

MEGA Brands Inc.

Consolidated Financial Statements
December 31, 2007 and 2006
(expressed in U.S. dollars)

March 30, 2008

Auditors' Report

To the Shareholders of MEGA Brands Inc.

We have audited the consolidated balance sheets of **MEGA Brands Inc.** as at December 31, 2007 and 2006 and the consolidated statements of earnings (loss), retained earnings (deficit), comprehensive income (loss) and accumulated other comprehensive loss, and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of MEGA Brands Inc. as at December 31, 2007 and 2006 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants

Montréal, Quebec

MEGA Brands Inc.

Consolidated Statements of Earnings (Loss)

For the years ended December 31, 2007 and 2006

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

	2007 \$	2006 \$
Net sales (note 4)	524,516	547,347
Cost of sales (note 4)	403,358	328,822
Gross profit	121,158	218,525
Marketing and advertising expenses	26,226	26,808
Research and development expenses	21,950	18,334
Other selling, distribution and administrative expenses	131,960	112,649
Gain on foreign currency translation	(6,394)	(4,846)
Voluntary product recall and replacement (note 4)	11,425	5,612
Product liability settlement and related expenses (note 5)	(2,800)	15,490
Litigation expenses (note 6)	5,445	4,769
Earnings (loss) from operations	(66,654)	39,709
Interest and other expenses		
Interest on long-term debt	25,395	22,526
Amortization of deferred financing costs	700	739
Other interest	417	177
	26,512	23,442
Earnings (loss) before income taxes	(93,166)	16,267
Income taxes (note 7)		
Current	(34)	(1,217)
Future	4,004	(7,864)
	3,970	(9,081)
Net earnings (loss) for the year	(97,136)	25,348
Earnings (loss) per share (note 8)		
Basic	(2.82)	0.79
Diluted	(2.82)	0.74

The accompanying notes are an integral part of these consolidated financial statements.

MEGA Brands Inc.

Consolidated Statements of Retained Earnings (Deficit), Comprehensive Income (Loss) and Accumulated Other Comprehensive Loss For the years ended December 31, 2007 and 2006

(in thousands of U.S. dollars)

	2007 \$	2006 \$
Retained earnings (deficit) – Beginning of year	12,636	(12,712)
Net earnings (loss) for the year	<u>(97,136)</u>	<u>25,348</u>
Retained earnings (deficit) – End of year	<u>(84,500)</u>	<u>12,636</u>
Comprehensive income (loss)		
Net earnings (loss) for the year	(97,136)	25,348
Other comprehensive loss, net of income taxes		
Loss on derivatives designated as cash flow hedges	<u>(4,016)</u>	<u>-</u>
Comprehensive income (loss) for the year	<u>(101,152)</u>	<u>25,348</u>
Accumulated other comprehensive loss		
Balance – Beginning of year	-	-
Impact of adopting the new accounting policies regarding financial instruments, net of income taxes	1,751	-
Other comprehensive loss, net of income taxes of \$(2,472)	<u>(4,016)</u>	<u>-</u>
Balance – End of year	<u>(2,265)</u>	<u>-</u>

The accompanying notes are an integral part of these consolidated financial statements.

MEGA Brands Inc.
Consolidated Balance Sheets
As at December 31, 2007 and 2006

(in thousands of U.S. dollars)

	2007	2006
	\$	\$
Assets		
Current assets		
Cash and cash equivalents	8,505	13,658
Accounts receivable (note 10)	125,784	161,612
Inventories (note 11)	91,681	140,630
Income taxes	8,219	9,317
Future income taxes (note 7)	4,286	8,354
Derivative financial instruments (note 19)	306	-
Prepaid expenses	19,650	12,025
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	258,431	345,596
Property, plant and equipment (note 12)	42,620	43,213
Intangible assets (note 13)	74,606	79,517
Goodwill (note 14)	298,938	300,829
Deferred charges	-	3,281
Future income taxes (note 7)	35,119	28,006
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	709,714	800,442
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Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	136,592	153,437
Additional considerations accrued on business combination (note 9)	54,775	57,825
Current portion of long-term debt (note 15)	8,303	9,609
	<hr/>	<hr/>
	199,670	220,871
Long-term debt (note 15)	252,441	302,345
Derivative financial instruments (note 19)	3,659	-
Future income taxes (note 7)	31,550	27,782
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	487,320	550,998
	<hr/>	<hr/>
Shareholders' Equity		
Capital stock (note 16)	308,601	236,088
Contributed surplus (note 17)	558	720
Retained earnings (deficit)	(84,500)	12,636
Accumulated other comprehensive loss, net of income taxes	(2,265)	-
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	222,394	249,444
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	709,714	800,442
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The accompanying notes are an integral part of these consolidated financial statements.

Approved by the Board of Directors

(signed) Marc Bertrand Director

(signed) Vic Bertrand Director

MEGA Brands Inc.

Consolidated Statements of Cash Flows

For the years ended December 31, 2007 and 2006

(in thousands of U.S. dollars)

	2007 \$	2006 \$
Cash flows from		
Operating activities		
Net earnings (loss) for the year	(97,136)	25,348
Items not affecting cash and cash equivalents		
Amortization of property, plant and equipment	15,753	12,462
Writeoff of property, plant and equipment	3,167	-
Amortization of intangible assets	740	667
Impairment of intangible assets	4,171	-
Amortization of deferred charges	-	1,044
Stock-based compensation plans	(1,205)	2,126
Future income taxes	4,004	(7,864)
Loss on disposal of property, plant and equipment	607	-
Loss (gain) on foreign currency translation	614	(2,610)
	(69,285)	31,173
Changes in non-cash operating working capital items (note 18(a))	59,662	(15,300)
	(9,623)	15,873
Financing activities		
Repayment of long-term debt	(9,574)	(28,998)
Repayment of subsidiary indebtedness upon acquisition	-	(624)
Change in revolving credit facility	(38,000)	40,000
Issuance of capital stock	71,296	3,882
Amortization of deferred financing costs	700	-
	24,422	14,260
Investing activities		
Acquisition of property, plant and equipment	(19,591)	(17,456)
Proceeds from disposal of property, plant and equipment	798	304
Business combinations (note 9)	(1,159)	(18,890)
	(19,952)	(36,042)
Decrease in cash and cash equivalents	(5,153)	(5,909)
Cash and cash equivalents – Beginning of year	13,658	19,567
Cash and cash equivalents – End of year	8,505	13,658
Supplementary disclosure of cash flow information (note 18(b))		

The accompanying notes are an integral part of these consolidated financial statements.

MEGA Brands Inc.

Notes to Consolidated Financial Statements

December 31, 2007 and 2006

(column figures are expressed in thousands of U.S. dollars, except per share data)

1 Nature of business

On June 15, 2006, the shareholders adopted a special resolution authorizing the Corporation to change its legal name from Mega Bloks Inc. to MEGA Brands Inc. On June 22, 2006, the Corporation filed the amendment to its articles of incorporation under the Canada Business Corporations Act to change its name. The legal names of the Corporation's principal subsidiaries have been changed to MEGA Brands America, Inc. (formerly Rose Art Industries, Inc.), MEGA Brands Europe NV (formerly Mega Bloks Europe NV) and MEGA Brands International (formerly Mega Bloks International Sàrl).

The Corporation designs, manufactures and markets a broad line of toys and stationery and activity products. The Corporation sells and distributes its products in over 100 countries under the MEGA BLOKS, ROSE ART, MAGNETIX and BOARD DUDES brands.

2 Significant accounting policies

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 valuation, 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.

MEGA Brands Inc.

Notes to Consolidated Financial Statements

December 31, 2007 and 2006

(column figures are expressed in thousands of U.S. dollars, except per share data)

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 the U.S. dollar (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 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 statement 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.

MEGA Brands Inc.

Notes to Consolidated Financial Statements

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(column figures are expressed in thousands of U.S. dollars, except per share data)

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.

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 year. 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.

MEGA Brands Inc.

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(column figures are expressed in thousands of U.S. dollars, except per share data)

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 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 the terms of the leases

Government grants

Government grants for property, plant and equipment acquisitions are netted against property, plant and equipment and 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 an 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 on December 31 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 were comprised mainly of financing charges. The financing charges were recorded at cost and amortized using the straight-line method over the term of the borrowing facility.

MEGA Brands Inc.

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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 liability method to account for income taxes. Under this method, future income 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.

3 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 require 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 rate method.

The Corporation adopted these standards on January 1, 2007, and the accounting consequences on the consolidated 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.

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(column figures are expressed in thousands of U.S. dollars, except per share data)

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.

MEGA Brands Inc.

Notes to Consolidated Financial Statements

December 31, 2007 and 2006

(column figures are expressed in thousands of U.S. dollars, except per share data)

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:

Asset/Liability	Category	Measurement
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

- i) 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.
- ii) The Corporation did 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:

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

MEGA Brands Inc.

Notes to Consolidated Financial Statements

December 31, 2007 and 2006

(column figures are expressed in thousands of U.S. dollars, except per share data)

Section 1506, “Accounting Changes”

On January 1, 2007, the Corporation adopted this Handbook Section which establishes 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 – Disclosure” and Accounting Standards Section 3863 “Financial Instruments – Presentation”. 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 relating to fiscal years beginning on or after October 1, 2008.

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

MEGA Brands Inc.

Notes to Consolidated Financial Statements December 31, 2007 and 2006

(column figures are expressed in thousands of U.S. dollars, except per share data)

4 Voluntary product recall and replacement

Year ended December 31, 2007

Pursuant to the April 19, 2007 and March 17, 2008 joint announcements with the Consumer Products Safety Commission (“CPSC”), the Corporation recorded charges totalling \$52.8 million related to the expanded MAGNETIX line of products. The charges include:

- a) Charges totalling \$41.4 million impacting gross margin which consist of returned goods, associated charges, freight handling costs and inventory writeoffs. These changes were allocated as a reduction of sales or included in cost of sales for respective amounts of \$26.7 million and \$14.7 million.
- b) Voluntary product recall and replacement expenses of \$11.4 million consisting of merchandising and handling expenses to sort goods at retail and costs related to the replacement program for consumers pursuant to the expanded recall campaign for MAGNETIX line of products.

In addition, the Corporation recorded an impairment charge of \$4.2 million on the trade name and intellectual property related to the MAGNETIX brand and a writeoff of \$3.2 million on moulds. These non-cash charges are included in other selling, distribution and administrative expenses and in cost of sales respectively.

Year ended December 31, 2006

- a) The Corporation recorded reimbursements of MAGNETIX products returned by customers of \$6.6 million as a reduction of sales. The Corporation also recorded writeoffs of MAGNETIX components of \$4.3 million as a result of design changes to such components.
- b) Under a voluntary recall and replacement program of MAGNETIX products jointly announced with the CPSC on March 31, 2006, the Corporation recorded product replacement expenses of \$5.6 million, consisting of freight costs to meet customer shipment dates due to manufacturing delays resulting from design changes to MAGNETIX products, related packaging and development costs, and product replacements for consumers.

5 Product liability settlement and related expenses

	2007 \$	2006 \$
Insurance recoveries	(3,600)	-
Settlement expenses (note 20(c))	800	13,500
Legal expenses	-	1,990
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	(2,800)	15,490
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MEGA Brands Inc.

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(column figures are expressed in thousands of U.S. dollars, except per share data)

In 2007, the Corporation received \$3.6 million from its insurers and expects to recover settlement amounts of \$9.9 million from its insurers and through other recourses.

6 Litigation expenses

The Corporation recorded litigation expenses of \$5.4 million in 2007 (2006 – \$4.8 million), mainly for the litigation with the former shareholders of MEGA Brands America (note 20(a)).

7 Income taxes

a) The following table is a reconciliation of the differences between the statutory income tax rate and the effective income tax rate:

	2007 \$	2006 \$
Income tax expense at Canadian statutory rate	(29,832)	5,209
Benefits arising from financing structures	(11,853)	(8,466)
Effects of foreign tax rate differences	11,642	(11,666)
Valuation allowance	27,842	-
Others	6,171	5,842
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Income tax expense (recovery)	3,970	(9,081)
	<hr/>	<hr/>

b) As at December 31, future income taxes are as follows:

	2007 \$	2006 \$
Future income tax assets		
Property, plant and equipment	3,151	3,075
Accrued integration charges and accrued liabilities	721	2,856
Share issue costs	1,389	411
Loss carryforwards	51,308	17,882
Interest deduction carryforward	7,348	7,049
Asset revaluation	(329)	2,571
Others	3,659	2,516
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	67,247	36,360
Valuation allowance	(27,842)	-
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	39,405	36,360
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MEGA Brands Inc.

Notes to Consolidated Financial Statements

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(column figures are expressed in thousands of U.S. dollars, except per share data)

	2007 \$	2006 \$
Future income tax liabilities		
Property, plant and equipment	6,948	7,075
Intangible assets and goodwill	16,750	11,914
Unrealized portion of foreign exchange gain	23	310
Others	7,829	8,483
	<u>31,550</u>	<u>27,782</u>
Future income taxes – net	<u>7,855</u>	<u>8,578</u>
Classified in the consolidated financial statements as		
Future income tax assets		
Current	4,286	8,354
Long-term	35,119	28,006
	<u>39,405</u>	<u>36,360</u>
Future income tax liabilities		
Long-term	31,550	27,782
Future income taxes – net	<u>7,855</u>	<u>8,578</u>

8 Earnings (loss) per share

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

	2007	2006
Numerator for basic and diluted net earnings per common share		
Net earnings (loss) attributable to common shareholders	<u>\$(97,136)</u>	<u>\$25,348</u>
Denominator for basic net earnings per common share		
Weighted average number of common shares outstanding	<u>34,407,400</u>	<u>32,220,495</u>
Basic earnings (loss) per share	<u>\$(2.82)</u>	<u>\$0.79</u>
Denominator for diluted net earnings per common share		
Weighted average number of common shares outstanding	34,407,400	32,220,495
Plus: Impact of stock options	-	1,968,539
Diluted average number of common shares	<u>34,407,400</u>	<u>34,189,034</u>
Diluted earnings (loss) per share	<u>\$(2.82)</u>	<u>\$0.74</u>

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For the year ended December 31, 2007, the exercise of outstanding stock options would have had a non-dilutive effect.

9 Business combinations

a) Rose Art Industries, Inc.

On July 26, 2005, the Corporation completed the acquisition of all voting shares of Rose Art Industries, Inc., Warren Industries, Inc. and their subsidiaries ("MEGA Brands America"), headquartered in Livingston, New Jersey. MEGA Brands America manufactures and markets arts and crafts and magnetic building sets and features school supplies. The acquisition was accounted for using the purchase method.

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

During the second quarter of 2006, the purchase price allocation was finalized and modified with adjustments relating primarily to non-cash working capital, future income taxes, and a corresponding entry to goodwill. In 2006, goodwill was reduced on an after-tax basis by \$7.2 million for a decrease in the integration and restructuring reserve, and \$7.3 million for additional consideration accrued and other adjustments to fair value of net assets acquired.

In 2007, goodwill was reduced by \$3.05 million for a decrease in other incentives accrued.

As at December 31, addition considerations accrued on business combination are as follows:

	2007	2006
	\$	\$
Contingent purchase price (note 20(a))	51,000	51,000
Other incentives	3,775	6,825
	<u>54,775</u>	<u>57,825</u>

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b) The Board Dudes, Inc.

On January 24, 2006, the Corporation, through its subsidiary MEGA Brands America, entered into an agreement to acquire all voting shares of The Board Dudes, Inc. (“Board Dudes”), a privately held corporation based in Corona, California. Board Dudes designs and distributes dry-erase boards, cork boards, foam boards, and school and locker products. The purchase price paid was \$17 million subject to certain adjustments and was financed through existing credit facilities. During the third quarter of 2006, as part of these adjustments, an amount of \$1.9 million was paid to the Board Dudes principals. Contingent consideration to the selling principals of up to \$7 million is payable between 2006 and 2009 depending on the attainment of certain performance targets. Any additional consideration will be recorded to goodwill. The transaction closed on February 1, 2006 and the results of operations are included in the consolidated statement of earnings as of this date.

On March 21, 2007, an additional consideration was recorded to goodwill of \$0.3 million. In addition, on June 30, 2007, the Corporation recorded an additional consideration of \$0.8 million relating to Board Dudes’ performance in 2006. Effective January 3, 2008, Board Dudes and MEGA Brands America merged, with MEGA Brands America being the surviving entity.

The acquisition was accounted for using the purchase method. The fair value of net assets acquired was as follows:

	2007	2006
	\$	\$
Assets acquired		
Non-cash working capital items	3,050	3,050
Property, plant and equipment	98	98
Intangible assets	7,990	7,990
Goodwill *	9,535	8,376
Long-term debt	(624)	(624)
	<hr/>	<hr/>
Non-cash assets acquired	20,049	18,890
Cash and cash equivalents	43	43
	<hr/>	<hr/>
Net assets acquired	20,092	18,933
	<hr/>	<hr/>
Consideration		
Cash	19,455	18,296
Acquisition costs	637	637
	<hr/>	<hr/>
	20,092	18,933
	<hr/>	<hr/>

* Goodwill is deductible for tax purposes.

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10 Accounts receivable

	2007 \$	2006 \$
Trade	115,398	153,076
Other	10,386	8,536
	<hr/> 125,784	<hr/> 161,612

11 Inventories

	2007 \$	2006 \$
Raw materials	15,849	16,806
Work in progress	6,351	17,850
Finished goods	69,481	105,974
	<hr/> 91,681	<hr/> 140,630

12 Property, plant and equipment

	<hr/> 2007		
	Cost \$	Accumulated amortization \$	Net \$
Buildings	466	18	448
Machinery and equipment	95,148	64,018	31,130
Computer equipment	9,591	6,278	3,313
Leasehold improvements	11,944	4,779	7,165
Computer equipment held under capital leases	1,480	1,472	8
Machinery and equipment held under capital leases	1,265	709	556
	<hr/> 119,894	<hr/> 77,274	<hr/> 42,620

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	2006		
	Cost	Accumulated amortization	Net
	\$	\$	\$
Land	44	-	44
Buildings	882	17	865
Machinery and equipment	83,594	53,277	30,317
Computer equipment	8,489	5,246	3,243
Leasehold improvements	10,401	2,745	7,656
Computer equipment held under capital leases	1,997	1,602	395
Machinery and equipment held under capital leases	1,265	572	693
	106,672	63,459	43,213

In 2007, the Corporation determined that MAGNETIX moulds with a net carrying value of \$3.2 million were written off.

13 Intangible assets

	2007		
	Cost	Accumulated amortization	Net
	\$	\$	\$
Trade name*	66,250	-	66,250
Customer relationships	8,530	900	7,630
Non-competition covenants	1,210	484	726
	75,990	1,384	74,606

MEGA Brands Inc.

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	2006		
	Cost	Accumulated	Net
	\$	amortization	\$
		\$	
Trade name*	67,750	-	67,750
Intellectual property*	1,500	-	1,500
Intellectual property	1,391	145	1,246
Customer relationships	8,530	477	8,053
Non-competition covenants	1,210	242	968
	<u>80,381</u>	<u>864</u>	<u>79,517</u>

* Unamortized intangible asset with indefinite service life

The trade name and intellectual property related to the MAGNETIX brand totalling \$4.2 million were impaired in 2007 and recorded in other selling, distribution and administrative expenses.

14 Goodwill

The changes in the carrying value of goodwill comprise the following:

	2007	2006
	\$	\$
Balance – Beginning of year	300,829	306,973
Acquisition of Rose Art Industries, Inc. (note 9(a))	(3,050)	(14,520)
Acquisition of Board Dudes (note 9(b))	1,159	8,376
	<u>298,938</u>	<u>300,829</u>

The Corporation performs the required annual impairment test as of December 31 of each year. As at December 31, 2007, the Corporation had \$299 million of goodwill, of which \$237 million is related to the Toys segment and \$62 million to the Stationery and Activities segment.

Testing for impairment is accomplished by determining whether the fair value of a reporting unit exceeds the book value of the net assets of that reporting unit as at the assessment date. The Corporation tests its goodwill for impairment using a two-step methodology. This methodology contains estimates and judgments that are subjective and uncertain, and thus may change over time.

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The Corporation conducts the initial step of the goodwill impairment test, consisting of the determination of fair value, by relying on the discounted cash flow method and market comparables. Key assumptions include estimated useful life of the long-lived assets, projections of trend price, production levels, production costs, market supply and demand, weighted average cost of capital and EBITDA multiple. The second step is performed only when the book value exceeds the fair value.

The above-listed assumptions used in the calculation models are interrelated. Based on a sensitivity analysis performed by the Corporation as at December 31, 2007, the fair value would exceed book value for the Toys segment by a range of 0.5% to 25% whereas for the Stationery and Activities segment, the excess would range from 2% to 39%.

Future changes in assumptions or the interrelationship of the assumptions may negatively impact future valuations. In future measurements of fair value, adverse changes in discounted cash flow assumptions or market comparables could result in an impairment of goodwill that would require a non-cash charge to the consolidated statement of earnings and may have a material effect on the Corporation's consolidated financial statements.

15 Long-term debt

	2007 \$	2006 \$
Credit facility		
Term A loan, maturing in March 2009 (note 15(a))	8,000	14,400
Term B loan, maturing in July 2012 (note 15(b))	254,150	256,750
Revolving term facility, maturing in July 2010 (note 15(c))	2,000	40,000
Other debt		
Obligations under capital leases, maturing up to May 2008 (note 15(d))	230	804
	264,380	311,954
Less: Amortization of deferred financing costs	3,636 *	-
	260,744	311,954
Less: Current portion of long-term debt	8,303	9,609
	252,441	302,345

* An amount of \$1 million is allocated to the current portion of the long-term debt.

On July 26, 2005, the Corporation entered into a \$400 million Credit Facility with a syndicate of banks. This Credit Facility was used to finance the acquisition of Rose Art Industries, Inc. The facility is secured by a movable hypothec on all assets of the Corporation. During the third quarter of 2006, the Corporation amended the Credit Facility by prepaying \$20 million of the Term A loan and increasing the revolving term facility by \$20 million. Under the terms of the Credit Facility, the Corporation must satisfy certain restrictive covenants as to financial ratios.

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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.

Subsequent to year-end, the Corporation obtained a waiver effective December 31, 2007 with regard to certain restrictive covenants (note 22(b)).

The Credit Facility is available under U.S. base rate loans or LIBOR loans at the option of the Corporation. The Term A loan and the revolving term facility bear interest at the published rates based on U.S. base rate plus 0.25% to 1.50% or LIBOR plus 1.25% to 2.50%. The Term B loan bears interest at LIBOR plus 2.00% to 2.25%.

- a) The Term A loan is a \$40 million credit facility. Payments are due in quarterly instalments of 2% and 4%.
- b) The Term B loan is a \$260 million credit facility. Payments are due in quarterly instalments of 0.25% and 93.25% at maturity.
- c) The revolving term facility is a \$120 million revolving credit facility.
- d) Obligations under capital leases are denominated and payable in Canadian dollars (CA\$227), and bear interest at 5.82%.

Repayment requirements on long-term debt during the next five years are as follows:

Year	Obligations under capital leases			Credit facility	Total
	Minimum payment \$	Interest \$	Principal \$	Principal \$	Principal repayment \$
2008	235	5	230	9,000	9,230
2009	-	-	-	4,200	4,200
2010	-	-	-	4,600	4,600
2011	-	-	-	2,600	2,600
2012	-	-	-	243,750	243,750
	235	5	230	264,150	264,380

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16 Capital stock

Authorized

An unlimited number of common shares without par value

Issued and outstanding

	<u>2007</u>		<u>2006</u>	
	Number of shares	Amount \$	Number of shares	Amount \$
Balance – Beginning of year	32,664,913	236,088	32,105,575	231,592
Shares issued *	3,850,000	71,367	-	-
Shares issued on exercise of options	77,938	1,146	559,338	4,496
Balance – End of year	<u>36,592,851</u>	<u>308,601</u>	<u>32,664,913</u>	<u>236,088</u>

* On July 25, 2007, the Corporation issued 3,850,000 common shares for gross proceeds of CA\$78.3 million.

17 Stock options, share unit, deferred share unit plan and contributed surplus

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

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

Immediately prior to the closing of the Initial Public Offering which occurred in 2002, the Corporation introduced a New Stock Option Plan. Under this plan, options to purchase common shares of the Corporation are granted at a subscription price of 100% of market value. Market value is determined as the closing price of the common shares on the Toronto Stock Exchange on the last date of trading prior to the effective date of the grant.

As at December 31, 2007, a total of 4,914,939 common shares remained authorized for issuance under the Corporation's stock-based compensation plans. Options are exercisable during a period not to exceed ten years after the date of the grant. The right to exercise the options accrues over a period of three years of continuous employment. However, if there is a change of control of the Corporation, the options become immediately exercisable. Options are adjusted proportionately for any stock dividends or stock splits attributed to the common shares of the Corporation.

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On March 24, 2004, the Board of Directors adopted a recommendation of the Compensation Committee that the Corporation voluntarily cap stock option grants at 15% of the number of common shares outstanding even though the Option Plan, as approved by the relevant regulatory authorities, allows for a significantly higher dilution rate when the available option grants under such plan are combined with option grants under the Initial Plan.

The following table summarizes all stock options outstanding as at December 31 under the Corporation's stock option plans:

	2007		2006	
	Number of options	Weighted average exercise price CA\$	Number of options	Weighted average exercise price CA\$
Options outstanding – Beginning of year	2,665,606	9.18	3,233,858	9.01
Exercised	(77,938)	13.74	(559,338)	7.96
Forfeited	(4,200)	20.44	(8,914)	22.13
Options outstanding – End of year	2,583,468	9.02	2,665,606	9.18
Options exercisable – End of year	2,583,468	9.02	2,610,425	8.94

The following table summarizes information about stock options outstanding as at December 31, 2007:

Range of exercise price CA\$	Number outstanding	Weighted average remaining contractual life in years	Weighted average exercise price CA\$	Number exercisable	Weighted average exercise price CA\$
3.85	1,396,536	1.8	3.85	1,396,536	3.85
14.50	1,063,246	4.4	14.50	1,063,246	14.50
18.25 to 25.65	123,686	5.7	20.37	123,686	20.37
	2,583,468	3.0	9.02	2,583,468	9.02

Stock-based compensation expense for stock options amounted to \$0.05 million in 2007 (2006 – \$0.2 million).

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- b) The Corporation's share unit plan, which became effective February 24, 2005, allows the Board of Directors to grant bonuses in the form of share units that are time- and performance-vesting after three years. The plan is non-dilutive and will be settled in shares purchased on the secondary market, or in cash at the option of the Corporation.

The following table summarizes the share units outstanding as at December 31, 2007 and 2006 under the Corporation's share unit plan:

	Number of units	
	2007	2006
Units outstanding – Beginning of year	354,984	65,768
Granted	136,739	295,028
Settled	(1,010)	(637)
Forfeited	(4,144)	(5,175)
Units outstanding – End of year	486,569	354,984
Share unit plan compensation charge	\$(1,394)	\$1,928
Accrued balance	1,079	2,473

- c) Deferred share unit plan

On March 29, 2007, the Corporation adopted a deferred share unit plan (the "DSU Plan") for its independent directors. The DSU Plan is intended to align the interests of such directors with those of the Corporation's shareholders. The DSU Plan became effective the first quarter of fiscal 2007.

Under the DSU Plan, each independent director may elect to receive up to 100% of their annual retainer fee in the form of deferred share units ("DSUs"), payable quarterly. The fair value of the DSUs is remeasured at each balance sheet date based on the Corporation's share price.

The following table summarizes the DSU Plan for the period ended December 31, 2007:

	Number of units
Units outstanding – Beginning of period	-
Granted	24,993
Units outstanding – End of period	24,993

Total compensation expense for the DSU Plan amounted to \$0.1 million.

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d) Contributed surplus

The following table summarizes charges to contributed surplus:

	2007	2006
	\$	\$
Balance – Beginning of year	720	1,136
Value of compensation cost associated with stock-based compensation expense	47	198
Stock options exercised	(209)	(614)
Balance –End of year	<u>558</u>	<u>720</u>

18 Consolidated statement of cash flows

a) Changes in non-cash operating working capital items

	2007	2006
	\$	\$
Accounts receivable	35,828	15,004
Inventories	48,949	(56,781)
Income taxes	1,098	(14,061)
Prepaid expenses	(7,625)	(3,619)
Accounts payable and accrued liabilities	(15,593)	43,237
Additional consideration accrued on business combination	-	(3,678)
Foreign currency translation relating to working capital items	(2,995)	4,598
	<u>59,662</u>	<u>(15,300)</u>

b) Supplementary information

Interest paid	22,726	22,217
Income taxes paid (recovered)	(1,282)	14,805
Non-cash item		
Additional considerations accrued on business combination	(3,050)	(12,572)

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19 Derivative financial instruments

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:

Foreign currency contracts	Notional amount \$	Average exchange rate	Maturing up to	Notional equivalent \$	Fair market value \$
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 CA\$	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:

Foreign currency contracts	Notional amount \$	Average exchange rate	Maturing up to	Notional equivalent \$	Fair market value \$
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)

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.

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As at December 31, 2007 and 2006, the interest rate swap agreements are with third parties for a notional value of \$150 million at a fixed rate of 4.66325%, maturing in July 2012. The Corporation is applying hedge accounting to these financial instruments. As at December 31, 2007, the fair value of these swaps is a loss of \$3.7 million (2006 – gain of \$2.8 million).

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 approximates fair value as at the balance sheet date 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.

20 Commitments and contingencies

- a) On May 8, 2006, Lawrence, Jeffrey and Sidney Rosen (the "Rosens"), former shareholders of MEGA Brands America, initiated litigation against the Corporation. The plaintiffs are seeking payment of certain amounts due under the terms of the Stock Purchase Agreement ("SPA") entered into between them and the Corporation on June 15, 2005. The Corporation is advancing defences and counterclaims alleging that the Rosens breached certain terms of the SPA and violated fiduciary duties to the Corporation. The Corporation accrued \$51.0 million in its 2005 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 accrual until the lawsuit is resolved. Based on management's assessment, no additional consideration is due for 2007.

On November 17, 2006, Lawrence and Jeffrey Rosen filed arbitration proceedings before the American Arbitration Association against the Corporation seeking unspecified damages for the Corporation's alleged breach of their respective employment agreements.

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- b) On March 31, 2006, the Corporation jointly announced with the U.S. Consumer Products Safety Commission (the "CPSC") a voluntary recall and replacement program of MAGNETIX building sets owned by families with children under the age of six. This action was taken in response to the death of a toddler and injuries to several children resulting from magnet ingestion. 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. On March 17, 2008, the Corporation and the U.S. jointly announced a voluntary global recall of the Corporation's MAGNAMAN Action Figures, 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.
- c) 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. Terms of the settlement include no admission of liability. 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. In 2007, the Corporation received \$3.6 million from its insurers and expects to recover the full amount from its insurers and through other recourses, although there can be no assurance that a favourable outcome will be achieved.

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 12 other incidents, of which nine occurred when children are alleged to have required surgery following the ingestion of multiple magnets.

- d) The Corporation is currently involved in a number of legal proceedings against its 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 unfavourable 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.
- e) The Corporation is also defending other claims which arose in the normal course of business.

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.

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- f) The Corporation has entered into operating leases for premises which it occupies totalling \$49.4 million. The minimum annual rent payable (excluding certain occupancy charges) for each of the next five years is as follows:

	\$
2008	15,110
2009	13,671
2010	12,346
2011	6,680
2012	1,630

- g) As at December 31, 2007, the Corporation had outstanding letters of guarantee totalling \$1.1 million (2006 – \$1.6 million) relating to financial guarantees issued in the normal course of business. These guarantees are issued under standby facilities available to the Corporation within the New Credit Facility.

21 Segmented information

Description of segments

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

- a) The Toys product lines comprise MEGA BLOKS construction toys in the preschool and boys 5-plus categories, MAGNETIX building sets for children 6-plus and MEGA games and puzzles for the family.
- b) The Stationery and Activities product lines are comprised of art materials (crayons, coloured pencils, highlighters and markers) sold mainly under the ROSE ART brand; writing instruments (pens, mechanical pencils and woodcase pencils) sold mainly under the ROSE ART, SRX and USA GOLD brands; dry-erase and cork presentation boards, organizers and accessories sold mainly under the BOARD DUDES brand, and ROSE ART and MEGA craft and activity sets.

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- c) Information by segment as to MEGA Brands' operations in geographic areas is presented below on the basis the Corporation uses to manage its business. Net sales are categorized based on location of the customer while long-lived assets are categorized based on their location:

Segmented information	2007	2006
	\$	\$
Net sales		
Toys	310,900	333,667
Stationery and Activities	213,616	213,680
	<hr/>	<hr/>
	524,516	547,347
	<hr/>	<hr/>
Geographic information		
Net sales		
North America *	352,678	397,778
International	171,838	149,569
	<hr/>	<hr/>
	524,516	547,347
	<hr/>	<hr/>
Earnings from operations		
North America	(18,094)	(11,728)
International	(48,560)	50,698
	<hr/>	<hr/>
	(66,654)	38,970
	<hr/>	<hr/>
Property, plant and equipment, intangible assets, and goodwill		
North America *	340,429	343,312
International	75,735	80,247
	<hr/>	<hr/>
	416,164	423,559
	<hr/>	<hr/>

* Includes net sales for Canada in 2007 of \$29.8 million (2006 – \$27.4 million).

* Includes property, plant and equipment for Canada in 2007 of \$29.4 million (2006 – \$31.1 million).

Other information

Three customers accounted for 45.7% of net sales for the year ended December 31, 2007 (2006 – two customers for 38.5% of net sales).

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(column figures are expressed in thousands of U.S. dollars, except per share data)

22 Subsequent events

- a) 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 allows the Corporation to place increased focus on its core toy business.
- b) On March 28, 2008, the Corporation executed a fifth amending agreement (the "Fifth Amendment") 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. 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 subject to certain conditions with respect to timing and sale price and to the release of the liens on the assets sold provided that the net consideration received will be used to make prepayment offers to the current lenders. Additionally, the EBITDA definition has been amended and a new financial covenant has been added whereby the Corporation will have to maintain a minimum EBITDA at the end of each of its second, third and fourth financial quarters of its 2008 financial year. Finally, for the 2008 financial year, the aggregate amount of outstanding borrowings under the revolving facility must not exceed certain limits.

23 Comparative figures

Certain of the prior year's figures have been reclassified to conform with the current year's presentation.