



MEGA Brands Inc.

Q2

Quarterly Report
Second quarter ended
June 30, 2006

Stock Exchange

Toronto Stock Exchange: MB

Shares Outstanding

(as at June 30, 2006)

32,208,784 Common Shares

Second Quarter Fiscal 2006 Trading History

TSX	(CA\$)
High:	\$24.95
Low:	\$20.71
Close:	\$22.82
Average volume:	149,662

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 2006	Q2 2005
Net sales	\$ 105.4	\$ 38.3
Earnings (loss) from operations	\$ 10.2	\$ (0.5)
Net earnings (loss)	\$ 4.1	\$ (0.5)
Earnings (loss) per share		
- Basic	\$ 0.13	\$ (0.02)
- Diluted	\$ 0.12	\$ (0.02)

Investor Relations

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

The following management's discussion and analysis of financial position and results of operations ("MD&A") for MEGA Brands Inc. (formerly Mega Bloks Inc.) (referred to hereunder as 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 June 30, 2006 and 2005, as well as with the audited consolidated financial statements and the MD&A for the year ended December 31, 2005. Our accounting policies have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") of the Canadian Institute of Chartered Accountants ("CICA"). This MD&A is current as of August 10, 2006.

All figures in this MD&A are expressed in U.S. dollars, (reporting and functional currency) unless otherwise indicated.

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: integration of MEGA Brands America Group's operations, international operations, difficulty in predicting consumer preferences and importance of new products, rate of growth or profitability, dependence on a few large customers, fluctuations in the price of plastic resins and currency rates, retail environment, financing and interest rate matters, litigation and its inherent uncertainty, product recall, risks relating to licensed products and seasonality of the toy and stationery industries. 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 this MD&A. When we state that we believe that the Corporation is well positioned for continued growth, that we anticipate sales growth in the upcoming year and that there is strong growth potential for ROSE ART® products in international markets, we have assumed that we will continue to succeed in integrating operations acquired in July 2005 with the Corporation's operations in a manner that gives rise to cost and revenue synergies, that we will succeed in implementing previously announced changes to our operations in a timely manner during 2006, that international markets that we service through our sales and marketing organization will have a strong interest both in ROSE ART products and in other products that we will offer, and that the retail markets into which we sell will continue to demonstrate strong demand for the Corporation's product lines. As described in the "Risks and Uncertainties" section 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

The Corporation operates under two geographical segments, North America and International. Sales and marketing are conducted through two product lines. Our toy product lines are comprised of MEGA BLOKS® and MAGNETIX® construction toys as well as games and puzzles. Our stationery and activity products lines include school supplies, writing instruments and other stationery products, craft and activity sets, art materials and boards.

Product innovation is the key success factor in the toy industry and the main driver of our sales growth. We annually renew about 40% of the previous year's sales with new product lines and extensions, enhancements and replacements of existing lines. We meet this competitive necessity through continuous investment in product development, including our world-class engineering, marketing and creative team, as well as state-of-the-art software tools.



Corporate overview (Continued)

Penetration of international markets is an important component of our long-term growth strategy. After validating the broad appeal of our products through distributor sales in many international markets, we invested in our own sales and logistical platform outside North America by establishing a subsidiary in Mexico in 1997, two subsidiaries in Europe, in 1998 and 2004, respectively, and a subsidiary in Australia in 2006.

Our international sales increased from \$27.9 million in 1999 to \$143.6 million in 2005. We believe there is strong growth potential for the ROSE ART brand in international markets through our existing sales and marketing organization. We also expect continued international growth in construction toys with the introduction of the MAGNETIX brand in new markets, the continued penetration of the MEGA BLOKS brand in key European markets and penetration of new markets in Europe, Asia and Australia.

Licensed products, which accounted for approximately 20% of sales in 2005, complement our internal product development initiatives. Our focus is on evergreen brands with enduring popularity and long-term sales potential. We will continue to selectively pursue licensing opportunities that have the potential to drive incremental sales growth and provide opportunities for product line expansion. In recent years, we have entered into licensing agreements with affiliates of The Walt Disney Corporation, Marvel Enterprises Inc., NASCAR and others. The proportion of our annual sales based on licensed properties remains below the average for the toy industry.

Our priority in 2006 is to successfully complete the integration of MEGA Brands America and its affiliates which were acquired in July 2005 ("MEGA Brands America Group"). This transaction, which closed in July 2005, strengthened our position in construction toys and significantly expanded our consumer reach through new product categories such as arts and crafts, stationery and games and puzzles. As part of our growth strategy, we will continue to pursue acquisitions that will strengthen our existing brands, expand our market position in North America and Europe, and contribute to our earnings.

Recent developments

On June 15, 2006, shareholders adopted a special resolution authorizing the Corporation to change its legal name to MEGA Brands Inc. The Corporation filed the amendment to its articles of incorporation under the *Canada Business Corporations Act* to change its name on June 22, 2006. 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 Sàrl (formerly Mega Bloks International Sàrl). The Corporation's popular brands such as MEGA BLOKS, ROSE ART, MAGNETIX and BOARD DUDES® will continue to remain associated with the products they are best known for.

Following the realignment of operations announced late in the first quarter of 2006, we significantly reduced activities or closed down distribution facilities in three of our U.S. plants and centralized North American distribution for products sourced in China in a new facility in Fife (Tacoma), Washington. Other announced actions to align operations, including the consolidation of the Canadian distribution centre in the Montreal manufacturing plant and the closure or partial shutdown of three U.S. plants, are proceeding on schedule and should be completed as planned. Costs related to the implementation of these and other operational changes amount to \$1.3 million as of June 30, 2006. A total of \$19.0 million has been accrued as part of the purchase price allocation in the 2005 audited consolidated financial statements.

The former shareholders of the MEGA Brands America Group are pursuing their lawsuit in the U.S. District Court for the Southern District of New York against the Corporation for the payment of the Contingent Purchase Price under the terms of the Share Purchase Agreement ("SPA") entered into between them and the Corporation on July 26, 2005. The Corporation accrued US\$51.0 million in its 2005 audited consolidated financial statements with respect to the Contingent Purchase Price pending final determination of amount owed. As at June 30, 2006, no disbursements have been made in regards to this additional consideration. The Corporation will continue to maintain the accrual until the lawsuit is resolved.



Recent developments (Continued)

The Corporation filed, on June 23, 2006, an answer and counter claim against the former shareholders in which the Corporation denied each and every material allegation relating to the lawsuit. The Corporation's counter claim alleges that the former shareholders failed to uphold certain terms of the SPA.

As announced at the end of the first quarter, the Corporation and the US Consumer Products Safety Commission ("CPSC") jointly launched a voluntary recall and replacement program of MAGNETIX building sets in the hands of families with children under the age of six. Consumers were advised to stop using the referenced sets and to return them to MEGA Brands America for a free replacement product suitable for young children under the age of six. Consumers were also advised to ensure that all small magnet parts were kept away from children who mouth objects, especially children under the age of three. Through this replacement program, we reaffirm our commitment to the ongoing education of parents and caregivers and will continue to urge them to keep all toys containing small parts out of the reach of young children. The Corporation, jointly with the CPSC, continues to monitor the performance of MAGNETIX building sets in the market to ensure that all safety standards are met. Approximately 11,650 calls have been processed to date under this program. Due to the seasonality of toy sales, it will be difficult to accurately predict the full impact on product sales until the first quarter of 2007. A total of five product liability lawsuits have been filed against the Corporation in relation to injuries allegedly caused by the ingestion of magnets from MAGNETIX. There can be no assurance that similar lawsuits will not be filed in the future.

There have been no material developments with regards to the previously announced product liability lawsuits that have been filed against the Corporation. These lawsuits are described more fully herein in the "Risks and Uncertainties" section. The Corporation is not able to assess with any certainty the outcome of these lawsuits or their impact, if any. As such, no amounts have been reserved in our interim financial statements.

In a decision dated July 10, 2006, in the matter of MEGA Brands Inc. vs. Lego Juris A/S, the Grand Board of Appeal of the Office for Harmonization of the Internal Market of the European Union ("OHIM") dismissed Lego's appeal from the July 30, 2004 decision of the OHIM Cancellation Division which had invalidated Lego's three-dimensional Community Trademark registration for a 2 x 4 stud brick design with respect to wares described as "construction toys". This latest decision, which is subject to further appeal, is consistent with the clear trend of the jurisprudence which favors public access to useful product configurations, like the basic Lego block, which are no longer protected by patents.

The Corporation is pleased to announce the appointment, effective August 11, 2006, of Daniel T. Motulsky to the board of directors of MEGA Brands Inc. Mr. Motulsky is a Partner and Managing Director of the global investment bank Lazard Frères & Co. Based in New York, he heads Lazard's global consumer products and retail practices. Mr. Motulsky will sit as an independent member of the board in place of Michel Coutu, who resigned from the board on August 9, 2006, because of time constraints after more than four years of service to the Corporation.



Selected financial information

The following table presents a summary of selected consolidated income statement data for the three-month and six-month periods ended June 30, 2006 and 2005:

(U.S. dollars thousands, except per share data) (Unaudited)	Three-month periods ended June 30,				Six-month periods ended June 30,			
	2006		2005		2006		2005	
	\$	% of Net sales	\$	% of Net sales	\$	% of Net sales	\$	% of Net sales
Net sales	105,410	100.0%	38,292	100.0%	186,955	100.0%	67,605	100.0%
Cost of sales	60,583	57.5%	22,536	58.9%	105,748	56.6%	39,735	58.8%
Gross profit	44,827	42.5%	15,756	41.1%	81,207	43.4%	27,870	41.2%
Marketing and advertising expenses	6,425	6.1%	3,795	9.9%	12,830	6.9%	6,898	10.2%
Research and development expenses	4,923	4.7%	1,911	5.0%	8,831	4.7%	3,588	5.3%
Other selling, distribution and administrative expenses	23,317	22.1%	10,535	27.5%	45,498	24.3%	19,303	28.6%
Earnings (loss) from operations	10,162	9.6%	(485)	(1.3%)	14,048	7.5%	(1,919)	(2.8%)
Interest expense								
Long-term debt	4,980	4.7%	187	0.5%	9,981	5.3%	485	0.7%
Other	56	0.1%	1	0.0%	(23)	(0.0%)	(45)	(0.1%)
	5,036	4.8%	188	0.5%	9,958	5.3%	440	0.7%
Earnings (loss) before income taxes	5,126	4.9%	(673)	(1.8%)	4,090	2.2%	(2,359)	(3.5%)
Income taxes								
Current	(3,149)	(3.0%)	507	1.3%	(7,199)	(3.9%)	(422)	(0.6%)
Future	4,225	4.0%	(640)	(1.7%)	6,661	3.6%	(219)	(0.3%)
	1,076	1.0%	(133)	(0.3%)	(538)	(0.3%)	(641)	(0.9%)
Net earnings (loss)	4,050	3.8%	(540)	(1.4%)	4,628	2.5%	(1,718)	(2.5%)
Earnings (loss) per share								
Basic	0.13		(0.02)		0.14		(0.06)	
Diluted ⁽¹⁾	0.12		(0.02)		0.14		(0.06)	
Weighted average number of outstanding shares								
Basic	32,181,129		27,333,612		32,151,538		27,320,659	
Diluted ⁽¹⁾	34,093,512		27,333,612		34,176,687		27,320,659	

(1) The dilutive effect of outstanding options under the treasury stock method for the three-month and six-month periods ended June 30, 2005 is nil as it was anti-dilutive.



The following table presents a summary of selected consolidated balance sheet data:

(U.S. \$ thousands)	June 30, 2006 (Unaudited)	December 31, 2005 (Audited)	June 30, 2005 (Unaudited)
	\$	\$	\$
Balance Sheet Data			
Working capital ⁽¹⁾	105,954	101,605	85,890
Capital assets	41,765	39,351	33,850
Total assets	723,672	720,495	153,037
Total debt	303,002	300,953	13,763

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

The following table presents Canadian dollar data for the three-month and six month periods ended June 30, 2006 and 2005:

(Canadian \$ thousands, except per share data)	Three-month periods ended June 30,		Six-month periods ended June 30,	
(Unaudited)	2006	2005	2006	2005
	\$	\$	\$	\$
Canadian Dollar Data⁽¹⁾				
Net sales	117,532	42,696	208,455	75,380
Earnings (loss) from operations	11,331	(541)	15,664	(2,140)
Net earnings (loss)	4,516	(602)	5,160	(1,916)
Earnings (loss) per share				
Basic	0.14	(0.02)	0.16	(0.07)
Diluted ⁽²⁾	0.13	(0.02)	0.16	(0.07)

(1) U.S. dollar financial data is converted into Canadian dollars at the June 30, 2006 period end exchange rate of CA\$1.1150 per US\$1.00, using the translation of convenience method.

(2) The dilutive effect of outstanding options under the treasury stock method for the three-month and six-month periods ended June 30, 2005 is nil as it was anti-dilutive.



Results of operations

Net sales

Net sales in the second quarter of 2006 increased 175.2% to \$105.4 million compared to \$38.3 million in 2005. The main factor contributing to this growth was the inclusion of the MEGA Brands America Group. Net sales for the second quarter reflect a shift in the shipments of certain products from June into July, resulting in lower sales than anticipated. This shift occurred mainly due to mid-stream quality control improvements and packaging changes for MAGNETIX building toys which resulted in lower shipment rates during the second quarter. Following the end of the second quarter, shipment rates accelerated in July in response to strong demand from retailers in North America and key European markets.

Net sales of toys increased 18.8% to \$45.5 million compared to \$38.3 million in the second quarter of 2005. Strong toy sales in Canada were offset by a decline in basic construction toy sales in the United States. Furthermore, sales in key European markets were also characterized by a shift of some shipments into the month of July.

Net sales of stationery and activity products reached \$59.9 million in the second quarter of 2006, reflecting a contribution from the beginning of back-to-school season in the United States. This compared to sales of \$35.9 million for the first quarter of 2006.

Net sales in North America increased 446.8% to \$80.7 million in the second quarter of 2006, compared to \$14.8 million for the corresponding period in 2005. International net sales were \$24.7 million, an increase of 4.9% compared to \$23.5 million in the second quarter of 2005. Reflecting the concentration of stationery and activity products sales in North America, International net sales accounted for 23.4% of consolidated sales compared to 61.5% in the corresponding 2005 period.

For the six-month period ended June 30, 2006, net sales increased 176.5% to \$187.0 million compared to \$67.6 million in the same period last year. Toy sales were up 34.8% to \$91.2 million compared to \$67.6 million for MEGA BLOKS construction toys in the first six months of 2005. Year-to-date shipments of MAGNETIX building sets are lower than in the same 2005 period; however, the brand remains strong with stable retail sales worldwide. Sales of stationery and activity products for the first six months of 2006 totaled \$95.8 million. North American sales reached \$142.1 million compared to \$30.3 million in the corresponding 2005 period, while International sales increased to \$44.9 million or 24.0% of total net sales, compared to \$37.3 million or 55.2% of total net sales in the first half of 2005.

Gross profit

Gross profit in the second quarter of 2006 was \$44.8 million, compared to \$15.8 million for the same period in 2005. Gross margin improved to 42.5% compared to 41.1% in the second quarter of 2005. The gross margin improvement was mainly due to changes in product mix featuring more boys 5+ products, as well as higher overall margins for our basic construction toys. As anticipated, stationery margins were lower than average margins generated by toy products. Plastic resin prices were in line with 2005 second quarter levels and did not negatively impact our gross margin.

For the six-month period ended June 30, 2006, gross profit was \$81.2 million compared to \$27.9 million for the same period in 2005. Gross margin was 43.4% compared to 41.2% in the first half of last year.



Results of operations (Continued)

Operating expenses

Marketing and advertising expenses were \$6.4 million compared to \$3.8 million in the second quarter of 2005. As a percentage of net sales, such expenses were 6.1% compared to 9.9% in the second quarter of 2005. This decrease reflects proportionately lower expenses for stationery product categories.

For the six-month period ended June 30, 2006, marketing and advertising expenses were \$12.8 million compared to \$6.9 million in the same 2005 period. As a percentage of net sales, such expenses were 6.9% compared to 10.2%. This decrease reflects proportionately lower expenses for stationery product categories.

Research and development expenses were \$4.9 million in the second quarter of 2006 and \$8.8 million in the first six months of 2006, compared to \$1.9 million and \$3.6 million in the respective 2005 periods. The increase is due to the addition of MEGA Brands America's research and development expenses.

Other selling, distribution and administrative expenses were \$23.3 million compared to \$10.5 million in the second quarter of 2005, mainly due to the addition of MEGA Brands America's expenses for the full quarter. These expenses represented 22.1% of net sales in the second quarter of 2006 compared to 27.5% in the second quarter of 2005. This decrease reflects proportionately lower expenses for MEGA Brands America and the leveraging of the Corporation's cost structure.

For the six-month period ended June 30, 2006, other selling, distribution and administrative expenses were \$45.5 million compared to \$19.3 million in the corresponding period of 2005. These expenses represented 24.3% of net sales compared to 28.6% in the first six months of 2005.

Earnings from operations

As a result of the above, earnings from operations reached \$10.2 million compared to a loss from operations of \$0.5 million in the second quarter of 2005. Earnings from operations amounted to \$1.7 million for North America and \$8.5 million for International.

For the six-month period ended June 30, 2006, earnings from operations were \$14.0 million compared to a loss from operations of \$1.9 million in the corresponding period of 2005. Earnings from operations amounted to \$6.4 million for North America and \$7.7 million for International.

Non-operating expenses

Interest expense was \$5.0 million compared to \$0.2 million in the second quarter of 2005, reflecting mainly borrowings used to finance the acquisition of the MEGA Brands America Group.

For the six-month period ended June 30, 2006, interest expense was \$10.0 million compared to \$0.4 million in the same 2005 period.

Income taxes

Income taxes were \$1.1 million compared to a recovery of \$0.1 million in the second quarter of 2005. For the six-month period ended June 30, 2006, income tax recovery was \$0.5 million compared to \$0.6 million in the corresponding period of 2005. For the second quarter, the tax rate used to establish the income tax expense is the applicable estimated effective rate of each entity of the Corporation. As a result of the acquisition of the MEGA Brands America Group, the Corporation expects to benefit from cash flow savings of approximately \$130 million over a period of 15 years.



Results of operations (Continued)

Net earnings

Net earnings were \$4.1 million, or \$0.12 per diluted share, compared to a net loss of \$0.5 million or \$0.02 per diluted share in the second quarter of 2005.

For the six-month period ended June 30, 2006, net earnings were \$4.6 million, or \$0.14 per diluted share, compared to a net loss of \$1.7 million or \$0.06 per diluted share in the 2005 period.

Shares outstanding

The basic weighted average number of shares outstanding in the second quarter of 2006 was 32,181,129 compared to 27,333,612 in 2005. The diluted weighted average number of shares outstanding in the second quarter of 2006 was 34,093,512. As at August 10, 2006, there was a total of 3,123,782 stock options outstanding.

Seasonality and quarterly fluctuations

We have historically experienced significant quarterly fluctuations in operating results and anticipate these fluctuations in the future. 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 quarter 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 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.

Liquidity and capital resources

Historically, our primary sources of liquidity have been cash flows generated 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

For the three-month period ended June 30, 2006, cash flows used for operating activities amounted to \$19.5 million, compared to \$2.1 million in the same 2005 period. This increase is explained mainly by changes in non-cash working capital items resulting from the build-up of higher inventory levels in anticipation of plant closures scheduled during the year and the addition of the MEGA Brands America Group business.

Cash flows generated from operating activities for the first six months of 2006 were \$13.4 million compared to \$23.9 million for the same period in 2005. This decrease is also mainly explained by higher inventory levels.



Liquidity and capital resources (Continued)

Financing activities

Cash flows from financing activities in the three-month period ended June 30, 2006 were \$3.9 million, reflecting mainly a drawdown of \$6.0 million of the revolving credit facility and the repayment of long-term debt. Cash flows from financing activities in the first six months of 2006 were \$3.0 million. In the same period last year, the Corporation repaid a portion of its former revolving credit facility and cash flows used in financing activities totalled \$11.2 million.

Anticipated sales growth in 2006 will result in increased working capital requirements mainly to finance trade accounts receivable and inventories. We will continue to fund our operations and working capital requirements with cash generated from operations and, as necessary, borrowings from our revolving credit facility. One of the anticipated uses of our free cash flow in 2006 is to reduce our long-term debt. We expect the level of capital expenditure to be higher in 2006 but to remain proportionally in line with sales growth.

Investing activities

Cash flows used for investing activities were \$4.7 million during the three-month period ended June 30, 2006 compared to \$3.6 million for the corresponding period in 2005.

For the first six months of 2006, cash flows used for investing activities were \$25.9 million compared to \$6.3 million in 2005. This increase was mainly related to the acquisition of The Board Dudes, Inc. ("Board Dudes") which closed on February 1, 2006.

Balance sheets

Our financial position continues to be strong notwithstanding the acquisition of the MEGA Brands America Group, Board Dudes and the related increase in total borrowings compared to the first six months of 2005. At the end of the second quarter of 2006, total cash and cash equivalents stood at \$10.2 million compared to \$19.6 million at the end of 2005 and \$12.0 million at the end of the second quarter of 2005. As at June 30, 2006, \$94.0 million remained available under our revolving credit facility to support working capital requirements going forward.

Working capital stood at \$99.8 million at the end of the second quarter of 2006, compared to \$101.6 million as at December 31, 2005 and \$85.9 million at the end of the second quarter of 2005. The Corporation's trade accounts receivable, inventories, accounts payable and accrued liabilities as at June 30, 2006 were higher than at the end of the same period last year. This reflects the larger scale of the business following the acquisition of the MEGA Brands America Group, Board Dudes and an inventory build-up in basic products in anticipation of plant closures.

Based on the MEGA Brands America Group's financial performance in 2005, an amount of \$51.0 million was accrued for as additional consideration for the acquisition of the MEGA Brands America Group as at December 31, 2005. No disbursements have been made in regards to this additional consideration nor has the entitlement of the former shareholders been conclusively determined according to the formulas set out in the SPA.

Total long-term debt was \$303.0 million at the end of the second quarter of 2006 compared to \$301.0 million as at December 31, 2005 and \$13.8 million at the end of the second quarter of 2005. We are in compliance with all covenants required under our credit facility.



Significant accounting policies and use of estimates

Our consolidated financial statements are prepared in accordance with Canadian GAAP using the U.S. dollar (functional currency) as the reporting currency. In preparing the financial statements in conformity with Canadian GAAP, management is 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 Note 2 of our 2005 Annual Consolidated Financial Statements. Management believes that the following accounting policies and estimates are most significant for the purposes of understanding and evaluating our financial results.

Revenue Recognition

Revenue is recognized upon (i) persuasive evidence of an arrangement exists, (ii) shipment of products to customers and customer takes ownership and assumes risk of loss, (iii) collection of the respective receivable is probable and, (iv) sales price is fixed or determinable. Accruals for customer discounts, rebates and defective allowances are recorded as the related revenues are recognized.

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.

Intangible assets

Intangible assets with a finite service life are accounted for at cost. They consist of customer relationships and intellectual property which are amortized over twenty years.

Intangible assets with indefinite service life, consisting of trade name and intellectual property, are accounted for at cost and are not amortized. Trade name and intellectual property are tested for impairment annually or more frequently if changes in circumstances indicate a potential impairment. As at December 31, 2005, the Corporation has performed an impairment test and no write-down was necessary.

Goodwill

Goodwill represents the excess of the acquisition cost of companies over the fair value of the identifiable net assets acquired and is not amortized. Goodwill is tested for impairment annually or more frequently if changes in circumstances indicate a potential impairment. As at December 31, 2005, the Corporation has performed an impairment test and no write-down was necessary.



**Significant accounting policies
and use of estimates (Continued)****Derivative financial instruments**

We use a combination of financial instruments to manage risks related to fluctuations in exchange rates and interest rates.

Foreign exchange contracts:

The Corporation applied Accounting Guideline 13, "Hedging Relationships", in January 1, 2004. The Corporation uses various derivative financial instruments to manage interest rate risk and foreign exchange rate risk and formally documents all relationships between derivatives and the items it hedges, 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.

The following table summarizes our foreign currency commitments as at June 30, 2006:

Foreign currency contracts (U.S. \$ thousands) (Unaudited)	Notional amount \$	Average exchange rate	Maturing up to	Notional equivalent US \$	Fair market value US \$
Sell - \$US to \$CAN	3,000	1.2406	Dec. 2006	3,000	338
- Euro to \$US	17,750	1.2950	Dec. 2007	22,987	96
- GBP to \$US	7,750	1.8692	Dec. 2007	14,486	58

Interest rate swaps:

The Corporation enters into interest-rate swap agreements in order to achieve an appropriate mix of fixed and variable interest rate debt and convert certain long-term debt from variable to fixed interest rates. The interest rate swap agreements involve the periodic exchange of payments without the exchange of the notional principal amount upon which the payments are based, and are recorded as an adjustment of interest expense on the hedged debt instrument. The related amount payable to, or receivable from, counterparties is included as an adjustment to accrued interest.

The following table summarizes our interest rate swap agreements as at June 30, 2006:

Interest rate swaps (U.S. \$ thousands) (Unaudited)	Notional amount	Fixed rate US\$	Maturing	Fair market value US\$
Interest rate swaps	150,000	4.66325%	July 2012	7,106

Stock options and share units

The Corporation uses the fair value method to account for all stock-based compensation. 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.

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 a period of three to five 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 share units are accounted by using the fair value method; they are expensed and credited to accrued liabilities over the vesting period.



Recent accounting changes

The CICA has issued the following new Handbook Sections:

- a) Handbook Section 3831, "Non-Monetary Transactions", effective for transactions initiated in periods beginning on or after January 1, 2006. This section prescribes to record non-monetary transactions at fair value unless the transaction has no commercial substance, it is an exchange of inventory, 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 June 30, 2006 unaudited consolidated financial statements.
- b) 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 all interim and annual financial statements for fiscal years beginning on or after January 1, 2006. The adoption of this new Handbook Section did not have a material impact on the June 30, 2006 unaudited consolidated financial statements.

Future accounting changes

The CICA has issued the following new Handbook Sections:

- a) Handbook Section 3855, "Financial Instruments - Recognition and Measurement", effective for interim and fiscal periods beginning on or after October 1, 2006. The section describes the standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. All financial assets, except for those classified as held-to-maturity, and derivative financial instruments must be measured at their fair value. All financial liabilities must be measured at their fair value if they are classified as held for trading purposes, if not, they are measured at their carrying value. The Corporation is currently evaluating the impact of the adoption of this new section on the consolidated financial statements.
- b) Handbook Section 1530, "Comprehensive Income", and Section 3251, "Equity", effective for interim and fiscal periods beginning on or after October 1, 2006. Comprehensive income is the change in equity of an enterprise during a period arising from transactions and other events and circumstances from non-owner sources. It includes items that would normally not be included in net income such as changes in the foreign currency translation adjustment relating to self-sustaining foreign operations and unrealized gains or losses on available for sale financial instruments. This section describes how to report and disclose comprehensive income and its components. Section 3251, "Equity", replaces Section 3250 "Surplus", and describes the changes in how to report and disclose equity and changes in equity as a result of the new requirements of Section 1530, "Comprehensive Income". Upon adoption of this section, the consolidated financial statements will include a statement of comprehensive income. The Corporation is currently evaluating the impact of the adoption of this new section on the consolidated financial statements.
- c) Handbook Section 3865, "Hedges", effective for interim periods beginning on or after October 1, 2006. This section describes when hedge accounting is appropriate. Hedge accounting ensures that all gains, losses, revenues and expenses from the derivative and the item it hedges are recorded in the statement of earnings in the same period. The Corporation is currently evaluating the impact of the adoption of this new section on the consolidated financial statements.

Risks and uncertainties

Integration of the operations of the MEGA Brands America Group

We may not realize the expected benefits of the MEGA Brands America Group acquisition, including anticipated sales growth or the estimated revenue and cost synergies. The expected cost synergies resulting from the recent acquisition of the MEGA Brands America Group assume that our integration plan will be successfully achieved and may be affected by, among other things: (i) the level of operational differences between our existing operations and those of the MEGA Brands America Group; (ii) whether the integration expenses incurred are higher than anticipated; and (iii) whether the integration process takes longer than planned as a result of the departure of Lawrence and Jeffrey Rosen (former shareholders of MEGA Brands America Group) or otherwise. In addition, the overall integration of the companies may result in unanticipated operational issues, expenses and liabilities, and a diversion of management's attention, which could have a material adverse effect on our financial condition, business operations, business prospects and results of operations.



Risks and uncertainties (Continued)

International operations

Our own sales, manufacturing and distribution facilities, as well as the utilization of third-party distribution, independent sales representatives and contract manufacturers, are subject to the risks normally associated with international operations, including: (i) costs associated with the repatriation of earnings; (ii) civil unrest and political and economic instability; (iii) significantly concentrated outbreaks of communicable diseases; (iv) greater difficulty protecting intellectual property rights; (v) complications in complying with foreign laws and changes in governmental policies; (vi) increased delivery lead time and potential for transportation delays and interruptions; (vii) the imposition of tariffs or trade sanctions; and (viii) the loss of "most favored" trading status by the People's Republic of China in the United States or the European Union. There can be no assurance that these risks will not result in a material adverse effect on our financial condition and results of operations.

Consumer preferences

Our business and operating results depend largely upon the appeal of our toy and stationery products. Our continued success will depend on our ability to enhance and extend existing product lines and to develop, introduce and gain consumer acceptance of new products. However, consumer preferences in our industry are continuously changing and are difficult to predict. Individual products typically have short life cycles, and there have been recent trends towards children outgrowing toys at younger ages, particularly in favor of interactive and high technology products, and an increased use of high technology in toys. There can be no assurance that: (i) any of our current product lines will continue to be popular for any significant period of time; (ii) any new products we introduce will achieve an adequate degree of market acceptance; or (iii) any new products' life cycles will be sufficient to permit us to recover development, manufacturing, marketing and other costs. A decline in the popularity of our existing products or the failure of new products to achieve and sustain market acceptance and to produce acceptable margins could have a material adverse effect on our financial condition and results of operations. Additionally, negative publicity surrounding the Corporation's MAGNETIX toys in the U.S. and other key markets as a result of the events described in the Corporation's joint announcement with the CPSC on March 31, 2006, may result in sustained and damaging loss of consumer confidence in the brand.

Rate of growth or profitability

There can be no assurance that our rate of growth will continue or that we will be able to maintain our present level of net sales or profitability. Furthermore, future growth, if achieved, may place a strain on our management and financial control systems, and there can be no assurance that management would be able to manage such growth effectively. Failure to manage any future growth experienced by us could have a material adverse effect on our financial condition and results of operations.

Customer concentration

For the year ended December 31, 2005, our two largest customers accounted for approximately 36.5% of net sales. We do not have firm purchase commitments from any of our customers. If some of these customers were to cease doing business with us or to reduce the amount of their purchases, by virtue of experiencing financial difficulty or otherwise, it could have a material adverse effect on our sales, financial condition and results of operations. In addition, most large retail chains have begun to sell private-label toys, arts and crafts and office products designed and branded by the retailers themselves. Such private label items may be sold at prices lower than our comparable products, and may result in lower purchases of our products by such retailers. Additionally, in recent years, several large customers engaged in price cutting of toy products during the holiday season, and arts and crafts and stationery products during the back-to-school season, which, if these trends continue, could have a material adverse effect on our gross profit, profitability and consumer perception of the brand equity of our products.



Risks and uncertainties (Continued)

Resin prices

Our principal raw material is plastic resin, which is subject to the volatility in crude oil prices. We do not hedge against adverse price fluctuations. Furthermore, limited supplier production capacity and strong demand have placed upward pressure on the price of resin. There can be no assurance that this pressure will decline. While we have succeeded in passing on a portion of the increase in the price of plastic resin to our customers, there is no assurance we will be able to continue to do so, particularly if there are substantial price increases or that price increases occur over a sustained period. These developments could have a material adverse effect on our financial condition and results of operations.

Currency fluctuations

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, Euro, British pound and Mexican peso. Our policy is to stabilize earnings by limiting foreign currency exposure mainly through forward exchange contracts. Our risk management approach is to have hedging mechanisms in place for a maximum period of 24 months. Our hedging policy strictly prohibits unauthorized speculative foreign exchange transactions. We only enter into forward contract agreements with solid financial counterparties. Furthermore, in order to limit the risk of incurring losses in the event the counterparty does not fulfill its obligation, we only enter into forward exchange contract agreements with members of our lending syndicate. We do this because we are not required to provide additional security and/or guarantees to the members of the lending syndicate other than the security package already in place under our credit agreement.

Seasonality

Our business is seasonal and therefore our annual operating results depend in large part on our sales during the third and fourth quarters. 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. The logistics of supplying more products within shorter time periods increases the risk that we will fail to achieve compressed shipping schedules, which may reduce our sales and affect our financial performance.

Risks relating to licensed products

While we attempt to balance our licensed and non-licensed product offerings, and to make a judicious selection of brands and entertainment properties which we license from third-parties, there is a risk that guaranteed royalty payments and advances thereon which we are required to pay to licensors may not be recouped from the sale of licensed products. Additionally, the sale of licensed products relating to entertainment properties, particularly theatrical releases, often presents limited durations during which our customers will carry licensed product inventory, which consequently could reduce demand for such licensed products.

Retail environment

As a result of the rationalization of the mass-market retail channel, some large North American retailers have experienced liquidity problems. If our key customers were to delay payments or cease doing business as a result of these problems or bankruptcy, this could have a material adverse effect on our financial condition and results of operations.

Construction toy litigation

We are currently involved in litigation proceedings, which, regardless of the outcome, may result in substantial expenses and divert the attention of management. The most significant proceedings against us involve our principal competitor, The Lego Group ("Lego"). Lego continues to challenge the Corporation's sale of functionally and aesthetically compatible construction toys in various markets. There can be no assurance that we will achieve a favorable outcome in any of these markets. The unfavorable disposition of pending litigation could have a material adverse effect on our financial condition, operations and business prospects.



Risks and uncertainties (Continued)

Regulatory and other litigation

We are involved in a number of litigious matters, including but not limited to environmental and product liability and there can be no assurance that additional litigation will not arise in the future. As previously disclosed, Lawrence, Jeffrey and Sydney Rosen have filed a complaint against the Corporation seeking payment of certain amounts due under the SPA. The unfavorable disposition of pending or future litigation could have a material adverse effect on our financial condition, business operations and business prospects. Litigation may result in substantial costs and expenses and may significantly divert the attention of management regardless of the outcome. There can be no assurance that we will be able to achieve a favorable settlement of pending litigation or obtain a favorable disposition of litigation that is not settled. In addition, current and future litigation, governmental proceedings, labor disputes or environmental matters could lead to increased costs or interruption of our normal business.

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 March 31, 2006, we jointly announced with the CPSC a voluntary recall and replacement program of MAGNETIX building sets in the hands of families with children under the age of six. There can be no assurance that additional incidents 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. Compliance with voluntary safety standards is not a guarantee against recalls, regulatory action, defects or breach of applicable safety standards. 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, 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 as has unfortunately occurred in the case of MAGNETIX, and we may be subject to claims and lawsuits resulting from such injuries. There is a risk that these claims or liabilities could exceed or fall outside the scope of our insurance coverage, or impede our ability to obtain adequate insurance coverage in the future.

On March 15, 2006, the family of a deceased toddler filed a product liability lawsuit against MEGA Brands America, Inc. in King County Superior Court, Washington. The lawsuit alleges defects in design and insufficiency in warnings that caused the death of a toddler who ingested several magnetic pieces from a MAGNETIX building set. Four other product liability lawsuits have been filed against the Corporation making substantially the same allegations as the first lawsuit with the exception that the injuries were less severe. They ranged from intestinal blockage requiring surgery to an ear infection. These lawsuits could have a material adverse effect on the Corporation's business, financial condition, business prospects and results of operations.

There can be no assurance that additional claims will not be brought in the future. Because the outcome of litigation is inherently difficult to predict, the Corporation is not able to assess with any certainty the outcome of these lawsuits or the impact, if any, of such lawsuits on the Corporation. It is possible that the outcome of these matters could entail significant expense for the Corporation and could have a material adverse effect on the Corporation's business, financial condition, business prospects and results of operations.

Financing and interest rates

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



Disclosure controls and procedures

We have complied with Multilateral Instrument 52-109 - Certification of Disclosure in Issuers' Annual and Interim Filings issued by the Canadian Securities Administrators and have filed form 52-109F2 - Certification of Interim Filings with the appropriate securities regulators in Canada. These certificates can be found on the SEDAR website.

Additional information

Additional information about MEGA Brands, including our Annual Information Form, 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,	
	2006 \$	2005 \$	2006 \$	2005 \$
Net sales	105,410	38,292	186,955	67,605
Cost of sales	60,583	22,536	105,748	39,735
Gross profit	44,827	15,756	81,207	27,870
Marketing and advertising expenses	6,425	3,795	12,830	6,898
Research and development expenses	4,923	1,911	8,831	3,588
Other selling, distribution and administrative expenses	23,317	10,535	45,498	19,303
Earnings (loss) from operations	10,162	(485)	14,048	(1,919)
Interest expense				
Long-term debt	4,980	187	9,981	485
Other	56	1	(23)	(45)
	5,036	188	9,958	440
Earnings (loss) before income taxes	5,126	(673)	4,090	(2,359)
Income taxes				
Current	(3,149)	507	(7,199)	(422)
Future	4,225	(640)	6,661	(219)
	1,076	(133)	(538)	(641)
Net earnings (loss)	4,050	(540)	4,628	(1,718)
Earnings (loss) per share (Note 8)				
Basic	0.13	(0.02)	0.14	(0.06)
Diluted ⁽¹⁾	0.12	(0.02)	0.14	(0.06)

(1) The dilutive effect of outstanding options under the treasury stock method for the three-month and six-month periods ended June 30, 2005 is nil as it was anti-dilutive.



Consolidated statements of deficit(in thousands of U.S. dollars)
(Unaudited)

	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2006	2005	2006	2005
	\$	\$	\$	\$
Balance, beginning of period	(12,134)	(53,498)	(12,712)	(52,320)
Net earnings (loss)	4,050	(540)	4,628	(1,718)
Balance, end of period	(8,084)	(54,038)	(8,084)	(54,038)



Consolidated balance sheets

(in thousands of U.S. dollars)

	June 30, 2006 (Unaudited) \$	December 31, 2005 (Audited) \$	June 30, 2005 (Unaudited) \$
Assets			
Current assets			
Cash and cash equivalents	10,156	19,567	11,962
Accounts receivable - trade	91,650	167,428	49,810
Accounts receivable - other	5,619	6,238	4,859
Inventories	136,159	82,280	41,947
Income taxes	16,329	-	3,857
Future income taxes	20,286	13,396	-
Prepaid expenses	8,361	8,324	3,922
	288,560	297,233	116,357
Capital assets			
Intangible assets	41,765	39,351	33,850
Goodwill	72,067	72,230	1,381
Deferred charges	317,042	306,973	-
	4,238	4,708	1,449
	723,672	720,495	153,037
Liabilities			
Current liabilities			
Accounts payable and accrued liabilities	117,298	108,025	29,710
Additional consideration accrued on business combination (Note 10)	55,712	74,075	-
Income taxes	-	4,744	-
Current portion of long-term debt	9,596	8,784	757
	182,606	195,628	30,467
Long-term debt	293,406	292,169	13,006
Future income taxes	21,929	12,682	8,075
	497,941	500,479	51,548
Shareholders' equity			
Capital stock (Note 4)	232,716	231,592	154,645
Contributed surplus	1,099	1,136	882
Deficit	(8,084)	(12,712)	(54,038)
	225,731	220,016	101,489
	723,672	720,495	153,037



Consolidated statements of cash flows(in thousands of U.S. dollars)
(Unaudited)

	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2006	2005	2006	2005
	\$	\$	\$	\$
Cash flows from operating activities				
Net earnings (loss)	4,050	(540)	4,628	(1,718)
Items not affecting cash and cash equivalents				
Amortization	3,481	2,332	6,808	4,173
Loss (gain) on foreign currency	(2,295)	1,319	(3,584)	1,543
Others	4,812	(579)	7,319	(22)
	10,048	2,532	15,171	3,976
Changes in non-cash operating working capital items	(29,518)	(4,599)	(1,735)	19,900
	(19,470)	(2,067)	13,436	23,876
Cash flows from financing activities				
Repayment of long-term debt	(2,339)	(268)	(3,953)	(386)
Change in revolving credit facility	6,000	–	6,000	(11,000)
Issue of capital stock	275	87	985	211
	3,936	(181)	3,032	(11,175)
Cash flows from investing activities				
Acquisition of capital assets	(4,733)	(2,237)	(8,433)	(4,965)
Acquisition of intangible assets	–	(1,381)	–	(1,381)
Proceeds from disposal of capital asset	54	–	54	–
Acquisition of subsidiary	–	–	(17,500)	–
	(4,679)	(3,618)	(25,879)	(6,346)
Increase (decrease) in cash and cash equivalents	(20,213)	(5,866)	(9,411)	6,355
Cash and cash equivalents, beginning of period	30,369	17,828	19,567	5,607
Cash and cash equivalents, end of period	10,156	11,962	10,156	11,962
Supplementary disclosure of cash flow information				
Interest paid	5,522	316	10,378	499
Income taxes paid	2,452	2,144	13,874	4,670
Capital assets acquired by means of capital leases	–	30	–	517



Notes to interim consolidated financial statements

For the three-month and six-month periods ended June 30, 2006 and 2005
(Column figures are expressed in thousands of U.S. dollars, except per share data)
(Unaudited)

1. Nature of business

On June 15, 2006, shareholders adopted a special resolution authorizing the Corporation to change its legal name to MEGA Brands Inc. (formerly Mega Bloks Inc.). The Corporation filed the amendment to its articles of incorporation under the *Canada Business Corporations Act* to change its name on June 22, 2006. 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 Sàrl (formerly Mega Bloks International Sàrl).

The Corporation designs, manufactures and markets a broad line of construction toys and magnetic toy sets, arts and crafts, stationery, school supplies, writing instruments and activity 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

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, 2005 except for the recent accounting changes described 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.

3. Recent accounting changes

The CICA has issued the following new Handbook Sections:

- a) Handbook Section 3831, "Non-Monetary Transactions", effective for transactions initiated in periods beginning on or after January 1, 2006. This section prescribes to record non-monetary transactions at fair value unless the transaction has no commercial substance, it is an exchange of inventory, 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 June 30, 2006 unaudited consolidated financial statements.
- b) 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 all interim and annual financial statements for fiscal years beginning on or after January 1, 2006. The adoption of this new Handbook Section did not have a material impact on the June 30, 2006 unaudited consolidated financial statements.

4. Capital stock

Outstanding share data

As at June 30, 2006, there were 32,208,784 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 additional income tax recovery recorded for the six-month period ended June 30, 2006 comes from 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 equalled 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 June 30, 2006, a total of 5,449,006 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 six-month period ending June 30, under the Corporation's stock option plans:

(in Canadian dollars)	2006		2005	
	Number of options	Weighted average exercise price \$	Number of options	Weighted average exercise price \$
Options outstanding, beginning of period	3,233,858	9.01	3,702,541	8.93
Granted	—	—	—	—
Exercised	(103,209)	11.11	(51,521)	5.09
Forfeited	(6,333)	22.77	(35,603)	20.07
Options outstanding, end of period	3,124,316	8.91	3,615,417	8.87
Options exercisable, end of period	3,045,854	8.60	3,370,641	8.01

During the period ended June 30, 2006, no options were granted.

The Company 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 and six-month periods ended June 30, 2006, \$0.1 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 over three to five years. This 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 for the six-month period ending June 30, under the Corporation's share unit plan:

	2006 Number of Units	2005 Number of Units
Units outstanding, beginning of the period	65,768	—
Granted	295,028	65,768
Settled	(637)	—
Cancelled	(5,175)	—
Units outstanding, end of the period	354,984	65,768

8. Earnings (loss) per share

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

	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2006	2005	2006	2005
Numerator for basic and diluted net earnings (loss) per common share:				
Net income (loss) attributable to common shareholders	\$ 4,050	\$ (540)	\$ 4,628	\$ (1,718)
Denominator for basic net earnings (loss) per common share:				
Weighted average number of common shares outstanding	32,181,129	27,333,612	32,151,538	27,320,659
Basic earnings (loss) per share	\$ 0.13	\$ (0.02)	\$ 0.14	\$ (0.06)
Denominator for diluted net earnings per common share:				
Weighted average number of common shares outstanding:	32,181,129	27,333,612	32,151,538	27,320,659
Plus impact of stock options ⁽¹⁾	1,912,383	—	2,025,149	—
Diluted average number of common shares ⁽¹⁾	34,093,512	27,333,612	34,176,687	27,320,659
Diluted earnings (loss) per share ⁽¹⁾	\$ 0.12	\$ (0.02)	\$ 0.14	\$ (0.06)

(1) The dilutive effect of outstanding options under the treasury stock method for the three-month and six-month periods ended June 30, 2005 is nil as it is anti-dilutive.



9. Derivative financial instruments

As at June 30, 2006, the Corporation's foreign currency commitments were all qualifying for hedge accounting. The fair market value of these financial instruments was a gain of \$0.5 million which is not recorded in the financial statements.

As at June 30, 2006, the Corporation's swap agreements were all qualifying for hedge accounting. The fair market value of these financial instruments was a gain of \$7.1 million which is not recorded in the financial statements.

10. Acquisition of subsidiaries

On July 26, 2005, the Corporation completed the acquisition of all voting shares of Rose Art Industries, Inc., Warren Industries, Inc. and their subsidiaries ("MEGA Brands America Group"), headquartered in Livingston, New Jersey. The MEGA Brands America Group manufactures and markets arts and crafts, magnetic building sets and features school supplies. The MEGA Brands America Group was a private corporation with a strong brand recognition in the United States.

The total purchase price consideration includes the assumption of \$37 million of outstanding MEGA Brands America Group debt for a net purchase price of \$319 million. This purchase price consists of \$292 million in cash at closing, \$20 million of MEGA Brands America common shares at a price of CA\$19.00 per share issued to the MEGA Brands America Group principals upon closing, and \$7 million of acquisition costs.

A contingent payment of up to \$50 million is payable in 2006 if MEGA Brands America Group's adjusted earnings before interest, taxes, depreciation and amortization ("EBITDA") for 2005 exceeds \$50 million, based on five times such incremental amount. The transaction also provides for additional earn-out payments of 50% of the amounts exceeding adjusted EBITDA thresholds of \$60 million, \$65 million and \$70 million in 2005, 2006 and 2007 respectively.

The former shareholders of the MEGA Brands America Group filed a lawsuit in the U.S. District Court for the Southern District of New York against the Corporation for the payment of the Contingent Purchase Price under the terms of the Share Purchase Agreement ("SPA") entered into between them and the Corporation on July 26, 2005. The Corporation accrued US\$51.0 million in its 2005 audited consolidated financial statements with respect to the Contingent Purchase Price pending final determination of any amount owed. As at June 30, 2006, no disbursements have been made in regards to this additional consideration. The Corporation will continue to maintain the reserve until the lawsuit is resolved. The Corporation filed on June 23, 2006, an answer and counter claim against the former shareholders, in which the Corporation denied each and every material allegation relating to the lawsuit. The Corporation's counter claim alleges that the former shareholders failed to uphold certain terms of the SPA.

The Corporation filed, on June 23, 2006, an answer and counter claim against the former shareholders in which the Corporation denied each and every material allegation relating to the lawsuit. The Corporation's counter claim alleges that the former shareholders failed to uphold certain terms of the SPA.

The transaction was fully financed by credit facilities totaling \$400 million, including a \$100 million revolving credit facility for working capital purposes.

The acquisition was accounted for using the purchase method. The Corporation has finalised the purchase price allocation to the assets acquired and the liabilities assumed based on management's best estimates of their fair value and taking into account all relevant information. During the second quarter of 2006, the purchase price allocation has been modified with adjustments primarily relating to non-cash working capital, future income taxes, and a corresponding entry to goodwill.



10. Acquisition of subsidiaries (Continued)

	2005
	\$
Assets acquired	
Non-cash working capital ⁽¹⁾	9,092
Capital assets	6,979
Future income tax assets	20,624
Intangibles	71,000
Goodwill ⁽²⁾	302,362
Long-term debt	(36,655)
Non-cash assets acquired	373,402
Cash and cash equivalents	7,933
Net assets acquired	381,335
Consideration	
Cash	292,503
Acquisition cost	7,329
Additional consideration accrued on business combination	61,503
Issuance of shares to the MEGA Brands America Group Principals	20,000
	381,335

(1) Includes integration liabilities of \$19.0 million for consolidation and closure of facilities and severance. As of June 30, 2006, \$1.3 million has been disbursed.

(2) Goodwill is deductible for tax purposes.

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. The Board Dudes designs and distributes an innovative range of products for the school, home and office supply markets. Primary product categories include dry erase boards, cork boards, foam boards, school and locker products, novelty items and storage products. The purchase price paid is \$17 million subject to certain adjustments and was financed through existing credit facilities. 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. The transaction closed on February 1, 2006.

The acquisition was accounted for using the purchase method. The purchase price has been allocated to the assets acquired and the liabilities assumed based on management's preliminary estimates of their fair value and taking into account all relevant information available at the time these statements were prepared. Consequently, changes are expected as the purchase price allocation will be finalized during 2006, mainly with respect to the intangible and goodwill allocations.



10. Acquisition of subsidiaries (Continued)

	2006
	\$
Assets acquired	
Non-cash working capital	2,625
Capital assets	152
Goodwill ⁽¹⁾	14,680
Non-cash assets acquired	17,457
Cash and cash equivalents	43
Net assets acquired	17,500
Consideration	
Cash	17,000
Acquisition cost	500
	17,500

(1) Goodwill is deductible for tax purposes.

11. Seasonal nature of business

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

12. Contingency

On March 15, 2006, the family of a deceased toddler filed a product liability lawsuit against MEGA Brands America in King County Superior Court, Washington. The lawsuit alleges defects in design and insufficiency in warnings that caused the death of a toddler who ingested several magnetic pieces from a MAGNETIX building set. The lawsuit claims compensatory and punitive damages and injunctive relief. Four other product liability lawsuits have been filed against the Corporation making substantially the same allegations as the first lawsuit with the exception that the injuries were less severe. They ranged from intestinal blockage requiring surgery to an ear infection. The Corporation is not able to assess with any certainty the outcome of these lawsuits or their impact, if any. As such, no amounts have been reserved as of June 30, 2006. It is possible, however, that the outcome of these matters could entail significant expense for the Corporation and could have a material adverse effect on the Corporation's business, financial condition, business prospects and results of operations.



13. Segmented information

The Corporation is in the process of establishing its business operating segments in light of the MEGA Brands America Group acquisition. The table below presents information by business segments as currently planned:

a) The following table sets out certain geographic market information based on client's location:

<i>Segmented information</i>	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2006	2005	2006	2005
	\$	\$	\$	\$
Net sales				
Toys	45,480	38,292	91,151	67,605
Stationery and Activities	59,930	—	95,804	—
	105,410	38,292	186,955	67,605

<i>Geographic information</i>	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2006	2005	2006	2005
	\$	\$	\$	\$
Net sales				
North America ⁽¹⁾	80,717	14,761	142,081	30,290
International	24,693	23,531	44,874	37,315
	105,410	38,292	186,955	67,605

⁽¹⁾ Includes net sales for Canada in 2006 for the three-month periods of \$5.4 million (\$2.5 million in 2005), and for the six-month periods of \$8.2 million (\$4.8 million in 2005).

	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2006	2005	2006	2005
	\$	\$	\$	\$
Earnings (loss) from operations				
North America	1,713	(1,855)	6,390	(1,675)
International	8,449	1,370	7,658	(244)
	10,162	(485)	14,048	(1,919)

	As at June 30,	
	2006	2005
	\$	\$
Capital assets, intangible assets, and goodwill		
North America ⁽¹⁾	424,522	34,639
International	6,352	592
	430,874	35,231

⁽¹⁾ Includes capital assets for Canada in 2006 for the six-month periods of \$31.6 million (\$33.2 million in 2005).

