common Shares issued and outstanding.

### 5. Income taxes

The tax rate used to establish the income tax expense for the quarterly results is the applicable estimated effective rate of each entity of the group. The effective tax rate reflects the Corporation's structure for tax purposes as well as the financing structure put in place following the acquisition of the MEGA Brands America Group.

### 6. Stock-based compensation plans

The Corporation has two stock-based compensation plans whereby, options may be granted to officers and other key employees of the Corporation and its subsidiaries to purchase common shares of the Corporation.

Under the Initial Stock Option Plan, the subscription price of each option equaled the estimated fair value of a share of the Corporation at the date of grant.

Immediately prior to the closing of the Initial Public Offering, the Corporation introduced a New Stock Option Plan. Under this plan, options to purchase common shares of the Corporation are granted at a subscription price of 100% of market value. Market value is determined as the closing price of the common shares on the Toronto Stock Exchange on the last date of trading prior to the effective date of the grant.

At March 31, 2007, a total of 4,946,577 common shares remained authorized for issuance under the Corporation's stock-based compensation plans. Options are exercisable during a period not to exceed ten years after the date of the grant. The right to exercise the options accrues over a period of three years of continuous employment. However, if there is a change of control of the Corporation, the options become



immediately exercisable. Options are adjusted proportionately for any stock dividends or stock splits attributed to the common shares of the Corporation.

On March 24, 2004, the Board of Directors adopted a recommendation of the Compensation Committee that the Corporation voluntarily cap stock option grants at 15% of the number of common shares outstanding even though the Option Plan, as approved by the relevant regulatory authorities, allows for a significantly higher dilution rate when the available option grants under such plan are combined with option grants under the Initial Plan.

The following table summarizes total stock options outstanding for the three-month period ending March 31, under the Corporation's stock option plans:

	2007		2006	
(in Canadian dollars except per share data)	Number of options	Weighted average exercise price \$	Number of options	Weighted average exercise price \$
Options outstanding, beginning of period	2,665,606	9.18	3,233,858	9.01
Granted	-	-	-	-
Exercised	(46,300)	17.72	(57,966)	14.93
Forfeited	(2,000)	14.50	(5,800)	23.29
Options outstanding, end of period	2,617,306	9.03	3,170,092	8.87
Options exercisable, end of period	2,577,306	8.84	3,091,530	8.57

The Corporation uses the fair value method to account for all stock-based compensations. This method requires awards of stock options to be measured on their date of grant using the fair value method. They are expensed and credited to contributed surplus over their vesting period. This credit is reclassified to capital stock when stock options are exercised. For the three-month period ended March 31, 2007, \$0.2 million was reclassified from contributed surplus to capital stock.

## 7. Share unit plan

The Corporation's share unit plan, which became effective February 24, 2005, allows the board of directors to grant bonuses in the form of share units that are time and performance vesting after three years. The plan is non-dilutive and will be settled in shares purchased from the secondary market, or in cash, at the option of the Corporation.

The following table summarizes the share units outstanding as at March 31, 2007 under the Corporation's share unit plan:

	2007	2006
	Number of units	Number of units
Units outstanding, beginning of the period	354,984	65,768
Granted	-	-
Exercised	(1,010)	-
Forfeited	(4,144)	-
Units outstanding, end of period	349,830	65,768

During the three-month period ending March 31, 2007, no units were granted.



## 8. Voluntary product recall and other charges

The Corporation recorded charges totaling \$35.2 million for the first quarter of 2007 related to the expanded MAGNETIX product recall and other charges. These charges reflect the Corporation's best estimate based on information available as at May 17, 2007. This includes:

- Estimated charges totaling \$30.5 million impacting gross margin which consist of returned goods, associated charges, freight handling costs and inventory write-offs.
- Estimated voluntary product recall and replacement expenses of \$4.7 million consisting of merchandising and handling expenses to sort goods at retail and costs related to the replacement program for consumers pursuant to the expanded recall campaign for MAGNETIX products.

## 9. Earnings (loss) per share

The following table sets forth the computation of basic and diluted earnings (loss) per share:

	Three-month periods ended March 31,	
	2007	2006
Numerator for basic and diluted net earnings (loss) per common share:		
Net income (loss) attributable to common shareholders	<b>(23,910)</b>	578
Denominator for basic net earnings (loss) per common share:		
Weighted average number of common shares outstanding	<b>32,692,164</b>	32,121,557
Basic earnings (loss) per share	<b>\$ (0.73)</b>	\$ 0.02
Denominator for diluted net earnings (loss) per common share:		
Weighted average number of common shares outstanding	<b>32,692,164</b>	32,121,557
Plus impact of stock options <sup>(1)</sup>	<b>1,694,090</b>	2,128,524
Diluted average number of common shares <sup>(1)</sup>	<b>34,386,254</b>	34,250,081
Diluted earnings (loss) per share <sup>(1)</sup>	<b>\$ (0.73)</b>	\$ 0.02

<sup>(1)</sup> The dilutive effect of outstanding options under the treasury stock method for the three-month period ended March 31, 2007 is nil as it was anti-dilutive.

## 10. Business combinations

On January 24, 2006, the Corporation, through its subsidiary MEGA Brands America, entered into an agreement to acquire all voting shares of The Board Dudes, Inc. ("Board Dudes"), a privately held corporation based in Corona, California. Board Dudes designs and distributes dry-erase boards, cork boards, foam boards, and school and locker products. The purchase price paid is \$17 million subject to certain adjustments and was financed through existing credit facilities. During the third quarter of 2006, as part of these adjustments, an amount of \$1.9 million was paid to the Board Dudes principals. On March 21, 2007, an additional consideration has been recorded to the goodwill for an amount of \$0.3 million. Contingent consideration to the selling principals of up to \$7 million is payable between 2006 and 2009 depending on the attainment of certain performance targets. Any additional consideration will be recorded



to goodwill. The transaction closed on February 1, 2006 and the results of operations are included in the consolidated statement of earnings as of this date.

The acquisition was accounted for using the purchase method. The fair value of net assets acquired is as follows:

	2007	2006
	\$	\$
Assets acquired		
Non-cash working capital	3,050	3,050
Property, plant and equipment	98	98
Intangible assets	7,990	7,990
Goodwill	8,718	8,376
Long-term debt	(624)	(624)
Non-cash assets acquired	19,232	18,890
Cash and cash equivalents	43	43
Net assets acquired	19,275	18,933
Consideration		
Cash	18,638	18,296
Acquisition cost	637	637
	19,275	18,933

#### 11. Changes in non-cash operation working capital items

	Three-month periods ended March 31,	
	2007	2006
	\$	\$
Accounts receivable	70,400	87,306
Inventories	(9,225)	(20,742)
Prepaid expenses	(1,069)	(1,484)
Income taxes	1,827	(15,472)
Accounts payable and accrued liabilities	(47,545)	(17,101)
Additional consideration accrued on business combination	(509)	(5,791)
Foreign currency translation relating to working capital items	(354)	1,207
	13,525	27,923

#### 12. Seasonal nature of business

Historically, the last two quarters have presented higher level of activity and produced better results than the first two quarters.



### 13. Contingencies

- a) On May 8, 2006, the former shareholders of Rose Art initiated litigation against the Corporation in the U.S. District Court for the Southern District of New York. The plaintiffs are seeking payment of the Contingent Purchase Price under the terms of the Stock Purchase Agreement ("SPA") entered into between them and the Corporation on July 26, 2005. The Corporation has filed an answer and counterclaim denying each and every material allegation relating to the lawsuit. The Corporation's counterclaim alleges that the former shareholders failed to uphold certain terms of the SPA. The Corporation accrued US\$51.0 million in its 2005 consolidated financial statements with respect to the Contingent Purchase Price pending final determination of the amount owed, if any. As at March 31, 2007, no disbursements had been made and the Corporation will continue to maintain the accrual until the lawsuit is resolved. Based on management's assessment as of May 17, 2007, no additional consideration is due.

On November 17, 2006, the former shareholders of Rose Art filed arbitration proceedings before the American Arbitration Association against the Corporation seeking unspecified damages for the Corporation's alleged breach of their respective employment agreements. The Corporation is contesting the proceedings.

- b) On March 31, 2006, the Corporation jointly announced with the U.S. CPSC a voluntary recall and replacement program of MAGNETIX building sets in the hands of families with children under the age of six. This action was taken in response to the death of a toddler and injuries to several children resulting from magnet ingestion.

On October 24, 2006, the Corporation announced that it had settled four lawsuits and ten claims related to injuries to children resulting from the ingestion of magnets. Terms of the settlement include no admission of liability. The aggregate amount paid to settle the lawsuits and claims is \$13.5 million and was recorded as a product liability settlement expense in the 2006 consolidated statement of earnings. The Corporation expects to recover substantially the full amount from its insurers and through other recourses, although there can be no assurance that a favorable outcome will be achieved.

On April 24, 2007 the Corporation learned that a lawsuit had been filed in the U.S. District Court of Indiana by the family of a child who is alleged to have sustained injuries related to magnet ingestion. The lawsuit is being handled by the Corporation's insurers. Including this case, four product liability lawsuits are outstanding against the Corporation for magnet related injuries. Insurers have confirmed coverage in all but one of these lawsuits. The Corporation is also aware of at least eleven other incidents in which children are alleged to have required surgery following the ingestion of multiple magnets. The Corporation is not able to assess with any certainty the outcome of the above lawsuits and claims or impact, if any. As such, no amounts have been reserved in our financial statements as at May 17, 2007.

- c) On March 28, 2007, the Corporation learned that a competitor who sells magnetic building sets primarily in Europe, Plastwood S.R.L. and Plastwood Corporation, filed a complaint against the Corporation in the U.S. District Court for the Western District of Washington alleging damages for false advertising and unfair and deceptive acts and practices. The Corporation has not been able to assess the outcome of this lawsuit or its impact, if any. Therefore, no amount has been reserved as at May 17, 2007.



## 14. Subsequent event

On April 13, 2007, the Corporation recovered an amount of \$1.0 million from its primary insurer in relation to the \$13.5 million product liability settlement and related expenses incurred in the third quarter of 2006. Discussions are ongoing with respect to the remaining amounts although there can be no assurance that a favorable outcome will be achieved.

On April 19, 2007, the Corporation jointly announced with the CPSC an expanded recall campaign for MAGNETIX building sets. The CPSC recall does not involve sets sold by MEGA Brands after March 31, 2006, age-labeled 6+ and sets that have a pre-printed magnet ingestion warning label. This action was taken in response to additional injuries to children reported to the CPSC following the initial March 31, 2006 recall announcement. Moreover, in order to eliminate confusion in light of media reports, the Corporation has taken additional steps to remove all MAGNETIX construction sets from retail shelves, in the U.S. market and in all international markets, that do not contain a pre-printed magnet ingestion warning label that was independently developed by the Corporation in the wake of the March 31, 2006 recall campaign.

As disclosed in the Corporation's 2006 annual MD&A under the "Risks and Uncertainties – Construction Toy Litigation" section, MEGA Brands is involved in various legal proceedings with companies in the LEGO Group ("LEGO"). On May 2, 2007, the German Federal Patent Court of Appeal issued a pair of decisions the upshot of which was to support the holding of the German Patent and Trademark Office in February 2005 invalidating LEGO's German trademark registration for a 2 x 4 stud brick design with respect to wares described as "construction toys". In these decisions, the German Federal Patent Court of Appeal aligns itself with the reasoning of the Grand Board of Appeal of the Office for Harmonization of the Internal Market of the European Union ("OHIM") in the matter of MEGA Brands Inc. vs. LEGO Juris A/S. The latter case, which was decided in July 2006, dismissed LEGO's appeal from the July 2004 decision of the OHIM Cancellation Division, which had invalidated Lego's three-dimensional Community Trademark registration for an identical trademark. MEGA Brands believes that these decisions, which are subject to further appeal, are consistent with the clear trend of the trademark jurisprudence favouring competitive access to useful product features, like the basic LEGO block, which are no longer protected by patents.

## 15. Segmented information

### *Description of segments*

The Corporation operates under two geographical segments, North America and International, with sales and marketing conducted through two product lines.

- a) The Toys product lines are comprised of MEGA BLOKS construction toys in the preschool and boys 5-plus categories, MAGNETIX building sets for children 6-plus and MEGA games and puzzles for the family.
- b) The Stationery and Activities product lines are comprised of art materials (crayons, colored pencils, highlighters and markers) sold mainly under the ROSE ART brand; writing instruments (pens, mechanical pencils and woodcase pencils) sold mainly under the ROSE ART, SRX and USA GOLD brands; dry-erase and cork presentation boards, organizers and accessories sold mainly under the BOARD DUDES brand, and ROSE ART and MEGA craft and activity sets.



c) Information by segment as to MEGA Brands' operations in geographic areas is presented below on the basis the Corporation uses to manage its business. Net sales are categorized based on location of the customer while long-lived assets are categorized based on their location:

<b>Segmented information</b>	<b>Three-month periods ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
Net sales	\$	\$
Toys	<b>54,137</b>	42,486
Stationery and activities	<b>35,969</b>	36,078
	<b>90,106</b>	78,564

<b>Geographic information</b>	<b>Three-month periods ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
Net sales	\$	\$
North America <sup>(1)</sup>	<b>66,189</b>	59,717
International	<b>23,917</b>	18,847
	<b>90,106</b>	78,564

<sup>(1)</sup> Includes net sales for Canada in 2007 of \$5.0 million (\$2.8 million in 2006)

	<b>Three-month periods ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
Earnings (loss) from operations	\$	\$
North America	<b>(36,052)</b>	4,868
International	<b>706</b>	(791)
	<b>(35,346)</b>	4,077

	<b>Three-month periods ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
Property, plant and equipment, intangible assets and goodwill	\$	\$
North America <sup>(1)</sup>	<b>345,801</b>	427,823
International	<b>80,755</b>	6,200
	<b>426,556</b>	434,023

<sup>(1)</sup> Includes property, plant and equipment for Canada in 2007 of \$33.0 million (\$31.6 million in 2006)

## 16. Comparative figures

Certain comparative figures from prior periods have been reclassified to conform to the presentation adopted in the current period.

