



# Q1

Quarterly Report

First quarter ended March 31, 2004

## Stock Exchange

Toronto Stock Exchange: MB

## Shares Outstanding

(as at March 31, 2004)

27,131,200 Common Shares

## First Quarter Fiscal 2004 Trading History

TSX (CA\$)

High:	\$22.66
Low:	\$19.60
Close:	\$19.95
Average volume:	90,652

## Transfer Agent

CIBC Mellon Trust Company  
1.800.387.0825

## Financial Highlights

(all figures in millions of U.S. dollars, except per share amounts)

	<u>Q1 2004</u>	<u>Q1 2003</u>
Net sales	<b>\$26.2</b>	\$22.7
Earnings (loss) from operations	<b>\$ (0.0)</b>	\$ 0.2
Net loss	<b>\$ (0.3)</b>	\$ (0.2)
Loss per share - Basic and diluted	<b>\$ (0.01)</b>	\$ (0.01)

## Investor Relations

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# Q1

Quarterly Report  
First quarter ended March 31, 2004

## Management's discussion and analysis of financial position and results of operations

*This quarterly management's discussion and analysis of financial position and results of operations ("MD&A") should be read in conjunction with the accompanying unaudited Consolidated Financial Statements and Notes for the three-month periods ended March 31, 2004 and 2003, as well as the annual MD&A and audited Consolidated Financial Statements and Notes for the year ended December 31, 2003 including the section on risks and uncertainties. The Company's accounting policies are in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") of the Canadian Institute of Chartered Accountants ("CICA"). This discussion and analysis compares performance for 2004 with 2003 and discusses issues and risks that may impact future operations.*

*In this MD&A, the terms "we", "us" and "our" refer to Mega Bloks Inc. ("Mega Bloks") and our subsidiaries.*

*(All figures are expressed in U.S. dollars, unless otherwise specified.)*

### Corporate overview

Mega Bloks is the world's second largest manufacturer and marketer of construction toys and the largest Canadian toy company. We design, manufacture and market a broad line of construction toys under the MEGA BLOKS brand, targeting the preschool and boys 5+ markets. Over 90% of our products retail for \$29.99 or less. Based on the enduring play value of our system of interlocking plastic building blocks, our products have broad appeal and enjoy relatively steady demand.

We employ more than 1,000 people serving over 100 countries from 14 offices around the world. We expanded our market reach outside North America by establishing Mega Bloks Latinoamerica S.A de C.V. in 1997 and Mega Bloks Europe N.V. in 1998. These subsidiaries directly support major international retailers while providing a logistical and administrative platform for our global operations. We market and distribute our products primarily through our own network in nearly all-major toy markets. In 2003, 63% of our consolidated net sales were recorded in North America, which is comprised of the United States and Canada, and the balance in the International market, which includes sales in all other countries.

Our overall business strategy is to increase net sales on a worldwide basis through the introduction of new product lines, extension and enhancement of existing product lines, as well as expanded sales to existing retail customers, penetration of additional retail channels and penetration of new geographic markets.

We operate a state-of-the-art manufacturing facility in Montreal, featuring multiple capacity plastic injection-molding machines, specialized automated counting systems and multi-product integrated assembly lines. Toys manufactured in this facility accounted for approximately 65% of 2003 sales and the remaining sales were derived from products manufactured under contract in Asia.

We successfully closed an Initial Public Offering ("IPO") in 2002 and listed our shares on the Toronto Stock Exchange.

### Recent developments

On April 29, 2004, the Supreme Court of Canada granted Kirkbi AG and Lego Canada Inc. ("Lego") leave to present an appeal to the Court from a July 14, 2003 decision of the Federal Court of Appeal. No hearing date for the appeal has been set at this time. Lego's action, which was dismissed by the Federal Court Trial Division and Federal Court of Appeal, claims that Lego has the exclusive right to the "look" of the knobs of stackable, interlocking toy blocks marketed by both Lego and Mega Bloks.



## Results of operations

The following table presents a summary of certain selected consolidated financial information for the three-month periods ended March 31:

Three-month periods ended March 31,				
(U.S. \$ thousands, except per share data)	2004		2003	
	\$	% of Net sales	\$	% of Net sales
<b>Earnings Data</b>				
Net sales	26,202	100.0%	22,651	100.0%
Cost of sales	15,259	58.2%	12,637	55.8%
Gross profit	10,943	41.8%	10,014	44.2%
Marketing, research and development and advertising expenses	3,713	14.2%	3,167	14.0%
Other selling, distribution and administrative expenses	7,539	28.8%	6,830	30.2%
Gain on foreign currency translation	(279)	(1.1%)	(159)	(0.7%)
Earnings (loss) from operations	(30)	(0.1%)	176	0.8%
Interest expense	437	1.7%	523	2.3%
Loss before income taxes	(467)	(1.8%)	(347)	(1.5%)
Income taxes	(140)	(0.5%)	(112)	(0.5%)
Net loss	(327)	(1.2%)	(235)	(1.0%)
Loss per share Basic and diluted	(0.01)		(0.01)	
Weighted average number of outstanding shares Basic	27,123,326		26,904,870	



The following tables present a summary of selected consolidated balance sheet data as at March 31 and Canadian dollar data for the three-month periods ended March 31:

As at March 31,		
(U.S. \$ thousands)	2004	2003
<b>Balance Sheet Data</b>		
Working capital <sup>(1)</sup>	\$ 75,044	\$ 46,273
Capital assets	34,835	31,229
Total assets	133,038	98,318
Total debt	26,000	26,160

Three-month periods ended March 31,		
(Canadian \$ thousands, except per share data)	2004	2003
<b>Canadian Dollar Data<sup>(2)</sup></b>		
Net sales	\$ 34,338	\$ 29,684
Earnings (loss) from operations	(39)	231
Net loss	(429)	(308)
Loss per share		
Basic and diluted	\$ (0.02)	\$ (0.01)

(1) Working capital is defined as current assets minus current liabilities.

(2) U.S. dollar financial data is converted into Canadian dollars at the March 31, 2004 period end exchange rate of CA\$1.3105 per US\$1.00, using the translation of convenience method.



### Net sales

Net sales in the first quarter of 2004 increased 15.7% to \$26.2 million compared to \$22.7 million in the first quarter of 2003.

In North America, net sales reached \$16.1 million in the first quarter of 2004, up 10.5% compared to \$14.6 million in the same period last year. International net sales increased 25.0% to \$10.1 million compared to \$8.1 million in the first quarter of 2003. In the first quarter of 2004, International net sales accounted for 38.5% of consolidated net sales compared to 35.6% in the same period last year.

During the first quarter, we achieved our overall growth through the continued success of our 2003 product initiatives and successful penetration of new geographic markets.

### Gross profit

Gross profit in the first quarter of 2004 was \$10.9 million, an increase of 9.3% compared to \$10.0 million in the same quarter last year. Gross margin was 41.8% compared to 44.2% in the first quarter of 2003. The decrease in gross margin is explained mainly by the year-over-year weakening of the U.S. dollar against the Canadian dollar, changes in product mix and higher commodity prices.

### Operating expenses

Marketing, research and development, and advertising expenses in the first quarter of 2004 were \$3.7 million, an increase of 17.2% compared to \$3.2 million in the same period last year. This increase is explained mainly by higher research and development infrastructure costs to support the Company's growth initiatives. As a percentage of sales, marketing, research and development, and advertising expenses were in line with last year at 14.2% compared to 14.0% in the first quarter of 2003.

Other selling, distribution and administrative expenses in the first quarter of 2004 totaled \$7.5 million, an increase of 10.4% compared to \$6.8 million in the same period last year. As a percentage of sales, such expenses declined to 28.8% compared to 30.2% in the first quarter of 2003, reflecting the leveraging of general and administrative costs.

We recorded a gain on foreign currency translation of \$0.3 million in the first quarter of 2004 compared to \$0.2 million in the same period last year reflecting the maturing of foreign exchange contracts at favorable rates.

### Earnings (loss) from operations

As a result of the above, results from operations in the first quarter of 2004 were break even compared to earnings from operations of \$0.2 million in the same period last year.

### Non-operating expenses

Interest expense in the first quarter of 2004 was \$0.4 million compared to \$0.5 million in the same period last year. This decrease reflects lower indebtedness in the first quarter of 2004 resulting from the repayment of the Term A credit facility totaling \$13.5 million which was then terminated on March 31, 2003.

Income taxes were not material in the first quarter of both years. Our effective income tax rate was 30.0% in the first quarter of 2004 compared to 32.5% in the same period last year.

### Net loss

Consequently, net loss in the first quarter of 2004 was \$0.3 million compared to \$0.2 million in the first quarter of 2003. Basic loss per share for both periods was \$0.01.

### Shares outstanding

The weighted average number of shares outstanding for the first quarter of 2004 was 27,123,326 compared to 26,904,870 for the first quarter of 2003.



### Seasonality and quarterly fluctuations

The toy business is seasonal and we have historically experienced significant quarterly fluctuations in operating results. As a result of this, 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 and second quarters as a result of fairly constant fixed operating expenses while net sales are at their lowest levels of the year. This seasonality is consistent with the results of other companies in the toy industry and we anticipate this will continue in the future.

### Liquidity and capital resources

We have historically funded our operations and capital requirements with cash generated from operations and borrowings under a revolving credit facility. 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 business, our working capital requirements are variable throughout the year. Our need for working capital typically grows through the first three quarters as inventories are built up for the peak sales period in the fourth quarter. For the same reason, our interim statements of cash flows 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.

Cash flows from operating activities, after changes in non-cash operating working capital items, totaled \$31.7 million in the first quarter of 2004 compared to \$39.5 million in the first quarter last year. This decrease was due to reduced non-cash working capital items, resulting primarily from a lower decrease in accounts receivable and increased inventory levels compared to the same period last year.

Cash flows from financing activities in the first quarter of 2004 totaled \$10.4 million compared to \$17.5 million in the same period last year. In the first quarter of 2004, we paid down our \$10.0 million revolving term bank loan balance and repaid \$0.4 million of long-term debt. In the first quarter of 2003, we repaid the remaining balance of \$13.5 million of our Term A credit facility and paid down our \$4.0 million revolving term bank loan balance.

Cash flows from investing activities amounted to \$3.0 million in the first quarter of 2004 compared to \$2.5 million in the same period of 2003. For both periods, these amounts reflect the acquisition of capital assets. We expect acquisitions of capital assets in 2004 to be consistent with 2003.

Cash and cash equivalents increased by \$18.4 million in the first quarter of 2004 compared to an increase of \$19.5 million in the same period of 2003. As at March 31, cash and cash equivalents stood at \$22.0 million in 2004 compared to \$22.4 million in 2003.

Anticipated sales growth in 2004 will result in increased working capital requirements mainly to finance trade accounts receivable and inventories. We expect to fund our operations and working capital requirements with cash from operations and borrowings from our revolving credit facility. Our objective is to use free cash flow generated in 2004 to further reduce our long-term debt.



## Balance sheet

Our financial position remained strong in the first quarter of 2004 culminating with total borrowings of \$26.0 million at the end of the first quarter compared to \$26.2 million at the end of the same period last year. The total debt to capitalization ratio was 0.26 as at March 31, 2004 compared to 0.36 in 2003. This is consistent with our objective of reducing our overall debt combined with our increased tangible net worth.

Working capital at the end of the first quarter of 2004 totaled \$75.0 million compared to \$46.3 million in 2003, reflecting higher trade accounts receivable and inventories.

Trade accounts receivable were \$37.1 million, an increase of \$19.5 million compared to \$17.6 million at the end of the first quarter of 2003. This is explained mainly by the strong growth in International net sales in the later part of the fourth quarter of 2003 as such sales typically carry longer selling terms than North American sales. In addition, the solid sales growth in the first quarter of 2004 contributed to this increase.

Inventories were \$28.8 million compared to \$17.7 million in the first quarter of 2003. This increase reflects mainly the weaker U.S. dollar compared to the Canadian dollar as at March 31, 2004 versus last year. The balance of the increase is explained mainly by tight inventory management policies implemented by North American retailers.

## Financial instruments

We are exposed to market risks attributable to fluctuations in foreign currency exchange rates, primarily changes in the value of the U.S. dollar versus other currencies such as the Canadian dollar, the Euro, the British pound and the Mexican peso. Our sales are primarily denominated in U.S. dollars while the majority of our expenses are incurred in Canadian dollars.

Our policy is to mitigate, when appropriate, our exposure to market risk by partially hedging such exposure using foreign currency contracts primarily to hedge expenses denominated in Canadian dollars and inter-company transactions denominated in other foreign currencies.

The following table summarizes our foreign currency commitments as at March 31, 2004 :

Foreign currency contracts	National amount \$	Average exchange rate	Maturing up to	National equivalent US \$	Fair market value including national equivalent US \$
Sell - \$US to \$CAN	26,050	1.5983	Dec. 2004	26,050	31,414
- Euro to \$US	40,350	1.1342	Dec. 2005	45,765	42,341
- Euro to \$CAN	3,000	1.6506	Dec. 2004	3,779	3,858
- GBP to \$US	18,750	1.6959	Dec. 2005	31,799	29,961

## Contractual obligations

Our future liabilities under firm contractual obligations, including debt repayments, capital leases and operating leases, are summarized in our annual MD&A for the year 2003. Since December 31, 2003, there has been no significant changes to our contractual obligations other than the repayment of our revolving term bank loan.



## **Significant accounting policies and use of estimates**

Our consolidated financial statements are prepared in accordance with GAAP using the U.S. dollar (functional currency) as the reporting currency. In preparing the financial statements in conformity with GAAP, we are required 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.

Our significant accounting policies are presented in our 2003 annual MD&A in Note 2 to the financial statements. We believe that the following accounting policies and estimates are most significant to assist in understanding and evaluating our financial results.

### **Revenue recognition**

We recognize revenues when our products are shipped to customers. Accruals for customer discounts, rebates and defective allowances are recorded as the related revenues are recognized. Accruals for returns are based on market data, historical trends and information from customers and are therefore subject to estimation.

### **Financial instruments**

We use a combination of financial instruments to manage risks related to fluctuations in exchange rates. The derivative instruments we use mainly are foreign exchange contracts. We formally assess, both at the hedge's inception and on an ongoing basis, whether the derivatives used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. Gains and losses on foreign exchange contracts are recognized through income and generally offset transaction losses or gains on the foreign currency cash flows, which they are intended to hedge. We do not use derivative financial instruments for trading purposes.

Gains and losses associated with derivative instruments, which have been terminated or cease to be effective prior to maturity, are deferred under other assets or liabilities and recognized in the statement of earnings in the period in which the underlying hedged transaction is recognized. In the event a designated item is sold, extinguished or matures prior to the termination of the related derivative instrument, a gain or loss on such a derivative instrument is recognized in the statement of earnings.

### **Stock-based compensation plans**

We have adopted the fair value method of accounting recommended by the CICA in Section 3870, "Stock-based Compensation and Other Stock-based Payments", prospectively for new stock-based compensation awards granted after January 1, 2003. The fair value of option awards is recognized as an expense and any consideration paid by employees on exercise of stock options is credited to share capital. The fair value of options is estimated on the date of grant using the Black-Scholes option pricing model, including certain assumptions such as risk-free interest rate, expected life of options and expected volatility of the our share price.

### **Inventories**

Inventories are stated at the lower of cost and market value. Cost is established based on the first-in, first-out method. Market value is defined as replacement cost for raw materials and net realizable value for work in process and finished goods.

## **Recent accounting pronouncements**

As of January 1, 2004, we have adopted Accounting Guideline 13, "Hedging Relationships", which deals with the identification, documentation, designation and effectiveness of hedges and also the discontinuance of hedge accounting, but does not specify hedge accounting methods. This guidance is applicable to hedge relationships in effect in fiscal years beginning on or after July 1, 2003.



### Recent accounting pronouncements (continued)

When the hedging relationship no longer qualifies as an effective hedge, hedge accounting will be discontinued prospectively and the financial instrument will be carried at fair value on the consolidated balance sheet as of the date hedge accounting was discontinued. Any subsequent changes in fair value will be recognized in "Gain/loss on foreign currency translation" in conformity with EIC-128, "Accounting for trading, speculative or non-hedging derivative financial instruments". When the financial instrument once again qualifies as a hedging relationship, hedge accounting will be applied again on as of the new date of designation. The adoption of this new standard did not have a material impact on our consolidated financial statements.

The CICA issued Handbook Section 3110, "Asset Retirement Obligations". The new standard focuses on the recognition and measurement of liabilities for obligations associated with the retirement of property, plant and equipment when those obligations result from the acquisition, construction, development or normal operation of the assets. The standard is effective for fiscal years beginning on or after January 1, 2004. The adoption of this new standard did not have a material impact on our consolidated financial statements.

The CICA issued Handbook Section 3063, "Impairment of Long-lived Assets", which is effective for fiscal years beginning on or after April 1, 2003. This section provides guidance on recognizing, measuring and disclosing impairment of long-lived assets. It replaces the write-down provisions in Section 3061, "Property, plant and equipment". The adoption of this new standard did not have a material impact on our consolidated financial statements.

### Risks and uncertainties

For a discussion of the risks that could affect our business, please refer to our annual MD&A for 2003. Since December 31, 2003, there has been no significant changes to our risks and uncertainties.

### Forward-looking statements

Certain statements made in this MD&A may constitute forward-looking statements and are subject to significant risks and uncertainties which are difficult to predict and assumptions which may prove to be inaccurate. The results or events predicted in these statements may differ materially from actual results or events. Certain of the risk factors which could cause results or events to differ materially from current expectations include the following: difficulty in predicting customer preferences and importance of new products, dependence on a few large customers, litigation, seasonality of the toy industry, fluctuations in the price of plastic resins and currency fluctuations. The forward-looking statements contained in this document represent the Company's expectations as of May 6, 2004 and, accordingly, are subject to change after such date. However, the Company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Additional information relating to Mega Bloks 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 amounts)  
(Unaudited)

	Three-month periods ended March 31,	
	2004	2003
<b>Net sales</b>	<b>\$ 26,202</b>	<b>\$ 22,651</b>
Cost of sales	<b>15,259</b>	12,637
Gross profit	<b>10,943</b>	10,014
Marketing, research and development, and advertising expenses	<b>3,713</b>	3,167
Other selling, distribution and administrative expenses	<b>7,539</b>	6,830
Gain on foreign currency translation	<b>(279)</b>	(159)
Earnings (loss) from operations	<b>(30)</b>	176
Interest expense		
Long-term debt	<b>414</b>	514
Other	<b>23</b>	9
	<b>437</b>	523
Loss before income taxes	<b>(467)</b>	(347)
Income taxes		
Current	<b>(590)</b>	(615)
Future	<b>450</b>	503
	<b>(140)</b>	(112)
<b>Net loss</b>	<b>\$ (327)</b>	<b>\$ (235)</b>
<b>Loss per share</b> (note 6)		
Basic and diluted	<b>\$ (0.01)</b>	<b>\$ (0.01)</b>



## Consolidated statements of deficit

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

	Three-month periods ended March 31,	
	2004	2003
<b>Balance, beginning of period</b>	<b>\$ (77,497)</b>	<b>\$ (106,014)</b>
Net loss	(327)	(235)
<b>Balance, end of period</b>	<b>\$ (77,824)</b>	<b>\$ (106,249)</b>



## Consolidated balance sheet

(in thousands of U.S. dollars)

	March 31, 2004 (Unaudited)	December 31, 2003 (Audited)	March 31, 2003 (Unaudited)
<b>Assets</b>			
Current assets			
Cash and cash equivalents	\$ 21,978	\$ 3,595	\$ 22,353
Accounts receivable - trade	37,096	93,417	17,552
Accounts receivable - other	3,223	4,617	1,948
Inventories	28,780	24,440	17,695
Income taxes	1,788	24	3,933
Prepaid expenses	4,140	3,823	2,083
	97,005	129,916	65,564
Capital assets	34,835	33,510	31,229
Deferred charges	1,198	1,292	1,525
	\$ 133,038	\$ 164,718	\$ 98,318
<b>Liabilities</b>			
Current liabilities			
Accounts payable and accrued liabilities	\$ 21,282	\$ 42,782	\$ 18,494
Current portion of long-term debt	679	955	797
	21,961	43,797	19,291
Long-term debt	25,321	35,489	25,363
Future income taxes	9,446	8,998	6,673
	56,728	88,224	51,327
<b>Shareholders' equity</b>			
Capital stock	153,769	153,729	153,219
Contributed Surplus	365	262	21
Deficit	(77,824)	(77,497)	(106,249)
	76,310	76,494	46,991
	\$ 133,038	\$ 164,718	\$ 98,318



## Consolidated statements of cash flows

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

	Three-month periods ended March 31,	
	2004	2003
<b>Cash flows from operating activities</b>		
Net loss	\$ (327)	\$ (235)
Items not affecting cash		
Amortization	1,737	1,649
Gain on foreign currency translation	(279)	(159)
Others	553	524
	<b>1,684</b>	<b>1,779</b>
Changes in non-cash operating working Capital items	<b>30,046</b>	37,715
	<b>31,730</b>	<b>39,494</b>
<b>Cash flows from financing activities</b>		
Repayment of long-term debt	(415)	(13,700)
Change in revolving term bank loan balance	(10,000)	(4,000)
Issue of capital stock	40	156
	<b>(10,375)</b>	<b>(17,544)</b>
<b>Cash flows from investing activities</b>		
Acquisition of Capital assets	(2,972)	(2,473)
	<b>(2,972)</b>	<b>(2,473)</b>
Increase in cash and cash equivalents	<b>18,383</b>	19,477
Cash and cash equivalents, beginning of period	<b>3,595</b>	2,876
<b>Cash and cash equivalents, end of period</b>	<b>\$ 21,978</b>	<b>\$ 22,353</b>
Supplementary disclosure of cash flow information		
Interest paid	\$ 417	\$ 709
Income taxes paid	<b>1,133</b>	6,881



## Notes to interim consolidated financial statements

For the three-month periods ended March 31, 2004 and 2003  
(Column figures are expressed in thousands of U.S. dollars, except per share data)  
(Unaudited)

### 1. Basis of presentation

The consolidated financial statements are expressed in U.S. dollars as it is the Company'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, 2003 except as noted below. However, they do not include all disclosures required under GAAP for annual financial statements and should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's latest Annual Report.

The 2003 consolidated financial statements have been restated to reflect the application of Canadian Institute of Chartered Accounts ("CICA") Handbook Section 3870, "Stock-based Compensation and Other Stock-based Payments" prospectively for new awards grants after January 1, 2003. During fiscal 2003, the Company adopted this application during the fourth quarter.

### 2. Changes in accounting policies

During the period, the Company has adopted the following new Accounting Guideline and Handbook Sections issued by the CICA:

#### *Hedging Relationships*

The CICA issued Accounting Guideline 13, "Hedging Relationships", which deals with the identification, documentation, designation and effectiveness of hedges and also the discontinuance of hedge accounting, but does not specify hedge accounting methods. This guidance is applicable to hedge relationships in effect in fiscal years beginning on or after July 1, 2003.

The Company adopted this Accounting Guideline effective January 1, 2004. The monetary or derivative financial instruments used in risk management and qualifying for hedge accounting will be recorded using hedge accounting.

When the hedging relationship no longer qualifies as an effective hedge, hedge accounting will be discontinued prospectively and the financial instrument will be carried at fair value on the consolidated balance sheet as of the date hedge accounting was discontinued. Any subsequent changes in fair value will be recognized in "Gain/loss on foreign currency translation" in conformity with EIC-128, "Accounting for trading, speculative or non-hedging derivative financial instruments". When the financial instrument once again qualifies as a hedging relationship, hedge accounting will be applied again as of the new date of designation.

The adoption of this new Accounting Guideline did not have a material impact on our consolidated financial statements.

#### *Asset Retirement Obligations*

The CICA issued Handbook Section 3110, "Asset Retirement Obligations". The new standard focuses on the recognition and measurement of liabilities for obligations associated with the retirement of property, plant and equipment when those obligations result from the acquisition, construction, development or normal operation of the assets. The standard is effective for fiscal years beginning on or after January 1, 2004.

The adoption of this new Handbook Section did not have a material impact on our consolidated financial statements.



## 2. Changes in accounting policies (continued)

### *Impairment of Long-lived Assets*

The CICA issued Handbook Section 3063, "Impairment of Long-lived Assets", which is effective for fiscal years beginning on or after April 1, 2003. This section provides guidance on recognizing, measuring and disclosing impairment of long-lived assets. It replaces the write-down provisions in Section 3061, "Property, plant and equipment".

The adoption of this new Handbook Section did not have a material impact on our consolidated financial statements.

## 3. Capital stock

### *Outstanding share data*

As at March 31, 2004, there were 27,131,200 Common Shares issued and outstanding.

## 4. Income taxes

The tax rate used to establish the income tax expense for the quarterly results is the applicable statutory rate of each subsidiary of the group which approximates the effective income tax rate of 30% for the three-month period ended March 31, 2004.

## 5. Stock-based compensation plans

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

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

Immediately prior to the closing of the Initial Public Offering, the Company introduced a New Stock Option Plan. Under this plan, options to purchase common shares of the Company 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, 2004, a total of 6,140,696 common shares remained authorized for issuance under the Company'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 Company, the options become immediately exercisable. Options are adjusted proportionately for any stock dividends or stock splits attributed to the common shares of the Company.

On March 24, 2004, the Board of Directors adopted a recommendation of the Compensation Committee that the Company 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 Compensation Committee is currently engaged in a review of various long-term compensation plans with a mandate to propose to the Board of Directors a plan that will replace in whole or in part the Option Plan with no or minimal dilutive effect on the number of common shares outstanding.



## 5. Stock-based compensation plans (continued)

The following table summarizes total stock options outstanding as at March 31 under the Company's Stock Option plans:

(in Canadian dollars)	2004		2003	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Options outstanding, beginning of period	3,866,825	\$ 8.66	3,925,483	\$ 7.76
Granted	58,586	20.80	142,100	20.70
Exercised	(11,668)	4.46	(61,283)	3.85
Forfeited	(18,734)	17.47	(17,319)	10.41
Options outstanding, end of period	3,895,009	\$ 8.82	3,988,981	\$ 8.27
Options exercisable, end of period	2,561,238	\$ 5.22	2,374,393	\$ 3.85

## 6. Loss per share

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

	Three-month periods ended March 31,	
	2004	2003
Numerator for net loss per common share - basic and diluted:		
Net loss attributable to common shareholders	\$ (327)	\$ (235)
Denominator for loss per common share - basic:		
Weighted average number of common shares outstanding	27,123,326	26,904,870
Loss per share - basic and diluted	\$ (0.01)	\$ (0.01)

### *Fair value method for the Company's stock based compensation plan*

CICA Handbook Section 3870, "Stock-based Compensation and Other Stock-based Payments", recommends the recognition of an expense for option awards using the fair value method of accounting for options issued after January 1, 2002. It permits the use of other methods, including the intrinsic value based method, provided pro forma disclosures of net income and earning per share applying the fair value method are made. In 2003, the Company adopted the recommendations of CICA Handbook Section 3870, with respect to the use of the fair value method to recognize an expense for option awards, prospectively for new awards granted after January 1, 2003. The fair value compensation expense recorded for the period ended March 31, 2004, in respect of these awards was \$0.1 million (\$21,000 in 2003).

The pro forma disclosures have been presented as if the recommended recognition provisions of Section 3870 for awards granted before 2003 had been adopted in 2004 and 2003.

	As reported		Pro forma <sup>(1)</sup>	
	2004	2003	2004	2003
Net loss	\$ (327)	\$ (235)	\$ (939)	\$ (885)
Loss per share - basic and diluted	(0.01)	(0.01)	(0.03)	(0.03)

(1) Compensation expense under the fair value based method is recognized over the vesting period of the related stock options. Accordingly, the pro forma results of applying this method may not be indicative of future amounts.



## 6. Loss per share (continued)

The fair value of options granted during the period ending March 31, 2004 and 2003 was estimated on the date of grant using the Black-Scholes option pricing model with the following assumption:

	2004	2003
Risk-free interest rate	4.38 %	4.93 %
Expected option life	6 years	6 years
Expected volatility	27%	27%
Expected dividends	0%	0%

The fair value of each option granted was \$CA7.50 (\$CA7.74 in 2003)

## 7. Seasonal nature of business

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

## 8. Subsequent event

On April 29, 2004, the Supreme Court of Canada granted Kirkbi AG and Lego Canada Inc. ("Lego") leave to present an appeal to the Court from a July 14, 2003 decision of the Federal Court of Appeal. No hearing date for the appeal has been set at this time. Lego's action, which was dismissed by the Federal Court Trial Division and Federal Court of Appeal, claims that Lego has the exclusive right to the "look" of the knobs of stackable, interlocking toy blocks marketed by both Lego and Mega Bloks.

## 9. Segmented information

The Company manages its business as a single operating segment - manufacturing and distribution of toys.

### *Geographic information*

The table below presents information by geographic region. Revenues are attributed to countries based on location of customer:

	<b>Three-month periods ended March 31,</b>	
	2004	2003
Net sales		
Canada	\$ 2,277	\$ 1,649
United States	13,846	12,938
International	10,079	8,064
	<b>\$ 26,202</b>	<b>\$22,651</b>