



# Q2

**Quarterly Report**  
 Second quarter ended  
**June 30, 2008**

## Financial Highlights

| (in million US dollars, except per share data)<br>(Unaudited) | Three-month periods<br>ended June 30, |       | Six-month periods<br>ended June 30, |        |
|---|---------------------------------------|-------|-------------------------------------|--------|
|   | 2008                                  | 2007  | 2008                                | 2007   |
|   | \$                                    | \$    | \$                                  | \$     |
| Net sales   | 106.4                                 | 121.5 | 185.8                               | 211.6  |
| Earnings (loss) from operations                               | (2.4)                                 | 8.7   | (13.1)                              | (26.7) |
| Net earnings (loss)   | (3.6)                                 | 4.0   | (13.2)                              | (19.9) |
| Earnings (loss) per share                                     |                                       |       |                                     |        |
| Basic   | (0.10)                                | 0.12  | (0.36)                              | (0.61) |
| Diluted <sup>(1)</sup>  | (0.10)                                | 0.12  | (0.36)                              | (0.61) |

<sup>(1)</sup> The dilutive effect of outstanding options under the treasury stock method for the three-month period ended June 30, 2008 and six-month periods ended June 30, 2008 and 2007 is nil as it is anti-dilutive.

## Stock Exchange

Toronto Stock Exchange: MB

## Shares Outstanding

(as at June 30, 2008)  
 36,612,202 Common Shares

## Trading History

| TSX             | (CA\$)  |
|-----------------|---------|
|                 | Q2 2008 |
| High:           | \$4.78  |
| Low:            | \$3.25  |
| Close:          | \$4.07  |
| Average volume: | 84,618  |

## Transfer Agent

CIBC Mellon Trust Company  
 1.800.387.0825

## Investor Relations

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## Management's Discussion and Analysis For the second quarter ended June 30, 2008

The following Management's Discussion and Analysis of Financial Position and Results of Operations ("MD&A") for MEGA Brands Inc. (formerly Mega Bloks Inc.) and its subsidiaries (referred to hereunder as "MEGA Brands", the "Corporation", "we", "our" and "us"), should be read in conjunction with the unaudited Consolidated Financial Statements and Notes thereto for the interim periods ended June 30, 2008 and 2007 as well as the audited consolidated financial statements and the MD&A for the year ended December 31, 2007. The financial information in this MD&A and in our financial statements has been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") of the Canadian Institute of Chartered Accountants ("CICA"). We also present certain non-GAAP financial measures, which we believe are useful to investors for comparing our performance from period to period. Please refer to the "Non-GAAP Financial Measures" section of this MD&A. This MD&A is current as of August 18, 2008.

All figures in this MD&A are expressed in U.S. dollars, (reporting and functional currency) 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: financing and interest rate matters, difficulty in predicting consumer preferences and development and acceptance of new products, risks related with product recalls, litigation and its inherent uncertainty, including the recovery of the full product liability settlement amount, realization of synergies, international operations, insurance coverage, growth or profitability, dependence on a few large customers, fluctuations in the price of plastic resins and other raw materials as well as currency rates, seasonality of toy and stationery industries, risks related to licensed products, retail environment, and construction toy litigation. The words "believe", "estimate", "expect", "intend", "anticipate", "foresee", "plan", and similar expressions and variations thereof, identify certain of such forward-looking statements, which speak only as of the date on which they are made. The Corporation disclaims any intention or obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, other than as required by applicable legislation. Readers are cautioned not to place undue reliance on these forward-looking statements. More information about the risks that could cause our actual results to significantly differ from our current expectations can be found in the "Risks and Uncertainties" section of the Corporation's 2007 annual MD&A and this MD&A. When we state that we expect to improve our financial performance through the implementation of our Value Enhancement Plan (the "VEP"), that we expect to generate additional annualized cost savings in specified amounts and that we have the financial resources and flexibility to meet working capital requirements leading up to the peak toy selling season, we have assumed that we will succeed in implementing our VEP, including the optimization of our product portfolio, in improving our business processes and strengthening of operations and supplier base in China, that we will succeed in realizing the cost and revenue synergies from the integration of MEGA Brands America and The Board Dudes, including without limitation, the synergies resulting from the downsizing and closing of manufacturing plants in North America and the concentration of distribution in our new facilities, that we will maintain or increase the quality of products manufactured in new locations, that we will be successful in reducing inventory levels, that we will maintain service levels in our new distribution facilities, that we will be able to attract and retain key personnel in key positions, that international markets that we service through our sales and marketing organization will have a strong interest both in ROSE ART brand and in other products that we will offer, and that the retail markets into which we sell will demonstrate strong demand for the Corporation's product lines. As described in the "Risks and Uncertainties" section of the Corporation's 2007 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 over 3,400 employees with offices, manufacturing facilities or distribution centers in 14 countries. The Corporation's products are sold in over 100 countries.

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

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

## Value Enhancement Plan

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

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

Subsequently, the Corporation completed the integration of MEGA Brands America. The Corporation closed its manufacturing and warehousing facility in Woodridge, New Jersey in December 2007. The remaining U.S. based production of MEGA Brands America was transferred to the Corporation's facilities in Canada and China or outsourced to Asian vendors. In addition, the Corporation opened another distribution center in Fife, Washington. The distribution activities of the Woodridge plant and of the Board Dudes were consolidated in the Corporation's expanded facilities in Fife. In January 2008, the Board Dudes was merged into MEGA Brands America and ceased to be a subsidiary. The Corporation has also streamlined its product portfolio and achieved operational and administrative synergies in its North American operations resulting in headcount reductions. These measures are expected to generate an additional \$12 million of annualized cost savings commencing in the second half of 2008.

On March 5, 2008, the Corporation announced its intention to explore the sale of its Stationery and Activities business. The sale of this business is being considered as a means of generating meaningful cash proceeds to reduce the Corporation's existing debt and allow the Corporation to place increased focus on its core toy business. The Corporation believes that this initiative will enable it to leverage its strengths and innovation culture by focusing on its core toy business, dedicate resources and management's attention to creating value through the execution of the VEP and provide a stronger and more flexible capital structure. The sale process is following its normal course.



## Recent Developments

On August 18, 2008, the Corporation executed a sixth amending agreement (the "Sixth Amendment") to its Credit Agreement dated July 26, 2005 providing for certain changes to the terms and conditions of its senior secured Credit Facilities maturing in 2012, including a waiver of the cumulative minimum EBITDA ratio covenant for the period ended June 30, 2008. Additionally, the Sixth Amendment introduces the concept of a new definition of the calculation of EBITDA allowing for the add-back of certain non-recurring and non-cash items. The covenant includes a minimum EBITDA at the end of each quarter up to and including June 30, 2010, at which point more stringent covenants previously in place under the Credit Agreement become effective. The revolving credit facility has been reduced to \$100 million.

On August 18, 2008, the Corporation announced the closing of a private placement offering of senior unsecured convertible debentures for gross proceeds of CA\$75 million. The proceeds of the Offering will be used as working capital and for general corporate purposes. The debentures, maturing on August 31, 2013, will bear interest at a rate of 8% payable semi-annually in arrears and will be convertible at the option of the holder at any time prior to the maturity date based on a conversion price equal to approximately CA\$3.19 per common share, subject to customary anti-dilution adjustments. The debentures will be convertible into 23,512,500 common shares, representing 39% of the common shares of the Corporation on an as converted basis. The debentures were issued to Fairfax Financial Holdings Ltd., Chiefswood Holdings Limited, The Owners Fund and Victor J. Bertrand Sr., the founder and chairman of the board of directors of the Corporation, with Fairfax investing CA\$64 million and Mr. Bertrand investing \$7 million in the offering. This financing was undertaken by the Corporation in connection with its consideration of its strategic alternatives, including the sale of its Stationery and Activities business. The financing was approved by the Toronto Stock Exchange and required certain amendments to the Corporation's credit facilities which were agreed to by the lenders.

Subsequent to the closing of the second quarter financial statements, the Corporation reached an agreement in principle with its insurers for the recovery of \$9.3 million in connection with a \$13.5 million settlement of lawsuits related to magnet ingestion recorded in 2006. The agreement in principle is subject to the timing of payment and usual documentation. The Corporation recovered \$3.6 million from its insurers in 2007.

On May 20, 2008, the Corporation welcomed Nicola Di Iorio as a director and a member of the Audit Committee of the Board of Directors. Mr. Di Iorio is a lawyer and a partner with the law firm Heenan Blaikie. A former professor at the law school of Sherbrooke University, he is a renowned expert in labour and employment law. The Corporation wishes to thank Jean-Guy Desjardins for his contribution as a director and chairman of the Audit Committee. Mr. Desjardins stepped down from the Board due to personal commitments. Keith B. Bowman, a director and member of the Audit Committee since 2007, has been appointed chairman of this committee.

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

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



products were approximately \$7.0 million in 2007 and costs related to these recalls were recorded in the Corporation's fourth quarter 2007 financial results.

## Selected Financial Information

The following table presents a summary of selected consolidated income statement data for the periods ended June 30, 2008 and 2007:

| (US \$ thousands, except per share data)<br>(Unaudited)    | Three-month periods<br>ended June 30, |                      |            |                      | Six-month periods<br>ended June 30, |                      |            |                      |
|--|---------------------------------------|----------------------|------------|----------------------|-------------------------------------|----------------------|------------|----------------------|
|  | 2008                                  |                      | 2007       |                      | 2008                                |                      | 2007       |                      |
|  | \$                                    | % of<br>Net<br>Sales | \$         | % of<br>Net<br>Sales | \$                                  | % of<br>Net<br>Sales | \$         | % of<br>Net<br>Sales |
| <b>Net sales</b>   | <b>106,385</b>                        | <b>100.0</b>         | 121,486    | 100.0                | <b>185,777</b>                      | <b>100.0</b>         | 211,592    | 100.0                |
| Cost of sales  | <b>71,630</b>                         | <b>67.3</b>          | 74,196     | 61.1                 | <b>123,219</b>                      | <b>66.3</b>          | 154,951    | 73.2                 |
| Gross profit   | <b>34,755</b>                         | <b>32.7</b>          | 47,290     | 38.9                 | <b>62,558</b>                       | <b>33.7</b>          | 56,641     | 26.8                 |
| Marketing and advertising expenses                         | <b>5,294</b>                          | <b>5.0</b>           | 4,464      | 3.7                  | <b>9,245</b>                        | <b>5.0</b>           | 10,771     | 5.1                  |
| Research and development expenses                          | <b>3,856</b>                          | <b>3.6</b>           | 6,428      | 5.3                  | <b>8,406</b>                        | <b>4.5</b>           | 11,685     | 5.5                  |
| Other selling, distribution and<br>administrative expenses | <b>26,008</b>                         | <b>24.4</b>          | 28,246     | 23.3                 | <b>53,566</b>                       | <b>28.8</b>          | 56,298     | 26.6                 |
| Voluntary product recall and replacement                   | -                                     | -                    | -          | -                    | -                                   | -                    | 4,700      | 2.2                  |
| Litigation expenses  | <b>2,311</b>                          | <b>2.2</b>           | 1,501      | 1.2                  | <b>3,453</b>                        | <b>1.9</b>           | 2,313      | 1.1                  |
| Product liability settlement and related expenses          | -                                     | -                    | (1,000)    | (0.8)                | -                                   | -                    | (1,000)    | (0.5)                |
| Loss (gain) on foreign currency translation                | <b>(336)</b>                          | <b>(0.3)</b>         | (1,027)    | (0.8)                | <b>1,019</b>                        | <b>0.5</b>           | (1,458)    | (0.7)                |
| Earnings (loss) from operations                            | <b>(2,378)</b>                        | <b>(2.2)</b>         | 8,678      | 7.1                  | <b>(13,131)</b>                     | <b>(7.1)</b>         | (26,668)   | (12.6)               |
| Interest and other expenses                                | <b>1,282</b>                          | <b>1.2</b>           | 6,664      | 5.5                  | <b>7,683</b>                        | <b>4.1</b>           | 12,787     | 6.0                  |
| Earnings (loss) before income taxes                        | <b>(3,660)</b>                        | <b>(3.4)</b>         | 2,014      | 1.7                  | <b>(20,814)</b>                     | <b>(11.2)</b>        | (39,455)   | (18.6)               |
| Income taxes recovery                                      | <b>(88)</b>                           | <b>(0.1)</b>         | (1,948)    | (1.6)                | <b>(7,594)</b>                      | <b>(4.1)</b>         | (19,507)   | (9.2)                |
| <b>Net earnings (loss)</b>                                 | <b>(3,572)</b>                        | <b>(3.4)</b>         | 3,962      | 3.3                  | <b>(13,220)</b>                     | <b>(7.1)</b>         | (19,948)   | (9.4)                |
| Earnings (loss) per share                                  |                                       |                      |            |                      |                                     |                      |            |                      |
| Basic  | <b>(0.10)</b>                         |                      | 0.12       |                      | <b>(0.36)</b>                       |                      | (0.61)     |                      |
| Diluted  | <b>(0.10)</b>                         |                      | 0.12       |                      | <b>(0.36)</b>                       |                      | (0.61)     |                      |
| Weighted average number<br>of outstanding shares           |                                       |                      |            |                      |                                     |                      |            |                      |
| Basic  | <b>36,612,202</b>                     |                      | 32,714,373 |                      | <b>36,603,579</b>                   |                      | 32,151,538 |                      |
| Diluted  | <b>36,612,202</b>                     |                      | 34,250,489 |                      | <b>36,603,579</b>                   |                      | 32,151,538 |                      |

1. The dilutive effect of outstanding options under the treasury stock method for the three-month period ended June 30, 2008 and for the six-month periods ended June 30, 2007 and June 30, 2008 is nil as it is anti-dilutive.



The following table presents a summary of selected Canadian dollar data for the three-month and six-month periods ended June 30, 2008 and 2007 as supplementary information for Canadian investors:

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

| (in thousands of Canadian dollars, except per share data) | Three-month periods<br>ended June 30, |         | Six-month periods<br>ended June 30, |          |
|---|---------------------------------------|---------|-------------------------------------|----------|
|   | 2008                                  | 2007    | 2008                                | 2007     |
| (Unaudited)   | \$                                    | \$      | \$                                  | \$       |
| Net sales   | <b>108,364</b>                        | 123,746 | <b>189,232</b>                      | 215,528  |
| Net earnings (loss)                                       | <b>(3,638)</b>                        | 4,036   | <b>(13,466)</b>                     | (20,319) |
| Earnings (loss) per share                                 |                                       |         |                                     |          |
| Basic   | <b>(0.10)</b>                         | 0.12    | <b>(0.37)</b>                       | (0.62)   |
| Diluted   | <b>(0.10)</b>                         | 0.12    | <b>(0.37)</b>                       | (0.62)   |

1. US Dollar financial data is converted into Canadian dollars as at June 30, 2008 period end exchange rate of CA\$1.0186 per US\$1.00, using the translation of convenience method.

## Results of Operations

### Net Sales

Net sales in the second quarter of 2008 decreased 12.4% to \$106.4 million compared to \$121.5 million in the corresponding period last year. This decrease reflects lower sales in the Toys and Stationery and Activities product lines as well as additional product recall charges.

Net sales of our Toys product lines declined to \$47.3 million compared to \$57.9 million in the second quarter of 2007. This decrease is due mainly to lower shipments of licensed toys in the Boys 5-plus category, offsetting increased sales of preschool construction toys. In the second quarter of 2007, the Corporation experienced strong sales of licensed products based on two major theatrical releases, Disney's "Pirates of the Caribbean: At World's End" and Marvel's "Spider-Man 3". The decrease in sales also reflects \$2.5 million of additional product recall charges related to MAGTASTIK and MAGNAMAN.

Net sales of Stationery and Activities product lines declined to \$59.1 million compared to \$63.6 million in the second quarter of 2007. This decrease is explained mainly by lower shipments of lower-margin children's activity products which have been discontinued under the Corporation's SKU rationalization program.

On a geographical basis, net sales in North America decreased to \$71.1 million compared to \$87.1 million in the second quarter of 2007. International net sales increased to \$35.3 million compared to \$34.3 million in the second quarter of 2007. International net sales accounted for 33.1% of total net sales in the second quarter of 2008 compared to 28.3% in the corresponding 2007 period.

For the six months ended June 30, 2008, net sales decreased to \$185.8 million compared to \$211.6 million in the same period last year. Sales of Toys declined to \$92.7 million compared to \$112.1 million in the first six months of 2007. This decrease is explained mainly by lower sales in the Boys 5-plus category which more than offset a strong performance in preschool construction. Sales of Stationery and Activities products decreased to \$93.1 million compared to \$99.5 million in the corresponding 2007 period. North American sales were \$123.4 million compared to \$153.3 million in the first six months of 2007, while International sales increased to \$62.4 million or 33.6% of total net sales, compared to \$58.3 million or 27.5% of total net sales for the first six months of 2007.

### Cost of Sales

Cost of sales was \$71.6 million compared to \$74.2 million in the second quarter of 2007. The Corporation continued to experience higher input costs and cost of sales also reflects the underutilization of its manufacturing facilities in Montreal and China.

For the six months ended June 30, 2008, cost of sales was \$123.2 million compared to \$155.0 million in the first six months of 2007. The 2007 figure includes voluntary product recall and other charges \$30.5 million.



## **Gross Profit**

Gross profit was \$34.8 million compared to \$47.3 million in the second quarter of 2007. Gross margin declined to 32.7% compared to 38.9% in the second quarter of 2007, mainly as a result of higher costs, unfavorable product mix due to lower sales of construction toys in the Boys 5-plus category as well as additional product recall charges.

For the six months ended June 30, 2008, gross profit was \$62.6 million and gross margin was 33.7% compared to \$56.6 million and 26.8% in the same 2007 period. Excluding voluntary product recall and other charges of \$30.5 million, gross margin in the first six months of 2007 was 41.2%.

## **Operating Expenses**

Marketing and advertising expenses increased to \$5.3 million compared to \$4.5 million in the second quarter of 2007. This increase reflects higher advertising spending in International markets. For the six months ended June 30, 2008, marketing and advertising expenses were \$9.2 million compared to \$10.8 million in the corresponding period last year.

Research and development expenses decreased to \$3.9 million compared to \$6.4 million in the second quarter of 2007. This decrease reflects mainly a reduction in third-party services, the completion of upfront R&D work for the new MagNext product line and cost savings resulting from the Corporation's SKU rationalization program. For the six months ended June 30, 2008, research and development expenses were \$8.4 million compared to \$11.7 million. This decrease is due mainly to the factors noted above and the timing of new product releases.

Other selling, distribution and administrative expenses decreased to \$26.0 million compared to \$28.2 million in the second quarter of 2007. This decrease reflects mainly a reduction in administrative expenses as well as lower warehousing costs offset by higher direct distribution costs. The Corporation recorded integration charges of \$0.9 million during the period relating to the centralization of distribution activities in North America. For the six months ended June 30, 2008, other selling, distribution and administrative expenses decreased to \$53.6 million compared to \$56.3 million in the corresponding 2007 period. Selling, distribution and administrative expenses for the first six months of 2008 include integration charges totaling \$2.2 million.

## **Loss from Operations**

Loss from operations was \$2.4 million compared to earnings from operations of \$8.7 million in the second quarter of 2007. In North America, loss from operations was \$11.3 million compared to earnings from operations of \$2.8 million in the second quarter of 2007. For the International segment, earnings from operations were \$8.9 million compared to \$5.9 million in the second quarter of 2007.

For the six months ended June 30, 2008, loss from operations was \$13.1 million compared to \$26.7 million in the corresponding period of 2007. The 2007 figure includes voluntary product recall and other charges of \$30.5 million, net of the recovery of \$1.0 million in product liability settlement from our insurers. Loss from operations in North America was \$23.1 million compared to \$33.3 million in the same 2007 period while earnings from operations in the International market amounted to \$9.9 million compared to \$6.6 million in the 2007 period.

## **Non-Operating Expenses**

Total interest expense was \$1.3 million compared to \$6.7 million in the second quarter of 2007. Interest on long-term debt and other interest declined to \$6.2 million compared to \$6.5 million in the second quarter of 2007, reflecting lower indebtedness. During the second quarter of 2008, the Corporation recorded an unrealized gain of \$5.6 million on derivative financial instruments related to the interest rate swap on part of its Term B credit facility.

For the six months ended June 30, 2008, interest and other expenses declined to \$7.7 million compared to \$12.8 million in the same 2007 period.

## **Income Taxes**

Income tax recovery was \$0.1 million compared to a recovery of \$1.9 million in the second quarter of 2007. For the six months ended June 30, 2008, income tax recovery was \$7.6 million compared to a recovery of \$19.5 million in the first six months of 2007, which reflected voluntary product recall and other charges recorded in the first quarter of 2007. The tax rate used to establish the income tax expense for the quarterly results is the applicable estimated effective rate of each entity of the group. The effective tax rate reflects the Corporation's



structure for tax purposes as well as the financing structure put in place following the acquisition of MEGA Brands America.

The future income tax assets are presented net of valuation allowance of \$28.9 million, as at June 30, 2008, and \$27.8 million as at December 31, 2007.

### Net Loss

Net loss was \$3.6 million or \$0.10 diluted loss per share compared to net earnings of \$4.0 million or \$0.12 diluted earnings per share in the second quarter of 2007.

For the six months ended June 30, 2008, net loss was \$13.2 million or \$0.36 per diluted share, compared to \$19.9 million, or \$0.61 per diluted share in the corresponding 2007 period.

### Shares Outstanding

As at August 13, 2008, there was a total of 36,612,202 common shares outstanding for a total book value of \$308.7 million and 2,545,512 stock options outstanding.

### 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.

### Selected Quarterly Financial Information

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

| (in thousands of US dollars , except per share data) | Q2-08           | Q1-08    | Q4-07    | Q3-07    | Q2-07    | Q1-07    | Q4-06   | Q3-06    |
|--|-----------------|----------|----------|----------|----------|----------|---------|----------|
| (Unaudited)  |                 |          |          |          |          |          |         |          |
| Net sales  | <b>106,385</b>  | 79,392   | 128,819  | 184,105  | 121,486  | 90,106   | 164,805 | 201,778  |
| <i>As a % of full year</i>                           | -               | -        | 24.6     | 35.1     | 23.2     | 17.2     | 30.1    | 36.9     |
| Gross profit   | <b>34,755</b>   | 27,803   | 28,691   | 35,826   | 47,290   | 9,351    | 51,533  | 90,547   |
| Earnings (loss) from operations                      | <b>(2,378)</b>  | (10,753) | (34,917) | (5,069)  | 8,678    | (35,346) | (1,026) | 26,379   |
| Net earnings (loss)                                  | <b>(3,572)</b>  | (9,648)  | (66,160) | (11,028) | 3,962    | (23,910) | 2,761   | 17,959   |
| Earnings (loss) per share – basic                    | <b>(0.10)</b>   | (0.26)   | (1.81)   | (0.31)   | 0.12     | (0.73)   | 0.09    | 0.56     |
| Earnings (loss) per share – diluted                  | <b>(0.10)</b>   | (0.26)   | (1.81)   | (0.31)   | 0.12     | (0.73)   | 0.08    | 0.53     |
| Cash flows from operating activities                 | <b>(13,067)</b> | (44,255) | 64,601   | (11,142) | (39,561) | (23,521) | 28,038  | (26,225) |



## 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

For the second quarter of 2008, cash flows used for operating activities were \$13.1 million, reflecting unfavorable changes in non-cash operating working capital due mainly to higher accounts receivable. For the second quarter of 2007, cash flows used for operating activities were \$39.6 million due primarily to unfavorable changes in non-cash operating working capital of \$45.8 million.

For the six months ended June 30, 2008, cash flows used for operating activities were \$57.3 million, due primarily to an unfavorable change in non-cash operating working capital items of \$43.2 million resulting from an increase in inventories and lower accounts payable and accrued liabilities. For the same 2007 period, cash flows used for operating activities were \$63.1 million due primarily to an unfavorable change in non-cash operating working capital items of \$32.2 million and cash flow used in operations before changes in non-cash working capital items of \$30.9 million. The unfavorable change in non-cash operating working capital items was mainly the result of a reduction in accounts payable and an increase in inventories, offset partially by a reduction in accounts receivable.

### Financing Activities

Cash flows from financing activities in the second quarter of 2008 were \$19.5 million, reflecting mainly a drawdown of \$26.5 million on the Corporation's revolving credit facility, and an unrealized gain of \$6.2 million on derivative financial instruments and the repayment of \$2.3 million of long-term debt. During this period, the Corporation continued to experience credit tightening by its suppliers in China. For the second quarter of 2007, cash flows from financing activities were \$43.7 million, reflecting mainly a drawdown of \$45.8 million on the Corporation's revolving credit facility and the repayment of \$2.3 million of long-term debt.

For the six months ended June 30, 2008, cash flows from financing activities amounted to \$64.0 million, reflecting mainly a draw-down of \$75.0 million of the Corporation's revolving credit facility and the repayment of \$4.7 million of long-term debt. For the same 2007 period, cash flows from financing activities amounted to \$65.3 million, reflecting mainly a draw-down of \$69.0 million of the Corporation's revolving credit facility and the repayment of \$4.7 million of long-term debt.

### Investing Activities

Cash flows used for investing activities in the second quarter of 2008 were \$2.8 million compared to \$5.5 million in the corresponding 2007 period. For the six months ended June 30, 2008, cash flows used for investing activities were \$7.4 million compared to \$11.3 million in the same 2007 period. The decreases in both periods partly reflect the benefits of a lower product count as well as the timing of new product releases.



## Balance Sheets

| (in thousands of US dollars)   | June 30,<br>2008 | December 31,<br>2007 | June 30,<br>2007 |
|--------------------------------|------------------|----------------------|------------------|
| (Unaudited)                    | \$               | \$                   | \$               |
| Working capital <sup>(1)</sup> | 104,336          | 58,761               | 146,798          |
| Property, plant and equipment  | 43,239           | 42,620               | 48,199           |
| Total assets                   | 744,140          | 709,714              | 808,700          |
| Long-term debt                 | 330,849          | 260,744              | 373,140          |

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

Since December 31, 2007, there have been significant changes to inventories, accounts payable and accrued liabilities and long-term debt.

Inventories increased to \$112.2 million as at June 30, 2008 compared to \$91.7 million at the end of 2007, reflecting the customary build-up of inventories in anticipation of back-to-school shipments and the resetting of store shelves by toy retailers for the Fall season.

Accounts payable and accrued liabilities as at June 30, 2008 decreased to \$112.3 million compared to \$136.6 million at the end of 2007 due to timing of purchases and payments to suppliers. Long-term debt at the end of the second quarter was \$330.8 million compared to \$260.7 million at the end of 2007, reflecting the drawdown of \$77 million on the Corporation's revolving credit facilities (\$2.0 million as at December 31, 2007 plus \$75 million in 2008).

As at June 30, 2008, the Corporation's debt was comprised primarily of \$4.8 million under its Term A facility maturing in 2009, \$252.9 million under its Term B facility maturing in 2012 and \$77 million drawn against its revolving credit facility. The Corporation held cash and cash equivalents of \$7.7 million and had exhausted the availabilities under its revolving credit facilities pursuant to the terms and conditions of the fifth amending agreement to its Credit Agreement signed on March 28, 2008.

On August 18, 2008, the Corporation executed a sixth amending agreement (the "Sixth Amendment") to its Credit Agreement dated July 26, 2005 providing for certain changes to the terms and conditions of its senior secured Credit Facilities maturing in 2012, including a waiver of the cumulative minimum EBIDTA ratio covenant for the period ended June 30, 2008. Additionally, the Sixth Amendment introduces the concept of a new definition of the calculation of EBIDTA allowing for the add-back of certain non-recurring and non-cash items. The covenant includes a minimum EBITDA at the end of each quarter up to and including June 30, 2010, at which point more stringent covenants previously in place under the Credit Agreement become effective. The revolving credit facility has been reduced to \$100 million. Concurrently, the Corporation closed a private placement offering of senior unsecured convertible debentures for gross proceeds of CA\$75 million. The proceeds of the offering will be used as working capital and for general corporate purposes. Management believes that these amendments to its Credit Agreement, combined with the proceeds of the offering, provide the Corporation with the financial resources and flexibility to meet working capital requirements leading up to the peak toy selling season and to continue implementation of its Value Enhancement Plan.

Please refer to the "Balance Sheet Data" and "Contractual Obligations" tables in the Corporation's annual MD&A for the year ended December 31, 2007 for additional information about its financial position.

## 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 up to the date of ineffectiveness.



## Changes in Accounting Policies and Use of Estimates

The Corporation's unaudited interim consolidated financial statements have been prepared in accordance with the Canadian generally accepted accounting principles ("GAAP") and use the same accounting policies and methods used in the preparation of the Corporation's 2007 annual audited consolidated financial statements except as described below. See the notes to the Corporation's 2007 annual audited consolidated financial statements for more information about the significant accounting principles used to prepare the financial statements.

### Deferred financing costs

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.

### Derivative financial instruments

#### *Risk management disclosures*

The Corporation is exposed to risks of varying degrees of significance which could affect its ability to achieve its strategic objectives for growth. The main objectives of the Corporation's risk management process are to ensure that risks are properly identified and that the capital base is adequate in relation to these risks. The principal financial risks to which the Corporation is exposed are described below.

Liquidity risk is the risk that the Corporation is not able to meet its financial obligations as they fall due or can do only at excessive cost. The Corporation manages this risk by maintaining detailed cash forecasts, as well as long-term Operating and Strategic Plans. The management of consolidated liquidity requires a constant monitoring of expected cash inflows and outflows which is achieved through a detailed forecast of the Corporation's consolidated liquidity position, to ensure adequacy and efficient use of cash resources. Liquidity adequacy is assessed in view of seasonal needs and the maturity profile of indebtedness. For the upcoming quarters, our credit agreement imposes borrowing restriction with regards to our revolving credit facility. The Corporation also constantly monitors any financing opportunities to optimize its capital structure and maintain appropriate financial flexibility.

The Corporation may have been in serious financial difficulty due to inadequate liquidity resulting from accelerated payment terms required from suppliers in this period of high demand of working capital before the peak toy selling season. It is expected that this situation will be remediated through a private placement totaling \$75 million to be closed on August 19, 2008 and through the renegotiation of its credit agreement with long-term lenders (see Note 18).

Management believes that the successful completion of these two transactions will allow for the realization of assets and settlement of liabilities in the normal course of business as they come due.

The following are the contractual maturities of financial liabilities as at June 30, 2008:

|  | Carrying amount | Contractual cash flows | Less than one year | Between one and five years | More than five years |
|--|-----------------|------------------------|--------------------|----------------------------|----------------------|
|  | \$              | \$                     | \$                 | \$                         | \$                   |
| Non-derivative financial liabilities:    |                 |                        |                    |                            |                      |
| Accounts payable and accrued liabilities | 112,289         | 112,289                | 112,289            | -                          | -                    |
| Revolving credit facility                | 77,000          | 77,000                 | -                  | 77,000                     | -                    |
| Term loan A and B                        | 257,650         | 257,650                | 7,400              | 250,250                    | -                    |
| Capital lease obligations                | 687             | 687                    | 351                | 336                        | -                    |
|  | <b>447,626</b>  | <b>447,626</b>         | <b>120,040</b>     | <b>327,586</b>             | -                    |



### Foreign currency risk management

The Corporation is exposed to market risks attributable to fluctuations in foreign currency exchange rates, primarily changes in the value of the U.S. dollar versus other currencies such as the Canadian dollar, Euro, British pound, Mexican peso and Australian dollar. The Corporation policy is to stabilize earnings by limiting foreign currency exposure mainly through forward exchange contracts. The Corporation risk management approach is to have hedging mechanisms in place for a maximum period of 24 months. The Corporation hedging policy strictly prohibits unauthorized speculative foreign exchange transactions. The Corporation only enters into forward contract agreements with acceptable credit profile financial counterparties.

The following table details the Corporation's sensitivity to a 10% strengthening of the Canadian dollars, the Euro and the GBP currency, which management believes is reasonably possible, on net loss against the US dollars. The sensitivity analysis includes foreign currency denominated monetary items and adjusts their translation at period end for a 10% change in foreign currency rates.

| Currency                     | Impact on net earnings (loss) |
|------------------------------|-------------------------------|
| (in thousands of US dollars) | \$                            |
| CA\$                         | (578)                         |
| Euro                         | (737)                         |
| GBP                          | 331                           |

The following table summarizes our foreign currency commitments as at June 30, 2008 :

| Foreign currency contracts | Notional amount | Average exchange rate | Maturing up to | Notional equivalent | Fair market value |
|----------------------------|-----------------|-----------------------|----------------|---------------------|-------------------|
|                            | \$              |                       |                | \$                  | \$                |
| Sell - Euro to US\$        | 26,854          | 1.4578                | Dec. 2009      | 39,149              | (2,578)           |
| - GBP to US\$              | 4,750           | 2.0519                | Dec. 2009      | 9,747               | 453               |
| - US\$ to Euro             | 854             | 1.5737                | July 2008      | 1,344               | -                 |
| - US\$ to GBP              | 150             | 1.9730                | July 2008      | 296                 | 3                 |

The following table summarizes our foreign currency commitments as at June 30, 2007 :

| Foreign currency contracts | Notional amount | Average exchange rate | Maturing up to | Notional equivalent | Fair market value |
|----------------------------|-----------------|-----------------------|----------------|---------------------|-------------------|
|                            | \$              |                       |                | \$                  | \$                |
| Sell - Euro to US\$        | 9,600           | 1.3333                | Dec. 2008      | 12,800              | (267)             |
| - GBP to US\$              | 3,600           | 1.9244                | Dec. 2008      | 6,928               | (268)             |

These derivative instruments have not been designated as hedges for accounting purposes. The associated liability is recorded in derivative financial instruments, and the unrealized loss has been recorded in the foreign currency translation account.

### Prices of Raw Materials

The Corporation principal raw material is plastic resin, which is subject to the volatility in crude oil prices. The Corporation does not hedge against adverse price fluctuations. Furthermore, limited supplier production capacity and strong demand have placed upward pressure on the price of resin. There can be no assurance that this pressure will decline. While the Corporation has succeeded in passing on a portion of the increase in the price of plastic resin to the customers, there is no assurance they will be able to continue to do so, particularly if there are substantial price increases or that price increases occur over a sustained period. Prices of other raw materials are also subject to fluctuations. Unfavorable swings in commodity prices could have a material adverse effect on the financial condition and results of operations.

An increase of 10% of the plastic resin would have had an effect of \$1.0 million on gross margin for the six month period ended June 30, 2008.



### *Fair value interest rate risk*

The Corporation enters into interest rate swap agreements to convert certain long-term debt from variable to fixed interest rates in order to achieve an appropriate mix of fixed and variable interest rate debt. The interest rate swap agreements involve the periodic exchange of payments without the exchange of the notional principal amount upon which the payments are based, and are recorded as an adjustment of interest expense on the hedged debt instrument. The related amount payable to, or receivable from, counterparties is included as an adjustment to accrued interest.

As at June 30, 2008 and 2007, the interest rate swap agreements are with third parties for a notional value of \$150 million at a fixed rate of 4.66325% maturing in July 2012 and the fair value of these swaps is a loss of 3.8 million (2007 – gain of \$5.1 million).

At the end of the first quarter 2008, the Corporation executed the fifth amending agreement to its Credit Agreement dated July 26, 2005 providing for certain changes to the terms and conditions of its senior secured Credit Facilities maturing in 2012. The fifth amending agreement introduced a LIBOR rate floor on the variable interest rate resulting to an ineffectiveness of the hedging relationship for its interest rate swap. The Corporation amortizes the loss over the remaining period of the long-term debt the derivative loss of \$10.0 million recognized to the comprehensive loss. In addition, any future variation of the fair value of the interest rate swap is recognized to the net results.

The Corporation's interest rate risk arises from long-term borrowings. Borrowings issued at variable rates expose the Corporation to cash flow interest rate risk. Borrowings issued at fixed rate expose the Corporation to fair value interest rate risk. Considering the introduction of the LIBOR rate floor as part of the fifth credit agreement, 100% (60% in 2007) of the Corporation's long-term debt is at variables rates.

As at June 30, 2008, with other variables unchanged, a 1% change in the LIBOR rate would have an impact of \$0.1 million on net loss before income taxes.

### *Credit risk*

Credit risk is the risk of an unexpected loss if a customer or third party to a financial instrument fails to meet its contractual obligations.

The Corporation reduces its credit risks arising from cash and cash equivalents, derivative financial instruments and deposits with banks and financial institutions by dealing with creditworthy financial institutions.

The Corporation's receivables consist of invoices to customers net of provisions for chargebacks for customer related programs. This risk is reduced through the analysis of the financial position of its customers, and the regular review of their credit limits, and by taking steps to mitigate the risk of loss by obtaining credit insurance. In addition, the Corporation believes there is no particular concentration of credit risks due to the geographic diversity of customers and the procedures for the management of commercial risks.

## **New accounting policies**

### *Financial instruments*

In December 2006, the Canadian Institute of Chartered Accountants ("CICA") issued the following standards effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007: Accounting Standards Section 3862 "Financial Instruments – Disclosure" and Accounting Standards Section 3863 "Financial Instruments – Presentation". These sections replace CICA 3861, revising and enhancing its disclosure requirements, and carrying forward unchanged its presentation requirements.

### *Capital disclosures*

In December 2006, the CICA published Section 1535, "Capital Disclosures". This new standard establishes disclosure requirements concerning capital such as: qualitative information about its objectives, policies and processes for managing capital; quantitative data about what it regards as capital; whether it has complied with any externally imposed capital requirements and, if not, the consequences of such non-compliance. This Section is effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007.

The additional disclosures, required as a result of the adoption of these standards, have been included in Note 4 and in Note 9 of the interim financial statements.



## *Inventories*

In June 2007, the CICA published Section 3031, "Inventories". This Section replaces CICA 3030, establishing standards for the measurement and disclosure of inventories and is effective for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2008. As at June 30, 2008, the adoption of this section has no significant impact on the consolidated financial statements.

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

### *Goodwill and intangible assets*

In February 2008, the CICA published Section 3064, "Goodwill and Intangible Assets". This new standard establishes standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. The requirements will be effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2008. The Corporation is currently assessing the impact that this accounting pronouncement will have on its consolidated financial statements.

### *Financial statement concepts*

In February 2008, the CICA issued amendments to Section 1000, "Financial Statement Concepts" to clarify the criteria for recognition of an asset and the timing of expense recognition. The new requirements are effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2008. The Corporation will apply the amendments to Section 1000 at the beginning of its 2009 fiscal year. The implementation of the amendments to Section 1000 will not have an impact the Corporation's results of operations, financial position and disclosures because the amendments are clarifications on the application of Section 1000.

## **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 2007 annual MD&A filed by the Corporation, which are hereby incorporated by reference. Changes to risks and uncertainties presented in the 2007 annual MD&A are described below.

As at August 13, 2008, the Corporation's litigation with Lawrence, Jeffrey and Sidney Rosen (the "Rosens"), former shareholders of MEGA Brands America in the U.S. District Court for the Southern District of New York ("Rosen Litigation") was still pending. The Rosens are seeking payment of the Contingent Purchase Price under the terms of the Stock Purchase Agreement ("SPA") entered into between them and the Corporation effective July 26, 2005. The Corporation is advancing defenses and significant counterclaims alleging, among other things, that the Rosens breached certain terms of the SPA. The Corporation accrued as a reserve \$51.0 million in its 2005 audited consolidated financial statements with respect to the Contingent Purchase Price pending final determination of the amount owed, if any. As at May 7, 2008, no disbursements had been made and the Corporation will continue to maintain the reserve until the lawsuit is resolved. No trial date has been set as at May 7, 2008. In addition, Jeffrey and Lawrence Rosen filed proceedings in 2006 before the American Arbitration Association against the Corporation seeking damages for the Corporation's alleged breach of their respective employment agreements. The arbitration with Lawrence Rosen has been settled for an undisclosed amount and the arbitration proceeding for Jeffrey Rosen is scheduled for hearing in September 2008.

As at August 13, 2008, the Corporation is a defendant in a total of four products liability litigations, three of which are being handled by its insurers. The Corporation is aware of at least eighteen additional incidents, of which certain where children are alleged to have required surgery following the ingestion of multiple magnets. The corporation has not been notified of any new product liability claims or lawsuits relating to MAGNETIX since the filing of the 2007 annual MD&A on March 30, 2008.

On April 14, 2008, the Corporation received notification from the U.S. Consumer Products Safety Commission (the "CPSC") of its intention to assess a civil penalty for the Corporation's alleged failure to comply with reporting requirements under the US Consumer Protection Safety Act with respect to incidents involving the Corporation's MAGNETIX toys which have been the subject of voluntary recalls in March 2006 and April 2007. The CPSC has not specified the amount of the penalty, it intends to seek nor the timing of their assessment. The Corporation is not able to assess with any certainty the outcome of this notification.



A class action suit was filed in the District of New Jersey on April 8, 2008 against MEGA Brands Inc. and MEGA Brands America, Inc. The class action is brought by a California resident, on behalf of all persons who purchased and/or received as a gift magnetic toys in the United States that were the subject of product recalls by the Corporation in March 2006, April 2007 and March 2008. The Corporation believes the suit is substantively without merit, and will contest the matter vigorously, although it is unable to assess with any certainty the outcome of this suit.

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.

### **Internal Control over Financial Reporting**

The Corporation's management, with the participation of the President and Chief Executive Officer and of the Executive Vice President and Chief Financial Officer, has designed internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements in accordance with the Corporation's GAAP. As of August 18, 2008, there has been no change in the Corporation's internal control over financing reporting that occurred during the Corporation's most recent interim period that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financing reporting.

### **Additional Information**

This MD&A is dated August 18, 2008. Additional information about MEGA Brands, including our Annual Information Form, is available on SEDAR at [www.sedar.com](http://www.sedar.com).



## Consolidated statements of earnings

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

(Unaudited)

|   | Three-month periods<br>ended June 30, |         | Six-month periods<br>ended June 30, |          |
|---|---------------------------------------|---------|-------------------------------------|----------|
|   | 2008                                  | 2007    | 2008                                | 2007     |
|   | \$                                    | \$      | \$                                  | \$       |
| <b>Net sales (Note 10)</b>                              | <b>106,385</b>                        | 121,486 | <b>185,777</b>                      | 211,592  |
| Cost of sales (Note 10)                                 | <b>71,630</b>                         | 74,196  | <b>123,219</b>                      | 154,951  |
| Gross profit  | <b>34,755</b>                         | 47,290  | <b>62,558</b>                       | 56,641   |
| Marketing and advertising expenses                      | <b>5,294</b>                          | 4,464   | <b>9,245</b>                        | 10,771   |
| Research and development expenses                       | <b>3,856</b>                          | 6,428   | <b>8,406</b>                        | 11,685   |
| Other selling, distribution and administrative expenses | <b>26,008</b>                         | 28,246  | <b>53,566</b>                       | 56,298   |
| Voluntary product recall and replacement (Note 10)      | -                                     | -       | -                                   | 4,700    |
| Litigation expenses (Note 16)                           | <b>2,311</b>                          | 1,501   | <b>3,453</b>                        | 2,313    |
| Product liability settlement and related expenses       | -                                     | (1,000) | -                                   | (1,000)  |
| Loss (gain) on foreign currency translation             | <b>(336)</b>                          | (1,027) | <b>1,019</b>                        | (1,458)  |
| Earnings (loss) from operations                         | <b>(2,378)</b>                        | 8,678   | <b>(13,131)</b>                     | (26,668) |
| Interest expense  |                                       |         |                                     |          |
| Interest on long-term debt                              | <b>6,158</b>                          | 6,502   | <b>11,429</b>                       | 12,549   |
| Change in fair value of interest rate swap (Note 9)     | <b>(5,578)</b>                        | -       | <b>(5,578)</b>                      | -        |
| Amortization of deferred financing costs                | <b>874</b>                            | 122     | <b>1,814</b>                        | 292      |
| Other interest  | <b>(172)</b>                          | 40      | <b>18</b>                           | (54)     |
|   | <b>1,282</b>                          | 6,664   | <b>7,683</b>                        | 12,787   |
| Earnings (loss) before income taxes                     | <b>(3,660)</b>                        | 2,014   | <b>(20,814)</b>                     | (39,455) |
| Income taxes (Note 5)                                   |                                       |         |                                     |          |
| Current   | <b>393</b>                            | (342)   | <b>1,314</b>                        | (1,768)  |
| Future  | <b>(481)</b>                          | (1,606) | <b>(8,908)</b>                      | (17,739) |
|   | <b>(88)</b>                           | (1,948) | <b>(7,594)</b>                      | (19,507) |
| <b>Net earnings (loss)</b>                              | <b>(3,572)</b>                        | 3,962   | <b>(13,220)</b>                     | (19,948) |
| Earnings (loss) per share (Note 11)                     |                                       |         |                                     |          |
| Basic   | <b>(0.10)</b>                         | 0.12    | <b>(0.36)</b>                       | (0.61)   |
| Diluted <sup>(1)</sup>                                  | <b>(0.10)</b>                         | 0.12    | <b>(0.36)</b>                       | (0.61)   |

<sup>(1)</sup> The dilutive effect of outstanding options under the treasury stock method for the three-month period ended June 30, 2008 and for the six-month periods ended June 30, 2007 and June 30, 2008 is nil as it is anti-dilutive.



## Consolidated statements of deficit

(in thousands of US dollars)

(Unaudited)

|                                     | Three-month periods<br>ended June 30, |                | Six-month periods<br>ended June 30, |                |
|-------------------------------------|---------------------------------------|----------------|-------------------------------------|----------------|
|                                     | 2008                                  | 2007           | 2008                                | 2007           |
|                                     | \$                                    | \$             | \$                                  | \$             |
| <b>Balance, beginning of period</b> | (94,148)                              | (11,274)       | (84,500)                            | 12,636         |
| Net earnings (loss)                 | (3,572)                               | 3,962          | (13,220)                            | (19,948)       |
| <b>Balance, end of period</b>       | <b>(97,720)</b>                       | <b>(7,312)</b> | <b>(97,720)</b>                     | <b>(7,312)</b> |

## Consolidated statements of comprehensive income (loss) and Accumulated other comprehensive income (loss)

(in thousands of US dollars)

(Unaudited)

|   | Three-month periods<br>ended June 30, |              | Six-month periods<br>ended June 30, |                 |
|---|---------------------------------------|--------------|-------------------------------------|-----------------|
|   | 2008                                  | 2007         | 2008                                | 2007            |
|   | \$                                    | \$           | \$                                  | \$              |
| <b>Net earnings (loss) for the period</b>   | <b>(3,572)</b>                        | <b>3,962</b> | <b>(13,220)</b>                     | <b>(19,948)</b> |
| <b>Other comprehensive income (loss), net of income taxes</b>   |                                       |              |                                     |                 |
| Gain (loss) on derivatives designated as cash<br>flow hedges  | 356                                   | 1,915        | (3,552)                             | 1,399           |
| <b>Comprehensive income (loss) for the period</b>   | <b>(3,216)</b>                        | <b>5,877</b> | <b>(16,772)</b>                     | <b>(18,549)</b> |
| <b>Accumulated other comprehensive income (loss)</b>  |                                       |              |                                     |                 |
| Balance, beginning of period  | (6,173)                               | 1,235        | (2,265)                             | -               |
| Impact of adopting the new accounting policy<br>regarding financial instruments, net of<br>income taxes | -                                     | -            | -                                   | 1,751           |
| Other comprehensive income (loss), net of income taxes  | 356                                   | 1,915        | (3,552)                             | 1,399           |
| <b>Balance, end of period</b>   | <b>(5,817)</b>                        | <b>3,150</b> | <b>(5,817)</b>                      | <b>3,150</b>    |



## Consolidated balance sheets

(in thousands of US dollars)

|  | June 30,<br>2008<br>(Unaudited) | December 31,<br>2007<br>(Audited) | June 30,<br>2007<br>(Unaudited) |
|--|---------------------------------|-----------------------------------|---------------------------------|
|  | \$                              | \$                                | \$                              |
| <b>Assets</b>  |                                 |                                   |                                 |
| Current assets   |                                 |                                   |                                 |
| Cash and cash equivalents  | 7,728                           | 8,505                             | 4,603                           |
| Accounts receivable  | 122,760                         | 125,784                           | 131,092                         |
| Inventories  | 112,236                         | 91,681                            | 162,566                         |
| Income taxes   | 9,902                           | 8,219                             | 9,234                           |
| Future income taxes  | 3,986                           | 4,286                             | 8,064                           |
| Derivative financial instruments   | -                               | 306                               | -                               |
| Prepaid expenses   | 21,991                          | 19,650                            | 11,506                          |
|  | <b>278,603</b>                  | <b>258,431</b>                    | <b>327,065</b>                  |
| Property, plant and equipment  | 43,239                          | 42,620                            | 48,199                          |
| Intangible assets  | 74,274                          | 74,606                            | 79,149                          |
| Goodwill (Note 12)   | 298,938                         | 298,938                           | 301,988                         |
| Derivative financial instruments   | -                               | -                                 | 5,089                           |
| Future income taxes  | 49,086                          | 35,119                            | 47,210                          |
|  | <b>744,140</b>                  | <b>709,714</b>                    | <b>808,700</b>                  |
| <b>Liabilities</b>   |                                 |                                   |                                 |
| Current liabilities  |                                 |                                   |                                 |
| Accounts payable and accrued liabilities                                     | 112,289                         | 136,592                           | 112,229                         |
| Additional consideration accrued on business<br>combination (Note 13 and 16) | 54,775                          | 54,775                            | 58,642                          |
| Derivative financial instruments   | 1,682                           | -                                 | 535                             |
| Current portion of long-term debt  | 5,521                           | 8,303                             | 8,861                           |
|  | <b>174,267</b>                  | <b>199,670</b>                    | <b>180,267</b>                  |
| Long-term debt   | 325,328                         | 252,441                           | 364,279                         |
| Derivative financial instruments   | 4,260                           | 3,659                             | -                               |
| Future income taxes  | 34,587                          | 31,550                            | 30,693                          |
|  | <b>538,442</b>                  | <b>487,320</b>                    | <b>575,239</b>                  |
| <b>Shareholders' equity</b>  |                                 |                                   |                                 |
| Capital stock (Note 4)   | 308,677                         | 308,601                           | 237,071                         |
| Contributed surplus  | 558                             | 558                               | 552                             |
| Deficit  | (97,720)                        | (84,500)                          | (7,312)                         |
| Accumulated other comprehensive income (loss)<br>net of income taxes         | (5,817)                         | (2,265)                           | 3,150                           |
|  | <b>205,698</b>                  | <b>222,394</b>                    | <b>233,461</b>                  |
|  | <b>744,140</b>                  | <b>709,714</b>                    | <b>808,700</b>                  |



## Consolidated statements of cash flows

(in thousands of US dollars)

(Unaudited)

|   | Three-month periods<br>ended June 30, |              | Six-month periods<br>ended June 30, |              |
|---|---------------------------------------|--------------|-------------------------------------|--------------|
|   | 2008                                  | 2007         | 2008                                | 2007         |
|   | \$                                    | \$           | \$                                  | \$           |
| <b>Cash flows from operating activities</b>                                       |                                       |              |                                     |              |
| Net earnings (loss)   | (3,572)                               | 3,962        | (13,220)                            | (19,948)     |
| Items not affecting cash and cash equivalents                                     |                                       |              |                                     |              |
| Amortization of property, plant and equipment                                     | 3,853                                 | 3,389        | 7,460                               | 6,409        |
| Amortization of intangible assets   | 166                                   | 183          | 332                                 | 368          |
| Stock-based compensation plans  | (203)                                 | 25           | (632)                               | (100)        |
| Future income taxes   | (481)                                 | (1,606)      | (8,908)                             | (17,739)     |
| Gain on disposal of property, plant and equipment                                 | -                                     | (20)         | -                                   | (240)        |
| Loss on foreign currency  | 245                                   | 246          | 890                                 | 383          |
|   | 8                                     | 6,179        | (14,078)                            | (30,867)     |
| Changes in non-cash operating working capital items (Note 14)                     | (13,075)                              | (45,740)     | (43,244)                            | (32,215)     |
|   | (13,067)                              | (39,561)     | (57,322)                            | (63,082)     |
| <b>Cash flows from financing activities</b>                                       |                                       |              |                                     |              |
| Repayment of long-term debt   | (2,312)                               | (2,330)      | (4,665)                             | (4,719)      |
| Change in revolving credit facility   | 26,500                                | 45,800       | 75,000                              | 69,000       |
| Amortization of deferred financing costs  | 875                                   | 122          | 1,815                               | 292          |
| Amortization of comprehensive loss on interest rate swap                          | 575                                   | -            | 575                                 | -            |
| Unrealized gain on derivative financial instruments related to interest rate swap | (6,153)                               | -            | (6,153)                             | -            |
| Addition to deferred financing costs  | -                                     | -            | (2,666)                             | -            |
| Issuance of capital stock   | -                                     | 72           | 76                                  | 774          |
|   | 19,485                                | 43,664       | 63,982                              | 65,347       |
| <b>Cash flows from investing activities</b>                                       |                                       |              |                                     |              |
| Acquisition of property, plant and equipment                                      | (2,763)                               | (5,540)      | (7,437)                             | (11,776)     |
| Proceeds from disposal of property, plant and equipment                           | -                                     | -            | -                                   | 798          |
| Business combinations (Note 13)   | -                                     | -            | -                                   | (342)        |
|   | (2,763)                               | (5,540)      | (7,437)                             | (11,320)     |
| Increase (decrease) in cash and cash equivalents                                  | 3,655                                 | (1,437)      | (777)                               | (9,055)      |
| Cash and cash equivalents, beginning of period                                    | 4,073                                 | 6,040        | 8,505                               | 13,658       |
| <b>Cash and cash equivalents, end of period</b>                                   | <b>7,728</b>                          | <b>4,603</b> | <b>7,728</b>                        | <b>4,603</b> |
| Supplementary disclosure of cash flow information                                 |                                       |              |                                     |              |
| Interest paid   | 2,538                                 | 6,143        | 8,231                               | 12,531       |
| Income taxes paid (recovered)   | 2,863                                 | 1,908        | 2,553                               | (2,094)      |
| Non cash item   |                                       |              |                                     |              |
| Property, plant and equipment acquired by means of capital leases                 | -                                     | -            | 622                                 | -            |



## Notes to interim consolidated financial statements

For the three-month and six-month periods ended June 30, 2008 and 2007  
(Column figures are expressed in thousands of U.S. dollars, except per share data.)  
(Unaudited)

### 1. Nature of business

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 U.S. dollars as it is the Corporation's functional currency and have been prepared under the going concern assumption 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, 2007 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 line of products, inventory valuation, valuation of provision on accounts receivable, future income taxes, intangible assets, goodwill, reserves and allowances, specifically those related to the integration costs, general liability and income taxes.

#### *Revenue recognition*

Revenue is recognized when (i) persuasive evidence of an arrangement exists, (ii) products are shipped to customers and the customer takes ownership and assumes risk of loss, (iii) collection of the receivable is probable, and (iv) the sales price is fixed or determinable. Accruals for customer discounts, rebates, incentives and defective allowances are recorded as the related revenues are recognized.

#### *Vendor allowance*

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

#### *Self-insurance*

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

#### *Foreign currency translation*

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



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

#### *Deferred financing costs*

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.

### **3. New accounting policies**

#### *Financial instruments*

In December 2006, the Canadian Institute of Chartered Accountants ("CICA") issued the following standards effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007: Accounting Standards Section 3862 "Financial Instruments – Disclosure" and Accounting Standards Section 3863 "Financial Instruments – Presentation". These sections replace CICA 3861, revising and enhancing its disclosure requirements, and carrying forward unchanged its presentation requirements.

#### *Capital disclosures*

In December 2006, the CICA published Section 1535, "Capital Disclosures". This new standard establishes disclosure requirements concerning capital such as: qualitative information about its objectives, policies and processes for managing capital; quantitative data about what it regards as capital; whether it has complied with any externally imposed capital requirements and, if not, the consequences of such non-compliance. This Section is effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007.

The additional disclosures, required as a result of the adoption of these standards, have been included in Note 4 and in Note 9.

#### *Inventories*

In June 2007, the CICA published Section 3031, "Inventories". This Section replaces CICA 3030, establishing standards for the measurement and disclosure of inventories and is effective for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2008. As at June 30, 2008, the adoption of this section has no significant impact on the consolidated financial statements.

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

#### *Goodwill and intangible assets*

In February 2008, the CICA published Section 3064, "Goodwill and Intangible Assets". This new standard establishes standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. The requirements will be effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2008. The Corporation is currently assessing the impact that this accounting pronouncement will have on its consolidated financial statements.

#### *Financial statement concepts*

In February 2008, the CICA issued amendments to Section 1000, "Financial Statement Concepts" to clarify the criteria for recognition of an asset and the timing of expense recognition. The new requirements are effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2008. The Corporation will apply the amendments to Section 1000 at the beginning of its 2009 fiscal year. The implementation of the amendments to Section 1000 will not have an impact the Corporation's results of operations, financial position and disclosures because the amendments are clarifications on the application of Section 1000.

### **4. Capital**

#### *Capital risk management*

Capital is defined as long-term debt net of cash and cash equivalents and capital stock, contributed surplus and deficit.



The following table summarizes certain information with respect to the Corporation's capital structure at the end of each period:

|   | June 30,<br>2008 | December 31,<br>2007 | June 30,<br>2007 |
|---|------------------|----------------------|------------------|
| Cash and cash equivalents   | (7,728)          | (8,505)              | (4,603)          |
| Long-term debt, including current portion                                       | 330,849          | 260,744              | 373,140          |
|   | <b>323,121</b>   | 252,239              | 368,537          |
| Shareholder's equity excluding<br>other accumulated comprehensive income (loss) | 211,515          | 224,659              | 230,311          |
| <b>Total capital</b>  | <b>534,636</b>   | 476,898              | 598,848          |

The Corporation's objectives when managing capital are:

- › to safeguard the Corporation's ability to continue as a going concern in order to provide returns to shareholders;
- › to maintain an optimal capital structure and reduce the cost of capital;
- › to make proper capital investments that are significant to ensure the Corporation remains competitive;

On March 28, 2008, the Corporation executed a fifth amending agreement (the "Fifth Amendment") to its Credit Agreement dated July 26, 2005 providing for certain changes to the terms and conditions of its senior secured Credit Facilities maturing in 2012. The Fifth Amendment waives the funded debt to EBITDA ratio covenant and the fixed charge coverage ratio covenant until September 30, 2008. Furthermore, through this Amendment, the lenders consent to the sale of the Stationery and Activities business subject to certain conditions with respect to timing and sale price and to the release of the liens on the assets sold provided that the net consideration received will be used to make prepayment offers to the current lenders. Additionally, the EBITDA definition has been amended to: net income plus interest expense, amortization and depreciation and income tax. The Corporation is subject to certain covenants on its credit facilities. The covenants include a minimum EBITDA and a maximum aggregate outstanding borrowing under the revolving facilities at the end of each of its second, third and fourth financial quarters of its 2008 financial year. In addition, the Corporation monitors the covenants on a monthly basis and the Corporation's Board of Directors reviews the covenants on a quarterly basis.

For the second quarter ended June 30, 2008, the Corporation did not meet the minimum EBITDA requirement under the Fifth Amendment of its credit facility. Subsequent to quarter-end, the Corporation obtained a waiver effective June 30, 2008 with regard to certain restrictive covenants and amendments to future covenants up to and including June 30, 2010 (Note 18 (a)).

Other than the covenants required for the credit facilities, the Corporation is not subject to any externally imposed capital requirements.

The Corporation normally invests between \$15 and \$20 million yearly in machinery and equipment to support existing and new product line initiatives as well as operational activities.

#### *Outstanding share data*

As at June 30, 2008, there were 36,612,202 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.

The future income tax assets are presented net of valuation allowance of \$28.9 million, as at June 30, 2008, and \$27.8 million, as at December 31, 2007.



## 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.

At June 30, 2008, a total of 4,895,588 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.

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

|   | 2008              |                                 | 2007              |                                 |
|---|-------------------|---------------------------------|-------------------|---------------------------------|
| (in Canadian dollars except per share data) | Number of options | Weighted average exercise price | Number of options | Weighted average exercise price |
|   |                   | \$                              |                   | \$                              |
| Options outstanding, beginning of year      | 2,583,468         | 9.02                            | 2,665,606         | 9.18                            |
| Granted                                     | -                 | -                               | -                 | -                               |
| Exercised                                   | (19,351)          | 3.85                            | (58,069)          | 15.47                           |
| Forfeited                                   | (2,681)           | 14.10                           | (2,100)           | 20.50                           |
| Options outstanding, end of year            | 2,561,436         | 9.06                            | 2,605,437         | 9.03                            |
| Options exercisable, end of year            | 2,561,436         | 9.06                            | 2,565,437         | 8.85                            |

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.

## 7. Share unit plan

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

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

|                                       | 2008     | 2007    |
|---------------------------------------|----------|---------|
| Units outstanding, beginning of year  | 486,569  | 354,984 |
| Granted                               | 327,512  | 136,739 |
| Exercised                             | (11,083) | (1,010) |
| Forfeited                             | (60,252) | (4,144) |
| Units outstanding, end of year        | 742,746  | 486,569 |
| Share unit plan compensation recovery | (641)    | (165)   |
| Accrued balance                       | 425      | 2,326   |

## 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 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 six-month periods ended June 30, under the Corporation's DSU Plan:

|  | 2008     | 2007 |
|--|----------|------|
| Units outstanding, beginning of the period | 24,993   | -    |
| Granted                                    | 30,816   | -    |
| Exercised                                  | (11,268) | -    |
| Forfeited                                  | -        | -    |
| Units outstanding, end of period           | 44,541   | -    |

## 9. Financial Instruments

### *Risk management disclosures*

The Corporation is exposed to risks of varying degrees of significance which could affect its ability to achieve its strategic objectives for growth. The main objectives of the Corporation's risk management process are to ensure that risks are properly identified and that the capital base is adequate in relation to these risks. The principal financial risks to which the Corporation is exposed are described below.

### *Liquidity risk*

Liquidity risk is the risk that the Corporation is not able to meet its financial obligations as they fall due or can do only at excessive cost. The Corporation manages this risk by maintaining detailed cash forecasts, as well as long-term Operating and Strategic Plans. The management of consolidated liquidity requires a constant monitoring of expected cash inflows and outflows which is achieved through a detailed forecast of the Corporation's consolidated liquidity position, to ensure adequacy and efficient use of cash resources. Liquidity adequacy is assessed in view of seasonal needs and the maturity profile of indebtedness. For the upcoming quarters, our credit agreement imposes borrowing restriction with regards to our revolving credit facility. The Corporation also constantly monitors any financing opportunities to optimize its capital structure and maintain appropriate financial flexibility.

The Corporation may have been in serious financial difficulty due to inadequate liquidity resulting from accelerated payment terms required from suppliers in this period of high demand of working capital before the peak toy selling season. It is expected that this situation will be remediated through a private placement totaling \$75 million to be closed on August 19, 2008 and through the renegotiation of its credit agreement with long-term lenders (see Note 18).

Management believes that the successful completion of these two transactions will allow for the realization of assets and settlement of liabilities in the normal course of business as they come due.



The following are the contractual maturities of financial liabilities as at June 30, 2008:

|  | Carrying amount | Contractual cash flows | Less than one year | Between one and five years | More than five years |
|--|-----------------|------------------------|--------------------|----------------------------|----------------------|
|  | \$              | \$                     | \$                 | \$                         | \$                   |
| Non-derivative financial liabilities:    |                 |                        |                    |                            |                      |
| Accounts payable and accrued liabilities | 112,289         | 112,289                | 112,289            | -                          | -                    |
| Revolving credit facility                | 77,000          | 77,000                 | -                  | 77,000                     | -                    |
| Term loan A and B                        | 257,650         | 257,650                | 7,400              | 250,250                    | -                    |
| Capital lease obligations                | 687             | 687                    | 351                | 336                        | -                    |
|  | <b>447,626</b>  | <b>447,626</b>         | <b>120,040</b>     | <b>327,586</b>             | -                    |

#### Foreign currency risk management

The Corporation is exposed to market risks attributable to fluctuations in foreign currency exchange rates, primarily changes in the value of the U.S. dollar versus other currencies such as the Canadian dollar, Euro, British pound, Mexican peso and Australian dollar. The Corporation policy is to stabilize earnings by limiting foreign currency exposure mainly through forward exchange contracts. The Corporation risk management approach is to have hedging mechanisms in place for a maximum period of 24 months. The Corporation hedging policy strictly prohibits unauthorized speculative foreign exchange transactions. The Corporation only enters into forward contract agreements with acceptable credit profile financial counterparties.

The following table details the Corporation's sensitivity to a 10% strengthening of the Canadian dollars, the Euro and the GBP currency, which management believes is reasonably possible, on net loss against the US dollars. The sensitivity analysis includes foreign currency denominated monetary items and adjusts their translation at period end for a 10% change in foreign currency rates.

| Currency                     | Impact on net earnings (loss) |
|------------------------------|-------------------------------|
| (in thousands of US dollars) | \$                            |
| CA\$                         | (578)                         |
| Euro                         | (737)                         |
| GBP                          | 331                           |

The following table summarizes our foreign currency commitments as at June 30, 2008 :

| Foreign currency contracts | Notional amount | Average exchange rate | Maturing up to | Notional equivalent | Fair market value |
|----------------------------|-----------------|-----------------------|----------------|---------------------|-------------------|
|                            | \$              |                       |                | \$                  | \$                |
| Sell - Euro to US\$        | 26,854          | 1.4578                | Dec. 2009      | 39,149              | (2,578)           |
| - GBP to US\$              | 4,750           | 2.0519                | Dec. 2009      | 9,747               | 453               |
| - US\$ to Euro             | 854             | 1.5737                | July 2008      | 1,344               | -                 |
| - US\$ to GBP              | 150             | 1.9730                | July 2008      | 296                 | 3                 |

The following table summarizes our foreign currency commitments as at June 30, 2007 :

| Foreign currency contracts | Notional amount | Average exchange rate | Maturing up to | Notional equivalent | Fair market value |
|----------------------------|-----------------|-----------------------|----------------|---------------------|-------------------|
|                            | \$              |                       |                | \$                  | \$                |
| Sell - Euro to US\$        | 9,600           | 1.3333                | Dec. 2008      | 12,800              | (267)             |
| - GBP to US\$              | 3,600           | 1.9244                | Dec. 2008      | 6,928               | (268)             |

These derivative instruments have not been designated as hedges for accounting purposes. The associated liability is recorded in derivative financial instruments, and the unrealized loss has been recorded in the foreign currency translation account in the consolidated statement of earnings.

#### Prices of Raw Materials

The Corporation principal raw material is plastic resin, which is subject to the volatility in crude oil prices. The Corporation does not hedge against adverse price fluctuations. Furthermore, limited supplier production capacity



and strong demand have placed upward pressure on the price of resin. There can be no assurance that this pressure will decline. While the Corporation has succeeded in passing on a portion of the increase in the price of plastic resin to the customers, there is no assurance they will be able to continue to do so, particularly if there are substantial price increases or that price increases occur over a sustained period. Prices of other raw materials are also subject to fluctuations. Unfavorable swings in commodity prices could have a material adverse effect on the financial condition and results of operations.

An increase of 10% of the plastic resin would have had an effect of \$1.0 million on gross margin for the six-month period ended June 30, 2008.

#### *Fair value interest rate risk*

The Corporation enters into interest rate swap agreements to convert certain long-term debt from variable to fixed interest rates in order to achieve an appropriate mix of fixed and variable interest rate debt. The interest rate swap agreements involve the periodic exchange of payments without the exchange of the notional principal amount upon which the payments are based, and are recorded as an adjustment of interest expense on the hedged debt instrument. The related amount payable to, or receivable from, counterparties is included as an adjustment to accrued interest.

As at June 30, 2008 and 2007, the interest rate swap agreements are with third parties for a notional value of \$150 million at a fixed rate of 4.66325% maturing in July 2012 and the fair value of these swaps is a loss of 3.8 million (2007 – gain of \$5.1 million).

At the end of the first quarter 2008, the Corporation executed the fifth amending agreement to its Credit Agreement dated July 26, 2005 providing for certain changes to the terms and conditions of its senior secured Credit Facilities maturing in 2012. The fifth amending agreement introduced a LIBOR rate floor on the variable interest rate resulting to an ineffectiveness of the hedging relationship for its interest rate swap. The Corporation will amortize over the remaining period of the long-term debt the accumulated fair value derivative loss of \$10.0 million recognized when hedge accounting was discontinued. In addition, any future variation of the fair value of the interest rate swap is recognized to the net results.

The Corporation's interest rate risk arises from long-term borrowings. Borrowings issued at variable rates expose the Corporation to cash flow interest rate risk. Borrowings issued at fixed rate expose the Corporation to fair value interest rate risk. Considering the introduction of the LIBOR rate floor as part of the fifth credit agreement, 100% (60% in 2007) of the Corporation's long-term debt is at variables rates.

As at June 30, 2008, with other variables unchanged, a 1% change in the LIBOR rate would have an impact of \$0.1 million on net loss before income taxes.

#### *Credit risk*

Credit risk is the risk of an unexpected loss if a customer or third party to a financial instrument fails to meet its contractual obligations.

The Corporation reduces its credit risks arising from cash and cash equivalents, derivative financial instruments and deposits with banks and financial institutions by dealing with creditworthy financial institutions.

The Corporation's receivables consist of invoices to customers net of provisions for chargebacks for customer related programs. This risk is reduced through the analysis of the financial position of its customers, and the regular review of their credit limits, and by taking steps to mitigate the risk of loss by obtaining credit insurance. In addition, the Corporation believes there is no particular concentration of credit risks due to the geographic diversity of customers and the procedures for the management of commercial risks.

## **10. Voluntary product recall and other charges**

### *Period ended June 30, 2008*

Pursuant to the March 17, 2008 joint announcements with the Consumer Products Safety Commission ("CPSC"), the Corporation recorded charges related to the expanded recall campaign for MAGNETIX line of products (MAGTASTIK and MAGNAMAN). These charges were recorded to the results of December 31, 2007. The Corporation has recorded \$6.5 million of charges to the results of December 31, 2007 and an additional charge of \$2.5 million during the second quarter of 2008. The Corporation believes that the cost recorded during this quarter



will be sufficient and appropriate to meet its future obligations related to the expanded MAGNETIX line of product recall and other charges for inventory write-off and customer charges.

*Period ended June 30, 2007*

In 2007, the Corporation recorded charges totaling \$35.2 million related to the expanded MAGNETIX product recall and other charges. This includes:

- › Charges totaling \$30.5 million impacting gross margin which consist of returned goods, associated charges, freight handling costs and inventory write-offs.
- › 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.

## 11. Earnings (loss) per share

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

|   | Three-month periods<br>ended June 30, |                | Six-month periods<br>ended June 30, |                  |
|---|---------------------------------------|----------------|-------------------------------------|------------------|
|   | 2008                                  | 2007           | 2008                                | 2007             |
| Numerator for basic and diluted net earnings (loss) per common share: |                                       |                |                                     |                  |
| Net earnings (loss) attributable to common shareholders               | \$ (3,572)                            | \$ 3,962       | \$ (13,220)                         | \$ (19,948)      |
| Denominator for basic net earnings (loss) per common shares:          |                                       |                |                                     |                  |
| Weighted average number of common shares outstanding                  | 36,612,202                            | 32,714,373     | 36,603,529                          | 32,703,330       |
| <b>Basic earnings (loss) per share</b>                                | <b>\$ (0.10)</b>                      | <b>\$ 0.12</b> | <b>\$ (0.36)</b>                    | <b>\$ (0.61)</b> |
| Denominator for diluted net earnings (loss) per common share:         |                                       |                |                                     |                  |
| Weighted average number of common shares outstanding                  | 36,612,202                            | 32,714,373     | 36,603,529                          | 32,703,330       |
| Plus impact of stock options <sup>(1)</sup>                           | -                                     | 1,536,116      | -                                   | -                |
| Diluted average number of common shares <sup>(1)</sup>                | 36,612,202                            | 34,250,489     | 36,603,529                          | 32,703,330       |
| <b>Diluted earnings (loss) per share<sup>(1)</sup></b>                | <b>\$ (0.10)</b>                      | <b>\$ 0.12</b> | <b>\$ (0.36)</b>                    | <b>\$ (0.61)</b> |

<sup>1.</sup> The dilutive effect of outstanding options under the treasury stock method for the three-month period ended June 30, 2008 and for the six-month periods ended June 30, 2007 and June 30, 2008 is nil as it is anti-dilutive.

## 12. Goodwill

The Corporation performs the required annual impairment test as of December 31 of each year. As at December 31, 2007, the Corporation had \$299 million of goodwill, of which \$237 million is related to the Toys segment and \$62 million to the Stationery and Activities segment. Testing for impairment is accomplished by determining whether the fair value of a reporting unit exceeds the book value of the net assets of that reporting unit as at the assessment date.

The Corporation tests its goodwill for impairment using a two-step methodology. This methodology contains estimates and judgments that are subjective and uncertain, and thus may change over time.

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

The above-listed assumptions used in the calculation models are interrelated. Based on a sensitivity analysis performed by the Corporation as at December 31, 2007, the fair value would exceed book value for the Toys



segment by a range of 0.5% to 25% whereas for the Stationery and Activities segment, the excess would range from 2% to 39%.

As at June 30, 2008, Management believes that there are no circumstances that indicate a potential impairment of goodwill that would trigger the updating of the initial step of the goodwill impairment test conducted as at December 31, 2007.

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

### 13. Business combinations

#### a) Rose Art Industries, Inc.

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

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

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

In 2007, goodwill was reduced by \$3.1 million for a decrease in other incentives accrued.

The following table sets forth the additional consideration accrued on business combination as at June 30<sup>th</sup>:

|                           | 2008          | 2007          |
|---------------------------|---------------|---------------|
|                           | \$            | \$            |
| Contingent purchase price | 51,000        | 51,000        |
| Other incentives          | 3,775         | 6,825         |
|                           | <b>54,775</b> | <b>57,825</b> |

#### b) The Board Dudes, Inc.

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

On March 21, 2007, an additional consideration was recorded to goodwill of \$0.3 million. In addition, on June 30, 2007, the Corporation recorded an additional consideration of \$0.8 million relating to Board Dudes' performance in 2006.



Effective January 3, 2008, Board Dudes and MEGA Brands America merged, with MEGA Brands America being the surviving entity.

The acquisition was accounted for using the purchase method. The fair value of net assets acquired was as follows as at June 30<sup>th</sup>:

|                               | 2008   | 2007   |
|-------------------------------|--------|--------|
|                               | \$     | \$     |
| 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  | 9,535  |
| Long-term debt                | (624)  | (624)  |
| Non-cash assets acquired      | 20,049 | 20,049 |
| Cash and cash equivalents     | 43     | 43     |
| Net assets acquired           | 20,092 | 20,092 |
| Consideration                 |        |        |
| Cash                          | 19,455 | 19,455 |
| Acquisition cost              | 637    | 637    |
|                               | 20,092 | 20,092 |

#### 14. Changes in non-cash operation working capital items

|  | Three-month periods<br>ended June 30, |          | Six-month periods<br>ended June 30, |          |
|--|---------------------------------------|----------|-------------------------------------|----------|
|  | 2008                                  | 2007     | 2008                                | 2007     |
|  | \$                                    | \$       | \$                                  | \$       |
| Accounts receivable  | (21,713)                              | (39,880) | 3,024                               | 30,520   |
| Inventories  | (14,514)                              | (12,711) | (20,555)                            | (21,936) |
| Prepaid expenses   | (3,873)                               | 1,879    | (2,341)                             | 519      |
| Income taxes   | (3,432)                               | (2,504)  | (1,683)                             | 83       |
| Accounts payable and accrued liabilities                       | 30,325                                | 6,479    | (23,671)                            | (41,067) |
| Foreign currency translation relating to working capital items | 132                                   | 997      | 1,982                               | (334)    |
|  | (13,075)                              | (45,740) | (43,244)                            | (32,215) |

#### 15. Seasonal nature of business

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

#### 16. Contingencies

- a) On May 8, 2006, Lawrence, Jeffrey and Sidney Rosen (the "Rosens"), former shareholders of MEGA Brands America, initiated litigation against the Corporation. The plaintiffs are seeking payment of certain amounts due under the terms of the Stock Purchase Agreement ("SPA") entered into between them and the Corporation on June 15, 2005. The Corporation is advancing defences and counterclaims alleging that the Rosens breached certain terms of the SPA and violated fiduciary duties to the Corporation. The Corporation accrued \$51.0 million in its 2005 consolidated financial statements with respect to the contingent purchase price pending final determination of the amount owed, if any. As at June 30, 2008, no disbursements had been made, and the Corporation will continue to maintain the accrual until the lawsuit is resolved. Based on management's assessment, no additional consideration is due for the second quarter ended June 30, 2008.

On November 17, 2006, Lawrence and Jeffrey Rosen filed arbitration proceedings before the American Arbitration Association against the Corporation seeking unspecified damages for the Corporation's alleged breach of their respective employment agreements. The arbitration with Lawrence Rosen has been settled for an undisclosed amount and the arbitration proceeding for Jeffrey Rosen is scheduled for hearing in September 2008.



On March 31, 2006, the Corporation jointly announced with the U.S. Consumer Products Safety Commission (the "CPSC") a voluntary recall and replacement program of MAGNETIX building sets owned by families with children under the age of six. This action was taken in response to the death of a toddler and injuries to several children resulting from magnet ingestion. On April 19, 2007, the Corporation announced an expanded voluntary recall and replacement program for MAGNETIX products jointly with the CPSC as well as in other jurisdictions where the products were distributed. On March 17, 2008, the Corporation and the U.S. jointly announced a voluntary global recall of the Corporation's MAGNAMAN Action Figures, MAGTASTIK and MAGNETIX JR. Pre-School Magnetic Toys. This action was taken in response to reported incidents of loose magnets and minor injury involving the aspiration of a magnet from a MAGTASTIK set.

- b) On October 24, 2006, the Corporation announced that it had settled four lawsuits and ten claims related to injuries to children resulting from the ingestion of magnets. Terms of the settlement include no admission of liability. The aggregate amount paid to settle the lawsuits and claims is \$13.5 million and is recorded as a product liability settlement expense in the 2006 consolidated statement of earnings.

As at August 13, 2008, the Corporation is a defendant in a total of four product liability lawsuits. The Corporation is also aware of at least eighteen other incidents, of which certain occurred when children are alleged to have required surgery following the ingestion of multiple magnets.

On April 14, 2008, the Corporation received notification from the U.S. Consumer Products Safety Commission (the "CPSC") of its intention to assess a civil penalty for the Corporation's alleged failure to comply with reporting requirements under the US Consumer Protection Safety Act with respect to incidents involving the Corporation's MAGNETIX toys which have been the subject of voluntary recalls in March 2006 and April 2007. The CPSC has not specified the amount of the penalty, it intends to seek nor the timing of their assessment. The Corporation is not able to assess with any certainty the outcome of this notification.

A class action suit was filed in the District of New Jersey on April 8, 2008 against MEGA Brands Inc. and MEGA Brands America, Inc. The class action is brought by a California resident, on behalf of all persons who purchased and/or received as a gift magnetic toys in the United States that were the subject of product recalls by the Corporation in March 2006, April 2007 and March 2008. The Corporation believes the suit is substantively without merit, and will contest the matter vigorously, although it is unable to assess with any certainty the outcome of this suit.

- c) The Corporation is currently involved in a number of legal proceedings against its principal competitor in the construction toy segment, The Lego Group ("LEGO"), which is also the leading manufacturer of such toys worldwide. LEGO continues to challenge the Corporation's sale of functionally and aesthetically compatible construction toys in various markets. These proceedings may result in unfavourable outcomes for the Corporation with the result that some of its products may not be sold in one or more markets, which consequently may have a material adverse effect on the Corporation's financial condition.
- d) The Corporation is also defending other claims which arose in the normal course of business.

The Corporation does not believe that the aforementioned proceedings in aggregate will have a material adverse effect on its consolidated financial position or results of operations. However, there can be no assurance that additional incidents, lawsuits or claims will not arise, or that additional enquiries by the CPSC or other regulatory authorities in respect of MAGNETIX or other products will not be brought in the future, or result in additional product recalls.

## 17. Segmented information

### *Description of segments*

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

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



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

| <b>Segmented information</b> | <b>Three-month periods<br/>ended June 30,</b> |             | <b>Six-month periods<br/>ended June 30,</b> |             |
|------------------------------|---|-------------|---|-------------|
|                              | <b>2008</b>                                   | <b>2007</b> | <b>2008</b>                                 | <b>2007</b> |
|                              | <b>\$</b>                                     | <b>\$</b>   | <b>\$</b>                                   | <b>\$</b>   |
| Net sales                    |   |             |   |             |
| Toys                         | <b>47,296</b>                                 | 57,923      | <b>92,699</b>                               | 112,060     |
| Stationery and activities    | <b>59,089</b>                                 | 63,563      | <b>93,078</b>                               | 99,532      |
|                              | <b>106,385</b>                                | 121,486     | <b>185,777</b>                              | 211,592     |

| <b>Geographic information</b> | <b>Three-month periods<br/>ended June 30,</b> |             | <b>Six-month periods<br/>ended June 30,</b> |             |
|-------------------------------|---|-------------|---|-------------|
|                               | <b>2008</b>                                   | <b>2007</b> | <b>2008</b>                                 | <b>2007</b> |
|                               | <b>\$</b>                                     | <b>\$</b>   | <b>\$</b>                                   | <b>\$</b>   |
| Net sales                     |   |             |   |             |
| North America <sup>(1)</sup>  | <b>71,131</b>                                 | 87,147      | <b>123,404</b>                              | 153,336     |
| International                 | <b>35,254</b>                                 | 34,339      | <b>62,373</b>                               | 58,256      |
|                               | <b>106,385</b>                                | 121,486     | <b>185,777</b>                              | 211,592     |

<sup>1</sup> Includes net sales for Canada in 2008 of \$11.9 million (\$10.0 million in 2007)

|                                 | <b>Three-month periods<br/>ended June 30,</b> |             | <b>Six-month periods<br/>ended June 30,</b> |             |
|---------------------------------|---|-------------|---|-------------|
|                                 | <b>2008</b>                                   | <b>2007</b> | <b>2008</b>                                 | <b>2007</b> |
|                                 | <b>\$</b>                                     | <b>\$</b>   | <b>\$</b>                                   | <b>\$</b>   |
| Earnings (loss) from operations |   |             |   |             |
| North America                   | <b>(11,259)</b>                               | 2,796       | <b>(23,056)</b>                             | (33,256)    |
| International                   | <b>8,881</b>                                  | 5,882       | <b>9,925</b>                                | 6,588       |
|                                 | <b>(2,378)</b>                                | 8,678       | <b>(13,131)</b>                             | (26,668)    |

|  | <b>As at June 30,</b> |             |
|--|-----------------------|-------------|
|  | <b>2008</b>           | <b>2007</b> |
| Property, plant and equipment, intangible assets, and goodwill |                       |             |
| North America <sup>(1)</sup>                                   | <b>341,333</b>        | 347,895     |
| International  | <b>75,118</b>         | 81,441      |
|  | <b>416,451</b>        | 429,336     |

<sup>1</sup> Includes property, plant and equipment for Canada in 2008 of \$29.9 million (\$33.6 million in 2007).

## 18. Subsequent event

On August 18, 2008, the Corporation executed a sixth amending agreement (the "Sixth Amendment") to its Credit Agreement dated July 26, 2005 providing for certain changes to the terms and conditions of its senior secured Credit Facilities maturing in 2012, including a waiver of the cumulative minimum EBIDTA ratio covenant for the period ended June 30, 2008. Additionally, the Sixth Amendment introduces the concept of a new definition of the calculation of EBIDTA allowing for the add-back of certain non-recurring and non-cash items. The covenant includes a minimum EBITDA at the end of each quarter up to and including June 30, 2010, at which point more stringent covenants previously in place under the Credit Agreement become effective. The revolving credit facility has been reduced to \$100 million.



On August 18, 2008, the Corporation announced the closing of a private placement offering of senior unsecured convertible debentures for gross proceeds of CA\$75 million. The proceeds of the Offering will be used as working capital and for general corporate purposes. The debentures, maturing on August 31, 2013, will bear interest at a rate of 8% payable semi-annually in arrears and will be convertible at the option of the holder at any time prior to the maturity date based on a conversion price equal to approximately CA\$3.19 per common share, subject to customary anti-dilution adjustments. The debentures will be convertible into 23,512,500 common shares, representing 39% of the common shares of the Corporation on an as converted basis. The debentures were issued to Fairfax Financial Holdings Ltd., Chiefswood Holdings Limited, The Owners Fund and Victor J. Bertrand Sr., the founder and chairman of the board of directors of the Corporation, with Fairfax investing CA\$64 million and Mr. Bertrand investing \$7 million in the offering. This financing was undertaken by the Corporation in connection with its consideration of its strategic alternatives, including the sale of its Stationery and Activities business. The financing was approved by the Toronto Stock Exchange and required certain amendments to the Corporation's credit facilities which were agreed to by the lenders.

## **19. Comparative figures**

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

