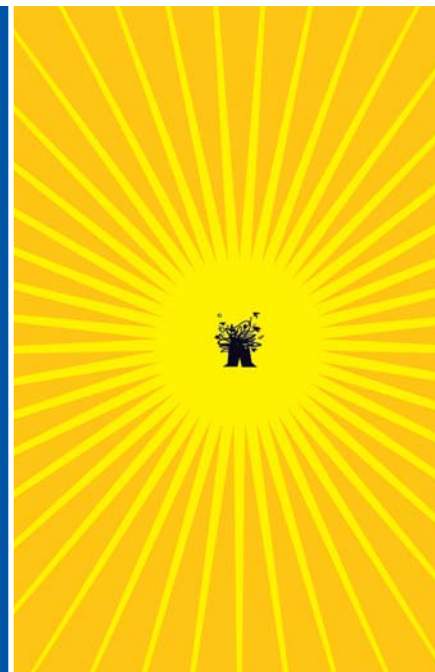


# MEGA Brands Inc.

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

For the fourth quarter and year ended December 31, 2007



### Financial Highlights

	Twelve-month periods ended December 31,		Three-month periods ended December 31,	
	2007 (Audited) \$	2006 (Audited) \$	2007 (Unaudited) \$	2006 (Unaudited) \$
(in million US dollars, except per share data)				
Net sales	524.5	547.3	128.8	164.8
Earnings (loss) from operations	(66.7)	39.7	(34.9)	(1.0)
Net earnings (loss)	(97.1)	25.3	(66.2)	2.8
Earnings (loss) per share				
Basic	(2.82)	0.79	(1.81)	0.09
Diluted <sup>(1)</sup>	(2.82)	0.74	(1.81)	0.08

<sup>(1)</sup> The dilutive effect of outstanding options under the treasury stock method for the twelve-month periods and three-month periods ended December 31, 2007 is nil as it is anti-dilutive

### Stock Exchange

Toronto Stock Exchange: MB

### Shares Outstanding

(as at December 31, 2007)

36,592,851 Common Shares

### Trading History

TSX	(CA\$)	(CA\$)
	Q4 2007	2007
High:	\$18.05	\$27.20
Low:	\$4.21	\$4.21
Close:	\$6.20	\$6.20
Average volume:	402,358	264,958

### Transfer Agent

CIBC Mellon Trust Company

1.800.387.0825

### Investor Relations

Eric Phaneuf, VP Corporate Development

(514) 333-3339 ext. 2538

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

For the fourth quarter and year ended December 31, 2007

*This Management's Discussion and Analysis of Financial Position and Results of Operations ("MD&A"), which is current as of March 30, 2008, should be read in conjunction with the audited Consolidated Financial Statements and Notes thereto for the years ended December 31, 2007 and 2006. The financial information in this MD&A and in our financial statements has been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") of the Canadian Institute of Chartered Accountants ("CICA"). We also present certain non-GAAP financial information, which we believe is useful to investors for comparing our performance from period to period. Please refer to "Specified Items Affecting Operations" section of this MD&A.*

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

### Forward-Looking Statements

All statements in this MD&A that do not directly and exclusively relate to historical facts constitute "forward-looking statements". These statements represent the Corporation's intentions, plans, expectations and beliefs. In certain instances, these statements require us to make assumptions and there is significant risk that these assumptions may not be correct. Furthermore, these statements are subject to risks, uncertainties and other factors, many of which are beyond the Corporation's control. These factors include and are not restricted to: financing and interest rate matters, difficulty in predicting consumer preferences and development and acceptance of new products, risks related with product recalls, litigation and its inherent uncertainty, including the recovery of the full product liability settlement amount, realization of synergies, international operations, insurance coverage, growth or profitability, dependence on a few large customers, fluctuations in the price of plastic resins and other raw materials as well as currency rates, seasonality of toy and stationery industries, risks related to licensed products, retail environment, and construction toy litigation. 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 expect continued international growth for the MEGA BLOKS<sup>®</sup> brand through market share gains in the upcoming year and that there is strong growth potential for the ROSE ART<sup>®</sup> brand in international markets, that we expect to improve our financial performance through the implementation of our Value Enhancement Plan (the "VEP"), that we expect to generate an additional \$12 million of annualized savings, that we will generate meaningful cash proceeds from the sale of our Stationery and Activities business, that we expect to recover from insurers and through other recourses substantially the full amount paid to settle the 2006 lawsuits relating to injuries to children resulting from the ingestion of magnets and that we expect to recover the full amounts of all claims and expenses related to MAGNETIX<sup>®</sup> as well as other expenses, including but not limited to the escrow fund provided for under the Stock Purchase Agreement ("SPA"), we have assumed that we will succeed in implementing our VEP, including the optimization of our product portfolio, in improving our business processes and strengthening of operations and supplier base in China, that we will succeed in realizing the cost and revenue synergies from the integration of MEGA Brands America and The Board Dudes, including without limitation, the synergies resulting from the downsizing and closing of manufacturing plants in North America and the concentration of distribution in our new facilities, that we will maintain or increase the quality of products manufactured in new locations, that we will be successful in reducing inventory levels, that we will maintain service levels in our new distribution facilities, that we will be able to attract and retain key personnel in key positions, that international markets that we service through our sales and marketing organization will have a strong interest both in ROSE ART brand and in other products that we will offer, that the retail markets into which we sell will demonstrate strong demand for the Corporation's product lines, that our insurers will not successfully deny any material portion of the claims, and that any such portion which may be denied will be recoverable against former shareholders of MEGA Brands America, that the number and quantum of self-insured product liability claims will not be material and that we will successfully complete the sale of our Stationery and Activities business. 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

MEGA Brands designs, manufactures and markets high quality toys and stationery products. Headquartered in Montreal, the Corporation has over 4,000 employees with offices, manufacturing facilities or distribution centers in 14 countries. The Corporation's products are sold in over 100 countries.

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

- Toys product lines are comprised of MEGA BLOKS<sup>®</sup> construction toys in the preschool and boys 5-plus categories, MAGNETIX<sup>®</sup> building sets for children 6-plus and MEGA<sup>™</sup> games and puzzles for families. Beginning in 2008, the Corporation will introduce a new generation of magnet play products under the MAGNEXT brand to replace MAGNETIX.
- Stationery and Activities product lines are comprised of art materials (crayons, colored pencils, highlighters and markers) sold mainly under the ROSE ART<sup>®</sup> brand; writing instruments (pens, mechanical pencils and woodcase pencils) sold mainly under the ROSE ART, SRX<sup>®</sup> and USA GOLD<sup>®</sup> brands; dry-erase and cork presentation boards, organizers and accessories sold mainly under the BOARD DUDES<sup>®</sup> brand, and ROSE ART craft and activity sets.

## Industry Overview

The traditional toy industry, which excludes video games and computer hardware and software, represents annual sales at wholesale of approximately \$16 billion in North America and \$40 billion worldwide. The Corporation competes in categories with total estimated manufacturers' shipments of approximately \$4 billion in North America and \$6 billion in the rest of the world. North American growth has stagnated in recent years and recorded a decline in 2007 explained mainly by unfavorable publicity following numerous toy recalls during the year. Outside North America, demand for traditional toys is increasing.

The Corporation currently participates in stationery product categories which amount to approximately \$16 billion in estimated manufacturer shipments. Most of the Corporation's products are currently sold in the School Supply segment of the stationery market, which represents approximately 14% of manufacturers' shipments, and is served mainly by mass retailers and food and drug stores. The much larger Office Supply segment of the stationery market, which is served mainly by specialty retailers, offers an attractive growth opportunity.

## Strategy, Objectives and 2007 Developments

### Product Innovation

Product innovation is the key success factor in the toy industry and the main driver of sales growth. In 2007, we renewed approximately 34% of the previous year's toy sales with new product lines and extensions, enhancements and replacements of existing lines. We meet this competitive necessity by investing 3-4% of sales on new product design, engineering, prototyping and development.

### Strategic Licensing

Licensed products, which accounted for approximately 28% of sales in 2007 compared to approximately 19% in 2006, complement our internal product development initiatives. In recent years, we have entered into licensing agreements with affiliates of The Walt Disney Corporation, Marvel Enterprises Inc., MTV Networks and others. Our focus is on evergreen brands with enduring popularity that have the potential to expand our product lines and drive incremental sales growth.

### International Growth

Penetration of international markets is an important driver of our long-term growth. We have established a strong sales, marketing and logistics organization in Europe and Mexico, a marketing partnership with Bandai in Japan, as well as distributorships covering more than 60 global markets. Our international sales increased 15% in 2007 to \$171.8 million compared to \$149.6 million in 2006.



We expect continued international growth for the MEGA BLOKS brand through market share gains in Western Europe and Australia, penetration of new markets in Central and Eastern Europe, and sales growth in Latin America, Asia, the Middle East and Africa. We increased our share in virtually all of our international markets in 2007. We believe there is strong growth potential for the ROSE ART brand in international markets through our existing sales and marketing organization. In 2007, we introduced a portfolio of ROSE ART craft and activity sets, as well as stationery products, and adapted these products for introduction into key markets.

### Value Enhancement Plan

On November 9, 2007, the Corporation announced a Value Enhancement Plan (the "VEP") to drive improved financial performance. The VEP targets a broad range of activities, including the following:

- Optimization of its product portfolio by focusing R&D and marketing resources on consumer driven product development and a continued focus on innovation as a key driver of performance.
- Improvement of its business processes to achieve the highest levels of customer satisfaction while significantly improving inventory turns.
- Realization of more synergies and savings, in addition to the \$7-10 million on an annualized basis projected from the first phase of the integration of MEGA Brands America in 2006. This will be achieved by completing the integration of MEGA Brands America, the integration of The Board Dudes, Inc. (the "Board Dudes") and the strengthening of the Corporation's operations and supplier base in China. These measures are expected to generate an additional \$12 million of annualized savings.

Subsequently, the Corporation completed the integration of MEGA Brands America. The Corporation closed its manufacturing and warehousing facility in Woodridge, New Jersey in December 2007. The remaining U.S. based production of MEGA Brands America was transferred to the Corporation's facilities in Canada and China or outsourced to Asian vendors. In addition, the Corporation opened another distribution center in Fife, Washington. The distribution activities of the Woodridge plant and of the Board Dudes were consolidated in the Corporation's expanded facilities in Fife. In January 2008, the Board Dudes was merged into MEGA Brands America and ceased to be a subsidiary.

Following these measures, the Corporation's North American plants will continue to supply approximately 25% of consolidated net sales, its plant in China 25%, focusing on high-volume production, and its Asian third-party supplier base, mainly in China, will account for the remaining 50%.

On March 5, 2008, the Corporation announced its intention to explore the sale of its Stationery and Activities business. The sale of this business is being considered as a means of generating meaningful cash proceeds to reduce the Corporation's existing debt and allow the Corporation to place increased focus on its core toy business. The Corporation believes that this initiative will bring significant benefits:

- Focus the Corporation on its core toy business, leveraging its strengths and innovation culture.
- Dedicate resources and management's attention to creating value through the execution of the VEP.
- Provide the Corporation with a stronger and more flexible capital structure.

### Other Developments

As at March 30, 2008, the Corporation's litigation with Lawrence, Jeffrey and Sidney Rosen (the "Rosens"), former shareholders of MEGA Brands America in the U.S. District Court for the Southern District of New York ("Rosen Litigation") was still pending. The Rosens are seeking payment of the Contingent Purchase Price under the terms of the Stock Purchase Agreement ("SPA") entered into between them and the Corporation effective July 26, 2005. The Corporation is advancing defenses and counterclaims alleging that the Rosens breached certain terms of the SPA and violated fiduciary duties to the Corporation. The Corporation accrued as a reserve \$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 December 31, 2007, no disbursements had been made and the Corporation will continue to maintain the reserve until the lawsuit is resolved. No trial date has been set as at March 30, 2008. In 2006, Jeffrey and Lawrence Rosen filed proceedings before the American Arbitration Association against the Corporation



seeking damages for the Corporation's alleged breach of their respective employment agreements. These arbitration proceedings are scheduled for separate hearings in 2008.

On March 27, 2008, the Corporation executed a fifth amending agreement (the "Fifth Amendment") to its credit agreement dated July 26, 2005 (the "Credit Agreement") providing for certain changes to the terms and conditions of its senior secured credit facilities (the "Credit Facilities") maturing in 2012. The Corporation's objective in requesting this amendment to the Credit Agreement is to ensure an orderly process that will maximize the value of assets in exploring the sale of its Stationery and Activities business announced on March 5, 2008. The Fifth Amendment waives the funded debt to EBITDA ratio covenant and the fixed charge coverage ratio covenant as of December 31, 2007 and until September 30, 2008, inclusively. Furthermore, through this amendment, the lenders consent to the sale of the Stationery and Activities business and to the release of the liens on the assets sold provided that the net consideration received from this sale will be used to make prepayment offers to the current lenders and, subject to certain conditions in relation to the timing and proceeds of such sale, this amendment also reduces the maximum amount available under the revolving Credit Facilities by introducing certain limitations on aggregate borrowings thereunder and increases certain fees and the interest payable in respect of the Credit Facilities. Finally, the EBITDA definition has been amended and a new financial covenant is added whereby the Corporation will have to maintain a minimum cumulative EBITDA at the end of each of its second, third and fourth financial quarters of its 2008 financial year.

On March 17, 2008, the Corporation and the US Consumer Products Safety Commission (the "CPSC") jointly announced a voluntary global recall of the Corporation's MAGNAMAN Action Figures and MAGTASTIK and MAGNETIX JR. Pre-School Magnetic Toys. This action was taken in response to reported incidents of loose magnets and a minor injury involving the aspiration of a magnet from a MAGTASTIK set. The design of the product lines affected by these recalls predates the redesign of the MAGNETIX building system in 2006. MAGNAMAN and MAGNETIX JR. sets have been discontinued and are no longer in production. Sales of recalled products were approximately \$7.0 million in 2007 and costs related to these recalls are reflected in the Corporation's fourth quarter 2007 financial results.

On July 25, 2007, the Corporation announced that it had closed a public offering of 3,850,000 common shares from treasury at a price of CA\$20.35 per share, for aggregate gross proceeds of CA\$78.3 million. The net proceeds of the offering were used to reduce the Corporation's revolving credit facilities.

On July 5, 2007, the Corporation executed a fourth amending agreement (the "Fourth Amendment") to the Credit Agreement providing for certain changes to the terms and conditions of its Credit Facilities maturing in 2012. The Fourth Amendment eliminated the first lien leverage ratio (as defined in the Credit Agreement) and relaxed the maximum total funded debt to EBITDA ratio to 4.50:1 effective June 30, 2007 until September 2008, thereafter decreasing gradually over time to 3.25:1 by the end of 2010 until maturity. In addition, the Fourth Amendment increased the limit of total indebtedness provided for in the Credit Facilities and increased certain fees and the interest payable in respect of the Credit Facilities.

On April 19, 2007, the Corporation announced an expanded voluntary recall and replacement program for MAGNETIX products jointly with the CPSC. This expanded recall was taken in response to additional injuries to children reported to the CPSC following the initial recall announcement. The Corporation also extended its MAGNETIX recalls to other jurisdictions in 2007. As of March 30, 2008, a total of four product liability lawsuits are outstanding against the Corporation for magnet related injuries. Insurers have confirmed coverage in all but one of these lawsuits. The Corporation is also aware of at least twelve other incidents of which nine where children alleged to have required surgery following the ingestion of multiple magnets.

The Corporation does not believe that the aforementioned proceedings in aggregate will have a material adverse effect on its consolidated financial position or results of operations. However, 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. The Corporation has set up a reserve of \$3.5 million for the aforementioned claims and litigation.

During the course of 2007, the Corporation recovered \$3.6 million from its insurers in connection with the \$13.5 million settlement, in October 2006, of four lawsuits and ten claims related to magnet ingestion. The



Corporation expects to recover substantially the full remaining amount of the 2006 settlement from its insurers and through other recourses.

## Specified Items Affecting Operations

The Corporation recorded Specified Items Affecting Operations ("Specified Items") in 2007 and 2006. Depending on their nature the Specified Items were recorded against net sales, in cost of sales or as operating expenses. This classification was determined in accordance with GAAP.

The following table summarizes all Specified Items Affecting Operations for both 2007 and 2006.

(in thousands of US dollars, except per share data) (Unaudited)	Years ended December 31,		Three month periods ended December 31	
	2007	2006	2007	2006
	\$	\$	\$	\$
Voluntary product recalls and other charges	60,279	16,029	25,079	13,758
Litigation expenses and reserve for contingencies	8,945	4,769	4,332	3,678
Inventory provisions and sales below cost	36,896	-	1,505	-
Integration expenses	-	8,303	-	8,303
Product liability settlement	(3,600)	15,490	-	1,463
	<b>102,520</b>	<b>44,591</b>	<b>30,916</b>	<b>27,202</b>

### Specified Items 2007

#### *Voluntary product recalls and other charges*

- The Corporation recorded charges and incremental costs of \$60.3 million (\$25.1 million in the fourth quarter) primarily related to the Corporation's product recalls during 2007. Of this annual cost, \$26.7 million related to reversal of sales and credits associated with recalled products, \$18.0 million related to write-offs of finished goods, components and fixed assets, and \$15.6 million related to impairment of intangibles and incremental advertising, logistics and administrative costs.

#### *Litigation expenses and reserve for contingencies*

- The Corporation recorded litigation expenses of \$5.4 million (\$0.8 million in the fourth quarter), mainly for the Rosen litigation. This amount is recorded as a separate line item in operating expenses. In addition, the Corporation recorded a reserve of \$3.5 million (\$3.5 million in the fourth quarter) for various potential claims. This amount is recorded in other selling, distribution and administrative expenses and in Product liability settlement and related expenses.

#### *Inventory provisions and sales below cost*

- The Corporation recorded a charge of \$20.0 million during the third quarter of 2007. This charge was primarily set-up as a result of the transition of MAGNETIX to MAGNEXT and other slow moving products. The total amount is recorded in cost of sales.
- The Corporation sold approximately \$26.3 million of excess inventory which resulted in a negative gross profit of approximately \$14.8 million. After freight charges of \$0.6 million, this action impacted earnings from operations by approximately \$15.4 million (nil in the fourth quarter). Of this amount, \$14.8 million is recorded as a reduction of gross profit, while \$0.6 million is recorded in other selling, distribution and administrative expenses.
- The Corporation recorded a charge of \$1.5 million (\$1.5 million in the fourth quarter) for inventory writedowns as part of the integration of its Chinese factories. This amount is recorded in cost of sales.

#### *Product liability settlement*

- The Corporation recovered \$3.6 million (nil in the fourth quarter) from its insurers in connection with the \$13.5 million settlement in October 2006 of four lawsuits and ten claims related to magnet ingestion. The amount recovered, net of settlement expenses in 2007, is recorded as a separate line item in operating expenses.



## Other Charges 2007

The Corporation also incurred other charges (the "Other Charges") of \$10.5 million in 2007 (\$6.4 million in the fourth quarter) which are not classified as Specified Items.

- The Corporation recorded integration charges of \$4.9 million (\$4.9 in the fourth quarter) related to the completion of the integration of MEGA Brands America. Of this amount, \$2.6 million is mainly related to plant closure costs of its New Jersey facility and other miscellaneous charges. This amount is recorded in cost of sales. The remaining \$2.3 million is mainly related to the disposal of equipment and the cost of moving the inventory to its distribution facility in Washington. This amount is recorded in other selling, distribution and administrative expenses.
- The Corporation recorded a charge of \$3.0 million (\$1.5 million in the fourth quarter), related to the termination of licensing agreements as part of its SKU rationalization program. The total amount is recorded in cost of sales.
- The Corporation recorded charges of \$2.6 million (nil in the fourth quarter) related to the sub-lease of excess warehouse space in Montreal at unfavorable terms and the set-up of a second-lien credit facility. This amount is recorded in other selling, distribution and administrative expenses.

## Specified Items 2006

### *Voluntary product recall and other charges*

- The Corporation recorded credits and charges of \$6.6 million (\$5.9 million in the fourth quarter) as a reduction of net sales. The net impact of these charges on gross profit amounted to \$6.1 million for the year (\$5.5 million in the fourth quarter).
- The Corporation recorded writeoffs of MAGNETIX components of \$4.3 million (\$4.3 million in the fourth quarter) as a result of the redesign of such components. These amounts are recorded in cost of sales.
- The Corporation recorded product replacement expenses of \$5.6 million (\$4.0 million in the fourth quarter), consisting of freight costs to meet customer shipment dates due to manufacturing delays for redesigned MAGNETIX products, development costs for the redesign of MAGNETIX components, and product replacements for consumers under the voluntary recall and replacement program for MAGNETIX products jointly announced with the CPSC. The total amount is recorded as a separate line item in operating expenses.

### *Litigation expenses*

- The Corporation recorded litigation expenses of \$4.8 million (\$3.7 million in the fourth quarter), mainly for the Rosen Litigation. This amount is recorded as a separate line item in operating expenses.

### *Integration charges*

- The Corporation recorded a charge of \$4.7 million (\$4.7 million in the fourth quarter) mainly related to inventory writeoffs following plant closures as part of the integration of MEGA Brands America. This amount is recorded in cost of sales.
- The Corporation recorded integration expenses of \$3.6 million (\$3.6 million in the fourth quarter), mainly related to branding, plant asset writeoffs, plant closure costs and other miscellaneous integration charges. This amount is recorded in other selling, distribution and administrative expenses.

### *Product liability settlement and related expenses*

- The Corporation settled four lawsuits and ten claims related to magnet ingestion and recorded product liability settlement and related expenses of \$15.5 million, consisting of \$13.5 million for the product liability settlement recorded in the third quarter and \$2.0 million of related legal expenses (\$1.5 million in the fourth quarter). The total amount is recorded as a separate line item in operating expenses.

Management believes that under the terms of the acquisition of MEGA Brands America, all claims and expenses related to MAGNETIX, as well as certain other expenses, are recoverable against the sellers, including but not limited to the \$15.0 million escrow fund provided for in the SPA. The Corporation also expects to recover substantially the full amount of the \$13.5 million product liability settlement from its insurers and through other recourses. However, there can be no assurance that a favorable outcome will be achieved.



## Selected Financial Information

The following table presents a summary of selected consolidated income statement data for the years ended December 31, 2007, 2006 and 2005, as well as the three-month periods ended December 31, 2007 and 2006:

(in thousands of US dollars, except per share data)	Twelve-month periods ended December 31, (Audited)			Three-month periods ended December 31, (Unaudited)	
	2007	2006	2005	2007	2006
<b>Net sales</b>	<b>524,516</b>	547,347	384,863	<b>128,819</b>	164,805
Cost of sales	<b>403,358</b>	328,822	214,668	<b>100,128</b>	113,272
Gross profit	<b>121,158</b>	218,525	170,195	<b>28,691</b>	51,533
Marketing and advertising expenses	<b>26,226</b>	26,808	24,573	<b>10,661</b>	10,562
Research and development expenses	<b>21,950</b>	18,334	9,402	<b>4,886</b>	5,858
Other selling, distribution and administrative expenses	<b>131,960</b>	112,649	71,074	<b>41,058</b>	27,861
Loss (gain) on foreign currency translation	<b>(6,394)</b>	(4,846)	2,796	<b>(1,354)</b>	(858)
Voluntary product recall and replacement	<b>11,425</b>	5,612	-	<b>6,725</b>	3,995
Product liability settlement and related expenses	<b>(2,800)</b>	15,490	-	<b>800</b>	1,463
Litigation expenses	<b>5,445</b>	4,769	-	<b>832</b>	3,678
Earnings (loss) from operations	<b>(66,654)</b>	39,709	62,350	<b>(34,917)</b>	(1,026)
Interest and other expenses					
Interest on long-term debt	<b>25,395</b>	22,526	9,310	<b>6,119</b>	6,419
Amortization of deferred financing costs	<b>700</b>	739	-	<b>148</b>	252
Other interest	<b>417</b>	177	954	<b>450</b>	371
	<b>26,512</b>	23,442	10,264	<b>6,717</b>	7,042
Earnings (loss) before income taxes	<b>(93,166)</b>	16,267	52,086	<b>(41,634)</b>	(8,068)
Income taxes					
Current	<b>(34)</b>	(1,217)	5,473	<b>(1,510)</b>	(5,126)
Future	<b>4,004</b>	(7,864)	7,005	<b>26,036</b>	(5,703)
	<b>3,970</b>	(9,081)	12,478	<b>24,526</b>	(10,829)
<b>Net earnings (loss)</b>	<b>(97,136)</b>	25,348	39,608	<b>(66,160)</b>	2,761
<b>Earnings (loss) per share</b>					
Basic	<b>(2.82)</b>	0.79	1.35	<b>(1.81)</b>	0.09
Diluted	<b>(2.82)</b>	0.74	1.26	<b>(1.81)</b>	0.08
<b>Weighted average number of outstanding shares</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2007</b>	<b>2006</b>
Basic	<b>34,407,400</b>	32,220,495	29,281,145	<b>36,592,704</b>	32,352,319
Diluted	<b>34,407,400</b>	34,189,034	31,390,456	<b>36,592,704</b>	34,289,179



The following tables present a summary of selected consolidated balance sheet data as at December 31, 2007, 2006 and 2005 and Canadian dollar data for the years ended December 31, 2007, 2006 and 2005 as supplementary information for Canadian investors:

<b>As at December 31,</b>			
(in thousands of US dollars)	<b>2007</b>	2006	2005
	\$	\$	\$
<b>Balance Sheet Data</b>			
Working capital <sup>(1)</sup>	<b>58,761</b>	124,725	101,605
Property, plant and equipment	<b>42,620</b>	43,213	39,351
Total assets	<b>709,714</b>	800,442	720,495
Total debt	<b>260,744</b>	311,954	300,953

<b>Twelve-month periods ended December 31,</b>			
(in thousands of Canadian dollars, except per share data)	<b>2007</b>	2006	2005
(Unaudited)	\$	\$	\$
<b>Canadian Dollar Data<sup>(2)</sup></b>			
Net sales	<b>518,274</b>	540,834	380,283
Net earnings (loss)	<b>(95,980)</b>	25,046	39,137
Earnings (loss) per share			
Basic	<b>(2.79)</b>	0.78	1.33
Diluted	<b>(2.79)</b>	0.73	1.25

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

(2) US dollar financial data is converted into Canadian dollars as at December 31, 2007 period end exchange rate of CA\$0.9881 per US\$1.00, using the translation of convenience method.

## Contractual Obligations

The following table presents a summary of contractual obligations for the following years:

	Years						After 5 years	Total
	2008	2009	2010	2011	2012			
Long-term debt	9,000	4,200	4,600	2,600	243,750	-	<b>264,150</b>	
Capital leases	445	218	218	-	-	-	<b>881</b>	
Operating leases	14,665	13,453	12,128	6,680	1,264	367	<b>48,557</b>	
<b>Total contractual obligations</b>	<b>24,110</b>	<b>17,871</b>	<b>16,946</b>	<b>9,280</b>	<b>245,014</b>	<b>367</b>	<b>313,588</b>	



## Results of Operations

### Year ended December 31, 2007 compared to year ended December 31, 2006

#### Net Sales

Net sales in 2007 were \$524.5 million compared to \$547.3 million in 2006. This decline is mainly explained by the reversal of sales and credits associated with recalled products and lower shipments of MAGNETIX products.

Sales of Toys declined 7% to \$310.9 million compared to \$333.7 million in 2006, mainly reflecting the reversal of sales and credits associated with recalled products and lower shipments of MAGNETIX products, offset by a strong performance in preschool product lines and increased sales of games and puzzles. The impact of Specified Items on Toys sales in 2007 amounted to \$21.0 million.

Sales of Stationery and Activities products were stable at \$213.6 million compared to \$213.7 million in 2006. Improved sales of presentation boards, art supplies and activities products were offset by lower shipments of writing instruments.

North American sales were \$352.7 million compared to \$397.8 million in the corresponding 2006 period. This decrease is due mainly to lower Toys sales. International sales increased to \$171.8 million or 15% compared to \$149.6 million. International net sales accounted for 33% of consolidated net sales in 2007 compared to 27% in 2006. This reflects continued strong growth in construction toy sales in the preschool category as well as sales of Stationery and Activities products. The impact of Specified Items on North American and International sales in 2007 amounted to \$7.5 million and \$7.7 million, respectively.

#### Cost of Sales

Cost of sales increased to \$403.4 million compared to \$328.8 million in 2006. This increase mainly reflects Specified Items and Other Charges in 2007 from the voluntary product recall, inventory revaluation, integration charges and termination of licensing agreements, as well as higher input costs.

#### Gross Profit

Gross profit was \$121.2 million compared to \$218.5 million in 2006. Gross margin declined to 23.1% compared to 39.9% in 2006.

Gross profit was impacted by the following factors in 2007:

- \$65.8 million of additional Specified Items in 2007 compared to 2006 resulting mainly from voluntary product recall, inventory provisions, sales below cost and termination of licensing agreements.
- Lower gross profit generated by the MAGNETIX product line of \$21.0 million due to lower unit sales and prices.
- Lower manufacturing efficiencies resulting primarily from the inventory reduction plan initiated by the Corporation and the downsizing of the Woodridge, New Jersey facility which was fully closed in December 2007. The impact of lower manufacturing efficiencies on gross profit amounted to approximately \$6 million.
- \$5.7 million of Other Charges recorded during the year.

#### Operating Expenses

Marketing and advertising expenses were slightly lower at \$26.2 million compared to \$26.8 million in 2006.

Research and development expenses increased to \$22.0 million compared to \$18.3 million in 2006. This planned increase reflects strong investment in new product initiatives across all product categories, including MAGNEXT.

Other selling, distribution and administrative expenses increased to \$132.0 million compared to \$112.6 million in 2006. This increase is mainly explained by additional Specified Items of \$4.0 million and



\$4.9 million of Other Charges. Approximately \$7.0 million of additional charges resulted from higher distribution costs, reflecting the significant growth in International sales, as well as incremental distribution costs incurred while operating several distribution centers in parallel in anticipation of the closure of the facilities in New Jersey and in California.

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

Mainly as a result of Specified Items and Other Charges, the Corporation reported a loss from operations of \$66.7 million compared to earnings from operations of \$39.7 million in 2006. Other factors contributing to the loss from operations were lower gross profit due to product mix and higher operating expenses.

### **Non-Operating Expenses**

Interest and other expenses amounted to \$26.5 million compared to \$23.4 million in 2006, reflecting higher average long-term debt through the first three quarters of 2007 and, to a lesser extent, higher interest rates.

### **Income Taxes**

Income tax expense was \$4.0 million compared to an income tax recovery of \$9.1 million in 2006. For 2007, the Corporation recorded a valuation allowance of \$27.8 million on future income tax assets resulting from losses carried forward originating mainly from Specified Items. The tax rate used to establish the income tax expense is the applicable estimated effective rate of each entity of the Corporation. The effective tax rate reflects the Corporation's structure for tax purposes as well as the financing structure put in place following the acquisition of MEGA Brands America.

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

Net loss was \$97.1 million, or \$2.82 per diluted share compared to net earnings of \$25.3 million, or \$0.74 per diluted share in 2006.



## Impact of Specified Items

The following tables present the impact of Specified Items on the 2007 and 2006 statements of earnings. Management believes that an analysis of 2007, 2006 and fourth quarters 2007 and 2006 operating performance before Specified Items is appropriate because such items are not typical of ongoing operations.

Twelve-month period ended December 31, 2007			(in thousands US dollars)				Three-month period ended December 31, 2007		
Audited 2007	Unaudited Specified Items 2007	Unaudited Before Specified Items <sup>(1)</sup>		Unaudited 2007	Unaudited Specified Items 2007	Unaudited Before Specified Items <sup>(1)</sup>			
524,516	15,182	539,698	Net sales	128,819	26,667	155,486			
403,358	(65,809)	337,549	Cost of sales	100,128	10,978	111,106			
121,158	80,991	202,149	Gross profit	28,691	15,689	44,380			
23.1%		37.5%	Gross margin	22.3%		28.5%			
26,226	-	26,226	Marketing and advertising expenses	10,661	-	10,661			
21,950	-	21,950	Research and development expenses	4,886	-	4,886			
131,960	(7,460)	124,500	Other selling, distribution and administrative expenses	41,058	(6,871)	34,187			
(6,394)	-	(6,394)	Gain on foreign currency translation	(1,354)	-	(1,354)			
11,425	(11,425)	-	Voluntary product recall and replacement	6,725	(6,725)	-			
(2,800)	2,800	-	Product liability settlement and related expenses	800	(800)	-			
5,445	(5,445)	-	Litigation expenses	832	(832)	-			
<b>(66,654)</b>	<b>102,521</b>	<b>35,867</b>	<b>Earnings (loss) from operations before financial expenses and income taxes</b>	<b>(34,917)</b>	<b>30,917</b>	<b>(4,000)</b>			

Twelve-month period ended December 31, 2006			(in thousands US dollars)				Three-month period ended December 31, 2006		
Audited 2006	Unaudited Specified Items 2006	Unaudited Before Specified Items <sup>(1)</sup>		Unaudited 2006	Unaudited Specified Items 2006	Unaudited Before Specified Items <sup>(1)</sup>			
547,347	6,606	553,953	Net sales	164,805	5,865	170,670			
328,822	(8,541)	320,281	Cost of sales	113,272	(8,628)	104,644			
218,525	15,147	233,672	Gross profit	51,533	14,493	66,026			
39.9%		42.2%	Gross margin	31.3%		38.7%			
26,808	-	26,808	Marketing and advertising expenses	10,562	-	10,562			
18,334	-	18,334	Research and development expenses	5,858	-	5,858			
112,649	(3,573)	109,076	Other selling, distribution and administrative expenses	27,861	(3,573)	24,288			
(4,846)	-	(4,846)	Gain on foreign currency translation	(858)	-	(858)			
5,612	(5,612)	-	Voluntary product recall and replacement	3,995	(3,995)	-			
15,490	(15,490)	-	Product liability settlement and related expenses	1,463	(1,463)	-			
4,769	(4,769)	-	Litigation expenses	3,678	(3,678)	-			
<b>39,709</b>	<b>44,591</b>	<b>84,300</b>	<b>Earnings (loss) from operations before financial expenses and income taxes</b>	<b>(1,026)</b>	<b>27,202</b>	<b>26,176</b>			

<sup>(1)</sup> The terms "net sales before Specified Items", "cost of sales before Specified Items", "gross profit before Specified Items", "gross margin before Specified Items", "earnings (loss) from operations before Specified Items", and "earnings (loss) before financial expenses, income taxes and Specified Items" do not have any standardized meaning under GAAP and are therefore unlikely to be comparable to similar measures presented by other companies. We present them as a measure of operating performance of our ongoing business without the effects of Specified Items. We exclude such items because they affect the comparability of our financial results between periods and could potentially distort the analysis of trends in business performance.



## Year Ended December 31, 2006 Compared to Year Ended December 31, 2005

### Adoption of EIC-156

In 2006, the Corporation adopted a new guideline issued by the Emerging Issues Committee of the CICA called EIC-156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Product)". As a result, 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. Under the former accounting standard used by the Corporation, such allowances were included in sales, cost of sales goods sold and marketing and advertising expenses. For comparative purposes, the Corporation has reclassified such allowances for 2005. The adoption of EIC-156 reduced net sales by \$25.8 million in 2006 and \$22.2 million in 2005 and by \$9.8 million and \$9.7 million in the fourth quarters of 2006 and 2005, respectively.

### Net Sales

Net sales increased 42.2% in 2006 to \$547.3 million compared to \$384.9 million in 2005. Higher net sales reflect mainly the inclusion of MEGA Brands America for the full year in 2006 compared to approximately five months in 2005, as well as organic growth in construction toys. Recorded against net sales in 2006 are \$6.6 million of Specified Items.

Net sales of Toys product lines reached \$333.7 million in 2006 compared to \$291.6 million in 2005, an increase of 14.4%. The majority of this increase reflects the inclusion of magnetic construction toys and games and puzzles for the full year compared to approximately five months in 2005. Organic growth in construction toys also contributed to the higher net sales.

Net sales of Stationery and Activities product lines increased 129.0% to \$213.7 million compared to \$93.3 million in 2005. This growth reflects the inclusion of MEGA Brands America for the full year in 2006 compared to approximately five months in 2005, as well as the contribution from Board Dudes.

Net sales in North America increased 56.4% to \$397.8 million compared to \$254.3 million in 2005, mainly as a result of the inclusion of MEGA Brands America for the full year in 2006 compared to approximately five months in 2005. Net sales of construction toys were stable, with higher sales in the preschool category and MAGNETIX offset by a slight decline in boys 5-plus products.

International net sales were up 14.6% to \$149.6 million compared to \$130.5 million in 2005. The Corporation increased its market share in the construction toy category in virtually all international markets in 2006 and gained the leadership position in this category in the United Kingdom and Spain for the first time. International net sales accounted for 27.3% of consolidated net sales in 2006 compared to 33.9% in 2005.

### Cost of Sales

Cost of sales increased 53.1% to \$328.8 million in 2006 compared to \$214.7 million in 2005. The majority of this increase is due to the inclusion of MEGA Brands America for the full year in 2006 compared to approximately five months in 2005. Recorded in cost of sales 2006 are \$8.5 million of Specified Items.

### Gross Profit

Reflecting the growth in net sales, gross profit increased 28.4% to \$218.5 million in 2006 compared to \$170.2 million in 2005. Gross margin declined to 39.9% compared to 44.2% in 2005. The decline in gross margin in 2006 is explained mainly by additional freight costs incurred in order to meet customer deadlines for the delivery of redesigned MAGNETIX products and higher magnet costs due to the escalation in commodity prices, for a combined impact of approximately \$10.0 million. In addition, Specified Items impacting gross profit amounted to \$15.1 million. Plastic resin prices in 2006 were in line with 2005 and did not negatively impact gross margin.

### Operating Expenses

Marketing and advertising expenses increased to \$26.8 million in 2006 compared to \$24.6 million in 2005. This increase reflects the inclusion of MEGA Brands America for the full year in 2006 compared to



approximately five months in 2005. As a percentage of net sales, such expenses declined to 4.9% compared to 6.4% in 2005. This decrease reflects the proportionately lower marketing and advertising expenses for Stationery and Activities product lines.

Research and development expenses were \$18.3 million in 2006 compared to \$9.4 million in 2005. This increase reflects mainly the inclusion of MEGA Brands America for the full year in 2006 compared to approximately five months in 2005. As a percentage of sales, such expenses increased to 3.3% compared to 2.4% in 2005.

Other selling, distribution and administrative expenses were \$109.1 million in 2006 compared to \$71.1 million in 2005. This increase reflects mainly the inclusion of MEGA Brands America for the full year in 2006 compared to approximately five months in 2005. These expenses were 19.6% of net sales in 2006 compared to 18.5% in 2005.

### **Earnings from Operations**

As a result of the above, earnings from operations were \$39.7 million in 2006 compared to \$62.4 million in 2005. Earnings from operations resulted in a loss of \$11.0 million in North America compared to earnings of \$40.3 million in 2005. International earnings from operations rose to \$50.7 million compared to \$22.1 million in 2005.

### **Non-Operating Expenses**

Interest expense was \$23.4 million in 2006 compared to \$10.3 million in 2005, reflecting mainly borrowings used to finance the acquisition of the MEGA Brands America. The acquisition closed effective July 26, 2005, which accounts for most of the difference in interest expense between the two years, with the balance explained by higher interest rates in 2006.

The Corporation recorded an income tax recovery of \$9.1 million in 2006 compared to an income tax charge of \$12.5 million in 2005. Before Specified Items, the effective tax rate in 2006 was 12.6% compared to 24.0% in 2005, reflecting mainly the proportionately higher earnings from operations in lower tax jurisdictions in 2006 compared to 2005. The tax rate used to establish income tax expense is the applicable estimated effective rate of each entity of the Corporation. The effective tax rate also takes into consideration the financing structure put in place following the acquisition of MEGA Brands America. As a result of this acquisition, the Corporation also expects to benefit from cash flow savings of approximately \$100.0 million over a period of 15 years from the deductibility of goodwill for tax purposes in the United States.

### **Net Earnings**

Net earnings were \$25.3 million or \$0.74 diluted earnings per share in 2006 compared to \$39.6 million or \$1.26 diluted earnings per share in 2005. Basic earnings per share were \$0.79 in 2006 compared to \$1.35 in 2005.

### **Liquidity and Capital Resources**

Historically, our primary sources of liquidity have been cash flows from operations and short-term borrowings under a revolving credit facility. Cash flows from operations could be negatively impacted by product recalls, 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 2007 amounted to \$9.6 million due primarily to lower earnings from operations resulting from Specified Items incurred during the year. This compares with cash flows from operating activities of \$15.9 million in 2006. The impact of Specified Items was partially offset by better working capital management.



## Financing Activities

Cash flows from financing activities amounted to \$24.4 million in 2007, reflecting mainly the issuance of common shares from treasury of \$71.3 million, offset by the repayment of \$38.0 million of the Corporation's revolving credit facilities and the repayment of long-term debt of \$9.6 million. In 2006, cash flows from financing activities were \$14.3 million reflecting mainly a drawdown in the Corporation's revolving credit facilities of \$40.0 million, offset by a repayment of \$29.0 million in long-term debt.

## Investing Activities

Cash flows used in investing activities amounted to \$20.0 million, reflecting mainly the acquisition of property, plant and equipment of \$19.6 million. In 2006, cash flows used in investing activities were \$36.0 million reflecting business combinations of \$18.9 million and the acquisition of property, plant and equipment of \$17.5 million. The amount included in business combinations in 2006 reflects mainly the acquisition by the Corporation of the Board Dudes in January 2006.

## Balance sheets

As at December 31, 2007, current assets stood at \$258.4 million compared to \$345.6 million at the end of 2006. This decrease is due mainly to lower inventories which declined to \$91.7 million compared to \$140.6 million in 2006, in accordance with the Corporation's inventory reduction plan. Trade accounts receivable declined to \$125.8 million compared to \$161.6 million in 2006 due to lower sales in the fourth quarter of 2007 as well as the timing of shipments and customer payments.

Current liabilities decreased to \$199.7 million compared to \$220.9 million in 2006. This decrease is due to lower accounts payable and accrued liabilities. The Corporation accrued \$51.0 million in its 2005 audited consolidated financial statements as additional consideration for the former shareholders of MEGA Brands America pending final determination of the amount owed, if any. No disbursements were made in regards to this additional consideration as at December 31, 2007.

Working capital stood at \$58.8 million compared to \$124.7 million as at December 31, 2006. This decrease is due mainly to the significant reduction in inventories in 2007.

(in thousands of US dollars)	December 31, 2007	December 31, 2006
(Unaudited)	\$	\$
Working capital <sup>(1)</sup>	58,761	124,725
Property, plant and equipment	42,620	43,213
Total assets	709,714	800,442
Total long-term debt	260,744	311,954

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

Long-term debt at the end of 2007 was \$260.7 million compared to \$312.0 million in 2006. As at December 31, 2007, the Corporation's debt was comprised primarily of \$8.0 million under its Term A facility maturing in 2009, \$254.2 million under its Term B facility maturing in 2012 and \$2.0 million drawn against its \$120.0 million revolving credit facility. The Corporation entered into interest rate swap agreements in 2005 to convert \$150.0 million of its Term B facility from variable to fix interest rates.

On March 28, 2008, the Corporation executed a fifth amending agreement to its credit agreement dated July 26, 2005 providing for certain changes to the terms and conditions of its senior secured credit facilities maturing in 2012. Among other things, this amendment waives the funded debt-to-EBITDA ratio covenant and the fixed charge coverage ratio as of December 31, 2008 and until September 30, 2008, inclusively.

As at December 31, 2007, the Corporation held cash and cash equivalents of \$8.5 million and had drawn \$2.0 million under its revolving credit facilities. Based on its forecasts, the Corporation believes that cash flows from operating activities combined with liquidity available under its revolving credit facility will be sufficient to meet its requirements for working capital, acquisition of property, plant and equipment, debt repayments and other financial obligations.



Please refer to the "Balance Sheet Data" and "Contractual Obligations" tables on page 9 of this MD&A for additional information about the Corporation's financial position.

### Seasonality and Quarterly Fluctuations

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

Operating results for any quarter are not necessarily indicative of results for any future period and are comparable only with corresponding periods of prior years. Our profitability is typically higher for the last two quarters as a result of fairly constant fixed operating expenses while net sales are at their highest levels of the year. Working capital needs typically grow through the first three quarters as inventories are built-up for the peak sales season. This seasonality is consistent with the results of other companies in the industry. 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.

### Selected Quarterly Financial Information

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

(in thousands of US dollars , except per share data)	Q4-07	Q3-07	Q2-07	Q1-07	Q4-06	Q3-06	Q2-06	Q1-06
(Unaudited)								
Net sales	128,819	184,105	121,486	90,106	164,805	201,778	102,200	78,564
<i>As a % of full year</i>	24.6	35.1	23.2	17.2	30.1	36.9	18.7	14.3
Gross profit	28,691	35,826	47,290	9,351	51,533	90,547	42,246	34,199
Earnings (loss) from operations	(34,917)	(5,069)	8,678	(35,346)	(1,026)	26,379	10,305	4,051
Net earnings (loss)	(66,160)	(11,028)	3,962	(23,910)	2,761	17,959	4,050	578
Earnings (loss) per share – basic	(1.81)	(0.31)	0.12	(0.73)	0.09	0.56	0.13	0.02
Earnings (loss) per share – diluted	(1.81)	(0.31)	0.12	(0.73)	0.08	0.53	0.12	0.02
Cash flows from operating activities	64,601	(11,142)	(39,439)	(23,351)	28,038	(26,225)	(19,470)	32,973

### Three-month period ended December 31, 2007 compared to three-month period ended December 31, 2006

Net sales in the fourth quarter of 2007 decreased 22% to \$128.8 million compared to \$164.8 million in the corresponding period last year. The decline in net sales is explained mainly by Specified Items recorded in 2007 and lower MAGNETIX and Boys 5-plus shipments during the quarter.

Net sales of Toys decreased by 29% to \$87.3 million compared to \$123.1 million in the fourth quarter of 2006. Sales of construction toys in the preschool category were very strong, offset by lower shipments in the Boys 5-plus product lines and MAGNETIX. The impact of Specified Items on Toys sales in the fourth quarter of 2007 amounted to \$26.7 million.

Net sales of Stationery and Activities were stable at \$41.5 million compared to \$41.7 million in fourth quarter 2006. Sales of activities products and presentation boards increased while sales of writing instruments were lower than in the fourth quarter of 2006.

On a geographical basis, net sales in North America decreased 30% to \$81.6 million compared to \$116.9 million in fourth quarter 2006, mainly as a result of lower Toys shipments and Specified Items.



International net sales were stable at \$47.2 million compared to \$47.9 million in the corresponding 2006 period, mainly due to the impact of Specified Items. International net sales accounted for 37% of consolidated net sales in the fourth quarter of 2007 compared to 29% in the corresponding 2006 period. The impact of Specified Items on North American and International sales in the fourth quarter of 2007 amounted to \$16.0 million and \$10.7 million, respectively.

Cost of sales decreased to \$100.1 million compared to \$113.3 million in the fourth quarter of 2006, a decrease of \$13.2 million. The decrease is mainly explained by the reclassification of Specified Items which, for the most part were charged against cost of sales in the first quarter of 2007 and from additional charges resulting from the voluntary product recall.

Gross profit decreased to \$28.7 million compared to \$51.5 million in the fourth quarter of 2006. Gross margin was 22% compared to 31% in the fourth quarter of 2006.

Gross profit in the fourth quarter of 2007 was impacted by the following factors:

- \$1.2 million of additional Specified Items compared to the fourth quarter of 2006.
- Lower gross profit generated by the MAGNETIX and the Boys 5-plus product lines of \$15.0 million due to lower unit sales and prices.
- Lower manufacturing efficiencies resulting primarily from the inventory reduction plan initiated by the Corporation and the downsizing of the Woodridge, New Jersey facility which was fully closed in December 2007. The impact of lower manufacturing efficiencies on gross profit amounted to approximately \$2.7 million.
- \$4.1 million of Other Charges recorded during the quarter.

Marketing and advertising expenses were to \$10.7 million compared to \$10.6 million in the fourth quarter of 2006.

Research and development expenses decreased to \$4.9 million compared to \$5.9 million in the fourth quarter of 2006 due to the timing of product development initiatives.

Other selling, distribution and administrative expenses amounted to \$41.1 million compared to \$27.9 million in the fourth quarter of 2006. This increase is mainly explained by \$5.6 million of Specified Items and Other charges and approximately \$7.3 million of additional charges resulting from higher distribution costs, reflecting the significant growth in International sales as well as incremental distribution costs incurred while operating several distribution centers in parallel in anticipation of the closure of the facilities in New Jersey and in California.

Mainly as a result of lower gross profit and Specified Items incurred during the quarter, loss from operations was \$34.9 million compared to a loss from operations of \$1.0 million in the fourth quarter of 2006.

Interest and other expenses decreased to \$6.7 million compared to \$7.0 million in the fourth quarter of 2006, reflecting lower debt levels.

In the fourth quarter of 2007, the Corporation recorded a valuation allowance of \$28.0 million on future income tax assets resulting from losses carried forward originating mainly from Specified Items. Consequently, income tax expense was \$24.5 million compared to an income tax recovery of \$10.8 million in the fourth quarter of 2006. The tax rate used to establish the income tax expense is the applicable estimated effective rate of each entity of the Corporation. The effective tax rate reflects the Corporation's structure for tax purposes as well as the financing structure put in place following the acquisition of MEGA Brands America.

Net loss was \$66.2 million, or \$1.81 diluted loss per share compared to net earnings of \$2.8 million, or \$0.08 diluted earnings per share in the fourth quarter of 2006.

Cash flows used in operating activities before changes in non-cash operating working capital amounted to \$26.3 million compared to cash flows generated of \$1.8 million in the fourth quarter of 2006. This change resulted mainly from the higher net loss in the 2007 period. After favourable changes in non-cash operating



working capital in both periods, cash flows from operating activities were \$64.6 million in the fourth quarter of 2007 compared to \$28.0 million in the corresponding 2006 period.

### Shares Outstanding

The basic weighted average number of common shares outstanding in 2007 was 34,407,400 compared 32,220,495 in 2006. The diluted weighted average number of shares outstanding in 2007 was 34,407,400 compared to 34,189,034 in 2006. The total number of shares outstanding as at December 31, 2007 was 36,592,851 compared to 32,664,913 at the end of 2006. As at March 30, 2008, there was a total of 36,612,202 shares outstanding and a total of 2,564,117 stock options outstanding.

### Outlook for 2008

We believe we have a strong product line-up in all of our categories for 2008, with the introduction of many new products, an exceptional licensed products offering and the continuous roll-out of arts and crafts and stationery products in new geographic markets. Through the VEP announced on November 9, 2007, we expect to optimize and improve our business processes to achieve the highest levels of customer satisfaction. We also expect to improve inventory turns and realize additional synergies and savings by completing the integration of MEGA Brands America and Board Dudes as well as by strengthening our operations and supplier base in China. Furthermore, the Corporation is exploring the sale of its Stationery and Activities business which would bring significant benefits such as providing the Corporation with a stronger and more flexible capital structure.

### Comprehensive Income and Accumulated Comprehensive Income

On January 1, 2007, the Corporation prospectively adopted new accounting standards on comprehensive income. The consolidated financial statements include a consolidated statement of comprehensive income, and accumulated other comprehensive income, which is presented separately under shareholders' equity in the consolidated balance sheet. The consolidated statement of comprehensive income presents net income, as well as "other comprehensive income items" which reflects the change in fair value of the interest rate swaps designated as cash flow hedging instruments, net of related income taxes. The accumulated other comprehensive income reflects the fair value of the interest rate swaps, net of related income taxes. Please refer to the "Changes in Significant Accounting Policies and Use of Estimates" section starting on page 18 of this MD&A.

### Significant Accounting Policies and Use of Estimates

#### Principles of consolidation and reporting currency

Consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") using the U.S. dollar (functional currency) as the reporting currency.

The consolidated financial statements include the accounts of the Corporation and its wholly owned subsidiaries since their date of acquisition. All intercompany balances and transactions have been eliminated on consolidation.

#### Use of estimates

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

#### Revenue recognition

Revenue is recognized when (i) persuasive evidence of an arrangement exists, (ii) products are shipped to customers and the customer takes ownership and assumes risk of loss, (iii) collection of the receivable is



probable, and (iv) the sales price is fixed or determinable. Accruals for customer discounts, rebates, incentives and defective allowances are recorded as the related revenues are recognized.

### **Vendor allowance**

Cash considerations received from vendors are deemed a reduction of the prices of the vendors' products or services and are accounted for as a reduction of cost of sales and related inventory when recognized in the Corporation's consolidated statement of earnings and balance sheet.

### **Self-insurance**

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

### **Research and development expenses**

Research expenses are charged to earnings net of related tax credits. Unless development expenditures meet Canadian GAAP for deferral, they are charged to earnings, net of related tax credits. Research and development expenses are presented net of tax credits of \$0.3 million for the year ended December 31, 2007 (2006 – \$0.3 million).

### **Foreign currency translation**

Monetary assets and liabilities denominated in currencies other than U.S. dollars (foreign currencies) and monetary assets and liabilities from foreign integrated subsidiaries are translated at the rates of exchange at the balance sheet date. Non-monetary balance sheet items denominated in foreign currencies and non-monetary balance sheet items from foreign integrated subsidiaries are translated at the rates of exchange prevailing at the respective transaction dates. Revenue and expense items arising from transactions in foreign currencies and from foreign integrated subsidiaries are translated into U.S. dollars at average rates during each reporting period. Gains or losses on foreign exchange are recorded in the consolidated statements of earnings.

All unrealized translation gains and losses on assets and liabilities denominated in foreign currencies are included in earnings for the year.

### **Derivative financial instruments**

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

When hedge accounting is applied, the Corporation formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. Gains and losses on foreign currency forward contracts designated as effective for hedge accounting are recognized in the consolidated statement of earnings during the same period as the underlying revenues and expenses. For interest rate swaps, the difference between the swap rate and the actual rate is reflected against the related interest expense.

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



### Foreign currency risk management

The Corporation enters into certain foreign currency forward contracts to manage the risks associated with foreign currency exchange rates, namely the Canadian dollar, the Euro, the British pound, the Mexican peso and the Australian dollar.

The following table summarizes our foreign currency commitments as at December 31, 2007:

	Notional amount	Average exchange rate	Maturing up to	Notional equivalent	Fair market value
Foreign currency contracts	\$			\$	\$
Sell - Euro to US\$	25,300	1.4455	Dec. 2009	36,571	(228)
- GBP to US\$	6,400	2.0449	Dec. 2009	13,087	537
- US\$ to CAD\$	1,900	1.0194	Jan. 2008	1,937	(20)
- US\$ to EURO	900	1.4409	Jan. 2008	1,297	16
- US\$ to GBP	220	1.9765	Jan. 2008	435	1

The following table summarizes our foreign currency commitments as at December 31, 2006:

	Notional amount	Average exchange rate	Maturing up to	Notional equivalent	Fair market value
Foreign currency contracts	\$			\$	\$
Sell - Euro to US\$	6,000	1.3021	Dec. 2007	7,813	(154)
- GBP to US\$	3,000	1.8746	Dec. 2007	5,624	(243)

The fair value of these forward contracts as at December 31, 2007 is \$0.3 million in favour of the Corporation (\$0.4 million in favour of third parties in 2006). These derivative instruments have not been designated as hedges for accounting purposes as the Corporation has terminated its designation of all hedging relationships for foreign currency forward contracts. The associated liability is recorded in derivative financial instruments and the unrealized loss has been recorded in the foreign currency translation account.

### Interest rate swaps

The Corporation enters into interest rate swap agreements to convert certain long-term debt from variable to fixed interest rates in order to achieve an appropriate mix of fixed and variable interest rate debt. 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 December 31, 2007:

	Notional amount	Fixed rate	Maturing	Fair market value
Interest rate swaps	\$			\$
2007	150,000	4.66325%	July 2012	(3,659)
2006	150,000	4.66325%	July 2012	2,828

### Stock options and share units

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 and reclassified to capital stock when the 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 based, which vest primarily over a three-year period. 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 as liabilities on a fair value basis by using the quoted market price of the common shares at the end of each period. The share units are treated as stock-based compensation and are expensed and credited to accrued liabilities over the vesting period.

On March 29, 2007, the Corporation adopted a deferred share unit plan for its independent directors. The deferred share units are treated as stock-based compensation and are expensed and credited to accrued liabilities. The share units are accounted for as liabilities on a fair value basis by using the quoted market price of the common shares at the end of each period.

### **Earnings (loss) per share**

Basic earnings (loss) per share is based on the weighted-average number of units outstanding during the period. The dilutive effect of stock options is determined using the treasury stock method.

### **Cash and cash equivalents**

Cash and cash equivalents include cash and short-term investments in money market instruments with maturities of three months or less.

### **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.

### **Property, plant and equipment**

Property, plant and equipment are recorded at cost and are amortized over the lesser of their estimated useful lives and the term of the lease using the straight-line method and the following amortization periods:

Buildings	25 years
Machinery and equipment	3 to 15 years
Computer equipment	3 to 5 years
Leasehold improvements	over terms of the leases

### **Government grants**

Government grants for property, plant and equipment acquisitions are netted against property, plant and equipment and are amortized on the same basis as the related asset. Government grants to create employment are recorded in earnings as a reduction of the related expenses when conditions are met.

### **Intangible assets**

Intangible assets with a finite service life are accounted for at cost less accumulated amortization. They consist of customer relationships and intellectual property which are amortized over twenty years and non-competition covenants which are amortized over five years.

Intangible assets with indefinite service life, consisting of the trade name and intellectual property, are accounted for at cost and are not amortized. The trade name and intellectual property are tested for impairment annually or more frequently if changes in circumstances indicate a potential impairment.

### **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 2007, the Corporation has performed an impairment test and determined that goodwill was not impaired.



## **Deferred charges**

In 2006, deferred charges are comprised mainly of financing charges. The financing charges were recorded at cost and were amortized according to the straight-line method over the term of the borrowing facility.

## **Impairment of long-lived assets**

Long-lived assets are reviewed for impairment by management whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment is assessed by comparing the carrying amount of an asset with its expected future net undiscounted cash flows from use together with its residual value (net recoverable value). If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value.

## **Future income taxes**

The Corporation uses the tax liability method to account for income taxes. Under this method, future tax assets and liabilities are determined according to differences between the carrying amounts and tax bases of assets and liabilities. They are measured by applying enacted or substantively enacted tax rates and laws at the date of the financial statements for the years in which the temporary differences are expected to reverse. Future income tax assets are recognized when it is more likely than not that the assets will be realized.

## **Credit risk**

The Corporation does not believe it is subject to significant concentration of credit risk. Cash and short-term investments are in place with major financial institutions. The Corporation is exposed to some credit risk on accounts receivable; however, the Corporation regularly monitors its credit risk exposure and takes steps to mitigate the risk of loss, including obtaining credit insurance. The Corporation's extension of credit is based on an evaluation of each customer's financial condition and the Corporation's ability to obtain credit insurance coverage for that customer.

The Corporation is exposed to credit risk in the event of non-performance by counterparties to its derivative financial instruments. It minimizes this exposure by entering into contracts with counterparties that are of high-credit quality. Collateral or other security to support financial instruments subject to credit risk is usually not obtained. The credit standing of counterparties is regularly monitored.

## **Fair value**

The Corporation has determined that the carrying value of its short-term financial assets and liabilities other than the derivative financial instruments above approximates fair values as at the balance sheet dates because of the short-term maturity of those instruments. The fair value of the Corporation's long-term debt approximates its carrying value as the majority of long-term debt bears interest at rates that vary based on the U.S. base rate and LIBOR.

## **New accounting policies**

### **Financial instruments**

On April 1, 2005, the Canadian Institute of Chartered Accountants ("CICA") issued three accounting standards: "Financial Instruments – Recognition and Measurement", "Hedges" and "Comprehensive Income". These standards requires the Corporation to make certain elections, upon initial adoption of the new rules, regarding the accounting policy to be used to account for each financial instrument. These sections also require that transaction costs incurred in connection with the issuance of financial instruments either be capitalized and presented as a reduction of the carrying value of the related financial instrument or expensed as incurred. If capitalized, transaction costs must be amortized to income using the effective interest method.

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



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

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

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

### *Section 3865, "Hedges"*

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

#### *Cash Flow Hedge*

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

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

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

### *Section 1530, "Comprehensive Income"*

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



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

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

Other information:

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

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

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

(in thousands of US dollars)	Reclassification	Increase (Decrease)	Total
	\$	\$	\$
<b>Assets</b>			
Deferred charges	(3,281)	-	(3,281)
Derivative financial instruments	-	2,828	2,828
	(3,281)	2,828	(453)
<b>Liabilities</b>			
Current portion of long-term debt	(711)	-	(711)
Long-term debt	(2,570)	-	(2,570)
Future income taxes	-	1,077	1,077
	(3,281)	1,077	(2,204)
<b>Shareholder's equity (deficiency)</b>			
Accumulated other comprehensive income	-	1,751	1,751
	(3,281)	2,828	(453)

#### *Section 1506, "Accounting changes".*

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

#### **Impact of accounting pronouncements not yet implemented.**

##### *Financial instruments*

The Canadian Institute of Chartered Accountants issued the following standards effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007: Accounting Standards Section 3862 "Financial Instruments – Presentation" and Accounting Standards Section 3863 "Financial Instruments – Disclosure". These sections replace CICA 3861, revising and enhancing its disclosure requirements, and carrying forward unchanged its presentation requirements.

##### *Capital disclosures*

In December 2006, the CICA published Section 1535, "Capital Disclosures". This new standard establishes disclosure requirements concerning capital such as: qualitative information about its objectives, policies and processes for managing capital; quantitative data about what it regards as capital; whether it has complied



with any externally imposed capital requirements and, if not, the consequences of such non-compliance. This Section is effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007.

#### *Inventories*

In June 2007, the CICA published Section 3031, "Inventories". This Section replaces CICA 3030, establishing standards for the measurement and disclosure of inventories and is effective for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2008.

#### *Goodwill and intangible assets*

In February 2008, the CICA published Section 3064, "Goodwill and Intangible Assets". This new standard establishes standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. The requirements will be effective for interim and annual financial statements starting October 1, 2008.

The Corporation is currently assessing the impact that these accounting pronouncements will have on its financial statements.

### **Risks and Uncertainties**

#### **Financing and Interest Rates**

Increases in interest rates, both domestically and internationally, could negatively affect the cost of financing both our 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.

#### **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, ongoing negative publicity surrounding MAGNETIX and other magnetic construction toys in the U.S. and other key markets may result in a loss of consumer confidence in the Corporation's brands.

#### **Product Recalls**

Product recalls, post-manufacture repairs of our products, product liability claims, absence or cost of insurance, and associated costs could harm our reputation, divert resources, reduce sales and increase costs and could have a material adverse effect on our financial condition.

We are subject to regulation by the US Consumer Products Safety Commission (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 17, 2008, the Corporation and the CPSC jointly announced a voluntary global recall of the Corporation's MAGNAMAN Action Figures and MAGTASTIK and MAGNETIX JR. Pre-School Magnetic Toys. This action was taken in response to reported incidents of loose magnets and minor injury involving the aspiration of a magnet from a MAGTASTIK set. On April 19, 2007, the Corporation announced an expanded voluntary recall and replacement program for MAGNETIX products



jointly with the CPSC as well as in other jurisdictions where the products were distributed. This action was taken in response to the death of a toddler and injuries to several children resulting from magnet ingestion. The Corporation, jointly with the CPSC and similar agencies in other jurisdictions, continues to monitor the performance of these toys in the market to ensure that all safety standards are met.

We have experienced, and may in the future experience, issues in products that result in recalls, withdrawals, or post-manufacture repairs or replacements of products. Enhanced testing implemented by us, as well as increased scrutiny by retailers and other parties, may reveal issues in our products that may lead to regulatory actions by these authorities. Individuals have asserted claims, and may in the future assert claims, that they have sustained injuries from our products, and we are and may be subject to lawsuits relating to these claims. There is a risk that these claims or liabilities may exceed, or fall outside of the scope of, our insurance coverage. Moreover, we may be unable to obtain adequate liability insurance in the future. Any of the issues mentioned above could result in damage to our reputation, diversion of development and management resources, reduced sales and increased costs, any of which could harm our business.

Recalls of our products could materially and adversely affect us by increasing costs in excess of current estimates. We have recorded, and in the future may record, charges and incremental costs relating to recalls, withdrawals, or replacements of our products, based on its most recent estimates of retailer inventory returns, consumer product replacement costs, associated legal and professional fees, and costs associated with advertising and administration of product recalls. Because these current and expected future charges are based on estimates, they may increase as a result of numerous factors, many of which are beyond our control, including the amount of products that may be returned by consumers and retailers, the number and type of legal, regulatory, or legislative proceedings relating to product recalls, withdrawals, or replacements or product safety in the US and in other jurisdictions that may involve us; and regulatory or judicial orders or decrees in the US and in other jurisdictions that may require us to take certain actions in connection with product recalls.

Recalls of products could result in unfavorable legislative actions, including new statutes, regulations and standards that may materially and adversely affect us. As a result of product recalls, withdrawals, or replacements we have been the subject of governmental actions and inquiries. Product recalls, withdrawals, or replacements have resulted in increased governmental scrutiny of magnetic products, and, in particular, toys containing magnets. There can be no assurance that we will not be subjected to future governmental actions and scrutiny that may lead to increased costs or to interruptions or disruptions of our normal business operations. In addition, regulatory agencies and legislatures in various countries, including the US, have undertaken reviews of product safety, and various proposals for additional, more stringent laws and regulations are under consideration. Current or future laws or regulations may become effective in various jurisdictions in which we currently operate and may increase our costs and disrupt our business operations, or possibly forbid the sale of certain toys containing magnets in one or more jurisdictions.

The Corporation's enhanced safety procedures, when fully implemented, and in the interim, may materially and adversely affect its relationship with vendors and make it more difficult for us to purchase and deliver products on a timely basis to meet market demands. Future conditions may require us to adopt further changes that may increase our costs and further affect our relationship with vendors. Our revised operating procedures and requirements for vendors, including enhanced testing requirements and standards, impose additional costs on us and on the vendors from which we purchase products. These changes also delay delivery of products. Our relationship with existing vendors may be adversely affected as a result of these changes, making us more dependent on a smaller number of vendors. Some vendors may choose not to continue to do business with us or not to accommodate our needs to the extent that they have done in the past. Because of the seasonal nature of our business and the demands of our customers for deliveries with short lead times, we depend upon the cooperation of our vendors to meet market demand for our products in a timely manner. There can be no assurance that existing and future events will not require us to impose additional requirements on our vendors that may adversely affect our relationship with those vendors and our ability to meet market demand in a timely manner.



Product recalls may harm our reputation and acceptance of our products by consumers, licensors and our retail customers, which may materially and adversely affect sales and profits. Recalls may also increase competitive pressures from other toy manufacturers. Product recalls, withdrawals, or replacements have resulted in coverage critical of the Corporation in the securities analyst community, in government circles and in the general and trade media. While we believe that we have acted responsibly and in the interests of safety, product recalls, withdrawals, or replacements may harm our reputation and the acceptance of our products by consumers, licensors and retailers. Our ability to enter into licensing agreements for products on competitive terms may be adversely affected if licensors believe that products sold by us will be less favorably received in the market. Our retail customers may be less willing to purchase our products or to provide marketing support for those products, such as shelf space, promotions, and advertising. Reduced acceptance of our products would adversely affect our sales and profits. Product recalls, withdrawals, or replacements may also increase the amount of competition that we have from other manufacturers. Some competitors may attempt to differentiate themselves from us by claiming that their products are produced in a manner or geographic area that is insulated from the issues that preceded recalls, withdrawals, or replacements of our products. To the extent that competitive manufacturers choose not to implement enhanced safety and testing protocols comparable to those that we have adopted, those competitors could enjoy a cost advantage that will enable them to offer products at lower prices than those charged by us.

## Litigation

We are involved in a number of litigious matters, including but not limited to environmental and product liability, and in particular, MAGNETIX product liability lawsuits and claims, and there can be no assurance that additional litigation will not arise in the future. Regardless of their outcome, these various matters may result in substantial expenses and divert the attention of management.

As previously disclosed, Lawrence, Jeffrey and Sidney Rosen (the "Rosens"), former shareholders of MEGA Brands America filed on May 8, 2006 a complaint against the Corporation seeking payment of certain amounts due under the SPA. The Corporation is advancing defenses and counterclaims alleging that the Rosens breached certain terms of the SPA and violated fiduciary duties to the Corporation. The Corporation accrued as a reserve \$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 December 31, 2007, no disbursements had been made and the Corporation will continue to maintain the reserve until the lawsuit is resolved. No trial date has been set as at March 30, 2008. Additionally, on November 17, 2006, Lawrence and Jeffrey Rosen filed arbitration proceedings seeking unspecified damages for the Corporation's alleged breach of their employment agreements. These arbitration proceedings are scheduled for separate hearings in 2008. The unfavorable disposition of pending or future litigation and arbitration could have a material adverse effect on our financial condition and results of operations. 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.

On October 24, 2006, the Corporation announced that it had settled four lawsuits and ten claims related to injuries to children resulting from the ingestion of magnets. The aggregate amount paid to settle the lawsuits and claims is \$13.5 million and is recorded as a product liability settlement expense in the 2006 consolidated statement of earnings. The Corporation expects to recover substantially the full amount from its insurers and through other recourses, although there can be no assurance that a favorable outcome will be achieved, and only \$3.6 million of insurance proceeds have been recovered to date. Other magnet ingestion lawsuits and claims against the Corporation may give rise to significant awards of damages, including punitive damages, or be settled for significant amounts for which the Corporation may not be insured or, if insured, for which the Corporation may not recover a significant portion of the amounts paid in damages or as settlements. The Corporation is not able to assess with any certainty the outcome of these lawsuits and claims or impact, if any. As such, no amounts have been reserved in our year-end financial statements. There can be no assurance that additional incidents, lawsuits or claims will not arise, or that additional enquiries by the CPSC or other regulatory authorities in respect of MAGNETIX or other products will not be brought in the future, or result in additional product recalls.

On September 14, 2006 and on December 5, 2006, two lawsuits related to magnet ingestion requiring surgical removal were served on the Corporation. The former lawsuit was settled by the Corporation's



insurers on October 9, 2007, the terms of which are confidential. The latter remains outstanding and is being handled by the Corporation's insurers. On March 29, 2007 the Corporation learned that a third lawsuit had been filed in U.S. District Court in Denver by the family of a child who is alleged to have sustained injuries from MAGNETIX. The lawsuit was settled by the Corporation on February 25, 2008, the terms of which are confidential. On April 24, 2007, the Corporation learned that a lawsuit had been filed in the US District Court for the Northern District of Indiana by parents of a child alleged to have suffered injuries from MAGNETIX. This lawsuit was settled on a confidential basis by the Corporation's insurers on February 25, 2008. On December 12, 2007, the Corporation learned that the father of a child alleged to have suffered injury from MAGNETIX had filed a lawsuit in the Superior Court of New Jersey against the Corporation. Similarly, a second lawsuit was filed against the Corporation on the same day by the same attorney on behalf of the mother of a toddler alleged to have suffered injuries as a result of MAGNETIX. Both matters are being handled by the Corporation's insurers. On January 4, 2008, the Corporation learned that a lawsuit had been filed in the US District Court for the Eastern District of Pennsylvania by the parents of a child who allegedly sustained injuries from MAGNETIX. This lawsuit is outstanding and is not covered by our insurance carriers. As at March 30, 2008, the Corporation is a defendant in a total of four product liability lawsuits. The Corporation is also aware of at least twelve other incidents of which nine where children are alleged to have required surgery following the ingestion of multiple magnets. The Corporation is not able to assess with any certainty the outcome of the above lawsuits and claims. The Corporation has set up a reserve of \$3.5 million for outstanding and potential claims against the Corporation. 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.

### **Realization of Synergies from the Integration of MEGA Brands America**

We may not realize the expected synergies of the MEGA Brands America acquisition, including anticipated sales growth or the estimated revenue and cost synergies. The expected cost synergies resulting from the acquisition of MEGA Brands America assume that (i) we will continue to manufacture products that maintain or increase the level of product quality; (ii) our new distribution centers are able to meet customer demand in a timely and efficient manner; (iii) that we are able to retain key personnel and attract qualified employees to consolidate the integration of MEGA Brands America at both the operations and administrative level. In addition and beyond the matters outlined in "Specified Items Affecting Operations", 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.

### **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, fiscal regulations 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; (viii) the loss of "most favored" trading status by the People's Republic of China in the United States or the European Union and; (ix) the difficulty of attracting and retaining local financial managers with knowledge and experience of North American accounting and internal control standards, and possessing English-language skills. There can be no assurance that these risks will not result in a material adverse effect on our financial condition and results of operations.

### **Insurance Coverage**

Although the Corporation believes it has adequate product liability insurance generally, there is a risk that 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. As a result of the voluntary recall and replacement campaign with the CPSC announced on March 31, 2006 and expanded on April 19, 2007 in connection with MAGNETIX building sets and the ensuing publicity and product liability lawsuits and claims against the Corporation, the cost of insurance coverage for these products manufactured before May 1, 2006 was prohibitive and as such, the Corporation is not insured for incidents occurring after December 1, 2006 for MAGNETIX products manufactured before May 1, 2006. Consequently, the unfavorable disposition of any



self-insured MAGNETIX related litigation could have a material adverse effect on our financial condition and results of operations.

As at March 30, 2008, insurance coverage has been confirmed subject to a standard reservation of rights for 3 of the 4 outstanding product liability lawsuits.

### **Growth or Profitability**

There can be no assurance that we will be able to restore our growth or profitability to historic levels. Furthermore, future growth, if achieved, may place a strain on our management and financial controls 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, 2007, our three largest customers accounted for approximately 45.7% 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.

### **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, Mexican peso and Australian dollar. 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.

### **Prices of Raw Materials**

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. Prices of other raw materials are also subject to fluctuations. Unfavorable swings in commodity prices could have a material adverse effect on our financial condition and results of operations.

### **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. The risk and



uncertainties pertaining to the seasonality of the Corporation's business will be more acute if the Corporation successfully concludes the sale of its Stationery and Activities business in the process announced by the Corporation on March 5, 2008.

### **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. There is also a risk that key licenses may not be renewed or may be revoked. 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**

The retail environment is highly competitive and there is no assurance that retailers who sell our products will not experience liquidity problems such as those that led to a rationalization of the mass-market retail channel in North America in recent years. If our key customers were to delay payments or cease doing business as a result of liquidity 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 a number of legal proceedings against our principal competitor in the construction toy segment, The Lego Group ("Lego"), which is also the leading manufacturer of such toys worldwide. Lego continues to challenge the Corporation's sale of functionally and aesthetically compatible construction toys in various markets. These proceedings may result in unfavorable outcomes for the Corporation with the result that some of its products may not be sold in one or more markets, which consequently may have a material, adverse effect on the Corporation's financial condition. On May 2, 2007, the German Federal Patent Court of Appeal issued a pair of decisions the upshot of which was to support the holding of the German Patent and Trademark Office in February 2005 invalidating LEGO's German trademark registration for a 2 x 4 stud brick design with respect to wares described as "construction toys". In these decisions, the German Federal Patent Court of Appeal aligns itself with the reasoning of the Grand Board of Appeal of the Office for Harmonization of the Internal Market of the European Union ("OHIM") in the matter of MEGA Brands Inc. vs. LEGO Juris A/S. The latter case, which was decided in July 2006, dismissed LEGO's appeal from the July 2004 decision of the OHIM Cancellation Division, which had invalidated LEGO's three-dimensional Community Trademark registration for an identical trademark. MEGA Brands believes that these decisions, which are subject to further appeal, are consistent with the clear trend of the trademark jurisprudence favoring competitive access to useful product features, like the basic LEGO block, which are no longer protected by patents. LEGO has appealed the German trademark cancellation decisions to the German Federal Supreme Court and there can be no assurances that the Corporation or the third-party in the related decision will prevail in their respective appeals or in any further proceedings. On June 12, 2007, the Court of Appeals for Den Bosch, the Netherlands, overturned a lower court ruling from 2005 in an unfair competition case, which ruling had prevented the Corporation from introducing its Lego and Duplo compatible construction toys to that country. The Corporation has since begun to offer its Mini and Micro MEGA BLOKS products to customers in the Netherlands, although the Den Bosch Court of Appeals decision has been appealed by LEGO to the Dutch Supreme Court, and there can be no assurances that the Corporation will prevail in this appeal or in any further proceedings. On July 17, 2007, the Supreme Court of Spain refused leave to Lego with full and final effect to appeal a decision of the Provincial Court of Madrid in 2004, which had cancelled Lego's brick design trademark registration and declared the Corporation's activities to not constitute unfair competition. On February 29, 2008, the Supreme Court of Italy vacated with full and final effect an injunction against the Corporation's sale of Mini and Micro MEGA BLOKS products in Italy that had been issued by the Milan Court of Appeal under the Italian unfair competition statute in 2003 and subsequently stayed pending the Corporation's appeal to the Supreme Court.



## 2007 Disclosure Controls and Procedures

We comply with Multilateral Instrument 52-109 - Certification of Disclosure in Issuers' Annual and Interim Filings issued by the Canadian Securities Administrators. The President and Chief Executive Officer and the Executive Vice-President and Chief Financial Officer together with Management, have evaluated the effectiveness of the Corporation's disclosure controls and procedures and the design of internal controls over financial reporting ("ICFR") as at December 31, 2007. They have concluded that the Corporation's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Corporation and its subsidiaries is complete and reliable.

During the course of its evaluation, which focused intensively on the integration of MEGA Brands America and its subsidiaries, Management identified a limited number of significant weaknesses that were not considered material either individually or in the aggregate. In response to the significant weaknesses identified, additional manual controls were performed for the annual closing process.

The following significant, non-material ICFR weaknesses have been identified and are described in conjunction with their corresponding remediation plans:

1. Lack of sufficient resources in our accounting and finance organization. Due to sustained organic growth combined with turnover to certain of its key senior financial employees, the Corporation lacks a sufficient complement of personnel with a level of financial reporting expertise commensurate with our financial reporting requirements. In fiscal 2008, we continued to implement a finance structure designed to meet the challenges presented by the overall growth of the Corporation. As such, additional accounting professionals will be hired to remediate this aspect of its ICFR.
2. Monitoring of non-routine and non-systematic transactions. We did not have effective compliance with controls that are in place to monitor and accurately record non-routine and non-systematic transactions. This weakness is primarily related to the difficulty of ensuring estimates are appropriately supported. During 2007, the Corporation needed to adjust its estimates with regards to inventory and receivables as it recorded its initial and adjusted charges for sales below cost, non-cash inventory revaluation, and MAGNETIX provision. The Corporation has performed additional testing after year-end to ensure that the accounting for such transactions is appropriate and materially correct.
3. Controls over financial reporting of Asian subsidiaries. We did not have effective compliance with controls that are in place to ensure adherence to the ICFR of foreign subsidiaries, particularly as concerns the monitoring and tracking of inventory in our China manufacturing facility. To address this ICFR weakness, the Corporation has instituted the process of analyzing inventory variances on a monthly basis and has seconded senior finance personnel to supervise the accounting procedures and inventory controls at the close of each quarter. The information technology platform of our Chinese facility was initially intended to be converted in 2007 to ensure more consistent and timely communication of financial and accounting information. This project has been delayed to 2008.

## Additional Information

This MD&A is dated March 30, 2008. 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 US dollars, except per share data)

(Unaudited)

	Three-month periods ended December 31,		Twelve-month periods ended December 31,	
	2007	2006	2007	2006
	(Unaudited)	(Unaudited)	(Audited)	(Audited)
	\$	\$	\$	\$
<b>Net sales</b>	<b>128,819</b>	164,805	<b>524,516</b>	547,347
Cost of sales	<b>100,128</b>	113,272	<b>403,358</b>	328,822
Gross profit	<b>28,691</b>	51,533	<b>121,158</b>	218,525
Marketing and advertising expenses	<b>10,661</b>	10,562	<b>26,226</b>	26,808
Research and development expenses	<b>4,886</b>	5,858	<b>21,950</b>	18,334
Other selling, distribution and administrative expenses	<b>41,058</b>	27,861	<b>131,960</b>	112,649
Gain on foreign currency translation	<b>(1,354)</b>	(858)	<b>(6,394)</b>	(4,846)
Voluntary product recall and replacement	<b>6,725</b>	3,995	<b>11,425</b>	5,612
Product liability settlement (reimbursement) and related expenses	<b>800</b>	1,463	<b>(2,800)</b>	15,490
Litigation expenses	<b>832</b>	3,678	<b>5,445</b>	4,769
Earnings (loss) from operations	<b>(34,917)</b>	(1,026)	<b>(66,654)</b>	39,709
Interest expenses				
Interest on long-term debt	<b>6,119</b>	6,419	<b>25,395</b>	22,526
Amortization of deferred financing costs	<b>148</b>	252	<b>700</b>	739
Other interest	<b>450</b>	371	<b>417</b>	177
	<b>6,717</b>	7,042	<b>26,512</b>	23,442
Earnings (loss) before income taxes	<b>(41,634)</b>	(8,068)	<b>(93,166)</b>	16,267
Income taxes				
Current	<b>(1,510)</b>	(5,126)	<b>(34)</b>	(1,217)
Future	<b>26,036</b>	(5,703)	<b>4,004</b>	(7,864)
	<b>24,526</b>	(10,829)	<b>3,970</b>	(9,081)
<b>Net earnings (loss)</b>	<b>(66,160)</b>	2,761	<b>(97,136)</b>	25,348
Earnings (loss) per share				
Basic	<b>(1.81)</b>	0.09	<b>(2.82)</b>	0.79
Diluted <sup>(1)</sup>	<b>(1.81)</b>	0.08	<b>(2.82)</b>	0.74

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



## Consolidated statements of retained earnings (deficit)

(in thousands of US dollars)

	Three-month periods ended December 31,		Twelve-month periods ended December 31,	
	2007	2006	2007	2006
	(Unaudited) \$	(Unaudited) \$	(Audited) \$	(Audited) \$
<b>Balance, beginning of period</b>	<b>(18,340)</b>	9,875	<b>12,636</b>	(12,712)
Net earnings (loss)	<b>(66,160)</b>	2,761	<b>(97,136)</b>	25,348
<b>Balance, end of period</b>	<b>(84,500)</b>	12,636	<b>(84,500)</b>	12,636

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

(in thousands of US dollars)

	Three-month periods ended December 31,		Twelve-month periods ended December 31,	
	2007	2006	2007	2006
	(Unaudited) \$	(Unaudited) \$	(Audited) \$	(Audited) \$
<b>Net earnings (loss) for the period</b>	<b>(66,160)</b>	2,761	<b>(97,136)</b>	25,348
<b>Other comprehensive loss, net of income taxes</b>				
Loss on derivatives designated as cash flow hedges	<b>(2,832)</b>	-	<b>(4,016)</b>	-
<b>Comprehensive income (loss) for the period</b>	<b>(68,992)</b>	2,761	<b>(101,152)</b>	25,348
<b>Accumulated other comprehensive loss</b>				
Balance, beginning of period	<b>567</b>	-	-	-
Impact of adopting the new accounting policy regarding financial instruments, net of income taxes	-	-	<b>1,751</b>	-
Other comprehensive loss, net of income taxes	<b>(2,832)</b>	-	<b>(4,016)</b>	-
<b>Balance, end of period</b>	<b>(2,265)</b>	-	<b>(2,265)</b>	-



## Consolidated balance sheets

(in thousands of US dollars)

	December 31, 2007	December 31, 2006
	(Audited)	(Audited)
	\$	\$
<b>Assets</b>		
Current assets		
Cash and cash equivalents	8,505	13,658
Accounts receivable	125,784	161,612
Inventories	91,681	140,630
Income taxes	8,219	9,317
Future income taxes	4,286	8,354
Derivative financial instruments	306	-
Prepaid expenses	19,650	12,025
	<b>258,431</b>	345,596
Property, plant and equipment	42,620	43,213
Intangible assets	74,606	79,517
Goodwill	298,938	300,829
Future income taxes	35,119	28,006
Deferred charges	-	3,281
	<b>709,714</b>	800,442
<b>Liabilities</b>		
Current liabilities		
Accounts payable and accrued liabilities	136,592	153,437
Additional consideration accrued on business combination	54,775	57,825
Current portion of long-term debt	8,303	9,609
	<b>199,670</b>	220,871
Long-term debt	252,441	302,345
Derivative financial instruments	3,659	-
Future income taxes	31,550	27,782
	<b>487,320</b>	550,998
<b>Shareholders' equity</b>		
Capital stock	308,601	236,088
Contributed surplus	558	720
Retained earnings (deficit)	(84,500)	12,636
Accumulated other comprehensive loss net of income taxes	(2,265)	-
	<b>222,394</b>	249,444
	<b>709,714</b>	800,442



## Consolidated statements of cash flows

(in thousands of US dollars)

	Three-month periods ended December 31,		Twelve-month periods ended December 31,	
	2007	2006	2007	2006
	(Unaudited) \$	(Unaudited) \$	(Audited) \$	(Audited) \$
<b>Cash flows from operating activities</b>				
Net earnings (loss)	(66,160)	2,761	(97,136)	25,348
Items not affecting cash and cash equivalents				
Amortization of property, plant and equipment	5,776	3,238	15,753	12,462
Writeoff property, plant and equipment	3,167	-	3,167	-
Amortization of intangible assets	190	313	740	667
Impairment intangible assets	4,171	-	4,171	-
Amortization of deferred charges	-	364	-	1,044
Stock-based compensation plans	(1,261)	798	(1,205)	2,126
Future income taxes	26,036	(5,703)	4,004	(7,864)
Loss on disposal of property, plant and equipment	867	-	607	-
Loss (gain) on foreign currency	909	21	614	(2,610)
	(26,305)	1,792	(69,285)	31,173
Changes in non-cash operating working capital items	90,906	26,246	59,662	(15,300)
	64,601	28,038	(9,623)	15,873
<b>Cash flows from financing activities</b>				
Repayment of long-term debt	(2,441)	(2,404)	(9,574)	(28,998)
Repayment of subsidiary indebtedness upon acquisition	-	-	-	(624)
Change in revolving credit facility	(58,600)	(20,000)	(38,000)	40,000
Issuance of capital stock	3	2,360	71,296	3,882
Amortization of deferred financing costs	148	-	700	-
	(60,890)	(20,044)	24,422	14,260
<b>Cash flows from investing activities</b>				
Acquisition of property, plant and equipment	(4,134)	(4,812)	(19,591)	(17,456)
Proceeds from disposal of property, plant and equipment	-	250	798	304
Business combinations	-	530	(1,159)	(18,890)
	(4,134)	(4,032)	(19,952)	(36,042)
Increase (decrease) in cash and cash equivalents	(423)	3,962	(5,153)	(5,909)
Cash and cash equivalents, beginning of period	8,928	9,696	13,658	19,567
<b>Cash and cash equivalents, end of period</b>	<b>8,505</b>	<b>13,658</b>	<b>8,505</b>	<b>13,658</b>

