

# MEGA Brands Inc.

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

For the Second Quarter ended June 30, 2007

### Financial Highlights

	Three-month periods ended June 30,		Six-month periods ended June 30,	
(U.S. \$ millions, except per share data) (unaudited)	2007 \$	2006 \$	2007 \$	2006 \$
Net sales	121.5	102.2	211.6	180.8
Earnings (loss) from operations	8.7	10.3	(26.7)	14.4
Net earnings (loss)	4.0	4.1	(19.9)	4.6
Earnings (loss) per share				
Basic	0.12	0.13	(0.61)	0.14
Diluted <sup>(1)</sup>	0.12	0.12	(0.61)	0.14

<sup>(1)</sup> The dilutive effect of outstanding options under the treasury stock method for the six-month period ended June 30, 2007 is nil as it is anti-dilutive

### Stock Exchange

Toronto Stock Exchange: MB

### Shares Outstanding

(as at June 30, 2007)  
32,722,982 Common Shares

### Trading History

TSX	(CA\$)
	Q2 2007
High:	\$24.32
Low:	\$19.62
Close:	\$20.81
Average volume:	344,950

### Transfer Agent

CIBC Mellon Trust Company  
1.800.387.0825

### Investor Relations

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## Management's Discussion and Analysis For the Second Quarter ended June 30, 2007

The following Management's Discussion and Analysis of Financial Position and Results of Operations ("MD&A") for MEGA Brands Inc. (formerly Mega Bloks Inc.) and its subsidiaries (referred to hereunder as "MEGA Brands", the "Corporation", "we", "our" and "us"), should be read in conjunction with the unaudited Consolidated Financial Statements and Notes thereto for the interim periods ended June 30, 2007 and 2006 as well as the audited consolidated financial statements and the MD&A for the year ended December 31, 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 measures, which we believe are useful to investors for comparing our performance from period to period. Please refer to the "Non-GAAP Financial Measures" section of this MD&A. This MD&A is current as of August 8, 2007.

The Corporation's reporting and functional currency is the US dollar and as such, all figures in this MD&A are expressed in US dollars unless otherwise indicated. Throughout this MD&A, 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: realization of synergies, litigation and its inherent uncertainty, including the recovery of the full product liability settlement amount and risks associated with product recalls, international operations, insurance coverage, difficulty in predicting consumer preferences and development and acceptance of new products, rate of 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, construction toy litigation and financing and interest rate matters. 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 the Corporation's 2006 annual MD&A and this MD&A. When we state that we expect continued international growth in construction toys, that we believe there is strong growth potential for our Stationery and Activities product lines in international markets, that we expect to realize operational efficiencies in the second half of 2007, that we expect net sales growth in North America and International markets, that we expect to recover from insurers and through other recourses substantially the full amount paid to settle the lawsuits relating to injuries to children resulting from the ingestion of magnets and that we expect to reduce inventory levels by the end of the year, we have assumed that we will succeed in realizing the cost and revenue synergies from the integration of MEGA Brands America including without limitation the synergies resulting from the downsizing and closing of manufacturing plants in North America and the concentration of distribution in one facility, 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 facility, 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 an interest in ROSE ART and MAGNETIX brands and in other products that we will offer, that the retail markets into which we sell will continue to demonstrate strong demand for the Corporation's product lines, that product recalls and negative publicity do not materially affect sales, 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 and that the number and quantum of self-insured product liability claims will not be material. As described in the "Risks and Uncertainties" section of the Corporation's 2006 annual MD&A and 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 approximately 5,500 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:

- The Toys product lines are comprised of 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 families.
- The Stationery and Activities product lines are comprised of art materials (crayons, colored 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.

## Strategy and Objectives

Product innovation is the key success factor in the toy industry and the main driver of our sales growth. We annually renew approximately 40% 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 net sales on an annual basis on new product design, engineering, prototyping and development.

Licensed products, which accounted for approximately 19% of sales 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 (Nickelodeon), NASCAR 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. The percentage of our annual sales based on licenses is lower than the 30-35% average for the North American toy industry.

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 another 60 global markets. We expect continued international growth in construction toys with the continued penetration of the MEGA BLOKS brand in key European markets and penetration of new markets in Europe, Asia and Australia, as well as through the introduction of the MAGNETIX brand in new markets.

We believe there is strong growth potential for our Stationery and Activities product lines in international markets. We have selected a portfolio of ROSE ART craft and activity sets and have adapted these products for introduction into our key European markets for 2007, complemented by a broad assortment of Disney licensed products. In Stationery, we have a dedicated sales force in five markets - United Kingdom, France, Italy, Mexico and Australia - and our products are available at retailers for the 2007 back-to-school season.

We plan to supplement our internal growth with selected strategic acquisitions that will reinforce our product range and consumer reach. In identifying attractive acquisition candidates, we are looking to: expand into basic and growing categories, strengthen our position in current core competencies, expand shelf space into multiple aisles, strengthen relationships with key retailers, expand global distribution and enter into new retail channels. Furthermore, we are looking for acquisitions that will offer significant synergies. Our priority in 2007 is to finalize the integration of MEGA Brands America.

With the integration of MEGA Brands America essentially completed, we expect to realize between \$7-10 million of operational efficiencies on an annualized basis commencing in the second half of 2007.



## Recent Developments

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. BMO Nesbitt Burns Inc., the underwriters, have also been granted an option, exercisable at any time up to 30 days following the closing of the offering, to purchase up to an additional 577,500 common shares on the same terms and conditions.

On July 5, 2007, the Corporation executed a fourth amending agreement (the "Amendment") to its credit agreement dated July 26, 2005 (the "Credit Agreement") providing for certain changes to terms and conditions of its senior secured credit facilities (the "Credit Facilities") maturing in 2012. The 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 Amendment increased the limit of total indebtedness provided for in the Credit Facilities. The Amendment also includes an undertaking by the Corporation to obtain within 30 days of its execution, proceeds of a debt financing subordinate to the Credit Facilities or an equity financing, at the discretion of the Corporation, in a minimum amount of CA\$50 million and to apply such proceeds to the repayment of outstanding loans under the revolving credit facilities. The Corporation fulfilled this undertaking by way of the common share offering noted above.

On June 18, 2007, the Corporation announced that the Court of Appeals for Den Bosch, the Netherlands, overturned a 2005 lower court ruling which had prevented the Corporation from introducing its Micro and Mini MEGA BLOKS toys in that country. Although the matter is subject to further appeal to the Dutch Supreme Court, the Corporation is free to begin selling its full line of construction toys in the Netherlands.

Effective June 8, 2007, the Corporation appointed Keith B. Bowman FCA to its Board of Directors. Mr. Bowman will sit as an independent director and as member of the audit committee. Mr. Bowman is the CEO of the Public Accountants Council for the Province of Ontario. During a four decade career with Ernst & Young Canada, Mr. Bowman held numerous senior positions, including Regional Managing Partner in Western Ontario and National Director of Assurance, Quality and Risk Management. He also acted as Chair of the Institute of Chartered Accountants of Ontario and served on that organization's Council from 1993 to 2000.

On April 19, 2007, the Corporation announced an expanded voluntary recall and replacement program for MAGNETIX products jointly with the US Consumer Product Safety Commission ("CPSC"). Approximately 9,600 consumer calls were received between April 19, 2007 and August 8, 2007, bringing the total to approximately 24,000 since the initial recall and replacement program was announced on March 31, 2006. This action was taken in response to additional injuries to children reported to the CPSC following the initial March 31, 2006 recall announcement. As of August 8, 2007, 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 eleven other incidents in which children are alleged to have required surgery following the ingestion of multiple magnets. Of these incidents, at least four involved the ingestion of non-magnetized spheres and/or entire pieces. The Corporation is not able to assess with any certainty the outcome of the above lawsuits and claims or impact, if any. As such, no amounts have been reserved in our financial statements.

In 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 was \$13.5 million and was recorded as a product liability settlement expense in the 2006 consolidated statement of earnings. Terms of settlement included no admission of liability. 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. The Corporation received, in April 2007, a first payment of \$1 million from its primary insurer and this amount has been included in the Corporation's consolidated statement of earnings for the three and six-month periods ended June 30, 2007. Discussions with the Corporation's insurers concerning additional payments are ongoing.



## Voluntary Product Recall and Other Charges

Following the April 19, 2007, joint announcement with the CPSC, the Corporation recorded charges totalling \$35.2 million, all of which were recorded in the first quarter of 2007, related to the expanded MAGNETIX product recall and other charges. The charges include:

- Estimated charges totaling \$30.5 million impacting gross margin which consist of returned goods, associated charges, freight handling costs and inventory write-offs.
- Estimated voluntary product recall and replacement expenses of \$4.7 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 products.

The Corporation incurred expenses totaling \$13.8 million during the second quarter ended June 30, 2007 related to the expanded MAGNETIX product recall and other charges, leaving an accrual of \$21.4 million for future expenses. The Corporation believes this amount to be sufficient and appropriate to adequately meet its future obligations related to the expanded MAGNETIX product recall and other charges for inventory write-off and customer charges.

Litigation expenses of \$1.5 million for the second quarter of 2007 and \$2.3 million for the six months ended June 30, 2007 are mainly related to the Rosen Litigation. As disclosed in the “Risks and Uncertainties – Litigation” section of the 2006 annual MD&A, as updated herein, the former shareholders of MEGA Brands America filed a complaint against the Corporation seeking payment of certain amounts due under the Stock Purchase Agreement entered into between them and the Corporation on June 15, 2005. Furthermore, two of the former shareholders who held executive positions filed arbitration proceedings seeking unspecified damages for the Corporation's alleged breach of their employment agreements. Litigation expenses are recorded as a separate line item in the operating expenses of the Corporation's consolidated statement of earnings.



## Results of Operations

(US \$ thousands, except per share data) (unaudited)	Three-month periods ended June 30,				Six-month periods ended June 30,			
	2007		2006		2007		2006	
	\$	% of Net Sales	\$	% of Net Sales	\$	% of Net Sales	\$	% of Net Sales
<b>Net sales</b>	<b>121,486</b>	<b>100.0</b>	102,200	100.0	<b>211,592</b>	<b>100.0</b>	180,764	100.0
Cost of sales <sup>(1)</sup>	<b>74,196</b>	<b>61.1</b>	59,954	58.7	<b>154,951</b>	<b>73.2</b>	104,319	57.7
Gross profit	<b>47,290</b>	<b>38.9</b>	42,246	41.3	<b>56,641</b>	<b>26.8</b>	76,445	42.3
Marketing and advertising expenses	<b>4,464</b>	<b>3.7</b>	3,844	3.8	<b>10,771</b>	<b>5.1</b>	8,068	4.5
Research and development expenses	<b>6,428</b>	<b>5.3</b>	4,168	4.1	<b>11,685</b>	<b>5.5</b>	7,397	4.1
Other selling, distribution and administrative expenses	<b>28,246</b>	<b>23.3</b>	24,879	24.3	<b>56,298</b>	<b>26.6</b>	48,184	26.7
Voluntary product recall and replacement	-	-	755	0.7	<b>4,700</b>	<b>2.2</b>	1,434	0.8
Litigation expenses	<b>1,501</b>	<b>1.2</b>	422	0.4	<b>2,313</b>	<b>1.1</b>	422	0.2
Product liability settlement and related expenses	<b>(1,000)</b>	<b>(0.8)</b>	168	0.2	<b>(1,000)</b>	<b>(0.5)</b>	168	0.1
Gain on foreign currency translation	<b>(1,027)</b>	<b>(0.8)</b>	(2,295)	(2.2)	<b>(1,458)</b>	<b>(0.7)</b>	(3,584)	(2.0)
Earnings (loss) from operations	<b>8,678</b>	<b>7.1</b>	10,305	10.1	<b>(26,668)</b>	<b>(12.6)</b>	14,356	7.9
Interest and other expenses	<b>6,664</b>	<b>5.5</b>	5,179	5.1	<b>12,787</b>	<b>6.0</b>	10,266	5.7
Earnings (loss) before income taxes	<b>2,014</b>	<b>1.7</b>	5,126	5.0	<b>(39,455)</b>	<b>(18.6)</b>	4,090	2.3
Income taxes (recovery)	<b>(1,948)</b>	<b>(1.6)</b>	1,076	1.1	<b>(19,507)</b>	<b>(9.2)</b>	(538)	(0.3)
<b>Net earnings (loss)</b>	<b>3,962</b>	<b>3.3</b>	4,050	4.0	<b>(19,948)</b>	<b>(9.4)</b>	4,628	2.6
Earnings (loss) per share								
Basic	<b>0.12</b>		0.13		<b>(0.61)</b>		0.14	
Diluted <sup>(2)</sup>	<b>0.12</b>		0.12		<b>(0.61)</b>		0.14	

<sup>(1)</sup> Cost of sales for the six months ended June 30, 2007 includes \$30.5 million related to the expanded MAGNETIX product recall and other charges.

<sup>(2)</sup> The dilutive effect of outstanding options under the treasury stock method for the six-month period ended June 30, 2007 is nil as it is anti-dilutive.



## Selected Canadian Dollar Data <sup>(1)</sup>

(Canadian \$ thousands, except per share data) (unaudited)	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Net sales	129,431	108,884	225,430	192,586
Earnings (loss) from operations	9,246	10,979	(28,412)	15,295
Net earnings (loss)	4,221	4,315	(21,253)	4,931
Earnings (loss) per share				
Basic	0.13	0.13	(0.65)	0.15
Diluted	0.12	0.13	(0.65)	0.14

<sup>(1)</sup> US dollar financial data is converted into Canadian dollars at the June 30, 2007 period end exchange rate of CA\$1.0654 per US\$1, using the translation of convenience method whereby all amounts are converted at the June 30, 2007 closing rate.

### Net Sales

Net sales in the second quarter of 2007 increased 18.9% to \$121.5 million compared to \$102.2 million in the corresponding period last year. Higher net sales are mainly related to strong demand from retailers for our Toys product lines.

Net sales of our Toys product lines in the second quarter of 2007 increased 39.5% to \$57.9 million compared to \$41.5 million in the second quarter of 2006. This growth was mainly driven by construction toys, with higher sales in all of our principal brands in the preschool category, and of theme toys based on two major theatrical releases, Disney's "Pirates of the Caribbean: At World's End" and Marvel's "Spider-Man 3" in the boys 5-plus category. Sales of MAGNETIX products also contributed to the sales growth during the quarter, mainly because the prior year's sales were lower as a result of shipment delays caused by design and packaging changes initiated by the Corporation during the second quarter of 2006.

Net sales of Stationery and Activities product lines in the second quarter of 2007 increased by 4.8% to \$63.6 million compared to \$60.7 million in the corresponding period last year. Higher stationery sales were offset by lower sales of activity products.

On a geographical basis, net sales in North America increased 9.8% to \$87.1 million compared to \$79.3 million in the second quarter of 2006. International net sales in the second quarter of 2007 were up 49.8% to \$34.3 million compared to \$22.9 million in the corresponding period of last year. Growth in both geographic segments was driven by construction toy sales in the preschool and boys 5-plus categories as well as by stationery products. International net sales accounted for 28.2% of consolidated net sales in the second quarter of 2007 compared to 22.4% for the corresponding period for the prior year.

For the six-month period ended June 30, 2007, net sales increased 17.0% to \$211.6 million compared to \$180.8 million in the same period last year. Sales of Toys were up 33.5% to \$112.1 million compared to \$84.0 million in the first six months of 2006 based on strong sales in the preschool category and on theme toys based on the two major theatrical releases mentioned above in the boys 5-plus category. Sales of MAGNETIX products for the six-month period ended June 30, 2007 were lower than the prior year. However, the brand remains strong with stable retail sales worldwide. Sales of Stationery and Activities for the first six months of 2007 increased by 2.9% to \$99.5 million compared to \$96.7 million for the corresponding period of the prior year. North American sales reached \$153.3 million for the first six months of 2007 compared to \$139.0 million in the corresponding 2006 period, while International sales increased to \$58.3 million or 27.6% of total net sales, compared to \$41.7 million or 23.1% of total net sales in the first half of 2006 due to solid growth in both the Toys and Stationery and Activities product lines.



## **Cost of Sales**

Cost of sales increased to \$74.2 million in the second quarter of 2007 compared to \$60.0 million in the corresponding period of 2006. For the six-month period ended June 30, 2007, cost of sales increased to \$155.0 million compared to \$104.3 million for the same period in 2006. For the purpose of financial statement presentation, MAGNETIX product recall and other charges of \$30.5 million are included in cost of sales for the six-month period ended June 30, 2007 (\$0.3 million in 2006).

## **Gross Profit**

Gross profit in the second quarter of 2007 increased to \$47.3 million compared to \$42.2 million in the second quarter of 2006. The gross margin declined to 38.9% in the second quarter compared to 41.3% in the second quarter of last year due mainly to sales of excess inventory and higher magnet costs. Plastic resin prices in the second quarter of 2007 were in line with the corresponding period last year.

For the six-month period ended June 30, 2007, gross profit was \$56.6 million compared to \$76.4 million for the same period in 2006. Excluding MAGNETIX product recall and other charges of \$30.5 million, gross margin was 41.2% compared to 42.3% in the first half of last year.

## **Operating Expenses**

Marketing and advertising expenses increased to \$4.5 million in the second quarter of 2007 compared to \$3.8 million in the second quarter of 2006. This increased investment in our brands reflects the timing of new product releases in 2007 compared to the second quarter of 2006. For the six months ended June 30, 2007, marketing and advertising expenses increased to \$10.8 million compared to \$8.1 million for the corresponding period of the prior year, again mainly due to timing of new product releases.

Research and development expenses increased to \$6.4 million in the second quarter of 2007 compared to \$4.2 million in the corresponding period last year. This increase is mainly related to expenses to support new product initiatives, some of which have occurred earlier this year compared to the prior year due to the timing of new product launches. For the six months ended June 30, 2007, research and development expenses increased to \$11.7 million compared to \$7.4 million for the corresponding period of the prior year again due mainly to the timing of new product launches.

Other selling, distribution and administrative expenses amounted to \$28.2 million in the second quarter of 2007 compared to \$24.9 million in the second quarter of 2006. This increase mainly reflects higher distribution expenses resulting from sales growth in international markets. For the six months ended June 30, 2007, other selling, distribution and administrative expenses increased to \$56.3 million compared to \$48.2 million for the corresponding period of the prior year, mainly to support our sales growth.

## **Earnings from Operations**

As a result of the above, earnings from operations were \$8.7 million for the second quarter of 2007 compared to \$10.3 million in the corresponding 2006 period. In North America, the earnings from operations for the second quarter of 2007 were \$2.8 million compared to \$1.8 million last year. International earnings from operations were \$5.9 million compared to \$8.5 million in the second quarter of 2006.

For the six-month period ended June 30, 2007, the loss from operations was \$26.7 million compared to an operating profit of \$14.4 million in the corresponding period of 2006. This amount includes the MAGNETIX product recall and other charges and litigation expenses of \$36.5 million, net of the recovery of \$1.0 million in product liability settlement from our insurers. The loss from operations in North America amounted to \$33.3 million compared to earnings from operations of \$6.7 million in the prior year while earnings from operations in the International market amounted to \$6.6 million compared to \$7.7 million in the same period of the prior year.



## **Non-Operating Expenses**

Interest and other expenses in the second quarter of 2007 were \$6.7 million compared to \$5.2 million in the same 2006 period, reflecting mainly an increase in average long-term debt and, to a lesser extent, higher interest rates. For the six months ended June 30, 2007, interest and other expenses amounted to \$12.8 million compared to \$10.3 million in the prior year, also reflecting the increase in average long-term debt and, to a lesser extent, higher interest rates.

## **Income Taxes**

Income taxes for the second quarter ended June 30, 2007 amounted to a recovery of \$1.9 million, compared to an expense of \$1.1 million in the corresponding period of the prior year. Reflecting the MAGNETIX product recall and other charges for the six months ended June 30, 2007, the income tax recovery was \$19.5 million compared to \$0.5 million in the prior year. The tax rate used to establish the income tax expense for the quarterly results is the applicable estimated effective rate of each entity of the group. The effective tax rate reflects the Corporation's structure for tax purposes as well as the financing structure put in place following the acquisition of MEGA Brands America.

## **Net Earnings**

Net earnings amounted to \$4.0 million or \$0.12 diluted earnings per share in the second quarter of 2007 compared to net earnings of \$4.1 million or \$0.12 diluted earnings per share for the corresponding period last year.

For the six months ended June 30, 2007, the net loss amounted to \$19.9 million, or \$0.61 per diluted share compared to \$4.6 million, or \$0.14 per diluted share for the corresponding period of the prior year.

Excluding the impact of MAGNETIX product recall and other charges and litigation expenses totalling \$22.8 million after income taxes or \$0.66 diluted earnings per share, the net earnings for the six-month period ended June 30, 2007 were \$2.9 million or \$0.08 per diluted share. This compares to net earnings of \$6.1 million or \$0.18 diluted earnings per share excluding the impact of MAGNETIX product recall and other charges in the corresponding period last year. Please refer to the "Non-GAAP Financial Measures" section on page 16 of this MD&A.

## **Shares Outstanding**

As at August 8, 2007, there were 36,572,982 common shares outstanding for a principal amount of \$311.9 million and 2,605,437 stock options outstanding, all of which were exercisable.

## **Seasonality and Quarterly Financial Information**

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 lower for the first two quarters as a result of fairly constant fixed operating expenses while net sales are at their lowest levels of the year. 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 our business. As a result of the seasonal nature of our business, our statements of cash flows for any quarter are generally not indicative of cash flows for a full year. Therefore, year-over-year comparisons between statements of cash flows are generally more meaningful than with the previous year-end.



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

(US \$ thousands, except per share data)	Q2-07	Q1-07	Q4-06	Q3-06	Q2-06	Q1-06	Q4-05	Q3-05
(unaudited)								
Net sales	121,486	90,106	164,805	201,778	102,200	78,564	166,234	154,203
<i>As a % of full year</i>	-	-	30.1	36.9	18.7	14.3	43.2	40.1
Gross profit	47,290	9,351	51,533	90,547	42,246	34,199	77,675	67,284
Earnings (loss) from operations	8,678	(35,346)	(1,278)	26,200	10,305	4,077	31,703	32,567
Net earnings (loss)	3,962	(23,910)	2,761	17,959	4,050	578	20,911	20,415
Earnings (loss) per share – basic	0.12	(0.73)	0.09	0.56	0.13	0.02	0.66	0.67
Earnings (loss) per share – diluted	0.12	(0.73)	0.08	0.53	0.12	0.02	0.61	0.62
Cash flows from operating activities	(39,439)	(23,351)	28,038	(26,225)	(19,470)	32,973	11,036	(9,871)

### 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 11 of this MD&A.

### 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 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

During the second quarter of 2007, cash flows used for operating activities were \$39.4 million due primarily to an unfavorable change in non-cash operating working capital items of \$45.7 million, offset by cash flows from operations before changes in non-cash working capital items of \$6.3 million. The unfavorable change in non-cash operating working capital items was mainly the result of an increase in accounts receivable. In the corresponding period last year, cash flows used for operations amounted to \$19.5 million as a result of a \$29.5 million unfavorable change in non-cash operating working capital items, offset by cash flows from operations before changes in non-cash working capital items of \$10.0 million.



For the six months ended June 30, 2007, cash flows used for operating activities were \$62.8 million due primarily to an unfavorable change in non-cash operating working capital items of \$32.2 million and cash flow used in operations before changes in non-cash working capital items of \$30.6 million. The unfavorable change in non-cash operating working capital items was mainly the result of a reduction in accounts payable and an increase in inventories, offset partially by a reduction in accounts receivable. In the corresponding period last year, cash flows from operations amounted to \$13.4 million as a result of cash flows from operations before changes in non-cash working capital items of \$15.2 million, offset by a \$1.7 million unfavorable change in non-cash operating working capital items.

## Financing Activities

Cash flows from financing activities in the second quarter of 2007 were \$43.5 million, reflecting mainly a draw-down of \$45.8 million of the Corporation's revolving credit facility and the repayment of \$2.3 million of long-term debt. The draw-down is mainly related to supporting working capital requirements. In the second quarter of 2006, cash flows from financing activities were \$3.9 million. For the six months ended June 30, 2007, cash flows from financing activities amounted to \$65.1 million, reflecting mainly a draw-down of \$69.0 million of the Corporation's revolving credit facility and the repayment of \$4.7 million of long-term debt. The draw-down is mainly related to working capital requirements. For the corresponding period of the prior year, cash flows from financing activities were \$3.0 million.

## Financial Position

(US \$ thousands) (unaudited)	June 30, 2007	December 31, 2006	June 30, 2006
	\$	\$	\$
Working capital <sup>(1)</sup>	146,798	124,725	105,954
Property, plant and equipment	48,199	43,213	41,765
Total assets	808,700	800,442	723,672
Total long-term debt	373,140	311,954	303,002

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

Since December 31, 2006, there have been significant changes to accounts receivable, inventories, accounts payable and accrued liabilities and long-term debt.

The \$30.5 million decline in accounts receivable is mainly due to timing of shipments and customer payments. Inventories increased to \$162.6 million as at June 30, 2007 compared to \$140.6 million at the end of 2006. During the first six months of the year, the Corporation built up inventories of basic products related to its Toys product lines. The Corporation's objective is to reduce inventory levels to a range of approximately \$110 million to \$120 million by the end of 2007. Accounts payable and accrued liabilities decreased by \$41.2 million due to timing of purchases and payments to suppliers. Total long-term debt at the end of June 2007 was \$373.1 million compared to \$312.0 million at the end of 2006. The \$61.1 million increase in long-term debt is mainly related to negative cash flows from operations before changes in non-cash working capital items of \$30.6 million and the unfavorable change in non-cash operating working capital items of \$32.2 million.

As at June 30, 2007, the Corporation's long-term debt was comprised mainly of \$11.2 million under its Term A facility maturing in 2009, \$255.5 million under its Term B facility maturing in 2012 and \$109.0 million drawn against its \$120.0 million revolving credit facility, offset partially by unamortized deferred financing costs of \$3.1 million.

Under the terms of its \$400 million Credit Agreement, as amended, the Corporation must satisfy certain restrictive covenants as to financial ratios. The Corporation was in compliance with all covenants of its Credit Agreement as at June 30, 2007.



## Foreign Exchange and Interest Rate Risk Management

The Corporation uses various derivative financial instruments to manage interest rate risk and foreign currency exposure and 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.

As at June 30, 2007, the Corporation had entered into foreign currency forward contracts to sell Euro 9.6 million and GBP 3.6 million at average rates of 1.3333 and 1.9244 respectively, maturing up to December 2008. The fair value of these forward contracts as at June 30, 2007 is \$0.5 million in favor of third parties. 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 accrued liabilities and the unrealized loss has been recorded in the foreign currency translation account.

As at June 30, 2007, the interest 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 and as a result the difference between the swap rate and the actual rate is reflected against the related expense. As at June 30, 2007 the fair value of these swaps was \$5.1 million in favor of the Corporation and was recorded in the balance sheet as an asset under derivative financial instruments. The change in fair value of these swaps was recorded in the statement of other comprehensive income and resulted in a \$1.9 million gain, net of income taxes, for the three months ended June 30, 2007 and a \$1.4 million gain, net of income taxes, for the six months ended June 30, 2006. Please refer to "Section 1530, Comprehensive Income" on page 13 for further information.

## Outlook for 2007

We believe we have a strong product line-up in all of our categories for 2007, with the introduction of many new products, an exceptional licensed products offering and the launch of arts and crafts and stationery products in new geographic markets. We expect net sales growth in North America and in International markets. With the integration of MEGA Brands America essentially completed, we expect to realize \$7-10 million of operating efficiencies on an annualized basis, commencing in the second half of 2007. The Corporation's objective is to reduce inventory levels to a range of approximately \$110 million to \$120 million by the end of 2007 and our inventory reduction plan could impact margins.

## Changes in Significant Accounting Policies and Use of Estimates

### Accounting Policies Implemented in 2006

EIC-156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Product)", was issued and provides guidance to companies that give incentives to customers or resellers in the form of cash, equity, free gifts, coupons and other. The adoption of EIC-156 is effective for fiscal years beginning on or after January 1, 2006. Since the adjustments were not material in the first half of 2006, the new guideline was implemented beginning in the third quarter of 2006 with an adjustment made in the nine-month period ended September 30, 2006. As a result, for comparative purposes, the Corporation has reclassified such allowances for the first two quarters of 2006. The adoption of EIC-156 reduced net sales by \$3.2 million in the second quarter of 2006 and by \$6.2 million for the six months ended June 30, 2006.

Handbook Section 3831, "Non-Monetary Transactions", effective for transactions initiated in periods beginning on or after January 1, 2006, requires non-monetary transactions to be recorded at fair value unless the transaction has no commercial substance, it is an exchange of product or property, it is a non-monetary non-reciprocal transfer to owners or it is not reliably measurable. The adoption of this new Handbook Section did not have a material impact on the Corporation's consolidated financial statements.



## **Accounting Policies Implemented in 2007**

### **Financial Instruments**

On April 1, 2005, the CICA issued three accounting standards: Financial Instruments – Recognition and Measurement, Hedges and Comprehensive Income. The standard 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. This new section also requires 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 of these new standards 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 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 will be 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 generally reviewed at each reporting period using the critical terms method.

#### *Cash flow hedge*

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

Effective derivative financial instruments, held 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 income. The changes in fair value recognized in other comprehensive income are reclassified in the consolidated statement of income under interest on long-term debt in the periods during which the cash flows constituting the hedged item affect income.

When the derivative 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 income under interest on long-term debt in the periods during which the cash flows constituting the hedged item affect income. 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 income.



### 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 income, 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.

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

<b>Assets / Liabilities</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

a) 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:

(US \$ thousands) (unaudited)	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)



b) New accounting standards regarding hedge accounting for effective cash flow hedges

Reconciliation of opening and ending accumulated other comprehensive income

**Accumulated other comprehensive income**

(US \$ thousands)	
(Unaudited)	\$
Accumulated other comprehensive income as at December 31, 2006, as reported	-
Adjustment for effective cash flow hedge, net of income taxes	1,751
Accumulated other comprehensive income as at January 1, 2007, as restated	1,751
Other comprehensive loss, net of taxes, for the period ended March 31, 2007	(516)
Accumulated other comprehensive income as at March 31, 2007	1,235
Other comprehensive loss, net of taxes, for the period ended June 30, 2007	1,915
Accumulated other comprehensive income as at June 30, 2007	3,150

**Consolidated statements of other comprehensive income**

(US \$ thousands)	
(Unaudited)	\$
Net earnings (loss) as at June 30, 2007	(19,948)
Gains on derivatives designated as cash flow hedges as at June 30, 2007	1,399
Other comprehensive loss for the period ended June 30, 2007	(18,549)

**Accounting Changes**

Handbook Section 1506, "Accounting Changes" 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**

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.

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 January 1, 2008: Accounting Standards Section 3031 "Inventories". This section replaces CICA 3030, establishing standards for the measurement and disclosure of inventories.

The Corporation will adopt these standards effective January 1, 2008 on a prospective basis without retroactive restatement of prior periods.

**Other**

There has been no other significant change in the Corporation's accounting policies and estimates and future accounting pronouncements since December 31, 2006. A description of these policies and estimates can be found in the Corporation's 2006 annual MD&A.



## Risks and Uncertainties

The Corporation is subject to a variety of business risks and uncertainties. Risks and uncertainties that could materially affect our business, financial condition and results of operations are disclosed in the “Risks and Uncertainties” section of the 2006 annual MD&A filed by the Corporation, which are hereby incorporated by reference. Changes to risks and uncertainties described in the 2006 annual MD&A are described below.

### Litigation Related to MAGNETIX

We are subject to regulation by the CPSC and similar state, provincial and international regulatory authorities and our products could be subject to involuntary recalls and other actions by such authorities. We may also voluntarily recall selected products out of concern for product safety. On April 19, 2007, we jointly announced with the CPSC an expanded recall of MAGNETIX building sets in response to additional injuries to children being reported to the CPSC following the March 31, 2006 initial recall announcement. Approximately 9,600 consumer calls were received between April 19, 2007 and August 8, 2007 bringing the total to approximately 24,000 calls.

We may experience defects in products after their production and sale to consumers. Recalls or defects could result in the rejection of our products by consumers, damage to our reputation, lost sales, negative publicity, fines or penalties, diverted development resources and increased customer service and support costs, any of which could have a material adverse effect on our financial condition, business operations and/or business prospects. Individuals may sustain injuries from our products and we may be subject to claims and lawsuits resulting from such injuries.

In 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 was \$13.5 million and was recorded as a product liability settlement expense in the 2006 consolidated statement of earnings. Terms of the settlement included no admission of liability. 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. The Corporation received, in April 2007, a first payment of \$1 million from its primary insurer and this amount has been included in the Corporation’s consolidated statement of earnings for the three and six-month periods ended June 30, 2007. Discussions with the Corporation’s insurers concerning additional payments are ongoing.

On September 14, 2006 and on December 5, 2006, two lawsuits related to magnet ingestion requiring surgical removal were served on the Corporation and remain outstanding. They are being handled by the Corporation’s insurers. On March 29, 2007 and on April 24, 2007, the Corporation learned that two other lawsuits had been filed in US District Court by families of children who are alleged to have sustained similar injuries. The lawsuits have been reported to our insurers. To date, our insurers have confirmed coverage in all but one lawsuit. The Corporation is also aware of at least eleven other incidents in which children are alleged to have required surgery following the ingestion of multiple magnets. Lawsuits have not been filed in these matters as of August 8, 2007. 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 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, negative publicity, fines or penalties.

### Construction Toy Litigation

As disclosed in the Corporation’s 2006 annual MD&A under the “Risks and Uncertainties – Construction Toy Litigation” section, MEGA Brands is involved in various legal proceedings with companies in the LEGO Group (“LEGO”). 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. 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 is subject to further appeal by LEGO, and there can be no assurances that the Corporation would prevail in any such appeal.

### **Non-GAAP Financial Measures**

The terms "impact of MAGNETIX product recalls and other charges and litigation expenses", "net earnings (loss) excluding the impact of MAGNETIX product recalls and other charges and litigation expenses" and "diluted earnings (loss) per share excluding the impact of MAGNETIX product recalls and other charges" do not have any standardized meaning under GAAP and are therefore unlikely to be comparable to similar measures presented by other companies. We present this information as a measure of operating performance of our ongoing business without the effects of unusual 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.

### **Additional Information**

This MD&A is dated August 8, 2007. 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 June 30,		Six-month periods ended June 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
<b>Net sales</b>	<b>121,486</b>	102,200	<b>211,592</b>	180,764
Cost of sales <sup>(1)</sup> (Note 9)	<b>74,196</b>	59,954	<b>154,951</b>	104,319
Gross profit	<b>47,290</b>	42,246	<b>56,641</b>	76,445
Marketing and advertising expenses	<b>4,464</b>	3,844	<b>10,771</b>	8,068
Research and development expenses	<b>6,428</b>	4,168	<b>11,685</b>	7,397
Other selling, distribution and administrative expenses	<b>28,246</b>	24,879	<b>56,298</b>	48,184
Voluntary product recall and replacement (Note 9)	-	755	<b>4,700</b>	1,434
Litigation expenses (Note 14)	<b>1,501</b>	422	<b>2,313</b>	422
Product liability settlement and related expenses	<b>(1,000)</b>	168	<b>(1,000)</b>	168
Gain on foreign currency translation	<b>(1,027)</b>	(2,295)	<b>(1,458)</b>	(3,584)
Earnings (loss) from operations	<b>8,678</b>	10,305	<b>(26,668)</b>	14,356
Interest expense				
Interest on long-term debt	<b>6,502</b>	4,980	<b>12,549</b>	9,981
Amortization of deferred financing costs	<b>122</b>	143	<b>292</b>	308
Other interest	<b>40</b>	56	<b>(54)</b>	(23)
	<b>6,664</b>	5,179	<b>12,787</b>	10,266
Earnings (loss) before income taxes	<b>2,014</b>	5,126	<b>(39,455)</b>	4,090
Income taxes (Note 5)				
Current	<b>(342)</b>	(3,149)	<b>(1,768)</b>	(7,199)
Future	<b>(1,606)</b>	4,225	<b>(17,739)</b>	6,661
	<b>(1,948)</b>	1,076	<b>(19,507)</b>	(538)
<b>Net earnings (loss)</b>	<b>3,962</b>	4,050	<b>(19,948)</b>	4,628
Earnings (loss) per share (Note 10)				
Basic	<b>0.12</b>	0.13	<b>(0.61)</b>	0.14
Diluted <sup>(2)</sup>	<b>0.12</b>	0.12	<b>(0.61)</b>	0.14

<sup>(1)</sup> Cost of sales for the six months ended June 30, 2007 includes \$30.5 million related to the expanded MAGNETIX product recall and other charges.

<sup>(2)</sup> The dilutive effect of outstanding options under the treasury stock method for the six-month period ended June 30, 2007 is nil as it was anti-dilutive.



## Consolidated statements of retained earnings (deficit)

(in thousands of US dollars)

(Unaudited)

	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
<b>Balance, beginning of period</b>	<b>(11,274)</b>	(12,134)	<b>12,636</b>	(12,712)
Net earnings (loss)	<b>3,962</b>	4,050	<b>(19,948)</b>	4,628
<b>Balance, end of period</b>	<b>(7,312)</b>	(8,084)	<b>(7,312)</b>	(8,084)

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

(in thousands of US dollars)

(Unaudited)

	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
<b>Net earnings (loss) for the period</b>	<b>3,962</b>	4,050	<b>(19,948)</b>	4,628
<b>Other comprehensive income, net of income taxes</b>				
Gain on derivatives designated as cash flow hedges	<b>1,915</b>	-	<b>1,399</b>	-
<b>Comprehensive income (loss) for the period</b>	<b>5,877</b>	4,050	<b>(18,549)</b>	4,628
<b>Accumulated other comprehensive income</b>				
Balance, beginning of period	<b>1,235</b>	-	-	-
Impact of adopting the new accounting policy regarding financial instruments, net of income taxes	-	-	<b>1,751</b>	-
<b>Other comprehensive income, net of income taxes</b>	<b>1,915</b>	-	<b>1,399</b>	-
<b>Balance, end of period</b>	<b>3,150</b>	-	<b>3,150</b>	-



## Consolidated balance sheets

(in thousands of US dollars)

	June 30, 2007 (Unaudited)	December 31, 2006 (Audited)	June 30, 2006 (Unaudited)
	\$	\$	\$
<b>Assets</b>			
Current assets			
Cash and cash equivalents	4,603	13,658	10,156
Accounts receivable	131,092	161,612	97,269
Inventories	162,566	140,630	136,159
Income taxes	9,234	9,317	16,329
Future income taxes	8,064	8,354	20,286
Prepaid expenses	11,506	12,025	8,361
	<b>327,065</b>	345,596	288,560
Property, plant and equipment	48,199	43,213	41,765
Intangible assets	79,149	79,517	72,067
Goodwill	301,988	300,829	317,042
Derivative financial instruments (Note 3)	5,089	-	-
Future income taxes	47,210	28,006	-
Deferred charges	-	3,281	4,238
	<b>808,700</b>	800,442	723,672
<b>Liabilities</b>			
Current liabilities			
Accounts payable and accrued liabilities	112,229	153,437	117,298
Additional consideration accrued on business combination (Note 11 and 14)	58,642	57,825	55,712
Derivative financial instruments (Note 3)	535	-	-
Current portion of long-term debt	8,861	9,609	9,596
	<b>180,267</b>	220,871	182,606
Long-term debt (Note 3)	364,279	302,345	293,406
Future income taxes	30,693	27,782	21,929
	<b>575,239</b>	550,998	497,941
<b>Shareholders' equity</b>			
Capital stock (Note 4)	237,071	236,088	232,716
Contributed surplus	552	720	1,099
Retained earnings (deficit)	(7,312)	12,636	(8,084)
Accumulated other comprehensive income net of income taxes	3,150	-	-
	<b>233,461</b>	249,444	225,731
	<b>808,700</b>	800,442	723,672

Contingencies (Note 14)



## Consolidated statements of cash flows

(in thousands of US dollars)  
(Unaudited)

	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
<b>Cash flows from operating activities</b>				
Net earnings (loss)	3,962	4,050	(19,948)	4,628
Items not affecting cash and cash equivalents				
Amortization of property, plant and equipment	3,389	3,133	6,409	6,115
Amortization of intangible assets	183	81	368	162
Amortization of deferred financing costs	122	215	292	406
Amortization of deferred charges	-	52	-	125
Stock-based compensation plans	25	587	(100)	658
Future income taxes	(1,606)	4,225	(17,739)	6,661
Gain on disposal of property, plant and equipment	(20)	-	(240)	-
Loss (gain) on foreign currency	246	(2,295)	383	(3,584)
	6,301	10,048	(30,575)	15,171
Changes in non-cash operating working capital items (Note 12)	(45,740)	(29,518)	(32,215)	(1,735)
	(39,439)	(19,470)	(62,790)	13,436
<b>Cash flows from financing activities</b>				
Repayment of long-term debt	(2,330)	(2,339)	(4,719)	(3,953)
Change in revolving credit facility	45,800	6,000	69,000	6,000
Issuance of capital stock	72	275	774	985
	43,542	3,936	65,055	3,032
<b>Cash flows from investing activities</b>				
Acquisition of property, plant and equipment	(5,540)	(4,733)	(11,776)	(8,433)
Proceeds from disposal of property, plant and equipment	-	54	798	54
Business combinations	-	-	(342)	(17,500)
	(5,540)	(4,679)	(11,320)	(25,879)
Decrease in cash and cash equivalents	(1,437)	(20,213)	(9,055)	(9,411)
Cash and cash equivalents, beginning of period	6,040	30,369	13,658	19,567
<b>Cash and cash equivalents, end of period</b>	<b>4,603</b>	<b>10,156</b>	<b>4,603</b>	<b>10,156</b>
Supplementary disclosure of cash flow information				
Interest paid	6,143	5,522	12,531	10,378
Income taxes paid (recovered)	1,908	2,452	(2,094)	13,874



## Notes to interim consolidated financial statements

For the three-month and six-month periods ended June 30, 2007 and 2006

(Column figures are expressed in thousands of US dollars, except per share data.)

(Unaudited)

### 1. Nature of business

On June 15, 2006, the shareholders adopted a special resolution authorizing the Corporation to change its legal name to MEGA Brands Inc. (formerly Mega Bloks 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 activities products. The Corporation sells and distributes its products in over 100 countries under the MEGA BLOKS, ROSE ART, MAGNETIX and BOARD DUDES brands.

### 2. Basis of presentation and significant accounting policies

The consolidated financial statements are expressed in US dollars as it is the Corporation's functional currency and have been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"), which requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results may differ from those estimates.

The unaudited interim consolidated financial statements have been prepared in accordance with GAAP on a basis consistent with those followed in the consolidated financial statements dated December 31, 2006 except for new accounting policies noted below. However, they do not include all disclosures required under GAAP for annual financial statements and should be read in conjunction with the Corporation's audited year-end consolidated financial statements and notes.

#### *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 revenue 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: provision for MAGNETIX product recall and other charges, inventory valuation, valuation of year-end provision on accounts receivable, future income taxes, intangible assets, goodwill, reserves and allowances, specifically those related to the integration costs, general liability and income taxes.

#### *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, and are not discounted.

### 3. New accounting policies

#### Financial instruments

On April 1, 2005, the CICA issued three accounting standards: Financial Instruments – Recognition and Measurement, Hedges and Comprehensive Income. The standard 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. This new section also requires 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 of these new standards 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 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 will be 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 generally reviewed at each reporting period using the critical terms method.

#### *Cash flow hedge*

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

Effective derivative financial instruments, held 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 income. The changes in fair value recognized in other comprehensive income are reclassified in the consolidated statement of income under interest on long-term debt in the periods during which the cash flows constituting the hedged item affect income.

When the derivative 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 income under interest on long-term debt in the periods during which the cash flows constituting the hedged item affect income. 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 income.

#### *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 income, 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>Assets / Liabilities</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*

a) 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:

(US \$ thousands) (unaudited)	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)



b) New accounting standards regarding hedge accounting for effective cash flow hedges

Reconciliation of opening and ending accumulated other comprehensive income:

**Accumulated other comprehensive income**

(US \$ thousands)	
(Unaudited)	\$
Accumulated other comprehensive income as at December 31, 2006, as reported	-
Adjustment for effective cash flow hedge, net of income taxes	1,751
Accumulated other comprehensive income as at January 1, 2007, as restated	1,751
Other comprehensive loss, net of taxes, for the period ended March 31, 2007	(516)
Accumulated other comprehensive income as at March 31, 2007	1,235
Other comprehensive loss, net of taxes, for the period ended June 30, 2007	1,915
Accumulated other comprehensive income as at June 30, 2007	3,150

**Consolidated statements of other comprehensive income**

(US \$ thousands)	
(Unaudited)	\$
Net earnings (loss) as at June 30, 2007	(19,948)
Gains on derivatives designated as cash flow hedges as at June 30, 2007	1,399
Other comprehensive loss for the period ended June 30, 2007	(18,549)

**Accounting changes**

On January 1, 2007, the Corporation adopted 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**

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.

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 January 1, 2008: Accounting Standards Section 3031 "Inventories". This section replaces CICA 3030, establishing standards for the measurement and disclosure of inventories.

The Corporation will adopt these standards effective January 1, 2008 on a prospective basis without retroactive restatement of prior periods.



#### 4. Capital stock

As at June 30, 2007, there were 32,722,982 common shares issued and outstanding.

#### 5. Income taxes

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

#### 6. Stock-based compensation plans

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

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

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

At June 30, 2007, a total of 4,934,808 common shares remained authorized for issuance under the Corporation's stock-based compensation plans. Options are exercisable during a period not to exceed ten years after the date of the grant. The right to exercise the options accrues over a period of three years of continuous employment. However, if there is a change of control of the Corporation, the options become immediately exercisable. Options are adjusted proportionately for any stock dividends or stock splits attributed to the common shares of the Corporation.

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

The following table summarizes total stock options outstanding for the six-month period ending June 30, under the Corporation's stock option plans:

	2007		2006	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
(in Canadian dollars except per share data)		\$		\$
Options outstanding, beginning of period	2,665,606	9.18	3,233,858	9.01
Granted	-	-	-	-
Exercised	(58,069)	15.47	(103,209)	11.11
Forfeited	(2,100)	20.50	(6,333)	22.77
Options outstanding, end of period	2,605,437	9.03	3,124,316	8.91
Options exercisable, end of period	2,565,437	8.85	3,045,854	8.60



The Corporation uses the fair value method to account for all stock-based compensations. This method requires awards of stock options to be measured on their date of grant using the fair value method. They are expensed and credited to contributed surplus over their vesting period. This credit is reclassified to capital stock when stock options are exercised. For the three-month and six-month periods ended June 30, 2007, \$0.2 million was reclassified from contributed surplus to capital stock.

## 7. Share unit plan

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

The following table summarizes the share units outstanding for the six-month period ending June 30, under the Corporation's share unit plan:

	2007	2006
	<b>Number of units</b>	Number of units
Units outstanding, beginning of the period	<b>354,984</b>	65,768
Granted	<b>136,739</b>	295,028
Exercised	<b>(1,010)</b>	(637)
Forfeited	<b>(4,144)</b>	(5,175)
Units outstanding, end of period	<b>486,569</b>	354,984

## 8. 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 as of the first quarter of fiscal 2007.

Under the DSU Plan, each independent director may elect to receive in the form of deferred share units ("DSUs"), up to 100% of their annual retainer fee and is payable quarterly to him or her. Under the DSU Plan, independent directors are credited, as of the last day of each fiscal quarter of the Corporation, a number of DSUs determined on the basis of the amount of deferred remuneration payable to such director in respect of such quarter divided by the value of a DSU, which is the weighted average of the trading price of the Common Shares on the TSX for the three trading days immediately preceding the last day of each fiscal quarter of the Corporation. Notwithstanding any election by an independent director, if on any award date he or she is not in compliance with the share ownership guidelines established by the Board, 50% of the basic annual Board retainer fee portion of the independent director's retainer payable on such award date shall be paid in DSUs (or such lesser percentage which may be necessary to bring the independent director into compliance with the share ownership guidelines). DSUs granted under the DSU Plan will be redeemable and the value thereof payable only after the director ceases to act as a director of the Corporation. The impact of the deferred share unit plan for the six months ended June 30, 2007 is not material.



## 9. Voluntary product recall and other charges

Following the April 19, 2007, joint announcement with the Consumer Product Safety Commission (“CPSC”), the Corporation recorded charges totalling \$35.2 million, all of which were recorded in the first quarter of 2007, related to the expanded MAGNETIX product recall and other charges. The charges include:

- Estimated charges totaling \$30.5 million impacting gross margin which consist of returned goods, associated charges, freight handling costs and inventory write-offs.
- Estimated voluntary product recall and replacement expenses of \$4.7 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 products.

The Corporation incurred expenses totaling \$13.8 million during the second quarter ended June 30, 2007 related to the expanded MAGNETIX product recall and other charges, leaving an accrual of \$21.4 million for future expenses. The Corporation believes this amount to be sufficient and appropriate to adequately meet its future obligations related to the expanded MAGNETIX product recall and other charges for inventory write-off and customer charges.

## 10. Earnings (loss) per share

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

	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2007	2006	2007	2006
Numerator for basic and diluted net earnings (loss) per common share:				
Net earnings (loss) attributable to common shareholders	\$ 3,962	\$ 4,050	\$ (19,948)	\$ 4,628
Denominator for basic net earnings (loss) per common shares:				
Weighted average number of common shares outstanding	32,714,373	32,181,129	32,703,330	32,151,538
Basic earnings (loss) per share	\$ 0.12	\$ 0.13	\$ (0.61)	\$ 0.14
Denominator for diluted net earnings (loss) per common share:				
Weighted average number of common shares outstanding	32,714,373	32,181,129	32,703,330	32,151,538
Plus impact of stock options <sup>(1)</sup>	1,536,116	1,912,383	1,615,301	2,025,149
Diluted average number of common shares <sup>(1)</sup>	34,250,489	34,093,512	34,318,631	34,176,687
Diluted earnings (loss) per share <sup>(1)</sup>	\$ 0.12	\$ 0.12	\$ (0.61)	\$ 0.14

<sup>(1)</sup> The dilutive effect of outstanding options under the treasury stock method for the six-month period ended June 30, 2007 is nil as it is anti-dilutive.



## 11. Business combinations

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 is \$17 million subject to certain adjustments and was financed through existing credit facilities. During the third quarter of 2006, as part of these adjustments, an amount of \$1.9 million was paid to the Board Dudes principals. On March 21, 2007, an additional consideration has been recorded to the goodwill for an amount of \$0.3 million. 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 as 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 June 30, 2007, the Corporation recorded an additional consideration amount of \$0.8 million relating to the performance of 2006. The Corporation paid this amount on August 1, 2007.

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

	June 30, 2007	December 31, 2006
	\$	\$
Assets acquired		
Non-cash working capital	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)
Non-cash assets acquired	20,049	18,890
Cash and cash equivalents	43	43
Net assets acquired	20,092	18,933
Consideration		
Cash	19,455	18,296
Acquisition cost	637	637
	20,092	18,933

## 12. Changes in non-cash operating working capital items

	Three-month periods ended June 30,		Six-month periods ended June 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Accounts receivable	(39,880)	(7,959)	30,520	79,347
Inventories	(12,711)	(31,593)	(21,936)	(52,335)
Prepaid expenses	1,879	1,579	519	22
Income taxes	(2,504)	513	83	(14,959)
Accounts payable and accrued liabilities	6,479	24,433	(41,067)	7,332
Additional consideration accrued on business combination	-	(12,296)	-	(18,087)
Foreign currency translation relating to working capital items	997	(4,195)	(334)	(3,055)
	(45,740)	(29,518)	(32,215)	(1,735)



### 13. Seasonal nature of business

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

### 14. Contingencies

On May 8, 2006, the former shareholders of Rose Art initiated litigation against the Corporation in the US District Court for the Southern District of New York. The plaintiffs are seeking payment of the Contingent Purchase Price under the terms of the Stock Purchase Agreement ("SPA") entered into between them and the Corporation on July 26, 2005. The Corporation has filed an answer and counterclaim denying each and every material allegation relating to the lawsuit. The Corporation's counterclaim alleges that the former shareholders failed to uphold certain terms of the SPA. The Corporation accrued US\$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 June 30, 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 as of August 8, 2007, no additional consideration is due.

On November 17, 2006, the former shareholders of Rose Art 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. The Corporation is contesting the proceedings.

On March 31, 2006, the Corporation jointly announced with the CPSC a voluntary recall and replacement program of MAGNETIX building sets in the hands of families with children under the age of six. 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 jointly announced with the CPSC an expanded voluntary recall and replacement campaign in response to additional injuries to children being reported to the CPSC following the March 31, 2006 initial recall.

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 was 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. The Corporation received, in April 2007, a first payment of \$1 million from its primary insurer and this amount has been included in the Corporation's consolidated statement of earnings for the three and six-month periods ended June 30, 2007.

On April 24, 2007 the Corporation learned that a lawsuit had been filed in the US District Court of Indiana by the family of a child who is alleged to have sustained injuries related to magnet ingestion. The lawsuit is being handled by the Corporation's insurers. Including this case, 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 eleven other incidents in which 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 or impact, if any. As such, no amounts have been reserved in our financial statements as at August 8, 2007.

On March 28, 2007, the Corporation learned that a competitor who sells magnetic building sets primarily in Europe, Plastwood S.R.L. and Plastwood Corporation, filed a complaint against the Corporation in the US District Court for the Western District of Washington alleging damages for false advertising and unfair and deceptive acts and practices. On June 15, 2007, the Corporation filed a motion to dismiss this lawsuit. However, pending the adjudication of this motion, the Corporation is not able to assess the outcome of this lawsuit or its impact, if any. Therefore, no amount has been reserved as at August 8, 2007.

As disclosed in the Corporation's 2006 annual MD&A and this MD&A under the "Risks and Uncertainties – Construction Toy Litigation" section, MEGA Brands is involved in various legal proceedings with companies in the LEGO Group ("LEGO"). 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. 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 is subject to further appeal by LEGO, and there can be no assurances that the Corporation would prevail in any such appeal.

## 15. Subsequent events

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. BMO Nesbitt Burns Inc., the underwriters, have also been granted an option, exercisable at any time up to 30 days following the closing of the offering, to purchase up to an additional 577,500 common shares on the same terms and conditions.

On July 5, 2007, the Corporation executed a fourth amending agreement (the "Amendment") to its credit agreement dated as of July 26, 2005 (the "Credit Agreement") providing for certain changes to terms and conditions of its senior secured credit facilities (the "Credit Facilities") maturing in 2012. The 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 Amendment increased the limit of total indebtedness provided for in the Credit Facilities. The Amendment also includes an undertaking by the Corporation to obtain within 30 days of its execution, proceeds of a debt financing subordinate to the Credit Facilities or an equity financing, at the discretion of the Corporation, in a minimum amount of CA\$50 million and to apply such proceeds to the repayment of outstanding loans under the revolving credit facilities. The Corporation fulfilled this undertaking by way of the common share offering noted above.

## 16. 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 are comprised of 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, colored 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.
- 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:



<b>Segmented information</b>	<b>Three-month periods ended June 30,</b>		<b>Six-month periods ended June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Net sales				
Toys	<b>57,923</b>	41,546	<b>112,060</b>	84,032
Stationery and activities	<b>63,563</b>	60,654	<b>99,532</b>	96,732
	<b>121,486</b>	102,200	<b>211,592</b>	180,764

<b>Geographic information</b>	<b>Three-month periods ended June 30,</b>		<b>Six-month periods ended June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Net sales				
North America <sup>(1)</sup>	<b>87,147</b>	79,300	<b>153,336</b>	139,017
International	<b>34,339</b>	22,900	<b>58,256</b>	41,747
	<b>121,486</b>	102,200	<b>211,592</b>	180,764

<sup>(1)</sup> Includes net sales for Canada in 2007 of \$10.0 million (\$8.2 million in 2006)

	<b>Three-month periods ended June 30,</b>		<b>Six-month periods ended June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Earnings (loss) from operations				
North America	<b>2,796</b>	1,830	<b>(33,256)</b>	6,698
International	<b>5,882</b>	8,475	<b>6,588</b>	7,658
	<b>8,678</b>	10,305	<b>(26,668)</b>	14,356

	<b>As at June 30,</b>	
	<b>2007</b>	<b>2006</b>
	<b>\$</b>	<b>\$</b>
Property, plant and equipment, intangible assets and goodwill		
North America <sup>(1)</sup>	<b>347,895</b>	424,522
International	<b>81,441</b>	6,352
	<b>429,336</b>	430,874

<sup>(1)</sup> Includes property, plant and equipment for Canada in 2007 of \$33.6 million (\$31.6 million in 2006)

## 17. Comparative figures

Certain comparative figures from prior periods have been reclassified to conform to the presentation adopted in the current period.

