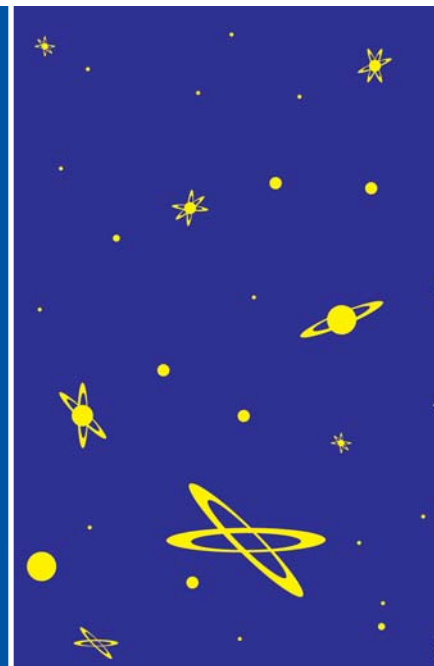


MEGA Brands Inc.

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

For the Third Quarter ended September 30, 2007



Financial Highlights

	Three-month periods ended September 30,		Nine-month periods ended September 30,	
(U.S. \$ millions, except per share data) (unaudited)	2007	2006	2007	2006
	\$	\$	\$	\$
Net sales	184.1	201.8	395.7	382.5
Earnings (loss) from operations	(5.1)	26.4	(31.7)	40.7
Net earnings (loss)	(11.0)	18.0	(31.0)	22.6
Earnings (loss) per share				
Basic	(0.31)	0.56	(0.92)	0.70
Diluted ⁽¹⁾	(0.31)	0.53	(0.92)	0.66

⁽¹⁾ The dilutive effect of outstanding options under the treasury stock method for the nine-month period ended September 30, 2007 is nil as it is anti-dilutive

Stock Exchange

Toronto Stock Exchange: MB

Shares Outstanding

(as at September 30, 2007)
36,592,101 Common Shares

Trading History

TSX	(CA\$)
	Q3 2007
High:	\$21.34
Low:	\$16.80
Close:	\$16.88
Average volume:	171,614

Transfer Agent

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Management's Discussion and Analysis For the Third Quarter ended September 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 September 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 November 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: toy recalls, 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 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 location, 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 4,500 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 in 2006 was 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 in 2007, complemented by a broad assortment of Disney licensed products. In Stationery, we have a dedicated sales force in five markets, namely in the United Kingdom, France, Italy, Mexico and Australia.

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 our recent acquisitions, namely MEGA Brands America and The Board Dudes, Inc. ("Board Dudes").



With the integration of MEGA Brands America essentially completed, the Corporation began to realize in Q3 2007 the impact of certain product cost reductions. These are estimated to reduce mostly cost of sales by \$7-10 million on an annualized basis.

Recent Developments

On October 16, 2007, the Corporation sought an injunction against a Canadian consumer report magazine that alleged that the Corporation is distributing one specific model of block that contains lead in excess of prescribed standards. The temporary interlocutory injunction was denied by the Court on October 17, 2007. However, Health Canada conducted separate testing on the same product and confirmed that there is no quantifiable level of lead in our product. The Corporation is currently considering whether further legal recourses in this matter are appropriate.

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

On July 5, 2007, the Corporation executed a fourth amending agreement (the "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.

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 12,000 consumer calls were received between April 19, 2007 and November 8, 2007, bringing the total to approximately 33,000 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 November 8, 2007, a total of three 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 fourteen other incidents in which children are alleged to have required surgery following the ingestion of multiple magnets. Of these incidents, at least six 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. A further \$2.6 million was received in September 2007 and this amount has been included in the Corporation's consolidated statement of earnings for the three and nine-month periods ended September 30, 2007. The limits of certain primary insurers' policies have now been exhausted and discussions with the Corporation's excess insurers concerning additional payments are now 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 \$22.3 million as of September 30, 2007 related to the expanded MAGNETIX product recall and other charges, leaving an accrual of \$12.9 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 \$2.3 million for the third quarter of 2007 and \$4.6 million for the nine months ended September 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 in this MD&A, the former shareholders of MEGA Brands America filed a complaint against the Corporation seeking payment of certain amounts alleged to be 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 September 30,				Nine-month periods ended September 30,			
	2007		2006		2007		2006	
	\$	% of Net Sales	\$	% of Net Sales	\$	% of Net Sales	\$	% of Net Sales
Net sales	184,105	100.0	201,778	100.0	395,697	100.0	382,542	100.0
Cost of sales	148,279	80.5	111,231	55.1	303,230	76.6	215,550	56.3
Gross profit	35,826	19.5	90,547	44.9	92,467	23.4	166,992	43.7
Marketing and advertising expenses	4,794	2.6	8,178	4.1	15,565	3.9	16,246	4.2
Research and development expenses	5,379	2.9	5,079	2.5	17,064	4.3	12,476	3.3
Other selling, distribution and administrative expenses	34,604	18.8	36,604	18.1	90,902	23.0	84,788	22.2
Voluntary product recall and replacement	-	-	183	0.1	4,700	1.2	1,617	0.4
Litigation expenses	2,300	1.2	669	0.3	4,613	1.2	1,091	0.3
Product liability settlement (reimbursement) and related expenses	(2,600)	(1.4)	13,859	6.9	(3,600)	(0.9)	14,027	3.7
Gain on foreign currency translation	(3,582)	(1.9)	(404)	(0.2)	(5,040)	(1.3)	(3,988)	(1.0)
Earnings (loss) from operations	(5,069)	(2.8)	26,379	13.1	(31,737)	(8.0)	40,735	10.6
Interest and other expenses	7,008	3.8	6,134	3.0	19,795	5.0	16,400	4.3
Earnings (loss) before income taxes	(12,077)	(6.6)	20,245	10.0	(51,532)	(13.0)	24,335	6.4
Income taxes (recovery)	(1,049)	(0.6)	2,286	1.1	(20,556)	(5.2)	1,748	0.5
Net earnings (loss)	(11,028)	(6.0)	17,959	8.9	(30,976)	(7.8)	22,587	5.9
Earnings (loss) per share								
Basic	(0.31)		0.56		(0.92)		0.70	
Diluted ⁽¹⁾	(0.31)		0.53		(0.92)		0.66	

⁽¹⁾ The dilutive effect of outstanding options under the treasury stock method for the three-month and the nine-month periods ended September 30, 2007 is nil as it is anti-dilutive.



Selected Canadian Dollar Data ⁽¹⁾

(Canadian \$ thousands, except per share data) (unaudited)	Three-month periods ended September 30,		Nine-month periods ended September 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Net sales	183,424	201,031	394,233	381,127
Earnings (loss) from operations	(5,050)	26,281	(31,620)	40,584
Net earnings (loss)	(10,987)	17,893	(30,861)	22,503
Earnings (loss) per share				
Basic	(0.31)	0.56	(0.92)	0.70
Diluted	(0.31)	0.52	(0.92)	0.66

⁽¹⁾ US dollar financial data is converted into Canadian dollars at the September 30, 2007 closing exchange rate of CA\$0.9963 per US\$1, using the translation of convenience method whereby all amounts are converted at the September 30, 2007 closing rate.

Net Sales

Net sales in the third quarter of 2007 decreased 8.8% to \$184.1 million compared to \$201.8 million in the corresponding period last year. The reduction in sales was primarily due to production delays in Asia that resulted in at least \$15 million of orders not shipped, as well as lower shipments of MAGNETIX products.

Net sales of our Toys product lines in the third quarter of 2007 decreased 11.8% to \$111.6 million compared to \$126.5 million in the third quarter of 2006. Our shipments of MAGNETIX products decreased by approximately \$16 million during the third quarter compared to the same period of last year. Given the Corporation's announcement of a second MAGNETIX product recall at the beginning of this year and recalls of magnet based products announced by other toy manufacturers in recent months, retailers have taken a very cautious approach in building inventory levels of MAGNETIX products. Furthermore, our 2006 third quarter results were characterized by higher levels of MAGNETIX sales due to a catch up in deliveries of the redesigned products. Finally, production delays in Asia resulted in at least \$10 million of unfulfilled orders, coming primarily in our boys 5-plus category. Construction toys sales were flat compared to last year with a strong performance of our Preschool products offset by lower shipments of boys 5-plus products.

Net sales of Stationery and Activities product lines in the third quarter of 2007 decreased by 3.7% to \$72.5 million compared to \$75.3 million in the corresponding period last year. Higher sales of Activities products were offset by lower Stationery sales, as this year's back to school season did not meet our expectations. Furthermore, approximately \$5 million of customer orders were not shipped during the quarter due to production delays in Asia. These orders were mainly related to new product initiatives in our activities product lines.

On a geographical basis, net sales in North America decreased 17.1% to \$117.7 million compared to \$141.9 million in the third quarter of 2006. The reduction in North America was caused primarily by lower shipments of MAGNETIX products which were approximately \$17 million lower than last year for the same period as well as production delays in Asia which resulted in approximately \$6 million of orders that were delivered in the first few weeks of the fourth quarter of the current year. International net sales in the third quarter of 2007 were up 10.9% to \$66.4 million compared to \$59.9 million in the corresponding period of last year. Growth in the International segment was driven by construction toy sales in the preschool category as well as sales of MAGNETIX, Stationery and Activities products. This growth was offset by at least \$9 million in orders not shipped as a result of production delays in Asia. Approximately \$2.8 million of the sales increase is attributable to changes in exchange rates. International net sales accounted for 36.1% of consolidated net sales in the third quarter of 2007 compared to 29.7% for the corresponding period for the prior year.

For the nine-month period ended September 30, 2007, net sales increased 3.5% to \$395.7 million compared to \$382.5 million in the same period last year. Sales of Toys were up 6.2% to \$223.6 million



compared to \$210.6 million in the first nine months of 2006 based on strong sales in the preschool category, in addition to solid growth in the boys 5-plus and games and puzzles categories. Sales of MAGNETIX products for the nine-month period ended September 30, 2007 were lower than the prior year. Sales of Stationery and Activities products for the first nine months of 2007 were flat at \$172.1 million compared to \$172.0 million for the corresponding period of the prior year. North American sales reached \$271.1 million for the first nine months of 2007 compared to \$280.9 million in the corresponding 2006 period, while International sales increased to \$124.6 million or 31.5% of total net sales during the nine month period ended September 30, 2007, compared to \$101.7 million or 26.6% of total net sales in the corresponding period of the prior year.

Cost of Sales

Cost of sales increased to \$148.3 million in the third quarter of 2007 compared to \$111.2 million in the corresponding period of 2006, an increase of \$37.1 million. Despite lower net sales, cost of sales increased by approximately \$19 million as a result of the sale of excess inventory below cost and by approximately \$20 million as a result of the recording of a non-cash inventory revaluation adjustment.

For the nine-month period ended September 30, 2007, cost of sales increased to \$303.2 million compared to \$215.6 million for the same period in 2006. Included in the 2007 cost of sales is \$30.5 million of MAGNETIX product recall and other charges, approximately \$28 million of resulting from the sale of excess inventory below cost and approximately \$20 million related to a non-cash inventory revaluation adjustment recorded during the third quarter.

Gross Profit

Gross profit in the third quarter of 2007 decreased to \$35.8 million compared to \$90.5 million in the third quarter of 2006. Gross margin declined to 19.5% compared to 44.8% in the third quarter of last year.

Gross profit for the quarter was impacted by the following factors:

- The sale of approximately \$19 million of excess inventory which resulted in a negative gross profit of approximately \$12 million. This is primarily related to the integration plan put in place following the acquisition of MEGA Brands America. In anticipation of plant closures in the United States, the Corporation had built higher levels of inventories in 2006 to avoid service issues with its key customers. In December 2007, the Corporation will close its manufacturing and distribution facility in New Jersey and Management has decided not to incur significant additional operating costs associated with keeping and transferring excess inventory to its distribution facilities located on the west coast of the United States.
- The recording of a non-cash inventory revaluation adjustment of approximately \$20 million. This expense was primarily set-up as a result of Management's decision to minimize any future financial impact related to the completion of its MEGA Brands America integration plan and the full integration of Board Dudes' operations scheduled in 2008. It was also influenced by a conservative approach in regards to potential impacts following Management's decision to transition its MAGNETIX product offering into an entirely new generation of magnetic play called MAGNEXT™. Preliminary responses to viewings of this new product at toy shows have been very positive. MAGNEXT is expected to reach retailers by mid-2008.
- Lower gross profit generated by the MAGNETIX product line of \$12 million due to lower unit sales and prices. Other product lines generated the same average gross margins compared to the prior year.
- Production delays in Asia which resulted in at least \$15 million of orders not shipped during the quarter. The gross profit impact of these unfulfilled orders amounted to approximately \$7 million.
- Lower manufacturing efficiencies resulting primarily from the inventory reduction plan initiated by the Corporation and the downsizing of the New Jersey facility which is scheduled to be fully closed by December 2007. The impact of these items on gross profit amounted to approximately \$4 million.



Excluding the impact of sales of excess inventory and the recording of a non-cash inventory revaluation adjustment described above, the gross margin was 38.1% for the quarter ended September 30, 2007.

For the nine-month period ended September 30, 2007, gross profit was \$92.5 million compared to \$167.0 million for the same period in 2006. Excluding the MAGNETIX product recall and other charges of \$30.5 million, the sale of excess inventory and the recording of a non-cash inventory revaluation adjustment, the gross margin was 41.3% compared to 43.7% in the same period of the prior year.

Please refer to the "Non-GAAP Financial Measures" section on page 18 of this MD&A.

Operating Expenses

Marketing and advertising expenses were reduced to \$4.8 million in the third quarter of 2007 compared to \$8.2 million in the third quarter of 2006. The decrease reflects the timing of new product releases in 2007, with more spending occurring earlier during the year related to products associated with theatrical releases. For the nine months ended September 30, 2007, marketing and advertising expenses were slightly lower than the prior year at \$15.6 million compared to \$16.2 million for the corresponding period of the prior year.

Research and development expenses increased to \$5.4 million in the third quarter of 2007 compared to \$5.1 million in the corresponding period last year. This increase is mainly related to expenses to support new product initiatives. For the nine months ended September 30, 2007, research and development expenses increased to \$17.1 million compared to \$12.5 million for the corresponding period of the prior year. The increase reflects our strong investment in new product initiatives across all product categories.

Other selling, distribution and administrative expenses amounted to \$34.6 million in the third quarter of 2007 compared to \$36.6 million in the third quarter of 2006. The improvement is mainly the result of lower product distribution costs and lower administrative expenses. The current quarter includes two non-recurring expenses, \$2.1 million related to the sub-lease of excess warehouse space in Montreal at unfavourable terms and \$0.5 million related to the set-up of a second-lien credit facility. This facility was subsequently eliminated as a result of an issue of common shares from treasury made by the Corporation in July 2007. For the nine months ended September 30, 2007, other selling, distribution and administrative expenses increased to \$90.9 million compared to \$84.8 million for the corresponding period of the prior year.

Earnings from Operations

As a result of the above, the loss from operations amounted to \$5.1 million for the third quarter of 2007 compared to earnings from operations of \$26.4 million in the corresponding 2006 period. In North America, the earnings from operations for the third quarter of 2007 were \$3.3 million compared to \$16.4 million last year. In International markets, the loss from operations amounted to \$8.4 million compared to earnings from operations of \$10.0 million in the third quarter of 2006. As a result of the tax structure implemented in conjunction with the Mega Brands America acquisition in July 2005, the majority of the inventory related charges described in the Cost of Sales section of this MD&A incurred this quarter are allocated to our International operations.

For the nine-month period ended September 30, 2007, the loss from operations was \$31.7 million compared to an operating profit of \$40.7 million in the corresponding period of 2006. This amount includes the MAGNETIX product recall and other charges and litigation expenses of \$36.2 million, once the recovery of \$3.6 million in product liability settlement from our insurers is netted. It also includes the inventory related charges described in the Cost of Sales section of this MD&A totalling approximately \$35 million. The loss from operations in North America amounted to \$29.9 million compared to earnings from operations of \$23.1 million in the prior year while the loss from operations in International markets amounted to \$1.8 million compared to earnings from operation of \$17.6 million in the same period of the prior year.

Non-Operating Expenses

Interest and other expenses in the third quarter of 2007 were \$7.0 million compared to \$6.1 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 nine months ended September 30, 2007, interest and other expenses amounted to



\$19.8 million compared to \$16.4 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 third quarter ended September 30, 2007 amounted to a recovery of \$1.0 million, compared to an expense of \$2.3 million in the corresponding period of the prior year. For the nine months ended September 30, 2007, the income tax recovery was \$20.6 million compared to an income tax expense of \$1.7 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 Corporation. The effective tax rate reflects the Corporation's structure for tax purposes as well as the financing structure put in place following the acquisition of MEGA Brands America.

Net Earnings

The net loss amounted to \$11.0 million or \$0.31 diluted loss per share in the third quarter of 2007 compared to net earnings of \$18.0 million or \$0.53 diluted earnings per share for the corresponding period last year. The impact of the MAGNETIX product recall and other charges, litigation expenses, the sale of excess inventory and the recording of a non-cash inventory revaluation adjustment amounted to \$0.80 diluted earnings per share for the third quarter of 2007 compared to \$0.28 diluted earnings per share for the corresponding period of the prior year.

For the nine months ended September 30, 2007, the net loss amounted to \$31.0 million, or \$0.92 per diluted share compared to earnings of \$22.6 million, or \$0.66 per diluted share for the corresponding period of the prior year. The impact of the MAGNETIX product recall and other charges, litigation expenses, the sale of excess inventory and the recording of a non-cash inventory revaluation adjustment amounted to \$1.49 diluted earnings per share for the third quarter of 2007 compared to \$0.32 diluted earnings per share for the corresponding period of the prior year.

Please refer to the "Non-GAAP Financial Measures" section on page 18 of this MD&A.

Shares Outstanding

As at November 8, 2007, there were 36,592,851 common shares outstanding for a principal amount of \$308.6 million and 2,583,468 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)	Q3-07	Q2-07	Q1-07	Q4-06	Q3-06	Q2-06	Q1-06	Q4-05
(unaudited)								
Net sales	184,105	121,486	90,106	164,805	201,778	102,200	78,564	166,234
<i>As a % of full year</i>		-	-	30.1	36.9	18.7	14.3	43.2
Gross profit	35,826	47,290	9,351	51,533	90,547	42,246	34,199	77,675
Earnings (loss) from operations	(5,069)	8,678	(35,346)	(1,278)	26,200	10,305	4,077	31,703
Net earnings (loss)	(11,028)	3,962	(23,910)	2,761	17,959	4,050	578	20,911
Earnings (loss) per share – basic	(0.31)	0.12	(0.73)	0.09	0.56	0.13	0.02	0.66
Earnings (loss) per share – diluted	(0.31)	0.12	(0.73)	0.08	0.53	0.12	0.02	0.61
Cash flows from operating activities	(11,142)	(39,439)	(23,351)	28,038	(26,225)	(19,470)	32,973	11,036

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 13 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 third quarter of 2007, cash flows used for operating activities amounted to \$11.1 million due primarily to a use of cash flows from operations before changes in non-cash working capital items of \$12.1 million. In the corresponding period last year, cash flows used for operations amounted to \$26.2 million as a result of a \$39.4 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 \$13.2 million.

For the nine months ended September 30, 2007, cash flows used for operating activities were \$74.2 million due to cash flow used in operations before changes in non-cash working capital items of \$43.0 million and an unfavorable change in non-cash operating working capital items of \$31.2 million. The unfavorable change in non-cash operating working capital items was mainly the result of a reduction in accounts payable, offset partially by a reduction in inventories. In the corresponding period last year, cash flows used for operations amounted to \$12.8 million as a result of a \$42.3 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 \$29.5 million.

Financing Activities

Cash flows from financing activities in the third quarter of 2007 were \$20.0 million, reflecting mainly the issuance of common shares from treasury of \$70.5 million, offset by a reduction of \$48.4 million in the



Corporation's revolving credit facilities and the repayment of \$2.4 million of long-term debt. In the third quarter of 2006, cash flows from financing activities were \$31.9 million reflecting mainly a drawdown in the Corporation's credit facility of \$54.0 million, offset by a repayment in long-term debt of \$22.6 million.

For the nine months ended September 30, 2007, cash flows from financing activities amounted to \$85.3 million, reflecting mainly the issuance of common shares from treasury of \$71.3 million and a drawdown of \$20.6 million of the Corporation's revolving credit facility, offset by the repayment of long-term debt of \$7.1 million. The draw-down is mainly related to working capital requirements. For the corresponding period of the prior year, cash flows from financing activities were \$34.9 million reflecting mainly a drawdown in the Corporation's credit facilities of \$60.0 million, offset by a repayment of \$26.6 million in long-term debt.

Investing Activities

Cash flows used in investing activities in the third quarter of 2007 were \$4.5 million, reflecting the acquisition of property, plant and equipment of \$3.7 million and additional consideration paid of \$0.8 million for Board Dudes relating to the performance of 2006. In the third quarter of 2006, cash flows used in investing activities were \$6.1 million reflecting the acquisition of property, plant and equipment of \$4.2 million and an adjustment in business combinations of \$1.9 million.

For the nine months ended September 30, 2007, cash flows used in investing activities amounted to \$15.8 million, reflecting mainly the acquisition of property, plant and equipment of \$15.5 million. For the corresponding period of the prior year, cash flows used in investing activities were \$32.0 million reflecting business combinations of \$19.4 million and the acquisition of property, plant and equipment of \$12.6 million. The amount included in business combinations in the prior year reflects mainly the acquisition by the Corporation of Board Dudes in January 2006.

Financial Position

(US \$ thousands)	September 30, 2007	December 31, 2006	September 30 2006
(unaudited)	\$	\$	\$
Working capital ⁽¹⁾	159,124	124,725	158,643
Property, plant and equipment	48,316	43,213	42,872
Total assets	811,868	800,442	842,349
Total long-term debt	321,559	311,954	334,358

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

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

Inventories decreased to \$120.0 million as at September 30, 2007 compared to \$140.6 million at the end of 2006. During the first nine months of the year, the Corporation built up inventories of basic products related to its Toys product lines in advance of the holiday season while selling excess inventory and reducing the carrying value of certain inventories. The Corporation's objective is to further reduce inventory levels to a range of approximately \$90 million to \$100 million by the end of 2007. Accounts payable and accrued liabilities decreased by \$47.4 million since December 31, 2006 to \$106.0 million due to timing of purchases and payments to suppliers. Total long-term debt at the end of September 2007 was \$321.6 million compared to \$312.0 million at the end of 2006. The increase in long-term debt is mainly related to working capital requirements.

As at September 30, 2007, the Corporation's long-term debt was comprised mainly of \$9.6 million under its Term A facility maturing in 2009, \$254.8 million under its Term B facility maturing in 2012 and \$60.6 million drawn against its \$120.0 million revolving credit facility, offset partially by unamortized deferred financing costs of \$3.9 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 September 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 September 30, 2007, the Corporation had entered into foreign currency forward contracts to sell Euro 7.8 million and GBP 2.9 million at average rates of 1.3391 and 1.9375 respectively, maturing up to December 2008. The fair value of these forward contracts as at September 30, 2007 is \$1.0 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.

In 2005, The Corporation entered into interest swap agreements 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 September 30, 2007 the fair value of these swaps was \$0.9 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 \$2.6 million loss, net of income taxes, for the three months ended September 30, 2007 and a \$1.2 million loss, net of income taxes, for the nine months ended September 30, 2007. Please refer to "Section 1530, Comprehensive Income" on page 15 for further information.

Outlook for 2007

With the integration of MEGA Brands America essentially completed, the Corporation began to realize in Q3 2007 the impact of certain product cost reductions. These are estimated to reduce cost of sales by \$7-10 million on an annualized basis. The Corporation's objective is to reduce inventory levels to a range of approximately \$90 million to \$100 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 \$6.2 in the first half of 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:

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

Other information:

- 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
	\$	\$	\$
Assets			
Deferred charges	(3,281)	-	(3,281)
Derivative financial instruments	-	2,828	2,828
	(3,281)	2,828	(453)
Liabilities			
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)
Shareholder's equity (deficiency)			
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

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 June 30, 2007	1,399
Accumulated other comprehensive income as at June 30, 2007	3,150
Other comprehensive loss, net of taxes, for the period ended September 30, 2007	(2,583)
Accumulated other comprehensive income as at September 30, 2007	567

Consolidated statements of other comprehensive income

(US \$ thousands)	
(Unaudited)	
	\$
Net loss as at September 30, 2007	(30,976)
Loss on derivatives designated as cash flow hedges as at September 30, 2007	(1,184)
Other comprehensive loss for the period ended September 30, 2007	(32,160)

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

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.

Toy Recalls

The toy industry has recently been the subject of a highly publicized and unprecedented number of product recalls primarily related to the presence of lead in paint used to decorate children's toys and the use of magnets in toys. The result has been a higher cost and scarcity of labour and other resources required to fill the industry's production needs, particularly in relation to products manufactured in Asia. Furthermore, to entice Asian manufacturers to complete orders in a timely fashion, certain toy companies have been offering more favourable payment terms. This trend is expected to continue for the foreseeable future. There can be no assurance that these risks will not result in a material adverse effect on our financial condition and results of operations.

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 12,000 consumer calls were received between April 19, 2007 and November 8, 2007 bringing the total to approximately 33,000 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. A further \$2.6 million was received in September 2007 and this amount has been included in the Corporation's consolidated statement of earnings for the three and nine-month periods ended September 30, 2007. The limits of certain primary insurers' policies have now been exhausted and discussions with the Corporation's excess insurers concerning additional payments are now ongoing.

On September 14, 2006 and on December 5, 2006, two lawsuits related to magnet ingestion requiring surgical removal were served on the Corporation. The former lawsuit was settled out of court by the Corporation's insurers on October 9, 2007. The terms of settlement are confidential. The remaining lawsuit is 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 fourteen 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 November 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.

On March 28, 2007, the Corporation learned that a competitor who sells magnetic building sets primarily in Europe, Plastwood S.R.L. and its U.S. affiliate, Plastwood Corporation, filed a complaint against the Corporation in the U.S. District Court for the Western District of Washington alleging damages for false advertising and unfair and deceptive acts and practices. On October 22, 2007, the Court granted the Corporation's motion to dismiss the complaint against MEGA Brands Inc. for lack of personal jurisdiction and additionally granted, in part, the motion of the remaining defendant, MEGA Brands America, Inc., to dismiss the majority of the claims for failure to state a claim upon which relief may be granted. The Court allowed the complaint to proceed to discovery only as to the plaintiffs' claim that certain unidentified structures depicted on MAGNETIX packaging are not capable of being assembled as shown and that those images constitute false advertising in violation of section 43 (a) of the U.S. Lanham Act. The Court's interim order is subject to appeal once the case is concluded as a final matter. Although the Corporation believes that it has valid defenses to the remaining claim, there can be no assurance that its contestation on the merits will be successful or that its impact will not be material. No amount has been reserved as at November 8, 2007.

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. LEGO has appealed the German trademark cancellation decisions to the German Federal Supreme Court and there can be no assurances that the Corporation or the third party in the related decision will prevail in their respective appeals or in any further proceedings. On June 12, 2007, the Court of Appeals for Den Bosch, the Netherlands, overturned a lower court ruling from 2005 in an unfair competition case, which ruling had prevented the Corporation from introducing its Lego and Duplo compatible construction toys to that country. The Corporation has since begun to offer its Mini and Micro MEGA BLOKS products to customers in the Netherlands, although the Den Bosch Court of Appeals decision has been appealed by LEGO to the Dutch Supreme Court, and there can be no assurance that the Corporation will prevail in this appeal or in any further proceedings.

Non-GAAP Financial Measures

The terms "impact of the MAGNETIX product recall and other charges, litigation expenses, the sale of excess inventory and the recording of a non-cash inventory revaluation adjustment" and "excluding the impact of the MAGNETIX product recall and other charges, litigation expenses, the sale of excess inventory and the recording of a non-cash inventory revaluation adjustment" 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 November 8, 2007. Additional information about MEGA Brands, including our Annual Information Form, is available on SEDAR at www.sedar.com.



Consolidated statements of earnings

(in thousands of US dollars, except per share data)

(Unaudited)

	Three-month periods ended September 30,		Nine-month periods ended September 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Net sales	184,105	201,778	395,697	382,542
Cost of sales (Note 9)	148,279	111,231	303,230	215,550
Gross profit	35,826	90,547	92,467	166,992
Marketing and advertising expenses	4,794	8,178	15,565	16,246
Research and development expenses	5,379	5,079	17,064	12,476
Other selling, distribution and administrative expenses	34,604	36,604	90,902	84,788
Voluntary product recall and replacement (Note 9)	-	183	4,700	1,617
Litigation expenses (Note 14)	2,300	669	4,613	1,091
Product liability settlement (reimbursement) and related expenses (Note 14)	(2,600)	13,859	(3,600)	14,027
Gain on foreign currency translation	(3,582)	(404)	(5,040)	(3,988)
Earnings (loss) from operations	(5,069)	26,379	(31,737)	40,735
Interest expenses				
Interest on long-term debt	6,727	6,126	19,276	16,107
Amortization of deferred financing costs	260	179	552	487
Other interest	21	(171)	(33)	(194)
	7,008	6,134	19,795	16,400
Earnings (loss) before income taxes	(12,077)	20,245	(51,532)	24,335
Income taxes (Note 5)				
Current	3,244	11,108	1,476	3,909
Future	(4,293)	(8,822)	(22,032)	(2,161)
	(1,049)	2,286	(20,556)	1,748
Net earnings (loss)	(11,028)	17,959	(30,976)	22,587
Earnings (loss) per share (Note 10)				
Basic	(0.31)	0.56	(0.92)	0.70
Diluted ⁽¹⁾	(0.31)	0.53	(0.92)	0.66

(1) The dilutive effect of outstanding options under the treasury stock method for the three-month and the nine-month periods ended September 30, 2007 is nil as it is anti-dilutive.



Consolidated statements of retained earnings (deficit)

(in thousands of US dollars)

(Unaudited)

	Three-month periods ended September 30,		Nine-month periods ended September 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Balance, beginning of period	(7,312)	(8,084)	12,636	(12,712)
Net earnings (loss)	(11,028)	17,959	(30,976)	22,587
Balance, end of period	(18,340)	9,875	(18,340)	9,875

Consolidated statements of comprehensive income and Accumulated other comprehensive income

(in thousands of US dollars)

(Unaudited)

	Three-month periods ended September 30,		Nine-month periods ended September 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Net earnings (loss) for the period	(11,028)	17,959	(30,976)	22,587
Other comprehensive income, net of income taxes				
Loss on derivatives designated as cash flow hedges	(2,583)	-	(1,184)	-
Comprehensive income (loss) for the period	(13,611)	17,959	(32,160)	22,587
Accumulated other comprehensive income				
Balance, beginning of period	3,150	-	-	-
Impact of adopting the new accounting policy regarding financial instruments, net of income taxes	-	-	1,751	-
Other comprehensive loss, net of income taxes	(2,583)	-	(1,184)	-
Balance, end of period	567	-	567	-



Consolidated balance sheets

(in thousands of US dollars)

	September 30, 2007 (Unaudited)	December 31, 2006 (Audited)	September 30, 2006 (Unaudited)
	\$	\$	\$
Assets			
Current assets			
Cash and cash equivalents	8,928	13,658	9,696
Accounts receivable	163,946	161,612	209,412
Inventories	119,971	140,630	137,742
Income taxes	8,965	9,317	8,753
Future income taxes	14,911	8,354	29,799
Prepaid expenses	15,702	12,025	9,148
	332,423	345,596	404,550
Property, plant and equipment	48,316	43,213	42,872
Intangible assets	78,967	79,517	71,986
Goodwill	301,988	300,829	318,962
Derivative financial instruments (Note 3)	916	-	-
Future income taxes	49,258	28,006	-
Deferred charges	-	3,281	3,979
	811,868	800,442	842,349
Liabilities			
Current liabilities			
Accounts payable and accrued liabilities	105,991	153,437	180,656
Additional consideration accrued on business combination (Note 11 and 14)	57,825	57,825	55,712
Derivative financial instruments (Note 3)	988	-	-
Current portion of long-term debt	8,495	9,609	9,539
	173,299	220,871	245,907
Long-term debt (Note 3)	313,064	302,345	324,819
Future income taxes	34,121	27,782	27,354
	520,484	550,998	598,080
Shareholders' equity			
Capital stock (Note 4)	308,598	236,088	233,294
Contributed surplus	559	720	1,100
Retained earnings (deficit)	(18,340)	12,636	9,875
Accumulated other comprehensive income net of income taxes	567	-	-
	291,384	249,444	244,269
	811,868	800,442	842,349

Contingencies (Note 14)



Consolidated statements of cash flows

(in thousands of US dollars)
(Unaudited)

	Three-month periods ended September 30,		Nine-month periods ended September 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Cash flows from operating activities				
Net earnings (loss)	(11,028)	17,959	(30,976)	22,587
Items not affecting cash and cash equivalents				
Amortization of property, plant and equipment	3,568	3,109	9,977	9,224
Amortization of intangible assets	182	26	550	188
Amortization of deferred charges	-	315	-	846
Stock-based compensation plans	157	778	57	1,436
Future income taxes	(4,293)	(8,822)	(22,032)	(2,161)
Gain on disposal of property, plant and equipment	(20)	-	(260)	-
Gain on foreign currency	(678)	(193)	(295)	(2,631)
	(12,112)	13,172	(42,979)	29,489
Changes in non-cash operating working capital items (Note 12)	970	(39,397)	(31,245)	(42,278)
	(11,142)	(26,225)	(74,224)	(12,789)
Cash flows from financing activities				
Repayment of long-term debt	(2,414)	(22,641)	(7,133)	(26,594)
Change in revolving credit facility	(48,400)	54,000	20,600	60,000
Amortization of deferred financing costs	260	-	552	-
Issuance of capital stock	70,519	537	71,293	1,522
	19,965	31,896	85,312	34,928
Cash flows from investing activities				
Acquisition of property, plant and equipment	(3,681)	(4,211)	(15,457)	(12,644)
Proceeds from disposal of property, plant and equipment	-	-	798	54
Business combinations (Note 11)	(817)	(1,920)	(1,159)	(19,420)
	(4,498)	(6,131)	(15,818)	(32,010)
Decrease in cash and cash equivalents	4,325	(460)	(4,730)	(9,871)
Cash and cash equivalents, beginning of period	4,603	10,156	13,658	19,567
Cash and cash equivalents, end of period	8,928	9,696	8,928	9,696
Supplementary disclosure of cash flow information				
Interest paid	6,570	5,542	19,101	15,920
Income taxes paid (recovered)	1,300	2,633	(794)	16,507



Notes to interim consolidated financial statements

For the three-month and nine-month periods ended September 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 customer charges 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 are carried at fair value in the consolidated balance sheet, including those derivatives that are embedded in other contracts but are not considered to be closely related to the host contract.

Section 3865, Hedges

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



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

Other information:

- 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 \$
Assets			
Deferred charges	(3,281)	-	(3,281)
Derivative financial instruments	-	2,828	2,828
	(3,281)	2,828	(453)
Liabilities			
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)
Shareholder's equity (deficiency)			
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 June 30, 2007	1,399
Accumulated other comprehensive income as at June 30, 2007	3,150
Other comprehensive loss, net of taxes, for the period ended September 30, 2007	(2,583)
Accumulated other comprehensive income as at September 30, 2007	567

Consolidated statements of other comprehensive income

(US \$ thousands)	
(Unaudited)	\$
Net loss as at September 30, 2007	-
Loss on derivatives designated as cash flow hedges as at September 30, 2007	(1,184)
Other comprehensive loss for the period ended September 30, 2007	(1,184)

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



4. Capital stock

As at September 30, 2007, there were 36,592,101 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 September 30, 2007, a total of 4,915,689 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 New Stock Option Plan, as approved by the relevant regulatory authorities, allows for a significantly higher dilution rate when the available option grants under such plan are combined with option grants under the Initial Plan.

The following table summarizes total stock options outstanding for the nine-month periods ending September 30, under the Corporation's stock option plans:

	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	(77,188)	13.83	(152,361)	11.41
Forfeited	(2,200)	20.73	(6,467)	22.63
Options outstanding, end of period	2,586,218	9.03	3,075,030	8.86
Options exercisable, end of period	2,586,218	9.03	3,013,902	8.61



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 nine-month periods ended September 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 are settled in shares purchased from the secondary market, or in cash, at the option of the Corporation.

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

	2007	2006
	Number of units	Number of units
Units outstanding, beginning of the period	354,984	65,768
Granted	136,739	295,028
Exercised	(1,010)	(637)
Forfeited	(4,144)	(5,175)
Units outstanding, end of period	486,569	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 following table summarizes the DSU Plan for the nine-month period ending September 30, under the Corporation's DSU Plan:

	2007	2006
	Number of units	Number of units
Units outstanding, beginning of the period	-	-
Granted	14,503	-
Exercised	-	-
Forfeited	-	-
Units outstanding, end of period	14,503	-



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 \$22.3 million to September 30, 2007 related to the expanded MAGNETIX product recall and other charges, leaving an accrual of \$12.9 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 September 30,		Nine-month periods ended September 30,	
	2007	2006	2007	2006
Numerator for basic and diluted net earnings (loss) per common share:				
Net earnings (loss) attributable to common shareholders	\$ (11,028)	\$ 17,959	\$ (30,976)	\$ 22,587
Denominator for basic net earnings (loss) per common shares:				
Weighted average number of common shares outstanding	35,574,486	32,224,335	33,670,899	32,176,070
Basic earnings (loss) per share	\$ (0.31)	\$ 0.56	\$ (0.92)	\$ 0.70
Denominator for diluted net earnings (loss) per common share:				
Weighted average number of common shares outstanding	35,574,486	32,224,335	33,670,899	32,176,070
Plus impact of stock options ⁽¹⁾	1,379,160	1,886,999	1,536,587	1,979,099
Diluted average number of common shares ⁽¹⁾	36,953,646	34,111,334	35,207,486	34,155,169
Diluted earnings (loss) per share ⁽¹⁾	\$ (0.31)	\$ 0.53	\$ (0.92)	\$ 0.66

⁽¹⁾ The dilutive effect of outstanding options under the treasury stock method for the three-month and the nine-month periods ended September 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. This amount was paid during the third quarter of 2007.

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

	September 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 September 30,		Nine-month periods ended September 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Accounts receivable	(32,854)	(112,143)	(2,334)	(32,796)
Inventories	42,595	(1,583)	20,659	(53,893)
Prepaid expenses	(4,196)	(787)	(3,677)	(742)
Income taxes	269	7,576	352	(13,497)
Accounts payable and accrued liabilities	(6,388)	63,358	(47,455)	70,456
Additional consideration accrued on business combination	(817)	-	-	(3,678)
Foreign currency translation relating to working capital items	2,361	4,182	1,210	(8,128)
	970	(39,397)	(31,245)	(42,278)



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 September 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 November 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. A further \$2.6 million was received in September 2007 and this amount has been included in the Corporation's consolidated statement of earnings for the three and nine-month periods ended September 30, 2007. The limits of certain primary insurers' policies have now been exhausted and discussions with the Corporation's excess insurers concerning additional payments are now ongoing.

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, three 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 fourteen 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 November 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 its U.S. affiliate, Plastwood Corporation, filed a complaint against the Corporation in the U.S. District Court for the Western District of Washington alleging damages for false advertising and unfair and deceptive acts and practices. On October 22, 2007, the Court granted the Corporation's motion to dismiss the complaint against MEGA Brands Inc. for lack of personal jurisdiction and additionally granted, in part, the motion of the remaining defendant, MEGA Brands America, Inc., to dismiss the majority of the claims for failure to state a claim upon which relief may be granted. The Court allowed the complaint to proceed to discovery only as to the plaintiffs' claim that certain unidentified



structures depicted on MAGNETIX packaging are not capable of being assembled as shown and that those images constitute false advertising in violation of section 43 (a) of the U.S. Lanham Act. The Court's interim order is subject to appeal once the case is concluded as a final matter. Although the Corporation believes that it has valid defenses to the remaining claim, there are no assurances that its contestation on the merits will be successful or that its impact will not be material. No amount has been reserved as at November 8, 2007.

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. LEGO has appealed the German trademark cancellation decisions to the German Federal Supreme Court and there can be no assurances that the Corporation or the third-party in the related decision will prevail in their respective appeals or in any further proceedings. On June 12, 2007, the Court of Appeals for Den Bosch, the Netherlands, overturned a lower court ruling from 2005 in an unfair competition case, which ruling had prevented the Corporation from introducing its Lego and Duplo compatible construction toys to that country. The Corporation has since begun to offer its Mini and Micro MEGA BLOKS products to customers in the Netherlands, although the Den Bosch Court of Appeals decision has been appealed by LEGO to the Dutch Supreme Court, and there can be no assurances that the Corporation will prevail in this appeal or in any further proceedings.

15. 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.

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



Segmented information	Three-month periods ended September 30,		Nine-month periods ended September 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Net sales				
Toys	111,562	126,522	223,622	210,554
Stationery and activities	72,543	75,256	172,075	171,988
	184,105	201,778	395,697	382,542

Geographic information	Three-month periods ended September 30,		Nine-month periods ended September 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Net sales				
North America ⁽¹⁾	117,715	141,862	271,051	280,879
International	66,390	59,916	124,646	101,663
	184,105	201,778	395,697	382,542

⁽¹⁾ Includes net sales for Canada in 2007 for the three-month periods of \$11.4 million (\$11.6 million in 2006), and for the nine-month periods of \$20.2 million (\$19.0 million in 2006).

	Three-month periods ended September 30,		Nine-month periods ended September 30,	
	2007	2006	2007	2006
	\$	\$	\$	\$
Earnings (loss) from operations				
North America	3,322	16,419	(29,934)	23,117
International	(8,391)	9,960	(1,803)	17,618
	(5,069)	26,379	(31,737)	40,735

	As at September 30,	
	2007	2006
	\$	\$
Property, plant and equipment, intangible assets and goodwill		
North America ⁽¹⁾	347,841	426,448
International	81,430	7,372
	429,271	433,820

⁽¹⁾ Includes property, plant and equipment for Canada in 2007 for the nine-month periods of \$33.1 million (\$31.5 million in 2006).

16. Comparative figures

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

