



MEGA Brands Inc.

**Q3**

Quarterly Report  
Third quarter ended  
September 30, 2006

## Financial Highlights

(U.S. \$ millions, except per share data) (Unaudited)	Three-month periods ended September 30,		Nine-month periods ended September 30,	
	2006	2005	2006	2005
	\$	\$	\$	\$
Net sales	<b>201.8</b>	154.2	<b>382.5</b>	218.6
Earnings from operations	<b>39.7</b>	32.6	<b>53.7</b>	30.6
Net earnings	<b>18.0</b>	20.4	<b>22.6</b>	18.7
Earnings per share				
Basic	<b>0.56</b>	0.67	<b>0.70</b>	0.66
Diluted	<b>0.53</b>	0.62	<b>0.66</b>	0.61
Product liability settlement expense				
Basic	<b>(0.26)</b>	—	<b>(0.26)</b>	—
Diluted	<b>(0.24)</b>	—	<b>(0.25)</b>	—
Earnings per share excluding product liability settlement expense <sup>(1)</sup>				
Basic	<b>0.82</b>	0.67	<b>0.96</b>	0.66
Diluted	<b>0.77</b>	0.62	<b>0.91</b>	0.61

<sup>(1)</sup> Earnings per share excluding product liability settlement expense is not calculated in accordance with Canadian Generally Accepted Accounting Principles. The Corporation believes this to be a relevant measure because it excludes an item that is not typical of ongoing operations and allows shareholders and other investors to compare the Corporation's performance for the three-month and nine-month periods ended September 30, 2006 with the similar 2005 periods.

## Stock Exchange

Toronto Stock Exchange: MB

## Third Quarter Fiscal 2006 Trading History

TSX	(CA\$)
High:	\$23.95
Low:	\$20.50
Close:	\$23.40
Average volume:	52,930

## Shares Outstanding

(as at September 30, 2006)  
32,257,936 Common Shares

## Transfer Agent

CIBC Mellon Trust Company  
1.800.387.0825

## Investor Relations

Alex Radmanovich  
(514) 333-3339 ext. 745  
Or by e-mail at [info\\_invest@megabrands.com](mailto:info_invest@megabrands.com)



[www.megabrands.com](http://www.megabrands.com)

## 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 September 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 November 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 and the recovery of the full product liability settlement amount, 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 Toys product lines are comprised of MEGA BLOKS® and MAGNETIX® construction toys as well as games and puzzles. Our Stationery and Activities product lines include school supplies, writing instruments, dry-erase and cork presentation boards and other stationery products, art materials and craft and activity sets.

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 a 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

A large number of the Corporation's toys have been selected for top toy lists and other consumer awards by numerous trade magazines, toy testers, teacher and parent organizations, consumer protection groups and various specialty publications in the United States and Canada. Among the featured toys are Tiny 'N Tuff® Off-Road Set, CAT® Construction Set, Buildable Noah's Ark™, MEGA Wagon™ and Magtastik® Deluxe Set in the preschool construction category; Pyrates™ Shark Escape and Pirates of the Caribbean The Black Pearl™ in boys 5+ construction and MAGNETIX® MagnaCase™. The Corporation is pleased with the high number of awards and mentions garnered in 2006.

The integration of MEGA Brands America Group is progressing according to plan and is expected to be substantially completed by the end of 2006. The Corporation expects to benefit from \$7-10 million of operational efficiencies commencing in 2007. As part of the purchase price allocation following the acquisition of MEGA Brands America Group, a total of \$19.0 million was accrued in the 2005 audited consolidated financial statements for integration costs. As at September 30, 2006, approximately \$2.3 million of such amount had been disbursed.

A trial date has not been set in regards to the litigation initiated against the Corporation in the U.S. District Court for the Southern District of New York by the former shareholders of the MEGA Brands America Group. The plaintiffs are seeking 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 has filed an answer and counter claim denying 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 accrued US\$51.0 million in its 2005 audited consolidated financial statements with respect to the Contingent Purchase Price pending final determination of the amount owed, if any. As at September 30, 2006, no disbursements have been made and the Corporation will continue to maintain the accrual until the lawsuit is resolved.



### Recent developments (Continued)

Following the end of the third quarter, the Corporation settled four lawsuits and ten claims related to injuries resulting from the ingestion of magnets. Terms of the settlement, which include no admission of liability, are confidential. The aggregate amount paid by the Corporation to settle the lawsuits and claims is US\$13.5 million. The Corporation has recorded this amount as a product liability settlement expense in its third quarter consolidated statement of earnings. The Corporation expects to recover substantially the full amount from its insurers and through other recourses, and will record such recoveries in the consolidated statements of earnings when the proceeds are received. One lawsuit related to magnet ingestion requiring surgical removal remains outstanding.

The Corporation has learned that Lego Juris A/S ("Lego") is appealing the July 10, 2006, dismissal by the Grand Board of Appeal of the Office for Harmonization of the Internal Market of the European Union ("OHIM") of its appeal from the July 30, 2004 decision of the OHIM Cancellation Division. This ruling invalidated Lego's three-dimensional Community Trademark registration for a 2 x 4 stud brick design with respect to wares described as "construction toys". The clear trend of jurisprudence in such matters favors public access to useful product configurations, like the basic Lego block, which are no longer protected by patents, and the Corporation does not expect Lego to succeed with its appeal.



**Selected financial information**

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

(U.S. \$ thousands, except per share data) (Unaudited)	Three-month periods ended September 30,				Nine-month periods ended September 30,			
	2006		2005		2006		2005	
	\$	% of Net sales	\$	% of Net sales	\$	% of Net sales	\$	% of Net sales
<b>Net sales</b>	<b>201,778</b>	<b>100.0%</b>	154,203	100.0%	<b>382,542</b>	<b>100.0%</b>	218,629	100.0%
Cost of sales	<b>111,231</b>	<b>55.1%</b>	86,919	56.4%	<b>215,550</b>	<b>56.3%</b>	126,109	57.7%
Gross profit	<b>90,547</b>	<b>44.9%</b>	67,284	43.6%	<b>166,992</b>	<b>43.7%</b>	92,520	42.3%
Marketing and advertising expenses	<b>8,178</b>	<b>4.1%</b>	7,242	4.7%	<b>16,246</b>	<b>4.2%</b>	11,506	5.3%
Research and development expenses	<b>5,262</b>	<b>2.6%</b>	2,156	1.4%	<b>14,093</b>	<b>3.7%</b>	5,744	2.6%
Other selling, distribution and administrative expenses	<b>37,407</b>	<b>18.5%</b>	25,319	16.4%	<b>82,905</b>	<b>21.7%</b>	44,623	20.4%
Earnings from operations	<b>39,700</b>	<b>19.7%</b>	32,567	21.1%	<b>53,748</b>	<b>14.1%</b>	30,647	14.0%
Interest and other expenses								
Product liability settlement	<b>13,500</b>	<b>6.7%</b>	—	0.0%	<b>13,500</b>	<b>3.5%</b>	—	0.0%
Interest on long-term debt	<b>6,126</b>	<b>3.0%</b>	3,698	2.4%	<b>16,107</b>	<b>4.2%</b>	4,183	1.9%
Other interest	<b>(171)</b>	<b>(0.1%)</b>	1,025	0.7%	<b>(194)</b>	<b>(0.1%)</b>	980	0.4%
	<b>19,455</b>	<b>9.6%</b>	4,723	3.1%	<b>29,413</b>	<b>7.7%</b>	5,163	2.4%
Earnings before income taxes	<b>20,245</b>	<b>10.0%</b>	27,844	18.1%	<b>24,335</b>	<b>6.4%</b>	25,484	11.7%
Income taxes								
Current	<b>11,108</b>	<b>5.5%</b>	5,535	3.6%	<b>3,909</b>	<b>1.0%</b>	5,113	2.3%
Future	<b>(8,822)</b>	<b>(4.4%)</b>	1,894	1.2%	<b>(2,161)</b>	<b>(0.6%)</b>	1,674	0.8%
	<b>2,286</b>	<b>1.1%</b>	7,429	4.8%	<b>1,748</b>	<b>0.5%</b>	6,787	3.1%
<b>Net earnings</b>	<b>17,959</b>	<b>8.9%</b>	20,415	13.2%	<b>22,587</b>	<b>5.9%</b>	18,697	8.6%
<b>Earnings per share</b>								
Basic	<b>0.56</b>		0.67		<b>0.70</b>		0.66	
Diluted	<b>0.53</b>		0.62		<b>0.66</b>		0.61	
Weighted average number of outstanding shares								
Basic	<b>32,224,335</b>		30,564,689		<b>32,176,070</b>		28,413,886	
Diluted	<b>34,111,334</b>		32,887,020		<b>34,155,169</b>		30,484,313	



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

(U.S. \$ thousands)	<b>September 30, 2006 (Unaudited)</b>	December 31, 2005 (Audited)	September 30, 2005 (Unaudited)
	\$	\$	\$
<b>Balance Sheet Data</b>			
Working capital <sup>(1)</sup>	<b>158,643</b>	101,605	125,487
Capital assets	<b>42,872</b>	39,351	41,475
Total assets	<b>842,349</b>	720,495	676,758
Total long-term debt	<b>334,358</b>	300,953	309,237

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

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

(Canadian \$ thousands, except per share data) (Unaudited)	<b>Three-month periods ended September 30,</b>		<b>Nine-month periods ended September 30,</b>	
	<b>2006</b>	2005	<b>2006</b>	2005
	\$	\$	\$	\$
<b>Canadian Dollar Data<sup>(1)</sup></b>				
Net sales	<b>225,043</b>	171,983	<b>426,649</b>	243,837
Earnings from operations	<b>44,277</b>	36,322	<b>59,945</b>	34,181
Net earnings	<b>20,030</b>	22,769	<b>25,191</b>	20,853
Earnings per share				
Basic	<b>0.62</b>	0.75	<b>0.78</b>	0.74
Diluted	<b>0.59</b>	0.69	<b>0.74</b>	0.68

(1) U.S. dollar financial data is converted into Canadian dollars at the September 30, 2006 period end exchange rate of CA\$1.1153 per US\$1.00, using the translation of convenience method.



## Results of operations

### Net sales

The Emerging Issues Committee of the Canadian Institute of Chartered Accountants ("CICA") issued EIC 156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Product)". 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 guideline did not have a material impact on the June 30, 2006 unaudited consolidated financial statements. For the third quarter of 2006, certain allowances given to customers in the normal course of business, for which the fair market value cannot be precisely determined, are recorded as a reduction of sales rather than in the cost of goods sold or as part of marketing and advertising expenses. For comparative purposes, the Corporation has reclassified such allowances in the consolidated statements of earnings for the three-month and nine-month periods ended September 30, 2005. The adoption of this guideline reduces net sales by the following amounts: Q3 2006 – \$9.8 million, Q3 2005 – \$9.3 million, year-to-date Q3 2006 – \$16.0 million, and year-to-date Q3 2005 – \$12.5 million.

Net sales in the third quarter of 2006 increased 30.9% to \$201.8 million compared to \$154.2 million in the corresponding period last year. The growth in net sales is explained mainly by strong demand from retailers in North America and key European markets for toys and stationery product lines. Also contributing to this growth is the inclusion of MEGA Brands America Group's net sales for the full quarter in 2006 compared to approximately two months in the corresponding quarter of 2005.

Net sales of toys reached \$126.5 million in the third quarter of 2006 compared to \$109.0 million in the third quarter of 2005, an increase of 16.1%. Basic construction toy sales were higher in North America than in the corresponding period last year. In addition, MAGNETIX sales enjoyed a strong increase, reflecting an additional month of sales compared to the third quarter of 2005. Finally, the fulfillment of the order backlog resulting from shipment delays caused by quality control improvements and packaging changes to MAGNETIX toys implemented in the second quarter of 2006 contributed to this growth.

Net sales of stationery and activity products increased 66.7% to \$75.3 million compared to \$45.2 million in the third quarter last year. This growth reflects the inclusion of MEGA Brands America Group for a full quarter compared to approximately two months in the same period last year and higher stationery sales, offset partly by lower sales of activity products.

Net sales in North America for the third quarter increased 44% to \$141.9 million compared to \$98.5 million in the corresponding 2005 period, mainly as a result of the inclusion of MEGA Brands America Group for the full quarter compared to approximately two months in the same period last year. International net sales were \$59.9 million, an increase of 7.6% compared to \$55.7 million in the third quarter of 2005. The growth in International net sales was below historical rates due to backlogs of certain items which in turn affected deliveries to customers. Mainly as a result of the concentration of stationery and activity products sales in North America, International net sales accounted for 29.7% of consolidated net sales in the third quarter of 2006 compared to 36.1% in the corresponding 2005 period.

For the nine-month period ended September 30, 2006, net sales increased 75% to \$382.5 million compared to \$218.6 million in the same period last year. Toy sales were up 21.4% to \$210.6 million compared to \$173.5 for the same period in 2005. Sales of stationery and activity products totaled \$172.0 million compared to \$45.2 million in the same nine-month period last year. North American sales reached \$280.9 million compared to \$127.4 million in the corresponding 2005 period. International sales increased to \$101.7 million or 26.6% of net sales, compared to \$91.3 million or 41.7% of net sales for the first nine months of 2005. For the nine-month period ended September 30, 2005, consolidated net sales only included approximately two months of sales generated by the MEGA Brands America Group.

### Gross profit

Gross profit in the third quarter of 2006 was \$90.5 million compared to \$67.3 million for the same 2005 period. Gross margin improved to 44.9% compared to 43.6% in the third quarter last year. The gross margin improvement was mainly due to product mix. Plastic resin prices were in line with 2005 third quarter levels and did not negatively impact gross margin.

For the nine-month period ended September 30, 2006, gross profit was \$167.0 million compared to \$92.5 million for the same period last year. Gross margin was 43.7% compared to 42.3% in the first nine months of 2005.



## Results of operations (Continued)

### Operating expenses

Marketing and advertising expenses increased to \$8.2 million compared to \$7.2 million in the third quarter of 2005. As a percentage of net sales, such expenses were 4.1% compared to 4.7% in the same period last year. This decrease reflects proportionately lower expenses for stationery product categories and a shift in such expenses to the fourth quarter of 2006.

For the nine-month period ended September 30, 2006, marketing and advertising expenses were \$16.2 million compared to \$11.5 million in the same 2005 period. As a percentage of net sales, such expenses were 4.2% compared to 5.3% in the first nine months of last year.

Research and development expenses were \$5.3 million in the third quarter and \$14.1 million in the first nine months of 2006, compared to \$2.2 million and \$5.7 million in the respective 2005 periods. The increase is mainly due to the addition of MEGA Brands America Group's research and development expenses.

Other selling, distribution and administrative expenses were \$37.4 million compared to \$25.3 million in the third quarter of 2005, mainly due to additional distribution expenses which were incurred in order to meet customer requirements, as well as the addition of MEGA Brands America Group's expenses for the full quarter compared to approximately two months in the same period last year. These expenses represented 18.5% of net sales in the third quarter of 2006 compared to 16.4% in the same 2005 period.

For the nine-month period ended September 30, 2006, other selling, distribution and administrative expenses were \$82.9 million compared to \$44.6 million in the corresponding 2005 period. These expenses represented 21.7% of net sales compared to 20.4% in the first nine months of 2005.

### Earnings from operations

As a result of the above, earnings from operations reached \$39.7 million compared to \$32.6 million in the third quarter last year. Earnings from operations were \$29.7 million for North America and \$10.0 million for International.

For the nine-month period ended September 30, 2006, earnings from operations were \$53.7 million compared to \$30.6 million in the corresponding 2005 period. Earnings from operations for the first nine months of 2006 were \$36.1 million for North America and \$17.6 million for International.

### Non-operating expenses

The Corporation recorded a product liability settlement expense of US\$13.5 million (\$8.4 million after taxes) in the third quarter. The Corporation expects to recover substantially the full settlement amount from its insurers and through other recourses, and will record such recoveries in the consolidated statements of earnings when the proceeds are received.

Interest expense in the third quarter was \$6.0 million compared to \$4.7 million in the same 2005 period, reflecting mainly borrowings used to finance the acquisition of the MEGA Brands America Group. The acquisition closed on July 26, 2005, which accounts for most of the difference between the two periods, with the balance explained by higher interest rates in the 2006 period. For the nine-month period ended September 30, 2006, interest expense was \$15.9 million compared to \$5.2 million in the same 2005 period. This increase is explained by the timing of the acquisition and higher interest rates in the 2006 period.

### Income taxes

Income taxes were \$2.3 million compared to \$7.4 million in the third quarter of 2005 and the effective tax rate was 11.3% compared to 26.7% in the 2005 period. For the nine-month period ended September 30, 2006, income taxes were \$1.7 million compared to \$6.8 million in the corresponding 2005 period and the effective tax rate was 7.2% compared to 26.6% in the 2005 period. The tax rate used to establish income tax expenses is the applicable estimated effective rate of each entity of the Corporation. The effective tax rate also takes into consideration the Corporation's structure for tax purposes as well as the financing structure put in place following the acquisition of the MEGA Brands America Group. As a result of this acquisition, the Corporation also expects to benefit from cash flow savings of approximately \$130 million over a period of 15 years.



## Results of operations (Continued)

### Net earnings

Reported net earnings were \$18.0 million, or \$0.53 per diluted share compared to \$20.4 million, or \$0.62 per diluted share in the third quarter of 2005. For the nine-month period ended September 30, 2006, reported net earnings were \$22.6 million, or \$0.66 per diluted share compared to \$18.7 million, or \$0.61 per diluted share in the same 2005 period.

The \$8.4 million after tax product liability settlement expense has an impact of \$0.24 and \$0.25 per diluted share, respectively for the third quarter and the nine-month period ended September 30, 2006.

Excluding the non-recurring product liability settlement expense, net earnings were \$0.77 and \$0.91 per diluted share, respectively for the third quarter and the nine-month period ended September 30, 2006.

### Shares outstanding

The basic weighted average number of shares outstanding in the third quarter of 2006 was 32,224,335 compared to 30,564,689 in the same 2005 period. The diluted weighted average number of shares outstanding in the third quarter of 2006 was 34,111,334 compared to 32,887,020 for the corresponding 2005 period. As at November 10, 2006, there was a total of 32,273,686 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 two 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 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

Cash flows used for operating activities in the third quarter of 2006 amounted to \$26.2 million compared to \$9.9 million in the same 2005 period. This increase is explained mainly by changes in non-cash operating working capital items resulting from the build-up of inventory levels in anticipation of plant closures scheduled during 2006 and the inclusion of the MEGA Brands America Group for the full quarter compared to approximately two months in the 2005 period.

For the nine-month period ended September 30, 2006, cash flows used for operating activities were \$12.8 million compared to cash flows of \$14.0 million generated in the same 2005 period. This decrease is also mainly explained by higher inventory levels built-up in anticipation of plant closures scheduled during 2006.



## Liquidity and capital resources (Continued)

### Financing activities

Cash flows from financing activities in the third quarter were \$31.9 million, reflecting mainly a drawdown of \$54.0 million of the Corporation's revolving credit facility and the repayment of \$22.6 million of long-term debt. As at the end of the third quarter, the Corporation had reduced the principal amount of its \$40-million Term A debt to \$20 million. For the same 2005 period, cash flows from financing activities were \$309.3 million, resulting mainly from borrowings and an issue of capital stock to finance the acquisition of MEGA Brands America Group.

For the nine-month period ended September 30, 2006, cash flows from financing activities were \$34.9 million, due mainly to \$60.0 million of drawdowns from the revolving credit facility, partly offset by long-term debt repayments of \$26.6 million. For the same period last year, cash flows from financing activities were \$298.1 million, resulting mainly from borrowings and an issue of capital stock to finance the acquisition of MEGA Brands America Group.

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.

### Investing activities

Cash flows used for investing activities in the third quarter were \$6.1 million, mainly for acquisitions of capital assets. For the corresponding 2005 period, cash flows used for investing activities amounted to \$292.8 million, reflecting mainly the acquisition of the MEGA Brands America Group.

For the nine-month period ended September 30, 2006, cash flows used for investing activities were \$32.0 million compared to \$299.2 million in the same period last year. The 2006 amount reflects the acquisition of The Board Dudes, Inc. which closed on February 1, 2006 and the 2005 figure is explained by the acquisition of the MEGA Brands America Group which closed on July 26, 2005.

We expect the level of capital expenditure to be higher in 2006 but to remain proportionally in line with sales growth.

### Balance sheets

Our financial position continues to be strong notwithstanding the acquisition of the MEGA Brands America Group and Board Dudes, and the related increase in total borrowings compared to the first nine months of 2005. At the end of the third quarter of 2006, total cash and cash equivalents stood at \$9.7 million compared to \$19.6 million at the end of 2005 and \$18.5 million at the end of the third quarter of 2005. As at September 30, 2006, \$60 million remained available under the Corporation's revolving credit facility to support working capital requirements going forward.

Working capital stood at \$158.6 million at the end of the third quarter of 2006, compared to \$101.6 million as at December 31, 2005 and \$125.5 million at the end of the third quarter of 2005. The Corporation's trade accounts receivable, inventories, accounts payable and accrued liabilities as at September 30, 2006 were higher than at the end of the same 2005 period. This reflects the larger scale of the business following the acquisition of the MEGA Brands America Group and Board Dudes, the timing of sales during the second and third quarters, as well as an inventory build-up in basic products in anticipation of plant closures planned during 2006.



### Balance sheets (Continued)

Based on the MEGA Brands America Group's financial performance in 2005, an amount of \$51.0 million was accrued as at December 31, 2005 as additional consideration for the acquisition of the MEGA Brands America Group. 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 Share Purchase Agreement.

Total long-term debt at the end of the third quarter of 2006 was \$334.4 million compared to \$301.0 million as at December 31, 2005 and \$309.2 million at the end of the third 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. No such circumstances have occurred in the nine-month period ended September 30, 2006. Annual impairment testing will be performed on December 31, 2006.



### 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 September 30, 2006:

Foreign currency contracts (U.S. \$ thousands) (Unaudited)	Notional amount \$	Average exchange rate	Maturing up to	Notional equivalent US \$	Fair market value US \$
<b>Sell - \$US to \$CAN</b>	<b>1,500</b>	<b>1.2406</b>	<b>Dec. 2006</b>	<b>1,500</b>	<b>167</b>
<b>- Euro to \$US</b>	<b>12,750</b>	<b>1.2961</b>	<b>Dec. 2007</b>	<b>16,525</b>	<b>239</b>
<b>- GBP to \$US</b>	<b>5,250</b>	<b>1.8731</b>	<b>Dec. 2007</b>	<b>9,834</b>	<b>(3)</b>

#### 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 September 30, 2006:

Interest rate swaps (U.S. \$ thousands) (Unaudited)	Notional amount	Fixed rate US\$	Maturing	Fair market value US\$
<b>Interest rate swaps</b>	<b>150,000</b>	<b>4.66325%</b>	<b>July 2012</b>	<b>2,854</b>

### 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 for 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 Section and guideline:

- 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 product or property, it is a non-monetary non-reciprocal transfer to owners or it is not reliably measurable. The adoption of this new Handbook Section did not have a material impact on the September 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 guideline reduces net sales as follows: Q3 2006 - \$9.8 million, Q3 2005 - \$9.3 million, year-to-date Q3 2006 - \$16.0 million, and year-to-date Q3 2005 - \$12.5 million.

### Future accounting changes

The CICA has issued the following new Handbook Sections:

- a) Handbook Section 3855, "Financial Instruments - Recognition and Measurement", applies to interim and annual financial statements relating to fiscal years 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", applies to interim and annual financial statements relating to fiscal years 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", applies to interim and annual financial statements relating to fiscal years 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 US Consumer Products Safety Commission ("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. Approximately 13,200 calls have been processed under this program, including 2,200 during the third quarter ended September 30, 2006. Since July 31, 2006, most retailers were no longer required by local regulatory authorities to post in-store safety notices relating to MAGNETIX toys and the Corporation believes the notices have been removed from virtually all retail stores in the U.S. 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. 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. There can be no assurance that additional incidents, lawsuits or claims will not arise, or that additional enquiries by the CPSC or other regulatory authorities in respect of MAGNETIX or other products will not be brought in the future, or result in additional product recalls. 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, fines or penalties diverted development resources and increased customer service and support costs, any of which could have a material adverse effect on our financial condition, business operations and/or business prospects. Individuals may sustain injuries from our products as has unfortunately occurred in the case of MAGNETIX, and we may be subject to claims and lawsuits resulting from such injuries. Although the Corporation believes it has adequate product liability insurance, there is a risk that such 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.

### 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. 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](http://www.sedar.com).



## Consolidated statements of earnings

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

	Three-month periods ended September 30,		Nine-month periods ended September 30,	
	2006 \$	2005 \$	2006 \$	2005 \$
<b>Net sales</b>	<b>201,778</b>	154,203	<b>382,542</b>	218,629
Cost of sales	<b>111,231</b>	86,919	<b>215,550</b>	126,109
Gross profit	<b>90,547</b>	67,284	<b>166,992</b>	92,520
Marketing and advertising expenses	<b>8,178</b>	7,242	<b>16,246</b>	11,506
Research and development expenses	<b>5,262</b>	2,156	<b>14,093</b>	5,744
Other selling, distribution and administrative expenses	<b>37,407</b>	25,319	<b>82,905</b>	44,623
Earnings from operations	<b>39,700</b>	32,567	<b>53,748</b>	30,647
Interest and other expenses				
Product liability settlement (Note 12)	<b>13,500</b>	—	<b>13,500</b>	—
Interest on long-term debt	<b>6,126</b>	3,698	<b>16,107</b>	4,183
Other interest	<b>(171)</b>	1,025	<b>(194)</b>	980
	<b>19,455</b>	4,723	<b>29,413</b>	5,163
Earnings before income taxes	<b>20,245</b>	27,844	<b>24,335</b>	25,484
Income taxes				
Current	<b>11,108</b>	5,535	<b>3,909</b>	5,113
Future	<b>(8,822)</b>	1,894	<b>(2,161)</b>	1,674
	<b>2,286</b>	7,429	<b>1,748</b>	6,787
<b>Net earnings</b>	<b>17,959</b>	20,415	<b>22,587</b>	18,697
<b>Earnings per share (Note 8)</b>				
Basic	<b>0.56</b>	0.67	<b>0.70</b>	0.66
Diluted	<b>0.53</b>	0.62	<b>0.66</b>	0.61



## Consolidated statements of retained earnings (deficit)

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

	Three-month periods ended September 30,		Nine-month periods ended September 30,	
	2006	2005	2006	2005
	\$	\$	\$	\$
<b>Balance, beginning of period</b>	<b>(8,084)</b>	(54,038)	<b>(12,712)</b>	(52,320)
Net earnings	<b>17,959</b>	20,415	<b>22,587</b>	18,697
<b>Balance, end of period</b>	<b>9,875</b>	(33,623)	<b>9,875</b>	(33,623)



## Consolidated balance sheets

(in thousands of U.S. dollars)

	September 30, 2006 (Unaudited) \$	December 31, 2005 (Audited) \$	September 30, 2005 (Unaudited) \$
<b>Assets</b>			
Current assets			
Cash and cash equivalents	9,696	19,567	18,511
Accounts receivable - trade	202,192	167,428	161,907
Accounts receivable - other	7,220	6,238	5,454
Inventories	137,742	82,280	102,572
Income taxes	8,753	-	-
Future income taxes	29,799	13,396	-
Prepaid expenses	9,148	8,324	5,680
	<b>404,550</b>	297,233	294,124
Capital assets			
Intangible assets	42,872	39,351	41,475
Goodwill	71,986	72,230	71,391
Deferred charges	318,962	306,973	264,796
	3,979	4,708	4,972
	<b>842,349</b>	720,495	676,758
<b>Liabilities</b>			
Current liabilities			
Accounts payable and accrued liabilities	180,656	108,025	153,703
Additional consideration accrued on business combination (Note 10)	55,712	74,075	-
Income taxes	-	4,744	7,743
Current portion of long-term debt	9,539	8,784	7,191
	<b>245,907</b>	195,628	168,637
Long-term debt	324,819	292,169	302,046
Future income taxes	27,354	12,682	9,154
	<b>598,080</b>	500,479	479,837
<b>Shareholders' equity</b>			
Capital stock (Note 4)	233,294	231,592	229,536
Contributed surplus	1,100	1,136	1,008
Retained earnings (Deficit)	9,875	(12,712)	(33,623)
	<b>244,269</b>	220,016	196,921
	<b>842,349</b>	720,495	676,758



## Consolidated statements of cash flows

(in thousands of U.S. dollars)

(Unaudited)

	Three-month periods ended September 30,		Nine-month periods ended September 30,	
	2006	2005	2006	2005
	\$	\$	\$	\$
<b>Cash flows from operating activities</b>				
Net earnings	17,959	20,415	22,587	18,697
Items not affecting cash and cash equivalents				
Amortization	3,450	3,567	10,258	7,740
Loss (gain) on foreign currency	(404)	664	(3,988)	2,207
Future income taxes	(8,822)	1,894	(2,161)	1,674
Others	778	212	1,436	1,050
	12,961	26,752	28,132	31,368
Changes in non-cash operating working capital items	(39,186)	(36,623)	(40,921)	(17,363)
	(26,225)	(9,871)	(12,789)	14,005
<b>Cash flows from financing activities</b>				
Proceeds from long-term debt	–	300,000	–	300,000
Repayment of long-term debt	(22,641)	(12,377)	(26,594)	(12,763)
Repayment of subsidiary indebtedness upon acquisition	–	(36,382)	–	(36,382)
Change in revolving credit facility	54,000	7,500	60,000	(3,500)
Issue of capital stock	537	54,891	1,522	55,102
Addition of deferred charges	–	(4,375)	–	(4,375)
	31,896	309,257	34,928	298,082
<b>Cash flows from investing activities</b>				
Acquisition of capital assets	(4,211)	(2,638)	(12,644)	(7,603)
Acquisition of intangible assets	–	(10)	–	(1,391)
Proceeds from disposal of capital asset	–	–	54	–
Acquisition of subsidiary (Note 10)	(1,920)	(290,189)	(19,420)	(290,189)
	(6,131)	(292,837)	(32,010)	(299,183)
Increase (decrease) in cash and cash equivalents	(460)	6,549	(9,871)	12,904
Cash and cash equivalents, beginning of period	10,156	11,962	19,567	5,607
<b>Cash and cash equivalents, end of period</b>	<b>9,696</b>	<b>18,511</b>	<b>9,696</b>	<b>18,511</b>
Supplementary disclosure of cash flow information				
Interest paid	5,542	2,740	15,920	3,239
Income taxes paid (recovered)	2,633	(4,182)	16,507	488
Capital assets acquired by means of capital leases	–	–	–	517



## Notes to interim consolidated financial statements

For the three-month and nine-month periods ended September 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 Section and guideline:

- 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 product or property, it is a non-monetary non-reciprocal transfer to owners or it is not reliably measurable. The adoption of this new Handbook Section did not have a material impact on the September 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 guideline reduces net sales by the following amounts: Q3 2006 – \$9.8 million, Q3 2005 – \$9.3 million, year-to-date Q3 2006 – \$16.0 million, and year-to-date Q3 2005 – \$12.5 million.

### 4. Capital stock

#### *Outstanding share data*

As at September 30, 2006, there were 32,257,936 common shares issued and outstanding.



## 5. Income taxes

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

## 6. Stock-based compensation plans

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

Under the Initial Stock Option Plan, the subscription price of each option 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 September 30, 2006, a total of 5,399,854 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 nine-month periods ending September 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	(152,361)	11.41	(103,807)	6.95
Forfeited	(6,467)	22.63	(41,037)	19.38
Options outstanding, end of period	3,075,030	8.86	3,557,697	8.86
Options exercisable, end of period	3,013,902	8.61	3,313,255	7.99

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

The Corporation uses the fair value method to account for all stock-based compensations. This method requires awards of stock options to be measured on their date of grant using the fair value method. They are expensed and credited to contributed surplus over their vesting period. This credit is reclassified to capital stock when stock options are exercised. For the three-month and nine-month periods ended September 30, 2006, \$0.1 million and \$0.2 million respectively 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 nine-month periods ending September 30, under the Corporation's share unit plan:

	<b>2006</b>	2005
	<b>Number of Units</b>	Number of Units
Units outstanding, beginning of the period	<b>65,768</b>	—
Granted	<b>295,028</b>	65,768
Exercised	<b>(637)</b>	—
Forfeited	<b>(5,175)</b>	—
Units outstanding, end of the period	<b>354,984</b>	65,768

## 8. Earnings per share

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

	<b>Three-month periods ended September 30,</b>		<b>Nine-month periods ended September 30,</b>	
	<b>2006</b>	2005	<b>2006</b>	2005
Numerator for basic and diluted net earnings per common share:				
Net income attributable to common shareholders	<b>\$ 17,959</b>	\$ 20,415	<b>\$ 22,587</b>	\$ 18,697
Denominator for basic net earnings per common share:				
Weighted average number of common shares outstanding	<b>32,224,335</b>	30,564,689	<b>32,176,070</b>	28,413,886
Basic earnings per share	<b>\$ 0.56</b>	\$ 0.67	<b>\$ 0.70</b>	\$ 0.66
Denominator for diluted net earnings per common share:				
Weighted average number of common shares outstanding	<b>32,224,335</b>	30,564,689	<b>32,176,070</b>	28,413,886
Plus impact of stock options	<b>1,886,999</b>	2,322,331	<b>1,979,099</b>	2,070,427
Diluted average number of common shares	<b>34,111,334</b>	32,887,020	<b>34,155,169</b>	30,484,313
Diluted earnings per share	<b>\$ 0.53</b>	\$ 0.62	<b>\$ 0.66</b>	\$ 0.61



## 9. Derivative financial instruments

As at September 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 \$0.4 million which is not recorded in the financial statements.

As at September 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 \$2.9 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 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 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)**

	<b>2005</b>
	<b>\$</b>
Assets acquired	
Non-cash working capital <sup>(1)</sup>	9,092
Capital assets	6,979
Future income tax assets	20,624
Intangibles	71,000
Goodwill <sup>(2)</sup>	302,362
Long-term debt	(36,655)
Non-cash assets acquired	373,402
Cash and cash equivalents	7,933
<b>Net assets acquired</b>	<b>381,335</b>
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
	<b>381,335</b>

(1) Includes integration liabilities of \$19.0 million for consolidation and closure of facilities and severance. As of September 30, 2006, \$2.3 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. During the third quarter of 2006, as part of these adjustments, an amount of \$1.9 million was paid to the Board Dudes principals. 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 <sup>(1)</sup>	16,600
Non-cash assets acquired	19,377
Cash and cash equivalents	43
Net assets acquired	19,420
Consideration	
Cash	18,920
Acquisition cost	500
	19,420

(1) Goodwill is deductible for tax purposes.

**11. Seasonal nature of business**

Historically, the first two quarters of the year are characterized by a lower level of activity and weaker results than the last two quarters.

**12. Contingencies and product liability settlement**

Following the end of the third quarter, the Corporation settled four lawsuits and ten claims related to injuries resulting from the ingestion of magnets. Terms of the settlement, which include no admission of liability, are confidential. The aggregate amount paid by the Corporation to settle the lawsuits and claims is \$13.5 million (\$8.4 million after taxes). The Corporation has recorded this amount as a product liability settlement expense in its third quarter 2006 consolidated statement of earnings. The Corporation expects to recover substantially the full settlement amount from its insurers and through other recourses, and will record such recoveries in the consolidated statements of earnings when the proceeds are received. One lawsuit related to magnet ingestion requiring surgical removal remains outstanding. The Corporation is not able to assess with any certainty the outcome of this lawsuit or its impact, if any. As such, no amount has been reserved as of September 30, 2006.

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 \$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 September 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.



### 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 September 30,		Nine-month periods ended September 30,	
	2006	2005	2006	2005
	\$	\$	\$	\$
Net sales				
Toys	126,522	109,042	210,554	173,468
Stationery and Activities	75,256	45,161	171,988	45,161
	<b>201,778</b>	154,203	<b>382,542</b>	218,629

<i>Geographic information</i>	Three-month periods ended September 30,		Nine-month periods ended September 30,	
	2006	2005	2006	2005
	\$	\$	\$	\$
Net sales				
North America <sup>(1)</sup>	141,862	98,519	280,879	127,354
International	59,916	55,684	101,663	91,275
	<b>201,778</b>	154,203	<b>382,542</b>	218,629

<sup>(1)</sup> Includes net sales for Canada in 2006 for the three-month periods of \$11.6 million (\$9.6 million in 2005), and for the nine-month periods of \$19.0 million (\$14.3 million in 2005).

	Three-month periods ended September 30,		Nine-month periods ended September 30,	
	2006	2005	2006	2005
	\$	\$	\$	\$
Earnings from operations				
North America	29,740	16,955	36,130	15,280
International	9,960	15,612	17,618	15,367
	<b>39,700</b>	32,567	<b>53,748</b>	30,647

	As at September 30,	
	2006	2005
	\$	\$
Capital assets, intangible assets, and goodwill		
North America <sup>(1)</sup>	426,448	373,518
International	7,372	4,144
	<b>433,820</b>	377,662

<sup>(1)</sup> Includes capital assets for Canada in 2006 for the nine-month periods of \$31.5 million (\$32.7 million in 2005).



## 14. Comparative figures

Certain comparative figures have been reclassified to conform with the current year presentation.

