Q2

Quarterly Report

Second quarter ended June 30, 2004

more

Stock Exchange

Toronto Stock Exchange: MB

Shares Outstanding

(as at June 30, 2004)

27,198,851 Common Shares

Second Quarter Fiscal 2004 Trading History

TSX	(CA$)
High:	$22.00
Low:	$19.20
Close:	$22.00
Average volume:	59,009

Transfer Agent

CIBC Mellon Trust Company
1.800.387.0825

Financial Highlights

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

	Q2 2004	Q2 2003
Net sales	**$ 30.2**	$ 26.6
Earnings from operations	**$ 0.2**	$ 0.8
Net Earnings (loss)	**$ (0.1)**	$ 0.2
Earnings (loss) per share		
Basic	**$ (0.00)**	$ 0.01
Diluted	**–**	$ 0.01

Investor Relations

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

This 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 June 30, 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", "our", and "Mega Bloks" refer to Mega Bloks Inc. 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 geographical 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 the 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.

On June 30, 2004, the Company amended its Credit Agreement bearing formal date of May 1, 2002. Through this Amendment Agreement, the Company and its lenders amended certain provisions of the Credit Agreement. First, the Company repaid $12.0 million of the Term B Credit Facility. The Term B Credit Facility was for an original amount of $25.0 million, of which 95% was payable at maturity in 2008. In addition, the Company increased its revolving credit facility to $57.5 million from $45.0 million. Strong free cash flow generated in 2003 and during the first six months of fiscal 2004 enabled the Company to repay approximately 50% of its Term B Credit Facility.

Results of operations

The following table presents a summary of certain selected consolidated financial information on a comparable basis to the same period of the previous year:

	Three-month periods ended June 30,				Six-month periods ended June 30,			
(U.S. $ thousands, except per share data)	**2004**		2003		**2004**		2003	
	$	**% of Net sales**	$	% of Net sales	**$**	**% of Net sales**	$	% of Net sales
Earnings Data								
Net sales	**30,168**	**100.0%**	26,580	100.0%	**56,370**	**100.0%**	49,231	100.0%
Cost of sales	**17,650**	**58.5%**	15,197	57.2%	**32,909**	**58.4%**	27,834	56.5%
Gross profit	**12,518**	**41.5%**	11,383	42.8%	**23,461**	**41.6%**	21,397	43.5%
Marketing, research and development and advertising expenses	**4,143**	**13.7%**	3,973	14.9%	**7,856**	**13.9%**	7,140	14.5%
Other selling, distribution and administrative expenses	**8,604**	**28.5%**	7,628	28.7%	**16,143**	**28.6%**	14,458	29.4%
Gain on foreign currency translation	**(445)**	**(1.5%)**	(1,034)	(3.9%)	**(724)**	**(1.3%)**	(1,193)	(2.4%)
Earnings from operations	**216**	**0.7%**	816	3.1%	**186**	**0.3%**	992	2.0%
Interest expense	**346**	**1.1%**	460	1.7%	**783**	**1.4%**	983	2.0%
Earnings (loss) before income taxes	**(130)**	**(0.4%)**	356	1.3%	**(597)**	**(1.1%)**	9	0.0%
Income taxes	**(39)**	**(0.1%)**	140	0.5%	**(179)**	**(0.3%)**	34	0.1%
Net Earnings (loss)	**(91)**	**(0.3%)**	216	0.8%	**(418)**	**(0.7%)**	(25)	(0.1%)
Earnings (loss) per share								
Basic	**(0.00)**		0.01		**(0.02)**		(0.00)	
Diluted (1)	**–**		0.01		**–**		–	
Weighted average number of outstanding shares								
Basic	**27,154,463**		26,963,090		**27,138,895**		26,934,141	
Diluted (1)	**–**		29,409,713		**–**		–	

(1) The dilutive effect of outstanding options under the treasury stock method for the three-month and six-month periods ended June 30, 2004 as well as the six-month period ended June 30, 2003 is not presented, as it is anti-dilutive.

The following tables present a summary of selected consolidated balance sheet data as at June 30 and Canadian dollar data for the three-month and six-month periods ended June 30:

(U.S. $ thousands)	As at June 30, 2004	2003
Balance Sheet Data		
Working capital [(1)]	**$ 61,692**	$ 45,085
Capital assets	**35,967**	33,466
Total assets	**119,240**	103,208
Total debt	**13,721**	25,978

	Three-month periods ended June 30,		Six-month periods ended June 30,	
(Canadian $ thousands, except per share data)	**2004**	2003	**2004**	2003
Canadian Dollar Data [(2)]				
Net sales	**$ 40,437**	$ 35,628	**$ 75,558**	$ 65,989
Earnings from operations	**290**	1,094	**249**	1,330
Net Earnings (loss)	**(122)**	290	**(560)**	(34)
Earnings (loss) per share				
Basic	**$ (0.00)**	$ 0.01	**$ (0.02)**	$ (0.00)
Diluted [(3)]	**$ –**	$ 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 June 30, 2004 period end exchange rate of CA$1.3404 per US$1.00, using the translation of convenience method.

(3) The dilutive effect of outstanding options under the treasury stock method for the three-month and six-month periods ended June 30, 2004 as well as the six-month period ended June 30, 2003 is not presented, as it is anti-dilutive.

Net sales

Net sales during the second quarter of 2004 increased 13.5% to $30.2 million compared to $26.6 million in the same period of 2003. In North America, net sales reached $14.8 million, up 5.1% compared to $14.0 million in the same period last year. International net sales increased 22.9% to $15.4 million compared to $12.5 million in the second quarter of 2003. International net sales accounted for 51.1% of consolidated net sales compared to 47.2% in the same period last year. During the second quarter, we achieved our overall growth through the continued success of our 2003 product initiatives and successful penetration of new geographic markets.

For the six-month period ended June 30, 2004, net sales increased 14.5% or $7.1 million, to $56.4 million, up from $49.2 million in the corresponding period of 2003. International net sales accounted for 45.2% of consolidated net sales compared to 41.8% in the same period last year.

Gross profit

Gross profit during the second quarter of 2004 was $12.5 million, an increase of 10.0% compared to $11.4 million in the same period of 2003. Gross margin was 41.5% compared to 42.8% in the second quarter of 2003. The decrease in gross margin is explained mainly by higher commodity prices, year-over-year weakening of the U.S. dollar against the Canadian dollar, and changes in product mix.

For the six-month period ended June 30, 2004, gross profit totaled $23.5 million compared to $21.4 million for the corresponding period of 2003, an increase of $2.1 million or 9.6%. As a percentage of net sales, gross profit was 41.6% for the six-month period ended June 30, 2004 compared to 43.5% for the same period in 2003.

Operating expenses

Marketing, research and development, and advertising expenses during the second quarter of 2004 were $4.1 million, an increase of 4.3% compared to $4.0 million in the same period of 2003. As a percentage of net sales, marketing, research and development, and advertising expenses were 13.7% compared to 14.9% in the second quarter of 2003, resulting mainly from timing of brand investment programs.

For the six-month period ended June 30, 2004, marketing, research and development and advertising expenses amounted to $7.9 million compared to $7.1 million for the corresponding period of 2003, an increase of $0.7 million or 10.0%. As a percentage of net sales, marketing, research and development and advertising expenses were 13.9% for the six-month period ended June 30, 2004 compared to 14.5% for the same period in 2003.

Other selling, distribution and administrative expenses during the second quarter of 2004 totaled $8.6 million, an increase of 12.8% compared to $7.6 million in the same period of 2003. As a percentage of net sales, such expenses were 28.5% compared to 28.7% in the second quarter of 2003. This percentage decrease was mainly attributable to the leveraging of general and administrative costs, which more than offset the increase in distribution and selling expenses.

For the six-month period ended June 30, 2004, other selling, distribution and administrative expenses amounted to $16.1 million compared to $14.5 million for the corresponding period of 2003, an increase of $1.7 million or 11.7%. As a percentage of net sales, other selling, distribution and administrative expenses were 28.6% for the six-month period ended June 30, 2004 compared to 29.4% for the same period in 2003.

We recorded a gain on foreign currency translation of $0.4 million during the second quarter of 2004 compared to $1.0 million in the same period last year reflecting the impact of foreign exchange contracts maturing.

For the six-month period ended June 30, 2004, gain on foreign currency translation decreased by $0.5 million to $0.7 million compared to $1.2 million for the corresponding period of 2003.

Earnings from operations

As a result of the above, earnings from operations during the second quarter of 2004 were $0.2 million compared to $0.8 million in the same period of 2003.

For the six-month period ended June 30, 2004, earnings from operations amounted $0.2 million compared to $1.0 million for the corresponding period of 2003.

Non-operating expenses

Interest expense in the second quarter of 2004 was $0.3 million compared to $0.5 million in the same period of 2003, a decrease of $0.2 million.

For the six-month period ended June 30, 2004, interest expense amounted to $0.8 million compared to $1.0 million for the corresponding period of 2003. This decrease reflects lower borrowing levels compared to the same period last year.

Our effective income tax rate was 30.0% during the second quarter and the six-month period of 2004.

Net earnings (loss)

Consequently, net loss in the second quarter of 2004 was $0.1 million or $0.00 per share compared to net earnings of $0.2 million or $0.01 per share in the second quarter of 2003.

For the six-month period ended June 30, 2004, our net loss was $0.4 million or $0.02 per share compared to break-even in the same period last year.

Shares outstanding

The weighted average number of shares outstanding for the second quarter of 2004 was 27,154,463 compared to 26,963,090 for the second quarter of 2003.

For the six-month period ended June 30, 2004, the weighted average number of shares was 27,138,895 compared to 26,934,141 in the same period last year.

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 $2.1 million during the second quarter of 2004 compared to cash flows used in operating activities of $7.4 million in the same period of 2003. This improvement was due to increased non-cash working capital items, resulting primarily from timing of trade accounts receivable compared to the same period last year.

Cash flows used in financing activities during the second quarter of 2004 totaled $12.0 million compared to $0.6 million in the same period last year. In the second quarter of 2004, this increase results from the $12.0 million repayment on June 30th of the Term B Credit Facility.

Cash flows used in investing activities amounted to $2.9 million in the second quarter of 2004 compared to $4.1 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 decreased by $12.8 million in the second quarter of 2004 compared to $12.1 million in the same period of 2003. As at June 30, cash and cash equivalents amounted $9.2 million in 2004 compared to $10.3 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 continue to use free cash flow to further reduce long-term debt.

Balance sheet

Our financial position continues to improve in 2004. At the end of June 2004, total borrowings amounted to $13.7 million compared to $26.0 million at the end of June 2003. This reduction in total borrowings resulted primarily from the repayment of $12.0 million of term debt. The total debt to capitalization ratio was 0.15 as at June 30, 2004 compared to 0.36 in 2003.

Working capital at the end of the second quarter of 2004 totaled $61.7 million compared to $45.1 million in 2003, reflecting higher trade accounts receivable and inventories.

Trade accounts receivable were $31.6 million, an increase of $10.9 million compared to $20.7 million at the end of the second quarter of 2003. Higher trade accounts receivable are explained primarily from increased sales and geographical mix of customers.

Inventories were $35.1 million compared to $25.5 million in the second quarter of 2003. This 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 June 30, 2004 :

Foreign currency contracts		Notional amount	Average exchange rate	Maturing up to	Notional equivalent	Fair market value including notional equivalent
		$			US $	US $
Sell	**- $US to $CAN**	**23,800**	**1.5099**	**Feb. 2006**	**23,800**	**26,690**
	- Euro to $US	**38,850**	**1.1383**	**Dec. 2005**	**44,225**	**41,202**
	- Euro to $CAN	**2,200**	**1.6513**	**Dec. 2004**	**2,710**	**2,751**
	- GBP to $US	**16,500**	**1.6937**	**Dec. 2005**	**27,947**	**26,483**

Contractual obligations

Our future liabilities under firm contractual obligations, including debt repayments, capital leases and operating leases, are summarized in our 2003 annual MD&A. Since December 31, 2003, there has been no significant changes to our contractual obligations other than the repayment of $12.0 million of our Term B Credit Facility.

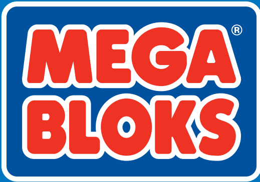
Significant accounting policies and use of estimates

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

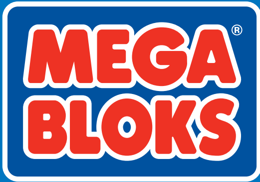
As of January 1, 2004, we have adopted Accounting Guideline 13, "Hedging Relationships", which deals with the identification, documentation, designation and effectiveness of hedges and also the discontinuance of hedge accounting, but does not specify hedge accounting methods. This guidance is applicable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

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.



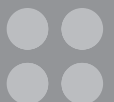
Risks and uncertainties

For a discussion of the risks that could affect our business, please refer to our 2003 annual MD&A. 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 July 28, 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.



Consolidated statements of earnings

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

	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2004	2003	**2004**	2003
Net sales	**$ 30,168**	$ 26,580	**$ 56,370**	$ 49,231
Cost of sales	**17,650**	15,197	**32,909**	27,834
Gross profit	**12,518**	11,383	**23,461**	21,397
Marketing, research and development, and advertising expenses	**4,143**	3,973	**7,856**	7,140
Other selling, distribution and administrative expenses	**8,604**	7,628	**16,143**	14,458
Gain on foreign currency translation	**(445)**	(1,034)	**(724)**	(1,193)
Earnings from operations	**216**	816	**186**	992
Interest expense				
Long-term debt	**282**	390	**696**	904
Other	**64**	70	**87**	79
	346	460	**783**	983
Earnings (loss) before income taxes	**(130)**	356	**(597)**	9
Income taxes				
Current	**419**	(988)	**(171)**	(1,597)
Future	**(458)**	1,128	**(8)**	1,631
	(39)	140	**(179)**	34
Net Earnings (loss)	**$ (91)**	$ 216	**$ (418)**	$ (25)
Earnings (loss) per share (Note 7)				
Basic	**$ (0.00)**	$ 0.01	**$ (0.02)**	$ (0.00)
Diluted	**$ –**	$ 0.01	**$ –**	$ –

Consolidated statements of deficit

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

	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2004	2003	**2004**	2003
Balance, beginning of period	**$ (77,824)**	$ (106,255)	**$ (77,497)**	$ (106,014)
Net Earnings (loss)	**(91)**	216	**(418)**	(25)
Related party transaction adjustment (Note 10)	**–**	(288)	**–**	(288)
Balance, end of period	**$ (77,915)**	$ (106,327)	**$ (77,915)**	$ (106,327)

Consolidated balance sheet

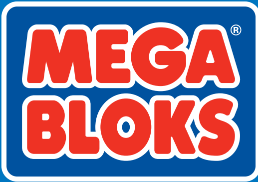
(in thousands of U.S. dollars)

	June 30, 2004 (Unaudited)	December 31, 2003 (Audited)	June 30, 2003 (Unaudited)
Assets			
Current assets			
Cash and cash equivalents	**$ 9,191**	$ 3,595	$ 10,291
Accounts receivable - trade	**31,629**	93,417	20,681
Accounts receivable - other	**2,217**	4,617	1,378
Inventories	**35,145**	24,440	25,470
Income taxes	**173**	24	8,406
Prepaid expenses	**3,815**	3,823	2,057
	82,170	129,916	68,283
Capital assets	**35,967**	33,510	33,466
Deferred charges	**1,103**	1,292	1,459
	$ 119,240	$ 164,718	$ 103,208
Liabilities			
Current liabilities			
Accounts payable and accrued liabilities	**$ 19,943**	$ 42,782	$ 22,347
Current portion of long-term debt (Note 3)	**535**	955	851
	20,478	43,737	23,198
Long-term debt (Note 3)	**13,186**	35,489	25,127
Future income taxes	**8,990**	8,998	7,797
	42,654	88,224	56,122
Shareholders' equity			
Capital stock (Note 4)	**154,067**	153,729	153,330
Contributed Surplus	**434**	262	83
Deficit	**(77,915)**	(77,497)	(106,327)
	76,586	76,494	47,086
	$ 119,240	$ 164,718	$ 103,208

Consolidated statements of cash flows

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

	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2004	2003	**2004**	2003
Cash flows from operating activities				
Net earnings (loss)	**$ (91)**	$ 216	**$ (418)**	$ (25)
Items not afftecting cash and cash equivalents				
Amortization	**1,853**	1,951	**3,590**	3,600
Gain on foreign currency translation	**(445)**	(1,034)	**(724)**	(1,193)
Others	**(390)**	1,128	**163**	1,631
	927	2,261	**2,611**	4,013
Changes in non-cash operating working capital items	**1,132**	(9,660)	**31,178**	28,082
	2,059	(7,399)	**33,789**	32,095
Cash flows from financing activities				
Repayment of long-term debt	**(12,249)**	(255)	**(12,664)**	(13,955)
Change in revolving term bank loan balance	**–**	–	**(10,000)**	(4,000)
Issue of capital stock	**298**	111	**338**	267
Related party transaction adjustment	**–**	(419)	**–**	(419)
	(11,951)	(563)	**(22,326)**	(18,107)
Cash flows from investing activities				
Acquisition of capital assets	**(2,895)**	(4,100)	**(5,867)**	(6,573)
	(2,895)	(4,100)	**(5,867)**	(6,573)
Increase (decrease) in cash and cash equivalents	**(12,787)**	(12,062)	**5,596**	7,415
Cash and cash equivalents, beginning of period	**21,978**	22,353	**3,595**	2,876
Cash and cash equivalents, end of period	**$ 9,191**	$ 10,291	**$ 9,191**	$ 10,291
Supplementary disclosure of cash flow information				
Interest paid	**$ 271**	$ 188	**$** 688	$ 897
Income taxes paid	**$ 255**	$ 2,920	**$** 1,388	$ 9,801



Notes to interim consolidated financial statements

For the three-month and six-month periods ended June 30, 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

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 is discontinued prospectively and the financial instrument is carried at fair value on the consolidated balance sheet as of the date hedge accounting is 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 is 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. Long-term debt

On June 30, 2004, the Company amended its Credit Agreement bearing formal date of May 1, 2002. Through this Amendment Agreement, the Company and its lenders amended certain provisions of the Credit Agreement. First, the Company repaid $12.0 million of the Term B Credit Facility. The Term B Credit Facility was for an original amount of $25.0 million, of which 95% was payable at maturity in 2008. In addition, the Company increased its revolving credit facility to $57.5 million from $45.0 million. Strong free cash flow generated in 2003 and during the first six months of fiscal 2004 enabled the Company to repay approximately 50% of its Term B Credit Facility.

	As at June 30,		As at December 31,
	2004	2003	2003
Term loan of $25.0 million, secured, maturing in May 2008 [(1)]	**$ 12,500**	$ 24,750	$ 24,625
Obligations under capital leases maturing at various dates up to November 2007 [(2)]	**1,221**	1,124	1,767
Loans, secured, maturing at various dates up to June 2004 [(3)]	**–**	104	52
Revolving term bank loan of $57.5 million, secured [(4)]	**–**	–	10,000
	13,721	25,978	36,444
Current portion	**535**	851	955
	$ 13,186	$ 25,127	$ 35,489

(1) Bearing interest at floating rates based on U.S. Base Rate plus 0.50% to 2.00% or LIBOR rate plus 1.50% to 3.00%, at the option of the Company, of which $11,750 is repaid at maturity, secured by a moveable hypothec on all assets of the Company. (As at June 30, 2003 and December 31, 2003, bearing interest at floating rates based on U.S. Base Rate plus 2.00% to 3.50% or LIBOR rate plus 3.00% to 4.50%, at the option of the Company, of which 95% is repaid at maturity, secured by a moveable hypothec on all assets of the Company.)

(2) Bearing interest at rates ranging between 5.92% and 10.57%.

(3) Bearing interest at rates ranging between 8.88% and 9.07%, secured by computer equipment having a net book value of $0.2 million.

(4) Bearing interest at floating rates based on U.S. Base Rate plus 0.25% to 1.75% or LIBOR rate plus 1.25% to 2.75%, at the option of the Company, secured by a moveable hypothec on all assets of the Company. (As at June 30, 2003 and December 31, 2003, revolving term bank loan of $45.0 million, secured, bearing interest at floating rates based on U.S. Base Rate plus 1.50% to 3.00% or LIBOR rate plus 2.50% to 4.00%, at the option of the Company, secured by a moveable hypothec on all assets of the Company.)

4. Capital stock

Outstanding share data

As at June 30, 2004, there were 27,198,851 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 statutory rate of each subsidiary of the group which approximates the effective income tax rate of 30% for the six-month period ended June 30, 2004.

6. 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 June 30, 2004, a total of 6,073,045 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.

The following table summarizes total stock options outstanding as at June 30 under the Company's Stock Option plans:

	2004		2003	
(in Canadian dollars)	**Number of options**	**Weighted average exercise price**	Number of options	Weighted average exercise price
Options outstanding, January 1	**3,866,825**	**$ 8.66**	3,925,483	$ 7.76
Granted	**58,586**	**20.80**	142,100	20.70
Exercised	**(79,319)**	**5.78**	(94,186)	4.19
Forfeited	**(57,968)**	**18.81**	(23,987)	12.93
Options outstanding, June 30	**3,788,124**	**$ 8.76**	3,949,410	$ 8.28
Options exercisable, June 30	**2,834,681**	**$ 6.32**	2,699,439	$ 5.14

7. Earnings (loss) per share

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

	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2004	2003	**2004**	2003
Numerator for basic and diluted net earnings (loss) per common share:				
Net earnings (loss) attributable to common shareholders	**$ (91)**	$ 216	**$ (418)**	$ (25)
Denominator for basic net earnings (loss) per common share:				
Weighted average number of common shares outstanding	**27,154,463**	26,963,090	**27,138,895**	26,934,141
Earnings (loss) per share - Basic	**$ (0.00)**	$ 0.01	**$ (0.02)**	$ (0.00)
Denominator for diluted net income per common share [(1)]:				
Weighted average number of common shares outstanding	**–**	26,963,090	**–**	–
Plus impact of stock option	**–**	2,446,623	**–**	–
Diluted common shares	**–**	29,409,713	**–**	–
Earnings per share - Diluted	**–**	$ 0.01	**–**	–

(1) The dilutive effect of outstanding options under the treasury stock method for the three-month and six-month periods ended June 30, 2004 as well as the six-month period ended June 30 2003 is not presented, as it is anti-dilutive.

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 six-month period ended June 30, 2004, in respect of these awards was $172,000 ($83,000 in 2003).

The pro forma disclosures have been presented as if the recommended recognition provisions of Section 3870 for awards granted in 2002 had been adopted in 2004 and 2003.

	Three-month periods ended June 30,				Six-month periods ended June 30,			
	As reported		Pro forma [(1)]		As reported		Pro forma [(1)]	
	2004	2003	**2004**	2003	**2004**	2003	**2004**	2003
Net earnings (loss)	**(91)**	216	**(713)**	(475)	**(418)**	(25)	**(1,642)**	(1,366)
Earnings (loss) per share:								
Basic	**(0.00)**	0.01	**(0.03)**	(0.02)	**(0.02)**	(0.00)	**(0.06)**	(0.05)
Diluted [(2)]	**–**	0.01	**–**	–	**–**	–	**–**	–

(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.

(2) The dilutive effect of outstanding options under the treasury stock method for the three-month and six-month periods ended June 30, 2004 as well as the six-month period ended June 30 2003 is not presented, as it is anti-dilutive.

7. Earnings (loss) per share (continued)

The fair value of options granted during the six-month periods ending June 30, 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)

8. Seasonal nature of business

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

9. Contingency

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 the 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.

10. Related party transactions

Related party transaction adjustment

On May 29, 2003, the Company closed a secondary offering through a filing of a Base PREP Prospectus with Canadian securities regulatory authorities. The secondary offering qualified the distribution of 6,223,240 common shares (the "Offered Shares") of the Company owned by certain shareholders. The Company did not receive any proceeds from the sale of the Offered Shares. The expenses (other than the Underwriters' fees) of the offering paid by the Company in the amount of approximately $419,000 ($288,000 net of income taxes) were recorded as a related party transaction adjustment reflected as an increase in deficit.

11. 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:

	Three-month periods ended June 30,		**Six-month periods ended June 30,**	
	2004	2003	**2004**	2003
Net sales				
Canada	**$ 1,873**	$ 1,697	**$ 4,150**	$ 3,346
United States	**12,883**	12,344	**26,729**	25,282
International	**15,412**	12,539	**25,491**	20,603
	$ 30,168	$ 26,580	**$ 56,370**	$ 49,231